GETTING MORE FROM YOU INVESTMENT PORTFOLIO

by Steve Brown

While many brokers treat a bank's investment portfolio as if it were a stand alone asset, for top performing banks, it is not. An investment portfolio creates asset diversification, permits fine tuning of the asset liability position, provides a place to put excess cash to work and most importantly - acts as a buffer for liquidity. A properly managed balance sheet and investment portfolio can add significant value to shareholders and allow a bank to price loans more efficiently. On a risk and cost adjusted basis, a bank's investment portfolio is often the most important segment of assets. Because the portfolio requires 1 to 3 people to administer, the cost of acquiring assets is deminimus. Further, credit risk is limited, liquidity is high, diversification is easily obtainable and the amount of capital is oftentimes less than 60% of loans. Because of these factors, an investment portfolio can offer a stellar total return when compared to other bank assets. Despite the investment portfolio's importance, independent banks have deemphasized it as of late. As lending has taken center stage, investments have slid from about 15% of assets in 2000 to under 10%. Not only are investment portfolios shrinking, but another trend has arisen - the percentage of the portfolio that is pledged and utilized has increased from an estimated 26% in 2000 to more than 71% today. More importantly, while the average time of pledge used to be under 60 days, it is now close to a year. With so many banks using their portfolio for repo, or to support FHLB advances, the question arises whether the investment portfolio helps with liquidity? The answer is, nowhere near the extent it once did. For banks that have their portfolio locked up, managers may find it difficult to liquidate assets to protect core deposits. In many cases, investment managers may want to rethink their entire investment strategy. Total return and liquidity become much less important, so banks should think about counterbalancing that. Increasing the use of pass-through mortgages is one strategy, as are investing in commercial mortgage backed securities ("CMBS"). CMBS are really a loan substitute for independent banks and the largest knock against these investments is the lack of liquidity. However, if you can't liquidate your assets, then why not go for return. A third strategy involves investing in floating rate MBS guaranteed by FNMA or FHLMC. Lower tier tranches with little cash flow protection should be the target. These are less liquid and have more volatile cashflow, but again, if your bank is simply pledging these assets against long-term funding, then cashflow stability matters less. Currently, this strategy can yield between 50bp to 160bp above Libor for a 20% risk weighted asset. Duration would be kept short, allowing banks to take more fixed interest rate risk in their loan portfolio. If your securities are not pledged and liquidity is truly the primary objective, then we recommend an overweighting of 3 to 5 year ladder of agency bullets to increase future total return in a falling rate environment. These liquidity/return balancing strategies are not for everyone, but for some banks they make perfect sense. To find out how to squeeze greater return for less risk from your portfolio, contact us for an updated review of your investment holdings and balance sheet.

BANK NEWS

Lending Pressure

If CA is any indication, credit union lending to small businesses is exploding. The NCUA reported that such lending in the state nearly tripled during the last 3Y, reaching $5.8B in 2005. In addition, nearly

33% of the state's credit unions made business loans to members during the past year, compared to 15% a decade ago.

Housing Perks

: In an effort to move excess housing inventory, homebuilders in some areas have reportedly begun offering potential buyers incentives worth as much as $100k. Among the most popular are swimming pools, golf memberships, cash bonuses, refunds, fee waivers, home landscaping, plasma screen televisions, as well as free washers, dryers and microwaves.

Fewer Job Cuts

The most recent Challenger survey found that announcements of job cuts fell by 45% from June levels. Overall, firings are 64% lower from the prior year and at the lowest level since June 2000.

Business Outlook

The most recent National City Corp. survey found that small-business owners' confidence declined nearly 2.5%, however 68.1% still feel confident about the economy. The dominant reasons cited for the sentiment change were tensions in the Middle East & higher fuel prices.

Sales Predictions

As gasoline prices continue to rise, retailers are worried that sales during the holiday season might be low. A usual barometer is back-to-school-sales, which have been off to a very slow start this season.

Retail Banking Structure

Wachovia Corp announced that it will split its regional banking business into three primary regions, rather than the current dual-regional focus, after it completes the acquisition of Golden West Financial (CA).