APRIL 18, 2023

Spears Abacus 1Q23 Commentary

I. Market Overview

Not that long ago, the common wisdom was that a full market cycle (a bull market followed by a bear market) lasted, on average, three years. Times have changed. It is not much of an exaggeration to say that the first quarter contained one and a half market cycles. Stocks rose nearly 10% in January, fell about the same amount over the next six weeks only to rise again starting in mid-March. When the dust settled, broad market averages of large company stocks advanced 7.5%. The star performer was the tech-heavy Nasdaq composite, which appreciated nearly 17%, recouping some of its 33% decline in 2022. Despite the gyrations, the real focus of the period was on a small handful of medium-sized banks that became household names overnight.

In the wrong hands, cheap money is the parent of bad decisions. At the risk of grossly oversimplifying a complex issue, we believe that the latest round of bank failures was the result of poor judgment, unrealistic optimism and the ultra-low interest rate environment of the past several years.

In previous commentaries, we have pointed out that speculation is a frequent side-effect of aggressive monetary policy. Think about meme stocks, NFTs (Non-Fungible Tokens), blank-check companies, 100-year bonds, certain types of venture capital investing and others. All soared in value in 2020-21 but came crashing back to earth in the face of rising interest rates last year.

It would be unfair to conclude that the failure of Silicon Valley Bank (SVB) was the result of this level of speculation. However, it is not a stretch to say that management literally bet the bank on the notion that interest rates would remain historically low for the foreseeable future and beyond.

Perhaps SVB management was lulled into overconfidence by knowing that its large portfolio of longer term U.S. government bonds would always be "money good." Management failed to account for the possibility of changing behavior among the bank's customers. As short-term rates rapidly rose, SVB's depositors became a less-reliable source of funding. The bank was trapped by poor investment decisions, and liquidation followed.

At this point, the failures of SVB and Signature Bank do not seem like the harbinger of systemic risks. Though rapidly rising interest rates were a common theme, each management team created its own specific set of problems. Regulators responded swiftly and appropriately. We believe the passing of time will show that the risks were isolated rather than broadly based. However, we do think that there will be longer term impacts for most banks. Regulatory scrutiny is almost certain to intensify. Lending standards have already tightened, but for how long is difficult to predict. There should be pressure on profit margins for all but the biggest banks for the foreseeable future.

As April begins, investors are already retraining their focus on employment, the economy and the future paths of inflation and interest rates. Markets are back to the business of differentiating between

good companies and bad and strong and weak management teams. We remain cautious with healthy levels of cash reserves ready to take advantage of bargain-priced investments should they appear.

II. Portfolio Thoughts

Warren Buffett once said one should "Invest in businesses that are so wonderful that an idiot can run them because sooner or later, one will." In addition to providing a comment on the quality of banking as a business model, we think that recent banking industry events highlight the importance of management. Poor decision-making by executive leadership at SVB and Signature Bank led to their demise. First Republic's equity is likely to be permanently impaired.

For a bank CEO, the post-COVID era offered a difficult trade-off. Fiscal and monetary policy was accommodative. Companies and households were awash in cash and deposits were abundant. Bank executives could sit on the excess liquidity or try to maximize current net interest income ("NII" - the difference between interest earned on loans and the interest paid on deposits) by investing surplus deposits in low-yielding loans and securities that were vulnerable to mark-downs if interest rates were ever to rise.

This trade-off wasn't a secret. JP Morgan CEO, Jamie Dimon, explained the options well on an October 2020 conference call in response to a question from Jefferies analyst, Ken Usdin, about putting the influx of deposits to work:

> *We're not going to invest in stuff making 50, 60 or 70 basis points so we get a teeny little bit more of NII. We're going to make long-term decisions for the company. And, if your NII, in the end, gets squeezed a little bit, so be it. But we don't want to be in a position where we lose lots of money because we made investments in 5 or 10-year securities which you'll lose a lot if rates go up. So, we're not protecting NII.*

Allocating balance sheet capital to longer duration securities to boost current earnings was a management decision. Some chose to ignore the risk that future interest rates would rise, but Dimon didn't. As a result, JP Morgan didn't just avoid a landmine, it solidified its reputation as a "fortress balance sheet" and appears likely to profit in the future from an influx of low-cost deposits and new customer relationships.

The example of JP Morgan's performance in the most recent banking crisis illustrates why we think that owning "wonderful" businesses that are also well-managed is the right strategy, especially in a difficult environment.

III. Personal Finance

It's well known that interest rates are higher than they have been in many years. The implications are sometimes obvious, for example, negative impacts such as higher mortgage rates or auto loan rates, or positive implications such as higher bank-deposit rates and bond yields. We wanted to point out a few less obvious implications. For a timely example, consider estimated quarterly tax payments. The tax code requires you to make payments evenly throughout the year either through wage withholding or quarterly payments. If you underestimate your required payments, you will be subject to a penalty and interest – that interest rate today is 7% (and may go higher throughout this year). That is more than double the 3% rate at the start of last year. While some may have been tempted to underpay when rates were low, 7% is a significant hurdle to overcome. Of course, if you have to make tax payments using a line of credit, your borrowing rate may be even higher. The prime rate, while less popular as a lending benchmark than in eras past, is still commonly used for many personal and home equity lines of credit. Today the prime rate stands at 8%, up from just 3.25% one year earlier.

Perhaps paradoxically, there are several financial planning opportunities when rates are high. For example, Qualified Personal Residence Trusts (QPRTs) are often used to make a future gift of your personal residence to others, usually your kids or grandkids. In short, it allows you to discount and freeze the value of that gift, as it only transfers to the beneficiaries after a specified number of years (generally 10 or more). Higher rates translate to a smaller current gift and therefore either less use of your lifetime gifting/estate credit, or less gift tax if there is no credit remaining. Likewise, Charitable Remainder Unit Trusts (CRUTs) are often used to make a current gift to a charity of a future actuarial amount. Higher interest rates result in a larger amount of the future gift, allowing more planning opportunities for the donor today.

We would be pleased to discuss these changes, and any opportunities they present, with you and/or your tax advisor.

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