Investment Update

Update on Regional Bank Volatility and Portfolios

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Highlights

- Following Friday's developments on Silicon Valley Bank, it was a tumultuous weekend for several regional banks.
- On Sunday evening, policy announcements were made with the intent of backstopping liquidity and signaling confidence in the banking system.
- In this Investment Update, we provide responses to key questions that have emerged over the past several days as well an update on portfolio positioning.

Overview

In this Investment Update, we provide responses to key questions that have emerged over the past several days related to regional banks and Sunday evening's policy announcements intended to backstop liquidity and signal confidence in the banking system. We also covered developments as they stood at the time in Friday's Weekly Investment Update.

What were the policy steps officials took last night?

Following Friday's developments on Silicon Valley Bank (SVB), it was a tumultuous weekend for several regional banks, with Signature Bank joining SVB as a failed bank and several other regional banks reportedly under pressure. On Sunday evening, a combination of the Federal Reserve, the FDIC, and the Treasury announced a two-prong plan to address the issue. First, all depositors of SVB and Signature bank would be made whole. This coverage includes those accounts with funds above the $250,000 typical FDIC threshold and was approved via the "systemic risk exception." Second, a new liquidity facility was created. The "Bank Term Funding Program" (BTFP) is providing banks additional funding with recourse up to one-year secured by Treasuries, agencies, and agency MBS at favorable terms and with no haircuts or fees. The "no haircuts" provision is particularly powerful given the stress that SVB faced as it was forced to sell high-quality assets at significant discounts given the recent increase in interest rates. However, there were additional funding options available for stressed institutions prior to the creation of the BTFP, so it seems likely to have been announced at least in part to instill confidence.

We believe there are likely to be additional policy steps to break this negative dynamic more definitively for the smaller and regional banks. While there are some political challenges to getting all parties in agreement for support, this situation strikes us as very different than was the case in 2008. Smaller and regional banks employ millions and are essential to communities and small businesses across the country. There are some compromised business models, such as SVB and Signature given their over-concentration on homogenous deposit bases and other practices, and earnings will be challenged because of the impact of higher rates on their portfolios. But overall, the credit quality of the small and regional banks' balance sheets is good with high-quality securities and more prudent lending standards than before the financial crisis. We do not believe there would be discussions regarding solvency of the sector more broadly were it not for the concern of psychological fear driving a run on deposits. It is likely, in our view, that policymakers will take additional steps to shore up confidence in this space amid these dynamics.

How far do these measures go toward stemming risk aversion?

Sentiment in the regional bank space remained highly

volatile as of Monday, indicating it may be necessary for the Fed, Treasury, and FDIC to do more to prevent a broader spread of fear in the banking sector. Depositor confidence is key to a bank's business model of using deposits to make loans and to hold other assets. The speed with which depositors can move funds has never been faster, and there is also a rapid information feedback loop between stock prices, headlines, and depositor sentiment. These factors are perhaps more intertwined and rapid than was ever the case in history. Deposit outflows are part of the larger set of valuation dynamics that drive down equity prices. This is a classic bank run situation, but, again, perhaps exacerbated in part because of the speed of transactions and information flow. In the SVB and Signature examples, deposits above $250,000 were only guaranteed after the bank failed and equity capital was pushed to zero. As a result, there is uncertainty as to how this will play out for other small banks, especially those with a higher exposure to small businesses and other corporate deposits which are often above $250,000, concentrated, and can move quickly.

The overall positive tone in the equity market on Monday indicates this probability is increasingly in market pricing, and the equity market is also reacting to lower interest rates, with the 10-year yield at 3.50% as of this writing from a high of about 4.25% in the fall. This is likely a reassessment of Fed policy and a reduction of risk premium in the curve given an increased probability of slower growth and inflation ahead (see the two sections below).

Will the Fed adjust its broader policy approach in light of these events?

Yes, the Fed is likely to at least temporarily moderate its rate hike cycle as a result of these events. There was increased probability of a 50bp hike at the March meeting following Fed Chair Powell's more hawkish testimony last week and due to stronger economic data of late. We think there is almost no chance of a 50bp hike now, and it is likely that the Fed pauses and may be done with hikes this cycle. Additionally, the Fed could pause the process of quantitative tightening until there is more clarity on the banking situation.

While contemporaneous economic data are strong, with first quarter GDP tracking as high as 3%, or much higher than even our constructive outlook had foreseen, we have been highlighting how policy is lagged. It is reasonable to expect declines in both growth and inflation from here even absent concerns regarding financial stability. Financial stability is core to the Fed's mission, and especially if other policy backstops prove to be complicated, they could stop raising rates to help with this objective. Also, even assuming the current bank volatility resolves itself, it is likely that credit creation will be more challenged in the months ahead, and this could provide another drag on otherwise strong economic growth. Either way, there is sufficient evidence to suggest the Fed should be prudent and evaluate the effect of past rapid and substantial tightening before doing more.

How do recent events affect the broader market outlook?

While there are some soft spots in the broader economy, worst-case scenarios have not materialized over the last few quarters, giving support of our expectations of a bond and equity market recovery from last year's downturn. As policy steps are taken to limit contagion to the specific risk that emerged in small banks, and as bonds reprice higher (lower in yield) to account for the shifting outlook, there is not enough evidence at this stage to change our broader outlook for the year.

That said, if stresses in regional banks do not subside, they could lead to much weaker growth given the important role that they play in the economy. Based on the Fed's definition, small banks account for 38% of all bank lending. Of this, they account for 37% of residential real estate loans and 67% of commercial real estate lending. In other words, weakness in this sector will lead to broader weakness in the economy. Additionally, the current stresses in the regional bank space highlight that risks increase and can be difficult to foresee following significant rate hikes.

Within public equity portfolios, what is the exposure to and view of the banking sector and regional banks in particular?

Bessemer portfolios are underweight the banking sector relative to benchmarks, especially within the small cap and regional bank sectors. On an all-equity basis, regional bank exposure is only 0.67% of an all-equity portfolio (versus 1.0% in the benchmark). Exposure to diversified banks is 4.2% versus 6.0% in the benchmark. The few small cap banks owned are high quality firms with diverse customer bases and exposure to growth regions in the U.S. Large Cap portfolios own some of the largest high-quality banks that are well-capitalized with ample cash reserves and

attractive dividends; these may attract deposits overtime. We address holdings in the Small and Mid Cap space and then the Large Cap space in turn below.

The Small and Mid Cap Core portfolio has no exposure to banks given the companies generally do not meet the team's broader investment philosophy. The only financial holdings are Nasdaq and Tradeweb, which are index, trading, and data companies. The U.S. Small Cap portfolio is notably underweight the banking industry with single stock risk well diversified across nine high quality holdings. The underweight position has been driven by concerns regarding deposit beta, (the relationship between deposit rates and their sensitivity to the change in short-term interest rates), loan growth, and net interest margins, which led the portfolio management team to intentionally diversify and underweight the bank exposure. The regional banks owned in the portfolio have diverse customer bases and loan books and compete in growth markets across the Midwest and Southeastern regions of the U.S. The banks also have solid management teams with a track record of conservative risk management and a history of sound capital allocation.

Bessemer Large Cap portfolios own high-quality banks that are well-capitalized with ample cash reserves. Large Cap Core is underweight financials and equal weight the banking industry, owning two of the largest banks, J.P. Morgan and Bank of America. The team believes that the scale of the large banks is a key advantage in a rapidly changing industry given the large bank's low cost of capital, ability to invest in digital platforms, and bundled product offerings. The portfolio has reduced exposure to a broker in the capital markets industry segment that also has a bank with higher deposit beta. The U.S. Select portfolio is underweight financials and modestly overweight banks, owning three of the largest banks, J.P. Morgan, Bank of America, and Truist Financial, as the portfolio's mandate for yield makes the safer large banks attractive given their 3-5% yield. The Large Cap Global portfolio is roughly equal weight both financials and banks, owning J.P. Morgan and Bank of America domestically and ING Group and HDFC Bank internationally, each of which has been deemed to be higher quality relative to their peer group.

The current environment brings to light Bessemer's investment philosophy of focusing on high-quality companies with solid management teams with an eye toward risk management. After years of low interest rates, the recent rise in rates means that banks who bought longer-dated bonds in search of yield, and failed to hedge their portfolios, may face losses if pressured to sell the securities in order to raise cash for redemptions. While SVB was an extreme example of this phenomenon, we are monitoring every bank's risk of facing similar pressures, in addition to the potential that some large banks may be beneficiaries of shifting deposits or other dislocations. Additionally, we expect to see increased regulations on regional banks, potentially focused on liquidity coverage as well as better monitoring of duration matching. Bessemer portfolio managers are continuing to monitor the current environment and feel comfortable with current positions in the highest-quality companies.

How is this ongoing situation affecting private market portfolios?

Our Private Markets programs do not have any direct banking relationship with SVB. Our investment and operational due diligence team has been in touch with our managers on an ongoing basis since stress with SVB emerged to understand any secondary exposures in our portfolios. Sunday evening's policy announcements addressed the vulnerability of underlying portfolio companies' deposits at SVB. There was concern around some portfolio companies' ability to make payroll and settle current liabilities until they could get access to their capital. With SVB claiming to bank nearly half of venture-backed tech and healthcare companies, there were potential broad implications of its failure absent the government backstop. The policy announcements now alleviate most of those concerns. There remains some question as to how quickly managers that used SVB for capital-call lines can re-establish those with other counterparties. This is a short-term financing question and not a long-term credit issue. The lines will likely be somewhat more expensive, as spreads on these facilities have widened over the last year and may widen further given stresses in the banking system. Meanwhile, it is possible managers will handle near-term capital calls directly with limited partners, potentially requiring Bessemer to make capital calls from investors in our programs in the near term. We will monitor this situation and keep investors apprised. We believe the high-quality, experienced management of the private firms within our program, as assessed by our investment and operational due diligence teams, position our portfolios well to navigate this risk.

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