Current Focus

March 2023

A monthly market comment from Rivers Capital Management. Views expressed here are subject to change and for professional advisors only

RIVERS CAPITAL MANAGEMENT

INTELLIGENT INTUITIVE INVESTING

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Summary

- Silicon Valley Bank collapsed due to higher interest rates and poor risk management
- Interest rate risk could have been avoided and will have been in larger banks
- Regulation for larger banks and better capital adequacy will avert systemic banking risk
- Refinacing debt for corporates and consumers will increase market volatility in 2023
- The Rivers portfolio allocation rremains underweight risk as we expect volatilty to continue

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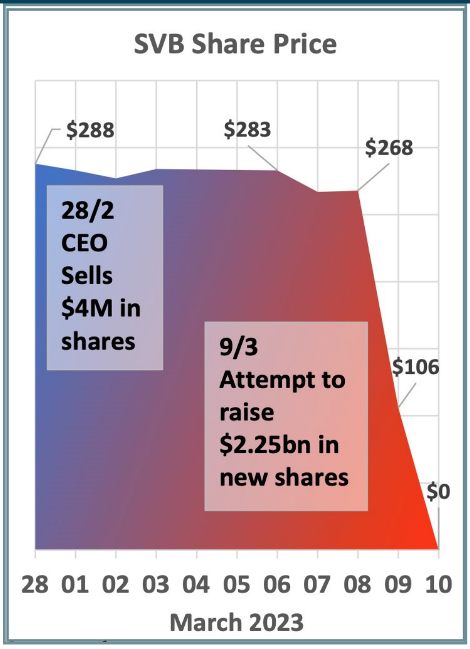
Market Comment

So far in 2023 investment markets have been volatile but just about positive. It is still early in the year but the unwelcome concurrence of falling bonds and falling equities that characterised 2022, has been absent in 2023. In January, neither were falling. In February, bonds were falling but equities were not. By early March this Focus was supposed to look at interest rate rises and why, inexplicably, many investors seemed to be underestimating the impact of higher interest rates. Particularly equity investors. The events surrounding the demise of the Silicon Valley Bank (SVB) have highlighted these risks. The causes and consequences of this bankruptcy are unavoidably the emphasis of the Focus now. Interestingly, almost 15 years to the day, this event is being compared to the Bear Stearns bailout and a step towards the great financial crisis (GFC) that followed. To be clear, from the start, we do not think this comparison is valid. The demise of this relatively unheard-of bank highlights some material risks that, in our view, remain underappreciated by investors. In truth, however, its bankruptcy is more of a lesson of poor risk management and lax regulation than it is a warning sign of a new financial crisis.

The collapse of SVB was the second biggest financial bankruptcy in the history of the US. It would be much further down that list if so many during the GFC had not been bailed out. SVB was not a bailout. As agreed during the weekend of March 11th/12th all depositors were protected from loss of their deposits, but all equity holders were wiped out. The problems for SVB started early in February as depositors, who were almost exclusively technology firms, started withdrawing funds, initially to cover costs. As a result of mounting withdrawals (from tech firms unable to raise capital) SVB was forced to sell the US Treasury Bonds it had held as capital. This crystalised significant top line losses and highlighted solvency risk, which led to a classic bank run by other institutional depositors. The cause of the losses and why they surprised other depositors were twofold; a total lack of sensible risk management practices and a lax regulatory regime.

It is no exaggeration to say the risk management at SVB was verging on the incompetent. There was an almost deliberate lack of diversification in depositors. Not only was there a very small number of sub $250k depositors (who, through the FDIC guarantee, get the same protection as retail UK bank depositors) but they were nearly all technology related businesses – i.e.



Source: tradingeconomics.com

customers susceptible to similar sector risk. Second, and ultimately the worst management decision, was the failure of SVB to hedge the interest rate exposure they had on their capital. For banks with sensible risk management, any capital held, even in tier one Government issued securities, would have the interest risk of those securities adequately hedged. This is typically, and easily, done through interest rate swaps. This will have a modest cost but would negate any interest rate exposure should that security have to be liquidated/sold before maturity. The fact that SVB used the accounting trick of booking these high quality liquid assets (HQLA – which have to be held as capital) as 'Held to Maturity' (HTM) assets not as 'Assets for Sale' (AFS) meant the losses could be hidden from public scrutiny. The fact they did this and that they did not hedge the risk was a managerial failure. The fact that they could do this was a regulatory failure.

That regulatory failure was specifically related to their size. Because SVB (conveniently) maintained its asset size to just under $250bn, it was able to record its capital assets using the Held to Maturity accounting method. As a result it did not have to record all its capital at current market value. It could instead just record the value as it would be at maturity. This in effect meant that unrealised losses of $15bn were, quite legally, hidden in the December 2022 reports from SVB. Given the duration of Treasuries and the extent to which rates have risen already, this remains a material risk for the banks of this size. That risk, however, does not exist for larger US banks. The introduction, by the US Federal Reserve, of a back-stop scheme, which enables banks to take loans, rather than fire-sell securities to meet withdrawals, looks likely to have stopped a broader contagion. Although the losses on small and regional banks do reflect this risk. That said, the strict capital requirements of large banks does make any systemic banking failure, similar to the one experienced 15 years ago, almost impossible, in our view.

This whole event highlights a number of risks which we continue to believe are underestimated by investors. There is not space here to cover these in detail but the Treasuries marked at par on SVB's balance sheet, hiding huge losses, should be compared to private equity assets using the same trick. The losses on bonds highlight the growing risks of refinancing and the liquidity risk of other unregulated institutions. This will impact nearly all credit lines, from governments to corporations. These risks are not adequately reflected in the high yield market where defaults can be expected to rise substantially. With inflation remaining stubbornly high, unemployment historically low and wages rising we do not share the growing expectation that interest rate rises will be reversed as a result of this. In the UK, where interest rates have a more direct effect on consumer spending and economic indicators are beginning to deteriorate, a pause is now likely. In the US, however, especially given the policies introduced to reduce financial risk, the Federal Reserve is unlikely to relent until inflation is materially lower. This will have consequences. The high yield market and much of the technology sector remain overvalued. A return to negligible interest rates is unlikely, and unwise.

The Rivers portfolios remain underweight risk with a short-duration Anchor allocation, a relatively underweight US equity exposure and Diversifiers allocated to gold, real asset and avoiding property.

Market Returns (£) - 28th Feb 2022	1 Month	YTD	1 Year	3 Year	5 Year	S/I*
Anchors						30/06/2016*
Cash	0.2%	1.5%	1.9%	2.1%	3.4%	3.7%
Inflation Linked UK Bonds	-4.8%	-14.4%	-33.6%	-29.9%	-19.0%	-13.2%
Gilts	-3.5%	-7.7%	-21.4%	-27.2%	-15.9%	-16.9%
Global Government Bonds (hedged)	-1.3%	-2.7%	-9.1%	-12.0%	-2.2%	-4.9%
Enhancers						
Global Corporate Bonds (hedged)	-2.5%	-1.4%	-10.4%	-11.8%	-0.6%	1.3%
Global High Yield (hedged)	-1.5%	3.0%	-6.2%	-3.2%	2.0%	15.0%
Emerging Market Bonds (hedged)	-1.1%	-2.2%	4.1%	-0.4%	5.5%	18.9%
FTSE 100 TR Index	1.8%	9.5%	9.6%	32.4%	31.7%	55.9%
FTSE All-Share	1.5%	8.7%	7.3%	28.9%	29.2%	55.2%
Global Equity (MSCI)	-0.8%	0.0%	2.7%	40.0%	58.8%	103.2%
European Equity (MSCI)	1.1%	13.3%	8.5%	30.4%	32.0%	68.1%
US Equity (S&P)	-0.8%	-2.9%	1.8%	46.7%	77.1%	127.5%
Japan Equity (Topix)	-1.0%	1.4%	2.3%	18.3%	12.3%	52.6%
Pacific Ex Japan Equity (MSCI)	-5.6%	-4.0%	-5.9%	5.3%	4.0%	53.2%
Emerging Market Equity (MSCI)	-4.9%	-6.1%	-6.1%	8.6%	3.6%	49.0%
Chinese Equity (Hang Sang)	-8.0%	-4.0%	-0.6%	-13.4%	-14.6%	28.2%
Indian Equity (Nifty)	-3.0%	-15.1%	-0.3%	42.6%	46.2%	85.1%
Diversifiers						
Commodity Index	-3.1%	-14.0%	6.1%	63.4%	47.9%	43.6%
Gold	-3.6%	2.6%	6.4%	18.6%	49.9%	42.9%
Silver	-10.6%	13.8%	-4.5%	29.3%	36.9%	14.0%
Brent Oil	-3.1%	-14.0%	6.1%	63.4%	47.9%	43.6%
UK Property	0.0%	-13.5%	-11.8%	0.0%	4.3%	14.1%
Global Property Shares	-0.1%	-7.6%	-21.7%	-10.9%	-2.5%	7.0%
Rivers Model Portfolios						
Rivers Preservation Portfolio	-0.5%	0.9%	-1.7%	1.3%	5.4%	14.5%
Rivers Cautious Portfolio	-0.6%	1.5%	0.3%	10.2%	17.4%	34.2%
Rivers Balanced Portfolio	-0.8%	1.8%	0.9%	15.3%	24.3%	46.1%
Rivers Adventurous Portfolio	-1.2%	1.6%	1.4%	20.1%	29.5%	54.7%
Rivers Aggressive Portfolio	-1.5%	1.9%	2.3%	23.8%	31.9%	64.7%
Rivers Cautious Income Portfolio	-0.9%	-1.4%	-4.3%	-0.1%	5.5%	12.5%
Rivers Balanced Income Portfolio	-0.8%	-0.5%	-1.8%	6.2%	12.2%	25.9%

Source: Financial Express in GBP (unhedged unless stated) as at 28th February 2023. *Rivers Portfolios since launch June 30th 2016
Model Performance is indicative only and is net of Rivers Capital Management Charge and Underlying Fund charge but not advisor or platform costs.