March 14, 2023 - Tandem Investment Advisors, Inc.

tandemadvisors.com/notes-from-the-trading-desk/march-14-2023

March 15, 2023

MARKET MOVERS & SHAKERS

Normally we start Notes by discussing the market movements of the past few weeks. This week, we are going to change that up just a bit. Instead, we are going to talk about the 800-pound gorilla in the room – banks. In the past week, the 128th, 16th, and then the 29th largest banks (according to the Federal Reserve's year end list of commercial bank assets) have all shuttered their doors. The reasons were varied to an extent, though the symptoms were largely the same. Either way, we haven't seen bank closures like this since the heart of 2008. First, Silvergate, a crypto friendly bank, announced on Wednesday that it would be closing its doors and liquidating its assets while making depositors whole. Silvergate found itself in the midst of a DOJ investigation into fraudulent dealings with FTX and Alameda Research. The crypto lender had a dramatic fall from its lofty price of $220 in late 2021. Perhaps an even steeper, and a more significant, fall from grace was SVB, or Silicon Valley Bank. The failure of SVB marked the largest failure since Washington Mutual in 2008. More on SVB in a bit though. On Sunday night, it was announced in a joint press release from the Federal Reserve and the Treasury Department that regulators would seize Signature Bank. The failure of Signature marked the third largest failure since 2008. Signature and SVB both had large deposit bases that were not insured by the FDIC, which left them more susceptible to a bank run. Unlike the Financial Crisis, these three banks failed due to a classic bank run. Silvergate and Signature were certainly hampered by their crypto exposure as well. But the issue for all three was simply deposit outflows. Like George Bailey in It's a Wonderful Life, there was simply a run on the bank. During the Financial Crisis, banks failed and/or suffered largely due to shaky balance sheets full of low quality and worthless assets – it was a credit crisis that stemmed from irresponsible risk management. Luckily, that is not the case today. There is no issue with the quality of the assets that were on SVB's books. In fact, a lot of its portfolio was actually made up of Treasuries. The issue was really in the risk management of duration, not credit quality, within the bank's portfolio. SVB, like many others, took on excessive duration risk, which when coupled with rising rates and panicky depositors led to a failure.

It's not just the panic-stricken depositors withdrawing their funds that should be blamed. There is plenty of blame to go around. SVB saw its deposits balloon over the past few years. Deposits grew from just under $50b in 2018 to nearly $190b by the end of 2021. Its deposits grew 65% in 2020 and then another 85% in 2021. That's far from normal. That outstripped the ~22% growth in 2020 and 11% growth in 2021 that the Federal Reserve reported across all commercial banks. Part of that swell in deposits was a result of the Fed's easy monetary policy and the COVID-era fiscal policy (think PPP loans and stimulus checks) that led to a financial system flush with cash. Seemingly all banks benefitted from the flux in cash following COVID-era policies, but SVB really got a two for one. The company benefitted just like other banks from the increase in deposits following stimulus, but it also catered a significant portion of its business to the startup and VC community. Valuations experienced a huge tailwind during the period of easy financial conditions. With tech, startups and VC all dramatically benefitting from higher valuations, these communities became even more flush with cash, which in turn swelled SVB deposits even more. SVB really was just a product of its environment that was arguably fostered by keeping rates too low for too long and by excessively easy financial conditions. Prior to 2022, yields were at extreme lows – which really hurt the profitability of many banks. Banks were unable to find attractive yields to generate profit. In search of yield, SVB (in hindsight irresponsibly, though hardly alone in doing so) extended the duration of its portfolio to generate a higher yield. QE starved banks of yields, and in turn encouraged this sort of risky behavior as banks went in search of profit. From 2016 to 2022, SVB's duration increased from 2 years to 5.7 years. Duration will be higher with longer maturity and duration will be higher with low yields – and SVB was two for two on those counts, extending its duration while in a low rate environment. Generally speaking, as duration increases, price becomes more susceptible to larger fluctuations. Per BlackRock, "As a general rule, for every 1% increase or decrease in interest rates, a bond's price will change approximately 1% in the opposite direction for every year of duration." In its 10-K at the end of 2022, SVB reported a duration of 5.7 years on its fixed income securities. Thanks to inflation and the Fed's aggressive hiking cycle, the 10-year Treasury increased from 1.5% at the end of 2021 to more than 4% by the end of this past February. The rapid rise in rates meant that SVB, as well as plenty of other banks, was sitting on a bunch of unrealized losses. Unrealized losses would not matter unless the bank needed to sell some of its portfolio to meet demand. Meanwhile, SVB's deposit base was contracting. All of a sudden, folks didn't need to leave their cash in a deposit account, they could go purchase T-Bills and get a higher yield than what a bank was offering. Again, SVB was sort of hit with a two for one – this time it was just to its detriment. As yields rose over the past year, valuations contracted. This led to lower valuations amongst startups, which led to a reportedly higher cash burn rate. As startups were burning cash, they were drawing down on their deposits. As deposits contracted, SVB needed to liquidate some of its portfolio, which in turn led to the realization of those losses and a need to raise capital. As the losses mounted, depositors became worried and began pulling their money, thus the vicious cycle was well under way. All that culminated with the failure of SVB, and incredible volatility among other regional banks.

Given the failure of three large banks – one really may have expected a market that was much worse for wear. Outperforming sectors last week were the traditionally defensive plays – staples, utilities, healthcare, and tech. The conventionally more cyclical sectors like energy, materials, and consumer discretionary all trailed the market – financials were obviously the worst performing! Quietly, some concerns around commercial real estate have been building in the market, but it was overshadowed by banking issues. REITs were down nearly 7% for the week and the weakness could easily be found amongst office REITs. There was some flight to safety later in the week as a rush into Treasuries led to a quick drop in yields. In fact, the 2-year U.S. Treasury only dropped more quickly during 9/11 and Black Monday in 1987 – not great company. Similarly, the market went from pricing in a 50-bps hike out of the Fed following Jerome Powell's congressional testimony last week, to some now clamoring for rate cuts.

TRANSITION UPDATES & NEWS **

The volatility towards the end of the week provided ample opportunity to put cash to work in new accounts or recent deposits. On the news front, ICE's attempted takeover of Black Knight is facing some regulatory hurdles as the FTC is set to challenge the purchase. The FTC is concerned that the acquisition would lead to a near-monopoly in loan-origination software. This ultimately led to Black Knight and ICE agreeing to sell Black Knight's Empower loan origination software system. However, the FTC did not think that the proposed sale would address the "anticompetitive effects" of the merger.

At the strategy level, we added to a long-time holding in Brown Forman on Friday afternoon. Brown Forman produces and distributes alcoholic beverages under a variety of well-known brand names such as Jack Daniels, Woodford, Old Forester, El Jimador, and Herradura. Brown Forman was purchased in all three strategies. The stock has now increased its cash dividend for 39 consecutive years. We also had the opportunity to add to our position in Akamai in our Equity strategy.

***The transition update describes activity taken by Tandem on the transition level, not the composite or firm-wide level. The transition update is applicable to new accounts and new money. New accounts and new money are not automatically invested on the first day. Rather, they are transitioned into our strategy over a longer time period that is dependent upon market conditions. This update describes that transition.*

Written By: Benjamin "Ben" Carew, CFA

Ben Carew is a shareholder, Vice President, and Portfolio Manager for Tandem Investment Advisors, Inc. Mr. Carew joined Tandem in 2013. Mr. Carew manages Tandem's trading desk, overseeing day-to-day investment operations, including trading, quantitative and fundamental research, and portfolio management. Mr. Carew also oversees Tandem's internship program. Mr. Carew is a regular member of the CFA Institute and the CFA Society

South Carolina. Mr. Carew currently serves as the Vice Chair for College of Charleston's School of Business Investment Program, a student program seeking to provide the opportunity for a select group of students to distinguish themselves academically, professionally, and personally. Mr. Carew is a graduate of the College of Charleston's School of Business, earning a Bachelor of Arts in Economics with a minor in Finance.