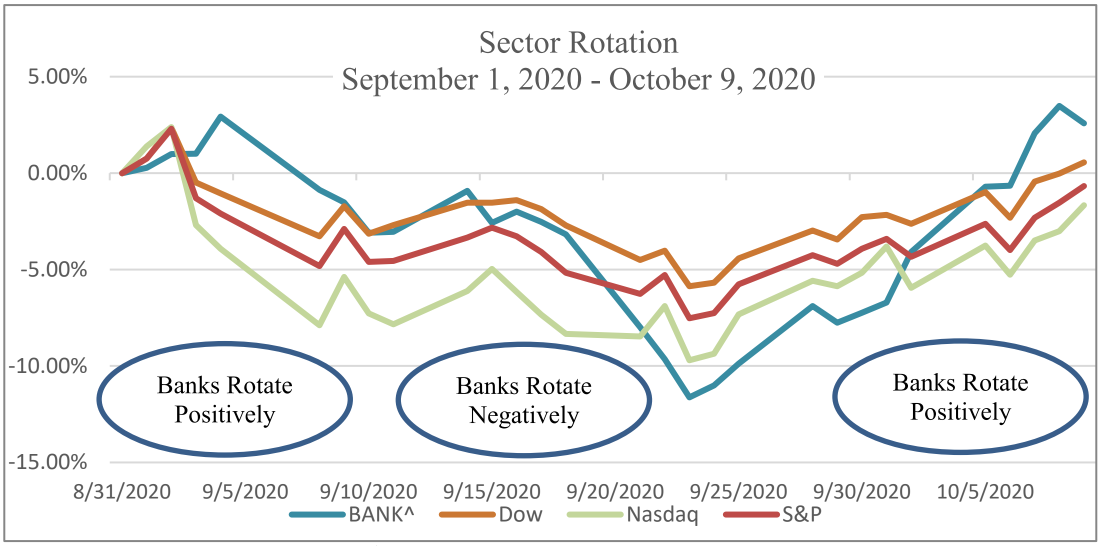
JOHN W. ROSENTHAL CAPITAL MANAGEMENT, INC.

3rd Quarter 2020 General Newsletter

Prologue: Strong Sector Rotation into Bank Stocks to Start Q4! Since September 1st, and especially since the beginning of October, bank stocks have outperformed broader market indices! In October ^BANK (Nasdaq Bank Index) is up 10.6% (as of 10/9/2020), while the DJIA is up only 2.9%. (Our Funds are also up in October by a similar amount as bank indices.) Below is a graph depicting the performance of ^BANK vs. broader market benchmarks. (Follow the blue line carefully and note the circled time periods!) We draw encouragement that investors may be beginning to embrace the fact that banks are considerably undervalued and this situation will hopefully continue to correct itself.



At the beginning of September, we saw what appeared to be the start of a sector rotation into banks as they outperformed major market indices for the first few days of the month. But the gale force headwinds of broader market declines dragged everything down. Now however, we believe the sector rotation into value-oriented bank stocks is more firmly rooted and taking hold. But, as we all know, uncertainty remains extremely high and there are many factors at play influencing all equity stock prices – including banks.

As always, we will forward our *3rd Quarter '20 Bank Performance Newsletter* at the conclusion of the current earnings season – especially detailing recently executed changes to each of our portfolios. Spoiler alert: banks are doing far better than their stock prices currently reflect! Big banks which have already reported Q3 results have beaten EPS estimates handily on lower provision expenses and higher overall revenues. We believe this will continue to help bank stock prices over time.

Headlines:

- **Loan Quality Remains Much Better than Investors Initially Expected; But New Loan Originations Slow**
  - **So Far, Non-Performing Loans (Industry Wide) Increase Only Modestly and Remain Steady at Our Banks**
  - **Deferred Loan Payments Shrinking Rapidly at All Banks as Borrowers Reinstate Payments**
  - **Allowance for Loan Losses are Robust and Provision Expenses Likely to Moderate Further in 2021**
  - **Volume of New Non-Residential Loans Slows at Large Banks but Steady at Community Banks**
- **Fee Income Continues to Significantly Boost Earnings**
  - **Forgiveness of SBA Guaranteed PPP Loans Underway and Corresponding Fee Income Accreting into Income**
  - **Residential Mortgage Loan Originations Expected to Remain Near All-Time Highs**
  - **Wealth Management Fees Rebound; Service Charges and Cash Management Fees Recover**
- **Uncertainty Remains due to Covid, the Election, Social Issues and Global Factors: Stock Prices Fall in September**
- **Equity Capital Continues to Exceed Well-Capitalized Guidelines and Current Dividends from Our Banks Remain Safe**
- **We've Terminated our Hedges and Believe Bank Stocks Will Continue to Rise! (See Chart Above)**

Q3 2020 Results

2020	Fund 1[1]	Fund 2[1]	Fund 3[1]	^BANK[3]	KRE[3]	KBE[3]	Russell 2000[2]
July	-2.4%	-4.2%	-4.4%	-3.3%	-2.1%	-1.5%	2.7%
August	3.9%	3.3%	0.03%	2.4%	2.9%	2.6%	5.5%
September	-7.9%	-7.0%	-4.1%	-7.2%	-6.8%	-6.8%	-3.5%
Q3 '20	-6.5%	-7.9%	-8.2%	-8.11%	-6.2%	-5.8%	4.6%
YTD '20	-25.8%	-33.8%	-31.6%	-36.8%	-37.5%	-36.2%	-9.6%

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

Third Quarter and YTD '20 Results vs. Benchmarks: In all candor, we are *very frustrated and exceedingly disappointed* with the stock price performance (not earnings) of banks in Q3 and believe the declines are unwarranted and unjustified. Analyzing price-to-tangible book value, price-to-earnings or discounted free cash flow, bank stock prices are inappropriately low. Thankfully, as noted in the prologue at the beginning of this letter, we believe this situation is turning a corner in October. And there's much room to run!

We take only very minor solace in the fact we've beaten our YTD benchmarks. While specific point-in-time measures (like quarterly statements) are customary and appropriate, please remember that your statements represent valuation on just one day. Again, if we sent statements using *current* valuations, they would reflect a roughly 10% higher appraisal. The balance of this letter will focus on why we believe banks continue to be undervalued and represent an excellent buying opportunity. Note: Mr. Buffet deployed at least $18.5 billion of Berkshire's cash hoard into stocks during the 3rd Quarter including a major investment in Bank of America.

Loan Quality Remains Much Better than Investors Initially Expected; But New Loan Originations Slow:

Many folks think of banks as quasi-public utilities. To an extent, that's true. While NOT all banks are created equal, they tend to provide certain key products and services critical to the flow of commerce – and lending is probably the most notable activity they undertake. Extending credit to worthy borrowers is the "straw that stirs the drink" at Community banks – and is a major source of revenue for them. It is NOT however, their only source of revenue.

Interest income generated from loans is achieved at low margins – even in the best of times. It is for this reason that incurring any loan losses from borrowers who can't repay the money they "rent" from banks must be kept to an absolute minimum. In short, this is why investing in banks with a superior & sustained record of loan quality (achieved through careful loan underwriting criteria) is the single-most important *financial* consideration in our investment decision making process. ("Culture" is the most important *overall* criteria!)

- **So Far, Non-Performing Loans (Industry Wide) Increase Only Modestly and Remain Steady at Our Banks**

Given our relentless focus on loan quality, it may not come as a shock to you that our banks have not yet experienced any large increases in problem loans. In fact, as highlighted in our *2nd Quarter Bank Performance Newsletter* for each of our 3 Funds, the YOY non-performing loans ratio actually *decreased* modestly in Funds 1 and 2 by 0.08% and 0.01% respectively, and was unchanged in Fund 3. That critical asset quality measure was holding steady at levels in the mid-40 basis point range – still well below the 1% level considered normal/good! Given the pandemic, how can that be?

This result is attributable to a variety of factors. Requiring appropriate down payments, i.e. maintaining appropriate levels of loan-to-value to protect collateral; relying on borrowers who have multiple repayment sources; and calling for personal guarantees are just a few examples of how our banks preserve loan quality. More recently, PPP Loans significantly helped many borrowers. Those forgivable fully-guaranteed SBA loans (i.e. gifts from Uncle Sam) provided extra *cash* to companies. In addition, if you stop and think about business activity and the cash collection cycle, you will recall that as sales slow, declining inventory and accounts receivable are converted to *cash*. In fact, the financial system is awash in cash right now. Furthermore, the unemployment benefits received by idled workers have kept them solvent and current on their debts. Consumer spending has also decreased during the pandemic (no trips to Disney) and cash flow for individuals has allowed them to keep on top of their financial obligations. Let's transition to another reason credit quality is holding up so well.

- **Deferred Loan Payments Shrinking Rapidly at All Banks as Borrowers Reinstate Payments**

Deferred loan payments offered to borrowers by banks at the outset of the pandemic (which were strongly encouraged/supported by banking regulators and exempted from being classified as "troubled debt restructurings") are declining markedly at all banks. By deferring either principal payments only – or both principal and interest payments, company's increased their cash reserves meaningfully. But again, the level of deferred loan payments is dropping fast. Specifically, deferred loans from 54 banks in the Raymond James coverage universe which have provided updated data on or after August 1, 2020, have seen median deferrals shrink from 15.1% at March 31st to 6.6% as of their latest update.

This key metric is likely to continue shrinking rapidly as the initial 90- or 180-day deferral periods roll off. Data from Q3 earnings releases will shed more light on the rate of improvement in loans coming off deferral and we'll report to you on this matter in our upcoming *3rd Quarter 2020 Bank Performance Newsletters*. This leading indicator of credit quality coming from banks in general (and our banks in particular) indicate the vast majority of borrowers are fulfilling their obligations to repay their loans and defaults and resulting loan losses will be manageable. Charge-offs will still occur at higher levels than before the pandemic. But again, updated forecasts on the overall strength of loan portfolios is much brighter than initial estimates.

- **Allowance for Loan Losses Robust and Provision Expenses Likely to Moderate in 2021**

We've emphasized the following point in our recent communications: the windfall of fees from the PPP Loan Program and the record setting revenue from residential mortgage loan fees has been a boon for banks. Most banks have used the majority of this largesse to significantly boost their Allowance for Possible Loan Losses.

The reports issued from banks so far this earnings season have shown a significant decline in additional reserve building during the 3rd quarter. The cushion for bad loans that existed *prior* to the onset of Covid-19, *combined with* the aggressive provisioning that occurred at banks earlier this year (and which seems to be peaking), appear to be sufficient to sustain potential future problem loans. While certain banks will undoubtedly be conservative and continue building their "rainy day fund", the need to do so given asset quality metrics looks to be diminishing. Having said that, it'll be some time before we see banks begin to "release" excess reserves via either no or negative provision expenses – but the drain on earnings from provisioning is, in our view, mostly complete.

- **Volume of New Non-Residential Loans Slows at Large Banks but Steady at Community Banks**

As you know, we like to deal in facts – not anecdotes. According to data from the Federal Reserve, loan volumes at the 25 largest banks in the country continued to decline in Q3. Specifically, they were down 2.2% in the 3rd Quarter on the heels of being down 2.3% in the 2nd Quarter. (Recall from above, sales are down; causing receivables and inventory to be converted to cash to pay down lines of credit.) However, loans at the so-called "smaller banks" were up 0.8% in Q3 after being up 5.9% in the 2nd Quarter. Those are the facts. If you listen to the talking heads on TV, you'll hear how "collapsing" loan volume is bad for banks. And indeed the interest and fee income from loans is very important to banks. But you'd miss the subtlety that Community banks are doing better than big banks as it relates to growing their loans. Finally, as we've harped about until you may be tired of hearing it, the PPP Loan Program has been great for Community banks and they've done proportionately much more of it than their big bank brethren. And, another round of PPP Loans is likely to be included in an additional stimulus bill from Congress. Of course, Community banks will again 'lead the charge' helping small business borrowers to avail themselves of this support from the government!

Fee Income Continues to Significantly Boost Earnings

We noted above that interest income from loans is a major revenue source for Community banks. From the beginning of our venture however, we've been drawn to banks which generate substantial revenues from *other* lines of business – including but not limited to residential mortgage banking activities, wealth management, insurance, cash management, and other fee-based activities. Accordingly, the proportion of overall revenue from these sources at our banks tends to be higher than the industry average. This diversification of income sources (i.e. being less reliant on spread revenue alone) has been and continues to be a very good thing for our banks.

- **Forgiveness of SBA Guaranteed PPP Loans Underway and Corresponding Fee Income Accreting into Income**

The process for *forgiving* PPP loans is underway (the SBA will actually repay banks for these loans – not the borrower) and this activity will accelerate in the coming months. Regulators have streamlined the process by automatically forgiving all loans under $50,000 and it appears both political parties are in favor of extending "blanket forgiveness" to all PPP loans under $150,000 as part of an additional stimulus bill which may be enacted into law soon. Given this forgiveness process is now occurring, the fee income from those loans that was *originally* being accreted into income over the 24 month life of those loans will be hastened (i.e. the remaining un-accreted fee will be fully recognized upon forgiveness) – driving bottom line earnings from those SBA Loan origination fees up meaningfully in the next few quarters.

- **Residential Mortgage Loan Originations Expected to Remain Near All-Time Highs**

Discussing interest rates and their impact on banks is of utmost importance. Low rates can be a double-edged sword for some banks; that is to say, their impact can be both positive and challenging. It's fairly obvious that in this historic low rate environment, buying new homes and financing them with a long-term mortgage, or refinancing existing mortgages is very attractive to consumers. As such, the fee income being generated by banks from originating and refinancing mortgages remains at record levels. Somewhat more subtle, but maybe equally beneficial to banks, low rates for borrowers lowers cash outflows for their clients making payments more affordable. Lower payments decreases the probability of loan problems or defaults. (This is one of myriad reasons we believe credit quality will remain stronger than most investors currently think.)

Those are two distinct "positives" of lower rates. The challenge, of course, with lower rates is preserving net interest margin – the difference between what banks earn on loans/investments and what they pay for deposits/other borrowings. Margins are shrinking at banks. One reason for this decline has to do with the 1% rate on PPP Loans. Obviously, those fully guaranteed SBA Loans are negatively impacting margins. But, as they are forgiven, (and we believe virtually all of them will be) their impact on margins will be eliminated. That is NOT to say however, the overall level of low rates is not further impacting margin. They are – especially for money-center and regional banks who serve larger corporate clients. We reiterate a key message: most Community banks have floors or minimum loan rates they charge borrowers for loans. Accordingly, margin pressure at our banks are less than the big banks. Finally, as we've repeatedly shared, it is not just the absolute level of rates that matters to banks but the shape of the yield curve. The yield curve is currently the steepest it's been in recent years and the difference between the 10 yr. UST and the 2 yr. UST is hovering around 60+ basis points – a huge spread compared to this time last year. Nonetheless, in total, margins are a current "headwind" for banks and remain a reason investors have some lingering concerns about future earnings. We are not ignoring this situation and will continue to monitor margins very carefully – as we always have!

- **Wealth Management Fees Rebound; Service Charges and Cash Management Fees Recover**

Generally speaking, wealth management fees are derived based on the dollar value of assets under management. Accordingly, as broader markets rebounded over the summer and valuations increased, so too have the fees charged on those accounts. This has resulted in a nice bump to fee income in Q3. Similarly, service charges and cash management fees which were waived or temporarily suspended at the beginning of sheltering-in-place have, to a large degree, been reinstated. All these fees combined are consequential and positively impact earnings at banks.

Uncertainty remains due to Covid, the Election, Social Issues and Global Factors: Stock Prices Fall in September

The single biggest enemy of equity markets is UNCERTAINTY. Uncertainty still rules the day, and we believe there are several key areas of ambiguity fueling market volatility. First, as fears of a another wave of Covid and the potential for widespread lockdowns ebb and flow, the world looks to when a vaccine will be available and how the prospect of natural herd immunity might provide clarity regarding the eventual eradication of the virus. Second, political uncertainty continues to run rampant. This includes vagueness regarding the prospect and timing of additional stimulus; a Senate fight to fill the Supreme Court seat of Justice Ginsburg; and of course the November Presidential Election. Third, the issue of race relations continues to be at center-stage of the national discourse with heightened expectations demanding more out of our nation's leaders and citizens. And fourth, global issues such as U.S. China relations, climate change, and the impact Covid-19 is having on nations across the globe – all add to investment indecision.

Today, physicians are grappling with the efficacy of various Covid treatments. Politicians and economists are contending with uncertainty about the virus's impact on the economy. And families are facing the uncertainty of everyday life, such as: can we attend a wedding, will a child be going back to school, or one's ability to earn an income. But one thing is certain: Covid cases are on the rise again and another wave is upon us. But we believe a lot has been learned about the virus already this year and a complete shutdown is not likely. Instead the U.S. may see more localized lockdowns as "hotspots" are identified. Best case scenario is a stable treatment will be identified, or better yet, a vaccine will be found and approved.

As you may recall from our *Second Quarter 2020 General Newsletter* we have long kept tabs on the market implications stemming from the political election cycle. We feel it is worth repeating our view that the impact any president can have on the economy and market depends on their ability to enact legislation (i.e. what party'(s) are in control of the executive and legislative branches of government). All this means that while volatility is sure to continue for the next month, there will surely be an eventual conclusion to the election. Investors crave clarity regarding political outcomes. But this time around, the tensions are so high and the possible outcomes so muddy, that many investors don't know on what to base their buying and/or selling decisions. In such an environment, most investors say, the most market-friendly outcome would be an overwhelmingly clear electoral result.

Lastly, social issues and various global factors continue to weigh on markets in various ways – and will continue to do so, just as they always have. Unlike Covid and the upcoming elections, which will eventually be resolved, these other market factors are always in view. Global factors will always shape the market and are a constant risk no matter where you invest your money. Currently we are waiting for the U.S. response to China's legislative body's new rules restricting exports vital to national security. China's export restrictions are likely a response to the U.S. crackdown on Huawei and TikTok. And so-on, and so-on. While different administrations will handle these situations in different ways, we believe they will always have an impact on the markets and will always be a part of our risk analysis.

Equity Capital Continues to Exceed Well-Capitalized Guidelines & Current Dividends from Our Banks Remain Safe

When Alexander Hamilton and Aaron Burr founded their rival banks in the 1780's, their charters required them to hold capital, but the rules were far simpler than the mountain of regulations facing today's banks. No matter how you look at it, banks in our portfolio are very well capitalized and continue to produce solid earnings – allowing them to keep paying dividends. Despite this fact, the Fed has decided to maintain prohibitions on share buybacks and a cap on dividend payments on banks with *more than* $100 billion in assets (that's not our banks) until at least the end of 2020. So, if you believe the banking sector is headed for a rally and you are partial to dividend paying stocks, opportunities to invest in the Community banking sector are likely to produce outsized results. Again, those Fed restrictions do not affect dividend payments of the Community banks in our universe. In fact, several of our bank holdings have increased their dividends – which we believe will entice more investors who are hungry for yield into the undervalued Community banking space.

We've Terminated our Hedges and Believe Bank Stocks Will Continue to Rise!

As we've professed on many occasions, we are *long-term value investors* – not day traders. In spite of that being our core investment approach and philosophy, given the uncertainty created by the pandemic, we felt duty-bound to protect your investment(s) to the very best of our abilities by passively and actively hedging since early March. The passive hedge we employed was to hold more cash than usual. While cash earned only a minimal return via interest, it did not decline in value as markets went down. We also utilized active hedges – primarily by shorting certain liquid bank stock ETF's. The net gain generated from our active hedging activities in 2020 are as follows: Fund 1: $2,472,662; Fund 2: $1,524,048; Fund 3: $45,357. **Total Hedging Gains for All Funds: $4,028,935!** Protecting your investments by creating this much value through our hedges is something we are proud of. Our success with this activity has contributed to our outperformance vis-à-vis our benchmarks.

But, as the heading of this section declares, we've terminated our hedges because we believe bank stocks will increase from here. And like the Oracle of Omaha, we've also deployed a substantial amount of the cash we had accumulated. Finally, as you might expect, the hedging gains we generated will be taxed as short-term capital gains. But, we've been careful to offset the vast majority of those gains with some short-term capital losses from our core portfolio and redeployed those proceeds into fresh new investments which we believe will produce higher returns over time.

Conclusions/Summary/Epilogue:

As always, there are positive and negative forces at work that influence performance and stock prices. Through this and previous communications, we've tried to show how bank revenues and expenses ebb and flow. This year, provision expenses have been much higher than usual but fee income has exploded due to PPP Loans and mortgage loan activity. Next year, provision expenses are very likely to moderate, but fee income probably won't match this year's bonanza. And so the cycle goes. Through it all, our banks stick-to-their-knitting and earn more than their peers. They've got the right cultures to carry them in good times and challenging times.

No one we know predicted a pandemic at the beginning of this year. But, it happened. Thankfully, banks are not the *cause* of any financial issues or crisis this time – but rather a major part of the solution to this pandemic. Long run, we are proud to support the banks who sustain the backbone of our nation's economy – small businesses. Our backing of the Community banking industry is not only a "feel good" thing to do – but has and WILL produce excellent investment results over a full investment cycle. Bank on it!

We ended our last Newsletter with the following statement and it's so important we'll repeat it again here. 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. In discussion with several investors, we've heard concerns about the implications of potential changes to tax policy (depending on who wins the election) and the effects those changes may have on the equity markets. The second link below addresses worries regarding potential changes to tax policy and its historic effect on stock indices. I think you'll be surprised to learn there is little correlation between stock price performance and tax policies. We believe the other links are also relevant, very informative, and enlightening and we warmly encourage you to click each of the links to peruse them carefully.

Banks Have a Chance to Come Up for Air – The Wall Street Journal
What's Tax Got To Do With It? – Morgan Stanley Wealth Management
On the Markets October 2020 – Morgan Stanley Wealth Management
Election State of Play – Raymond James & Associates

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