



## Angel Oak's Pate: Community Banking Sector Is Better Prepared Than Most For Pandemic

Friday, April 3, 2020

Chuck Jaffe, in The NAVigator podcast, interviewed Cheryl Pate, portfolio manager for Angel Oak Capital. Read the Q & A below as Chuck discusses with Cheryl why she says that the community banking sector is better positioned than most to ride out current market conditions.



Cheryl Pate

While lower rates and a flatter yield curve can be negatives, Pate explains how the leverage she has in managing her closed-end funds is helping to position the issues to weather the market storm quickly.

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

**CHUCK JAFFE:** Cheryl Pate, portfolio manager at Angel Oak Capital is here and we're talking financials and community banks today 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, which is 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. My guest today is Cheryl Pate, portfolio manager at Angel Oak Capital. One of the folks on the team for the Angel Oaks Financials Income Fund and the Financials Strategies Income Term Trust. If you want more information on the things she does, go to [AngelOakCapital.com](http://AngelOakCapital.com). If

you want to get directly to her portfolio's ad, /Fins, and it will get you to the financial strategies funds. Cheryl Pate, welcome to The NAVigator.

**CHERYL PATE:** Thanks so much for having me.

**CHUCK JAFFE:** We are living in really interesting times, both for financials and the market and more. When it comes to the closed-end fund space, there's been a lot of talk as the market has gotten hairy, when it comes to using leverage. So let's talk about where leverage fits in in the community bank and the non-financials banking strategy, etcetera. Do you use it? And how dangerous or safe do you feel it is right now? How much is the use of leverage changing right now?

**CHERYL PATE:** We do employ leverage in our closed-end fund strategy. The leverage limitations under the 40 Act are quite low, and I would say we use leverage more opportunistically. We have been using leverage to invest in anticipation of the closing of a previously announced merger with another closed-end fund. The merger has been approved by both of our boards of directors, but is still pending shareholder approval. We do have two facilities that we can tap into for Fins. One is a long-term facility, a three-year bank line, and one is a shorter-term repo facility. So we like to take a proven approach to balancing the two types of facilities we have available to us, particularly in the current market environment. We have reduced our leverage somewhat over the last few weeks. Currently we're sitting around twenty-five percent net leverage roughly equally divided over those two facilities.

**CHUCK JAFFE:** In terms of the broader strategy, looking at interest rates and you know it's an interesting time for lenders, etcetera. So the community bank picture, as you're looking at community banks right now, how optimistic are you? How much is this ride out the storm territory?

**CHERYL PATE:** There's no doubt that the banking sector will be hit much like every other sector in the economy. We do expect profitability in their net interest margins to compress, and we do think delinquencies will rise as we move into a recessionary environment. However having said that, we do believe that the community banking sector is much better prepared to deal with this type of pandemic crisis than most other sectors of the economy. And so why is that? A couple things I want to briefly highlight in terms of important fundamental factors in the banking industry. First capital ratios are at multi-decade highs for U.S. commercial banks. So if we look at common equity tier 1, which is a regulatory capital

ratio, that's up almost forty percent since the last financial crisis, and tangible capital has almost doubled over that timeframe. As a result, banks much better equipped to deal with a crisis of this magnitude. The second thing I'd highlight is liquidity. Liquidity to banks has improved over the last decade as well, helped by stronger regulatory requirements, so we've seen significant growth in deposits over the last several years. And most importantly, banks have increased their quality of funding. The term deposit funding, edu really, have declined from a peak of thirty percent to just twelve percent of the funding base today. With the low-cost core deposits, your checking and savings accounts have seen a commensurating brace. And then finally I'd highlight the credit quality is at close to all-time best levels. So while it is difficult to determine magnitude of the increase in delinquencies as a result of the pandemic, we do expect the impact to the banks will be less severe than the prior cycle as banks have de-risked and de-levered over the last decade. Those underwriting standards are stricter, capital levels are higher. And final point I'd highlight here is, it's important to remember that after the last crisis, the regulators implemented significant changes to strengthen the banking system. The largest overhaul to the regulatory environment was the Dodd-Frank Act, and the current pandemic is exactly the type of event that Dodd-Frank was implemented to address. With increased capital levels, have better quality capital, we have improved liquidity, and tighter credit standards. So in other words, Dodd-Frank was enacted to allow banks to weather crises like this.

**CHUCK JAFFE:** While we're looking at weathering this crisis, we are also looking at interest rates that are lower for longer, and are going to be lower still if that's even possible, for longer than folks could expect. How have low-interest rates affected the community banks? And how have they affected the performance of your fund and closed-end funds in the space, versus traditional funds and ETFs?

**CHERYL PATE:** Yeah, I think that's a really good question. Absolute level of rates and the shape of the yield curve absolutely impact the net interest margins of banks and their resulting profitability. Lower rates and a flatter yield curve do tend to be pretty negative for banks. Most banks are what we would call asset sensitive. So what that means is their assets or their loan portfolio will reprice faster than their deposit or their liabilities. So as a result, when we see rates decline, you'll generally see margins compress. We've seen that trend over the last few quarters, and we certainly expect it to continue at an accelerated pace from here.

The other thing I would highlight though, is when you think about low-interest rates, that also means that borrowers get some relief in the interest payment burden, making it a little bit easier for them to meet scheduled payments. So overall, the tighter interest margin tends to impact the company's earning profile and equity valuation. And we see that impact more in the stock price versus the debt, which is the sector that we're really focused on. The other thing worth noting is that there's a negative correlation between interest rates and bond valuation. So theoretically as rates fall, the bond value improves, and that helps mitigate some of the exposure from higher credit spreads.

**CHUCK JAFFE:** And as you look at the community bank space going forward, there's been a lot of talk about as we come through the viral economy, things will be forever changed. One of the things that is expected is mergers in a lot of different areas, where certain companies will be impacted or weak as they come out, others will try to scoop up assets that they can. Will we see some sort of a wave of mergers and consolidations in community banking?

**CHERYL PATE:** Yeah, the U.S. banking sector, when we look at it, is highly over banked today. Consolidation has been a positive tailwind for the last number of years. We've certainly seen an increase in M&A over the past several years as the regulatory backdrop became a little bit more friendly post-financial crisis. And secondly, as banks have been searching for cost savings and efficiencies to boost their profitability. If we look at 2019, we saw a significant increase in the consolidation rate as regulators became more positively disposed towards larger deals. We saw lower premium transactions, including mergers with equals, come to the forefront. Which is a positive in our view given reduced execution risk. So we have been expecting M&A to accelerate from current levels as you focus on driving better scalability given tough earnings and interest rate environments. As we move toward a recessionary environment, we do expect credit costs are going to increase, we think could incent more banks to consolidate. If we think about from a timing perspective, I think you could see a temporary slowing of activities in the early days of a recession. If we look back to the financial crisis, we did see a decline in M&A in 2008 and 2009, followed by a sharp increase in consolidation activity beginning in 2010. And I think it is likely we could follow a similar path here.

**CHUCK JAFFE:** Cheryl, really interesting stuff. Thank you so much for taking the time to join us.

**CHERYL PATE:** Thank you 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'm Chuck Jaffe your host, learn more about my work and my show at MoneyLifeShow.com. To learn more about 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, portfolio manager at Angel Oak Capital working on the Financials Income Fund and the Financial Strategies Income Term Trust. Learn more at AngelOakCapital.com. The NAVigator is available every Friday, please subscribe where you find all your favorite podcasts. Stay safe everybody, we'll talk to you again next week.

*Recorded on April 3rd, 2020*

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