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THE FRONTBURNER

Welcome to the February edition of ***The FrontBurner***! As you can imagine, we have hit the ground running in the new year. We didn't slow down when COVID introduced itself to the world, so there is no reason to slow down now. We have too much we want to do to make your lives easier; especially as the environment in which we operate just continues to get more and more complicated. Isn't it nice to know you have a partner out there whose sole purpose is to make your life better?

Last month, we talked a little bit about one such area where life is getting more complicated – CECL. This month, we'll tackle another – Capital Markets. It is no secret to anyone we here at VolCorp have been investing in this service for you for years with the development of **vPortfolio**. It should also come as no surprise that we invest daily (thank you Investments Department) in your understanding of what is going on in the markets, what types of investments truly make sense for your risk/reward profile, and who and how to trust those who work in this space. In this month's edition of ***The FrontBurner***, we try to take that education we provide one-on-one daily to many of you out to the masses. After all, almost all of us are putting some investments in our portfolios. And, absolutely all of us need to be careful and informed in how we do it.

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With that, I hope you enjoy this month's edition of ***The FrontBurner***.

Jeff Merry, President/CEO

INVESTOR BEWARE

The first quarter of 2020 delivered a real gut punch to the world. With yields on a steady climb and on their way to a possible normal rate environment, we saw credit unions start to really put excess funds back to work. The mood was getting better everywhere, and investors that had been on the sidelines trying to time the market recovery were finally coming back and seeing value in investments. There were likely conversations with Boards expecting to see increases in income, and then the floor fell out from under our feet. A microscopic enemy that had never been spoken about in 99% of American homes would soon replace ISIS as the number one terror threat.

Enter the pandemic and lockdowns that would wreak havoc on the economic front worldwide. Yields dropped, investors ran, the Fed had to cut rates over the weekend and seemingly overnight the world went from profitable to our worst enterprise risk situation. Now it isn't just the falling yields and virus that began to worry us, it was the aftermath that would leave credit unions searching for income in an environment without borrowers. Fast forward a couple months and add to the lack of borrowers a steady stream of new liquidity and the need to understand new government programs such as the PPP or Paycheck Protection Program. To put it simply, a perfect storm of excess liquidity and low income drew targets on the backs of credit union leadership. Please understand that for the purposes of this article and the limitations one sitting can levy, the events and timetables are being simplified and that is in no way meant to diminish the weight of the pandemic and the losses suffered by so many.

So, the markets now smell like Boston Harbor at low tide. Yields are stuck in the muck that is exposed by the low tide, and investors are left searching for any bonds that can make up for the lack of income that we laid out to our Boards just a couple months prior in our newly minted 2020 budgets.

Cue the wolves dressed in sheepdog clothing.

You see, for years we have struggled to stand in front of the misguided promises of better yields from outsiders promising that they are smarter than us, shinier than us, and more sophisticated. What they really offer, in many cases, are bad decisions served up as higher yielding mortgage-backed securities and SBAs with structures that will shed the higher yield for losses as the underlying collateral defaults and the agencies make bond holders whole (to principal) and leave you with increased pre-pay speeds and thus negative yields as you write-down your premiums.

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We have seen credit unions invest in 10-30-year pools that offer only slightly better yields than Treasuries based on their weighted average lives, and those are the best of the securities we see going into these portfolios. Here is just one example:

Do you want to buy a SBA that the broker states is 100% guaranteed by the government, at a high $109 premium in this market?

For the record, the SBA market has been getting $109-$114 dollar prices for years, and yes, they are fully guaranteed by the U.S. Government, however only to principal, but I digress.

Sure, they show that currently it pays at a yield 20 bps more than a callable or 25 bps more than a Treasury. However, that 109 price equates to a premium of 9% of your par value. Consider an investment of $1MM in this SBA. You have a $1MM par position and a $90K premium. You expect this to pay you 1.80% with an average life of 4-years at current pre-pay speeds (prepay speeds refer to the speed with which the underlying collateral in the bond is being paid off by the borrowers).

Oh, did we mention these are all small business loans guaranteed by the U.S. Small Business Administration? That is important because these are all small businesses that are paying these off. The same small businesses being destroyed by the pandemic. So as the borrowers lose their business, they default on the loans and the agency pays the bond holders back their portion of the principal.

For simplicity, let's say this has 2 loans in it and half just disappeared overnight. You now have a 10-year bond, with a 4-year average life, that just became a $500K position. You now have $45K in premium because you just wrote off $45K as a loss going straight to your income statement. How long will it take you to recoup the $45K on a monthly basis? If the bond was paying you 1.8% on $1MM, you were prepared to account for roughly $19,620 in annual income (roughly because we are not taking normal paydowns into account here.) However, now you are earning only $9,810...and you need to net out the $45K you lost in premium so your income on this one position is now negative $35,190 on a fully-guaranteed bond that was originally paying .25% more than a Treasury to the average life. The Treasury had a guarantee to principal, but no paydowns so no concern over losses, and would have earned you $15K annually (with no paydowns to change that income.) So, you lost $35K in order to possibly earn only $4K more on this position. Now I may not be as shiny and smart as those guys, but I do not think that is a valid risk versus reward equation.

This example is definitely simplistic and while only having 2 loans in the bond, it might seem to overstate the risk, but it only seems that way. The reality is they can have 100 loans and lose most of them. Over time, the bond will reveal itself to have been a bad investment in this market, precisely why most brokers outside the industry will sell them. They are off-loading bad bonds to those that do not understand them. They are preying on our need for income and relying on our lack of desire to explain the reality of the economic and capital markets environments to our Boards. Further, they are earning a really big commission selling this stuff. Treasuries pay, but not like these do. We can earn as much as 8-times the commission of a Treasury on a mortgage-backed security, because the market prices them higher...but that doesn't make them a good buy. Please do not misunderstand my point. There are good SBAs, but they are not high yielding, they are par handles and a lot are floating rate on our balance sheet. There are also good mortgage-backed bonds, but they are not high-premium and they are not as readily available today as Treasuries. In fact, in this market, with rates on the rise, you have to be very careful that those 4-year average lives do not turn into 7-8-year average lives.

My point is there is no magic investment that solves the capital markets dilemma. Do not chase yield without understanding every aspect of the bond you are buying. Would you buy unsecured debt from another credit union without understanding the borrowers? Why buy the bond that you wouldn't underwrite? Simply put, you do it because you are promised or drawn a false picture of what to expect. You are led into a bad investment by a bad broker. Because they have no skin in the game, they feel free to simply pocket the commission and walk away.

The reality is they do not understand the credit union business model and they never will because they are bankers chasing after the Wall Street leftovers, instead of trying to understand our need to serve our members. We are very good at what we do and stand together as a team rather than compete for your dollars as individuals. Every day we manage to serve you, build new tools just for you to help minimize the stress of your investments, and manage our own portfolio that also exists in this low-rate environment. It is very necessary to have those that can separate themselves from the credit union industry because they do drive the capital markets and allow the markets to continue to thrive in both the high and low tides, but we also need those of us who work in both worlds that can bridge them together and serve.