

KEY RATES ::

Fed Funds Target	0.25%
Discount Rate	0.75%
Prime Rate	3.25%
3-mo LIBOR	0.23%
2-yr Treasury	0.43%
3-yr Treasury	0.91%
5-yr Treasury	1.72%
10-yr Treasury	2.73%
2-yr Swap	0.57%
5-yr Swap	1.81%
10-yr Swap	2.85%
5-yr A Corp Yield	2.44%
5-yr A BQ Muni Yield*	2.51%

* Tax Equivalent Yield

ECONOMIC DATA ::

Q4 GDP Growth	2.4%
February CPI YoY	1.1%
Unemployment Rate	6.7%

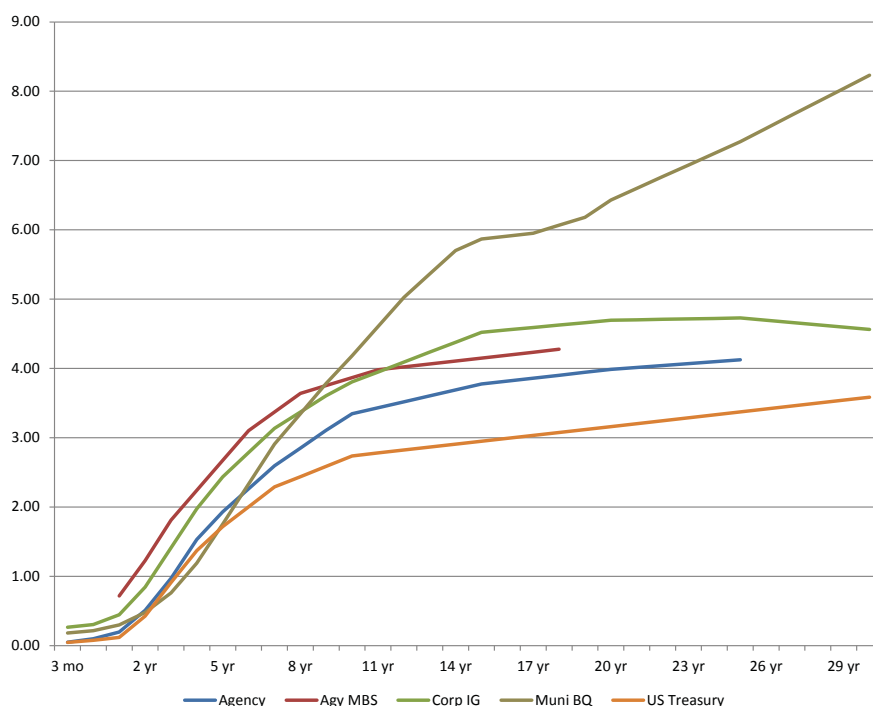
UPCOMING EVENTS ::

April 30 - Next FOMC Meeting

In This Issue

The Plan to Wind Down Fannie & Freddie	Page 2
By: Cliff Reynolds, CFA	
Economic Analysis - Fed Digests Mixed Data	Page 3
By: Ryan Craft, CFA	
Bond of the Day - FFELP Student Loans	Page 6
By: Ryan Craft, CFA	
Risks of the Held to Maturity Classification	Page 9
By: Cliff Reynolds, CFA	

Yield Curve



All data as of 3/25/2014

EDITORS ::

Cliff Reynolds, CFA
cr@acrinv.com

Ryan Craft, CFA
rc@acrinv.com

CONTACT US ::

P :: 888.882.0072
636.449.4900

E :: info@acrinv.com
W :: www.acrinv.com



The Plan to Wind Down Fannie & Freddie | Cliff Reynolds, CFA

While the futures of Government Sponsored Enterprises Fannie Mae and Freddie Mac are still largely undecided, new details from congress were recently released that give a clearer picture of what housing finance may look like in a post Fannie/Freddie world. We are still far from the end, and like most legislative actions, the beginning stages are filled with more questions than answers, but one thing is for sure – meaningful change is coming.

The outline, released by Tim Johnson (D., SD) and Mike Crapo (R., ID), provides the clearest picture yet into how congress may go about winding down the mortgage giants. Their plan calls for privately capitalized firms to replace Fannie and Freddie. These firms would pay fees to a new government agency called the Federal Mortgage Insurance Corporation (FMIC), who would then insure the mortgage backed securities issued by the new highly capitalized firms against catastrophic losses.

To better understand what this changes consider how things are now. Even before Fannie and Freddie were placed under conservatorship in 2008, the agencies bought loans from mortgage originators, packaged them into securities and sold them to investors. Fannie and Freddie insured the securities they sold against all losses, while the agencies themselves carried an implicit backing from the federal government. The system remains more or less the same post-conservatorship. The main difference being that both Fannie and Freddie currently send all profits to the US Treasury in exchange for the preferred stock purchased by the federal government to recapitalize the agencies and cover losses resulting from the housing crisis.

The urge to reform the current landscape is twofold. First, the old system of implicit guarantee is flawed and the mixture of private capital and government bailouts makes for murky waters. Secondly, thanks to an improving housing market and an interest rate environment and government policy that strongly incentivized borrowers to refinance, the agencies are posting annual profits measuring in the tens of billions and as of Q1 2014 profits sent to the Treasury will eclipse the size of the bailout. If legislators were waiting for the mess to clear up, now is the time to act.

Under the proposed new system, the Federal Housing Finance Agency (FHFA), the conservator of Fannie Mae and Freddie Mac and the Federal Home Loan Banks, would be absorbed into the FMIC. Soon after that both Fannie and Freddie would be prohibited from conducting new business, but their shutdown would not affect the rights and obligation of holders of outstanding debt obligations or mortgage backed securities guaranteed by Fannie or Freddie. The proposal explicitly states that “The full faith and credit of the United States is pledged to the payment of all amounts required under these debt obligations or mortgage-backed securities.”

Losses would be covered differently under the new system. The catastrophic insurance provided by FMIC would kick in after bondholders have already realized the first 10% of losses. The Johnson/Crapo plan leaves the implementation of that structure open ended, but one can expect it to look like the methods of subordination that already exist in the non-agency mortgage-backed securities market.

The plan doesn't put a price on the cost of FMIC insurance, which will manifest itself directly in the cost of mortgage financing. Instead the plan calls for the mortgage insurance fund to be initially seeded with money from assessments on Fannie Mae and Freddie Mac and sustained going forward by insurance fees on FMIC-backed securities. The plan targets a reserve ratio of 1.25% within five years of implementation and 2.5% within ten years.

While many of the details are subject to change, one detail appears unavoidable – higher mortgage costs will

(continued on page 3)

become a reality. A smaller government backstop means that investors will have to consider the credit risk of their investment and adjust expected returns accordingly. It may come as a shock to both borrowers and investors at first, but after time I expect this to become the norm. While Ginnie Mae will continue on in its current form, it will remain a relatively small portion of the market and the conventional mortgage market will be better off long-term.

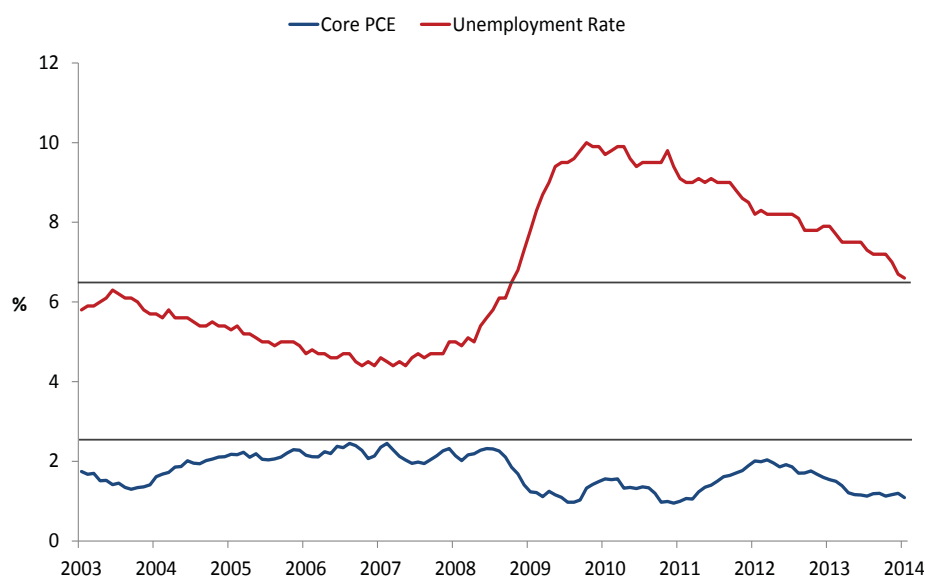
Economic Analysis - Fed Digests Mixed Data | Ryan Craft, CFA

“Boy, that escalated quickly... I mean, that really got out of hand fast.” Ron Burgundy

The market reaction to Janet Yellen’s first FOMC statement and press conference quickly turned ugly. Rather than speaking in vague generalities like her predecessors, Ms Yellen was more frank in her responses during the press conference. When she defined the ubiquitous “extended period of time” as being about six months, the market sold off quickly as forward curves adjusted to a much shorter horizon for raising Fed Funds than previously anticipated. Based on the latest Fed economist forecasts and Ms Yellen’s comments, the market now anticipates a Fed Funds hike in early-mid 2015. Before the FOMC meeting, Fed Funds was expected to remain unchanged until early 2016.

Now, all of this depends upon the accuracy of the Fed’s forecasts. The Fed maintains that the course for future monetary action will be data dependent and is not predetermined. Since the Fed has a dual mandate to both maximize employment along with broad price stability, it is not surprising that the committee remains focused on employment data and core inflation as the key drivers of policy.

Despite what the economics textbooks say about the Phillips Curve, lately there has been a very weak relationship between employment and inflation. The Unemployment Rate has steadily fallen and is currently at 6.7%. Even though the Fed has eliminated their explicit threshold of a 6.5% Unemployment Rate and instead is relying on qualitative factors, this trend indicates the need for tighter monetary policy in the near future according to traditional Fed models.



Inflation, on the other hand, has remained well below the Fed’s target of 2%. The Core PCE Index, the Fed’s preferred measure of inflation, decelerated for much of 2012 and 2013, but has stabilized in the low 1% range. Many of the FOMC members have expressed an interest in having this north of 2% as a way to promote economic growth (more likely, as a way to inflate away our massive debt burden, but more on that later).

(continued on page 4)

As long as inflation remains tame, the Fed is likely to be very slow to remove stimulus, let alone tighten monetary conditions. This is because the employment picture is not as robust as it may appear looking at the trend of the Unemployment Rate. The primary reason for the decline in the Unemployment Rate is a decline in the Labor Force Participation Rate, not a surge in new jobs. The percentage of people participating in the labor force is at the lowest rate it has been since the 1970's. In fact, the past few years has only seen job growth keep pace with population growth. So while the total number of jobs has nearly risen to the level before the crisis, the ranks of the unemployed has grown too.

Looking even deeper into the employment picture reveals more cracks that are masked by the declining Unemployment Rate. The percentage of workers who are full time remains well below the long term average. Additionally, the total number of hours worked was relatively flat through 2013 and showed a decline over the past few months. Both of these indicators point to potential underemployment and do not point to robust demand for labor. These are the primary reasons that the Fed recently removed the 6.5% threshold.

To be fair, there are positives in the labor market as well. The duration of unemployment continues to decline, layoffs are down and the number of voluntary separations (Quits Rate) has been increasing as well. This is positive as it shows a growing confidence in the ability to find a job.

Despite a raging stock market over the past year, the broad economy is still sluggish as evidenced by mixed economic signals. GDP growth has languished in the 2-3% growth range. On the surface this seems solid, but when taken into context of past business cycles, this has been very weak.

Forward looking economic indicators have taken a troubling turn over the past few months. Many of the talking heads on TV are quick to dismiss this as weather related to a brutal winter, but that does not explain why many warm weather climates are slowing more than their cold weather brethren. For example, housing has undergone a marked slowdown beginning in September. Record cold and snow across much of the country would logically slow down housing sales and starts. Why, then, has the West region been the worst performing region in the country? Much of that region is currently in a drought. Since when has warm, dry weather hindered the housing market? In contrast, the Northeast experienced growth in home sales in January despite the weather. Since this slowdown has coincided with a steep rise in mortgage rates, it may be more plausible that tighter credit conditions have been more harmful than the weather.

Manufacturing tells a similar story as many of the regional indices have begun to show weakness over the past few months. Only time will tell if this is the result of an inventory hangover from the fourth quarter or if it represents a new trend. With slack in employment, a slowing manufacturing outlook and a slowing housing market, it is tough to envision GDP growth breaking out of the 2% rut we have been in for the past few years.

However, these are all just symptoms. The real force behind all of this remains the Federal Reserve. Future Fed policy will continue to weigh heavily on the economy and markets. With the Fed likely to conclude its bond buying program later in 2014 and the prospect for a rise in short term rates in 2015, there is definitely a bias for rates to increase in the near future.

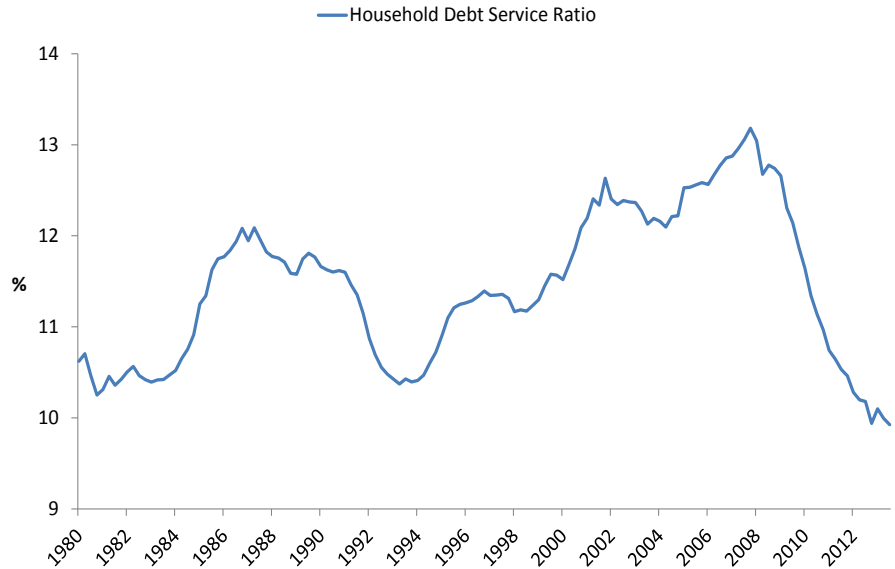
Debt

The financial crisis was largely a result of overleveraged households. Since then, households have made great

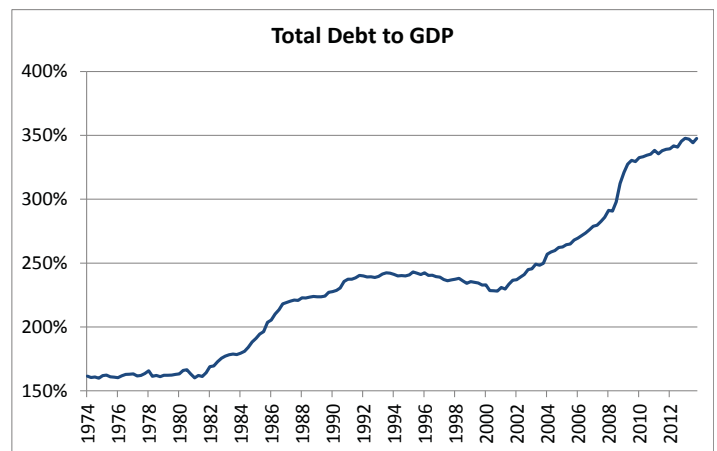
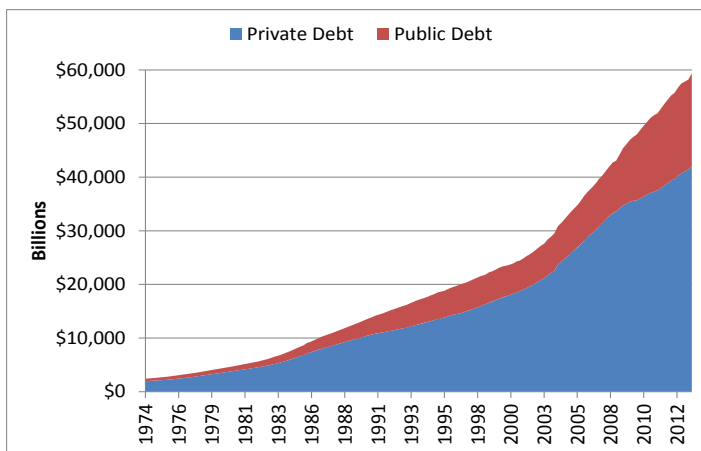
(continued on page 5)

strides in repairing their balance sheets. The Household Debt Service Ratio is at the lowest levels seen in over 30 years. While some of the reasons for such a low level are defaults (foreclosures and short sales) and historically low interest payments, this is a positive for the future outlook of the economy. This is a much healthier position for households to be in and should allow for households to manage a rise in interest rates.

The rest of the economy, however, is a bit of a different story. While households have been deleveraging, corporations and the government have been piling on more debt. With interest rates so low, corporations have taken advantage of cheap capital and continue to issue large quantities of corporate bonds. The US Government continues to run massive budget deficits, resulting in an explosion of Treasury bond issuance. In essence, the US has been trying to solve a debt crisis with even more debt.



Total debt, both public and private, for the US now stands at \$58 trillion (this does not even include future obligations such as Medicare or Social Security) compared to \$45 trillion in 2008. To put this in perspective, total debt is now 350% of GDP compared to 275% in 2008.



This is important because it shows that the economy is more leveraged today than at any other time in modern history. It stands to reason, then, that movements in interest rates will have a much greater impact today than in the past. With more leverage, increases in interest rates will consume more economic resources. Therefore, smaller moves in rates may slow the economy much faster than what many are used to seeing. This could effectively cap interest rates for the short term as small increases dramatically slow the economy, resulting in a flight to quality into bonds.

Many investors were surprised by the lack of movement in long term interest rates during the last Fed tightening

(continued on page 6)

cycle in 2003-2004. Debt to GDP was high then too, from a historical standpoint, at nearly 250% of GDP. We are now at 350%.

Recent history has provided some support to this view. The rate of a 30yr mortgage jumped in 2013 to 4.5%, which is still a historically low rate on the 30yr mortgage. It only took a 100bps move to have a dramatic effect on the housing market and put the brakes on mortgage underwriting activity in the second half of the year.

This is not an interest rate forecast, rather a hypothesis on long run behavior. Like most, we have a bias for rising interest rates in the short term. However, predicting interest rate movements is a lot like filling out an NCAA Basketball Tournament bracket. Most quickly become worthless as it never plays out like the experts think it will.

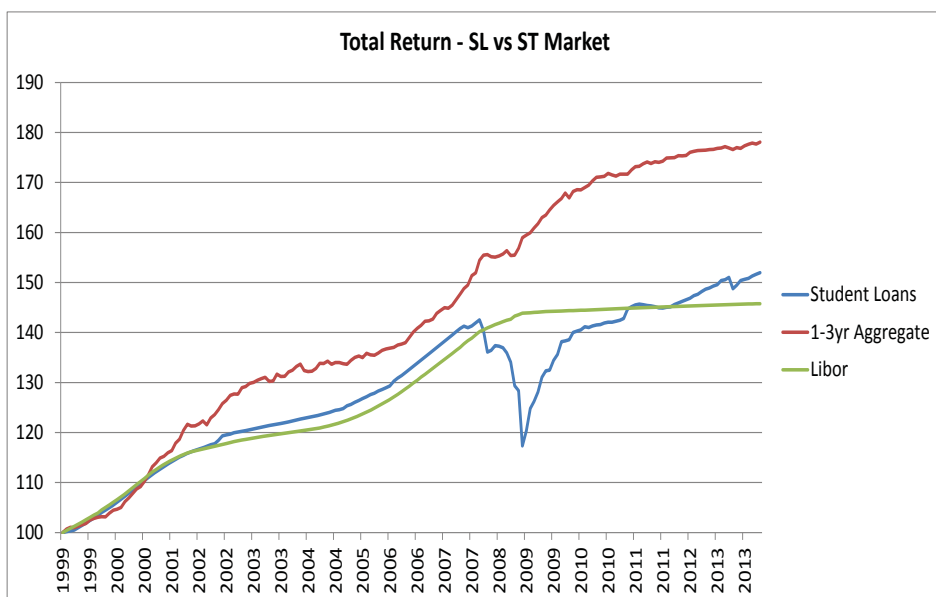
Bond of the Day - FFELP Student Loans | Ryan Craft, CFA

With interest rate volatility increasing, portfolio duration has become a popular topic in ALCO discussions. This has led to conversations about short duration investments and potential cash alternatives where a bank can earn more than cash without taking on interest rate risk. One sector that we have seen pitched this way is Asset Backed Securities (ABS) backed by FFELP Student Loans.

On the surface, ABS backed by FFELP Student Loans look appealing. They have government-backed collateral and their coupons float monthly with no cap at very high margins compared to other floating rate bonds. However, that last sentence should set off alarms. In our experience, yield does not come for free, so there must be a reason that the market price on these is 100 bps over the risk free rate.

Floating rate with a government guarantee would seem to take nearly all of the risk out of the bonds, but investors are getting paid a premium of 100 bps for holding these bonds over other floating rate, government backed bonds. We decided to take a deeper look into this sector to find out what this additional yield is compensating for.

First, we took a look at the entire AAA rated student loan ABS market from a historical pricing perspective. Has past performance been consistent with cash? If not, what classes has its performance been comparable? This will provide insight into where the market is pricing risk on these bonds.

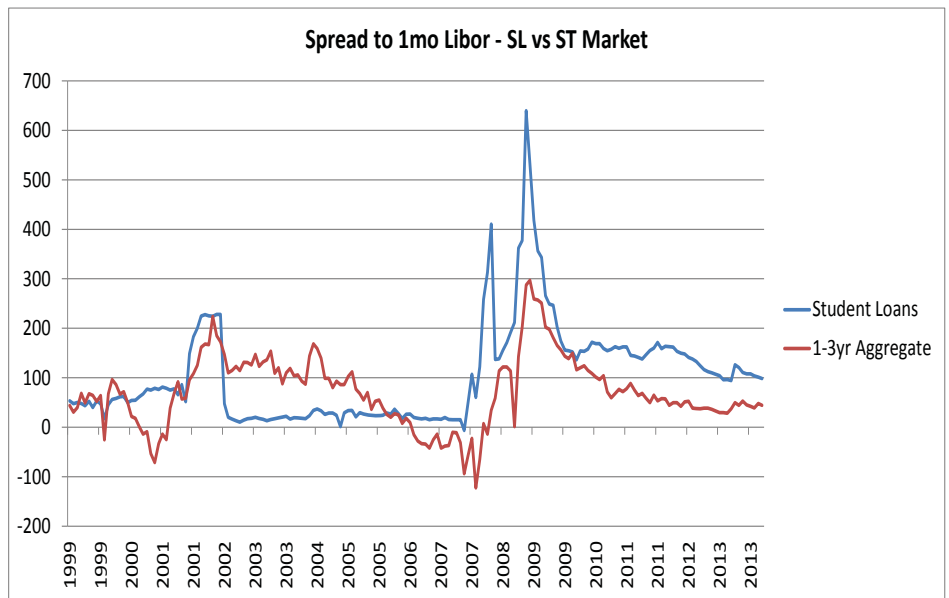


These two charts show the total return performance since 1999 of the FFELP student loan index compared to the performance of 1 month Libor and the 1-3yr Barclays Aggregate Index (composed of investment grade corporate bonds, MBS, and Treasuries). The second chart shows the yield spread over Libor for both the Student Loan index and the Aggregate index.

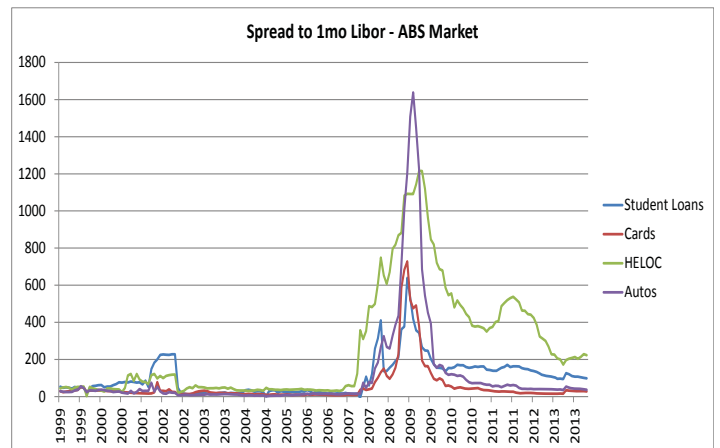
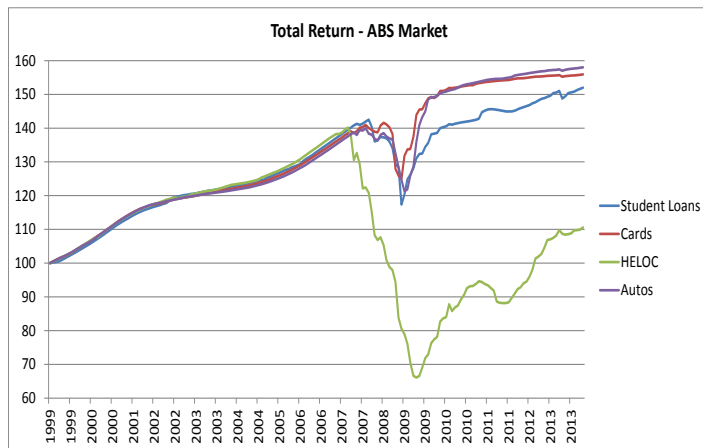
Prior to 2008, these performed similar as expected. In fact, the student loan index is very similar to Libor

(continued on page 7)

with a fairly consistent and low spread over Libor. During this period, one could argue that it acted as a cash alternative. However, all of this changed in 2008. While the Aggregate investment grade index continued its steady performance and Libor leveled off due to low rates, the Student Loan index became extremely volatile. This is highlighted by a -17.34% total return in 2008 with yields soaring to over Libor+600bps. This spike quickly abated in 2009, but spreads on Student Loan bonds remain elevated compared to other floating rate bonds.



The next two charts compare Student Loan ABS to other forms of Asset Backed Securities. They all performed similar pre-2008 and all got hit hard during 2008. Since then, their performance has been mixed. ABS backed by Home Equity loans has been the worst and continues to hold the highest spread. ABS backed by credit card receivables and auto loans have snapped back to pre-crisis levels. Student Loan paper remains at elevated spreads.



Another way to look at this is to simply evaluate the average return and standard deviation on a monthly basis for each of these sectors. From 1999 through January 2014, Student Loan ABS has had an average monthly return of 0.23% with a standard deviation of 0.92%. This is very volatile for a zero duration asset. Compare that to 1 month Libor that had an average monthly return of 0.21% with a standard deviation of 0.19%. Over this time, they have had similar average returns, but the price volatility of the ABS is nearly 5 times that of Libor, which is a proxy for cash. This is why we would not consider this a cash alternative. The potential price volatility is too great and too unpredictable to be considered a cash-like position.

	Student Loans	Cards	HELOC	Autos	1-3yr Aggregate	1 month Libor
Avg. Monthly Return	0.23%	0.25%	0.06%	0.26%	0.32%	0.21%
Standard Deviation	0.92%	0.87%	1.86%	0.81%	0.42%	0.19%

(continued on page 8)

Why would ABS with explicit credit concerns currently trade at tighter spreads and possess lower historical volatility than Student Loan ABS with a government guarantee? There is not one primary reason, but instead it appears to be a combination of factors that is keeping market spreads elevated:

Liquidity:

Trading in the market has historically been dominated by leveraged accounts. This has increased turnover and made for liquid trading markets. During 2008, this was a major reason for the plummet in prices. As accounts were forced to raise cash and deleverage, these were caught up in the storm and sold for liquidity purposes, not necessarily due to credit concerns. Since then, many of the buyers of this paper left the market or will no longer buy this paper due to past experience with it. This leaves a smaller pool of buyers. Additionally, this is a dying sector. In 2010, the US Government discontinued the FFELP program and began a Direct Lending program for student loans. This means that there is no new issuance of FFELP loans, which hampers liquidity as the new issue market aides in price discovery.

Credit:

From a credit perspective, these are relatively safe investments, but fall short of the backing held by GSE debt. These would be considered a step below GNMA, FNMA, FHLMC, etc. from a credit perspective. Where GSE bonds are backed by government insured mortgages that are collateralized with real estate, FFELP bonds are simply unsecured debt. These bonds are just receivables with no collateral; only a pledge by the borrower and a partial government guarantee.

The guarantee is also different. FFELP bonds themselves are NOT guaranteed by the government. The loans are guaranteed, so in theory the bond is guaranteed. However, the bond itself is not guaranteed. This is different from GSE bonds where the bond itself carries a government guarantee on timely principal and interest payments.

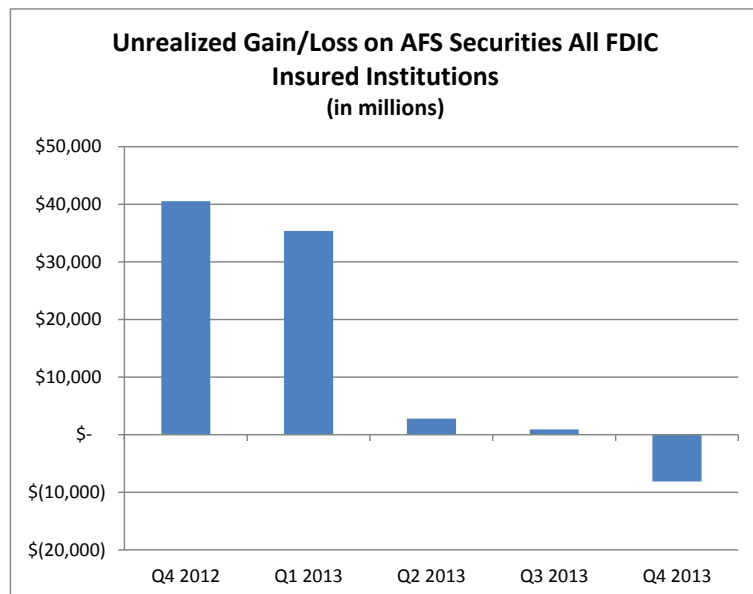
The credit exposure is illustrated in the fact that these deals are structured with overcollateralization and subordination structures. These are intended to add credit protection to the bondholders and define the waterfall for potential principal losses in the future. These are characteristics that are unnecessary in GSE debt where there is a full faith and credit pledge by the US Government on 100% of the principal and interest.

Additionally, there is counterparty risk with the servicers of each deal. The underlying loans are guaranteed by the Department of Education, typically up to 97% of the principal. The process for servicing these loans along with the mechanism for the government make-whole payments opens the door for potential counterparty risk. Due diligence must be performed on the servicers, which for any given deal will be multiple. Several servicers have delayed or even ceased issuing public financial statements. This is cause for concern and can be seen in wider spreads on the bonds where these servicers play a major role.

Ultimately, we believe that these, along with other sectors of the ABS market, could serve a purpose in a bank's portfolio. They could provide a way to introduce a measured amount of credit risk to maintain the portfolio's yield while lowering the overall duration. However, due to the lower liquidity and higher price volatility, we feel that these should be purchased with a multi-year holding period in mind. They are subject to too much price volatility to have any confidence in being able to liquidate in an efficient manner to meet cash demands.

Risks of the Held to Maturity Classification | Cliff Reynolds, CFA

As Ryan Craft wrote in his article 2013 Bond Performance Review in last quarter's issue of ALM Insights, 2013 was a historically bad year for fixed income investors. In fact, 2013 was only the third year since 1977 that the Barclays Total Bond Market Index posted a negative total return. Interest rates across the entire curve rising from all-time lows were the obvious culprit for poor performance, but the effect on banks varied depending on interest rate risk in the securities portfolio.

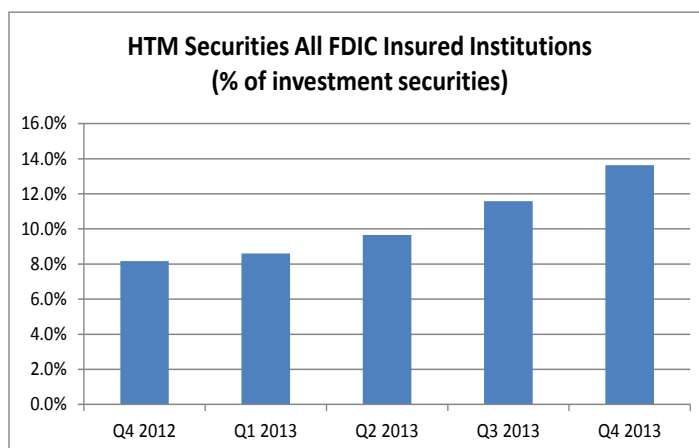
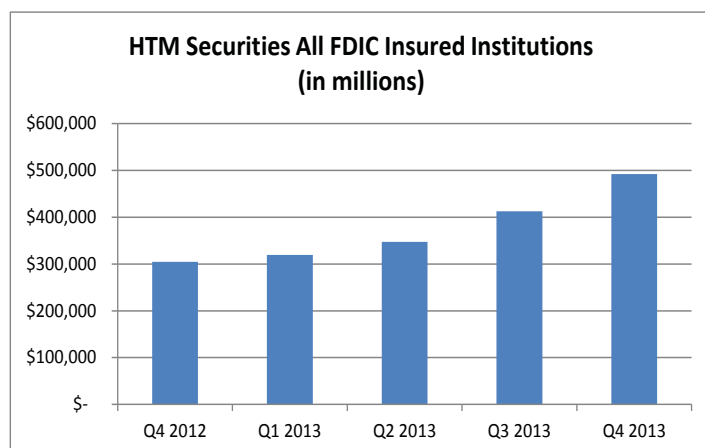


Varied as it may have been, the effect was widespread. Just consider the change in unrealized gain/loss on bank's balance sheets throughout 2013.

The sharp rise in interest rates in May and June took the industry as a whole from an unrealized gain of \$35 billion to just under \$3 billion, and the next wave in November and December took the position to an unrealized loss of over \$8 billion.

This move in interest rates saw the ten-year Treasury rise past 3% by the end of 2013 - still very low by historical standards. Fearing that 2013 was just the beginning of a sustained period of rising interest rates, banks reacted to the selloff by moving securities from the Available for Sale category to Held to Maturity in

order to remove the mark-to-market volatility from the balance sheet and protect tangible equity.



The move can be seen whether you look at it on a dollar basis or a percentage of all securities. Given the sudden move in the industry and the conversations we've had with banks on this subject, I thought this would be a good chance to review the implications of moving investment securities to Held to Maturity.

Securities categorized as HTM are reported at amortized cost, while AFS and trading securities are reported at fair value. Banks include the net unrealized holding gains and losses on AFS securities in AOCI rather than as part of the bank's net income (loss).

(continued on page 10)

There are some restrictions on the types of securities that can be placed in the HTM category – such as interest only strips and convertible debt securities. However, no restrictions prevent a bank from pledging HTM securities as collateral for a loan or repurchase agreement, as long as the agreement is not effectively a sale.

If a security that was placed in the HTM category is either sold or moved to either AFS or Trading, the entire HTM portfolio is considered “tainted” resulting in the reclassification of all HTM categorized securities to AFS. All future purchases must also be classified as AFS and the bank would be prohibited from using the HTM classification for two years.

There are some exceptions made for selling securities classified as HTM that include significant deterioration in the issuers creditworthiness, changes in tax law, bank mergers and changes to regulatory and capital requirements. These do not include raising money for liquidity, portfolio repositioning or a change in the bank’s capital ratios.

(Source: Office of the Comptroller of the Currency)

Many banks have sacrificed flexibility in exchange for not having to stomach future price volatility. If too much of the securities portfolio is classified as HTM, the portfolio fails to function as safe source of liquidity – possibly hurting the bank’s ability to fund future loan growth or reposition the portfolio to better suit its needs.

With bonds performing much better so far this year, I would venture to say that many securities that were placed in to the HTM category after falling in value in 2013 have recovered some but can’t be sold without tainting the remainder of the HTM category for the bank. Instead, the unrealized loss was locked in when it was moved to HTM and doesn’t reflect the latest rally.

The Held to Maturity classification can be a useful tool in many cases, but it can also be misused. Making a classification change without fully considering the implications could lead to unintended effects down the road. Like everything in investing there is no such thing as a free lunch. Taking advantage of the benefits of the Held to Maturity classification can risk sacrificing the benefits of having a securities portfolio in the first place.

Notice to Clients: Please remember to contact ACROPOLIS’ Investment Management, LLC if there are any material changes to your financial situation or investment objectives or if you wish to impose, add or modify any reasonable restrictions to our investment management services. A copy of our current written disclosure statement as set forth on Part 2 of Form ADV continues to remain available for your review upon request.

Legal Disclaimer: This publication is provided as a service to clients and friends of ACROPOLIS’ Investment Management, LLC solely for their own use and information. The information in this publication is not intended to constitute individual investment advice and is not designed to meet your particular financial situation. You should contact an investment professional before deciding to buy, sell, hold or otherwise consider a particular security or investment strategy based on this publication. Information in this publication has been obtained from sources believed to be reliable, but the accuracy, completeness and interpretation are not guaranteed and have not been independently verified. The information in this publication may become outdated and we are not obligated to update any information or opinions contained in this publication.

© ACROPOLIS’ Investment Management, LLC 2008. All rights reserved.