FINANCIALS UPDATE

Financial Sector Update – 22 March 2022

Alan Pullen, Portfolio Manager and financials specialist at Magellan.

We have had a lot of questions recently about the volatility in the market due to the collapse of Silicon Valley Bank and, just over the weekend, the emergency sale of Credit Suisse to its bigger Swisse rival UBS.

So, let's start with how we got here, and then we'll talk about the implications for markets and the Magellan Global Fund:

- The current issues really kicked off with Silicon Valley Bank
- Following a failed capital raising almost 2 weeks ago SVB faced a bank-run and effectively failed, with regulators stepping in to take control of the bank.
- SVB was the largest bank failure since 2008, albeit the bank accounts for less than 1% of total US banking system assets.
  - SVB's problems were *mostly* idiosyncratic, it had a narrow model focused on the early-stage technology industry, a weak deposit franchise, and they mismanaged their balance sheet.
  - While mostly idiosyncratic, several other US banks with similar characteristics came under pressure, including the failure of 2 banks focused on services to the crypto sector.
- Keep in mind that the US has thousands of banks and failures are not uncommon, but the size of SVB and the failure of 3 banks in quick succession has some eery similarities to the early stages of the global financial crisis, and there was a risk of a loss of confidence in the banks more generally and bank-runs; when depositors lose their faith in an institution and try and withdrawal their money at once even a well-capitalised bank can be vulnerable, and in the era of social media and electronic money, this can happen pretty quickly.
  - In addition, almost all banks are facing losses on the securities they hold due to the increase in interest rates, these are safe US treasuries or government guaranteed Mortgage Backed Securities, so they are not going to default, but their value does go down as rates increase. This is mostly an accounting issue, as these securities approach maturity they return to par value.
  - In fact, for most banks the first order impact of higher rates is actually positive, as the return they earn on assets increases more than the rate paid on liabilities.
  - Nonetheless, the reporting of the failure of SVB has focused heavily on their securities losses, impacting confidence in the banking system more broadly.
- In light of the risk of bank-runs US regulators reacted quickly, announcing that all depositors in the failed banks will be protected. In addition, the Fed has established a new funding facility providing additional liquidity to the banking system should it be required.

Nonetheless, given these issues the market looked for other banks that may be vulnerable, which brings us to Credit Suisse.

- Credit Suisse has struggled with low profitability over recent years, reporting losses in both 2021 and 2022, and notable governance failures, including the loss of $5.5bn on the failure of a US hedge fund a couple of years ago and money laundering violations.
- They faced deposit outflows in 2022, undertook a capital raising, and embarked on a significant restructure of their business model.
- Nonetheless, given heightened scrutiny on banks, Credit Suisse's weaknesses resulted in a loss in investor and depositor confidence.
- The failure of Credit Suisse is a much bigger deal than SVB, given its size and international linkages and would raise the risk of a financial crisis.
- Because of this risk they are designated a GSIB, a Globally Systemically Important Bank, essentially this means its will not be allowed to fail. And indeed, regulators stepped in quickly to resolve the situation, with the bank sold to its stronger rival UBS over the weekend. While shareholders and holders of some hybrid capital instruments have taken a significant amount of pain, this resolves the risk of the bank failing and impacting the financial system more generally.

The common thread is that these were banks with weak business models. Despite the surface similarities to the GFC, our broad view is that the banking sector is in a very different place to the GFC; capital levels are higher, credit losses are low, and profitability for most banks is solid. This is particularly true for the large retail banks in the US, Europe, and Australia for that matter. Combined with the rapid response from regulators our view is that the likelihood of this spiralling into second financial crisis is low.

However, banks with weaker business models will continue to come under scrutiny, and given the importance of confidence in banking, further issues in the sector cannot be ruled out entirely.

Ok, so now what does that all mean for markets.

- While we think the risk of a widespread financial crisis is low, it’s not zero and further evidence of financial contagion would obviously create significant volatility.
- We also need to think about the second order impacts here. Smaller banks in the US are important sources of loans for businesses and are likely to pull back on lending. Combined with decreased risk appetite more generally, this can only increase the risk of a recession.
- The Federal Reserve is likely to be more circumspect with rate increases, albeit they are in a tough spot given inflation remains elevated.
- This is also an environment where the risk of accident happening is higher. We are seeing some concerns in the bond market given some hybrid instruments of Credit Suisse were bailed in for example, or there may be ripples through the private asset markets which is often quite leveraged. We can’t say for sure what this might be, but risks are clearly elevated.

So finally, how is Magellan positioned and how has it impacted our funds.

- Well, I should point out that given Magellan focuses on high quality companies we have no exposure to Credit Suisse or Silicon Valley Bank, they simply don’t pass our quality filter.
- In fact, the Global Fund has only very limited exposure to banks. We did hold 2 banks last year as rate increases resulted in an improvement in profitability but sold one of those

holdings late last year as economic risks rose. So our only exposure is a ~2% position in US Bancorp, one of the highest quality banks in the industry.

- While we do think the risk of a full-blown financial crisis is low, the risk to economic growth has increased and we can’t rule out a black swan type event in the current environment.
- Nonetheless, Magellan's focus on high quality companies and downside protection means the portfolio well placed in the event of volatility in markets. An uncertain environment favours high quality companies; those with competitive advantages, strong balance sheets, and idiosyncratic growth drivers, and valuations are attractive. To date, the portfolio is performing as we would expect in the environment, and remains well placed to weather any further volatility.