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Our bank investments remain anchored by OceanFirst (OCFC). I remain optimistic on OCFC's prospects, as well as the opportunities in the sector overall. The KBW Nasdaq Bank Index declined 19.2% in 2018 while the S&P 500 Financials fell 14.7%.[1] It is ironic, to say the least, that market prices dropped in a year featuring a large tax cut and the ongoing "normalization" of interest rates (to say nothing of very benign credit conditions, decent growth, and a generally sound economy). This is yet another example of expectations trumping all else, and why I find it more reliable to consider multi-year business value as the key investment barometer.

The overwhelming majority of individual banks I follow also saw significant declines in the market price of their equity during 2018, but those declines imply dour fundamentals in 2019 and beyond. I am not dismissive of the chances of a recession this year – or any year – but when a recession inevitably arrives most banks will face it with good credit profiles, ample reserves, and plenty of liquidity. Earnings will decline as many banks add to credit reserves and slow or reverse asset growth, but that is normal.

I will repeat my comment of recent years: I see the U.S. banking industry as better capitalized and safer overall than at any other point in its modern history. Regardless of what the economy produces in 2019, much lower security prices and a suddenly gloomy market temperament offer an attractive opportunity over the next several years.

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OCFC shares returned (12.3%) during 2018 – including a (12.7%) result in December alone – but the company made progress in its business. The acquisition of Sun Bancorp closed in January 2018 and was well integrated by the fall. In October, OceanFirst also announced its acquisition of Capital Bank of New Jersey for $80 million.[2] It is a small deal but nonetheless an excellent fit from an operational, geographic, and financial perspective.

It is important to remember that OceanFirst has a stable, low-cost deposit base paired with conservative credit and lending profile. As interest rates have increased the company has benefited from its deposit franchise – the cost of deposits has lagged rate increases to an impressive degree, all while the bank has increased its share of funding from core deposits – and yet the market's valuation on those deposits has fallen by about half.[3]

When the economy does enter a downturn, the company will benefit from its credit discipline and excess liquidity, having intentionally avoided overconcentration in commercial real estate and loans with weak structures. And as we wait to see how macro conditions will develop, OCFC is plowing ahead with its profitable, efficient operation. Credit quality is excellent, with non-performers at just 0.3% of total assets. Net income is running close to 1.2% on assets and 15% on tangible common equity, and the company's efficiency ratio is in the low-50% range, a level on par with the best community banks in the country. I remain impressed by CEO Chris Maher and his team, and their strategy should work well in a variety of future environments.

At a current earnings yield of approximately 10%, the expectations baked into the stock price are low. I am as vigilant as ever for signs of credit deterioration, a degradation of the culture, or management mistakes, but other than some marginal reallocation to new opportunities I expect to hold our OCFC investment for the foreseeable future.

A brief update on our other community bank investments:

Bank H was a new investment in 2017. This bank navigated a boom-and-bust in the local economy, producing excellent credit results and good profits along the way. It also has a large, low-cost deposit base that would be very valuable to an acquirer. A sale of the company remains possible but looks less likely than it did a year or two ago. The recent market price for this investment implied very low expectations, and our decision to hold, buy more, or sell in favor of a better opportunity will be determined by the investment prospects here weighed against our other options.

Bank I was a new investment in the second quarter of 2018. It remains a very small position as we paused our buying to pursue other opportunities. This bank has made progress in recent years by keep a lid on expenses and leveraging its net interest income. Depending on the company's prospects and the other opportunities available during 2019 I would expect to increase our investment or sell the shares we currently hold.

The following table reflects our current holdings in community banks as of December 31, 2018.

	P/TBV[1]	NPAs[2]	TCE[3]	Div. yield	Buyback[4]	NIM[5]	ROA[6]	ROCE[7]	P/E[8]	Efficiency Ratio[9]	MHC Conv.[10]	Core deposit premium[11]
OCFC	1.6x	0.3%	9.3%	3.0%	0%	3.6%	1.3%	13.0%	11.0x	54%	n/a	8.4%
Bank H	1.0x	0.2%	7.5%	0.0%	0%	3.1%	0.8%	10.0%	10.5x	80%	n/a	-0.2%
Bank I	1.1x	0.3%	7.9%	2.8%	0%	3.3%	0.9%	11.0%	9.7x	70%	n/a	1.7%

Price data as of 2 January 2019. Sources: SEC filings, Call Reports, FactSet, and Anabatic estimates.
Figures reflect the most recently reported quarter and are adjusted and estimated as applicable to reflect current annualized levels.

[1] Market price divided by tangible book value, as reported
[2] Non-performing assets (non-performing loans + foreclosures / other real estate owned) divided by total assets, as reported
[3] Tangible common equity divided by tangible assets, as reported
[4] Estimated percentage of the company's current shares outstanding likely to be repurchased under existing buyback authorization
[5] Net interest margin, adjusted and annualized
[6] Return on assets, adjusted and annualized
[7] Return on common equity, adjusted and annualized

[8] Market price divided by net income per share, adjusted and annualized
[9] Efficiency Ratio = non-interest expenses divided by the sum of net interest income and non-interest income, as reported
[10] Mutual holding company conversion — the year in which the company converted to public ownership
[11] The core deposit premium is the excess of equity market value over tangible book value, expressed as a percentage of core deposits

[1]Both are indices presented for reference only, and the latter is even less relevant than the former. Both figures include dividends. Source: Nasdaq and Standard & Poor's.
[2]CANJ provides an excellent funding base with a 0.46% average cost of deposits and a 70% loan-to-deposit ratio. It is also surprisingly profitable, posting a trailing ROA of over 1.3% and ROTCE of over 14% (on a reasonable level of 9.2% tangible common equity). The efficiency ratio of 55% and near absence of non-performing assets – 0.08% at the recent quarter – point to an operational fit as well. The worst thing I can find about the deal is that it wasn't big enough to make a large difference for OceanFirst overall.
[3]As noted in previous letters, approximately 85% of OceanFirst's total deposits are "core" deposits and the total cost of deposit funding in the third quarter of 2018 was just 39 basis points – 0.39% – up from 33 basis points in the first quarter and 29 basis points in the prior year period. The core deposit premium stood at approximately 8% at December 31, 2018, down from 16% at June 30, 2018.

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