Long Term Bonds as an Investment Trap

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Federal regulators are trying to prevent the failure of the 16th largest bank in the country from spreading throughout the financial system. Silicon Valley Bank (SVB) was closed by regulators after a run on deposits. Although panic by depositors was the immediate cause of the bank's collapse the seeds of the bank's demise were planted during the Pandemic. The bank believed that interest rates would remain low for the indefinite future and purchased long term bonds. Now we can see long term bonds as an investment trap in an inflationary period when the Federal Reserve is steadily raising interest rates.

Why Buy Long Term Bonds?

A few years ago we wrote an article about **how to invest without losing any money**. The article was aimed at individual investors and not at banks. During most of the time since the Financial Crisis, interest rates were historically low. Investors flocked into stocks, especially tech stocks, whose earnings were strong. Although stocks outperform many other investments over time, investors can get caught in volatility cycles and lose money. Thus, we discussed how one could buy US Treasuries, corporate bonds, or CDs at a bank in order to guarantee that the value of an investment (in dollars) steadily grows with interest. The downside to this approach is when you will need your money in a hurry at a time when interest rates are going up!

What Is a Bond Worth?

The problem that confronted SVC bank was that they needed to raise capital in a hurry due to a run on the bank. They had reserves, but the reserves were in long term bonds that had become less valuable as rates went up. The present value of a bond is determined by a **discount rate** when current interest rates are higher than when the bond was issued and when one expects interest rates to remain higher for life of the bond. The interest rate for a 10-year Treasury as of August 2020 was 0.57% and in January of 2023 it was 3.55%. Depending on what one expects future interest rates to be for the next several years, the current value of a 2020 10-year Treasury could be as little as **half of the face value**! When you may need your money as cash in a hurry, this is where you can see long term bonds as an investment trap.

SVB Crisis Spreads to Regional Banks

SVB had a lot of assets. According to the FDIC at the end of 2022 SVB had deposits of $175.4 billion and **total assets** of $209 billion. Anyone with even multiple accounts with SVB will be fully covered by FDIC if their balances are less than $250,000. Those who are hurting are companies with greater balances, payroll to make, and expenses to cover. Early estimates are that, barring a buyout by a large bank, many depositors will get about half of their money back. The immediate problem going forward is that this may turn into a crisis that spreads throughout regional banks if depositors take their money and move to larger banks.

Signature Bank Closure

The next in line after SVB was **Signature Bank** in New York. This regional bank focused on real estate loans and then, just before the start of **crypto winter**, started welcoming crypto deposits as well. This strategy seems to have caused a situation similar to that of SVC with its long term bonds and they closed their doors to avoid a bank run from forcing the issue. The FDIC has taken over this bank as well. Meanwhile the **KBW regional banking index** is down by more than 20% over the last month.

Tracking a System Problem Back to the Initial Issue

Banks are required to have reserves to handle problems like the run on SVB bank or the closure of Signature Bank. However, investment decisions made before the bank gets in trouble are often at the root of the issue. In the case of SVB it was that they believed that interest rates would stay low forever and in the case of Signature it was that crypto was going to go up forever (largely due to low interest rates). The reason that banks can pay interest is that they put deposits to work on loans and other investments that generally earn a higher return than the interest that they pay. When that business model is flipped on its back with more money going out than coming in, the bank is at risk for what happened to SVB, Signature, and perhaps more regional banks in the days ahead.

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