JOHN W. ROSENTHAL CAPITAL MANAGEMENT, INC.

2020 Annual Letter to Investors

Prologue: Q4 '20 results were outstanding! All 3 Funds posted gains well in excess of 30% for the quarter. See table below. Of equal significance, each Fund has increased by at least an additional 6% so far in January. To us, this reinforces two crucial investment lessons: 1) think long-term; and 2) be diversified. Having outstanding community banks as part of your overall portfolio will consistently pay off over time.

In our year-end email message to you, we suggested that 2020 was a "tumultuous year"! Upon reflection, that description, or any other we might have used, would have been an understatement. We know of no adjectives to adequately describe 2020. The number of, "never in our lifetimes have we seen…" are off the charts. Thus, the ubiquitous term "unprecedented", is not an overstatement this year.

In spite of all that happened, our banks weathered the various storms exceedingly well and, in fact, flourished! Their success is attributable to the leadership teams and the cultures they have inculcated. Key among those characteristics is a cautious/conservative overall approach to banking, coupled with extraordinary levels of client service. Given this, we are confident the stock price performance of our banks in 2021 will continue the increases which began in Q4 '20, and will ultimately reflect the full and fair value of these companies.

Headlines:

- **2020 Capped Off by Robust Stock Price Gains in Q4 '20 and Solid Start to 2021 (See Info Below)**
- **Payroll Protection Program ("PPP Loans") Have Been and Will Continue to Be a Major Boon for Community Banks – with $284 Billion of Additional Funding Approved by Congress in December**
- **Mortgage Banking Origination Fees Set Records in 2020 as Refi Boom and Housing Markets Explode**
- **The Yield Curve Steepened Dramatically During Q4. The Spread between the 10 and 2 yr. UST has increased from 0.31% a year ago, to 0.96% as of Jan. 15, 2021. The Steepening Shape of the Yield Curve Continues to Positively Influence Bank Stocks**
- **Asset Quality Remains Stable; Loan Deferrals Shrink and Charge-offs Holding Steady Compared to Pre-Pandemic Levels**
- **Reinstatement of Stock Buyback Programs Approved By Feds**
- **Irrespective of All Else, the Pandemic and the General Election Remain the Driving Stories of 2020**

Summary Data Tables (Results): The first table below presents our performance this quarter – by month and QTD cumulatively – as well as YTD results. In some periods we outperformed our benchmarks or broader market indices; and in others we did not. The second table presents our 2-year return for the period beginning January 1, 2019 and ending December 31, 2020. While no real consolation this year, beating our benchmarks is not inconsequential.

As previously communicated, and consistent with our belief that the market for bank stocks had "bottomed out", we terminated our active hedges in September. Nonetheless, imbedded in the full year results below are the realized gains from our hedging activities. To recap, the 2020 net hedging gains in Fund 1 were $2.5 million, Fund 2, $1.5 million, and Fund 3, $45k. We are pleased to have enhanced the value of your investment(s) by these actions.

Q4 2020 & Full Year Results

2020	Fund 1[1]	Fund 2[1]	Fund 3[1]	^BANK[3]	KRE[3]	KBE[3]	Russell 2000[2]
October	12.8%	15.8%	11.1%	13.6%	14.4%	11.8%	2.04%
November	13.2%	13.0%	11.2%	14.3%	15.7%	16.5%	18.3%
December	7.6%	8.7%	6.8%	8.9%	10.0%	9.1%	8.5%
Q4 '20	37.4%	42.0%	32.0%	41.5%	45.6	11.8%	31.0%
YTD '20	1.9%	-6.1%	-9.7%	-10.6%	-9.0%	-9.4%	18.4%

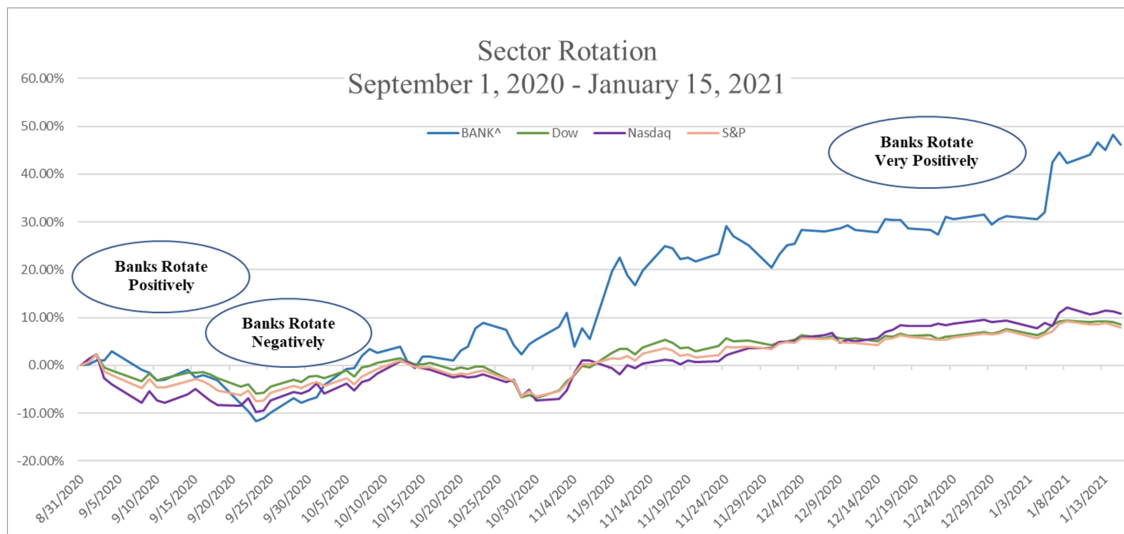
1. Average monthly net rate of return after fees/expenses
2. Russell 2000 is a small-cap stock market index and "BANK" is the Nasdaq Small Cap Bank Index
3. BANK is the Nasdaq Small Cap Bank Index, KRE and KBE are regional bank stock ETF's

Two Year Cumulative Results

	Fund 1	Fund 2	Fund 3	^BANK	Russell 2000[4]
Cumulative 2-Year [5]	19.32%	16.6%	0.00%	8.3%	45.6%

4. Average 2-year net rate of return after fees/expenses between January 1, 2019 and December 31, 2020

2020 Capped Off by Robust Stock Price Gains in Q4 '20 and Solid Start to 2021:



This is the third consecutive letter in which we have shown this chart. It clearly demonstrates how banks have gained favor over broader market indices since the beginning of Q4 '20. Our contention and strong conviction that banks were *oversold* prior to then seems to be borne out by this graph. We refer you to the link at the end of this letter to review our September 8th publication *"Calling a Bottom to Bank Stocks"*. The 30+% quarterly stock price gains highlighted in the table on page 1 along with the 6+% gains posted so far in January, have begun to correct the undervalued situation with bank stocks. But, based on our careful analysis of price/earnings and price/book multiples (which remain significantly below historic levels) and earnings forecasts, *we believe there is still more upside to come.*

In fairness, and somewhat understandably (due to the immense level of uncertainty which existed at the start of the pandemic, combined with investors "long memories" regarding the credit and liquidity crisis of 2008-09), banks were marked down aggressively in the early days of the virus. And it has taken a while for many investors to fully comprehend various factors that make this situation *vastly* different from 12 years earlier. Let's review:

First and foremost, prior to the beginning of the pandemic, banks were the strongest they've been in decades! Very high tangible capital levels, excellent loan quality (i.e. historically low levels of non-performing loans), stout reserves for possible loan losses, strong earnings being derived from diversified revenue streams, and good growth prospects all contributed to the enormous strength in the industry. This "starting point" was infinitely different (i.e. vastly stronger) from the balance sheets and earnings situation of many of the largest banks in the country before the Great Recession. Overlay the strength of the banking industry at the beginning of this year with management teams who responded quickly, properly, and thoughtfully once the pandemic struck, and you ended up with community banks which haven't just survived but thrived. We've detailed the strength of our bank's operating and financial performance in our regular quarterly *Bank Performance Newsletters.* We will, of course, send that final report for 2020 in about 3 weeks – further emphasizing the strong financial and operating outcomes posted by our banks. *Simply put, banks have been part of the **solution** to this crisis, not a cause of it.*

Secondly, the better-than-expected most recent *earnings and loan quality metrics* posted by banks cannot be overlooked any longer. 3rd quarter outcomes showed declining provision expenses, stable levels of non-performing loans, record setting mortgage loan origination income, accelerated recognition of PPP loan fees, good net interest income from increased loan volumes (even despite declining margins), and solid overall expense control. That combination of positive factors generally caused bank earnings to exceed analyst's expectations by *wide* margins. This is one of the main reasons why bank stock prices increased so handsomely during Q4.

Payroll Protection Program ("PPP Loans") Have Been & Will Continue to be a Major Boon for Community Banks

Monetary policies implemented by the Federal Reserve and fiscal stimulus from the CARES Act have greatly assisted everyone – including banks. As we have shared throughout the year in our various communications, the windfall of fees and incremental interest income from the fully government guaranteed PPP loans has been a boon to all banks – but especially community banks, as the proportion of PPP loans underwritten by community banks dwarfs that of the money center banks. This unanticipated source of fee income (since no one expected a pandemic and the CARES Act which followed) has helped banks build their Allowance for Possible Loan Loss Accounts to help absorb possible future loan charge-offs – while facilitating the continuation of solid profits and increasing tangible book value during 2020.

While the primary purpose of the PPP program has been to help employers keep employees on the payroll and keep the overall economy as stable as possible, community banks have most certainly benefitted by serving as the (well-compensated) intermediary for distributing these funds from the SBA to employers. This has been a much overlooked and underappreciated godsend for the financial services industry – and a key reason for our confidence that bank stocks will continue to rebound in 2021.

On the Sunday evening following Christmas, Mr. Trump signed the $900 billion pandemic relief bill, the second-largest federal stimulus package after the $2 trillion CARES Act. This bill extended and enhanced many of the benefits initiated by the CARES Act including additional unemployment benefits and direct stimulus payments to individuals. Of importance for the banks in our portfolios, the legislation restarts the SBA's PPP lending program authorizing up to $284 billion in additional federally backed loans for small businesses. This is simply huge for our banks! It will result in another significant round of fee income from the PPP loans being originated by banks through the SBA. If needed, it will support additional reserve building. <u>*More likely, this time around, much of that fee income will fall to the bottom line!*</u>

The initial PPP lending program authorized in March 2020 provided some $525 billion to more than 5 million recipients. While the original program was occasionally criticized for its loopholes and complexity, the new "Economic Aid to Hard Hit Small Businesses, Nonprofits and Venues Act" clarifies questions about the loan process and adds rules for applicants. While many of the provisions remain the same, some changes include: capping loans at $2 million (compared to $10 million); applicants must now have no more than 300 employees (instead of up to 500); and applicants must demonstrate at least a 25% drop of gross receipts during *any* 2020 quarter compared to the same period a year ago. The bill also expands the type of covered expenses to include things like cloud computing or remote-work software; and equipment for government-mandated sanitation and social-distancing, such as sneeze guards or air filtration systems. It's simply a great help for small businesses.

As we look ahead to forgiveness phase of the various PPP programs, the new bill simplifies the process for businesses that received less than $150k to have their loans forgiven; requiring only a description of how much loan money was spent on payroll, and how many employees the recipient was able to retain. Previously that "simplified process" was for businesses who received $50k or less. <u>*We can't emphasize it enough: the PPP Loan Program was a fabulous help to folks in 2020 and will be so again in 2021!*</u>

<u>**Mortgage Banking Origination Fees Set Records in 2020 as Refi Boom and Housing Markets Explode:**</u>
The robust response from the Federal Reserve in reaction to the emergence of 2020's novel coronavirus**,** along with changing consumer preferences, created a perfect confluence of events that resulted in a record year for the housing and mortgage industries. In 2020, the U.S. economy saw rates fall to record lows *16 times*, with origination volume eclipsing $4 trillion. Mortgage rates have now closed the year at record lows with 30-year fixed rates at 2.86% (a full percentage point below one year ago). Overall refinance activity was 124% higher year-over-year, and purchase applications were roughly 26% greater. This huge increase has translated into tremendous fee income for banks in 2020, shoring up income statements for almost every bank in our portfolio.

We have already written about the tremendous impact this increased fee income had in 2020, but as the new year begins, what should we expect in 2021? The consensus is we will see rates rise; but when and by how much is another question. Just how the international community is able to deal with the pandemic, and the corresponding impact those outcomes will have on the global economy, will be the driver of interest rates – which in turn will influence mortgage activity. But inflation and the Federal Reserve's desire to keep rates low will also play a role.

Our forecast is that the current demographic trend (i.e. the ongoing exodus from big cities to the suburbs/rural areas), combined with low rates, will mean mortgage loan origination will continue to be a source of substantial fee income for our banks in 2021. While these origination numbers are expected to decline following 2020's banner year, total volume is still expected to be the second-highest in the past 15 years. And there is a distinction that should be made between purchase and refinance loans. While refinancing activity will likely drop off as rates rise, the MBA mortgage industry outlook predicts that purchase loan volume will increase to a record high in 2021. In summary, we believe the strong level of mortgage activity will continue into the new year as many first-time home buyers who have been stuck on the sidelines (due to the strong competition and seriously low supply in 2020) look to enter the market.

<u>**The Yield Curve Steepened Dramatically During Q4:**</u> As noted in the headline, the *spread* between the 10- and 2-year UST increased from 0.31% at Dec. 31, 2019 to 0.95% as of Jan. 15, 2021. While the overall level of rates remains low, the steeper yield curve most definitely helps banks. Effectively, deposit costs have remained near zero, but the yields banks can generate on loans and investments is rising. Although net interest margins will continue to be impacted by the extraordinarily low 1% rate charged on all PPP loans, the steeper yield curve will help stabilize margins.

We remind everyone that net interest income is a function of a variety of factors. Margin is only one. Volume is another. And, with $284 billion of new PPP loans being pumped into the economy, the "volume" of loans should again generate more incremental net interest income for our banks. And again, as noted in the previous section, the low level of interest rates is a major reason for the massive amount of fee income being generated by banks as they refinance existing mortgages and underwrite fresh residential mortgage loans on newly purchased homes. <u>*The takeaway is low rates can impact banks both positively and negatively.*</u>

<u>Asset Quality Remains Stable:</u> We have made mention of a couple important facts which bear repeating here. First, prior to the pandemic, non-performing loans and charge-offs at banks were very low. We also highlighted that, early on during the pandemic, bank stocks were marked down aggressively – primarily due to investor's *uncertainty* regarding borrower's ultimate ability to repay loans and the resulting impact that would have on bank profits. Uncertainty regarding non-performers and the ultimate potential for loan charge-offs has NOT gone away completely. However, the passage of time, combined with the ongoing stimulus being provided by Uncle Sam, analysts can now glean "most likely outcomes" somewhat more clearly. It now appears loan losses will not be as bad as initially thought.

You may recall at the onset of the pandemic, banks were encouraged by regulators (almost required) to provide payment deferrals to clients who requested temporary forbearance. Many borrowers *required* loan payment deferrals – but the vast majority did not. Yet, debtors from both groups applied for and received payment deferrals. Postponing payments provided a cash cushion against the ongoing uncertainty which borrowers faced. Most loan deferrals were granted for 90 days. Upon the maturation of that 3-month grace period, the great bulk of nonpayers began paying their loans as originally scheduled. Some, however, applied for an additional deferral of 90 more days. That second deferral period is currently maturing for most borrowers and we expect to see a continuation of the trend of more clients with deferred loans going back to regular payments. These facts suggest the deferrals helped tide borrowers over for a time; but they are now liquid and comfortable enough to return to normal payment status.

Another round of forgivable PPP loans will add further liquidity to borrowers and enhance cash flow allowing them to make payroll *<u>and</u>* loan payments. The cash received is for the purpose of making payroll, and having that expense covered by a PPP loan provides a business with liquidity to make loan payments from other cash generated by the business. Our contention is that not only has the incremental interest income and fee income from PPP loans allowed banks to build reserves, it has provided useful cash to their borrowers helping them to keep their loan payments current. This "bridge" has been crucial for borrowers *and* lenders.

It will take several more quarters to understand the ultimate cost of bankruptcies and loan defaults. Again, much of that will depend on our ability to control the virus. Nonetheless, our belief is that the final tally of loan write-downs and charge-offs will <u>not</u> come close to exceeding the levels seen during the Great Recession. And here's the kicker: banks have already largely reserved for the possibility of those levels of loan defaults and will very likely continue the path of lower or negative provision expenses going forward. This is another of the key reasons sophisticated analysts suggest financials will outperform in 2021. We refer you to the link entitled, *"<u>2021 Annual Outlook for Banks</u>"* at the end of this letter for further review of the forecast for banks.

<u>Reinstatement of Stock Buyback Programs Approved by Feds:</u> On 12/18/20, the Federal Reserve lifted the stock buyback suspension it temporarily imposed on the nation's largest banks earlier this year. *<u>Bank stock indices increased by as much as 5% in after-hours trading that day</u>*. While the restriction did not apply to smaller banks, the curtailment spooked the market and the whole financial sector suffered. The Fed's removal of these prohibitions on buybacks sent a strong signal to investors that they now believe capital levels are more than sufficient to allow them – signaling a strong vote of confidence for the financial sector.

<u>The Pandemic and the General Election Remain the Driving Stories of 2020:</u> It is a blinding flash of the obvious that the pandemic and the general election have been the main stories of 2020. Here's an amazing example of one of the "never in our lifetimes have we seen": how about, current dollar GDP contracting by 34% in Q2 and exploding by 38% in Q3. Holy smokes. Again, you've all heard the various letters being used to describe the economic recovery: V, U, W, etc. No matter the letter or the concept behind it, no one would've predicted the wild swing in economic activity this year caused by Covid-19.

We refer you to the link at the end of this letter entitled, *"<u>US Policy Pulse: Preparing for Biden's First 100 Days</u>"*. As an investor, you are entitled to consume professional advice regarding potential outcomes. This information may help you with your ongoing investment decisions.

Among the most relevant matters coming from the new administration – *especially for all of us as banks stock investors* – is the "financial team" being proposed by Mr. Biden. Clearly, the nomination of Ms. Yellen as Secretary of the Treasury has been warmly welcomed by bankers and investors in banks. Ms. Yellen has a wealth of experience; has proven to be a stable, calm leader; and is exceedingly bright – as well as generally dovish toward banks. The day after she was announced as the nominee for Treasury Secretary, bank stock indices popped 2.6%.

<u>Conclusions:</u> It's been a wild year! Much <u>un</u>certainty remains. The inoculations against Covid-19 (and its mutations) have begun. This provides hope. But, while we are not out of the woods quite yet, each day that passes brings us one day closer to the end of this nightmare. Through all the ups and downs, our bank management teams have responded appropriately to ALL their constituents and we are confident they will continue to do so throughout this recovery.

This time last year, we were celebrating the particularly good results of 2019 and looking forward to 2020. Who knew what was in store? We wish to repeat some longstanding, sage investment advice which we included in last year's letter – as it seems more appropriate than ever:

"*Price is what you pay. Value is what you get.*"
"*The stock market is designed to transfer money from the active to the patient.*"
"*Buy low and sell high.*"
And of course, as the great Warren Buffet once said, "*Remember the stock market is manic depressive.*"

The banks in our portfolio have and will continue to produce real, lasting value and that will ultimately be reflected in their stock prices. It takes courage, but if you have conviction and patience, buying low will in fact achieve the "transfer of money from the active to the patient". And yes, Buffet is right. The market is manic depressive. But, as long-term value investors, we can live through these "cycles" and still come out on top.

As we near the completion of our letter, we wish to finish on a reflective note and offer a little perspective. As difficult and stressful as 2020 has been, there were "silver linings" which occurred throughout the year. Sometimes we all had to look hard for them. But, they were there. We must always remember to count our blessings – and we consider our relationship with you among the most sacred and important gifts in our lives!

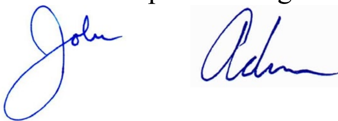
Miscellaneous Details Regarding the Logistics of our Investment:

1) **Your Annual Year-End Statement(s) have been mailed to you and you should receive them shortly.**
2) **Your K-1(s) will be mailed to you early March**.
3) **Adding to Your Investment.** Included at the end of this letter is a simple form for you to complete in order to begin the process. Or, you may just pick up the phone and call me at 574-243-6501 and we'll take it from there.
4) **Audited Financial Statements.** The annual audited statements for our Funds will be emailed to you in late February. Also attached to that message will be a copy of our Privacy Policy and a link to our Form ADV.
5) **Annual Investor Meeting:** We will attempt to hold our annual investor meeting later this year – conditions permitting. We'll email your invitation well in advance of any meeting.

Given the length, breadth and depth of this letter, the Appendices with various charts which we normally include have been added to our website and we invite you to peruse them there. The website is www.rosenthalpartners.net and the password/login to the Investor ONLY section of the site is: banksrus

As you review your statements, we warmly invite you to reach out with questions or comments. You may reach us by reply to this email or by calling the office at 574-243-6501, John's cell at 574-276-1128, or Adam's cell at 440-667-5974.

With warmest personal regards,



P.S. As has become our custom in the last several Newsletters, we are pleased to supplement our information with the following interesting, relevant and worthwhile links. We warmly encourage you to tackle these at your convenience.

Calling a Bottom to Bank Stocks – September 8, 2020 by John W. Rosenthal Capital Management, Inc.
US Policy Pulse: Preparing for Biden's First 100 Days – Morgan Stanley
2021 Annual Outlook for Banks – Raymond James
On the Markets – January 2021 – Morgan Stanley

Past performance may not be indicative of future results. Therefore, no current or prospective client should assume that the future performance of any specific investment, investment strategy (including the investments and/or investment strategies recommended by the advisor), will be profitable or equal to past performance levels. Additionally, Form ADV Part II for John W. Rosenthal Capital Management, Inc., filed with the Secretary of State of Indiana, is available on line at www.rosenthalpartners.net - or if you would like to receive a paper copy of our Form ADV Part II and/or information regarding the firm's proxy voting policy you may contact us at the number provided above and we will mail them to you immediately.

Additional Investment Form

I wish to *increase* my investment by: ___________________________________
(Fill in any dollar amount ≥ $10,000)

Fund 1 Fund 2 Fund 3
(Circle the one(s) that you wish to increase your investment)

Name: ____

Email: ____

Best Phone #: ____

I understand you will forward additional paperwork for me to execute which will indicate that I continue to accept *all* the terms and conditions of the Limited Partnership Agreement.

Please return this form using any of the following options:

Scan and email to: john@rosenthalpartners.net
or

Fax to: 574-243-4377
or

Mail to:
John W. Rosenthal Capital Management, Inc.
4220 Edison Lakes Parkway
Ste. 310
Mishawaka, Indiana 46545

THERE IS NO NEED TO SEND CASH NOW

We will Invoice You at the Proper Time

Questions Please Call 574-243-6501