# Angel Oak's Pate: Bank Debt Should 'Outperform In The Current Environment'

Friday, October 27, 2023

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 (FINS). Read the Q&A below as Cheryl says the banking industry's wild ride since the failure of Silicon Valley Bank in March has created "a market dislocation" in pricing for bank equities and debt, which has created a strong opportunity for bank debt to outperform moving forward. Pate notes that the banking industry has quelled fears over failure contagion, the Fed is nearing the end of the rate-hike cycle, and deposits have stabilized and banks have proven resilient and posted solid earnings, which should combine to create stronger results as the rebound from last March continues.

Cheryl Pate

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**CHUCK JAFFE:** We're checking in on the banking sector with Cheryl Pate, senior portfolio manager at Angel Oak Capital, 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 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 will point you in the right direction. And today it points us in the direction of the banking industry with Cheryl Pate, senior portfolio manager at Angel Oak Capital, where she is one of the managers of the Angel Oak Financial Strategies Income Term Trust, that's ticker symbol FINS…. Learn more about the firm at AngelOakCapital.com, and then add a /FINS to get directly to information on the fund. And if you want to learn more about closed-end funds, interval funds, and business-development companies in general, go to AICAlliance.org, the website for the Active Investment Company Alliance. Cheryl Pate, it's great to have you back on The NAVigator.

**CHERYL PATE:** Thanks Chuck, it's great to be back.

**CHUCK JAFFE:** Now you were last on at the end of March, we were three weeks into the bank collapses of Silicon Valley Bank and Signature Bank, and you described that time and I quote, "As a once in a decade opportunity for the banking space." The interesting thing is that at that point I think you, me, and pretty much everyone thought there might be more shoes to drop in terms of bank failures and the rest, but everything calmed down and healed pretty quickly. So now, a little more than six months later, where are we in the opportunity set for the banking space?

**CHERYL PATE:** It has been a wild ride since March, but our key takeaway, and it is similar to when we last talked in March, there's a market dislocation clearly in the sector in terms of what we see in pricing of bank equities and bank debt, but really that pricing opportunity really highlights the ability for bank debt to outperform in the current environment. And I say that because a lot of things have happened in the last six plus months, number one, the fear of contagion risk has really faded since there wasn't a spillover effect into the sector at large, which we did not believe there would be. Secondly, we've got the Fed at or near the end of its rate hiking cycle and we've gone through several bank earnings seasons now, we went through first quarter, second quarter, and now we're the bulk of the way through third quarter as well, but what we really have seen is the resiliency of the sector. We've seen deposit flows stabilize, credit remains benign, loan growth is still happening, so there's a lot to like what's coming out of earnings, and we have started to see some recovery on bank equities, though it's been choppy and volatile. Bank debt tends to follow a little bit after the equities, it's a little bit of a laggard from that perspective and that's why the opportunity set is so robust. But we've also seen the large banks have begun issuing normal course debt post-earnings, and M&A has resumed to the sector, so where we sit today, we think there's a great opportunity, particularly in the sector of the market that we're focused in, investment grade bank debt of smaller community banks.

**CHUCK JAFFE:** Do you believe, given where rates have stayed for a while, given inflation and the rest, that the problems that the banking industry was facing, the ones that had everybody scared that there'd be more failures, that those are gone? In other words, that we're not going to have something that really kind of, not necessarily reins the gain, but really makes it much tougher sledding or diminishes interest in the sector?

**CHERYL PATE:** We sort of think about the events of March in a couple different ways. On one side you had the regional bank failures of some fairly unique business models that were not really representative of the sector overall, they were highly concentrated, lending on the deposit platforms, they had a lot of uninsured deposits, and that is fairly A-typical from your traditional bank. The other thing that has been persisting for several quarters is the impact of higher rates and inflation on securities portfolios, the banks typically have fairly long-duration portfolios invested in things like Agency MBS, which from a credit quality concern, there is no concern, but they have been impacted by the rise in rates and you're sitting on some unrealized losses. What the regulators did in the wake of the events in March, I think, solves a lot of that for the sector overall in the bank term funding program and allowing banks to pledge their securities at par, but the other thing that I think really has happened is volatility has declined and we're really seeing the deposit flows have stabilized. At the early onset we saw a lot of regional bank deposit flows going to the large banks, in the community banks that we focus on, there was really not much of an impact actually. They tend to be relationship lenders in their local communities and we didn't see as much of that impact. But that flow from regionals to money centers has stabilized, we're seeing better trends in terms of deposit data, and that has really been our concern versus normal course credit normalization at this point in the cycle. So liquidity, securities portfolios, we feel pretty good about where we sit today.

**CHUCK JAFFE:** Let's jump in quickly on earnings season, because the large banks have been killing it thus far this earnings season. Smaller banks and the community banks, where you focus, it's been a little bit more mixed, although I may have small sample sizes, I'm looking there. So what's your take on earnings for what's been happening in the banking sector generally and the ones that you favor particularly?

**CHERYL PATE:** And we would separate I think into three pieces here, the large banks, the regional banks, and the community banks, and absolutely the large banks came out really strongly, beating expectations on net interest income, not only beating but beating and raising guidance as a positive, highlighted deposit flows, pricing, tracking better than expected. And credit generally holding in, we're starting to see a little bit of normalization but nothing overly concerning at this point. As we moved into the regional reporting season, I think we had always been more concerned about the regionals in this type of environment given that they have less diversified business models and more exposure to commercial real estate, which is the area that we're most concerned about from a credit quality perspective. I would agree with you that results have been mixed in the regional space, we've seen some good trends and we've seen some misses. I think that has weighed on sentiment on the equity side in the last couple of weeks, and then the community banks tend to be later in the cycle to report, so we're sort of just getting into the meat of that now. But we've always thought a barbell strategy in the banking sector makes sense, we like the large banks, we like the small banks, the regional banks have been in a bit of a tougher spot given their portfolio concentrations and also the likely impact of higher regulation hitting that sector particularly hard. We feel pretty good about the community banks. Again, they tend to have higher levels of non-interest bearing deposits because they are relationship driven, and we didn't see much churn there. So that does help them from NII perspective when we're thinking about deposit pricing and betas moving higher, so in a little bit better spot there despite a fairly plain vanilla business model of lending and taking deposits.

**CHUCK JAFFE:** One other thing that we should point out in the limited time we have left, is that FINS, the fund that we're focusing on here, which does investment grade debt, et cetera, unlike an open-end fund, a term trust, you can say it's not just a good entry point to be in the business or the sector, you can say it's a particularly good point at certain times to be entering a term trust. I think this is one of those times with FINS. Could you explain why?

**CHERYL PATE:** I think there's a few things that we find for FINS as an attractive entry point today. And I do agree, you have a term trust structure here, it's a 2031 maturity, and we're trading at a 13% discount today. So that discount accretes to NAV over the remaining life of the fund, but a couple other things I would highlight, and you mentioned as well, this is an investment-grade debt fund focused on the banking sector. It's priced at a 10% yield to worst right now, and looking through the portfolio, and it's a seasoned portfolio here, we have almost 60% of the fund repricing higher over the next 36 months, meaning that the average coupon is increasing over 470 basis points. These bonds have an average price in the low 90s, implying up to 10 points of price appreciation as the bonds move into the floating-rate and call period, so that's a really unique feature of the subordinated debt that we invest. It's a 10-year, no-call five, tier 2 capital instrument, there is a high incentive for banks to call these near the call date, and in the meantime, you get a re-price up to floating-rate coupon in the high single digits, low double digits. I think that's fairly compelling. And then the last thing I would highlight is we feel so strongly about the sector and the fund overall, we increased the dividend 15% in September as a result of a lot of the things we've talked about today. Final point I'd make is there's dry powder to deploy here, and we have very low-rate fixed leverage through senior notes in this fund, so from a lot of different facets it is well positioned and attractive today in our view.

**CHUCK JAFFE:** Thank you so much for helping us understand why the fund is attractive, but also more broadly, why the banking sector, in spite of that kind of overhang, that little hangover, is still attractive too. Cheryl Pate, thanks for joining me on The NAVigator.

**CHERYL PATE:** Thank you.

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