Kevin R. O'Brien
Portfolio Manager

Jason A. Kish
Portfolio Manager

Steven R. Labbe
Portfolio Manager

John D. Gillespie
Managing Member / Founder

Q1
2023

ISSUED MAY 19, 2023

Prospector Partners Quarterly Commentary

Current Market Environment

The first quarter of 2023 was akin to a play with three distinct acts. However, unlike a traditional play in which the first act introduces a problem, the second act a complication, and a resolution in the final act, the problem in this saga (rapidly rising interest rates) pre-dates the beginning of the story. And in the end, the audience is left unsure of a resolution. (Hey, we didn't say it was a good play).

The year began with steadily decreasing treasury yields throughout January as the market inferred disinflationary signals from recent economic releases. With expectations rising for an end to Fed rate hikes and continued relative strength in the economy, talk of a "soft landing" (or even "no landing") abounded. Many of the stocks and industries that had the worst 2022 performance rallied against this backdrop of declining interest rates. For example, Tesla was up over 40% in January, Meta and Amazon were both up over 20% and growth stocks significantly beat value during the month. In fact, this trend would continue through the entire quarter and the turmoil that lie ahead, as market returns were largely driven by technology and communication services stocks. Indeed, the ten top contributors to S&P 500, dominated by stocks within these sectors, contributed almost 90% of the benchmark's total return of 7.5% in the quarter. Apple, Nvidia and Microsoft alone contributed half of the benchmark's return during the quarter.

"Act two" came in early February with a very strong jobs report, followed later in the month with CPI, retail sales and PPI all coming in above expectations. These readings caused a sharp reversal in Treasury yields as well as hawkish commentary by members of the Fed. Expectations quickly increased for peak Fed funds rate, Treasury yields marched higher, and rekindled concerns of a "hard landing" cooled the stock market.

The first quarter's tumultuous final act came in March, with the failure of Signature Bank and Silicon Valley Bancorp, causing a sharp stock market selloff and fears of bank runs and further contagion. The demise of these banks, as alluded to earlier, was partly due to the significant rise in interest rates over the preceding year. In short, this rise in yields caused negative marks to the banks' asset portfolios, which, in turn, raised concerns over the banks' weakened capital bases. Concerned depositors (a high percentage of which held balances above the FDIC insured amounts) started pulling money, and a run on the banks ensued. While the Federal Reserve and U.S. Treasury stepped in to guarantee depositors of these two institutions in an attempt to stem additional bank runs, still unresolved is to what extent bank regulations will become tighter following these bank failures. Given this recent turmoil, an update on our thinking and positioning is warranted.

Bank Sector Update

To dispel any concern, Prospector did not have direct exposure to any failed banks, or banks deemed as having a high risk of failing (such as First Republic or PacWest). We were fortunate to enter the first quarter with lower exposure to the sector relative our recent history. Despite our concern regarding securities portfolios with significant unrealized losses in tandem with tightening financial conditions, the recent string of bank runs and failures undeniably took us by surprise. We applaud regulators for quickly establishing a large emergency borrowing facility for banks (the BTFP) as a liquidity backstop, and guaranteeing deposits of the failed institutions (implicitly for future failures as well, some would argue). While raising the FDIC insurance cap above $250k would be preferable, doing so would require Congressional action.

However, we are pessimistic on the sector outlook over the short-to-medium term. While rising deposit costs have plagued the industry in recent quarters, this issue will likely become worse. We have heard of multiple banks proactively reaching out to customers to assuage fears and negotiate a higher rate to retain deposits. This crisis has been in the public "limelight" causing Americans to question the safety of their deposits, and the prospect of earning a higher rate at a competing bank or via a money market fund. Also, regional banks will likely bear increased regulatory scrutiny and related costs as a result of this crisis, in addition to higher FDIC assessment fees. This is especially true for banks with over $100 billion in assets based on policy recommendations from the White House, but could also apply to banks as large as $750 billion. Many of the proposed changes can be enacted by regulators and do not require congressional approval. In addition, we expect banks to pull in the reigns on lending which will further pressure net interest income, along with the side effect of slowing the economy. While credit quality has been strong to date, our base case is a further deterioration in credit quality and higher loan loss reserves. Finally, in the near-term it is difficult to make the case for large share buyback programs or M&A activity as the sector will likely be under pressure to build capital levels and reserves. The combination of these aforementioned factors should lead to a significant reduction in forward earnings estimates in the coming quarters.

Given this outlook, we have reduced overall exposure to the banking sector. In due time, an argument can be made that banks will once again be an attractive buying opportunity. Ultimately,

the implementation of new regulation and oversight may drive affected banks to become acquisitive in an effort to gain offsetting cost and revenue synergies. Our goal will be to identify banks that are prime takeover candidates in this scenario. However, we first require clarity on potential bank regulation, the realization of negative earnings revisions, an increase in capital and reserves, and a further deterioration in credit quality and sentiment before we begin to "warm up" to the prospect of once again being overweight banks.

Further Implications

The failures of Silicon Valley and Signature Bank will likely have significant implications not only for future banking regulations, but also for the economy as a whole. A cloud of uncertainty hangs over lending institutions, which, combined with continued risk of deposit flight, will almost certainly lead to a considerable pullback in lending. This, we fear, will have the result of further cooling an economy which is already in the midst of a Fed-hike induced slowdown. Thus, in addition to the aforementioned reduction in bank exposure, we took other actions with higher odds of a recession in mind. Long-time investors will recognize this "stock market distress playbook" as we have detailed in prior writings and have employed over the last 25+ years at Prospector. As in past times of stress, during the March turbulence, we decreased gross exposure in long/short portfolios — reducing overall risk during this period of heightened uncertainty. Additionally, we reduced cyclicality in portfolios and increased exposure to less cyclical industries like consumer staples, defense, healthcare and property-casualty insurance. While we always tend to have a low leverage, high-quality bias, we looked for any opportunities to upgrade portfolio holdings.

Make no mistake — by no means were we only "playing defense." We took every opportunity to benefit from the ensuing volatility by quickly reacting to opportunities created from uncertainty. For example, as banks sold off in March, many other non-bank financial service stocks saw significant declines in sympathy, despite having bright prospects and none of the funding concerns the banks had. We feel we were able to make purchases at attractive prices given this "baby with the bath water" reaction. We also added to industrial and technology holdings with exposure to secular growth trends of electrification and automation. These companies have solid balance sheets, produce substantial cash flows, and sell for attractive valuations. We feel our recent portfolio actions, including the aforementioned examples, leave investors on even more solid footing and well positioned for future gains.

Outlook

Over the last 15 months, the Federal Reserve has aggressively raised interest rates in an effort to lower inflation, and equity and bond market declines have been meaningful. Markets seem likely to remain volatile until interest rate increases are behind us. The U.S. and rest of the world continue to manage the impacts of high inflation, geopolitical events, China's rotation from a "zero-COVID" policy, and now, stresses within the banking system. In our assessment, the probability of Federal Reserve policy error and/or recession has increased, and now seems likely.

Employment remains strong. Supply / demand imbalances in the labor market suggest further wage gains, which partially mitigates the impact of inflation on the consumer. We expect continued pressure on housing prices as a result of higher interest rates and affordability concerns. However, the shortage of housing after over a decade of underinvestment following the Great

Financial Crisis should prevent a disastrous decline in home prices. Lower-income consumers have been most impacted by the current inflationary environment, but consumer balance sheets remain generally healthy for the majority of Americans, and consumer credit quality remains strong at the moment. COVID-related headwinds continue to dissipate. These are reasons to believe a recession could be less significant than the previous two recessionary periods.

Following years of lower interest rates helping to drive ever-higher growth-stock valuations, we feel value investing is ripe for a period of outperformance. We continue to find opportunities to invest in quality businesses with solid balance sheets and cash flows, whose share prices have detached from our assessment of the fundamentals.

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370 Church Street, Guilford, CT 06438
203.458.1500

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