RMB Mendon Financial Funds

RMB FUNDS

Commentary: February 2019

In reviewing the final returns from the fourth-quarter earnings season, which concluded in February, we continue to feel comfortable about the outlook for the group generally and enthusiastic about the Funds specifically. By taking KBW's bank research universe, we can look broadly at industry trends for banks of all sizes. Loan growth for the year was the greatest for SMID-cap banks at 10%. Operating income came in better than expected as net interest income was stronger due to higher net interest margins (once again, SMID-cap banks were the strongest). Non-interest expense was in line and credit quality remained solid as the median non-performing asset ratio fell for both the year and quarter.

Looking further into the outlook for the group, Sandler O'Neill + Partners updated its aggregate model for all of the banks in its coverage universe. The firm now expects 2019 bank earnings to grow 7.4% versus 2018 and 2020 earnings to grow 7.1% versus 2019 (for comparison's sake, KBW expects 7.8% and 7.2% growth, respectively). Assumptions do not appear heroic, and the outcome is attractive. Sandler expects net interest margins of 3.63% and 3.61% (recognizing a slower Fed) and operating leverage (growth of operating revenue over operating expenses) of 150 bps and 180 bps. This more than makes room for the normalization of credit provisioning in 2019 and 2020 (provisions growing 16.5% and 36.1%, respectively) as we come off a low base. The results are a return on tangible common equity of 13.9% and 13.6% and tangible book value growth of 9.3% and 9.1%, while maintaining historically strong tangible common equity ratio levels of 9.5% and 9.7%. The firm did a good job in the piece characterizing the environment, writing, *"At this point, investors are cognizant that the group's recent tailwinds (rates, tax reform, macro growth, and deregulation) are giving way to some slowing momentum. They also seem, however, to have become more comfortable with the group's stable profitability, strong credit, good capital return prospects, and attractive valuations. The perception of a frothier M&A environment has helped the situation, too."*

We often argue that you cannot paint the entire sector with one brush, as you cannot paint "the U.S. banking sector" with one brush. While the two investment banks mentioned above estimate mid- to high-single-digit earnings growth for the respective bank universes, there is significant differentiation caused by asset size, business mix, and geography. Looking at the Funds, we see earnings growth multiples of what the overall industry is expecting along with discounted valuations. Interestingly, much of this earnings growth is the result of a concentration of thoughtful merger combinations that, while panned when announced or in the near term, are creating meaningful value going forward.

Lastly, we met with over 30 companies toward the end of the month at a well-attended bank conference hosted by KBW. The analysts there stated that discussions "*ranged from the sustainability of loan growth in light of ongoing economic uncertainty, deposit initiatives including potentially moderating betas, early steps being taken to reduce asset sensitivity, ongoing franchise investment notably from technology initiatives, and credit quality."* We come away with a different version of events from our meetings – in that, it is clear to us that while the fundamentals of the industry remain healthy, management teams were spooked by the price action in the fourth quarter and are seriously reevaluating options to create return for shareholders, having more options now than almost any time that we can remember due to recent dynamics and the rate at which companies are compounding capital. Banks in many markets where we are concentrated continue to seize and will seize on opportunities created by in-migration and disruption caused by the BB&T Corp. (BBT)/SunTrust Banks Inc. (STI) transaction. The list of potential merger structures and partners is widening in light of the Chemical Financial Corp. (CHFC)/TCF Financial Corp. (TCF) and BBT/STI combinations, and announced capital return in the form of buybacks has exploded since the fourth quarter.

We continue to meet with management teams extensively and are constantly looking for signs of inflecting economies every time we travel. Currently, we do not see the tell tales of rampant speculation or overly excessive optimism on the part of regulated depositories (non-regulated financials may be another story, however). We still believe that a material disconnect exists between the rate at which banks are compounding capital and how banks are presently being valued. As such, we are extremely positive on the opportunity set and our ability to create meaningful return 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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