

## ALM First Partner's Report – 3rd Quarter 2006

By Tom Manley, ALM First Managing Director

**G**reetings from the beach on Kiawah Island, South Carolina, where we just wrapped up another successful ALM First Financial Forum. We have reviewed the feedback from attendees, and the response has been overwhelmingly positive. Some great recommendations were also submitted, and we will work hard to implement your suggestions into our Forums in the future.

At ALM First, we always listen very intently to what you have to say. Why? Because you are the source for all of the ideas we implement. I can point to every service that we provide and recall the genesis of that service to be a client recommendation or conversation. The Financial Forum is no different, and it continues to evolve as you help us make it better each year.

Speaking of the Forum, go to your calendar now and circle July 25 - 27, 2007, the dates for the 2007 Financial Forum. It will be held at another wonderful location: The Ritz-Carlton, Bachelor Gulch in Beaver Creek, Colorado.

Continuing with the education theme, our annual Financial Institute will be held here in Dallas at the Gaylord Texan from February 5 - 7, 2007. The Financial Institute is a more rigorous academic review of finance when compared to the Financial Forum. For registration details, please watch our website.

As you know, ALM First places the highest premium on internal education as well. There is no program that we hold in greater esteem than the Chartered Financial Analyst (CFA) program, and we're pleased that our staff already boasts five Chartered Financial Analysts. This program is extremely difficult, and recognized globally as the highest standard for finance education. The testing portion of the program culminates in three levels of examination. This year, ALM First had three candidates testing for various levels of the program. We are extremely proud to announce that Travis Goodman and Matthew Henry both passed level III, and consequently will be receiving their charters soon. Kunal Khara passed level II and will begin his studies for the final level III next year. It is a real accomplishment that these gentlemen have passed these tests, since the passing rate for each level was less than 50 percent.

It seems that in each of our newsletters we have a new service to discuss, and this quarter is no different. In evaluating a problem that a client had with liquidity several



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# ALM First Congratulates NAFCU "Professionals of the Year"

Recently, two ALM First clients were recognized by the National Association of Federal Credit Unions as "Professionals of the Year."

Cary J. Anderson of LA DOTD Federal Credit Union in Denham Springs, Louisiana, was selected in the category for credit unions with less than \$150 million in assets. Carlo Cestra of Digital Federal Credit Union (DCU) in Marlborough, Massachusetts, was honored for credit unions with \$150 million or more in assets.

We at ALM First would like to give them both our heartfelt congratulations and applaud their dedicated efforts to the credit union industry.

## ALM First Financial Institute 2007 The Gaylord Texan, Grapevine, Texas February 5-7th, 2007

The ALM First Financial Institute will return in 2007 offering ALM education sessions and training for credit union employees and board members. Again this year we will offer two tracks: A/LM Fundamentals and Current Topics in Balance Sheet Management.

Sessions for the A/LM Fundamentals track will include Bond Math, Interest Rate Risk Using Gap, NII and NEV; Understanding Economic Statistics and their Effect on the Yield Curve; Case Studies; and Bloomberg.

Current Topics in Balance Sheet Management will incorporate sessions on Optimizing the Investment Portfolio in the Current Economic Environment, Static Pool Analysis, Securities Lending, Liquidity Analysis and Strategies, Commercial Lending and Case Studies.

We will also incorporate roundtable discussions during the afternoon session to discuss pertinent topics that currently impact credit unions. If there is a particular subject you would like addressed, please feel free to email Lisa McDaniel at [lmcdaniel@almfirst.com](mailto:lmcdaniel@almfirst.com).

Watch our website for registration details and the full agenda. We look forward to seeing you in February!

months ago, we recognized that our clients need a better tool in which to measure liquidity and its changes into the future. Therefore, I am excited to announce the development of the ALM First Liquidity Forecasting Model. Very similar to "ALM First On Demand" in look and feel, it will be available through our extranet, this service will allow you to access a model interface for your balance sheet. It lets you provide assumptions and actions that will feed directly into our cash flow model. After you access the Liquidity Forecasting Model, the results will be posted to your report page on the extranet a few days later. We will have this additional service and a demo up on our website in the coming months, so watch for additional information about this exciting new tool.

I will finish by saying that Angela, Emily, and I are so fortunate to be working with such a great staff here in Dallas, and collectively we are very grateful to work with you, our clients.

I look forward to seeing you at the Financial Institute in February.

Warmest regards,

Tom Manley

# ALM First Employees Make the Grade

**M**any of you are probably familiar with, or have heard of, the Chartered Financial Analyst® (CFA) program and all that it entails. The CFA is a self-study, graduate-level program that combines a broad-based course of study with professional conduct requirements.

The employees of ALM First that elect to sit for the CFA are involved in a rigorous, three level study and exam process. This year, ALM First had three employees continue their participation in the program. Matthew Henry and Travis Goodman sat for and successfully completed level III and will soon receive their charters, while Kunal Khara sat for and successfully completed level II.

First awarded in 1963, the CFA charter is the designation of professional excellence within the global investment community. The CFA Program offers a truly global educational challenge where candidates build a fundamental knowledge of investment principles that is relevant in every market around the world.

The original program focused on equity security analysis in a U.S. setting and emphasized ethical and professional standards. Today, those topics are still prominent, but they are presented in a global context along with other topics, including fixed-income analysis, alternative and derivative investments, and portfolio management.

Studying and sitting for the CFA exam takes a considerable amount of time and dedication for those that undertake this extensive process. The Principals and staff of ALM First wish to congratulate these three outstanding individuals on their success!



*Matthew Henry*



*Travis Goodman*



*Kunal Khara*

## Change to NCUA Call Reports

Beginning in June, there was a change to the NCUA Call Reports. The June 2006 NCUA 5300 report now requires that certificates be identified as corporate credit union, natural person credit union, or bank issued. Accordingly, ALM First has reclassified all corporate certificates as Security Group CD with security types ACP (amortizing), CCD (bullet), C-CD (callable), and CDF (floating rate). All other certificates are reclassified as Security Group MMKT with types CD (bank bullet) and CDCU (natural person credit union bullet).

# Ask Emily

## Do you think that callable securities have a place in our portfolio right now?

Callable securities can present unique opportunities and risks depending on various interest rate outlooks. We will often allocate a small percentage into the portfolio for reasons explained in this article. In a falling rate environment, callables have little to no potential for gains. However, in a rising rate environment, most callables will outperform bullet securities.

Callable securities allow the issuer the right to “call away” or mature the security prior to maturity. An issuer will exercise this “right” when rates fall, for they can reissue the security at a lower funding cost.

All callable securities are not made equal, since there are many different types of call options. The issuer can offer a one-time option, which is called a “European” call, or a continuous option, which is called an “American” call. Call options can also have different call frequencies, such as annual, semi-annual, quarterly, or even monthly.

If you believe that rates will fall, bullets will outperform *all* non-derivative investment sectors. However, in rising rate environments, callable securities outperform bullets with equal maturities, especially those that have the greatest amount of call optionality at the time of purchase. Here is an example. Suppose that you are considering investing in a five-year callable with a *one-time*, six-month call option versus a five-year bullet. The five-year callable security is trading at a spread of 50 basis points over the five-year bullet. Let’s suppose that rates rise by 75 basis points over a period of six months. The security will not be called and will therefore turn into a bullet. Your newly formed bullet is yielding 50 basis points higher than the alternative bullet and therefore has less of a price loss. Now let’s suppose that rates move up only 25 basis points. In this case, your security will probably be called. That’s all right, since you can most likely invest in a 4.50-year bullet security at a higher rate.

Callable securities have less of a price loss in a rising rate environment. Given the example above, the price loss of a bullet in the up 100 basis point scenario is approximately 4 percent (depending upon the coupon). However, the price loss of the callable is about 2.50 percent, for the call option has lost value and the spread has narrowed. Theoretically, callable securities (where the coupons are close to market) have negative convexity in the base case scenario. The negative convexity lessens (and can turn positive) as interest rates rise.



## Welcome to ALM First!

*We’re pleased to welcome the following credit unions which became ALM First clients during the 2nd quarter:*

VyStar FCU  
Jacksonville, Florida  
Terry West, CEO  
\$3+ billion in assets

Universal 1 Credit Union  
Dayton, Ohio  
Loren Rush, CEO  
\$267 million in assets

*ALM First would also like to welcome our new WesCorp clients:*

Altura Credit Union  
Riverside, California  
Mark Hawkins, CEO  
\$800 million in assets

Health Associates FCU  
Orange, California  
Thomas Viguera, CEO  
\$34 million in assets

SAFE Credit Union  
North Highlands, California  
Henry Wirz, CEO  
\$1.3 billion in assets

Schools FCU  
Rancho Domingue,  
California  
Terry Janke, CEO  
\$120 million in assets

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## Ask Emily *Continued from page 4*

If you believe that interest rates will rise in the near future and then subsequently fall, consider purchasing a security with a short one-time call option. For example, a five-year security with a one-year, one-time call option will give you call protection – but rates will most likely fall in 2007 and the security will be called. If you believe that rates will rise between now and year end, invest in a five-year security with a three-month, one-time call. In today's market, you will receive an additional 50 basis points for the risk, and if you are lucky, the security will turn into a bullet at the time that rates fall. If you can't find these in the market, your corporate credit union can most likely structure one for you.

In summary, callable securities can have a place in an investment portfolio. Having said that, you might want to save the idea for a later point in time. Economic indicators are now pointing toward the potential for falling rates by the end of the year. At this point in the interest rate cycle, we recommend increasing the allocation to bullet securities and decreasing exposure to callable securities.

<sup>1</sup> Negative convexity securities are those that lose more income should rates rise than gain should rates fall. Positive convexity securities are the opposite.

## Employee spotlight



### **Michael Manley, Fixed Income Trader**

I've been at ALM First a little over two-and-a half years, and have had a great time getting to know many of you. Some still think of me as the "other" Manley around here, but I prefer to be thought of as "the Manley with hair."

My official title is Fixed Income Trader, and I continue to fulfill that role here at the firm. In addition to buying and selling bonds, and compiling the daily offering sheet, I write the commentary that many of you receive every day and provide market color to the advisors. I take great pride in my job, and I love the satisfaction that comes from finding the right bond at the best price available for our clients.

As many of you know, I am a big sports fan and play golf as much as I can before the football season starts. Once my beloved TCU Horned Frogs open their season, it becomes increasingly harder to leave the couch.

I have really enjoyed the friends I have made here at ALM First. Feel free to call me anytime for market color (or sports talk).

## On the Calendar

### **FHLB Boston Trends, Challenges, and Solutions: A Seminar for Credit Union Directors and Management**

Best Western Royal Plaza,  
Marlborough, Massachusetts  
October 5, 2006

*Emily Hollis will present "The Asset-Liability Management Process - Managing a High-Performance Institution"*

### **Economics and Investments Seminar**

Hosted by the Maryland & District of Columbia Credit Union Association, CUNA and CUNA CPD  
Maryland & District of Columbia Credit Union Association,  
Columbia, Maryland  
October 11, 2006

*Cullen Coxe and Travis Goodman will present:*

- *Is the Economy Headed Higher - Or Off a Cliff?*
- *ALM Strategies in Flat Yield Curve Environment*
- *The Role of Investments in Your Credit Union*

### **Corporate One FCU Asset/Liability Management Conference**

Hilton Columbus at Easton,  
Columbus, Ohio  
October 18, 2006

*Tom Manley will discuss interest rate risk and its implications to management and financial statements*

October 19, 2006

*Angela Calvert will present "Mortgage Servicing Rights"*

### **The 2006 Aerospace Conference**

Gaylord Texan Resort, Grapevine,  
Texas

October 23, 2006

*Emily Hollis will present "Asset Liability Management"*