ARTICLE

WHAT IF THE PROJECTIONS ARE WRONG?

Letting rate projections dictate investment strategy is risky business

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Recently, I reviewed a presentation about how to invest in a rising interest rate environment. During this program, the speaker laid out a very detailed rationale for rate hikes in 2019. Supporting that rationale, were several charts displaying the yield curve shape and most importantly, the often-referred-to Federal Open Market Committee (FOMC) dot plot chart. The speaker then explained how a credit union could adjust the investment portfolio to take advantage of the projected opportunity offered by the projected rate hikes. He also used the word "inevitable" in reference to two separate rate increases predicted for the immediate future.

While the presenter and I had several disagreements regarding his solution to the rising-rate conundrum, the two issues concerning me most were:

1. The idea of basing portfolio adjustments on *projected* opportunity
2. The notion that any rate projection will *inevitably* come to pass

In addressing these issues, I want to first emphasize what we all know—projections are forecasts of what might be. They are met and not met. If we use projections to guide strategy, we rise and fall with those projections, mitigating or outright squelching any efforts to hold a steady course. To illustrate that point, we are now a mere 30 days beyond that speaker's presentation and the "inevitables" he spoke of have not held true. The presenter and many others projected the FOMC would increase the overnight rate twice in 2019. But according to the most recent FOMC communications, there now seems to be a resignation regarding those hikes, and for the foreseeable future, the Fed has put rates on hold—meaning the market now anticipates no rate movement of any kind.

We point out this swift change in Fed sentiment not to be critical of the presenter's strategy, but to help credit unions understand that trying to predict rate movement is very difficult. There are no "inevitable" ups or downs. The state of the market depends on too many unpredictable variables for us to actually "know" what will happen and building a portfolio based on predictions can lead to some very harmful results. Risking other people's money requires a broader and better understanding of not just what you think will happen, but what might happen *if those predictions are proven wrong.* As Winston Churchill put it in reference to politics: "A politician needs the ability to foretell what is going to happen tomorrow, next week, next month, and next year. And to have the ability afterwards to explain why it didn't happen."

SO WHAT SHOULD THE CREDIT UNION MANAGER DO?

We highly suggest constructing portfolios in which the financial outcome in multiple interest-rate environments is clearly understood. Reviewing projected cash flows resulting from various "what-if" rate scenarios takes some effort, but the task isn't difficult to accomplish. As we stated in an earlier paper, investing can be simple if you diligently do the math *before* you're hit with an unexpected rate drop or hike. If you do the math using multiple rate scenarios and create appropriate performance benchmarks, there will be no surprises when the market swings one way or the other and you'll be prepared to minimize risk and maximize opportunity in each environment. Carefully analyzing projected investment outcomes over a specified time horizon, under various interest-rate situations, and against a properly constructed benchmark based on your credit union's unique needs and goals, can keep your credit union on course no matter what's projected or comes to pass. Understanding projected returns under those what-if scenarios as well as understanding the impact each scenario has on the entire balance sheet takes time, diligence and patience, but it's the only way to create consistent performance success.

Whenever this topic of adjusting balance sheets to align with forecasts comes up, I am reminded of an ALCO meeting I was directing many years ago. I was still stuck in the same mindset of first justifying the projection, then using projected rates as the basis for balance sheet construction, and then building a portfolio to behave well in that environment. After making the case for a rate move, supplementing my rationale with more graphs and economic background than I had ever before produced for an ALCO group, I confidently presented my construction strategy. But before the strategy went up for a vote, an executive with many more years of experience asked a question I couldn't answer: "What if you're wrong?"

Clearly, I had put all my confidence in the forecast, and my follow-through was based on the assumption that the forecast was perfect. As soon as I was able to regain my composure, I vowed never to be in a position like that again. I

vowed to find a way of building portfolios that would help credit unions avoid the pitfalls of strategizing around predictions and do away with the question: *what if I'm wrong?* That *way* is benchmarking. When credit unions build benchmarks fine-tuned and tailored to their unique needs and goals; when they run what-if scenarios using appropriate, expertly-constructed benchmarks to guide the way, investment decisions are simple and consistent performance success is attainable. Because investment portfolios based on projections succeed and fail with projections, benchmarking your way to success has been proven to be the safer, steadier and more profitable path. For more on the benchmarking process, please see our previous paper, *Performance Optimization for Credit Unions—How to build useful, effective benchmarks.*