

Preface

The investment portfolio is a potential source of significant earnings for banks. However, fully realizing this potential can also pose significant risks. Limiting these risks to acceptable levels is the job of the investment officer (or the chief investment officer or other individual who, regardless of title, has responsibility for investment decisions). The investment officer is also responsible for achieving the bank's investment objectives in a safe and sound manner that fully complies with the provisions of the bank's investment policy.

In the end, the effectiveness with which the investment officer performs is as much a function of his or her knowledge of investment markets and instruments as it is of the regulatory, accounting, financial, and economic forces that affect investment performance. In addition, the investment officer must not only know what all of these areas are about, but also understand how they interrelate. The challenges are:

- To gain the necessary knowledge
- To remain up-to-date as investment markets and instruments change
- To be able to apply this knowledge to make better investment and portfolio management decisions

These are not small challenges. Hardly a year goes by without another innovation in fixed-income securities markets. Step-up securities, floating-rate securities with caps and floors, floating-rate securities with minimum fixed rates, securities callable at almost any time, collateralized mortgage obligations (CMOs) with extension risk protection but no call risk protection, CMOs with call risk protection but no extension risk protection — these are just a few of the changes introduced in the past decade. Indeed, the term “fixed-income security” has become a misnomer with the proliferation of securities that have interest rate-contingent cash flows, such as floating-rate, inverse floating-rate, and step-up bonds. Even though the term “fixed income” is still applied, it's far more accurate to describe these securities as “debt” securities.

How do investment officers cope with all of this? Managers of large portfolios have staffs to help them analyze all of the alternative investment choices. Sophisticated computer models and

mathematical tools are used to pick the most attractive investments. However, the vast majority of bank investment officers must rely on their common sense combined with information and advice supplied by brokers.

Common sense is essential. However, common sense, or an intuitive feel for investment logic, is often inadequate when available investments have so many complex features. Some investment features, which make a complicated product seem like a great deal, are actually far less beneficial than they appear.

It is natural to rely on brokers for information and analysis — especially for complex securities. For the most part, brokers and experienced managers have built long-term relationships based on trust. However, the people selling these securities do not always have the most complete or the most objective information about them. For that reason, it is absolutely essential that bank investment officers understand the information that is provided by brokers.