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Dear Client:

While we just published our quarterly deep dive on the subject, the collapse of Silicon Valley Bank (SVB) continues to evolve and the picture that has emerged deserves comment. Despite its size (<$200B in deposits), SVB was not a traditional retail bank and was at the center of a unique financial ecosystem composed of venture capital (VC) firms and their portfolio companies. It acted more like an investment bank than a commercial bank, taking risks that more conservatively run banks would not likely have assumed. Understandably, when your clientele is at the epicenter of the fast-money crowd, one must cater to them, or someone else will. And SVB went head long into servicing this client set. In the years following the dot-com crash, most banks no longer made loans against illiquid private shares. SVB did. Most banks wouldn't make unsecured loans to start-ups that had no assets (let alone or positive cash flow). SVB did. And most would not give VC firms low interest-rate loans to allow the firms a way to juice their returns. SVB did. While it doesn't appear that they had booked any credit impairments (we'll know once those loans are sold off), but a highly leveraged and incredibly concentrated deposit base cried uncle in unison, and the bank's collapse began.

The bank's balance sheet exploded prior to and through the pandemic. According to its investor presentation in January, SVB banked with nearly half of U.S. venture-backed technology and life-sciences companies, including 44% of recent technology and health-care company IPOs. In 2009, SVB's deposits totaled $9B. By the time it was taken over by the FDIC in March, deposits had ballooned to a staggering $215B -- the result of a booming VC industry generating a flood of deposits that vastly outgrew its loan opportunities. SVB could have kept the deposits in cash of course but, as we wrote in the quarterly letter, that's not how things work in a fractional reserve banking system. Banks make money from money, so deposits need to be put to work -- either as loans or invested in securities. With analysts clamoring for higher net income (and a higher stock price), there was enormous pressure on SVB to invest its deposits into securities that would provide attractive yields.

SVB management embarked on a strategy to juice profits that eventually triggered an internal risk warning. According to Bloomberg (4/3/23), a company model showed that sharply higher interest rates could have a devastating impact on bank earnings. Rather than heed their own internal alarms, SVB executives changed the model's assumptions, thus validating its profit-driven strategy. They were profoundly misplaced but, instead of shifting course to mitigate that risk, they doubled down on a strategy to deliver near-term profits, displaying an appetite for risk that set the stage for SVB's stunning meltdown.

SVB's problem wasn't that the company invested in risky debt securities, per se, but rather that it had invested in longer-dated securities at the top of a prolonged, Fed-supported market. They effectively made two bets: one that the Fed wouldn't move off its ZIRP policy and, two, that its customers wouldn't want their money all at the same time. Obviously, in retrospect, it misjudged the latter when the former occurred, forcing them to put up for sale a big chunk of its underwater bond portfolio.

Betting that the Fed wouldn't start raising interest rates after thirteen years was, of course, colossally stupid. Buying huge sums ($80B) of intermediate duration Agency MBS (bonds that extend duration when rates move higher) rather than short duration U.S. Treasuries -- and assuming the risk was worth the additional yield they earned -- is inexplicable. In the end, it almost doesn't matter how the wildfire got started. What matters is that it did start and that nearly everyone headed for the exits at once as the panic spread through the valley. This is a point in time that we are likely nearer to the beginning than the end.

Regards,

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U.S. Large Cap Equity Strategy

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