KOA WEALTH MANAGEMENT®

Q1 2023 MARKET COMMENTARY

Apologies on the delay of my Quarterly Note here in April, but my wife insisted on a Family Vacation (Spring Break - Cabo) and frankly there was more than usual to "Unpack" in recent weeks… not from the trip… but from the failure of the second largest bank (Silicon Valley Bank) in our country's history. I continue to believe that we are in a midst of the bursting of an Asset Bubble – Keith McCullogh of Hedeye loves to call it "The Mother of All Bubbles". In 20 years of managing other people's money – you learn many things – one of them is that Risk seems nowhere to be found and then happens all at once. The violent movement that appears, usually isn't caused by a singular event, it's really just the culmination of pressure building under the surface and then bang – it erupts.

- SILICON VALLEY BANK
- CASH
- DEBT
- EQUITY
- REAL ESTATE

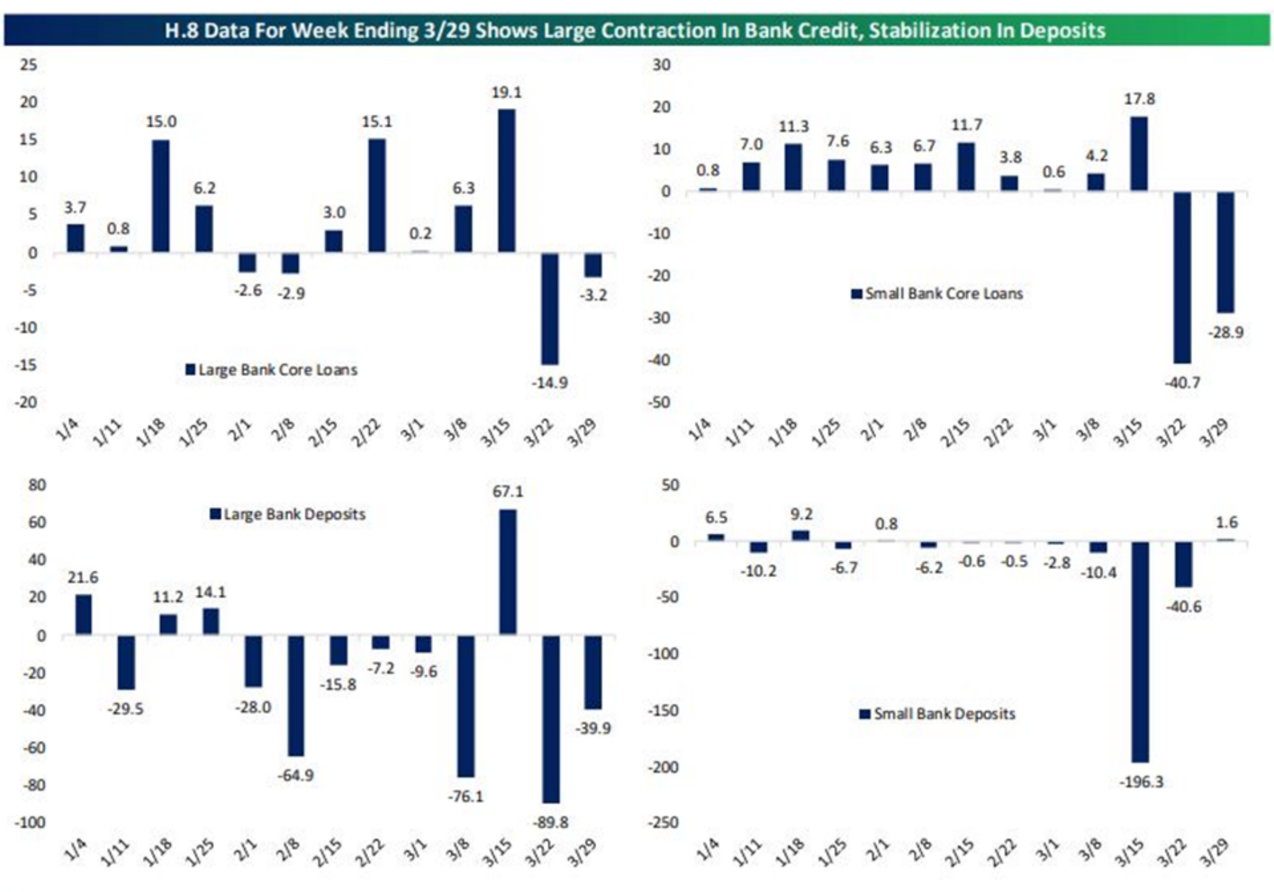
SILICON VALLEY BANK (SVB)

The recent failure of Silicon Valley Bank (SVB) – the second largest bank to fail in US history (Second only to Washington Mutual in 2008) is a fascinating story of gross mismanagement by its C-Suite/Risk Managers but also a Testament to how Technology… the industry which it so faithfully served for 40 years, ironically was its downfall. Gone are the days where our parents and grandparents had to stand in a line at a bank with a teller to request withdrawals of their money. If you ask any banker from that era, they'd tell you that amid a "Bank Run", they'd instruct the tellers to count the money slower so as to serve as few customers as possible that day. No More! Now it's a few clicks on a mobile app or a banks' site online and whoosh your money can be sent anywhere via ACH or wire. That's how 42 billion [1] was pulled from Silicon Valley bank on the Thursday alone before it failed the next day. What sparked the panic? Prominent VCs and others in the Tech community hopping on Twitter and other Social Media stoking panic that SVB was in trouble and that all uninsured deposits should be pulled from the bank. The speed at which the bank failed is sure to have reverberating effects for the thousands of banks across the country not ring-fenced by the Fed's "Too Big to Fail" … which we will discuss. Sadly however, the biggest losers – will ultimately be the Tech/Biotech companies/leaders who banked at SVB. SVB grew up in the Valley with the Valley. They provided loan programs to startups and founders that other banks were simply unwilling to underwrite. Moving forward the next generation of founders will find launching/funding/financing their fledging companies to be more difficult. Will this stifle the speed of innovation moving forward? It's hard to say – but SVB failure will have repercussions that may not be fully understood for years.

[1] NPR – The Collapse of Silicon Valley Bank

In our opinion, however, the greatest risk from SVB failure is what's happening to the thousands of regional, community and local banks across the country. Most banks have been seen deposit bases slowly and steadily shrinking after the orgy of cash pushed into the economy in 2020 through the first half of 2021.With SVBs failure we saw an accelerated pace of deposits leaving these banks in a couple of different ways 1) Depositors shuffling their feet over to one of the 4 largest banks (JP Morgan, Bank of America, Wells, Citigroup) 2) Investors spreading their Uninsured Deposits amongst multiple banks 3) Opting to leave their uninsured deposits at their bank but pushing that cash into securities (Money Market Funds, Treasury Bills, etc.). Any of these three choices reduce the deposit base of a bank and ultimately their ability to make new loans. Banks over the last 12 months had already been raising their Underwriting Standards for borrowers, something banks do when we are getting closer to the end of an expansionary cycle and worries of credit risk/default on loans already made by the bank start to creep in.

Banks can generally survive loan losses (Reserves of profits are set aside exactly to deal with this issue)… but if they don't have enough liquidity to meet depositor demands – they go under. Bespoke[1] had some great charts out just this morning April 10th that highlight this exact point. Small Bank Core Loans have shrunk -40.7% the week of 3/22 and -28.9% the week of 3/29. While this is only a two-week sample, these numbers are off a cliff. Surprisingly even in the Large Banks we saw Core Loans drop -14.9% the week of 3/22 and -3.2% the week of 3/29.IF lending happens to contract as significantly as these data points might indicate then we don't believe the Fed nor the markets are prepared or properly priced for the more abrupt slow down that could follow in the economy. Cost of borrowing had already gone up tremendously over the last year – but if borrowers are unable to get loans altogether – that's an even bigger problem. One that can surely hit spending… or affect solvency on the personal and/or business level.



[2] Bespoke Morning Line Up April 10th, 2023

MarketWatch

Let's Take A Closer Look

While we saw some nice gains in Q1 on the almost all major markets followed by investors:

- **S&P 500 +7.46%,**
- **Nasdaq 100 (QQQ) +20.71%,**
- **Russell 2000 +2.7%,**
- **Barclays Aggregate Bond +3.23%**

We've seen some sharp reversals of last year's big winners:

- **Oil -5.23%,**
- **Natural Gas -50.78%,**
- **Energy (XLE) -4.34%.**

A new year can often bring new leadership and we've seen that at least through the first three months of this year. We would still caution our investors however not to get lulled to sleep with a sense that the sell-off of 2022 has run its course and we are now on the mend and will soon revisit old highs here in the US Equity and Bond Markets. Below, we'll discuss our thoughts on the current state of each of the major asset classes that we're invested in and our opinion in regard to how we are treating each in accordance with our outlook for 2023.

Cash

With the Federal Funds rate now plumbing 5% here in the US, our investors can now garner 5% yields on short term Treasury Bills/Bonds. We have been active in relaying this update to clients and have been gathering new capital to "Park" in this holding pen. We believe Treasury Bills to be a superior vehicle currently to Money Market Funds and CDs which commonly compete for these cash management opportunities.Interest from Treasury Bills are not subject to State Income Tax, a fact that's material for our clients who reside in CA and other high income tax states. They are also the most liquid security in the world – making them a superior source of liquidity when measured against CDs.

Equity

Given the general sell-off we've seen in Public Equity Markets; we find them currently more attractive than Private Equity Markets. However, the recent move up in Public Equities highlights the adage of wanting to be a more selective buyer in the current market. Earnings for many companies are still adjusting lower, a process which started in Q4 of 2021 to Q1 of 2022. Multiples, given where interest rates sit currently are not particularly cheap either. While there are always things happening in the market giving us opportunities in specific stocks or sectors, the broad-based indexes are not particularly interesting as an investment for new money. In Private Equity/VC – unless companies have been forced to raise new equity capital, we believe their values are largely over-valued, relying on marks from the 2021 time period (Peak valuations). While we expect more attractive prices will hit this area of the market as well, it will be a slower process and perhaps something we'll look more intently at in 2024.

Debt

Outside of Cash Management – Debt is our preferred asset class for this year, thanks in large part to what the Federal Reserve has done in raising interest rates so aggressively over the last year. We see many current opportunities in US Treasuries, Essential Service/GO Municipal Bonds and Direct Lending. In regard to our US Treasury exposure, we are using a barbel approach holding 3–6-month Treasury Bills on the front end capturing the highest yield on the curve, while using ETFs to own the 20-30 year part of the curve which has the highest interest rate sensitivity (Duration). If the economy runs into trouble, our long-term bonds should rally nicely giving us the chance to liquidate those positions (Booking profits) and roll that capital into new opportunities in a period of volatility. If we're wrong about those long rates moving lower, then we still have our Treasury Bills that we can liquidate and again turn into opportunistic capital. For our larger Accredited Investors, we are utilizing Direct Lending Strategies currently garnering 9-10% yields. We are comfortable with the compensation we are receiving for the credit risk we hold there. In the event of a credit dislocation, we would simply look to take larger positions as the loans they hold are marked down and the yields rise.Given my earlier comments that banks are pulling away from lending in these markets, the lack of competition is providing very wide spreads and excellent terms for our lenders. In addition to these Private Market opportunities in Credit, we will also be looking at Public Markets opportunities should spreads reach a level where we can invest with equity-like returns while being higher up in the capital structure.

Real Estate

We have been telling our clients for the last 6-9 months that the terrific returns we saw in our Private Real Estate Portfolios from 2019 through 2022 were probably due for a break here in 2023. Through the first quarter, that has proven to be the case with all three of our Core Private REITs slightly negative on a total return basis YTD.While we don't have any concerns about the underlying portfolios regarding the assets they own (Heavy in Residential and Industrial), all three are subject to the double-edged sword of liquidity (Our investors are able to redeem monthly, but so is everyone else invested in the REITs). Two of the three have specifically hit their 5%liquidity gates in Q4 of 2022 and again here in Q1 of 2023. Given the unfulfilled requests still left over from Q1, I would expect them to cap out at 5% again for Q2. The funds have the liquidity to meet these redemptions, so there isn't an immediate issue, but ideally, we'd like to see these redemptions continue to wind down as we move through the year. The managers can feel more comfortable deploying their capital into new value-added investments, if they aren't worried about maintaining cash to meet redemptions. Turning our attention to the Public REIT markets, this is where we believe the real opportunities exist. Many public REITs traded at premiums regarding their market caps vs. their underlying NAVs (Value of their Real Estate) in 2021. The sell-off in this sector has caused many of these market caps to now trade at a discount to their NAVs. We are focused on areas that we like which include cell phone towers, data centers, industrial real estate. We already own a lot of residential real estate (Apartments and Single-Family homes) in the Private Portfolios that unless they're a screaming bargain, we'll probably refrain from adding any additional allocation there. One public REIT I'm currently watching is in the Office Space – specifically Healthcare oriented (Lab/ Research space). While Office in general is NOT where you want to own Commercial Real Estate globally, this REIT caters to the Pharma/Biotech & University/Non-Profit Research space. These tenants are cash rich and do not have a lot of optionality in switching to new space in major research hubs of San Diego, Boston, Bethesda, etc.

It’s nice to start any year in the black. We are all for getting back to positive returns for our clients, but we want to preach caution. We believe lower values on assets are still in front of us which causes us to sit with larger cash balances/Treasury Bills for clients. We do believe that once markets bottom, and the recovery begins that we’ll trade to new highs in future years. We just don’t want to move back to fully invested allocations for clients too early – if we can avoid the full brunt of drawdowns to come and put our clients in a better position to capitalize on those lower prices, then we give them the best chance for elevated returns when risk taking returns to the markets.

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