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Facing the Future with Optimism and Courage
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In the News

U.S. stocks experienced a volatile first quarter, yet the major indexes produced gains despite a banking crisis in March that caught the financial world by surprise. The S&P 500 gained 7.5% and there were 16 days when the index rose by 1% or more and 13 days when it fell by 1% or more. Still a lot of volatility, but at least there were more wins than losses. My Lazy Golfer portfolio consists of five Vanguard index funds-- allocated 40% to the Total Stock Market Index Fund (VTSMX), 20% to the Total International Stock Index Fund (VGTSX), 20% to the Inflation Protected Securities Fund (VIPSX), 10% to the Total Bond Market Index Fund (VBMFX) and 10% to the REIT Index Fund (VGSIX). It has an annual expense ratio of 0.17%. Rebalance the portfolio on your birthday and ignore the stock market for the rest of the year. In the first quarter, the Lazy Golfer rose 5.4%. The events of the last three years: a global pandemic, the Russian invasion of Ukraine, spiking inflation, rising interest rates, ongoing recession fears, and a banking crisis led to many worrisome headlines. Yet the Lazy Golfer yielded an annualized average return of 10.9% for the three years ending March 31, 2023 and an annualized 6.1% for the past 5 years, according to Morningstar. You could have done worse.

This month's episode of What Could Go Wrong? focuses on the rapid collapse of Silicon Valley Bank (SVB), a bank that almost no one outside of Silicon Valley even knew existed - until last month when it became the second largest bank failure in United States history. Why did it fail so suddenly, and what lessons does its failure provide for investors?

The US has a fractional reserve banking system. When you open a bank account, the bank keeps only a fraction of your deposit available for withdrawals. The remainder is used to generate income for the bank by financing consumer loans, mortgages, business loans, or by being invested in high quality bonds. Depositors still have immediate access to their money, to be paid from the bank's reserve capital. But if too many depositors seek to withdraw all their money at the same time, known as a bank run, the bank may be unable to meet the demand.

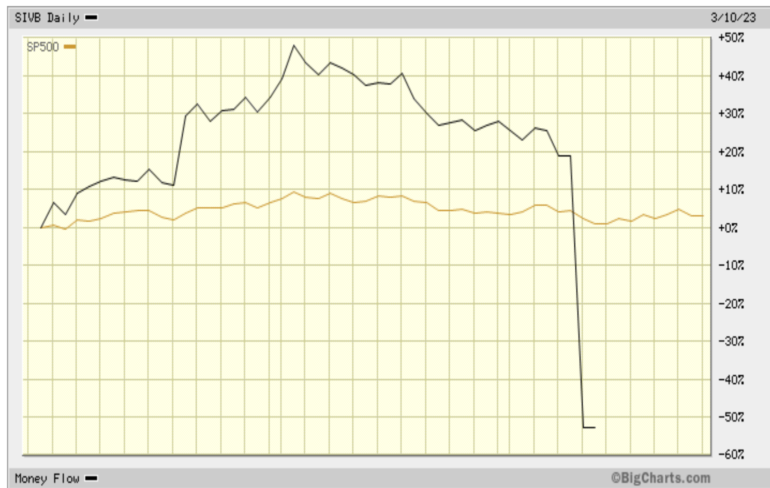
SVB catered primarily to Silicon Valley tech startups and venture capital firms, many of which found it difficult to get funding from other lenders. The bank grew quickly, and deposits poured in during the early months of the pandemic. At its peak, SVB had about 38,000 corporate accounts, more than $200 billion in assets but few individual retail depositors. In other words, SVB had plenty of assets and thousands of depositors, yet, essentially, it had just one depositor – Silicon Valley startup companies. Thus, its financial health was tied to the tech industry's ups and downs. It is estimated that more than 90% of SVB's corporate accounts exceeded the $250,000 FDIC deposit insurance limit.

In 2022 the overriding issue for the economy was inflation. The Fed was raising interest rates and rising rates cause bond prices to fall. For example, if you own a $10,000 US Treasury bond that pays 2% interest and similar, newly issued bonds are yielding 4%, no one will pay you $10,000 for your bond. Its value depends on how soon it will mature. Bonds close to maturity will decline less than bonds with several years to go before maturity. Using a financial calculator, we can compute that, in our example, if your bond is 2 years from maturity, its value would be $9,623. If it is seven years from maturity the price would be $8,800. The buyer of your bond will receive $10,000 when the bond matures, earning a capital gain to compensate for the smaller interest payments. Although US Treasury securities are considered to have no default risk, they are subject to interest rate risk (also known as duration risk).

SVB bought risk-free, long-dated Treasury bills and government backed mortgage bonds when rates were low — which sank in value as interest rates rose. SVB executives took the risk that if interest rates rose and client withdrawal requests increased at the same time, they might be unable to meet withdrawal demands without selling longer dated bonds at a significant loss. After five years of strong growth, the tech industry was hit by the slowing global economy in 2022. Its corporate customers began withdrawing money from SVB to make payroll and meet other financial obligations. Customer withdrawals exceeded short-term reserves and SVB took a nearly $2 billion loss when it sold long-dated bonds to finance the withdrawals. SVB's hastily announced plans to raise capital failed when its stock price tumbled. Its corporate clients, fearing a loss of their uninsured deposits, began an old-fashioned run on the bank. They withdrew $42 billion on March 9th. On March 10th, SVB did not have the cash to fill billions of dollars of new withdrawal requests and the FDIC stepped in and closed the bank. Time to failure: less than 48 hours from announcing its plans to raise capital and a morning shuttering on March 10th. Simply put, Silicon Valley Bank made long-term investments with money that might be needed in the short-term. Hey, what could go wrong?

The run on SVB was fueled by panic on social media platforms and in public and private chat groups. One Tweet with 2.4 million views and 3,400 re-Tweets shouted –*"Run on the bank! Get your money out. First thing on Monday. US banks are in trouble. FED emergency meeting. Deposits may get locked. Possible withdrawal limits. When markets collapse, your bank deposits that US banks use to invest may be in danger. Cash is king. Get out now!"* It was the first digital bank run in history. SVB depositors didn't have to make their way to the bank, stand in line all day and get cash in $100 bills from tellers. They withdrew billions of dollars instantly using a cell phone app or a few clicks of a mouse.

In an appearance March 28th before the Senate Banking Committee, Michael Barr, the Fed's vice chairman for banking supervision, said the Fed had raised concerns with SVB before its March 10th collapse and had given the bank poor ratings for risk management. *"Fundamentally, the bank failed because its management failed to appropriately address clear interest-rate risk and clear liquidity risk"*. Barr added that examiners at the San Francisco Federal Reserve bank identified these problems but *"those actions were not acted upon in a timely way"*. SVB overbought high-quality, long-term bonds and didn't hedge against the possibility of a rapid rise in interest rates. Why these obvious risks were unaddressed or unnoticed by the bank's risk officers remains a mystery.



SVB Financial Group (SIVB) is the parent company of Silicon Valley Bank. This chart compares the share price of SIVB to the S&P 500 Index this year through March 10th, the day the FDIC took control of SVB. The stock closed on Monday, March 6th at $284/share. One week later, SVB Financial Group filed for Chapter 11 bankruptcy. On March 31st, the price of the stock was 8 cents per share. The market capitalization of SIVB went from several billion dollars to zero in less than a week. It was replaced in the S&P 500 by Insulet, a manufacturer of medical devices with $1.3 billion of revenue in 2022. Net effect of SVB's failure on S&P 500 Index fund owners – too small to notice. Despite never being mentioned in the headlines, the risk of owning individual stocks was once again clearly revealed.

Whenever a significant market event occurs, especially one that nobody predicted, financial media commentators engage in 20/20 hindsight. "Of course this happened, anyone could see it coming." But, of course, no one did. I don't recall reading any 2023 market forecasts which predicted the failure of one of the nation's largest banks. It's just the latest example of the unavoidable uncertainty that all investors must learn to live with.

When it comes to managing our finances, many things are outside our control. But that's no excuse for overlooking the things that we can control. Fortunately for SVB customers, the government guaranteed all their deposits. FDIC deposit insurance limits are $250,000 per depositor, per insured bank, for each account ownership category. For people with large balances, there are ways to ensure that all of their funds remain covered by FDIC insurance. A married couple could have $1 million insured at a single bank by putting $250,000 in individual accounts under each spouse's name and $500,000 in a joint account. You can also have accounts at multiple banks or place some of your excess cash in a money market fund in a brokerage account or in a short-term Treasury ETF. You'll earn some interest and have no worries about credit risk or bank runs.

Banks are just like investors – prudent money management requires that assets (or customers) be diversified for safety. This isn't a sophisticated concept. Grandma knew not to put all her eggs in one basket. Adopting sensible investing principles that have stood the test of time - such as having a long-term perspective, periodic portfolio rebalancing and broad portfolio diversification - are our best defenses to deal with the next unpredictable, unavoidable financial crisis.

Active Managers' Scorecard

There are, broadly speaking, two competing investment strategies. The older, more common strategy is called active management. Active fund managers attempt to identify stocks that will outperform the market and avoid those that they believe will underperform. The other strategy is known as passive management (called evidence-based investing by some proponents who think that passive sounds, well, too passive). Retail passive investing began in 1976, when John Bogle, then the CEO of Vanguard, launched the first retail index fund that tracked the S&P 500 Index. Index funds match the return of an asset class by owning most or all of the securities in the asset class. Passive index investors make no attempt to outperform the market. They accept current prices as the best estimate of fair value and receive the return of the capital markets at virtually no cost.

S&P's Indexes Versus Active (SPIVA) Scorecard is a semiannual report that compares the performance of actively managed mutual funds to their S&P benchmark index. The latest SPIVA Scorecard, covering the 20 years ending December 2022, notes that 2022 was the 13th consecutive year in which the majority of large-cap domestic stock funds underperformed the S&P 500 Index – despite the fact that the S&P 500 lost 18% last year. Additionally, 50% of actively managed domestic stock funds underperformed the S&P 1500 Total Market Index last year.

Proponents of active management admit that it is difficult for large-cap fund managers to outperform the S&P 500 Index because the stock market efficiently prices large-cap stocks. But they assert that in less efficient markets, such as small-cap stocks and emerging market stocks, active managers have an edge. But this assertion is not supported by the evidence. According to the latest SPIVA Scorecard, over the past 10 years, 85% of actively managed emerging market stock funds underperformed their benchmark S&P index and 95% of actively managed domestic small-cap core funds underperformed the S&P 600 Small Cap Index.

Fund Asset Class	1 YR	3 YRS	5 YRS	10 YRS	20 YRS	
Large-Cap Growth	F	F	F	F	F	2%
Large-Cap Value	F	P	F	F	F	13%
Mid-Cap Growth	F	F	P	F	F	8%
Mid-Cap Value	F	F	F	F	F	8%
Small-Cap Growth	F	F	F	F	F	3%
Small-Cap Value	P	P	F	F	F	8%
Domestic REITs	F	F	F	F	F	13%
Int'l Large Stocks	F	F	F	F	F	6%
Int'l Small Stocks	F	F	F	F	F	15%
Emerging Market Stocks	F	F	F	F	F	3%

Data as of December 31, 2022

This is the year-end 2022 SPIVA report card for active managers. The far-left column lists ten popular stock asset classes. The next five columns give a pass or fail grade to active managers in each asset class for the past 1, 3, 5, 10 and 20 years. If more than 50% of actively managed funds in an asset class outperformed their benchmark S&P index, they get a passing grade of P for that period. If the majority underperformed, they get a failing grade of F. The last column notes the percentage of active funds in the asset class that survived and outperformed their benchmark index for the past 20 years.

The reason long-term performance results are so poor, and bound to remain so, is due to the compounding effect of the performance shortfalls as the years go by.

The Scorecard also tracks the longevity of mutual funds. Of the 2,253 domestic stock funds available to investors on January 1, 2003, only 725 (32%) were still in business on January 1,2023. Typically, poor performing funds are merged into other funds or liquidated. If we assume that the surviving funds have the most talented managers, the removal of less talented competitors will make it even harder for active managers to outperform in the future.

Mutual fund managers are hardworking, educated, talented and confident investing professionals. They have access to a worldwide network of information from securities firms, data providers, and news sources. Each day they make millions of trades in the global financial markets that aggregate vast amounts of information, yielding consensus pricing that is difficult to outsmart. In investment speak we say that all their trades create a market that is "efficient" at pricing stocks. Not every stock is perfectly priced, but it's impossible to determine with any assurance which stocks are mispriced. To outperform, a fund manager must outsmart the collective pricing wisdom of all other investors, know how the future will be different from what other investors expect and how prices will react to unexpected news.

By eliminating manager risk, minimizing taxes and keeping management fees and transaction costs low, index fund investors have outperformed most active investors over the long-haul, even in asset classes in which markets are less efficient at setting prices. So, a tip of the cap to active managers. Index investors "piggyback" on their research and efforts. We accept current prices as the best estimate of fair value. As the SPIVA report reveals, most active funds fail to provide economic value for their investors in excess of their additional costs, especially over longer time horizons.

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