Arrowmark's Staggs On An Income-Generating Alternative Play On Banks

Friday, October 18, 2024

Chuck Jaffe, in this episode of The NAVigator podcast interviewed Dana Staggs, President of Arrowmark Financial Corp. Read the Q&A below as Dana and Chuck talk about how regulatory capital relief securities – bank-generated floating-rate notes that are currently producing yields of up to 15 percent – can function as an alternative investment. Dana notes that due to their emergence during the financial crisis of 2008, regulatory capital relief securities can also function efficiently in low-rate environments. Staggs says he believes the economy has "a lot of room to absorb continued declines in interest rates," and that banks are relatively healthy right now. However, he notes that concerns over potential troubles in commercial real estate can't be ignored.

The podcast can be found on AICA's website by clicking here: https://aicalliance.org/alliance-content/pod-cast/

Dig into current investment strategies, the latest trends, and new developments in the closed-end fund industry at the Active Investment Company Alliance's Annual Roundtable. The event now in its sixth year is Wednesday, November 13th in New York City and will combine informative panels, engaging speakers, and valuable networking opportunities with leaders in closed-end funds, interval funds, and business-development companies. AICA events are known for their high-quality advisor-centric content and for enabling meaningful discussion and interaction with the top minds in closed-end funds. Advisors can get seven

CE credits for attending. Go to AICAlliance.org/events to get complete details and to see the full schedule, and through Halloween night use the code NAVIGATOR30 for a 30% discount on registration costs.

CHUCK JAFFE: Dana Staggs, president of Arrowmark Financial Corp. is here, and we're talking about generating income by investing in banking, but not in the way that most people invest in banking, it's time for The NAVigator. Welcome to The NAVigator, where we talk about all-weather active investing and plotting a course to financial success with the help of closed-end funds. The NAVigator is brought to you by the Active Investment Company Alliance, a unique industry organization representing all facets of the closed-end fund business from users and investors to fund sponsors and creators. If you're looking for excellence beyond indexing, The NAVigator will point you in the right direction. And today we're looking in the direction of regulatory capital securities with Dana Staggs, president of Arrowmark Financial Corp., which is a non-diversified closed-end fund trading under the symbol BANX. Now the investment objective is to provide shareholders with current income, and that is pretty common, what's not common is that Arrowmark Financial achieves that objective by investing in banking related assets across the spectrum from community banks to global money center banks. It's about alternative investments in banking, it's not your typical fund that buys bank stocks. The fund invests across asset classes including term loans, structured debt, regulatory capital relief securities – we'll talk a lot about them – and then to a lesser extent, equity. You can learn about what it does and how it works by going to IR.ArrowmarkFinancialCorp.com. And to learn more generally about closed-end funds, interval funds, and business-development companies visit AICAlliance.org, the website for the Active Investment Company Alliance. Dana Staggs, welcome back to The NAVigator.

DANA STAGGS: Thanks, Chuck. Thanks for agreeing to speak with me and looking forward to our conversation.

CHUCK JAFFE: I think I've summed up what Arrowmark does reasonably well without getting bogged into the jargon, because we have to dig in a little bit to the jargon. You were on the show early in the year, then, and I know again now, the vast bulk of your portfolio are in regulatory capital relief securities, these are things that are made with banking institutions.

Help us understand why we want to invest in regulatory capital relief securities and what makes them different from other investments that we make with a bank like common equity or a preferred stock, and maybe why we want a mix of equity and preferreds and regulatory capital relief securities.

DANA STAGGS: Absolutely. Chuck, regulatory capital relief securities comprise approximately 89% of our portfolio today. On a high level, these are floating-rate securities, so think of these as a fixed spread over a floating-rate index. Today they're yielding, at least in our portfolio, between 14 and 15%, and so if one thinks about the floating rate as being around 4-5%, that's suggesting high single-digit spreads over floating rate, maybe even double-digit spreads over a floating rate. They benefit from what I would characterize as a stable NAV, so the valuations don't move much up or down, especially being a floating-rate instrument, they're not subjected to a lot of the movements you see with fixed-rate long duration investments as interest rates change, they also have a very low correlation to a lot of other investment products. Stepping back, what are they? At the simplest level, think of these as banking institutions are required to hold a certain amount of capital, think of this as risk-based capital, a lot of people think of this as common equity or preferred equity, against the risk and size of their loan book. Regulators require them to maintain certain ratios, and what a regulatory capital relief security is, is it gives a banking institution another tool in order to manage those ratios. Instead of increasing the amount of risk-based capital that they have, we can transfer the risk, at least some of the risk, from a high-quality book of loans that the bank will have. Think of these as several hundred to over several thousand loans in a portfolio, we can transfer some of that risk from the banking institution to our investors, in return for doing that we will get this coupon that I mentioned.

CHUCK JAFFE: In terms of who you're working with, because we said it's community banks all the way up to the giants, the brand names, how much does that impact your returns? I mean, if you're working with the most secure financial institutions in the world, are you getting much less return? Do you go up the risk scale? Does it work a bit like we might think with say, bonds, where you go out the risk scale towards junk, you're getting better returns, you're taking on more risk? How much of this is size matters, et cetera?

DANA STAGGS: So first, the regulatory capital relief securities that we hold in the closed-end fund BANX, those are all done with the most high-quality banks, think of these as the money center banks, a lot of them are the too big to fail banks. Now as far as the risk premium, as far as the amount of return you're making, think of this as an alternative investment product. It's a solution that provides a value-add to banking institutions, and as a result, the return you're making I think is actually a very strong risk-adjusted return, in the sense I think a lot of investors view it as a form of alpha that they're receiving on these products. Again, this is done because I think we're helping banking institutions solve complexities around regulatory capital, and as a result our investors benefit from that.

CHUCK JAFFE: We are at what we think is the start of a rate cutting cycle. It's not a cycle until there's more than one rate cut. How do these securities typically perform in a declining interest rate environment?

DANA STAGGS: Understand that these securities, they've gotten more and more prevalent since the Great Financial Crisis, and if one thinks about the interest rate environment we were in in the 2010 to 2020 area, a lot of that was a zero-interest rate environment. And so these were designed and born out of that type of environment, we happen to have benefited from a rising interest rate environment, but these will and are designed to perform at the lowest rates out there. More specifically to the fund, today we're out earning our distribution. Where our declared distribution is 45 cents, we're earning 70 cents for Q2 versus a 45 cent declared distribution, and that's been primarily driven by a mixture from our lower yielding legacy products which were the subordinated loans and the preferred securities into the higher yielding regulatory capital relief securities. Also it benefits from the rising interest rate environment, but we feel like there's a lot of cushion between our declared distribution of 45 cents and our earnings of 70, we have a lot of room to absorb continued declines in the interest rate.

CHUCK JAFFE: When you were last on the show we were still feeling some of the fallout or the potential fallout from the Silicon Valley Bank collapse, and there was a lot of worry about what was going to happen in the banking industry with regard to commercial real estate because commercial real estate has been such a mess since Covid. A lot of that pressure seems to have eased, so does that make this a more favorable environment that way?

DANA STAGGS: I do think that a lot of those idiosyncratic issues that we saw with Silicon Valley Bank and Signature Bank, really driven by what was a very rapid increase in interest rates and how it infected the value of their fixed-income securities. A lot of those kind of idiosyncratic issues have seemed to have subsided for the banking industry. I do think that the banking industry today is much healthier than it was before the Great Financial Crisis. At the same time, where would I keep my eye? I think that commercial real estate and exposure that banking institutions have to those is a place to continue to understand and scrutinize, I think that's why a professional manager who understands the banking space is the way to go. Stepping back, the amount of commercial real estate that you see in the larger banks, the money center banks, the risk around commercial real estate is very much driven by the type of real estate that's done, it's driven by the geography that it's done in, and also about the exposure around that, and the money center banks just have a better quality book. They're typically around low double digits, say 10-13% of their loan book is in commercial real estate. You will see some of the regionals kind of orders of magnitude more than that, and I feel like the money center banks are in a much better position relative commercial real estate in a lot of the regionals.

CHUCK JAFFE: Dana, really, really interesting. Of course we're going to see a rate cutting cycle and what that does, and we're going to watch the performance of the fund and I hope we get a chance to chat with you again down the line as we watch this all play out.

DANA STAGGS: Thank you, Chuck. I appreciate you having me on your podcast, it was great.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. And yes, I'm Chuck Jaffe, I'd love it if you'd check out my show on your favorite podcast app or by going to MoneyLifeShow.com. And if you want to learn more about interval funds, closed-end funds, and business-development companies go to AICAlliance.org, that's the website for the Active Investment Company Alliance. And if you want to get a cool piece of closed-end fund history, we've got one of those for you too, because the Active Investment Company Alliance and Money Life are celebrating our fifth anniversary of working together on The NAVigator by giving away two copies of the 1991 closed-end classic, *Investing in Closed-End Funds: Finding Value and Building Wealth*, co-authored by George Cole Scott, father of John Cole Scott, chairman of AICA. If you want to enter, tell us the year when closed-end funds first started trading on the New York Stock Exchange. Send your guess along with your name and address to Chuck@MoneyLifeShow.com by six PM Eastern Time on October 22nd. We'll announce a winner next week. Thanks to my guest Dana Staggs, president of Arrowmark Financial Corp., a non-diversified closed-end fund trading under the ticker symbol BANX. Learn all about it at IR.ArrowmarkFinancialCorp.com. The NAVigator podcast is new every Friday, make sure you don't miss an episode by subscribing or following along on your favorite podcast app. And if you like this podcast, please leave a review and tell your friends about us, because that stuff really does help. We'll be back next week, and until then, have a great time and happy investing, everybody.

Recorded on October 18th, 2024

To request a particular topic for The NAVigator podcast please send an email to:
TheNAVigator@AICalliance.org

Click the link below to go to the home page of Active Investment Company Alliance to learn more:
https://AICalliance.org/

Disclosure: *Views and opinions expressed are for informational and educational purposes only as of the date of production/writing/speaking and may change without notice at any time based on a multitude of factors. Speaker's/presenter's/author's opinions are their own and may not necessarily represent the opinions of AICA, its Board, or its staff. Materials may contain "forward-looking" information that is not purely historical in nature, such as projections, forecasts, market return estimates, proposed or expected portfolio composition, and other items. Listed closed-end funds and business development companies trade on exchanges at prices that may be above or below their NAVs. There is no guarantee that an investor will be able to sell shares at a price greater than or equal to the purchase price or that a closed-end fund's discount will narrow. Non-listed closed-end funds and business development companies do not offer investors daily liquidity but rather offer liquidity on a monthly, quarterly or semi-annual basis, often on a small percentage of shares. Closed-end funds often use leverage, which can increase the fund's volatility (i.e., risk). Actual distribution amounts may vary with fund performance and other conditions. Past performance is no guarantee of future results. This material is not intended to be a recommendation or investment advice, does not constitute a solicitation to buy, sell or hold a security or an investment strategy, and is not provided in a fiduciary capacity. Shares of closed-end funds are subject to investment risks, including the possible loss of principal invested. Closed-end funds frequently trade at a discount to their net asset value (NAV).*