Risk Management Amid Credit Concerns and Cockroaches

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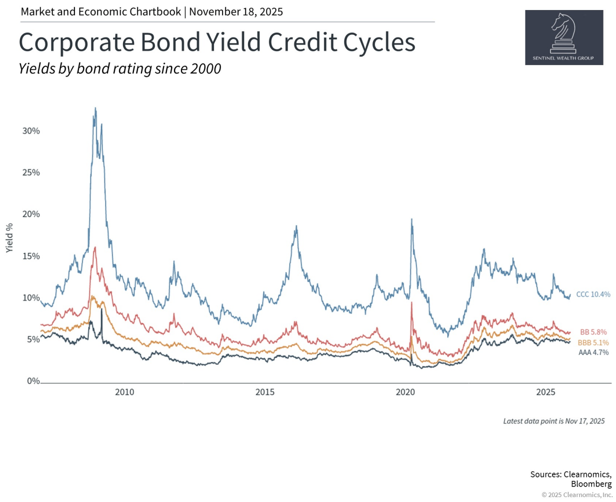
There's an old saying that criminals rob banks because that's where the money is. However, in today's financial system, money isn't just in banks anymore, but across different types of financial institutions. While the hope among policymakers was to reduce the risk to banks after the global financial crisis, this has created new challenges. With recent bankruptcies leading to investor concerns of cracks in the credit market, it's important for long-term investors to maintain perspective on what this truly means.

Since 2008, significant lending activity has shifted to "non-depository financial institutions" (NDFIs) such as private credit funds, mortgage companies, insurance companies, online lenders, and more. The key is that these lenders are not banks since they do not accept customer deposits, so are not subject to traditional banking regulations. However, banks are still connected to these issues - in fact, loans by banks to NDFIs have grown to $1.2 trillion.[1] This structure adds a layer of opacity to the financial system and is thus sometimes referred to as "shadow banking."

Why is this coming up in the news today? The past few months have witnessed a few cases of alleged fraud among specific borrowers. In September, subprime auto lender Tricolor collapsed after allegedly using the same cars as collateral for multiple loans. Auto parts supplier First Brands filed for bankruptcy around the same time amid concerns about off-balance-sheet debt.[2] More recently, fraud allegations have been raised against affiliated companies Broadband Telecom and Bridgevoice, based on fake invoices used in asset-based finance deals.[3]

The comment that reflects investor concerns the most is JPMorgan CEO Jamie Dimon's recent statement that "when you see one cockroach, there are probably more." While these individual cases are concerning and have led to brief market swings, the question is whether they represent broader problems in credit markets and warrant comparisons to the 2008 financial crisis or the 2023 banking crisis. For long-term investors, understanding this distinction is crucial since managing risks is not about reacting to each headline, but about holding a portfolio that can perform well through periods of uncertainty.

Comparing today's concerns to past crises provides important context

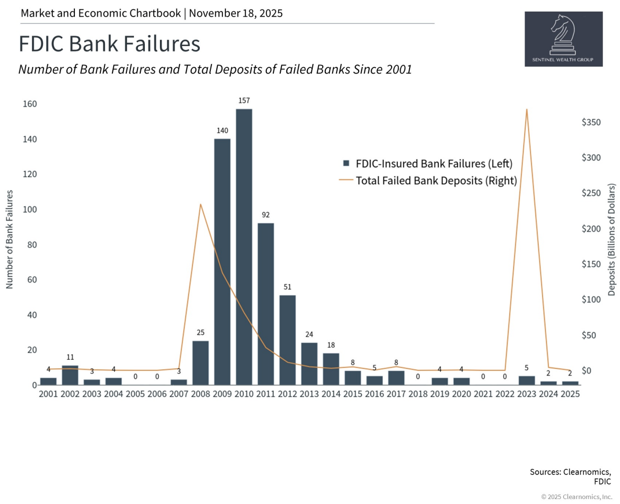


When credit problems emerge, it's natural to draw comparisons to 2008 or 2023. While certain cases of fraud were revealed during the 2008 financial crisis, what made it systemic were neither these cases nor the housing crash itself, but the significant financial leverage among the largest institutions. In many cases, these leveraged positions eclipsed the amount of equity held at each company, leading to disorder in the financial system.

A more relevant comparison might be to the 2023 banking crisis, when several regional banks failed within days of each other. That revealed a different kind of vulnerability: the mismatch between bank assets and liabilities when interest rates rose rapidly. These banks had concentrated customer bases including tech startups for Silicon Valley Bank and cryptocurrencies for Signature Bank and Silvergate. This made these banks vulnerable to sector-specific problems.

While there were concerns at the time, this did not translate into a broader economic downturn. That said, the 2023 crisis demonstrates how quickly confidence can evaporate in modern financial markets before rebounding again. As is always the case, these examples emphasize the importance of not overreacting to headlines. The chart above highlights both historical credit shocks and the fact that bond yields and spreads are still stable today.

Credit cycles are a major component of economic turning points



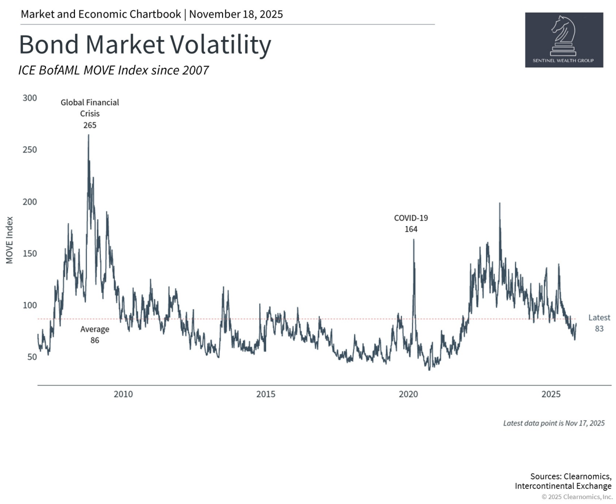
Throughout history, it has often been credit and debt cycles that have driven the most significant economic expansions and contractions. When there is abundant liquidity in the financial system, there is often more credit being extended to both businesses and individuals. This pattern of lending and borrowing during expansionary periods has repeated itself across different eras, from the railroad boom of the 1800s, to the roaring twenties a century ago, to the housing bubble of the mid-2000s.

However, it’s important to distinguish the perspective of a large bank from that of long-term investors. For large financial institutions, each loan matters and can result in write-offs that affect quarterly earnings. For investors, what matters is whether these issues are “systemic,” affecting the broader economy and portfolios across a variety of investments.

The situation is still evolving and there could be more cases of fraud and bad loans. However, markets have already calmed after the initial bankruptcy reports, and there are a few key facts to keep in mind.

First, the dollar amounts involved, while significant for individual institutions, represent a small fraction of the overall financial system. Second, larger banks are generally well-capitalized and diversified across many lending categories, reducing their vulnerability to problems in any single area. Third, unlike past crises, there's no evidence yet of a broader economic challenge that would cause widespread credit problems. The chart above shows that the banking system has been more stable over the past two years.

Stock and bond markets have remained relatively calm



The stock and bond markets have experienced brief periods of uncertainty again in recent months, driven by tariffs, the government shutdown, financial concerns, and questions around AI companies. And yet, during this period, major stock market indices have also continued to reach new all-time highs, while bond returns have also supported balanced portfolios.

For long-term investors, the key lesson is that recent headlines around financial fraud and bankruptcies are a natural part of credit cycles and the functioning of financial markets. While individual cases may be concerning, this is separate from whether it affects the broader financial system. Either way, it’s clear that adjustment will be needed among lenders, especially non-bank ones.

The bottom line? Recent credit problems by private lenders have raised concerns, but markets have also calmed in recent weeks. For long-term investors, these challenges highlight the importance of risk management that aligns portfolios with long-term goals.

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The S&P 500 is an unmanaged index of 500 widely held stocks that is generally considered representative of the U.S. stock market. There are different index construction methodologies for the S&P 500. The more commonly used version of the index weights companies using their total

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