Marble Harbor Investment Counsel, LLC
First Quarter, 2023 Letter

We are pleased to send an excerpt from our quarterly client letter that discusses our current thinking. We welcome your thoughts.

Sincerely,

Paul Davis, L.J. Harrington, Eric Robb, Daniel Rosenblatt and Howie Cowan

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There are times when quality and security are far less valued than excitement and sizzle … Ironically, one of the big "knocks" amongst Wall Street analysts is that the bank has been too conservative – that they have far too much in reserves and shareholders' equity held against possible future losses… i.e., they should be more aggressive.
Marble Harbor Quarterly Letter, Third Quarter 2020

We wrote this about one of our bank investments in the fall of 2020. At that time Silicon Valley Bank (SVB) was the excitement and sizzle of the banking industry, a $300 share price on its way to $700. It now sits at zero. Clients understandably have had a lot of questions about SVB's fall from grace and the state of the banking system in general. We thought we would share our thoughts about what happened at Silicon Valley, the state of the banking industry and how we invest in banks.

Silicon Valley Bank was a different kind of bank than the ones you own. It catered to the venture capital, technology and startup community. Unlike most other banks who have a mix of depositors, more than 80% of SVB's customers were commercial entities, far more than any other bank. With the boom in funding young technology companies in 2020 and 2021, the bank grew quickly, as early-stage companies deposited the money from their Initial Public Offerings (IPOs). They grew so quickly that they didn't have time to do what most banks do with deposits – make loans. Instead, they invested the money in seemingly safe long term securities – government backed bonds and high quality mortgages.

You'll recall that in the summer of 2021, interest rates were low. Short-term interest rates were 0.1%, while 10-year Treasury Bonds were offering for a comparative king's ransom of 1.2%. We wrote to you at that time that both short-term and long-term rates were historically *unattractive* investments. Since you weren't being paid much to lend for 10 years, if you invested in short-term bonds, you would at least have the opportunity to reinvest as rates rose. With 10-year bonds, you were locking in singularly poor rates for a decade. Silicon Valley Bank *had* to invest all of their booming deposits in something, so rather than grit their teeth and wait for better days investing in short-term Treasuries as we did for you, they mostly invested in 10-year paper to earn an extra one percent. They were buying safe credits, but they were taking on the risk that interest rates might rise someday. This seemed to us like picking up nickels in front of a freight train.

With their depositors, SVB also had a specific industry-concentration risk. They catered to venture-backed companies, private equity, venture capitalists and technology companies. While

on the surface these areas may seem to exist in different worlds, ultimately they all rose and fell based on similar factors, such as a strong stock market and low interest rates. In 2020 and 2021, the IPO market was booming, and their customers put much of that money into the bank, swelling deposits. However, as the IPO market cooled, many of these lossmaking companies had to withdraw money from the bank to fund operating expenses.

Coincident with deposits starting to exit, interest rates began to rise with a vengeance. The 10-year Treasury got to 4%, but perhaps more importantly, short-term rates reached 5%. When a 3 month Treasury Bill yielded little more than a bank account, companies didn't mind leaving their cash in the bank. When they could earn 50 to 100 times more in a Treasury Bill, companies accelerated their withdrawals. As interest rates rose, the value of their long-term bonds fell. The change in rates created an unrealized loss on Silicon Valley's balance sheet that was equal to the size of their shareholders' equity. In other words, if you reflected the bonds' actual market prices, there would be no value left for the stockholders.

In March, when SVB tried to reposition some of their short-term investments and raise capital to cover the loss in deposits, the shortfall on their balance sheet became apparent. The company did a poor job of explaining the need for new capital, and customers saw this as a sign of fundamental weakness. Since more than 80% of their depositors were corporations without FDIC insurance, customers shot first and asked questions later. Many tried to take out all of their money at once, creating a run on the bank. The FDIC stepped in, and the rest is history. It's hard to believe that by reaching for a paltry one percent, the bank's management destroyed the company.

Over the years, we have researched Silicon Valley Bank, as well as failed brethren, Signature Bank and Credit Suisse. SVB was the golden child, basking in the glamor of their successful venture-backed tech clients. They grew revenues and deposits much faster than their staid peers, and their stock price shone. They reflected the ethos of the time that technology companies were the future and could do no wrong. We shied away from SVB as well as Signature and Credit Suisse because banks generally *shouldn't* grow fast. Fast growth is often a sign of reckless underwriting or short sighted practices. It's the opposite of what we look for in banks.

It's important to keep in mind that banks are levered entities: They borrow money from depositors and then lend it out. Since banks are levered, we look for conservative ones that take measured risk and use reasonable leverage. Risks can come in different forms. Risk can come from underlying investments like in the mortgage crisis of 2008, or it can come from counterparty risk, recession risk, or the interest rate duration risk and industry concentration risk that did in Silicon Valley Bank.

The banks we own are prudent underwriters of loans, have a healthy mix of depositor types with appropriate leverage on their balance sheets, and conservative management. Banks are not a place to take risk. We own them for you to generate income and a modest investment return. For us a rapidly growing bank is a big, red flag.

A question you may be asking yourself is whether this is a systemic issue. The volatility that we're now seeing in the banking sector is much different than 2008 and 2009. The financial crisis was triggered by bad mortgages packaged up into complex securities called CDOs and sold to banks. When the housing market fell, this created stress on bank balance sheets and led to the

failure of Bear Stearns, Lehman Brothers and others. That behavior was pervasive amongst banks at that time. Today, bank balance sheets are much cleaner with fewer bad loans. Banks do have interest rate risk on their balance sheet, but by and large, the industry is much healthier than it was. The FDIC and the Fed have stepped in much earlier this time and calmed nerves, as they should, because no bank can withstand a run.

SVB was unique. Their reliance on commercial deposits, some bigger than $3 billion, from technology companies helped the bank grow in the good times but also left it vulnerable when the tide turned in technology. This combined with the poor positioning of their balance sheets led to a situation that was liable to lead to a run on the bank. Most of the banking industry, and certainly the banks you own, are not similarly positioned.

We have stress tested our banks, and we are confident that they have strong balance sheets, reasonable leverage and conservative operating profiles. Their stocks have been volatile with the rest of the banking sector, but their operations are sound. Our banks may be boring, and rising interest rates may pressure earnings for a spell, but in difficult times, we are confident they will deliver. That's why we invested in them in the first place. Quality and security may not always matter to Wall Street, but they matter to us.

Sincerely,

Paul, Eric, LJ, Dan and Howie

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