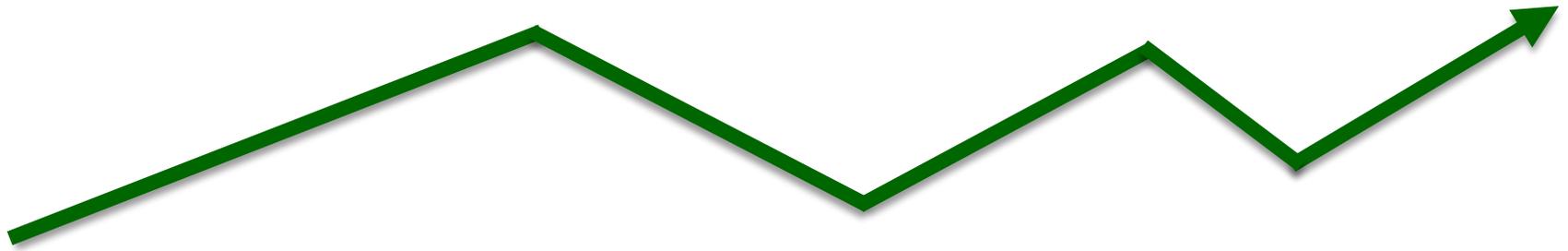


McQueen

Financial Advisors



Successful Investment and Bond Portfolio Strategies for Maximizing Earnings in a Rising Rate Environment

May 5th, 2022

Charley McQueen – President & CEO



McQueen Financial Advisors, Inc. was founded by Charley in 1999 to provide specialized investment and consulting services to financial institutions. Today, his company advises clients throughout the United States and manages investment portfolios with a combined value in excess of \$12.5 billion.

With over 25 years of experience, Charley oversees McQueen Financial Advisors core services of Investment Portfolio Management, Asset/Liability Management, and Valuations & Advisory Services.

A frequent speaker at financial institution conferences, Charley has provided board of director's education and training on a variety of topics. Additionally, he regularly provides training for bank and credit union examiners and certified public accountants.

Charley is a graduate of Western Michigan University, with a BBA in Management.

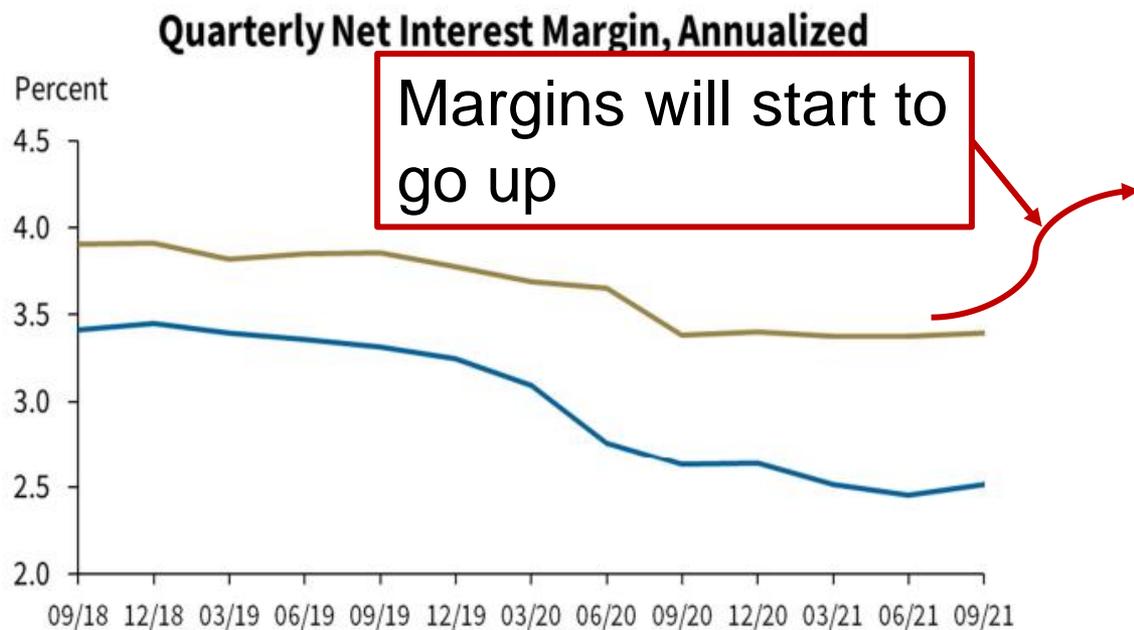
Key Take Aways:

1. Asset classes
2. What not to buy
3. Portfolio duration
4. How to purchase bonds
5. Portfolio & the Balance sheet
6. Employee Benefit Prefunding account
7. Charitable donation account

McQueen Financial Advisors

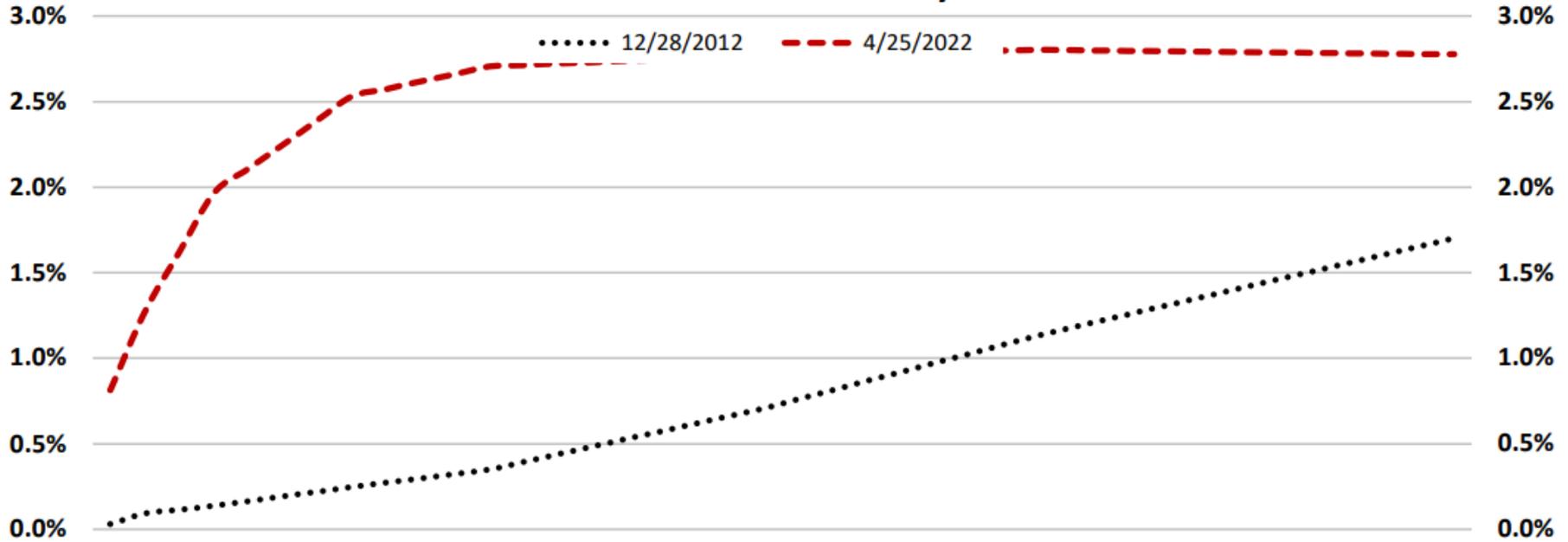


**“Rising
Interest
Rates! Yay!”**



Economic Update

Current & Historical US Treasury Yield Curves

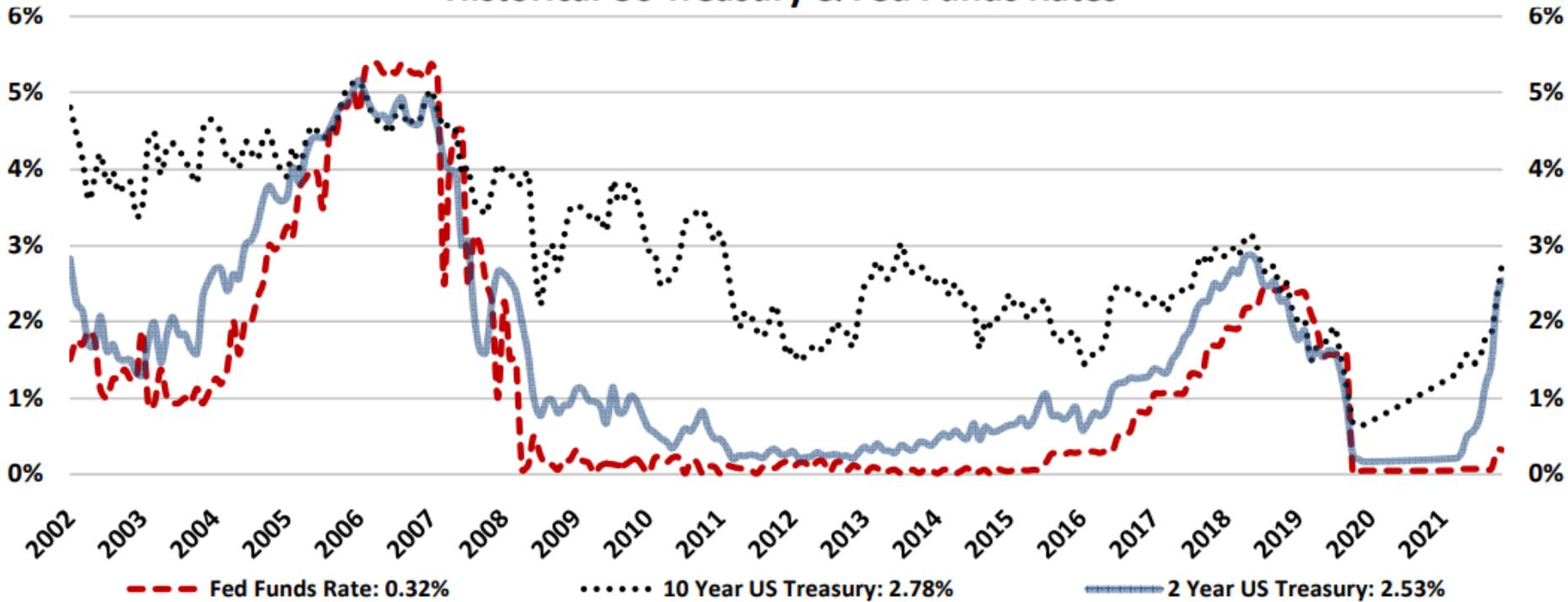


	3 Mo	1 Yr	2 Yr	3 Yr	5 Yr	7 Yr	10 Yr
12/28/2012	0.03%	0.14%	0.25%	0.35%	0.71%	1.14%	1.70%
4/25/2022	0.81%	1.96%	2.53%	2.70%	2.77%	2.80%	2.78%
Change	0.78%	1.83%	2.28%	2.36%	2.06%	1.67%	1.07%

Source: MFA Economic Update

Economic Update

Historical US Treasury & Fed Funds Rates



Source: MFA Economic Update

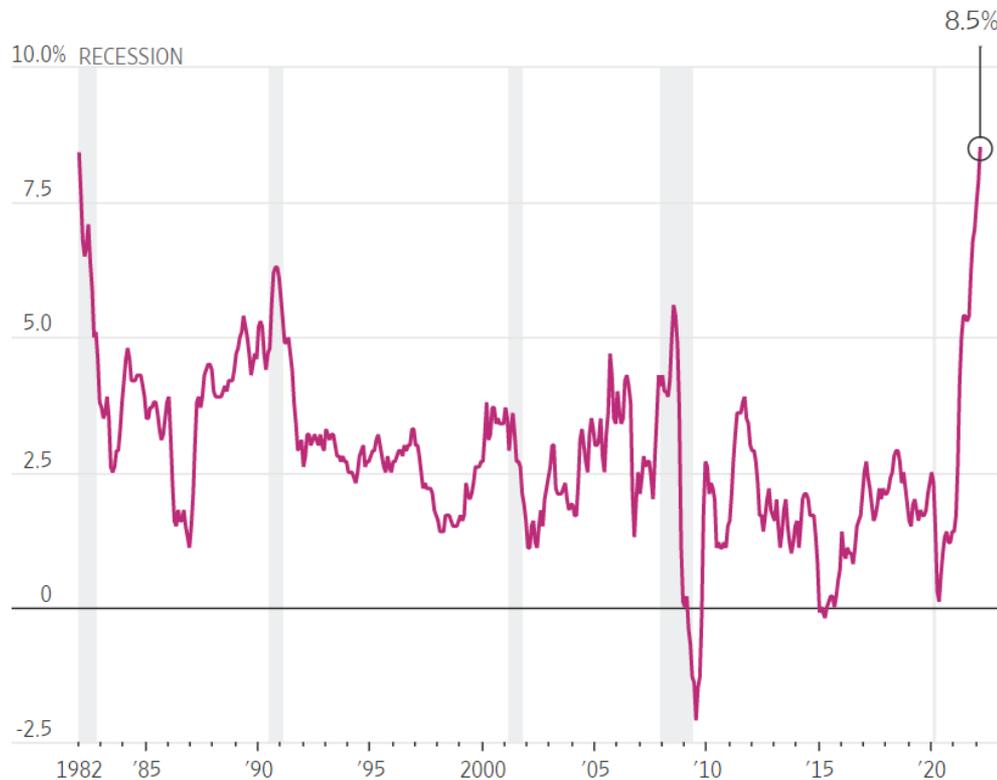
Fed Funds Target Rate



FOMC Meeting Dates and Implied Rates



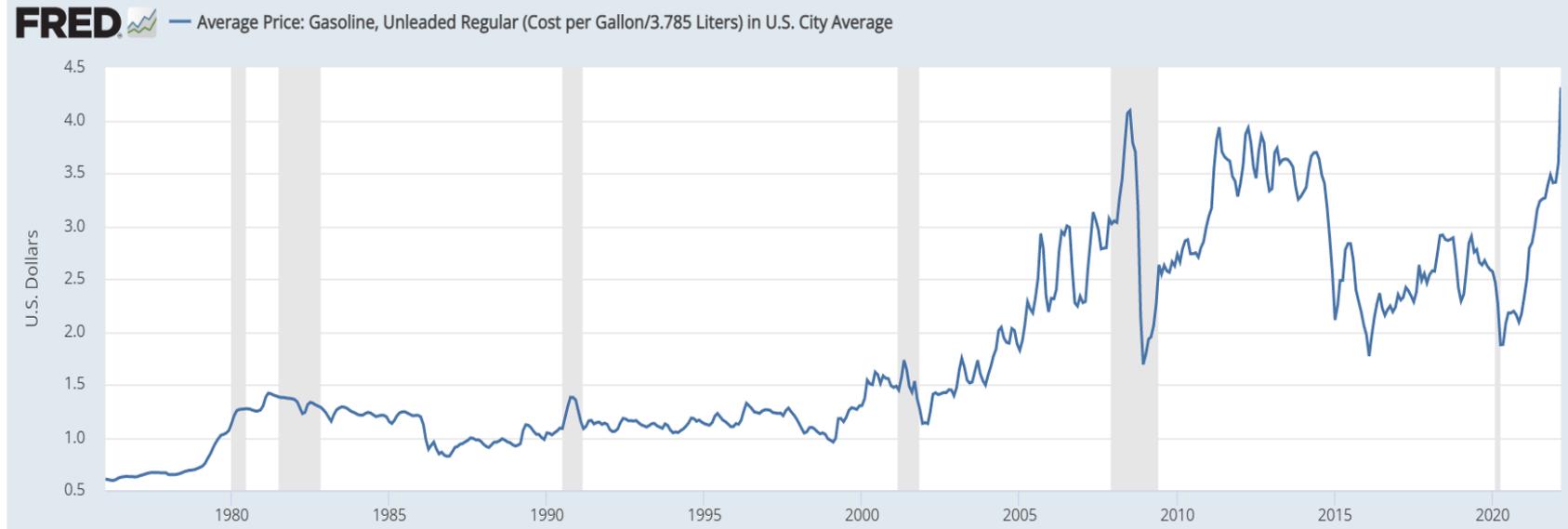
Economic Position



Observations:

1. Last time we were this fast was 1982.
2. Volker set out to crush inflation in the 1980s
3. Today – COVID-19 is causing transportation / logistical issues.
4. We would expect logistics to improve and prices to fall.
5. Wage-based inflation is permanent (especially with a smaller workforce).
6. Gasoline (up 45%), Auto (up 37%) and furniture (up 19%) are the biggest increases.

The Consumer



2022 has great potential

Points to ponder:

- Margin will improve
- Inflation may moderate
- Food and gas prices will slow the economy
- Commercial real-estate may have bumps

Portfolio Management

Portfolio Diversification

Why Diversify?

- Avoid concentrations
- Shifts in relative value
- Manage risk
- Manage maturity ladder/portfolio average life

How to Diversify:

- Asset Class
- Duration
- Purchases
- Portfolio Type

Take
Away
#1

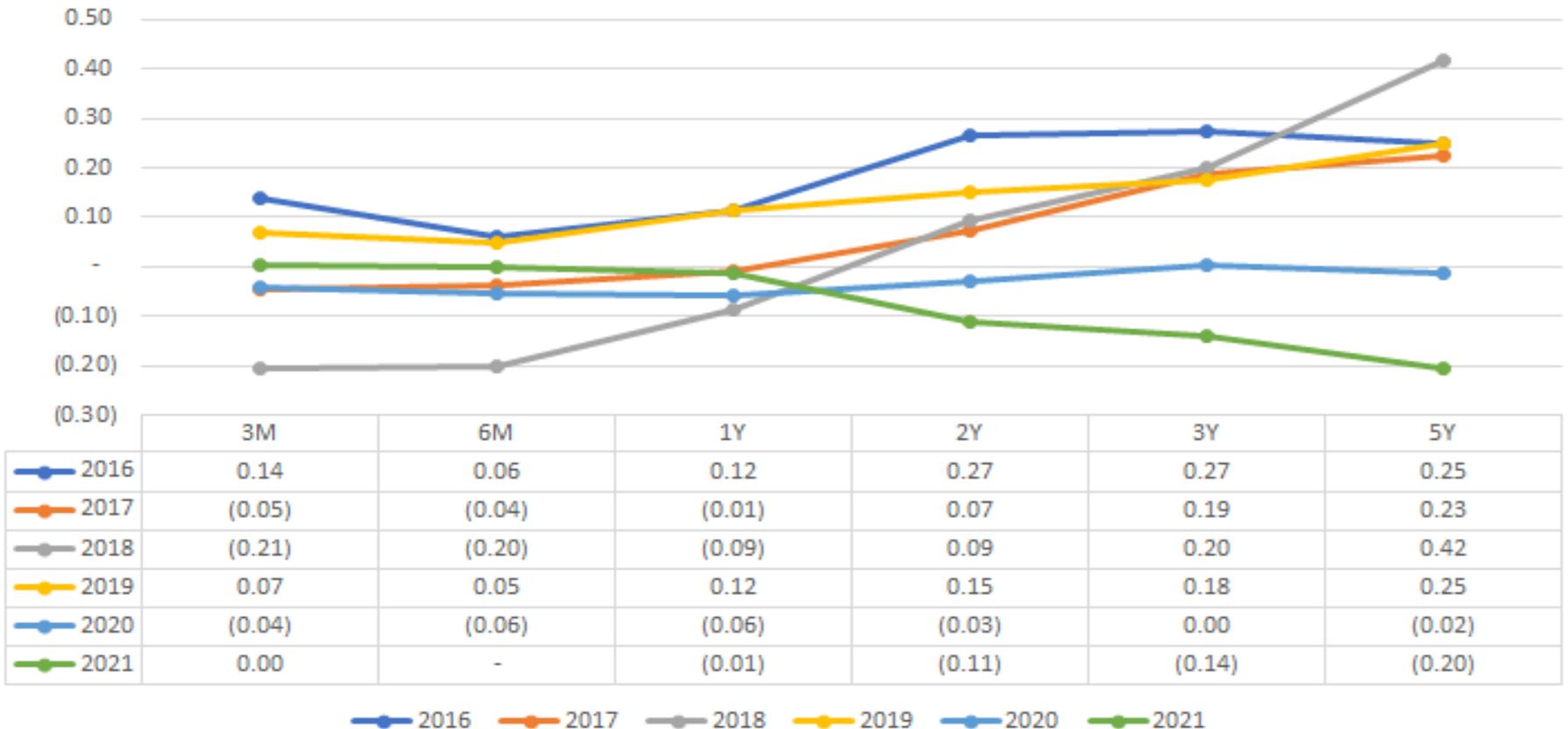
Asset Classes:

*What we like in a rising
rate environment...*

Certificates of Deposit

Certificates of Deposit (CDs): Offered by financial institutions and provide a fixed term and coupon rate.

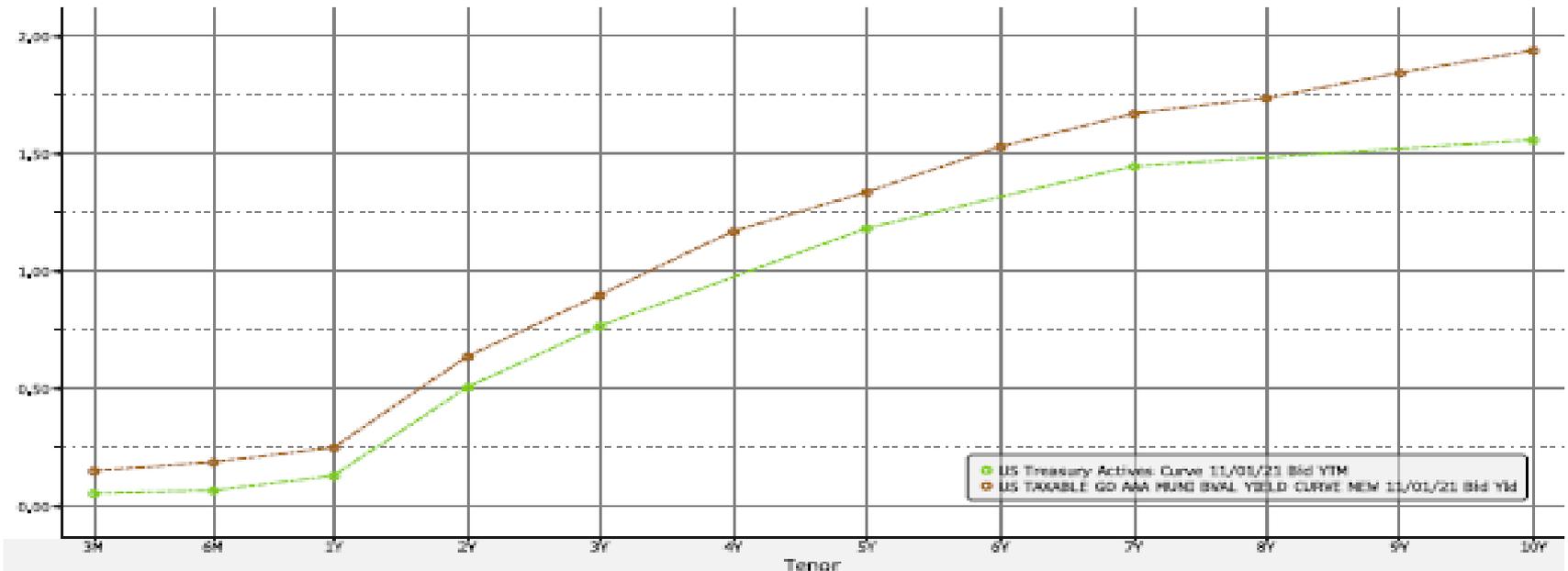
CD vs T Note Spreads



Municipal Bonds, cont.

Tax Status

- Taxable - interest income is subject to taxation. Yields are higher to compensate.
- ~~General Market Tax-exempt~~ - interest income is exempt from taxation. Yields are quite low.
- ~~Bank-Qualified Tax-exempt~~ - interest income is exempt from taxation



Municipal Bonds

Municipal Bond: Debt issued by a U.S. State or local municipality such as a city, school district, or building authority.

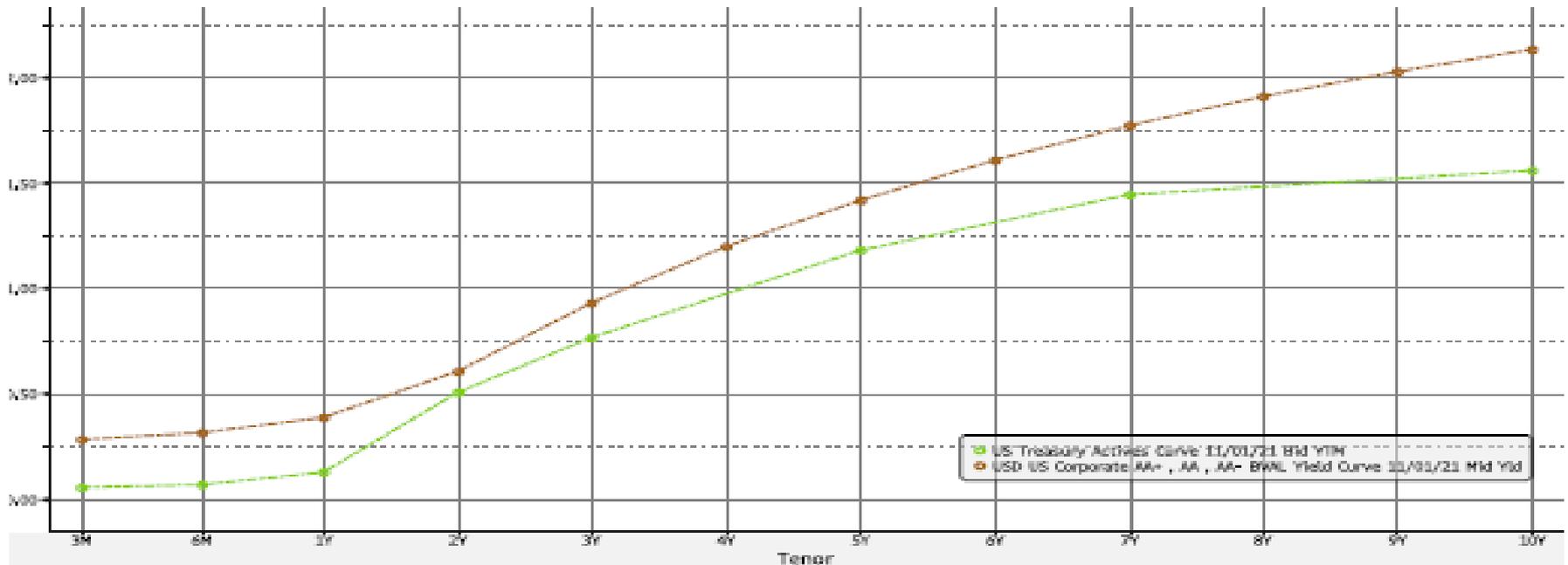
General Obligation (GO)

- Bonds are secured by the municipality's full faith and credit and taxing authority
- Limited Tax GO = the municipality can only raise taxes within the voter-approved limits to meet debt service
- Unlimited Tax GO = the municipality can raise taxes beyond the voter-approved limits if necessary to meet debt service

Corporate Bonds

Corporate Bonds: Debt issued by U.S. Corporations

- Similar to Muni Bonds, these are subject to credit risk and therefore tend to offer higher yield versus Treasury and Agency options.
- Be very careful with credit

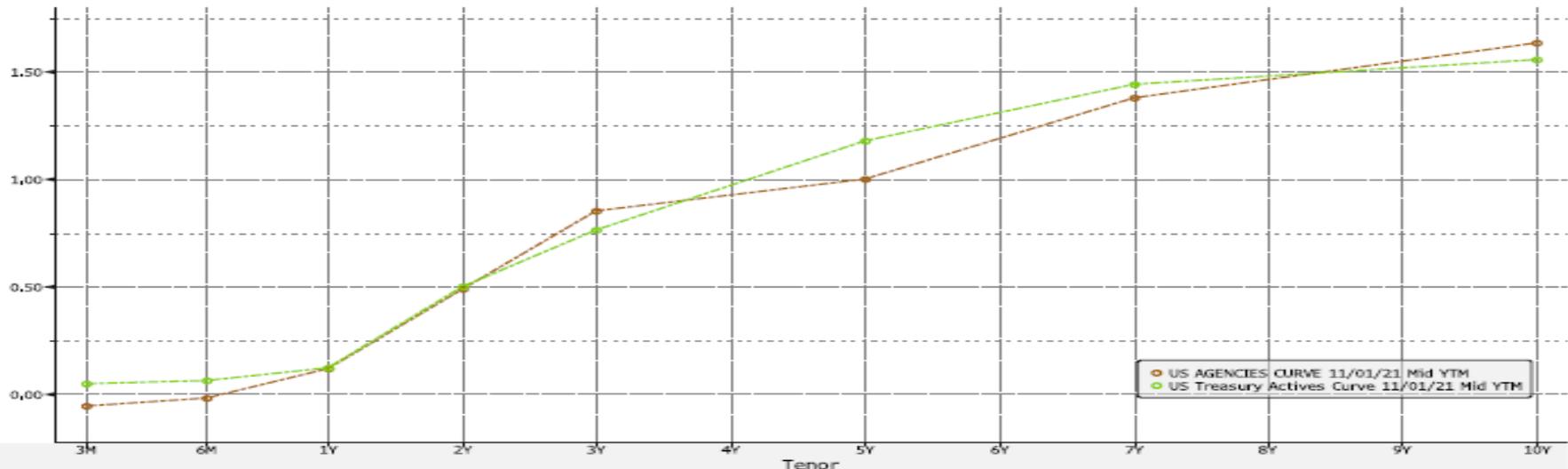


US Agency Bonds

US Agency Bonds: Debt issued by a Government Sponsored Enterprise (GSE)

Structure:

- Bullet – We like
- Callable – If you model to the maturity, ok – but....
 - NEGATIVE CONVEXITY



MBS & CMO: Amortizing Bonds

MBS & CMOs: Residential mortgage loans securitized into a bond with a coupon and maturity date

MBS: vanilla pass-through structure where principal and interest payments are passed through to the investor

CMO: waterfall structure where cashflow is prioritized depending on structure of security

MBS & CMO: Amortizing Bonds

Things to consider:

- Prepayment Risk
- Extension Risk
- Loan Portfolio
- Run at super slow pre pay speeds – such as 5 CPR



**Take
Away
#2**

What not to buy

Mutual Funds

Mutual Fund: A company that pools money from many investors and invests the money in securities such as stocks, bonds, and short-term debt.

- Dividends are not guaranteed
- NAV may decrease
- Fees
- Mark-to-market accounting treatment means NAV fluctuations impact income statement

Points to Ponder:

- Interest rate risk: generally, bond funds' value will go down when interest rates go up
- Credit risk
- Prepayment & extension risk
- When one person sells (or the fund sells a bond) losses are realized

**Take
Away
#3**

Portfolio Duration

Portfolio Duration

What is duration?

Duration is the measurement of sensitivity to a change in interest rates. It is NOT average life.

It considers:

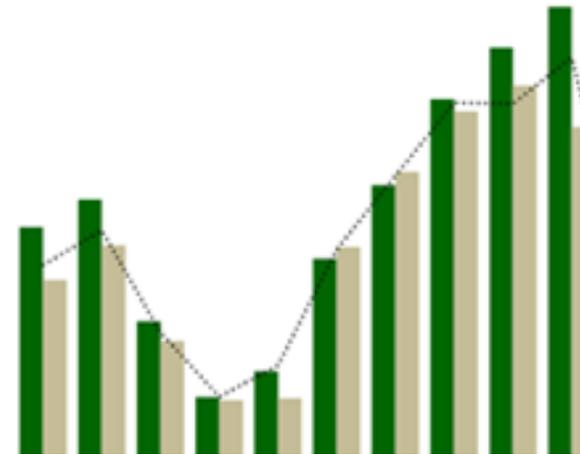
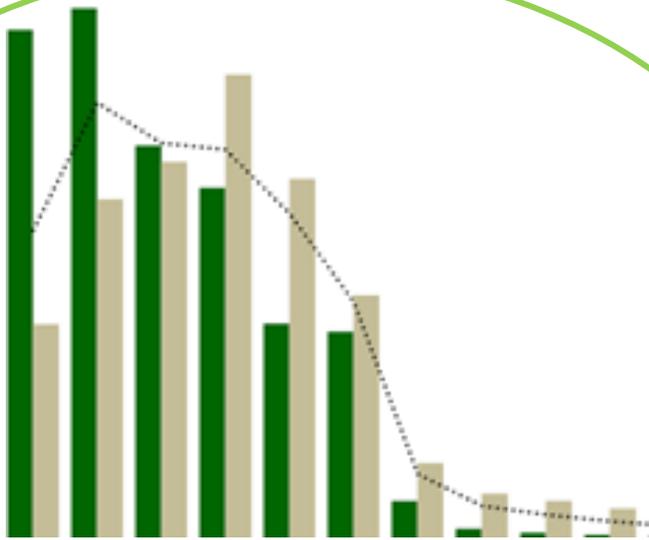
- maturity
- yield
- coupon
- call features

Typically, the higher the duration, the longer the portfolio average life. Consequently, the longer the average life, the higher the price sensitivity.

Portfolio Duration - How?

Maturity Ladder

- Diversity!
 - Asset Classes
 - Final Maturity
 - Optionality



Portfolio Duration - How?

Convexity: How the duration of a bond changes as interest rates change.

- Negative convexity = duration increases as rates increase
 - MBS
 - Callable bonds
 - 'Lower' coupon bonds
- Positive convexity = duration decreases as rates increase
 - Floating rate bonds
 - 'Higher' coupon bonds

Portfolio Duration - How?

Price Sensitivity: How much does the price of our bond change as interest rates fluctuate?

1% rise in rates

Duration	Change	Market Value
1 year	-1%	990,000.00
5 years	-5%	950,000.00
10 years	-10%	900,000.00

1% drop in rates

Duration	Change	Market Value
1 year	1%	1,010,000.00
5 years	5%	1,050,000.00
10 years	10%	1,100,000.00

Assume initial investment of \$1MM

How do we purchase bonds?

- SEC Registered Investment Advisor
- Broker Dealer:
Work with at least 3 – and hopefully more

If your broker does your bond accounting, they know everything....

Portfolio Management

**Take
Away
#5**

How do we best manage the portfolio?



Key Takeaways

Diversification is key!

- Asset Classes
 - Limits risk in any given sector
- Term
 - Create a solid ladder that provides cashflow from both static maturity securities as well as amortizing securities
- Risk
 - Holistic Balance Sheet management of loans, investments, and liabilities

Key Takeaways

Unique Portfolio for your unique Credit Union

- Balance sheet
 - Complement
 - Lots of mortgage loans? Less in the portfolio...
- Convexity
 - Negative convexity is not your friend
 - Loans have it (all loans)
 - Some investments have it

Key Takeaways

Unique Portfolio for your unique Credit Union

- Risk
 - Moderate risk by structure and diversifications
 - Consumer?
 - Commercial?
 - Big picture (Balance Sheet)

Alternative Portfolios

Alternative Portfolio Management:

- Employee Benefit Pre-funding (EBPA)
- Charitable Donation Account (CDA)

Alternative Portfolio Management

What are Alternative Portfolios?

A way to increase earnings and take on a different type of risk:

- Provide additional earnings
- Offset benefit or gifting costs
- May invest in normally impermissible investments including:
 - Corporate Bonds
 - Preferred Stocks
 - ETFs
 - Mutual Funds
 - Stocks, etc.

Market Adoption for Alternative Portfolio's

Employee Benefit Plans:

- 29% of Credit Unions
- Programs are for everyone:
- Asset size range of \$400 Thousand to \$18 Billion

Charitable Donation Accounts:

- 5% of Credit Unions
- Programs are for everyone
- Asset size range of \$12 Million to \$18 Billion

Employee Benefit Prefunding

Take
Away
#6

Employee Benefit Account (EBPA):

The NCUA allows credit unions to direct a portion of their excess liquidity into investments to cover benefit expenses.

Employee Benefit Prefunding

Typical benefit expenses include:

- Health insurance premiums
- Life insurance costs
- Retirement benefit costs
 - 401(K)
 - 457(b)
- Post-employment plans (pay to management post-retirement)

Employee Benefit Prefunding

How an EBPA works:

- Invest up to 25% of capital
- For example \$10,000,000
- We earn 5.00% (low estimation as our average is close to 6.00%)
- $\$10,000,000 * 5.00\% = \$500,000$

You now have \$500,000 in earnings to apply to your benefit costs!

Employee Benefit Prefunding

What do we do with the earnings?

- All of the earnings go to cover expenses
- Mentally – we can look at this as “free” earnings to cover expenses. Why?
- Apply half of the \$500,000 (\$250,000) to pay benefits
- Apply half of the \$500,000 (\$250,000) to replace earnings that the standard investment portfolio would have had.

In the end, you have at least \$250,000 more in earnings to cover Employee Benefit Expenses.

Employee Benefit Prefunding

Question:

What does it take to pay an executive three years' salary post-retirement?

- Pay of \$100,000 a year
- Insurance costs of \$25,000 a year
- Therefore we need to earn \$125,000 a year

Invest the following to achieve the goal:

- \$5,000,000 invested at 5.00% (example as our average yield is close to 6.00% today)
- $\$5,000,000 * 5.00\% = \$250,000$

Employee Benefit Prefunding

The Result:

- Half of the \$250,000 (\$125,000) per year goes to the retiring employee
- Half of the \$250,000 (\$125,000) per year goes to the Credit Union.

Effectively, there is no cost to the Credit Union to provide this benefit

Charitable Donation Account

Take
Away
#7

Charitable Donation Account (CDA):

The NCUA allows credit unions to direct a portion of their excess liquidity into investments to cover gifting to charities.

Charitable Donation Account

- CDA portfolios are required to gift a minimum of 51% of the income
- You can gift more if you want
- You can only gift to 501 C (3) charities
- Gifting clean up actions
- Foundation

Charitable Donation Account

What is your Social Mission?

You can use your CDA to:

- Focus on giving to your social mission
- Create a foundation to grow your giving with the community
- Focus on your community

Charitable Donation Account

Question:

What does it take to donate \$100,000 to charities today?

WITHOUT A CDA:

- \$10,000,000 in assets earning 1.00% to support this giving
- $\$10,000,000 * 1.00\% = \$100,000$

If we use a CDA:

- \$2,000,000 in assets earning 5.00%
- $\$2,000,000 * 5.00\% = \$100,000$

Charitable Donation Account

Your giving is “Free” with a CDA. How?

- \$4,000,000 in assets earning 5.00%
- $\$4,000,000 * 5.00\% = \$200,000$
- Donate 51% = \$100,000
- Return to earnings 49% = \$100,000

You have a net yielding asset of 2.50% which is higher than most investment options. Therefore the giving is “free”.

Sample Portfolio - Balanced

Sample Credit Union
Alternative Portfolio Management

Balanced Portfolio Sample

Order of Payment	Description		Estimated Yield ^a	Par Amount	Allocation	
Corporate Bonds						
1	<i>Corporate bond payments are more secure than preferred stock and common stock dividends.</i>		3.25	4,500,000	30.00%	
Preferred Stocks						
2 A	<i>Non-Perpetual Preferred stocks pay a predetermined dividend. The preferred dividend must be paid out before common dividends. Non-Perpetual Preferred stocks have a stated maturity date.</i>		3.50	2,250,000	15.00%	
2 B	<i>Perpetual Preferred stocks pay a predetermined dividend. The preferred dividend must be paid out before common dividends. Perpetual Preferred stocks have no stated maturity date.</i>		4.00	2,250,000	15.00%	
Common Stocks						
3	<i>Common stock dividends are not predetermined and vary according to company performance. Common stock also has return potential from price appreciation. ^c</i>	Estimated Dividend ^a	2.50	8.50	6,000,000	40.00%
		Return Potential ^d	6.00			

Gross Yield	5.50	15,000,000
<u>Est. Annual Income</u>	<u>825,000</u>	

Current Net Income	3,830,258
<u>Est. Income Increase</u>	<u>825,000</u>
Est. Net Income	4,655,258
Increase to Income	21.54%

Key Take Aways:

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The entire MFA team is here to help

**Thank you &
Questions**



Charley McQueen
charley@m-f-a.com
248.548.8400