Manole Capital Management
1st Quarter Investor Newsletter March 2023
March Madness is Banking, not Basketball

MANOLE CAPITAL MANAGEMENT

MCM

Introduction:

In our quarterly newsletter, we will begin by discussing a few macros issues, like recent changes to the indices (S&P 500, Russell), the stock market, share repurchases, the labor environment, the Fed, inflation trends and of course interest rates.

However, instead of spending too much time delving into the macro picture, we will spend the vast majority of our newsletter focused on specific Fintech and financial issues. We believe our value add and differentiation is best exhibited in discussing issues in our area of expertise – Fintech.

In our FINTECH world, we will:

1) Conduct a deep dive into the collapse of Silicon Valley, the resulting volatility, and possible banking ramifications.
2) Provide a link to an 8-page discussion on the CFPB's proposal to limit credit card late fees.

Don't worry! At the end of our newsletter, we will still include our Cliff Clavin section of useless and totally inconsequential tidbits of information.

Classifications & Labels:

As a reminder, we define FINTECH as ***"anything utilizing technology to improve an established process."*** We have owned many of our holdings for decades (some since their IPO's) and their GICS classification does not impact our portfolio construction or management.

As you can see on our Flagship FINTECH portfolio monthly tear sheet, we currently own names that are considered by GICS to be in Technology, Financial, Industrial and Real Estate sectors. However, in our opinion, our holdings represent wonderful examples of our version of FINTECH companies.

Developed in 1999 by MSCI and Standard & Poor's, GICS (Global Industry Classification Standard) classifies all major public companies into 11 different sectors. In addition, there are 24 industry groups, 69 industries and 158 sub-industries that all major public companies get classified into.

Each year, there are subtle edits to sector weights and modest changes occur in certain sub-industries. Specifically, there are 250 US stocks that are getting impacted with this year's re-alignment. For index managers, managing billions of dollars, these changes can be significant and require days of trading to re-align their portfolio to its assigned benchmark.

We are not benchmark focused and our "active share" is quite high (in the mid-to-high 90's%). Within the Technology sector, we do not own Amazon, Apple, Facebook, Google, Netflix, or Microsoft. Within the Financial sector, we do not own any traditional banks or insurance companies. We exclusively focus on the emerging FINTECH industry and consider ourselves to be bottoms up, fundamental research analysts; we invest with a long-term perspective, and absolutely are not "benchmark huggers."

As this FactSet, S&P slide shows, the largest sector in the S&P 500 and the Russell 1000 is Technology, weighted at 27.2% and 26.5% respectively. With this year's GICS changes (in mid-March), the Technology weighting is getting lowered by over 300 basis points - in both indices - with a fairly equivalent increase to the Financial sector from roughly 12% to 15%.

S&P Index Sector Changes

	S&P 500		
	Old	**New**	**Chg**
Communication Services	7.65	7.65	0.00
Consumer Discretionary	10.56	10.09	-0.47
Consumer Staples	6.70	7.17	0.47
Energy	4.91	4.91	0.00
Financials	11.75	14.50	2.75
Health Care	14.39	14.39	0.00
Industrials	8.58	9.01	0.43
Information Technology	27.18	24.00	-3.18
Materials	2.81	2.81	0.00
Real Estate	2.67	2.67	0.00
Utilities	2.79	2.79	0.00

Source: Factset, Standard & Poor's, Jefferies

Note: Data as of /31/2023

In our Fintech industry, we are seeing a fairly significant number of payment companies, like Fiserv, Fidelity Information Systems, Fleetcor, Global Payments, MasterCard, Square, and Visa, getting moved from the Technology sector to the Financial sector. Following these moves, Visa, Mastercard and PayPal will become 3 of the top 6 names in the Financial sector, moving ahead of traditional banks and brokerages like Wells Fargo, Morgan Stanley, and Citigroup. Also, we are seeing some companies like Automatic Data Processing, Broadridge Financial, Jack Henry, and Paychex get moved from Technology into the Industrial sector.

Since the S&P 500 is a sized weighted index, the Technology sector will become more tied to names like Apple and Microsoft. These two mega-caps are already over 40% of the total sector's weight, which became even more concentrated when Google and Facebook were switched from Technology to Communication Services. Following these changes, Financials will become the 2nd largest sector, behind Technology. Adding the Technology and Financial sectors together (i.e., Fintech) would be nearly 40% of the S&P 500.

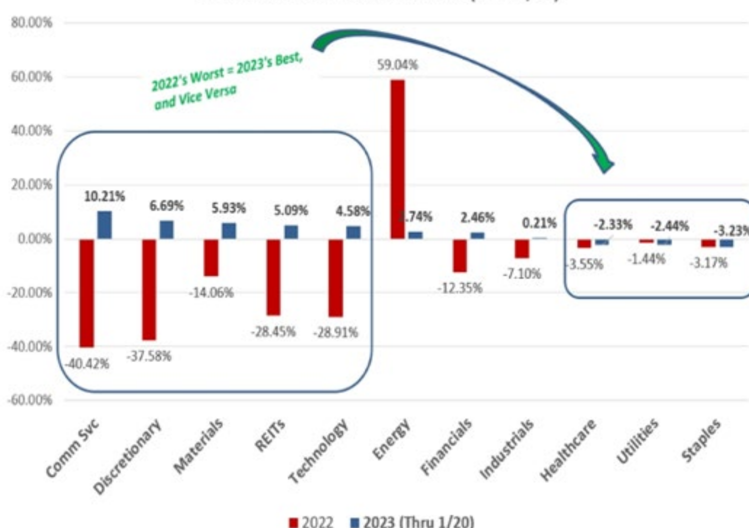
GICS Changes:

We somewhat disagree with the move of these payment companies from Technology to Financials, but it is really irrelevant to our longer-term investment thesis. Is Visa a financial company because it helps to move payments from consumers to merchants to banks or is it a technology company because it can process 60,000 transactions a second? Frankly, its formal GICS classification doesn't matter. More importantly, Visa is an excellent example of a secularly growing FINTECH company that meets many of our investment criteria and desirable characteristics for an investment (click here).

How do these benchmark changes impact our investment process? Not one bit! However, these sector reclassifications may have short-term trading impacts to our holdings. There are over $200 billion dollars tied to sector specific index funds and ETF's, like the XLK for Technology or the XLF for Financials. As Technology index managers get properly weighted, they will sell-out of some of our holdings, while Financial index managers will create new positions. Since there is more money tied to the Technology sector, this might have a short-term, negative trading impact. In the grand scheme of things, this is "much to do about nothing", but it should create some noise towards month end.

The Stock Market:

In 2021, the S&P 500 surged +28.1%, as risk assets soared, interest rates were lowered, and the government instituted a massive fiscal stimulus. The hangover was awful in 2022, as the S&P 500 fell (18.1%) and tried to absorb tougher conditions and significant monetary tightening. This type of polar opposite market reactions reminds us of the G. Michael Hopf's quote, "Hard times create strong men, strong men create good times, good times create weak men, and weak men create hard times."



As this BTIG chart shows, the sectors that underperformed in 2022, like Communication Services, Consumer Discretionary and Technology, all started the year in positive territory. Once again, the contrast between news out of the tech industry and its performance in the market could not be starker. Despite many tech companies issuing layoffs, recession warnings, and grim earnings forecasts, the tech-focused Nasdaq had its best January performance since 1999. Then, with the majority of S&P 500 companies reporting, volatility rose, and the market began to sell off. In February, the S&P 500 fell by (2.6%) and it is surprisingly flat so far in March.

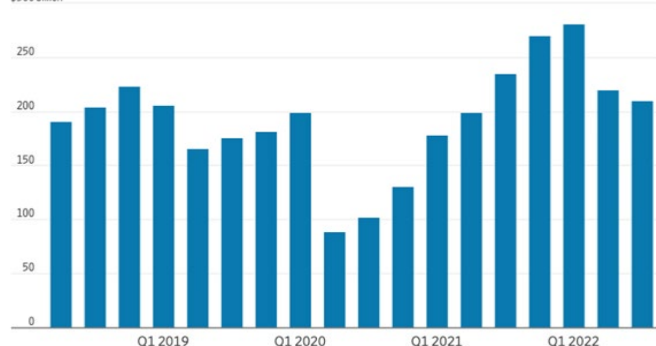
At the beginning of the year, the vast majority of market "experts" believed the first 6 months of this year would be a challenge and then the Fed will reverse its tightening policies, "pivot" and begin to ease. Following some tax loss selling in December, the S&P 500 rose +6.3% in January. It was as if investors were chasing momentum and no longer pricing in a "hard landing" or even a "soft landing". It seemed like investors were pricing in a market take-off and "no landing" scenario.

As we continue to emphasize, we anticipate and expect a volatile 2023 filled with geopolitical issues and monetary and fiscal uncertainty. As many of you know, we aren't in the prediction business. We find merit in John Kenneth Galbraith's quote regarding predictions. He said, "There are two kinds of forecasters. Those who don't know, and those who don't know they don't know."

Buybacks:

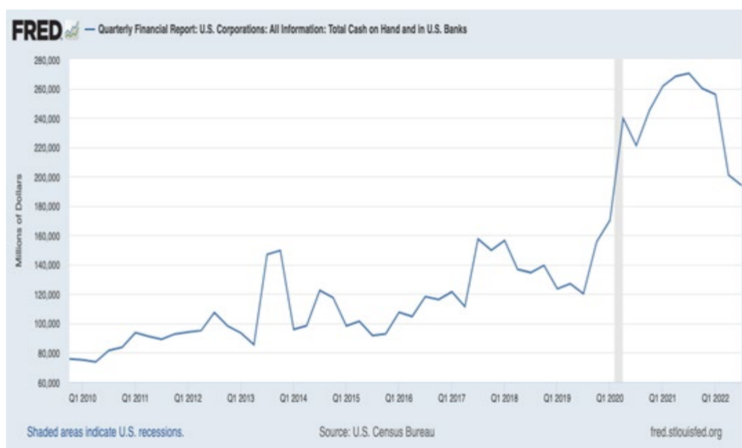
For our process, it is critically important how management teams allocate capital. When a company generates cash flow, it has several options about how to redeploy those funds. It can re-invest back into the business and fuel future growth opportunities. Or, it can make acquisitions, payout a dividend or even repurchase its shares. How a management team redistributes its cash flow is critical in our analysis, as it is a reflection on capital structure effectiveness and how a management team looks at optimizing shareholder returns.

There are a few key reasons companies buy back their shares. The first is to demonstrate confidence in their business and relay a positive and optimistic sentiment to shareholders. The second is to return capital to shareholders, in a tax-efficient manner. When a company pays a dividend, shareholders are taxed as income of the amount. When a company buys its own stock back, it does not accrue additional taxes for its owners, as there isn't a taxable event. Lastly, reducing the number of shares outstanding helps accelerate earnings per share. On the same amount of earnings, EPS increases as the denominator shrinks. Why are companies focused on EPS growth. Well, in the 4th quarter of 2022, less than 70% of S&P 500 companies exceeded earnings expectations, which was a low beat rate relative to its history.



As this S&P Dow Jones slide shows, US companies have spent hundreds of billions in recent quarters on stock buybacks. These management teams believe stock buybacks are a good use of capital and also shows a high degree of confidence and conviction in their forward-looking expectations. For the first time, stock buybacks by companies in the S&P 500 are on track to surpass $1 trillion in a calendar year. New stock buyback authorizations reached $220 billion by mid-February, which is on pace to equal a new record.

US corporations are flush with cash, as this US Census Bureau and St. Louis Federal Reserve chart shows. However, the new corporate tax on stock buybacks (1%, effective January 1st) hasn't seemed to have bothered management teams enough for them to rethink this capital allocation strategy.



Of the two dozen companies we own (on the publicly traded FINTECH front), well over 90% of them have active buyback authorizations. We have owned Verisk Analytics (ticker VRSK) since its IPO on October 6th, 2009. It continues to generate significant excess free cash flow and management is returning capital to shareholders via both dividends and buybacks. In early March, VRSK announced that it entered into an ASR (accelerated share repurchase) to repurchase $2.5 billion of stock. This ASR has the potential to remove nearly 9% of VRSK's 155 million outstanding shares.

Jobs:

We believe that a fully employed and well-paid labor force typically supports a healthy consumer. Nonfarm payrolls in January were fantastic, and they were 3x what economists were expecting at 517,000. February also provided better than expected results, with another 311,000 jobs created. Unemployment sits at a 54-year low of 3.4%.

As that stronger than expected economic data hit, the market began to sell off. Why is good news taken as bad news by Wall Street? Well, a tight labor market supports higher wage growth and higher wage growth adds to inflationary issues. Then, if inflation isn't dramatically coming down, the Fed has to continue to hike rates. So, a strong jobs market makes Chairman Powell's job more difficult. We believe that it is counterproductive to want unemployment to rise and for the economy to falter, just to have the Fed come to the market's rescue by "pivoting" and lowering rates.

Fed Chairman Powell continues to emphasize that the Fed will remain data dependent, so this type of economic data is critical to understand the path forward. The job market continues to be very resilient, which continues to give the Fed the necessary data and ammunition to raise rates or at least keep them higher for longer.

Our problem with this scenario is that there is way too much focus on monetary policy, as the market is fixated on every word coming from Fed officials. This type of investing mindset places too much emphasis on the Fed's role in determining economic and earnings growth. We believe that equity market performance is driven by company specific earnings. We don't hear many economists discussing what would happen if economic resilience translated into corporate earnings resilience. Wouldn't that be a positive, especially for certain stocks that are attractively valued? As 2023 unfolds, we believe stock selection will lead to alpha generation in our portfolios.

Are interest rates important? Absolutely, but they aren't the make-or-break factor the drives our economy. In our opinion, a healthy economy, with a strong labor market and consumers spending money, is what moves our markets forward. If you are invested in second-class companies, with levered balance sheets and questionable outlooks, then the forward outlook could be challenging. If you are invested in world-class companies, with recurring revenue, leading market share and generate free cash flow, you can handle turbulent conditions.

The Fed:

We appreciate the difficulty of Chairman Powell's job. The Fed remains in a precarious position. On one hand, it has to raise interest rates to fight high inflation, which it says its main goal. On the other hand, the Fed has to ensure that it doesn't push the economy into a recession while juggling a crisis of confidence in our banking industry.

Fed Chairman Powell, in his semiannual testimony on monetary policy before the US Senate Committee on Banking, Housing, and Urban Affairs, said that due to the latest stronger than expected economic data, "the ultimate level of interest rates is likely to be higher than previously anticipated." He emphasized tighter conditions when he said, "The process of getting inflation back down to 2% has a long way to go and is likely to be bumpy." After Chairman Powell spoke, his loyal lieutenants then commented. Atlanta Fed President, Raphael Bostic, said that he is still in favor of raising interest rates in "steady" quarter point increments. This was seconded by Richmond Fed President, Thomas Barkin, when he said he supported "smaller 25 basis point moves, rather than the larger 50 basis points moves" that others have called for.

MANOLE CAPITAL MANAGEMENT

The old adage of "DON'T FIGHT THE FED" seems apropos. When the Fed says that rates will be "higher for longer", we simply nod our head and factor that into our proprietary models. We aren't going to hope for a pivot and sudden cut in interest rates, to get a boost in some of our technology holdings. That seems like wishful thinking…

Interest Rates:

Following another 25-basis point increase in Fed Funds on March 22nd, 2023, the next date to mark on your calendars is May 3rd. Now, we don't guess where rates are going and prefer to examine the CME's FedWatch Tool (click here). Using this as the market's expectations, we can see that 49% of the market is expecting another 25-basis point hike, while 51% believes the Fed will pause. This is remarkably different from expectations from just a month ago, when the market was 73% expecting a 25-basis point increase and 26% were expecting a 50-basis increase.

The Fed has repeatedly said they will be data dependent with their decisions despite many calling for an end to their restrictive policies. Those analysts / experts believe continued increases will push the US economy into a recession, later this year. In fact, at the 23 largest US financial institutions, nearly 80% of their economists are predicting a recession in 2023. Sentiment is clearly not positive or too optimistic and that's before we even discuss Silicon Valley and the banking crisis.

Inflation:

February 2023 consumer prices gained +6.0% year-over-year (+40 basis month-over-month). While this is lower than June's +9.1% annual rate, which was the highest since 1981, it isn't a positive development. Even excluding the volatile food and energy categories, core inflation was still +5.5%, which still presents a problem. There is good reason to think inflation will keep falling, but it has remained stubbornly high. While the process of getting inflation down has begun, it is far above the Fed's 2% target.

JP Morgan Chase CEO Jamie Dimon cautioned against prematurely declaring victory in the fight against painfully high inflation. He recently warned the Fed could raise interest rates higher than expected, especially if price pressures prove to be "sticky."

To use a plane analogy, especially since the market continues to use these hard vs soft vs no landing scenarios, the economy was cruising along at 30,000 feet into early-March. There were some modest bumps, with FTX's bankruptcy, an inverted yield curve, the war in Ukraine and pesky inflation, but nothing too serious. It's a good thing we kept our seat belt buckled, because once SVB happened, the plane experienced some major turbulence.

Fintech:

We like to start out all of our discussions by telling investors who we are. We are FINTECH investors, and we define Fintech as *"anything utilizing technology to improve an established process."*

We realize that half of Fintech is financial, but we don't invest in traditional, credit sensitive banks. Having managed money during the Financial Crisis, we learned firsthand how certain opaque and balance sheet intensive financials could go bankrupt or insolvent.

We prefer transaction-based businesses, generating recurring revenue, with sustainable margins, and significant cash flow. From our perspective, the perfect example of a FINTECH business is the secularly growing payments industry. Names like Visa or Mastercard, that generate revenue and profit per swipe or transaction, without the underlying credit sensitivity or risk associated with that underlying line of credit.

Banking 101:

Banks are quite different from our payment companies. To simplify a complicated business, banks make money by "borrowing short" from customers, in the form of demand deposits, checking accounts, and CDs. Then, bankers "lend long", presumably at a higher rate, with credit cards, auto loans, mortgages, etc.

In the event a bank doesn't lend these assets to clients, it can purchase "safe" securities and hopefully earn a higher yield. The way-too-simple goal of any bank is to profit by earning the interest rate spread in an upwardly sloping yield curve environment.

However, we've been dealing with an inverted yield since October of last year, as the Fed has raised rates 7x in 2022, with more on the way and just another 25 basis points announced by the Fed last week. These types of large rate swings can catch certain banks unprepared and ill-equipped to handle withdrawals and volatility. That's really where we were 2 weeks ago, before this banking crisis.

The Banking Crisis of March 2023:

How did we get here? I think we need to start in early November, when FTX collapsed. That was on November 8th and 9th. More and more information has come out, but clearly the risk management systems in place and regulatory scrutiny was lacking. Risk management is the takeaway from that failure, and we'll hit on that point again in a little bit.

Then, earlier this month, Silvergate collapsed. As a crypto custodian and digital currency intermediary, Silvergate was supposed to be a safe exchange between various counterparties. It is down (92%) this year and clearly was not the stabilizing force it claimed to be.

Afterwards, the banking crisis kicked off with the sudden and almost shocking failure of Silicon Valley Bank, which we'll shorten to SVB for the rest of this discussion.

SVB was the 16th largest bank in the country, but it now has the notorious ranking as the 2nd largest bank failure in history, just behind Washington Mutual in 2008 (as this chart shows). In our opinion, SVB was a risk management failure coupled with a a classic "bank run", and not similar to the credit problems the market dealt with during the Financial Crisis.

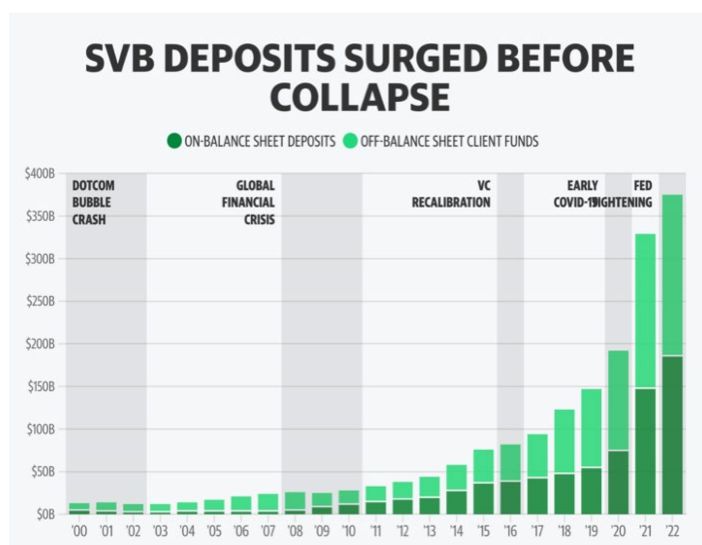
Now, we'll review five key points that led to SVB's downfall.

Point #1 is Clients:

First of all, SVB had a concentrated client base of mostly money losing VC backed entities, that were constantly drawing down their balances. Last year, as the market fell (18%), many money losing companies found the environment much more challenging to raise funds. These companies and depositors used SVB as a traditional bank, some at the recommendation of their private equity sponsors. SVB was known to be the bank of choice for start-ups, and it actually relished that reputation. These weren't small "mom and pop" retail banking accounts, that fell under the $250,000 FDIC insured protection level. Some of these firms had millions of dollars at SVB and had material risk to their firm's longevity if something were to happen to their cash.

SVB had significant client cash concentrations, with Roku at $487 million, Rocket Lab at $380 million, Block Fi at $227 million, Ginkgo Bioworks at $740 million and Circle with $3.3 billion of cash deposited with the bank. If SVB didn't provide liquidity to them, there was no way these firms could make payroll. So, there was too much client concentration at SVB, with specific clients that weren't FCF positive and were probably, on average, too large.

Point #2 is Investments:



The second key point leading to SVB's collapse was related to their investment portfolio. Many of SVB's depositors experienced large inflows of capital into their business during 2020 and 2021, when times were good, and the market was positive. As this SVB investor slide shows, its deposits and assets balloon by over 300% to over $150 billion.

At that time, interest rates were still close to zero. SVB was unable to generate much in terms of a rate spread and wasn't much of a traditional bank lender, so it conservatively invested these client assets in US Treasuries.

We want to emphasize a key point. We have no problem with SVB safely purchasing these assets, as Treasuries are a much safer choice than investing in 30-yr fixed mortgages, 10-yr commercial proprieties, auto loans or even unsecured credit cards. The timing wasn't ideal, but the choice was sound and fairly conservative.

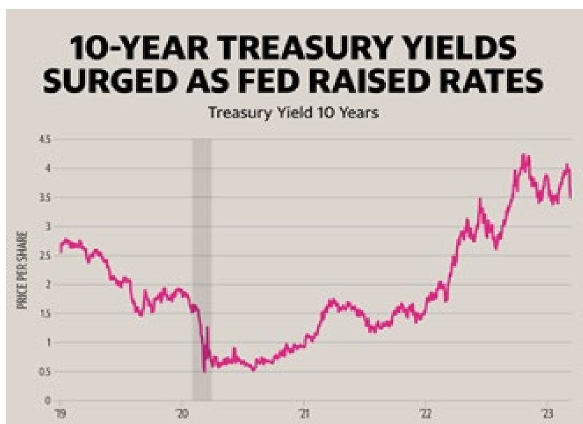
With over $120 billion of depositor money into US notes, SVB was earning less than a couple of hundred basis points for its credit and duration risk. As that point in time, SVB probably thought it was perfectly situated. However, the problem for SVB comes when the Fed decides to hike interest rates 7x in 2022.

Point #3 is Accounting:

Banks can classify their investment portfolios multiple ways. They can be HTM or held to maturity. They can be trading assets and even be in a bucket called AVS or available for sale securities. In simple terms, SVB held bonds that they classified as HTM, which lost money on paper as interest rates rose. Under current accounting rules, bonds that are HTM are not required to be measured at fair value on the balance sheet. Therefore, if a bank has a lot of unrealized losses, investors would not have been aware of the extent of those losses because the balance sheet would not show them. For accounting purposes, HTM bonds are carried at their original interest rate when issued, typically called the amortized cost. Even though the real-world value has changed, as interest rates climbed, accounting treatment ignores these changes. Some call this "ostrich accounting" and simply burying one's head in the sand.

From an accounting perspective, the logic goes: If temporary market value movements reflect circumstances that do not impact the amounts expected to be collected in the future, it should not directly impact the carrying value of those assets on the financial statements, whether positive or negative. These bonds are worth less than what SVB paid for them, but they still have obvious value. If a bank sells "more than an insignificant proportion" of its HTM investments before maturity, it must classify all remaining HTM assets as AVS and consider the portfolio "tainted".

This 100% legal, accounting technique permits the bank to keep these investments at par and not mark them to market. If they were trading assets or available for sale investments, the bank would take the price movements, both up and down, into their quarterly income statements. With HTM investments, the accounting treatment essentially smoothes out the gains and losses, as long as the assets are actually "held to maturity". The investment can be kept at par, regardless of its true and current valuation, as long as the bank plans on holding the security through its maturity.



As yields climbed (as this chart shows), the next question is what does SVB's management and risk teams do?

As of the end of last year, SVB had roughly $120 billion in investments, versus $74 billion of loans to borrowers. Of the $120 billion in bond investments, $91 billion was classified in HTM investments (at its amortized cost). There is an opportunity for the bank to classify some of these assets as CECL or current expected credit losses, but it looks SVB did not establish any reserves for credit losses on these investments. Considering they were Treasuries, guaranteed by the US government, this isn't surprising. On this portfolio, SVB was truly underwater by $15.6 billion, but had only a $6 million reserve. This is a critical accounting aspect to understand, and it had a large impact on SVB's eventual collapse.

Following the SVB debacle, there is renewed interest in having the FASB (Financial Accounting Standards Board) change its accounting rules for HTM. Seven years ago, this was a topic in accounting circles, but nothing arose from those talks.

Two FASB members (Harold Schroeder and Thomas Linsmeier) dissented and stated that the board's *"decision to retain existing classification and measurement guidance represents a significant lost opportunity to provide users with the information necessary to understand the potential risks in financial instruments that have caused significant issues in past economic crises."* Both also said existing accounting rules failed *"to require additional disclosures that provide users with a better understanding of the duration risk, interest-rate risk, and liquidity risk of financial instruments, which they believe have led to significant market uncertainty in past financial crises".* Both were spot on but were unfortunately overruled.

Point #4 is Risk Management:

As everybody knows, higher rates have an inverse impact on bond prices, so this Fed tightening should cause a large downward revision to SVB's investment portfolio. That's just simple mark-to-market accounting. However, as we just mentioned, SVB doesn't need to mark this portfolio down, as it is classified as HTM.

CME Group Hits Daily Trading Volume Record of More Than 66 Million Contracts

March 14, 2023 9:57 AM EDT

CME Group Hits Daily Trading Volume Record of More Than 66 Million Contracts

As this volatility is occurring in the market, we don't have a clear picture of what SVB is doing. Most banks and financial institutions have a defined risk management program and team in place, that adjusts and adapts to a changing environment. When rates skyrocket, like they did in 2022, banks can hedge their rate exposure with exchanges like the CME, which we have owned for over 2 decades. In fact, as this email notification from the CME shows, it just hit record interest rate volumes last week, as this banking crisis intensified. Not all financials are sensitive to interest rates in the same way. Derivative exchanges actually benefit from volatility, and some can handle this volatility much, much better. Now, some banks complain that the cost to hedge is too expensive. However, in our opinion, this is a "necessary evil", when one has a well-functioning risk management program.

So, what did SVB's risk management team do during 2022, as rates were continuously raised? Well, we have heard that it not only didn't have the necessary hedges in place, but it apparently didn't have anybody even sitting in that key risk management role.

Dating back to 2021, the Federal Reserve Bank of San Francisco began issuing SVB citations for how it was handling risk. It was negatively flagged for not having enough cash on hand - in the event of a crisis. Last summer, the San Francisco Fed put SVB in "full supervisory review", for what it called "deficient risk controls". We believe their failure to have a risk manager in place or any kind of adequate hedges, likely was the key aspect of its ultimate failure.

Point #5 is Liquidity:

That's leads to our last point that led to SVB's failure. Many of SVB's large clients got worried a couple of weeks ago and began to withdrawal money. Or maybe they just drew down balances to cover bi-monthly payroll. Either way, there was a call for liquidity by SVB's depositors and this is what led to this "bank run".

As we discussed, SVB didn't have that cash in their bank vault, as it was invested in US government paper. Since SVB suddenly needed capital to repay its depositors, it sought advice from Goldman Sachs. GS purchased over $50 billion of investments from SVB, which led SVB to record a $2.1 billion loss. To put "some lipstick on this pig", SVB claimed that it was only an after-tax loss of $1.8 billion. Once GS purchased SVB's investment portfolio (at a material discount), the portfolio became "tainted".

The transaction provided SVB needed liquidity, but it also alerted Wall Street of a potential problem. After the purchase, GS then tried to raise $2.25 billion of additional capital for SVB, but there was already too much "blood in the water". Should GS have reversed timing of the portfolio sale and capital raise? Would SVB still be around if they tried to raise capital first and then sell some assets to GS? We'll never really know. When no "white knight" appeared, the stock cratered, left a massive capital hole, and led to its demise.

In our opinion, SVB failed because:

- Its client base was too concentrated, especially with money losing, VC-backed companies.
- SVB had a large asset / liability mismatch and a massively mis-constructed balance sheet.
- It was borrowing short (heavy deposit weighting) and lending long (purchasing long duration securities).
- This mismatch came to light as rates rose in 2022, but SVB didn't hedge or perform adequate risk mgmt.
- When a drawdown of deposits and withdrawals occurred, it forced the bank to sell its investment portfolio.
- This forced them into a negative and unrealized net equity position, a capital deficit and led to a spiraling of additional outflows and additional losses.

Changes Are Coming:

Did this banking crisis need to happen? Are there other issues still lurking underneath these headlines? What are some of the key takeaways, from our perspective?

We attribute much of this as a company specific problem, that has unfortunately cascaded to other players. We believe one of the longer-term impacts will be lower bank profitability moving forward.

Profits Are Going Down!

Right now, the average bank generates a profit margin of roughly 16%. We wouldn't be surprised to see that permanently get lowered to say 12% or 13%. The headwinds on profitability will likely come from several issues. We anticipate significantly higher FDIC premiums, especially if the insurance cap gets lifted above $250,000. How do we know this is coming? Well, FDIC Chairman Martin Gruenberg just hinted at it during his Senate testimony. He said that the FDIC will likely propose a new rule that assesses a special fee on banks because it guaranteed all deposits at failed SVB and Signature Bank.

In addition, we believe banks will likely tighten their lending standards. If you were running a bank today, we imagine you'd likely hold onto your capital a little tighter in this type of volatile environment, right? We can't quantify this headwind, but we have to guess that banks will add additional risk management procedures.

In addition, costly compliance burdens are absolutely on the rise. Finally, we expect banks to keep a more liquid balance sheet, which will pressure their profitability. All of these issues will pressure margins and drive bank profitability lower.

M&A:

In addition to lower profits, we expect some changes to banking M&A. In the short-term, the only M&A will probably be just distressed deals, like the First Citizens deal mentioned above. Most banks will choose to "hunker down" and focus on specific, internal issues right now.

Over the intermediate term, it will be challenging to do deals, if one doesn't fully understand the regulatory environment. Will regulators choose to alter how banks classify their investment portfolios. With regulatory scrutiny on interest rate marks, whether banks have investments in the HTM or AVS bucket, we believe it makes merger math more difficult.

Longer-term, we think bank M&A will increase. Any expected increase in regulatory burdens will disproportionally burden smaller banks. Some will simply choose to sell out and make life easier on themselves. Finally, there are still too many banks in the US. On a per capita basis, there are 12.8 financial institutions per 1 million US citizens, which ranks 6th in the world. For comparison purposes, Canada only has 5 large banks (Toronto Dominion (TD), Royal Bank of Canada (RBC), Bank of Nova Scotia, Bank of Montreal, and Canadian Imperial Bank of Commerce (CIBC).

Over the past decade, the banking industry has seen an average of about 228 deals per year. We would not be surprised to see that number rise to perhaps 350 per year. Longer-term, we wouldn't be surprised to see the total number of banks, credit unions, thrifts, community banks here in the US fall by 20% from today's bloated levels.

Regulatory Changes:

After the Financial Crisis, the market received thousands of pages of new regulations, in the form of Dodd-Frank reforms. We expect this crisis will lead Washington to act. Never underestimate regulators taking advantage of a crisis by instituting more powerful controls over an industry.

Will regulatory changes impact how banks account for their bank security portfolios? Will HTM continue to ignore mark-to-mark accounting? Will all bank investments be forced to run through the income statement and bring heightened volatility and fluctuations to earnings? Can regulators force banks into solid risk management procedures? We aren't sure, but we won't be surprised to see these type of valuation and accounting changes come out of this crisis.

In the camp of "you can't make this stuff up", the co-author of Dodd-Frank was Massachusetts Congressman Barney Frank. Following 32 years of service, Barney retired. What was he recently up to? Well, Barney was on the Board of Directors for NY-based Signature Bank, which was seized by regulators just days after SVB.

Other Challenges:

SVB isn't the only troubled financial institution right now. For example, First Republic seems to be gaining significant market attention. Its recent turmoil reminds us of Long-Term Capital Management in 1998. Back then, Long-Term Capital Management blew up almost overnight. They had tremendous leverage, which became exposed by an emerging market crisis. There would have been an enormous dislocation in the fixed income market, risking serious contagion to others, if there wasn't a strong market response. The Fed got the biggest investment banks together and essentially told them to fix "their problem", by each contributing capital to stabilize the situation, without taxpayer capital. This was enough to placate the situation and a large potential problem was averted.

Fast forward to today and we see similar actions by the Fed. A week or so ago, the Fed "not so politely" asked big banks like JPM, Citi, Wells Fargo, Goldman Sachs, Morgan Stanley, and others to infuse $30 billion of capital into First Republic to fortify their equity base. Sounds familiar, right?

Another Financial Crisis tactic was forcing certain entities to acquire weaker participants. JP Morgan acquired Bear Stearns in March of 2008 for $1.4 billion (with $30 billion of Federal Reserve backstops), as well as WaMu for $1.9 billion. Eventually, JP Morgan came to regret those deals. Years after it helped save those two companies, government regulators slapped $19 billion of fines against JP Morgan. So much for helping out the industry. It is no wonder Jaime Dimon, CEO and Chairman of JPM, isn't interested in doing any more "shotgun weddings".

During the Financial Crisis, the Fed and Treasury were forced to create programs to prevent mass contagion. Our regulators placed significant reforms on the investment banks and had the investment brokers convert into banks overnight. In 2010, Dodd-Frank rules were enacted that fortified capital requirements and instituted many rules (like the Volker rule) that prohibited proprietary trading.

Now that we have seen SVB and Signature Bank collapse, there are contagion problems affecting other regional banks. Initially, the Fed, Treasury and FDIC came out and backstopped that key $250,000 depositor guarantee. That was their first priority and they successfully provided that level of stability.

Then, it created a new vehicle, called BTFP or bank term funding program. This essentially gives a bank a 1-year loan or liquidity with the pledging of US Treasuries, agency debt, mortgage-backed securities, and other qualifying assets as collateral. The key for us was that all of these assets will be valued at par, which clearly isn't mark-to-market accounting, right? The BTFP is key source of liquidity that banks can utilize on their "high-quality securities", eliminating their need to quickly sell those securities in times of stress. Just like SVB had to do. This was right out of Paulson's and Bernanke's playbook in 2007 and 2008.

Will these recent actions do enough to stabilize the market? Will there be additional actions taken? Will the government institute additional regulatory protections and rules? We believe more is coming, but a key takeaway, from our perspective, is that banking margins will head lower. The key for us is that the US will continue to backstop the banking industry, as it is way too systemically important to allow to falter. It touches every aspect of consumer and business life, and the government cannot risk ***not*** having a strong and resilient US banking system. Period, end of story.

Unintended Consequences:

We started this discussion by mentioning how FTX and Silvergate's collapse had some impact on banking problems this month. It is quite interesting to see what has happened to digital currencies since March 10th and this wave of banking volatility. Bitcoin is up nearly 70% this year. Coinbase, the dominant digital currency exchange is up a whopping 80% this year, although it received a Wells notice last Friday.

A Bernstein analyst called recent banking sector jitters *"the perfect setting for Bitcoin, Ethereum and the rest of the decentralized-financial system, to stand apart from the centralized banking system."* Others have said that crypto is a solution to this banking failure, and that our current system is too opaque and fraught with continuous regulatory lapses.

Could Bitcoin actually be a "flight to quality" asset, as banks struggle? We aren't going to make that statement, but we are fascinated to see it rallying in the midst of this banking turmoil.

Conclusion:

We are wrapping up our newsletter with an interesting comment from President Biden. Now, we never bring politics into our research and aren't going to start now. We simply want to highlight a key point that he made last week, right as SVB failed.

He said, *"Investors in the banks will not be protected. They knowingly took a risk and when the risk didn't pay off, investors lose their money. That's how capitalism works."* Now, we agree with his point, but it was interesting timing to say right as the banking industry just experienced its 2nd largest failure in US history and regulators were providing assurances that the banking system was resilient and safe. We simply find it interesting that he felt compelled to mention that the government would not bail out investors in this failed bank and to tell the public exactly how capitalism really works.

Our takeaway is that more regulation is coming, and it will pressure bank profitability. Instead of regional or smaller credit unions or community banks thriving, we anticipate that the big banks will only get bigger.

The goal with Dodd-Frank was to limit how the market was susceptible to systemically important financials and prevent any banks from becoming "too big to fail." Following this bout of banking volatility, universal banks like JP Morgan Chase, Bank of America, Citi, Wells Fargo, and Schwab gained assets and got bigger at expense of weaker regionals banks.

Two weeks post SVB's collapse, deposit concerns for regional banks remain a key focus. For example, the top 25 domestically chartered banks saw their market share increase to 66.4%. These large financial institutions garnered over $108 billion of new inflows, at the expense of the next largest 850 banks. This is unfortunate and exactly what the regulators do not want to happen, but it appears to be what is occurring. The big are getting bigger and becoming "too big to fail".

We look forward to speaking with you soon!

Warren Fisher, CFA
Founder and CEO
Manole Capital Management

<u>But wait, there's more!</u>

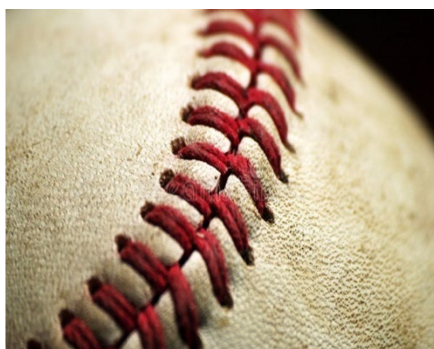
We felt it would be too much to insert our recent note on CFPB late fees into this investor newsletter. If you wish to read our 8-page research piece on the future of credit card late fees, simply click here. We didn't want our newsletter exceeding 20-pages…

Cliff Clavin

In the 1980's, one of our favorite TV shows was ***Cheers.*** The know-it-all postal worker was named Cliff Clavin and played by John Ratzenberger. This new segment highlights some useless information that Cliff would be proud of.

Even the Tooth Fairy isn't immune to inflation. According to Delta Dental, the value of a single lost tooth is at a record high $6.23, up +16% year-over-year. Back in 1998, the average lost tooth fetched $1.30 per tooth.

Teeth aren't the only things rising in price. The national average hourly rate for a babysitter increased +9.7% in 2022 to $22.68 per hour, after a +11% increase in 2021. The cities with an above average hourly baby-sitting rates are San Francisco at $25.24, Seattle at $24.60, Austin at $22.81, and Los Angeles at $22.74.



Major League Baseball has the longest regular season, with a long, hot, and grueling 162 game schedule. Here in Florida, we host 15 teams during Spring Training, known as the Grapefruit League.

During the 6-month MLB regular season (from April through September) has historically been a sub-par period for the stock market and investors. According to Bespoke Research, since World War II, the S&P 500 has averaged a total return of just +4% during the MLB regular season versus an average of +8% during October through March. Maybe everybody should take the summer off and re-invest this fall?

This year, the Girl Scouts launched a new cookie called the Raspberry Rally. Not only is this new cookie an instant hit, but it is apparently 100% sold out. On eBay, a single box is selling for as much as $79.99, which is the equivalent of 16 boxes of our favorite – Thin Mints.

MANOLE CAPITAL MANAGEMENT

DISCLAIMER:

Firm: Manole Capital Management LLC is a registered investment adviser. The firm is defined to include all accounts managed by Manole Capital Management LLC. **In general:** This disclaimer applies to this document and the verbal or written comments of any person representing it. The information presented is available for client or potential client use only. This summary, which has been furnished on a confidential basis to the recipient, does not constitute an offer of any securities or investment advisory services, which may be made only by means of a private placement memorandum or similar materials which contain a description of material terms and risks. This summary is intended exclusively for the use of the person it has been delivered to by Warren Fisher and it is not to be reproduced or redistributed to any other person without the prior consent of Warren Fisher. **Past Performance:** Past performance generally is not, and should not be construed as, an indication of future results. The information provided should not be relied upon as the basis for making any investment decisions or for selecting The Firm. Past portfolio characteristics are not necessarily indicative of future portfolio characteristics and can be changed. Past strategy allocations are not necessarily indicative of future allocations. Strategy allocations are based on the capital used for the strategy mentioned. This document may contain forward-looking statements and projections that are based on current beliefs and assumptions and on information currently available. **Risk of Loss:** An investment involves a high degree of risk, including the possibility of a total loss thereof. Any investment or strategy managed by The Firm is speculative in nature and there can be no assurance that the investment objective(s) will be achieved. Investors must be prepared to bear the risk of a total loss of their investment. **Distribution:** Manole Capital expressly prohibits any reproduction, in hard copy, electronic or any other form, or any re-distribution of this presentation to any third party without the prior written consent of Manole. This presentation is not intended for distribution to, or use by, any person or entity in any jurisdiction or country where such distribution or use is contrary to local law or regulation. **Additional information:** Prospective investors are urged to carefully read the applicable memorandums in its entirety. All information is believed to be reasonable, but involve risks, uncertainties and assumptions and prospective investors may not put undue reliance on any of these statements. Information provided herein is presented as of the date in the header (unless otherwise noted) and is derived from sources Warren Fisher considers reliable, but it cannot guarantee its complete accuracy. Any information may be changed or updated without notice to the recipient. **Tax, legal or accounting advice:** This presentation is not intended to provide, and should not be relied upon for, accounting, legal or tax advice or investment recommendations. Any statements of the US federal tax consequences contained in this presentation were not intended to be used and cannot be used to avoid penalties under the US Internal Revenue Code or to promote, market or recommend to another party any tax related matters addressed herein.