BANK STOCKS: WHY COMPASS DOESN'T BUY THEM

The week of March 6th saw Silicon Valley Bank (SVB), a regional bank based in northern California, thrust into the headlines as the third largest bank failure in American history. How did a bank that appeared to be functioning normally on Monday need to be seized by the government on Friday? The answer to this question lies in a combination of factors, but can primarily be said to be due to SVB's poor risk-management decisions, and the bank's inability to deal with the impact of rising interest rates. These two main factors are opaque and don't readily show up on the financial statements that banks issue.

Now to be sure, SVB had some unique aspects to its business. As the name partially suggests, they marketed their services mostly to the venture capital industry in Silicon Valley. And not just to venture capital firms, but also to the start-up companies funded by them and to the many executives employed in the industry. These clients, both individually and as companies, had large deposit balances at SVB, well above the $250,000 FDIC insurance cap. According to a published report from S&P Global, SVB was carrying about 95 percent of their deposits at uninsured levels. This left SVB exposed to a flight of deposits, because many clients would (and did) move balances above $250,000 elsewhere as soon as they became concerned about the bank. Management of SVB compounded their exposure by purchasing long-term maturity U.S. Treasury bonds with the uninsured deposits.

When the Federal Reserve began increasing interest rates in the spring of 2022, the value of these bonds began to drop. Because the Fed raised interest rates over 4 percent in 2022, the longer term U.S. Treasury bond dropped in value by over 20 percent. For example, a $1 million, 15 year U.S. Treasury bond purchased in January of 2022 was only worth about $750,000 to $800,000 if SVB needed to sell it last week.

When executives and venture capitalists lost confidence in the bank's equity capital position last week and started pulling large deposits, SVB was forced to sell their longer-term bonds at a substantial loss. The withdrawal demands at SVB were larger than the market value of the equity capital in the bank, necessitating the Fed and the FDIC to step in. However, if SVB had purchased bonds with a shorter maturity to manage their risk better, any losses would have been modest.

This situation is an example of why Compass avoids purchasing bank stocks. Due to the nature of the balance sheet reporting for the industry, we don't know where the risk is hiding. In this case, most of the Wall Street analysts that focus on bank stocks did not see this coming either. There is a reasonable probability that this situation will create an environment where banks start making fewer loans in the near term, which would likely result in a slowdown in economic activity. Thankfully, at Compass we focus on building a portfolio of companies with strong balance sheets and transparent income and cash flow statements. Our companies will likely be able to grow in this environment, and many have the ability to obtain additional financing if they need it. Our portfolio is well positioned for the potentially challenging times ahead. We would love to talk with you about it in further detail.

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COMPASS PHILOSOPHY

As an independently-owned firm, Compass provides customized investment services to individuals, foundations/endowments, trusts, and retirement plans. Our objective is to preserve and enhance the real purchasing power of our clients' wealth over time.

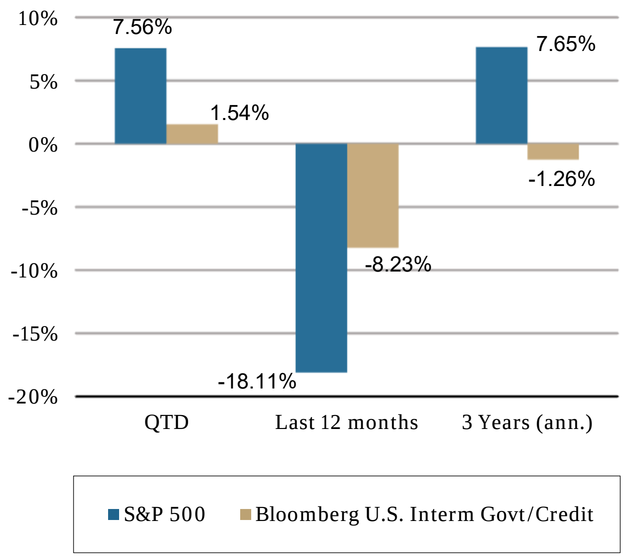
Our clients value working directly with a seasoned and experienced team of portfolio managers to help them navigate their investments relating to:

- -Building a quality portfolio
- -Retirement
- -Sale of a business
- -Divorce
- -Inheritance
- -Trust distribution

Our experienced team is always available to provide financial advice and review your financial assets.

MARKET INDICES

Total Return as of 12/31/2022



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AUM

$1.8 billion

INCEPTION

1988

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