Gold Investment
Portfolio Manager

Investment Letter

Q1-23 Investment Letter (No. 63)

April 25, 2023

OVERVIEW

Dear Clients and Friends,

We are pleased to provide this quarterly report for the period ended March 31, 2023. This report will be divided into three sections: (1) What's New, (2) Market Recap, and (3) Commentary.

WHAT'S NEW

FIRST HOME SAVINGS ACCOUNT (FHSA)

We are pleased to announce that our custodian, Credential Qtrade Securities Inc., will soon be offering First Home Savings Accounts (FHSA). FHSA are a new registered savings account designed to help first-time homebuyers save for a down payment on their first home on a tax-free basis, ***up to certain limits.***

Once you've opened an FHSA, you can contribute up to $8,000 per year, up to a ***lifetime maximum of $40,000***.

The contributions are tax-deductible, which means that you can claim them as a deduction on your income tax return, which can help reduce your tax bill. Additionally, any income earned within the account will grow tax-free.

When you're ready to purchase your first home, you can then withdraw the funds from your FHSA tax-free and you do ***not*** have to pay the funds back.

To qualify for an FHSA – you must fit the below criteria:

- be 18 years of age or older
- be a first-time home buyer – *you have not owned a home in the last four years*
- be a resident of Canada
- have a SIN

It is possible to use the First Home Savings Account (FHSA) in conjunction with the Home Buyers' Plan (HBP) feature within a Registered Retirement Savings Plan (RRSP).

If you have any questions or would like more information, please do not hesitate to contact our admin department at 780-436-9955 or clientexperience@gold-im.com.

2023 REVIEWS

GIM would like to remind you of its obligations to conduct annual “Know Your Client” (“KYC”) reviews. Investment reviews are a great way for us to update you on your account and for you to keep us informed on your personal and financial circumstances so we can best serve you. You may receive communication from our admin department shortly to schedule a review with one of our portfolio managers. If you wish to speak with someone or have a change in your circumstances, please do not hesitate to contact our office anytime.

ACCOUNT CONTRIBUTIONS

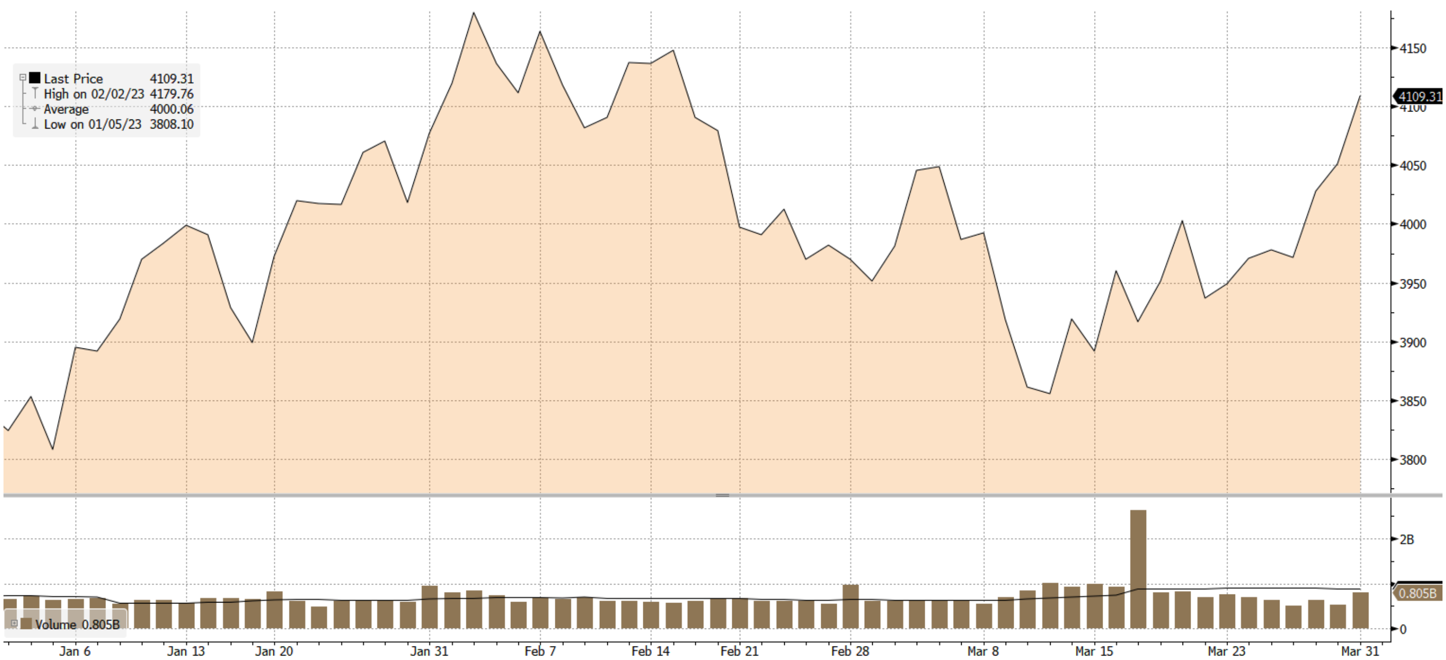
There are numerous benefits to contributing to your investment accounts regularly, including:

- Increasing your savings for retirement, emergencies, children’s education, a home purchase, or other purposes. We target securities that are deeply discounted and provide the great value.
- Take advantage of *dollar cost averaging,* where securities are purchased at regular intervals to lower your average cost over time and thereby increase your overall returns.
- Some contributions may generate additional grant or bond payments from the government when deposited to education or disability savings plans (subject to contribution room and government grant/bond conditions).

There are many convenient ways you can deposit to your investment accounts. You can make a bill payment (not e-transfer) through your online banking, electronically sign a form for a one-time pull from your chequing account or write a cheque. You may make a one-time deposit or set up automatic recurring deposits with a frequency that works well for you. We remind all clients to check their contribution room for any registered account before contributing. For instructions or assistance with any of these methods or help checking your room with Canada Revenue Agency, please contact our office and speak with our Client Experience team.

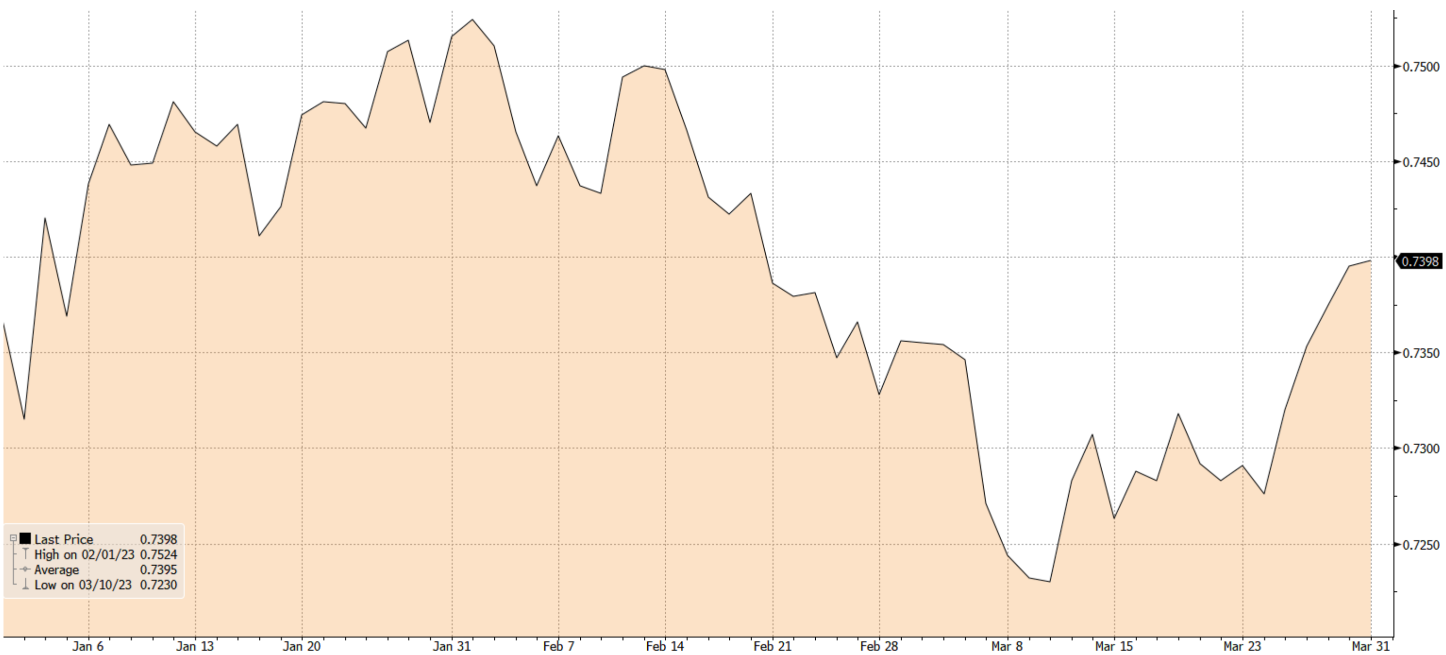
MARKET RECAP

The S&P 500 Index (in USD) increased 6.64% for the three-month period ending March 31, 2023. The Index hit a high of 4,179.76 on February 2 after its low of 3,808.10 on January 5, 2023.



The S&P/TSX Composite Index increased 2.91% in the first quarter of 2023. The Index reached a high of 20,767.38 on January 31, compared to its low of 19,378.84 on March 15.

The Canadian Dollar quoted in USD (CADUSD) closed almost flat, with a smll increase of 0.04% during the first quarter of 2023. CAD/USD closed at a low of 0.7230 on March 10, 2023, after it reached a high of 0.7524 on February 1, 2023.



COMMENTARY

This quarter's newsletter covers 3 different topics. We had started writing the newsletter on April 10 when the latest update on FTX came across our desk. We could not resist talking about it. The second part of our newsletter is on interest rates, inflation and household debt. We conclude with a discussion about the recent failures of small U.S. banks.

Part 1. FTX Crypto-Exchange Downfall

FTX, the cryptocurrency exchange, went under in spectacular fashion in late 2022. The 31-year-old founder, Sam Bankman-Fried, had convinced sophisticated investors that he was a genius.[1]

FTX was worth US$32 billion at its peak.[2] Investors in FTX included well known institutions such as Sequoia Capital, Softbank, Tiger Global Management, BlackRock and Ontario Teachers' Pension Plan. This list includes retired NFL player Tom Brady and his supermodel ex-wife Gisele Bundchen. Ontario Teachers' put in US$95 million.[3] Collectively investors provided almost US$2 billion.

A report by the new managers appointed by FTX's creditors was filed with the Delaware bankruptcy court on April 9, 2023. This report is fascinating, even salacious. A new item that we have not seen before was a computer hack that cost US$432 million in stolen funds, blamed on non-existent cyber controls. *What is profoundly disturbing is that Mr. Bankman-Fried and his managers were unaware of the hacking attack and gigantic theft.*

The opening remarks of the report are particularly damning, with emphasis ours.

> "Despite the public image it sought to create of a responsible business, the FTX Group was tightly controlled by a small group of individuals who showed little interest in instituting an appropriate oversight or control framework. ***These individuals stifled dissent, commingled and misused corporate and customer funds, lied to third parties about their business, joked internally about their tendency to lose track of millions of dollars in assets***, and thereby caused the FTX Group to collapse as swiftly as it had grown. In this regard, while the FTX Group's failure is novel in the unprecedented scale of harm it caused in a nascent industry, many of its root causes are familiar: ***hubris, incompetence, and greed***." [4]

Hubris *(húbris)* is extreme or excessive pride or dangerous overconfidence, often in combination with arrogance.[5] We are reminded of Leonardo DiCaprio portraying Jordan Belfort in The Wolf of Wall Street who magnificently said,

"One thing I can promise you, even in this market, is that I never ask my clients to judge me on my winners. I ask them to judge me on my losers because I have so few."

Here's a direct quote from Mr. Bankman-Fried about Alameda Research, FTX's sister company, which demonstrates his hubris. Again, the emphasis is ours.

> "Alameda is ***unauditable***. I don't mean this in the sense of "a major accounting firm will have reservations about auditing it"; I mean this in the sense of "we are only able to ballpark what its balances are, let alone something like a comprehensive transaction history." ***We sometimes find $50m of assets lying around that we lost track of; such is life***." [4]

At least this arrogance explains why he didn't notice hackers stealing US$432 million from his firm. Sometimes the truth is stranger than fiction.

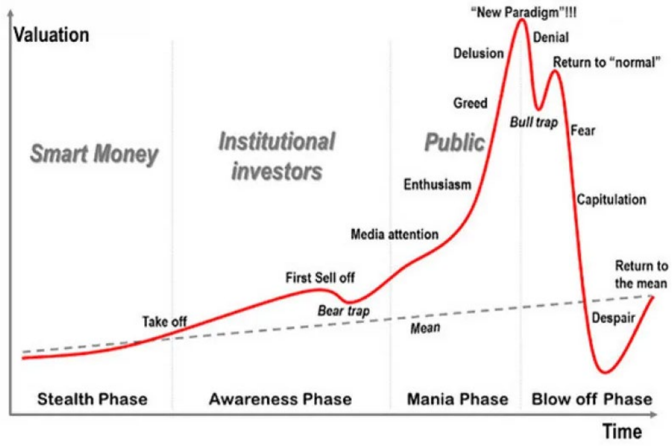
Mr. Bankman-Fried has been charged with several financial crimes and is currently out on US$250 million bail.[6] The bail amount is spectacular because Bernie Madoff, who was behind the world's largest Ponzi scheme at US$65 billion[7], only had to post US$10 million bail. Mr. Bankman-Fried will get his day in court to defend himself. Unfortunately, his investors will likely get nothing back.

[1] https://www.investopedia.com/what-went-wrong-with-ftx-6828447
[2] https://www.cnbc.com/2022/01/31/crypto-exchange-ftx-valued-at-32-billion-amid-bitcoin-price-plunge.html
[3] https://variety.com/2023/digital/news/ftx-investors-img-tom-brady-robert-kraft-1235484342/
https://www.nytimes.com/2022/11/11/technology/ftx-investors-venture-capital.html
[4] https://www.courtlistener.com/docket/65748821/1242/1/ftx-trading-ltd/
[5] https://en.wikipedia.org/wiki/Hubris
[6] https://www.nytimes.com/2022/12/23/nyregion/sbf-bail-agreement-explained.html
[7] https://www.investopedia.com/terms/b/bernard-madoff.asp

Conclusion. The collapse of FTX and its related companies is a cautionary tale for investors.

- Firstly, if something sounds too good to be true it probably is. We have repeatedly said low risk and high reward is not possible. There is no such thing as getting "something" for "nothing".
- Secondly, even sophisticated investors can miss the warning signs that are only evident in hindsight. Almost US$2 billion was invested into FTX and it is likely the recoverable amount is negligible. The legal, auditing and regulatory costs of winding down FTX will probably be far greater than what investors get back.
- Thirdly, and a corollary to the second, is that new investors are at a disadvantage. Neophyte investors are as smart as everyone else, but they don't know what they don't know. The best teacher in the investing world is our worst mistakes. No amount of theory extracts a better lesson than a bad trade.
- Finally, there is a big difference between speculation and prudent risk taking. Speculative investments have a mania phase where everyone wants in because it appears to be easy money; this peaks with the *"New Paradigm"!!!* The next phase is the blow off where the bubble starts bursting; this usually means a permanent loss. In contrast, prudent investing means that investments will survive through an up/down investing cycle and will be set to participate in future cycles. A common mistake by DIY investors they confuse the difference between speculation and prudence.

Chart 1 – The New Paradigm



Source: Dr. Jean-Paul Rodrigue Dept. of Global Studies & Geography Hofstra University

Part 2. Interest Rates and the Perils of Debt

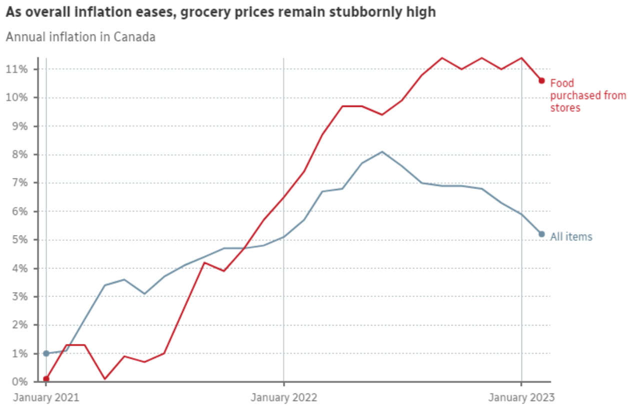
On April 12, 2023, the Bank of Canada ("BoC") kept its overnight rate unchanged at 4.50%. The overnight rate – also called the policy interest rate – is the rate at which major participants in the money market borrow and lend one-day funds to each other.[8]

In his remarks the BoC's Governor, Tiff Macklem, said the "policy rate may need to remain restrictive for longer to return inflation to the 2% target".[9]

This is what we've been telling clients during their annual reviews. Raising interest rates to fight inflation was the easy work. The hard work is to get inflation down to the target 2%. In February 2023, general inflation was 5.2%[10] but food inflation remained stubbornly double digit at 10.6%.[11]

[8] https://www.bankofcanada.ca/rates/indicators/key-variables/policy-instrument/
[9] https://www.reuters.com/markets/bank-canada-says-rates-may-have-remain-restrictive-longer-2023-04-12/
[10] https://www.rateinflation.com/inflation-rate/canada-historical-inflation-rate/
[11] https://www.cbc.ca/news/business/canada-inflation-february-2023-1.6785472

Chart 2 – Inflation Trend Canada

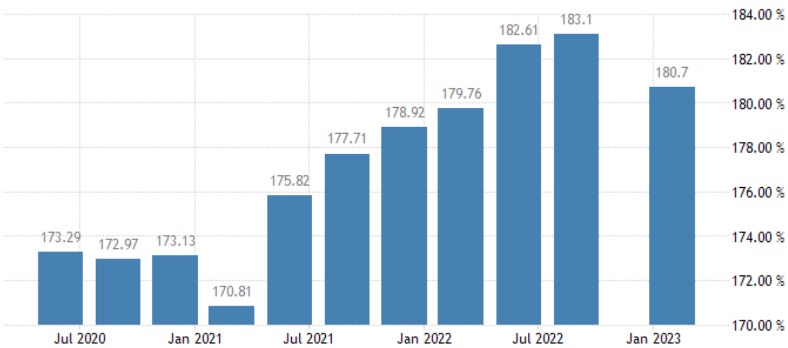


Source: www.cbc.ca/news/business/canada-inflation-february-2023-1.6785472

Inflation is making the cost of living more expensive, so it is imperative to get it down. But high interest rates are also causing enormous stress on Canadian households.

Canadians' debt was already at record highs before interest rates shot up last year. The chart below, courtesy of Trading Economics, shows the level of household debt to disposable income is near a record high of 180.7%. This level of debt is higher than pre-COVID19 pandemic. This means that for every dollar of after-tax income there is $1.81 of debt. Debt in this case includes consumer credit, mortgages and non-mortgage loans.[12]

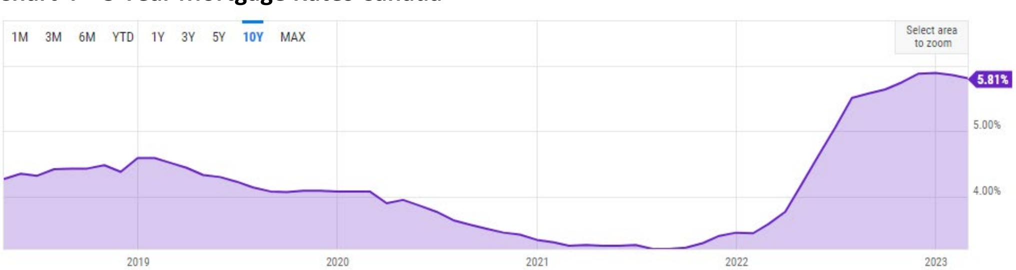
Chart 3 – Canadian Household Debt to Disposable Income



Source: https://tradingeconomics.com/canada/households-debt-to-income

With high inflation households cannot afford an increase in their mortgage rates. In 2021, the average 5-year mortgage was as low as 3.20% and some clients told us they were able to get even lower rates. The current average 5-year mortgage rate is 5.81%.[13] The median house price in Canada was $703,875 in calendar 2022.[14] Assuming a family purchased at this average price with a 20% down payment and locking in a 3.2% rate, the monthly payment is $2,723 over 25 years. If the same family has to use a 5.81% rate the monthly payment is $3,539, a jump of $816.[15] Not all of the disposable income can go to servicing debt. There needs to be money for essentials like food, utilities, vehicles, insurance and gasoline. Now add an extra $800 a month to pay higher mortgage costs and Canadian households have a problem.

Chart 4 – 5 Year Mortgage Rates Canada



Source: https://ycharts.com/indicators/canada_5year_conventional_mortgage_lending_rate

[12] https://www150.statcan.gc.ca/n1/daily-quotidien/221212/dq221212a-eng.htm
[13] https://ycharts.com/indicators/canada_5year_conventional_mortgage_lending_rate
[14] https://www.statista.com/statistics/604228/median-house-prices-canada/#
[15] https://tools.td.com/mortgage-payment-calculator/

The pain to the Canadian household from inflation and higher borrowing costs is very real. Many households may have locked in at lower rates but those that have renewals in the upcoming year will be in for an unpleasant surprise.

The Bank of Canada believes such pressure on Canadians will ultimately result in lower interest rates. Our friends at Desjardins Securities articulates the BoC strategy nicely:

> *"As households renew their mortgages, more income will be devoted to debt-service costs which will weigh on consumption and GDP. Also similar to our forecast, the BoC sees economic slack opening up in the second half of this year. By the end of the year, officials see inflation back down to 2.5%."* [16]

Conclusion. The Canadian economy is going through a good old fashioned economic cycle. High inflation begets high interest rates to fight inflation. The average Canadian household will be going through an unpleasant time with high cost of living and increased costs to servicing debt. The unknown is going to be how long we have to endure this combination of high inflation and high interest rates.

As for the investment markets, higher volatility has accompanied this part of the economic cycle. Investors will see their accounts fluctuate more. In our view this is normal and just a feature of the investment cycle.

Part 3. U.S. Bank Runs and the Failure of Asset/Liability Management

We end our newsletter with a topic that set the financial media alight in the past month. It is the bank runs in the U.S., which ended with a run on the second largest Swiss bank, Credit Suisse.

A "run" on a bank is when all the depositors want their money back. Banks never have enough cash in their system to fund such an event so a run will cause a bank to collapse. Banks take in deposits and then lend the money out or use it for investments. That's why they do not keep cash on hand. The deposits get put to work generating income and they are not necessarily liquid, meaning the bank cannot convert a loan or investment into cash immediately.

The news started with 2 small banks, Silicon Valley Bank ("SVB") and Silvergate Capital.

Silvergate Capital was a crypto-focused bank.[17] A portion of their business was providing banking services for crytpo-exchanges and crypto-dealers. The failure of FTX, discussed in Part 1 of this letter, was the catalyst for a run and FTX was one of Silvergate's clients. The fact that a bank was simply dealing with a crypto firm was enough for depositors to get jittery. In bank-speak we call this *conjunctive risk*.

We put on our analyst hat and looked at their Dec. 31, 2022 results.[18] We wish we didn't. A bank's main business is lending money. Silvergate had a miniscule US$1.086B of loans compared to their holding of $9.83B of securities – largely government bonds (this embarrassing disclosure is buried deep in the press release). So, they took in deposits and bought bonds instead of doing what normal banks do, which is to lend the money out with depositors' money.

When interest rates shot up in 2022 the price of the bonds fell. When depositors showed up to take their money out, Silvergate had to liquidate their bonds at a loss; the bonds may have been perfectly safe, but they had to be sold to give depositors back their money. Silvergate took a $886 million loss on the sale of their bond holdings for 2022. The combination of association with crypto and lack of money for depositors set off a run on Silvergate which resulted in its collapse.

Silicon Valley Bank (SVB). We also dove into the annual report (called a 10-K). SVB did what Silvergate did with its deposits, except it was even more self-destructive.[19]

[16] Morning Pulse, Desjardins Securities, April 13, 2023
[17] https://www.barrons.com/articles/silvergate-short-sellers-bank-collapse-bfc88b93
https://www.marketwatch.com/story/what-happened-to-silvergate-capital-and-why-does-it-matter-28cd13a
[18] https://ir.silvergate.com/news/news-details/2023/Silvergate-Capital-Corporation-Announces-Fourth-Quarter-2022-Results/default.aspx
[19] https://www.techtarget.com/whatis/feature/Silicon-Valley-Bank-collapse-explained-What-you-need-to-know#
https://s201.q4cdn.com/589201576/files/doc_financials/2022/q4/4Q22-SIVB-Earnings-Release-Final.pdf
https://www.ft.com/content/f9a3adce-1559-4f66-b172-cd45a9fa09d6
SEC Form 10-K 2022

SVB specialized in providing banking services to technology start-ups. These companies are funded by venture capitalists, so they will typically have tens if not hundreds of millions of dollars on deposit. SVB received significant deposits from tech start-ups starting in 2020, the year of the COVID-19 pandemic. Tech start-ups were popular as there was a demand for technology as people around the world isolated and worked from home or remote locations. SVB took in these deposits and didn't buy just low risk government bonds; they also bought mortgage bonds. Mortgage bonds are even more sensitive to rising interest rates than government bonds.

Chart 5 – SVB's Hold to Maturity Bonds

	December 31, 2022									
	Total		One Year or Less		After One Year to Five Years		After Five Years to Ten Years		After Ten Years	
(Dollars in millions)	Net Carry Value	Weighted Average Yield	Net Carry Value	Weighted Average Yield	Net Carry Value	Weighted Average Yield	Net Carry Value	Weighted Average Yield	Net Carry Value	Weighted Average Yield
U.S. agency debentures	$ 486	1.91 %	$ 1	2.39 %	$ 118	2.50 %	$ 367	1.72 %	$ —	— %
Residential MBS:										
Agency-issued MBS	57,705	1.56	—	1.65	25	2.38	1,066	2.32	56,614	1.54
Agency-issued CMO - fixed rate	10,461	1.48	—	—	90	1.47	129	1.71	10,242	1.48
Agency-issued CMO - variable rate	79	0.74	—	—	—	—	—	—	79	0.74
Agency-issued CMBS	14,471	1.63	39	0.45	153	0.86	966	1.93	13,313	1.62
Municipal bonds and notes	7,416	2.82	29	2.26	235	2.48	1,362	2.74	5,790	2.85
Corporate bonds	703	1.86	—	—	115	1.72	588	1.88	—	—
Total	$ 91,321	1.66	$ 69	1.25	$ 736	1.90	$ 4,478	2.43	$ 86,038	1.63

Source: SVB 10K annual report, p.66

$86B of $91B (95%) of bonds classified as "Hold to Maturity" have >10 years maturity

To spice up SVB's bond portfolio even more, 95% of its bonds classified as "Hold to Maturity" were not only mortgages and corporates, but their maturities were 10 years or longer, and long-term bonds are significantly more sensitive to rising interest rates than short term bonds.

Holding mortgage bonds *or* long duration bonds is bad when interest rates go up aggressively, like in 2022. But holding *both* is catastrophic.

When interest rates surged last year, the market price of SVB's bonds fell. When depositors started asking for their money, SVB had to sell their bond holdings at a loss. Then word spread through the venture capital community, and this caused a run on the bank.

Conclusion. Silvergate and SVB had specific issues. We are therefore quite comfortable about the integrity of the U.S. banking system.

President Biden announced on March 13, 2023 that all depositors will be made whole, which immediately stopped the runs on the banks.[20] Up until this time, only US$250,000 of deposits were insured through FDIC (in Canada $100,000 per bank account is insured through CDIC).

We are of the opinion that what happened to these small banks was not going to affect the entire banking system. While unfortunate, the problem was not bad credit – namely losses on making bad loans. We would have been quite concerned if this were the case.

Fundamentally, what SVB and Silvergate got very wrong was mismatching assets and liabilities. They held long term bonds funded by short term deposits. Most bankers would not have done anything as outlandish. Good bankers (and the vast majority of senior bankers are good) understand Asset-Liability Management, which is the matching of duration of assets and liabilities.

Finally, we point out there are almost 5,000 FDIC insured banks in the U.S. and there have been 563 bank failures since the year 2001.[21] Yet no one seemed to care until 2023 when the mainstream media decided to make an issue of it.

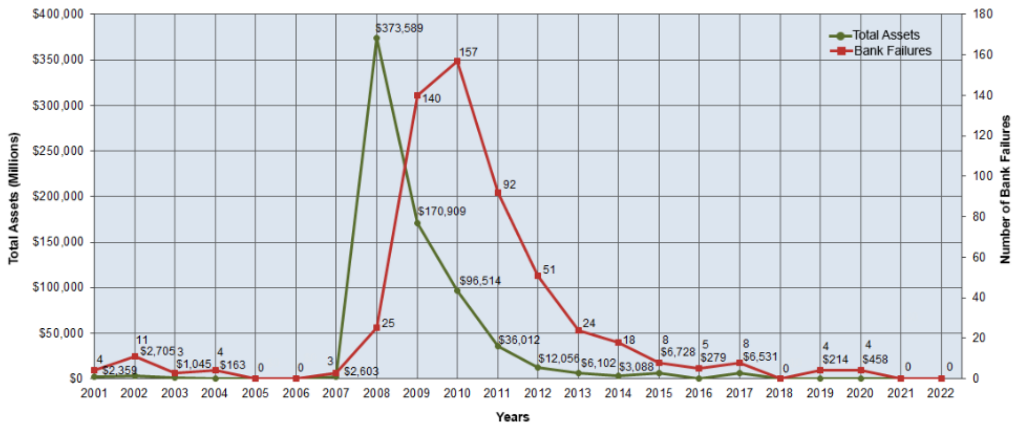
Of the bank failures, there were 4 failures in 2020 and 4 in 2019. Almost all the failures are small banks. Yet these events were never hyped in the media until, well, the media decided to hype them.

[20] https://www.cnbc.com/2023/03/13/thats-how-capitalism-works-biden-says-of-svb-signature-bank-investors-who-lost-money-in-failed-banks.html
[21] https://www.fdic.gov

Chart 6 – 563 bank failures in U.S. since 2001

Bank Failures in Brief – Summary 2001 through 2023

There were 563 bank failures from 2001 through 2023. Please select the year buttons below for more information.



Closing Summary									
	2001	2002	2003	2004	2005	2006	2007	2008	2009
	2010	2011	2012	2013	2014	2015	2016	2017	2018
	2019	2020	2021	2022	2023				

Summary by Year
(Approximate asset dollar volume based on figures from the press releases)

Years	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Bank Failures	4	11	3	4	0	0	3	25	140	157	92	51
Total Assets (Millions)	2,358.6	2,705.4	1,045.2	163.1	0	0	2,602.5	373,588.8	170,909.4	96,514.0	36,012.2	12,055.8

Years	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Bank Failures	24	18	8	5	8	0	4	4	0	0	2
Total Assets (Millions)	6,101.7	3,088.4	6,727.5	278.8	6,530.7	0	214.1	458.0	0	0	319,400.0

Source: https://www.fdic.gov/bank/historical/bank/

Part 4. Summary

All of our clients have Canadian bank accounts. The structure of the Canadian banking system is different than in the U.S.; ours is much more consolidated. If our clients have deposits with major Canadian banks, their money will be perfectly safe – Canadian bankers understand Asset-Liability Management. Our Canadian financial institutions are truly world class. They have in place security systems and safeguards against hacking and theft. There is no way they would not notice hackers stealing $432 million, unlike FTX's management.

Our biggest concern right now are the effects of inflation and high interest rates on Canadians. High interest rates and high inflation are common themes around the world, but our focus is on Canada and the U.S. where most of our clients spend their time. We are pleased to see the BoC and U.S. Fed are both focused on aggressively getting inflation under control and, with it, lowering interest rates. Until then, Canadian households will have to bear the twin pains of high inflation and high interest rates.

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Thank you for entrusting us with your investments. As always, we welcome your questions and comments. You can contact GIM by telephone: 1.888.436.9955, fax: 1.866.541.7947 or email: invest@gold-im.com

Yours truly,

GOLD INVESTMENT MANAGEMENT LTD.

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