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Three Investment Resolutions for the New Year

Plano, TX -- This time of year, forecasts abound for 2012 concerning the local and global economy, stock market returns and even the actions of credit union members. While everyone would like to see improvement over 2011, many factors that are beyond credit union control—Europe's continuing debt crisis, the U.S. presidential election in November, and unsolved budget problems in Washington, D.C., to name a few—have the potential to sidetrack economic progress.

To add to the tension, most credit union leaders have some concern about what to do with the growing investment portfolio that has replaced what used to be a healthy loan portfolio. Even seasoned investors have found themselves in a quandary over the mismatch of basic lessons from Economics 101, according to Sarina Freedland, senior investment officer at Catalyst Strategic Solutions.

"We are beginning to see glimmers of progress in economic growth that would tempt us to believe we are at the beginning of a growth cycle that would lead to higher interest rates. That means buying short-term investments, right? However, we have heard many times over the Federal Reserve's intentions to keep interest rates at extreme low levels until mid-2013, not to mention the European Central Bank's recent move to actively lower interest rates. So, that means locking up yields for longer periods."

Credit union managers struggling to make sense of these mixed messages have reason to be optimistic, Freedland said. "A year ago, earning even the slightest margin over cost of funds seemed impossible. However, most credit unions managed to eke out enough return to satisfy examiners and members. But, credit unions will continue to rely heavily on investment portfolio income to replicate revenue streams. Currently, every $1 in loan principal received requires $2.65 in investment principal."

Freedland offered credit unions three resolutions to maximize investment returns in 2012:

1. Don't wait for rates to rise – stay invested.

It would be tempting to say that rates have been at their lows for long enough and should start rising, despite what the Fed says. Recent job reports show net job gains of over 100,000 a month for the past five months, and housing sales are gaining traction rather than falling. Given this scenario, a prudent investor might think it best to hold onto cash rather than lock in low rates. Most individuals believed this a year ago, too, but rates continued to fall throughout 2011. The two-year Treasury is lower by almost 40 basis points, while the 10-year note is down over 130 basis points.

Staying in cash in hopes of higher rates will only rob credit unions of needed interest income. Investing in a two-year Agency at 0.65 percent could earn an additional 40 basis points over what the credit union would earn by keeping liquid funds in cash, or $4,000 for every $1 million invested (in the first year). If the credit union stays true to its investment ladder with call and maturity dates evenly spread out, it is protected and will have funds to invest when rates do make the turn.

2. Don't get lazy with liquidity.

Credit unions added close to $400 billion in new balances in 2011, an increase of five percent in the 12 months ending September 2011. CUNA is forecasting another five percent share growth for 2012, while also predicting a three percent increase in loan demand. If reports from retailers about holiday shopping trends are any indication, credit unions could see a nice improvement in loan demand. It remains to be seen whether holiday shopping trends point to improving loan demand, or if high unemployment will hold the line on members' big ticket spending. Maintaining adequate liquidity could be trickier in 2012.

Even though today's liquidity profile is strong, credit union managers must continue to protect their long-term cash needs. The consumer is fickle and can change buying habits abruptly due to sales promotions, government tax provisions, even the prospect of landing a new job. Portfolios will have to be managed proactively through 2013, setting aside a reasonable cushion of available funds and paying greater attention to the investment ladder.

3. Don't fall for the "bond of the day".

The bond-of-the-day strategy won't work in 2012. Credit unions will need to become more selective in their purchases. This year, the structure will be as important as the coupon. In other words, the credit union may have to give up that enticing higher coupon to gain some protection. Common sense says to buy along the yield curve, keeping a close eye on short-term needs, and watch the portfolio cash flow structure closely.

Choosing portfolio duration is not always straightforward. Strategically, investment duration targets depend on the credit union's prevailing loan-to-asset ratio. The lower the ratio, the further out on the curve a credit union should consider going with its investments. For most active credit union portfolios, that means extending out to the three- to four-year area of the curve. Extending much past four years at this time will not provide enough yield to make up for a lack of liquidity.

A good rule of thumb for the right type of investment to buy is to look at the credit union's ladder type, which varies according to credit union size, loan-to-share ratio and member base. Short-term cash flow ladders can be filled with premium callable structures that are better yielding than bullet Agencies. Also known as cushion callables, these structures provide a higher yield-to-call return, while giving some protection if the bond is not called. If a credit union typically buys certificates of deposit, consider the higher-paying negotiable, or Depository Trust Corporation (DTC), CDs. These CDs offer the same guarantee protection, with a little more yield to boost return.

For that interim ladder of two to five years, callable structures with longer lock-outs are ideal. The further out the call, the more protection against reinvestment risk. With the front end of the yield curve relatively flat, there is very little to gain in this market by adding more call option. For instance, if the three-month lockout option is being exercised, rates have moved lower and the credit union will be investing at the reduced levels. With interest rates virtually stagnant now, it pays to gain the interest rate protection over earning five more basis points.

Amortizing investments also fit well into this portion of the portfolio. Credit unions have been heavily involved in 10- to 15-year mortgage backed securities (MBS) and collateralized mortgage obligations (CMO) paper the past few months. The shorter final maturities equal average lives of two to five years, generally with yields better than most callable structures, and with less prepay volatility. Be careful of the premium in the shorter mortgage paper.

Unfortunately, no one investment formula fits all credit unions. But all credit unions can benefit from keeping a close eye on liquidity levels this year, said Freedland, especially for any changes in patterns. "Good indicators for when to adjust investing patterns are when deposits begin to shrink and when members' appetites for loans increase."

For more information about Catalyst Strategic Solutions' investment offerings, contact Mike McGinnis at 800.301.6196.

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