



Angel Oak's Pate: Financials Are At A Good Point 'For Valuations To Take Off From Here'

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Chuck Jaffe, in The NAVigator podcast interviewed Cheryl Pate, portfolio manager for Angel Oak Capital. Read the Q & A below as Cheryl says that banks took steps to shore up their balance sheets and now are sitting on excess reserves, which should boost earnings in the latter half of 2021. Coupled with a positive picture on interest rates, inflation, and government oversight, she

says valuations are poised to show gains next year, although she notes that she has a slight preference for owning financial debt versus equity in the year ahead.



Cheryl Pate

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CHUCK JAFFE: Cheryl Pate, portfolio manager at Angel Oak Capital is here and we're diving into the financial sector, welcome to The NAVigator. This is the NAVigator, where we talk about all-weather active investing and plotting a course to financial success with the help of closed-end funds. The NAVigator's brought to you by the Active Investment Company Alliance, a unique industry organization that represents all facets of the closed-end fund industry, from users and investors to fund sponsors and creators. If you're looking for excellence beyond indexing, The NAVigator's going to point you in the right direction. Joining me again today on The NAVigator, it's Cheryl Pate, portfolio manager for Angel Oak Capital. Specifically she runs Angel Oak Dynamic Financial Strategies Income Term Trust, that's

DYFN, and the Angel Oak Financial Strategies Income Term Trust, that is FINS. Both closed-end funds that you can learn about at AngelOakCapital.com, and if you want to get directly to information pages on the funds, AngelOakCapital.com/ and then put in the ticker symbol, it's FINS or DYFN. If you want to learn more about closed-end fund investing, go to AICAlliance.org, the website for the Active Investment Company Alliance. Cheryl Pate, great to have you back on The NAVigator.

CHERYL PATE: Thanks Chuck, I'm really excited to be here today.

CHUCK JAFFE: I'm excited to dive into financials because it is a sector that is starting to get to where we're hearing more buzz about it. Absolutely brutalized, and if you want to say something nice about it, you're calling it a value sector, and now it's showing some signs of life. So as we head into 2021, how do you see it playing out? Is it that banks and financial services companies can get back to some sense of normal without the economy getting back to full normal?

CHERYL PATE: I think that's right. And our view on the sector, banks specifically but also financials more broadly, has really been predicated on the significant strengthening of capital ratios, credit underwriting, and risk management over the past decade. Obviously this has been an unprecedented year, and one of the things that we really tracked closely is loan modification trends. And we've seen vast improvement over the past several quarters there, moving from deferrals sitting around 15-20% of loan portfolios, down to low single digits today. So when we look forward to 2021, we actually have a pretty positive view. Banks really added proactively to both loan loss reserves and capital bases pretty significantly over 2020. And in fact if we continue along the trajectory that we're on today, we think we're sitting on excess reserves actually, which should be a boost to earnings in the second half of 2021, helping drive some growth in earnings over the course of the next year.

CHUCK JAFFE: Banks and the financial institutions cannot blame their troubles on politics necessarily, but some folks have said that with the change in administration will come a change in fortunes for a few industries, and the banking sector has been one of them. Do you think we're going to see much of a change for the ongoing fortunes of financial companies as a result of the Biden administration?

CHERYL PATE: I think we're really only going to see fairly modest changes with Yellen coming in as treasury secretary, really a known quantity, therefore a methodical market-

based approach. So when we had the largest regulatory overhaul coming out of the financial crisis and the Dodd-Frank Act, we really significantly strengthened the banking system where we really only expect modest changes at the margin. One area that we do think probably does start to accelerate in the coming years however is mergers and acquisitions. We're running 60% below the typical year for 2020 given the Covid pandemic, but we've started to see an acceleration in the last couple of months in terms of some larger deal announcements. And I do think that will continue in 2021 under the new administration, and banks are really going to be searching to find efficiencies with rates at the zero-bound.

CHUCK JAFFE: When you consider the troubles that—well, the whole market went through it, but they seem to be exacerbated for the financial services industry. Is this one of those cases where the real benefits of owning an industry that's having that kind of fluctuation comes out in closed-end funds? Because if financials are a value sector as so many people are saying they are, well now I can buy things that are naturally discounted and undervalued at a bigger discount because your funds and others like them are trading at significant discounts. Is this a case where this is where you really wind up having closed-end funds shine in an environment where we expect to see a snapback, so you bought in at a particular bargain price and you're able to really rebound that much faster?

CHERYL PATE: Absolutely. When we look at what financials have done over the course of the year, I would say the drawdown was not as severe as what we saw in corporate credit broadly, probably about half of that. But what really has impacted the sector, it's been really lagging, that rally that we've seen over the last few months. And I think it's a couple of reasons, number one, we had record issuance in terms of tier-two capital this year. But also the Fed specifically excluded the banking sector from the corporate buying program, so we've really seen sort of flattish returns over the last few months, and I think that's poised to change. We've worked through more than \$10 billion dollars of issuance in the community bank debt sector, spreads are starting to tighten, and that's really playing through to legacy portfolios that we expect could really see a benefit in a total return perspective and pricing of the fund. So we think we're really at a good point for valuations to start to takeoff from here.

CHUCK JAFFE: Yet that requires that banks, and also in financial services, insurances companies are able to make money, which is definitely harder for them when rates are as low as they are and are likely to stay. How big a concern is the rate picture in all of this?

CHERYL PATE: I think we are concerned about earnings growth potential in the low-rate environment we are in. That would speak to our preference for financial debt over equity, given that we do think there is some margin compression that will come through, although that's slowing as we worked through the last couple of quarters. And then of course banks tend to price their loans off prime, so you do have a natural lift between the funding cost and the margin at which they're making the loans at. But that has certainly been muted and has weighed on the equity side of the equation. On the debt side, we really benefited from incremental capital and reserve build, which just continued to build that cushion that we have on the debt side.

CHUCK JAFFE: Does that mean that in these conditions you are steering the funds that much more towards the debt side of things?

CHERYL PATE: Yeah, our key overweight is going to be on the debt side, particularly in these markets. I think we're more opportunistic on the equities side, and it's sort of story-driven or potentially M&A driven. But the core of the portfolio and likely where we're adding the incremental dollar today is going to be on the debt side.

CHUCK JAFFE: Is inflation the wildcard in all of this for the financial sector?

CHERYL PATE: Yeah, I think we have clearly the Fed at the zero-bound for the next several years, and a V-shaped recovery in expectation. So where does that play out with the Fed unlikely to tighten prematurely? It's likely on the long end of the curve where we could see some higher inflation starting to move that up. In our view that potentially pressures more traditional fixed-income, longer duration investment grade corporates, and that's really why we've been so favorable on strategies focused on high current income and short duration. Similar to financial services debt where we're looking at duration in, call it a two-and-a-half type range compared to broader corporate credit at an eight. That's how we would be positioning for a potential inflationary pressures in the coming few years.

CHUCK JAFFE: Cheryl, thanks so much for joining me to talk about.

CHERYL PATE: Thanks so much for having me on.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. I am Chuck Jaffe, please check out my show on your favorite podcast app or at MoneyLifeShow.com. To learn more about closed-end funds, interval funds, and business-development companies go to AICAlliance.org, the website for the Active Investment Company Alliance. They're on Facebook and LinkedIn @AICAlliance. Thanks to my guest Cheryl Pate, portfolio manager at Angel Oak Capital, the firm is online at AngelOakCapital.com. The NAVigator podcast is normally available on Fridays, but through the holidays, Thursdays to accommodate the holidays. We hope you're accommodating the holidays and having great ones, you'll subscribe on your podcast app and you'll come back next week. Stay safe everybody.

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