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Why Your Portfolio Duration is Important

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With lending at record high volumes, investments may not be a top priority at your credit union. Institutions with high loan volume probably focus most investments in short maturities to keep an ample funding supply and meet target liquidity ratios.

However, even with a short-term portfolio in mind, setting a specific portfolio duration may be beneficial for your credit union. Your investment portfolio should be complimentary to the risk/return profile. If your credit union has a large percentage of long term loans and therefore faces a high amount of Net Economic Value (NEV) volatility in upward rate environments, a short-term investment portfolio may be the best compliment. But how short should you go… six months, one year?

The answer may be found in a process called **benchmarking**. The idea behind benchmarking is to compare various portfolio durations and specifically assess the impact to your credit union. For example, a credit union with a one-year duration portfolio may be questioning whether they can take on the risk of a longer portfolio. The benchmarking process would take their ALM results, remove their investment portfolio and replace it with a laddered portfolio of non-callable agencies. Through the analysis of several "what if" runs of various portfolio durations, the credit union could then compare the results, for example:

				1.0 yr			
	-200	**-100**	**0**	**100**	**200**	**300**	**400**
Yield of Investment Portfolio	0.47%	0.48%	0.55%	0.89%	1.22%	1.55%	1.89%
Capital Ratio	11.84%	11.00%	10.43%	9.65%	8.67%	7.68%	6.77%
Net Income	202	293	209	162	103	40	-21
NEV Volatility	13.51%	5.48%		-7.46%	-16.87%	-26.38%	-35.07%
				1.5 yr			
	-200	**-100**	**0**	**100**	**200**	**300**	**400**
Yield of Investment Portfolio	0.60%	0.61%	0.72%	0.97%	1.22%	1.47%	1.72%
Capital Ratio	12.00%	11.16%	10.28%	9.30%	8.13%	6.95%	5.86%
Net Income	259	350	281	199	104	45	-43
NEV Volatility	16.71%	8.56%		-9.52%	-20.95%	-32.43%	-43.01%
				2.0 yr			
	-200	**-100**	**0**	**100**	**200**	**300**	**400**
Yield of Investment Portfolio	0.79%	0.83%	0.94%	1.16%	1.37%	1.58%	1.79%
Capital Ratio	12.34%	11.29%	10.05%	8.88%	7.52%	6.16%	4.91%
Net Income	344	447	378	280	169	54	-61
NEV Volatility	22.80%	12.33%		-11.66%	-25.20%	-38.70%	-51.19%

In this situation, the credit union can easily see an improvement in their net income projections by extending beyond a one-year duration, but faces more NEV Volatility and lower capital ratios in the higher rate environment. This comparison of results should lead to a group discussion among the ALCO to determine how much risk the credit union is willing to take considering the current interest rate environment. The additional income generated by a longer duration portfolio may be attractive to some, but the increased NEV volatility risk on the balance sheet may be unattractive to others.

Once a group decision has been made on the appropriate portfolio duration, this can provide direction to the person in charge of the investments.

Establishing a benchmark will also allow you to finally have a metric for portfolio performance. Common benchmarks in the financial markets include the S&P 500 and the J.P. Morgan Government Bond Index (which represent a diverse basket of individual investments chosen to represent a market segment). Since your portfolio is unique to your institution and constrained by credit union regulations, it is not possible to compare the performance to standard industry benchmark. The benchmark of non-callable laddered agencies is considered a passive investment. If you have chosen to be an active investor, you will want to know if the portfolio risks that you have taken, such as call option or pre-payment risks, have allowed you to outperform this benchmark of non-callable agencies. Once you have chosen the benchmark that best suits your risk/return profile, you will have a constant metric to compare your portfolio performance.

Setting a clear portfolio duration for your institution helps to put management on the same page in terms of balance sheet risk and provides a benchmark for measuring portfolio performance. Through the continuous monitoring of your investment performance and duration, you can build a portfolio that benefits your credit union well into the future.

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