ClearBridge Investments

From the Risk Manager's Desk – Preparing, Persisting Through a Bank Crisis

24 May 2023

Key Takeaways

- The speed with which March's bank crisis unfolded illustrated the need for both pre-emptive and proactive approaches to risk management.
- By monitoring our investment and trading activity across the firm, we coordinated a response to sell out of the banks we felt were most susceptible to elevated risks.
- The crisis has spurred new short- and long-term structural challenges to the banking industry that will require further risk evaluation as they unfold.

Banking Crisis a Tale of Two Risk Managements

March saw the first major risk event of the calendar year as the collapses of Silicon Valley Bank (SVB) and Signature Bank spurred a bank run and crisis of confidence in small and midsize regional banks. The speed with which these events unfolded illustrated the need for both pre-emptive and proactive approaches to risk management. This two-pronged approach, as well as ClearBridge's philosophy of incorporating risk in fundamental research and portfolio construction decisions (as we discussed last quarter), allows us to respond quickly and decisively to major risk events.

Pre-emptive Risk Management Provides Warnings

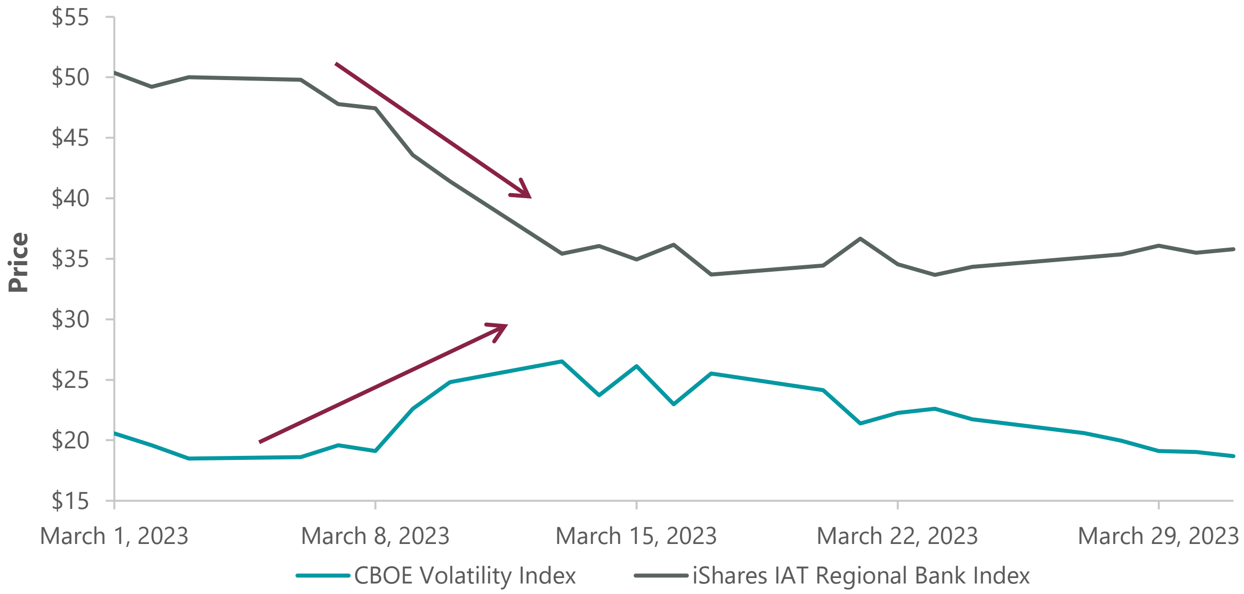
We believe risk management is an ongoing process intended to help our portfolio managers identify key insights into the current state of the market. For example, starting in the summer of 2022, we became concerned with emerging excesses within the venture capital (VC) and private equity (PE) industries and felt that a shock to these industries could spill over into companies closely tied to the innovation economy. Using several different methods, including academic distress models based on historical data, leverage ratios, price levels and changes in the price of credit default swaps and corporate debt, we presented our investment teams with multiple perspectives on the potential for financial distress in their portfolio holdings.

Over the following months, our portfolio managers incorporated this analysis to reassess their exposure to the risk of financial distress and/or rising interest costs from future debt refinancings. These discussions contributed to the decisions to exit many of these highly leveraged companies. At the same time, our financials analysts on ClearBridge's Sector Research Team focused on the headwinds plaguing regional banks with greater depositor and geographic concentration, as well as those with outsize exposure to VC and PE depositors. As a result, by the end of the fourth quarter of 2022, our managers had eliminated exposure to SVB across the firm and entered 2023 with most of our portfolios underweight to the banking industry, specifically to smaller, regional banks.

Proactive Risk Management Takes Actions

As the bank crisis emerged, one of the unique challenges was the speed with which it unfolded. Unlike prior bank runs, the widespread use of online and mobile banking allowed depositors to withdraw their deposits outside normal banking hours. Both depositors and investors allowed sentiment to overshadow banks' underlying fundamentals, putting high-quality banks with manageable earnings risk and little fear of capital losses at risk of the same liquidity and funding adequacy as higher-risk names.

Exhibit 1: Regional Banks Declined as Volatility Surged



As of 31 March 2023. Source: Bloomberg, FactSet.

As the crisis unfolded, we were able to draw on our experiences during numerous crises over the past two decades, particularly the risk management playbook we developed in the wake of the 2008 Global Financial Crisis. Starting the night before the collapse of SVB, we moved swiftly to deploy additional risk management systems and processes in order to monitor our investment positions, research and trading activity across the firm's portfolios. This included reviewing market index and sector returns, examining performance of risk factors and running short-term risk attributions for our portfolios. Additionally, we began coordinating with other areas of the firm to respond tactically to a very fluid environment. As a result of these efforts, while 27% of ClearBridge portfolios entered March 2023 with regional bank overweights relative to their respective benchmarks, by the end of March no ClearBridge portfolio had an overweight and only a few maintained overweights to the broader financials sector.

Bank Crisis Has Elevated Risks

We continue to closely monitor the banking industry due to both the near- and long-term repercussions from the March crisis. In the near term, we anticipate stop-gap measures put in place by both regulators and the industry will help bolster banks' abilities to survive the kind of rapid deposit outflows that caused the collapses of SVB and Signature Bank in March and JPMorgan's fire-sale acquisition of First Republic Bank in May. However, these measures could prove insufficient to stem another wave of negative investor sentiment. We are also closely evaluating the risk of a recession, which we believe is higher due to the broad economic impact of banks further draining liquidity from the financial system by curtailing new loan issuance.

While small banks may continue losing deposits and market share to large banks, they tend to have deposits within the FDIC-insured limit, which we believe will help as a buffer against withdrawals. However, we believe the greater risk lies in midsize banks, which need to maintain a certain scale to compete against both larger and smaller banks. Should these banks continue to face outflows and negative investor sentiment, we anticipate a wave of consolidation as those who persevere acquire those who fail.

At the same time, in some cases, investors are throwing out the baby with the bathwater in the banking sector. Banks are trading at historic lows, reflecting an adverse economic outcome, while the rest of the market is reflecting a different economic outcome. However, we believe banks, including small community banks in niche markets as well as well-managed super regionals, have a role to play in the overall economy, and they will be rewarded accordingly over time. Such pessimism we see today creates attractive entry points for companies that should be net beneficiaries of the current crisis.

About the Author

Farhan Mustafa, CFA

Managing Director, Head of Investment Risk Management, Head of Quantitative Research

- 20 years of investment industry experience
- Joined ClearBridge Investments in 2003
- MBA from Robert H. Smith School of Business, University of Maryland, College Park
- BA in Economics and Computer Science from Washington and Lee University