The Conservative Strategist

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The biggest scam of all

While everyone is talking about the biggest banking crisis since 2008, I'd like to change the subject — tangentially at least. Much has been made about how *Silicon Valley Bank* (SVB) stumbled in a business that isn't exactly difficult. If you take in billions in deposits and pay nothing or next to nothing on them, then lending out those deposits at a positive spread shouldn't be rocket science.

Asset-liability matching

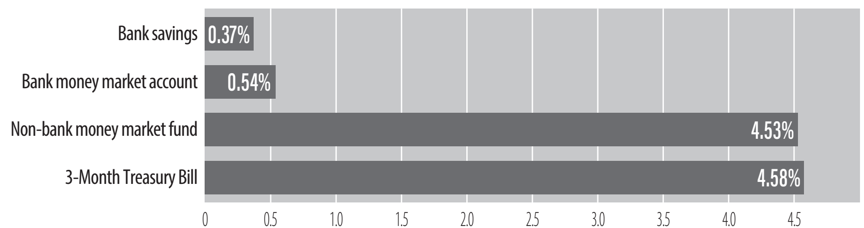
All you have to do to avoid trouble is roughly match the liquidity and duration of your assets and liabilities. If you have day-to-day liability to redeem bank deposits, for instance, then your corresponding investments should not be in illiquid corporate loans or long-term securities. SVB violated this fundamental precept, and when depositors came for their money, the bank had to sell illiquid loans and long-term bonds into a depressed market, taking gigantic losses that led to insolvency.

Temptation of the past few years

Now you could kind of see how SVB could get into this jam over the past few years, which saw short-term rates at or near zero. They (and other banks like *First Republic*) stretched for yield, by lending to less than pristine credits and by going out to 20- and 30-year maturities to earn a couple of extra points. When interest rates rose precipitously, the prices of these long-term bonds plummeted. Understandable to some extent, though SVB's strategy was especially reckless and risk-ignorant.

No-brainer

Average yields in the week of March 20, 2023



The ridiculous gulf between bank and non-bank money market instruments can only be explained by what economists term ***pure tacit collusion:*** *The capacity for oligopolistic participants (in this case the big banks) to fix prices that nearly all participants (including regional and small banks) follow. Banks know how 'sticky' customer funds can be, and exploit that. Don't let them get away with it.*

Bank greed

My beef isn't with the incompetency of selected banks, and the inadequacy of government oversight. It's with the obscene greed of these banks, and the seeming mass acceptance of the rawest deal in finance. That is this: Even after short-term interest rates have skyrocketed, the average bank money market account is paying a pathetic 0.44% per year in interest. The banks are taking those deposits and lending them out to corporate borrowers at 5%, 7%, even 10% rates. The profits are breathtaking. We're not talking some small overall sum, either. At latest count there was over $6 trillion in bank money market accounts, and another $3 trillion in other savings accounts from retail customers alone. That's $9 trillion on which the banks could earn a no-brainer 4% profit per year right now just reinvesting in T-Bills. Total estimated profit: $360 billion.

Why no revolt?

Bank customers have only themselves to blame. Money market funds pay up to eight to ten times as much as the average bank money market account. No, they are not FDIC insured, but 300 to 400 basis points per year is a ridiculously high price to pay for such insurance. Sure, some bank customers need to keep money in low-yielding bank accounts for reasons of convenience. But most money is there by sheer inertia. Surely there is an order of magnitude more money there than is necessary. ■

The Markets	March 31, 2023	Price/Yield	Gain, Qtr	Gain, YTD
US Stocks (S&P 500/Vanguard Index)		4109.31	7.46%	7.46%
International Stocks (Vanguard Index)		17.73	6.64%	6.64%
Emerging Markets Stocks (Vanguard Index)		25.58	3.58%	3.58%
Real Estate Stocks (Vanguard REIT Index)		27.62	1.73%	1.73%
Bonds (30 year US Treasury/Vanguard Index)		3.67%	6.34%	6.34%
Dollar (US Dollar Index)		102.60	-0.89%	-0.89%
Gold (London Afternoon Fix)		$1965.80	8.38%	8.38%
Money Market Funds (Vanguard Federal - VMRXX)		4.78%	1.13%	1.13%*

*change in yield

Portfolio Planning

Schwab's financial position is strong

In the wake of the collapse of *Silicon Valley Bank,* the stocks of a number of other regional banks and even brokers were hit hard, with much collateral damage in the equities of companies based in the Bay Area.

Charles Schwab Corp.'s stock (symbol: SCHW) did not escape the damage. It dropped 36% peak-to-trough during the crisis.

Cash sorting concerns

Concerns centered around so-called ***cash sorting*** among *Schwab Bank* customers: The notion that the crisis would accelerate any tendency for customers to pull their money from low-yielding bank deposits and transfer to higher-yielding money market funds (including *Schwab*'s own, among the highest-yielding in the industry). Such action *en masse* could cause *Schwab Bank* to have to sell bonds from its portfolio to meet such redemptions. Since interest rates have risen sharply of late, potential losses from such sales could raise concern among depositors about *Schwab*'s health, and a vicious cycle of cash sorting and bond redemptions could ensue, risking an old-fashioned bank run.

Schwab no SVB

However, the odds of a *Silicon Valley Bank*-type run are minimal, for two reasons.

First, let's talk depositor profile. The great majority of SVB's deposits were among a relatively small number of commercial customers which needed day-to-day liquidity for business purposes. More than 94% of deposits of these customers were above the FDIC limit of $250,000 per account, and thus uninsured. When news spread on social media of SVB's fragile condition, these large customers bolted with their uninsured deposits, pulling the virtual rug out from under the bank.

By contrast, *Schwab Bank* has a much more diversified depositor base, consisting largely of retail customers which do not require day-to-day access to their accounts. Fully 80% of the money at *Schwab Bank* falls within the FDIC $250,000 per account limit (that's in the top 5 among the nation's largest 100 banks). So there are not the ingredients for panic we saw at SVB.

Second, *Schwab Bank* maintains a far more conservative, liquid and diversified portfolio than SVB. Its capital is well in excess of regulatory requirements. Whereas much of SVB's portfolio was held in illiquid loans and long-term Treasury securities, *Schwab Bank* holds only a small portion of its portfolio in loans, and the great majority in a variety of Treasury and agency securities across the maturity spectrum.

Further, *Schwab Bank* has ample liquidity, including $100 billion of cash flow from cash on hand, $8 billion per month in proceeds from CD issuance, and $300 billion in access to standby credit facilities. This all compares to $360 billion in total deposits. This prompted *Schwab* CEO Walt Bettinger to tell the Wall Street Journal: "There would be a sufficient amount of liquidity right there to cover if 100% of our bank's deposits ran off. Without having to sell a single security."

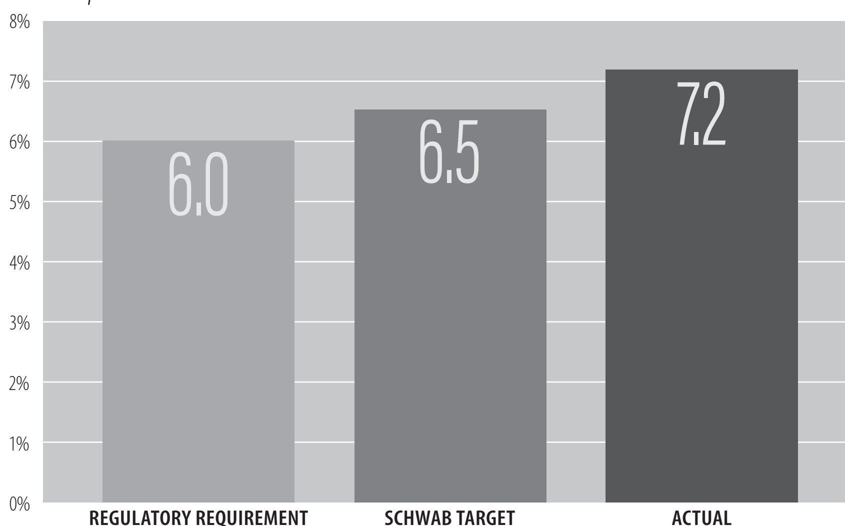
The calm after the storm

Perhaps the best evidence of *Schwab*'s strong financial condition is the reaction of its customers. *Schwab Bank* saw only moderate outflows (roughly $10-15 billion out of $360 billion). during the week of the crisis, and the brokerage division, of which you will soon be part, actually saw billions of net inflows to augment its already $7.4 trillion in overall customer assets.

There's even an argument to be made that this crisis will be a long-run benefit to *Schwab,* as concerns about the health of the regional banking system drive fund flows into the *Schwab* orbit. We hope those concerns will prove overdone, however, as the health of the regional banking system is essential to the formation and flourishing of small- and medium-sized businesses that are the heart of American commerce. ■

Schwab's liquidity is ample

Tier 1 capital ratios as of December 2022



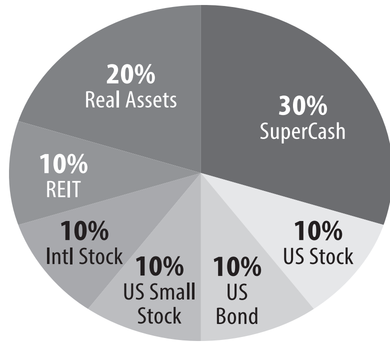
At the end of 2022, Charles Schwab *had $36.6 billion of shareholders' equity and a tier 1 leverage ratio of 7.2%, which are fairly good. The company has an internal target of 6.5% to 6.75% for its tier 1 leverage ratio and the regulatory minimum is 6%. Included in the company's shareholders' equity is about $28 billion of unrealized losses, so shareholders' equity would be upward of $60 billion without the unrealized losses.*

Source: Morgan Stanley, Bankrate.com

SuperDiversified Portfolios (SDPs)

Q1 was a tale of three months

SDP1 *Conservative*

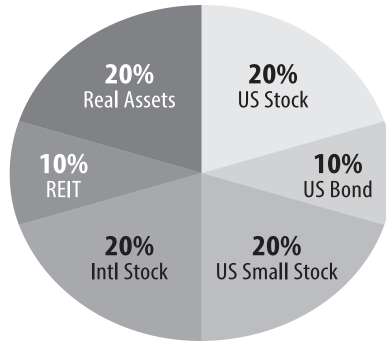


1st Quarter **2.46%**

Last 12 Months **-7.55%**

2023 started off strong, with a powerful January Effect lifting all stocks, especially those that lagged in 2022. This often happens after down years. When the calendar turns, fund managers, incentivized as they are, tend to take on more-than-usual risk in a bid to get ahead of their peers.

SDP2 *Moderate*



1st Quarter **2.04%**

Last 12 Months **-7.34%**

The euphoria did not last. February was a consolidation month, and then the *Silicon Valley Bank* news hit the tape in early March. Smaller stocks and value stocks were hit particularly hard. This may produce a special opportunity: Small-cap value was already relatively cheap before the crisis — now even cheaper.

The above model portfolios are not intended to indicate the performance of any real account, but reflect the composite performance, before fees, of the percentage allocations in the asset classes and funds listed in the table below. Seasonal Strategy's actual allocations vary from these models, and among portfolios.

How the Sectors Performed

REITs get caught in wave of banking fear

Asset Class	Mutual Fund	Performance 1st Quarter '23	Performance Last 12 Months
SuperCash	PIMCO Instl Low Duration	1.18%	-1.16%
	Merger	-0.06%	0.47%
	Calamos Market Neutral	3.10%	-0.17%
US Stock	Vanguard Index Trust 500	7.46%	-7.86%
US Bond	Vanguard Long-Treasury	6.34%	-16.61%
US Small Stock	Vanguard Small-Cap Index	3.70%	-9.44%
Intl Stock	Vanguard Intl Index	6.64%	-4.64%
REIT	Vanguard REIT Index	1.73%	-20.23%
Real Assets	PIMCO Commodity Real Return	-5.46%	-17.45%

Best / Worst

In the wake of March's banking crisis, investors are worried that commercial real estate is trapped in a kind of pincer movement between tenants and lenders. The REIT averages dropped nearly 10% in March, with office REITs leading the way, down 24%.

As Morningstar writes: "Investors now view REITs as one of the next areas where pressures could mount. That's especially the case as bank failures lead lenders to become more conservative in providing loans, which in turn could mean that struggling businesses will find it even more difficult to meet their financial obligations."

Baby with the bathwater

When one company faces a crisis and its stock tanks, it not uncommon to see most or all stocks in the same sector get punished severely, as scared investors start to see ghosts everywhere. That was certainly the animus in March, when the bankruptcies of *Silicon Valley Bank* and *Signature Bank* sent shockwaves throughout the regional banking sector.

In-KRE-dible

The clearest measure of pain in the regional banking sector is the selloff in the key regional bank exchange-traded fund, *SPDR S&P Regional Banking* (symbol: KRE). From a pre-crisis high of 65.32 in late January, KRE has sold off to a low of 41.90 at this writing (3/24). That's a 35.85% decline, a full-blown bear market in the sector. Except for a few months in the early pandemic, KRE is as low as it's been since August of 2016.

Good numbers…

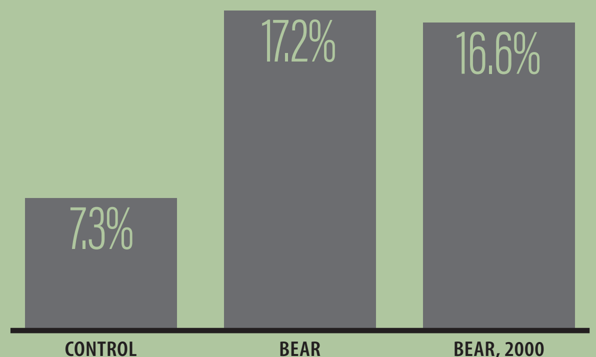
The average price/earnings ratio of the 25 stocks in KRE is roughly 7, while the average dividend yield clocks in at 3.6%. These numbers are both far superior to the average S&P 500 stock.

…but perhaps they get better

KRE traded as low as 27 in the collapse of 2020, so there is your downside. Certainly if more bank crises emerge, it can approach that number, which would make any subsequent recovery even more robust. We are interested in the mid-30s.

Why buy KRE on weakness

KRE forward 12-month return since 2006



Column 1 shows the average 12-month return for KRE since inception. Column 2 shows the average 12-month return for KRE if it is bought after a 20% or greater decline from a prior high (as is currently the case). And Column 3 shows the average 12-month return if bought after a 20% decline but also after it rebounded to close above its 200-day moving average. This third method helps from "catching a falling knife" and it does not give up much return potential.

Source: DM Martins Research

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For our TD Ameritrade Institutional clients

Four years later, the Schwab/TD Ameritrade integration is finally upon us

Well, we're nearly there folks. After the original announcement of *Charles Schwab*'s takeover of *TD Ameritrade,* our *TD Ameritrade Institutional* clients will finally move to *Schwab Institutional.*

The date of the move? Labor Day weekend.

That's Saturday September 2, 2023 through Tuesday, September 5, 2023.

Here's what's happening and how it affects you:

1. The transition should be simple, rather seamless, and entirely digital. There will be no need for new applications or other paperwork. *Schwab* will transfer your assets and there is nothing you need to do.
2. Your relationship with me and *Seasonal Strategy* will not change. I will continue to be your adviser on your accounts, and there will be no need to sign any additional authorizations.
3. You will have a new *Schwab* account number, so you will need to update any direct deposits or recurring payments that you have set up directly with your bank or other third parties. Any instructions set up on *TD Ameritrade* will transfer over.

Here's what you need to do to make the transition as easy as possible:

A. Now…

Set up your **AdvisorClient®** credentials.

If you haven't already done so, go to **advisorclient.com** to set up your login ID and password. This is the easiest way to view your accounts and balances and to get access to *Schwab Alliance,* the client service center at *Schwab* that you will be able to access both online and by phone once the transition is upon us. It's staffed with an experienced team dedicated to answering questions and addressing issues from clients of advisers.

B. August…

Set up your new *Schwab* credentials.

28 days before the transition weekend, you will be sent information you will need to set up your new *Schwab* credentials, including *Schwab Alliance* Login ID and password. Simply follow the instructions to set them up.

C. Late August/Early September…

Try to avoid important transfers or other transactions right before Labor Day.

The transition should be smooth, but it's best not to tempt fate. So try to avoid complex transactions or requests right before the transition weekend. ■

Your transition timeline

Here's a look at what's happening and when