JOHN W. ROSENTHAL CAPITAL MANAGEMENT, INC.

3rd Quarter 2021 General Newsletter

2021 Annual Investor Meeting To Be Held "*Virtually*" on Monday October 25th, 8:00 a.m. EST

We hope you received your invitation to our meeting. It was sent by email on Monday Sept. 20th with an explanation of our decision to "go virtual". If you haven't yet registered, you may do so by clicking the following link: register here

Prologue: We've experienced a solid uptick in the value of our portfolios this quarter. (See Results Table below.) During the last 2 weeks of the quarter, bank stocks broke out of their summer long "range-bound" pattern. The third quarter was influenced by various factors – including uncertainty surrounding the Delta variant, slightly lower interest rates and the typical summer doldrums which seem omnipresent in the 3rd Quarter annually. But after the September Federal Open Market Committee meeting, rates have risen, the yield curve has steepened and general concerns over the economic reopening have calmed. While the ambiguity surrounding a possible real estate bubble in China, i.e. a potential default by Evergrande, roiled equity markets for a couple of days, those fears have also subsided – at least for now. The upshot: another increase in the value of your investment(s) this quarter!

As outlined in our recent *2nd Quarter Bank Performance Newsletters,* earning from our banks remained stellar. And initial releases from banks for Q3 continue to exceed analysts' forecasts. We expect good 2nd half earnings performance from our banks, with strong bottom-line profits – which we believe will translate into further stock price appreciation. So far this October, the Nasdaq Bank Index (^BANK) is up by 2.6% and our Funds are up by a similar percentage. More news is summarized below; please read on.

Headlines:

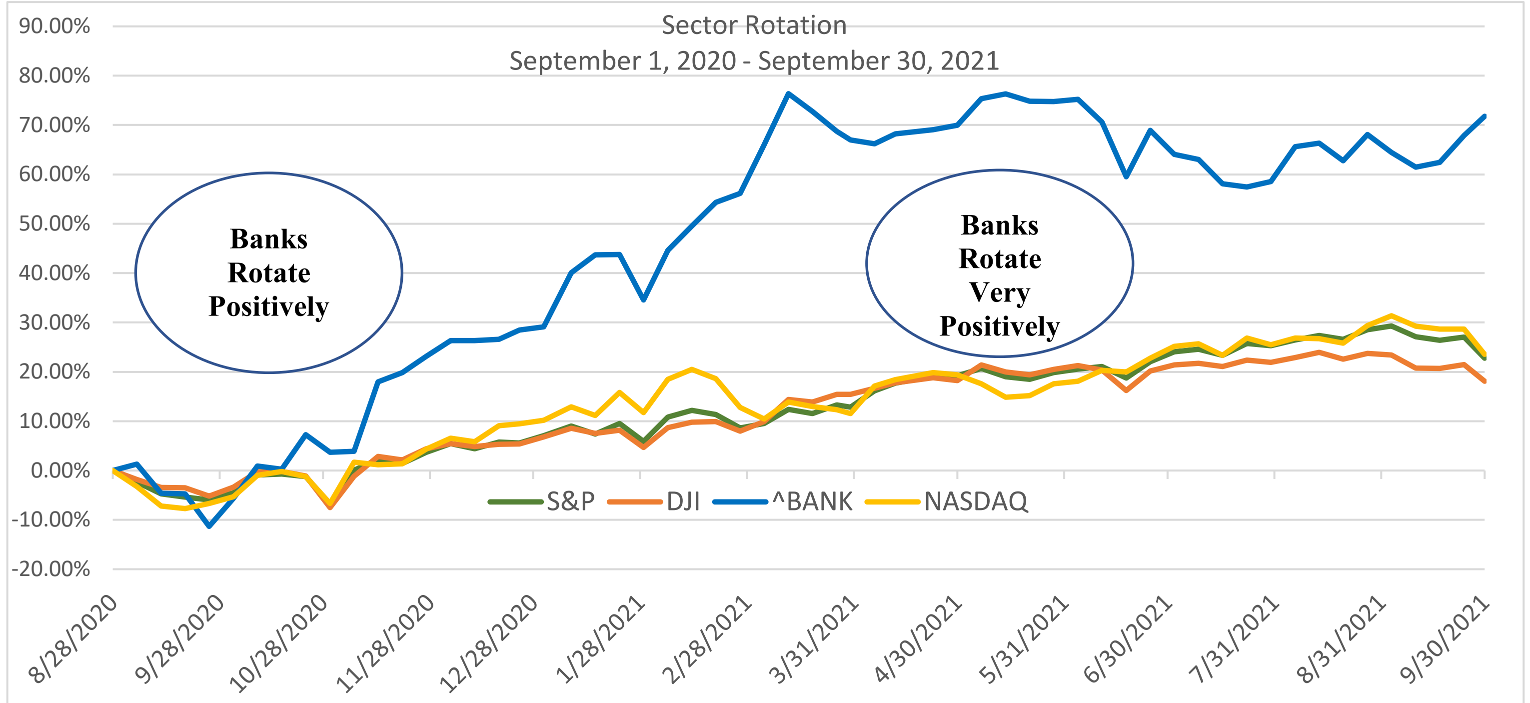
- **Yet Another of our Portfolio Holdings was Acquired this Quarter – Bringing the Total Number of Our Banks Bought Out This Year to Eight**
- **The Consistent "Themes" Driving Strong Bank Earnings Performance are:**
  - **Lower Provision Expenses due to Strong Overall Asset Quality**
  - **Strong Overall Expense Control**
  - **Continued Accretion of PPP Loan Fee Income from the Ongoing Forgiveness Process**
  - **Sustained (but below record) Fee Income from Residential Mortgage Loan Originations**
  - **Adequate levels of Net Interest Income due to Larger Balance Sheets from the Glut of Deposits**
- **In September, We met with the Management Teams of 13 Banks in Our Portfolios. Common Takeaways:**
  - **Hiring Talent is a Concern. Retaining People from Acquisitions Improves Merger Dynamics & Metrics**
  - **Our Banks Anticipate and are Preparing for Rate Increases**
  - **Asset Quality is Strong!**
- **We are Back on the Road Meeting with Banks. Similarly, we are Eager to Hold 1-on-1 meetings with You! Please let us know if you want to Huddle So We Can Coordinate Schedules as we Plan our Travels**

Summary Results Table: The table below presents our performance this quarter – by month, QTD and YTD. We also included results from the prior three quarters at the bottom of the table to highlight the incredible results which occurred in our portfolios late last year and early in 2021. As to be expected, in some periods we outperformed our benchmarks or broader market indices; and in others we did not. Generally, we have done well against our benchmarks.

Results Table

2021	Fund 1[1]	Fund 2[1]	Fund 3[1]	^BANK[3]	KRE[3]	KBE[3]	Russell 2000[2]
July	-1.6%	-1.3%	-1.9%	-3.3%	-4.5%	-3.6%	-3.7%
Aug.	3.6%	4.0%	3.0%	4.6%	5.3%	5.4%	2.1%
Sept.	5.0%	3.8%	2.2%	3.6%	2.8%	1.5%	-3.1%
Q3 '21	7.1%	6.4%	2.9%	4.7%	3.4%	3.1%	-4.6%
YTD '21	28.5%	28.6%	26.7%	33.0%	31.0%	27.3%	11.6%
Q2 '21	-0.5%	2.7%	1.7%	-0.6%	-1.2%	-1.1%	4.1%
Q1 '21	21.7%	19.0%	21.2%	27.8%	28.3%	24.8%	12.4%
Q 4 '20	37.4%	42.0%	32.0%	41.5%	45.6%	42.0%	31.0%

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



Sector Rotation Paints a Clear and Compelling Picture: We've updated this graph and can't help but share it with you once again. A picture is worth a thousand words and this picture tells the clear story that banks have outperformed broader market indices since last September *by a very wide margin* – up over 70% vs. the mid-teens or less for major market indices! The message we hope you take from this is that our banks were *very strong* entering the pandemic and they were undeservedly "marked down" during the initial "panic phase" at the onset of the coronavirus. The cumulative returns over time from your investment(s) with us have been very good and we encourage you to review the Appendices to this Newsletter available on our website: www.rosenthalpartners.net. The password for the investors only section is: banksrus

Mergers and Acquisitions Update: As reviewed in prior newsletters, the deal flow for U.S. bank merger and acquisitions continues to surpass expectations. And the September results pushed up the tally of deals past $50 billion for only the second time in a given year since 2007 according to S&P Global Market Intelligence. With three months left to the year, 2021 has already nearly doubled the total bank M&A dollar volume of $27.8 billion in 2020. Lastly, but certainly not least, we have enjoyed enhanced returns from the acquisition of three banks in each of our Funds contributing to their overall stellar performance this year.

Three-fourths of the way through 2021 it is still difficult to generalize why M&A activity has surged year-to-date (even though we have discussed possible rationales in prior newsletters: i.e. synergies in technology, carry over from deals scheduled in 2020, concerns about changes in tax policy, board fatigue, etc.). In reality, a bank's decision to merge/sell is some combination of all those factors and more. That is why we continue to invest in banks with sound metrics, solid management, and located in great markets. It is our belief that greater regulatory scrutiny and higher valuations across the board will place these banks at the "top of the heap" as valuable targets, i.e. able to command a premium acquisition price, as acquirers look to prudently deploy capital over time.

Drivers of Performance: As always, there are positive and negative factors (tailwinds and headwinds) which influence operations and financial outcomes in any business (including banks). In the headlines, we touched on several key themes driving bank performance. Let's recap certain dynamics at play today influencing performance and bank stock prices.

Tailwinds:

1. Strong asset quality leads to much lower provision for loan loss expenses. It's hard to overemphasize how important it is that loan quality has remained so resilient during the pandemic! The much-feared loan charge-offs that folks anticipated due to Covid have not materialized. Fiscal and monetary policy, most especially including the PPP loan program, have flooded the financial system with liquidity and allowed borrowers to remain current with their loan obligations. Furthermore, temporary loan deferrals sanctioned by congress and the regulators also provided additional "breathing room" for debtors. The deferral period is over and an overwhelming percentage of borrowers who received deferrals have returned to regular payment status. Profit margins for banks are, by their very nature, slim – providing less room to absorb loan losses. *This is why loan quality has and will always be our hot button!* At the beginning of the pandemic cycle, banks provided aggressively for possible loan losses but are now reducing, ceasing or reversing provision expenses. This "unwinding" or "negative expense" is wonderful – and helping build tangible book value with higher profits. But, this windfall is also temporary. Once some sense of normalcy returns, this trend of no or negative provision expenses will abate. But, for now, it's a definite positive for earnings and further building upon existing strong capital positions at our banks.

2. Rising rates and a steeper yield curve are definitely helping to stabilize the recent downward trend in net interest margins. Bank stocks have gone up markedly since the conclusion of the last Fed meeting after which Chairman Powell announced that tapering of their bond buying program (quantitative easing) would likely start late this year. The yield on the 10-year UST bounced from 1.30% on September 20th before that news, to 1.55% as of October 13th. Similarly, the spread between the 2- and 10-year UST has widened from 1.10% pre-meeting to 1.18%, i.e. the yield curve has steepened. Given the massive amount of deposits being held in banks today, they are under no pressure to raise rates on deposit accounts and will be very reluctant/slow to do so for the foreseeable future. "Savers" are not able to generate acceptable yields which have been historically available in either banks deposit products or bonds. Therefore, equity markets continue to benefit from investor inflows seeking some yield.
3. As outlined above, M&A activity is robust and clearly this phenomenon is a current benefit for banks which are attractive acquisition candidates.
4. Price Earnings ratios remain below recent historic levels and provide impetus for further stock price increases over time.
5. Community banks will face less regulatory risk from the imposition of new rules than their big bank brethren and shouldn't be as impacted by congressional or regulatory intervention.
6. Continued accretion of PPP loan fees remains a current positive; but this source of income will eventually run its course once the forgiveness process is complete.
7. Operating expenses are in check. They say 'necessity is the mother of invention'. Banks, like many businesses, have continued to learn how to do more with less in the face of this crisis. The pandemic seems to have further accelerated the adoption of various bank technologies by clients. The decades-long investment in technology updates and upgrades by banks is now paying off even more quickly than anticipated as the espousal of such technology was necessitated by the outbreak of Covid-19.

Headwinds:

1. The glut of deposits being held in banks from all the stimulus is a double-edged sword. As noted above, this has helped borrowers remain current on their debt obligations. But there are very limited options for banks to deploy those deposits into higher yield earning assets at this time. This has negatively impacted bank net interest margins, at least temporarily. This situation is referred to as a negative mix variance. That is to say, excess deposits are being temporarily invested in earning assets yielding less than the current overall margin. Thus, the result is decreasing bank margins. While pundits focus on declining margins, they spend little time talking about the absolute level of *net interest income*. While margins are down, most banks are experiencing an <u>increase</u> in net interest income simply due to the increased volume of overall earning assets – albeit this glut of deposits is earning far less now than it would be historically. Simply put, the volume i.e. larger overall balance sheets of banks are making up for the negative mix variance currently being experienced by banks. Like with many of the other issues we are discussing, this too is a temporary condition. Once deposits are drawn down (spent) the mix variance will revert to a positive situation.
2. The main headwind faced by banks today is that the glut of deposits is currently constraining loan growth. Loan growth exploded due to the PPP program in 2020 and early 2021. As these loans are now being forgiven, loan growth is being impacted by those PPP loan payoffs. New loan growth, while <u>not</u> non-existent, is harder to come by since usage under traditional working capital lines of credit is low because companies are still sitting on cash. Our banks are faring much better as it relates to loan growth than the industry. Community banks led the way with the PPP loan program and have attracted many new borrowing clients from this initiative and outreach. So, yes, loan growth is and will be harder to come by and is a headwind in today's environment. But, as the economic re-opening continues to gain steam, deposits are likely to decrease and loans likely to increase.
3. Mortgage loan fees from refinancing activity is slowing and may slip further as rates rise. Purchase mortgage activity remains adequate for the time being – but depending how far and how fast rates rise, purchase mortgage loan fee income could be negatively impacted in the future.

<u>Meetings with Banks:</u> Even though business operations changed, we were able to stay in touch with investors and bank management teams throughout 2020 and into 2021 as we took advantage of the various virtual meeting options at our disposal. While these virtual meetings allow us to check in on bank operations and keep tabs on the various headwinds experienced by financial institutions across the country, they are no substitute for being on sight with our various investments. But now that many pandemic restrictions are lifting, we're back on the road.

So, what have we learned being back on the road?:

1. Banks with strong cultures got stronger. How, you ask? Because taking care of their employees and communities is a cornerstone of community banking. The past 16 months were hard for everyone, but our community banks made sure to take care of their own through loan deferrals, PPP loan originations, freezes on overdraft and ATM fees, and a flexible and safe environment for their employees. We believe that the goodwill created over these past months will pay dividends for years to come.
2. Virtual work will continue to evolve, but management teams are eager to get employees and customers back onsite, <u>safely</u>. Banks had to pivot to virtual interactions with team members and customers. While the investment in these technologies will add value for banks in the long run, we continue to hear about all the ways banks are making it safer for employees and customers to return.

3. Crypto is the new buzzword. No, none of our banks are investing in bitcoin (or its equivalents), but more indirect exposure to crypto currencies is being discussed. Most of these discussions revolve around a bank's ability to assist with the market making of various blockchain based currencies providing an alternative way to add deposit dollars and fee income to the balance sheet.
4. Common concerns: While geopolitical and inflationary concerns are keeping bank management teams up at night, we can now add hiring to that list. Hiring top talent was a core concern for most of the banks we've met with. Luckily there are multiple ways that banks bring in key people. For example, the surge in M&A has assisted banks to merge with or acquire talent. Additionally, the strong culture of our banking institutions makes it easier for management teams to "lift-out" whole teams of strong bankers with robust books of business and referral contacts. Hiring has been a recent struggle for businesses across the country and banks are no exception.

Being back on the road has allowed us to reconnect with the wonderful banks in our investment portfolios and see, first-hand, how they came through the pandemic stronger than ever before. But we are also eager to reconnect with each of you. Out of an abundance of caution, our large Annual Meeting gathering has moved to a virtual platform, but we'd love to meet with each of you (individually or in small groups) when possible. Please let us know when you would like to huddle and we will plan a safe meeting.

Conclusion: Many reputable investment professionals have recommended clients overweight financials at this point in the economic cycle. We concur with this advice! Bonds will lose value as rates rise and are a very difficult asset class to recommend to investors. Cash isn't earning enough and likely won't for a long time. And while cash doesn't lose principal value in an identical fashion to bonds when rates rise, the *purchasing power* of cash does diminish in an inflationary environment. Higher interest rates seem likely and even inevitable to us. This fact is a very compelling reason why investors should overweight financials. Margins will very likely expand and bottom-line profits should follow.

We are overjoyed you have invested with us and remain bullish on bank stocks. However, we would be remiss if we didn't say very clearly that the likelihood of the massive continued % increases in bank stocks is unlikely to go on forever. We anticipate 2022 might be a more "normal year" for bank stocks with returns meeting our goals of low double-digit annual gains. IF we achieve that forecast, the compounding on the value of your initial investments will be very attractive. As we will share during our upcoming Annual Meeting, $81 billion of Buffet's net worth of $84 billion came after he turned 65. (Compounding is truly a beautiful thing.)

We encourage you to call or email with any questions. As always, you may reach us by dialing the office at 574-243-6502, John's cell at 574-276-1128, or Adam's cell at 440-667-5974. Or by email: john@rosenthalpartners.net or adam@rosenthalpartners.net

With warmest personal regards,

As has become our custom, 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.