

The Comprehensive Approach to Fixed Income Portfolio Strategy and Management

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Overview

- The Fed and Interest Rates
- Yield Curve Analysis
- Interest Rate Risk (IRR) and Liquidity Risk
- Portfolio Management & Strategies
 - Risk vs. Return
 - Identifying Value in Today's Market
 - Investment Alternatives: Loan Participation and Subordinated Debt
- Conclusions



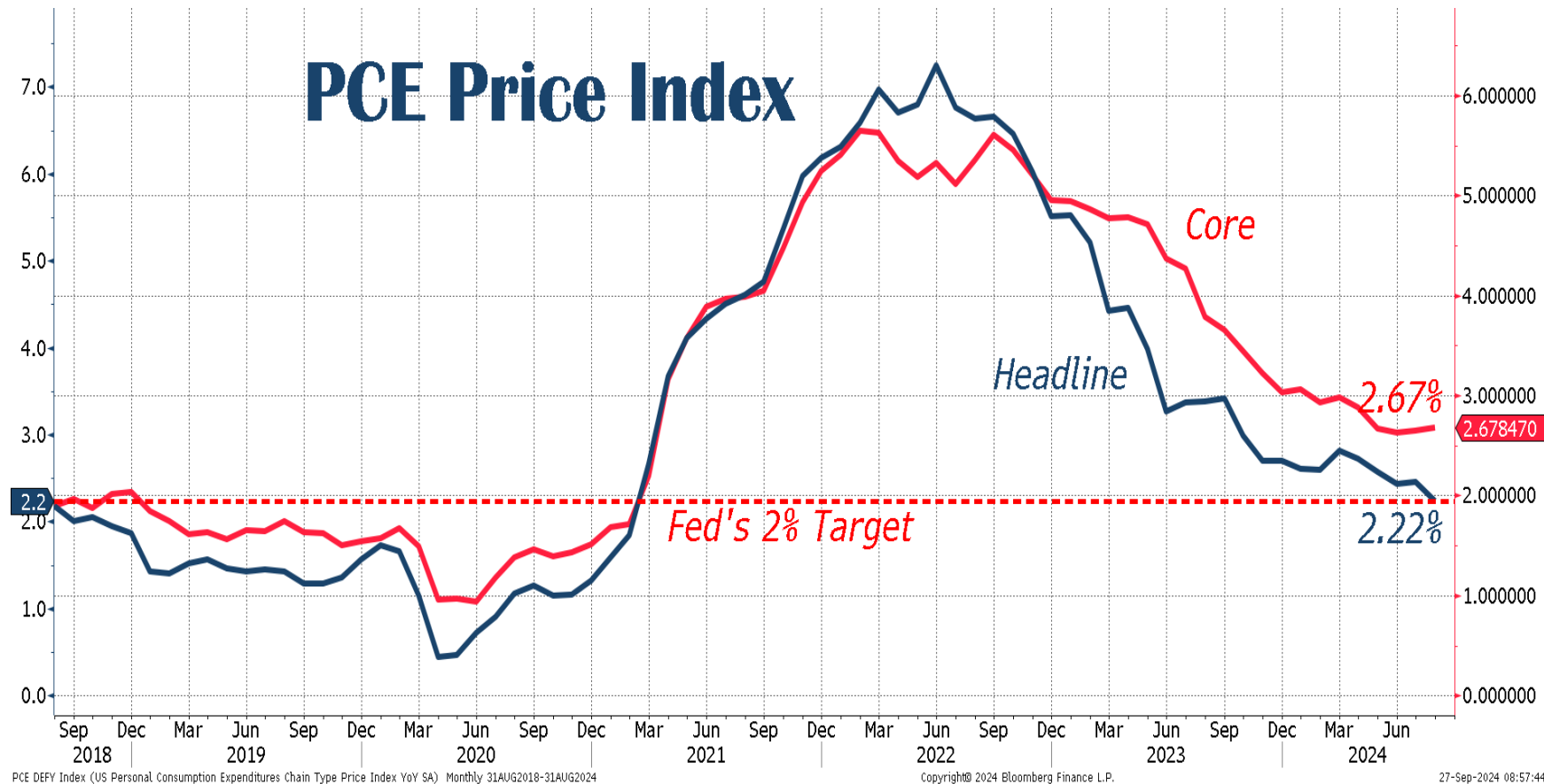
Economic Perspective

Base Case View:

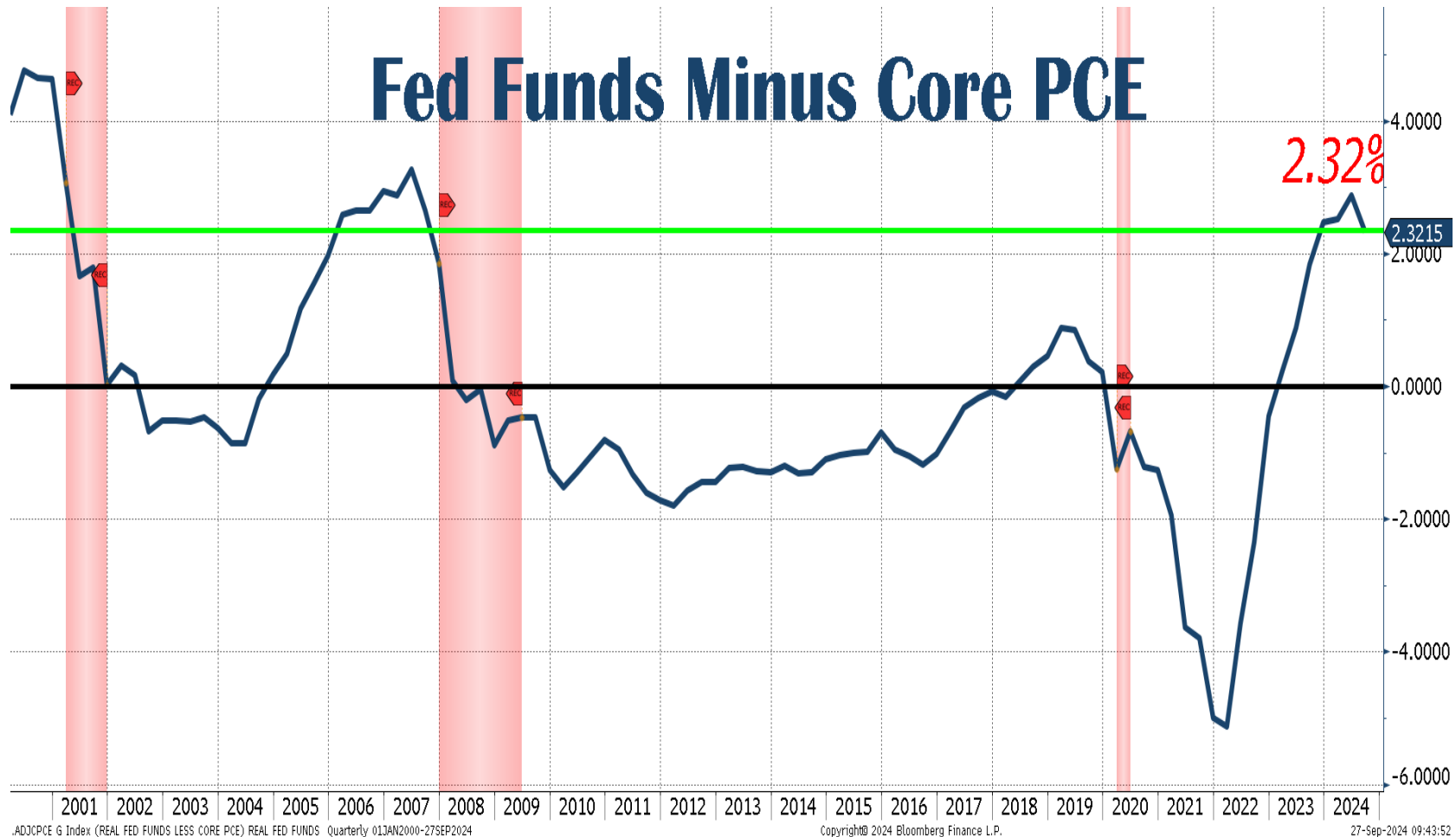
- U.S. economic growth slows
- Recession cannot be ruled out!
- Inflation to trend lower
- Fed to normalize rates



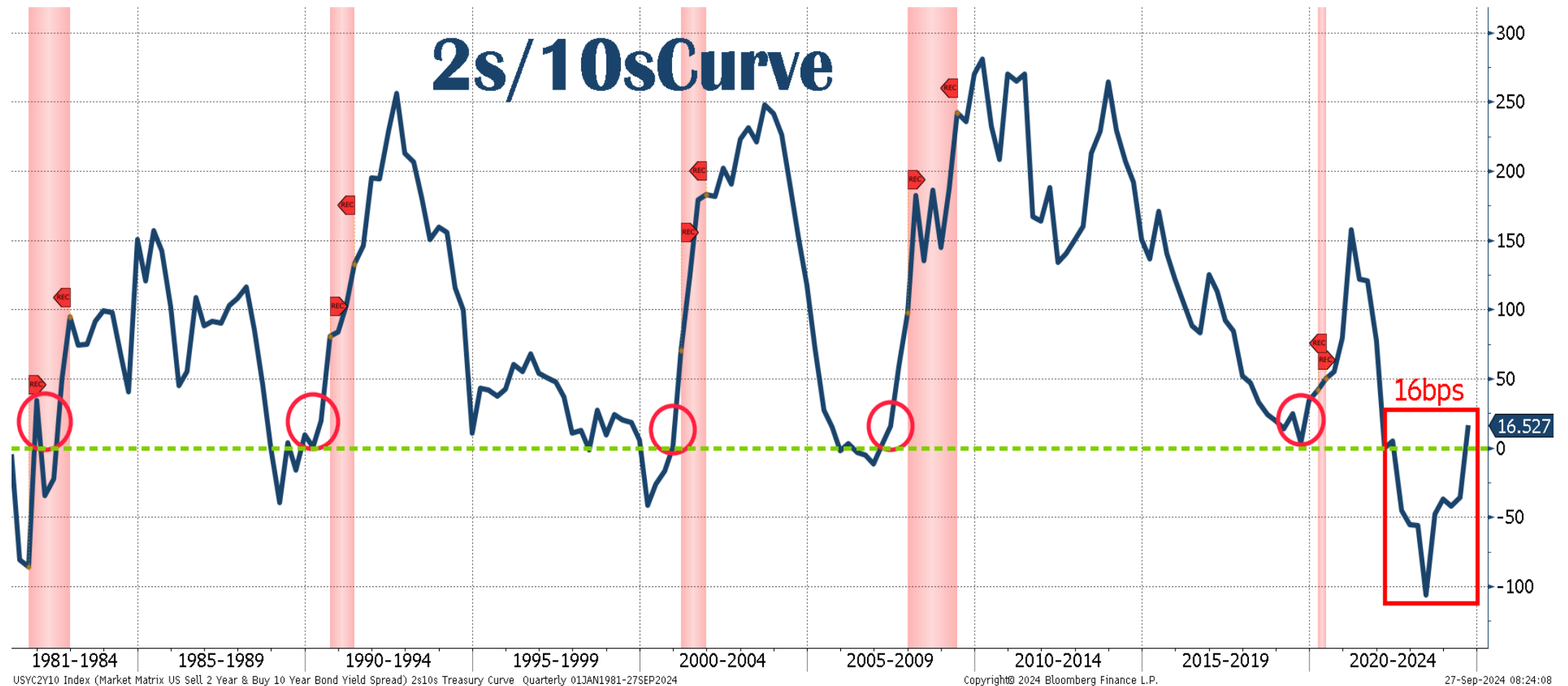
Disinflation Continues Toward Fed's Target



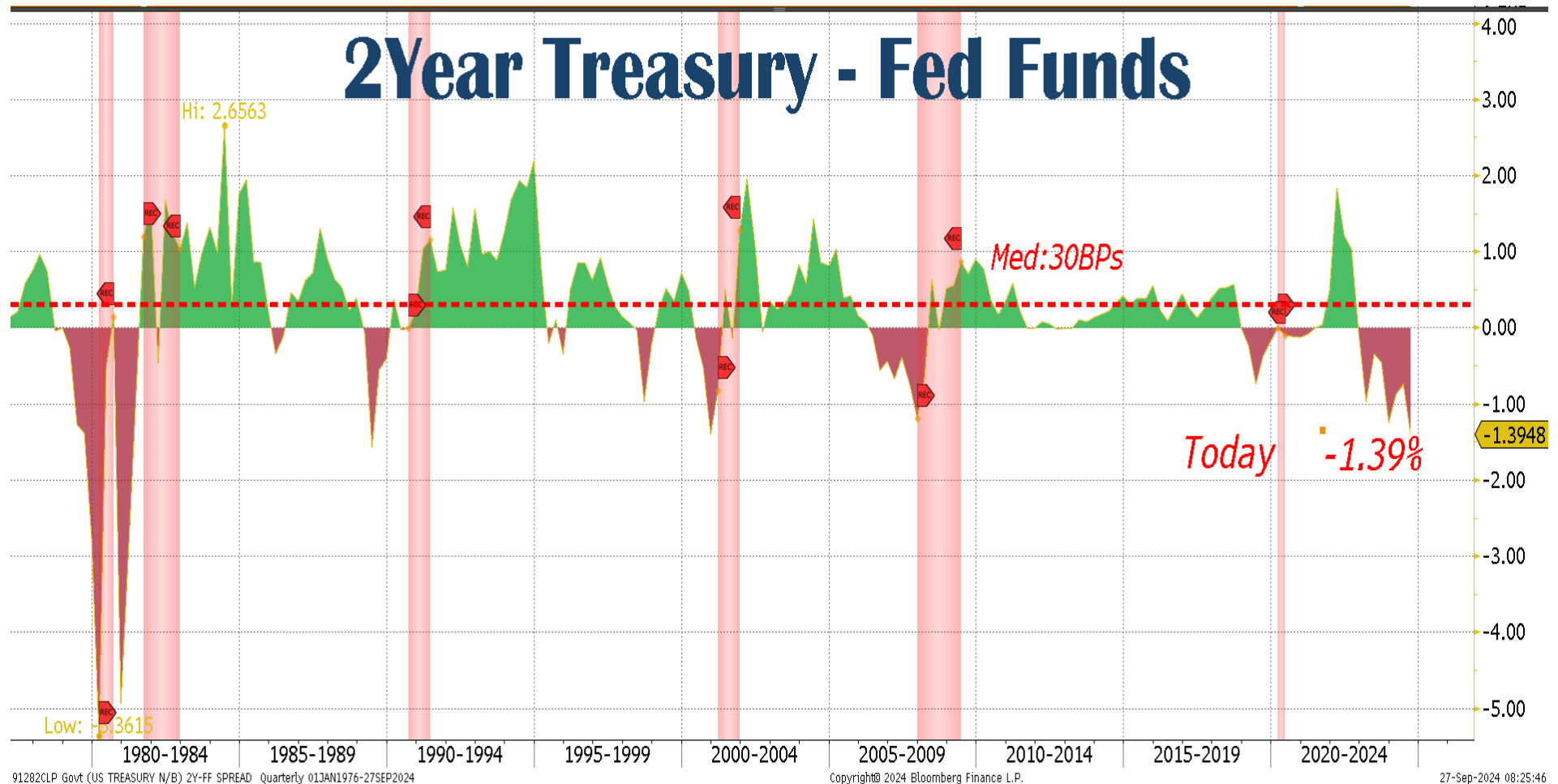
The Fed Remains Tightest in 17 Years!



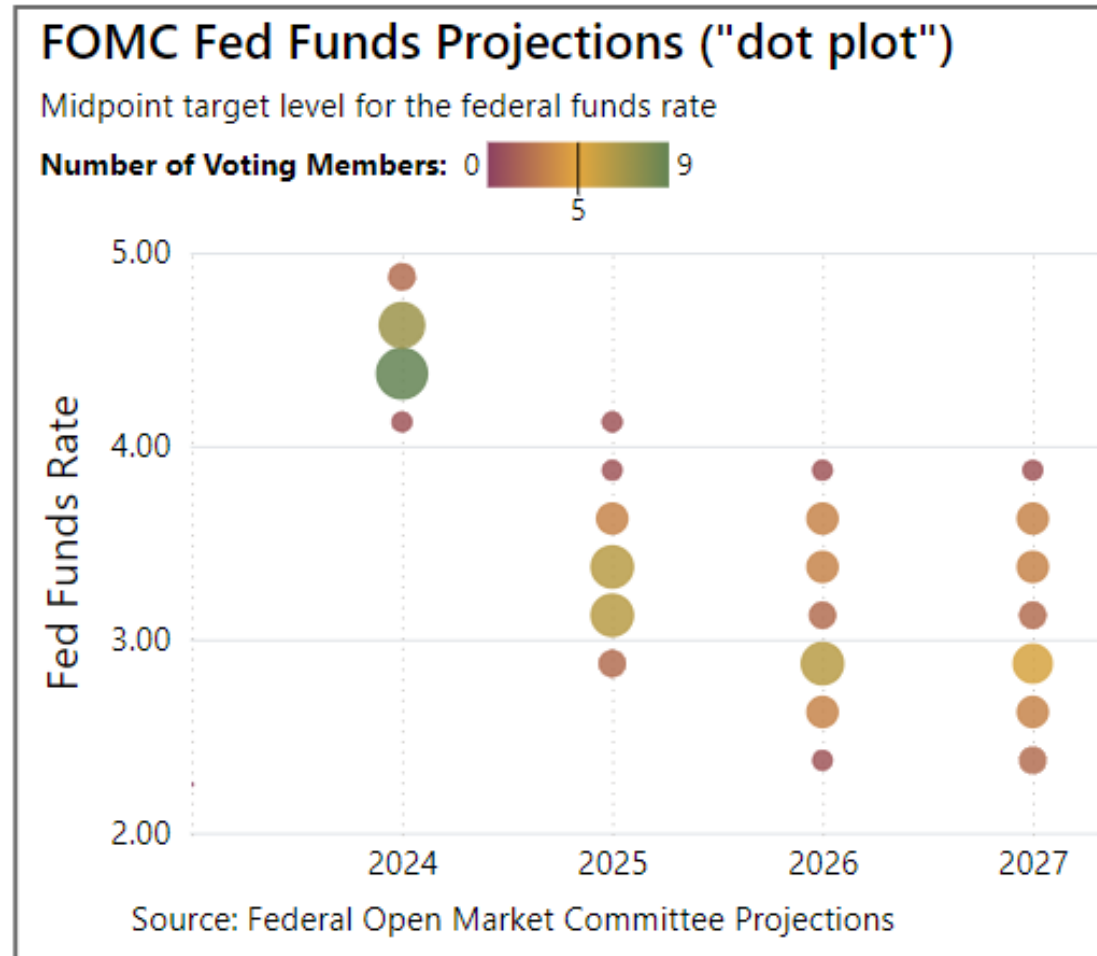
The “Uninversion” of Yield Curve is Key Signal



Market Says the Fed is Too Tight



The Fed Has No Clue...

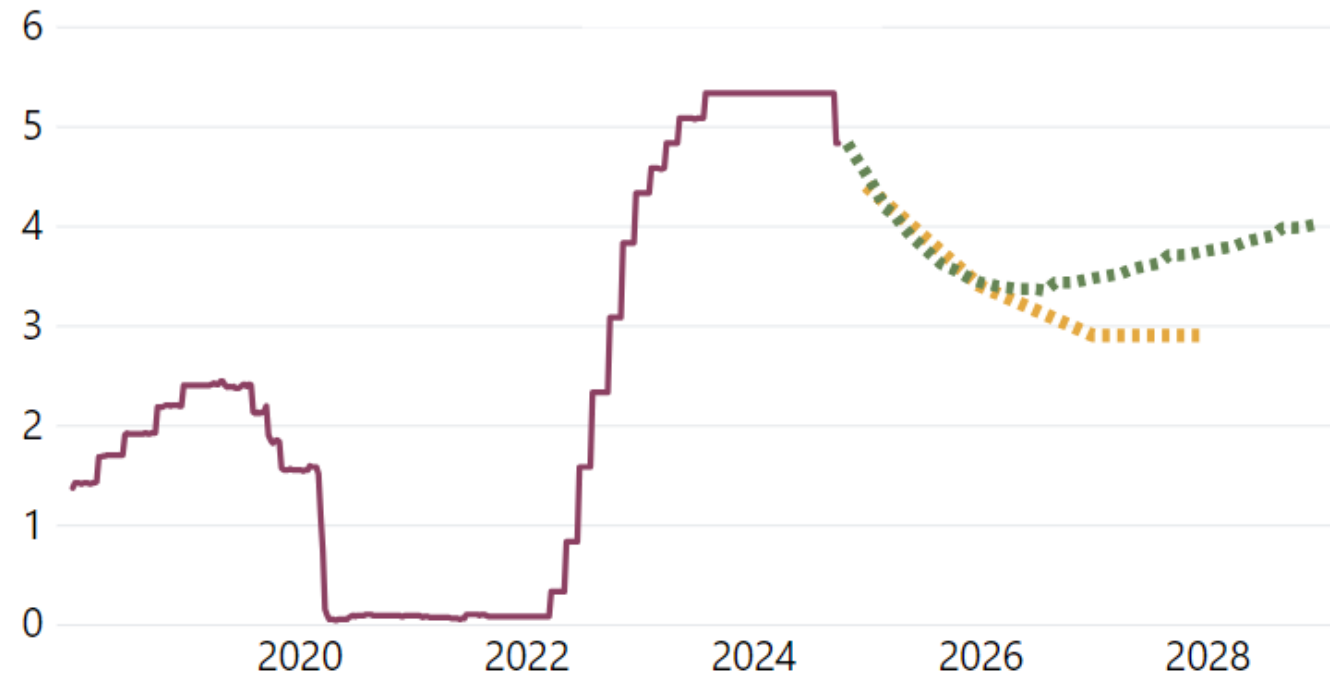


Market vs. Fed Projections

Fed Funds since 2018 with Forecast through 2028

Futures Market vs Federal Open Market Committee Forecast

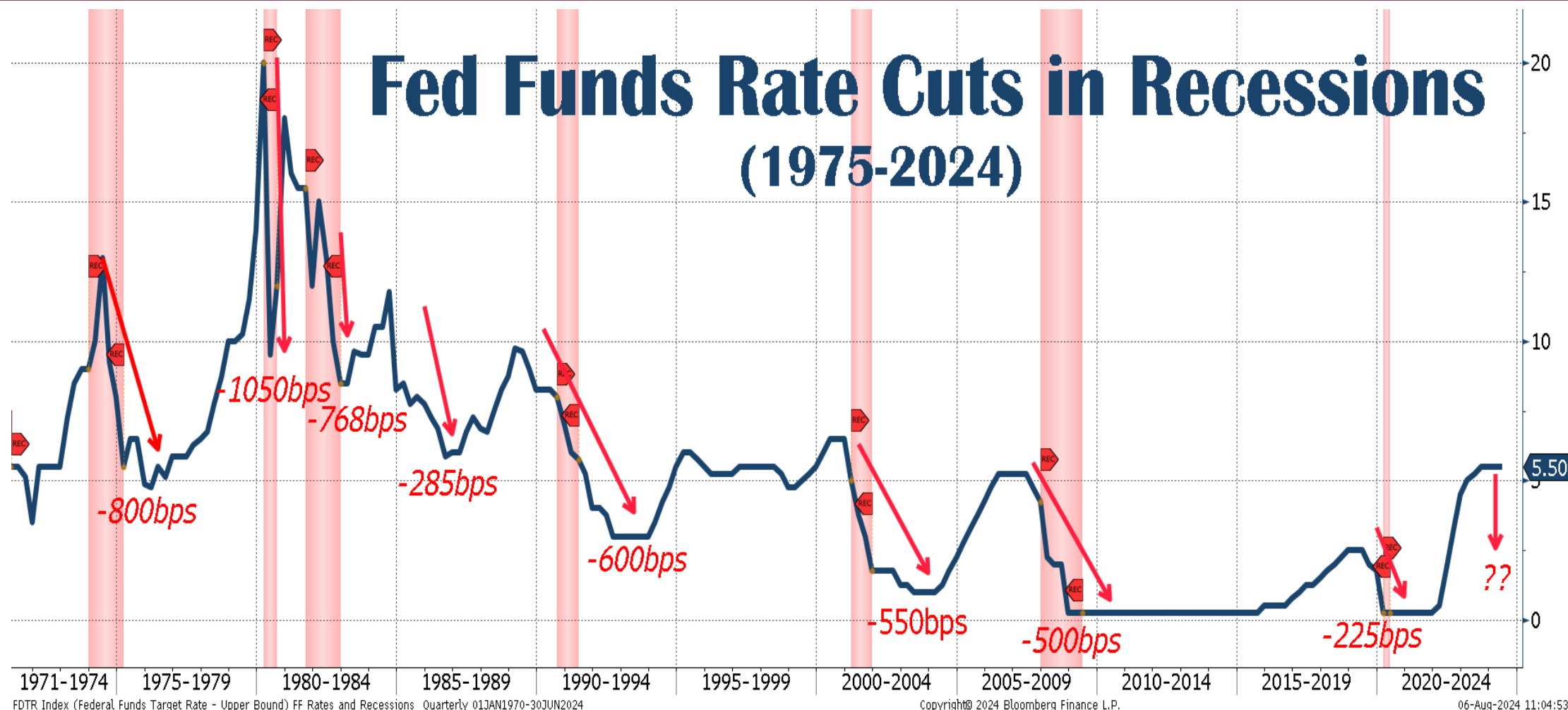
● FOMC Projection ● Fed Funds ● Futures Market



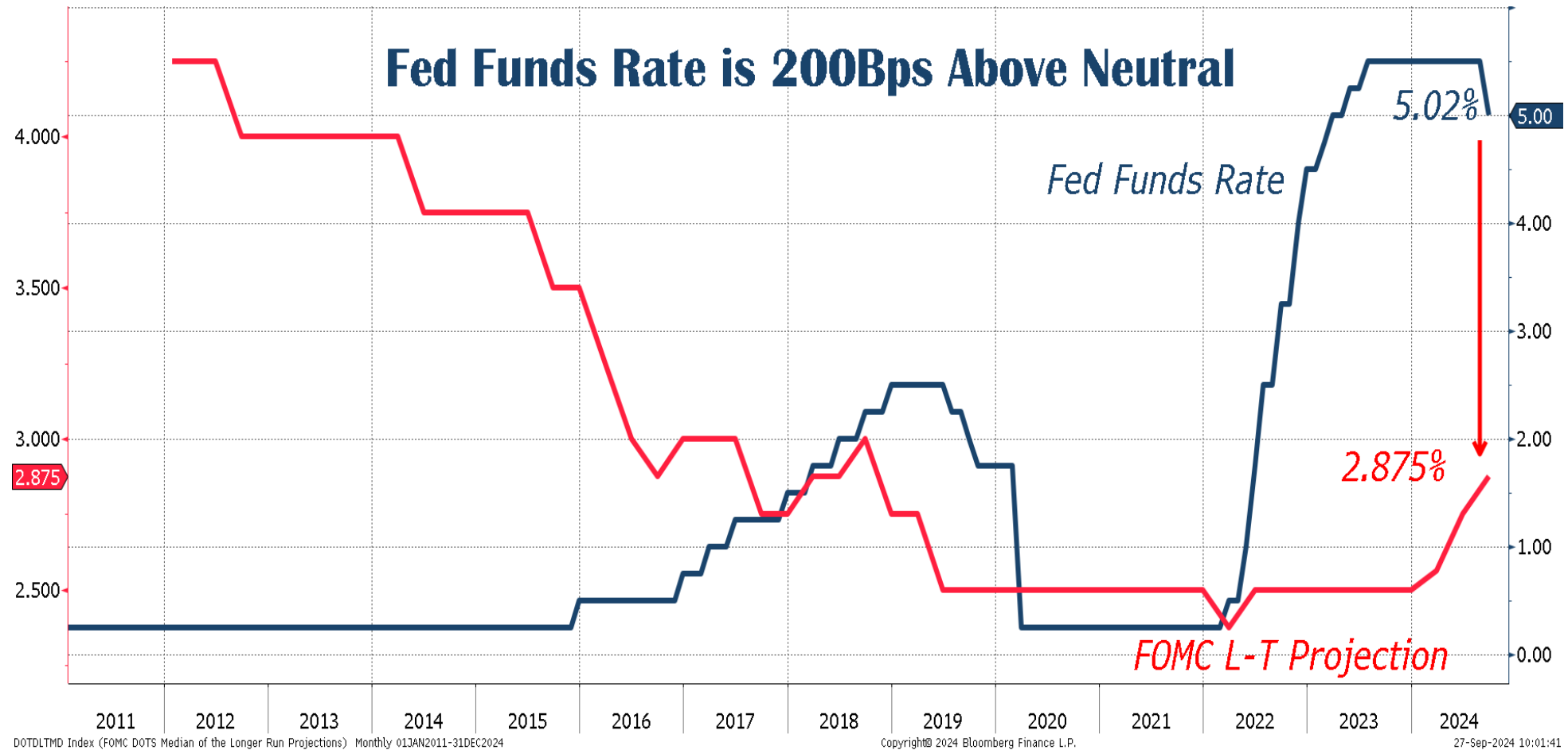
Source: Federal Reserve, Chicago Mercantile Exchange



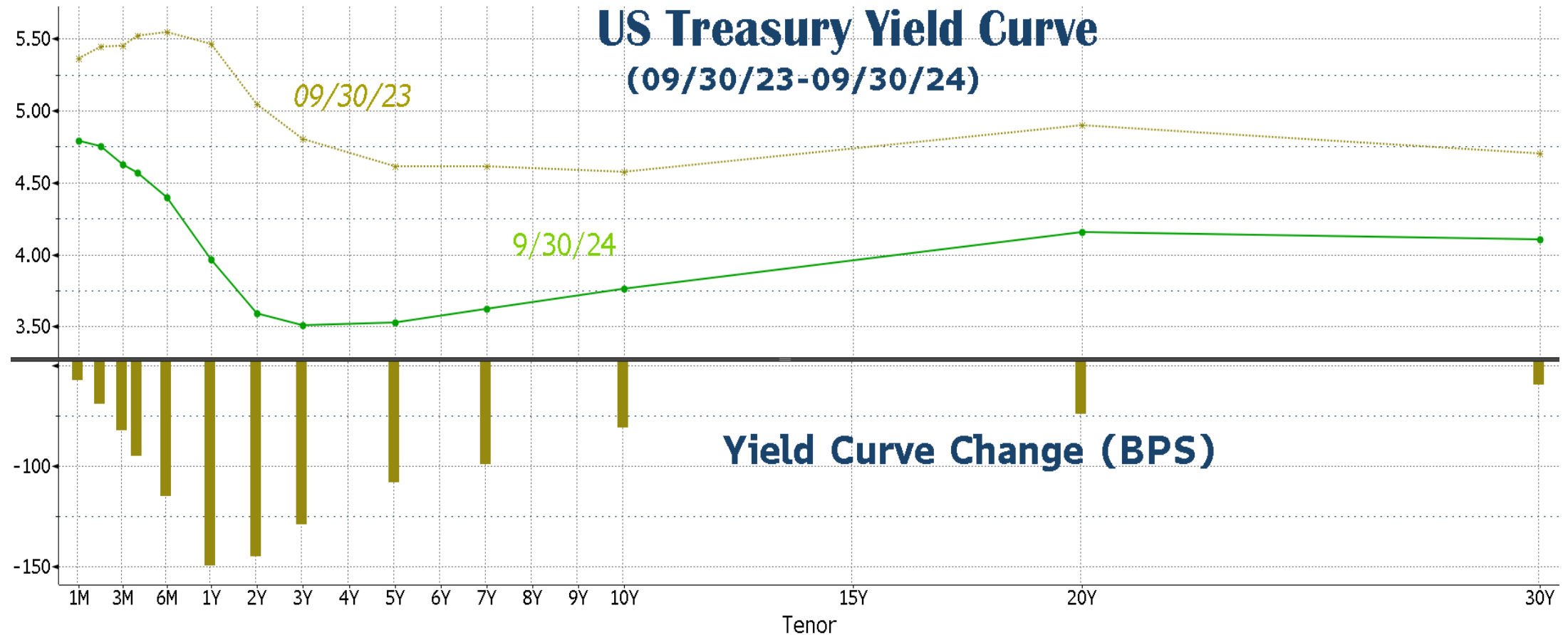
In Recession, the Fed Undoes Recent Tightening



Do Not Need a Recession for Lower Rates!



Treasury Yields Have Already Declined

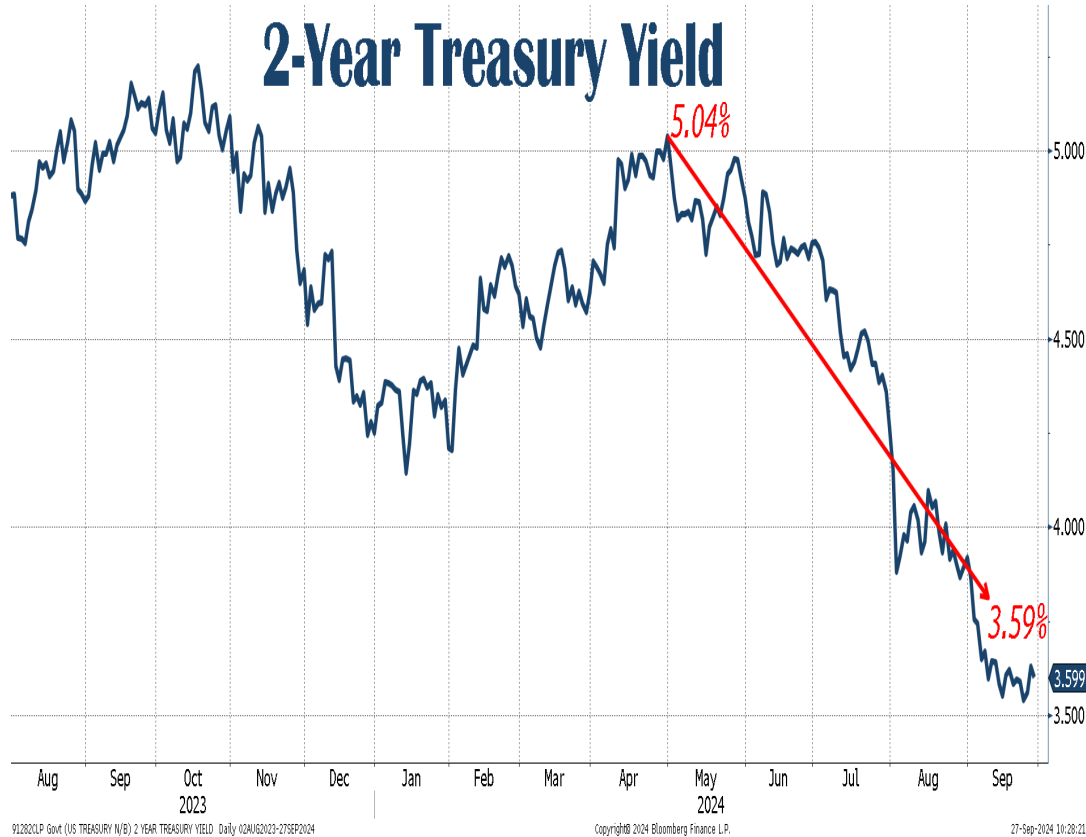


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How Much Lower Can Yields Go?



If Past is Prologue...

80% of prior tightening cycle gets recouped in the ensuing easing cycle.

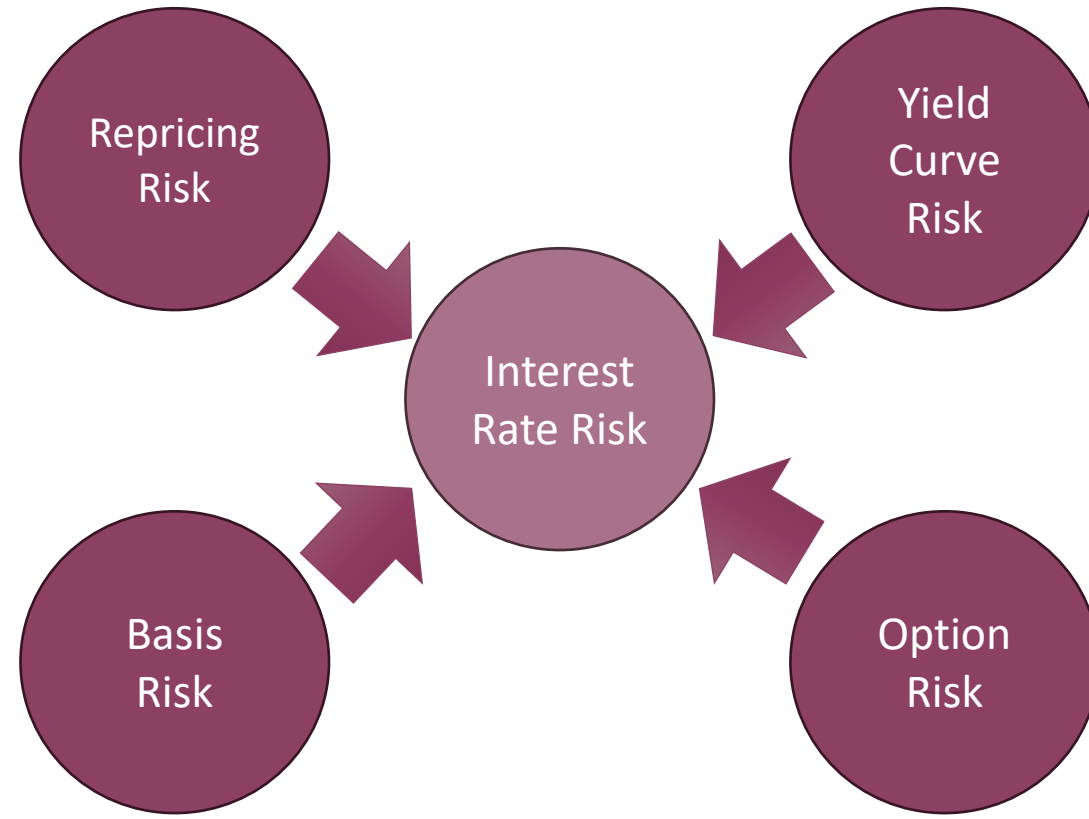
If so...

- Fed funds rate drops to 1.75%.
- 2- and 5-year Treasury yields decline to 2.0% and 2.5%, respectively.



Defining Interest Rate Risk and Liquidity Risk





Interest rate risk (IRR) is the risk to earnings or the market value of a balance sheet due to changes in future interest rates.



Repricing Risk

Repricing risk is the risk of changes in interest income and interest expense when financial contracts mature and their coupon rates reprice at different timing intervals.

Short-term deposits
repricing higher
immediately

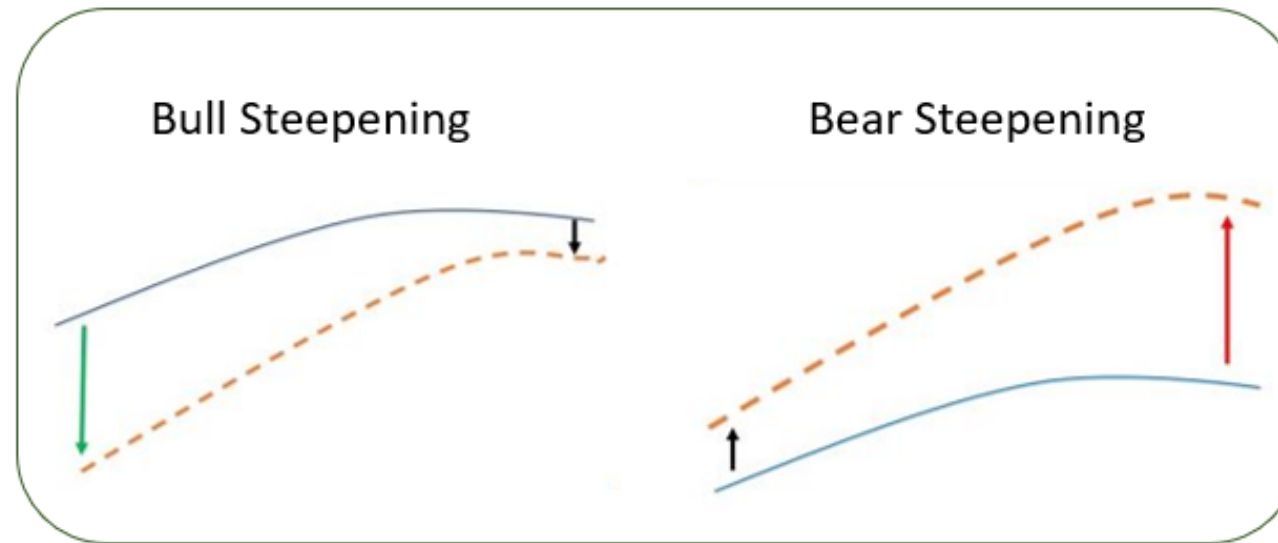
VS.

Long-term fixed
rate loans reprice in
several years



Yield Curve Risk

Yield curve risk refers to changes in portfolio values caused by uneven shifts in the slope and/or shape of the yield curve.



Option Risk

Option risk refers to the risk that cash flows change due to embedded options in assets, liabilities or off-balance sheet positions.

- Loan prepayment or extension
- Investment call or step up
- Deposit runoff
- Negative option liability

CASH FLOW



Liquidity Risk

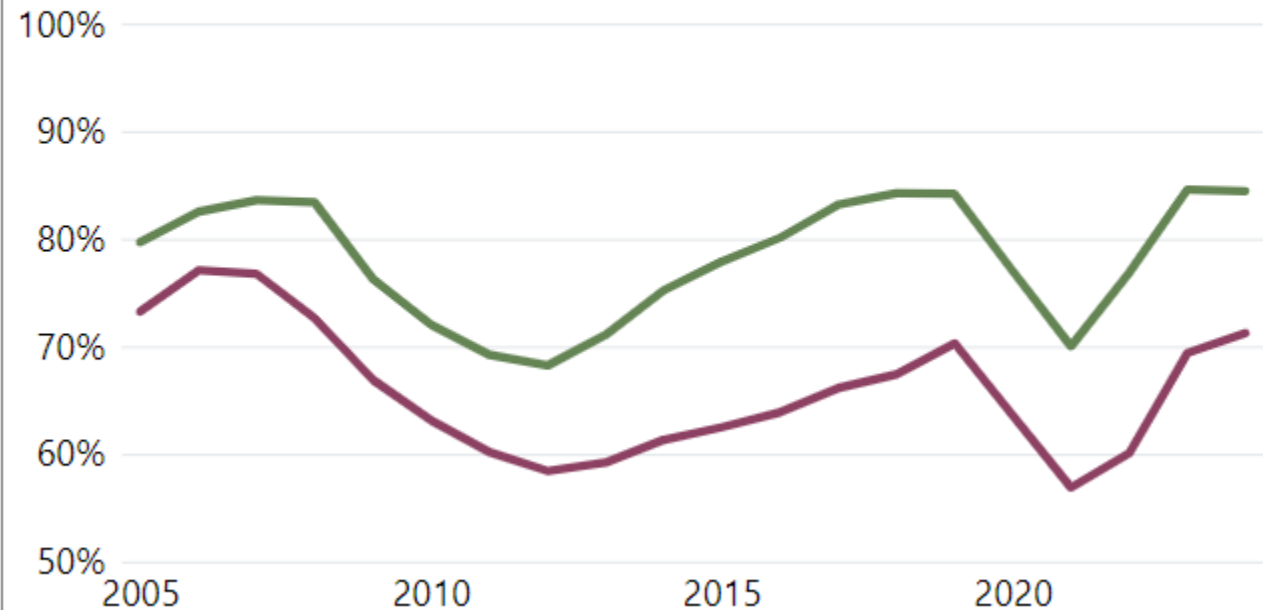
Liquidity risk refers to a company's inability to meet its cash or collateral obligations which can threaten its financial position, normal business operations and existence.



Credit Union Liquidity

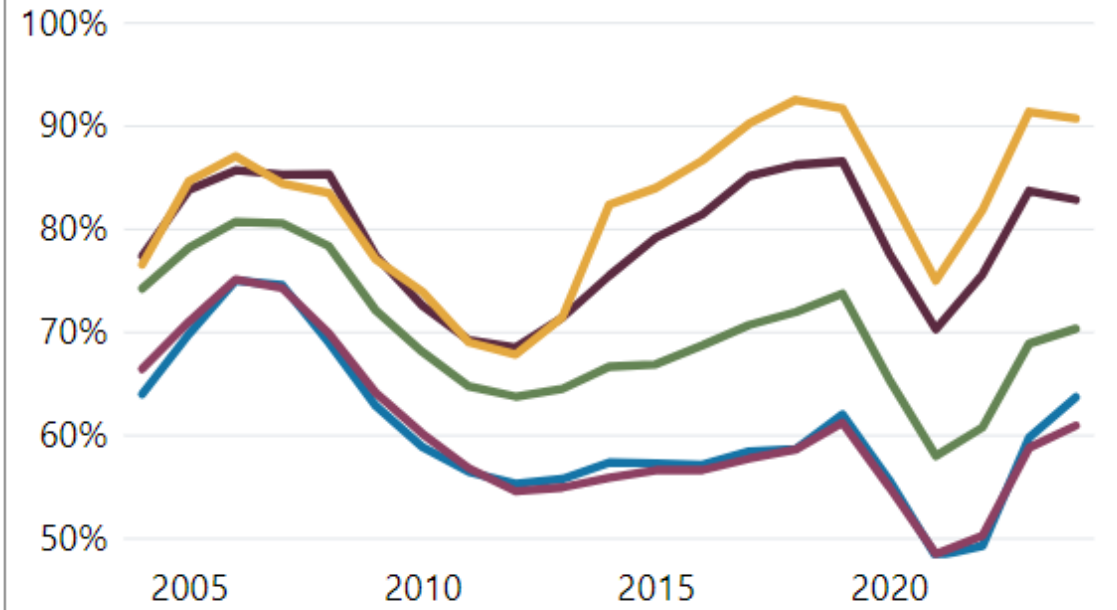
Loan to Share Ratio

● Aggregate Industry ● Median LTS

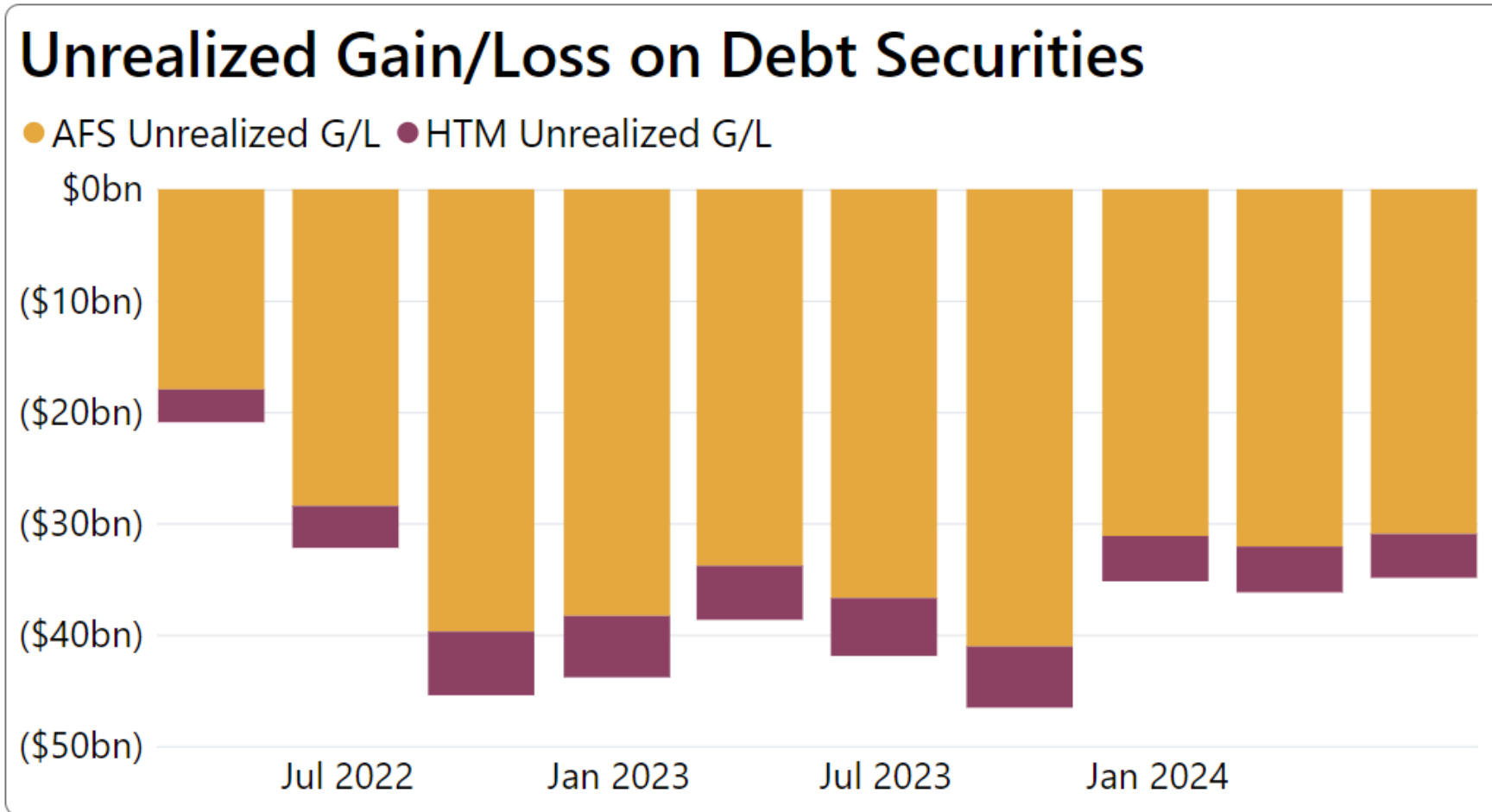


Median Loan to Share Ratio by Asset Size

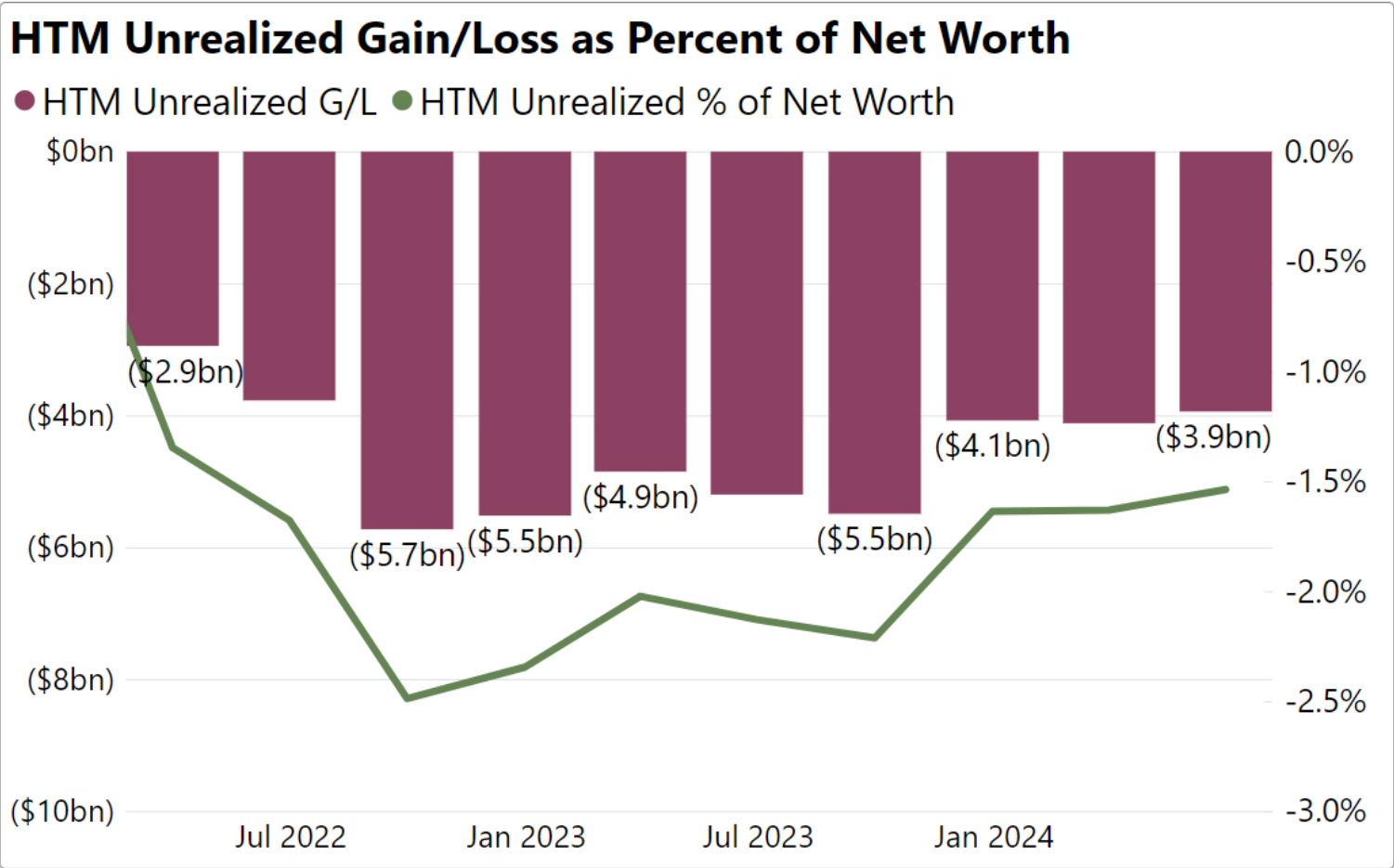
● <\$10M ● \$10M-\$49M ● \$50M-\$249M ● \$250M-\$2B ● >\$2B



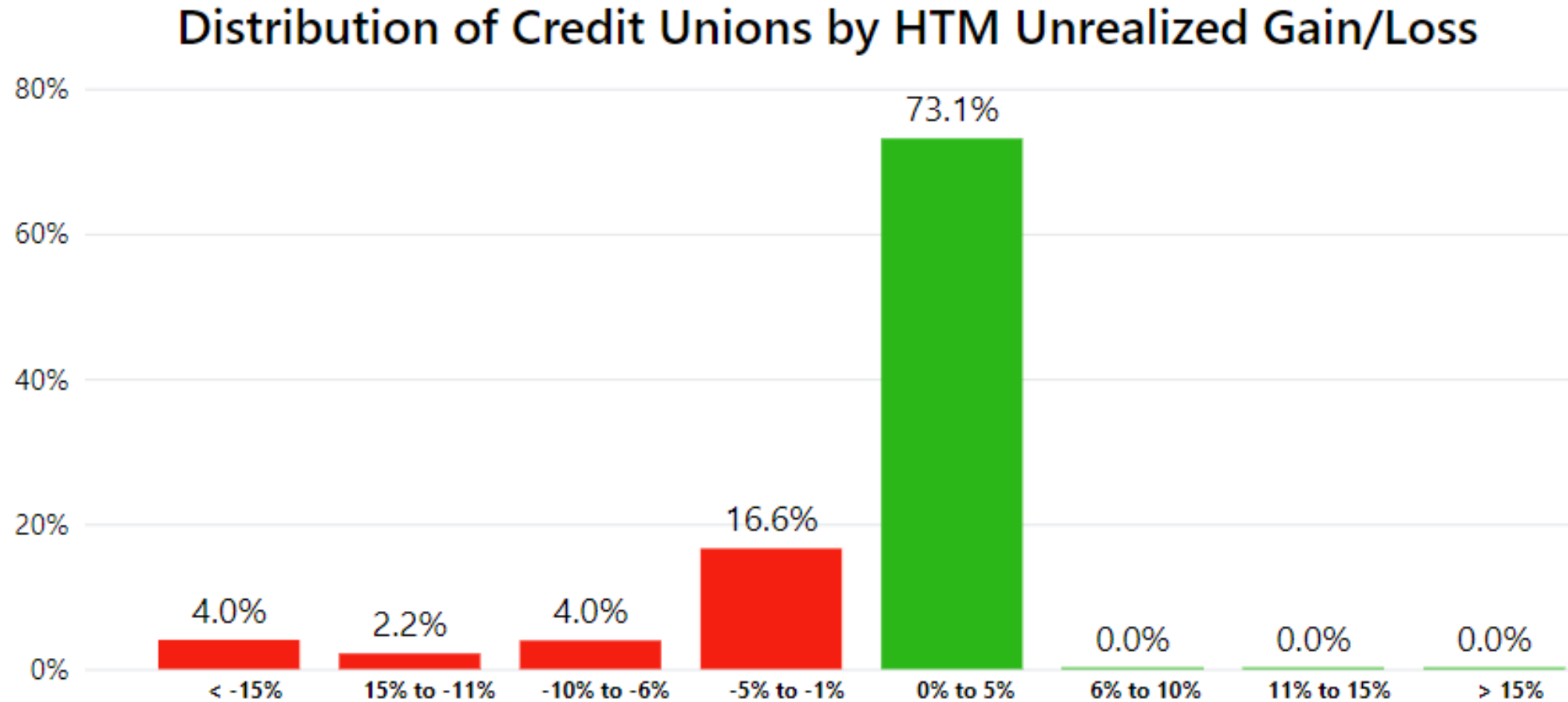
Credit Union Unrealized Losses on Securities



Credit Union Unrealized Losses on Held-to-Maturity Securities



Credit Union Unrealized Gain/Loss on Held-to-Maturity Securities



Portfolio Management & Strategies

Need to Focus on Relative Value



Portfolio Management & Strategies

Relative Yield Comparison

[View Current Specials](#) ↓

Term (years)	Alloya Certificates	SimpliCD *	US Treasuries *	Agencies	Mortgage Backed Securities **	Bank Notes	Loan Participations **
1	4.16%	4.37%	4.19%	4.21%	4.59%	4.59%	6.61%
2	4.00%	3.89%	3.98%	4.00%	4.38%	4.38%	6.52%
3	3.91%	3.81%	3.90%	3.93%	4.45%	4.65%	6.52%
4	3.96%	3.64%	3.90%	3.94%	4.50%	4.60%	6.62%
5	3.95%	3.71%	3.90%	3.94%	4.80%	4.60%	6.62%

* Average Yield ** Weighted Average Lives

Yields are for informational purposes and are subject to change at any time and without notice. For the most up to date yield information, please contact your Account Executive | Last Updated: 10/10/2024



Portfolio Management & Strategies

- Keep it simple – laddered strategy still works
- Treasuries or other fixed coupon / fixed maturity investments
- Must maintain a disciplined approach for this strategy to be successful

1965-1980	Secular Bear Market
	5-Year Ladder
Average Return	5.5%
Minimum Return	3.2%
Maximum Return	9.6%

1981-2023	Secular Bull Market
	5-Year Ladder
Average Return	5.6%
Minimum Return	-3.9%
Maximum Return	15.5%



Portfolio Management & Strategies

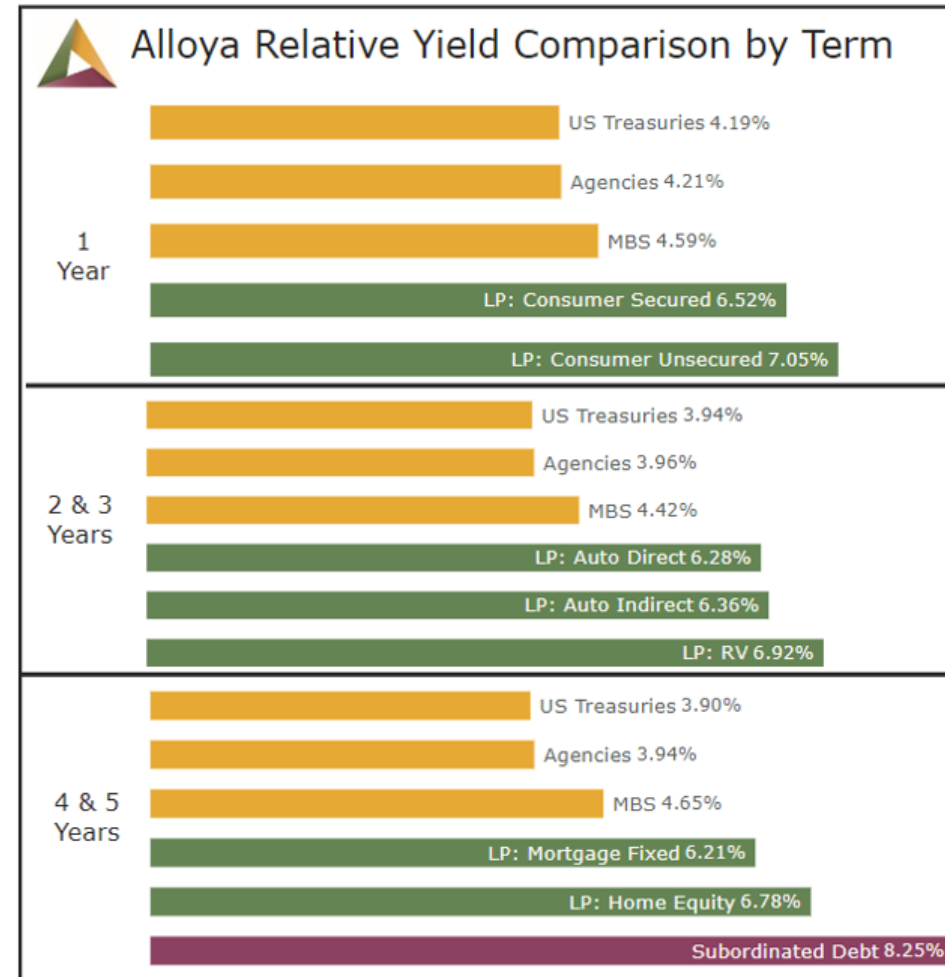
- Strong case for Treasuries
 - Investment portfolios have extended due to slower prepayments in amortizing securities
 - Low liquidity and price risk
- Smaller investors might prefer CDs
 - Pros: No premiums or discounts; easy safekeeping
 - Cons: Less liquidity; investment limits



Portfolio Management & Strategies

Add other risk-appropriate investments/alternatives when you need them:

- MBS and CMOs – will provide spread, cash flows, extension
- Bank notes and corporate bonds – credit risk in return for spread/yield
- Loan participations and subordinated debt

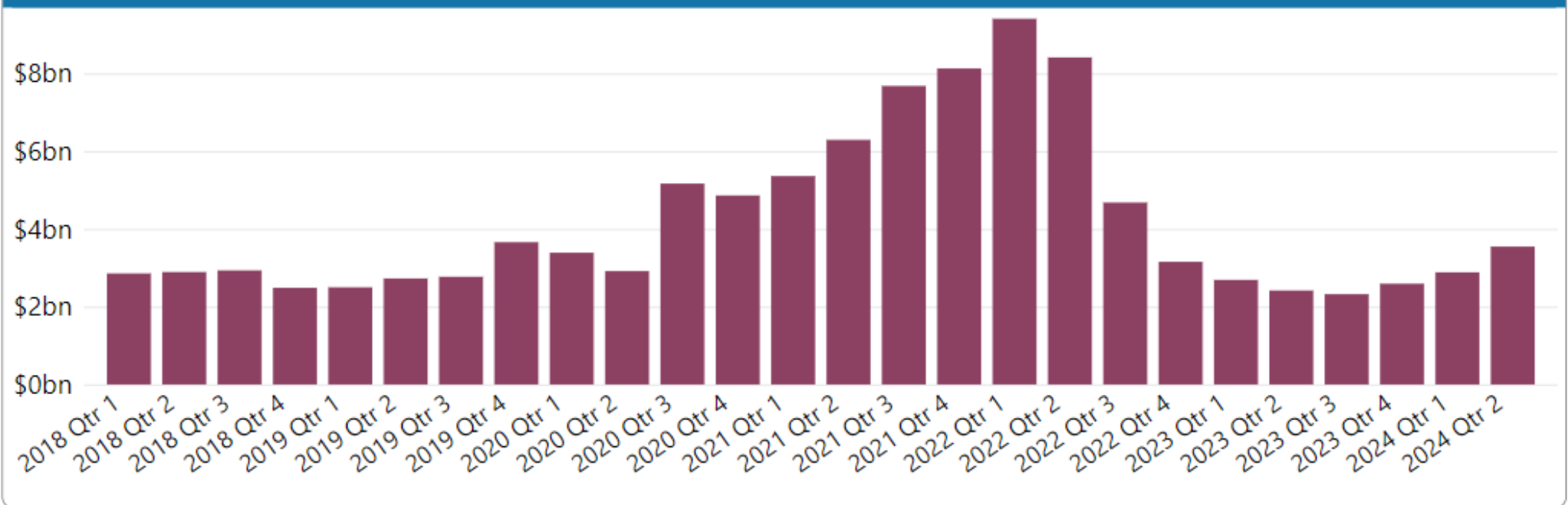


Investment Alternative: Loan Participations

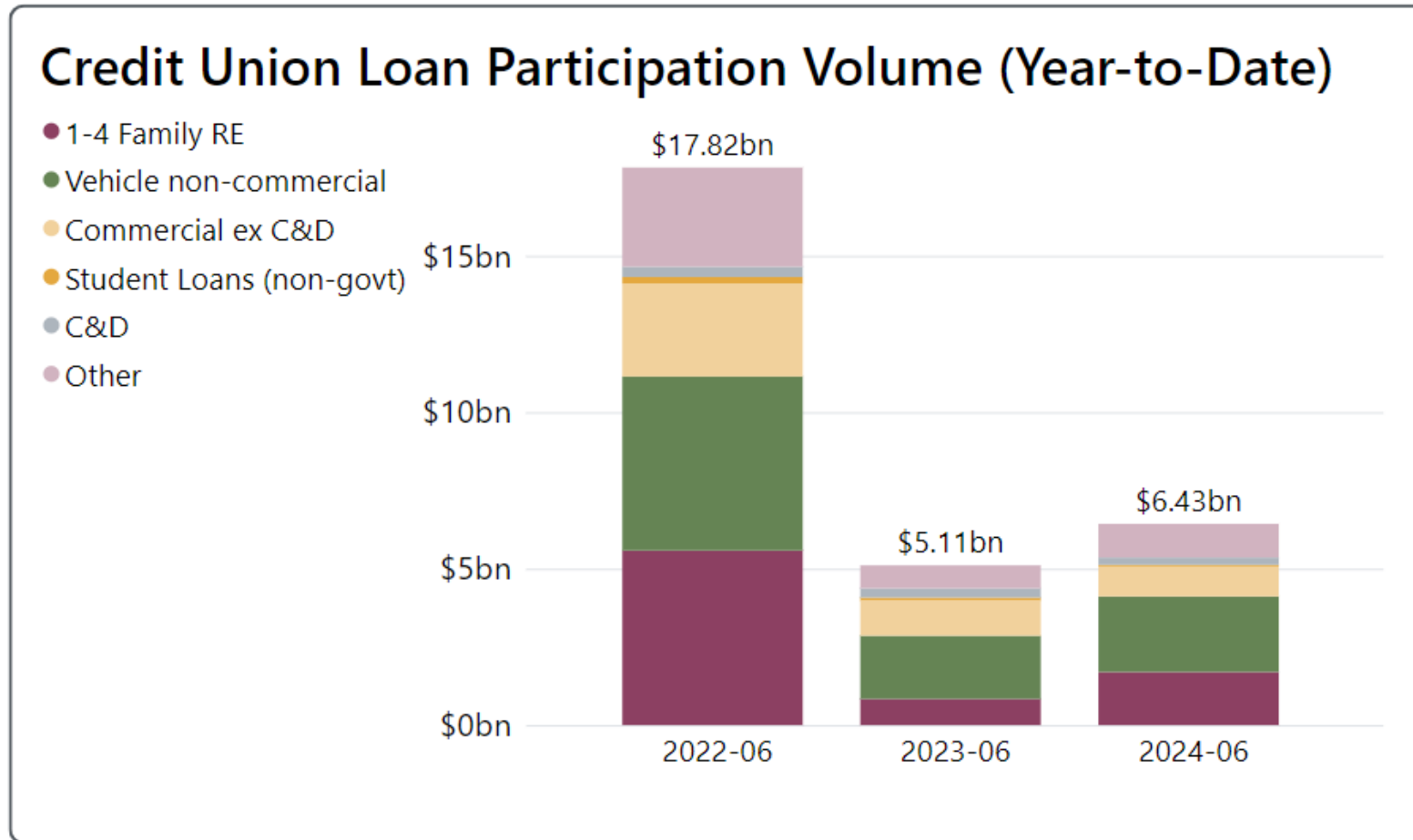


Loan Participation Market

Credit Union Loan Participation Volume by Quarter



Loan Participation Market: Loan Type



Loan Participation Market: 5-Year Change

	6/30/2024
CU's with LP Outstanding	2034
% of CU's with LP Outstanding	44%
CU's with LP Purchased	1942
CU's with LP Sold	861
5 Yr Change in # of CU's with LP	▲ 92
5 Yr Change in % of CU's with LP	▲ 5%
LP Purchased Outstanding	\$60bn
5 Yr \$ Change in LP Purchased Outstanding	▲ \$28bn
5 Yr % Change in LP Purchased Outstanding	▲ 86%



Investment Alternative: Subordinated Debt



Subordinated Debt Investment

What is Subordinated Debt?

Subordinated debt is a borrowing designed to receive favorable regulatory capital treatment by the NCUA:

- ☐ Eligible to count towards **net worth** and **risk-based capital** ratios for issuers
- ☐ Unsecured investment (each deal must be approved by NCUA)
- ☐ Business plan and financials **must** be able to support growth plan and service debt to obtain NCUA approval
- ☐ Credit unions investing in credit unions to support the credit union movement!

How do I Invest?

Gaining access to view available offerings is simple:

- ☐ Broker/dealer agreement signed
- ☐ Non-disclosure agreement signed (one time)
- ☐ Subordinated debt policy (can be included in investment policy)

Be mindful of investment limits:

- ☐ 15% of net worth to one borrower (issuer)
- ☐ 25% of net worth in aggregate investment in sub debt



Why Issue Subordinated Debt?

Enhances Capital Ratios

- Backfill for growth that has already occurred
- Restrained deposit and loan opportunities

Direct Internal Investment

- Branch renovations
- Grand re-opening
- New technology

Footprint Expansion

- New branches
- **Mergers/acquisitions***
- New states and counties



Typical Terms

- ❑ Typical terms will be a **10-year maturity with a 5-year no call feature**. Yearly, starting at year 6 the principal will pay down by 20% until full maturity at year 10.
- ❑ Interest rates can be **fixed**, as well as **fixed-to-floating** in the final five years.
- ❑ **Quarterly interest payments** will be received until maturity.

Year	Principal Remaining at Year-End
1-5	100%
6	80%
7	60%
8	40%
9	20%
10	0%



Recent Market for Subordinated Debt

- ❑ Most credit unions will likely be in the 7.50% - 8.50% range.
- ❑ Yields will be dependent on the size and financial strength of the issuing credit union.
- ❑ Larger subordinated debt issuances may consider a rating by a rating agency (>\$40 million).

Issuance Size	IG Egan Jones	Kroll BBB-	Kroll BBB	Kroll BBB+	Unrated
50MM	8.000% +/-	8.000% +/-	8.000% +/-	8.000% +/-	7.500%- 8.500% +/-
50MM-100MM	8.000% +/-	8.000% +/-	8.000% +/-	8.000% +/-	
100MM+	8.000% +/-	8.000% +/-	8.000% +/-	8.000% +/-	



Conclusions

- Fed funds will most likely revert to a “normalized” level
- Need to manage risk with all assets, including the investment portfolio
- Study all options and understand their risk/return profiles
- Don't be complacent; stay active in the market one way or another



Questions?

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