15th March 2023

The Adaptive Asset Allocation Report

A Model driven Business Cycle Trend Following approach to investing

Flash Note No.1

Silicon Valley Bank: Never just one cockroach

"What you find is there's never just one cockroach in the kitchen when you start looking around" – Warren Buffett

Dear Readers,

With the pace and rapidity with which the Fed has been tightening – all the while peddling the "soft landing" narrative – something was bound to break. And it finally has. **Last week we saw Silicon Valley Bank shut down by regulators in the second-largest bank failure in US history** − after the 2008 collapse of Washington Mutual.

This failure is significant. SVB was the 16th largest bank in the US, the largest bank by deposits in Silicon Valley, and half of the global tech sector banked with SVB. This bank has been a major lender to budding startups and counted many key Venture Capital (VC) firms as its clients with large amounts of deposits with the bank.

So how did we get here? Overly easy monetary policy saw VCs boom, leaving SVB awash with excess deposits – which they used to buy large amounts of Mortgage-backed securities. These are a type of bond linked to a pool of underlying mortgages. Generally, the price of these securities tend to fall when the Fed hikes interest rates. And that's exactly what happened − as the Fed continued to tighten the interest rate screws, the value of these securities fell. SVB made one major mistake: they invested in riskier longer-term mortgage-backed securities rather than less-risky shorter-term ones. This compounded the losses. As the losses began to pile up, the bank had to sell some of their other investments to make up the money they lost. The news spread and depositors – mainly VC backed companies and tech workers – began withdrawing their money in droves, resulting in a run on the bank. In short, the search for 'extra yield' blew up the bank. In reality, it's more complicated than that, but **a cocktail of easy money, poor risk management, corporate greed and lax regulatory oversight caused this.**

Back in August last year, **the Fed Chairman clearly stated at a speech at Jackson Hole** that there would be pain. It was clear they were going to hike interest rates until something broke. **So it shouldn't come as a big surprise**. Only when the tide goes out do we really get to see who's been swimming naked. And SVB was certainly swimming in flagrante. Unfortunately, when it comes to the world of risk, there's never just one cockroach in the kitchen when you start looking around.

Since the news broke of SVB, markets have sold off over contagion fears. Financial (bank) stocks have been hit especially hard. The regulators have been working quickly to stem the fallout and minimize the risk of further bank runs. If they don't, it will cause a full-blown financial crisis. Already, we've seen the authorities announce full protection for all SVB depositors, launch a new emergency bank funding program, shut down Signature Bank − another bank with systemic risk − and remove senior management of both banks. In the UK, HSBC has stepped in to buy SVB's UK arm. The Chancellor has reassured the markets that all deposits have been protected and banking services are back to normal. All this without the need to deploy taxpayer funding. It remains to be seen whether these actions are sufficient to restore confidence in the stability of the banking and financial system, arrest market contagion and prevent a chain reaction.

In light of the current market conditions, **we have rerun the AAA Model to determine how much the asset rankings have been impacted**. The results, shown in the Appendix, reveal that **there have been some significant shifts.** Whilst equities still feature in the Strongest Assets group, the composition of this group has changed meaningfully. World Equities, formerly ranked amongst the Strongest group has fallen to the Weak Category. US Equities, at the centre of the storm, have also fallen to the Weak category having slipped from Strong. World Quality Equities have slipped to the Strong Asset group and unsurprisingly, Japan Equities have strengthened as investors have flocked to the Japanese Yen owing to its safe-haven status. Meanwhile Gold, another safe-haven asset, has been propelled to the very top of the Strongest Assets. EU Equities have not shifted much, but UK Equities have slipped out of the Strongest Asset group owing to SVB induced losses.

The change in the asset rankings indicate that **investors are not taking outright bearish positions, but they are reducing risk exposure** and hedging their bets holding Gold bullion and indirect exposure to the Yen − by way of unhedged Japan equity exposure. Also, in a strong bear market we need to be cognizant of one other thing: the model will always arrange the assets in the best order of relative performance, but the strongest assets may still go down, just at a slower rate than the other assets. We can mitigate this risk in two ways: firstly, by implementing a **portfolio stop-loss level** and secondly, by **holding more cash**.

In the former case, we simply calculate the portfolio drawdown on a daily basis and **when the maximum drawdown of the portfolio exceeds a certain percentage – say 10% – then we liquidate the entire portfolio**. Losing 10% means we only have to make 11% to breakeven. Not that hard. If we lose 30% of our capital, then we have to make 43% just get back to the same level. That's more difficult. Now, if we happen to lose 50% of our portfolio capital then we have to make 100% just to breakeven. That's very challenging. So it's in our best interest to limit portfolio drawdowns. If you are unfamiliar with how to calculate the portfolio drawdown, you can use this spreadsheet we have put together to guide you how to perform the calculation.

There is one caveat though – **if markets crash then we may not have time to liquidate our portfolio** (convert it to cash) before a significant drawdown has occurred. In times of market instability and volatility, it can be challenging to sell assets quickly and at a fair price. In extreme market crashes, there may be limited liquidity and trading activity, which could make it difficult to sell assets at all. This can result in a significant drawdown in the value of our portfolio before it can be liquidated. Therefore, it is important to have a well-diversified portfolio and a plan in place for managing risk in different market conditions. At the moment, the AAA Model is more diversified than it was last month, holding Gold bullion, Global High Yield bonds, EU and Japan Equities. However, **we can reduce the risk further by holding some cash along with these other assets**. As cash is currently ranked in the Strong Asset category (see Appendix) the opportunity cost of holding it is low. The main risk, however, is that we will underperform inflation, but that is a risk we can afford to live with at the moment.

There is another reason we advocate holding more cash at the moment: **the trend strength of the strongest assets is weak.** We can show this by plotting the composite trend strength of the four strongest assets in the AAA Model over time (Figure 1). This trend strength is based on our proprietary calculation. As can be seen, the trend strength of the strongest assets waxes and wanes over the business cycle. When it is as weak as it currently is, then this suggests that the opportunity cost of being fully invested in the strongest trending assets is lower than normal. In essence, **we can afford to hold more cash than normal as we are not being paid to take a lot of risk at the moment.**

It is essential to keep in mind that **the current crisis and bear market is ongoing**, and the situation remains fluid. Therefore, it is advisable to maintain a high level of liquidity and remain vigilant to any potential risks that may arise in the coming days or weeks. By taking a cautious approach and being prepared for different scenarios, investors can navigate these challenging times more effectively and protect their investments in the long run. Good Luck.

If you have any questions or comments, please write in to aaa@bytetree.com.

You can find our research online at https://bytetree.com/research/aaa

Best Wishes,

Robin Griffiths | Rashpal Sohan

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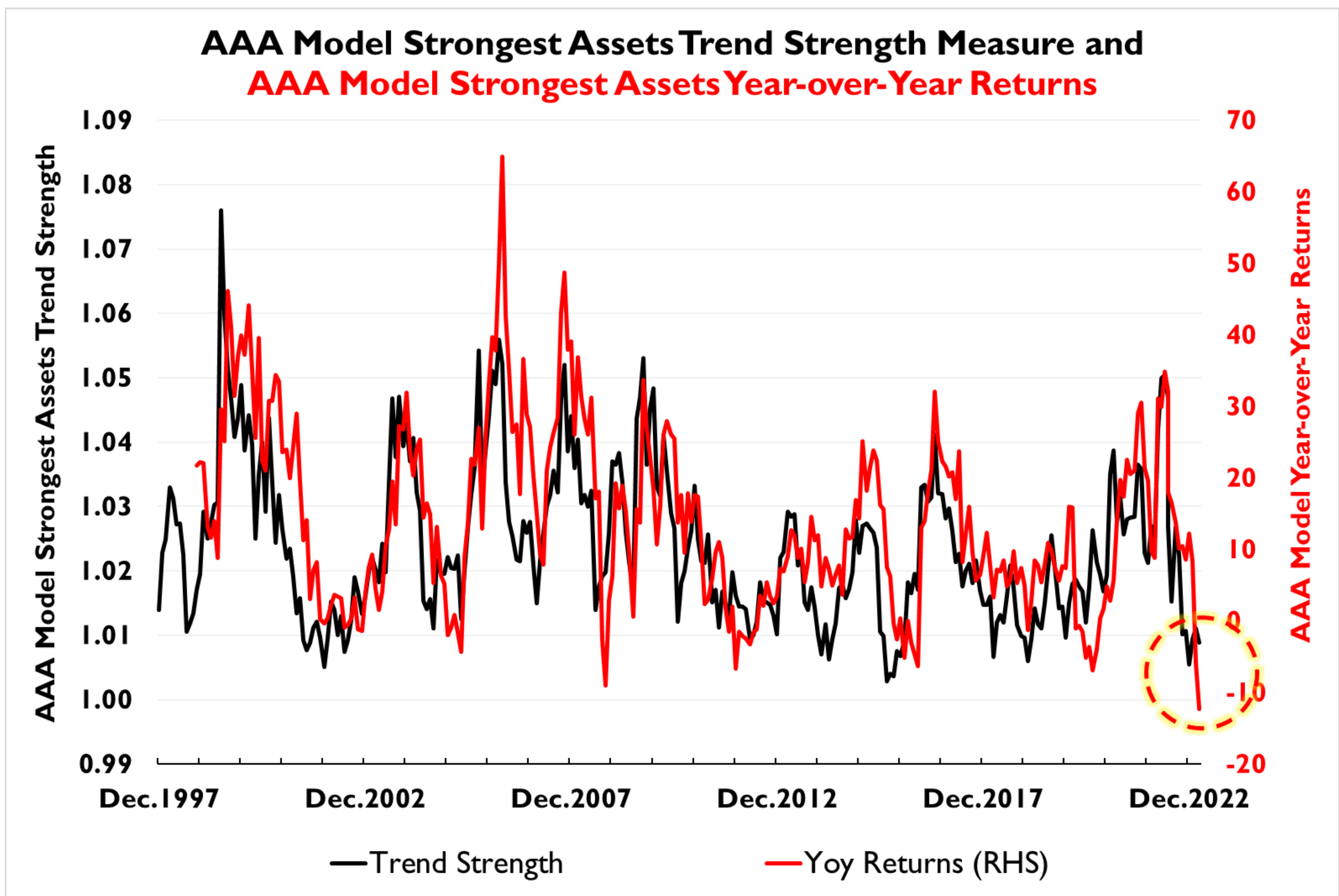
► **Figure 1: The average trend strength of the AAA Model Strongest Assets is weak suggesting that the opportunity cost of holding excess cash and not being fully invested remains low**



Source: ByteTree, Refinitiv Datastream

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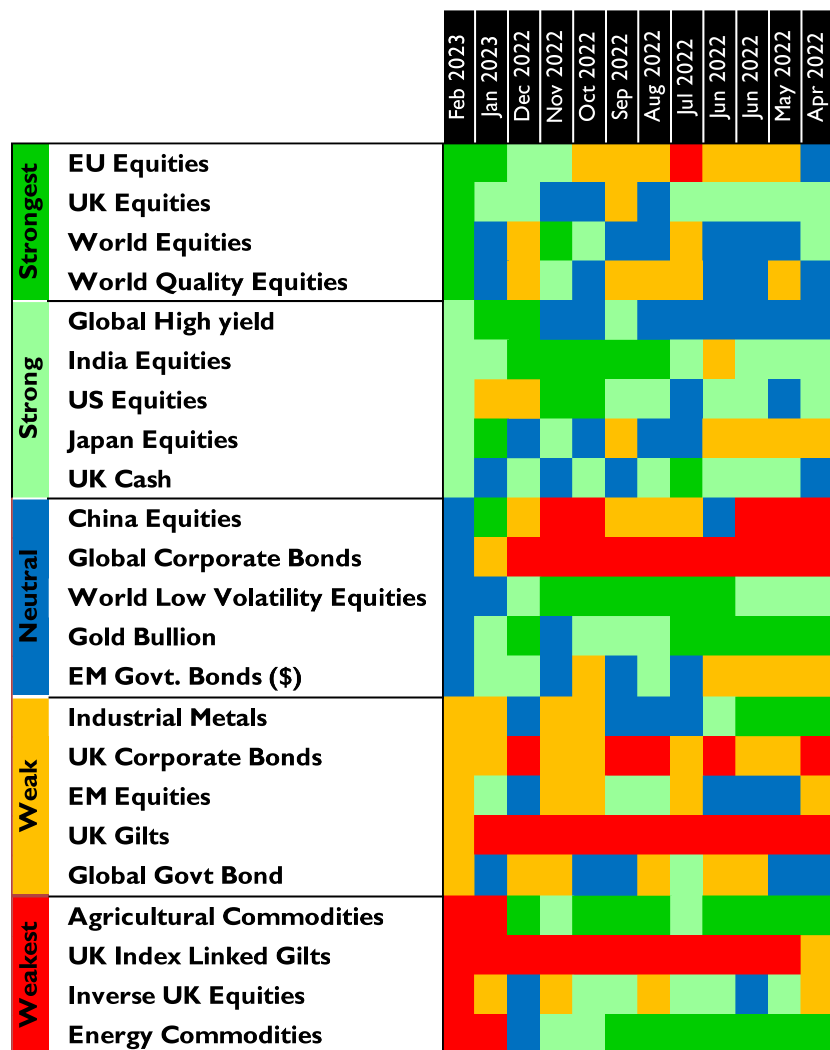
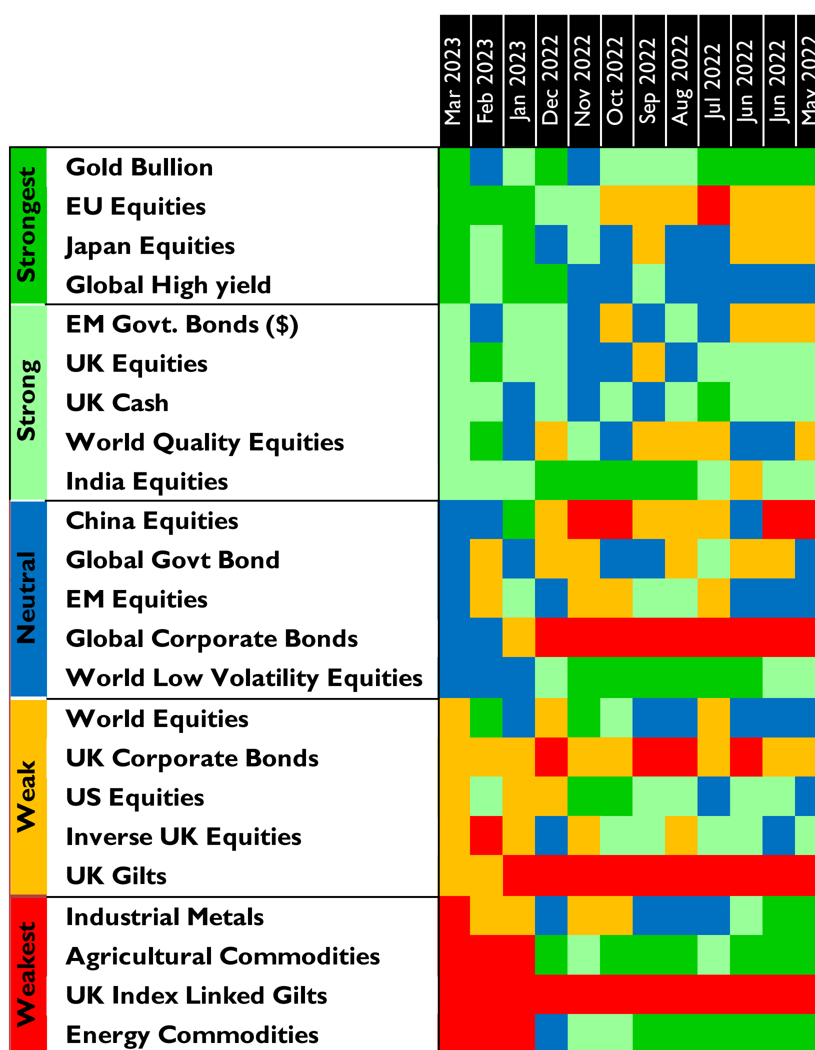
AAA Model Ranking
GBP Portfolio

Model Ranking Date: 28th **February 2023** and 13th **March 2023**

▼ 28th February 2023



▼ 13th March 2023



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The Editors

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► **Robin Griffiths** is Editor of The Adaptive Asset Allocation Report. Prior to this he was the Editor of the Dynamic Investment Trends Alert, a market newsletter for private investors published by Southbank Investment Research. Robin has served as Head of Multi-Asset Research & Advisory at the ECU Group. He was previously Chief Technical Strategist at HSBC Investment Bank for 20 years, before becoming Head of Global Asset Allocation at Rathbones, and then a director and technical strategist for Cazenove Capital Management. Robin was a Partner of WI Carr and Head of Technical Analysis at Grieveson Grant. Robin is a committee member and former chairman of the International Federation of Technical Analysts, and former chairman, now fellow, of the British Society of Technical Analysts. Robin has been a member of ECU's Global Macro Team for over 20 years. Robin has won several Technical Analyst awards for his research.

Rashpal Sohan
Managing Editor

► **Rashpal Sohan** is Managing Editor of The Adaptive Asset Allocation Report. Prior to this he was the Managing Editor of the Dynamic Investment Trends Alert, a model driven investment publication for private investors published by Southbank Investment Research. Rashpal is a consultant data scientist who has developed the model for The AAA report. Rashpal holds a keen interest in data driven insights using Visualisation and Machine Learning and holds a Masters in Data Science from City, University of London, with distinction. His dissertation was on the topic of a Risk-Based Dynamic Asset Allocation Strategy using Ensemble Machine Learning and was awarded the City University Computer Science Outstanding Project Prize. The underlying trend algorithm from his dissertation forms the basis of the AAA Model. Rashpal has served as Senior Macro & Quantitative Strategist to the ECU Group, and built several fundamental and quantitative models for use in Dynamic Asset Allocation. Rashpal has over 15 years of experience in Asset Allocation, having previously served as Senior Asset Allocation Analyst for one of the UK's largest discretionary investment management firms, Rathbone Brothers. He holds a first class honors degree in Actuarial Science from the London School of Economics, is a qualified Financial Risk Management (FRM) professional and has passed all three levels of the Chartered Financial Analyst (CFA) Program. As a consultant Data Scientist, Rashpal has done projects for ByteTree, where he helped extract key insights from their Network Demand set of indicators using Machine Learning and Data Visualisation and has also done Data Science projects in Facial Recognition, Reinforcement Learning, Recommender Systems and the influence of regional personality differences on the UK's vote to leave the European Union amongst others. Rashpal has won several Technical Analyst awards for his research, together with his business partner.

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