Good morning, Clients

We have witnessed significant financial instability surrounding the banking system recently. The chaos started with Silvergate Bank, a relatively small bank with $6 billion in deposits, catering almost exclusively to cryptocurrency-related businesses. As the crypto world started to implode in 2022, Silvergate began to lose deposits as business customers withdrew cash. Ultimately, these deposit outflows led to an old-fashioned run on the bank and failure last week. Next was Silicon Valley Bank (SVB), the 16th largest bank in the US with over $200 billion in deposits. SVB was a financial staple in the venture capital world, providing funding and business banking services for start-ups and larger businesses. 2022 was a difficult year for venture capital and money-losing businesses, and these businesses began to withdraw deposits from SVB. Business customers became concerned about liquidity and flooded SVB with deposit requests, ultimately forcing the FDIC to step in and take the bank over on Friday morning. In about 24 hours, SVB went from a large, thriving bank to closed for business with the FDIC unwinding its assets to meet deposit requests. Lastly, Signature Bank, a NY-based bank also catering to crypto-related businesses and high-net-worth individuals, was closed this last weekend. It had $110 billion in assets.

SVB and Signature were the second and third largest bank failures in US history, by asset size. Only Washington Mutual, with $307 billion (failed in 2008) was larger.

A few logical questions:

1. Why are some banks failing?

The banking business is quite simple. Banks take customer deposits (liabilities for banks) and invest in assets, including loans and securities (mostly bonds). In essence, banks borrow short-term (deposits) and lend long-term (loans, bonds). Banks make money when the interest they pay for deposits is less than the interest they earn on loans and securities – this gap is called net interest margin (NIM). In the 2020-2021 banks took trillions of dollars of deposits on their balance sheets from customers who received government stimulus, coupled with incredible monetary stimulus in the form of the Federal Reserve increasing liquidity in the system (called QT, or quantitative easing). These deposits forced banks to invest – and given loan demand was somewhat muted, banks invested in bonds (US treasury and agency securities like MBS).

As interest rates were near zero, banks were paying 0% for deposits and earning 2% on investment portfolios and 4-6% on loans, resulting in a healthy NIM. From March of 2022 through March of this year, the Fed raised short-term rates by nearly 5% - the fastest pace in 40 years. Long-term interest rates increased significantly, resulting in large unrealized losses on banks' bond portfolios. As of March 10th, this "unrealized" loss totaled more than $600 billion (source: FDIC). Banks can assign bonds to a "Held to Maturity" bucket on their balance sheet and avoid marking the assets to market, instead valuing them at par. When customers start to withdraw cash, it forces banks to sell assets (loans or bonds). Loans are not liquid so banks will sell bonds and when the bonds are trading at losses (in this case, because of higher interest rates) the banks realize large losses.

Remember, banks are often leveraged 10 to 1 – meaning for every dollar of equity value on the balance sheet, they typically have 10 or more dollars of assets. If banks start to sell assets at a 5-10% loss, significant equity value is wiped out. In fact, that is the case for SVB and Signature – both had large unrealized losses in its bond portfolio that it was forced to realize as customers withdrew funds. Both banks also had grown deposits significantly in recent years (hot deposits) and instead of having millions of customers (like Bank of America) with small deposits amounts, they have concentrated deposits with large customers who can easily move deposits in search of higher yields or because of liquidity concerns.

2. What can be done by the Federal Reserve and US Treasury to limit the damage?

On Sunday, March 12th the Federal Reserve announced a new "Bank Term Funding Program" designed to lend money to banks based on eligible collateral (US treasury bonds, MBS, etc.). The program is designed to lend confidence to the banking system and let depositors know banks have access to capital. The collateral value is based on the par value of the pledged assets, meaning if a bank has a portfolio with a 10% unrealized loss due to higher interest rates, it will receive the ultimate maturity value, not the lower market value.

The FDIC also announced it will insure all deposits at now failed SVB and Signature, not just deposits below the $250,000 cap. In the case of business-focused banks like SVB or banks catering to businesses and high-net-worth households, many deposit balances were above $250,000. In the case of SVB, about $175 billion of the $200 billion in deposits were above this threshold. Now customers in those failed institutions will have access to their deposits today (Monday).

3. What is ECM doing to protect client cash assets?

ECM is constantly managing cash with two primary goals: **reduce risk** and earn a return. Most of our client assets are in custody at Charles Schwab. For client securities like equities, bonds, and money markets, these assets are held in client accounts, segregated from Charles Schwab bank. Cash sitting in clients' accounts (not invested in treasury bills, CDs, money markets, etc.) is held at Schwab Bank and is insured (FDIC) up to $250,000. We do not have any cash at Schwab Bank above the insured levels unless a client is making a large distribution this week.

In summary, **we do not have uninsured deposits at Schwab or other institutions**. Client accounts are owned separately and segregated from any corporate assets at Schwab or other institutions. Schwab published this piece on recent events this morning.

4. What is ECM doing to ensure client investment portfolios, primarily equity securities, are not exposed to these risks?

We have several investments in the financial services space, including banks (JP Morgan, Bank of America), investment firms/broker-dealers/custody (Charles Schwab, Bank of New York Mellon), and niche financial services companies like Pathward (formerly Meta Financial) and The Bancorp.

We are speaking with management teams from each company and evaluating the balance sheet impact from any deposit outflows, including:

- Any bank run/liquidity risks within our portfolio, including deposit composition.
- Access to funding and liquidity to meet outflows.
- Cost of such funding, and impact on near-term and long-term earnings.

We do not have any investment exposure to SVB or Signature. As of today, we do not believe any of our financial services investments have "run on the bank" or liquidity risk.

As always, our focus is on you, the client. We will evaluate risk, protect your assets, and manage your portfolios in a manner we would like our portfolios managed if our roles were reversed.

Thank you for your confidence and don't hesitate to call if you have any questions.

Sincerely,

John Barker

March 13, 2023