ALM Insights

ACROPOLIS® INVESTMENT MANAGEMENT
Registered Investment Advisor

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Timeless principles · Timely advice

KEY RATES ::

Fed Funds Target	0.25%
Discount Rate	0.75%
Prime Rate	3.25%
3-mo LIBOR	0.28%
2-yr Treasury	0.40%
3-yr Treasury	0.70%
5-yr Treasury	1.43%
10-yr Treasury	2.55%
2-yr Swap	0.54%
5-yr Swap	1.63%
10-yr Swap	2.77%
5-yr A Corp Yield	2.49%
5-yr A BQ Muni Yield*	2.83%

* Tax Equivalent Yield

ECONOMIC DATA ::

Q1 GDP Growth	1.8%
May CPI YoY	1.4%
Unemployment Rate	7.6%

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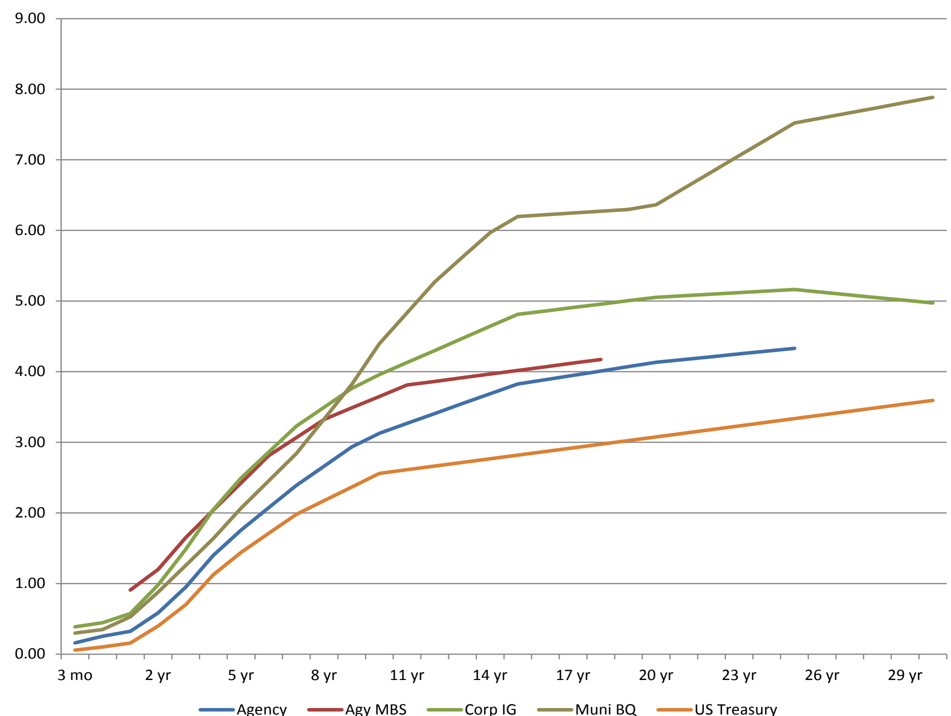
Yield Curve



All data as of 6/26/2013

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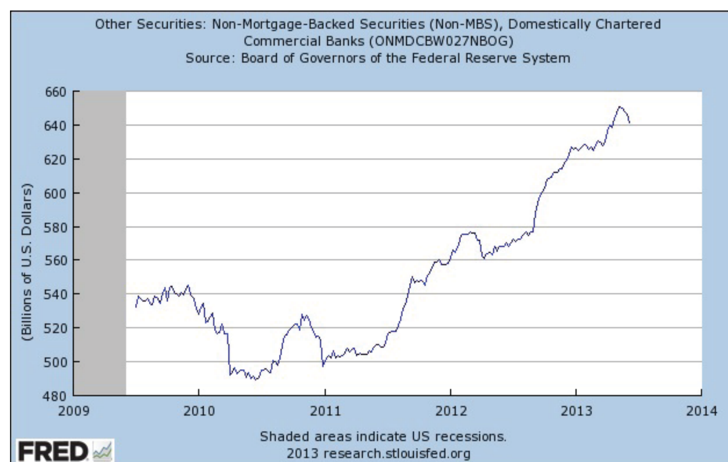
The Risk of Concentration | Cliff Reynolds, CFA

Over the last few years, as yields have fallen and remained extremely low, a growing number of banks have increased their allocation to non-government bond sectors in search of more attractive yield opportunities. Even if banks avoided taking gains through selling as rates fell, the natural process of bond's maturing has lowered the book yield of the investment portfolio and hurt return expectations. Some banks remain content with holding a securities portfolio free of credit sensitive product, but the industry wide trend is pretty apparent.

The graph to the right shows the holdings of non-government, non-MBS securities by banks – a category made up mostly of corporate and municipal bonds. This trend is by no means alarming on its own. Loan growth is far below desired levels for most banks. Those same banks are flush with deposits and eager to make loans to credit worthy borrowers, but unfortunately the demand for credit has drastically trailed the supply, resulting in a very competitive market for banks to conduct business as usual. Put another way, many banks are in a position to take more risk, but opportunities to do so have become more difficult to find. Adding risk to the securities portfolio may be an appropriate way to fill that gap. But what does an investor get for that added risk?



At the foundation of financial market theory is the notion that investors are naturally risk averse. Given that aversion to risk, if an investor was presented with two investment choices with identical expected returns but different levels of risk, the investor will always choose the investment with less risk. As a result, investors demand higher rates of return in exchange for taking additional risk – an idea that applies across all asset classes, (equities, real estate, high yield bonds, etc.)

Bond Sectors	Annualized Return
US Govt Bonds	6.76%
US Credit	7.70%
Excess Return	0.94%

The risk premium for corporate bonds, representing compensation for the inherent risk of the market, resulted in about 100 basis points of excess return over government bonds over the last 25 years. (A risk premium of similar size exists for municipal bonds.)

It's important to point out that those figures are calculated using an index that captures the entire market for these securities. The market portfolio, as it is called, consists of thousands of issues – making it almost impossible for even a very large investor to recreate. While it is unnecessary for managers to replicate an entire index to be adequately diversified, many non-government bond portfolios owned by banks and other financial institutions are constructed in a way that exposes the investor to far greater risks than the inherent risk of the market.

While it is common for a bank to concentrate lending activity where it has the expertise, proper risk management limits extreme concentration within one lending sector or large loan balances with a single borrower. The same thinking is applicable to the securities portfolio.

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Without proper diversification in a portfolio, the outcome of one single credit can dominate the outcome of the entire portfolio. While defaults of investment grade corporate and municipal borrowers are rare, the market's expectation of default risk is constantly changing. Yield oriented investors often overlook the effect that short and intermediate-term price volatility can have on the portfolio - thinking they can just hold bond positions to maturity. But as a major source of liquidity for the bank, the portfolio's value based on marked-to-market pricing cannot be ignored. Concentrated position risk, (also called unsystematic or idiosyncratic risk), provides no added compensation to investors and is avoidable through careful management of the portfolio.

Since opportunities for loan growth are difficult to find in this environment, a larger than normal allocation to corporate bonds in the portfolio can be justified. However, concentrated positions cannot. The added risk of being overly exposed to a single credit or industry has a negative impact on the portfolio without any added return to the investor. Often considered to be the only "free lunch" in the investing world, diversification provides advantages no investor can afford to ignore.

Economic Update - We Want More, We Want More | Brent Vondera

The US economy remained in expansion mode during the second quarter of 2013, even as global growth continues to wane, as massive deficit spending and the most aggressive monetary policy in history keeps us afloat.

On the international scene, economic fragility is conspicuous. Europe remains in recession for a seventh-straight quarter. Economies in Asia deteriorate as China's slowdown persists, Japan can't shake its long malaise and expansion within the Newly-Industrialized Countries (NICs) stumble. Latin America is dragged lower as its growth engines (Brazil and Mexico) grind to a halt.

While the US withstands this global economic torpor, the pressures are evident as we have yet to see GDP print anything close to trend growth during this expansion. The best we've seen is 2.6% year-over-year growth, and the average since the recession technically ended is a pathetic 1.6% (trend growth, or the long-term average, is 3.2%).

Despite these persistent economic headwinds, the unprecedented nature of monetary decisions – namely, ZIRP and QE -- is not justified. To the contrary, this policy is one of the main reasons we remain in this lowly state.

Let's not forget that it was the FOMC's wild policy stance during the initial years of the 21st century that brought us the housing bubble (then crash) and an explosion of debt that's been the main impediment to hitting average growth rates. Frankly, it goes beyond that as it was the reckless liquidity injections during the late 1990s (for fear of a Y2K problem that many said was a ridiculous concern) that inflated the tech bubble and kicked off this now 13-year period of paltry annualized stock-market returns.

This is precisely why we continue within this epoch of successive bubbles. The debt levels that hamper our ability to grow will not be expunged until the FOMC ceases and desists. Instead of allowing the markets to resolve this issue, monetary policy merely encourages the debt excess.

And it's this debt – now at fresh highs in terms of the consumer and a gargantuan 70% higher with regard to the federal government – that we must use to adjust the real state of the economy. Let's face it this is not the 1980s when we still had plenty of room to expand this credit. No, at these levels the diminishing marginal utility of debt has taken hold; it won't only do additional economic damage, but forces debt service costs to explode once the Fed

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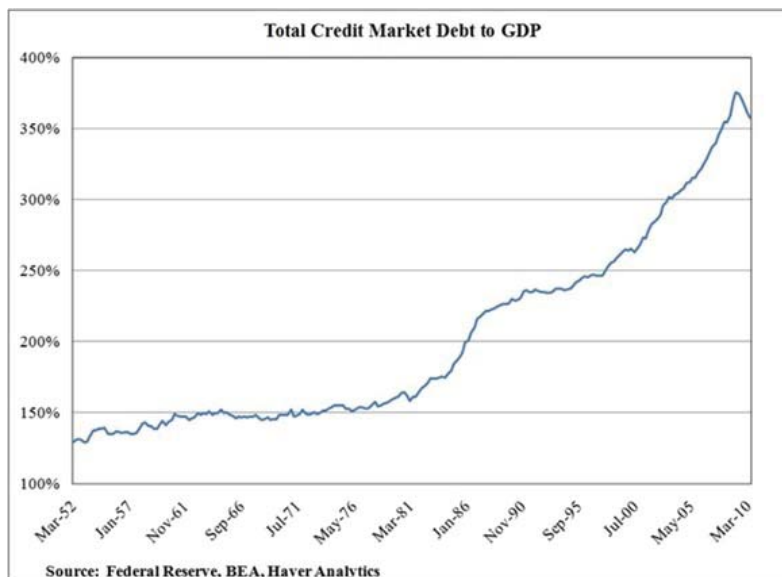
loses control. (The federal debt situation is a primary element for these aggressive monetary actions – it's called monetization– no matter how many times Mr. Bernanke refuses to acknowledge such.)

Indeed, all through this expansion, which began in late 2009 (officially), real GDP has been contracting by $1.75 trillion per year when adjusting for debt expansion. The federal government's debt is now meaningfully above 100% of GDP and when we include all of the debt within the economy it comes to a crushing 350%.



While this situation is evident to market participants, the actions of central bankers has been to take the short-term focus away from fundamentals and condition everyone to not just expect more monetary action but to yearn for it. It all reminds me of the AT&T commercials in which Beck Bennett sits around a table with several children and asks remedial questions. The overall theme of these advertisements is: "it's not complicated." The specific spot I'm thinking of is where one of the kids explains that more is better than less and when they really like something, as she expresses, "we want more, we want more."

As a result, business decision makers along with investors are incentivized to game the system. At the corporate level, it involves borrowing to expand dividend payouts and stock buybacks in order to keep equity prices from falling – it's certainly not revenue and operating-income growth rates that have been propelling prices. At the investor level, it involves people lurching and searching for yield/return as the Fed's "financial repression" drives real returns negative within safer financial assets. This is all fine and good for a while, but a house of cards does not stand for long.

What we lack is a proper allocation of capital, driving these vital funds into the areas that deliver future growth and productivity that lead to higher living standards. As a result, +160k/month payroll growth has become the new norm (half what we truly need) and the lowest-paying sectors of the labor market drive the job creation we do have.

It really isn't that complicated. Why can't the Ph.D.s responsible for these polices understand that?

Unruly Interest Rates | Ryan Craft, CFA

Recently, I found myself on the Acropolis corporate jet, also known as Southwest Airlines. Being too cheap to spend my company's money on the preferred boarding upgrade, I was relegated to the back of the boarding line and one of the lucky people to sit right in front of a row of preschoolers. These kids had perfected the art of whining, crying, and kicking to get what they wanted from poor mom and dad. Staring at a long and loud flight, I popped on my headphones and turned up the music which allowed me to forget about the temper tantrum behind me and focus on getting some work done.

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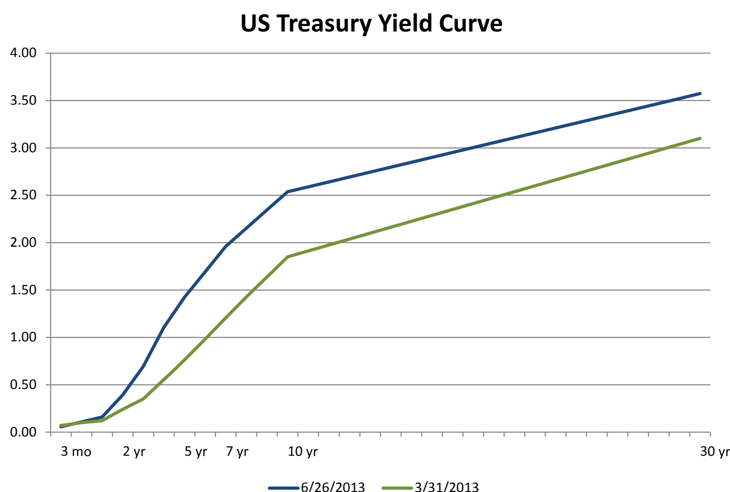
Why am I starting with this mundane travel note? While watching the market react to the recent FOMC meeting, I realized that those kids have nothing on bond traders when it comes to tantrums. Traders want more Fed cash and when it looks like it isn't coming, they are going to make it loud and uncomfortable for everyone.

Interest rate volatility increased violently in the second quarter as the market became spooked about the Federal Reserve's eventual exit. It began with Ben Bernanke publically discussing the concept of tapering, or reducing the amount of bond purchases by the Fed. His comments that the economic fundamentals may warrant tapering sometime in 2013 caused bond markets to begin selling across the board.



On June 19th, the FOMC meeting concluded with the status quo remaining in place, but the statement opened the door for a reduction in QE later this year and QE potentially ending completely around mid-2014. The market reaction was swift as interest rates spiked and continued to climb for the following few days. As of this writing, Treasury rates have increased 60-80 basis points on most maturities past three years. Corporates, muni's, and MBS all performed even worse as spreads widened out as well. This begs a few questions: Why was the market caught so off guard? What happens next? What changes should be made to my bond portfolio?

Was this jump in yields warranted? The answer to this question depends on whether you are a long term investor or a short term trader. Part of this movement is driven by the current argument in the market about stock and flow. The Fed argues that the biggest influence of interest rates is the overall stock of debt that is trading, also known as the float. They believe that as long as they hold their current portfolio, the effects of QE will remain in the economy as it means the float is permanently lower. With this point of view, monetary tightening only occurs once bonds are sold or the Fed Funds rate is increased.

The market, however, looks at this situation much differently. The market believes that it is the marginal dollars invested, or flow, that will drive future interest rates. Therefore, when the Fed stops purchases, or even decreases the amount it purchases via tapering, interest rates will have to increase as there are fewer buyers in the market for the next trade.

The flow camp drove the massive sell off in bonds as traders rushed to be the first out the door. The selling pressure drove up interest rates, which then created a negative feedback loop as portfolio managers sold more to hedge positions and manage duration. This recent volatility has thus far been driven by speculation as the economic fundamentals have changed little over the course of the year and the Fed remains tied to its outlook and triggers for future movement. After all, it was primarily speculators and short term trading that drove rates to their ultra-low levels. Traders have been gaming the Fed throughout this Quantitative Easing experiment (just google Tuesday POMO for evidence).

What is the appropriate level? Where does the market go from here? Unfortunately, a case could be made for either direction. On one hand, the market realizes that QE must end at some point. It has been ineffective at

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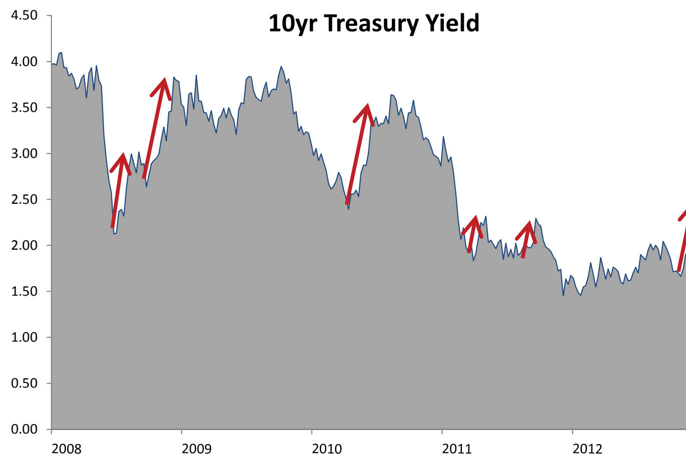
stimulating the broad economy and the Fed's balance sheet risks destabilizing the markets by distorting risk and inflating asset prices. If tapering is right around the corner, that means the 800lb gorilla is going back in its cage, leaving the rest of the market to sort itself out and clean up the mess. Sounds like the flow argument could be on to something and rates could rise further from here.

On the other hand, there is a pretty strong case to be made for rates falling from here – that this market went too fast too soon. After all, this has happened nearly every year for the past five years, not to mention that the 10yr Treasury is now 80bps higher in yield now than before the latest round of QE was even announced, let alone implemented. After the latest market reaction, the Fed predictably sent out multiple Fed presidents to essentially backpedal and tamper down the tapering expectations. It seems that the Fed is testing the waters of what the market reaction will be and not necessarily ready to exit QE so soon.



What about the fundamentals? Housing has been the brightest star of the economy this year, one that was highlighted by Bernanke during the press conference. After the run up in rates, the rate on a new 30yr mortgage will run around 4.75%, up from a low of 3.5% just six months ago. What impact will that have on the emerging housing market? Due to the long home buying process, this effect will not show up in the data until this fall.

The Fed has spoken at length about the wealth effect. This is supposedly a phenomenon where people feel wealthier so they spend more, resulting in increased economic activity. The Fed used QE to artificially inflate asset prices such as stocks, bonds, and houses in order to make people feel more "wealthy." If QE drove these prices up, where do they go when QE disappears? Stock prices have fallen along with bonds in June, so this indicates that investors see lower earnings in a post-QE market.

The reality is that the economy has so much leverage that interest rate movements are magnified. Compared to past economic cycles where the Fed would raise rates 400+ basis points and induce a minor recession to calm inflation, this cycle is much more interest rate sensitive as the excessive leverage means that nominal interest rates reign over all sectors of the economy, which is likely to put a cap on how high rates ultimately can go.

If I were a gambler, I would bet on rates to fall from these levels by the end of the year for many of the reasons listed above. Not because the natural market rate of interest is lower than the current curve, but because the Fed will blink and attend to the temper tantrum currently being thrown by the markets. In this monetary game of chicken, anything is possible over a short term horizon.

This brings us to the question of what action to take in one's portfolio given all of this change. Interest rate movements are unpredictable. Rather than attempting to pick the direction of rates, a bank can structure its portfolio to win regardless of the outcome. By using the investment portfolio as a counterweight to the entire balance sheet, a bank can perform well in any directional movement of rates. This is the point of having a robust Asset Liability Management system in place.

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Identify Risk
Through Asset-Liability modeling, the bank can identify where it is exposed and quantify the current interest rate risk in the balance sheet. Remember, the results of any model are only as good as the reliability of the inputs and assumptions. These inputs and assumptions should be continually checked, back tested, and stressed. No model will ever be an accurate predictor of the future, but it can be a helpful tool for shedding light on where risk may be hiding.

Develop Strategy to Immunize Risk
Within ALCO, create a strategy to over time neutralize any imbalances. The strategy may include deposit and loan pricing to induce certain behavior, trading in the securities portfolio to alter duration, leverage strategies, derivatives, or a combination of these.

Efficiently Execute Strategy
A strategy is only effective if properly executed. For the bond portfolio, this step involves identifying the type of bonds that accomplish the goals set forth in ALCO and then trading those bonds at the best prices possible.

Monitor, Evaluate, Repeat
Monitor and evaluate the effectiveness of the current strategy in order to make necessary adjustments to changing conditions.

None of this is rocket science. In fact, most of it is just elementary school math. The key is to remain committed to the process and not get distracted chasing outsized return. In baseball terms, be content to grind out singles and doubles and don't swing for the fences.

A good process can act like a good set of noise cancelling headphones. Whether Bernanke silences the crying market with more QE candy, or stands tough and allows the market to continue its tantrum, a robust process and proper strategy allows one to tune out the noise and focus on the task at hand.

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