Q&A: High Discipline in High Yield Investing

With a potentially flat-to-rising interest rate environment, high yield investments are coming into greater focus as an attractive option for fixed income investors. The Angel Oak High Yield Opportunities Fund offers a disciplined approach to credit analysis, with the goal of outperforming over a full market cycle. Matthew Kennedy, CFA®, Senior Portfolio Manager at Angel Oak Capital, gives us an inside look into his process and outlook for the high yield market.

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The Relative Rising Tide of Rising Rates

While interest rates present potential risks to nearly all fixed income investors, there may be a silver lining to upcoming market changes. High yield securities can offer several distinct advantages relative to more traditional fixed income asset classes. In fact, rising rates may be a sign of a strengthening economy, which can support the more economically-sensitive market segment.

Q: Are you concerned about rising rates? How do you anticipate rising rates impacting your strategy?

A: With interest rates near historic lows, fixed income investors, and for that matter all investors, should be concerned about rising interest rates. There are two potential benefits that high yield corporate bonds could offer in a rising interest rate environment. First, the higher yield received from owning below investment grade-rated debt relative to that available on U.S. government fixed income securities or investment grade fixed income securities, provides the capacity to absorb or mitigate the negative impact of rising rates and still generate positive total return. All else equal, if interest rates rise 1%, the market value of a bond with a duration of five yielding 8% will decline 5%, but the 8% yield being earned will more than offset the decline in market value, resulting in a positive total return for the 12-month period of approximately 3%. Compared with an investment grade-rated bond with a duration of five that yields less than 5%, for the same 1% increase in interest rates, the total return for the 12-month period would be negative.

The second potential benefit is that when interest rates move higher in the U.S., it's typically associated with an improving economic environment. When you have an improving economic environment, the expectation would be that high yield companies would be able to benefit from rising demand for their products and services. If the economy is particularly strong, you might see some pricing power, margin expansion and cash flow growth. Growth in cash flow, relative to debt, is the basis of an improvement in the issuer's credit profile, with better debt service coverage and lower leverage. This improvement in the issuer's credit profile should translate into improvement in the valuation of its bonds. The issuer might even get a credit rating upgrade, but that's usually a lagging indicator rather than a predictor of outperformance. This improvement in valuation has the potential to also offset, or mitigate, the negative impact from rising rates.

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Angel Oak
CAPITAL ADVISORS

Taking a Deeper Dive into Value

Angel Oak's portfolio managers take a risk-managed approach to investing in high yield. We are focused on risk-adjusted returns with the objective of outperforming the benchmark over a full market cycle with a lower volatility of returns.

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

A: Within the context of our risk-managed approach to high yield investing, there are two key features of our investment strategy. The first is our emphasis on relative value. In order to deliver competitive risk-adjusted returns, we need to be disciplined when it comes to valuations. We need to ensure that we are getting compensated for the risk we are taking and not chase the market when valuations are rich or full. We monitor valuations at a high level within the high yield market and relative to other assets classes, like investment grade credit and structured credit products. When valuations reach a threshold where we don't believe we are being compensated appropriately for the risk being taken, we will begin transitioning the portfolio to a more defensive return profile. This could help ensure that when the market sells off, we won't give back all of what we achieved in terms of performance during the bull market. On the flip side, when the market does sell off and valuations reach thresholds where we believe we are being appropriately compensated for the risk being incurred, we will begin to transition the portfolio to a more aggressive return profile. The benefit is twofold in that we are seeking to preserve capital by reducing the risk profile before the market turns and trading liquidity dwindles, while also reducing the volatility of returns. Markets have a tendency to overreact in both directions, and we want to take advantage of that for the potential benefit of long-term performance.

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The second key element of our strategy is intensive fundamental research. This is the cornerstone of what we do, and where the team spends the majority of its time on a daily basis. We employ a bottom up process when it comes to issuer and security selection. Also, we approach things more conservatively when calculating ratios and analyzing the numbers, and prefer to do all the analysis internally. Key things we look for are improving trends, positive free cash flow and strong liquidity. Having access to liquidity is essential to help protect against refinancing risk in the event access to the capital markets is limited, like we experienced during the depths of the financial crisis. Liquidity can be in the form of cash on the balance sheet, credit facility availability or a combination of both.

The other thing we look for is quality management teams. This is obviously very subjective, but we want management teams that have a history of doing what they say they will do. This last point is critical given the asymmetric risk associated with fixed income investing. There have been instances where management teams have taken actions that solely benefit equity shareholders at the expense of their fixed income investors, and we prefer to try to avoid companies where we feel the risk in doing something along those lines is high (or if management has a reputation of not being bondholder friendly).

Different for a Reason

Q: What differentiates the Angel Oak High Yield Opportunities Fund from its peer group, and how should investors think about the fund?

A: This really ties back into how we manage the high yield portfolio from a risk management perspective. We are disciplined in our use of various relative value measurement tools to reposition the portfolio, and we avoid chasing riskier investment opportunities if not appropriately compensated or rewarded for the risk being incurred. We also have the ability to allocate a small portion of the portfolio to other high-yielding asset classes, like collateralized loan obligations, convertible bonds and preferred stock. We do so only when these asset classes look attractive from a risk/reward basis relative to high yield corporate debt. We are able to allocate a portion of the portfolio to these other asset classes to diversify the portfolio, reduce interest rate risk, enhance yield and potentially improve the overall risk/reward profile of the fund. Aside from our goal of generating a higher level of interest income, modern portfolio theory tells us that adding high yield to an existing portfolio that doesn't already have any high yield could result in higher expected returns and a lower standard deviation of returns as the portfolio benefits from the correlation differences between high yield and the other fixed income assets in the portfolio.

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Managing Your Risk

While the goal of any strategy is to make investment gains, proper focus on risk can help preserve earned wealth. Angel Oak has a commitment to lower volatility returns and risk assessment.

Q: How do you manage risk?

A: We think of risk in terms of valuation and making sure we are getting compensated appropriately for the level of risk being incurred. Valuations within the high yield market tend to move from overvalued to undervalued, and we want to capitalize on that inefficiency. When valuations appear rich or full, we begin to transition the portfolio to a more defensive return profile in an effort to reduce the chance of giving back positive performance when the market turns. When valuations appear cheap, we begin to transition the portfolio to a higher return profile. This is essentially, buy low/sell high, but it takes discipline. The natural tendency for people is to attempt to outperform by taking even more risk when valuations are rich.

Good Buys in Today's Environment

Markets may experience volatility going forward, but many economic indicators are optimistically positive.

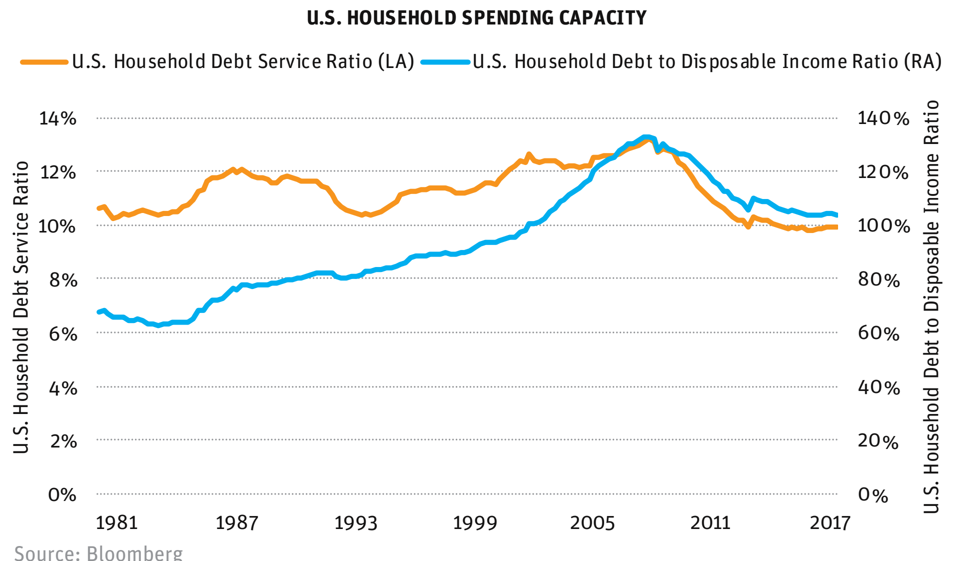
Q: Are there any specific sectors you find attractive in today's market?

A: We see the high yield market as attractive at current valuation levels. We also have a positive view on the U.S. economy. However, we are not expecting extraordinary growth, given the global backdrop, but think the economy can continue to grow approximately 2% per year. Something we watch in particular is household spending capacity, which has normalized, with both the debt service and household debt to disposable income ratios dropping significantly from peaks hit in 2008.

The following indicators also support our outlook:

- The unemployment level is low (4.2%).
- New job creation is at a healthy pace (1.8 million over the past 12 months).
- Wages are moving in the right direction.
- The consumer appears to be in a relatively strong position, with household leverage at the lowest levels since 2002.
- Bank lending growth is running in the mid-single digits.
- Home values have continued to appreciate at a respectable pace, up over 5% year-over-year.
- Gasoline prices remain relatively low, supporting consumer spending (approx. $2.56/ gal. vs. avg. $3.48 from 2011 to 2014).

U.S. HOUSEHOLD SPENDING CAPACITY



Source: Bloomberg

From a global perspective, China's government continues to support its economy which completes its 19th CPC National Congress in October. China reported 3Q gross domestic product of 6.8%, and has been relatively steady over the last two years. Retail sales has been resilient, increasing at more than 10% year-over-year consistently for the last two years. Industrial production has been stable over the last two years, averaging over 6.3% year-over-year. The concern regarding China's debt level remains, but the government has been cautious in terms of implementing changes so as not to upset the economy. The eventual impact of the decision by the U.K. to separate from the European Union is still unknown, but it will take years to negotiate and implement, dampening the impact as the market will have time to adjust. The global economy recently entered a synchronized expansion, benefiting from years of central bank easy monetary policies. In that context, the sectors where we currently have the largest overweights include Basic Industry, Energy, Capital Goods, and Financial Services.

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Cash Flow: The total amount of money being transferred into and out of a business, especially as affecting liquidity.
Correlation: A statistical measure of how two securities move in relation to another.
Duration: An approximate measure of a bond's price sensitivity to changes in interest rates.
Free Cash Flow: A measure of a company's financial performance, calculated as operating cash flow minus capital expenditures.
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. The standard deviation has been calculated since inception.
U.S. Household Debt Service Ratio: The ratio of total required household debt payments to total disposable income.
U.S. Household Debt to Disposable Income Ratio: The ratio of debt payments to disposable personal income.

The Funds' investment objectives, risks, charges and expenses must be considered carefully before investing. The statutory prospectus and summary prospectus contain this and other important information about the investment company, and may be obtained by calling 855-751-4324 or visiting www.angeloakcapital.com. Read them carefully before investing.

Diversification does not guarantee a profit or protect from loss in a declining market.

Opinions expressed are subject to change, not guaranteed, and should not be considered investment advice.

Past performance is no guarantee of future results.

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. The Fund may make short sales of securities, which involves the risk that losses may exceed the original amount invested.

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