Q&A: Flexible Income Fund - Targeting Opportunities in Corporate Financials

The Angel Oak Flexible Income Fund takes a distinctive approach to credit investing, actively allocating across higher-yielding fixed income instruments that are not generally adversely affected by interest rate volatility. The flexible nature of the Fund provides the portfolio managers with the freedom to invest in securities outside of established indices, lowering the expected correlation with traditional fixed income investment returns.

Navid Abghari
Senior Portfolio Manager
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Navid Abghari, Senior Portfolio Manager, provides an overview of the Angel Oak Flexible Income Fund, its current opportunity set, and why it might make sense to have the Fund as part of a fixed income portfolio.

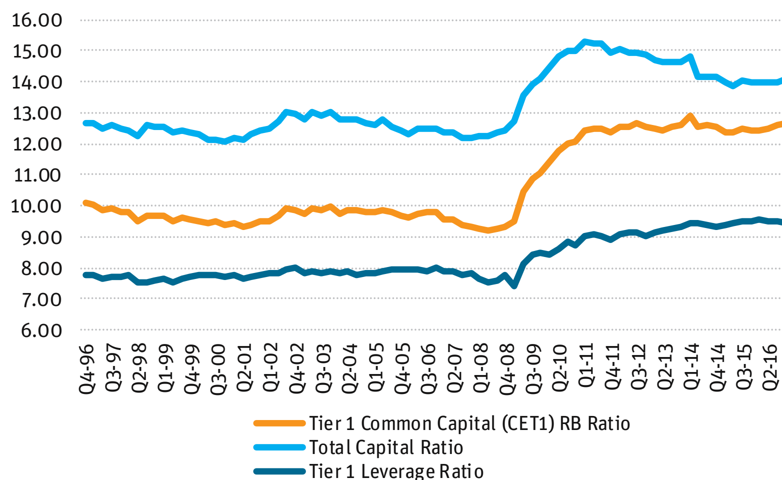
Q: What are the key features of your investment strategy?

A: The Fund seeks to generate income and total return by actively allocating across a combination of fixed income asset classes that have the potential to produce superior risk-adjusted returns. With a focus on finding relative value opportunities, the Fund has the flexibility to move among a broad range of assets, not only seeking excess returns, but also limiting correlations with traditional fixed income markets.

Q: Where are you finding the opportunities for your strategy today, and how do you plan to position the Fund over the next 12 months?

A: Currently, we see community bank subordinated debt as one of the best relative value opportunities in the fixed income universe. The recent financial crisis was largely a function of overleverage on both consumer and bank balance sheets. Since then, we've seen a massive shift in how those two sectors operate that has been driven primarily by new regulations. Whether it's the Dodd-Frank legislation or Basel capital standards, banks are subject to unprecedented levels of supervision, resulting in much cleaner balance sheets. On the liability side of the balance sheet, banks have on average 30% more equity capital today than they did in 2007. On the asset side, regulators require banks to hold a certain amount of reserves and capital for each asset on their balance sheet, and the increasingly punitive treatment of riskier assets by regulators has constrained banks' ability to book these assets. The result has been a significant reduction in nonperforming assets and overall credit risk.

FIGURE 1: BANK CAPITAL RATIOS



Source: SNL as of 12/31/2016.
Past performance does not guarantee future results.

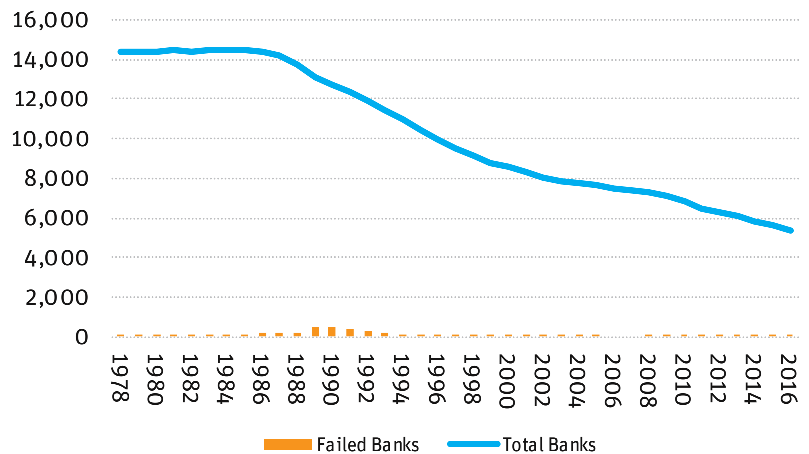
If we take a step back and see how this compares with the broader corporate universe you will see a stark difference. Much of the easy money provided by central banks around the world ultimately made its way onto corporate balance sheets. Non-financial corporates have utilized this low rate environment as an opportunity to re-lever their balance sheets through stock buybacks and debt-financed M&A activity. Average leverage for investment grade corporates is now at an all-time high: higher than what was experienced in 2007 and even higher than during the dot.com days of the early 2000s. Not only do we think banks are fundamentally better positioned than the broader credit universe of firms, but the yields we're able to achieve also contribute to the attractiveness of the opportunity.

Our average community bank holding is currently yielding north of 5.5% and rated investment grade, whereas in comparison the average BB corporate issue currently yields about 4.5% according to the Bloomberg Barclays Investment Grade Corporate Bond Index. For these reasons, we've been actively rebalancing the portfolio to be overweight community bank debt. We've increased our exposure to community banks from 20% at the beginning of 2016 to close to 50% at present. Additionally, our large bank allocation has increased to 20%, with a focus on the most liquid issues available. These banks have the same underlying fundamental drivers, with the main difference being less yield but more liquidity. That brings our total financials exposure to about 70% of the portfolio, with the goal of maintaining a 65% to 75% allocation for the next 12 months, with a consistent proportion of community banks and larger money center banks. The remaining balance will be allocated among collateralized loan obligations, commercial mortgage-backed securities and cash, with allocations varying slightly depending on market opportunity.

Q: Can you explain the structure and history of the community bank subordinated debt market?

A: Historically, community banks have financed themselves almost exclusively through the use of deposits and equity capital. During the early 2000s, a new Tier 1 capital instrument called trust preferred securities (TruPS) was introduced. Between 2000 and 2007, approximately $70 billion of TruPS were issued by banks in the U.S. However, during the crisis, many issuers exercised their option to defer interest payments, severely degrading their performance. As of May 2010, these types of securities are no longer counted as Tier 1 capital, and new issuance of TruPS has essentially ceased.

FIGURE 2: FAILED BANKS VS. TOTAL FDIC INSURED COMMERCIAL BANKS



Source: FDIC as of 12/31/2016.

Given that issuing common equity is dilutive to existing shareholders, there's really no viable source of additional capital for many community banks other than subordinated debt, which qualifies as regulatory Tier 2 capital. As a result, subordinated debt has really become the capital instrument of choice for community banks. The most popular structure is a 10-year non-call five fixed-to-floating structure. These bonds have a ten-year final maturity, are callable after five years at the issuer's option, at which point the coupon also converts from a fixed rate to a floating rate plus a spread over 3M LIBOR. However, subordinated debt only receives Tier 2 capital treatment as long as its outstanding maturity is greater than five years, after which the instrument begins to lose its capital eligibility, with one-fifth of its eligibility amortizing over each of the final five years. This is the reason the issuer has the option to call the issuance with five years remaining. The favorable treatment of subordinated debt as Tier 2 capital can also impact an issuer's likelihood of calling the deal, as there could be certain scenarios under which the bank might exercise their call to reissue at a wider spread.

Q: How do you expect deregulation to impact the opportunity?

A: We do expect deregulation to be a key theme of the new presidency, but in our mind, the changes in regulation will be beneficial to us as community bank debt investors. Most of the focus of discussions on bank deregulation have been centered on Dodd-Frank, which has significantly increased the cost of doing business for banks, especially smaller community banks. The increased compliance, risk management and legal costs of Dodd-Frank have stifled the profit-generating potential of community banks. Relaxing at least some of these constraints will improve community banks' ability to generate profits, enhancing their credit profile. However, it's highly unlikely that the U.S. would diverge from the international Basel Accord on regulatory capital requirements. The Trump administration would struggle to garner support for a regulatory framework giving U.S. banks the ability to have more leverage and take on riskier assets than the rest of the developed world. Therefore, we believe the U.S will remain aligned with existing international capital standards for the foreseeable future, ensuring a high degree of safety and soundness in the banking industry.

Q: What differentiates the Angel Oak Flexible Income Fund from its peer group, and how should investors think about the Fund?

A: The Angel Oak Flexible Income Fund has a high proportion of investment grade assets, and we think it has a compelling risk-return profile when evaluated relative to the Bloomberg Barclays Investment Grade Corporate Bond Index. One key distinguishing feature is high income. The Angel Oak Flexible Income Fund currently has a 30-day SEC yield of 4.85%* as of March 31, versus 3.3% for the Index. Also, our fund has a lower duration of 2.7 years, compared with 7.3 years for the Index. Further, banks generally perform more strongly in a rising rate environment, as assets tend to reprice upwards more quickly than liabilities, thereby improving net interest margins. We believe a key differentiating factor of the Angel Oak Flexible Income Fund is its ability to benefit from continued strengthening in the banking industry.

*The 30-day SEC Unsubsidized yield for the Angel Oak Flexible Income Fund is 4.41%.

DEFINITIONS AND DISCLOSURES

30-Day SEC Yield: The SEC yield is an annualized yield based on the most recent 30-day period. Subsidized yields reflect fee waivers in effect. Without such waivers, yields would be reduced. Unsubsidized yields do not reflect fee waivers in effect.
Correlation: A statistical measure of how two securities move in relation to one another.
Effective duration: Measures a portfolio's sensitivity to changes in interest rates. Generally, the longer the effective duration, the greater the price change relative to interest rate movements.
Bloomberg Barclays Investment Grade Corporate Bond Index: Measures the investment grade, fixed rate, taxable corporate bond market. It includes U.S. dollar denominated securities publicly issued by U.S. and non-U.S. industrial, utility, and financial issuers.
LIBOR: A benchmark rate that some of the world's leading banks charge one another for short-term loans. It stands for Intercontinental Exchange London Interbank Offered Rate and serves as the first step to calculating interest rates on various loans around the world.
Spread: The difference in yield between a U.S. Treasury bond and a debt security with the same maturity but of lesser quality.
Tier 1 Common Capital (CET1) RB Ratio: Measurement of a bank's core equity capital compared with its total risk-weighted asset that signifies a bank's financial strength.
Total Capital Ratio: The percentage of a bank's capital to its risk-weighted assets.
Tier 1 Leverage Ratio: The relationship between a banking organization's core capital and its total assets.

Mutual fund investing involves risk; principal loss is possible. Investments in debt securities typically decrease when interest rates rise. This risk is usually greater for longer-term debt securities. Investments in lower-rated and nonrated securities present a greater risk of loss to principal and interest than higher-rated securities. Investments in asset-backed and mortgage-backed securities include additional risks that investors should be aware of, including credit risk, prepayment risk, possible illiquidity, and default, as well as increased susceptibility to adverse economic developments. Derivatives involve risks different from and, in certain cases, greater than the risks presented by more traditional investments. Derivatives may involve certain costs and risks, such as illiquidity, interest rate, market, credit, management, and the risk that a position could not be closed when most advantageous. Investments in derivatives could lose more than the amount invested. The Fund can make short sales of securities, which involves the risk that losses in securities may exceed the original amount invested. Investments in foreign securities involve greater volatility and political, economic, and currency risks and differences in accounting methods. The Fund is nondiversified, so it may be more susceptible to being adversely affected by a single corporate, economic, political, or regulatory occurrence than a diversified fund. For more information on these risks and other risks of the Fund, please see the prospectus.

Bond ratings are grades given to the bonds to indicate their credit quality as determined by a private, independent rating service, such as Standard & Poor's. The firm evaluates a bond issuer's financial strength, or its ability to pay a bond's principal and interest in a timely fashion. Ratings are expressed as letters, ranging from AAA, which is the highest grade, to D, which is the lowest grade. In limited situations, when a rating agency has not issued a formal rating, the advisor will classify the security as nonrated.

Must be preceded or accompanied by a prospectus. To obtain an electronic copy of the prospectus, please visit www.angeloakcapital.com.

It is not possible to invest directly in an index.

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