JOHN W. ROSENTHAL CAPITAL MANAGEMENT, INC.

2nd Quarter 2020 General Newsletter

Prologue: You may have noticed we added a *Quick Overview Summary* to the back of your quarterly statement(s). It includes some of the info provided below. But this *General Newsletter* expounds on that synopsis and provides much more "color" on the state of the industry, the overall investment environment and our outlook for the future. As always, we will forward our *2nd Quarter '20 Bank Performance Newsletter* at the conclusion of the upcoming earnings season – especially detailing recently executed enhancements to each of our portfolios. Please read on.

Headlines:

- **Quality Has Never Counted More than it Does Now! Our Holdings Include Some of the Best/Strongest Community Banks in the Country!**
- **Stock Prices Bounce from Pandemic Lows of Q1 – See Tables Below**
- **Government-guaranteed Payroll Protection Program ("PPP Loans") Skyrocket at Community Banks and Provide Windfall of Origination Fees from SBA**
- **Equity Capital Continues to Exceed "Well-Capitalized" Guidelines and Current Dividends from Our Banks Remain Safe**
- **Fee Income from Residential Mortgage Loan Originations Expected to Break Records**
- **Portions of the Increasing Overall Revenues at Banks Likely to be Used to Boost Allowance for Possible Future Loan Losses ("ALLL account")**

Q2 2020 Results

2nd Qtr. '20	Fund 1[1]	Fund 2[1]	Fund 3[1]	BANK[3]	KRE[3]	KBE[3]	Russell 2000[2]
April	9.4%	7.0%	1.1%	12.0%	17.0%	16.1%	13.7%
May	1.1%	-0.5%	0.3%	-1.4%	0.1%	0.5%	6.4%
June	1.7%	2.4%	-0.7%	1.1%	1.5%	1.2%	3.4%
Cumulative Q2	12.5%	8.9%	0.6%	11.7%	18.9%	17.9%	25.0%

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

Year-to-Date 2020 Results

YTD '20	Fund 1[4]	Fund 2[4]	Fund 3[4]	BANK[3]	KRE[3]	KBE[3]	Russell 2000[2]
Q 1	-29.4%	-34.0%	-25.9%	-38.5%	-43.4%	-42.6%	-30.9%
Q 2	12.5%	8.9%	0.6%	11.7%	18.9%	17.9%	25.0%
Cumulative YTD	-20.6%	-28.1%	-25.5%	-31.3%	-32.8%	-32.3%	-13.6%

4. Average quarterly net rate of return after fees/expenses

Second Quarter and YTD '20 Results vs. Benchmarks: The tables above show the absolute and relative performance of our three Funds. Most noteworthy is the substantial positive YTD variance we've achieved vs. our benchmarks. This positive variance from our yardsticks, authenticates our stated objective of "providing our investors certain downside protections" and demonstrates our success at generating alpha.

Generally, we have participated in a nice rebound from the pandemic lows seen in Q1. But, volatility still exists. During the first 10 years of our venture, seeing an +/- 1% daily move in stock prices was very unusual and occurred infrequently. In today's world, stock prices can commonly vacillate by +/- 2 – 5% daily. (The next time you see me, you'll notice my gray hair has turned white. Not at all due to any long-term reservations about our investments; but rather, because it is difficult to make sense of these wild short-term swings.) We all know *headlines and lingering uncertainty* are driving this capriciousness (more than current operating performance and actual financial results). And we believe this variability is likely to continue throughout the summer and probably the rest of the year. But, in spite of our expectation for uneven movements in stock values, we remain confident our high-quality banks will continue to out-earn peers, and investors will realize the undervalued nature of these companies and the stock prices of our holdings will ultimately jump disproportionately higher.

What drives our conclusion is our ongoing analysis of this situation. The first bullet point in the Headlines on page 1 makes the claim that we own stock in some of the strongest and best community banks in the country. Our "proof" of that assertion has always centered on the superior asset quality metrics, (i.e. excellent loan portfolios), exceedingly strong capital ratios, and above-peer earnings from our banks – coupled with our judgment on the superlative corporate cultures inculcated by the leaders or our companies. Our fundamental premise has been, is, and will always be – "QUALITY COUNTS". Given the coronavirus and its impact on the economy, now more than ever, loan quality counts. There is no question that every bank in the country will experience certain stresses on their loan portfolios. It's the nature of the lending business to extend credit to all manner of borrowers across a broad spectrum of businesses and industries – as well as a diverse group of individual consumers. But, based on historical performance and the all-important "credit cultures" of our banks, we fervently believe these banks will fare better than the average. Unfortunately, only time will unequivocally corroborate this belief. In the meantime, the *herd investment mentality has discounted almost **all** banks* (with only minimal demarcation) based on the ongoing uncertainty surrounding loan quality. When this is all over – and it will eventually end – we believe the difference between average vs. our well-above average banks, will be very rewarding for all of us.

Pointing to the single biggest event for banks during Q2, community banks shone more brightly than their big bank brethren and provided a tremendous service to existing and new clients by stepping up to provide PPP Loans to small business borrowers. Getting into the weeds a bit – since the end of Q1, the first installment PPP Loans issued by many community banks under the CARES Act ($350 billion) has concluded, and the second segment of that program ($310 billion) is underway. This historic funding for small businesses is a real boon for both the borrowers (and their employees) whose businesses are being helped – but also, for banks who've underwritten these **government guaranteed loans** (against which no capital allocations are required as part of the all-important "risk-based" capital calculation). While the interest rate on these PPP Loans is very low and will therefore reduce net interest margins slightly; incrementally, this tsunami of new loans will still boost *interest income.* **More importantly, the fee income generated from this PPP Loan activity will be unprecedented!** Origination fees being paid to lenders by the SBA for PPP Loans vary from 1 – 5% depending on the size of the loan. In discussions with our banks, it appears most of them are averaging between 2 – 2.5% fees on PPP Loans. As an example, a bank who has facilitated $500 million in PPP Loans will likely receive fee income of around $11 million! We anticipate most of this windfall will be used to boost the allowance for loan loss account. In essence, the government has helped banks reserve for a very meaningful part of potential future loan losses which they may ultimately incur. *This is an incredibly positive development for banks and, we believe, is not quite fully understood or appreciated by all investors*. Plus, the number/quality of **new client relationships community banks are developing from this PPP initiative** is invaluable and should lead to future cross-selling opportunities – driving various revenue streams higher over time.

Another source of increased revenues for banks this quarter has been the tremendous uptick in mortgage loan origination fees – from both refinancing and newly originated residential home loans – due to historically low interest rates. But the wildcard yet to be fully accounted for is the pending non-cash provision for loan loss expenses which banks will record. Again, stay tuned for our *2nd Quarter '20 Bank Performance Newsletter*. Finally, as emphasized in the Headlines, based on the very strong capital levels and forecast profits at our banks, we believe the current dividend payouts from them are sustainable and that higher-yielding, dependable dividend paying stocks, (like ours) are those to which investors are flocking.

<u>Preserving Value and Macro Portfolio Positioning:</u> Given these unprecedented times, in our last several letters we've noted the implementation of a hedging strategy to protect and preserve the value of your investment(s). By virtue of this hedging strategy, we've generated an YTD (thru June 30) net increase in value equivalent to 4.7% of the total value of Fund 1. Similarly, we've produced an YTD net increase in value in Fund 2 equivalent to 4.5% of the total Fund value. The vast majority of these increases in value have now been permanently recognized as "realized gains". Since the construct of the holdings in Fund 3 are themselves a natural downside hedge, we've done only a very limited amount of hedging in that Fund. Nonetheless, our modest activity in Fund 3 has spawned YTD permanent realized gains of $13,570 of value; and we had no open hedging positions in Fund 3 at quarter end. In addition to these "active hedges", we are maintaining more <u>cash</u> than usual as a "passive hedge" in our Funds. Cash earns only a small positive return in this environment and does not increase in value as stocks decrease. That, of course, is why we call it a passive hedge. Ordinarily, we maintain 1 – 4% of our resources in cash. Throughout most of Q2, cash was closer to 15%. We anticipate deploying this cash when appropriate. For now, having more greenbacks than usual is prudent.

Winners, Losers and the so-called "Fed Put": You already know this, but one of several reasons markets began to rebound is that there are companies which are generating record revenues and profits. Plexiglas makers (these barriers/dividers are here for good), tin can producers (how much tuna is in your pantry?), Clorox Bleach (we can't get enough) and Zoom (the new way to gather in a group) are only a few examples of "winners". In addition, you'll be hard-pressed to buy a new bicycle (none are available and makers can't keep up with the backlog of pre-ordered bikes) and demand for swimming pools is at an all-time high. Conversely, cruise lines, hotels and recreational venues (among others) are not faring nearly as well.

Beyond the good or bad fortune one might have to be a bleach maker vs. a cruise line, the Fed has clearly signaled it is pulling out all the stops to support the overall economy and the American people. The Federal Reserve started buying *corporate bonds* in Q2 as part of a $250 billion program funded by the CARES Act, which was approved back in March. The Fed is making this program anonymous — just buying up corporate bonds without any specific company asking it to. That avoids any stigma from companies requesting Fed help. The added liquidity to the corporate bond market has helped keep corporate bond yields from increasing to levels that might hinder or even prevent companies from accessing debt markets at reasonable prices. This is on top of the Fed buying multi-holding bond exchange-traded-funds (ETF's) which it also began acquiring in the 2nd quarter – as well as mortgage-back-securities it has bought at various times since quantitative easing started.

In the capital markets, a rising tide lifts all boats. By buying hundreds of billions of dollars in bonds, the Fed is essentially freeing up capital that will have virtually nowhere else to go but to the stock market. The Fed's interventions and the promises of more involvements are one of the reasons the stock market has been so strong since late March. It remains to be seen how far this trend might go. The Fed's interventions were certainly helpful to the 2009-20 bull market. And, as a general rule, it's a bad idea to "fight the Fed". It has a much bigger wallet than any of us.

We've talked before about the various levers available to the Fed to stimulate financial activity. One such device has clearly been pulled is decreasing interest rates to benefit personal and corporate borrowers, which in turn leads to greater cash flow/profits and fuels spending. But a low rate environment can be a challenge to bank earnings as it may narrow the spread banks earn on loans.

All these Fed actions have a ripple effect on banks. Their injection of liquidity may have a very positive impact on overall loan quality as monies are being provided to help some companies make it to the other side of the pandemic without having to renegotiate terms or default on loans. "Managing markets" (and by extension rates) so centrally is not new for the U.S.; and while "free markets" are what our capitalist system is based on – extraordinary times require extraordinary measures. Using financial jargon, many analysts, commentators and pundits refer to these special actions as "the Fed put" – meaning the Fed is likely to provide as much cover to protect the asset values of market participants as they can. Their collective actions make it far easier for folks to "keep calm and carry on".

Why Are Bank Stocks Currently Lagging Certain Market Sectors? It's a question that begs to be asked and answered. The main answer is because **uncertainty** in the banking sector remains a bit higher than some other sectors. As an example – currently, people are more likely to pay their cell phone bill than their mortgage. So, monthly payments to Verizon continue uninterrupted and therefore Verizon has performed better than the bank index.

We'll give more air to the subject of uncertainty below. We now submit another reason financials have lagged the broader market rebound. People have long memories. It was mostly the **big** banks that were in some trouble during the Great Recession and given that relatively recent history, investors are worried that banks may once again experience difficulty in this pandemic-related environment. Thus, so far, the recovery in bank stock prices has been somewhat more muted than other sectors. We've spent a great deal of time and space sharing info about how much stronger the banking system (as a whole) is today than it was in the go-go days at the start of the new millennium. All of which is still true today!

Again, the virus has caused tremendous uncertainty. Its impact on banks will start to be more fully understood during this upcoming earnings season. But, once more, NOT ALL BANKS ARE CREATED EQUAL. Mr. Dimon will kick off earnings season by disclosing how JP Morgan Chase has performed and what actions they've taken. JPM is huge, and some may extrapolate that what happens there will or should happen elsewhere. I assure you that is NOT completely the case. One more time, our community banks are different. We continue to assert – better! Their prices WILL reflect that over time. But for now, uncertainty is constraining an even more robust recovery in all bank stock prices.

Unrest, the Election and an Update on the Recovery: Rising geopolitical and geo-economic tensions continue to escalate in 2020. This year's presidential election, Iran's proxy war, U.S. China relations, climate change, the coronavirus pandemic, and racism (just to name a few) have all played a role in shaping the current economic climate. Each of these issues can impact the market on its own, but they are all magnified and politicized when it comes to an election year. For example, race has been a defining issue in American politics since before the country formally came into existence, and today the issue is back at the center of a national debate amid shifting attitudes and heightened expectations that are demanding more than sympathetic rhetoric from political leaders. With these issues in the forefront of minds across the country, it is all but certain to impact voting in November. So what does that mean?

In a research note published June 30, analysts at Deutsche Bank wrote, "attention will focus on the U.S. Presidential election in what looks to be a tight race, which has historically meant a range bound market until the uncertainty is resolved, followed by a strong rally into year-end – regardless of who won." So does the market really care who wins? For now, all we can do is look at track records and platforms of the candidates to glean what is yet to come.

In a second term, it is our opinion that President Trump would continue focus on deregulation, an "America First" approach to trade, and tax reductions (which may make permanent or expand the tax cuts in the 2017 Tax Cuts and Jobs Act). By contrast, Mr. Biden would seek to increase spending on climate change mitigation, expand access to federally funded healthcare, and raise taxes on corporations and high-income earners. But no president can make dramatic policy changes unilaterally. That is why we believe it is equally important, if not more so, to pay attention to which party wins control of the House of Representatives and the Senate.

It is worth bearing in mind that the impact any president can have on the economy and market depends on their ability to enact legislation. To be able to put in place more controversial policies, control of both the House of Representatives and the Senate would be necessary. Let's take a look back at history: in 1985, 2013, and 2019 (all years when congressional control was split between Republican and Democrats) the stock market gained more than 30%. And based on data from CNBC, the market rallied more when Congress was split than it did when a particular party held the presidency. Since 1976, stocks delivered an average annualized return of 14% with a Democratic president, just higher than the average annualized return of 11% for a Republican president. Both return figures (based on which party occupies the presidency) are lower than the average annual return of 17% delivered when Congress is split; suggesting that if investors are concerned about market implications of politics, they should focus more on which party wins the legislative branches than they do on who wins the presidency. To us that means markets tend to like 'checks and balances' to make sure one party doesn't have too much sway – and that tension limits market uncertainty in terms of legislative risk. Of course, this is just when drawing correlations to the stock market – and each individuals policy concerns should always be a voter's top priority at the polls.

No matter whose camp you're in, we're confident that Messrs. Trump and Biden both have their eyes on the market. One reason being the S&P 500 has predicted every presidential election winner since 1984, and 87% of winners since 1928. When stocks are higher in the 90-day period before the election the incumbent party usually wins.

So what does the rest of 2020 look like? We argue that the market is further along in its recovery than most would have expected just a month or two ago. All the Fed actions mentioned above seem to be working. State and local governments have been empowered to make decisions based on what's needed to protect their own citizens and the prospect of a nationwide shutdown looks unlikely. We are, by no means, out of the woods. But the declining unemployment numbers, which have consistently been beating expectations, seem to indicate we are on the right path. Only time will tell, but we take solace in the belief that Fed Chairman, Jerome Powell and Treasury Secretary, Steven Mnuchin are helping, not hurting, the markets.

Conclusions/Summary/Epilogue: Diversification is a tried-and-true technique for managing your investment portfolios. We've often touted the virtues of a diversified portfolio. While real, true "performance" is (and should be) measured over a long period of time, we think it is also important to note that being diversified has severely hurt performance this year…..and concentration in just the 10 largest market cap companies (which are predominantly tech related and are trading at 31 X forward earnings vs. a market historical average of 16 X) have generated higher returns than holding a diversified portfolio. Who'd have picked these 10 largest cap companies exclusively for their portfolio before coronavirus?

We, like you, want all of the upside and none of the down – every year….and this year is frustrating as the "normal" approach to investing and allocations has been suboptimal. However, we most certainly do believe that over a full market cycle, 5 – 10 years, these anomalies will normalize and balance out….but in the short run they can be disappointing (or joyful) depending on your asset allocation.

Finally, we believe that your investment with us in the "best-of-the-best" community banks in the country will continue to be a rewarding part of your overall portfolio. Looking at a slightly longer time horizon than these past few months/years, it becomes more obvious that financials deserve to occupy a healthy spot in your portfolio. The 10-year return for Financials as measured by GSPF (a bank index) show a 113.74% total return. The ABA Community Bank NASDAQ Index is up 197.52%. GSPF beats the energy, utility, and communication services sectors; (not totally surprisingly) it lags the IT, consumer discretionary, and health care sectors; and it's pretty much even with the consumer staples, materials, and industrial sectors. That's just raw data for the immediate past 10 years. If you were to slice and dice it differently, various sectors would lead or lag at any point in time. Remember 2016? Financials rose by 40+% in one year alone!

Your specific returns with us have varied depending mostly on when you invested with us. But, we believe to our core, that having outstanding community banks in your portfolio is most definitely a good idea. Our personal investments in our Funds remain resolute and unswerving based on our analysis and intellectual study – not our emotions.

As always, you may reach us by replying 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,

John Adam

P.S. We've found the following materials to be very informative, useful and enlightening and we warmly encourage you to click the link to peruse them.

Presentation on the Upcoming Election: From Raymond James
On The Markets: from Morgan Stanley

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

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.