Angel Oak
CAPITAL ADVISORS

Compelling Opportunities Amid Market Volatility

12/28/18

Throughout 2018, we improved the quality of the Angel Oak Multi-Strategy Income Fund (ANGIX) by defensively rotating into predominantly high-quality areas of the U.S. structured credit markets. Historically tight spreads, amid concerns of an aggressive Federal Open Market Committee, quantitative tightening, a late-stage corporate credit cycle, trade wars, and geopolitics all weighed on our risk appetite throughout the year. We took advantage of the favorable credit environment in the first three quarters of 2018 to improve the credit quality of ANGIX, all while maintaining income as interest rates shifted higher. This higher-quality positioning has dampened pricing volatility during the recent market turmoil and has enabled us to begin to shift into areas that have widened out alongside broader markets, but exhibit stable or improving credit fundamentals. We were well-positioned prior to the recent weakness, and while this recent change in sentiment happened sooner than expected, significant opportunities have begun to emerge in various areas of the U.S. structured credit landscape. Notable areas of pronounced weakness include certain new issue non-agency residential mortgage-backed securities (RMBS) and certain portions of the collateralized loan obligation (CLO) capital structure.

Read our prior piece detailing Recent Allocation Shifts in Preparation of Increased Market Volatility

→ Click here

One area of new issue non-agency RMBS we liked from a fundamental standpoint, but thought expensive over the last year, was agency credit risk transfer (CRT) deals. CRT markets are off markedly over the fourth quarter despite continued favorable housing and consumer credit fundamentals. The bonds we are targeting have enough credit enhancement to potentially withstand a housing downturn while not suffering any principal loss. Similar to our legacy RMBS holdings, these bonds carry a floating rate coupon and can be purchased at prices well below par. The discounted purchase price allows the yield to improve if the underlying borrowers prepay their mortgage and offer current yields in the mid- to high-single digits with potential price appreciation. The other area that remains attractive is new issue non-QM transactions. These deals experienced some widening due to stronger new issue supply in the fourth quarter. At wider spreads, we see attractive opportunities across the capital structure given the attractive characteristics and performance of the underlying collateral.

CLOs have also been a victim of recent market volatility, with the credit curve steepening dramatically. Throughout the capital structure, indiscriminate selling has pushed bonds substantially lower in price in the fourth quarter. Our conservative approach toward CLOs over the past year has allowed us to be opportunistic during this latest sell-off in targeting bonds with very attractive return profiles. While CLOs and corporate credit have been an area of concern from a credit fundamental perspective, the market assumptions on defaults and recoveries have gone too far too fast. We are now able to buy high-quality, seasoned bonds with significant price discounts. When we look at potential further downside risk versus base case and upside scenarios, we see that we are being compensated handsomely for the risk. The opportunities we see in the CLO market today present loss-adjusted yields ranging from 5% to 10% and offer significant potential for price appreciation.

Our mission is to identify the best relative value in the U.S. structured credit markets over the full credit cycle. We were cautious over the past year due to a host of post-crisis concerns and were confident there would be a better entry point. We believe the time to make a portfolio shift is nearing, as compelling yield and total return opportunities are emerging. While market timing can be difficult, our defensive positioning and ample liquidity will allow us to take advantage of these opportunities and potentially enhance returns in 2019.

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AUTHORS:

Sreeni Prabhu
Co-CEO, Chief Investment Officer

Sam Dunlap
Senior Portfolio Manager

Berkin Kologlu
Senior Portfolio Manager

Colin McBurnette
Portfolio Manager

Clayton Triick, CFA®
Portfolio Manager

David Wells
Senior Portfolio Strategist

Loan-to-value (LTV): A calculation to determine the ratio of a loan to the value of an asset purchased.

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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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