Q&A: Community Bank Debt Market and the Angel Oak Flexible Income Fund

Cheryl Pate, CFA®, Senior Portfolio Analyst for the Angel Oak Flexible Income Fund (ANFIX), provides a snapshot of the bank debt market, where Angel Oak is finding compelling investment opportunities within the sector, and an overview of ANFIX and why it might make sense to have the Fund as part of a fixed income portfolio.

Q: Who is Angel Oak Capital Advisors?

A: Angel Oak Capital Advisors is an alternative credit manager focused on providing fixed income investment solutions using a value-driven approach. Our key competencies are in structured credit and corporate credit. One of our fundamental competitive advantages is identifying dislocations across credit markets created by macroeconomic, financial, or regulatory events. As of March 31, 2018, the firm manages approximately $8.7 billion in assets under management.

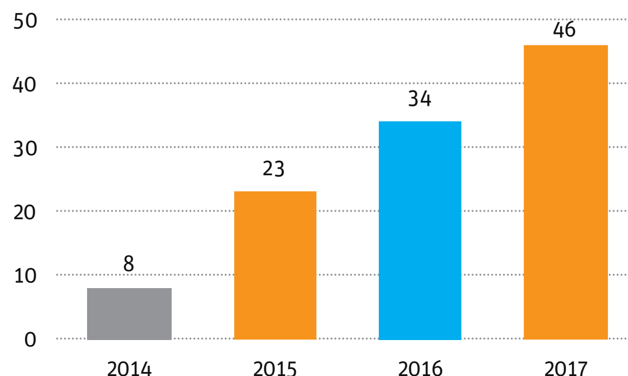
Q: Discuss your outlook for the banking sector.

A: We find the banking sector attractive given strong capital and credit profiles, the potential for some marginal regulatory relief, and the backdrop for higher rates, which is generally a favorable scenario for banks. Post-financial crisis, the banking industry is near all-time highs from a capital and credit quality perspective. The banking sector has added close to 4% of common equity since the crisis, and credit risk has declined sharply in the face of enhanced loan underwriting standards and increased regulatory oversight. We see several tailwinds for banks, and community banks in particular. First, we believe higher rates will benefit the largely asset-sensitive balance sheets of community banks, where assets typically reprice upward more quickly than deposits. Second, we expect to see a reduction in regulatory compliance expenses as government proposals come to pass. Finally, we anticipate continued consolidation, given the need for scale, the overbanked nature of the U.S. financial system, and improved equity valuations post-election.

Q: Tell us more about the bank debt market and why you find it compelling.

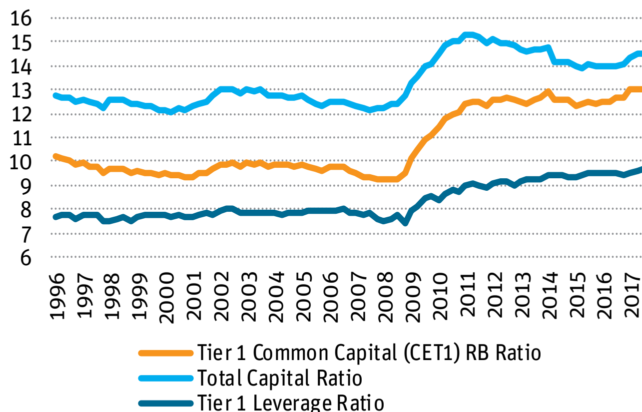
A: We think the bank debt market may offer compelling returns for investment grade risk. Community bank debt provides a high relative coupon and strong underlying credit profile, particularly in the smaller-bank space. This is a market that came to fruition in 2014, and we believe still has a long runway of investment opportunity. We expect annual issuance in the $4 billion to $6 billion dollar range in 2018, and expect the market could be $8 billion to $10 billion annually in a mature market. Additionally, one thing we find particularly compelling about this market, is the fact that bank debt typically has exhibited less interest rate sensitivity than traditional areas of fixed income.

BANK DEBT DEAL PARTICIPATION



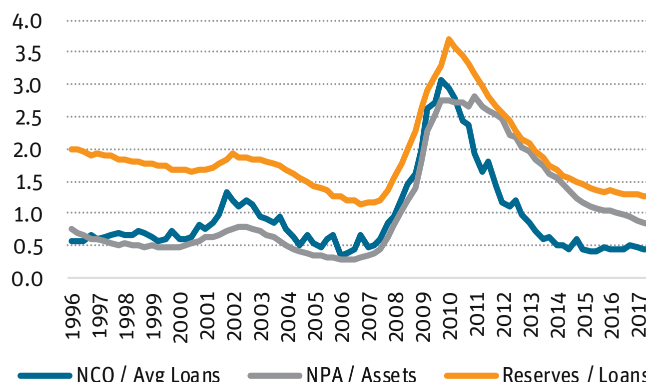
Source: Angel Oak Capital Advisors.

BANK CAPITAL RATIOS



Source: SNL as of 12/31/2017.

BANK ASSET QUALITY RATIOS

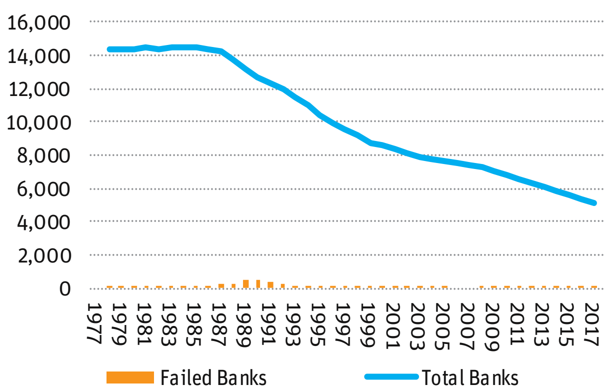


Source: SNL as of 12/31/2017.

Angel Oak
CAPITAL ADVISORS

To expand on the thesis a little more, and why we have such a positive outlook on the banking sector, one of the unique things about the banking industry today is that the regulatory environment has caused banks to increase their capital base by more than a third since the crisis, in stark contrast to the broader corporate market where leverage has increased to record levels. This market today is extremely healthy relative to the past 50 years, and we feel we are investing in high credit quality institutions at yields normally associated with high yield corporate credit. Additionally, we look for bank earnings and thus debt servicing ability to benefit from higher interest rates as well as the recently enacted corporate tax changes. Again, there is a consolidation wave underway, where larger banks are acquiring smaller banks. This is obviously a plus for the strategy, as the debt of the smaller bank is assumed by the larger bank, and should benefit from price appreciation. These trends are very much a positive for the bonds we are buying within the Flexible Income Fund, and are reflective of Angel Oak's distinct investment strategies which have historically sought to identify regulatory dislocations in the market post-crisis.

TOTAL FDIC INSURED COMMERCIAL BANKS VS. BANK FAILURES



Source: FDIC as of 12/31/2017.

Q: Angel Oak has really emerged as a market leader in bank debt investing, hasn't it?

A: Yes, Angel Oak has been one of the largest and most active investors in the community bank debt market. Since 2014, we have participated in more than 125 deals and have accumulated over a billion dollars in community bank debt. The key to this is our strategic sourcing advantage through an extensive network of 70 regional and national broker/dealer relationships, as well as our proprietary quantitative credit and default model and enhanced diligence process.

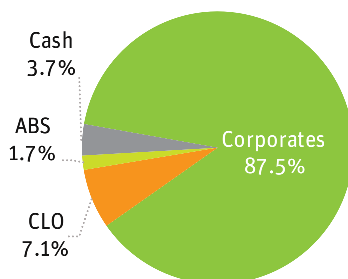
Q: Why invest in the Flexible Income Fund?

A: We see three potential key advantages for investors. First, from an income perspective, we believe there is an opportunity for higher levels of monthly income than traditional fixed income, with the strategy focused on optimizing a mix of attractive yielding bank debt. Secondly, the Flexible Income Fund offers retail investors the opportunity to access a niche market. Retail investors can leverage the expertise of the leading manager in the asset class, providing access to an otherwise hard-to-reach market segment. Our strategy focuses on investment grade-rated community banks, where we see an opportunity to extract high coupons from banks that may have less access to capital markets due to asset and deal size. Finally, we see potential portfolio diversification benefits. As we've highlighted, this is a banking sector-focused, fixed income strategy which has historically exhibited low correlation to both interest rate movements and other areas of the fixed income market.

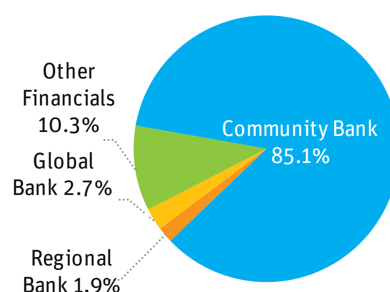
Q: Describe the current allocation of the Fund, and do you anticipate any changes over the next 12-18 months?

A: The Fund focuses on debt investments in financial services companies with a particular focus on community banks. As of March 31, 2018, 88% of ANFIX is invested in financial services debt. Community bank debt accounts for 85% of the financials allocation, non-bank financials account for 10% and global and regional banks account for 5%. Over the next 12-18 months, we see the best opportunities in community banks based on the acceleration observed in the pipeline for community bank debt primary issuance.

SECTOR BREAKDOWN[1]



CURRENT FINANCIAL ALLOCATION[1]



[1]As of 3/31/18.

ABS: Asset-backed security.
CLO: Collateralized loan obligation.
Correlation: A statistical measure of how two securities move in relation to one another.
NCO: Net charge-off.
NPA: Non-performing asset.
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.

Opinions expressed are as of 3/31/18 and are subject to change at any time, are not guaranteed, and should not be considered investment advice.

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

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

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 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 non-diversified, 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.

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