Q&A: High Yield Opportunities Fund 2Q 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.

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Matt Kennedy, head portfolio manager for the Angel Oak High Yield Opportunities Fund, provides a review of second quarter results and where he is finding opportunities in the high yield market heading into the last half of the year.

Q: The Angel Oak High Yield Opportunities Fund (ANHIX) returned 1.69% during the second quarter and has delivered 4.34% for the year. What were the main contributors to and detractors from the Fund's performance for the quarter and year?

High Yield Spread History
Bank of America Merrill Lynch High Yield Master II Index
As of June 30, 2017

OAS refers to Option Adjusted Spread.
Source: Bank of America Merrill Lynch

A: For both the quarter and year, energy was the largest positive contributor to performance from an attribution basis. In the second quarter, over half of the outperformance in the energy allocation can be attributed to two positions, the largest being an offshore drilling company primarily focused in Southeast Asia and the Middle East. The company completed an initial public offering in the quarter, raising equity and using the proceeds to purchase additional drilling rigs, significantly improving its credit profile. The second position is a specialty products company that's getting some traction in improving its financial performance after its refinery and operations suffered early in 2016 when energy and oil prices came under pressure. On a year-to-date basis, these same two companies accounted for the bulk of the energy allocation and outperformance, along with an additional company that produces wood pellets as a substitute for burning coal and using coal-fired energy plants, which is getting a lot of interest with the global focus on emissions.

In terms of detractors, the biggest detractor for the quarter was a holding in the automotive sector, an auto parts supplier. The company had some operational issues in early 2016 due to excessive demand growth, which pressured margins and cash flow. However, in the past 12 months it has made some changes, increasing capacity and addressing the issues, and making progress in improving its margins and cash flow. Also, this company's bonds were significant contributors to performance in the first quarter. However, in the second quarter, we've seen investors taking profits and locking in gains, especially after the pace of auto sales have been coming off of peak record levels over the past few months.

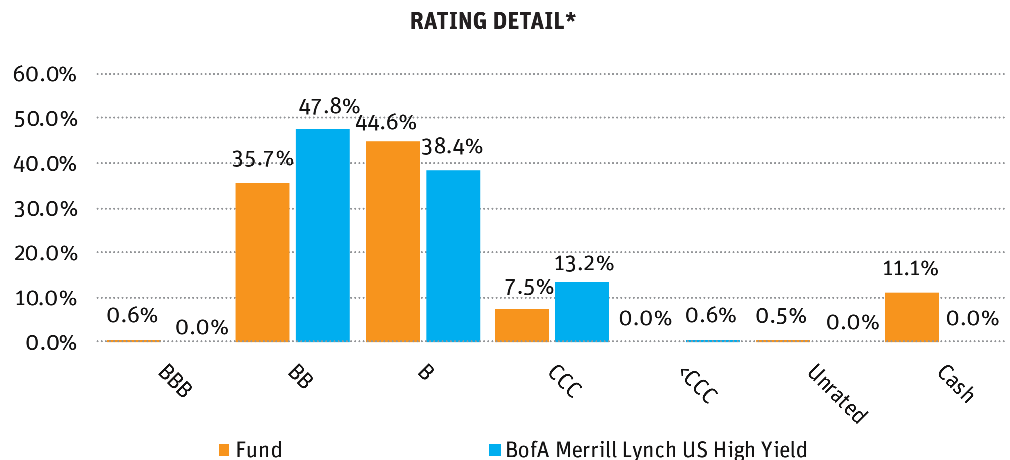
With regard to detractors on a year-to-date basis, the telecom sector has been the biggest detractor through a combination of being underweight the sector, which has done relatively well year-to-date, and having a position in a wireline company that has had some issues integrating recent acquisitions. We actually reduced that position earlier in the year by about two-thirds, but the remaining position was still a drag on performance in the second quarter, and year-to-date. The company has been through this before with acquisitions, but it does generate significant free cash flow, and we expect it to be able to address the issues with regard to the integration and stabilize financial performance in the near future.

Q: With such a strong run in high yield over the past 12-15 months, some market participants are worried that spreads are too tight. How do you think your strategy could perform if there were a spread widening scenario?

A: In terms of our strategy, we focus on risk-adjusted returns and outperformance over a full market cycle. A key part of that strategy is focusing on valuation and the risk/reward trade-off. We want to ensure we're being compensated for the risks we are taking, and emphasize capital preservation as part of that. Because of our emphasis on valuation and risk/reward as well as capital preservation, periods of market weakness or spread widening have been those where we generated our largest outperformance. Think along the lines of periods like 2011, late 2015/early 2016 -- those are good examples of how the strategy has performed during periods of spread widening. Strong performance during market sell-offs also contributes to our lower standard deviation of returns relative to the market and the peer group, leading to attractive risk-adjusted returns.

Q: Are there specific sectors you find attractive in today's market, and are there any sectors you are avoiding or that the Fund is underweight?

A: In general, we are very positive on the U.S. economy and are primarily focused on sectors that we think will continue to benefit from the current economic environment. The current environment looks very positive when it comes to employment, slowly rising wages, low interest rates -- those are all positives from a fundamental perspective for corporate credit. The Federal Reserve has started to raise interest rates and is expected to begin reducing the size of its balance sheet in the near future, though with inflation running below expectations, we expect any rate increases to be gradual. In that context, we're currently overweight in basic industries, which is a very broad category. However, within that sector, we like companies leveraged to the housing market, especially home builders and building materials companies. Demand for homes remains strong, and low interest rates continue to support affordability. Another sector we are overweight in is capital goods, which should benefit from a pickup in manufacturing and infrastructure spending, whether driven by fundamental economic growth or fiscal policies. In terms of underweights, healthcare is a sector that we've been underweight in for quite a while. The underweight is a combination of valuation and overall general uncertainty. Valuations are tight in the healthcare space, and when coupled with the uncertainties surrounding the Affordable Care Act, the risk/reward trade-off doesn't appear attractive.



Source: BofA Merrill Lynch as of 6/30/17.
Diversification does not assure a profit or protect against any losses in a declining market.
*Unrated consists of corporate bonds that do not have ratings and excludes Equities and ETF's. Typically, there are three ratings on every bond. If the three ratings are not identical, Angel Oak will use the following procedures: 1) If one of the three ratings is different, we will use the dominant rating (the rating that is the same from two rating agencies), 2) if all ratings are different, we will use the middle rating, and 3) if there are only two ratings, we will use the higher rating.
Ratings determined by S&P.

Q: How do you feel the High Yield Opportunities Fund differentiates itself from its peers, and what are some potential advantages of owning a fund like ANHIX in both up and down markets?

A: We view the Fund as being differentiated by its emphasis on risk-adjusted returns, as well as its flexible relative value approach to asset allocation. The Fund is focused on valuation, risk/reward and capital preservation. When we aren't being compensated appropriately, we will reduce the risk profile of the Fund, such as in a current environment like this, and position the Fund to take advantage of valuations when the market eventually reprices. Additionally, we will take advantage of relative value opportunities or dislocations with other high yielding asset classes, such as collateralized loan obligations, when we believe the risk/reward trade-off is attractive relative to high yield corporate bonds. Also, our small size allows us to take meaningful positions in names where we have a high degree of conviction. Our size also allows us to be nimble in getting into or, more importantly, getting out of a position without moving the market, which we view as a big advantage given the changes in the liquidity environment post-financial crisis.

Q: What is your outlook for the high yield market for the remainder of 2017, and how is the Fund positioned?

A: This year has certainly gotten off to a great start. Fundamentals look positive, with economic growth running at approximately 2 percent over the past 12 months. Unemployment is low and continues to move down, wages are moving higher -- albeit gradually -- and inflation remains relatively low. With that backdrop and the continued strong demand for income by investors, we expect more of the same in the second half of the year, although probably less in the way of spread tightening relative to the first half, and more in the way of carry, in terms of the composition of total return.

DEFINITIONS AND DISCLOSURES

Bank of America Merrill Lynch (BAML) 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. It is not possible to invest directly in an index.
Cash Flow: The net amount of cash and cash-equivalents being transferred into and out of a business, especially as affecting liquidity.
Free Cash Flow (FCF): A measure of a company's financial performance, calculated as operating cash flow minus capital expenditures. FCF represents the cash that a company is able to generate after spending the money required to maintain or expand its asset base.
Spread: The difference between the current bid and ask prices for a stock.
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.

High Yield Opportunities Fund Performance:

Total Returns (As of 6/30/17)	2Q 2017	YTD	1 Year	3 Years	5 Years	Inception[1]
Class I	1.69%	4.34%	13.28%	4.81%	6.71%	10.09%
Class A at NAV	1.71%	4.29%	13.07%	4.56%	6.48%	9.83%
Class A at MOP[2]	-0.55%	1.94%	10.50%	3.77%	5.99%	9.53%
BofA Merrill Lynch High Yield Index	2.14%	4.91%	12.75%	4.48%	6.91%	12.78%

[1]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.
[2]Returns shown for A Shares at MOP reflect the maximum sales load of 2.25%.

Angel Oak High Yield Opportunities Fund Expense Ratios by Share Class*

	Class A	Class I
Gross	1.34%	1.08%
Net	0.90%	0.65%

*Gross expense ratios are reported as of the 5/31/17 prospectus. The net expense ratios are reported as of the 1/31/17 Annual Report and are referenced in the 5/31/17 prospectus. The Adviser has contractually agreed to waive fees through 5/31/18.

Current performance may be lower or higher than performance data quoted. Performance quoted is past performance and is no guarantee of future results. 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 to the most recent month-end can be obtained by calling 855-751-4324.

Mutual fund investing involves risk. Principal loss is possible. Investments in debt securities typically decreases 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. Investments in foreign securities involve greater volatility and political, economic and currency risks and differences in accounting methods. 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.

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