Banks, Bonds & Baseball Event Recap

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June 2015

Earlier this month, our firm hosted our Banks, Bonds & Baseball event in downtown St. Louis. Our team and industry experts provided attendees with insightful presentations, thought-provoking activities, and panel discussions. After the conference concluded, we enjoyed a private suite at Busch Stadium as the Cardinals faced the Brewers. The game unfortunately resulted in a victory for the Brewers but was nonetheless entertaining. The suite was lively throughout the evening as attendees shared laughs with old friends and made new connections with fellow industry professionals.

Below we highlight the various themes from each segment of the conference.

Keynote Speaker, Shep Hyken: Delivering Customer/Client Amazement

Imagine you enter a restaurant on your lunch break and run into a colleague who is leaving the same establishment. You ask, “How was the food?” Your colleague replies, “Eh, it was okay.” What’s your reaction? Does this make you excited or perhaps somewhat disappointed for your prospective lunch experience? Would the restaurant be proud of the impression it left with your colleague? This example conveys the central theme of Shep’s presentation.

Shep noted that in a recent study of highly competitive customer-centric industries (such as restaurants or hospitality), up to 80% of customers who described an establishment or its services as “satisfactory” did not plan on returning to conduct future business. There has been an apparent shift in the alignment of consumer expectations where “satisfactory” is no longer acceptable. Clients now expect business interactions to be above average in exchange for their continued business and loyalty. The ability to consistently exceed a customer’s expectations may be the fine line between a “satisfied” customer and a loyal customer. In a competitive industry, customer loyalty is critical to a company’s survival and success. The challenge to constantly exceed client expectations is a notion that transcends any single industry. While the relationships between a company and its clients tend to be stickier in financial services relative to other industries, there will always be a level of expectation held by clients (even including those perceived as the most loyal bunch).

An underlying theme of the presentation was the importance of creating confidence and doing so through “magic moments,” which are simply business interactions that leave the customer with a better-than-average impression. Shep shared a list of ten strategies and concepts to help achieve “magic moments” consistently. The list included but was not limited to: managing the first impression, exerting expertise, displaying enthusiasm, building rapport, striving for consistency, communicating effectively, and showing genuine appreciation. Additionally, it’s important to consider the responsibility that each individual affiliated with the business inherently holds as they come in contact with clients or potential clients. At any given time, that individual could become a representation of the entire organization. From interns to executives, every employee should remain cognizant of customer service and its importance as a pillar of the business.

The presentation included lively stories and a few impressive magic tricks to help relay the theme of amazement in exceeding expectations.

Panel – Other Asset Classes to Consider

The panel was moderated by John Smith, Managing Director, and consisted of four panelists:

- Greg Parsons, Chief Executive Officer at Semper Capital Management
- Paul Nikodem, Executive Director at Nomura Securities International
- Jay Redlingshafer, Vice President at Bancorp Services
- Nick Trentmann, Director & Portfolio Manager

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The panelists shared their expertise on an array of alternative asset classes. With Treasury rates near historic lows, many investors are seeking alternative investment products to provide higher returns while still offering a substantial degree of safety. In the search for opportunities to garner additional income for the investment portfolio, the investor has to determine whether he/she is willing to accept the various risks associated with the alternative product. Below is a recap of the discussion regarding investment products that may provide additional opportunities for the contemporary institutional investor.

Mortgage Backed Securities (MBS)

Semper Capital Management currently holds a view that MBS (specifically the legacy, non-agency portion of the market) offer an attractive source of yield and total return. They shared several fundamental and technical factors that provide a favorable framework for the product.

While others view the opportunity as a shrinking market, there is still roughly one trillion dollars in tradable paper outstanding. In addition to the encouraging market liquidity, the paper is tremendously fragmented which theoretically provides a complexity premium to the space. The resulting opportunity allows investors to locate securities with very specific characteristics as there are over 80,000 individual CUSIPs in this market.

Considering that the market for securitizing private label home loans is effectively dead for the time being, the gradual buy down in the MBS market has the potential to provide holders with a degree of price support. In other words, there could be an ongoing floor of support for this product, due to the supply and demand relationships that stem from its shrinking availability.

Semper's philosophy is that there is still a high level of addressable opportunity throughout this market.

Collateralized Loan Obligations (CLOs)

A CLO is an investment vehicle backed by a pool of debt, primarily first-lien senior secured loans. The pool consists of various tranches, the most junior of which is referred to as the "equity" tranche. Generally, the CLO has a collateral manager responsible for the credit selection process and managing the assets of the vehicle. Recent transactions typically have a stated final maturity of 10 to 13 years. However, the average life of each tranche will realistically be shorter as it depends upon the prepayment of the underlying loans and any redemption rights or callability. The products are generally callable prior to their stated maturity, and most recently transactions have included a 2 to 4 year non-call period.

As discussed by Nomura during the panel, a benefit of the CLO product is its ability to satisfy an investor's customized risk/reward profile and targeted debt ratings. The investor is able to obtain a broad diversified exposure to the US leveraged loan market. Additionally, CLOs provide a wider spread than a number of similar products holding identical credit ratings.

It's important to distinguish the difference between CLOs and asset-backed collateralized debt obligations (CDOs). CLOs largely outperformed CDOs through the recent crisis as the CLOs displayed significantly higher levels of recovery on defaulted assets. The underlying collateral of the CLO is first-lien, senior secured leveraged loans compared to subordinate tranches of MBS, CMBS, and asset-backed CDOs. Also, there are no swaps or synthetic securities associated with CLOs, and the maximum maturity is much shorter for CLOs when compared to CDOs.

Using the Simplified Supervisory Formula Approach (SSFA) formula, CLOs could be appropriate for banks from the AAA to A tranches. Due to the low delinquency rates and the effect on SSFA, banks and insurance companies have been large buyers of this product.

Bank-Owned Life Insurance (BOLI)

Per Bancorp Services, the primary benefit of BOLI is to provide an institutional investor with the ability to convert taxable returns into tax-free returns using a life insurance investment vehicle.

BOLI is different from other investments in that it cannot be designated as Held-to-Maturity or Available-For-Sale. Rather, BOLI is marked-to-market at each reporting period with the gains and losses flowing through other income. This potential for volatility in income reporting, compounded by the effects of the 2008 recession, caused a sharp decline in the issuance of BOLI contracts.

BOLI is a complex, structured financial instruments with above average return potential for tax paying investors, but it comes with limitations on liquidity and balance sheet flexibility. Many new product features have been created to address product limitations. If you are interested in investing in BOLI or have BOLI in your portfolio, consider involving our team to work with you and potential BOLI sellers to evaluate what is best for your unique situation.

Bank Issued Debt

Bank issued debt is senior or subordinated debt issued by bank holding companies to access the debt capital markets, providing them the ability to raise capital without common equity dilution.

Recently, we have seen an increase in bank debt opportunities. The yield on this paper is approximately 4.50% to 6.00%. The paper is commonly issued at a fixed rate, but floating rate and fixed / floating offerings are also available. The stated maturity is typically 10-years, and the risk weighting is at 100%. In most cases, the debt is either rated by Kroll or is Not Rated.

If it's an appropriate holding for your portfolio, we currently recommend purchasing this paper in the primary market, as there is a measurable premium when utilizing a broker-dealer to purchase the debt from another investor's portfolio.

Securitized Bank Debt

Bank debt securitizations are also available. Several of the common characteristics are comparable to single issuer bank debt, but there is subordination due to the securitization of the product. Similar to other securitized products, the pool is divided into various subordinated debt and equity tranches. Additionally, principal and interest are paid in waterfall method.

As with all structured product, there are trade-offs between features and risks. If you are interested in evaluating such structures, contact us for assistance

We are expecting more bank debt issuances and securitizations in the coming months.

Bank Executive Panel Discussion

Our thanks to this year's panel participants:

- Bruce Lammers, Chief Executive Officer at Ridgestone Bank
- Brian Leeker, Chief Financial Officer at The Business Bank of St. Louis
- Jim Wagner, Chief Executive Officer at Parkside Financial Bank & Trust
- Don Hutson, Partner at BKD

The responses were refreshingly candid, which provided an insightful basis for discussion. Several of the topics transcended the banking sector and were applicable to other industries, including insurance.

The panel was excellent in voicing the challenges and opportunities currently facing regulated industries.

- Challenges include amplified regulatory scrutiny, particularly Basel III, higher costs in hiring internal compliance/regulatory experts, increased competition from non-bank organizations, succession issues, and shareholder expectations.

- In some geographical pockets, the gap between seller and buyer price expectations poses a challenge for banks seeking growth and expansion.

- Since 2008, the issue of shareholder liquidity has been daunting for a number of banks. Those unable to address liquidity have become common targets for sale. At this time, shareholder liquidity is one of the leading drivers of consolidation.

- One opportunity for successful banks has been harnessing technology to increase productivity. It's a ubiquitous trend in the industry, regardless of the size of an institution. As discussed on the panel, personnel costs for banks have increased approximately 20% since 2007, yet productivity has increased roughly 28%, outpacing that cost structure. While much has been invested in compliance and regulatory burden, other areas of operations have reduced staffing requirements.

- There has been a substantial shift from branching networks to mobile banking, targeting a more technologically savvy customer base. While physical branches remain a viable delivery channel, a continuation of the shift from physical to mobile remains on the horizon.
- Additional opportunities include the impact of consolidation of competition and recent signs of economic stability.

B.Y.O.P. Activity

Brandon Janosky, *Director & Portfolio Manager*, introduced an interactive presentation dubbed "Build Your Own Portfolio." While the title was self-explanatory, the activity posed a complex challenge. The audience was split into five teams, each with a pool of investable funds. In the first half of the activity, the groups were provided with a yield curve and sample yield table for various asset classes as a foundation for their decision-making.

The teams were asked to derive an asset allocation strategy for their portfolios, with the insinuation of a potentially unseen shift in rates. After much deliberation and banter, the teams confidently submitted their strategies which were subsequently entered into a total return calculator. With the press of a button, rates were instantly hiked by 150 basis points. The rates rollercoaster continued as rates then dropped 200 basis points. With each shock in rates, the attendees were able to see their respective portfolios perform in comparison to other portfolios in each rate scenario. The juxtaposition of each group's total returns provided an exciting element of competition. As the rate scenarios evolved, attendees were able to see that the information derived from their sample yield tables didn't necessarily lead to the total return performance they anticipated.

In the latter half of the activity, groups were provided with a sample total return table as their reference. The table listed various securities with the yield and the total return in various rate scenarios. In addition, optionality became a factor as callable bonds and step-up bonds were added to the mix. The teams were then asked to revise their asset allocation strategy based on the new information. As the new allocations were submitted and tested by unexpected rate movements, it became apparent that certain teams had constructed versatile portfolios that outperformed their peers throughout the wide range of circumstances

The underlying theme of the exercise was that although every investor has a bias to a degree, the construction of a well-balanced portfolio through open discussion and cooperation can perform effectively, even in the aftermath of unforeseen events. Many participants concluded that facing such tasks without outside assistance was both risky and exhausting.

Conclusion

It is difficult, if not impossible, to encapsulate an entire conference in the space provided by a monthly newsletter. The depth of the discussions both during and in addition to the presentations and panels would be impossible to replicate. Instead, we suggest attending the conference in person next year! If you or others at your organization are interested in joining, please let us know and we can add you to our invite list. Also, do not hesitate to reach out if you are interested in further discussing any of the presentation topics.