First Quarter 2023 Commentary

A little more than halfway through the first quarter, Hollywood declared that the best movie of the year was *Everything Everywhere All At Once*. That title seems like an apt description of recent economic news. Some tech stocks almost doubling in three months, regional banks failing, the Federal Reserve hiking interest rates to levels not seen in decades… it's enough to make an investor's head spin.

And how did the market react to this tumult? Coming off the brutal year of 2022 for both stocks and bonds, most major stock averages were up strongly in January, then dipped a bit in February, and then advanced again in March. But that only describes the averages, which are comprised of dozens and sometimes hundreds of stocks. If we zoom in to look at sector- or even company-specific performance, we can see that there was incredible variation for the first quarter.

Tech stocks were practically on fire, with the Nasdaq Composite index returning a staggering 17.0% in the first three months. The stock of Meta Platforms, the parent of Facebook and Instagram, was up 76%. The Dow Jones Industrial Average barely kept its head above water, returning only 0.9% for the quarter. The S&P 500, which contains many companies from both the red-hot tech sectors and stodgier industries like financials and consumer products, was just about in the middle of those two, posting a total return of 7.5%.

Of course, the biggest news of the quarter, and the reason behind the big discrepancy between the market averages, was the huge decline in stock prices of banks and related financial companies, specifically regional banks. What caused it? Well, it's quite a story…

A (Tragic) Banking Story

In his highly acclaimed, international bestseller, *Sapiens*, historian Yuval Noah Harari makes the compelling argument that we humans have become the dominant organism on this planet due to our ability to collectively believe in stories, myths, and fictions. Nation states, corporations, and currencies are examples of these 'imagined realities,' and throughout time they accumulate tremendous power.

For our purposes, let's focus on the imagined reality of money and banking. For the banking system to properly function, we all need to believe in the story that if we put a green piece of paper into something called a 'bank,' that green piece of paper is going to be there tomorrow if we need it. But as a matter of fact, banks only have in their possession about $1 for every $10 that customers deposit into their accounts. They typically loan out the money that has been deposited to others, like Jimmy Stewart's character explains near the end of *It's a Wonderful Life*. Or, as Harari writes, "What enables banks –and the entire economy—to survive and flourish is our trust in the future. This trust is the sole backing for most of the money in the world."

The problem with stories such as this one is that, on a whim, people may start telling different, competing stories. Harari cites the French revolution as an historical example:

> "In 1789 the French population switched almost overnight from believing in the myth of the divine right of kings to believing in the myth of the sovereignty of the people."

During the first quarter we saw the story of the 16th-largest bank in the U.S. completely change in a span of 48 hours. The bank went from a highly-respected financial institution to the second-largest bank failure in U.S. history in just two days. That, in turn, affected the entire economy and the stock market.

Silicon Valley Bank (SVB), as the name suggests, was based in Silicon Valley, home to many tech entrepreneurs. Due to the low level of interest rates of recent years, venture capitalists raised cheap money and flooded tech startups with cash. These startups, in turn, deposited all those funds into SVB; in fact, SVB tripled its deposit base during the pandemic. SVB then had to do something with all those deposits. They couldn't lend it out, because its customers didn't need loans, so they bought "safe" long-term government bonds.

As interest rates began to rise, the cheap money that venture capitalists relied on to fund tech entrepreneurs was gone. That meant that these entrepreneurs needed to get their cash from their SVB accounts. SVB, in turn, had to sell their "safe" government bonds to satisfy these redemptions. But these long-term bonds were anything but safe, as they had declined massively in value due to the rise in interest rates. This created enormous losses for the bank, causing its depositors to freak out and demand their money back. Tech entrepreneurs are a close-knit community and they all behaved like a herd of buffaloes, creating a classic 'run on the bank.' SVB was insolvent in 48 hours.

Collateral Damage

Like almost all other financial stocks, the ones we own—Bank of America, Wells Fargo, and Charles Schwab—declined significantly in sympathy with this banking crisis. Nevertheless, we believe there are marked differences between our holdings and SVB. SVB's main problem was its lack of diversification—on multiple fronts: its business was concentrated in one area (Silicon Valley), and on one type of customer (the tech entrepreneur), and its balance sheet had one predominant type of asset (long-dated bonds, instead of a diversified book of loans like most banks). As interest rates rose, they were hit with a double whammy: depositors needed their funds, while the bank's assets—which were sold to satisfy withdrawals—declined in value. If SVB had had a more diversified deposit base, they would most probably have been able to hold their bonds until maturity without incurring any losses. One other wrinkle in the story is that the vast majority of SVB's deposits were higher than the FDIC-insured cutoff of $250,000, prompting these depositors to panic even more.

Bank of America and Wells Fargo have a widely diversified depositor base, with customers ranging from huge corporations to the grandmother down the street. They have a nationwide footprint, and most of their deposits are below $250,000. The fact that they are among the four largest banks in the country means that they must pass rigorous stress tests every year, resulting in high levels of capital on their balance sheets.

While Charles Schwab does own a bank, it is primarily a diversified brokerage firm with millions of customer accounts. This business generates significant amounts of cash flow, so the company is insulated from the calamity that affected SVB. In fact, as the stock of Schwab declined during the quarter, its executives were buying stock for their personal accounts. From March 14th to March 17th, executives and insiders spent more than $8 million of their own money buying over 130,000 shares of Schwab stock. That is a sign of confidence we cannot ignore.

Everything Everywhere All At Once

When some market sectors zig, others zag, and still others scramble for dear life, it can be a difficult task to know where to focus one's attention. We do our best to act with prudence, care, and equanimity to the vicissitudes around us. Everything is indeed happening everywhere, and sometimes all at once, and it's our job to steer your ship through these choppy waters. Thank you for voyaging together with us. We'll report again on our progress three months from now.

Sincerely,

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