ALM Insights

ACROPOLIS®
INVESTMENT MANAGEMENT
Registered Investment Advisor

March 2013 • Volume 1, Issue 4

Timeless principles · Timely advice

KEY RATES ::

Fed Funds Target	0.25%
Discount Rate	0.75%
Prime Rate	3.25%
3-mo LIBOR	0.28%
2-yr Treasury	0.25%
3-yr Treasury	0.38%
5-yr Treasury	0.80%
10-yr Treasury	1.93%
2-yr Swap	0.42%
5-yr Swap	0.98%
10-yr Swap	2.05%
5-yr A Corp Yield	1.70%
5-yr A BQ Muni Yield*	2.15%

* Tax Equivalent Yield

ECONOMIC DATA ::

Q4 GDP Growth	0.1%
February CPI YoY	2.0%
Unemployment Rate	7.7%

UPCOMING EVENTS ::

March 27 - Continuing Resolution Expires

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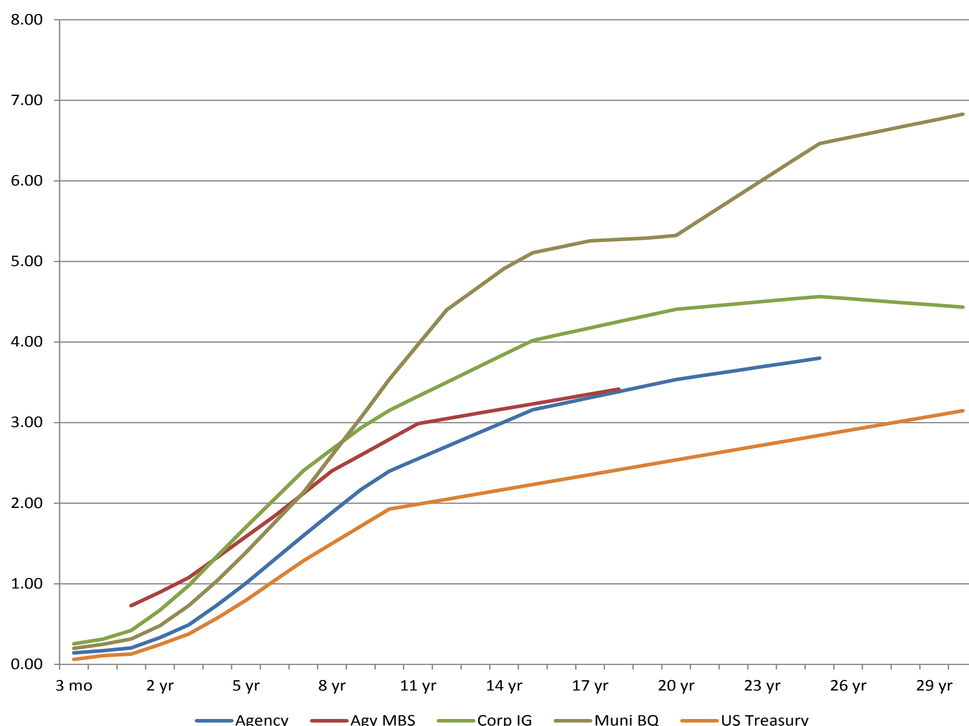
Yield Curve



All data as of 3/20/2013

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The Role of Portfolio Construction | Cliff Reynolds, CFA

In the September issue of ALM Insights, we had an article that asked whether yields going up was good or bad for banks. The article touched on interest rate risk and how this "sleeping giant" can rear its ugly head when rates do finally turn around for good. We also concentrated on how other facets of the bank could perform in a scenario where a much improved economy is the catalyst for a rate change. In this issue, I'd like to take a step back and look at the role portfolio construction can play in performance.

It hasn't been too terribly long since we've seen a rate move like we're witnessing now. In three previous years, we have made highs in the yield on the 10-year treasury near the end of the first quarter, only to march lower throughout the rest of the year. Many of the reasons for the current rate move should sound familiar, including moderately improving economic data and talk of small adjustments to ultra-easy monetary policy from Fed officials. The previous moves accompanied similar data and Fedspeak, only to reverse as holes appeared in the progress.

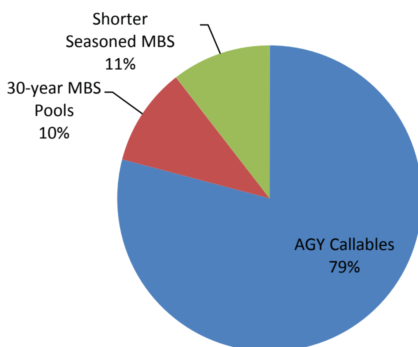
Through modeling, investors are able to see the effects that proposed changes in their portfolio can have on expected risk and return. Of course, models are only as good as their inputs and in the end, the usefulness of any model is limited to the variety of scenarios that can be run. That said, results from any model should be taken with a grain of salt including the results I present here.

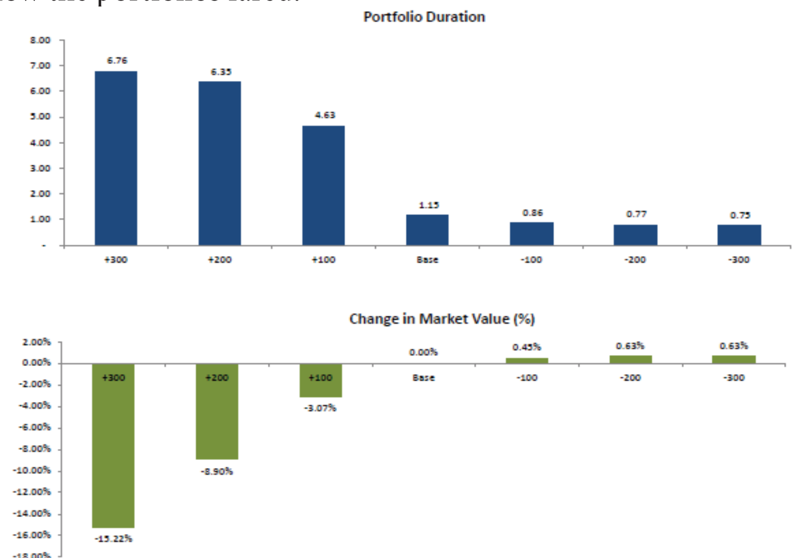
Bond Sectors	Duration	Yield (%)	Spread (bps)
Agency Bullets	3.76	0.70	7
Long Agency Callables	0.50	1.41	130
30-year MBS Pools	4.44	2.16	128
Shorter/Seasoned MBS	3.01	1.67	121
CMO Floaters	0.05	0.51	43
Corporate Bonds	2.90	1.43	100
BQ Municipals	5.49	2.77*	169

* Tax Equivalent Yield

For the sake of simplicity, I divided the bond market into seven different sectors. Each sector has its own risk and return characteristics and serves a different purpose in the portfolio. To show how each sector reacts in different scenarios, I built 4 portfolios, each with a large allocation to one sector, and ran them through various shocks to identify the weaknesses in each strategy. Here is how the portfolios fared:

Portfolio 1 – Heavy Weight to Callables





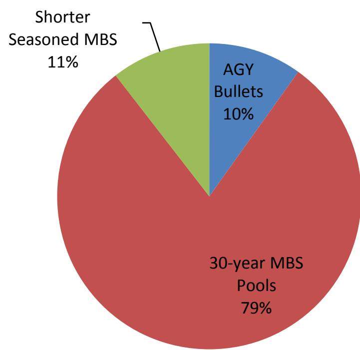
What sticks out most about a portfolio with a large allocation to longer-dated callable agency debentures is high yield relative to the current duration. In the base case the portfolio of 80% callables and 20% MBS has a yield of 1.51% and a 1.15 year average duration.

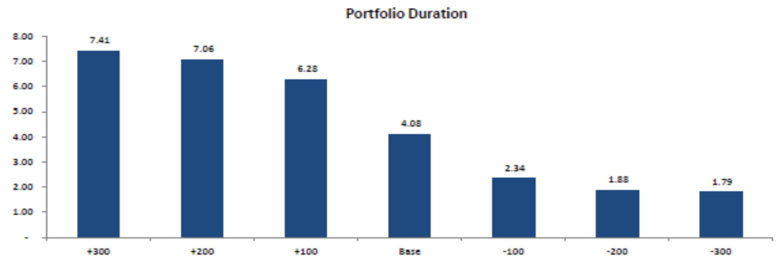
(continued on page 3)

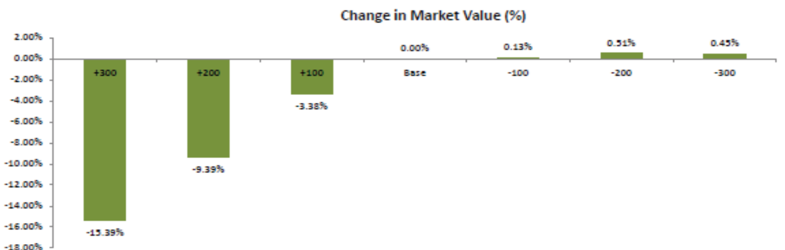
Given the current rate environment, most of the bonds in this portfolio are highly callable, leading to the very low duration. The final maturities of the bonds are in 5 to 15 years but because rates are so low they aren't expected to make it that long and their current pricing reflects those expectations.

On the surface this portfolio may seem low risk, but the relatively high yield is compensation for risk not seen in a current duration number. In an uprate scenario, the agencies are no longer callable and they begin to be priced closer to their actual maturity date. This has a dramatic effect on performance. See how the duration extends in the uprate scenarios shown in the above chart. The portfolio with a 1.15 year duration in the base extends to a 6.76 year average duration and feels the full force of the rate move. The portfolio has virtually no credit risk, but in the end it is very exposed to one negative scenario while there's not much chance to capture any upside in the market.

Portfolio 2 – Heavy Weight to 30-year MBS



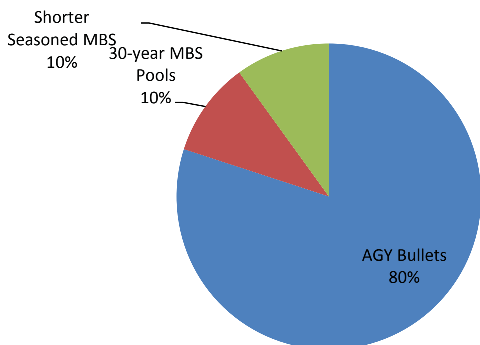


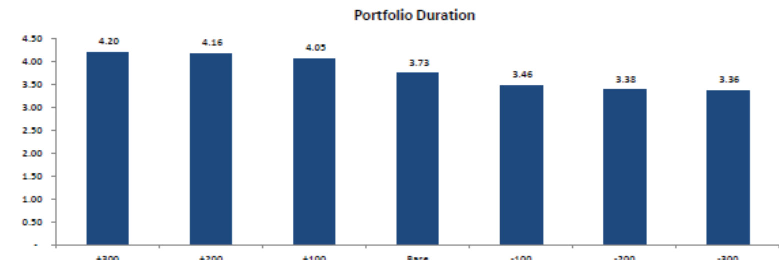


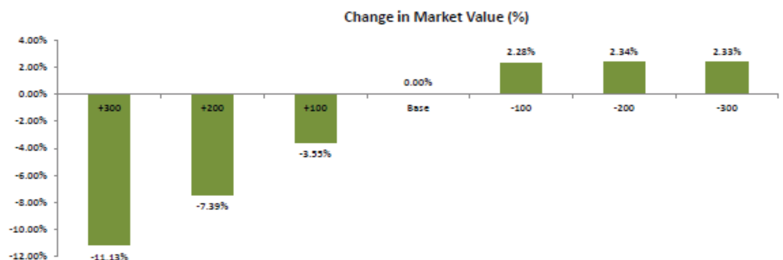
There are many similarities between a portfolio heavily weighted toward 30-year MBS and a portfolio of longer-dated callable agencies. Like callable agencies, 30-year MBS trade at a positive spread to bullets of similar duration, and again, that spread is compensation for risk not presented in base case duration analysis.

As rates rise, and refinancing activity in the mortgage market slows down, the duration of a portfolio with a heavy weight to long MBS will extend. Much like the callable portfolio, true duration risk is unknown at the time of purchase because it can change dramatically – leaving a portfolio with a heavy weight to this sector highly exposed should interest rates rise.

Portfolio 3 – Heavy Weight to Short Agency Bullets







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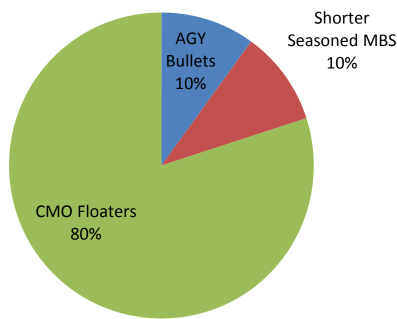
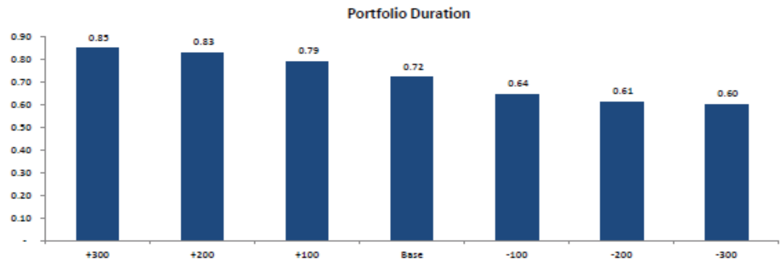
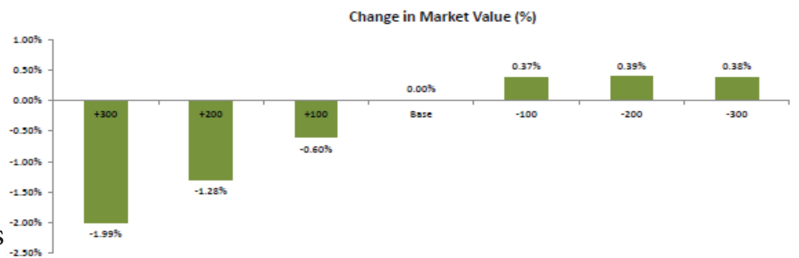
On the other end of the spectrum from the two previous portfolios is one comprised mostly of short bullets. Compared to the callable portfolio, the bullet portfolio has a higher duration in the base case and lower yield. Because the bullets aren't callable before maturity they are priced to the maturity date for the entire life of the bond. Without that uncertainty of repayment of principal the investor is compensated less as evidenced by the lower yield.

This situation is a little different than the previous two. The portfolio isn't susceptible to extension, but with a base case duration of 3.73 years and a market yield under 1%, the risk return profile of the portfolio still isn't very good. Again, concentration is the culprit. The concentration in the portfolio doesn't rid the portfolio of risks, (a duration of 3.73 is on the high end of where the average bank would like their securities portfolio to be), and market of yield of .94% is pretty low for that level of interest rate risk.

Portfolio 4 – Heavy Weight to Floating Rate CMOs







Often used as cash alternatives, floating rate tranches of CMOs go even farther down the risk spectrum. Because the securities have very low durations and typically trade near par, a portfolio concentrated in floater CMOs is very insulated from interest rate and pre-pay risk. Of course, low risk doesn't mean no risk. Floating rate CMOs are traded in the secondary market so there is some price volatility. A portfolio concentrated in these securities is highly exposed to the price risk in that market, and while the risk is small, so too are expected returns in the sector.

Conclusion

As investment managers, we spend a lot of time touting the benefits of diversification. Diversification comes in different shapes and sizes to best suit the goals of the investor but is always centered on the aim of improving the risk/return profile of the portfolio as a whole. In the world of total return investing, diversification may take the cake as the most important characteristic within a portfolio, but it doesn't get the attention it needs from yield-oriented investors.

Valuation, of course, plays a large part in the portfolio construction process, but ultimately the future is unknown. Modeling can be useful but it can't be depended on as a crystal ball. While you can carefully map out the characteristics of your portfolio, movements in the market are unpredictable. Thus, seeing value in one sector is not justification to become overly concentrated. In cases where the portfolio is being used as a hedge on the bank's balance sheet, concentration in certain sectors can certainly be justified. But, for most banks with a general yield orientation, a focus on diversification can improve the risk/return profile of the portfolio in a meaningful way.

Bond of the Day - Credit Securities | Ryan Craft, CFA

"CLO Spreads at Record Lows Fuel Demand for Leveraged Loans" – Bloomberg

Take a guess as to when this headline was published. 2005? 2006? 2007? If you guessed any of those years, you were incorrect. This is a headline from March 8th, 2013. As the Federal Reserve has forced interest rates down for nearly five years, investors have continued to push further out the risk spectrum in search of yield. The market has now come full circle and investors are once again pushing up prices on anything with income - all while claiming things are different this time. With this in mind, we thought now would be a good time to review the basics of credit and its use in a portfolio.

There are two primary sources of return in bonds: duration and credit. Duration affects the bond's price sensitivity to changes in interest rates. The other statistically significant source of return is credit. Credit refers to the risk of the bond making timely interest and principal payments. Many bonds are guaranteed by the government, such as Treasuries and GSE debt, and are deemed to be without credit risk (don't laugh, for this exercise let's pretend US Treasury bonds are still risk-free). All other bonds trade with a yield premium above the risk-free rate, or credit spread, that is demanded by investors as compensation for the risk of default.

As a major source of return in fixed income, credit is a critical component when constructing a balanced portfolio. Not only do credit securities offer a higher yield compared to risk-free assets, but they can help to diversify a bond portfolio. Credit spreads are not static and will widen and contract based on economic conditions. This means that credit securities will not always act the same as their credit-free counterparts. When included as part of a balanced portfolio, this can lower overall portfolio volatility in the long run.

This is true in both individual and institutional portfolios. With bank portfolios, however, there is a caveat. Most bank balance sheets are already loaded with credit risk in the form of loans. Lending is the reason banks are in business, not to mention the primary profit center. This leaves most bank balance sheets already highly exposed to illiquid, credit risk assets. Therefore, the extent a bank uses credit in its securities portfolio should be related to the entire balance sheet of the bank.

Just as a bank will use its investment portfolio to offset the duration risk of its balance sheet, credit in the bond portfolio should complement the overall credit quality of the balance sheet. This means that, for most banks, credit should not be used in the securities portfolio. The primary purpose for a bank's investment portfolio is safety and liquidity. Return and income should be secondary goals. If the bond portfolio accounts for less than 10% of the bank's assets, it is our recommendation that it only serve as a pool of liquidity. A bank can only afford to take so much risk with its capital. Our recommendation is to take credit risk in the loan portfolio, where the bank has a better understanding of the credit and it is receiving a greater return on its investment. Credit securities should be viewed as loan substitutes and only added to the bond portfolio when the bank cannot grow its loan portfolio to an appropriate size.

For banks that would like to add credit risk to their investment portfolio, let's consider the market. Currently, yields and spreads are at record lows on most products, particularly corporate bonds. For institutions that can benefit from tax-exempt income, intermediate to long term municipals currently offer the most attractive return potential.

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Credit Yields & Spreads

Sector	Maturity	Yield	Spread Over Treasury (bps)
CLO (AAA)	Floating	1.58%	148
CLO (AA)	Floating	2.28%	218
ABS Autos (AAA)	3 yr	0.55%	14
IG Corporate Bonds	3 yr	0.98%	58
BQ Muni's (TEY)	3 yr	1.52%	112
CMBS (AAA)	3 yr	1.71%	131
CMBS (AA)	3 yr	1.96%	156
ABS Credit Cards (AAA)	5 yr	1.16%	25
IG Corporate Bonds	5 yr	1.67%	82
BQ Muni's (TEY)	5 yr	2.02%	116
CMBS (AAA)	5 yr	2.21%	131
CMBS (AA)	5 yr	3.15%	225
IG Corporate Bonds	10 yr	3.12%	112
BQ Muni's (TEY)	10 yr	4.15%	215

Credit securities can take many different forms. Each one will be influenced by different factors and risks. Understanding the risks and being able to accurately price the risk is essential to managing a portfolio of credit securities. There is an old saying amongst bond traders, "there is no such thing as a bad bond, just a bad price." The following section will briefly discuss the various securities found in bank portfolios and factors relating to their valuation:

Corporate Bonds

When someone talks about adding credit to a bond portfolio, most often they are referring to buying corporate bonds. Corporate bonds make up about 25% of the entire US bond market. It is a highly liquid market and made up of many names people can recognize. For most issuers, timely financial data is available along with third party ratings from Moody's, S&P, and Fitch. This makes it possible to have a systematic approach to credit evaluation prior to purchase as well as ongoing analysis.

The biggest obstacle for most banks in constructing a corporate bond portfolio will be the cost/benefit of time to manage it. While there are many tools for performing credit due diligence on corporate bonds, there will still be unforeseen adverse events once in a while. The only way to protect the portfolio from this is to purchase a highly diversified portfolio, which will require bonds from at least 30 different issuers. Performing due diligence and continuing to monitor the credit of over 30 companies is a full time job in itself. Currently, "A" rated corporate bonds yield a meager 82 bps over Treasuries for a five year maturity. Factor in additional trading costs for maintaining this portfolio, and the additional return may not be enough to justify the costs.

Municipal Bonds

Municipal bonds are the most widely used form of credit risk in bank portfolios. For most of their history, munis have been a safe, sleepy market with a very low default rate. Investors bought munis for a safe source of tax-free income. This has changed slightly over the past few years. As bond insurance has disappeared and muni defaults have increased, there has been a heightened awareness of the credit risk. It is important for investors to remember that there is a vast difference between various types of muni bonds and some corners of the market are much safer than others. Investors must research the financial data of any issue. This is one of the biggest drawbacks to muni bonds. Financial data is not standardized and can often be very stale for outstanding issues. An issuer will provide up to date financials when a bond is issued, but after that it is common to only receive annual updates that can already be over six months old once issued. One other point for concern is the liquidity of the muni market. It is a very fractured market, so bid/offer spreads on bonds can be quite wide. Additionally, banks are constrained to bank qualified issues which are small in size by nature. This can make it difficult to quickly purchase large quantities of bonds. For a more in depth look at buying municipal bonds, check out the September 2012 issue of ALM Insights.

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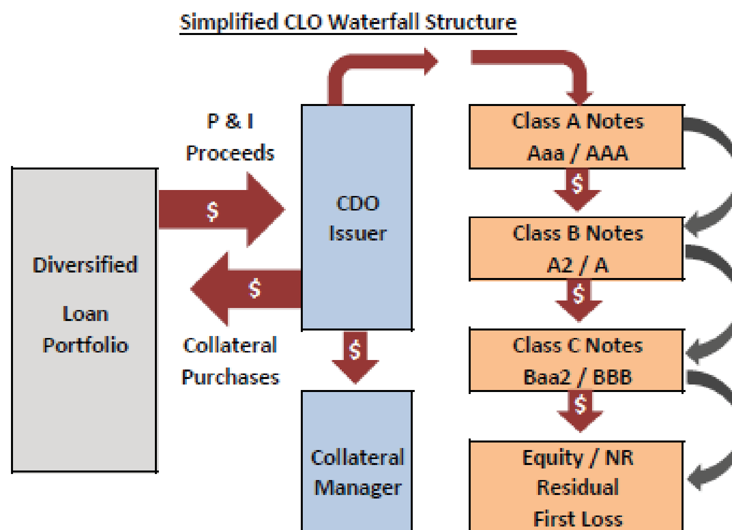
Collateralized Loan Obligations (CLOs)



Also known as leveraged loans, CLOs are the latest big product being pushed by trading desks. These are essentially pools of junk bond type loans, or loans issued to finance leveraged buyouts. The difference here is that these poor standalone credit loans will get pooled together, structured, subordinated, carved up and then sold to the public with shiny new AAA ratings. Sounds familiar, huh? These were popular for a few years from 2005-2007 before they imploded along with the rest of the structured credit market in 2008. However, there are differences between those sold then and those being sold now. Today's version does contain tighter covenants and higher levels of credit support… for now. As these deals have grown in popularity, there are reports of covenants being weakened rather than lowering the yield in new deals. This is a sign that this yield-starved market is willing to take even more risk rather than give up any yield. The inner workings of CLOs are much too complex to cover in this space.

If you would like detailed information, feel free to contact me and I can provide you with it offline. For the purpose of this article, I will just issue a strong word of caution: Be certain to understand what you are buying. It is imperative that an investor in CLOs can understand the underlying collateral and the subordination or over-collateralization structure. CLOs are able to offer a higher credit rating than its underlying collateral due to diversification of credit and subordination of losses (see the nearby diagram for a simplified example). This is the result of a very complex waterfall of cash flows complete with tests and triggers that can divert cash flows based on conditions. All of these scenarios and circumstances need to not only be understood, but also modeled and stress tested, typically using a program such as Bloomberg or Intex. Given the due diligence demands associated with CLOs, we do not recommend them for most banks. Only institutions with the proper resources and expertise should consider them for inclusion in their securities portfolio.

Commercial Mortgage Backed Securities (CMBS) & Non-Agency Mortgage Backed Securities (MBS)

CMBS and non-agency MBS are similar in that they are CMO structured pools based on mortgage collateral. Both receive credit enhancement through subordination and overcollateralization structures (similar to CLOs). The difference is that CMBS cover commercial properties where non-agency MBS are for nonconforming 1-4 family mortgages. The non-agency MBS market fell apart after the housing crisis in 2008. Since then, new issuance has been virtually non-existent. Therefore, the only activity in this space is from older bonds created prior to 2007. The lack of depth and new issue liquidity make this a difficult market to enter. CMBS, on the other hand, have seen a resurgence over the past few years. Like CLOs, investors in CMBS must gain intimate knowledge of the structure and underlying collateral composition of each deal. Due to the large size of the underlying mortgages, the credit in CMBS pools is usually much more concentrated than their residential counterparts.

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Asset Backed Securities (ABS)

Asset Backed Securities are the "other" category for securitized credit. These are pools of securitized loans such as credit cards, home equity, auto loans, student loans, etc. Due to the nature of the underlying loans, ABS are usually shorter duration than most mortgage securitized products. Ultimately, the ABS bonds will take on the characteristics of the underlying collateral in the deal. Therefore, the continuing theme is that an investor must have a thorough understanding of the loans securing the deal in order to understand the likelihood of repayment.

One common theme with all of these credit related securities is the need to understand and quantify the credit risks involved. In the past, these were purchased and deemed safe simply because they had achieved a AAA rating from a third-party rating agency. In 2008, the major flaws of the ratings agencies were exposed for the world to see. No longer can an investor rely primarily on a rating. It is a good place to start, but proper due diligence requires much more data. For banks, this is now a regulatory requirement due to changes made last year as part of Dodd-Frank. At a bare minimum, investors should be able to look at detailed information on the collateral of any deal. They should read the prospectus of any structured deal and have an understanding of the waterfall, triggers, and what impacts they would have on the bond in question. Market-based credit metrics are also very important to monitor. In 2007-2008, credit spreads moved wider long before any rating agency warned of problems. If a bond's credit spread does not line up with its peer group, there is a reason. It is not a "cheap" bond, rather it is the market saying that it is more risky than its rating implies. Credit spreads and other market-based metrics, such as Credit Default Swaps (CDS), will offer the first real-time evidence of a problem on the horizon.

Bonds are basically loans that can be easily bought and sold on a secondary market. Set aside a percentage of assets solely for liquidity and safety. As the portfolio grows beyond that, the bank may entertain adding credit exposure as loan substitutes. It is important to not just add credit in search of yield, but only add credit in a strategic manner within the context of the entire bank's balance sheet. Today's low yields have pushed investors out the yield spectrum and find them holding increasingly more risk in search of any yield. Do not fall into this trap. Even though yields are low, one must manage risk accordingly, then look to maximize return within those risk parameters.

Economic Update - The Juice is Loose | Brent Vondera

The US economy continued to expand in the first quarter of 2013, marking the 15th straight quarter of expansion following the worst recession since the Great Depression.

However, despite the severity of that recession, the current business-cycle expansion remains the weakest in the post-World War II era – slowing to just a 1.6% rate on a year-over-year basis, as of the latest data. (Normally, the deeper the contraction, the stronger the expansionary bounce. How strong of a rebound? On average, the best GDP print, following the deepest postwar contractions, is 10.4%. This time the best print we've seen is 2.8%, which occurred in the third quarter of 2010. The reason for the weakness is largely a debt excess that hasn't been expunged.)

That this is the reality, yet the stock market hit new highs, bond spreads are about as tight as they get and most analysts talk as if things are "fixed" doesn't, prima facie, pass the common sense test. But underneath it all, we have central banks running monetary policy with a historically unprecedented fervor. Many people mistake inflated asset prices for organic and fundamentally driven growth even as policymakers have made quite clear their objective is to inflate. This situation is the subject of this article.

The latest economic data is mixed. While what have been some of the most depressed aspects of the economy –

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such as housing – show renewed life, the things that matter most – such as jobs and real incomes -- leave much of society in a bad spot.

Manufacturing activity has shown a couple soft spots during this business-cycle upswing, only to recover each time. The latest exhibition of this trend is the bounce that occurred in the back half of the first quarter after noticeable weakness during the final months of 2012 and into 2013. Driving these rebounds has been an auto industry that assembles vehicles at a pace that normally accompanies the strongest of economic periods. More recently the housing market has come in to help as homebuilders have begun to ramp up residential construction from all-time low levels – some of which is healthy as we need more rental units, some is not as we don't need additional single-family homes.

Like the automakers, the consumer continues to spend as if all is well, leaving the personal consumption segment of GDP at an unsustainable 70% of the economy – the long-term average is 65% and I suspect we'll get there again, but not until an adjustment is allowed to occur. The housing situation intrigues me the most as there's a sense out there that things "are back." We shall see if that's really the case, or rather it's the near record-low mortgage rates making this all a short-term fantasy. Meantime, while payrolls remain in expansion mode, the pace of labor-market improvement is woefully inadequate if we are to absorb the 12 million people who are officially out of work and the additional seven million who are not in the labor force (but say they "want a job"). Those not officially in the labor force are the people who lurk in the shadows of the data. The unsettling upward trajectory in food stamp recipients and social security disability insurance rolls provides some evidence of this for people who do not delve into the job-market data. For those that do choose to dive into that data, the sorry state of our labor force is clear as day.

As a result of this job-market weakness, after tax incomes are losing to even the low level of inflation that is present (don't hate me, I understand real-world inflation is higher than the stats show, but I can only gauge things off of the data they present me). Over the past year, real after-tax incomes are essentially flat, but have dipped to negative territory since the third quarter of 2012. More distressing, real per capita income remains 6% below the 2008 peak and is up less than 1% at an annual rate since 2000. Again, all the while, consumerism continues as if the fundamentals were stronger – a clear function of stock market gains and the interest-rate environment.

And then we have the corporate side of the equation. The position of US corporations looks quite strong as they've enjoyed a 13-quarter streak of profit growth. These large, often multinational, firms have benefited greatly from the fact that little more than half of the 10.6 million payroll jobs they extinguished during the recession have been added back. (Typically at this stage in the cycle, we would have surpassed the previous employment high, but for this cycle payrolls remain 4.6 million below the 2007 mark.) Another major propellant of this earnings expansion is incomparably aggressive monetary policy. Specifically, the Fed's bond-buying scheme has forced interest-rate spreads to compress as if the economy were on fire. Firms have used this opportunity to increase debt, and instead of focusing these borrowed funds toward productive purposes (such as technological build out) they've tilted the cash to buying back shares and increasing dividend payouts. It's no mystery why S&P 500 earnings per share continue to grow even as the revenue side has nearly flat-lined again -- decrease the float by buying back shares and those earning-per-share figures will extend their expansion for longer than would otherwise be the case.

(There was a time in which investors – and most surely value investors – would shun a company that used debt in such a manner. However, these days such metrics are ignored, with many applauding the effort as it keeps the stock-market dream alive.)

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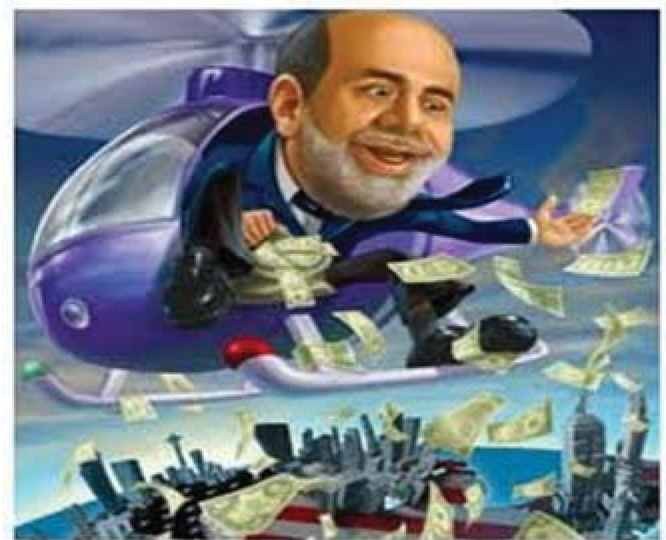
Other analytical considerations have also been abandoned in this epoch of monetary policy gone wild. There is very little concern about economic reality as the central bank juices a move to risk assets like never before. You rarely hear anyone concerned about this weak nature of economic growth, debt levels that are not only unsustainable but building in excess, or the fact that our society is increasingly becoming dependent on government handouts.

Instead, all most people seem to worry about is how long the Fed, among other central banks, will continue to expand liquidity. Instead of buying because investors see value, they have been pushed into the equity and corporate bond markets as any return whatsoever from relatively safe assets has been removed. Put all the major central banks together and they've electronically created $10 trillion. In 2013, the Fed alone will pump another $850 billion into the system, and the Japanese look ready to at least match that number. When you're going to add $140 billion/month, then yes that newly "printed" cash will find its way into financial assets, but it doesn't mean the foundation is solid.



Many have said that things would've been much worse if they hadn't engaged in this aggressive policy. And that may be true in a simplistic sense, for a time. But we'd be past that moment by now, with much less debt to boot and organic growth that drives prosperity for all segments of society – at least those that choose to participate in economic activity. This view that a few central bankers can navigate the economy and avoid recession is delusional, so the argument that things would have been worse doesn't have merit in my world as the next big contraction has merely been delayed…and the longer the delay the worse the next recession will be as gaming monetary policy leads to the malinvestment – otherwise known as misallocation of resources.

We seem to have this supreme confidence in central bankers, willing to allow them the freedom to experiment in their attempt to micromanage the economy, as we forget the mistaken policy decisions of the past – the Arthur Burns Fed of the 1970s, Greenspan's Fed of the late 1990s and the Greenspan/Bernanke Fed of a decade ago. And if those previous errors produced the double-digit inflation of the 1970s, the tech bubble of the late 1990s and the housing/debt bubble that began to pop in 2007, this more rapacious policy action will certainly deliver its own excesses; if nothing else it extends and further inflates the debt bubble.

In this sense, what central banks have done, and continue to do, has not kept us from the "worst" at all, but engenders another terrible outcome as complacency remains grossly misplaced and investor fear is nonexistent – the fear that keeps us all honest and cognizant of the risks we take. That few find it strange the stock market has reached record highs (granted, barely higher than the levels first hit in the year 2000, but record highs nonetheless), while central banks, by their actions, illustrate their dire view of the world economy pretty much says it all. Yet, such commentary is seen as unwelcome. Why, for its clarity? Simply for the reason that Wall Street compensation won't be maximized?

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We are in unchartered waters here. The juice is loose and I'm not talking about O.J. runnin' from the cops in his white Bronco. No, I'm talking about a band of Keynesian madmen flyin' around in their money-dropping helicopters. Getting the market's amphetamine back in the bottle is going to be an arduous and economically harmful task.

How long can they prop things up? I do not know; they'll continue until they can't. What I can say with confidence is that this behavior produces undesirable outcomes. But after the past 15 years and several iterations of wildly aggressive monetary policy, we already know this. Right?

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