The Upgrade Wave in Legacy Non-Agency RMBS

The opportunity set within the legacy non-agency residential mortgage-backed securities (NA RMBS) market continues to evolve. The asset class has moved from distressed in the early years of the post-crisis period to opportunistic relative value today. Currently, NA RMBS spreads (or discount margins) are approximately 300 basis points (bps), and market participants debate the prospects of additional spread tightening from current levels as most of the NA RMBS universe is below investment grade. In our view, a catalyst for future spread tightening is the potential tailwind from rating agency upgrades, most notably for bonds moving from below investment grade to investment grade.

Incredibly, approximately 81% of the NA RMBS market is still below investment grade (Figure 1), but according to Bank of America Merrill Lynch non-agency MBS research, Moody's, S&P and Fitch are preparing for large-scale upgrades of legacy non-agency RMBS. Upgrades in NA RMBS began in earnest in 2014 with approximately $10-$20 billion upgraded per quarter, and market participants expect the trend to potentially double over the next two years. Upgrades typically tighten NA RMBS spreads by approximately 25 bps, but when a bond is upgraded from below investment grade to investment grade, the spread could potentially tighten by approximately 100 bps.

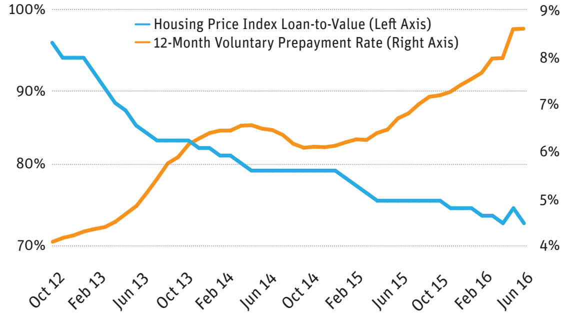
FIGURE 1
OUTSTANDING BALANCE (%)

Collateral Type	Investment	Split	Non-Investment	Not Rated
Alt-A	4.9%	0.3%	92.2%	2.6%
Option ARM	2.5%	0.7%	93.2%	3.5%
Prime Jumbo	20.0%	1.0%	59.3%	19.6%
Subprime	10.0%	3.7%	81.3%	5.0%
Others*	12.2%	0.4%	33.7%	53.7%

As of 7/31/16
Source: Morgan Stanley Research, Intex
*The "Others" bucket consists of non-agency RMBS that does not fall into the other 4 categories – including, but not limited to, deals in Intex labeled as Scratch & Dent, Non-Performing Loan and Reperforming Loan.

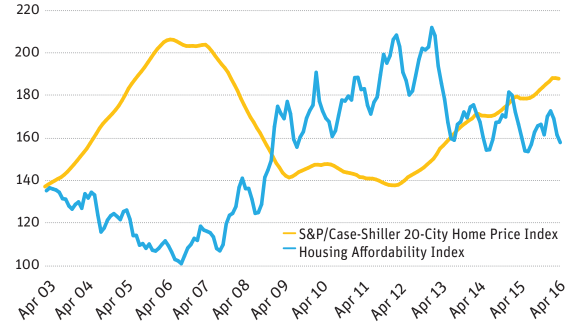
The NA RMBS market has seen sharp improvements in its valuations due to increasing levels of home equity, illustrated by loan-to-value ratios (LTVs) declining by over 30% since 2012 (Figure 2) and the consistent positive trend in US home prices (Figure 3) coinciding with an increase in voluntary prepayment rates and falling delinquencies. Improving fundamental performance should continue to drive upgrades in the space for positions with credit enhancement still intact. Riding an upgrade wave has been an intermediate-term focus for the mortgage credit strategy in our funds. Selectively targeting bonds with the potential for credit rating upgrades can provide the next level of price appreciation and enhance the total return potential for our NA RMBS allocation. Across the entire legacy market, the majority of upgrades are expected to be in subprime collateral. However, many prime, Alt-A and option adjustable-rate mortgage (ARM) bonds – which our strategies target – exhibit similar characteristics and provide potential for future upgrades. Approximately 40% of Angel Oak Multi-Strategy Income Fund's allocation to NA RMBS has the potential to be upgraded at some point in the future. Of that 40%, we estimate approximately 33% has the potential to be upgraded to investment grade over the next few years.

FIGURE 2
HPI VS. LTV



Source: Bloomberg as of 7/31/16

FIGURE 3
HOUSING AFFORDABILITY & HOME PRICE INDEX



Source: Bloomberg as of 5/31/16

Angel Oak CAPITAL ADVISORS

ABOUT ANGEL OAK CAPITAL ADVISORS, LLC

Angel Oak Capital Advisors is an investment management firm focused on providing compelling fixed-income investment solutions for its clients. Backed by a value-driven approach, Angel Oak Capital seeks to deliver attractive risk-adjusted returns through a combination of stable current income and price appreciation. Our experienced investment team seeks the best opportunities in fixed income, with a specialization in mortgage-backed securities and other areas of structured credit. As of 6/30/16, Angel Oak Capital has over $5.5 billion in assets under management through a combination of mutual funds, private funds and separately managed accounts.

DISCLAIMER

S&P/Case-Shiller 20-City Home Price Index: The leading measures of U.S. residential real estate prices, tracking changes in the value of residential real estate both nationally as well as in 20 metropolitan regions.
Spread: The difference in yield between LIBOR and a debt security with the same maturity but of lesser quality.
Housing Affordability Index: Measures whether or not a typical family could qualify for a mortgage loan on a typical home. An index above 100 signifies that a family earning the median income has more than enough income to qualify for a mortgage loan on a median-priced home, assuming a 20 percent down payment.

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.

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 result in losing 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.

It is not possible to invest directly in an index.

All current and future holdings are subject to risk.