WINTHROP WEALTH

THE SILICON VALLEY BANK FAILURE

HOW IT HAPPENED, HOW IT IS BEING RESOLVED AND A RENEWED EYE ON RISK MANAGEMENT

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Late last week we saw the largest bank failure since 2008 when Silicon Valley Bank (SVB), a subsidiary of SVB Financial (ticker: SIVB), failed to meet its customer withdrawal requests. We have summarized what happened below and provided some additional thoughts on the topic. This is not a time for panic, but instead a time to rethink risk exposure and how your personal and business cash is managed.

What happened?
What occurred at Silicon Valley Bank was an absence of necessary risk management and diversification, in our opinion.

SVB Financial (ticker: SIVB) is the parent company of Silicon Valley Bank. SVB was founded in 1983 and was the 16th largest bank in the United States. At the end 2022, SIVB had a market capitalization of $13.6 billion and was about a 0.04% weighting in the S&P 500. For context, the nation's largest bank, JP Morgan had a market cap of $393 billion and was about a 1.2% weighting in the S&P 500 at the end of last year.

SVB had a uniquely concentrated client base, which included many venture capital and startup firms. According to its website, Silicon Valley Bank did business with about half of all venture capital-backed startups in the United States. The post-pandemic environment, which was flush with "cheap money" from massive amounts of fiscal and monetary stimulus, was a boom-period for many startup companies who were long on innovative ideas and short on profits. As the company's target clients were thriving in a once-in-a-generation period, SVB's deposits surged from $60 billion to nearly $200 billion from Q1 2020 through Q1 2022.

How Silicon Valley Bank invested their new deposits can easily be characterized as a lapse in judgment and risk management. In a period of historically low interest rates, SVB invested many of their deposits in long-term Treasuries and Agency Mortgage-Backed Securities (MBS). While Treasuries and Agency MBS have little default risk, both face considerable risk of loss If interest rates increase (sending bond prices down) AND the securities are sold prior to maturity. . Government bonds and Treasuries are guaranteed by the US government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. Please see our **Client Question: Bond Primer**, which outlines the difference between various types of bonds, details the mechanics of the bond market, and goes into detail on why bond prices move inversely to interest rates.

In 2022, the tab came due for the "cheap money" post-pandemic period, which created the perfect negative storm for Silicon Valley Bank's client base and investment portfolio. In order to tame inflation, the Fed began aggressively raising interest rates and tightening monetary policy. Consequently, SVB's clients were no longer flush with cash and thus began to draw down their balances – cash hungry start-up companies required even more cash to operate as inflation made everything from borrowing costs to labor costs more expensive and end customer demand started to weaken. Meanwhile, long-term interest rates spiked higher, which created losses in the bank's bond portfolio (the company announced unreal-ized portfolio losses of over $17 billion at the end of 2022). As customers kept pulling money from the bank, SVB needed to sell securities to fund withdrawals. On March 8th, SVB stated it sold a portion of their portfolio, which resulted in a loss of about $1.8 billion. Furthermore, SVB announced a plan to raise $2.25 billion in new capital.

On March 9th, customer withdrawals accelerated as several prominent venture capital firms advised pulling money from the bank. Word spread quickly as reports estimate that customers attempted to pull $42 billion worth of deposits. A bank run occurred in less than 48 hours. Silicon Valley Bank could not meet withdrawals and collapsed. SVB became the largest bank to fail in the United States since Washington Mutual in 2008.

What was the government response?
On Sunday, March 12th the Federal Reserve, Treasury, and FDIC made three major announcements:

1. All depositors at Silicon Valley Bank will have full access to their funds starting Monday, March 13th.
2. Signature Bank (a New York based bank with a significant cryptocurrency depositor base) also failed. All depositors will also have full access to their funds.
    - Note – the FDIC has ability to guarantee all deposits at an individual bank if that institution is deemed a systemic risk to the broader financial system. Only Congress has the authority to guarantee deposits for the entire banking industry.
3. The Fed created a new facility called the Bank Term Funding Program (BTFP) that will offer loans of up to one year to banks pledging Treasuries, Agency MBS, and other qualifying assets as collateral. It is important to note that these assets will be valued at par.

While the government's response should help calm markets and remove contagion risk, the full impact on the banking industry as it relates to future loans and deposits are unclear at this time.

Winthrop Thoughts:

Any business failure is hard to stomach. Especially, when the business is a bank that is tied into the fabric of our financial system. In many ways our financial system is the foundation of our society and access to it is critical. It is how we buy our morning coffee, get a loan to pursue higher education, pay our employees, borrow to buy a house or a car, save for retirement and more. Trust is integral to its proper functioning. However, that doesn't mean we can ignore the fact that banks can be mismanaged and make bad bets. SVB, Signature and Silvergate (a bank to the crypto industry) all shared similarities in their demise: niche clientele and mismanagement of their balance sheets.

Going forward we believe that it makes a lot of sense to proactively manage your bank cash reserves. This means structuring accounts so that deposits are insured. Utilizing insured cash accounts and insured cash sweep programs along with having more than one banking relationship if you need guaranteed access to your funds (especially for operating businesses) is prudent. Also, we believe now may be a great time to take advantage of the higher interest rate environment by purchasing Treasuries – this diversifies your risk by being a creditor to the US Government and provides a return free of state tax.

How does Winthrop Wealth view risk management and diversification?
Winthrop Wealth operates in a different business than Silicon Valley Bank, however, risk management diversification are fundamental pillars of our philosophy and process.

Risk management serves as the foundation for all our wealth management decisions. Risk management starts with the financial planning process, which seeks to optimize account structures, considers tax mitigation strategies, and determines the target investment asset allocation based on our client's willingness and ability to accept risk. From an investment perspective, risk management does not mean the prevention of loss, as all forms of investing involve the risk of loss. Rather, investment risk management means optimizing the portfolio's potential risk and return tradeoff within a specific set of parameters determined by the financial plan. We then set guardrails and have the technology to monitor any portfolio drift away from the target allocations. All of this adds up to our Total Net Worth Approach. *Please remember that no strategy assures success or protects against loss. Investing involves risk including loss of principal.*

Proper diversification is another way we enhance our risk management process. Our financial planning process helps manage the high-level exposures by looking our clients' entire financial picture (all of their assets and liabilities). First and foremost, our planning process seeks to identify and solve for any potential asset/liability gaps that would create significant negative financial exposure. It also helps determine individual client cash needs, making sure that those needs are reserved for with a combination of low-risk securities and cash. Finally, our financial planning process helps refine asset location and ownership/titling as well as reducing concentration risk and asset class overlap.

When it comes to the money that we directly manage, we construct diversified portfolios across regions, countries, market caps, factors, styles, sectors, industries, credit qualities, and interest rate sensitivities and tilt toward the areas we feel provide the most potential benefit. We do not go with an "all eggs in one basket approach" as the market constantly undergoes violent rotations across asset classes. *Please remember that asset allocation does not ensure a profit or protect against loss. There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio.*

History has numerous examples of aggressive and under-diversified fund managers who appeared clairvoyant in certain market environments only to look incompetent when the tide inevitably changed. The 2020-2022 time period was ripe for this kind of behavior. There are easy parallels between the collapse in Silicon Valley Bank and recent significant declines in several well-known investment funds. Both can be traced back to inadequate risk management and diversification.

Moving forward, we will continue to follow our time-tested playbook during market volatility. As we have done in the past, we will attempt to make lemonade out of lemons by tax-loss harvesting (please view our **Client Question on the benefits of Tax Loss Harvesting**), rebalancing, and repositioning during these periods.

Please see our commentaries on **Navigating Volatile Markets** and **Market Timing Does Not Work**, which add valuable context during difficult market environments by stressing the benefits of a diversified portfolio and a long-term disciplined approach to investing.

What Protections Can I Expect with Regard to Bank Deposits?

In light of volatility and uncertainty surrounding banks in the news this week, we would like to provide some additional information on various coverage terms you may see referred to in various media publications, as well as how these apply to bank depositors and investors.

FDIC Insurance: The Federal Deposit Insurance Corporation (FDIC) protects bank customers in the event that an FDIC-insured depository institution fails. The FDIC acts as both an insurer and oversees the receivership of closed or failed banks to protect customers.

The FDIC was established under the Banking Act of 1933 to provide stability and enable additional federal intervention in the banking system during the Depression Era when bank runs and failures were more frequent.

Importantly, bank customers don't need to purchase deposit insurance; it is automatic for any deposit account opened at an FDIC-insured bank. Deposits are insured up to at least $250,000 per depositor, per FDIC-insured bank, per ownership category.

Remember, cash alternatives and money market products are generally not FDIC insured.

For more information, please visit **www.fdic.gov** where you can read more on coverage limits, ownership categories, and access an online calculator to help determine how many of your assets are within coverage limits.

What Protections Can I Expect with Regard to Investment Accounts?

It is important to be aware that accounts at LPL Financial or another broker/dealer are not FDIC-insured. All investing involves risk, including loss of principal. Winthrop Wealth relies on a qualified custodian to hold all client assets which we manage. This helps to safeguard customer assets under certain circumstances but does not protect against market loss or investment risk.

Qualified Custodians: Accounts managed by Winthrop Wealth are held with a qualified custodian, like LPL Financial. In fact, the SEC requires that registered investment advisors maintain accounts at qualified custodian. The qualified custodian must hold the funds or securities in an account either under the client's name or under the adviser's name as agent or trustee for its clients—separate from the assets of the advisor.

SIPC Protection: Congress created Securities Investor Protection Corporation in 1970 to protect customers of member broker/dealers that may fail financially, be liquidated, or are otherwise unable to meet obligations to securities clients. If any securities or cash are missing from eligible customer accounts, SIPC steps in and, within certain limitations, works to return customers' cash, stock, and other securities held at the firm. SIPC does not protect customers against losses from the rise and fall in the market value of investments. SIPC membership provides account protection up to a maximum of $500,000 per customer, of which $250,000 may be claims for cash. More information is available at www.sipc.org.

Excess of SIPC Coverage: Most securities firms offer additional account protection beyond SIPC's limits (commonly referred to as "Excess of SIPC Coverage"). This coverage is provided through private arrangements between securities firms and insurance companies. For example, LPL Financial has Excess of SIPC protection from London Insurers to cover the net equity of customer accounts up to an overall aggregate firm limit of $750,000,000, subject to conditions and limitations. Excess of SIPC coverage does not protect customers against losses from the rise and fall in the market value of investments.

What about Money Market Investments in an LPL account?

While not all money market instruments are FDIC-insured, for those client accounts in the LPL Insured Cash Account ("ICA"), there is a brochure available by contacting your advisor that describes in detail how the ICA functions to provide insured deposits.

LPL Insured Cash Account: Under the ICA program, LPL Financial ("LPL"), acting as agent, will automatically transfer (or "sweep") available cash balances in eligible accounts—including proceeds of securities transactions, dividend and interest payments, cash deposits, and other monies—into interest-bearing deposit accounts ("Deposit Accounts") insured by the FDIC.

Any deposits (including certificates of deposit) that you maintain (i) directly with a Bank or (ii) through an intermediary (such as LPL or another broker-dealer) in a particular FDIC-defined Ownership Category will be aggregated with your cash balances from the ICA program held at the same Bank and in the same Ownership Category for purposes of calculating the $250,000 limit. It is important that you monitor your assets and cash deposits at all Banks. Please notify your financial professional of deposit accounts that you hold with any Bank on either of the Priority Bank Lists, so that your financial professional may ensure that LPL does not sweep ICA program cash into that Bank on your behalf.

In addition to the above-linked resources, the SEC maintains an investor resource site aimed at consumers, which provides education and resources on investing, investment products, fees and investment professionals. **www.investor.gov**

DISCLOSURES:

Content in this material is for general information only and not intended to provide specific advice or recommendations for any individual.

The economic forecasts set forth in this material may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

All indexes mentioned are unmanaged indexes which cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. Past performance is no guarantee of future results.

The Standard & Poor's 500 Index is a capitalization weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

Government bonds and Treasury bills are guaranteed by the US government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value.

Financial planning is a tool intended to review your current financial situation, investment objectives and goals, and suggest potential planning ideas and concepts that may be of benefit. There is no guarantee that financial planning will help you reach your goals.

Asset allocation does not ensure a profit or protect against loss. There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio.

Diversification does not protect against market risk. All investing involves risk which you should be prepared to bear.

Securities offered through LPL Financial, Member FINRA/SIPC. Investment Advice offered through Winthrop Wealth, a Registered Investment Advisor and separate entity from LPL Financial.