MONONGAHELA CAPITAL MANAGEMENT

PERCEPTIONS

1st Quarter, March 31, 2023	03/31/2023	% Change 1st Quarter	% Change Year to date
Dow Jones Industrials	33,274.15	0.93 %*	0.93 %*
S & P 500	4,109.31	7.50 %*	7.50 %*
Russell 2000	1,802.48	2.74 %*	2.74 %*
BC Aggregate BD Index		2.96 %	2.96 %
10 YR. Treasury Yield	3.47 %		
30 YR. Treasury Yield	3.65 %		

** Includes reinvested dividend*

"All we know are the facts, ma'am."
Joe Friday, Dragnet.

Dragnet was a very popular detective television series (originally a black and white film) set in Los Angeles in the early 1950s. The protagonist, Sergeant Joe Friday, played by Jack Webb, laconically narrates a weekly storyline that is based on actual cases. Sergeant Friday, a no-nonsense policeman with a deadpan expression delivered in a staccato style, was known for his pursuit of the truth in solving cases. The tag line eventually was shortened in a parody film starring Dan Aykroyd to "Just the Facts, ma'am" and became culturally synonyms with presenting the facts without embellishment or exaggeration. As financial reporting and standards have evolved over time, we often feel like Sergeant Friday, looking for just the facts when reviewing financial statements; headline financial reporting often obfuscates the message the reports are delivering.

Warning Signs

The most extraordinary story of the first quarter was the collapse of Silicon Valley Bank (SVB). Interestingly, SVB received a clean audit report from KPMG LLP on February 24th, 2023, three weeks before filing for bankruptcy. While KPMG's report may have been technically correct, there were warning signs lurking beneath the surface numbers.

SVB, founded in 1983, was the center of banking in Silicon Valley, supporting many tech start-ups, venture capital firms and the technology industry in general. Along with the tech industry, SVB had experienced explosive growth, with assets growing from $14 billion in 2010 to over $209 billion by the end of 2022. The stock began 2010 trading at $42 per share and peaked in November 2021 at $763 per share. Banking is and should be a fairly dry business, with measured growth and an emphasis on risk management. Clearly, extraordinary growth in a very ordinary, low margin business flashed the first warning sign.

The second warning sign was mismatching asset/liability duration risk, particularly in a rising interest rate environment. Duration is a measure of a bond's sensitivity to a change in interest rates. On the asset side, SVB invested in long-dated government bonds with extended durations, very sensitive to interest rate risk. The liability side was demand-deposits with the potential for extreme short-term duration; they could be withdrawn at any time. In the case of SVB, somewhat unique in the banking industry, over 90% of the deposits were uninsured because they were over the FDIC insured limit of $250,000. As interest rates surged, the long-term bond portfolio was dropping in value just as the tech industry was downsizing and in need of their deposits. Once the withdrawals began, particularly uninsured funds, confidence was lost and the panic was on. SVB, with mismatched asset/liabilities, was unable to meet withdrawal demands. The bank collapsed in a matter of days.

Perhaps the strongest warning sign for SVB was the treatment and valuation of held to maturity (HTM) bonds on their balance sheet. Under current accounting rules, HTM bonds are not required to be measured at fair value on the balance sheet; rather the bonds are valued at their amortization cost. They are not marked to market and the price remains static on the balance sheet. However, the fair value is noted in the notes to financial statements. In the case of SVB, the December 31, 2022 financials show HTM assets on the balance sheet of $91.3 billion, but in the footnotes on page 125, the fair value is noted at $76.1 billion, a difference of $15.2 billion. The total shareholder equity of SVB on December 31st, 2022 was $16.3 billion, leaving almost no liquidity in the event deposits were withdrawn. That is exactly what happened the week of March 5th and SVB was bankrupt by week's end.

There are of course many other intangibles in the failure. Management and the Board of Directors bear responsibility for massive mismanagement, the Federal Reserve regulators seem to have been remiss on assessing and stress testing for interest rate risk, and Greg Becker, the President and CEO of SVB was also a Class A director on the Federal Reserve Board of San Fransico, at the very least, a conflict in appearance.

We read all financial reports, even audited reports, with a healthy dose of skepticism. Like a forensic accountant, the most important task is evaluating and interpreting the financial reports. Professional due diligence requires us to look beyond the data presented and asses potential risk going forward. As value investors, we were able to avoid owning any shares of SVB or the other two banks that filed for bankruptcy in the first quarter, Signature Bank and Silvergate Bank. There were too many warning signs to risk your capital.

As risk adverse investors, we try to follow Warren Buffett's most important rule: "Rule #1 is never lose money, Rule #2 is never forget Rule #1." We and Warren Buffett make mistakes, but our mindset is one of protecting capital and thoroughly researching the risk of every position we take. Beyond searching for "Just the Facts," interpreting and looking beyond the numbers is an integral piece of our due diligence.