Angel Oak's Pate Sees 'A Once-In-A-Decade Opportunity For The Banking Space'

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed Cheryl Pate, senior portfolio manager at Angel Oak Capital, co-manager of the Angel Oak Financial Strategies Income Term Trust. Read the Q&A below as Cheryl says that current problems in the banking sector are setting up a recovery, noting that 'opportunities like this are fairly rare, probably a once-in-a-decade opportunity for the banking space,' with the biggest opportunities being on the debt side as spreads start to normalize under the rules and conditions. Pate says investors have good reason to believe that discounts for bank-oriented closed-end funds are likely to narrow as sentiment improves for the sector, with debt benefitting from a consolidation cycle in the industry while the equity benefits from renewed confidence and better positioning for the future.

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 at Angel Oak Capital is here to talk about the problems and opportunities in the banking system now, this is 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's going to point you in the right direction. And today we're looking in the direction of Cheryl Pate, senior portfolio manager at Angel Oak Capital, where among other things, she's one of the managers on the Angel Oak Financial Strategies Income Term Trust, that's ticker symbol FINS. Now you can learn about the firm at AngelOakCapital.com, and if you add a slash and FINS to that, well, you'll get information on the fund. And to learn more about closed-end funds, interval funds, and business-development companies generally go to AICAlliance.org, the website for the Active Investment Company Alliance. Cheryl Pate, it's great to have you back to The NAVigator.

CHERYL PATE: Thank you for having me, Chuck.

CHUCK JAFFE: These are, I don't know, curious, alarming, interesting, pick whatever adjective works for you when it comes to the banking system right now. Just a few weeks ago everybody was worried that we were going to have massive contagion and some sort of quasi if not mini to major collapse. Now things seem to have calmed down, but that doesn't mean things aren't bubbling under the surface. So set the tone for us, how do you see the banking system and its security and safety right now?

CHERYL PATE: It certainly has been an interesting three weeks for us in the banking sector. I think when we analyze what's gone on, and more importantly what's the forward look, we separate it into two pieces really. We have on one side the failure of Silicon Valley Bank and Signature Bank, and some of the related contagion around geographic and concentrated risks in deposit portfolios, and then we have the question of the banking system overall, which really has been more of a AOCI issue. So we've been concerned for some time about the impact of rapidly rising rates on banks' investment portfolios, which frankly grew significantly coming out of the pandemic, and loan growth was anemic at that time. A lot of excess liquidity was deployed into long-duration MBS during the time period and we've seen unrealized losses mount over the last year as rates moved up so rapidly, so those have been a negative impact to AOCI as well as capital levels. So that's been our primary concern, but really to be clear here, we don't think there is a systemic issue in the banking sector. What really gave us some comfort around this was that weekend three weekends ago when the failure of Silicon Valley happened on Friday and then Signature over the weekend, what we took away as the positive was the Treasury, the Fed, the FDIC came out with a proactive approach fully covering all deposits of the failed banks, but more importantly to us, setting up the Bank Term Funding Program, the BTFP. What that does is widen the eligible assets that banks can pledge, but also, and this is the key point, allows them to pledge those assets at par. What that does is solve for the unrealized loss AOCI issues that have really impacted the sector over the year, and doesn't put banks into a forced seller position for money-good portfolios.

CHUCK JAFFE: There's been a lot of talk about do we need to change regulation, do we need to change the rules, or do we just need to have the time for this to play out? Because the real culprit is rates rising as quickly as they have and by as much as they have in that short time. Do we need to see massive overhauls or does time heal this one?

CHERYL PATE: We are going to see some responses both on the regulatory side and also the bank management side, and to be clear, this is the first time we've gone through this type of liquidity event in a 24-hour news flow environment with social media, and that I do think will cause some re-thinking by the regulators. I do think going forward we are going to have higher regulation, but also we'll likely have higher capital levels, higher liquidity buffers, and frankly a revamp of the deposit insurance program is something that likely takes a little bit longer to get our hands around but is probably needed in the new state of the world. And from bank management team perspective, I think we shift even more defensively here. So what we're expecting is banks will be increasing liquidity, some of those things will come at a cost such as raising their deposit rates, but also lowering their risks, tightening lending standards even further, which have been tightening for some time, and increasing spreads as well as boosting balance sheets quality, things like loan-loss reserves and stockpiling capital, stopping buybacks in this type of environment.

CHUCK JAFFE: Where's the opportunity? What are you buying? What are you saying, "Yeah, I wouldn't touch this in this time"?

CHERYL PATE: When we step back we think, what's happened in the sector and what's the likely go-forward? I think opportunities like this are fairly rare, they're probably sort of a once-in-a-decade type opportunity for the banking space. And we look across debt, preferreds, equities, spreads are really wide on the debt side and a lot of things I highlighted previously support the debt; higher regulation, higher capital, higher liquidity, all of that is really good for the debt on a forward look. But volatility has been particularly high on the preferreds and equity sides as well, and we take a look at drawdowns in the banking sector versus the next 12 months returns for example. On average if we look back to 2010, it's been about a 12% drawdown and a 28% rebound, so there are compelling opportunities I think on the equities side, but really where we see the biggest opportunity is on the debt side as spreads start to normalize in the new regime.

CHUCK JAFFE: I know that closed-end fund managers don't spend a lot of time typically worrying about the discount, but in times like these discounts get wide, is the expectation that somebody who gets interested in FINS, or anything in this space, is going to wind up seeing that as confidence returns to the sector that naturally discounts will narrow?

CHERYL PATE: I do think discounts will narrow. If we take it in two pieces, I think there's, number one, upside to the NAV here, for example we've locked in really low-cost fixed-rate financing in this market, that's about a 45 cent benefit to the NAV that has not been realized because the liabilities aren't [inaudible] to market. But also we do expect there'll be a consolidation cycle in the banking industry, that's really good for the bank debt, you typically see pretty nice price appreciation, let's say five to 10 points on average, plus the go-forward is higher coupons and higher yields. We have a lot of dry powder to invest in this environment, we did increase our liquidity and reduce our leverage during the heightened period of volatility a few weeks back, and that really gives us some dry powder to now shift to the offense. That being said, once we get I think some comfort on the sector overall, and we have bank earnings coming up in a couple weeks, I think you will see a lot more granularity in terms of concentrations on the deposit on the lending side. Once you get that sentiment improvement coming back to the sector, I think that really will help the discounts as well.

CHUCK JAFFE: Ultimately if you and I are talking again in six months to a year, is the expectation that at that point we will have reached stability with the industry and improved performance for funds like FINS that are in there?

CHERYL PATE: I think that's right. I think we've gone through a period of volatility on the liquidity concerns on some isolated banks, I think the systemic response from the regulators does a lot to help the system as a whole. And our forward look would suggest we're in a better place six months from now, particularly in a fund that's dedicated to this strategy where we think there's a lot of upside.

CHUCK JAFFE: Cheryl, really interesting stuff, thanks so much for taking the time to join me. I look forward to having that conversation down the line.

CHERYL PATE: Thank you.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. And yeah, that's me, and you can find out all about my hour-long weekday podcast by going to MoneyLifeShow.com or by looking for it anywhere you find the good podcasts. 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, on Facebook and LinkedIn @AICAlliance. Thanks to my guest Cheryl Pate, senior portfolio manager at Angel Oak Capital, co-manager of the Angel Oak Financial Strategies Income Term Trust, FINS. Learn about the firm at AngelOakCapital.com, add /FINS to that for information on the fund. The NAVigator podcast is new every Friday, ensure you don't miss an episode by going to where you get those good podcasts and following us there. We'll see you again next week, everybody. Happy investing.

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