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FFG Partners Market Pulse Newsletter, Q1 2023

Given the recent events in the market surrounding the banking system, we felt it would be prudent for us to send out a letter outlining our thoughts and strategy for managing the portfolios. Top of mind for everyone is whether or not our assets are safe. Therefore, we would like to first explain how our new relationship with Goldman Sachs (GS) puts us in a different position than what is occurring within the traditional banking sector in general.

First and foremost, our relationship with GS is custodial in nature. Custodian banks above all are concerned with the safekeeping of the financial assets that belong to their clients. They are not a traditional lending institution that takes in customer deposits and lends them out to others. They are bound by regulatory obligations which include rules designed to ensure broker-dealers maintain sufficient liquid capital, and that they segregate customer funds and securities from the funds and securities of the broker-dealer. Interestingly enough, all of the bad press that had been plaguing GS over the past few months regarding the shutting down of their consumer banking business has turned out to be a considerable positive for them. Since they have very little in the way of a traditional banking business funded by customer deposits, they are not at risk of a liquidity crunch caused by clients pulling those deposits.

Now that we have some peace of mind regarding the safety of our assets, we thought it would be instructive to outline what has caused the chaos in the banking system. We are not dealing with a case of esoteric financial assets going bust, bad lending or credit default swaps. Rather, this is the outcome of the financial markets working exactly as we would expect them to. Understanding this further requires a little lesson in corporate finance. When interest rates go up asset prices go down, and when interest rates go down asset prices go up. This simple equation is taught to all first-year corporate finance majors and is the hallmark of their freshman year. For us nerds, we refer to this equation as bond math. This inverse relationship between interest rates and asset prices is the main culprit of the current baking turmoil.

As with any financial panic, the seeds of the upheaval were sowed during the last boom. During the pandemic, the Fed flooded the economy with liquidity, which mostly ended up in the banking system as deposits. These deposits were then invested by the banks in long duration assets such as 30-year treasury bonds and mortgage-backed securities in hopes of earning a little extra yield. In banking parlance, this is referred to as borrowing short and lending long. In a benign interest rate environment, there is really nothing wrong with this, and rather typical. Banks pay their customers minimal interest on their deposits (borrowings) and earn the spread from their longer duration holdings (lending). Everyone is happy except for the customer who is earning nothing on their deposits. However, due to the historically rapid rise in interest rates, this entire dynamic was flipped on its head.

For the first time in over a decade, depositors were now able to earn a substantial yield on their cash holdings. The banks, not wanting to let go of a good thing, never raised their yields on deposits. This forced people to find alternatives and pull their money from the banks to invest in higher yielding money markets and treasury bills. At the same time, the rising interest rates negatively impact the value of the banks' long duration assets. If you remember from above, the increase of interest rates leads to a decrease in asset values. The banks found themselves in a vulnerable position where they had to satisfy withdrawal requests while their asset values were shrinking. At some point, the liabilities become larger than the assets and you find yourself in a liquidity crunch. One the market gets a whiff of trouble, everyone starts to move in the same direction, fast! People start to pull their deposits, which weakens the bank's position, leading more people to pull their deposits, etc. Eventually a classic panic unfolds, and the bank fails.

If this is so simple, how come so many smart people missed such an obvious ramification? Market participants, the Fed and politicians were all hyper focused on two numbers – inflation and interest rates. When people are so singularly focused, they tend to overlook important details and make poorly thought-out decisions. The fight against inflation with the crude tool of raising interest rates was so important, that the second order effects of this strategy were basically ignored. We at FFG understood this implicitly and were reducing our exposure to long duration risk assets throughout 2022.

This naturally leads to the questions of how are we positioned and are we being negatively affected by what is going on in the markets? Although we cannot avoid all of the volatility, we believe we are positioned constructively to circumvent most of it, with the ability to take advantage of the opportunity when it becomes available.

Firstly, we have a very significant cash position that is mostly invested in an institutional money market fund. We are currently earning close to 4.5% on our capital with little volatility and market exposure. This allows us to patiently wait out the current market environment while earning a favorable return. Secondly, we have a relatively large allocation to fixed income securities made up of treasuries, corporate bonds, and municipal bonds. We began placing these during the fall of last year just when interest rates were hitting their peak. Unlike the banks outlined above, that bought long duration bonds with low interest rates, we used the rising interest environment to our advantage and purchased bonds that pay us a substantial yield. Importantly, we have no exposure to bonds issued by financial institutions and therefore are not subject to the liquidity risk of the banks. Many investors are now clamoring to own the bonds we purchased months ago as evidenced by the historic drop-in interest rates and “flight to safety” over the last few weeks. Lastly, we began placing the first of our structured notes last week. These are principal protected investments thar return our principal if the markets are down, but provide a substantial return if they are positive.

We believe that with a considerable portion of the portfolios invested in non-equity securities, we are positioned favorably for the current market environment. Although we do not have a crystal ball, we believe that the increased volatility we have been experiencing will likely continue. The ramifications from the historic rise in interest rates are still not all clear and have yet to be fully felt by the markets and economy. We believe a certain level of prudence is required to manage through the current environment, and we plan to do just that for the foreseeable future.

We look forward to hearing from you and answering any questions you may have.

Yours Truly,

Gabriel Levy, CFA
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