Why Are Junk-Rated Bonds Behaving Like Investment-Grade Bonds?

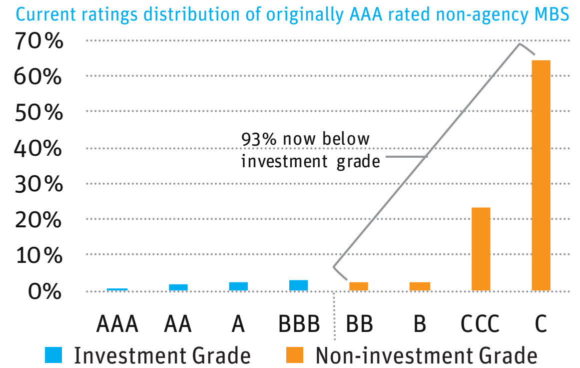
June 2019

Over the past three years, the non-agency (NA) RMBS market has exhibited investment-grade-like volatility during periods of stress, particularly for legacy RMBS, despite carrying a junk rating and offering yields of approximately 5%. This behavior is unique to NA RMBS within the fixed income universe. A rating from a nationally recognized statistical rating organization is an indication of the likelihood that the respective bond will meet all its interest and principal obligations in a timely manner. Due to the depth of the housing crisis, approximately 90% of the legacy RMBS bonds that were originally rated AAA were downgraded to junk due to the perception of inadequate protection in the form of junior bonds (Figure 1). One aspect of a bond that the rating agencies do not consider when determining its current rating is the current market price. If a bond's current market price is $85 and the bond will likely recover 95% of its principal, it has 10 points of cushion before a dollar of invested capital is lost, but it will be, by definition, below investment grade or not rated. Today, there is approximately $835 billion of NA RMBS outstanding, of which 80% is below investment grade or not rated. Despite the lack of, or below-investment-grade rating, we believe our allocation to the NA RMBS market should continue to perform well throughout risk-off environments and much better than its junk rating would imply, due to the following factors:

- Robust structure and position in the capital stack
- Deeply discounted market prices
- Lower future loss projections amid favorable housing fundamentals

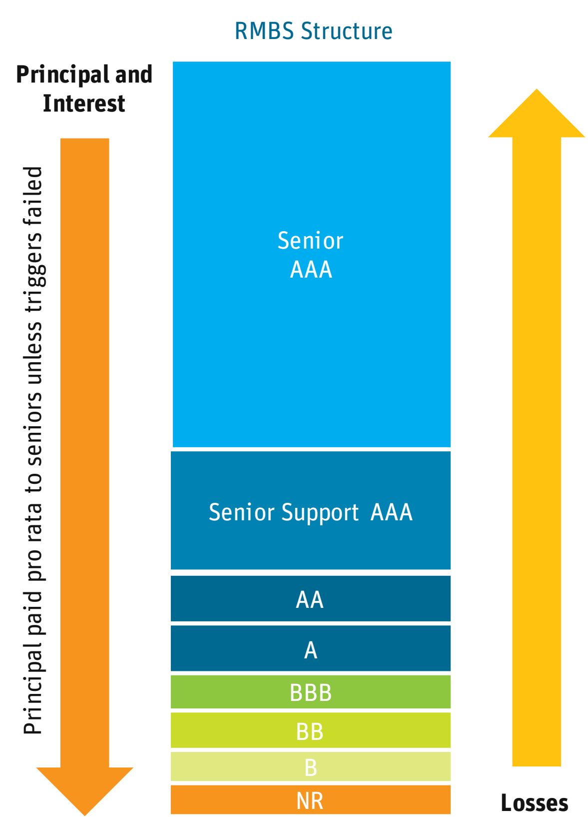
Capital structure plays a major role in the outcome of all securitized credit. The senior tranches receive principal first and losses last (Figure 2). As defaults occur, the senior tranches are the most insulated against loss of principal, as the subordinate bonds in the capital structure absorb losses until they are written down to zero (a more detailed explanation of structure and how it works is found on page 6 of our "Seeking to Improve Quality While Maintaining Income" white paper). One reason for the stability of the Angel Oak Multi-Strategy Income Fund (ANGIX) portfolio has been our positioning within the capital structure for our NA RMBS investments. In legacy RMBS, we invest at the most senior part of the capital structure. Today, in new-issue RMBS, we invest across the capital structure in an effort to take advantage of credit enhancement levels that are reflective of much more draconian scenarios for housing and mortgage credit than we see occurring in the next downturn. For example, BBB-rated tranches in non-QM securitizations today often exhibit higher credit enhancement levels than AAA bonds issued during the pre-crisis period. Even in a severe economic downturn, we see a number of below-investment-grade tranches recovering par. Additionally, due to investors' decreased reliance on ratings, some issuers choose to issue senior

FIGURE 1: MOST NON-AGENCY MBS ORIGINALLY RATED INVESTMENT GRADE ARE NOW BELOW INVESTMENT GRADE



Source: JPMorgan as of 4/30/19.

FIGURE 2: SAMPLE NA RMBS STRUCTURE



bonds without ratings. The senior tranches of some reperforming loan deals have more than 30% credit enhancement yet do not have a rating. Despite some of these tranches being below investment grade or not rated, they should be well protected from further losses even in an economic downturn, which is why in our view, NA RMBS outperformed other credit asset classes in 4Q18.

A more detailed discussion of our view on fundamentals can be found in our 1Q 2019 ANGIX quarterly webcast.

NA RMBS are backed by hundreds of mortgage loans, and the cash flows of the bonds are determined by how many borrowers repay their mortgages and how much is recovered in the event of default. When NA RMBS are underwritten, all of the underlying loans are stressed for future performance. In simulation scenarios, loans are defaulted, recovery rates are determined, and voluntary prepayments are projected. This stress may lead to an outcome where a loss from par is expected. Due to the potential for loss, market participants tend to be conservative in their underwriting assumptions at purchase time. These conservative assumptions provide a cushion in performance expectations to the extent real estate fundamentals deteriorate. However, mortgage credit performance has continued to improve, thanks to robust labor markets, improving wages, and significant home equity driven by home price appreciation, amortization, and, as it relates to new issue, conservative underwriting standards.

Our rigorous bottom-up credit process takes current and future losses into account when we are underwriting and re-underwriting holdings of NA RMBS. The critical component of our underwriting process is forecasting an ultimate intrinsic value of the bonds we target while taking severe stress scenarios into account. Interestingly, the majority of our holdings still trade at significant discounts to par and, in our view, are still well below their ultimate intrinsic value. Since the launch of ANGIX, collateral performance has been better than our underwritten expectation for losses. Collateral improvement creates additional total return upside potential for these positions.

The fourth quarter of 2018 is a recent example of how NA RMBS behaved more like investment grade bonds than the rating would imply. Credit spreads globally came under pressure, led by a sharp sell-off in the equity markets. During the quarter, the Bloomberg Barclays High Yield Index was off 4.53% and the S&P LSTA Leveraged Loan Index was off 3.42%. Meanwhile, NA RMBS, represented by the holdings in ANGIX, returned 0.73% during the period. Strong fundamentals, position in the capital structure, deeply discounted dollar prices, and lower future loss expectations are why we believe the best risk-adjusted return profile in today's credit markets continues to be NA RMBS.

Angel Oak's portfolio management team employs a top-down strategy focused on identifying valuation dislocations within the U.S. structured credit markets combined with a bottom-up credit selection process. The team invests opportunistically across the capital structure, with a focus on relative value to maximize risk-adjusted returns over a full credit cycle. Angel Oak specializes in NA RMBS, collateralized loan obligations, commercial mortgage-backed securities, asset-backed securities, and agency MBS.

For more information, please visit www.angeloakcapital.com.

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Multi-Strategy Income Fund Performance:

Total Returns (as of 3/31/19)	1Q 2019	YTD	1 Year	3 Year	5 Year	Inception[1]
Class I	1.30%	1.30%	3.29%	5.64%	3.92%	7.01%
Class A at NAV	1.23%	1.23%	3.05%	5.35%	3.65%	6.78%
Class A at MOP[2]	-1.01%	-1.01%	0.72%	4.57%	3.18%	6.47%
Bloomberg Barclays U.S. Agg. Bond Index	2.94%	2.94%	4.48%	2.03%	2.74%	2.89%
Bloomberg Barclays U.S. Corp. High Yield Index	7.26%	7.26%	5.93%	8.56%	4.68%	6.43%
S&P/LSTA Leveraged Loan Index	5.13%	5.13%	3.03%	5.31%	3.08%	3.95%

[1]The inception date of the Angel Oak Multi-Strategy Income Fund A Class (ANGLX) was 6/28/11, while the inception date of the Institutional Class (ANGIX) was 8/16/12. The returns of ANGIX shown for periods prior to the inception date include the returns of ANGLX and are adjusted to reflect the operating expenses of ANGIX.

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

Performance quoted is past performance and is no guarantee of future results. Current performance may be lower or higher than the performance data quoted. 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 for the most recent month end for the Angel Oak Funds can be obtained by calling 855-751-4324 or by visiting www.angeloakcapital.com.

Expense Ratios	Class A	Class I
Gross	1.37%	1.12%
Net	1.22%	0.97%

Gross expense ratios are reported as of the 5/31/19 prospectus. The net expense ratios are reported as of the 1/31/19 Annual Report and are referenced in the 5/31/19 prospectus. The Adviser has contractually agreed to waive fees through 5/31/20.

QM: Qualified mortgage.
RMBS: Residential mortgage-backed securities.
Bloomberg Barclays U.S. Corporate High Yield Bond Index: An unmanaged market value-weighted index that covers the universe of fixed rate, non-investment grade debt.
Cash Flow: Periodic coupons received by the bondholder during their holding period.
S&P/LSTA U.S. Leveraged Loan 100 Index: Designed to reflect the performance of the largest facilities in the leveraged loan market.
Spread: The difference in yield between LIBOR and a debt security with the same maturity but of lesser quality.
Tranche: A portion of debt or structured financing. Each portion, or tranche, is one of several related securities offered at the same time but with different risks, rewards, and maturities.

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. For more information on these risks and other risks of the Fund, please see the Prospectus.

Must be preceded or accompanied by a prospectus. To obtain an electronic copy of the prospectus, please visit www.angeloakcapital.com.
It is not possible to invest directly in an index.

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