RPIA

Investment Case Study

Extracting Value from GSIBs Following a Banking Crisis

Background

The collapse of Silicon Valley Bank (SVB) in March – at the time, the second-largest bank failure in U.S. history – sent reverberations through the global financial sector. While the crisis heightened concerns about the stability of the market, it led to price dislocations in the financial sector that created significant opportunities for the investment team at RPIA to capitalize on.

The crisis severely impacted Global Systematically Important Banks (GSIBs) as investors feared spillover from the collapse of regional banks. Despite concerns, we identified the widened GSIB credit spreads as an opportunity since the large banks were well-positioned to endure, and possibly even benefit, from the crisis.

Using our increased exposure to GSIBs over the last quarter as an example, this case study illustrates how we actively navigate volatile market conditions by applying a rigorous and disciplined investment process to protect investor capital and consistently extract value from the global credit market.

Image 1: RPIA Investment Process

Identify Top-Down Investment Themes

The **Investment Committee** identifies macro opportunities to focus our research efforts.

Fundamental Analysis

The **Reseach Team** uses traditional financial and ESG analysis to determine what we believe to be the most compelling issuer(s).

Security Selection

We utilize **proprietary technology and expertise** to select the optimal security within an issuer's capital structure.

Size and Execute Position

The **Execution Team** sizes the investment based on conviction level, liquidity considerations, and existing portfolio exposures.

Continuous Engagement from the Risk Management Team & Oversight Through the Risk Committee

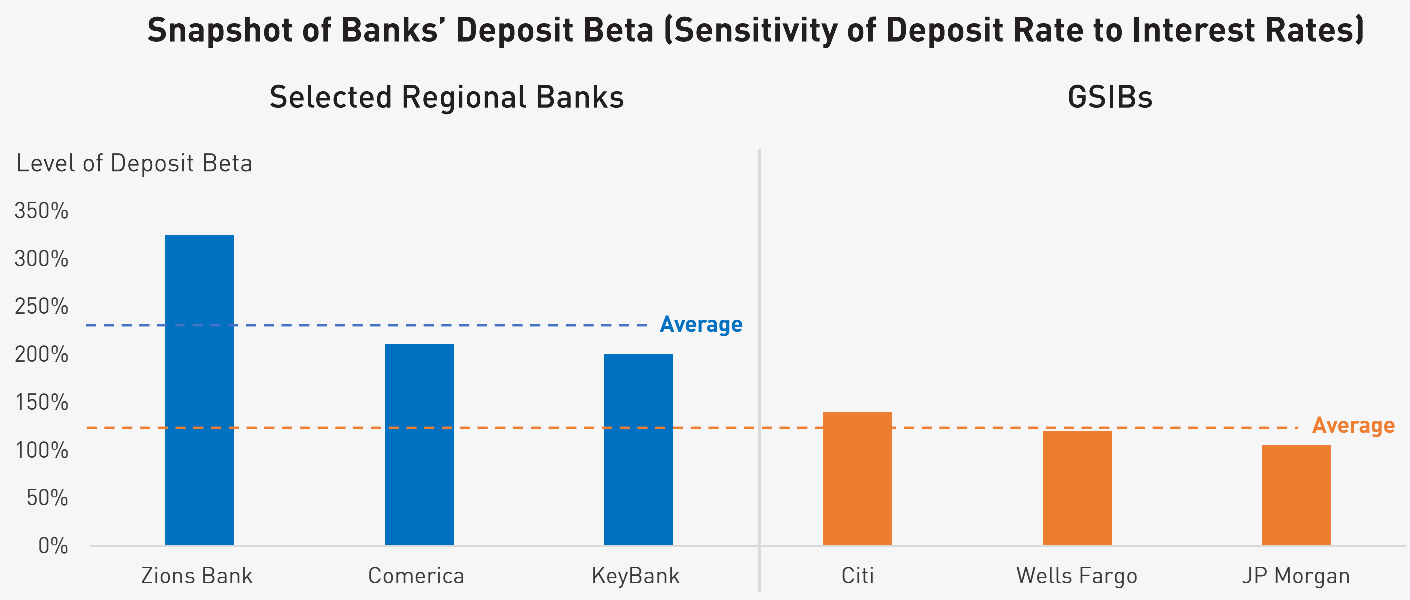
Step 1: Identification of Top-Down Theme

Recognizing overarching trends and market shifts that have the potential to significantly impact the investment landscape is the launch point of our investment process.

In the wake of SVB's collapse, credit spreads on all financial institutions, including GSIBs, widened. Regional banks found themselves grappling with deposit outflows driven by depositor concerns over contagion. In a bid to retain deposits, these banks were compelled to raise deposit rates, further exacerbating their challenges.

Capitalizing on the turmoil, GSIBs benefitted from this influx of deposits diverted from their regional counterparts. Unlike their regional peers, GSIBs did not need to offer elevated deposit rates to attract inflows, thus bolstering their profitability. With more stable and diversified loan portfolios compared to regional banks, GSIBs were in some ways beneficiaries of the crisis. Our Investment Committee saw the widened spreads as an opportunity for us to build positions in high-quality, liquid issuers at attractive valuations.

Chart 1: Deposit Beta Rose Significantly for Regional Banks in Q2



Source: Moody's. Data as of Q2 2023.

Step 2: Fundamental Analysis

Using traditional financial and ESG analysis, our credit researchers identified Wells Fargo as one of the most attractive opportunities in the sector. With a large and diverse consumer and commercial lending franchise across the U.S., a robust deposit and branch network, one of the top market shares based on deposits, and a stable core deposit base across its geographically diverse footprint, the bank was well-positioned to endure the crisis.

Additionally, Wells Fargo's second-quarter results were solid, beating analyst estimates and underscoring the investment thesis. In June, the bank also passed the Federal Reserve's 2023 stress test with favorable results and expected its stress capital buffer to decrease, which reflected its strong capital position.

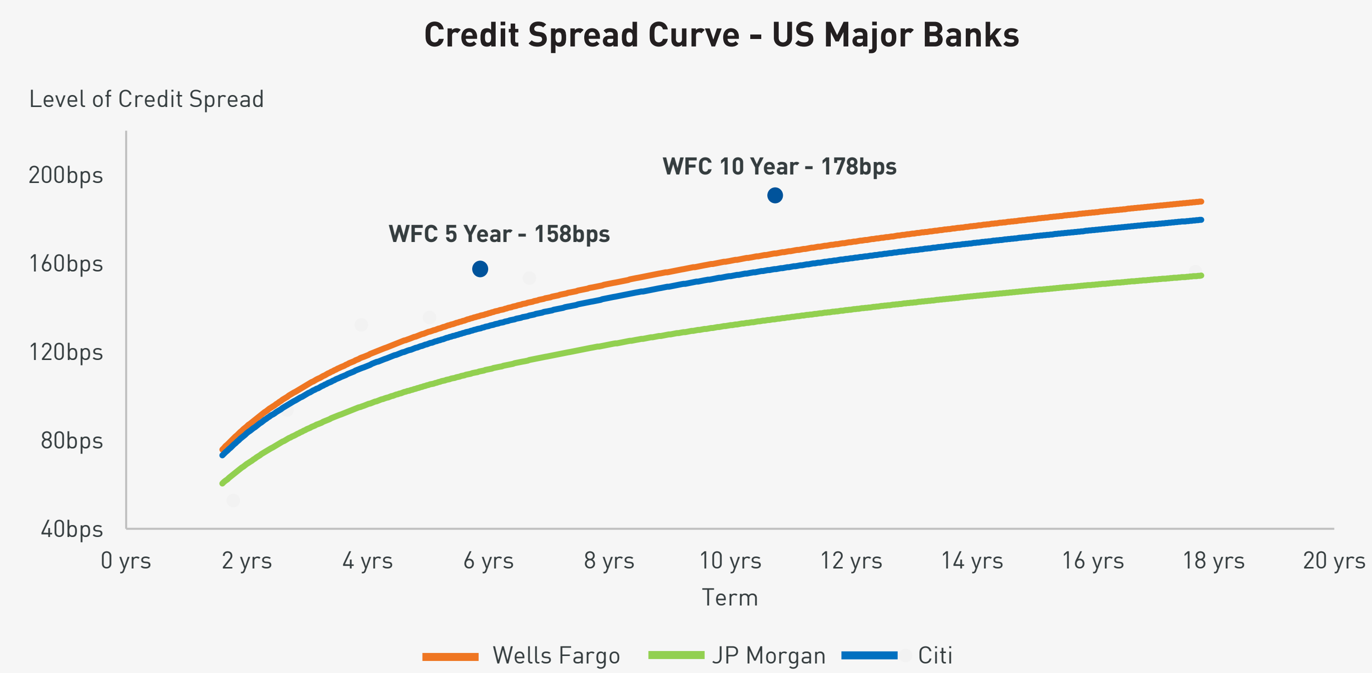
Compared to other U.S. banks, spreads for Wells Fargo were higher and offered greater upside potential, making it more attractive from a relative valuation standpoint. While Wells Fargo's comparatively high commercial real estate exposure subjects the bank to higher asset risks, its strong broader credit profile and higher upside potential offset these risks.

Step 3: Security Selection

While there were many bonds outstanding for Wells Fargo, after speaking with management ahead of their earnings, the team suspected the bank would issue debt after the Q2 2023 earnings announcement. Proactively engaging with the issuer, we registered interest in advance, strategically positioning ourselves for participation.

As projected, Wells Fargo issued a two-tier senior unsecured bond deal. This two-part issuance was introduced to the U.S. market and comprised of a 6-year bond with a non-callable period of 5 years (6nc5) alongside an 11-year bond with a non-callable period of 10 years (11nc10). In this stage of the process, our portfolio managers leverage our proprietary trading technology for optimal security selection. Our technology enables us to very quickly determine that these new issuances were trading at a discount of 5 to 10 basis points (bps) compared to existing bonds in the market.

Chart 2: Newly Issued WFC Bonds Traded at a Notable Discount Compared to Existing Bonds



Source: Bloomberg, RPIA. Data as of July 18, 2023.

Step 4: Size Position & Execute

Our execution portfolio managers evaluated our conviction level, liquidity considerations, and existing portfolio exposure, and collaborated with the risk management team to determine our position sizing.

Given our high conviction level, the considerable deal size, well-covered book that is 200-300% subscribed, and the strong demand for GSIB debt given the light issuance year-to-date, we submitted a substantial order. We received a total allocation of $110 million across the two tranches with $20 million allocated toward the RP Broad Corporate Bond strategy (RP BCB). To enhance our strategic positioning, we seized the opportunity to add additional bonds in the secondary market immediately after the initial allocation to align with our desired allocation target, which is typically more than 3% of the portfolio for high conviction ideas.

Outcome & Monitoring

After initiating the position in Wells Fargo, we saw strong performance from both bonds, with the 6nc5 and 11nc10 bonds tightening 18 bps and 21 bps, respectively. Notably, the 11nc10 bond was the top contributor to RP BCB's performance in July.

From a sector perspective, the RP BCB portfolio increased exposure to GSIBs from 9% at the end of the first quarter to 20% at the end of the second quarter. These positions contributed 17 bps in gross credit returns to the strategy.

The Role of Risk Management

Our Risk Management Team is actively involved in every step of the investment process, and their insights are particularly valuable during the position sizing and execution stage. They engage collaboratively with portfolio managers to determine appropriate size allocations, employing both quantitative methodologies and qualitative assessments. When assessing Wells Fargo, our model found that the 11nc10 bonds were in the 94th percentile of overall liquidity among investment grade corporate bonds, with high expected daily volumes and low cost of liquidation, even under stressed scenarios. The execution portfolio managers are then able to size and execute the position based on the Risk Management team's insights.

Monitoring our positions is a critical part of our investment strategy, particularly under volatile conditions. Once a position is initiated, our Portfolio Management and Risk Management teams monitor realized and mark-to-market profit and loss, as well as the bond's behavior relative to the market, its sector, and its close peers. Our portfolios are tested against their risk limits four times a day to ensure compliance, and any unusual behavior is relayed in real time. Additionally, profit and loss at the portfolio, security type, sector, ticker, and bond level are analyzed to uncover areas of uncompensated risk, which are discussed and resolved in real time or at our weekly Risk Committee meetings.

Outlook

Although several economic indicators point to challenging macroeconomic conditions in the coming quarters, we continue to see compelling opportunity in high-quality financials, particularly GSIBs with their stronger funding base, high degree of diversification, and sensible capital levels. As we continue to monitor our positions, we believe there is still potential for excellent risk-adjusted returns. Our methodical investment process in conjunction with our team's expertise equips us with the right toolbox to identify relative value opportunities and act quickly and effectively on best ideas on behalf of our investors.

CONTACT US

Guest Reception
43 Hazelton Avenue
Toronto ON M5R 2E3

Deliveries
39 Hazelton Avenue
Toronto ON M5R 2E3

www.rpia.ca

DIRECT AND INSTITUTIONAL

+1 647 776 2566

investors@rpia.ca

INVESTMENT ADVISORS

+1 647 776 2565

advisorservices@rpia.ca