PODCAST TRANSCRIPT

Banking Turmoil and Opportunities

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ALEX BERNSTEIN: Hello, I'm Alex Bernstein. And you're listening to The Alger Podcast, Investing in Growth and Change. The banking industry has had a number of upheavals over the past month, leaving investors with a lot of questions, including *are there more to come?* To answer some of these questions, I'm joined today by Alger Dynamic Opportunities Portfolio Manager Dan Brazeau. Dan, thanks so much for joining me today.

DAN BRAZEAU: Thanks, Alex. Great to be here.

ALEX: Dan, just to jump right in, from your perspective, what exactly happened in the banking sector this past month?

DAN: So, the banking sector was really thrown into a tailspin with the fall of Silicon Valley Bank last month. Even though it wasn't a "too big to fail" bank, SIVB's failure was viewed as a potential canary in the coalmine for the sector in general and perhaps even the economy over the next year. At a basic level, Silicon Valley Bank did a poor job with asset/liability management and was ultimately done in by an old-fashioned bank run.

Their venture capital funded customer base was taking deposits out of the system which SIVB was meeting by selling securities at a loss, and when the company attempted to raise capital to offset the deposit outflows, the venture capital community that Silicon Valley Bank relied upon pulled approximately $42 billion of deposits out in one day. So, there are very few banks that can handle that kind of a run-on deposits, and Silicon Valley Bank ultimately had to be shut down as a result.

ALEX: And you don't see this as a repeat of the banking crisis of 2008-2009?

DAN: No. It's completely different than that period. The Great Financial Crisis of '08, '09 was marked by poor credit and banks and lenders loosening their lending standards in the previous few years. The banking crisis is completely different from this one. This one has not been set in motion because of subpar lending but because of deposit outflows and the need for liquidity.

Back then it was really caused by poor lending, shoddy lending standards, a lot of junkie assets on balance sheets. The interesting thing here is if you look at Silicon Valley Bank or other banks that are in trouble, I think their assets are actually pretty pristine.

The issue is that they were borrowing short with short-term deposits and went and purchased longer-duration assets, government securities that were at low interest rates, and so if you had to sell those securities which they did when deposits started flowing out, you were selling them at a loss, and that's totally different than what happened in 2008, 2009 where the assets on the balance sheet were, in many cases, pretty bad. So it's different, but yet the outcome is the same. Your bank got taken over by the government.

ALEX: Dan, one question a lot of investors are asking is, is this an isolated problem? Or is there more uncertainty to come with banks?

DAN: I think this crisis will hit banks differently. I think some will not be impacted at all while others could actually be beneficiaries. That said, in general it seems as though the flow of deposits over the past month have been out of smaller and regional banks and into the larger banks which I think are viewed as safe havens. So, in the financial crisis of '08, '09, too big to fail was viewed as sort of a negative connotation of these big banks that could go under, and now, I think you're actually seeing these banks being, at least in the short term, beneficiaries of some of the deposit flows.

ALEX: Dan, do you think the core problem here was that these banks were unprepared for this kind of run?

DAN: Correct. I think, in general, there's very few banks that can withstand a bank run where 25, 35, 40 percent of your deposits leave the system in the course of a day or three days. Banks are just not set up like that. So you really can't fault Silicon Valley Bank per se for that kind of a bank run, but what they did leading up to that happening, certainly you can fault them for sort of what they did with their balance sheet.

ALEX: And do you think their risk managers are now doing anything differently in light of this?

DAN: I think risk managers at banks really need to evaluate risks on a number of different levels and different areas of potential risk. While credit risk is perhaps the area that is most focused on by risk managers at banks, the failure of Silicon Valley Bank has shown that interest rate risk and asset/liability mismatches need to be considered as well. So, this should be core to the risk management of all banks, but clearly some have done a better job than others. As far as what Silicon Valley Bank could have done differently, at the time rates were rising, I think it's sort of too late to avoid those losses. I think the problem is that they invested in long duration, fixed rate assets when rates were exceedingly low so that they were in a tough spot once those rates started to rise. So, the lesson is that once the problems start, it's really impossible to go back and fix. You have to be prepared ahead of time.

ALEX: The Fed has indicated that rate increases will likely be slowing through the rest of the year. Does this bode well for the industry?

DAN: In general, I would say that it does. I think slowing of rates should bode well for the banking industry, but a slowing of rates will likely coincide with some weakening of the economy. So, on the one hand, a slowing of rate increases helps banks as it pertains to their interest rate risk and asset/liability management. However, the offset to that would likely be an increase to credit losses and credit issues in the coming quarters.

ALEX: Dan, Silicon Valley Bank was a backbone to so many tech firms. One has to ask, what might be the trickle-down effect on some of these companies?

DAN: Well, as you mentioned, the government stepped in and reassured depositors at Silicon Valley Bank that they would be made whole. So, this was obviously a relief to the venture capital and tech community. So, there should be very little near-term disruption to sort of that tech ecosystem. That said, Silicon Valley Bank was a key banking partner to tech and early-stage companies. So, I think there could be some longer-term impacts if that void is not filled by other banking institutions in the coming months.

ALEX: And should investors be expecting the government to step in and assist every time a bank faces a crisis like this?

DAN: I don't think that investors should expect that the government will step in on every bank failure, but they are clearly willing to step in on a limited basis as we've seen. So, if there are only a handful of failures, then the government could theoretically backstop more depositors, but that seems unsustainable on a large-scale basis unless there are extraordinary measures put in place which would likely take the cooperation of Congress, regulators and so forth. So, on a smaller scale, I would expect the government to step in. On a larger scale, that's really not sustainable.

ALEX: And do you foresee other bank failures looming on the horizon?

DAN: Yes. I believe there will be more banks that fail in the coming months due to deposit runs and asset/liability mismatches. If the problem spreads, there could be all-system failures due to credit issues down the road.

If the issue can be contained to a few outlier banks, then perhaps it won't spread to other parts of the economy. However, if banks dramatically cut back on lending and/or see a credit problem accelerate, then it could negatively impact other parts of the economy. So, the next few months could prove to be critical with regard to how this all plays out.

ALEX: Dan, I wanted to shift over and talk about you and the Weatherbie team, as portfolio managers. How are you and the team viewing banks now in your portfolios?

DAN: We're being extremely cautious as it pertains to banks and financial institutions at the moment. Some highly regarded institutions were allowed to fail in the span of a few days, and that was rather shocking really to investors that had been following these banks for a long time. Although we believe there will be some banking winners as a result of the current disruption, it's not an environment where we feel like it pays to get more aggressive with our financial services positions at the present time.

ALEX: Did this situation impact your process at all?

DAN: The process remains unchanged in the sense that we continue to dig deep and get to know our companies well. If anything, the quick demise of these banks demonstrates to us that we need to consider a wide variety of unforeseen scenarios when evaluating companies. You may not be able to anticipate every single black swan event, but a thorough and collaborative research process should help to eliminate most blind spots over time.

ALEX: Dan, I know we do have some bank holdings in our portfolios. What do you look for exactly, when you're looking at banks?

DAN: So, we do have a couple of holdings, but they're pretty small at this point. At the beginning of the Silicon Valley Bank crisis, we did decide to cut back our bank positions to be more cautious on the sector. So, we have not changed that stance.

Historically it's been a little bit tricky in the bank sector because we're growth investors. So, we want to see growth. At the same time, too much growth can be a negative for banks. You don't want to see them growing too quickly and getting into some credit problems. So, we've always taken a pretty cautious view in getting into banks, making sure they have a fair amount of growth but, at the same time, are good stewards of capital and cautious in terms of their lending standards. So that won't change, but I'd say the bar has been raised in terms of what could get into the portfolio at this point, given that it's going to be a lot harder at least in the near term for a lot of these banks to see the kind of returns that they had even a couple quarters ago.

ALEX: Is this current situation providing any opportunities?

DAN: I would say the current situation is providing us with some additional shorting opportunities. There are banks that we believe are not well-positioned for the new landscape, and we're currently evaluating a number of different banks that could work as shorts. In addition, the current crisis could spread to other areas, and so we are interested in finding companies that could be at greater risk in a tight credit environment.

ALEX: Have you added any shorts?

DAN: We did. We've added at least one name. We're in the process of looking at a couple others. So, we're actively looking for names that could work on the short side. Of course, a lot of the banks that are at extreme risk have gone down a lot in the past month. So, we're trying to find names that maybe haven't been hit quite as hard that have more downside the market's not really appreciating. So, that's really what we're focused on.

ALEX: Dan, what do you think investors should expect from the banking industry through the rest of the year?

DAN: I think generally speaking, we should expect more turmoil. I think when Q1 earnings are released, and we've got a better picture of what worked and what didn't work for these banks, we believe there's going to be certainly some banks that saw a lot of outflows, and many of those banks are not going to be able to handle that. So, when these banks announce earnings, and they say, hey, deposits are down five, ten, 20 percent in the quarter, will that spur another mini bank run in individual names or across the sector? It's really too early to know, but we could see this small fire spreading over the course of the next quarter or two.

Then beyond that, you've got potentially tighter lending standards, and these banks will need to adjust how they lend, how they treat the asset side of their balance sheet to adjust for less liquidity on the deposits flowing out faster on the liability side. So, if that results in tighter credit standards, you could see it spread to other sectors that rely on borrowing, that they're going to have to borrow at higher cost or may not be able to borrow at all. So, this could have some knock-on effects down the road that folks are not anticipating.

ALEX: ALEX: Dan, what's the one thought you'd like investors to take away from this conversation?

DAN: I think first, that this banking crisis is different than what was experienced during the Great Financial Crisis, and really this kind of environment with a very real threat of additional bank runs hasn't been experienced in our lifetimes. It pays to be thoughtful and diligent I think with regard to how this might spread, and our team continues to take a diligent approach when it comes to investing on both the long and short sides, and we believe that this will serve us well as we get through the current crisis just as it did during the Great Financial Crisis and other difficult periods.

We went through the Great Financial Crisis. The team here at Weatherbie Capital experienced that. So, we've got a pretty experienced team to help deal with these issues. Just no crisis rhymes with the one that happened before, but there are some things that can be learned in each successive one that pay dividends down the road.

ALEX: Dan, thanks so much for talking with me this afternoon.

DAN: Thanks, Alex. Great talking with you.

ALEX: And thank you for listening. For more thoughts on the banking industry, information on Dynamic Opportunities and the Weatherbie portfolios, and for more of our latest insights, please visit www.alger.com.

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