

# AMBASSADOR

A L E R T

2010-2<sup>nd</sup> Quarter

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## Thoughts on a Summer Morning

Recently I had the opportunity to start the day at a local diner with my dad and his younger brother, my Uncle Dick, who was in town for a few days from New Mexico. When I say "younger brother," Uncle Dick is 84. It was fascinating to sit there and listen to these two guys, both veterans of WWII, both accomplished professionals in their chosen fields, as they talked about life and about history. It's curious how as time goes by, it is easier to see these two guys as brothers and as boys rather than just as fathers and as hard-working professionals. It's also curious how little I have sat down and tapped into their cumulative wit and wisdom.

It wasn't until after my mom died a few years ago that Dad and I started to go out for breakfast. While we always had a good relationship, we rarely got together and talked about life like this. Now, pretty much every month, Dad and I make it a point to head off to a local diner to start the day. Sometimes we talk about what has happened over the past month; sometimes we talk about family and growing up; sometimes we just talk. Always it is fascinating and often it is enlightening to talk to this person I have known and loved all my life, but far too rarely talked to on such a basic level.

Breakfast with Dad has taught me many lessons. Of course, there are the many wonderful things from a personal perspective, but these eggs and home fries mornings have also reminded me to look harder at the many other resources that are available to me from a professional perspective. Resources that are so close and familiar that they sometimes become virtually invisible. Resources like people I work with or have worked with in the past. Reference or educational resources that are familiar and available, but never really used. It is amazing how much of value is so close at hand, and so easy to overlook.

So look around. What resources, what people, what sources of knowledge or counsel are at your fingertips, but also so familiar that you forget about their value? Look at them again. Reconsider and reconnect. It's not too late. After all, it took me close to 50 years to ask Dad out for breakfast.

Enjoy your summer!

*Allen Collins*  
Managing Director

## 2010 2<sup>nd</sup> QUARTER MARKET AND ECONOMIC RECAP

The second quarter of 2010 was vastly different than first quarter. In fact, Q2 was very much the antithesis of Q1 by almost every account in regards to the markets and the economy. Recall that Q1 was marked by improving economic data, a rallying stock market, tighter credit spreads and rising treasury yields. Conversely, Q2 was marked by weakening economic data, declining stock prices, wider credit spreads, and

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significantly lower treasury yields. At the end of Q1, I talked about how far the markets and the economy had come over the past year. In the three months since then, economic and market conditions have experienced a precipitous regression, reminding us all how tenuous the current recovery is at this time.

Specific to the stock market, the action in Q2 can only be described as atrocious, as the Dow, Nasdaq, and S&P 500 registered losses of 9.97%, 12.0%, and 11.86%, respectively, putting all three indices in the red for the year. More notable was the Q2 close on the S&P 500 at 1030.71, below the technically important support level of 1040. This critical level was tested twice before in Q2, holding each time to rally thereafter. However, three times must be the charm or, perhaps, curse is a better choice of words. As the 1040 support level finally broke down, this trading pattern traced the second shoulder in the bearish "head and shoulders" formation, as technicians like to call it, suggesting that a further decline to the low 900s in coming weeks is plausible. Ultimately, fundamentals drive stock valuations in the long term, but technicals unequivocally impact stock prices in the short term, particularly in an environment defined by volatility and uncertainty, which is precisely where we are today. And, speaking of volatility, the VIX, widely regarded as the "fear index" and a measure of the implied volatility of the S&P 500 over the next 30 days, climbed 96.36% in the quarter, closing at 34.54, up from 17.59, suggesting that investors should buckle up for a bumpy start to the 3<sup>rd</sup> quarter.

In regards to the credit markets, wider spreads were omnipresent across the fixed income spectrum from high grade (investment grade) to high yield, as risk appetite subsided. In tracking those spreads, let us look at the Markit CDX North American Investment Grade Index, which measures a basket of 125 investment grade 5-year corporate debt issues across various sectors versus treasuries. This index closed Q2 at 122.9 basis points, up from 88.1 bps since the end of Q1, a spread widening of 39.49%. To provide some historical context, the average spread since the launch of this index in October 2005 is 104.9 bps, which includes the high of 279.3 bps registered on 12/5/08. Let us also look at the Markit CDX North American High Yield Index, which measures a basket of 100 non-investment grade entities versus treasuries. This index closed Q2 at 651.2 bps, up from 552.9 bps since the end of Q1, a spread widening of 17.78%. At the end of the day, spreads remain markedly stronger than the crisis days of late 2008 and early 2009, but the trend in Q2 was disconcerting and should be monitored. Further deterioration will erode confidence and destroy wealth, highlighting the necessity for a reversal to tighter spreads.

As a result of the aforementioned action in the equity markets and wider credit spreads, coupled with perpetual issues in Europe and concerns that China's economy, the third largest in the world, is slowing, U.S. treasury yields declined markedly in the quarter. As one can see in the table below, yields declined anywhere from 40 bps to 90 bps from the 2-year to the 30-year treasury, with the greatest moves occurring on the long end of the curve. The net effect of this phenomenon has been a flattening of the yield curve. Specifically, the 2-year/10-year spread has flattened by 47.5 bps from 281.0 bps at the end of Q1 to 233.5 bps as of the end of Q2, while the 2-year/30-year spread has flattened by 40.4 bps from 369.7 bps at the end of Q1 to 329.3 bps as of the end of Q2.

Treasury Term	Yield (%) 3/31/10	Yield (%) 6/30/10	Change (bps)
3-month	0.150	0.170	2.0
6-month	0.231	0.217	-1.4
1-year	0.379	0.309	-7.0
2-year	1.016	0.601	-41.5
3-year	1.571	0.974	-59.7
5-year	2.544	1.780	-76.4
7-year	3.275	2.415	-86.0
10-year	3.826	2.936	-89.0
30-year	4.713	3.894	-81.9

Source: Bloomberg Finance

Recall that in the 1st quarter recap, I highlighted the tug of war occurring between those like Bill Gross, head of PIMCO, who were calling for an end to the 20-year bull-run for treasuries versus those who believed that the possibility for a double dip recession could perpetuate the flight to quality trade. Clearly, the flight to quality trade was back in full force during Q2, as investors re-priced risk and reassessed the outlook for Fed monetary policy and the economic recovery. As I have been saying for some time, I believe rates will stay lower for a lot longer on deflationary pressures, global imbalances, and global sovereign debt issues. (Please see Eric Tesche's article in this newsletter on how to navigate this low interest rate environment.) It appears that market participants are starting to concur with my assessment. In fact, fed funds futures contracts are not pricing in the first Fed tightening until Q1 2011, while J.P Morgan's chief economist revised his forecast for an eventual Fed tightening until the Q4 2011. While nobody knows with certainty, it would

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not surprise me at all if the Fed's "extended period" extended to 2012. On the economic front, data, particularly in the second half of the quarter, disappointed across the board. Manufacturing, while still suggesting that the economy is growing, has pulled back from recent highs. Housing continues to remain a problem with overhanging inventory, lack of real demand, and strategic foreclosures. In fact, let's consider some of the housing data released in the past month. Housing Starts ("MoM" month over month) were down 10.0%, Building Permits (MoM) were down 5.9%, Existing Home Sales (MoM) were down 2.2%, and New Home Sales (MoM) were down an astounding 32.7%, an all time low. Any way you slice it, the residential housing market is on the verge of being on life support, and one could argue that it's been on life support with artificially low interest rates, tax credits, foreclosure moratoriums, and loan modifications; yet, the data is not improving. Retail Sales and Consumer Confidence tell a similar story, and the employment outlook is bleak. The gains in jobless claims have stalled of late trending in the wrong direction with the four-week average coming in at the highest level since the week ending March 6<sup>th</sup>, and private sector job growth that everyone expected hasn't materialized. Net-net, Q2 was an ugly quarter economically and pragmatically speaking there isn't much at all to get excited about. (Please view the following link to view our Chief Economist Dr. John Walker's weekly take on the economy: <http://www.ambfg.com/Markets/EconomicCommentary/tabid/520/Default.aspx>).

As we move into Q3, the news isn't all bad and there are a few positives to consider. First, corporate balance sheets, excluding financials, are in perhaps the best shape they've ever been in, as cash on hand is at the highest levels in over 50 years. At some point this cash will be put to work on investments, cap-ex, and mergers and acquisitions if and when the uncertainties wane. Secondly, 2<sup>nd</sup> quarter corporate earnings announcements should remain strong on higher productivity and solid top-line revenue growth. Corporate profits are the greatest form of stimulus, and hiring new workers should follow at some point in the near future if profit growth persists. Specific to stock valuations, 20% of stocks carry higher dividend yields than the 10-year treasury, suggesting that stocks are cheap and that a bottom will be found soon.

At some point in Q3, financial regulatory reform will get passed. And, while it falls well short and doesn't address the root of the problem, which is FNMA and FHLMC,

passage will represent some form of certainty. Likewise, Goldman Sachs could settle with the SEC, removing another uncertainty from the table. At some point, BP (British Petroleum), will figure out how to cap the gushing oil well and that story will subside. Collectively, these uncertainties, once removed, could lift psychology and the markets and find us all in better shape in three months. Remember, too, that the congressional elections will be a major story in three months and could provide a much needed lift to the markets and the economy, depending on the outcome. Let's hope so because the current negativity is for the birds!

**Matthew T. Resch, CFA**  
**Managing Director**

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## ***Is Your Portfolio Optimized?*** ***(Part 1 in a Series)***

A community bank's CEO can be evaluated based on growth in earnings per share, asset growth, efficiency ratios, stock performance, and other legitimate measures. There is no shortage of metrics for assessing a CEO's performance. What about the bank's tellers? Have they done a good job? At the end of the day, if your customers feel well served and the beginning and ending cash balances all balance, then their work has been successful. What about the performance of the manager in charge of the bank's investment portfolio? Assessing a portfolio manager's performance is not so easy. How can we objectively measure his performance?

### ***Principal-Agent Problem***

While many banks have someone on staff or on the board with a CPA, it is rare to find somebody with a CFA. (The CFA stands for "chartered financial analyst" and is the industry's most recognized credential for security analysis and portfolio management.) The lack of portfolio management expertise in community banks is not a surprise because the loan portfolio is the primary source of interest income, while the investment portfolio is a secondary source. If someone has expertise in loan management, he will likely aspire to work at a bank. In contrast, if someone's expertise is investment management, he will likely

target a money management firm...not a community bank, because the pay is better on Wall Street.

The portfolio manager at a bank should create a portfolio that meets the objectives specified for the portfolio, including helping to maximize the bank's value. If the manager (the "agent") is doing this work effectively, then the shareholders (collectively termed the "principal") are being well-served and there is no "agency problem." (Michael C. Jensen and William H. Meckling are credited in the literature with doing the seminal work on agency theory.) A manager that needs a portion of the portfolio to ensure sufficient liquidity could split the portfolio into two pieces, one containing short-term, highly-liquid securities and another piece with longer duration, perhaps greater credit risk securities that will generate higher returns over time. If the manager elects to structure the entire portfolio for liquidity, exceeding the bank's current liquidity requirements, then the asset allocation is suboptimal, because interest income is unnecessarily being sacrificed. Thus, a principal-agent problem exists in that the portfolio manager is underperforming for the shareholders. Unfortunately, detection by the CEO or board of suboptimal asset allocation in the portfolio is nearly impossible. Moreover, shareholders could pour over the annual report, 10-K and 10-Q reports for days and they would not see any problems.

### *Value-Destroying Agency Costs*

Often it is hard to quantify agency costs that stem from a principal-agent problem—these being the costs incurred by a firm when managers miss opportunities to maximize value. Two highly regarded finance experts, Eugene F. Brigham and Michael C. Ehrhardt, in their book titled *Financial Management Theory and Practice* (12e), identify six ways a manager's actions can generate agency costs and destroy firm value:

1. Managers spend time on outside interests during company time;
2. Managers spend money on unnecessary perks;
3. Managers avoid making tough, but the right decisions because they might hurt a friend inside the firm;
4. *Managers might take excessive or too little risk;*
5. Managers might stockpile too much free cash flow into investments rather than returning it to investors; and
6. Managers might not release all the information desired by investors.

I italicized the fourth action because this article focuses on it. It might seem misguided to say that a manager *is not taking enough risk with the investment portfolio*, but that is a distinct possibility. Unless you are 100% invested in T-bills, the portfolio has *some* risk, but is it sufficient to maximize the bank's value? There is an optimal level somewhere in between too much risk and too little risk. The goal is to find the optimal level. There is an opportunity cost from portfolio underperformance, associated with suboptimal asset allocation, which can be termed an agency cost. During the financial crisis, there were notable examples that surfaced, such as Lehman Brothers and AIG, where risk was mismanaged. Whenever risk is mismanaged, it is not always apparent that this is intentional. The reality is that managing risk—and, certainly, an investment portfolio—is a tough task. Managing risk in a portfolio is part art and part science, as the expression goes.

Using an amount of \$100 million in assets as the basis, I can estimate the impact from underperformance of a bank's investment portfolio. If 30% of the assets are in investments earning 100 basis points lower than average because of too conservative investment choices, and the bank's marginal tax rate is 35%, then the lost earnings are \$195,000. If management were able to recoup those foregone earnings through more optimal management of the portfolio, that increase would boost ROA by 20 basis points. This analysis is scalable to your bank. For example, if your bank is ten times the size used for this scenario, the lost earnings estimate would be ten times as large, but the ROA effect would be the same.

### *Constrained Optimization*

The title to this section sounds rather technical. Yet, the task at hand facing a bank's portfolio manager is exactly that—a constrained optimization. What exactly do I mean by this term? Think about a portfolio manager's challenge when handling a bank's investments. The portfolio has to provide a degree of liquidity to satisfy deposit withdrawals, pay expenses and for other purposes. This liquidity requirement might be the most significant constraint. Assets that need to provide liquidity should have short duration and low credit risk attributes. Correspondingly, these low-risk assets will produce low returns as the tradeoff for high liquidity.

The bank will likely have a policy on total credit risk. How many credit risk “buckets” does your bank employ? Banks need granular segmentation of credit risk to help manage their overall exposure. Each asset provides incremental expected return and incremental credit risk. Depending on how much credit risk is in the loan portfolio, your bank should have a tangible credit risk constraint imposed on its investments to ensure that the bank’s overall level of credit risk is at a prudent level. For starters, all banks need a minimum BBB-rating on any fixed-income investments it purchases, as all bonds need to be investment grade.

Finally, there is interest-rate risk to consider. Is your bank using a matching strategy where you match the duration of assets with that of liabilities? Perhaps you use a laddered approach that enables you to extend durations, yet have assets maturing each month to cover expenses and liabilities that need to be met. Whatever your strategy, there is likely a duration constraint that the portfolio manager must observe. So we are up to three constraints and counting. Some banks have more constraints. Constrained optimization in the context of portfolio management is the process of choosing investments that will produce the maximum return for the portfolio without violating any of the constraints.

So what is the easiest way to meet all these constraints? Should a manager simply invest the entire portfolio in short duration, low credit risk securities in order to play it safe? That strategy would satisfy all constraints and is easy to implement. The problem is that this strategy guarantees low returns and is suboptimal. Yet, the board is unlikely to voice concern, and the CEO is busy with 101 other priorities. So the portfolio manager looks like he is doing an adequate job, he collects his paycheck (and, perhaps, a bonus), and no one complains. Even though “earnings” are one of the CAMELS components, I doubt that a regulator will raise any red flags because of excess liquidity, no matter how much this might adversely impact earnings. Moreover, there is no clear mechanism for resolving the principal-agent problem of too little risk-taking by a bank’s portfolio manager.

### Measuring Portfolio Performance

The most common way to measure performance of a bank’s portfolio is to compare the yield to other portfolios as reported in the *Uniform Bank Performance Report (UBPR)*. We know that yields present an incomplete picture, but the industry focuses on them. Suppose we have two portfolios that are purchased at the same time—portfolio A and portfolio B, each having a yield of 4%. Now suppose that market rates rise to 5%. The manager of portfolio A sells all his investments and reinvests at 5%, while the manager for portfolio B does nothing, so his portfolio still yields 4%. Which manager is doing a better job? Based on yield, the manager of A is generating a 5% yield, 100 basis points higher than manager B’s yield of 4%. So manager A appears to be the “better” portfolio manager.

The comparison between managers A and B is a simplistic example of exactly what can happen when using *UBPR* data to assess performance. When I used this example during one of my lectures at Kutztown University, students were quick to point out

that this ignores the losses realized when portfolio A was turned over (sometimes referred to as “churning” when done frequently and the net gain is dubious). Yields tell an incomplete story for two reasons. First, they ignore realized losses from the portfolio. Second, they ignore the risks that the portfolio manager is taking. In Part 2 of this series of articles we will discuss some of our research that looks at several worthwhile measures for assessing portfolio performance using a risk–return approach. Unfortunately, there is no comprehensive end-all-be-all measure or statistic that can be used to assess portfolio performance. Instead, performance measurement requires a variety of measures, each one providing incremental but valuable information. A more complete assessment of the portfolio’s performance at a bank helps to answer the question: Is your portfolio optimized? We’ll continue this important discussion in Part 2 of our series.

**John S. Walker, Ph.D., CFA**  
**Director of Research and Chief Economist/Ambassador**  
**Financial Group, and Associate Professor of Finance/Kutztown**  
**University**

## Okay. Now What?

Many portfolio managers have spent the last few quarters preparing for interest rates to rise. Yet as each week passes we do not seem any closer to that rising-rate scenario. Many are now asking, “Okay. Now what?”

I know that I am not going to shock anyone when I say that there are no “home runs” out there as far as the bond market goes. While banks can take some comfort in the fact that the yield curve is steep, yields are historically low and, in most sectors, spreads are very tight. Therefore, even though deposits (generally speaking) are cheap and fairly easy to bring in, finding profitable uses for the proceeds is quite challenging. Unless you are fortunate enough to be in an area where loan growth is above normal and credit quality is solid, it is a very difficult time. Even if you are one of the fortunate institutions capable of growing quality loans, surely writing those loans at these yield levels is a bit unnerving. Yields will eventually move and deposits will become much more expensive. Funding 4.75% 30-year mortgages with deposits at these levels is nice, but it obviously won’t last forever.

“Forever” is about how long it seems since the Fed last moved interest rates. Actually it has been 20 months since the target rate has changed. Going back to 1970, that is the longest stretch of time that we have seen the Fed inactive. In fact, most market participants expect the Fed to remain on the sidelines until at least 2011 and some don’t expect movement until 2012. The good news is that the pain that can be associated with rising rates seems pretty far away. The bad news is that we are trapped in an environment of very low rates and few attractive loan or investment alternatives.

The mortgage market is a prime example of how difficult it has become. The FNMA 30 commitment rate is hovering near all-time lows. Currently it is roughly 4.20%. Ugh. Every bank would love to have a bunch of those on the balance sheet! In the MBS market, prices there will give investors nosebleeds. Plain vanilla FNMA 15-year 4.00% pass-throughs are currently right around \$104. That's a yield of roughly 2.95%. How many can I put you down for!?! Interestingly, MBS pricing has moved up dramatically since the Fed stopped buying them in March. I'm going to go out on a limb and say that prices are near the top. In all seriousness, however, if FNMA 15-year 4.00% MBS were to reach \$105, the yield on the security would begin to go negative under some prepayment expectations. Although we have all seen some weird things over the past couple of years, that scenario seems very unlikely. That is why we have been encouraging customers to move out of MBS, or at the very least, not to purchase any more at these levels.

One strategy that may be compelling for some institutions is selling MBSs at rather significant profits and cutting deposit pricing even further. Who needs to grow liabilities when there are so few compelling assets to purchase? If deposits start to leave, the bank can fund loan growth with cash; the reduction in income associated with the sale of relatively high-yielding securities can be offset by the gain on the sale. While growing the balance sheet in a steep yield curve environment is usually what conventional wisdom tells you to do, there is nothing conventional about this environment. Margins will continue to be under pressure. I would love to say that the battle to stop margin compression can be fought and won on the asset side of the balance sheet. However, that is not the case. Unless the bank is taking on significant risk, the graph of your yield on earning assets over time will continue to look like a downhill ski slope. The task is trying to have the graph of your cost of funds look the same.

One sector that remains fairly attractive is the tax-exempt municipal market. Despite the fact that supply has been fairly low over the past month, spreads are attractive. The municipal market and the Treasury (UST) market have become "inverted." By this I mean the pretax yield on a 10-year tax-exempt municipal is now higher than a 10-year UST. That phenomenon was almost never seen prior to 2008–2009. For the first several months of this year, the relationship was normal (UST yield > muni yield), but municipal yields have fallen much less than USTs, making them attractive once again. Similarly, while the yields and spreads are not quite as compelling, taxable municipals represent value as well. Finally, even though corporate bonds are four-letter words around many boardroom tables, the fact is that spreads in that sector have widened out lately as well.

These are challenging times in many respects. Combine that with the fact that the summer is here and we all want to focus on things that are not as frustrating as the current interest rate and investing environment. But the fact is that opportunities are around, just not maybe in the places we are used to finding them.

**Eric Tesche**  
**Managing Director**

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