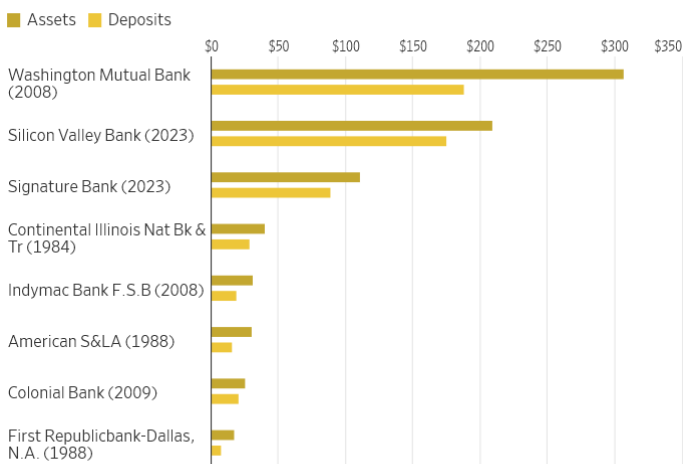


outlook

Too Mid-sized to Fail

Failed banks are dominating the headlines, and for good reason. Silicon Valley Bank (SVB), with \$209 billion in assets, was the second-largest bank failure in U.S. history. Shortly after SVB failed, Signature Bank, with \$110 billion in assets, became the third-largest bank failure in U.S. history. Continental Illinois National Bank and Trust was the fourth largest to fail, in 1984, with \$40 billion in assets. The largest bank failure ever was Washington Mutual, which had \$307 billion in assets when it failed during the 2008 financial crisis. Eventually, Washington Mutual was sold to JP Morgan for \$1.9 billion. Even more extensive failures occurred with Lehman Brothers and Bear Stearns; technically, these companies weren't banks but were considered investment banks at the time. Lehman was the largest bankruptcy filing in U.S. history, with over \$600 billion in assets.

Biggest bank failures



Note: Signature Bank assets and deposits as of Dec. 31, 2022
Source: FDIC, New York Department of Financial Services

Bear Stearns was rescued by JP Morgan, but let's not kid ourselves; they failed too, with about \$400 billion in assets. Since the 2008 financial crisis, banks and investment banks have been lumped together and now they are all considered banks. In comparison to Lehman and Bear Stearns, SVB is small potatoes. Apparently, today, even mid-sized banks are too big to fail!

SVB was idiosyncratic, and it failed because it was mismanaged. It's not an indictment of the banking system.

Although I'm sure more bank failures will occur this year, I do not believe it's a 2008-style financial crisis. In 2008, there were 25 bank failures, 140 in 2009, and 157 in 2010, and 185 banks closed between 2011 and 2014. Poorly managed banks will always fail. Hopefully, the worst is behind us, and future failures will be contained to small banks.

The Fed created the environment that fueled SVB's problems, as it engaged in quantitative easing by buying bonds and putting cash in the hands of investors. Much of this cash went to banks. Most banks invested this money prudently. The managers of SVB decided to buy long-term bonds when interest rates were at all-time lows, even though the Fed was crystal clear in alerting the world that interest rates would soon increase.

What did SVB do to protect its long-dated bond portfolio? Nothing. It's pure and simple mismanagement. I'm sure SVB didn't expect its client base to pull their deposits simultaneously. Making things worse, SVB decided to concentrate its customer base on one sector of the economy: technology companies. This concentration was another mistake made by management. At Roffman Miller, we preach diversification and risk management.

SVB's decision to concentrate on one economic sector is like us building a stock portfolio only utilizing technology companies. Taking a big sector bet like this is reckless, and that decision falls in management's lap. As you know, our portfolios are diversified, and we closely monitor how much money goes into any company and sector.

Regarding the bond portfolio, SVB was overweight in long-term bonds to the tune of \$91 billion. By the end of 2022, SVB had 90% of their bond holdings in long-dated, mortgage-backed securities yielding less than 2%! When interest rates rose, the value of these bonds plummeted. Then, when the run on SVB began, they had to sell these long-term bonds at a loss which caused the FDIC to step in. Once again, this was a classic case of mismanagement.

To begin with, they shouldn't have been loading up on long-term bonds. Secondly, as Roffman Miller has in our bond

ladders, they should have had maturity diversification. Putting so much capital in long-term bonds at historic lows in interest rates is beyond reckless; it's incompetent. This isn't Monday morning quarterbacking; it's common sense. At Roffman Miller, we've built short-term bond ladders for our clients. If interest rates rise, the value of our bonds will fall on the Schwab statement, but we're not selling before maturity. As a result, our bonds are guaranteed by the sponsoring organization to return 100% of the principal and make interest payments along the way.

Furthermore, when our bonds mature, if interest rates are higher, we'll reinvest the proceeds in higher-rate bonds, increasing our clients' cash flow. Our clients will thus benefit from rising rates with a buy-and-hold-to-maturity bond ladder.

This is not 2008, but it's more like the S&L (Savings and Loan) crisis from the 1980s. In the 1980s we experienced significant interest rate increases which affected smaller banks that were less heavily regulated. Paul Volcker was the Federal Reserve Chairman in 1979 and vowed to tame inflation. He then raised interest rates at an incredible pace. As rates rose, the market value of long-dated mortgages quickly declined. Most of the investments for the S&Ls were in mortgages that were falling in value, but at the same time the S&Ls had to pay depositors more to attract assets due to rising interest rates. Subsequently, our government decided to let the weakest S&Ls fail and backstopped the survivors. Sound familiar? This reminds me of a famous quote from Voltaire, "History never repeats itself. Man always does."

During the fallout of the S&L crisis from 1980 to 1995, over 1,000 lenders went bankrupt, yet the world didn't end. Investors who bought the S&P 500 index during this time frame and reinvested all dividends made a return of 901% or 15% per year! Not so bad.

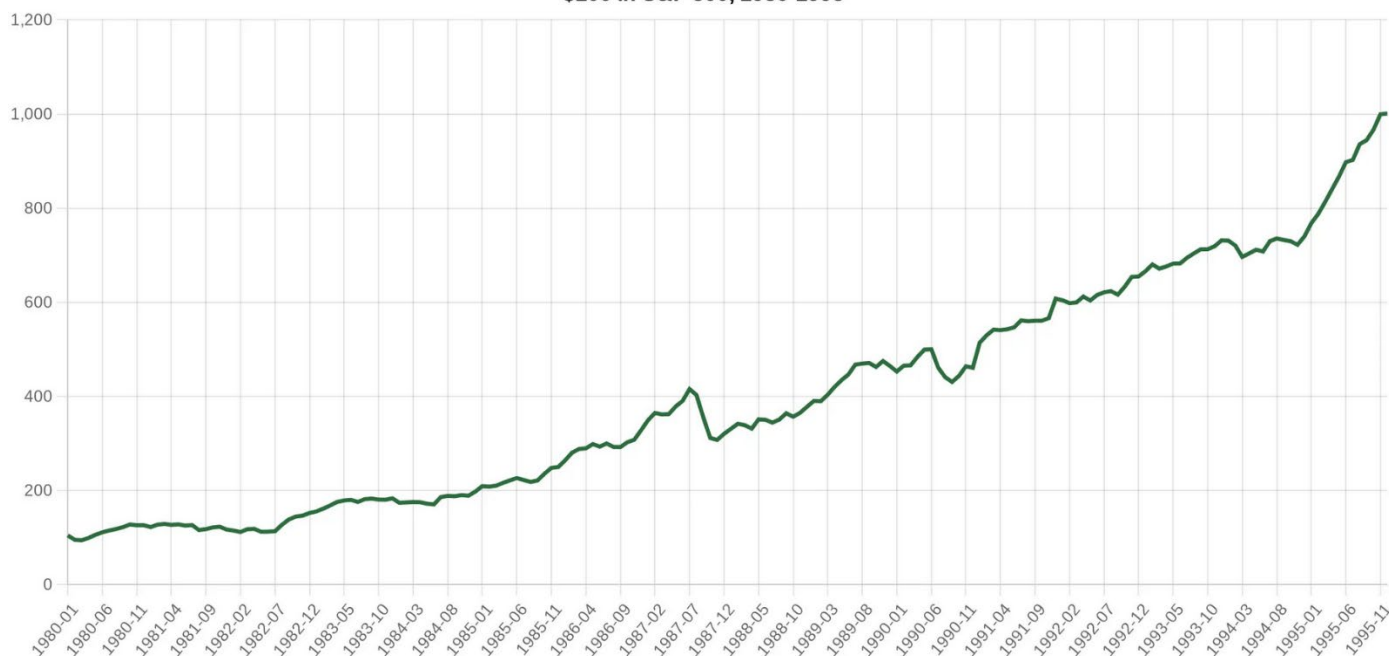
The banking system in 2008 had balance sheet and credit-related issues. The banks had toxic loans and bad mortgages on the books. The entire financial system was on the brink. Now it's a sentiment issue, a psychology issue. It's an issue simply because people are scared. Accordingly, people are pulling money from smaller banks and moving it to larger banks.

Today's crisis of confidence is isolated to smaller banks. Bank balance sheets are much stronger now compared with 2008. But the reaction to the current situation could be banks getting even more conservative. Following SVB's collapse, small and mid-sized banks might reduce lending and stop buying long-term securities. Reduced lending can later lead to a recession, as these smaller banks lend to small businesses, which employ 80% of our workforce. Additionally, small companies might stop investing and hiring due to fear.

All of this will lead to a recession. Mr. Powell, you wanted to tame inflation; tighter lending standards will certainly accomplish that.

Smaller banks with many uninsured deposits (FDIC) are particularly vulnerable. If a bank has large customers, many with balances above the FDIC limits, it can be problematic if these customers pull their deposits simultaneously. For instance, at SVB, more than 85% of depositors held balances above FDIC insurance limits. When word hit the street that the bank was trying to raise capital, a flood of uninsured depositors rushed for the exits. This was a classic run on the bank. At Signature Bank, over 90% of deposits were not insured through the FDIC. These banks were in the country's top 1% of uninsured depositors. First Republic, where 68% of deposits are uninsured, remains in the headlines and its future is indeterminate. In comparison, about 20% of Schwab Bank's depositors are above FDIC insurance levels.

\$100 in S&P 500, 1980-1995



To prevent this from happening again, regulators might take big bank stress tests down to the regional banks. After 2008, large banks were forced to issue bonds as an additional means of acquiring capital. If a crisis occurred, the bonds could be written off. In addition to their common equity, these bonds could provide the bank with capital and form a buffer known as the total loss-absorbing capacity (TLAC).

The TLAC buffer is meant to protect depositors, not investors. However, mid-sized and smaller banks lobbied to be exempt from these rules. SVB Chief Executive Greg Becker told Congress in 2015, "SVB, like our mid-sized market peers, does not pose systemic risk."

This is the same executive who sold more than \$3.6 million of company stock less than two weeks before the enormous bond losses were disclosed. Raising capital through bond issuance is more expensive than relying on customer deposits, but the buffer it provides is worth the cost.

Applying TLAC to mid-tier banks should make the banking sector more robust and safer as regional banks reduce risk and manage their books more conservatively. The banking sector might become more utility-like. This would be good for bank

creditors, but it would likely reduce profitability and shareholder returns. This increased regulation would increase market shares for big money-center banks whose size instills confidence for depositors. Larger banks would benefit as large customers move their deposits from smaller regional banks to those that are too big to fail.

The largest bank in the country is JP Morgan, followed by Bank of America. Schwab is the eighth largest bank and is poised to gain significant deposits due to its size and brand. We'll also see more consolidation in the banking industry, building on a long-running trend. In the 1990s, the U.S. had 10,000 FDIC-insured commercial banks. Today, we have 4,700. Our current banking crisis will accelerate this trend. As usual, the strong will get stronger at the expense of smaller competitors.

If you would like to review your asset allocation, financial plan, or discuss how to put additional cash to work, please contact your Roffman Miller Investment Advisor. On behalf of our entire team, thank you for your continued trust and confidence.

Bob Hofmann, CFP®
President

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