Q&A: Multi-Strategy Income Fund - The Fed, Trump and Rising Rates

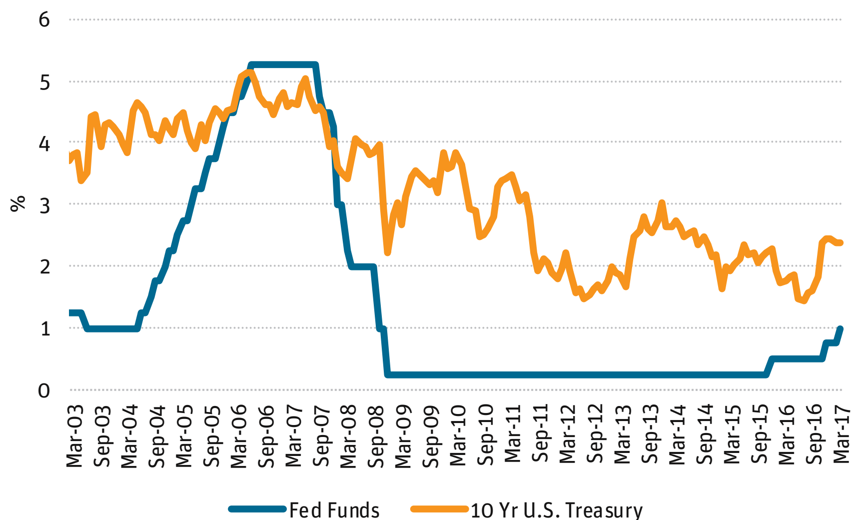
While interest rates continue to test historical lows, improving economic conditions and an impending end to the Fed's quantitative easing program make the prospects for rising rates even more of a reality. While rising rates could significantly impact much of the traditional fixed income market by eroding principal, the Angel Oak Multi-Strategy Income Fund is well-positioned to potentially outperform in a rising rate environment.

Sam Dunlap
Senior Portfolio Manager
Angel Oak Capital Advisors

Sam Dunlap, senior portfolio manager, provides an overview of the fixed income market, our views on the Fed, and a performance update on the Angel Oak Multi- Strategy Income Fund.

Q: The Fed raised rates in both December 2015 and 2016, and again this March. It's expected to raise rates at least two more times in 2017. With the Fed in play, where do you see the best relative value?

10 YEAR U.S. TREASURY YIELD AND FED FUNDS RATE



Source: Bloomberg.
As of 3/31/17.

A: We still see the best relative value in floating rate legacy non-agency residential mortgage-backed securities (RMBS), particularly bonds at the top of the capital structure. Legacy non-agency RMBS remains attractive due to its wide spreads, floating rate coupons, deeply discounted dollar prices, improving voluntary prepayment speeds, and appreciating collateral. We believe legacy non-agency RMBS should continue to perform quite well given hawkish Fed monetary policies and reflationary growth prospects. Moreover, while the bonds we target at the top of the capital structure in legacy non-agency RMBS are currently well below investment grade, we believe legacy non-agency RMBS should be able to withstand harsh economic and housing scenarios going forward, given the deeply discounted dollar price at which we were able to purchase these bonds and our expectations for improving prepayment scenarios. Targeted opportunities also exist in non-agency commercial mortgage-backed securities (CMBS) and collateralized loan obligations (CLOs) due to their wide spreads relative to traditional corporate credit, notably tranches rated A and BBB-. In particular, BBB- investment grade tranches of new issue non-agency CMBS are attractive relative to investment grade corporates. For example, BBB- spreads are approximately 450 basis points wider than BBB corporate bonds. CLOs also represent relative value due to their floating rate structure, strong credit fundamentals and wide spreads relative to traditional corporate credit, particularly tranches rated BBB-.

Q: Since the election, the markets are pricing in an economy that will begin to grow faster, as tax reform, deregulation, and infrastructure spending are all promised under the Trump agenda. What are some sectors you think should benefit the most in this type of environment?

A: Although the recent Trump bump has lost some steam, we believe it will begin to regain momentum as the administration improves its ability to negotiate with the establishment, particularly with the Freedom Caucus. We believe the winners will continue to be risk assets that perform well in inflationary environments such as equities, real estate, real estate-backed assets, floating rate securities, short duration assets, and high current carry credit spread assets.

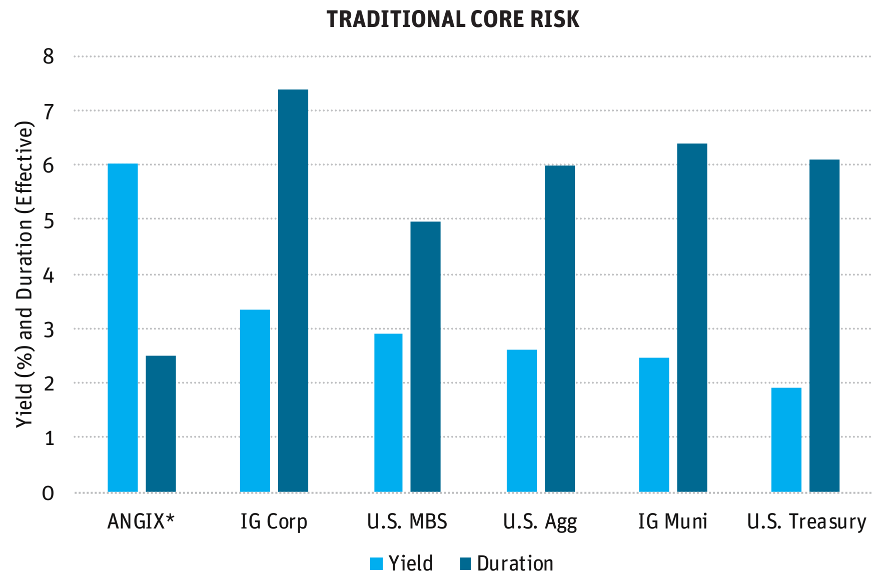
Q: The Angel Oak Multi-Strategy Income Fund, (ANGIX) has performed well during periods of rising rates. What are some of the key reasons for this?

A: ANGIX historically has had a short effective duration profile that has benefited fund performance during periods of rising rates. Moreover, the historical overweighting to floating rate legacy non-agency RMBS at the top of the capital structure has been a key factor in reducing the interest rate sensitivity of the Fund. Legacy non-agency RMBS exhibits de minimis interest rate risk while having a high-quality credit risk profile. Credit-sensitive assets have historically performed well in the post-crisis period, as risk-on trades are typically driven by spurts of growth and reflationary expectations during rising rate scenarios. Growth and inflationary environments are very positive for legacy non-agency RMBS in particular. Record low single family home inventories coupled with a Fed that has expressed very little concern about home price inflation has been very good news for mortgage credit investors, as the underlying collateral value of the bonds continues to surprise to the upside. This is also helping drive prepayment velocity as loan-to-value ratios are dropping. Rising rates increase floating rate coupons and decrease credit spreads, both of which have been beneficial to our total return.

Q: Bank loans are the typical go-to investment in the retail world for floating rate exposure. However, ANGIX is approximately 60% floating rate. Why do you feel your floating rate strategy is well-positioned for 2017?

A: Generally speaking, we favor floating rate credit and are positive on bank loans in this credit environment. However, we believe there is more total return potential in the floating rate legacy non-agency RMBS market simply because of the deeply discounted dollar prices of the asset class compared to bank loans. For example, in early 2016, the weighted average dollar price for bank loans was approximately $89 and bank loan total return performance was approximately 10%. Currently, the weighted average dollar price for bank loans is approximately $99 and the current spread of the bank loan market is approximately 416 basis points. Furthermore, we believe there is more upside potential in the legacy non-agency RMBS market because our weighted average dollar price of the exposure is still approximately $82 on the dollar. Moreover, because of the voracious demand for anything floating rate, the bank loan market has received a huge amount of inflow. Increased investor demand for floating rate bank loans has driven credit spreads tighter, and the bank loan market is undergoing a huge refinancing wave. In addition to the high dollar price of the asset class, the credit spread earned on these assets as a whole continues to tighten. We believe the discounted dollar price of the legacy non-agency RMBS market, coupled with the scenario improvement we are seeing in prepayments, should result in our strategy outperforming traditional bank loan funds in 2017.

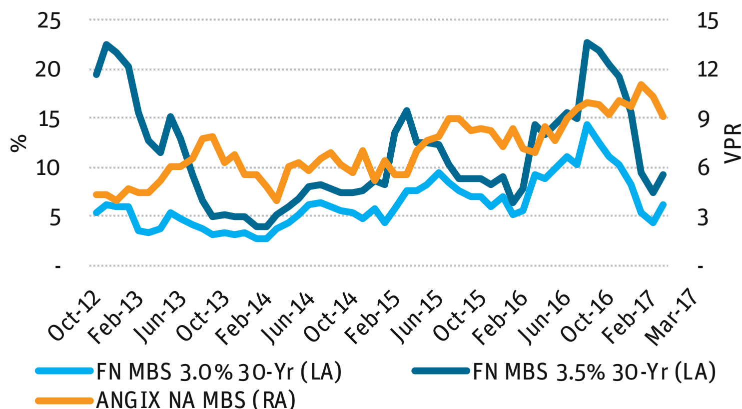
TRADITIONAL CORE RISK



Source: Bloomberg.
As of 3/31/17.
Past performance does not guarantee future results.
*Yield shown is distribution yield.
For the Angel Oak Multi-Strategy Income Fund (ANGIX), subsidized yields reflect fee waivers in effect. Without such waiver, yields would be reduced. Unsubsidized yields do not reflect fee waivers in effect. As of 3/31/17, the subsidized and unsubsidized 30-Day SEC yield for ANGIX were 4.96% and 5.00%, respectively.

Q: In a market where interest rates are rising, agency mortgages have typically performed poorly. Recently, the Fed mentioned that it has begun looking into potentially unwinding its balance sheet that was built up during the crisis. What effects do you think this will have on fixed income markets, and what areas do you think are most at risk?

A: We believe that reductions in the Fed's bond portfolio will potentially add volatility to the fixed income market, and we believe agency RMBS is most at risk. Agency RMBS is negatively convex, causing the total return to underperform in a declining and rising rate environment. The asset class is negatively convex because the mortgages that back agency RMBS can generally be prepaid at any time at the option of the borrower. As rates rise, fewer borrowers will prepay and the weighted average life of most agency RMBS will extend. This reduces valuations in a rising rate environment as less principal is available to reinvest at higher rates. Conversely, as rates are falling, borrowers are more likely to prepay their mortgage, forcing investors to reinvest at lower market rates. What makes non-agency RMBS so unique are the discounted dollar prices. As previously mentioned, the average dollar price of our positions is $82. Prepayments are actually beneficial because investors receive these cash flows at par. As prepayments increase, yields increase, credit spreads decrease, and average lives shorten – all of which are beneficial to total return. We've actually observed our prepayments increasing during the recent uptick in rates.



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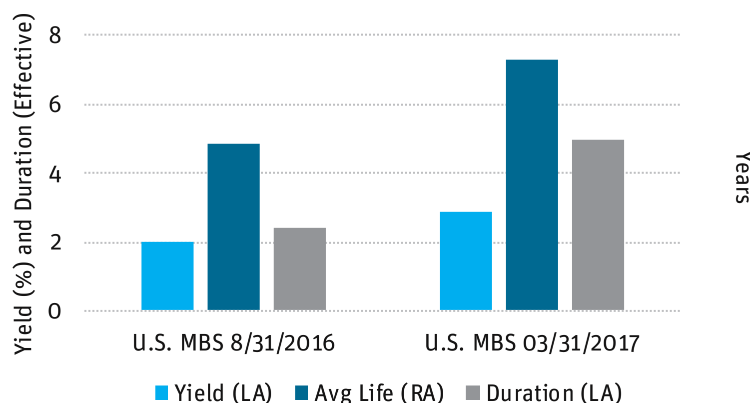

Source: Bloomberg.
As of 3/31/17.

DEFINITIONS AND DISCLOSURES

Basis point: One-hundredth of 1 percent, and used to denote the percentage change in a financial instrument.
Cash Flow: The net amount of cash and cash-equivalents being transferred into and out of a business, especially as affecting liquidity.
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.
Floating rate: A floating-rate security is an investment with interest payments that float or adjust periodically based upon a predetermined benchmark.
Spread: The difference in yield between a U.S. Treasury bond and a debt security with the same maturity but of lesser quality.
Tranche: One of a number of related securities offered as part of the same transaction.
Bloomberg Barclays U.S. Aggregate Bond Index: An unmanaged index that measures the performance of the investment-grade universe of bonds issued in the United States. The index includes institutionally traded U.S. Treasury, government-sponsored, mortgage, and corporate securities.

Multi-Strategy Income Fund Performance:

Total Returns (As of 3/31/17)	1Q 2017	YTD	1 Year	3 Years	5 Years	Inception[1]
Class I	1.80%	1.80%	8.93%	3.86%	6.08%	8.06%
Class A at NAV	1.71%	1.71%	8.59%	3.57%	5.84%	7.85%
Class A at MOP[2]	-0.59%	-0.59%	6.19%	2.79%	5.36%	7.43%

[1]The inception date of the Angel Oak Multi-Strategy Income Fund A Class (ANGLX) was June 28, 2011, while the inception date of the Institutional Class (ANGIX) was August 16, 2012. The returns of ANGIX shown for periods prior to the inception date include the returns of ANGLX and are adjusted to reflect the operating expenses of ANGIX.
[2]Maximum Offering Price takes into account the 2.25% maximum initial sales charge.

Angel Oak Multi-Strategy Income Fund Expense Ratios by Share Class*

	Class A	Class I
Gross	1.41%	1.19%
Net	1.24%	0.99%

*Gross expense ratios for the A Class and the Institutional Class are reported as of the 5/31/16 prospectus. The Adviser has committed contractually to waive fees and/or reimburse expenses so that net annual fund operating expenses do not exceed certain levels through 5/31/17 and may be discontinued at any time by the Fund's Adviser after 5/31/17.

Performance quoted is past performance and is no guarantee of future results. Current performance may be lower or higher than the performance data quoted. The investment return and principal value of an investment in the Fund will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance for the most recent month end or a prospectus for the Angel Oak Funds can be obtained by calling 855-751-4324 and you can visit www.angeloakcapital.com to obtain month-end performance.

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 non-rated 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. Investing in derivatives could lose more than the amount invested. The Fund may make short sales of securities, which involves the risk that losses may exceed the original amount invested.

Bond ratings are grades given to bonds that 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 the rating agency has not issued a formal rating, the advisor will classify the security as non-rated.

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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