Angel Oak's Pate: Aggressive Fed Action Puts Community Banks In A Sweet Spot

Friday, September 9, 2022

Chuck Jaffe, in this episode of The NAVigator podcast interviewed Cheryl Pate, senior portfolio manager for the Angel Oak Financial Strategies Income Term Trust. Read the Q&A below as Cheryl says that community banks stand out as a part of the financial sector that is poised to benefit into 2023, as banks will likely see the bulk of continuing rate hikes fall directly to the bottom line. Even with that boost, however, she favors bank debt right now compared to holding bank stocks, noting that banks had an excess of deposits generated during the pandemic period and that is being flushed from the system and fee income is falling due to lower loan growth and higher costs, which have created headwinds to earnings. With capital levels at multi-year highs and high levels of liquidity and reserves, Pate sees opportunity in banking-sector debt now that coupons have been "rising nicely," plus she sees community banks as attractive merger candidates which should give a boost to their paper as transaction activity increases into next year.

Cheryl Pate

The podcast can be found on AICA's website by clicking here: https://aicalliance.org/alliance-content/pod-cast/

CHUCK JAFFE: Cheryl Pate, senior portfolio manager for the Angel Oak Financial Strategies Income Term Trust is here, and we're talking the banking sector and more now on The

NAVigator. Welcome to 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 is 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 is going to point you in the right direction. And today it is pointing us in the direction of Cheryl Pate, she is senior portfolio manager at Angel Oak. Angel Oak Capital, which you can learn about at AngelOakCapital.com. But if you add /FINS to that, well, you will get directly to the information on the Angel Oak Financial Strategies Income Term Trust, her closed-end fund. If you want to learn more about investing in closed-end funds generally go to AICAlliance.org, the website for the Active Investment Company Alliance. Cheryl Pate, welcome back to The NAVigator.

CHERYL PATE: Thanks Chuck. Thanks for having me back.

CHUCK JAFFE: Cheryl, it's been awhile since you were last on The NAVigator, it was actually the end of 2020. At that time you were running two Angel Oak closed-end funds, the Financial Strategies Income Term Trust, FINS, but also the Dynamic Financial Strategies Income Term Trust, DYFN. The two funds were merged. So before we get into the banking sector, let's just talk a little closed-end fund business at Angel Oak. What was the thinking behind the merger? And how has it changed anything, if at all, for you moving forward?

CHERYL PATE: I think really these were two funds that had separate and distinctive strategies when they were first launched, but the fact is over time they became much more similar in terms of investment strategies and allocations across the financial sector. So really we thought there were three key reasons that a merger between the two funds made a lot of sense, the first being economies of scale. And really if you think about it, a larger fund has a much more efficient cost structure and fixed-fund expenses such as fees paid to some third-party service providers, platform fees and the like are now being divided out over a much larger asset base. Secondly, really the favorable impact on secondary market trading, there's a clear positive correlation between the size of the closed-end fund and liquidity on the secondary market. The increase in assets really should result in increased liquidity and better execution spreads in the secondary market in our opinion. Ultimately what this does is result in lower price volatility and a tighter bid-ask spread to our shareholders. And the

third reason was improved investment opportunities and greater diversification. We expect that the combination and resulting larger assets under management will drive higher investment opportunities, greater diversification in portfolio investment, the ability to trade larger positions, and additional sources of leverage or more competitive leverage terms, and more favorable transaction terms.

CHUCK JAFFE: Now let's dig into financials. You run Angel Oak Financial Strategies Income Term Trust, you're also manager of Angel Oak Financials Income Fund, that's an open-end fund, ANFIX. So you have a mandate to be in financials. But when I talk with money managers on my show *Money Life*, there's a set of them that really want to avoid financials right now, they don't like what the market and the high inflation, rising interest rate sector does for financials. And then there's the other segment of the managers who are value investors saying, "Hey, I think there's going to be a good future." But for you, you've got to be in financials. Where are you going? What are you gravitating towards? And what are you moving away from in financials given the times we're facing?

CHERYL PATE: We're most positive on the community banking sector across financial services broadly, and within community banks, on the debt side versus the equity side. Really that is a look ahead, not only to the latter half of 2022, but also into 2023. And when we step back and think about the fundamentals of the banking sector in particular, clearly you have a Fed that's been much more aggressive than expected in raising the Federal Funds Rate, and really, banks are direct beneficiaries of higher rates. The bulk of the rate hike falls directly to the bottom line as they're able to charge higher rates on the lending products that they're extending to customers. Whereas their funding costs, which is largely cheap checking and saving accounts, deposit-type accounts, don't move much. So you have this net interest margin that is poised to see outsized expansion, and you have an economy that is re-levering post-Covid. So you have loan growth ticking up pretty dramatically, you're seeing margin expansions, both of which are good for banks' bottom lines. Now on the flip side, why are we more positive on the bank debt market versus equities? Really I think we're going through a little bit of a transition as banks re-optimize their balance sheets. You're seeing some of that excess liquidity that has been a function of the post-Covid world where banks really were distributing a lot of stimulus, PPP and the like, and you had an excess of deposits generated during this time period. So rightsizing, reoptimizing your balance sheet, seeing the margin in

the expansion in the loan growth, but in terms of near-terms earning growth headwinds, we do expect you will see some lower fee income as some of the mortgage re-fi falls off as rates rise. And you also have a higher expense given the inflationary backdrop, and we do expect some credit normalization. So that might mean slower earnings growth going forward, but from a debt perspective, you have capital levels at multi-decade highs, de-risked balance sheets, high levels of liquidity and loan-loss reserve, and we feel really good about the opportunities of banking sector debt where we're starting to see coupons move up pretty nicely.

CHUCK JAFFE: There is some expectation that we will see a wave of mergers and acquisitions as we get through a recession and what have you. Are you expecting that? And if so, how do you think you'll play that?

CHERYL PATE: Yeah, absolutely, banking sector consolidation is actually a significant alpha generator for this strategy. And you're right, we still have over 5,000 banks in the US. We're highly over-banked, there's ample opportunity for continued consolidation. And if we step back to where we came out of the post-Covid pandemic, we saw really pronounced resurgence of M&A activity in 2021. Year-to-date 2022, volumes are running lighter than last year, and I think that's fairly unsurprising due to the macro volatility and uncertainty in the market today. However, I would still say that deal value is annualizing at levels in line with 2018, 2022, and is still one of the highest years since 2007, but clearly a little bit below 2021 record levels. We do expect that there will be a re-acceleration of M&A activity in 2023 as we work through some of the uncertainty, we get some more clarity on rate hikes and the expected pace moving in 2023. And what this does for the sector, it's clear that there is a need for enhanced efficiency. Costs are rising, generally, given the inflationary pressures, compensation is one of the largest expenses for banks, and you also have this increased focus on technology investment spend. And so M&A is a big positive in our view for community banks in particular, and that's because there are clear scale benefits to consolidation within the banking sector. Now when we think about the knock-on effect onto community bank debts specifically, typically a smaller institution is acquired by a larger institution, and the debt of the smaller bank is acquired by the bigger bank. That typically results in spread tightening and price appreciation of the bonds that we are investing in, and our portfolios have typically seen roughly twice the level of consolidation relative to the sector at large. Due

to the nature of the types of bank that are issuing debt, they tend to be higher growth, more strategic, more capital optimizing type of institutions. In other words, banks that would be attractive M&A candidates.

CHUCK JAFFE: Cheryl, last question, and this gets back to the fund itself, there were some notes that were issued by FINS in the last year. Explain how they work and what they're doing for the strategy.

CHERYL PATE: We issued some longer duration fixed-rate senior notes about a year ago, in July of last year, and really the issuance was part of our risk-management process. First in terms of stability of funding with longer dated maturities, and secondly to decrease the fund's exposure to potential increases in interest rates. We've seen clearly significant moves in treasury rates since then, so the timings have turned out to be very favorable in our opinion. So what we did is we issued $85 million across to tranches, $40 million in a five-year maturity and $45 million in a seven-year maturity. The spread on the five-year at issuance was 145 basis points, and the spread on the seven-year was 150 basis points. What that did was bring our weighted cost of financing on a fixed-rate basis at under 2.6%. The five-year treasury was at 90 basis points when we loft in the financing, and it's now sitting north of 3.4%. So really in our view, these senior notes are a hidden value that's not currently recognized in the fund's market value.

CHUCK JAFFE: Really interesting. Cheryl, thanks so much for joining me to talk about it. I look forward to the next conversation down the line.

CHERYL PATE: Thank you, Chuck.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. And yes, that's me, and you can learn all about my hour-long weekday podcast by going to MoneyLifeShow.com, or check us out on your favorite podcast app. To learn more about interval funds, closed-end 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, she's senior portfolio manager for the Angel Oak Financial Strategies Income Term Trust, that's ticker symbol FINS, and you can learn more about it at AngelOakCapital.com/FINS. The NAVigator podcast is new every Friday, ensure you don't

miss anything by following along on your favorite podcast app. We look forward to seeing you here again, and until we do that, happy investing everybody.

Recorded on September 8, 2022

To request a particular topic for The NAVigator podcast please send an email to: TheNAVigator@AICalliance.org

Click the link below to go to the home page of Active Investment Company Alliance to learn more:

https://AICalliance.org/

Disclosure: *Views and opinions expressed are for informational and educational purposes only as of the date of production/writing/speaking and may change without notice at any time based on a multitude of factors. Speaker's/presenter's/author's opinions are their own and may not necessarily represent the opinions of AICA, its Board, or its staff. Materials may contain "forward-looking" information that is not purely historical in nature, such as projections, forecasts, market return estimates, proposed or expected portfolio composition, and other items. Listed closed-end funds and business development companies trade on exchanges at prices that may be above or below their NAVs. There is no guarantee that an investor will be able to sell shares at a price greater than or equal to the purchase price or that a closed-end fund's discount will narrow. Non-listed closed-end funds and business development companies do not offer investors daily liquidity but rather offer liquidity on a monthly, quarterly or semi-annual basis, often on a small percentage of shares. Closed-end funds often use leverage, which can increase the fund's volatility (i.e., risk). Actual distribution amounts may vary with fund performance and other conditions. Past performance is no guarantee of future results. This material is not intended to be a recommendation or investment advice, does not constitute a solicitation to buy, sell or hold a security or an investment strategy, and is not provided in a fiduciary capacity. Shares of closed-end funds are subject to investment risks, including the possible loss of principal invested. Closed-end funds frequently trade at a discount to their net asset value (NAV).*