Catalyst

INTEGRITY ASSET MANAGEMENT

PORTFOLIO UPDATE AND MARKET OUTLOOK

April 30, 2023

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With the Failure of First Republic Bank, I thought it was a good time to update our current thinking on the banking industry as an investment. The short answer is we are not positive. We see problems beyond the market's current focus on deposit runoff/securities losses and increased regulation. We are expecting a potential multi-year cycle of margin pressure and asset quality issues. The market, in our opinion, has not priced in these additional concerns.

The rapid rise in interest rates has a longer risk tail than just the current liquidity crisis. As I write this (4/30/2023), the going rate for a one-year certificate of deposit (CD) is roughly 5%. At least that is the rate that a bank will have to pay if they wish to attract funds. The average cost of funds in the Russell 2500 Value banks is about 1.75%. Worse, the average asset yield is about 5.0%. Assuming the average life of a bank's portfolio is five years, 20% of the assets will run off and need to be replaced. (They don't really need to be replaced and that's a discussion for another time). This will likely pressure net interest margins, profits, and returns on equity (ROE). We believe that bank stock valuations are heavily determined by marginal ROE. The expected margin compression could take a few years to cease, keeping pressure on valuations. We don't believe this is factored into today's valuations. *(continued on page 2)*

Preliminary Performance (%)

Representative Accounts

	MTD			QTD			YTD		
	Gross	Net	vs. Benchmark*	Gross	Net	vs. Benchmark*	Gross	Net	vs. Benchmark*
Small Cap Value	-1.01	-1.03	+1.49	-1.01	-1.03	+1.49	2.12	1.84	+5.25
Small/Mid Cap Value	-0.28	-0.35	+1.05	-0.28	-0.35	+1.05	3.03	2.74	+2.99
Mid Cap Value	0.28	0.21	+0.27	0.28	0.21	+0.27	2.68	2.40	+1.35
Micro Cap Value	-4.18	-4.21	-0.74	-4.18	-4.21	-0.74	-6.69	-6.95	+1.73

Source: SEI

Past performance does not guarantee future results. Representative accounts include: Integrity Small Cap Value Equity Strategy, Integrity Small/Mid Cap Value Equity Strategy, Integrity Mid Cap Value Equity Strategy, Integrity Micro Cap Value Equity Strategy. Performance is preliminary and subject to change. Benchmark comparison is versus gross performance.

Market Returns (%)

	MTD	QTD	YTD
S&P 500® Index	1.56	1.56	9.17
Nasdaq 100® Index	0.26	0.26	20.95
Russell 2000® Growth Index	-1.16	-1.16	4.84
Russell 2000® Value Index	-2.49	-2.49	-3.13

Past performance does not guarantee future results. Indices represent different segments of the market and are not correlated to the strategies above, with the exception of the Russell 2000® Value Index, which is the benchmark for Integrity Small Cap Value Equity.

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In addition to margin compression, we are becoming increasingly wary of credit quality. Credit has yet to show signs of stress. Loan losses are about 10 basis points. However, there are threats to that rosy picture. The Federal Reserve is trying to slow inflation. This entails slowing the economy and increasing unemployment. Will they hit the goldilocks soft landing? Possibly. However, a recession or slowdown is likely to bring with it increased credit costs.

Most concerning is commercial real estate (CRE). Banks were making 3-5 year CRE loans not that long ago at rates below 3%. About 40% of all CRE mortgages will need to be refinanced by the end of 2025 according to Howard Marks (Lessons from Silicon Valley Bank 4/17/2023). What happens when these loans come due? Banks can't make money lending at 3% if their marginal cost of funds is 5%. How many of these projects that were profitable at 3% will be at 6%? I don't know the answer, but my guess is not all of them. Based on this, we are expecting loan losses to increase, putting further pressure on earnings and capital. For reference, losses peaked near 1.4% of loans in the financial crisis and hit 75 basis points during the early 1990's banking crisis. They rose to 30 basis points in the early 2000s. The best of these scenarios is still a tripling of current losses.

Bank stocks have been under pressure. Most of this stems from the liquidity crisis and recent bank failures. In our view, the stocks are not currently reflecting potential multi-year pressure on earnings and capital from elevated funding costs, subdued asset yields, and declining asset quality. Integrity loves controversy. We have found some of our best ideas in situations like this. The group currently trades near book value. We think that's expensive relative to our outlook. If we are right about the coming pressures, prices should move below book value. Therefore, we don't see a favorable risk/reward opportunity right now.

Attribution:

U.S. equities, as measured by the S&P 500, ended the month with a gain of 1.56% as corporate earnings results lifted investor sentiment in the face of rate-hike uncertainty and a possible recession. For the month, the S&P 500 outperformed both the Nasdaq and the Russell 2000 Value Index which returned +0.66% and -2.49% respectively. Growth outperformed value across three of our four benchmarks, with mid cap value beating mid cap growth as the exception. Three of our four strategies outperformed their respective benchmark for the month of April. The lone exception was micro cap value, which underperformed its benchmark.

Composite Performance (%) *as of December 31, 2022*

	1 Year		5 Year		10 Year	
	Gross	Net	Gross	Net	Gross	Net
Small Cap Value	-6.67%	-7.61%	5.76%	4.71%	10.74%	9.64%
Small/Mid Cap Value	-6.97%	-7.90%	6.75%	5.68%	10.91%	9.81%
Mid Cap Value	-6.04%	-6.84%	7.29%	6.43%	11.69%	10.78%
Micro Cap Value	-10.73%	-11.63%	5.29%	4.24%	11.56%	10.45%

Returns for periods greater than one year are annualized. Returns reflect the reinvestment of dividends and other earnings and are expressed in U.S. dollars. Gross-of-fees returns for the representative account are presented before management and custodial fees but after all trading expenses.

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INTEGRITY ASSET MANAGEMENT

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All investments carry a certain degree of risk including the possible loss of principal, and an investment should be made with an understanding of the risks involved with owning a particular security or asset class. Interested parties are strongly encouraged to seek advice from qualified tax and financial experts regarding the best options for your particular circumstances.

Each representative account serves as the model against which all accounts in each respective strategy are managed. The representative accounts are actual portfolios and the information provided, including performance, will vary for other accounts. The representative accounts are being used solely as tools to help demonstrate how performance can be attributed to the investment policies applied in the management of each strategy.

Net-of fees returns reflect gross performance less investment management fees, which are calculated by deducting 1/12 of the highest tier of the standard fee schedule in effect for the period noted (the model fee). The composite model fee for each period is either the highest tier of the current fee schedule or a higher value, whichever is required to ensure the model composite net-of-fee return is lower than or equal to the composite net-of-fee return calculated using actual fees. Actual fees may vary depending on, among other things, the applicable fee schedule and portfolio size. The firm's fees are available on request and may be found in Part 2A of its Form ADV.

*The Integrity Small-Cap Value Equity Strategy is benchmarked to the Russell 2000® Value Index. The Integrity Small/Mid-Cap Value Equity Strategy is benchmarked to the Russell 2500™ Value Index. The Integrity Mid-Cap Value Equity Strategy is benchmarked to the Russell Midcap® Value Index. The Integrity Micro-Cap Value Equity Strategy is benchmarked to the Russell Microcap® Value Index.

Index returns reflect the reinvestment of dividends and other income but do not reflect advisory fees or any other expenses. Indexes are unmanaged and one cannot invest directly in an index.

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Advisory services offered by Victory Capital Management Inc., an SEC-registered investment advisor, 15935 La Cantera Parkway San Antonio, TX 78256.

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