BEING AN INVESTMENT CATCHER IN THE RYE

by Steve Brown

We took the news of J.D. Salinger's passing hard, as the Catcher in the Rye was one of those books (like the Great Gatsby) that we carried around in the back left pocket of faded jeans when we were 15 to help bridge the gap between adolescence and adulthood. Like most boys, we identified with Holden Caulfield, as he tried to make sense of the world. A recurring theme of the book was this notion that adults often say one thing, yet conduct themselves in a manner that is counter to their statements or persona.

Later in life, Salinger's writings also helped us understand bank investment portfolio management. When we were taught that securities investments were one of the major uses of a bank's capital and funding, we struggled when we analyzed how many of the top performing banks have significantly under-performing investment portfolios compared to peers. We were even more confused when most investment classes talked about the yield of investments as if the portfolio should be managed in isolation.

As we matured, we came to understand the confusion and hypocrisy around bank investment management. One major lesson learned is the fact that investment management is not about yield, but about liquidity and the counterbalancing of risk. To excel when building an investment portfolio, managers have to first understand their loan portfolio. Because banks face a much larger risk/return ratio in their lending and deposit portfolios, bank management should start there. The more risk (liquidity, interest rate and credit) in lending and deposits, the less risk that should be taken in the investment portfolio.

Take interest rates for example. Banks can only handle a finite amount of interest rate risk. As such, why take this risk in an investment portfolio if it doesn't support a core competency like customer relationships? The investment portfolio is one of the most flexible tools a bank has, yet most managers treat it like a static asset. Similar to interest rate risk, the same concept applies to credit. A loan portfolio that is heavily concentrated in real estate and tied to the general economy should be offset by investments in non-correlative assets to counterbalance this risk and help mitigate an economic downturn - such as Treasuries, agencies, healthcare, agriculture, utilities and others.

Another overlooked aspect of an investment portfolio is its size relative to other assets. Contrary to how 90% of portfolios are managed, the size of the portfolio should grow when credit times are good and shrink when times are bad. While counterintuitive, this is because when economic stress is present, lending risk is lower and returns are higher. As such, the math shows capital should flow out of investments and into lending. Conversely, as cap rates fall (for banks that are concentrated in CRE), the investment portfolio should increase in size, in order to offset the growing credit risk on the balance sheet. With each dollar of capital, bank managers must ask - "how do I achieve the lowest COMBINED risk-adjusted return for the balance sheet?" Then, alternatives need to be weighed and asset allocations made first with the goal of achieving liquidity, next with the goal of counterbalancing risk and THEN with the goal of achieving a superior risk-adjusted return within the investment portfolio.

As Holden pointed out, life can be simple and confusing at the same time. To keep your investment portfolio from being the awkward, half-formed yearnings for yield, take a look at the loan and deposit portfolios and ask, "What can I do with investments to lower the bank's overall risk?" Once that question is answered, investment maturity is right around the corner.

BANK NEWS

6 Banks Closed (15 YTD)

On Friday, the FDIC closed: [1] First National Bank of Georgia ($833mm, GA). Community & Southern Bank, a new charter in GA, will purchase all deposits for a 1.25% premium and nearly all assets with 73% under a loss share. [2] Florida Community Bank ($876mm, FL). Premier American Bank, NA, a new charter in FL, will acquire all deposits for a 0.4% premium and $499mm in assets with 61% under a loss share. [3] Marshall Bank, NA ($60mm, MN). United Valley Bank ($154mm, ND) will buy all deposits for a 7.35% premium and essentially all assets with 40% under a loss share agreement. [4] Community Bank and Trust ($1.21B, GA). SCBT, NA ($2.77B, SC) will assume all deposits for no premium and practically all assets with 68% under a loss share. [5] First Regional Bank ($2.18B, CA). First-Citizens Bank & Trust Co ($15.82B, NC) will acquire all deposits for no premium and $2.2B in assets with 92% under a loss share. [6] American Marine Bank ($373mm, WA). Columbia State Bank (3.17B, WA) will purchase all deposits for a 1.0% premium and approximately all assets with 68% under a loss share. These closings are estimated to cost the DIF $1.86B.

US Budget

President Obama is proposing a $3.8T budget that will push the deficit to an all time high of $1.6T, before eventually dropping to the equivalent of 5% of GDP in 2013.