RMB Mendon Financial Funds

Commentary: October 2018

October was an extremely difficult month for financials. Most banks reported in line with 3Q18 earnings, and next year's estimates were nudged down 1–2%, on average. Despite slightly lower earnings forecasts, the KBW Bank Index (BKX) was down -5.55%, and the Nasdaq Bank Index was down -8.88%, essentially re-rating the entire group in one month.

It did not matter if a company missed, met, or beat earnings expectations—there was not an earnings release that could prevent stocks from being sold swiftly and violently. Interestingly, this wasn't against a backdrop of widening spreads, risk-off trades, or signals from other fear indicators. In fact, market betas for SMID-cap banks are as low as they have been since the early 2000s as a result of stronger balance sheets and solid credit for the group. Deposit costs are on the rise, and loan growth is decelerating for some, but operating leverage remains extremely healthy. For example, JPMorgan Chase & Co. (JPM) had 4.6% loan growth, resulting in 7.2% net interest income growth. We believe many investors are painting the entire group with the same brush despite the wide dispersion of fundamentals depending on size, geography, and balance sheet composition. In the trough of October's market, bank stocks that were down the most were asset-sensitive banks in the Southeast and Southwest, which play a dominant role in our portfolio.

The indiscriminate sell-off in the group was amplified by various technicals and narratives present. At the lows of the month, month-to-date combined financial ETF outflows were $2.5 billion, almost half of the total outflows since the peak on March 15. Anecdotally, we heard stories of large international holders liquidating ETF positions, one manager-directed ETF switching from all financials to all biotech, rumored liquidations, and other such hearsay—which increases in velocity as markets worsen. Other reasons cited for the sell-off in financials (many of which moved to the greater market) included: soft loan growth, rising betas, a flatter yield curve, LIBOR vs. the fed-funds rate, tariffs, global growth, Turkey, China, Venezuela, Argentina, Saudi Arabia, Brazil, quantitative easing (QE), quantitative tightening (QT), late cycle, peak profitability, elections, lack of catalysts, the Fed going too far, the Fed not going far enough, stagflation, hyperinflation, and deflation, among others.

Having invested in the group for over 22 years, we look back to our portfolio for examples of drawdowns similar to what we witnessed in October, the last of which was January/February 2016 when the Fund and related indexes were both down materially, seemingly without good reason. At the time, we had a concentration in North Carolina-based community banks as we thought there was critical mass for outsized returns due to the state's strong economy and ensuing mergers and acquisitions (M&A) potential. Notable during this period were three banks we discuss often in our letters: BNC Bancorp, Park Sterling Corp., and Yadkin Financial Corp. All were down 15–20% for the first two months of 2016 but finished the year up 25%, 47%, and 36%, respectively. Presently, we have a similar concentration in Texas-based community banks for the same reasons as North Carolina in 2016. These names were down 6–15% for the month, with absolutely no change to their intrinsic value.

The industry has the highest capital levels in over 70 years, is exceedingly profitable, and its credit is currently benign. Despite this, banks are trading at price-to-earnings (P/E) ratios lower than pre-presidential election levels and at relative valuations we have not seen for years. In this environment, we are encouraged to see many insiders aggressively purchasing their own shares and stock repurchase programs either being initiated or increased. During the last week of October alone, 15 banks announced new/additional buyback authorizations for a combined amount of $1.9 billion. Additionally, one of our holdings executed half of its authorization (or 1.7% of its float) in two weeks' time. We urge investors to take advantage of the disconnects we currently see between the group's fundamentals and the technical pressure it is under. We are extremely confident in our portfolio's ability to generate meaningful absolute and relative returns going forward.

As always, we welcome your feedback, comments, and questions.

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All investing involves risk including the possible loss of principal. The RMB Mendon Financial Services Fund and the RMB Mendon Financial Long/Short Fund are sector funds. These types of funds may be susceptible to factors affecting their industries, and the funds' net asset values may fluctuate more than a fund that invests in a wider range of industries. Because these funds concentrate their investments in one sector of the economy (financial services) and invest in derivative securities (currently RMB Mendon Financial Long/Short Fund engages in short sales of equities), investors should consider the risk that the funds may experience greater volatility than funds that invest across several sectors.

An investment cannot be made directly in an index. The index data assumes reinvestment of all income and does not bear fees, taxes or transaction costs. The investment strategy and types of securities held by the comparison index may be substantially different from the investment strategy and types of securities held by your account.

The KBW Bank Index [BKX; PHLX/KBW Bank Index] is an unmanaged index comprised of 24 geographically diverse stocks representing national money center banks and leading regional institutions. One may not invest directly in an index. The KBW Bank Index performance data quoted above are total return numbers.

The NASDAQ Bank Index includes securities of NASDAQ-listed companies classified according to the Industry Classification Benchmark (ICB) Banks. The NASDAQ Bank Index performance data quoted above are total return numbers.

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