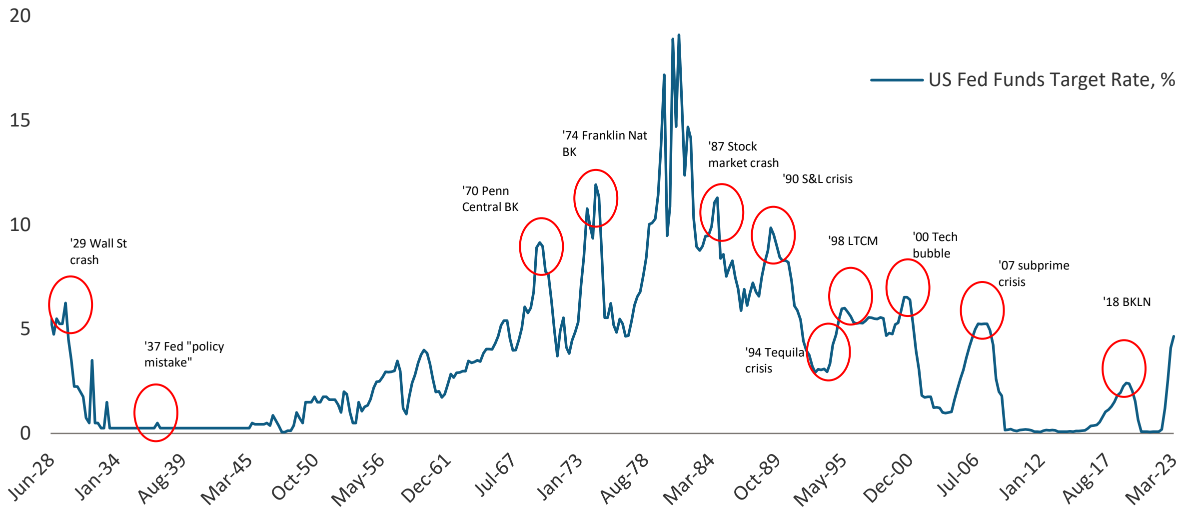
Dear Shareholder,

'Move fast and break things' – *Mark Zuckerberg* (or was it, Jerome Powell?)

Over the past three years financial markets have been whipsawed by central banking action. The recent bout of inflation was fuelled by excessively easy monetary and fiscal policy which reversed aggressively in 2022.

When liquidity dries up, especially to the extent seen in 2022, things break, starting with the most fragile.



Source: St. Louis FRED, Bloomberg

Reductively, this matters for equity investors on two fronts: **valuation risks** and **earnings impact**.

Without dwelling on valuation too long, it's worth pointing out this isn't simply a theoretical conversation, there are real choices for investors now that yields have risen to 4%. Tax-equivalent yields on Muni bonds in the US and Gilts in the UK (due to their tax exemptions) are 5-6%[1], which isn't far off the long-term return from equity markets of 8-9%[2] per year.

As we have discussed before, valuation decisions are *always relative*. This is as true within equity markets, when choosing one stock over another, as it is for allocators across the world who can invest in other assets.

Back to the present, and the recent events at Silicon Valley Bank (SVB), Credit Suisse and others.

How much further the situation spreads depends, again, on central bank action. It's clear the central bank, in pursuit of an economy which is not too hot and not too cold, will seek to cap and collar economic activity and market levels.

Anyone pretending to know how future events unfold needs not only to diagnose the problems, but also second guess the cures.

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[1] Financial Times, "Gilts are becoming munis and no-one seems to have noticed", March 2023

[2] Barclays Equity Gilt Study, 2022

Why are we here?

The Fed printed such a large amount of money during Covid that the excess became deposits within the banking system. These rose 35% in 3 years from 2019 to 2022.[3] At the same time, inflation expectations were low and central bank guidance was for steady interest rate rises.

Irresponsible management teams, possibly fearing rebuke from quarterly focused shareholders for "underearning", took the opportunity to earn a higher spread by buying higher yielding, but more rate-sensitive, longer-dated securities.

Sheep spend their life fearing the wolf, only to be eaten by the shepherd.

As we now know, the shepherd changed its spots and, within a year, interest rates had risen over 3%, causing major mark-to-market losses on those assets; sufficient, in some cases like SVB, to wipe out all the equity of the business. A deposit flight ensued, and the bank was in receivership within 48 hours.

This is where the story gets more interesting. The measures taken by the Fed, and by the Swiss National Bank in support of Credit Suisse, were deployed rapidly and were sufficiently large to mitigate the risk of contagion.

Monetary policy is now quite distinct to central banks' **financial stability** apparatus, as Bernanke intended when expounding this system ten years ago.[4]

So, there you have the cap and collar strategy – tight monetary policy to drive slower economic growth, undo the excesses of the money-printing experiment, and financial stability palliatives to keep the economy alive should it take seriously ill.

Whether it works is another question, but the strategy is clear and "fighting the Fed" has been a losing strategy for most of the past 100 years.

<u>On Banks</u>

We own JPMorgan and Bank of America shares (and Goldman Sachs, for which the recent events are far less impactful given its business mix).

Bank balance sheet assets are cash, loans, and investments, with funding liabilities in the form of deposits and debt / bonds.

Banks are allowed to designate their investment assets in two ways: Available for Sale (AFS) or Held to Maturity (HTM). AFS securities are held at fair value, with any moves between reporting dates reflected in mark-to-market changes, meaning their value fluctuates with interest rate and credit risk changes. HTM assets are held at cost as they are not *intended* to be sold. The expectation from regulators is that assets designated HTM won't be reclassified, however, they do acknowledge circumstances can change. Should this happen, a mark-to-market revaluation is triggered, impacting their book value and regulatory capital.

Reclassification of HTM assets to AFS therefore only really happens if banks are in such a tight liquidity position (due to deposit flight) that they cannot cover these outflows from their cash on hand, or even by selling their AFS assets, forcing them to eat into their nest egg of HTM securities.

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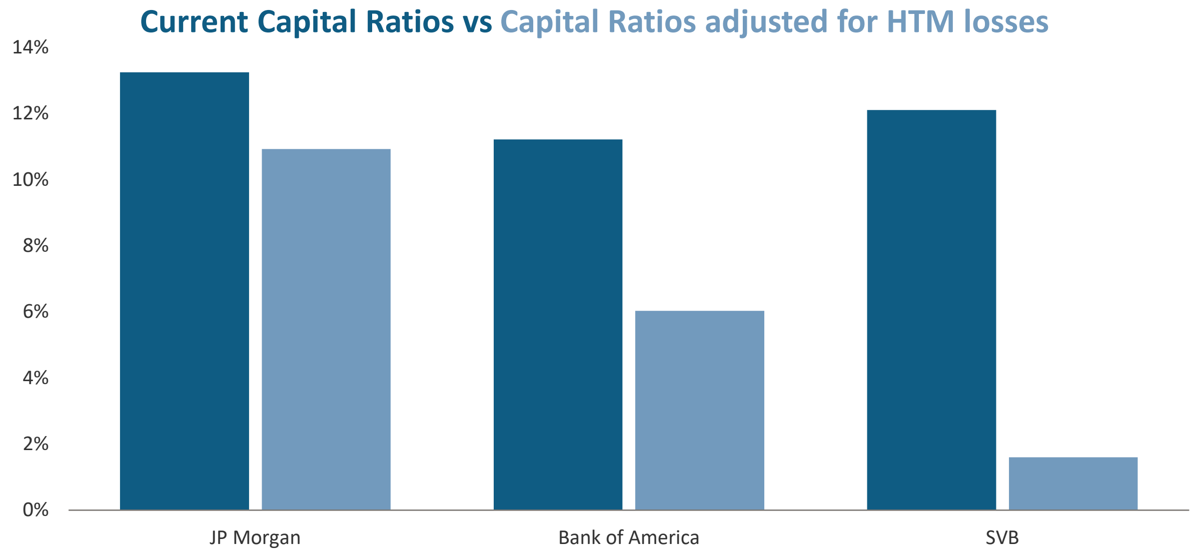
[3] US Commercial Bank Liabilities Deposits as published weekly by the Fed
[4] "Fostering Financial Stability", Ben S. Bernanke at the 2012 Federal Reserve Bank of Atlantic Financial Markets Conference

In SVB's case, deposit flight occurred incredibly fast with 25% of depositors withdrawing their cash in a single day.[5] This is a feature of digital banking that clearly causes greater fragility in the event of a loss of confidence.



Source: JPMorgan, Bank of America 10K & Latitude
Reported CET1 ratios adjusted for unrealised losses on Held to Maturity portfolio of investments.
Losses adjusted for tax at statutory tax rates.
As of 31.12.2022

Clearly, this issue is not a risk for JPMorgan although, at first glance, it appears concerning for Bank of America. The questions one needs to ask is what needs to happen to necessitate breaking into the HTM portfolio piggy bank, and what else is happening within the bank to offset these risks.

Please ask if you would like to see more detail on this working but, in summary, Bank of America would need to suffer c.50% deposit outflows to force a mark to market on their HTM assets. There are several reasons we think this is unlikely. The first is size. With $1.9 trillion of deposits (vs. SVBs c$200bn) Bank of America is a systemic part of the depositary base in the US, and system deposits would need to meaningfully contract for them to be impacted. The second is diversity. Bank of America is a broad-based bank with an array of depositors (not narrowly focused on the tech companies in Silicon Valley as SVB was). The third is support from the Fed. The new "BTFP" facility allows banks to borrow up to 100% of the par value of their HTM assets, removing the need for an outright sale.[6]

As of December 2022, the rise in interest rates has generated an ***unrealised*** $100bn loss on Bank of America's HTM assets. The most likely outcome is that these bonds mature at par and no loss is suffered, although an opportunity to earn a higher return in today's interest rate environment is of course forgone. If these bonds were bought above par, then some portion of this loss *may have* to be realised from 2033 onwards as this is the earliest maturity within the portfolio.

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[5] https://www.bloomberg.com/news/articles/2023-03-11/svb-depositors-investors-tried-to-pull-42-billion-on-thursday?leadSource=uverify%20wall
[6] Bank Term Funding Programme announced by the Fed in March 2023

The flip side is that the recent move in interest rates has also driven an $8bn ***realised*** **annual** increase in profits today[7].

In both banks, solid management decisions have avoided the duration risk trap which others have fallen into.

Why Own a Stock Today?

This is an evergreen question that we ask ourselves about all our portfolio holdings. With banks, as with all cyclicals, our thought process goes as follows:

1. Do we believe in structural growth?
2. Is the business less cyclical than prior cycles?
3. Could the company emerge stronger when it passes through the eye of an inevitable downcycle?

We believe in the structural returns from our holdings. They have generated an average 15% return on capital in a very tricky decade, and the next cycle should present further consolidation opportunities (c.f. Credit Suisse finally retiring their investment bank).

Both banks have around a third of the leverage they had prior to the 2008 crisis, and three times the liquidity. Capital-light fee-based businesses are a larger contributor to their bottom lines, and credit risk within trading has been vastly reduced due to proprietary trading regulation. Asset quality is significantly higher, with mortgages at lower loan-to-value ratios made to homeowners with higher average FICO scores. All told, the cyclicality in the businesses through asset exposure, credit risk, and balance sheet leverage are lower than any point in the recent past, and revenues are more diverse.

Finally, to the inevitable down cycle. We will see in a few days the impact of the recent malaise as they report Q1 earnings, and we expect solid deposit figures following depositor flight to safety from regional banks in the US. Given the tightening of financial conditions within the regional banks, we also expect loans to migrate to the money centre banks, creating long-term customer relationships with high franchise value.

Trading at 9x normalised earnings the stocks are cheap and, while we don't have a particular view on when they might re-rate, the strength shown through this difficult period (which is likely not over) will shine through in above-average intrinsic value growth, as well as potentially higher valuations, as we move through the next five years.

As ever, please get in touch with anyone in the team if you have any questions.

Happy Easter,

Freddie Lait

[7] Bank of America Annual Report 2022