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Angel Oak High Yield Opportunities Fund Quarterly Review

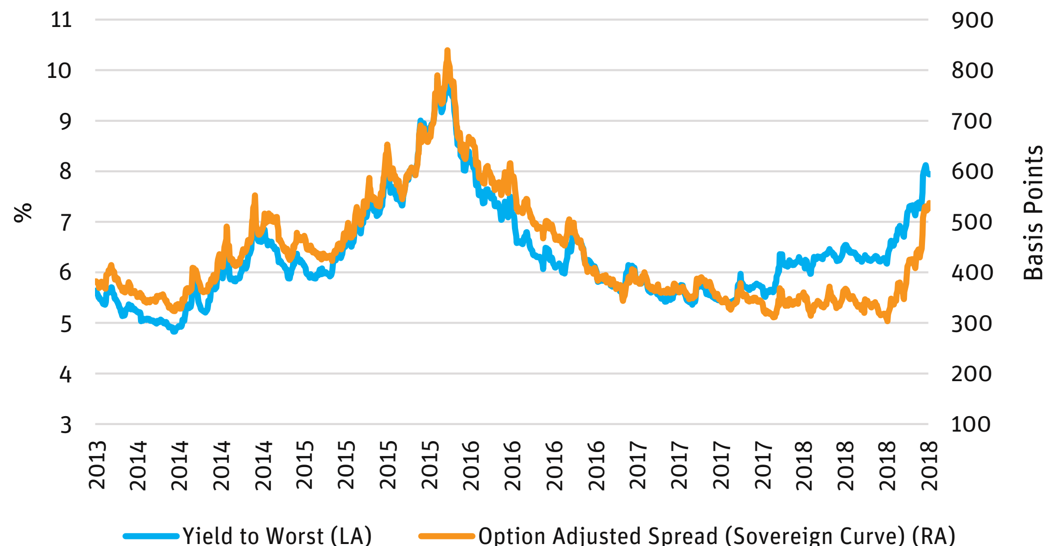
December 31, 2018

Angel Oak
CAPITAL ADVISORS

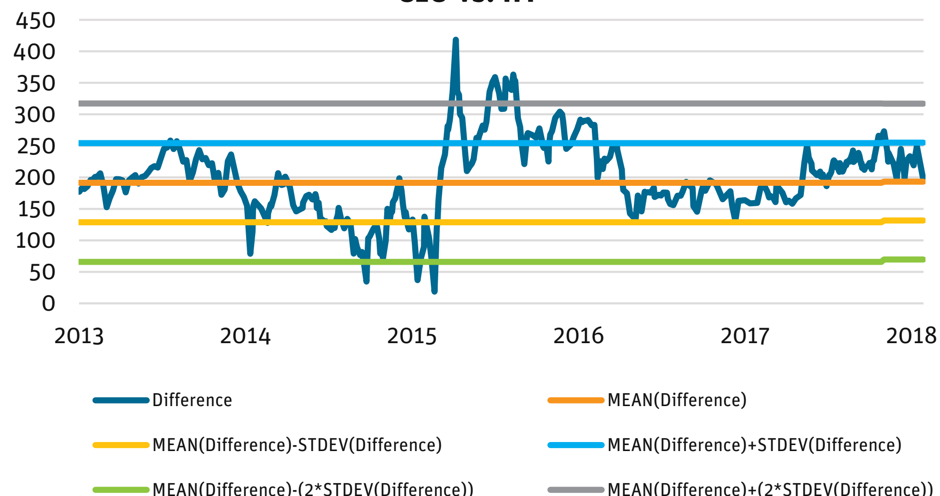
Quarter in Review

- High yield returns for the fourth quarter were negative, with the Bloomberg Barclays U.S. Corporate High Yield Index down 4.53%. Credit spreads widened sharply the last two months of the year after trading in a range of roughly 310 basis points to 370 basis points for most of the year. The selloff was triggered by overly enthusiastic comments from the Federal Reserve chairman regarding the durability of the economic expansion and that it was well below the neutral rate, further compounded by subsequent comments that the balance sheet reduction was on autopilot.
- The domestic economy has been robust, with double-digit gains in corporate earnings, 2.6 million new jobs created over the last twelve months (the most since 2015), and GDP improving to 3.4%. However, growth outside the U.S., particularly in Europe and China, continues to deteriorate, exacerbated by the trade dispute. With the impact of the Tax Cuts and Jobs Act fading in 2019, and global growth deteriorating, concerns are rising with regard to the ability of the U.S. economy to decouple from the rest of the world.
- In aggregate, high yield credit fundamentals continue to improve and leverage has declined over the last nine quarters from 4.6x to 3.9x. Margins, free cash flow, and interest expense coverage continue to improve as well. S&P recently highlighted that a rise in interest expense as a percentage of EBITDA precedes a rise in the default rate, and currently, it continues to improve. S&P estimates the default rate will improve from 2.7% in September 2018 to 2.5% by September 2019.
- Recent Institute for Supply Management surveys have indicated a deterioration in the outlook, especially with regard to new orders. The negativity could stem from a combination of the trade dispute, the decline in equity valuations, widening credit spreads, and tighter financial conditions. China is taking steps to ease monetary policy, and the Federal Reserve has made remarks indicating more sensitivity to financial markets. Progress on a trade agreement with China, and less-aggressive monetary policy tightening in the U.S., have the potential to extend the economic expansion and benefit credit spreads.
- High yield valuations are at the most attractive levels in almost three years. With what appears to be a Federal Reserve more sensitive to what financial market activity may be communicating, combined with potential for positive event risk associated with trade, a solid high yield credit profile in aggregate, and expectations for continued declines in defaults rates, the return potential for high yield appears attractive for 2019.

Benchmark Performance	9/30/18	12/31/18	Quarterly Change (bps)
2-Year Treasury	2.82	2.49	-33
5-Year Treasury	2.95	2.51	-44
10-Year Treasury	3.06	2.68	-38
UST 2s/10s Spread	24	18	-6
Oil	73.25	45.41	-3,801
Iron Ore	66.02	70.58	+691
VIX	12.12	25.42	+10,974
S&P 500 Total Return Index	5,763	4,984	-1,352
Bloomberg Barc U.S. Corp IG Index	106	153	47
Bloomberg Barc U.S. Corp HY Index	316	526	210

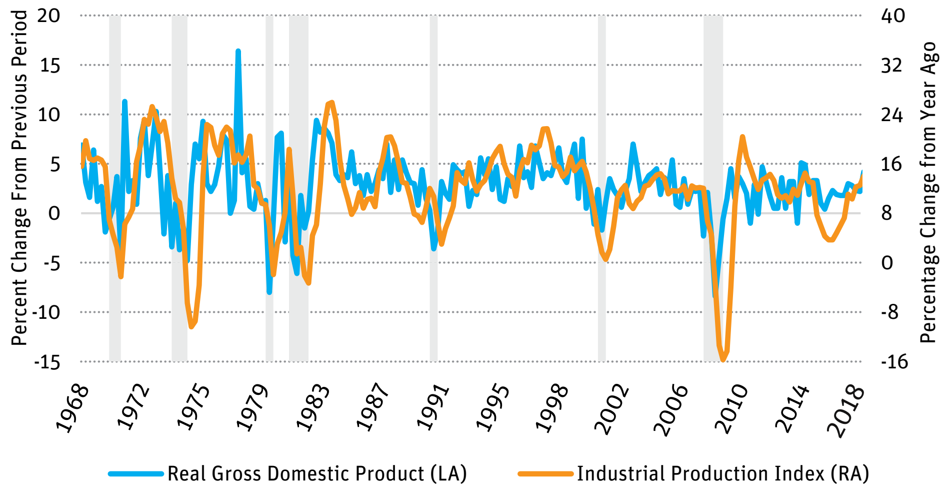


Source: Bloomberg of 12/31/18.

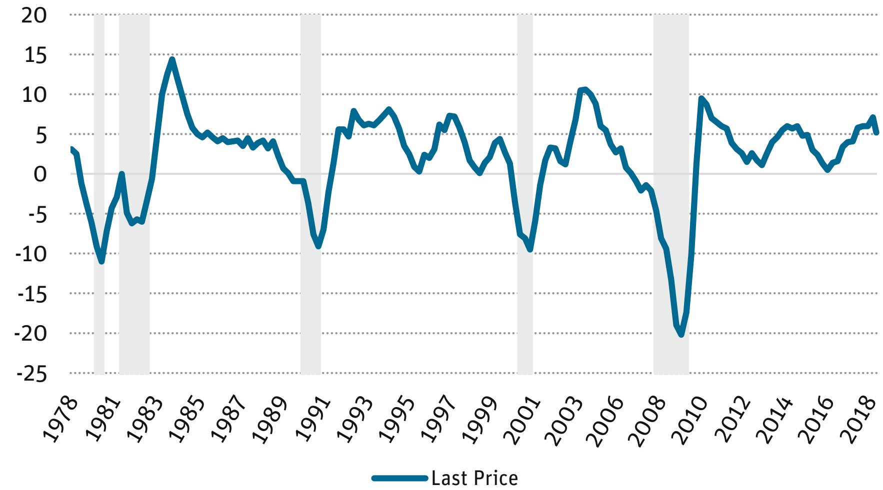


Source: Citigroup as of 12/31/18.

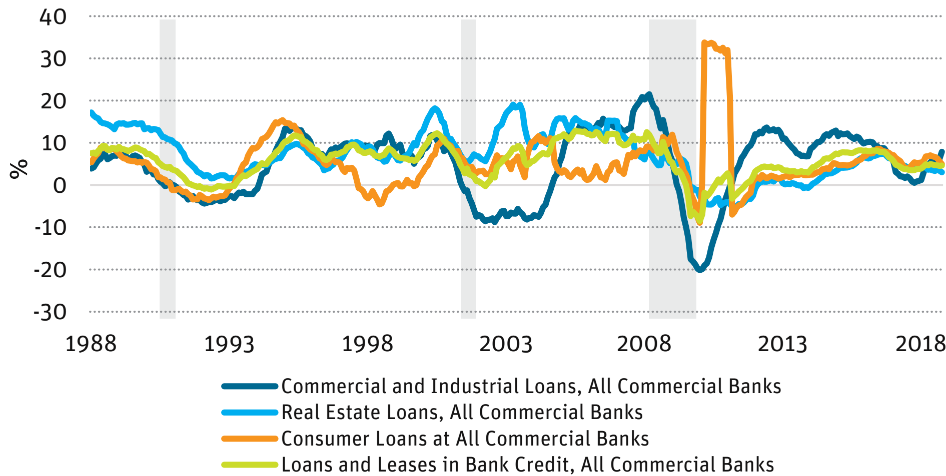
Fundamental Backdrop



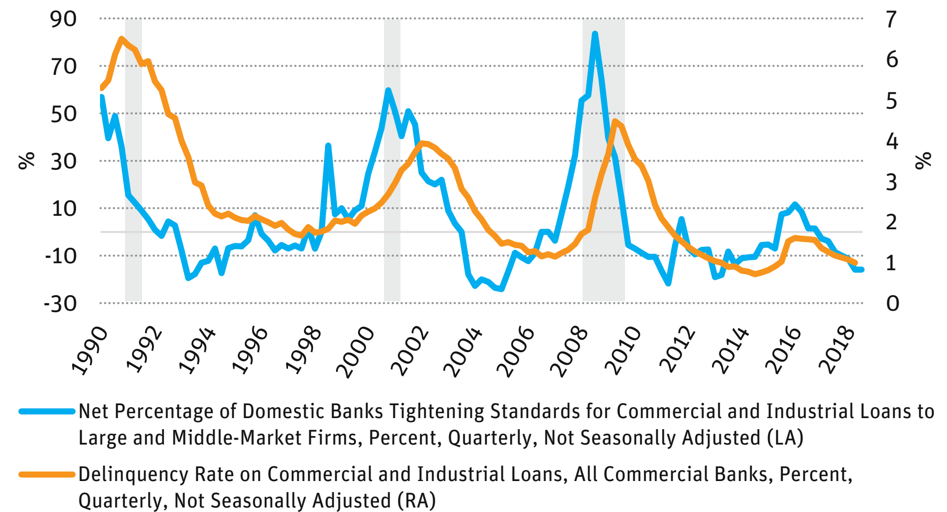
Source: FRED as of 12/31/18.



Source: S&P 500 as of 12/31/18.



Source: FRED as of 12/31/18. Shaded gray bars represent periods of recession.



Source: FRED as of 12/31/18.

Portfolio Performance

Summary

- The Angel Oak High Yield Opportunities Fund returned -4.42% in the quarter ending December 31, 2018, slightly outperforming the Bloomberg Barclays U.S. Corporate High Yield Index, which -4.53%. For the full year 2018, the Angel Oak High Yield Opportunities Fund returned -2.40%, slightly lagging the Bloomberg Barclays U.S. Corporate High Yield Index, which returned -2.08%.
- After high yield credit spreads hit post-crisis tights of 303 basis points on October 3rd, things quickly unraveled, sparked by Federal Reserve Chairman Powell's comments that we are a long way from neutral. The selloff was further compounded by the Federal Reserve chairman's comment that the balance sheet runoff (i.e., quantitative tightening) was on autopilot, along with weakening economic data from China and Europe and plunging oil prices.
- Typically, investors look to the high yield market as a leading indicator of potential weakness in economic and corporate fundamentals; however, this time around, risk assets sold off in unison.
- In contrast to the first nine months of the year, the CCC-rated segment of the market underperformed. CCC credit spreads widened by 405 basis points and returned -9.28% for the quarter. Reflecting the risk-off environment in the quarter, the BB-rated segment of the market was the outperformer, widening a relatively modest 148 basis points, but it still returned -2.91% for the period.
- Although the collateralized loan obligation (CLO) allocation gave back some in the fourth quarter, returning -2.54%, it contributed positively to performance, outperforming the Bloomberg Barclays U.S. Corporate High Yield Index, which returned -4.53%. For the full year, the CLO allocation generated a positive return of 4.23%, outperforming the Bloomberg Barclays U.S. Corporate High Yield Index, which returned -2.08% by 631 basis points.

				Annualized		
Net Total Returns as of 12/31/18	**3 Mo.**	**YTD**	**1 Yr.**	**3 Yr.**	**5 Yr.**	**SI[1]**
Class I	-4.42%	-2.40%	-2.40%	6.95%	4.17%	8.56%
Class A at NAV	-4.38%	-2.71%	-2.71%	6.70%	3.93%	8.30%
Class A at MOP[2]	-6.53%	-4.93%	-4.93%	5.89%	3.46%	8.05%
BBgBarc U.S. Corporate High Yield TR USD	-4.53%	-2.08%	-2.08%	7.23%	3.83%	10.76%
ICE BofAML High Yield Index	-4.67%	-2.26%	-2.26%	7.27%	3.82%	10.73%

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. [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 expense of Class A. [2]Maximum Offering Price takes into account the 2.25% maximum initial sales charge.

FUND INFORMATION AS OF 12/31/18

	Class A	Class I
Gross Expense Ratio	1.28%	1.03%
Net Expense Ratio^	0.90%	0.65%
SEC Yield (Subsidized)	5.78%	6.20%
SEC Yield (Unsubsidized)	5.38%	5.78%

FUND CHARACTERISTICS

Fund Assets (All Classes)	$49.0 mm
Number of Securities	111
Distribution	Monthly
Effective Duration	3.7
Average Coupon	6.32
Average Yield-to-Worst (%)	7.51

FUND STATISTICS

(Since Inception)	Fund[3]	Index
Standard Deviation	5.6	7.5
Sharpe Ratio	1.5	1.4
Correlation to Index	0.9	1.0
Positive Months (%)	71.8	71.8
Negative Months (%)	28.2	28.2

[3]ANHIX

^The Adviser has contractually agreed to waive fees through 5/31/19.

Sector Attribution

		Q4 2018*	YTD 2018*
	% of Market Value	Attribution (%)	Attribution (%)
Corporates	83.4	-4.03	-2.16
CLOs	6.9	-0.16	0.44
Equities & ETFs	0.2	-0.11	-0.10
Cash	9.5	0.05	0.08
Fund Expenses	-	-0.17	-0.66
Total	100.0	-4.42	-2.40

*Net and unaudited. Attribution is calculated using an internal model, thus, returns may vary from the Fund's total return.

Corporates:

- For the fourth quarter, the high yield corporate bond allocation returned -4.92% and contributed -403 basis points to the total return of the Fund. The high yield corporate bond allocation underperformed the benchmark return of -4.53%, reflecting our overweight to a couple of issuers that experienced idiosyncratic operating issues in the third quarter and our significant underweight to the defensive communications sector.
- Energy was the sector with the largest positive contribution to quarterly performance, returning -8.68% compared with the benchmark, which returned -10.04%. The positive contribution was widely distributed and more than compensated for the negative contribution from holdings in a shallow water offshore drilling company and another in a specialty hydrocarbon products company, which traded off with the drop in crude oil prices despite their improving credit profiles. The basic industries sector was the second-best positive contributor to quarterly performance, returning -3.79% compared with the benchmark, which returned -5.13%. The positive contribution came primarily from two holdings. The first is a small nitrogen fertilizer manufacturer centrally located in the Midwest that is benefiting from improving supply/demand fundamentals, and the second is an ice melt manufacturer and salt supplier experiencing improved pricing and margins following last year's better-than-average winter in the Midwest.
- Sectors detracting from performance include consumer cyclicals, which returned -4.70% compared with the benchmark, which returned -3.42%. The negative contribution came primarily from holdings in a home builder and in an auto parts supplier, both of which are interest-rate-sensitive sectors. A third detractor was a holding in a semi-trailer manufacturer that experienced issues with its suppliers due to logistical constraints attributable to the tight labor market. Capital goods was a negative contributor to quarterly performance, returning -4.79% compared with the benchmark, which returned -3.09%, and was attributable to a train system manufacturer that missed cash flow projections due to delayed deliveries and a buildup in working capital

CLOs:

- CLOs widened in the fourth quarter as loan prices were down significantly, loan funds saw consistent outflows, and liquidity needs from redemptions and rebalancing added pressure alongside the broader market end-of-year risk-off tone. Short duration and high coupon defensive profiles continued to fare better but were still down.

Sector Exposure

	Weighted Avg. Price	% of Market Value		% Change	Option Adjusted Spread		Bps Change	Yield-to-Worst		Bps Change
		9/30/18	12/31/18		9/30/18	12/31/18		9/30/18	12/31/18	
Corporates	94.70	85.9	82.8	-3.1	337	557	220	6.38	8.16	178
CLOs	95.56	7.0	6.8	-0.2	654	740	86	9.53	10.21	68
Equities & ETFs	18.00	0.0	0.2	0.2	N/A	N/A	N/A	N/A	N/A	N/A
Cash	100.00	7.1	9.5	2.4	N/A	N/A	N/A	N/A	N/A	N/A
Total	94.42	100.0	99.1		335	516	181	6.15	7.51	136

Corporates:

- The selloff in the fourth quarter was largely driven by comments from the Federal Reserve chairman leading investors to believe the Federal Reserve was on a preset course to raise interest rates until the economy broke, regardless of the lack of inflation and the risk that slowing growth outside the U.S. would eventually result in slowing domestic growth. Additionally, the seasonally weak liquidity exacerbated the selloff.
- Growth in the U.S. is expected to slow in 2019, but the consensus expectation is not for a recession. The U.S. economy appears to be in a much stronger position than most of its developed-market peers, with relatively robust GDP, low unemployment, accelerating wage gains, and modest inflationary pressures. The U.S. is also better positioned with regard to trade disruptions with China, with ~12% of the economy output based on manufacturing and ~13% based on exports.
- With the beneficial impact of the Tax Cuts and Jobs Act waning in 2019, corporate earnings growth will slow from the double-digit pace in 2018, but is still expected to be in the mid-to-high single digits. High yield corporate fundamentals appear strong with leverage, margins, and interest coverage improving over the last nine quarters and leverage at the lowest level since prior to the financial crisis.
- Credit spreads widened abruptly and sharply in the last couple of months of the year to levels not seen in almost three years. Credit spreads on the Bloomberg Barclays U.S. Corporate High Yield Index widened 210 basis points from 316 basis points to finish the year at 526 basis points, which is just inside the long-term average of 550 basis points. Similarly, yields gapped higher to close the year at just under 8%.
- With the Federal Reserve chairman's recent comments, as well as those from multiple regional presidents, the Federal Reserve appears more receptive to interpreting financial market moves and more cognizant of the policy actions already taken and their lagged impact on the economy. Additionally, the Federal Reserve has adjusted its comments to assure markets that rate increases are not on a preset course and that even the balance sheet reduction plan would be revisited if necessary.
- With what now appears to be a Federal Reserve willing to pull back on monetary policy tightening in the face of slower global growth, trade tensions, and a lack of inflation pressures, there is a good probability the current expansion can continue past 2019. In that context, we continue to favor our overweights to fundamentally sound issuers generating positive free cash flow and prioritizing balance sheet strength in basic industries and capital goods.

CLOs:

- Recent market volatility has created an opportunity for us to take advantage of market dislocations. We will look for bonds with loss-adjusted yields in the high-single-digit to low-double-digit range with significant potential for price appreciation.

Definitions

CLO: Collateralized loan obligation.
EBITDA: Earnings before interest, taxes, depreciation, and amortization.
Average Coupon: Equal to the total interest payments of an issue divided by bond year dollars.
Average Yield-to-Worst: The lowest potential yield that can be received on a bond without the issuer actually defaulting.
Basis Points (bps): One hundredth of one percent and is used to denote the percentage change in a financial instrument.
Bloomberg Barclays U.S. Corporate High Yield Index: An unmanaged market value-weighted index that covers the universe of fixed-rate, non-investment grade debt.
Bloomberg Barclays U.S. Investment Grade Corporate Index: An index that covers the publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements. To qualify, bonds must be SEC-registered.
Cash Flow: The net amount of cash and cash-equivalents being transferred into and out of a business, especially as affecting liquidity.
CBOE SPX Volatility Index (VIX): A key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices.
Correlation: A statistical measure of how two securities move in relation to another. Index used for comparison is the Bloomberg Barclays U.S. Corporate High Yield Index.
Effective Duration: Measures a portfolio's sensitivity to changes in interest rates. Generally, the longer the effective duration, the greater the price change relative to interest rate movements.
Industrial Production Index: An economic indicator that measures real output for all facilities located in the United States manufacturing, mining, and electric, and gas utilities (excluding those in U.S. territories).
ISM Manufacturing Index: An index that is based on surveys of more than 300 manufacturing firms by the Institute for Supply Management (ISM).
ISM Non-Manufacturing Index: An index based on surveys of more than 400 non-manufacturing firms' purchasing and supply executives by the Institute of Supply Management (ISM).
LIBOR: A benchmark rate that some of the world's leading banks charge each other for short-term loans. It stands for Intercontinental Exchange London Interbank Offered Rate and serves as the first step to calculating interest rates on various loans throughout the world.
Option-Adjusted Spread (OAS): The yield spread which has to be added to a benchmark yield curve to discount a security's payments to match its market price, using a dynamic pricing model that accounts for embedded options.
S&P 500 Total Return Index: An American stock market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ.
Sharpe Ratio: A statistical measure that uses standard deviation and excess return to determine reward per unit of risk. A higher Sharpe ratio implies a better historical risk-adjusted performance. The Sharpe ratio has been calculated since inception using the 3-month Treasury bill for the risk-free rate of return.
Spread: The difference in yield between a U.S. Treasury bond and a debt security with the same maturity but of lesser quality.
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.

Disclosures

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. 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.

It is not possible to invest directly in an index.

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

Opinions expressed are as of 12/31/18 and are subject to change at any time, are not guaranteed, and should not be considered investment advice.

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