Managing Your Investment Portfolio in a Rising Rate Environment
April 22, 2014

Protect Principal • Maintain Liquidity • Enhance Returns • Provide Fiduciary Control
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Welcome

- This will be an education session oriented to small and mid-sized credit unions
- About 45-60 minutes
- Questions are welcome

Objectives

- Tapering: what does it mean and how might it affect your investment portfolio
- Strategies for investing in a rising interest rate environment
- Better and more efficient execution for buying and selling bonds and certificates of deposit

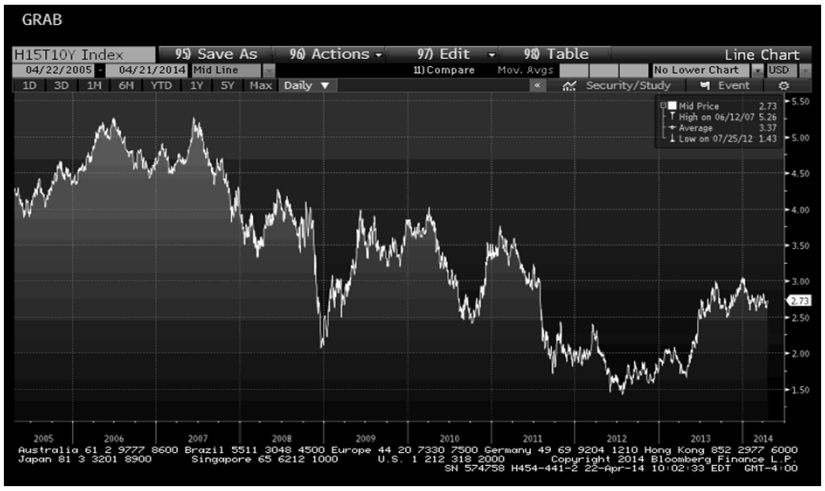
3

FED Tapering Bond Purchases

- Federal Open Market announced a $10 billion per month over the last three meetings taper moving from $85 Billion monthly to $55 Billion monthly:
  - Quantitative Pledge:
    - Keep interest rates low until unemployment falls below 6.5% or inflation tops 2.5%
  - Outlook for 2014:
    - Exptected to continue to reduce open market bond purchases by $10 billion per meeting until October of 2014
  - Fed Official Survey: 5 of 19 said the first interest rate increase could come in 2014, 13 of 19 said 2015. Only one said 2016.

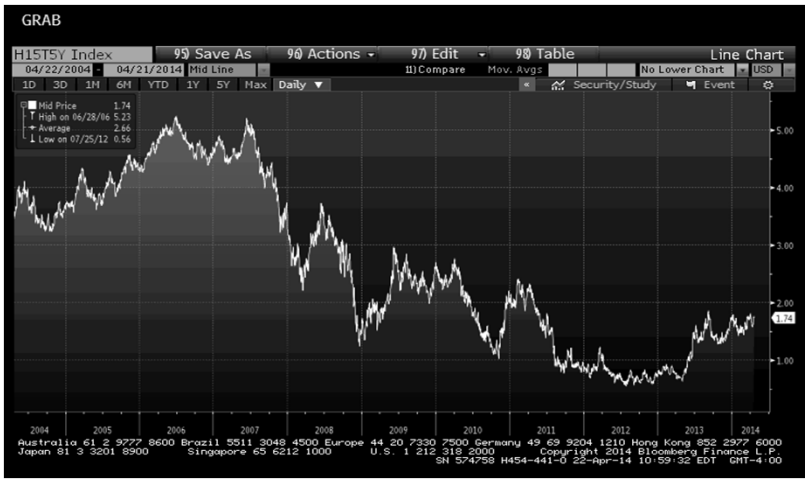
4

Yield History on 10 Year Treasury



5

Yield History on 5 Year Treasury



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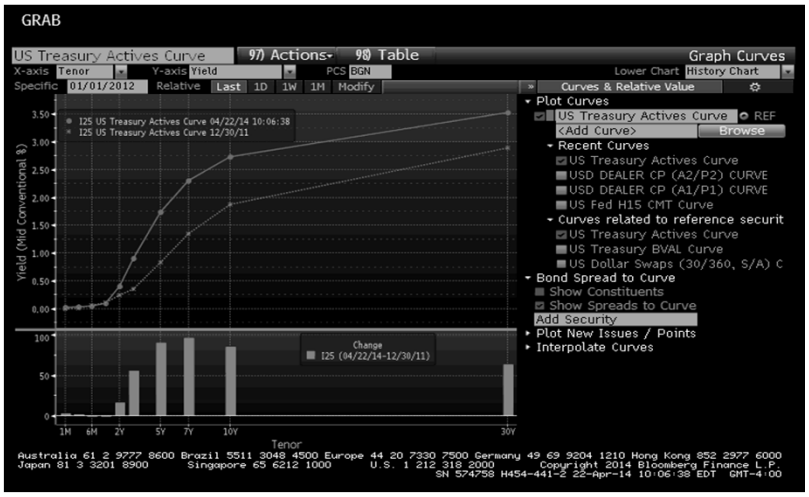
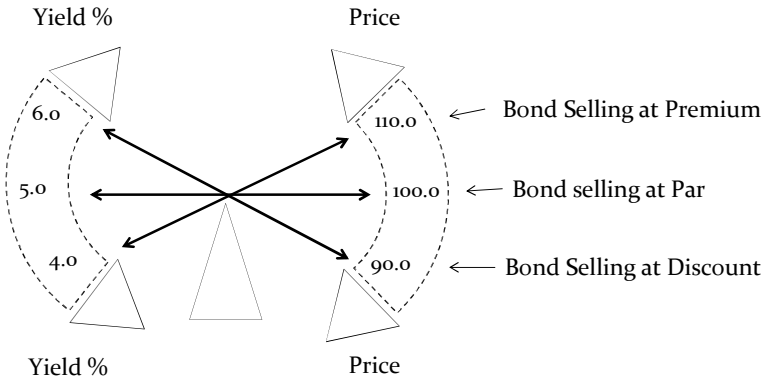
What have interest rates been doing?



7

Bond Price vs. Yield

- Bond Prices and Yields are **INVERSELY** related.



8

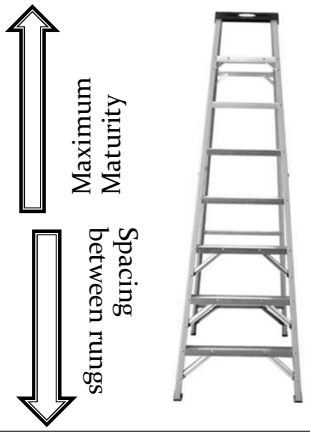
Strategies for Investing in a Rising Rate Environment

- Shortening Your Ladder
- Asset Class Diversification

9

How to Create a Bond Ladder

- Rungs: By taking the total $$ amount that you are planning to invest and dividing it equally by the total number of years for which you wish to have a ladder
- Height of Ladder: The distance between the rungs is determined by the duration between each maturity. Pick a maximum maturity
- Materials: Just like real ladders, bond ladders can be made of different materials. Government bonds, municipal bonds, corporate bonds, CD's



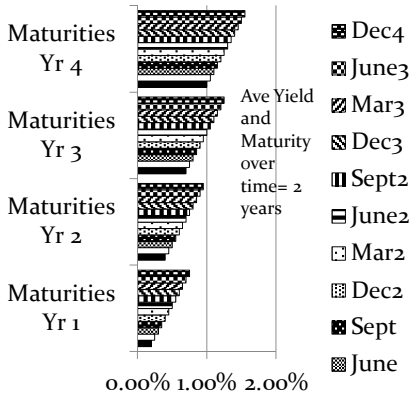
The ladder itself is very simple to create:

Just picture and actual ladder.

10

Example of a Bond Ladder

- Manage interest rate risk in a disciplined manner with regular cash to roll over into new bonds at changing rates.
- Effectiveness hinges on buy-and-hold to maturity strategy. If you sell early or concentrate on one rung exposes to additional risks.



Average yield across the portfolio can mirror a short loan portfolio

Portfolio size dictates the instruments to invest in

11

Bond Market Classifications:

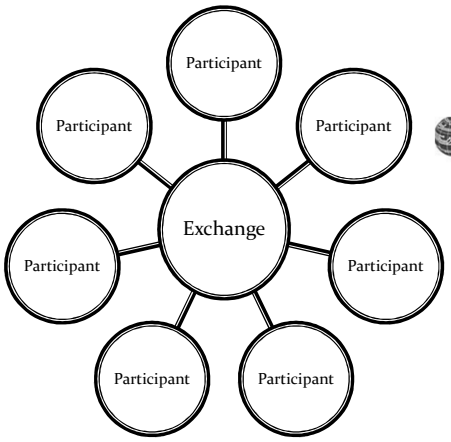
Bond	Liquidity	Credit Rating	Cash Flow	Optional Interest Rate Risk
U.S. Treasuries	Very High	AA+/Aaa/AAA	Semi-Annual Payments	Not Callable
U.S. Agencies	Very High	AA+/Aaa/AAA	Semi-Annual Payments	Callable and Not Callable
Mortgage Backed Securities (MBS)	High	Same as U.S. Agency or Other issuer if Private	Monthly payment principal and interest	Maturities can extend or shorten
Municipal Bonds	Medium	Depends on Issuer	Semi-Annual Payments	Callable and Not Callable
Certificates of Deposit (CD)	Low	FDIC insurance up to limit	Periodic	Not Callable
Corporate Bonds	Medium	Depends on Issuer	Quarterly Payments	Variable and Fixed Interest Rate Risk

12

Transparency in the Bond Market

How Stocks Trade

- Brokers bring buyers and sellers together:
  - Earn a commission for doing so
  - Are indifferent to price
  - Transparent trading price



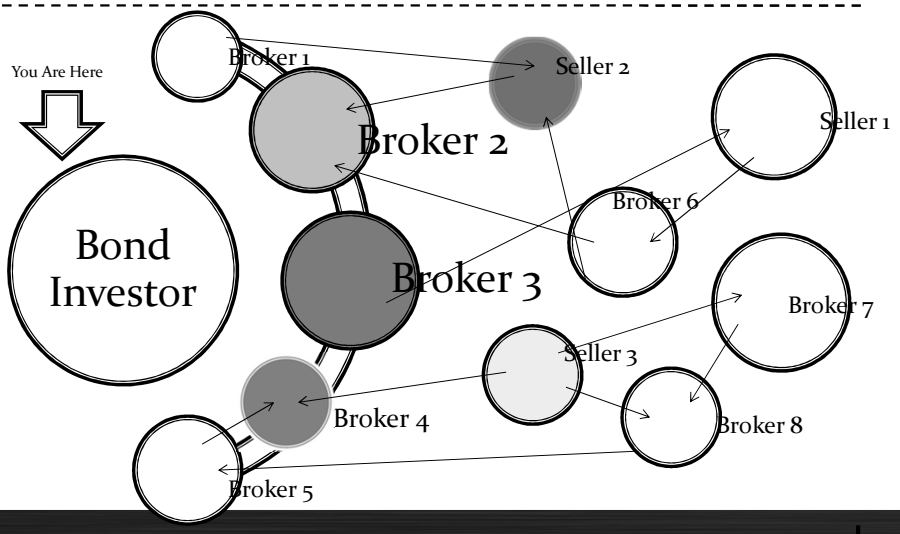
NYSE

NASDAQ

TOKYO STOCK EXCHANGE

London STOCK EXCHANGE

How Bonds Trade



15

Bond Trading Terminology

- Bonds generally trade anywhere in the world that a buyer and seller can strike a deal. ***There is no central place or exchange for bond trading, as there is for publicly traded stocks.***
- Bond Dealers: occupy the central role in the vast network of telephone and computer links that connect interested players. The dealers "make a market" to provide liquidity for bond investors.
- Bond Investors: major bond investors are financial institutions (including credit unions), pension funds, mutual funds, and governments from anywhere in the world.
- Bid-Offer Spread: The price difference between what the trader will buy a bond at, and the price at which the trader will sell a bond. ***The interests of the buyer can be in direct opposition with the bond dealer.***
- Basis Point: is a hundredth of a percentage point. Example if a yield moves from 3.5% to 3.0% it has moved 50 basis points.
- Spread: Non-federal government bonds are quoted on the basis of a yield spread over a similar maturity government bond. "This CD is 25 bps over treasuries."

16

Step 1: Update Investment Policy

- Define your allowable asset classes (State Charter versus Federal Charter)
- Define your maximum maturity parameters
- Define CU roles and responsibilities
- List approved investment managers or brokers
- Set up reporting minimums (investment portfolio review and board oversight)

17

Step 2: Select your Custody

- Select independent custody not tied to your broker
- Credit Unions can contract with any custody agent
  - Examples: Northern Trust, JP Morgan, Bank of New York, Wells Fargo, US Bank.
  - Corporate Credit unions contract with the custody agents listed.
- Perfected interest: the custody agent knows you as the client and owner of the securities in your portfolio. Assets are *not* commingled or held on the balance sheets of a financial institution

18

Step 3: Select your Reporting

- A single custody platform facilitates comprehensive reporting.
- Reporting can be provided by custody agent.
- Options for reporting.
  - Excel Spreadsheets (Small Portfolios)
  - Custody Agent Statements
  - Other Reporting Providers: Yield Book, Clearwater, Advent/Axys

19

Step 4: Select Brokers or Managers

Broker Dealers	Investment Managers
▸ Transaction based relationships. No transparency on bond mark-ups or commissions ▸ Send you fixed income inventory. Can look for a specific need that you have ▸ Best to use at least three brokers and speak with them regularly on pricing ▸ Must be disciplined and pay attention to your ladder or strategy	▸ Fee based relationships. Transparency on bond mark-ups or commissions ▸ Non transactional. Pay a fee regardless of trading activity ▸ Independent advice not dependent on selling each month ▸ Help shoulder fiduciary responsibility and discipline to pursue a ladder or strategy

20

NCUA Regs Affecting Credit Unions

- Code of Federal Regulations Part 703-Investment and Deposit Activities
  - 703.3-Investment Policies
    - A Federal credit union's board of directors must establish written investment policies consistent with the Act, this part, and other applicable laws and regulations and must review the policy at least annually.
  - 703.4-Recordkeeping and Documentation Requirements
    - Required documentation includes, where applicable, bids and prices at purchase and sale and for periodic updates, relevant disclosure documents or a description of the security from an industry-recognized information provider, financial data, and tests and reports required by the Federal credit union's investment policy and this part.
  - 703.6-Credit Analysis
    - A Federal credit union must conduct and document a credit analysis on an investment and the issuing entity before purchasing it, except for investments issued or fully guaranteed as to principal and interest by the U.S. government or its agencies, enterprises, or corporations or fully insured (including accumulated interest) by the National Credit Union Administration or the Federal Deposit Insurance Corporation. A Federal credit union must update this analysis at least annually for as long as it holds the investment.
  - 703.11-Valuing Securities
    - Before purchasing or selling a security, a Federal credit union must obtain either price quotations on the security from at least two broker-dealers or a price quotation on the security from an industry-recognized information provider.
    - At least monthly, a Federal credit union must determine the fair value of each security it holds.
    - At least annually, the Federal credit union's supervisory committee or its external auditor must independently assess the reliability of monthly price quotations received from a broker-dealer or safekeeper.
  - 703.12-Monitoring Securities
    - At least monthly, a Federal credit union must prepare a written report setting forth, for each security held, the fair value and dollar change since the prior month-end, with summary information for the entire portfolio.
    - At least quarterly, a Federal credit union must prepare a written report setting forth the sum of the fair values of all fixed and variable rate securities held that have one or more of the following features:
      - (1) Embedded options;
      - (2) Remaining maturities greater than 3 years; or
      - (3) Coupon formulas that are related to more than one index or are inversely related to, or multiples of, an index.

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