



Johannes Palsson Shares His Insights on Community Banks

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Ajay Singh at MutualFunds.com got the opportunity to have a discussion with Johannes Palsson, Managing Director and Senior Portfolio Manager at Angel Oak Capital Advisors. Johannes' primary focus is on investment research and management of community and regional bank debt across the firm's strategies. Johannes shared his insights on the U.S. community banking space and Angel Oak's Financials Income Fund (ANFIX). Read on to learn more.

MutualFunds.com: Could you tell us about yourself and the recent addition of Kevin Parks to the Angel Oak portfolio team?

Johannes Palsson (JP): At Angel Oak, I focus primarily on investment research and asset management of our community and regional bank debt strategies. Not surprisingly, I've spent the majority of my career working in and around community banks. Before joining Angel Oak, I was Chief Financial Officer at The Brand Banking Company, a \$2 billion community bank with strong roots in the Atlanta area. I helped lead the bank through the 2007-08 financial crisis, which provided me with valuable hands-on experience in nearly every market environment.

My team at Angel Oak has grown steadily over the past few years. We have evolved from having a narrow investment mandate in community bank debt, to expanding our work to include active trading, securitizations and ongoing expansion into non-bank financial institutions, including insurance companies, asset managers, Real Estate Investment Trusts (REITs) and Business Development Companies (BDCs).

Kevin Parks' knowledge and familiarity within the community banking sector and our fund's strategy make him an excellent addition to our team. He will enhance our expertise in niche investments like Trust preferred securities (TruPS) and microcap bank equities. For the past several years, Kevin has managed his own long-short equity fund, concentrating on the community bank space, and sub-advised on a small equity sleeve within Angel Oak's Financials Income Fund (ANFIX).

MutualFunds.com: What is the Financials Income Fund's strategy?

JP: Angel Oak's Financials Income Fund pursues current income and total return with an environmental, social and governance (ESG) aligned approach. It seeks to offer investors an attractive yield for investment-grade risk with low correlation to the broader fixed-income market. Specifically, the Fund invests in the following:

- Financial services institutions such as banks, insurance companies, REITs and BDCs
- Senior debt, subordinated debt, trust-preferred, preferred and common equity securities in the financial subsectors noted above
- Responsible Financial Institutions (RFIs) that exhibit strong alignment with ESG factors

MutualFunds.com: What role can the fund play in an investor's portfolio?

JP: We believe the Fund could be a good addition to both investment-grade and high-yield portfolios, given the investment-grade characteristics of the Fund's underlying banks and the attractive high-yield coupon, as some investors do not understand the sector very well. Investors tend to be under-allocated to financials broadly, and Angel Oak believes this strategy is an attractive way to gain exposure.

MutualFunds.com: Within financials, could you explain your focus on community banks?

JP: Angel Oak defines its universe of community and regional banks as institutions with less than \$30 billion in assets, and we believe this sector offers the best value in terms of bank debt. When compared with their larger counterparts, smaller institutions operate more simply, focusing on lending and gathering deposits within their local footprint. Community banks tend to have lower exposure to more volatile business lines, such as capital markets. Lower-cost core deposits fund most community banks, and on average they carry higher levels of regulatory capital versus their larger peers.

We see the community bank sector as an opportune area of growth. Community banks have been using subordinated debt in the post-crisis period to optimize their regulatory capital and fund both organic and inorganic growth. The community bank subordinated debt market has more than \$20 billion outstanding, and annual issuance should reach \$4 billion to \$6 billion in 2020. Issuance in 2020 should benefit from the refinancing of deals issued in the infancy of the market in 2014-15, as they are coming into their call period.

The community bank debt market is underrepresented in benchmarks and has little analyst coverage or institutional following. The niche market characteristics and ensuing market dislocation could allow investors to extract excess yield.

The U.S. banking sector is highly overbanked relative to the banking sectors of other developed countries. We expect consolidation activity to accelerate in the current rate environment. In turn, this should drive price appreciation in the bonds of acquired institutions, which typically are the smaller institutions.

MutualFunds.com: Could you comment on the size/number of community banks in the U.S. and how that large investment universe offers opportunities to spread risk across holdings?

JP: The U.S. has approximately 5,200 community banks, and over the past five years Angel Oak has invested in about 200 of them. As a result, we have provided our investors with a diversified portfolio across geographic regions. We expect continued growth in the overall market with increased diversification of issuers as the market matures.

Consolidation activity has steadily increased in the industry. In the U.S., we have one bank for every 57,000 people, whereas many other industrialized nations, such as Germany and France, have one bank for every 2 million people. We don't foresee the U.S. adopting that ratio, but we believe the consolidation trend will continue and likely accelerate. Consolidation has provided positive alpha for our Financials Income Fund's strategy return, with smaller banks being absorbed into larger institutions that tend to trade at tighter spreads.

MutualFunds.com: What is the outlook for community banks for 2020 and beyond?

JP: Our outlook for 2020 and beyond is bright. We believe the financial sector offers one of the most compelling risk/reward opportunities within corporate credit, and it currently offers near all-time highs from capital and credit quality perspectives. Over the past decade, the banking industry, in particular, has added significantly more equity, reduced balance sheet risk and increased regulatory oversight.

The banking sector's current capital levels are nearly 250 basis points higher on a total capital basis and roughly 375 basis points higher on a common equity Tier 1 basis (CET1) when compared with trough levels over the past 20 years. We expect to continue making investments in defensive profiles, building on the existing allocation and evaluating relative value across structured products.

The Bottom Line

Johannes Palsson helped us understand that community and regional banks offer good value in terms of bank debt as smaller institutions tend to have lower exposure to more volatile business lines, such as capital markets and on average carry higher levels of regulatory capital versus their larger peers. The outlook for the banking industry looks bright as over the past decade, the industry has added significantly more equity, reduced balance sheet risk and increased regulatory oversight.

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Past performance is no guarantee of future results. The investment return and principal value of an investment in the Fund will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost.

Mutual fund investing involves risk. Principal loss is possible. Investments in debt securities typically decrease when interest rates rise. This risk is usually greater for longer-term debt securities. Investments in lower-rated and nonrated securities present a greater risk of loss to principal and interest than higher-rated securities do.

Investors should carefully consider the investment objectives, risks, charges and expenses of the Angel Oak Mutual Funds. This and other important information about each Fund is contained in the Prospectus or Summary Prospectus for each Fund, which can be obtained by calling Shareholder Services (855-751-4324) or clicking here. The Prospectus or Summary Prospectus should be read carefully before investing.