Q&A: High Yield Opportunities Fund 1Q 2017 Performance Review

The High Yield Opportunities Fund seeks to provide current income and maximize long-term risk-adjusted returns relative to the market, with an emphasis on minimizing downside risk. The Fund is diversified and invests principally in high yield corporate bonds rated below investment grade.

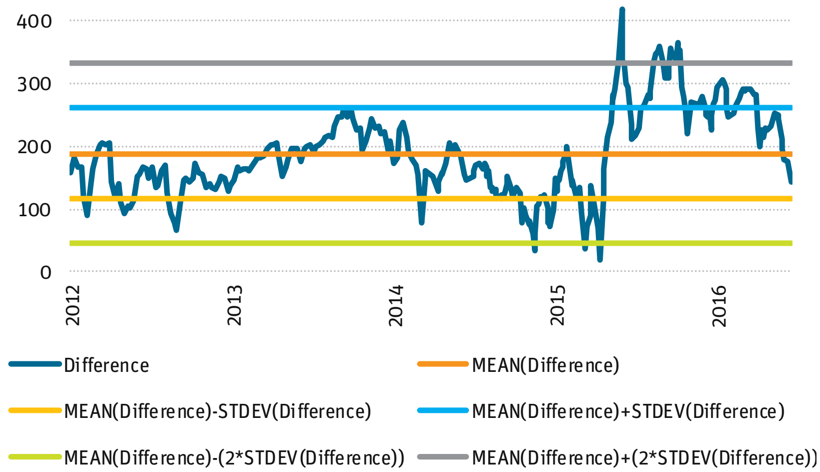
Matt Kennedy, head portfolio manager for the Angel Oak High Yield Opportunities Fund, provides a review of first quarter results and his outlook on the high yield market over the next six to 12 months.

Matthew Kennedy, CFA®
Senior Portfolio Manager
Head of Corporate Credit
Angel Oak Capital Advisors

Q: How did the High Yield Opportunities Fund (ANHIX) perform during the first quarter?

A: The total return for the Angel Oak High Yield Opportunities Fund in the first quarter was 2.60%. This was slightly behind the Bank of America Merrill Lynch U.S. High Yield Index, which returned 2.71%. Breaking down the quarter, we had a very strong January, outperforming the benchmark by about 58 basis points, as the value in some of our positions was recognized by the rest of the market. In February, the Fund lagged the index as CCCs, the most speculative segment of the high yield market, significantly outperformed. We are currently underweight CCCs and have reduced our exposure as valuations on specific holdings reach what we consider full valuation.

CLO VS. HY



Source: Citigroup as of 3/31/17.

In March, the Fund was essentially in line with the benchmark. In the first quarter, high yield in general performed very well. Underlying the performance was the optimism and enthusiasm associated with the Trump administration's proposals regarding infrastructure spending, tax reform, and deregulation, which, if enacted, would be beneficial to economic activity, including job creation, wages, and overall economic growth.

Since the election, surveys of manufacturing, small business optimism, economic expectations, and consumer confidence have all spiked higher. This reflects strong positive views regarding the outlook for the economy, and could translate into positive performance for risk assets—including high yield—that should benefit directly from an improving economy. A pickup in growth should translate into increased demand for products and services, higher revenues, improved margins and cash flows, and stronger credit profiles overall, which should support tighter credit spreads and improved valuations for high yield issuers. Now, all we need is for companies to convert that optimism into actual increases in spending and hiring.

Q: What were the main contributors and detractors to the Fund's performance during the first quarter?

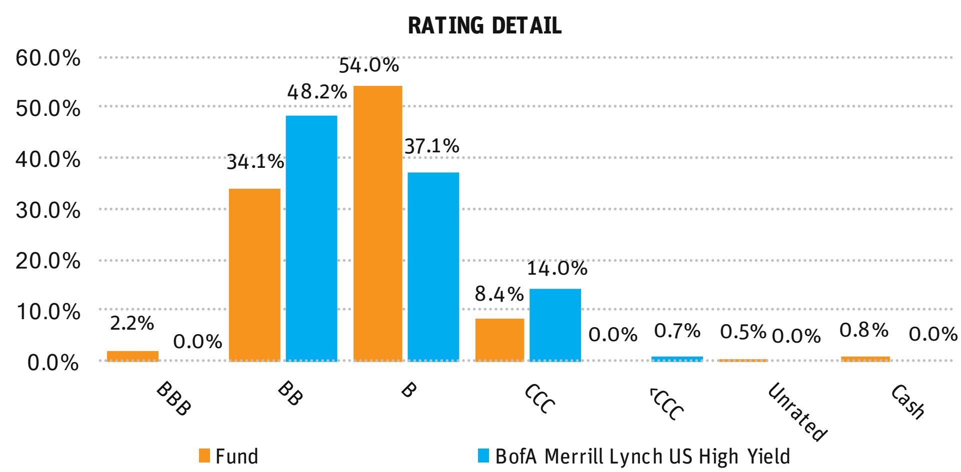
A: Collateralized loan obligations (CLOs) were a very significant positive contributor to performance during the quarter and underscored our flexible, relative value approach to managing the Fund. Currently, our allocation to CLOs is approximately 10%. From an attribution standpoint, CLOs contributed approximately 40 basis points to the total return of the Fund. We initiated the allocation to CLOs in the third quarter of last year, taking advantage of the widening that occurred in the first part of the year. The spread differential between BB rated CLOs and the Bank of America Merrill Lynch U.S. High Yield Index was over two standard deviations wide of its average. We increased the allocation as we headed into the end of the year, as the election outcome and the new administration's policy proposals boosted expectations for an increase in growth and potentially higher inflation.

Total Returns (as of 3/31/17)[3]	Prior Qtr.	YTD	1 Year	3 Years	5 Years	Inception[2]
ANHIX	2.60%	2.60%	17.06%	5.20%	6.68%	10.18%
ANHAX at NAV	2.53%	2.53%	16.74%	4.89%	6.42%	9.92%
ANHAX at MOP	0.23%	0.23%	14.10%	4.11%	5.94%	9.61%
Index[1]	2.71%	2.71%	16.88%	4.62%	6.85%	12.91%

[1]Bank of America Merrill Lynch U.S. High Yield Index.
[2]The inception date of the Angel Oak High Yield Opportunities Fund I Class (ANHIX) was 3/31/09, while the inception date of the A Class (ANHAX) was 7/31/12. The returns of ANHAX shown for periods prior to the inception date include the returns of ANHIX and are adjusted to reflect any applicable sales charges and the higher annual operating expenses of Class A.
[3]The Adviser has contractually agreed to waive fees through 5/31/18. The gross expense ratio for the Fund is 1.22% and 0.97% for the A and I Share Classes, respectively. The net expense ratio for the Fund is 0.90% and 0.65% for the A and I Share Classes, respectively. Gross and net expense ratios are reported as of the 5/31/16 prospectus.
Performance quoted is past performance and is no guarantee of future results. Returns shown for A Shares at NAV do not reflect the maximum sales load of 2.25%; if reflected, performance would be lower than shown.

The portfolio can benefit in two ways from the CLO allocation. First, they were very attractive relative to high yield corporate bonds from a valuation perspective. We expect the valuation differential to normalize, in which case CLOs should outperform high yield corporate bonds as they did in the first quarter. Second, CLOs are floating rate and have essentially no interest rate risk, making them very attractive in a rising interest rate environment. The Federal Reserve raised interest rates in March and forecasts that it may raise interest rates as many as two to three more times in 2017 and another three to four times in 2018, assuming the economy continues to perform as expected. Within the corporate bond allocation, the automotive sector was the largest positive contributor to returns from an attribution perspective. The Fund's automotive holdings returned 9% compared with the benchmark, which returned just 2.13%. Although we were overweight the sector, the outperformance was primarily attributable to a single holding, an automotive parts supplier, which has been in the process of expanding operations to address greater than expected demand. It is no longer at the point where it is incurring additional costs for labor, outsourcing, or expedited shipping, and margin and cash flows are improving rapidly. Retail was also a significant positive contributor from an attribution perspective. The Fund's allocation to the retail sector returned a positive 2.37% compared with the benchmark, which was negative 0.56%. Retail, especially department stores and fashion-oriented retail, has been under pressure recently. We have only about a 50% weight in the retail sector. Relative to the benchmark, we had approximately a 2.2% allocation compared with the benchmark, which is approximately a 4.7% allocation to retail. Within our retail holdings, we currently do not have any exposure to department stores, clothing, or fashion retail, which are at the epicenter of the current secular shift in consumer shopping trends.

In terms of detractors, telecommunications was the largest detractor from performance. On an attribution basis, the Fund's telecommunications holdings generated a negative return of 1.22% compared with the benchmark, which returned a positive 4.21%. The Fund's underweight accounted for part of the underperformance. The Fund had only a 2.6% allocation to telecommunications compared with the benchmark, which has about a 10.4% allocation to telecommunications. It was also partly attributable to a specific wireline issuer in the portfolio that missed revenue and earnings expectations due to issues with the integration of recent acquisitions.



Source: BofA Merrill Lynch as of 3/31/17.
Ratings determined by S&P.

Q: If some of Trump's policies are enacted, are there any sectors you feel will benefit? And if so, how are you positioning your portfolio?

A: Since the inauguration, the new administration has focused primarily on making use of executive orders to implement changes in order to work quickly and efficiently without Congress. These changes have been less focused on stimulating the economy and more focused on undoing the policies of the prior administration. With regard to the economy, the new administration's priorities are focused primarily on tax reform, infrastructure spending, and deregulation, all of which could be significant from an economic materiality standpoint. Although it isn't directly associated with one of the three areas mentioned, the administration and Congress attempted to repeal the Affordable Care Act. This included significant cuts in government spending that would have provided legislators more flexibility when it came to crafting tax reform. Even though Congress and the president weren't able to repeal the Affordable Care Act, we still expect some form of tax reform to occur although it will be more limited and occur later than expected. We're still of the opinion that it will benefit the economy at the margin.

Prior to the election, we thought the U.S. was the strongest of the major economies, and we've been orienting the portfolio to benefit from improvement in domestic growth. We still believe that's the case. Any benefit from tax reform, infrastructure spending, and deregulation would only reinforce that opinion. We are overweight the basic industries, capital goods, and financial services sectors, which we would expect to be the primary beneficiaries from a pickup in domestic economic activity. Our basic industries and capital good holdings encompass home builders, building material companies, chemical companies, and manufacturing companies, all of which benefit directly or indirectly from increased domestic demand resulting from the Trump administration's proposed policies.

Q: What is your outlook for the next six to 12 months, and how is the Fund positioned?

A: In terms of growth, we continue to expect global growth to pick up from last year. The International Monetary Fund recently increased its forecast for global growth in 2017 from 3.4% to 3.5%. Activity in the European Union appears to be picking up, with recent manufacturing sentiment surveys moving sharply higher. China is also in the middle of its National Congress, which is its leadership election that takes place every five years. Consensus and expectations are for growth to be stable during this leadership transition. In fact, China recently reported 6.9% year-over-year growth in gross domestic product at the end of the first quarter. Fundamentals in the U.S. look solid, with interest rates historically low, unemployment still at only 4.7%, and wage growth picking up to 2.7% and possibly accelerating if the economy continues to add jobs. The Federal Reserve continues on its path of raising interest rates, having just raised the federal funds rate for the third time in March to a target of 0.75% to 1.00%. It continues to state that the rate of increases will be gradual and data driven. Currently, the Federal Reserve estimates that if the economy continues to perform in line with its expectations, it will raise rates approximately three times in 2017. We viewed the recent interest rate increases as affirmation of the strength of the underlying economy in the U.S., given that the Federal Reserve recently raised rates in December as well. If the Trump administration makes good on any or all of its proposed policies with regard to tax reform, infrastructure spending, and deregulation, the growth rate in the U.S. could accelerate. In this context, we've allocated approximately 10% of the portfolio to CLOs to take advantage of their attractive yield relative to high yield corporate bonds, as well as to reduce the interest rate sensitivity of the portfolio overall. CLOs are floating rate assets, have no interest rate risk, and are beneficial during the current Fed interest rate cycle.

With regard to the corporate portfolio, it is still early in the new presidency, and we continue to position the portfolio to benefit from increased domestic growth drivers in housing, construction, and manufacturing, which would benefit directly from any incremental increase in the rate of growth resulting from the implementation of any of the proposed policies. Additionally, we are cognizant of current valuations and the potential for rising rates, and we're also exiting holdings where we feel the risk/reward no longer makes sense in the context of maximizing long-term risk-adjusted returns.

DEFINITIONS AND DISCLOSURES

CLO: Collateralized Loan Obligations.
Bank of America Merrill Lynch U.S. High-Yield Index: Tracks the performance of below investment grade, but not in default, U.S. dollar denominated corporate bonds publicly issued in the U.S. domestic market, and includes issues with a credit rating of BBB or below, as rated by Moody's and S&P.
Basis Point: A unit equal to one hundredth of a percentage point.
Cash Flow: The net amount of cash and cash-equivalents moving into and out of a business.
Floating Rate: A floating-rate security is an investment with interest payments that float or adjust periodically based upon a predetermined benchmark.
Credit Spread: The difference in yield between two bonds of similar maturity but different credit quality.
Standard Deviation: A statistical measure of portfolio risk used to measure variability of total return around an average, over a specified period of time. The greater the standard deviation over the period, the wider the variability or range of returns and hence, the greater the fund's volatility—calculated since inception.