Silicon Valley Bank Seizure Roils Markets

In early March, regional banks, led by Silicon Valley Bank (SVB), became the collateral damage of the Federal Open Market Committee's (FOMC) dramatic rate increases that began in March of 2022.

The genesis of the issues that ultimately felled SVB was not credit risk associated with bad loans, but rather the risk the bank's assets had to interest rates, or in this case, rapidly rising interest rates. The exposure SVB maintained in their portfolio of securities available-for-sale (AFS), while additive to operating earnings during the rock bottom rates of the pandemic, turned swiftly against them as the federal funds target rate was raised from 0.25% in March 2022 to a 5.0% upper limit by the end of March 2023. The 5.0% upper limit of the fed funds target is a level not seen since August of 2007.

The value of a bond, or a portfolio of bonds, is inversely related to the directional change in interest rates. The longer the time to maturity of bond investments, the more significant the price movement will be. When SVB made public disclosures of both the size of their portfolio of available-for-sale securities and how impacted they were to the current interest rate environment, depositor concern was piqued. Within days, depositors rushed to withdraw their deposits from SVB. This concentrated group of depositors included companies and individuals with ties to the ecosystem of private technology and life science company formation. This classic 'run on the bank' turned a serious liquidity problem, that likely could have been managed over time, into a death sentence for the nearly 40-year-old Silicon Valley institution. Silicon Valley Bank became the largest bank failure since 2008. On Friday March 10, the Federal Deposit Insurance Corporation (FDIC) took receivership of SVB, ultimately auctioning the bank's assets two weeks later to First Citizen's Bank.

The FOMC, the Treasury Department, and the FDIC collaborated on the heels of SVB's seizure to stem the potential contagion of additional runs on bank deposits, extending a lifeline in the form of loan facilities. The RWA portfolio had no direct exposure to Silicon Valley Bank but does maintain a position in First Republic Bank (FRB). FRB became vulnerable due to its high percentage of deposits that exceeded the FDIC insurance threshold. In addition to the new credit facilities offered to FRB by the government agencies, a syndicate of banks, including JP Morgan, aided the bank by making a $30 billion unsecured deposit at the bank.

With the size of the SVB failure, coupled with a hastily arranged acquisition of troubled European bank Credit Suisse the following week,

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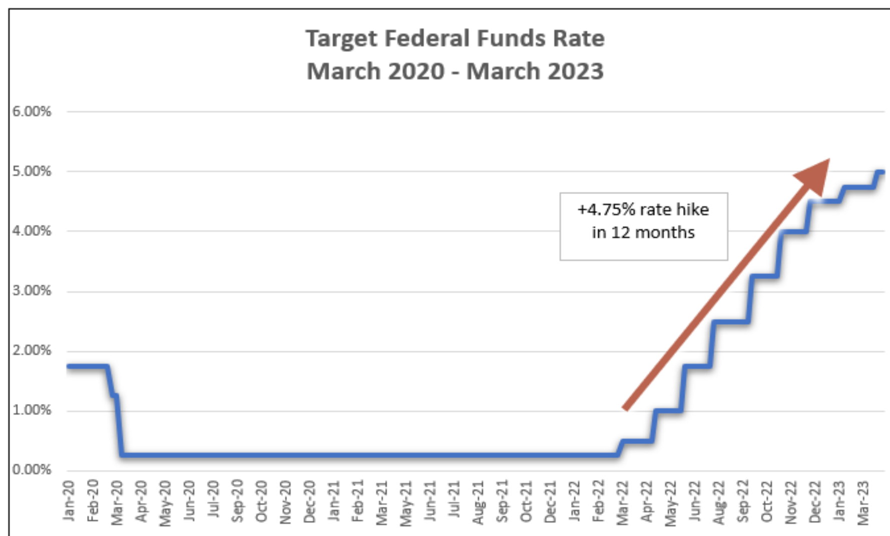
comparisons were immediately made to the onset of the 2007-2009 financial crisis, when the banking sector came under intense scrutiny with significant reverberations throughout the global banking system. Recall, however, that the catalyst then was a credit crisis, where borrowers were unable to service their loans and the collateral that backed loans, often real estate, was worth less than the loan value. These bad credits, and the financial derivatives built with them, crippled both the financial system and the world economy, ultimately leading to the Great Recession. Today, credit is not the primary concern, but rather the mismatch of mid to long-term assets, with short-term liabilities resulting in unsecured depositors seeking an assurance that their deposits are safe. During the Great Recession, assets were destroyed as the value of bad loans were written off as losses. The current flight of deposits to tier 1 banks like JP Morgan, which enjoy an implied government backing as systemically important financial institutions, has been disruptive but not destructive to assets.

In recent RWA Quarterly Commentaries we focused on the challenge the FOMC has faced in controlling the inflationary pressures that persist today. Their aggressive rate increases have been aimed at both retracing the pandemic era rate reduction and additional hikes to generate a real return on short-term fixed income investments. With the recent developments in the banking sector, the FOMC now has an additional task of alleviating instability and depositor concern caused by the historic pace of rate increases. In March, on the heels of the banking crisis, the FOMC increased their target rate by another 0.25% to 5.0%, indicating they will persist with their fight against inflation.



Source: YCharts

Economic inflation data has provided some encouraging signs that the worst of inflation is behind us. The core Consumer Price Index (CPI) continues to fall, now measuring a year- over- year increase of 5.5%. The FOMC references an alternative measure, the core Personal Consumption Expenditure (PCE) which measured 4.6% in their most recent release. The services component of economic inflation, however, remains stubbornly elevated. With this mixed bag of data, it is increasingly difficult to predict the FOMC's next move. The overall trajectory of FOMC policy will certainly be data driven, but they do not appear to be backing away from the "higher for longer" mantra regarding rates.

Market participants' attention turns toward fears of what the 'next shoe to drop' will be as a result of banking instability and high interest rates. A likely conclusion is that turmoil in the banking industry will lead to tighter lending standards, while higher rates reduce the demand for commercial and consumer loans. That combination will further pressure a business community already challenged by waning growth. We anticipate increased scrutiny on the value of alternative assets, which can range from a portfolio of private companies to pools of real estate, subject to valuation pressures due to the higher interest rate environment. These assets are often slow to adjust in a negative pricing environment. We do not anticipate a significant additional event, but rather a slowly worsening environment for businesses. Many analysts are forecasting a corporate earnings recession in 2023 as company profit margins tighten due to stubborn labor costs and higher borrowing costs.

Despite the uncertain environment, capital markets enjoyed positive returns across all classes. The stocks of the S&P 500 rose 7.5% in aggregate led by a rally in the technology and communication sectors, both bouncing back after a challenging 2022. The technology sector appreciated 21.8% followed closely by the communications sector at 20.5%. International markets also had a strong start to the year, with developed international rising 8.5% and emerging markets at 3.9% Small company stocks were the laggards, historically exposed to borrowing and having a high concentration to the banking sector. The S&P 600 finished slightly in the black at 2.6%. The bond markets did their part in adding return to the portfolio with the Bloomberg Aggregate Bond Index improving 3.0% in the quarter.

We anticipate market volatility to continue into the second quarter. Company earnings announcements, particularly from the financial sector, will allow for a data-driven analysis of the impact of banking turmoil during the quarter's final weeks. Additionally, company announcements will help validate or dismiss concerns of a looming earnings recession. The FOMC will remain front and center as their rhetoric around the current and future direction of their target will dictate the direction of the equity markets in the short term.

Are My Assets Safe?

The recent failures of Silicon Valley Bank (SVB) and Signature Bank (SB) have many questioning the safety of their deposits and investments. While this fear has been largely dormant in the U.S. during the last 15 years, the agencies charged with insuring consumers' assets are still alive and well. Let's consider Roberts Wealth Advisors' primary custodian, Charles Schwab, which is both a broker-dealer and a bank, to explain how the assets we manage are protected.

How are my investments at Charles Schwab protected?

At Schwab brokerage, clients' securities (stocks, bonds, Treasurys, certificates of deposit, mutual funds, and money market mutual funds) are kept separate from the assets Schwab maintains as a business. The SEC Security Protection Rule safeguards client assets at brokerage firms by preventing those firms from using customer assets to finance their proprietary business activities. In the very unlikely event that Schwab's business entity should become insolvent, these segregated brokerage securities are protected against creditors' claims.

In addition, Schwab is a member of the Securities Investor Protection Corporation (SIPC). This entity was created in 1970, as a federally mandated, private nonprofit organization to protect customers in the rare event their brokerage firm fails. SIPC only protects the custody function of the broker-dealer, which means that it works to restore securities and cash to clients if the broker-dealer fails (bankruptcy), and client assets are missing due to fraud or other causes.

According to SIPC, most broker-dealer firm failures happen with no impact on client securities. Since their inception, 99% of eligible investors got their investments back in the failed brokerage firms' cases that were handled. SIPC provides up to $500,000 of protection for brokerage accounts held in each separate capacity (e.g., individual, joint, trust). Up to $250,000 of that total can be applied to protect cash within the account holder's account that is not yet invested in securities.

How is my cash at Schwab Bank protected?

In most brokerage accounts at Charles Schwab, the sweep cash feature is a deposit of Schwab Bank. Additionally, Schwab Bank cash products include Investor Checking and Savings accounts. The Schwab Bank sweep feature pays interest on idle cash by automatically 'sweeping' cash balances from the brokerage account to one or more program banks. These products are all eligible for insurance under the Federal Deposit Insurance Corporation (FDIC).

The FDIC is an independent agency started in 1933 as a way for consumers to confidently place their money at thousands of FDIC insured banks across the country. It maintains the Deposit Insurance Fund which is backed by the full faith and credit of the U.S. government.

The FDIC insures accounts held at member banks up to $250,000 per depositor, per insured bank, based on ownership category. Ownership categories include individual, joint, and trust accounts to name a few. All the deposits at Schwab Bank are protected by FDIC insurance. That includes investor checking and savings accounts, and certificate of deposit accounts (CDs) held at Schwab.

Example 1: If you have a Schwab brokerage account, in your name as an individual, with two $250,000 CDs from two different banks, and you have no other deposits at those banks, your CDs would be covered for a total of $500,000 ($250,000 at each bank). However, if those two CDs are from the same bank, then FDIC insurance would cover a total of only $250,000 (leaving $250,000 of these CDs uninsured by the FDIC).

Example 2: If you have a Schwab Bank Investor Checking account, in just your name, with $200,000 and a Schwab brokerage (non-retirement) account with Bank Sweep Feature, in just your name, that has swept cash balances of $75,000 into deposits at Schwab Bank, then FDIC insurance would cover a total of $250,000 (leaving $25,000 of these deposits uninsured by the FDIC).

It is worth noting that in the most recent bank crisis, the FDIC guaranteed all balances of Silicon Valley Bank depositors, even when those balances exceeded the current limits. U.S. lawmakers have already begun discussions around raising the deposit insurance cap and we expect to see those talks continue.

Portfolio Activity

Index Performance	Q1	YTD
Dow Jones Industrial	0.93%	0.93%
Standard & Poor's 500	7.50%	7.50%
Nasdaq Composite	17.05%	17.05%
MSCI EAFE (International)	8.47%	8.47%
Russell 2000 (Small Company)	2.74%	2.74%
MSCI ACWI (Global Stock)	7.31%	7.31%
Barclays Intermediate Term Bond	2.96%	2.96%
Barclays Municipal Bond	2.78%	2.78%
Barclays Short Term Bond	1.82%	1.82%

The main areas of focus during the first quarter were exiting positions where we believed the near-term opportunities had declined, and taking advantage of higher interest rates on the fixed income and cash segments of our portfolios. In aggregate, we were net sellers of equities and net buyers of both bonds and cash as we worked our way through a quarter of volatility.

Our equity sales focused on two names: Salesforce (CRM), where we took our position down by half, and Masco (MAS), where we exited our position entirely. Salesforce is an industry leader in customer relationship management software and one that we believe will continue to grow in the years ahead, but a big jump in the stock price and several recent events gave us pause and led us to resize the position.

Towards the end of the fourth quarter, Salesforce witnessed executive departures including its co-CEO and expected future sole-CEO Bret Taylor. There were also separate stories of clashes between management and founder Marc Benioff related to power structures within the firm. Further, as Salesforce reduced headcount over the course of the first quarter, there were reports of employees becoming unhappy with the uncertainty of their work environment.

Salesforces' unstable culture was a notable factor in our decision to reduce our position. Salesforce has historically projected the image of an innovative, startup culture through its 'trailblazer' campaigns, but that now appears to be changing. Instead, Salesforce has enacted vitality curves privately into its HR processes after public discussion led to blowback on the idea. We think that represents a sea change in the way current and prospective employees will view the company and could lead to further internal issues down the line.

We also exited our position in Masco (MAS) during the quarter. Masco is a leader in various home improvement and building product categories and has been a major beneficiary of pandemic remodel activity, but our analysis led us to conclude that near-term growth would be harder to achieve. Additionally, we maintain other positions with direct exposure to the home remodel trend, such as Home Depot (HD) and Williams Sonoma (WSM), where product diversification and valuation are more compelling.

Our main purchase in equities during the quarter was to add to our existing position in Medtronic (MDT). The company is a U.S.-based, Irish-headquartered medical device company that sells pacemakers, defibrillators, and insulin pumps. Medtronic is a name we have held for some time, but recent declines in the stock price, as well as signs of green shoots in hospital procedures, caused us to become incrementally more positive on the near-term opportunity.

Finally, the majority of the activity took place within the cash asset class where we shifted a significant value of cash deposits into purchased money market funds or short-term U.S. Treasury Notes. Purchased money market funds, like Schwab Value Advantage, pay attractive yields and are collateralized by securities primarily backed by the U.S. government and its agencies. That means cash continues to play an important role in portfolio returns as we navigate the volatility in these markets.

TOP 10
U.S. HOLDINGS

- **Apple**
- **Microsoft**
- **Alphabet**
- **Amazon**
- **Trane Technologies**
- **J.P. Morgan**
- **Cisco Systems**
- **Thermo Fisher**
- **Qualcomm**
- **Visa**

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There are a number of SEC regulations and disclosures we adhere to in an effort to ensure we are in compliance with the heightened standards of the profession. These disclosures are available in a public format. Below are some of the regulatory filings Roberts Wealth Advisors publishes to our clients.

- The SEC maintains the Investment Advisor Public Disclosure (IAPD) website. On that website, you can navigate to find public disclosures of any individual advisor or advisory firm that is registered with the SEC (https://adviserinfo.sec.gov/).
- On an annual basis, registered investment advisors file Form ADV and make it available to clients. Roberts Wealth Advisors updates its filing during the first quarter of each year and offers a copy in our second quarter reports. Form ADV outlines any material changes to the business (e.g., physical address change of the CA office) that has taken place and all disciplinary actions that have been enacted on our firm (none to note) in addition to details of our business operations like assets under management.
- Form CRS (Customer Relationship Summary) is another annual filing that is updated and made available to clients via our website, roberts-wa.com. Form CRS is a brief relationship summary designed to help individuals make informed choices regarding whether an investment advisory firm is best suited to meet their particular circumstances and investment objective.

The RWA Privacy Policy is also updated and provided annually to remind clients we are keeping non-public information secure and private. A highlight of the privacy policy is that we do not sell your information. It is shared with third parties only in circumstances when it enhances our service offering to you. Your information is never sold or shared by RWA for marketing or other purposes.

Additionally, each RIA is required to perform an annual compliance review. This reviews firm policies and procedures to assure compliance with the prevailing regulations applicable to advisors. Some of these regulations include trading, account maintenance, and reporting procedures to assure we are treating clients fairly and being efficient with the money we are tasked with managing.

It is important for us to maintain the confidence clients have placed in us to act in your best interest in the management of your financial objectives. In addition to the integrity of our firm and its members, there is a robust regulatory environment intended to make sure you are being well served.

Featured Stock: Zoetis (ZTS)

Zoetis is a global leader in the animal health industry and focuses on the entire medical process from discovery to commercialization of medicines, vaccines, diagnostics, and other treatments. The business is broadly split into two key segments- companion animals, which includes cats, dogs, and horses, and livestock, which includes cattle, swine, poultry, fish, and sheep. The business is also well diversified geographically with just over 50% of its revenues coming from the U.S. and the remainder coming from dozens of other countries around the world.

Zoetis is not a new name for the portfolio, but it is one that we felt demanded a larger position, which we took advantage of during some weakness in the fourth quarter. The company is highly levered to a movement that we believe is one of the strongest secular trends in the consumer space today, namely, the humanization of pets. Medical treatments for companion animals account for roughly 70% of domestic revenues and nearly 60% of total revenues, rendering pet care the largest focus of the business.

Recent industry research projects that the global pet economy could reach nearly $500B annually by 2030, which would be a 54% increase from the level last year. And while this trend was accelerated by the pandemic and led to early gains for food and toy-oriented companies, we believe the next leg of growth in this industry is likely to come from the medical side. That same thought process explains the decision to offload Chewy from our portfolio at the same time last year.

As one example of this trend, a report from 20 years ago published by The Pet Fund, a nonprofit organization, showed that about 20% of its funding requests were related to cancer treatment. As of last year, that same number had climbed to over 60%. Additionally, it's estimated that in the U.S., only about 4% of dogs and just under 1% of cats are insured – as medical costs become a larger component of pet ownership, we believe the percentage of covered pets will increase and lead to further diagnostics, treatments, and operations that should directly benefit companies like Zoetis.

Finally, while the U.S. continues to be the largest market for pet-related products, the total non-U.S. market is approximately 50% larger, and growth in spending from abroad is expected to outpace spending here at home. We believe that Zoetis' position as one of the largest players in this space, combined with its global reach, will enable it to disproportionately benefit from further growth in the industry. For these reasons, we have increased our position to among the largest in our portfolio.

Topic Spotlight

Generative Artificial Intelligence

One of the biggest stories over the last few months has been the unveiling of generative artificial intelligence (AI) into the mainstream through programs like ChatGPT, Bard, and ERNIE Bot. Each of these individual applications have been funded or developed by major tech companies, with Microsoft funding ChatGPT, Google launching Bard, and China's Baidu releasing ERNIE Bot.

So, what exactly does AI do and where could things lead? Well, we asked the question of ChatGPT and will let it explain for itself.

"Explain Generative AI in Layman's Terms in Less than 250 Words."

Generative AI is a type of artificial intelligence that is designed to create new things, like images, music, or text, that are similar to what humans can create. It's like having a machine that can learn how to draw, compose music, or write stories.

How does it work? Generative AI uses algorithms that are trained on huge amounts of existing data. It analyzes patterns and structures in the data, and then uses that knowledge to generate new content that is similar to what it has learned. For example, if it has been trained on a lot of pictures of cats, it might be able to generate new pictures of cats that look very realistic.

One of the coolest things about generative AI is that it can create things that humans have never seen before. Because it's not limited by human creativity or imagination, it can come up with new and unique ideas that we might not have thought of on our own.

Generative AI has many practical applications, from helping artists and designers create new works, to generating text for chatbots or virtual assistants. It can even be used in healthcare, finance, and other industries to generate predictions or simulations based on complex data.

However, like any new technology, there are also concerns about the potential risks and ethical implications of generative AI. It's important to use it responsibly and make sure that it doesn't cause harm to individuals or society as a whole.

Thus, while AI exposure appears more direct through programs like ChatGPT and Bard, the use of artificial intelligence is widespread in the business world today. We own direct exposure to this theme through our positions in Microsoft and Alphabet, but several other core holdings also rely on artificial intelligence to run their operations.

As an example, Adobe has incorporated AI into its offerings through its Sensei AI program for nearly a decade, using predictive intelligence to create unique customer experiences based on historical behavior and preferences. JPMorgan utilizes AI not only for fraud detection and prevention, but also for other cases like personalized online banking and AI-powered virtual assistants. Furthermore, GSK has just begun to apply AI and machine learning to its large datasets to identify higher probability of success for its vaccines and treatments.

The hype around programs like ChatGPT stems from the fact that these programs are ushering in the next era of AI, namely, generative AI. Traditional AI was instrumental in making predictions of outcomes, but generative AI takes this a step further to the creation process itself. As we move forward, we are likely to hear more and more about this type of artificial intelligence and its growing role in enterprise software.

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