RAYMOND JAMES | INVESTMENT MANAGEMENT

Investing in the wake of Silicon Valley Bank

Yes, banks face challenges, but don't expect the contagion of bank runs to spread.

Silicon Valley Bank's sudden implosion this month likely is more an outlier in its industry than an omen of a looming systemic failure.

That's the consensus of a panel of portfolio professionals focused on banking, monetary policy, and the economy at Eagle Asset Management. Moderated by Matt Orton, CFA, the Head of Advisory Solutions and Market Strategy at Raymond James Investment Management, the panel included Eagle's James Camp, CFA, Managing Director, Fixed Income and Strategic Income; Andrew Adebonojo, CFA, Senior Research Analyst; and Enrique Acedo, Research Analyst.

HOW AND WHY SILICON VALLEY BANK FAILED

"The way a bank works is it borrows short to lend long," Orton said. It takes in demand deposits – checking accounts from which depositors can withdraw at any time – and pays very little interest on those deposits.

It then invests that money in longer-term assets such as bonds that don't get paid back for years and have, until the last year, historically paid relatively low rates of interest. These long-term investments can create problems for a bank if interest rates rise quickly and if a lot of depositors start pulling out their money. "It's an obvious problem," Orton said, "but the business of banking is how you manage those sorts of risks."

Silicon Valley Bank's problems were exacerbated because it had:

- disproportionately invested its deposit base in very long-duration bonds – many of them U.S. Treasury bonds and agency mortgage-backed securities that Orton noted were quite safe – and
- a perilously concentrated customer base. Many of its deposits were much larger than the $250,000 insured by the Federal Deposit Insurance Corp. (FDIC). A large percentage came from startups that had raised large amounts of money from venture capital as well as from the venture capitalists themselves. When interest rates rose, venture capital funding dropped, and depositors began to withdraw their money.

The week of March 6, Silicon Valley Bank sold a portion of its bonds at a loss to cover the accelerating withdrawals, then announced that it would sell stock to raise new capital. Instead of reassuring depositors and shareholders, these moves rattled both groups. The bank's shares dropped more than 60% in a day, and depositors – some urged by venture capitalists and social media to withdraw their money while they could – unleashed an uncontrollable run on the bank. When the proposed stock issue unraveled, the bank scrambled to find a buyer. By Friday of that week, the FDIC had taken over and closed the bank.

WHAT MAKES SILICON VALLEY BANK AN OUTLIER

What happened at Silicon Valley Bank, panelists say, was something like a plane crash. It didn't result from a single failure, but from a series of failures, some rooted in the market that the bank served. Few banks, panelists said, have a depositor base as narrow and as sensitive to interest rate changes as Silicon Valley Bank.

"This failure is a series of missteps," Camp said. "This is not systemic. I will make that point very clearly. "

Instead, it "is part of the Fed's doing," said Camp. By quickly raising interest rates, "the Fed was going to create accidents," and "this is one very glaring accident that they created."

Moreover, unlike in 2008, the challenges facing banks now are not generally tied to bank investments in unsound credit. Instead, by flooding the economy for years with abundant liquidity, the Fed created a lot of 2% mortgages that have ended up on banks' balance sheets as a form of interest rate risk.

"These were not credit mistakes," Camp said. "This was a franchise that had value. This was an asset-liability mismatch that is a consequence of 0% interest rates going to 5% almost overnight in the last 12 months and a balance sheet that was taking massive demand deposits and (was unable) to manage itself. And even after these issues, had they not botched the capital raise we think the bank would have been fine."

What further stands to make Silicon Valley bank an outlier, Camp said, are the steps that the U.S. Federal Reserve, U.S. Treasury, and FDIC took to bolster the financial system the weekend following the bank's takeover.

That intervention, which included ensuring that all depositors would be repaid in full, "absolutely will stop contagion," he said. "It will significantly stop more runs on banks."

GUARDRAILS AND RISKS IN THE BROADER FINANCIAL SECTOR

For larger banks, risks are cushioned by enhanced capital requirements stemming from the Dodd-Frank Wall Street Reform and Consumer Protection Act passed after the Great Recession, Acedo said.

The largest money-center banks – those with market capitalizations above $250 billion – are required to maintain more capital than ever: as much as 500 to 700 basis points of extra capital compared to what would be required at a smaller bank that isn't subject to those rules.

For super regional banks, the extra capital requirements would be in the 250- to 350-basis point range.

"The regulators come up with a stress scenario and these banks basically have to hold enough high-quality, liquid assets to be able to function with deposit outflows during a stress period for about 30 days," Acedo said. "It gives you a little bit of a margin of safety on the larger banks relative to some of the smaller ones.

"You also have vastly more diversified client bases, both on the asset side and also the liability side," as well as more diversified revenue streams, he said. "So I think it's very unlikely that you see a bank run like you saw at Silicon Valley or even Signature Bank."

Still, Acedo said, "this liquidity issue was something that nobody really expected, but I think it changes the game." It will be more difficult for large banks that are subject to stress-test requirements to raise dividends, and the industry is probably looking at more regulation, higher FDIC deposit premiums, and increases in other expenses.

Among smaller banks, heavy exposure to commercial real estate could pose credit issues and create some asset-liability mismatches, Adebonojo said. As a result of rising interest rates, a lot of bank investments in large office buildings or similar commercial projects are underwater – meaning that the asset is worth less than the outstanding mortgage – "so we've been cautious in the small- to mid-cap bank space for those reasons."

Another potential problem is whether small- and mid-cap banks can attract the kinds of deposits they need to meet their ambitious growth targets.

"It's going to be hard for a lot of banks to hit any kind of growth target without seeing severely deteriorating margins," Adebonojo said.

IMPLICATIONS FOR MONETARY POLICY

Don't expect this crisis to push the Fed toward a more dovish monetary policy. All panelists expect the Fed to follow through with a 25-basis point interest rate hike in March.

"The economy, to us, is still headed for recession," Camp said. "Perhaps it deepens a bit because of the liquidity constraints that are put on the markets. The Fed has always had to drive a deep, deep slowdown to get price levels under control. … I don't think the episodes of the last week changed that trajectory. And I think our forecast, our positioning, and our outlook still supports a material economic slowdown, compression of margins, a lower earnings growth rate for the S&P 500 Index, and a return to balanced portfolio investing, including fixed income."

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Historically, bonds have indeed provided less volatility and less risk of loss of capital than has equity investing. However, there are many factors which may affect the risk and return profile of a fixedincome portfolio. The two most prominent factors are interest-rate movements and the creditworthiness of the bond issuer. The risk of a change in the market value of the investment due to changes in interest rates is known as interest-rate risk. Interest-rate risk is subject to many variables but may be analyzed based on various data (e.g., effective duration). The risk that the issuer may default on interest and/or principal payments is often referred to as credit risk. Credit risk is typically measured by ratings issued by ratings agencies such as Moody's and Standard & Poor's. Bonds issued by the U.S. Government have significantly less risk of default than those issued by corporations and municipalities (see below for a discussion of the risk associated with convertible securities). However, the overall return on Government bonds tends to be less than these other types of fixed-income securities. Finally, reinvestment risk is the possibility that the proceeds of a maturing investment must be invested in a lower yielding security, all other things held constant, due to changes in the interest-rate environment. Investors should pay careful attention to the types of fixed-income securities which comprise their portfolio, and remember that, as with all investments, there is the risk of the loss of capital.

Investing in large-cap companies is based on the expectation of positive price performance due to continued earnings growth or anticipated changes in the market or within the company itself. However, if a company fails to meet that expectation or anticipated changes do not occur, its stock price may decline. Moreover, as with all equity investing, there is the risk that an unexpected change in the market or within the company itself may have an adverse effect on its stock. As with all equity investing, there is the risk that a company will not achieve its expected earnings results, or that an unexpected change in the market or within the company will occur, both of which may adversely affect investment results. The biggest risk of equity investing is that returns can fluctuate and investors can lose money. Not every investment opportunity will meet all of the stringent investment criteria mentioned to the same degree. Dividends are not guaranteed and must be authorized by the company's board of directors.

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risk of equity investing is that returns can fluctuate and investors can lose money. Not every investment opportunity will meet all of the stringent investment criteria mentioned to the same degree. Trade-offs must be made, which is where experience and judgment play a key role.

Asset-backed securities and mortgage-backed securities are created by pooling loans from a variety of sources and issuing bonds which are backed by these loans. Creditworthiness stems from the credit quality of the underlying loans, as opposed to corporate bonds in which creditworthiness is derived from the earning power of the issuing company. The primary risk of these securities is interest-rate risk. Rising interest rates might cause loan principal prepayments to slow, resulting in less available principal to invest at prevailing higher rates. Conversely, rate decreases might accelerate prepayments, leaving more dollars to invest at lower rates.

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Basis points (bps) are measurements used in discussions of interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01%.

Underwater assets are worth less than their purchase price or the money owed on the purchase.

Dovish, hawkish, and centrist are terms used to describe the monetary policy preferences of central bankers and others. Hawks prioritize controlling inflation and may favor raising interest rates to reduce it or keep it in check. Doves tend to support maintaining lower interest rates, often in support of stimulating job growth and the economy more generally. Centrists tend to occupy the middle of the continuum between tight (hawkish) and loose (dovish) monetary policy.

Margin compression is what happens when input costs rise faster than the sale price of a product. As a result, the producer's profit margins decline over time.

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