GETTING Ã¢Â€ÂœHIGHÃ¢Â€Â ON INVESTMENTS

by Steve Brown

Someone over at General Mills has a sense of humor as they now have 60's icons Cheech and Chong hawking "magic" brownies. Of course the new "magic" is fiber, which is a little depressing if you are over 50, but the spots make you chuckle. The marketing campaign is around the "Magic Brownie Adventure" and has the duo making their way to the "Burning Pole" (a "crazy desert festival") in a VW Van full of the low cal/high fiber product. The product plays into the continuing trend that your food needs to work double duty.

In similar fashion, banks have been abusing their investment portfolios for years - often satisfied with a frothy yield and a helping of densely packed risk. Our belief is that a bank's investment portfolio is more about liquidity and it should serve as a counter balance to the rest of the balance sheet. It should provide liquidity to manage loan and liability growth, while providing a buffer on risk. In short, a bank's portfolio should be customized to enhance total balance sheet performance in what we call a "wholesome, total balance sheet performance."

Take for instance the fact that banks think nothing of taking interest rate risk in their investment portfolio. Liability duration is a like a valuable commodity, with only a limited amount of protection to go around. Why use this scarce commodity on investments when it could be used to satisfy franchise-important customers with fixed rate lending? Banks with a material amount of floored or fixed rate loans may want to consider more floating rate mortgages or corporate bonds currently trading around Libor + 25bp. Yes, the absolute yield leaves something to be desired, but what you lose in your investment portfolio you more than make up for on your lending portfolio.

Non-correlative credit risk is another aspect of investing where CFOs often have a suboptimal investment structure. Most CFOs think nothing of building a portfolio around mortgages, agencies and financial corporate bonds, all credits that move in a 90% or higher correlation with commercial real estate and the general economy - the exact risk these banks already carry in the rest of their balance sheet. Instead of acting as a counter balance, most bank investment portfolios exacerbate risk in the balance sheet all for an additional 5bp to 25bp of yield. A far better strategy might be to build a portfolio of Treasuries plus non-correlative corporate credit risk (such as healthcare, tech, agriculture and many industrial names). Then, when real estate takes a hit, these suggested holdings should register gains that can be harvested to solve some loan credit issues if needed.

After interest rate and credit risk, banks also often don't fully build their investment portfolio to offset optionality and liquidity issues. Banks that don't have prepayment protection in their loan portfolio may need to consider extending duration in their investment portfolio. This will help offset falling rates and a flattening curve, as we see in "Operation Twist." Further, banks that leverage their portfolios for customer repos need to design another type of portfolio, in order to compensate for the reduced liquidity that customer repos entail.

Our point is to underscore our unique investment philosophy when it comes to total bank performance. Like magic brownies, bank investment portfolios have to work harder to deliver value to the rest of the organization. Most brokers don't understand how the rest of your bank operates and frankly, they probably don't care. This is one reason we ask you to add us to your list of approved brokers or investment managers. If you would consider this, we would love to conduct a whole balance sheet review and show you how to better manage risk and increase overall bank performance through your investment portfolio. All this takes is an electronic version of your portfolio after quarter-end and about 15 minutes of your time. If you are interested in setting this up, shoot us an e-mail so we can show you how to turn those empty yield calories into "magic" to take your bank performance higher.

BANK NEWS

M&A

BB&T said it will acquire Maryland-based Atlantic Risk Management, marking the 2nd acquisition in a week. Atlantic is a commercial property and casualty and employee benefits broker with operations in Baltimore and DC.

Muni Pressure

The National League of Cities reports US municipalities are seeing increased strain from falling real estate taxes and reduced state and federal aid. Overall, some 57% of municipal officials said finances were worse in fiscal 2011 than last year.

Lending Standards

Conforming mortgage limits are set to fall on Oct 1st. Wells Fargo is among some banks reportedly considering reducing down payment requirements from 25% to 20% for jumbo loans in certain unnamed markets.

More Capital

International bank regulators are expected to ignore strong lobbying efforts and require the biggest financial institutions in the world to hold extra capital according to reports. The Basel Committee meets today and tomorrow to discuss a proposal released in July that would require 28 mega-banks to hold between 1% and 2.5% of extra capital as a percentage of their risk-weighted assets (on top of a base 7% capital requirement for all banks). Regulators say the surcharge is needed to make sure these super-sized banks can absorb sudden losses without damaging the financial system or requiring taxpayer bailouts.