



## Weekly Post: Managing the Investment Portfolio

October 6, 2016

Dear Clients-

Last week, I talked about the importance of more frequently monitoring the your loan portfolio on a monthly than rather than quarterly basis. The projected loan portfolio inflows of payments, pipeline of loan production, and the change in interest rate sensitivity (duration) often prompts investment decisions. Securities investments enable you to adjust the cash level, interest rate risk exposures, and the liquidity coverage ratio.

While the investment transaction may be small relative to the size of the balance sheet, , any investment decision needs to take into consideration the particular bonds that provide highest yield or total returns, while adjusting the balance sheet exposure to the target levels.

Community banks and credit unions tend to use smaller transaction size (odd lots) and trade less frequently when it comes to securities investing. Therefore, the executable prices can differ from the market fair prices. Some securities such as step-up coupon callable agency bonds can affect the risk profile of the balance sheet. Further, regulators often seek justification any investment decision.

THC Risk Officer™ provides a systematic procedure to manage this investment process taking the above mentioned issues into consideration. This Post explains.

### Challenges

- Based on the loan portfolio analysis, I will have too much cash, which bonds should I buy?
- Should I buy high premium MBS vs callable agency bonds to seek lower duration investments?

### Solution

Step 1: *Understanding the 'market' prices.* In Trade Simulation, THC provides a set of benchmark bonds. THC updates the bond prices daily based on the THC fair pricing model, benchmarked against some of the actively traded bonds. You can determine the earnings and changes in risk exposure by clicking on *Simulation* .

However, your brokers or you may like to consider other bonds actively traded in the market that contain indicative prices closer to executable levels by your specific broker. In this case, you can upload these bonds and brokers' prices easily by clicking on *Inventory*

### Market Wisdom - Art Hilliard\*

#### Portfolio Size Considerations

Many think that they can't buy or sell loans unless they have sufficient size to interest investors.

- Although some investors like to see larger transactions, many will do smaller deals.
- That certainly is true when it involves peer-to-peer transactions with other banks and credit unions
- In fact, single loan transactions are routinely completed
- Recall that in past scratch and dent transactions, there were investors who bid on as few as one loan

Don't let size concerns stop you from buying or selling :

- Make sure data and loan files are in good shape and send loans out for bid
- If buying, announce that there is no limit on size. TFO gives you the opportunity to do that on the system
- When it comes to portfolio transactions, many don't do them simply because they haven't tried

Art Hilliard has been in the mortgage industry for 29 years. He has originated, managed secondary marketing, securitizations and settlements, provided mortgage financial advisory and performed multiple mortgage portfolio sales and acquisitions. He was past president of the Illinois Mortgage Bankers Association.



Some of our clients have made arrangement with their brokers to use Risk Officer™ to down load their bonds and prices regularly. THC cloud-based technology allows for the seamless connectivity among users.

You or the brokers can update the inventory PATH file (terms & conditions data input file) if necessary. When needed, the brokers can provide you their ask prices using the *Price Update File*. You can just upload the data. The process is almost automated, enabling you to have access to broker prices to be precise in choosing the bonds to buy.

**PATH File :** [?](#)

**Price Update File :** [?](#)

**Upload :**



 Assign to a Bank

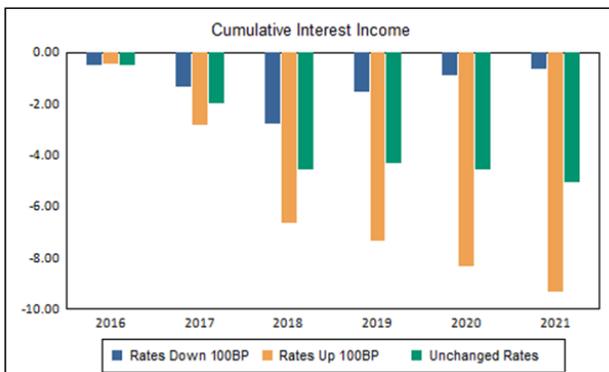
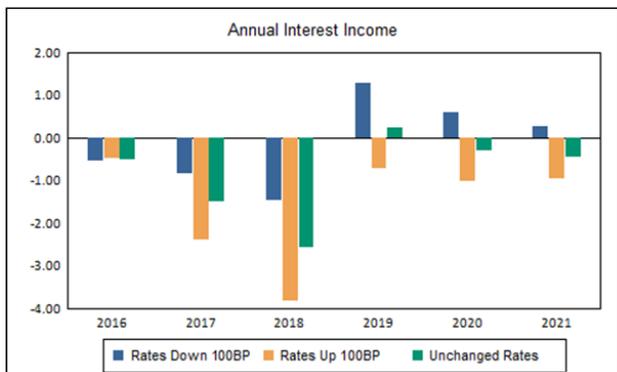
**Numerical Example**

**Step 2. Evaluate Alternative Investments** You can select the bonds and simulate the results to identify the earnings and changes in risk profile. The investment may be funded by FHLB borrowings. In this case, the EVE ratio may also be affected. The Trade Simulation report enables you to make multiple alternative simulations to decide on the best risk and return trade offs for your balance sheet based on your brokers' prices.

**Step 3 Generate Report** For an investment, I suggest that you use the Bond Swap report. Note that the Bond Swap report also allows for buying/selling loans. To illustrate, I show two pages of the report. In this transaction, I buy an agency bond and sell an MBS. The report below lists the Gain/Loss, yield pick up, change in WAL.

<b>Bond Swap Summary</b>			
	<b>Sell</b>	<b>Buy</b>	<b>Diff</b>
<b>Transaction overview</b>			
Par Value	197.24	200.00	-2.76
Book Value	205.87	204.82	1.05
Market Value	204.82	204.82	-
Gain/Loss	-1.05	-	-
Book Yield%(TEY)	2.20	0.88	-1.32
Market Yield%(TEY)	2.31	0.88	-1.43
WAL	4.61	2.20	-2.41
Transaction Valuation Period(year)	4.61	-	-
<b>Results - after tax, through valuation period</b>			
Interest Income	19.22	8.75	-10.47
After tax gain/loss	-	-	-0.73
Net Benefit	-	-	-11.21
Breakeven period	-	-	-
<b>Cash Effect</b>			
Market Value as of Report Date(clean)	204.82	203.79	1.03
Accrued Interest Receive	-	-	-
Accrued Interest Paid	-	1.03	1.03
Cash received as settle	-	-	-
Tax impact from sold items	-	-	-0.31

The report also shows the projected net interest income over five years under alternative rate shocks. The simulated results will identify the extension or prepayment risk of MBS and callable bonds, as illustrated below.



The analysis is not confined to rates shocked up or down. You can choose many alternative stress test scenarios, as described below

**Cashflow Scenarios:**

- |  |   |   |
|--|---|---|
| <input type="checkbox"/> Shock Down 300 BP | <input type="checkbox"/> Shock Down 200 BP          | <input checked="" type="checkbox"/> Shock Down 100 BP |
| <input checked="" type="checkbox"/> Base   | <input checked="" type="checkbox"/> Shock Up 100 BP | <input type="checkbox"/> Shock Up 200 BP              |
| <input type="checkbox"/> Shock Up 300 BP   | <input type="checkbox"/> Shock Up 400 BP            | <input type="checkbox"/> Flattener                    |
| <input type="checkbox"/> Rampup            | <input type="checkbox"/> Declining                  | <input type="checkbox"/> Rising                       |
| <input type="checkbox"/> Rampup 100        | <input type="checkbox"/> Rampup 200                 | <input type="checkbox"/> Rampup 300                   |
| <input type="checkbox"/> Rampup 400        |   |   |

The extensive analysis enables you to invest in securities with embedded options for ALCO meeting, Board presentation and regulatory review.

**Conclusion:**

Investment enables you to manage liquidity, adjust balance sheet sensitivity, and enhance earnings as market opportunities arise. Risk Officer™ inventory function allows brokers to provide you their indicative prices. Trade Simulation function enables you to select the optimal transactions using multiple alternative trades. The Bond Swap report provides you the report for ALCO, Board presentation, and regulatory review.

*If you have any questions regarding the investment process, please do not hesitate to contact THC.*

Regards,  
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*THC is NOT a broker-dealer. THC only offers an analytical platform for clients to work together to meet your customers' needs or your balance sheet requirements. THC does not collect any commission.*

\*Art Hilliard is the Principal at AHilliard Company assisting banks, credit unions, and mortgage companies with mortgage advisory and asset sales and acquisitions.

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