

First Empire Securities

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Credit Union Investment Portfolio Strategy

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Introduction

- Current Economic Environment
- Current Investment Opportunities
- Total Return Strategy

Economic Environment

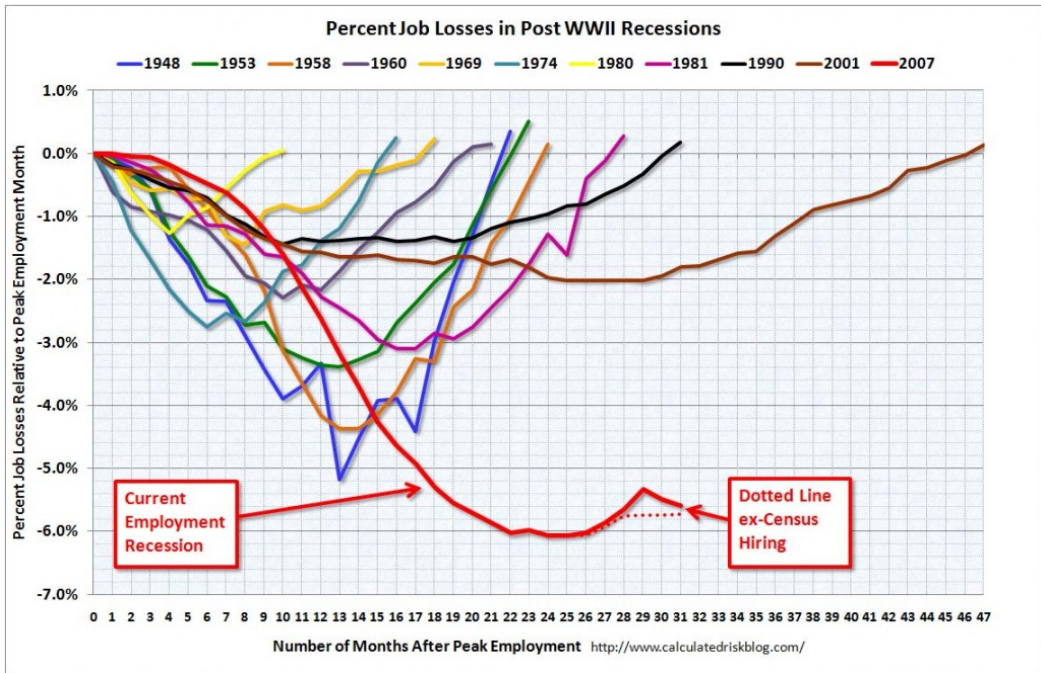
- Interest Rates: Fed on hold for the foreseeable future.
 - The market consensus believes the Fed will not raise interest rates for at least a year. Many in the market believe it will be well into 2012.
- Market pricing in very slow growth.
 - Yield curve is flattening: the long end of the curve rallying indicating slow growth.



Source: Bloomberg L.P.

Economic Environment

- What will cause the Fed to raise rates?
 - Reducing Unemployment
 - Inflation Expectations
- Unemployment is stagnant:
 - National unemployment rate at 9.5%.



Economic Environment

- Inflation Expectations:
 - An increase in rates is also determined by inflation expectations.
 - Fed’s goal for long term inflation is 2.0%
 - Market is pricing in 1.29% inflation.

5 Year Breakeven (Real Yields – TIPS)



Source: Bloomberg L.P.

Economic Environment

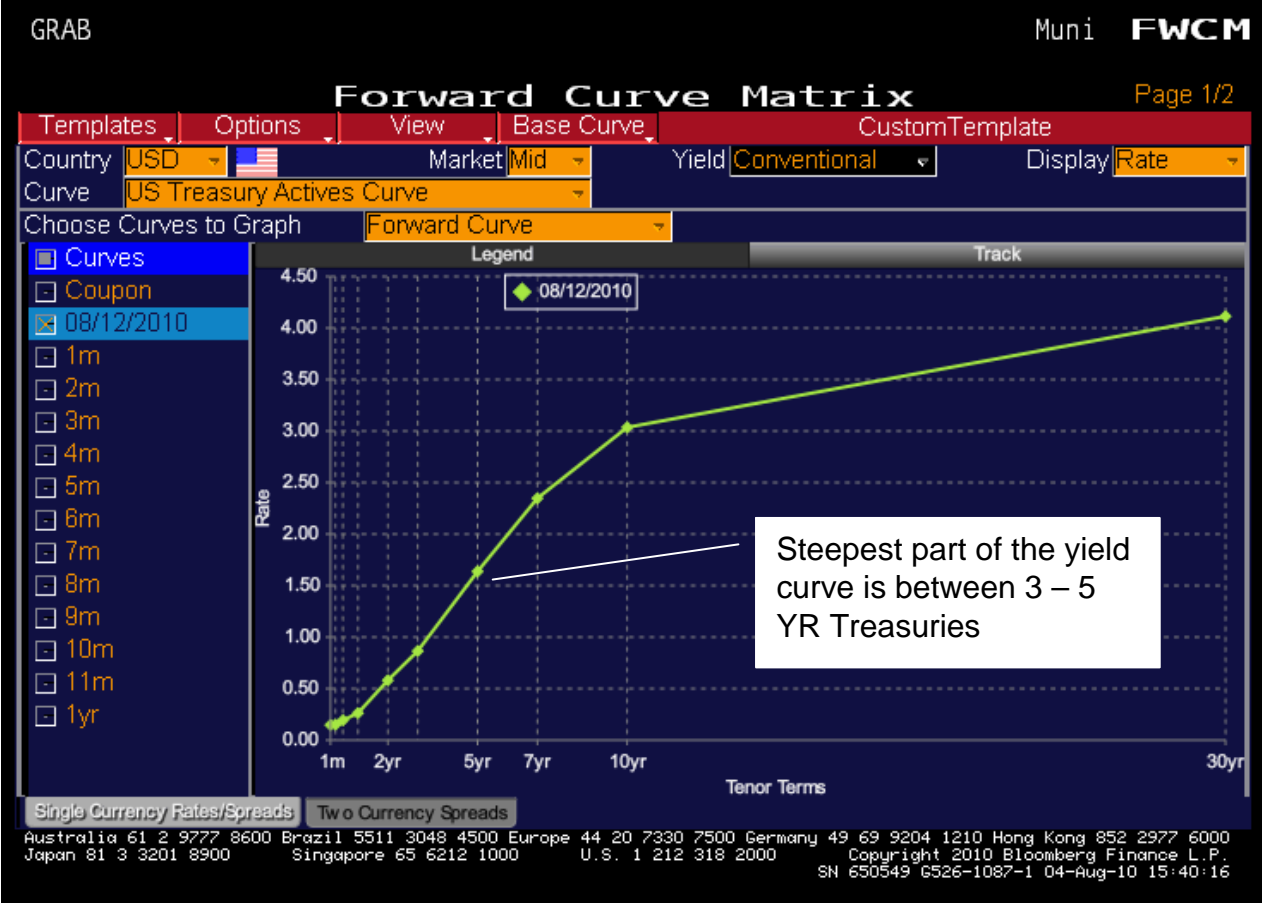
- Double Dip Recession?
 - Unlikely in the next two quarters, but there is a chance longer term.
 - We see very slow growth moving forward.
 - Bond market is pricing in slow growth – flatter yield curve.
 - Two year treasury note is at the lowest level ever and anchored there for the time being.
 - The market is indicating an inflation rate of less than 1.5%.

Current Investment Opportunities

- With Fed Funds 25 basis points and yields on treasury notes at the lowest levels ever, there still are opportunities in investments.
- One of the best opportunities is to take advantage of the steep yield curve.

Current Investment Opportunities

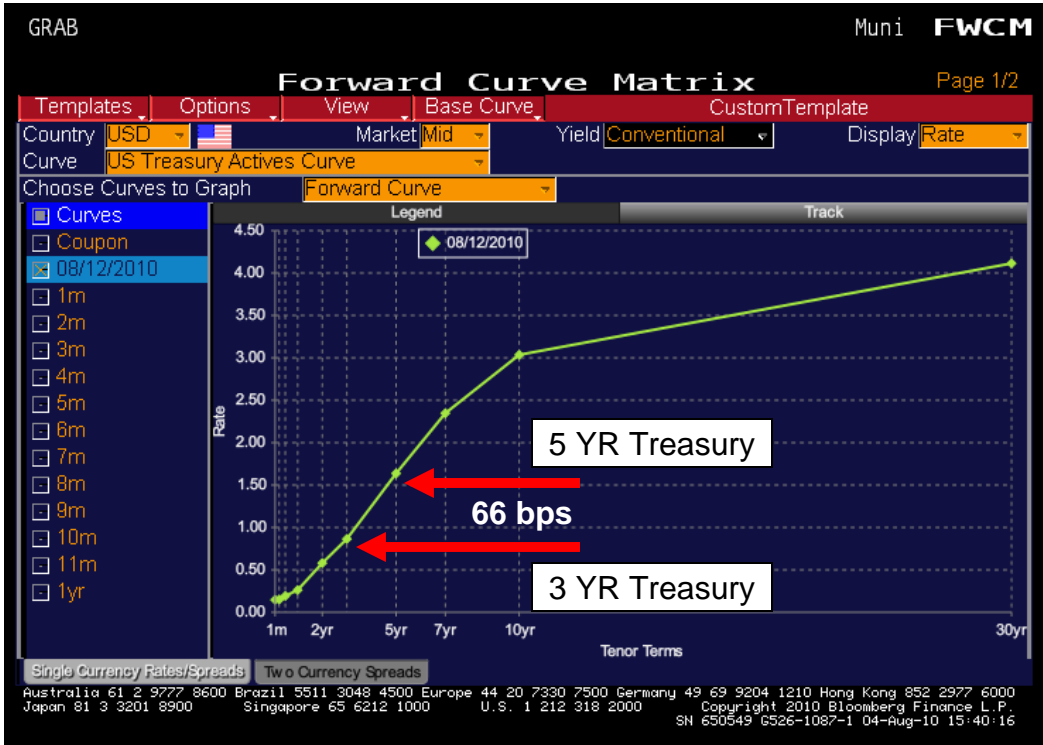
- Steep Yield Curve:



Source: Bloomberg L.P.

Current Investment Opportunities

- What does roll down the curve mean?
 - Bonds price relative to U.S. treasury bonds. If you own a three year bond it prices relative to three year treasuries.
 - In a year, a three year bond becomes a two year bond and will price relative to two year treasuries.
 - With a steep yield curve two year treasuries yield less than three year treasuries. This will lead to a higher bond price because lower yields equate to higher prices.



Source: Bloomberg L.P.

Current Investment Opportunities

Roll Down: Change in Price

Bond priced at par.

Priced to 5 YR

FHLB 2.450 08/24/17 (313370NM6)			
Spread	100.75 bp	vs	T 1 ³ / ₄ 07/31/15
Price	100-00		101-15 14:13:33
Yield	2.450000	Wst	1.442497 S/A

Source: Bloomberg L.P.

Bond priced off of 5 year Tsy

Bond rolls down from 5YR to 3 YR Maturity

Bond now at a premium

Priced to 3 YR

FHLB 2.450 08/24/17 (313370NM6)			
Spread	100.75 bp	vs	T 0 ³ / ₄ 08/15/13
Price	100.657274		99-29+ 14:14:04
Yield	1.783919	Wst	0.776419 S/A

Source: Bloomberg L.P.

Bond priced off of 3 year Tsy

Total Return Strategy

- Total Return is a core portfolio strategy that seeks maximum return consistent with the preservation of capital and cautious risk taking.
- As opposed to buy and hold, the traditional credit union investment strategy, total return considers the price appreciation of a bond and the realization of the gain by selling the bond in the market.

Total Return Strategy

- **Total Return example:**
 - Bond Coupon: 5.0%
 - Purchase Price: 100.00
 - Current Market Price: 104.00
 - Hold period: 180 days
 - Funds Invested: \$1MM

Interest Income for 180 days:	\$25,000
+Mark to Market Gain:	\$40,000
Total Return:	\$65,000

Total Return Strategy

- Total Return Actual Example:
 - FNMA 5.5 Coupon Mortgage Backed Securities started to increase in May.
 - In July, we recommended to a credit union to sell their higher coupon MBS.
 - The security gained ~\$16K in price for every \$1MM invested.
 - The interest income generated ~\$9K for every \$1MM invested
 - This yielded a 2.38% total return or \$25K for every \$1MM invested in 4 months.

Price of FNMA 5.5 MBS



Source: Bloomberg L.P.

Total Return Strategy

- We recommend utilizing this strategy only on a portion of the investment portfolio in order to enhance investment income.
- Buy bonds that one would be comfortable holding to maturity as to maintain safety and soundness.
- Utilizing this strategy requires more active management of the investment portfolio, but can:
 - Reduce interest rate risk.
 - Generate more income.
 - Grow the credit union.

Conclusion

- For the foreseeable future we anticipate the U.S. Economy to be in a slow growth environment with risks to downside.
- We find investment opportunities buying bonds in the three to five year part of the yield curve.
- Take advantage of yield curve utilizing a total return perspective to help grow the credit union.

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Thank You!



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