



Current Thoughts on Recent Bank Failures

You are probably already aware that the second largest bank failure in U.S. history occurred on Friday when California state regulators halted the operations of **Silicon Valley Bank (SVB)** and placed it into receivership. On Sunday New York regulators did the same for a self-proclaimed crypto-currency specialist called **Signature Bank**. This note seeks to highlight potential ramifications for the asset markets based on the current state of this evolving development, and it seeks to clarify where we stand with our investment strategies.

No Need to Panic

Fortunately, regulators have already taken an important step to limit the risk of a systemic panic. Specifically, the FDIC confirmed that depositors of these two failed banks will be made whole, and more importantly, the Federal Reserve has opened a special lending facility for banks that allows them to pledge U.S. Treasury and agency securities (of which banks own *trillions*) as collateral for loans at 100-cents on the dollar, regardless of the current market price of the securities being pledged.¹ This is a big deal because it strikes at the root of the problem in the banking sector right now (more on this below).

To use Silicon Valley Bank as an illustration, the collapse of this bank had nothing to do with bad loans. This is *not* like the Global Financial Crisis in 2008, which was driven by stupid loans going bad throughout the real estate sector. Today's problem is all about interest rate risk, rather than credit risk, which might make it easier to resolve.

SVB suffered from an extreme version of a balance sheet mismatch problem that affects all banks today to some degree. In brief, the primary liability on a typical bank balance sheet – customer deposits – does not change in value when interest rates rise by 450 basis points in less than a year, as just happened in the U.S. credit markets. However, the value of a typical bank's assets – loans to customers and U.S. Treasury and agency securities – can drop *a lot* when interest rates jump by 450 basis points in a year. Indeed, longer-maturity Treasury and agency securities have collapsed to 70-80 cents on the dollar today, from 100-cents on the dollar barely one year ago. And these are bonds with *zero credit risk*.

Banks are required to mark their securities portfolios to market every quarter and report these values in various places on their financial statements (specifics vary based upon a categorization framework that is not necessary to describe for this note). This means that the *unrealized* losses on a bank's bond portfolio are available for anyone to see. System-wide, the losses are enormous because the move in interest rates has been enormous.

¹ Source: Federal Deposit Insurance Corp. (FDIC) and the Federal Reserve; March 12, 2023

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In the case of SVB, it went bust because it had a much higher than normal concentration of Treasury and agency securities on its balance sheet (relative to loans), and the unrealized loss on these securities reached a magnitude that exceeded the bank's regulatory capital requirement. Importantly, SVB did not collapse until a wave of withdrawals from its depositors *forced* the bank to sell many of its bonds, thereby converting what had been unrealized losses into realized losses on the balance sheet.

Why the Fed's Move on Sunday Matters

Within reason, banks can withstand unrealized losses on their balance sheet indefinitely. However, when these losses are crystalized through a sale, or a write-off, the regulatory capital of the bank becomes impaired. The Fed's new lending facility is important because it provides a mechanism for banks to meet the withdrawal requests of their customers (again, within reason) without selling bonds at a loss. Instead, banks can now pledge their Treasury and agency securities as collateral for a loan from the Fed at 100-cents on the dollar, regardless of the market price of the bonds being pledged.

The Fed is hopeful, as are we, that a combination of reassurance for depositors in the failed banks, plus this new mechanism to prevent banks from becoming forced sellers of their underwater bonds, might be enough to prevent depositors at other banks from triggering another bank run. The answer to this question should become clearer in the next few days.

Near-Term Impact on Our Investment Strategies

Managed Equity Strategies: We have been concerned about the possibility of something breaking in the financial system due to the rapid Federal Reserve tightening, without knowing the exact shape such a breakage would take. We purposefully limited our risk exposure, including recent sales of positions with material private equity backing.

One major effect of the banking crisis is the reduction of interest rates as well as expectations for Federal Reserve tightening. We believe this environment favors a quality growth orientation. Well-capitalized growth stocks tend to do well during periods of declining interest rates and relative Fed support. Since the crisis began, the *Managed Equity Dividend* strategy has performed in-line with or better than its benchmark and the *Managed Equity Growth* strategy has outperformed its benchmark and the broader stock market.²

The most direct impact in our Managed Equity strategies is bank stocks, where the news is mostly encouraging. We only have one bank stock each in these two strategies – **JP Morgan** in *Managed Equity Growth* and **Fifth Third Bank** in *Managed Equity Dividend*.

² Source: Bloomberg; Orion; Measured from 03-08-23 to 03-13-23

JP Morgan is arguably a net beneficiary of the recent turmoil in the banking sector due to its status as a safe haven for depositors seeking a more stable home for their banking needs. Indeed, JP Morgan's share price reflects this dynamic, having outperformed the *S&P Regional Bank Index* by approximately 22 percentage points over the past 30 days.³

Fifth Third's management recently reiterated its quarterly outlook and emphasized the company's conservative structure. The stock has performed in-line with the *S&P Regional Bank Index* over the past 30 days, which unfortunately means it is down about 29% over that period.⁴ We intend to keep the position in Fifth Third for at least the next few days to see how depositors react to the recent regulatory support for the sector. At this time, we would not rule out the possibility adding to the position at some point, but we also remain open to the possibility of selling it.

Whatever we do with Fifth Third, we believe patience is warranted in the very near-term because it is a much different bank than SVB (or Signature) in multiple important ways. First, its deposit base is comprised of more than 60% insured deposits (versus roughly 10% at SVB).⁵ This is important because Fifth Third's insured deposits are smaller (less than \$250,000), more diverse, and they have no incentive to transfer because they are under the FDIC insurance cap. The opposite was true at SVB, where it was *rational* for its large deposit holders to flee at the first hint of trouble.

Fifth Third is also broadly diversified on the asset side of its balance sheet, with loans sprinkled throughout in the prosperous regions of the Midwest and Southeast, and one of the smallest exposures to commercial real estate among regional peers.⁶ In contrast, SVBs asset base was dominated by securities that must be marked to market, and the loans SVB did originate were dominated by one sector – venture-backed tech.

On the intangible side of the ledger, Fifth Third management is conservative, as indicated by one of the most transparent financial reporting structures in the banking sector. For example, Fifth Third categorizes its entire securities portfolio as "Available for Sale" (AFS), as opposed to "Held to Maturity" (HTM). Mark-to-market changes in AFS positions must be reported in the income statement every quarter, whereas HTM securities need only be reflected in earnings when they are sold. The cynical term for HTM securities is "Hide to Maturity." Unfortunately, this dynamic causes Fifth Third's unrealized losses to look larger than many peers who use HTM more extensively, but it is an apples-to-oranges comparison in most cases.

³ Source: Bloomberg; Total returns include dividends for JPM and the index for the period 02-13-23 to -3-13-23; JPM - 7.6% vs. index -29.2%

⁴ Source: Bloomberg; 02-13-23 to -3-13-23

⁵ Source: Company Filings; Wall Street Journal; Bloomberg

⁶ Source: Company presentation

Looking at other potential holdings that have exposure, we highlight is **Brookfield Asset Management** in the *Growth* strategy, and **Ares Capital Corp** and **Blackstone** in the *Dividend* strategy. We believe each is very well capitalized with major financial backing. In the near-term at least, we expect private equity lending activity to slow, but these companies are also designed to take advantage of financial disruptions when they happen. We suspect they will have opportunities to do so again this time. It is also worth noting that we reduced the allocation to these stocks materially last year in preparation for possible underperformance during a Fed tightening cycle.

Fixed Income: All of our fixed income strategies have performed well in the wake of last week's bank failures because interest rates have declined materially across the entire yield curve. We accentuated the benefit of this move in rates in the two bond ETF models by lengthening the average maturity of these strategies last Thursday – literally *hours* before the wheels came off at SVB. To the extent the fragility of the banking sector causes the Fed to rethink the trajectory of its interest rate policy, this decision to lock in attractive interest rates for longer may prove beneficial.

Dynamic Allocation: The Dynamic Allocation strategy made an incremental shift toward caution last Friday when it reduced its allocation to the *S&P 500 Index* from 40% to 10%. The risk market sectors within this strategy get reviewed weekly for a possible change. We expect more risk market sectors to come out of the portfolio in the coming weeks if financial markets continue to wobble during this timeframe.

Macro Considerations

The most striking macro consideration we are assuming right now is a likely tightening of credit standards throughout the economy. At the venture capital end of the spectrum, SVB claims to have been the banker for almost half of all initial public offerings and SPAC listings in the last two years.⁷ It goes without saying that the removal of an intermediary of this magnitude should be a wet blanket on startup and private equity capital formation for some time.

Regarding traditional bank lending, there are two ways to replenish capital on a bank's balance sheet. One way is to raise new equity capital. This is what SVB tried to do, but word of the equity sale literally triggered the run on the bank. Needless to say, other banks may be reluctant to try their luck at an equity raise for a long time. The more traditional way replenish bank capital is to make fewer loans.

The next few days should be telling in terms of magnitude, but a material tightening of credit conditions throughout the economy seems inevitable after last week. This should result in a less vibrant economy for the foreseeable future with implications for security selection and risk management across all our strategies. We will keep you posted as best we can.

⁷ Source: Company presentations

Disclosures

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The **S&P Regional Bank Index** seeks to track the performance of publicly traded domestic regional banks.

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