

AMBASSADOR

A L E R T

2010-1st Quarter

THE AMBASSADOR TEAM

Joshua Albright
Financial Analyst,
Ambassador Financial

Luz (Lucy) Boyer
Administrative Coordinator,
Ambassador Financial

Allen Collins
Managing Director,
Ambassador Financial

Ryan Epler
Vice President,
Ambassador Financial

James R. Gillen
Managing Director,
Ambassador Financial

Timothy J. McDonald
Chairman,
Ambassador Partners

Robert J. Pachence Jr.
Managing Director,
Ambassador Financial

Michael Rasmussen
Managing Director,
Investment Banking,
Ambassador Financial

Matthew T. Resch, CFA
Managing Director,
Ambassador Financial

Eric R. Tesche
Managing Director,
Ambassador Financial

John S. Walker, Ph.D., CFA
Director of Research,
Ambassador Financial

Firm Update

I was out taking a walk with our dog, Haley, last night and sort of lost track of time. I glanced at my watch. It was closing in on eight o'clock but was still surprisingly light out. No doubt about it, summer is on its way. This winter wasn't a bitter one around here, but it was a constant one, cold and snowy and gray. Curiously, though, despite more of a need to shovel the driveway than usual, and than I'd prefer, it was a season that pretty well zipped by. Instead of getting worn down by the relentless weather, the season was so busy in, and out, of the office that in some ways it's sad to see the winter end. I've never really looked at the winter this way before, but those longer nights gave me time to get more done.

It's not just a personal thing though. Winter has been another season of opportunity for Ambassador Financial Group. We are always on the lookout for quality people to add to our organization and we are very fortunate to announce that an old associate of ours, James R. Gillen, has joined us as Managing Director – Business Development. Jim brings to our firm a wide variety of experiences from both sides of the banker's desk. Jim has served as president and CEO of a community bank as well as a senior bank strategist at BancIntelligence.com, where he provided direction and insight to bankers in their quest to improve performance and franchise value.

We are delighted that Jim has joined the team and is out and about sharing his experience and expertise for the benefit of Ambassador Financial Group and our clients.

Allen Collins
Managing Director

JUST HANG ON A LITTLE LONGER... IT WON'T BE LIKE THIS FOREVER (I HOPE!)

While visiting and speaking with customers the past couple of months, I have picked up on a fairly consistent theme—"being tired." Tired of banks still being blamed for everything. Tired of the regulatory environment. Tired of the trading range interest rates are in. Tired of politicians. Tired of sub-par performance. Just tired.

It seems to me that one year ago people were more optimistic than they are now, probably because things were so bad that there was no place to go but up! Ironically, the level of pessimism out there is probably a good indicator that things will be better

soon. It is in times like these that many feel the urge to just "ride it out" or "wait to see what happens." That is clearly understandable. After all, with spreads in all asset classes at or near historic lows and interest rates still pretty unappealing, there are probably few cards up the sleeve, so to speak, when it comes to managing the investment portfolio.

Last quarter we made the argument that the best strategy in this environment was the barbell strategy. We continue to believe that this makes the most sense.

- Continued on page 2



Continued from page 1 -

In addition, there is at least one specific idea that we feel merits strong consideration; even though it is not a "silver bullet," it will help a portfolio at the margin.

One of several interesting events of the past few months was the decision by FHLMC and FNMA to "buy back" the 120+ day delinquent mortgages from MBS pools. FHLMC did this in February and it appears that FNMA will be moving forward in April and May. The result of the FHLMC purchases was prepayments that went through the roof. As one might expect, MBS pools with high coupons were hit hard. However, the asset class that seemed to fare the worst was hybrid ARMs. Because of things like small overall pool size, low loan count, poor geographic composition, and the nature of the hybrid ARM borrower, balances in some pools were cut in half.

Fortunately, many customers were able to sell these bonds before being hit. Some may ask why we would recommend selling a bond to avoid a significant paydown. After all, if you sell a bond, you lose all of it; if you get a paydown, only a portion goes away. There are a few reasons why this was and still is an effective (and arguably essential) strategy.

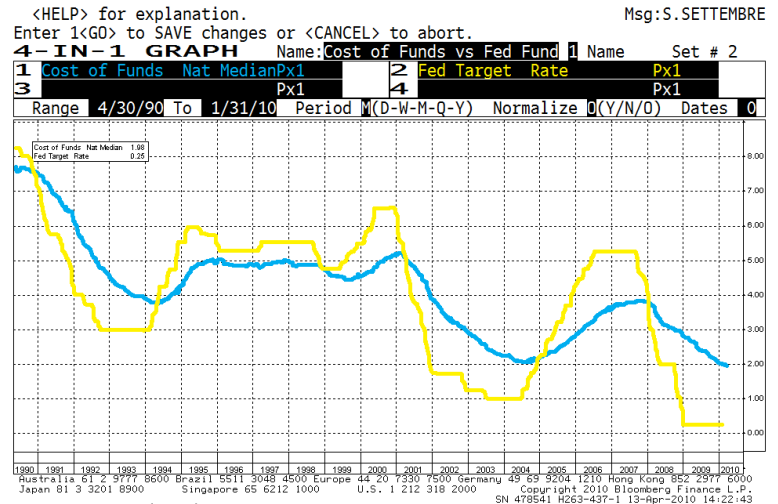
Despite the looming big paydowns, the market was and still is providing very strong bids for this paper. Customers have been and are still able to realize significant profits on many hybrid ARMs. We feel that it is better to sell the bond at a premium and take a profit rather than just wait for the prepayment to come in at par. Secondly, many of these pools are low yielding. Many people were buying hybrids a couple of years ago at healthy premiums with coupons between 3% and 5%. Combine the premium with low coupons and very erratic prepayments and you get an asset that is not very attractive. Third, many of these pools have a coupon reset in the next 12 months or so. However, in almost all cases, the coupon will be resetting down.

The next logical question someone might have is: how is it possible to get strong bids on these bonds given their poor profile? There are two answers to this: one is practical and one is philosophical. On the practical side, there is essentially no new issuance of hybrid ARMs. To create "new" pools, larger firms create pools of pools, i.e., mega-pools. By purchasing these pools and repackaging them with several others, their underlying performance can be somewhat hidden. (Can you sense my cynicism?)

Philosophically, there are still many market participants who believe the hybrid "story." To many salespeople, traders, investment advisors and asset/liability providers, the concept of the hybrid ARM is great. We feel, however, that their performance does not justify their popularity.

Therefore, even though many may think that the cow has left the barn, there is still an excellent opportunity to sell these bonds. The reinvestment will certainly vary from one customer to the next; but speaking generally, moving into 15-year pass-throughs with 4% to 4.5% coupons will smooth out cash flows and, in many cases, be higher-yielding than the poorly-structured hybrid.

Shifting gears a bit, I want to mention the liability side of the balance sheet and fed funds. Obviously, one of the bright spots for institutions is that cost of funds continues to fall. There is concern that this may be coming to an end. Despite this, I think that cost of funds has more room to fall. Below is a look at the relationship between the National Monthly Median Cost of Funds Index (COFI) and the fed funds target rate (FFTR).



Notice the relationship between COFI and FFTR as rates were low in '92-'93 and '03-'04. In both cases, the COFI bottomed out roughly 100 basis points above the FFTR. The COFI is currently 1.98%, and if history were to repeat itself, it could fall another 70 basis points! It seems crazy, but we all have seen wild and crazy things in the past couple of years.

While there has been some speculation recently that the Fed may be moving rates soon, I am not sure the fundamentals justify it. In fact, analyzing the fed funds futures market leads to interesting conclusions. The current probability of a rate hike to 50 basis points at the June FOMC meeting is only 17.2%. It rises to only 21.4% by the August meeting. It is not until the November meeting that the odds are greater for a 50 basis points target than a 25 basis point target (39% versus 33%).

This means that the yield curve will likely remain very steep throughout most of the year. Recently, some institutions have been trying to get depositors to extend out on the CD curve by offering specials. This can often be

- Continued on page 3

a difficult and expensive endeavor. With the possibility that rates may be at these low levels for awhile longer and most banks' cost of funds will continue to fall (with no rate wars on the horizon), running CD specials in the 2-3 month range may be a better strategy.

This environment has been challenging for everyone and nothing seems to come easy anymore. One year ago

we were just a few months removed from Armageddon that seemed likely at the end of 2008. Unlike now, the spreads on many assets back then were very wide. It certainly has been a grind lately and it is getting tiresome. Despite this, there are still some strategies to employ to improve portfolio performance that may not be there in the next several months. We won't be in this situation forever, I hope. In the meantime, don't just "wait to see what happens."

Eric R. Tesche
Managing Director

Top Ten Things a Community Bank Can Do to Destroy Shareholder Value

The title of this article will tell you two things about the author. First, I am a fan of David Letterman's Top Ten List, and, more importantly, I care about community banks. This article is the outgrowth of watching a merger that closed this month. The target institution had been a well run community bank for many years. By the time this transaction was announced, this institution was in bad shape and needed to find a buyer. What circumstances caused the change in this institution? The following Top Ten List is one man's opinion on some of the issues that may have affected the target institution.

Being bankers, the audience should be accustomed to disclaimers. Here is mine. All of the information used to form my opinion is publicly available. I have never pursued the target institution as a client within my investment banking practice. My interest in authoring this piece is to educate other community bankers. Please enjoy my list.

TEN – *Over-compensate your investment banker*

Let's start with an easy one. According to SNL Securities, the target institution will pay an investment banking fee of approximately 2.2% of the total transaction value. Sell side investment banking fees average 1% of total transaction value. An acquirer will always review transaction expenses within its due diligence and adjust the pricing for the transaction accordingly if actual expenses differ from assumed expenses. For that type of fee, the investment banker should conduct a thorough due diligence review that is more than a conference call, which was the case in this deal.

NINE – *Waste managerial resources on the TARP program*

According to the "Background of the Merger" section of the prospectus, the target institution pursued TARP funds

for approximately six months beginning in November of 2008. The institution's efforts during this period should have been focused on creating a transaction with a strong partner.

EIGHT – *Deal with private equity in a naïve manner*

The dilutive effects of a private equity investment in the target institution during the first half of 2009 would have been devastating to existing shareholders. From an existing shareholder's perspective, it was fortunate that the investment banker was unable to find a private equity investor.

SEVEN – *Acquire another institution while your own house is not in order*

How this rule gets violated always amazes me. The acquisition of another institution puts additional pressures on the human resources of the buyer. Resolution of troubled assets also requires the time and effort of management. Too full of a plate causes bad execution throughout the organization. Continued bad execution will cause problems with the regulators. Lights out.

SIX – *Engage investment bankers that claim to be able to solve all of the institution's issues*

According to the "Background of the Merger" section of the prospectus, the target institution retained an investment banker during the first quarter of 2009. The investment banker is an industry leading firm who most likely pitched their ability to: a) sell distressed assets; b) manage and improve the institution's regulatory relationship; c) identify and promote investment by private equity players; and d) manage and run a sales process that

results in the greatest value to shareholders.

In my opinion, the target institution received poor execution from its investment banker on all fronts. It would seem that the first three tasks were unsuccessful. Concerning the fourth, the acquiring institution initiated discussions and drove the process, maintaining the superior negotiating position throughout the process.

FIVE – *Hire executives that are not actively engaged in the institution's service area*

Community banks are relationship driven enterprises. Especially on the commercial side, many commercial customers do business with their bank due to a relationship with an executive who has an in-depth knowledge of the customer and its marketplace. An executive who has not been engaged locally can not offer this knowledge to the customer.

FOUR – *Maintain a credit rating system that is not in sync with your regulator*

One has to assume that this was the case at the target institution. As of the end of the first quarter of 2009, the target institution reported the following asset quality ratio: nonperforming assets and those 90+ days past due as a percentage of total assets were 1.58%. Information contained in a press release from the target institution would suggest that the OCC was not of the same opinion concerning the institution's asset quality.

THREE – *Sell the institution from a position of weakness*

The first rule of deal-making is to sell from a position of strength. This was not the case in this transaction and the deal pricing proves this point. The announced per share purchase price is approximately 28% of the 52-week high

at the time of announcement. The publicly available information suggests that the target institution really had no other option to pursue than to sell.

TWO – *Grow the commercial real estate portfolio too aggressively*

This strategy has and will ultimately always be a destroyer of value for community banks.

Now, for the #1 thing a community bank can do to destroy shareholder value...

ONE – *Fail to groom a successor for the chief executive officer*

The typically stated reasons for this occurrence are numerous: lack of talent at the next level of management; lack of resources within the business model to retain talented individuals; lack of long-term leadership at the board level to demand identification and mentoring of successors; or the inability of an outgoing CEO first to delegate responsibility and ultimately to pass on the leadership role. It is unknown by outsiders if any of the above stated circumstances were at work at the target institution. What is known is that the target is no longer a strong independent community bank, which is a shame.

I hope that this article has shed some light on a very serious topic. I also hope that the lighthearted style of the article does not cause any banker to miss the importance of these mistakes that can occur. Errors in managerial judgment, like the ones cited above, will destroy a community bank's value. Thank you for taking the time read my Top Ten List; I imagine you have your own ideas that can add to my list. Whether you agree with my list as presented or have your own, make sure you do not engage in any of these value-destroying actions.

Mike Rasmussen
*Managing Director,
Investment Banking*

2010 First Quarter Market and Economic Recap

It is absolutely remarkable how far the markets have come over the past year. That phrase is one you have heard more than once from me during the meteoric rise of the U.S. equity markets, and the equally impressive inexorable tightening of spreads in the credit markets. That trend continued in Q1 2010, marking the fourth consecutive quarter that the major U.S. equity indices registered gains. To be specific, the Dow, Nasdaq, and S&P 500 experienced gains of 4.1 percent, 5.7 percent, and 4.9 percent, respectively. More notable have been the gains witnessed since equities bottomed on March 9, 2009. Since that dreadful day last year, the Dow, Nasdaq, and S&P 500 are up 65.8 percent, 89.0 percent, and 72.9 percent, respectively, which can only be described as once in a generation type returns.

In regards to the credit markets, the aforementioned tightening of spreads has continued in both the high grade (investment

grade) and high yield arenas. Tighter spreads are ubiquitous across the credit spectrum, marking a return to normalcy in markets that were dysfunctional not so long ago. To put these spreads into context, the Markit CDX North American Investment Grade Index, which measures a basket of 125 investment grade 5-year corporate debt issues across various sectors versus treasuries, closed at 88.1 basis points at quarter-end. Compare this to the record high spread of 279.3 basis points registered on 12/5/08. In the high yield space, the Markit CDX North American High Yield Index, which measures a basket of bonds issued by 100 non-investment grade entities versus treasuries, closed the quarter at 552.9 basis points, compared to its high of 1924.6 basis points witnessed on 3/9/09. At the end of the day, traders of

corporate debt have been knocking the cover off the ball with the tightening that has occurred. More importantly, history suggests that tighter credit spreads, particularly to the degree this market has experienced, portends marked future improvements in the labor markets going forward. Only time can prove this to be true, but we appear to be on the right path.

As a result of much better functioning equity and credit markets, corporations—both large and small—across every sector have been able to sure up their respective balance sheets by coming to market with IPOs, secondary equity offerings and a record amount of debt issuance. Excess liquidity coupled with investor confidence has created insatiable demand for risky (spread) assets, and companies are taking full advantage of this. Interestingly, there is even talk that a few leveraged buyout (LBO) deals are in the works. LBOs were unthinkable over the past 24 months during this credit crisis; so this speaks to how far the markets have come. The fact that private equity can now borrow on a large scale to fund deals is incredible. Ultimately, I'm not sure the advent of LBOs is a good thing as excess leverage created this recent crisis. However, deal flow is excellent for the markets, the restoration of confidence, and the recovery of wealth. And one can only hope that the terms of the LBOs are prudentially more responsible.

While the economy has not experienced the same gains as the market, there continues to be a general uptick in economic activity. Intuitively, this makes sense as the markets traditionally act as a leading indicator, auguring future improvements on the economic front. To be precise, the most recent fourth quarter GDP revision was 5.6 percent, signaling a significant acceleration in economic growth. Moreover, the consensus forecast among economists is to grow at roughly 3.0 percent for 2010. In addition to GDP, other indicators from consumer spending to retail sales suggest that economic activity is on the rise. ISM Manufacturing, which measures the change in manufacturing activity on a monthly basis, also tells a similar story. Its most recent reading of 59.6 on 3/31/10 was the highest since July, 2004, and the graph below suggests that

50 suggests that the economy is contracting. In addition to the metrics mentioned above, it is also important to note that actual inflation and inflation expectations remain well anchored.

On the flip side, however, not everything is rosy in the U.S. economy and many headwinds remain. While the the employment picture has stabilized, the fact remains that the recovery to date has been jobless. The unemployment rate remains awfully close to the 10 percent level, and the job growth that many expected has yet to develop. On a positive note, the change in non-farm payrolls released April 2, 2010 did indicate the first meaningful pick-up in jobs in some time. While some expect job growth to accelerate throughout the year, the unemployment rate might actually drift a little higher as workers re-enter the workforce. More importantly, the U-6, which is a broader measure of unemployment capturing those workers who have given up looking for jobs as well as part-time workers who seek full-time employment, remains elevated at 16.9 percent of the workforce. That number is astounding and speaks to what remains a difficult task in improving the economy over the long term.

In addition to the weak employment picture, the residential housing market continues to remain tenuous at best. While price declines have bottomed and, in some instances, prices in certain markets are on the rise, the outlook remains weak. The government has thrown everything under the sun to ignite the housing market, from tax credits and artificially low mortgage rates to loan modifications and foreclosure moratoriums. While the net impact of these programs has helped, it hasn't remedied all the problems. Oversupply, a weak consumer, and lack of access to credit remain concerning issues, and one shouldn't be surprised if housing experiences another modest decline once the government removes the punchbowl. These government initiatives have created nothing more than a moral hazard. Ultimately you and I, and the rest of the American taxpayers, will pay for the losses on Fannie Mae's and Freddie Mac's books in bailing out overextended borrowers and fraudulent lenders. Perhaps that is our social obligation, but I'll reserve those comments for another day. Throw in the looming commercial real estate overhang and I think it is a bit premature to grant this economy a permanent stay of execution.

On the interest rate front, the yield curve remains historically steep with the 2-year/10-year spread closing the quarter at 280 basis points. Recall that a steep yield curve historically portends higher short-term rates, but not necessarily higher longer-term rates. To that end, many people continue to make the broad statement that interest rates are going to rise without qualifying the rate term. The curve very rarely moves in a parallel fashion and the long end has already moved considerably which explains the steep curve. (Please visit the following link to view the fourth quarter Ambassador Alert article "Is It Soon Time to Shift Strategy" authored by Eric Tesche to gain a historical perspective on this phenomenon: http://www.ambfg.com/Portals/15/News/Ambassador_Alert_for_Web.pdf).

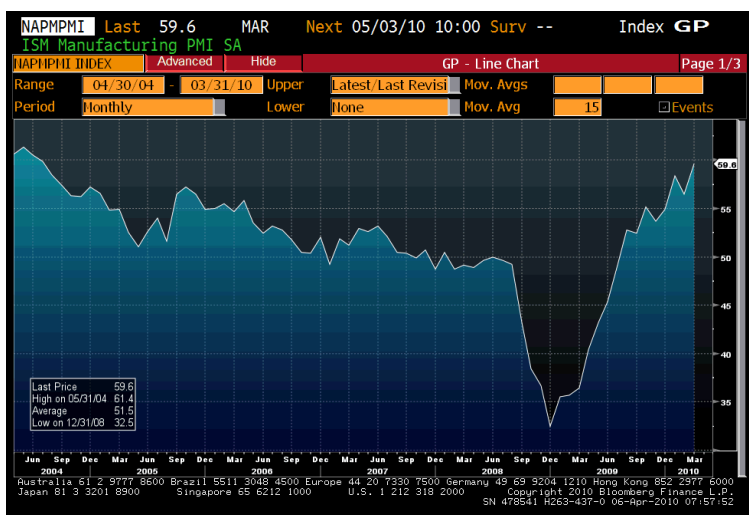


Image source Bloomberg Finance

the economy is poised to experience a "V" shaped recovery. To put this economic metric into context, a reading above 50 suggests that the economy is expanding, while a reading below

In the current environment there is an interesting tug-of-war occurring amongst traders and market participants concerning the outlook for treasury yields. Some are calling this the end of the great treasury bull market, while others believe treasuries are the safest place to be. This tug of war is really a battle between monetary policy and fiscal policy. On the monetary policy front, the Fed can maintain “exceptionally low rates for an extended period,” as inflation remains tame and economic conditions remain dicey. From a pure economic and monetary policy perspective, I believe longer-term treasuries, as measured by history (see “Is it Soon Time to Shift Strategy”), could remain where they are as the Fed tightens and the curve flattens. I can’t foresee sustainable economic growth reaching a level for years that would warrant significantly higher short-term rates, let alone significantly higher longer-term rates. Interestingly, and as an aside, the weaker outlook for the euro, given the problems in Greece, has strengthened the U.S. dollar in relative terms, which is anti-inflationary. A stronger dollar would help thwart inflation, allowing the Fed to maintain lower interest rates.

On the fiscal policy front, however, sovereign debt issues are now front and center, and the rising U.S. deficit has many concerned. In the last full week of March, the U.S treasury auctioned \$44 billion two-year notes, \$42 billion five-year notes, and \$32 billion seven-year notes, all of which matched prior records set for debt issuance. Unfortunately for the U.S., the auctions were the weakest ones received in some time, causing many to question the future outlook for yields. The bond vigilantes, at some point, might drive yields higher in light of the fiscal irresponsibility displayed in Washington. With record-matching treasury auctions taking place essentially every other week, it won’t take long for the vigilantes to make their mark. It is also interesting to see the comments from PIMCO head, Bill Gross, about the outlook for a “united credit market.” His point was that with growing fiscal deficits, sovereign debt would begin to trade like credit, meaning their yields would converge with riskier assets. This is already being witnessed in the markets as corporate issues such as Berkshire Hathaway, Procter & Gamble, and Johnson & Johnson have been trading at a negative spread to treasuries. In addition, seven and ten year swap spreads traded negative to treasuries towards the end of the first quarter. Both of these phenomena are extremely rare in the history of the credit markets, but

when people fear the backstop (i.e., the U.S. government) is less than 100% creditworthy, whacky things can happen.

This push-pull between treasury investors will be interesting to follow in the coming weeks and months and will prove critical to the longer-term outlook for the economy and the markets. In the short-term, the cyclical economic recovery trumps the longer-term implications to the fiscal issues. I would not be surprised to see U.S. equity markets continue to move higher in the second quarter, nor would I be surprised to see credit spreads tighten further as excess liquidity gets invested. However, the rubber will meet the road at some point on the fiscal front. One can only hope that the private sector continues to improve and that our growing fiscal deficit begins to decline. Unfortunately, that requires faith and confidence in our government, which I lack at the moment. That being said, enjoy the run that we are on as it won’t last forever.

Matthew T. Resch, CFA
Managing Director

DISCLOSURE:

Nothing presented herein is an offer to sell, nor the solicitation of an offer to buy an interest in Ambassador Opportunity Fund. Any such offering can only be made pursuant to the Fund’s offering circular. In addition, the information presented is for informational purposes only. This is not an offer or solicitation to purchase or sell any security through Ambassador Financial Group, Inc., a current member of FINRA/SIPC. For more information contact us at 610-351-1633