ROSENTHAL | HENRY
CAPITAL ADVISORS

# February 2023 Quick Overview Summary
# (Not so "Quick", this time.)

**Important Notes to Readers**: Monthly Investor Statements and 2022 K-1's are available via our secure online portal. The link to that site is: https://app.lpx.fund/. If you have any issues accessing your documents, please let us know and we will provide them to you immediately.

First, returns in our portfolios during February were flat. But given other more pressing issues, we have moved the Summary Results Table for the month to the end of this letter. Details are still provided – just later in this note.

Next, Stephen Covey's 2nd Habit in his *7 Habits for Highly Successful People* is: Begin with the End in Mind. So, before we get into an update on broader banking issues, we provide you this further information about OUR results. MTD in March as of the 14th, KRE (the broad banking index to which we compare ourselves) has declined 26% – while Fund 1 is down roughly 17% and Fund 2 is down approximately 14%. Year-To-Date, KRE has dropped 23% while Fund 1 is down 15% and Fund 2 is down 9%. Again, this highlights the defensive nature of our portfolios and our ability to beat our benchmarks. This result includes a nice increase of 5 and 3% respectively for Fund 1 and 2 yesterday. Our Funds are down approximately 1% so far today while our benchmark is off slightly more than that this morning. Please see the **Conclusion** at the end of this letter for more related data.

**Bullet Point Summary/Headlines of the Current State of the Banking Industry:**

- As you undoubtedly know, three significant bank failures occurred last week: Silvergate Bank (a "crypto" bank), Silicon Valley Bank (a specialty bank catering to venture capital backed start-up businesses), and Signature Bank (a bank which had a niche of providing "clearing services" for crypto currency transactions). All three were "specialty" banks – **not** traditional "bread-and-butter" community banks.
- We initially believed these 3 bank failures wouldn't cause any "contagion" in the industry and would be recognized as isolated incidents for the unique situations they were. Unfortunately, there has most certainly been "spill over" concerns that have rippled across the broader industry – at least for the last few days.
- These 3 bank failures were caused by liquidity crises within each of the banks – not some overarching loan quality issues pervasive in the overall economy like those which led to the Great Recession of 2008-09. These banks failed due to a classic "run on the bank".
- The overall economy is, in fact, currently still doing quite well – although the chances of a recession later this year have increased for a variety of reasons – most especially due to the likelihood of continued rising rates.
- Over the past weekend, the Federal Reserve exercised its authority and decided to make *all* depositors of these institutions whole. Additionally, they created and made available to all banks a new Bank Funding Term Program ("BFTP") which allows any bank to borrow 100% against the par value of treasury and certain other government backed securities without having to "mark-to-market" these pledged securities; and therefore, avoid realizing any losses by "selling" these bonds outright. Accordingly, bank capital will not be impacted by pledging bonds and borrowing for up to 1 year against these securities. These aggressive actions are intended to instill confidence in the banking system as a whole – even though the vast majority of banks will never avail themselves of this new Bank Funding Term Program.
- The FDIC will cover the cost of liquidating these banks by charging all banks additional assessments on their FDIC insurance coverage. As all politicians are touting, this will not be a taxpayer financed bailout.
- Given the non-traditional nature of these banks, the Fed and FDIC were not able to find any buyers on such short notice for the entire institutions. As they now proceed to liquidate these banks, it is possible that buyers will emerge for various parts of these failed banks. As mentioned last Friday in our note, SIVB owns the former Boston Private – a blue-blood wealth management firm. In our view, that part of their company has significant value, and

we believe several bidders will emerge for it as part of a less hectic, non-deadline driven, non-emergency induced process. Selling pieces and parts of these entities will reduce the ultimate cost to the FDIC.

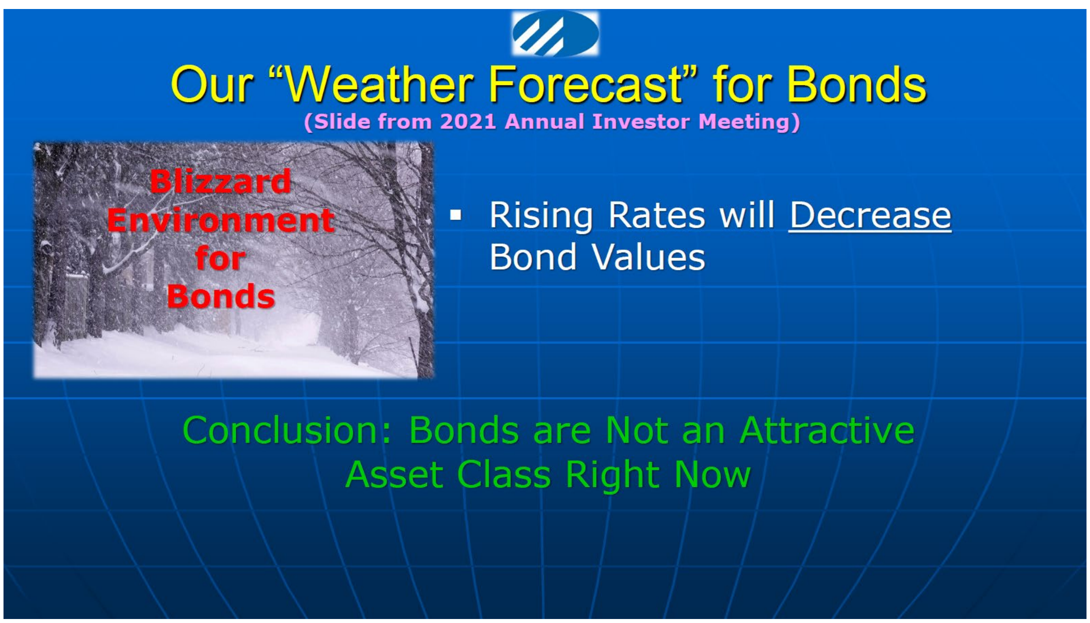
- We will now proceed with a much more detailed explanation of how all this happened and why – and what we believe will take place next.

**The Anatomy of a Funding Crisis that Precipitated an Old-fashioned "Run" on These Banks:**

We begin by re-emphasizing that a bank run occurred not because of any massive "loan quality problems"; but because of a liquidity crisis. Why did this liquidity crisis occur?

We will focus mostly on SIVB, but the basic issues were not that different at the other banks which were closed. We have previously mentioned that SIVB served venture capital backed start-up businesses. It is critical to note that virtually all of their clients qualified for and benefitted immensely from the PPP loan program introduced during the pandemic. As their clients applied for and received PPP loans, the bank became **awash** in deposits from their clients from these PPP loans. Many banks enjoyed a similarly large influx of deposits. Banks had to decide what to do with all this cash. In the case of SIVB, they decided to "reach for yield" and invested in longer-dated bonds.

"We interrupt this program to remind you of the slide we showed at **both** our 2021 & 2022 annual investor meetings."




"We now return to our regular programming." In a rising rate environment, having invested in long-term bonds when rates were low, those bonds owned by SIVB have lost value over time. (Increasing bond yields decrease the value of lower yielding bonds.) SIVB undoubtedly believed that deposits would stay, and clients would not drawdown those balances so rapidly.

The process of managing interest rate risk is referred to as Asset/Liability Management or the ALCO function. Obviously, rates have risen faster and further than the management team at SIVB assumed. As these V/C backed small businesses deployed their cash (burn rate) for the various purposes for which they were intended – and began withdrawing from the bank at a pace and at a time earlier than expected, SIVB found it necessary to sell bonds to fund those deposit withdrawals. They had to sell them at a substantial loss. The next domino to fall was the fact that they then needed to raise more capital as they incurred losses, and they needed that cash to fund deposit outflows. When they announced their proposed \$2.25 billion capital raise, that definitely tipped off folks that there was a significant problem. What happened next is that the V/C owners of the small businesses in which they invested told those companies to withdraw their deposits. \$42 billion in deposits were moved out of the bank last Thursday alone. Approximately 20% of the total size of the bank.

At that point, the "price" at which they might have been able to attract new capital in terms of price per share was either too low – or non-existent. Next morning, i.e., Friday, without having raised capital and having no ability to fund further withdrawal requests – as they say in tennis – it was game, set, match.

SIVB was not only unique regarding the clientele they served, but they were also a complete outlier in another way. A whopping 94% of SIVB's clients maintained balances in their accounts in excess of the $250,000 FDIC insurance limit. This is more than "unusual" – it is unprecedented. Given that so many clients exceeded the FDIC insurance limits, this greatly exacerbated the urgency with which they withdrew their money. It was a snowball of enormous proportions.

The worry among depositors and investors alike regarding whether other banks might be in a similar situation was significant. <u>Very few banks</u> have similar desperate situations. Most traditional, normal, community banks did not get greedy and stretch for yield by buying long-dated bonds when rates were rising. Their margins didn't go up as much by avoiding this stretch for yield. But nor did the value of the assets into which they placed all the PPP money collapse. Furthermore, and of utmost importance, most banks don't have anywhere near the level of deposits in excess of the FDIC insurance limits as SIVB did.


These banking companies and their boards of directors will have their pants and skirts sued off. And they should. What they did was to take an enormous amount of interest rate risk. As is absolutely inevitable in any situation like this, the "naked finger pointing" to assign blame began immediately. Some folks seized the opportunity to blame the Fed for raising rates to far and too fast. We don't buy that argument so much. Some blame the supervisory authorities for being "asleep at the switch" regarding this situation. We believe that there is some truth to that and that examiners bear some responsibility. But without a doubt, the main blame lies with the management and board of directors of these banking companies. Look again at the slide we shared at each of the last two annual investor meetings. If simpletons like us from small town middle America know that investing in bonds in a rising rate environment is a "blizzard", then surely, they should have known this too. They blew through all the redlights, stop signs, yield signs, and conservative banking practices and gave in to greed.

**<u>Why, then, did this event ripple over and spread fear about other banks – especially regional banks?</u>**

Until investors could more fully and carefully assess whether other banks' bond portfolios were substantially underwater and whether other banks had the unprecedented number of depositors that exceeded the FDIC insurance limits, the "abject fear" of what <u>*might*</u> be, caused virtually all bank stock prices to go down. Now that generalist investors have done their analysis and "caught up" to us specialists to understand that most banks bond portfolios remain plenty liquid to meet depositors ongoing liquidity needs – and that the level to which most banks depositors exceed the FDIC insurance is roughly 20% (not 94% like SIVB) some calm, and sanity appears to be returning to the market.

**<u>Which banks are more safe – SIFI banks (Strategically Important Financial Institutions) deemed "too-big-too fail" – or smaller banks?</u>**

Certainly, there has been limited movement afoot for some clients to move money to the largest banks in the country. I've said this before: fear is a powerful motivator. So, the most fearful folks could quickly decide to move money to the SIFI banks – which have an implied guarantee of the U.S. government. Alternatively, some depositors are simply spreading their deposits around to various banks, regardless of the size of the bank, but not in excess of the FDIC limits. It is somewhat hard to fault that logic – at least at this time. But we must never forget that the biggest banks are also involved in myriad different "activities" – which also involve significant risks. Community banks rarely engage in capital markets activities undertaken by the big guys. So, given that the "crisis du jour" seems to suggest big banks are the safe choice for now – we assure you that there are a host of complex risks undertaken by the money-center banks that don't make this issue a "no brainer". Are we going to be just like Canada and have only a few major banks? We don't believe that will be the case anytime soon.

Now that things are apparently starting to settle down a bit, we believe that the panic that gripped folks for the last few days will subside – in time – and that the rebound for bank stocks will continue. Once more, this is NOT the "systemic" asset quality problem as it existed in 2008-09. This is a more clear-cut case of an egregious set of errors made by the management teams of a few banks. That is why we and other professional bank analysts have said this is NOT a long-term crisis which is similar to the events which brought about the near collapse of the global financial system. We are not, "On the Brink" (the title of Secretary Paulson's book about the perfect storm of many events that caused the tremendous pain of the Great Recession). We ***are*** suffering through a major scare caused by the malfeasance and gross mismanagement by 3 banks. This too shall pass. So, we say yet again, "Keep Calm and Carry On".

If you agree with our analysis and wish to increase your investment with us, please contact us. The next date at which our partners may add to their investment(s) is April 1. If you wish to do this, we will make it happen. Call or email us: 574-276-1128 or john@rosenthalpartners.net At last, below are the results we posted for February.

**Summary Results Table:** The table below presents our performance by month and YTD as of 2/28/2023; as well as the last 4 years.

| | Fund 1[1] | Fund 2[1] | ^BANK[2] | KRE[2] | S&P 500[3] | Russell 2000[3] |
|---|---|---|---|---|---|---|
| Feb. '23 | -0.1% | 0.0% | -0.7% | -0.9% | -2.9% | -2.2% |
| Jan. '23 | 2.9% | 5.0% | 4.3% | 5.8% | 6.5% | 10.1% |
| YTD | 2.7% | 5.0% | 3.6% | 4.8% | 3.4% | 7.7% |
| 2022 | -13.0% | -11.2% | -18.4% | -17.1% | -19.4% | -21.6% |
| 2021 | 37.7% | 32.7% | 39.7% | 37.0% | 26.9% | 13.7% |
| 2020 | 1.9% | -6.1% | -10.6% | -9.0% | 16.3% | 18.4% |
| 2019 | 17.4% | 22.7% | 21.2% | 27.1% | 28.5% | 23.7% |

1. Average monthly net rate of return after fees/expenses
2. BANK is the Nasdaq Small Cap Bank Index and KRE are regional bank stock ETF's
3. Russell 2000 is a small-cap stock market index; S&P 500 tracks performance of 500 large companies
4. Year to date results January 1, 2023 – February 28, 2023

## Interim Update:

- We are writing this as of Tuesday afternoon March 14th – before we send it to you all on Wednesday. Today marked an important "up day" in the market and community bank stock indices increased 2.1% – with our Funds increasing by roughly 5% and 3% (Fund 1 & 2 respectively). We are hopeful this may be the beginning of a meaningful ongoing rebound, with today's rally carrying over to the days ahead.
- MTD in March, KRE has declined 26% while Fund 1 is down roughly 17% and Fund 2 is down approximately 14%. YTD, KRE has dropped 23% while Fund 1 is down 15% and Fund 2 is down 9% (as of 3/14/2023). Again, this highlights the defensive nature of the portfolio and our ability to beat our benchmarks.
- Of note, our portfolios still contain substantial unrealized gains totaling 21% of the portfolios; and we currently maintain cash holdings of 14%.

## Conclusion:

Finally, in addition to the raw data presented above, during this volatile time, we feel especially compelled to share a very important part of our philosophical approach to investing. Picking individual stocks remains critical to our success. But so too, does managing the "overall portfolio". What do we mean by this?

First, having a nicely diversified pool of investments within the portfolio is a fundamental principle of good stewardship. We maintain 26 separate bank stock investments in Fund 1 and 27 in Fund 2. Beyond just the "number of positions", there are other demographic factors which we monitor (like geography) to help ensure the diversity of our Funds.

Furthermore, we maintain a critical discipline regarding overall portfolio management by "rebalancing" the portfolio if/when a particular stock position grows to be an "outsized" part of the entire portfolio by virtue of its more significant appreciation in value compared to other holdings.  Selling “big winners” can pull on your heartstrings a bit.  One might be tempted to assume that this “outperformance” will continue indefinitely.  But as the ole saying goes, “pigs get fat and hogs get slaughtered”.  Therefore, we pare our “champions” as needed, book our gains, and rebalance the portfolio to preserve diversification.

As always, you may reach us by calling the office at 574-243-6502, John’s cell at 574-276-1128, or Adam’s cell at 440-667-5974.  Or by email: john@rosenthalpartners.net or adam@rosenthalpartners.net

With warmest personal regards,

*John and Adam*

As always, past performance may not be indicative of future results.  Therefore, no current or prospective client should assume that the future performance of any specific investment, investment strategy (including the investments and/or investment strategies recommended by the advisor), will be profitable or equal to past performance levels.