ROSENTHAL | HENRY
CAPITAL ADVISORS

March 2023 Quick Overview Summary

(Again, this month: Not so "Quick")

Summary Results Table: The table below presents our performance by month and YTD as of 3/31/2023; as well as the last 4 years.

Results Table

	Fund 1[1]	Fund 2[1]	^BANK[2]	KRE[2]	S&P 500[3]	Russell 2000[3]
March '23	-19.3%	-17.1%	-24.6%	-28.8%	3.5%	-5.0%
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	-17.2%	-12.9%	-21.9%	-25.3%	7.0%	2.3%
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 – March 31, 2023

Good riddance to March! (It gave us a whole new perspective on the term *March Madness.* Geez!) We take no solace that we bested our bank benchmarks this month. It was the single worst month in the history of our Funds. Period. Things have stabilized and we are roughly flat so far in April.

As noted in our cover email to this letter, we've had a bit of "writers' cramp" trying to figure out how to convey all that needs to be shared in a manner that makes the most sense and is most easily digested. Normally, we start with "Headlines" and then expound on them. Our approach this month is to "take one subject at a time". That seems to us the best way to tackle this information sharing. So, here it goes:

What was the Root Cause of the Failure of Silicon Valley Bank; and Does it Mean that the Entire Banking Industry is in Trouble?

Obviously, much has been written about this catastrophe. We've read many different articles on this matter. The best synopsis of this situation we've seen came from an article written by Mitch Zacks of *Zacks Investor Managemen*t. He writes:

> The 2008 Global Financial crisis was characterized by complex securities, too much leverage on bank balance sheets, and in many cases, excess risk-taking. There is also a strong argument that a well-meaning accounting rule, FAS 157, created unintended consequences in the banking sector as it forced many banks to take massive write-downs on hard-to-value assets (mortgage-backed securities, collateralized debt obligations, etc.), which crippled capital ratios and froze credit markets overnight. Many banks went from well-capitalized one day to insolvent the next, while also holding sizable portfolios of mortgage-backed securities that no buyer wanted.
>
> **The current banking crisis – if we can call it a crisis – looks nothing like what I've just described above.** Instead of balance sheets riddled with subprime mortgages, derivatives, and near-worthless MBS portfolios (when marked-to-market), Silicon Valley Bank's (SVB) problems were rooted in taking in too many uninsured deposits and investing them in arguably the most boring, safe securities available: U.S. Treasuries and *federally backed* mortgage securities.
>
> The risk of default on U.S. Treasuries and federally backed mortgage securities is essentially 0%, which hardly qualifies SVB as taking on too much risk. But the bank did appear to fail in another aspect of basic risk management: accounting for interest rate risk. As interest rates rise, the fair market value of fixed-rate securities falls, which means a bank may be forced to accept losses on these assets if they need to sell them to cover liabilities (deposits). That is, of course, what happened to SVB.

Mismanaging interest rate risk is not new ground for banking problems in the U.S., historically speaking. The savings and loan crisis of the 1980s was driven by a mismatch between long-term loans and short-term deposits, which crushed S&L's when interest rates rose sharply in the late 1970s in the Fed's effort to fight inflation (sound familiar?).

In SVB's case, supervisors at the Federal Reserve Bank of San Francisco had issued the bank six citations in the previous year, warning the bank that it was vulnerable to trouble and had "matters requiring immediate attention." By July of last year, the SF Fed had put SVB in full supervisory review and rated the bank as deficient in governance and controls. In the fall, regulators met with the bank to discuss their exposure to losses as interest rates rose. SVB did essentially nothing in response.

Perhaps the lesson to garner from SVB's failure is that warnings and citations from regulators only matter if banks take steps to resolve issues, and/or if regulators take bold action like forcing the bank to turn away deposits or to raise capital, or both. SVB also had the glaring problem of 94% <u>un</u>insured deposits from an undiversified set of customers, which made it extremely vulnerable to a bank run.

Fed supervisors in San Francisco may have held back from taking stronger action on SVB last year because of a mindset among Fed supervisors that <u>un</u>insured deposits – versus brokered deposits or wholesale short-term funding – were a relatively stable and secure form of funding. That may very well still be the case, but as SVB showed, having those deposits concentrated in specific sectors (technology, life sciences) and with niche clientele (venture-capital funded companies) means the word can spread quickly that deposits are fleeing – which can trigger the psychological effect of a bank run.

<u>Bottom Line for Investors</u>

As I've written before, SVB was largely in a league of its own when it came to the level of <u>uninsured deposits</u> and unrealized losses on fixed-rate securities. The warnings the bank received from regulators in the year before its failure – and the lack of action taken in response – also pegs this as a crisis of mismanagement, in my view, <u>not</u> a symptom of systemic risk lurking elsewhere in the banking sector.

I think the biggest risk now is in how banks and legislators respond from here. The Fed, for instance, is now weighing higher capital and liquidity ratios for banks with over $100 billion in assets, lower than the current $250 billion threshold.

The community banks in which we invest are not $100 billion in size. And we completely agree with his assessment that this is <u>not</u> a symptom of "systemic risk" lurking elsewhere in the banking sector like 2008-09. 94% of SIVB's deposit accounts held cash in excess of the $250,000 FDIC insurance limits. This compares to the industry average for all banks of approximately 20% of deposit accounts in excess of the FDIC insurance level. This banking failure was a "perfect storm" of mismanagement. Once the bank failed to raise additional capital to cover losses realized by selling bonds to fund withdrawals, the run began (at the behest of venture capitalists instructing the companies into which they invested to move their deposits), and it was put into receivership with the FDIC. All this occurred in less than 36 hours.

Harkening back to 2008-09, the plan put in place by the Feds then was called TARP – which stood for Troubled Asset Relief Program. The "troubled assets" that existed back then were primarily mortgage-backed securities that were questionable as to their ultimate value due to the proliferation of sub-prime mortgage lending. Those troubled assets were pervasive on balance sheets of banks and brokerage firms who packaged and sold them **<u>everywhere</u>**. Again, that is NOT the situation now. Many banks have a certain amount of unrealized losses in their bond portfolios, due to rising rates – **<u>but the ultimate "principal amount" of these bonds is NOT in jeopardy</u>**. By holding them to maturity, the unrealized loss declines as the maturity date nears – and they will be paid in full the face value of the bond. That's a huge difference between now and back then.

Of utmost importance, the Fed recently provided ALL banks in the country the opportunity to pledge their bonds and receive par value for them as a loan, if they need to drum up liquidity to meet depositors withdrawal requirements. Very few banks will avail themselves of this funding source. But if they do, they will not have to "realize" actual cash

losses by doing so. This, of course, preserves capital in the bank. The availability of the Bank Funding Term Program ("BFTP") has gone a long way to stabilize markets and assuage fears related to liquidity concerns.

Is Now a Good Time to Invest in Bank Stocks? Only you can answer that question for yourselves. We have always advised that you maintain a diversified portfolio. If you are underweight banks and/or if you believe that banks are currently significantly undervalued, it may be a good idea to consider adding to your position of banks. Obviously, we hope you might choose to do that with us. Some of the biggest exchange traded funds focused on banks and other financial stocks are seeing solid interest from investors as the failures of SVB and Signature Bank recede in the rear-view mirror. Specifically, KRE, a bank focused ETF to which we compare our performance, saw inflows of $24.1 million in the last week. We do not want you to blindly "follow the herd". But this may be an indication that investors fears may be diminishing and that the oversold situation of March might begin to reverse itself soon. Furthermore, banks have begun to release earnings. The majors announced massive profits and revenues compared to analyst's expectations. While that didn't immediately carry over to smaller banks, we anticipate regional and community bank earnings in the upcoming weeks to be strong as well. Hopefully, that will add more positive momentum and begin to slow the "sentiment contagion" that has unjustly (in our opinion) gripped the markets these past few weeks. Before you make any decisions about this, we strongly encourage you to read the remainder of our letter.

What's Really Going on with Deposits and What is Likely to Happen to Net Interest Margins?
If you only read the headlines or listen to soundbites, you would think that all the deposits from every community bank in the country are going to the big banks. That is simply not true. Data released by the Federal Reserve on Friday, April 14, for the week ending April 5, indicated that total deposit balances increased 0.2% for the large banks and were up 0.4% for the small banks. This was a reverse of the 2.4% decrease at the large banks and the 4.7% decrease at the small banks in 1Q. Are these movements solely related to fears that larger depositors have about holding cash in smaller banks? Absolutely not! Undoubtedly, there was some of that taking place. But as we have outlined in two years' worth of our letters to you, deposits were set to shrink of their own accord. Why? The answer is that PPP money provided by the government to borrowers continued to be drawn down and be deployed in a host of ways: increased working capital needs, increased payrolls due to hiring, more capital improvement projects. Oh, and during the 1st quarter every year, there happens to be something called "Tax Day" – which draws down deposit balances from clients.

We get frustrated when Jamie Dimon, the de facto spokesperson for the industry, makes comments like "the banking issues are not over". At best, that isn't helpful. At worst, it's self-serving. JP Morgan/Chase would certainly benefit from more money flowing to them. I've worked at a money-center bank. I've banked at a money-center bank. I can promise a couple things: first, the client service simply cannot match that of a community bank. Secondly, if you don't "fit" into one of their "boxes" they don't want you. Third, the costs of their products and services are not set up to be favorable to small businesses.

Let's get real for a second. Most clients of most community banks want and need special attention and customized products and borrowing services. And guess what? They get them at their local bank – not from the behemoths. For larger depositing clients, most of them avail themselves of something called "sweep accounts". Ever heard of them? Sweep accounts will, in fact, become more widely utilized after this most recent liquidity event at those darned specialty banks. A sweep account moves money (over a certain dollar amount) out of bank deposit accounts into a variety of sweep products: money market sweeps, government bond sweeps, repo sweeps, etc. Banks charge clients FEES to utilize these sweep products. So, instead of making spread income from that deposit, they make fee income. You don't get that information from the headlines and soundbites.

Bankers are often labeled as stodgy or not very creative. I wholeheartedly disagree. Necessity is the mother of invention. And inventive we are. Banks have access to a wide range of funding sources. Some of you have heard that banks get funding from the Federal Home Loan Banks. This is an excellent source of cash for banks and the borrowing costs are market driven. But there are a host of other, far more creative ways for banks to raise money.

One obscure source which few people are aware of is something called IntraFi. In short, this entity has many banking members who share large dollar denominated deposits among and between each other. If someone has a $1 million deposit account (say a CD) that amount can be divided into 4 shares of $250,000 each and spread around to the other member banks. It is a very cost effective and efficient way to raise cash in the form of deposits. ICS is another source for banks to tap as needed. ICS stands for insured cash sweep. Instead of sweeping monies into money market, government, or repo sweeps, banks can "sweep" into other banks. Nifty – eh?

Our point is: banks will always have ways to fund good loans at a price that makes sense. We believe that the falderal regarding everyone moving their deposits to SIFI banks, it substantially overblown. Things will return to their natural equilibrium in time. And that has already begun.

But what about the cost of deposits and their impact on margins? Again, for years we've indicated that deposit costs would not remain near zero forever. Banks are experiencing pressure to increase the rates they pay on deposits. There is no doubt about that. Before proceeding, let's share a chart:

Year	Fund 1 Margin	Fund 2 Margin
2020	3.33%	3.36%
2021	3.11%	3.31%
2022	3.89%	3.99%

This chart shows the weighted average NIM for our banks during the past 3 years. As you can see, and as we promised would happen, margins increased dramatically in 2022 as the Fed began to raise rates. Folks are now (overly) concerned that margins are falling. They will – and we have forewarned you about this. But please note that they are declining from a much higher starting point than was the case in 2021. The community banking sector didn't collapse when their margins were in the lower 3's. And it won't as they decline from the high 3's presently – to the mid 3's in the future.

In many ways, we are more focused on Net Interest Income growth than NIM, especially given the liquidity challenges in the near term. But NIM *is* a key indicator of profitability and impacts valuation. While overall deposit levels are likely better than the quarter end reported Fed data, the mix shift from noninterest bearing accounts to interest bearing time deposits (a trend that was further amplified in March) likely results in looming net interest margin pressure in 2Q23 and beyond.

What Might Happen to Loan Growth and Loan Quality?

Over the last 20 years, first quarter results (across the industry) are typically the softest of the year – with 1Q23 appearing to follow historical trends. After stripping out FDIC bridge bank data, loan growth is likely to be nearly flat. Even before the March turmoil, credit and lending standards tightened "naturally" (we'll explain that shortly), which likely puts pressure on FY23 loan growth guidance. You may recall from our past annual investor meetings; our banks have always exceeded the industry average for loan growth. Even with the possibility of slower loan growth, net interest income growth could still be very acceptable given margins at predicted levels.

Again, if you only listen to less educated pundits (many of whom have "an agenda"), you might conclude that lending is coming to a screeching halt due to the recent bank failures. And again, we assure you that this isn't true. Loans are the "straw that stirs the drinks" for banks – as they tend to be the major source of revenue for community banks. Banks want to lend! However, it isn't the recent failure of the 3 specialty banks that may cause a slow-down in lending. Rather it is most likely to be higher interest rates that create that outcome. As a banker, and a bank analyst, we know full well that a bank's loan underwriting standards are critical to their success. Most banks underwrite loans to a particular "debt service coverage" ratio. As rates rise, debt service coverage becomes more difficult. It is for this reason that loan volumes might slow. This phenomenon was well underway before the recent bank failures. Nonetheless, we know our banks will do all they can to make new loans in a safe fashion and to maintain their current loan book.
Finally, as it relates to loan volumes, we share some more "hard data": loan balances rose 0.2% from the prior week at the nation's 25 largest domestically chartered banks and loan balances rose 0.1% at the nation's small banks. At the

large banks, the 0.2% increase in total loans reflected a 0.7% increase in commercial and industrial (C&I) loans, and a 0.5% increase in other loans, partially offset by a 0.1% decrease in commercial real estate (CRE) loans, a 0.1% decrease in consumer real estate loans, and a 0.1% decrease in consumer loans. Turning to the small banks, the 0.1% increase in total loans reflected a 0.4% increase in C&I loans, a 0.1% increase in CRE loans, a 0.1% increase in consumer real estate loans, and a 0.1% increase in consumer loans, partially offset by a 0.5% decrease in other loans.

Turning our attention to loan "quality", the focus seems to be predominantly on commercial real estate loans. Community banks certainly extend CRE loans to their borrowers. We pay close attention to whether and how much of the CRE loan portfolio is extended to "owner occupied businesses" (doctors & dentists offices, local manufacturing companies, headquarters offices for local companies, etc.) which are generally much less risky vs. income producing CRE (hotels, multi-tenant office buildings, retail use shopping centers, etc.) which are generally considered riskier. Common wisdom suggests that office buildings and retail are the most vulnerable sectors of the market with the possibility of an upcoming recession. We tend to agree with that.

After the "real" financial crisis of 2008-09, most CRE lenders moved their advance rates on CRE to much lower levels, i.e., 60-70% – that is to say, developers had to inject far more equity into projects than compared to the early 2000's. Advance rates have crept up since the Great Recession, i.e., to approx. 80%; but developers are still required to have more "skin in the game" than was the case before the 2008-09 crisis, i.e., advance rates of 90-95%. Having more equity at risk is not only safer for the bank, but it also provides greater incentive to the developer to work hard to protect their equity in any given project. Only time will tell how this will play out in the months ahead. A lot depends on how deep and how long any potential recession might last. (More on that later).

At present, and as anticipated, borrowers are still in fine shape. As we have outlined many times before, we watch "leading asset quality indicators" like a hawk. We do anticipate that during upcoming earnings releases, we will see more provision for loan losses (building the "allowance for possible future loan losses") as overall economic uncertainty has risen. Non-cash "provision" for possible future loan losses and "actual" loan losses in the form of charge-offs are often two very different things. We watch both.

As highlighted in our 2023 Annual Letter to Investors, the biggest wildcard for earnings this year is how loan quality will hold up. Not only do higher rates impact this outcome, but a host of global and domestic factors will also determine this outcome. (We'll discuss those later). This uncertainty is another reason bank stock prices have declined of late.

<u>How will Regulators and Congress be Likely to Respond to Recent Events?</u>

We've already highlighted the Bank Funding Loan Program the Fed has put in place. It is a very good thing and has helped settle some liquidity concerns. What else might happen?

As mentioned earlier, the size of banks which may be subject to more scrutiny and regulations is likely to decrease to $100 billion institutions vs. the current $250 billion size. Both higher capital and bigger cushions of liquidity are possible outcomes of further regulation. This is unlikely to affect our community banks within the portfolios we maintain.

Furthermore, as you hopefully read in Mr. Buffet's remarks, he believes that all deposits will be protected by the FDIC. They certainly covered all depositors in the case of SVB and Signature Bank. The debate will center around whether the Too-Big-To-Fail banks now have too big of an advantage over smaller banks. This two-tier system has "worked" – primarily because community bankers have allowed it to work. But if ALL banks deposits are not insured to infinity, this policy may no longer be workable. We have a guess (and it is just that, a guess) that the most likely outcome is that the insured deposit levels from the FDIC will increase to $1 million from the current $250,000 level. This would add further stability to deposit funding for our community banks. We will see what happens.

Clearly, bank regulators must be feeling a little jittery these days — in short order, three US Banks and Credit Suisse became victims of a "crisis of confidence". The weekend after SVB was closed, a buyer didn't immediately emerge. But as we predicted, a few weeks later, after the dust settled a bit, First Citizens acquired most of the deposits and a

substantial loan book from the failed institution. They have a meaningful "put" to the FDIC on loans which may not be collectible. But this has been a common feature of FDIC sales of banks for a long time. This relatively quick resolution of most of SVB has provided a quiet sense of satisfaction at the FDIC and Fed. Furthermore, as of now, the failures were contained to these 3 banks. Nonetheless, on the heels of these recent happenings, regulators are considering imposing tougher rules requiring banks to ready themselves for faster runs on deposits as officials search for lessons from the recent turmoil that led to these failures.

Interest Rates and the Economy:

The clarion call for a possible recession in 2023 is sounding. Inflation continues to decline but is still higher than the Fed target. The Fed has announced its intentions to keep interest rates higher for longer. But there isn't consensus about what that means. Some still have the view that the central bank will actually cut rates later in 2023. For months, market participants have bet that the Fed will be forced to stop raising rates far sooner than the central bank currently plans. In the futures market, traders are currently betting the Fed will cut rates to 4.5% by year-end. That implies two rate cuts in the latter half of this year – if the FOMC raises again in May as expected.

Next, as everyone knows, 2024 is an election year. Historically, the Fed has preferred to "move to the sidelines" – although the "date" at which it does so seems to be later and later every election cycle. Regardless, the consensus is that a recession is more likely to occur than previously forecast. As formerly mentioned, the question now becomes how deep and how long a recession may last. That's a "crystal ball question" and we don't have a clear answer.

So much of the future economic outlook depends on other factors: global and domestic. The dominating headlines regarding worries about banks will very quickly be replaced by the fight over increasing the debt ceiling. Congress (specifically the House of Representatives) and the White House appear ready to play a very dangerous game of "chicken" over this issue. A default by the U.S. on its debt could have far reaching and severe consequences. That portends more volatility in the short run. Solving that issue is only one part of the equation. The ongoing war in Ukraine, increased tensions between the U.S. and China and other factors, all impact the Global and Domestic growth outlook. But know this: no matter the path or challenges, community banks are here to stay and will continue to provide the critically important intermediary function they have forever – and do so in an appropriately profitable way!

Conclusion:

Last month our "Quick" Overview Summary was 4 ½ pages. This month it's 6. (Rats.) But we do hope you find our deep discussions about all the nuances and intricacies regarding banks worthwhile. From a portfolio point of view, we share with you that we have increased our cash from roughly 10% earlier this year to approximately 16% now. Given all that is going on, this just seems prudent to us.

As noted in the cover email to this letter, we will be hosting our 2023 Annual Investor Meeting in early June. Details will be forthcoming soon. We look forward to seeing you then. Until then, of course and 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.

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