HORUS

ASSET MANAGE-
MENT

QUARTERLY LETTER TO OUR CO-INVESTORS

APRIL 2023

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Dear co-investor,

New year, new turmoil? The major stock markets of the world ended the first quarter of the year with solid gains, but overshadowed by a banking crisis not seen since 2008. Against this volatile backdrop, our Horos Value Internacional fund gained 6.0% in the first three months of the year, compared to a 5.4% rise in its benchmark index. Horos Value Iberia was up 6.1% over the period, compared to a 10.8% rise of its benchmark.

As usual, I would like to take this opportunity to update our longer-term performance. Since the inception of Horos (May 21, 2018), Horos Value Internacional has returned 34.0%, underperforming the 47.1% gain of its benchmark index, while Horos Value Iberia has returned 10.9%, slightly below the 13.4% return of its index. Moreover, since 2012, the returns achieved by this management team stand at 228% for the international strategy and 177% for the Iberian strategy, compared to 203% and 90% in their benchmark indices, respectively.[1]

Despite these year-to-date gains, a turbulent March saw the abrupt fall of several U.S. banks, such as **Silicon Valley Bank**, and the most notable collapse of **Credit Suisse** in Europe. Are the central banks' rate hikes the cause of this banking crisis? Are the cases of U.S. regional banks so different from what happened with **Credit Suisse**? Are there other underlying structural problems that explain these recurring crises in the sector? We will devote most of this first quarterly letter of 2023 to try to answer these questions and explain our approach to the financial sector.

Thank you for your confidence.

Yours sincerely,

Javier Ruiz, CFA
Chief Investment Officer
Horos Asset Management

[1] The data includes the performance of the portfolio management team in its previous professional period working for another asset management firm (from May 31, 2012 for the international strategy and September 30 for the Iberian strategy, until May 22, 2018 in both cases, when they joined Horos AM). Past performance is not a guarantee of future performance.

Executive summary

The list of financial mistakes is unlimited, with past errors being continually repeated.

— Santiago López Díaz

This first quarter of 2023 confirms what we have always said at Horos: the banking business is fragile and unsustainable and only the existence of exclusive privileges for this sector (such as the existence of central banks and deposit insurance schemes) allow the system to stay afloat. Given the somewhat true impression that the accelerated rise in interest rates by central banks is behind the recent banking crisis, with the collapse of **Silicon Valley Bank**, **Signature Bank** and **Credit Suisse**, we are of the opinion that the banking model suffers from a series of structural problems (such as the maturity mismatch, high financial leverage and moral hazard) that make it susceptible to continuous crises which, in one way or another, we all end up paying for. In this letter we will try to explain what has happened, why it has happened and what kind of financial businesses are part of our portfolios.

As usual, we will discuss the most significant changes that we have made to our portfolios. On the one hand, we can highlight that Horos Value Internacional fully exited the following positions in: the data services company for the oil and gas industry **TGS**, the oil and gas producer **Spartan Delta** (after divesting a large part of its assets to Crescent Point Energy), the financial holding company **MBIA** and the aviation and defense company **Dassault Aviation**, as we found other more attractive alternatives. On the other hand, we invested in the multi-brand restaurant chain operator **AmRest Holdings**, in the testing, inspection and certification company **Applus Services**, in the engineering company and operator of wind and power transmission concessions **Elecnor** and, finally, in the investment vehicle managed by Bill Ackman **Pershing Square Holdings**. Horos Value Iberia sold the entire stakes in **Vidrala** and **Altia Consultores** (after almost ten years as shareholders of the Galician consulting company) and initiated a new position in **AmRest Holdings**.

The inevitable fault

The Fed can't raise interest rates this quickly without severe consequences.
— Kyle Bass

Every cycle of interest rate hikes ends up breaking something. This is certainly the sentence that has been repeated the most in recent weeks by the investment community and the specialized financial media. Yet it is no less true for that reason. The most paradigmatic examples of this are the bursting of the dotcom bubble at the beginning of the first decade of this century, with its subsequent recessionary period in several developed economies, or of the great global real estate bubble that triggered one of the biggest financial crises in living memory (which is why it ended up being known as the Great Recession). In both cases, the unwritten rule that every period of rate hikes ends when there is a crack in the financial markets was fulfilled, given the fear that its consequences will be even more dire if the tight monetary policy of the moment is not reversed.

To better understand this process, let me draw a parallel with geology. Specifically, the lithosphere (the most solid layer of the planet Earth) is divided into different segments called tectonic plates. These plates float on another "plastic" layer called asthenosphere, moving on it by the effects of convection currents (different temperatures). When the tectonic plates move, they generate pressures in the lithosphere by "colliding" against each other. On many occasions, this built-up pressure ends up being released in the form of a crack or fault on the Earth's surface. Well, it is easy to see how the cycle of interest rate hikes can be compared to the movement of tectonic plates that generate more and more pressure on the financial system until the market (the lithosphere) eventually breaks somewhere (fault). However, the similarity does not end here. Usually, geological faults trigger earthquakes, with the terrible consequences we all know when they are of greater severity. This last part is precisely what central banks always try to avoid when they make a change in their monetary policy stance, since, **if they maintain this pressure on the market, the potential earthquake could turn into a financial and economic crisis.**

Why do I bring this up? Because it is very likely that, in this first quarter of 2023, we have reached that point of maximum pressure where something has broken in the market. If in 2022 the historic (because of its speed) rise in interest rates had been the main trigger for the significant losses suffered by most assets, in this new year we are facing its dangerous and unpredictable second-order effects. Indeed, the rapid and sharp rise in interest rates by central banks (especially the Federal Reserve) in response to high inflation, which they partly fueled in collusion with

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fiscal stimulus from governments worldwide to counter the pandemic-induced economic slowdown, has shaken up the global banking system in a way not seen in a long time.[2] The big question marks right now are, obviously, whether this increase in interest rates has come to an end, whether the fault will eventually lead to an earthquake and, if it does, the level of destruction it will cause.

The (other) fault of Silicon Valley

SVB committed one of the most elementary errors in banking: borrowing money in the short term and investing in the long term.
— Lawrence H. Summers

Although in hindsight the causality of events in the financial markets usually seems very evident, the reality is that very few people were able to foresee the bankruptcy of one of Silicon Valley's most emblematic banks: **Silicon Valley Bank**. This entity was established forty years ago with the aim of focusing on providing financing services to newly created firms (such as start-ups) and vehicles that invest in them (venture capital and private equity), as well as offering private banking services to Silicon Valley's high net worth individuals. We are therefore talking about a bank that specializes in a particular niche in this sector and which, until recently, was among the twenty largest in terms of assets in the United States. To achieve this milestone, **Silicon Valley Bank** was able to benefit from the big investment boom in technology companies (including crypto-assets) in recent years, as evidenced by its customers' deposits reaching a value of c. $190 billion in 2021, compared to almost four times less in 2018. However, **this tremendous growth concealed the seed of the subsequent destruction of the iconic bank**. On the one hand, the bank, faced with the inability to grow its loan portfolio at the rate at which it was attracting deposits, invested the excess funds in financial assets (notably, U.S. government agency mortgage-backed securities or MBS) to such an extent that, at the end of 2022, investments in securities accounted for 44% of its assets, far exceeding the c. 27% represented by its loans (its supposedly underlying business).[3] On the other hand, its financial leverage increased by 70% over the period, with its assets reaching a size 17 times greater than its equity at the end of 2022. So far, beyond a possible exuberance in the technology market that could be behind its high asset growth, nothing seemed to foreshadow what was to come. Consider that the leverage ratio of many banks is at similar levels, so this figure does not indicate a higher risk specific to this bank. In addition, the asset portfolio was of very high

[2] Rallo, J.R. (January 13, 2023). Los estímulos provocaron el grueso de la inflación en EEUU. *El Confidencial*.
[3] Kinder, T., McCrum, D., Gara, A. and Franklin, J. (February 22, 2023). Silicon Valley Bank profit squeeze in tech downturn attracts short sellers. *Financial Times*.

quality, so they were not taking on credit risk with their investments.

However, the catastrophe occurred practically overnight. On March 8, **Silicon Valley Bank** announced *realized* losses in its fixed income portfolio of nearly $2 billion and the intention to raise capital by $2.25 billion to address this hole in its capital base.[4] Before proceeding, it is important to note that a financial institution that classifies its investments as held-to-maturity assets does not have to mark-to-market its value, i.e., it does not take into account whether this portfolio is currently generating profits or losses. Why is this relevant? Because **Silicon Valley Bank** accounted for about $91 billion of its $120 billion of investments as held-to-maturity securities and, therefore, unless it sold them, it would not impact its performance on its income statement or balance sheet. Having clarified this aspect, two questions underlie the bank's loss and capital raise announcement. First, why did the value of its fixed-income portfolio decline so sharply? The answer was discussed in detail in our previous quarterly letter (see here). Simply put, the Federal Reserve's interest rate hikes caused a drop in the value of fixed-income assets not seen in decades. In the case of **Silicon Valley Bank**, the market value of its held-to-maturity investments was well below the $91 billion booked on its balance sheet. Specifically, its value was just over $76 billion. Thus, by accounting standards, its asset base showed investments worth $15 billion more than their market value. A figure that, on the other hand, compared to shareholders' equity of just over $16 billion. In other words, in the unlikely event that **Silicon Valley Bank** had to sell its held-to-maturity securities, it would have to suffer losses that would volatilize almost all the bank's net worth. An unlikely scenario, but not impossible?

In fact, the following question is much more interesting: why did **Silicon Valley Bank** sell these securities, realizing losses on part of its portfolio, and not wait for these investments to mature? If its intention was not to sell them, why this U-turn, especially when it was going to take such a big loss? Quite simply, because the lack of confidence in the market and the loss of creditors, i.e. its depositors, had already become palpable long before this announcement. On the one hand, the bank's share price had collapsed by around 65% from the end of 2021 until before this announcement, so it was clear that the investment community was beginning to worry about the deterioration in its liquidity position (defined, in this case, as a decrease in the current assets to meet its liabilities). On the other hand, the entity began to experience a significant loss of deposits, which are the liabilities that were financing its loans and investments. The weak business performance of its clients (among which there were companies related to crypto-assets), better investment alternatives or, perhaps, a certain lack of confidence, could be some of the reasons

[4] Franklin, J. and Gara, A. (March 9, 2023). Silicon Valley Bank launches $2.25bn share sale to shore up capital base. *Financial Times*.

behind these outflows. Be that as it may, the bank saw its deposits fall by $16 billion from one year to the next, which forced it to request financing (at a much higher cost) for $15 billion from the Federal Loan Home Bank, in exchange for pledging collateral three times more than what was requested.[5] A very clear sign of the severity of the deposit outflows that were already taking place in 2022 and which **became clearly unsustainable when the company was forced to sell investments held to maturity at a significant loss**.

As fear is irrational and uncontrollable, panic soon set in, as evidenced by the 60% plunge in **Silicon Valley Bank**'s share price on March 9, making its desired (and necessary) capital raise impossible. On March 10 (just one day later!) the end of the bank was consummated, following its closure ordered by the Federal Deposit Insurance Corporation (the U.S. banking regulator) in the face of the massive request for withdrawals ($42 billion or a quarter of the total) by its customers that same day.[6] I think the following comment by James Gorman, CEO of Morgan Stanley, reflects very well the historic nature of this stampede of depositors:

> *...with a click of an iPhone, $42B left one bank in one day. To give you a sense of the order of magnitude, in the financial crisis of '08, one bank lost $17B in a week, so the rate of withdrawal was 20 times what it was then.*[7]

But why did so many people apply to withdraw their money *en masse*? Because the Federal Deposit Insurance Corporation, as in other countries, does not guarantee the total amount of a bank's deposits when they exceed a certain limit. In the case of the United States, coverage reaches a maximum of $250,000 per deposit and, in the case of **Silicon Valley Bank**, 94% of its deposits exceeded this amount. Keep in mind that this entity offered its services to firms, investment funds and high net worth individuals. As an example, the TV platform **Roku** had close to $500 million deposited in this bank.[8] Therefore, if its default materialized, almost none of its depositors would get their money back. Naturally, the investment community and depositors were quick to wonder whether there were other banks in the same situation as **Silicon Valley Bank** and, making clear the fragility of the banking model, contagion became inevitable.

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[5] Weil, J. (March 10, 2023). SVB Tapped Home Loan Bank for $15 Billion in Funding at End of 2022. *The Wall Street Journal*.
[6] FT Reporters (March 11, 2023). Silicon Valley Bank shut down by US banking regulators. *Financial Times*.
[7] Statements by James Gorman, CEO of Morgan Stanley, as reported by the Twitter account @TheTranscript_.
[8] (March 14, 2023). SVB, Signature racked up some high rates of uninsured deposits. *S&P Global Market Intelligence*.

The first tremors

[Lack of] liquidity kills you quick.
— Perry G. Mehrling

It soon became clear that the hole hidden in **Silicon Valley Bank**'s balance sheet could also be extended to other entities in the U.S. banking sector. According to data from the Federal Deposit Insurance Corporation, U.S. banks were sitting on unrealized losses on their investments of about $620 billion at the end of 2022.[9] Therefore, the risk of another case like that of the Californian bank was real and the market was quick to point it out. Share prices of other regional banks began to crash, including **Signature Bank**, **First Republic Bank**, **Western Alliance Bancorp** and **PacWest Bancorp**. That same weekend, the U.S. Treasury and the Federal Reserve issued a joint statement outlining different measures to try to prevent the feared earthquake.

The U.S. Treasury announced a partial bailout of **Silicon Valley Bank**. Specifically, it announced that it would guarantee all the bank's deposits, regardless of their amount, although the bank's shareholders and bondholders would lose everything. The partial bailout, without going into its rationale and implications, sought to contain systemic risk and "clean" the bank of those liabilities that were not deposits, in order to subsequently auction it and recover the money granted to the rescued depositors (it would finally be acquired by **First Citizens Bancshares**).[10] Furthermore, in the event that this sale price was not sufficient, the Treasury would levy a special tax on the rest of the banks to cover this bailout (its implementation is not proving to be so easy).[11] The Treasury also announced that it was going to intervene in **Signature Bank**, applying the same conditions as it did to **Silicon Valley Bank**. Why did it also intervene in Signature Bank? It seems that **Signature Bank** had a significant exposure to entities related to crypto-assets, whose performance in 2022 put many of these companies in a very fragile situation (as a curiosity, there is not much agreement on the reasons that led the Treasury to intervene this entity and not others in a similar situation and, even more so, after the announcement by the Federal Reserve that I will now detail and that the bank could have benefited from).[12]

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[9] Federal Deposit Insurance Corporation (last updated on March 29, 2023). *Remarks by Chairman Martin J. Gruenberg on Recent Bank Failures and the Federal Regulatory Response before the Committee on Financial Services, United States House of Representatives*.
[10] Ackerman, A. (March 27, 2023). First Citizens Acquires Much of Failed Silicon Valley Bank. *The Wall Street Journal*.
[11] Doherty, K., Levitt, H. and Johnson, K. (March 29, 2023). FDIC Considers Forcing Big Banks to Pay Up After $23 Billion Hit. *Bloomberg*.
[12] The Editorial Board (March 17, 2023). Signature Bank's Crypto Execution. *The Wall Street Journal*.

Meanwhile, the Federal Reserve launched the **Bank Term Funding Program** (BTFP) which, among other things, allows banks that use it to obtain one-year funding to cover possible deposit losses, in exchange for high-quality collateral, such as government bonds or mortgage-backed securities (MBS). Thus, banks lose the urgency of having to sell their investment portfolio at a loss and avoid the potential impact on their equity. Not only that, but this program also has a particularity that makes it much more attractive compared to other Federal Reserve funding schemes. Specifically, the Fed will recognize the face value of the collateral, rather than its market value. Recall that banks' fixed income securities had sharply declined in value as a result of rising interest rates. Therefore, this measure "erases" these unrealized losses that would be considered in other Federal Reserve funding programs (implying the need for more collateral requirements), such as in the discount window where, actually, a haircut on the market value of the assets put up as collateral may be required.[13]

In summary, on the one hand, the Treasury announced the bailout of **Silicon Valley Bank** and **Signature Bank** depositors, letting shareholders and bondholders lose everything. On the other hand, the Federal Reserve launched an advantageous funding program for the entire U.S. banking system. However, the chronicle of events does not end here. The following week, after its share price fell by around 80% in a few days, **First Republic Bank** received a "small" private bailout from the major U.S. banks. Specifically, entities such as **JPMorgan** (some sources say that its CEO, Jamie Dimon, highly respected by the industry and the regulator, was called by Treasury Secretary Janet Yellen and Federal Reserve Chairman Jerome Powell to discuss different scenarios), **Bank of America**, **Wells Fargo** or **Citigroup**, to name the largest contributors, teamed up to inject $30 billion in deposits into the Californian regional bank.[14] Two reasonable questions that one could ask about this are: a) why did this bank's share price continue to plunge after the Treasury and Federal Reserve measures, and b) why was the bailout carried out by the private sector?

On the first question, we are again talking about a niche Californian regional bank. In this case, **First Republic Bank** serves high net worth individuals in its region, which may make it more prone to herd behavior among its depositors. Moreover, as was the case with **Silicon Valley Bank**, the bulk of its deposits exceeded the limit covered by the Federal Deposit Insurance Corporation. Therefore, the fear of deposit flight in a context of great distrust towards these entities may have been what triggered this bailout. As for the second question, I do not know if the real

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[13] Aldekoa, J. (March 14, 2023). ¿Qué es el "Bank Term Funding Program" de la Fed? *Dinero y Banca*.
[14] Masters, B., Aliaj, O. and Politi, J. (March 17, 2023). The 'three Js' who put together a rescue deal for First Republic. *Financial Times*.

motives for a private bailout will ever be made public. However, it is very clear that the largest banks are not being treated in the same way as regional banks, and this is encouraging a perverse dynamic that is difficult to control. Indeed, the official consideration of the six largest U.S. banks as too big to be allowed to fail because of systemic risk fears (the famous "**too big to fail**" term coined during the Great Recession) means that they are perceived as the safest in the United States by their depositors since, in essence, their bailout would be implicitly guaranteed by the U.S. taxpayer.[15] For this reason, much of this deposit outflow from the regional banks, where deposits are covered up to $250,000, has gone to the large institutions.[16] Of course, Janet Yellen's March 17 statement that a bank's deposits above $250,000 would only be guaranteed when failure to do so would mean incurring "systemic risk" and "significant financial and economic consequences" did not help either.[17]

To conclude this section, I would like to point out that the deposit outflows experienced by the U.S. banking sector (and elsewhere) are not only the result of a sudden panic triggered by the collapse of **Silicon Valley Bank**. There is also another factor of a structural nature that is generating what some have called the bank *walk*, due to its relative slowness ("bank walk" as opposed to the classic term "bank run") and which refers to the steady drain of deposits seeking shelter in other more profitable alternatives, such as money market funds or government bonds.[18] Obviously, one can say that, if banks want to retain these deposits, all they have to do is pay more for this funding. The problem is that, most likely, a large part of their loan and investment portfolio offers meager returns, having been locked in during the many years of a zero-interest rate world. Therefore, financing themselves now, well above this level, would greatly narrow their net interest margins, decapitalizing their balance sheet over time. All in all, the pressure already seems too high for many institutions, which are beginning to raise the interest paid to depositors to avoid a situation like that of **Silicon Valley Bank**.[19]

On top of this, there are the higher capital requirements imposed by Basel III (such as the Supplementary Leverage Ratio (SLR) implemented in the United States), which make it difficult for banks to grow their balance sheets excessively, so they have no great incentive to retain their deposits at all costs. This is especially true after a pandemic period in which this capital requirement was suspended to accommodate the injection of liquidity from economic stimulus and the drastic halt

[15] Peck, E. (March 23, 2023). How "too big to fail" banks became a symbol of safety. *Axios Markets*.
[16] Levitt, H., Doherty, K. and Surane, J. (March 14, 2023). Too-Big-to-Fail Lenders Rake In Deposits After Three Banks Fail. *Bloomberg*.
[17] Konish, L. (March 17, 2023). Yellen says uninsured deposits may be at risk in future bank failures. Here's how FDIC coverage works. *CNBC*.
[18] Tran, H. (January 9, 2023). Fed reverse repos hit a new record: An unhealthy development. *Atlantic Council*.
[19] Heeb, G. (April 16, 2023). Banks Are Finally Facing Pressure to Pay Depositors More. *The Wall Street Journal*.

in consumption, which allowed all financial institutions to grow their assets above normal levels.[20] It is ironic that it is precisely the Federal Reserve's policy of keeping rates at 0% for so long that encouraged banks to invest in the very long term with tiny returns, but sufficient to obtain a small spread on interest-free financing, and now the central bank's aggressive rate hikes are wiping out part of this sector. At the end of the day, as the economist Juan Ramón Rallo emphasized a few weeks ago in one of the videos on his popular (and highly recommended) YouTube channel:

> *Central banks are now debating between inflation or financial destruction.*[21]

The aftershock reaches Europe

> *A bank's value is its reputation and its stability. As clients question these things, they are seeing safer options elsewhere, which puts a strain on CS [Credit Suisse] revenue and financial and liquidity position.*
> — Patrick Armstrong (investor who held a short position against Credit Suisse in 2022)

In a financially globalized world such as ours, it was very difficult for the U.S. banking earthquake not to end up, in some way, generating aftershocks on the European continent. It is true that the more traditional banks seem to be relatively less exposed to interest rate risks, as they generally have less exposure to fixed-income securities and a more stable depositor base. However, those banks more dependent on investment banking and with more volatile funding sources have come under greater pressure in recent weeks. Thus, **Credit Suisse**, a bank whose origins date back to 1856, would eventually succumb, becoming the first major banking casualty of monetary policy tightening.

In truth, **Credit Suisse**'s problems date back long before the current scenario of financial sector stress. In the last three years alone, the institution has been embroiled in scandals and situations of the most varied nature: the resignation of its CEO for spying on former employees, highly controversial multi-million dollar losses in its investment banking division (Greensill Capital or Archegos Capital Management cases), huge fines for bribes in Mozambique, the hasty departure of its next CEO (the Portuguese Horta-Osório, a specialist in turning around distressed financial institutions) for breaking Covid-19 rules, fraud in one of its

[20] Gara Afonso, Marco Cipriani, and Gabriele La Spada (December 2022). Banks' Balance-Sheet Costs, Monetary Policy, and the ON RRP. *Federal Reserve Bank of New York Staff Reports, no. 1041.*
[21] Juan Ramón Rallo (March 12, 2023). *¿Quiénes son los principales perjudicados de la quiebra del SVB?* Youtube. https://www.youtube.com/watch?v=IURO6SToaJs&t

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divisions in Bermuda (including suicide), money laundering from drug trafficking and, last but not least, although less "flashy", it would publish in February 2023 its worst results since the financial crisis of 2008.[22] In a business where reputation is everything, such as that of a bank, this sequence of events ended up denting the confidence of its creditors. In the fourth quarter of 2022 alone (several weeks before the events at **Silicon Valley Bank**) **Credit Suisse** saw 37% of its deposits disappear.[23]

However, the final trigger for the bank's collapse came on March 9, precisely the same day that the Federal Deposit Insurance Corporation intervened **Silicon Valley Bank**, when the U.S. Securities and Exchange Commission (SEC) halted the release of the bank's annual earnings report due to discrepancies in the accounting for its borrowing and lending activities. On March 14, **Credit Suisse** finally published its report, but admitted a significant flaw in its accounting and reporting procedures. The final straw came on March 15, when in an interview for Bloomberg TV, the Saudi National Bank (the bank's largest shareholder) stated that it would not take part in a potential new capital raise of the Swiss bank. On that day, its shares lost 25% of their value. On March 16, the Swiss National Bank intervened in a last attempt to save the bank, granting it a loan facility of up to 50 billion Swiss francs.[24] Its share price recovered much of the ground lost the previous day, but the joy was short-lived. A day later, it was leaked that **Credit Suisse** was still not containing the stampede of deposits, despite the intervention of the central bank. Finally, not without controversy (as could not be otherwise given the bank's history) and with significant support from the Swiss National Bank and the Swiss government, **UBS** (the other historic Swiss bank) agreed to acquire **Credit Suisse** on March 19.[25]

As was the case with **Silicon Valley Bank**, fears of a European contagion were very evident during those weeks. Other institutions perceived by the market as (relatively) similar to **Credit Suisse**, such as some French and German banks and, in particular, **Deutsche Bank**, saw their shares tumble. Predictably, the major central banks (Federal Reserve, European Central Bank, Bank of England, Swiss National Bank, Bank of Japan and Bank of Canada) announced coordinated action to inject dollar liquidity into the financial system to stop the bleeding.[26] For now, a major catastrophe has been averted and we are certainly not going to be the ones to say whether there will be more casualties in the financial earthquake we have been

[22] Englundh, J. (March 21, 2023). Credit Suisse's Demise: A Timeline of Scandal and Failures. *Morningstar*.
[23] Balezou, M. (March 15, 2023). Credit Suisse Is No More. What Went Wrong? *Bloomberg*.
[24] Franklin, J., Walker, O. and Noonan, L. (March 16, 2023). Credit Suisse shares rally after $54bn lifeline from Swiss central bank. *Financial Times*.
[25] Massoudi, A., Moriss, S., Fontanella-Khan, J., Noonan, L., Walker, O. and Jones, S. (March 19, 2023). UBS agrees $3.25bn rescue deal for rival Credit Suisse. *Financial Times*.
[26] Cox, J. (March 19, 2023). Fed, other central banks set joint liquidity operation. *CNBC*.

experiencing since early March. Nor are we going to try to predict whether central banks are going to stop their rate hike cycle, as markets seem to assume, or whether a severe economic recession is coming. We remain convinced, as always, that **staying true to our investment process is the best tool to face any scenario that may arise in the future**.

Finally, before discussing the main changes in our portfolios during the quarter, I would like to dedicate the next two sections to highlighting the real problems in the banking business and how banks differ from our investments in financial businesses.

The great fault in the making

All banks fund a position in illiquid assets by issuing liquid liabilities.
— Daniel H. Neilson

Indeed, based on what has been said so far, one could come to the understandable conclusion that the Federal Reserve's monetary policy has been the trigger for the current banking crisis, first by keeping interest rates so low for so long and, then, by raising them so aggressively. However, although there is some truth in this, there are other **structural and endogenous problems in the banking business model that make it prone to these periodic liquidity and solvency crises**. Specifically, I would like to highlight the three that I consider most fundamental: maturity mismatch, financial leverage and moral hazard.

Maturity mismatch, as we explained in our quarterly letter on the causes of economic cycles (see **here**), consists of keeping a balance sheet structure in which the maturities of assets differ from those of liabilities. Specifically, assets tend to have much longer maturities than liabilities. Why do banks operate with this mismatch? Quite simply, because it is much more profitable. Generally, except in atypical market situations, long-term financing will always be more expensive than short-term financing, since the interest rate reflects, among other things, the time preference of economic agents, their risk aversion or their inflation outlook. Therefore, essentially what a bank does is to earn a spread for borrowing money in the short term at a lower cost than the return it earns for lending money in the long term, or, in other words, for **arbitraging the interest rate curve**.

The problem with this maturity mismatch is that, as we have already explained here, it can become unsustainable. **Assets, having longer maturities, are much more illiquid than bank liabilities.** Consider a thirty-year mortgage that is financed with demand deposits. As long as clients keep their money in the bank, it would not suffer any liquidity problems from operating with such a large maturity mismatch (thirty-year maturity of assets versus deposits that may require repayment tomorrow). However, if something happens that leads to deposit outflows, a liquidity crisis is guaranteed, since the bank will not be able to repay these deposits with a mortgage that it will not be paid in full until the thirty years have passed. That is why **Silicon Valley Bank** and the rest of the banks mentioned above collapsed, because their liabilities matured in the short term and their assets in the long term. When deposits began to exit these institutions, they had to sell their illiquid assets at a discount at the prevailing market price, creating a permanent hole in their balance sheets. This brings us precisely to the second structural problem of the banking business: **financial leverage**.

It is not only that banks operate with an unsustainable financial intermediation model, but also that the returns they earn with this intermediation is so low that they need to take on more debt (leverage) than any other business in order to achieve attractive returns for their shareholders. Listed Spanish banks, for example, have earned a return on assets that has averaged between 0.3% and 0.5% in recent years, according to Bloomberg data.[27] This means that **in order to increase this return they have to leverage their balance sheet, greatly increasing the size of their assets in relation to their equity** (financing this increase in assets with external funds, instead of with their own capital). How much? Up to levels where, in some cases, banks' assets can be 20 times their equity. With that 20x leverage, shareholder returns (return on equity) can reach low double digits.[28] Certainly a more attractive level than the very low return achieved without such leverage. The problem with excessive debt? Basically, that a small loss or asset impairment can take a large part of your equity or, in the most dramatic cases, even exceed it. If we take the example of a 20x leveraged bank, it would only take a small impairment of 5% in its assets to evaporate the entire net worth of the entity. This is why a bank's risk management is so important in the long term. Any mistake can take the bank down with it.

> *Because leverage of 20:1 magnifies the effects of managerial strengths and weaknesses, we have no interest in purchasing shares of a poorly-managed bank at a "cheap" price. Instead, our only interest is in buying into well-managed banks at fair prices.*[29]

[27] Return on Assets (ROA) is calculated, in its simplest form, by dividing the profit generated by a business by its assets.
[28] Return on Equity (ROE) is calculated, in its simplest form, by dividing the profit generated by the business by its equity.
[29] Warren Buffett's letter to Berkshire Hathaway shareholders in 1990, explaining his investment in the bank Wells Fargo.

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Finally, there is the **moral hazard** structural problem. In any other sector, an organization incurring the liquidity and debt risks assumed by the banking sector would, at some point, go bankrupt. Such a bankruptcy would entail the loss of the capital invested by its shareholders and creditors. However, the banking sector is not governed by the rules of ordinary businesses, as we have already seen, and benefits from privileges that condition everything. First, the central bank acts as lender of last resort, granting banks financing that they would otherwise be unable to obtain in times of financial stress. Second, the government (i.e. the taxpayer) guarantees deposits up to a certain limit or even in full, so that depositors or creditors of the bank have no need to discipline the mismanagement of these institutions (e.g., by moving deposits to better managed institutions that assume less investment risk or maturity mismatch risk). Given this, **what incentive do bank managers have to incur less liquidity risk with their intermediation business or reduce the leverage on their balance sheet?** The bank makes much more money by taking these financial risks and, in the hypothetical event of a liquidity crisis, the central bank and the taxpayer will normally end up bearing the burden of the losses that may be incurred.[30] A textbook case of "heads I win, tails you lose."

For all these reasons, although we do not rule out investing in a bank at some point, we have stayed away from this sector for so many years. This is not to say that financial businesses are uninvestable. In fact, when they are well managed and do not assume these risks, they are very profitable businesses for their shareholders, as demonstrated by the companies we own in our portfolios.

Towards solid ground

Banking is very good business if you don't do anything dumb.
— Warren Buffett

To explain the merits of our investments in the financial sector, I would like to end with a quick review of the difference between the management of their businesses, compared to the two risks we have just discussed, i.e., maturity mismatch and (excessive) financial leverage of traditional banking (obviously, moral hazard has no place here, as the privileges of banking do not apply to these companies). Specifically, I am going to focus on the purest cases of financial intermediation in which we are invested: **AerCap**, **ALD Automotive**, **Sun Hung Kai & Co** and **S&U**.[31]

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[30] McQuillan, L.J. (April 11, 2023). FDIC Deposit Insurance, Moral Hazard, and Boom-and-Bust Cycles. *Independent Institute*.
[31] GCO (insurance), Alantra Partners (asset management) and Petershill Partners (asset management) have business models that are broadly different from those of the banking sector, making the comparison meaningless.

Let us start with maturity mismatch, which is the first of the structural problems in banking. We own a stake in **AerCap** and **ALD Automotive**, two companies with very similar businesses in their essence. In short, these entities borrow money to acquire assets (aircraft and automobiles, respectively), lease them for a period of time (on average, seven and four years) and sell them at the end of their contract (in the case of **AerCap**, the longer useful life of its aircraft means that the contracts are usually renewed at maturity). If these companies were to operate like a bank, they would borrow at very short maturities and would have to continually roll over that financing to avoid falling into an unsustainable liquidity risk, should they have to repay their debt (their assets are leased). However, as we have already seen, operating with such a maturity mismatch would be a recipe for failure. In fact, **Guinness Peat Aviation**, the company that pioneered the aircraft leasing business in the 1970s and 1980s, ended up going bankrupt (among others), for over-reliance on short-term financing.[32] A lesson never to be forgotten by Aengus Kelly, CEO of **AerCap** and the person who inherited the unloved assets of **Guinness Peat Aviation** after its sale to **GECAS** in 1996 (by a twist of fate, Kelly eventually acquired **GECAS** two years ago):

> *You cannot run this business with a short-term liability structure or a balance sheet that is not conservative.*[33]

As a result, **AerCap** has a weighted average maturity on its debt of seventeen years. And **ALD Automotive** does not assume maturity mismatch risks, as its policy is to "finance assets with a duration identical to that of the leasing contract."[34]

As for **Sun Hung Kai & Co**, a consumer loan and mortgage company, and **S&U**, a provider of loans for the purchase of second-hand cars and bridge financing for the purchase of real estate, there is also a residual or zero risk of maturity mismatch. In the case of **Sun Hung Kai & Co**, the company finances its short-term assets (consumer loans) with short-term liabilities (such as bank deposits), while it takes on long-term debt and uses its own capital to finance the granting of longer-term loans (mortgages). In addition, it is important to note that this is one of the three divisions of this company, which further mitigates the potential risks of this business. **S&U** grants loans to its customers with an average maturity of four and a half years in the case of loans for the purchase of second-hand cars and less than one year for bridge financing for the purchase of real estate. To finance these transactions, **S&U** has debt that matures, on a weighted basis, in just under four years.

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[32] Brown, C. (September 25, 2009). *Crash Landing: An Inside Account of the Fall of GPA*. Gill & Macmillan Ltd.
[33] Hepher, T. and Humphries, C. (March 10, 2021). Hard lessons help AerCap boss Kelly rebuild air finance titan. *Reuters*.
[34] ALD Automotive annual report 2022 (page 44).

Therefore, it is easy to see that none of the four companies are taking on significant maturity mismatch risk in their operations. But what about their balance sheet or leverage risk? Indeed, as our investment style would have it, these businesses do not stand out for needing excessive debt to earn high returns. **AerCap** has a financial leverage of just over 4x, **ALD Automotive** slightly over 5x, the consumer finance arm of **Sun Hung Kai & Co** less than 2x and **S&U** around 2x. These levels are far lower than the nearly 20x leverage that a bank can have. Despite this, these companies manage to earn returns on equity ranging between 12% and 18%. In a simplistic and unrealistic exercise, if we were to apply the same leverage used by banks to the particular case of **S&U**, this return could soar to over 120%. However, neither we nor, of course, the Coombs family (managers of the company for more than 80 years) would be willing to take such financial risks:

> *We have a mantra of steady sustainable growth in the company. We don't like growth for growth's sake. We really want growth which is consistent with our long-term appetite for good returns on capital employed and for sustainable growth.*[35]

Main changes to our portfolios

Some people look... and say, 'Wow, you're changing.' I say, no, we're not changing at all. The opportunities that the market is creating have changed.
— Bill Nygren

The following is a summary of the most significant changes to our funds' portfolios:

HOROS VALUE INTERNACIONAL
Stake decreases & exits:

COMMODITIES (16%)
Holdings discussed: Spartan Delta (exited) and TGS (exited)

Two companies that gave us exposure to the oil and gas sector exited the portfolio this quarter. Specifically, we sold **Spartan Delta** following the sale of the bulk of its Montney area assets to **Crescent Point Energy**. The management team of **Spartan Delta** had already communicated a few months ago that they were not satisfied

[35] Graham Neary - Financial and Investment Commentary (November 23, 2018). Cube Podcast #5: Interview with S&U plc (SUS). Youtube. https://www.youtube.com/watch?v=AV59FXyNNU0

with the company's market valuation and that they would seek the best alternative to unlock its value. Finally, they decided to divest these assets at a somewhat lower valuation than our estimates, and will mainly retain the Deep Basin assets, which require less capex and therefore have a more stable cash generation profile for the next few years. Although we are convinced that **Spartan Delta**'s management team will continue to do an excellent job at the operational and capital allocation levels, our conservative approach to this type of investment means that we prefer to sell our position after this corporate deal, which in our opinion leaves the company unattractive relative to other alternatives that we added to the portfolio during the quarter.

The strong performance of **TGS** in recent months led us to exit the position, as its margin of safety was no longer wide enough. Certainly, **TGS** is a clear example of how we can benefit from continuously monitoring our old portfolio holdings, waiting for the best moment to invest in them again. If we include our previous professional stage, this is the fifth time we have bought shares in the company, taking advantage of cyclical downturns in the industry in which it operates. On each occasion we have earned significant returns, so let us hope for a sixth time!

OTHER

Holdings discussed: Naspers (4.1%), Aoyuan Healthy Life (0.6%), Dassault Aviation (exited) and MBIA (exited)

Let us begin with the companies exiting the fund. We sold our entire stake in the aviation and defense company **Dassault Aviation** following its outperformance over the period. This was also the case with **MBIA**, where the announcement of the hiring of Barclays to seek the best value creation alternatives for its shareholders (including the sale of the company itself) contributed to its strong performance. As with **TGS**, **MBIA** is an example of an investment in which we have been in and out on several occasions, always delivering a very positive return for Horos Value Internacional.

Meanwhile, we trimmed our stake in **Naspers** after a more than 40% gain in the fourth quarter of last year. Despite this, we continue to hold a very significant position in the South African holding company that owns a major stake in the Chinese technology giant **Tencent Holdings** ("Tencent"). The reasons? Our positive outlook for the Tencent business, the possibility of acquiring that business at a discount through **Naspers** and, not least, **Naspers'** optimal current capital allocation decisions, which are creating huge value by selling **Tencent** shares and, with those proceeds, "buying them back" at a discount when acquiring **Naspers** shares.

Finally, this quarter we cut our valuation of Chinese real estate services company **Aoyuan Healthy Life** (which has been unlisted for months, awaiting the release of pending earnings reports) following the news that its parent, developer **China Aoyuan**, had sold more than half of its stake in its subsidiary (29.9% of the shares) at a price of HK$1.179 per share (about a 35% discount to the average of its last five trading days). Based on this new market information, we decided to adjust our valuation to this transacted price.

Stake increases & new stakes:

COMMODITIES (16%)

Holdings discussed: Mistras Group (4.5%) and Atalaya Mining (2.7%)

We increased our stake in **Mistras Group** during the quarter in view of the evident recovery of its business this past 2022, as well as our solid cash generation prospects for 2023 and the following years. The company has continued to reduce its debt and has also announced important measures to execute a cost-cutting plan that will undoubtedly contribute to improving the profitability of the business and its cash-generating ability. We believe that the company is completely off the radar of the investment community, both because of its exposure to the oil and gas industry (to which it provides inspection, testing and maintenance services) and because of its small size (about $150 million market capitalization at year-end 2022), which is creating a great investment opportunity.

Additionally, we increased our investment in **Atalaya Mining**. The positive outlook for the copper price, as well as the upbeat news that the company is releasing on some of its undeveloped assets, lead us to raise our conservative valuation of this business, which is extremely well managed by Alberto Lavandeira.

FINANCIALS AND HOLDINGS (30%)

Holdings discussed: Pershing Square Holdings (1.9%)

After nearly five years out of **Pershing Square Holdings** ("Pershing"), in which it has appreciated by approximately 130%, we re-initiated a new stake in this vehicle managed by Bill Ackman. Why have we done so after this rally? Because the market is not recognizing the value created over the period by the investments in this vehicle. In fact, at the time we opened this position, **Pershing**'s discount to NAV

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was at an all-time high (c. 35%). We do not believe this large discount makes sense, especially after Ackman's excellent results in recent years and with a portfolio invested in businesses that are generally of high quality and stable cash generation. Obviously, Ackman does not share the market's view either and is taking advantage of the discount to generate value by buying back its own shares. For all these reasons, and assuming a conservative return on its investments over the next few years, we find that **Pershing**'s attractive risk-return trade-off justifies adding it back to our portfolio.

OTHER

Holdings discussed: Applus Services (2.1%), AmRest Holdings (2.0%) and Elecnor (1.4%)

We have long argued that the Horos Value Internacional portfolio will always reflect the best investment ideas we find in the world and, as we also emphasize, this includes the Spanish market. A market that we know very well and that, for many reasons, is today off the radar of investors. When this happens, it usually generates great investment opportunities (Hong Kong would be an even more extreme case). Reflecting what I have just mentioned are the new stakes initiated this quarter in **Applus Services**, **Elecnor** and **AmRest Holdings** ("AmRest"). Since the first two have already been explained on other occasions, being present in Horos Value Iberia, I will focus on **AmRest** (in which we also invested with our Iberian fund).

AmRest is the largest independent operator of multi-brand restaurant chains in Central and Eastern Europe. The company is, on the one hand, a franchisee of top-tier brands such as KFC, Pizza Hut, Starbucks and Burger King and, on the other hand, owner of brands such as La Tagliatella and Sushi Shop, in which it acts both as franchisor and operator of its own restaurants. The company went through a difficult period in 2020 with the Covid-19 pandemic, although it managed to overcome it without a capital raise that would have been extraordinarily dilutive for its shareholders. Despite the company's recovery in FY2021, Russia's invasion of Ukraine, which began in February 2022, led **AmRest** to exit Russia, whose business accounted for more than 10% of revenues and 12% of EBITDA of the group's total. This, among other problems, caused the company's share price to fall by 30% in 2022. We believe that a leading company like **AmRest**, managed by a family with a long-term vision, with an excellent reputation among its franchisors and with a lot of experience in the sector and in the markets where it operates, will generate solid future returns for shareholders, overcoming the current market problems.

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HOROS VALUE IBERIA
Stake decreases & exits:

OTHER

Holdings discussed: Vidrala (exited) and Altia Consultores (exited)

This quarter marks the exit of **Altia Consultores** ("Altia") from our Iberian portfolio, a company in which we invested when it had a market capitalization of just over €20 million and which has since multiplied its value almost tenfold. The reason for selling the position is very simple. As much as it pains us, after so long as shareholders, we believe that its margin of safety no longer justifies keeping our stake in the Galician consulting firm. But what did we see as so special about this small business to invest in it back in 2013 and, in particular, to remain loyal shareholders for so many years? Possibly what struck us most at the time was its corporate culture. A hallmark of the group's identity, fiercely championed by Tino Fernández, its chairman and largest shareholder. I still remember how much we were impressed by the first meeting with Tino, showing his frankness, professionalism and continuous focus on cost containment, three essential attributes to thrive as a business in the competitive consulting sector, where poor execution can mean losing reputation and greatly diminishing its usual meager margins.

Over time, **Altia** also impressed us with its excellent capital allocation decisions, acquiring businesses at always attractive prices (such as the bargain purchase of Exis or the more complex, due to the pandemic situation, acquisition of Portugal's Noesis) and creating significant value for its shareholders. In addition to optimal capital allocation, there was an extraordinary human team, made up of the company's veterans, Nacho Cabanas (CFO and director), Fidel Carrasco (director of corporate development and director) and Moncho Costa (director of managed services and director) and the younger members, Luis Castro (Noesis' CFO) and Lola Suárez (corporate development). They were all always very professional in our interactions and willing to dedicate their time to help us better understand the company's business. This cocktail of alignment of interests, human team and unwavering corporate culture explains why we have enjoyed a cumulative return of approximately 1,000%, including dividends, in this unforgettable adventure as investors. We would like to express our enormous gratitude to Tino and his wonderful team.

Furthermore, we exited our investment in the glass container manufacturer **Vidrala** after its strong stock market recovery. The company benefited greatly from the margin expansion experienced by its business, following the price increases passed on to its customers and the significant drop in energy costs.

Stake increases & new stakes:

OTHER

Holdings discussed: Atalaya Mining (4.1%), AmRest Holdings (3.5%) and Grupo Ecoener (2.4%)

The stake increase in **Atalaya Mining** and the addition of **AmRest Holdings** to the portfolio are for the same reasons already explained above. Regarding the increased weighting in **Grupo Ecoener**, we took advantage of the share price correction during the quarter (which brought it to all-time lows) to increase our exposure to this company that develops and operates renewable energy assets, which is currently trading at a valuation that does not give any value to its pipeline of projects.

Highlights:

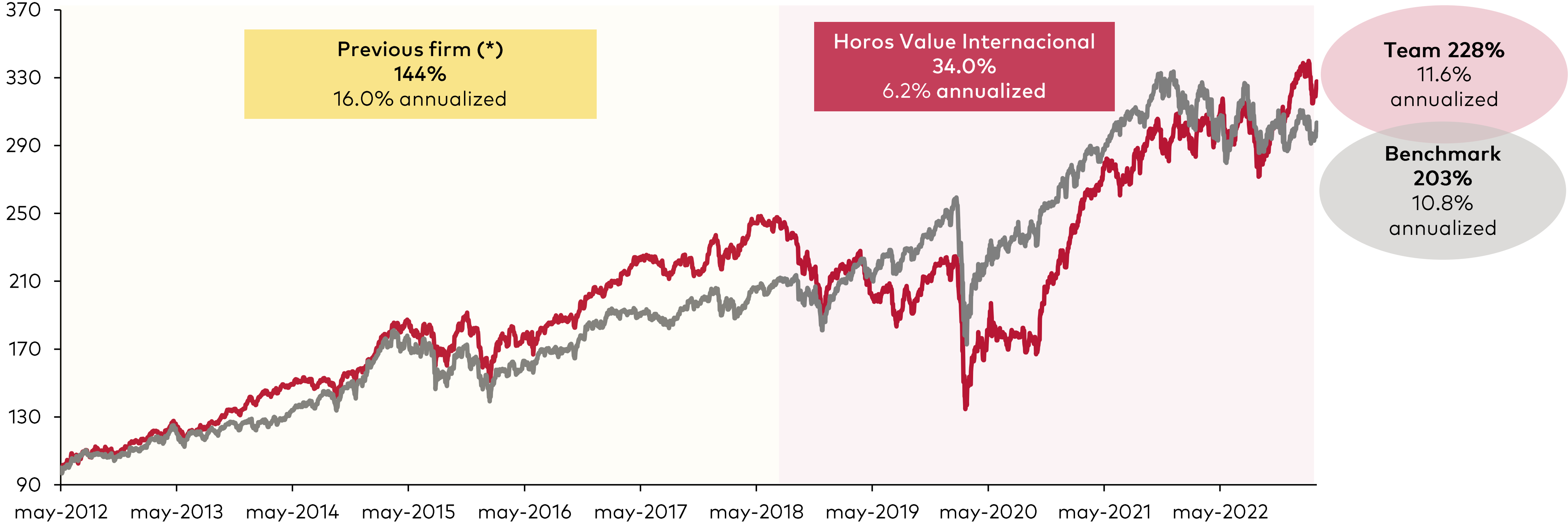
OTHER

Holdings discussed: Sonaecom (2.4%)

As we pointed out in our previous quarterly letter, **Sonaecom** received a takeover bid on December 21 last year from the Portuguese holding company **Sonae**, which already controlled close to 90% of the company. We also commented that the offered price of €2.5 per share was far from a reasonable valuation. For this reason, we decided to communicate our disagreement and reasoning to the Portuguese regulator. The good news is that, after the deadline for the takeover bid, **Sonae** has not achieved sufficient acceptance by the rest of the shareholders, so the deal has not prospered and will have to wait, at least twelve months, to try a new assault (hopefully at more reasonable prices if a new offer is made).

Returns

Historical returns of the management team in the **International Strategy**



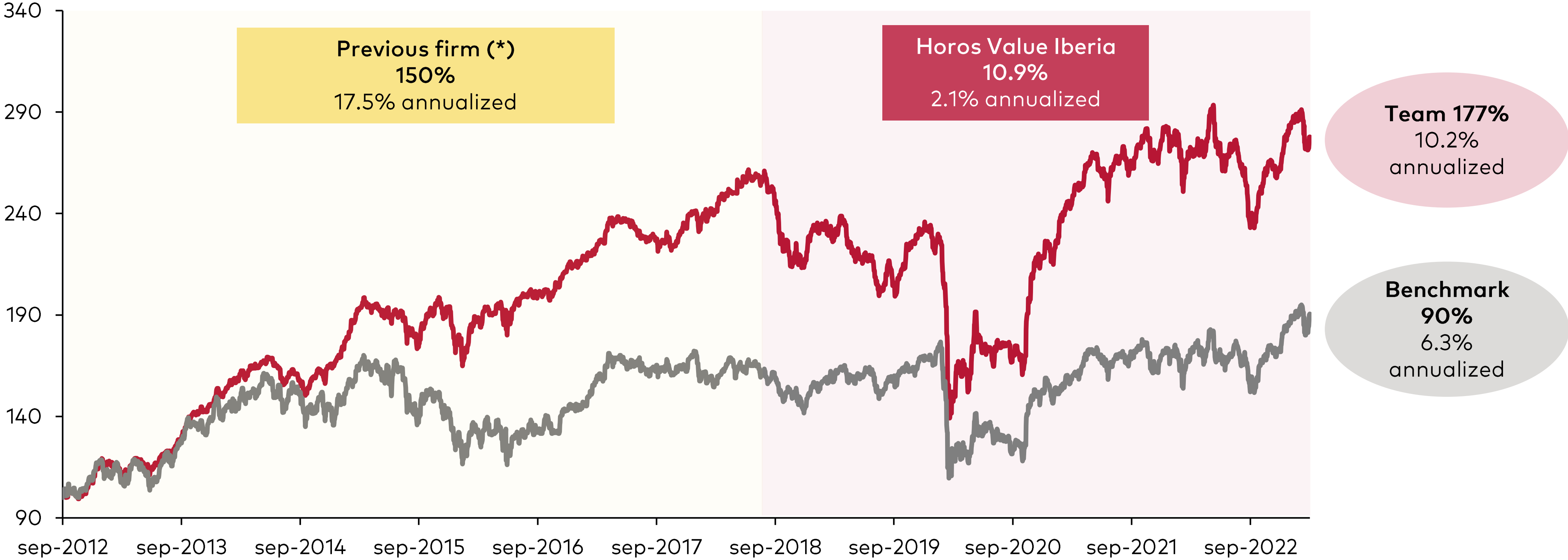
Data cover the period between the 30th May 2012 and 31st March 2023.

*Previous firm returns correspond to the management team performance achieved in their previous profesional stage, where they worked for a different asset management firm. This "previous stage" corresponds to the period between the 30th May 2012 and 22nd May 2018.

Past performance is no guarantee of future performance. The Fund's investments are subject to market fluctuations and other risks inherent to investing in securities, so the acquisition of the Fund and the returns obtained may vary both upwards and downwards and an investor may not recoup the amount initially invested. Decisions to invest or divest in the Fund must be made by the investor in accordance with the legal documents at all times, and in particular on the basis of the Regulations and the Fundamental Data for the Investor (DFI) of each Fund, accompanied, where appropriate, by the Annual Report and the last quarterly Report. All this information, and any others, will be available to you at the headquarters of the Manager and through the website: www.horosam.com

Returns

Historical returns of the management team in the Iberian Strategy



Data cover the period between the 30th September 2012 and 31st December 2022.

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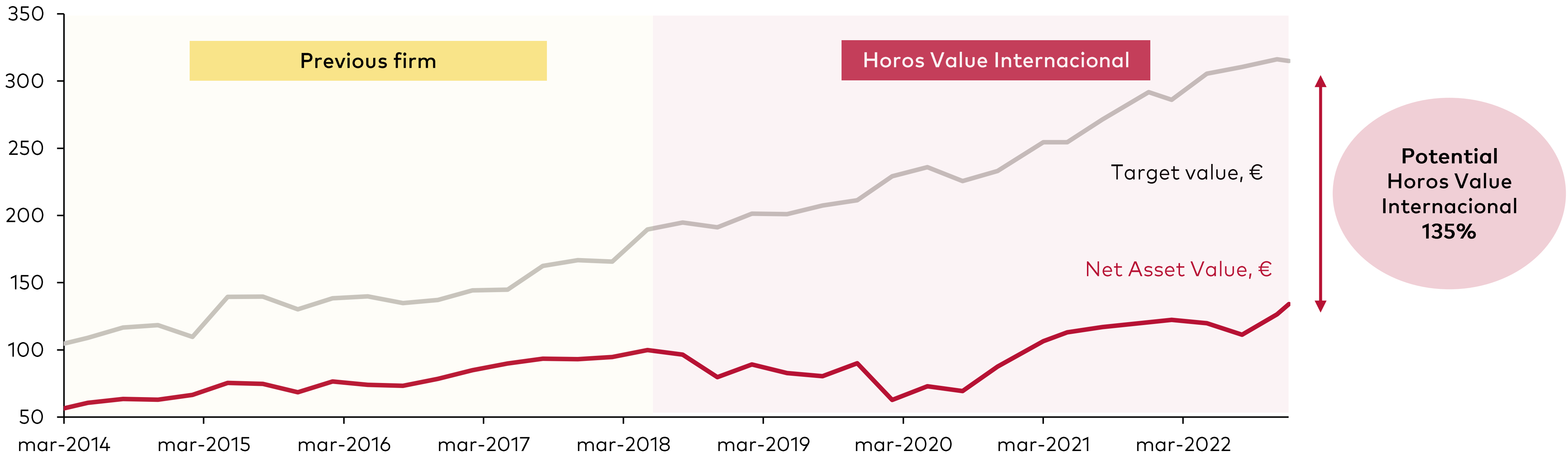
Upside Potential

Target value vs. Net Asset Value of the **Management Team**



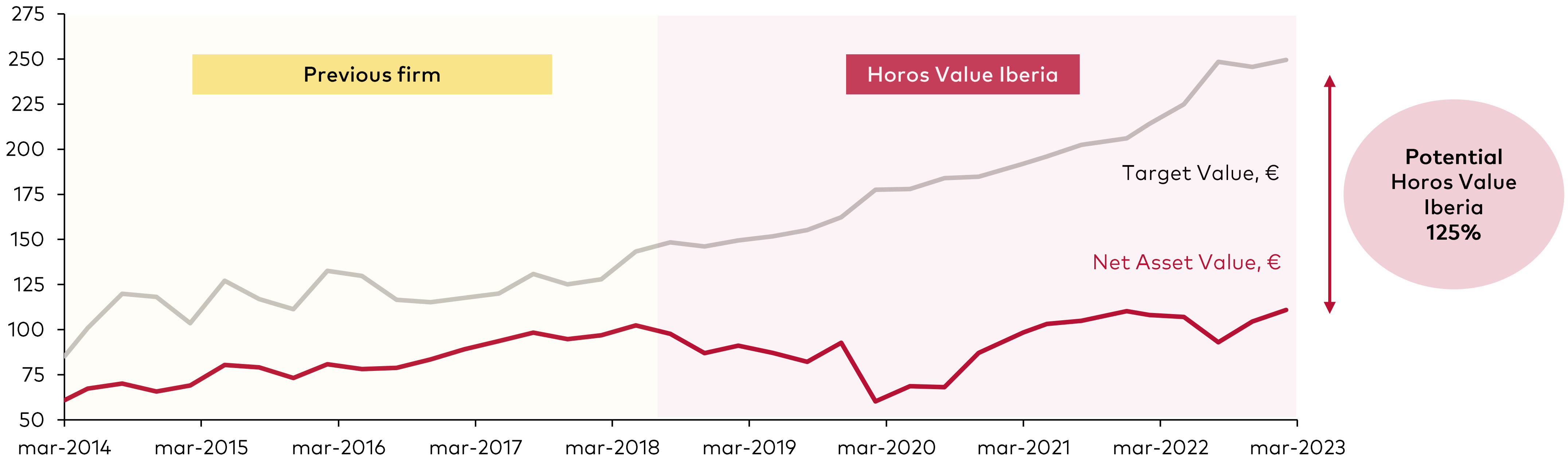
Data cover the period between the 31st March 2014 and the 31st March 2023.

Previous firm data correspond to the period when the management team worked for a different asset management firm. For the NAV calculation, this previous firm performance has been used, and as a base for retrieving the simulated NAV within this period, the NAV of Horos Value Internacional at 23rd May 2018, the day when the management team joins the project.

For the target value calculation, we perform an individual assessment of each Investment included in the portfolio. Specifically, we make a three-year estimate of the value of each company in which we invest. To do this we calculate, in a conservative way, the future cash flows we think the business will generate over the next three years in order to estimate the company future value (understood as market capitalization adjusted for net financial position). Subsequently, with this data we estimate the EV/FCF multiple (future value of the company divided by its normalised free cash flow, adjusting the latter for extraordinary items) at which each company would be priced. Finally, as a result of the qualitative analysis we do on each company, we assign an exit multiple to each investment (how much we think each business is worth trading at) and compare it with the previous figure to estimate the potential or attractiveness of the investment. Occasionally, given the nature of the investments, other generally accepted valuation methods would be used such as sum of parts, discounted cash flow or price to book value multiples.

Upside Potential

Target value vs. Net Asset Value of the **Management Team**



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Top 10 Holdings
Horos Value Internacional

Holding	%	Theme
Mistras Group	4.6%	Industrial
Semapa	4.3%	Financial
Naspers	4.2%	TMT
ALD Automotive	4.2%	Financial
Aercap Holdings	3.9%	Financial
Fairfax India	3.8%	Financial
Catalana Occidente	3.4%	Financial
Gestamp Automocion	3.2%	Industrial
Sung Hung Kai and Co	3.0%	Financial
Aperam	2.9%	Commodities

Top 10 Holdings
Horos Value Iberia

Holding	%	Theme
Semapa	7.0%	Financial
Horos Value Internacional	6.3%	Financial
Catalana Occidente	6.1%	Financial
Iberpapel	5.3%	Industrial
Gestamp	5.2%	Industrial
Merlin Properties	4.7%	Real estate and construction
Aperam	4.6%	Commodities
Elecnor	4.4%	Engineering
Atalaya Mining	4.1%	Commodities
Applus	4.0%	Engineering