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The Krygier Report

An exclusive newsletter from Mark J. Krygier, Senior Portfolio Manager | April 2023 www.krygierwealthmanagement.ca

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Nobody asked for my opinion!

I must admit that I had to chuckle when I first heard about the demise of Silicon Valley Bank (SIVB) in California. While I feel terrible for any consumers who were threatened by the potential loss of their hard-earned capital, I was more than a little surprised by the “oversight” (or lack thereof) by the risk managers at the bank itself. Also shocking was the lack of supervision by the federal bank regulators, who are supposed to oversee the risk management of financial institutions in order to avoid another 2008-09 financial crisis. The circumstances surrounding the SIVB debacle were undoubtedly unique, but the errors in judgement which were made were, in my opinion, elementary. When I first sit down with a new client, or when an existing client wants to deposit additional funds into their investment account, I always, and I repeat always, ask the same question – “When do you need the money?” In my way of thinking, that is so basic a question that it almost need not be asked, but I ask it anyway and I do so – every single time. Why? Very simply – how can I even begin to formulate a plan for investing for a particular client if I don’t have this most basic of parameters clear? Is this money meant to be invested for long-term growth with no foreseeable prospect of capital withdrawals? Is it meant to provide a steady stream of income, without the need for capital withdrawals for the foreseeable future? Alternatively, is this short-term deposit money which will be withdrawn within 1-6 months, or a year or even two years? Clearly, if I don’t have on my “salesman’s hat” and instead I am thinking about the needs of my clients and <u>their</u> personal use of <u>their</u> money, I need to have these questions answered with as close to 100% clarity as possible before I can invest a penny. Apparently the SIVB bankers didn’t share this same line of reasoning. Today those bankers are looking for new jobs.

The bankers at SIVB were dealing with an unusual type of clientele – venture capitalists. These clients would raise hundreds of millions if not billions of dollars and deposit them with SIVB for safe keeping, while they mulled over their next deal. In theory, at a moment’s notice, any one of these clients could withdraw all their funds if the right deal came their way – that is the nature of venture capitalists. They need to be nimble, and they need all their money to be available at a moment’s notice – in theory. As a result, amongst their total client base, these bankers were sitting on billions of dollars of cash in their clients’ accounts. Traditional banking profits stem from the “spread” between what banks pay their clients for “loaning” the banks money (in GICs, CDs or savings accounts) and what the banks can earn on that money by lending it out (for mortgages, lines of credit, etc.). Therefore, the bank will pay out a small amount of interest on the deposits of the account holders and try to make some profit via this spread on the deposits. However, rather than investing in short-term T-bills (treasury bills backed by the federal government) or other safe, short-term “money-market” investments which would also provide liquidity in the event that the account holders in fact withdrew their funds, the bankers chose to try and squeeze just a little bit more profit for the bank’s bottom-line by investing in 2-year Treasury bills which provided slightly higher rates than the money-market instruments, thereby widening the “spread.” To paraphrase the “Bard”, “therein lies the rub…”.

One of Sir Isaac Newton's famous laws of physics is that, "an object in motion remains in motion at a constant speed and in a straight line unless acted on by an unbalanced force." To say that the bond market was "in motion" up to 2022 is an understatement. For the previous 30 years, bond yields had essentially been collapsing, as yields went from high double digits (18%+) in the '80s to less than 1% by 2021. As bond prices move inversely to bond yields (as, for what would you be willing to pay more – a bond yielding 3% or a bond of the same quality and maturity paying 5%?), while yields were collapsing, bond prices were soaring. That "story", however, is "so yesterday". For the first time since the early '80s when Paul Volker was Chairman of the US Central Bank (the "Fed"), Jerome Powell raised rates faster and higher in 2022, in a belated attempt to conquer inflationary pressures which were exacerbated in a post-Covid world. When those short-term rates got jacked up, many got caught off guard, including retail clients with variable mortgages, and, to the point of this newsletter – institutions holding bonds or other fixed income instruments whose maturities did not align with the timing of potential demands for liquidity. When SIVB clients chose to make large withdrawals from their account holdings, the bank was forced to sell the 2-year treasuries at current (much lower) prices – known as "mark to market". Therefore, while holding two-year Treasury bills was not a "credit" problem (versus what the financial institutions suffered in the "sub-prime" crisis of '08-09), it was a "rate" problem. This rate problem forced these bankers, who had sought to squeeze just a little bit more of profit to the bottom line, to liquidate their holdings in safe treasury bills, but prior to their maturity, thereby causing the bank needless losses of billions of dollars overnight and pushing the bank into insolvency. Truly an astounding turn of events.

Bottom line

Successful investing does not have to be rocket science. It does however require a little bit of common sense, and unfortunately it seems that itself is not too common. At the very least, you need to start the investing process by identifying what are your needs for your available investible assets? Are they intended to use for a short-term need like buying a house, paying a large tax bill, or a potential business deal that could arise at any time? Or are they truly intended for long-term investing, such as capital which is to be passed on to the next generation, or as a pool of capital from which one will generate income in retirement throughout one's lifetime? Set aside the greed for potential short-term gains and be realistic about the need for one's money. While this is only the first step to success, missing it can mean losing everything!

Global benchmarks

As at March 31, 2023 (Canadian $ Returns – except where noted)

Asset class	YTD	1 year	3 years
S&P/TSX Composite T/R (Canada)	4.6%	-5.2%	18.0%
S&P 500 TR - **US$**	7.5%	-7.7%	18.6%
NASDAQ Composite - **US$**	16.8%	-14.1%	16.6%
MSCI Europe Index Price Return	9.6%	6.8%	10.9%
MSCI Emerging Markets	3.3%	-6.2%	3.9%
China S.E Shanghai A Price Return	6.1%	0.4%	5.6%
MSCI World Index Price Return	7.0%	-1.1%	13.1%

Asset class	YTD	1 year	3 years
30-year U.S. T-Bond - **US$**	6.6%	-18.8%	-13.6%
10-year U.S. T-Bond - **US$**	4.3%	-6.5%	-6.4%
Long GOC Bond (2053)	7.1%	-10.1%	-10.1%
10-year GOC Bond	4.3%	-1.2%	-4.1%
5-year GOC Bond	2.4%	0.1%	-1.9%
3-month CDN T-bill	1.1%	2.4%	0.9%
US$/CDN$ (1.3515)	-0.3%	8.1%	-1.3%

Source: RBC Capital Markets Quantitative Research

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