Alexis Investment Partners, LLC
Practical Tactical

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AIP Update – Our thoughts on bank failures and market volatility

We hope this message finds you well and that you find this information helpful. Friday's failure of Silicon Valley Bank (SVB) and subsequent market turbulence was a big enough news event to prompt us to share some background and thoughts along with our current assessment of broader implications.

Rest assured that we were not invested in SVB and had no direct exposure to SVB. We do feel for SVB employees and are disappointed by the bank's failure. When we talk about, "tighter financial conditions," we are generally referring to higher borrowing costs and less options to get loans. Bank failures are both a symptom and a cause of tight conditions.

We expect that the loss of SVB and pressure on regional banks more broadly may contribute to slowing growth. That said, this is a sign that the Fed is nearing the end of the current tightening cycle, which has historically been good news for investors. In other words, we are concerned about slowing growth but less worried about near-term stock market volatility.

We were concerned about SVB customers Friday, but those issues were addressed this weekend when the Fed and FDIC committed to provide liquidity to all depositors regardless of their balance and to the broader banking system if needed.

Is there anything we need to do now?

In case you don't read through this full message, we'll state up front that for most of our clients, the only suggestion we have at this time is to continue to communicate with us with respect to any concerns or liquidity needs. If you were hesitant to add to your investments when the market was falling last year, this pullback is giving you another opportunity to buy good companies at relatively cheaper prices. This is possibly also a good time to consider Roth IRA conversions.

Who was Silicon Valley Bank?

Founded roughly forty years ago, Silicon Valley Bank was best known for serving start-up and venture capital firms and founders. SVB was not just a niche bank. It was the 16th largest lender in the US with $200 Billion in assets. Its failure was the largest since the Great Financial Crisis (GFC) and the second largest in US history.

Like most banks, SVB served both individuals and businesses, both as a place to deposit funds and by providing a broad range of loans and services. One unique feature of SVB is that it catered to very wealthy depositors. It is estimated that as much as 90% of SVB deposits were uninsured. That's very different from most banks.

Why did SVB fail?

Banks take in money from depositors and profit by issuing loans. When banks have more deposits than loans, they also invest in bonds (mainly treasury bonds and mortgage-backed securities). SVB experienced rapid deposit growth in the last few years - before the Fed started raising interest rates. The mistake SVB made was that they invested a significant portion of these deposits in longer duration bonds at very low yields. When interest rates rose, these bonds declined in value.

Normally, SVB could have held these bonds until they matured at full value and avoided realizing losses. The problem with this happens when the bank needs to sell bonds prior to maturity. Sales then take place at market value and losses are realized, at which point the bank needs to raise capital to meet regulatory requirements.

Last week, SVB decided to sell its bond portfolio and raise capital through a share offering to avoid a credit rating downgrade and strengthen liquidity. This backfired as depositors grew concerned about liquidity needs and pulled significant cash out in a “run on the bank”. SVB was unable to raise capital and was forced into FDIC conservatorship.

What happens next?

Normally, FDIC insurance is limited to deposits up to $250,000 per depositor, per FDIC insured bank, per ownership category. Regulatory action this weekend expanded this protection to all depositors and put resources in place to allow banks that would otherwise need to sell bonds to instead provide those bonds at par value as collateral to the Fed in exchange for one year loans to meet any liquidity needs.

Although depositors can feel secure, meaning that businesses will be able to process payrolls and expenses as usual and individuals have full access to funds, SVB stock and bond investors will face losses. It is too early to know the full extent of those losses as that depends on the sale of SVB’s assets. These may be sold over time by the FDIC, but the most common outcome is that another bank will eventually purchase SVB in a deal brokered by the FDIC.

More broadly, bank stocks are pressured this morning, but we expect this should subside in the next few days as depositor confidence improves. It is difficult to know how potentially greater costs might hurt bank earnings, but stock prices have probably already priced in more damage than most will realize.

Why is this run/failure impacting the stock prices of so many other banks?

Most of the spillover appears to be panic due to uncertainty, which is normal considering such a large failure could happen this quickly to a large, well-established bank. Most banks have less leverage, shorter-term portfolios and a broader depositor base (mainly serving customers with balances conforming to FDIC limits) and are therefore less susceptible to runs.

Perhaps more relevant is that the Fed has made it clear that depositors don't need to move away from regional banks for fear of loss. Some banks may face runs, but they will have unlimited liquidity to meet withdrawals.

How is this impacting our investment thesis?

We currently view the failure of SVB as evidence that financial conditions have tightened, and we are near the end of the current Fed tightening cycle. The Fed's action this weekend should be sufficient to stem contagion, but it will take time to know the full repercussions in terms of bank regulations, profitability, and overall financial conditions.

The negative reaction from markets has been notable, and it may take time to restore confidence. Positive trends remain intact, and this continues to look more like a correction / buying opportunity than something more ominous.

We are always looking for ways to invest opportunistically within the context of a disciplined long-term strategy consistent with risk and return objectives. Sometimes we tactically turn more defensive. At least for now, this is not one of those times.

One of the reasons we have been so negative regarding low yielding bonds over the last years and focused on very short-term treasury bills more recently is that we view liquidity as a critical component of successful investing. Although our clients are primarily individual investors and small businesses that aren't subject to bank runs, circumstances change over time and bonds are supposed to represent the part of portfolios that can be used to meet cash flow needs at any time (especially during periods of market volatility). As yields rise, it makes sense to diversify our fixed income holdings. We still see this as premature, and our fixed income allocation remains very conservative.

Other considerations:

If you have money in bank accounts in excess of FDIC limits, this may serve as a reminder that banks can fail quickly. Considering that you can purchase short-term US treasury bills yielding 5%, it's difficult to justify holding large balances in low yielding bank accounts.

Schwab stock has been under pressure, in part because Schwab also owns bonds on its balance sheet that have lost value. We continue to believe Schwab is in a very different position than SVB, in part because Schwab has seen record inflows of capital including last week – but mainly because they are much more broadly diversified. We are happy to discuss this further if you have any questions or concerns.

We also think this is a good time to remind our clients that coverage from SIPC and the FDIC only pertains to cash. Investments in stocks, bonds, ETFs, and mutual funds (including money market funds) are assets that you own and if something were to happen to Schwab – which we do not anticipate – those investments would remain yours and not subject to creditor claims. Market values would surely be volatile in the event of a Schwab failure, but your accounts with all of your holdings would ultimately transfer to another custodian.

As always, we welcome your questions and comments. Please note that we can only speak to what we can observe today. If things change as we get more information in the weeks ahead, we will send updates.

Best wishes and warm regards,

Jason Browne

925-457-5258

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