Angel Oak
CAPITAL ADVISORS

2021 Outlook

Opportunities in structured and corporate credit

- INCOME IS KING AT THE ZERO BOUND.
- WE ARE CAUTIOUS ABOUT DURATION GIVEN FED POLICY AND BRISK GROWTH AHEAD ON THE HEELS OF THE VACCINE.
- STRUCTURED CREDIT AND HIGH YIELD ARE CHEAP AND GENERATE HIGH CURRENT INCOME WITH LESS INTEREST RATE SENSITIVITY.
- STRONG U.S. CONSUMER AND U.S. HOUSING.
- HISTORIC PREPAYMENT ACTIVITY EXPECTED TO CONTINUE IN 2021.

Back to the Zero Bound

Doc: "Great Scott! How did we get back to the zero bound?"

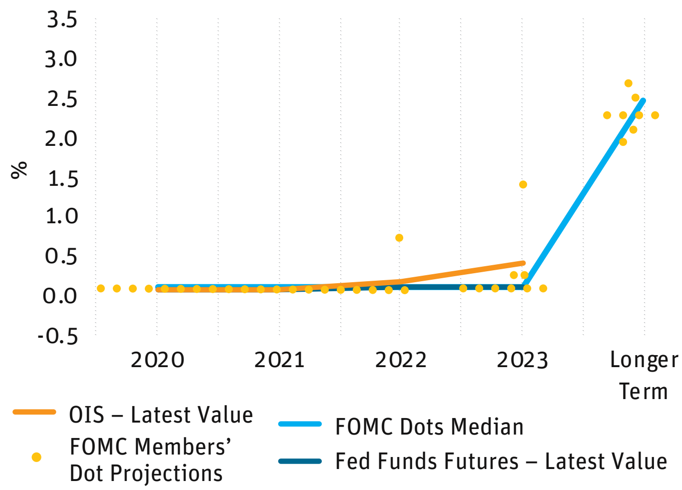
McFly: "You don't even want to know …"

Doc: "How long will we be here?"

McFly: "2023."

The vaccine is here, the Fed is at the zero bound until 2023, and the economic recovery is V-shaped. The ascent of risk assets has been profound and — watch out — long end! A once-in-a-lifetime fiscal and monetary stimulus deployed to stave off the economic fallout from COVID-19, coupled with an effective vaccine, fueled a breathtaking rally in risk assets in the second half of 2020. We expect the economic recovery to continue its V-shape well into 2021, bringing with it the start of a new economic cycle. The once-feared end of the post-global financial crisis (GFC) credit cycle is upon us, and now the perennial fear of rising long-term interest rates is becoming much more realistic. With the Fed on hold until at least 2023 (Figure 1), high-quality income opportunities are becoming scarce, but opportunities in U.S. structured credit and high yield abound. Income should be king in 2021 and beyond. For income-focused investors, we overwhelmingly favor short-duration opportunities in U.S. structured credit backed by mortgage and consumer collateral, select high-yield issuers, select collateralized loan obligation (CLO) tranches, and financials rather than longer-duration areas of fixed income. We remain cautious about non-agency commercial mortgage-backed securities (CMBS) due to structural changes to the commercial real estate (CRE) market as a result of COVID-19. We remain focused on higher-quality subsectors within CMBS and avoiding risk down in the capital structure. Not only will income be a critical component of total return in the coming year, but also less interest rate sensitivity at the long end of the curve will be a differentiating factor, considering the brisk growth ahead.

FIGURE 1: FED ON HOLD UNTIL AT LEAST 2023



Source: Bloomberg as of 11/30/20.

Incredibly amid a pandemic, most risk markets had a banner year, thanks to Chairman Powell, Secretary Mnuchin, and the vaccine manufacturers. The historic monetary and fiscal stimulus in response to COVID-19 and the subsequent release of a vaccine all in one calendar year led to some of the greatest financial market moves of all time. According to Bank of America Securities (BofAS), 2020 experienced "the quickest bear market of all time [the] greatest policy panic of all-time … [and the] greatest Wall Street rally of all-time … and in Q4 2020, investors rush[ed] to discount the greatest main street recovery of all-time." November marked the turning point for the next phase of growth as market participants fully began to price in the effects of the highly effective vaccine and a return to normal life in 2021. Also according to BofAS, "November was the best month for the Dow since 1987, the best month for the S&P 500 since 1928, the best month ever for the Russell 2000, the best month ever for energy, the best month ever for industrials, and the best month for financials since 2009."

Risk markets are clearly getting ahead of what is expected to be a historically robust recovery in 2021. After contracting by an estimated 4% in 2020, U.S. GDP is expected to be up approximately 4%-5%, the highest growth since the late 1990s.[1] We are bullish on growth due to pent-up demand caused by the pandemic and release of the vaccine, all in concert with the fiscal and monetary bazookas used to stave off the worst of the economic consequences of the pandemic. As Chairman Powell recently stated at the December press conference, "We will aim to achieve inflation moderately above 2% for some time so that inflation average is 2% over time and longer-term inflation expectations remain well anchored at

We expect the economic recovery to continue its V-shape well into 2021, bringing with it the start of a new economic cycle.

FIGURE 2: 2020 RETURN

	NOVEMBER 2020	YTD 2020
BBgBarc U.S. Agg. Bond	0.98%	7.51%
BBgBarc U.S. Corp. IG	2.79%	9.89%
BBgBarc U.S. Corp. HY	3.96%	7.11%
Russell 2000 TR	18.43%	19.96%
S&P 500 TR	10.95%	18.40%
Energy	28.28%	-32.84%
Financials	16.90%	-1.69%
Industrials	15.97%	11.06%

Source: Morningstar Direct as of 12/31/20.

[1]High Frequency Economics, BofAS.

2%." We clearly don't expect the exceptional growth ahead or the potential inflation that may come with it to remotely deter the Federal Open Market Committee (FOMC) from its ultra-accommodative policy anytime soon. 2021 will usher in the continuance of the zero bound, unabated QE4, and perhaps additional fiscal stimulus. As we touched on extensively in our 2020 Election Commentary, we don't expect the FOMC to tighten prematurely in this recovery. It is committed to higher inflation and the social mobility gained from upward wage pressure. Something must give in that environment, and in our view, it will be the long end of the risk-free curve. This will put downward pressure on the prices of traditional fixed-income assets, including investment grade corporates, which is why we favor the high current income and the short-duration characteristics structured credit and high yield offer at the zero bound.

The historic monetary and fiscal stimulus in response to COVID-19 and the subsequent release of a vaccine all in one calendar year lead to some of the greatest financial market moves of all time.

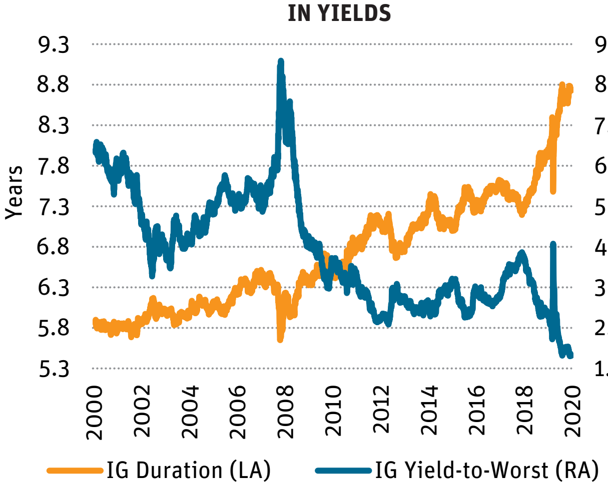
The Bloomberg Barclays U.S. Corporate Bond Index (IG Corp Index) currently has a lackluster yield and an all-time high-duration profile. In fact, the duration has never been this high, and the yield has never been this low (Figures 3 and 4). Incredibly, this is the first time the real yield for the IG Corp Index has ever gone negative (Figure 5). This risk/return profile is skewed to the downside. For example, IG Corp Index spreads are 26 basis points (bps) away from all-time tights (Figure 6) with a duration of approximately 9. If 10-year note yields were to rise to 1.50% from the current level of 0.90%, a very reasonable possibility in our view, and spreads were unchanged, the IG Corp Index would be down approximately 5.40% in price and would receive 1.82% in yield, for a total return of -3.50%. While we are optimistic about IG credit even amid these tight levels, we would encourage investors seeking income alternatives to consider credit exposure with much less interest rate risk. U.S. structured credit, predominantly mortgage and consumer credit, has offered much more attractive current income with less interest rate sensitivity as well as the potential for additional total return through spread tightening. In our view, the areas we target in U.S. structured credit, high yield, and financials all exhibit those attractive characteristics of high current income, lower duration, and the potential for additional spread tightening, further enhancing total return.

FIGURE 3*

	12/31/19 DURATION	12/31/20 DURATION	12/31/19 YIELD	12/31/20 YIELD
ANGIX	1.80	2.43^	4.71%	4.16%
ANFIX	3.20	2.55^	3.98%	4.81%
ANHIX	3.16	2.62^	6.26%	3.75%
AOUIX	0.71	0.66^	3.00%	1.47%
ASCIX	1.72	2.19^	9.14%	8.54%
BBgBarc U.S. Agg. Bond	6.16	6.42	2.31%	1.12%
BBgBarc U.S. Corp. IG	7.91	8.75	2.84%	1.74%
BBgBarc U.S. Corp. HY	3.07	3.40	5.19%	4.18%

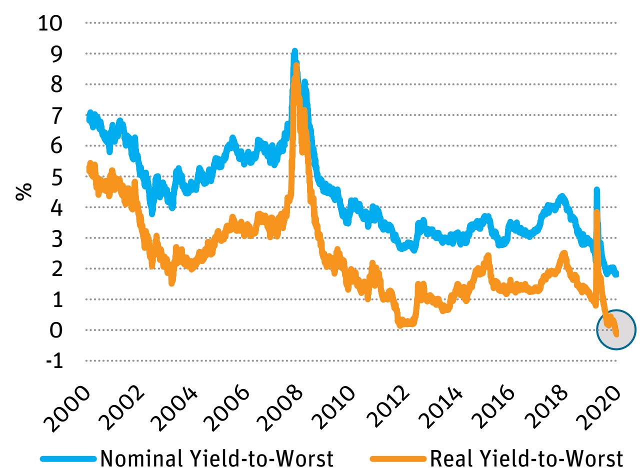
^Estimated as of 12/31/20.
Source: Angel Oak Capital Advisors and Bloomberg as of 12/31/20.

FIGURE 4: NEW HIGHS IN IG DURATION AND NEW LOWS IN YIELDS



Source: Bloomberg and Goldman Sachs as of 12/21/20.

FIGURE 5: IG REAL YIELDS ARE IN NEGATIVE TERRITORY FOR THE FIRST TIME IN HISTORY

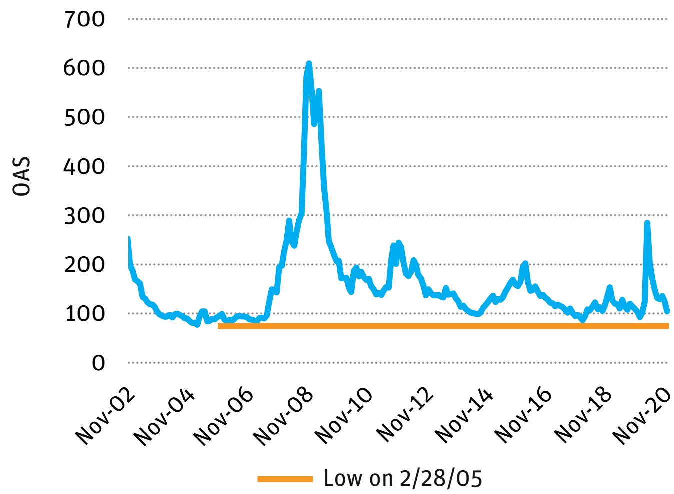


Source: Bloomberg and Goldman Sachs as of 12/21/20.

*The subsidized and unsubsidized 30-day SEC yields as of 12/31/20 were 4.13% and 4.13% for ANGIX, 4.38% and 3.96% for ANFIX, 4.29% and 4.06% for ANHIX, 1.65% and 1.38% for AOUIX, and 7.58% and 2.22% for ASCIX, respectively.

Structured credit recovered like other risk assets in 2020 but are still mostly wider for the year. Also, the lack of duration in the asset class was one of the culprits of 2020 underperformance, but we believe this profile will lead to outperformance in the year ahead. As illustrated in Figure 7, the areas we target have retraced the significant widening experienced in March but are still wider year-to-date. We still see additional upside in 2021 due to the high current income and favorable credit fundamentals supporting the areas we target, especially mortgage and consumer credit.

FIGURE 6: BLOOMBERG BARCLAYS IG INDEX OAS

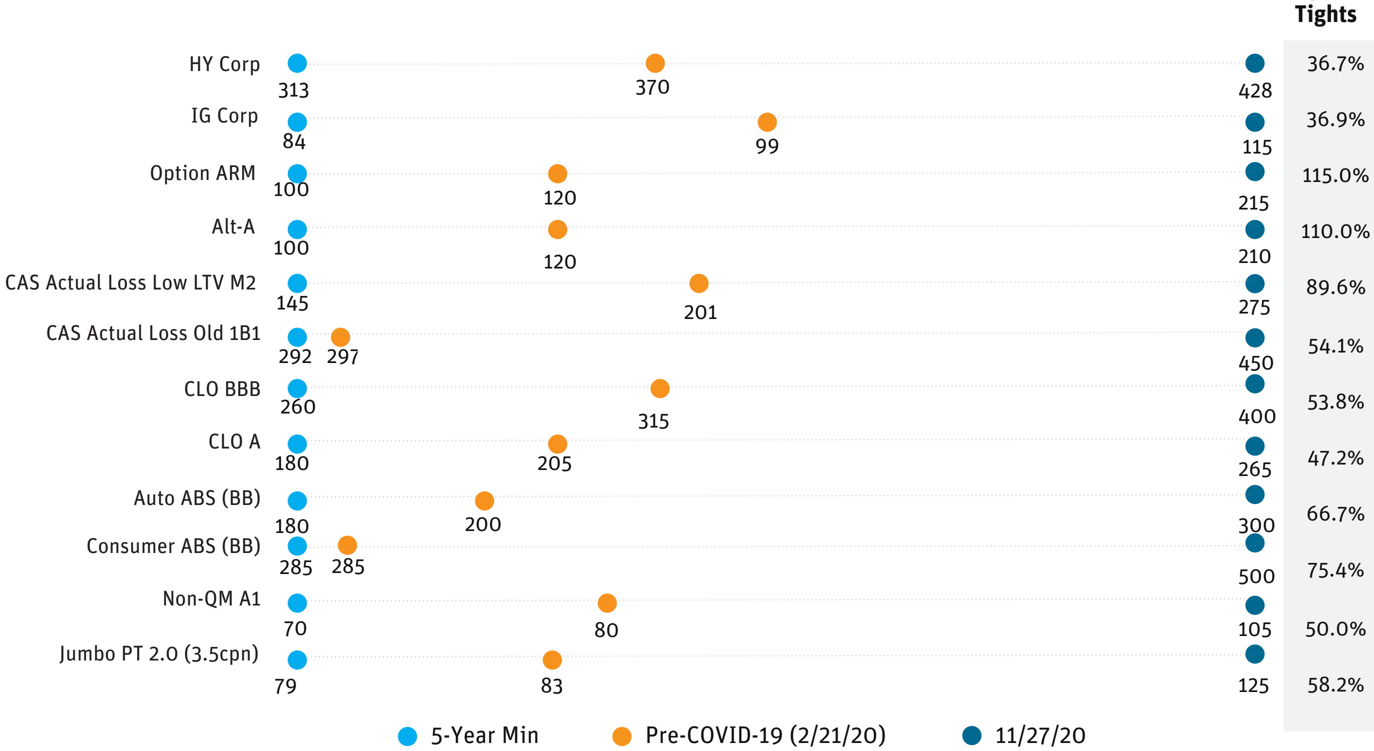


Source: Bloomberg as of 11/30/20.

NON-AGENCY RESIDENTIAL MORTGAGE-BACKED SECURITIES (NA RMBS)

We were bullish on NA RMBS going into COVID-19, and we became even more so afterward as valuations were punished by COVID-19. This remains the case heading into 2021. Residential mortgage credit fundamentals continue to benefit from secular macroeconomic tailwinds. Lack of supply, historic demand, and all-time lows in mortgage rates fueled home price appreciation (HPA), housing activity, and prepayment speeds beyond most market participants' wildest dreams. Mortgage credit fundamentals were called into question in March as economic shutdowns led to surging unemployment and historic requests for forbearance. Ironically, the same reason that drove the historic increase in unemployment and forbearance, the pandemic, forced nearly one-third of all Americans to reevaluate their living conditions.[2] The result is clear: Americans prefer single-family housing, and demand has been incredible.

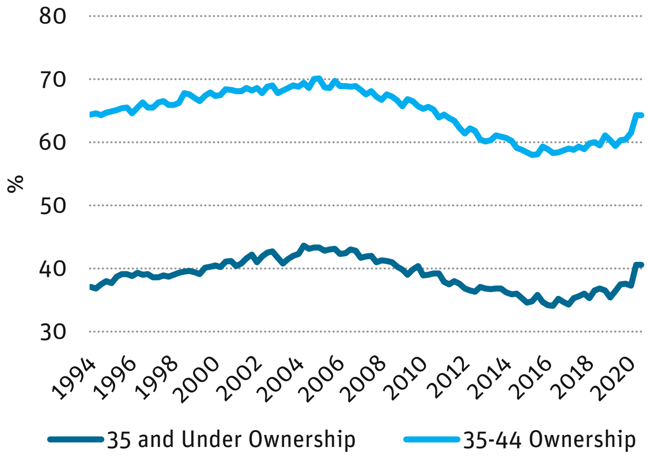
FIGURE 7: CREDIT SPREAD RETRACEMENT – SELECT SECTORS



Source: BofAS and Angel Oak Capital Advisors as of 11/30/20.

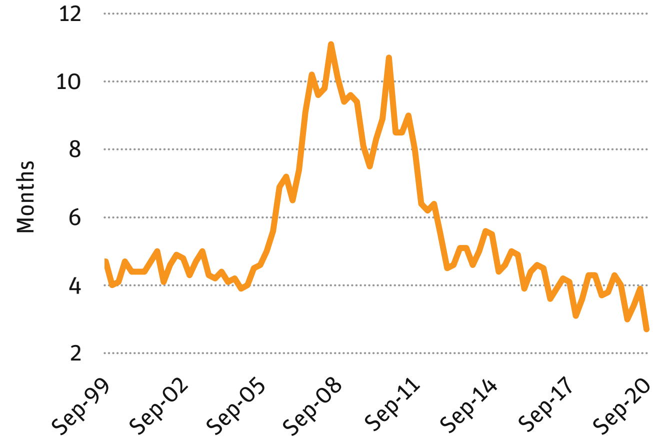
[2] Citi.

FIGURE 8: HOMEOWNERSHIP BY DEMOGRAPHIC



Source: Bloomberg as of 9/30/20.

FIGURE 9: SUPPLY OF EXISTING HOMES



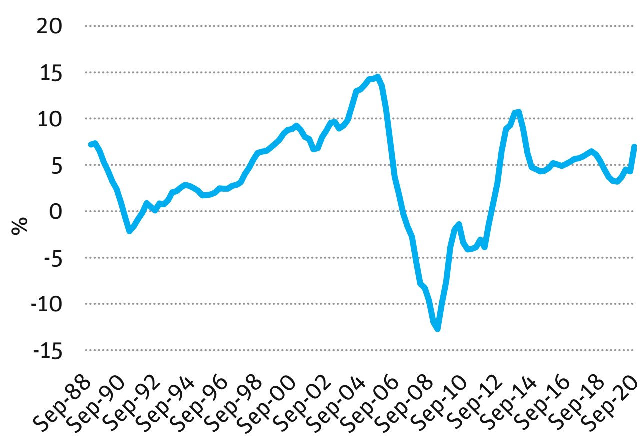
Source: Bloomberg as of 9/30/20.

Prior to COVID-19, the millennial generation, the largest generation in U.S. history, was already entering their formative years for home buying. COVID-19 pulled forward some of that demand in the near term, but we expect they will continue to form households at approximately one million per year over the medium term, which will continue to bolster demand for many years to come (Figure 8). Combined with the shortage of supply going into the pandemic, home prices have been surging (Figures 9 and 10). Moreover, acceptance of working from home and fleeing dense urban areas, which experienced more stringent lockdowns and social unrest, caused millennials, Gen Xers, and even boomers to considering homeownership outside the city.

Rising demand, shrinking supply, and all-time-low mortgage rates combined to create a surge in home prices through 2020. Home prices recently rose 6.7% year-over-year in September (Figure 10). This was beyond all market participants' expectations, especially amid the tightening of residential credit conditions witnessed in the aftermath of the COVID-19 crisis in March (Figure 11). The rise in home prices eased market participants' concerns surrounding expected losses from future foreclosures as delinquencies spiked in the second quarter. Encouragingly, residential mortgage delinquencies continue to fall as the economy and labor markets continue to improve, and we expect they will continue to decline in 2021 as servicers apply battle-tested loss-mitigation strategies adopted in the aftermath of the GFC and natural disasters to address borrowers' needs and to protect bondholders (Figure 12). According to the Mortgage Bankers Association, forbearance related to COVID-19 fell to 5.48% across all mortgages for the first week of December, down from the peak of 8.53% in June. With the favorable supply and demand backdrop within the U.S. housing market, we do not anticipate COVID-19-related delinquencies to result in liquidation. However, if liquidation is the ultimate result of the COVID-19-related delinquencies in 2021, we expect strong recoveries due to robust HPA, attractive loan-to-value (LTV) profiles we target, and all-time-low mortgage rates.

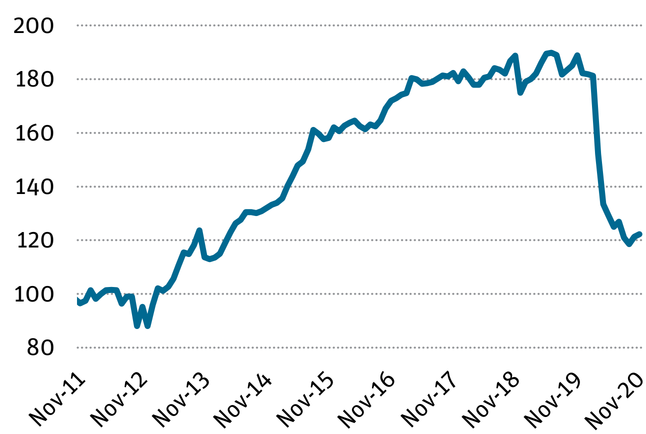
The question ahead in 2021 is whether HPA will continue at the current pace. We expect it will, and believe another 5% of HPA in 2021 is reasonable, as the supply-and-demand dynamics as well as the current level of mortgage rates are here to stay over the medium term. The historic supply-and-demand imbalance of U.S. housing will not be fixed anytime soon; hence the optimism among U.S. home builders (Figure 13). We expect supply will eventually solve the problem, but it may take years to catch up to demand.

FIGURE 10: S&P CORELOGIC CASE-SHILLER INDEX YOY%



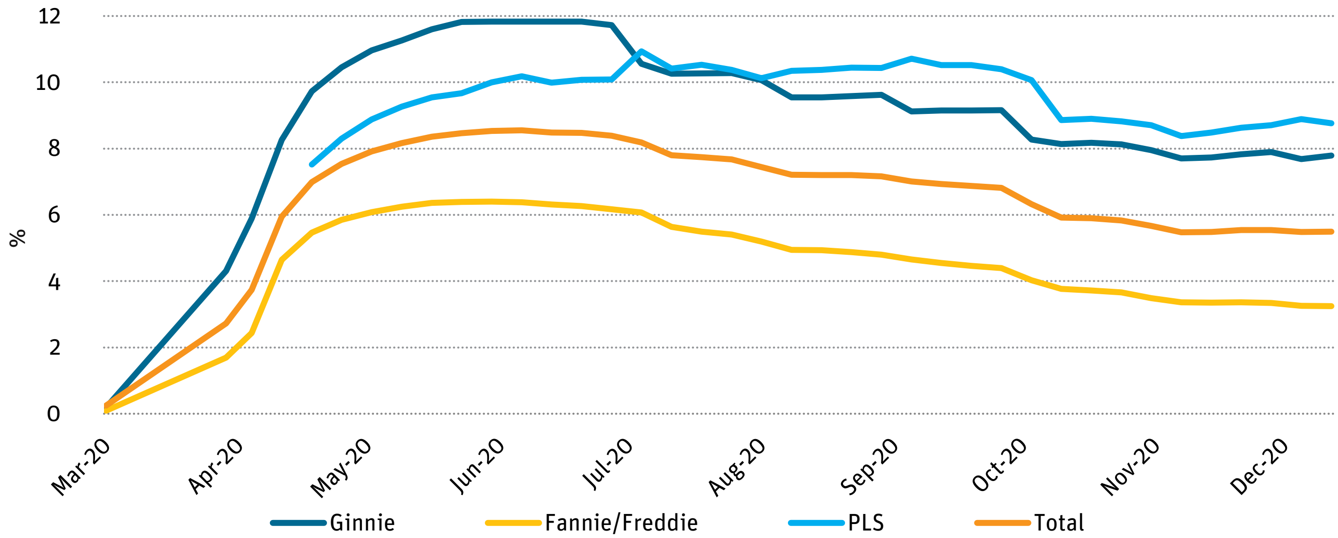
Source: Bloomberg as of 9/30/20.

FIGURE 11: MORTGAGE CREDIT AVAILABILITY INDEX



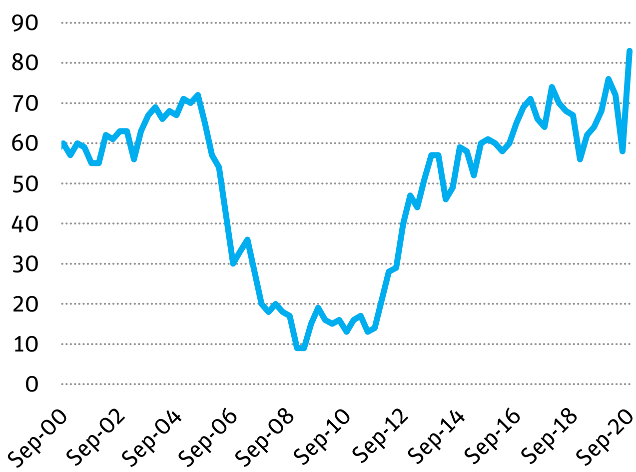
Source: Bloomberg as of 11/30/20.

FIGURE 12: MBA FORBEARANCE SURVEY



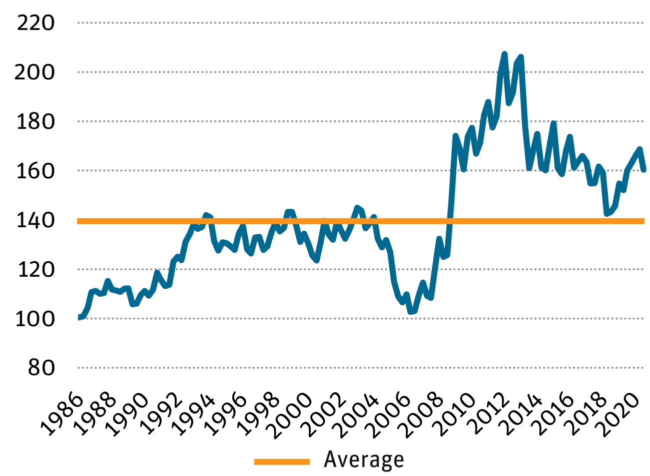
Source: Morgan Stanley.

FIGURE 13: NATIONAL ASSOCIATION OF HOME BUILDERS MARKET INDEX



Source: Bloomberg as of 9/30/20.

FIGURE 14: HOUSING AFFORDABILITY INDEX



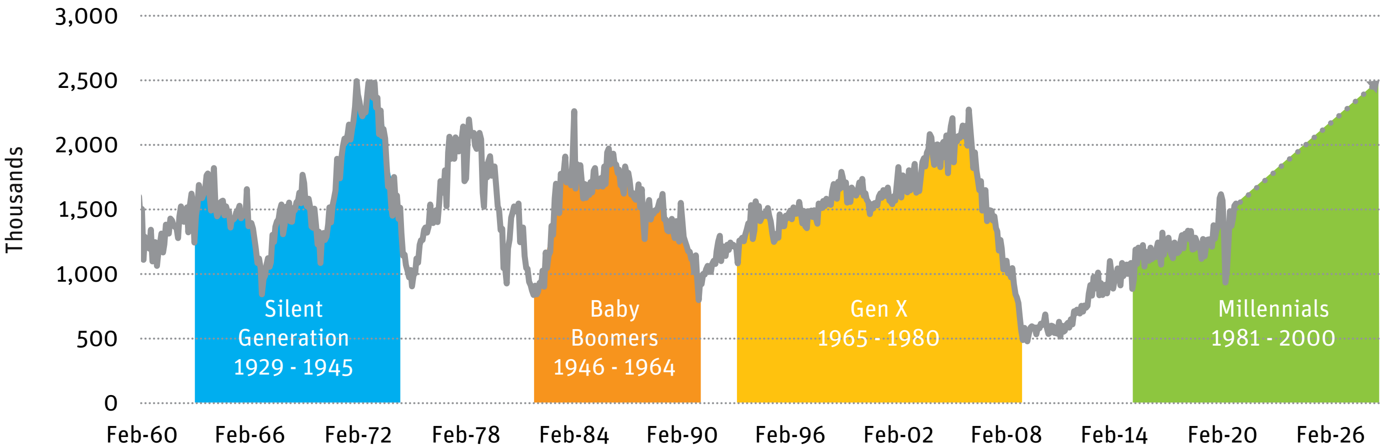
Source: Bloomberg as of 9/30/20.

Single-unit housing starts were up 20% year-over-year in September but are just now above the average starts over the past 36 years (Figure 15). In the meantime, while builders catch up with demand, existing home inventory is at an all-time low. Ironically, the tight housing market and subsequent rise in home prices are not weighing on affordability (Figure 14). Thanks to all-time-low mortgage rates, affordability is still well above long-run averages.

We expect mortgage rates will remain at historic lows in 2021 even amid an uptick in risk-free rates due to a further narrowing of the primary-secondary mortgage spread (Figures 16 and 17). As highlighted in our 2020 Mid-Year Outlook, residential mortgage originators were simply overwhelmed with capacity issues in the second half of 2020 and were able to achieve favorable pricing power. This is best illustrated in the primary-secondary mortgage spread. Despite the mortgage market's volatile ride in 2020, this has been an extraordinarily profitable year for mortgage originators, resulting in the initial public offering activity witnessed in 2020. We believe this spread will continue to narrow in 2021 as originators increase staff and reap the benefits of recent fintech investments. Moreover, the Fed has historic leeway to continue their feverish pace of agency mortgages and Treasuries to stave off the fallout of the pandemic which is critical to sustain one of the few bright spots of the U.S. economy. Their appetite for agency mortgages at these levels is very important. Negatively convex fixed rate agency mortgages at 5,000 year lows in interest rates[3] are a difficult value proposition at any investment committee meeting except the FOMC. That is why we are vocal proponents of Chairman Powell. QE4's size, scope, and tenor has been historic, and we expect it to continue to shock and awe.

[3]BofAS.

FIGURE 15: HOUSING STARTS AND COMPARATIVE SIZE OF GENERATIONS AGE 25-45



Source: Bloomberg and Fundstrat as of 11/30/20.

This should continue to fuel robust prepayment activity across our NA RMBS holdings in 2021, which bodes well for current income as well serves as a catalyst for additional total return due to spread tightening on the improved prepayment outlook.

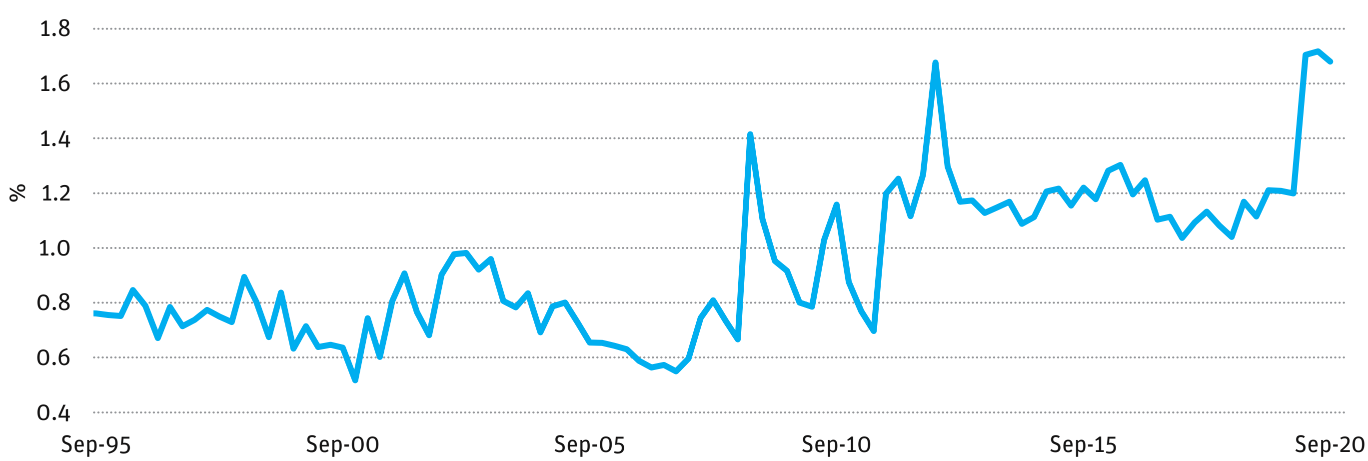
Our favorite area in which to express the potential for increased prepayment activity continues to be senior legacy NA RMBS. We believe these bonds are resilient to higher delinquencies and are still at attractive dollar price discounts. This increases upside potential and may enhance current income due to robust prepayment activity. The weighted average loan-to-value (WALTV) ratio of our legacy holdings continues to improve as bonds amortize and home prices increase. The bonds we target in our legacy portfolio have low WALTVs and high weighted-average coupons (WAC). The average 30-year fixed-rate mortgage rate is 2.71%, 134 bps below our WAC.[4]

Lower WALTVs and higher gross WACs are driving prepayment activity in our legacy portfolio, and we continue to target these profiles at meaningful discounts (Figure 18). While legacy NA RMBS prepayments have lagged other areas of NA RMBS like nonqualified mortgage (non-QM), credit risk transfer (CRT), and prime jumbo, we are starting to see meaningful ascent in our legacy prepayments, which we think are well positioned to accelerate further in 2021.

FIGURE 16: 30-YEAR MORTGAGE RATE

Source: Bloomberg as of 12/16/20.

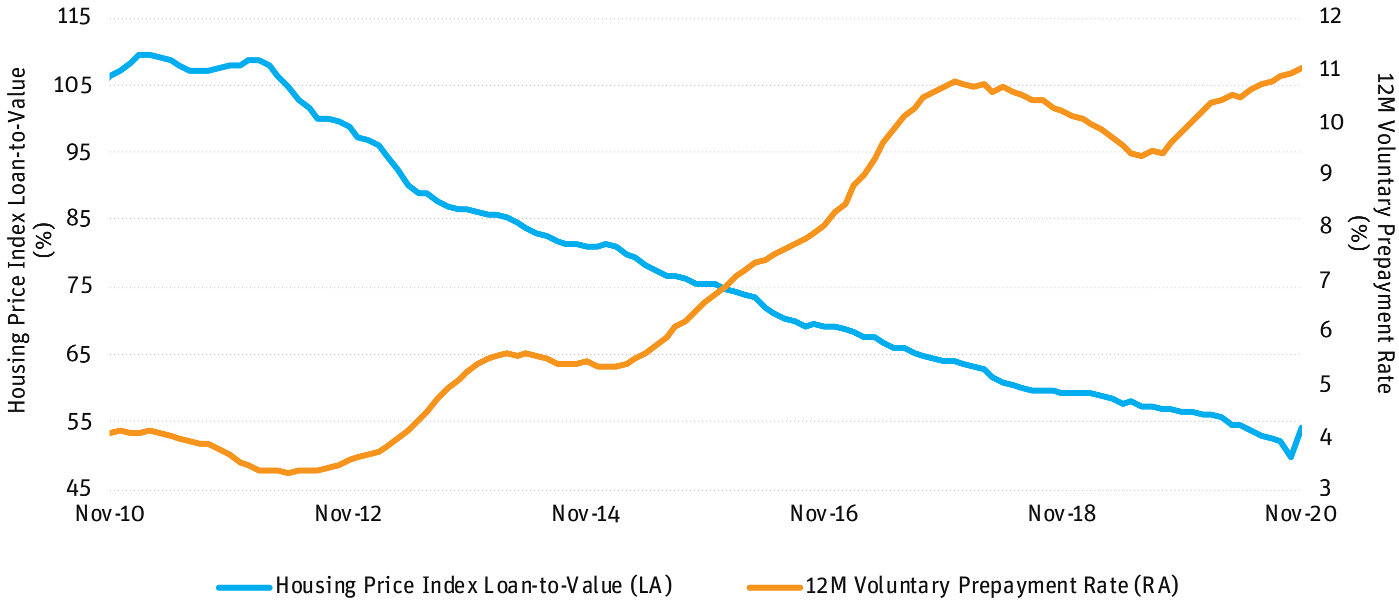
FIGURE 17: PRIMARY-SECONDARY MORTGAGE RATE SPREAD



Source: Bloomberg as of 9/30/20.

[4]Angel Oak Capital Advisors, Bloomberg.

FIGURE 18: LEGACY RMBS HPI LTV & VPR



Source: Angel Oak Capital Advisors as of 11/30/20.

Last year, we were optimistic about call activity in our legacy NA RMBS, but expectations for call activity diminished after capital markets seized in the second quarter. We expect call activity to resume in 2021, as seasoned loans with favorable loan-to-value profiles and high current coupons look more attractive, delinquent loan economics improve amid the reliquification of the capital markets, and the hunt for yield begins anew.

Apart from legacy NA RMBS, we favor mezzanine and subordinate bonds of NA RMBS 2.0 securitizations. These include prime jumbo, non-QM, and CRT. We have seen meteoric increases in prepayment speeds in these subsectors. CRT and prime jumbo are nothing short of extraordinary. Supply technicals have been supportive for all NA RMBS, but they were especially so in 2020, as the RMBS 2.0 primary market ground to a halt in March. Gross issuance was down 20%, creating scarcity value in the second half of 2020 as investors clamored to reinvest paydowns in a shrinking but fundamentally favorable asset class. Normalizing capital market conditions enabled the primary market to restart in the second half of 2020, especially in non-QM, but the lack of origination during the height of the COVID-19 crisis kept a lid on total volumes. We expect a pickup in issuance in 2021, and we believe it will be well received by market participants in light of the high current income and improving credit fundamentals NA RMBS 2.0 offers (Figure 19).

Credit spreads are still wider on a year-to-date basis in our favored areas of residential mortgage credit despite the positive mortgage fundamentals and technicals. We attribute this mostly to the lack of direct government support and headwinds in capital allocation models driven by uncertainty surrounding post-pandemic delinquency. We view these areas as not only attractive sources of income at the zero bound but also areas of additional total return, as we expect spreads to continue to tighten as delinquency and prepayment data surprise to the upside in 2021.

FIGURE 19: NON-AGENCY RMBS ISSUANCE

	2018	2019	2020	2021E
Prime Jumbo/ Seasoned	$25,766	$22,235	$19,778	$30,000
Resi Re-REMIC	$2,856	$1,857	$1,407	$2,000
NPL/RPL	$59,375	$49,031	$34,131	$35,000
GSE Risk Share	$27,281	$30,248	$20,784	$30,000
Single-Family Rental	$9,118	$4,180	$9,655	$6,000
Non-QM/Alt-A	$15,738	$32,855	$25,631	$28,000
Fix/Flip	$15,738	$1,580	$1,960	$3,000
Mortgage Insurance CRT	$3,135	$5,238	$4,563	$6,000
TOTAL	**$144,467**	**$147,224**	**$117,909**	**$140,000**

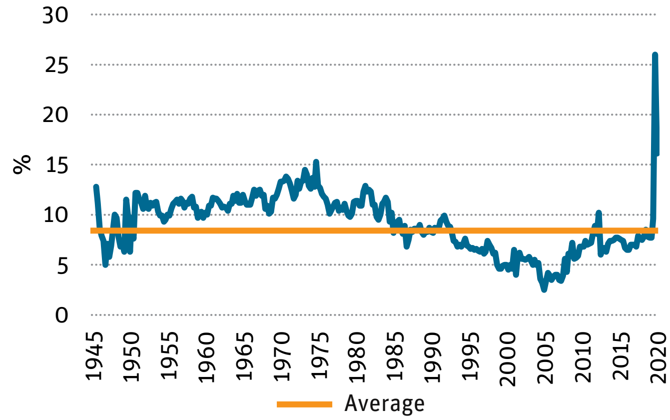
Source:Citi.

CONSUMER ABS

Like NA RMBS, consumer asset-backed securities (ABS) credit fundamentals were favorable heading into COVID-19, and we believe they will continue to improve coming out of COVID-19. 2021 will bring herd immunity, brisk growth, shrinking unemployment, fiscal stimulus, and rising wages, which should continue to strengthen U.S. consumers, given their recent propensity to save and improve the health of their balance sheets. While we view additional fiscal stimulus as very positive, we are not reliant on stimulus to protect the integrity of the cash flows we seek. Moreover, the high-quality income and short-duration characteristics of the bonds we target may bode well for solid performance in 2021.

Looking back on 2020, concerns in consumer ABS began to quickly mount as delinquencies began to rise in the second quarter, especially in areas of auto and consumer loan ABS. As we took a step back to assess the impact of COVID-19 across our portfolios, short-duration consumer ABS became one of our highest areas of conviction due to the favorable position of consumer balance sheets and robust structural support in the asset class, even in the aftermath of the initial crisis. Human panic drove consumers to hoard cash and toilet paper. While savings have dwindled from the highs reached at the peak of the panic, savings still exceed those of any period of the post-WWII era (Figure 20), and the additional stimulus ahead should further increase consumer savings to get to the finish line of herd immunity by the end of the second quarter and full employment by the end of 2021.

FIGURE 20: U.S. PERSONAL SAVINGS % OF DISPOSABLE INCOME



Source: Bloomberg as of 9/30/20.

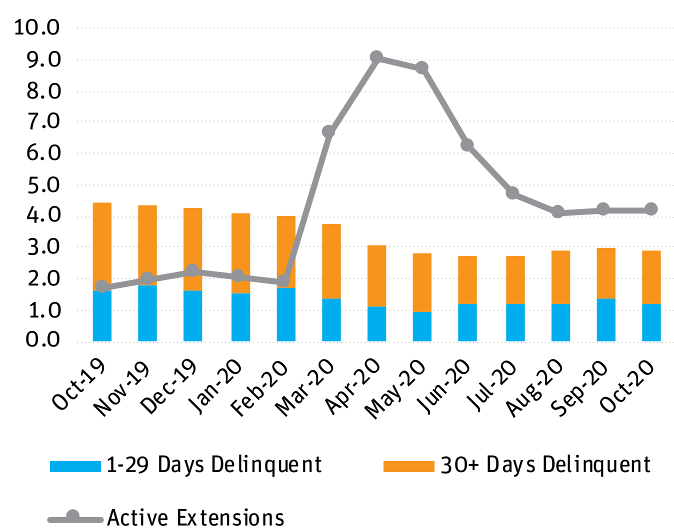
Again, akin to NA RMBS, fundamental credit performance has been incredibly strong and resilient in consumer ABS. Credit underwriting tightened sharply following the onset of the pandemic, both at the originator and rating agency levels, leading to changes in tiering among individual securities and sectors. For example, overcollateralization targets increased in some cases by 50%-100% to potentially further protect senior bondholders. Various changes in market standards following the pandemic have created alpha opportunities within ABS markets.

> Various changes in market standards following the pandemic have created alpha opportunities within ABS markets.

We are pleasantly surprised by the resiliency of consumer ABS, considering the pandemic. Delinquencies and expected losses have been far below post-pandemic expectations given the short-term destruction of the labor market. There has been an increase in extensions across all areas of consumer ABS, but we think the new stimulus bill will be very important to ease concern surrounding extensions and delinquencies in the months ahead. For example, delinquencies unexpectedly decreased in consumer loan ABS relative to pre-COVID-19 levels. Even though this decline in delinquencies was more than offset by a rise in extensions, the collateral stress remains well below what many market participants had initially feared (Figure 21). Most believe this had to do with the historic stimulus and a hands-on approach to loan servicing. Risk retention or "skin in the game," has led to more economic and bondholder-friendly servicer behavior.

Market opportunities within consumer ABS in the second half of 2020 were significant. We attribute this to the fact that investors didn't have a historical data set to point to for performance in consumer loan ABS under this level of economic stress. Given these types of unsecured consumer loans originated by the likes of Prosper and Lending Club were largely untested during the GFC, modeling the extent of defaults at higher levels of unemployment was difficult to fully ascertain. Our ABS team utilizes a combination of expected delinquencies, modifications, and extensions to fully capture collateral stress. Interestingly, even using this combination to fully capture "stressed" loans, the increase in expected defaults within consumer loan ABS pools remains well below levels needed to create defaults in the ABS bonds and thus illustrates the structural protections this sector provides.

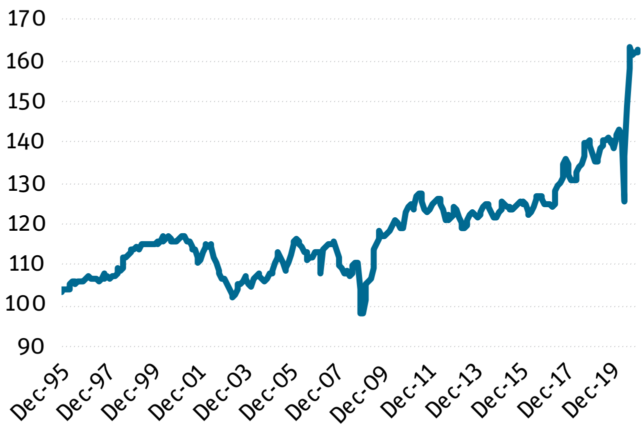
FIGURE 21: CONSUMER LOAN ABS EXTENSION RATES AND DELINQUENCIES



Source: Kroll as of 10/31/20.

Another area of consumer ABS that continues to surprise to the upside is auto ABS. Not only have defaults outperformed expectations, but so have used car prices. Car prices have experienced a true V-shaped recovery (Figure 22). Used car

FIGURE 22: MANHEIM U.S. USED VEHICLE VALUE INDEX



Source: Bloomberg as of 12/31/20.

values are up approximately 16% year-over-year according to the Manheim Used Vehicle Value Index. This has increased recovery rates when cars are liquidated through defaults and has helped create lower net losses and ultimately flatter cumulative net loss curves (Figures 23 and 24). Overall, we see value in seasoned subordinate auto ABS tranches due to current market valuations and lower mark-to-market LTVs given the rise in used car valuations.

Technicals in ABS are also favorable heading into 2021. Like most areas of structured credit, the consumer loan ABS primary market supply was incredibly light in the fourth quarter, and income-focused investors clamored for bonds. For example, the last consumer loan ABS deal in 2020 priced on October 30, and overall ABS supply is down approximately 20% in 2020. We are optimistic we will see more issuance in the first quarter, but we expect the current lack of supply and feverish demand for bonds bode well for further spread tightening in the new year, as it began in earnest in November. Below-investment-grade assets in most consumer ABS, such as auto and credit cards, also meaningfully tightened, and the credit curve flattened in the fourth quarter.

> Overall, we see value in seasoned subordinate auto ABS tranches due to current market valuations and lower mark-to-market LTVs given the rise in used car valuations.

Despite the recent spread tightening in both auto and consumer loan ABS, we continue to see opportunities. Both subsectors exhibit high current income, short duration, and wide spreads relative to pre-COVID-19 levels. We believe both subsectors are poised to tighten further, especially down in the capital structure as consumer credit trends, particularly delinquency and prepayment trends, continue to surprise to the upside. Finally, lack of supply due to the credit shock in March created a favorable technical environment that we believe is poised to tighten spreads to all-time tights in the new year.

The negative economic impact of COVID-19 on U.S. consumers has been substantial. However, consumer ABS has served an important role in channeling capital to individuals to ensure that they have access to transportation to their place of employment and have flexibility in their financing options. Dependable access to credit contributes to greater social stability and ultimately a more sustainable economy, even through a severe crisis. Angel Oak has begun monitoring the environmental, social, and governance (ESG) factors associated with consumer ABS securities and will be using proprietary metrics to ensure that investor capital is deployed in a way that optimizes sustainability and the social benefits that broad access to consumer credit provides.

FIGURE 23: PRIME AUTO LOAN PERFORMANCE

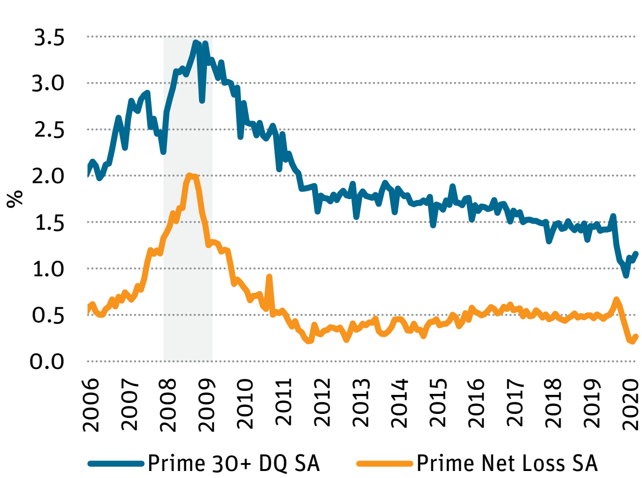
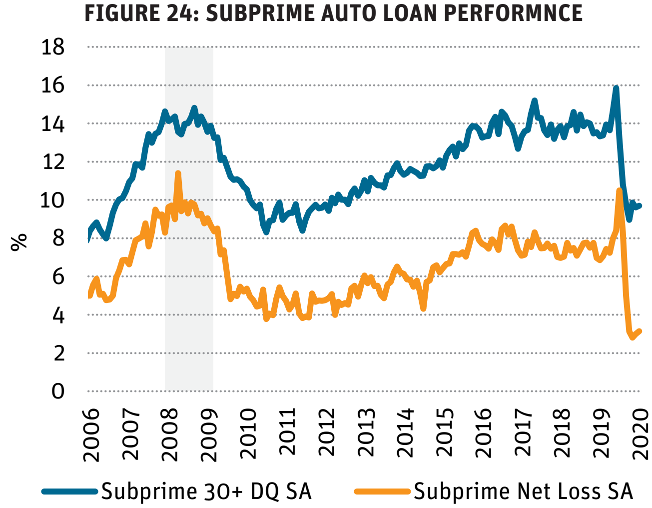


FIGURE 24: SUBPRIME AUTO LOAN PERFORMNCE



Source: BofAS and Intex as of 11/30/20. Shaded gray bars represent periods of recession.

HIGH-YIELD CORPORATE CREDIT

While conditions were relatively benign to start the year, the high-yield market experienced a roller-coaster year in 2020. Investors had to rapidly adjust to a material and unexpected deterioration in fundamentals caused by escalating pandemic cases and an unprecedented economic shutdown in late March and April. As a result, the option-adjusted spread of the Bloomberg Barclays High Yield Index reached a peak of +1,100 bps in late March compared to +338 bps to start the year. Confidence in risk markets improved quickly once the Federal Reserve announced in late March its expanded asset purchase programs, including corporate bonds for the first time, while Congress enacted sizable fiscal stimulus measures to support small businesses, the unemployed, and the most negatively impacted sectors. Many companies also quickly initiated actions to reduce operating costs and capital spending to match suppressed levels of demand to conserve liquidity.

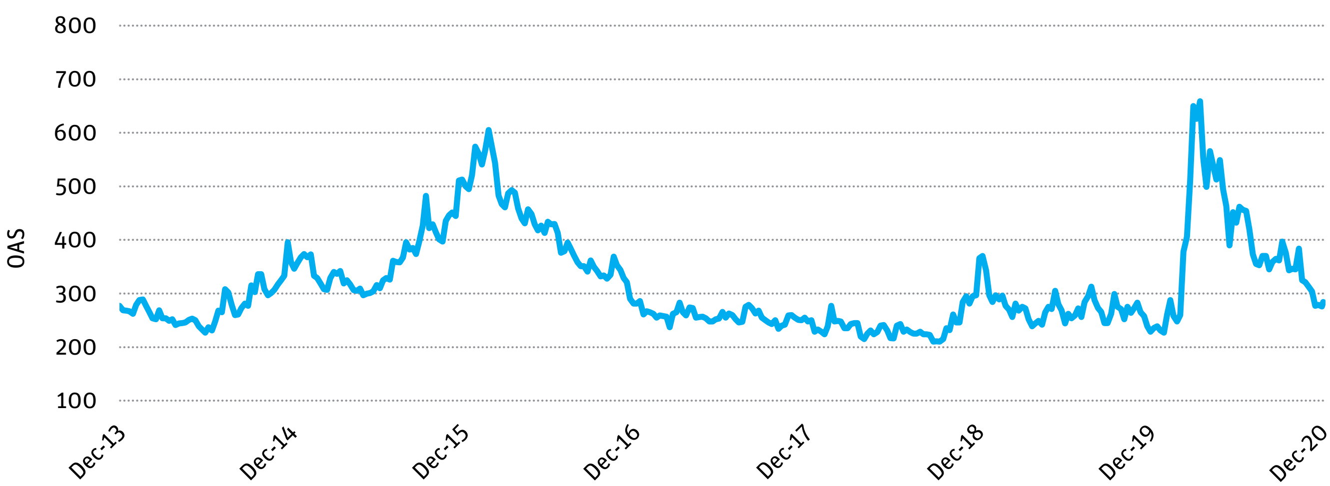
Looking into 2021, the backdrop for high-yield credit is favorable on nearly all fronts. Despite a recent increase in pandemic cases, the U.S. economy has been slowly recovering since the trough in the second quarter and will be further supported by multiple vaccine rollouts into 2021. Improving economic trends will allow companies to start to repair their balance sheets, and when combined with current favorable access to capital markets, default rates are expected to decline significantly in 2021. Global central banks, including the Federal Reserve, have been key to the return of confidence and remain supportive of risk markets. Policy rates in the U.S. are likely to remain near the zero bound in the medium term. Congress also recently passed an additional fiscal stimulus package to bridge the gap between the vaccine roll-out and an eventual return to economic growth. The new administration should translate into no drastic changes to regulation or tax policy while announced appointees, such as former Fed Chair Janet Yellen for Treasury secretary, have been well received. Technical trends in the high-yield market are also supportive — the primary market for high-yield issuers has been very active, with record levels of new-issue supply as companies proactively refinance near-term maturities. Supply has partially been absorbed by strong inflows into the high-yield asset class. Looking forward, most expect primary issuance activity to decline in 2021 while the global hunt for yield continues.

Valuations in high yield are optically less attractive, with yields at all-time lows. However, in the context of a slowly improving economy and expectation for continued low policy rates combined with strong demand for income-yielding assets globally and attractive relative value to other asset classes, we expect high yield to generate favorable total returns in 2021. Factoring in current yield levels with the potential for modest spread tightening back to pre-pandemic levels (Figure 25), partially offset by modest upward pressure on Treasury rates, risk-adjusted total returns for U.S. high yield could be very favorable in 2021. We do see risk that interest rates could rise modestly as the economy recovers, but in the event rates do increase, high yield is better positioned with a duration of approximately 3.5, less than half that of the investment-grade index, which is closer to 9 (Figure 26).

In the context of a slowly improving economy and supportive monetary and fiscal policies, we prefer issuers that are well positioned in cyclical subsectors, such as basic industries, transportation, and certain finance-related industries. Another area of opportunity is certain energy-related issuers that should benefit from higher demand levels as the economy improves.

While the backdrop for high yield is generally favorable, we are watching for any emerging risk factors that may cause periods of short-term volatility. Most likely culprits include disruptions in vaccine deployment and/or low vaccination rate, reversal of recent economic gains, and slower-than-expected labor market improvement.

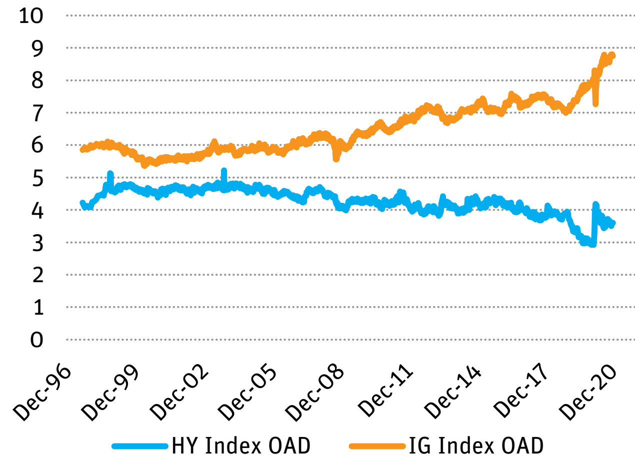
FIGURE 25: HY QUALITY DIFFERENTIAL HISTORY (HY VS IG)



Source: Bloomberg as of 12/21/20.

We remain cautious about subsectors and companies that were struggling before the pandemic due to either secular headwinds or idiosyncratic issues such as poor balance sheets or disappointing cash flow generation. An example includes the retail sector. We are more cautious on certain leisure subsectors, where current valuations have rebounded materially, while balance sheets remain significantly stressed. We also remain underweight certain high-quality sectors, including communications, pharmaceuticals, and health insurance, due to tight spreads and unattractive return opportunities.

FIGURE 26: DURATION DIFFERENCE HY VS. IG



Source: Bloomberg as of 12/21/20.

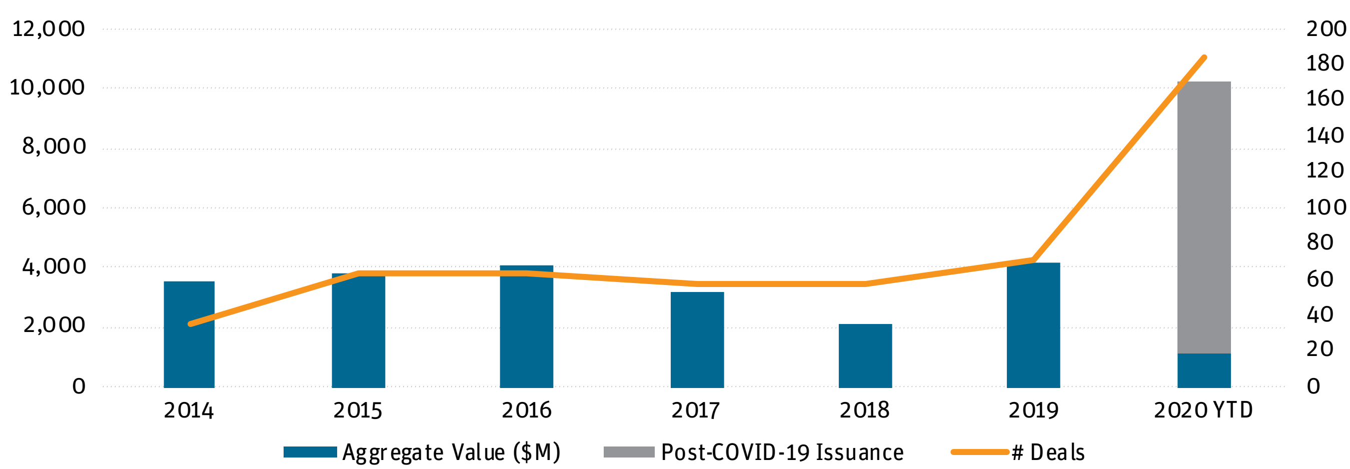
We began to actively engage with the senior management of the invested firms within our high-yield strategy in 2020 to ensure that these firms are employing sustainable business and employment practices to ensure strong alignment with ESG factors. Environmental risk has always been a component of our due diligence when conducting industry- and firm-level analyses, and the impact of COVID-19 has highlighted many important social factors such as the provision of health care, safe working environments, fair remuneration and retention policies, and ethical employment practices. We use a proprietary ESG scorecard methodology to assess each invested company's alignment with ESG factors to ensure that they are on a long-term positive trajectory in addressing ESG issues.

U.S. FINANCIALS

The financial debt sector is one of our highest-conviction ideas in investment-grade corporate credit for 2021. Community bank debt in particular should benefit from high current income, low duration, and the potential for outsized total return from spread tightening following a record year of Tier 2 debt issuance and the return of mergers and acquisitions (M&A). Fundamentally, the banking sector is well positioned for 2021, as the capital, liquidity, and funding profiles of banks have improved vastly in the past decade on the back of increased regulations. Over the course of 2020, banks added to their already multidecade-high levels of capital with record subordinated debt issuance (Figure 27); loan loss reserves were built up significantly, and loan modifications have trended down to low-single-digit levels.

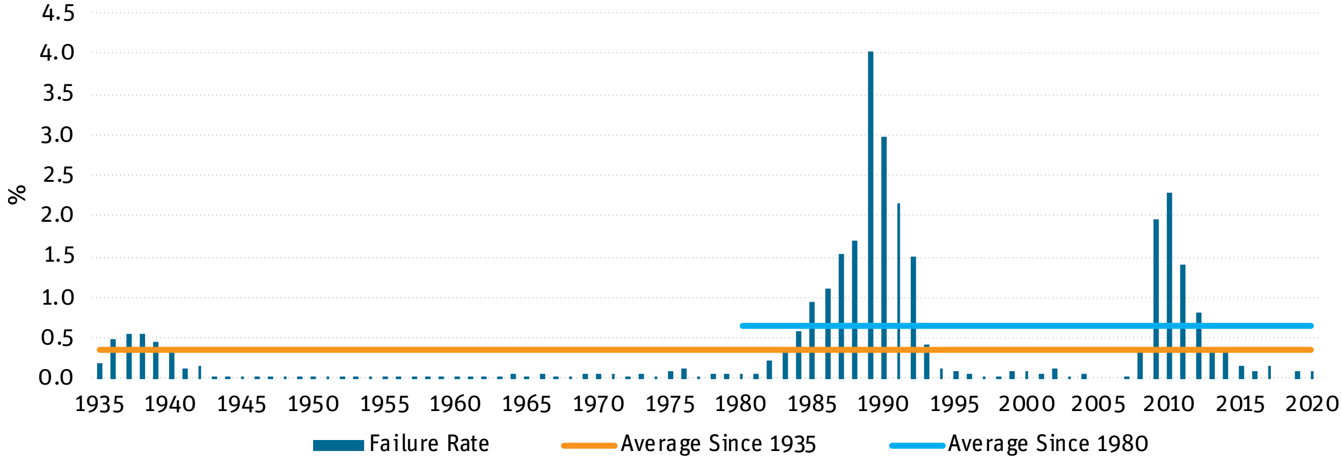
From a performance perspective, while the bank debt sector was not immune to spread widening at the onset of the COVID-19 pandemic, drawdowns were roughly half of what we saw in investment-grade corporate credit broadly. Bank debt has been slower to recover given (1) the Fed specifically excluding the banking sector from corporate debt-buying programs and (2) record subordinated (Tier 2) debt issuance; however, we believe the sector will benefit from spread tightening as issuance levels normalize. Additionally, we look for a re-acceleration in M&A activity following a pandemic-driven slowdown in 2020, with volumes down approximately 60% from 2019. With a muted outlook for revenue growth with rates at the zero bound, banks will increasingly be focused on driving earnings growth through enhanced efficiency (including M&A), share buybacks, and potential reserve releases.

FIGURE 27: COMMUNITY BANK DEBT PRIMARY ISSUANCE



Source: Piper Sandler, KBW, Performance Trust as of 11/15/20. Pre-COVID-19: Period prior to 3/31/20. Post-COVID-19: Period after 3/31/20.

FIGURE 29: COMMERCIAL BANK FAILURE RATE



Source: FDIC as of 9/30/20.

This cycle is clearly different from that of the GFC, with banks going into the pandemic with capital levels at or near multidecade highs and taking a proactive stance to shore up balance sheets over the past few quarters, most notably via subordinated debt (Tier 2 capital). In stark contrast to the GFC when the government provided a capital backstop for banks, the community bank universe ($50 billion or less in asset size) has raised a record $10+ billion of subordinated debt in 2020, with $9+ billion raised after April 24. As the market re-opened, spreads were at levels last seen in the infancy of the community bank sub-debt market. Moving through the recent supply of bank debt, spreads have begun to normalize back toward 2019 levels, a trend we expect to accelerate into 2021, providing the potential for price appreciation in addition to the attractive coupons currently provided by these investment-grade instruments.

Fundamentally, the banks are on strong footing. The capital, liquidity, and funding profiles of banks have improved vastly in the past decade on the back of increased regulations. Throughout the pandemic, the strength of the system has been evident as banks took on the role of facilitators and distributors of support to affected consumers and businesses, most notably through loan modifications and the Paycheck Protection Program (PPP).

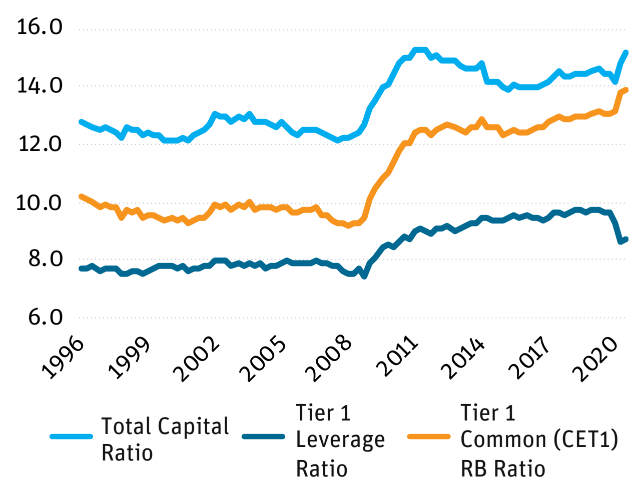
- Capital ratios remain near multidecade highs for U.S. commercial banks (Figure 28), with common equity Tier 1 capital up approximately 40% from trough levels and tangible capital roughly doubling. Recent stress test results demonstrate the excess capital in the banking system, and the resumption of buybacks/dividends up to 100% of the prior four quarters' net income highlights the moderate approach by regulators in recognizing the excess capital and allowing banks to drive higher earnings growth at the zero bound, while still potentially preserving the safety and soundness of the system.

- Liquidity at banks has increased, helped by stronger regulatory requirements. The quality of funding has improved as banks de-emphasized term deposits in favor of low-cost core deposits. Low-cost deposits have increased significantly since March, as recipients of PPP funds generally took a conservative approach and left much of the proceeds in their deposit accounts.

- Credit quality: We expect the impact of rising credit costs to banks will be less severe than in the prior cycle, as banks have de-risked and deleveraged over the past decade and have added significantly to loan loss reserves over the course of 2020. Loan modification trends are positive, with modifications improving from 15%-20% of lending portfolios in the early days of the pandemic to low-single-digit levels as of November, placing banks in a strong position to weather any potential credit migration.

- Low default rates: Bank failure rates are low (Figure 29), with most failures coming in smaller, private banks. Nearly 60% of bank failures are of banks with less than $100 million in assets, and nearly 90% of all bank failures are of banks with under $500 million in assets. Only four banks failed in 2020, in line with 2019 levels. The bank failure rate is just 0.36% going back to 1935.

FIGURE 28: BANK CAPITAL RATIOS



Source: S&P Global Market Intelligence as of 9/30/20.

- ESG alignment: With robust capital ratios and liquidity, community-oriented banks have been prepared to proactively assist small businesses and local consumers throughout this uncertain economic environment, most notably through the PPP where community banks deployed the majority of the proceeds. These banks have historically played a key role in ensuring the sustainability of their local communities by providing credit where larger out-of-market financial institutions are unwilling or unable to lend. They have also traditionally been substantial supporters of charities and nonprofit organizations in their footprint. We use a proprietary ESG scorecard methodology to assess each invested institution's alignment with ESG factors to ensure that they are on a long-term positive trajectory in addressing ESG issues.

CMBS

La Caridad 78 was a Cuban-Chinese restaurant located in the Upper West Side of Manhattan. They would close in observance of Thanksgiving and the Lunar New Year holiday each year; otherwise, customers had counted on them to serve delicious meals year after year since 1968. Higher-profile places like the 21 Club restaurant (since 1930), the Roosevelt Hotel (since 1924), and La Caridad 78 all closed their doors in New York City forever in 2020, succumbing to the financial pressures of the COVID-19 pandemic. Reflecting on all the effects of the pandemic, there are probably too many to name. The thematic answer to sum it up would probably be "CHANGE," especially as it relates to CRE, and thus CMBS. The most attractive aspect of investing in CRE has always been the stability and steadiness of the investment. The root of this stability is found in a CRE property's long-term leases to tenants, which help generate consistent monthly income. Traditions can be a powerful force. The pandemic proved to be a major disrupting force in CRE, and coupled with the changing of predictable behavioral patterns for many people, "How long can this impact last?" is a question many will continue to try to answer in the CRE markets in 2021.

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The problems in the retail property sector, especially the larger shopping centers and malls, have been highlighted years ago. We were expecting some of these properties to begin transforming this year, moving away from the traditional selling of goods to more entertainment/food-oriented services. Even discounting any pandemic-related delays in construction or heavy renovation, Warner Media's decision to release movies simultaneously in theaters and on HBO Max may become another stumbling block that will be hard to overcome. The retail and hospitality sectors were impacted the most by the pandemic simply because they could not operate, leaving the properties with zero income. These trends were reflected in CMBS' delinquency picture, as 10% of the outstanding loans in both the conduit and single-asset single-borrower (SASB) deal universe are classified as delinquent. Retail or lodging properties make up 75% of that total.

The office property sector was more of a tale of two cities. We didn't see the underperformance of delinquent payments as compared to those in retail and hospitality. Despite numerous employers moving toward a remote working environment, office landlords were able to keep up on their monthly payments in 2020. Simply put, physical occupancy does not have to equal economic occupancy. For the better part of 10 years (or maybe longer), many employers subscribed to a "densification" notion, where the goal was to be as efficient with floor space as possible, even placing individual workers in smaller and smaller workstations, aka WeWork or "coworking." Currently, the trend has almost completely reversed, where employers are opting for more flexible space to adhere to social distancing guidelines, or they are just not utilizing the same amount of office space. There are mixed feelings about which would make more sense when it comes down to the working-from-home concept or returning to the office when it's safe. Jamie Dimon, JPMorgan CEO, in October commented on the negative effects of having "thousands of bankers and traders working from home are being felt more and more. Employees had been less productive, and that the spontaneous creativity gained from working in the office was lacking." Then Sundar Pichai, Alphabet CEO, in December announced that Google will push back its return date to the office and also test the idea of a "flexible workweek," where employees can work from home for two days, and the other three days in the office will be "collaboration" days, arguing this will "lead to greater productivity, collaboration and well-being." Even in the financial industry, Deutsche Bank announced in November they would consider a similar hybrid workforce model. It's difficult to prognosticate where the office subsector is headed, but the direction may ultimately be decided on the battlegrounds of vaccination. Employers in 2021 will have to decide how they will approach this topic: Will they require employees to be vaccinated before returning to the workplace?

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As most would have expected, Amazon and other companies with large e-commerce footprints thrived over the past six months. Most of us had to transform our lives into a more "virtual" world these past nine months, which supports why the industrial/warehouse property sector saw numerous market transactions with higher valuations in 2020. The New York Times noted that "Amazon's e-commerce warehouses, package distribution centers and hubs for back-end computing gear occupied more than 190mm sq. ft. of space in North America at the end of 2019. That's bigger than the footprint of Kroger's nearly 2,800 supermarkets." As the focus for last-mile delivery is moving toward quicker and more efficient results, any CRE that relates to helping the supply chain will benefit, especially in areas that are close to larger populations.

In March 2020, the immediate reaction was to make a comparison to the GFC and the aftermath of the losses in 2009. Unlike the GFC, this current crisis is not the result of overleverage in the financial system. Prior to February 2020, all metrics pointed to an expansionary economy and a healthy consumer. As a result, many economic forecasts looked very different overnight. Since it wasn't a fundamental or a structural issue, many investors would assume a V-shape recovery was very possible in CRE. However, most of us underestimated how long this disruption would last. The positive news from the current vaccine data points to this path of full recovery and that we will get there at some point down the road. But for CRE owners, the longer these disruptions last, the more they could impact behavioral patterns, which can stress longer-term leases, and thus potentially lower valuations on properties. Investors are ready to take advantage of any dislocation in the CRE markets. There is approximately $344 billion of dry powder (cash on the sidelines) targeting CRE as of June 2020, which should provide support to CRE prices.[5]

> Despite numerous employers moving toward a remote working environment, office landlords were able to keep up on their monthly payments in 2020. Simply put, physical occupancy does not have to equal economic occupancy.

However, CRE is expected to remain in demand from investors next year. The reasons can range from investors viewing CRE as a safe haven despite the pandemic or political uncertainty, as a hedge to inflation, or as a diversified income option. The CRE markets received small benefits through the PPP, but additional stimulus — especially if the government will backstop business interruption insurance — will dramatically improve any recovery scenario in 2021. The low-rate environment provides a positive catalyst for property owners, with 10-year Treasury rates declining by 102 bps year-to-date through 12/11/20, although a decline in rates does not offset the decline in top-line revenue caused by the pandemic. Some property owners will be forced to close shop, while others will continue to fight for more "time," as some forbearance arrangements will have expired. In 2020, commercial rents generally didn't reflect market conditions. This can be a slippery slope because lower market rents don't inspire property development or renovations. If the U.S. economy doesn't pick up and unemployment stays relatively higher than the pre-pandemic numbers, property owners can face some refinancing risk. There will be a shortage of lenders because valuations will be adjusted lower to reflect lower net operating income. This can lead to higher volatility in spread movement and a higher adjustment to reflect increased risk in the CMBS markets, and thus we remain cautious about non-agency CMBS, particularly in lower parts of the capital structure.

While conduit AAA spreads have completely retraced to pre-pandemic levels with a small boost from TALF 2.0 and due in larger part to from institutions just having more dry powder to invest, especially those seeking income, lower parts of the capital structure remain much wider. As a result, the conduit credit curve (spread difference between AAA- and BBB-rated securities) is much steeper than in the past few years, which reflects some of the potential headwinds facing the CMBS market (Figure 30).

> As the focus for last-mile delivery is moving toward quicker and more efficient results, any CRE that relates to helping the supply chain will benefit, especially in areas that are close to larger populations.

While we are cautious on CMBS, there are several areas we believe are attractive tactical opportunities in 2021. First, as we mentioned earlier, the root of this crisis is not a fundamental hiccup. Extending operating time to prevent defaulting will be the goal of many property owners. As expected in 2020, numerous bank lenders pulled back on their lending operations to reduce exposure to CRE, especially in retail and hospitality. There will be numerous property owners looking for extra capital to help bridge their financial gaps. Nonbank lenders will have multiple choices, as there will be more continued demand from sponsors looking for capital than at any time in the past 10 years. The pandemic provided a large backlog of refinance and acquisition opportunities across all asset classes. Expectations of tighter lending standards and increased coupons should provide attractive yields for select conduit and SASB issues in 2021.

[5]Preqin.

FIGURE 30

	CMBS AAA	CMBS BBB-	DIFFERENCE
12/11/2020	74	475	401
12/31/2019	82	305	223
12/31/2018	100	435	335
12/31/2017	75	480	405
12/31/2016	100	560	460
12/31/2015	135	515	380
12/31/2014	95	385	290

Source: BofAS.
Note: Spreads prior to 2017 are non-risk retention spreads.

Second, the pandemic placed the health care property sector, senior housing, and skilled-nursing facilities in the eye of the storm. Giving the vaccine to the most vulnerable age group first can hopefully relieve some of those operating challenges in the sector. The demand drivers have not changed much. America's aging population will continue to grow, and the need for care will increase. According to the U.S. Census Bureau, there were 40.3 million U.S. residents 65 years and older in the 2010 Census, and on July 1, 2019, there were 54 million. We favor bonds backed by loans to multifamily or nursing home properties that can eventually qualify for permanent U.S. Department of Housing and Urban Development loans. Higher transaction volumes are expected in the sector due to recent industry consolidation, which means a greater demand for these loans. The defined path to exit of these loans, coupled with the robust demand drivers, creates a bright outlook for this niche area.

Third, the lodging and hospitality sector — in particular the select service-segment — is expected to see opportunities in the arena, as a need for capital to continue operations will be critical for some operators until it is safe enough for travel to rebound. As compared to the full-service segment (which includes larger resort-type properties or hotels reliant on conference-type events), the select-service segment has performed better and will adjust more quickly to higher operating expenses to meet new health standards. Full-service segment year-over-year revenue per available room declined 74%, while the select-service segment has declined only 26%.[6] Select service should also benefit from any increases in both the business traveler and the transient tourist markets.

Overall, we are cautious about CMBS in 2021, which is related to long-term cash flow uncertainty for large portions of the CRE market, including retail, office, and hospitality. However, we will remain tactical in our CRE-related strategies in 2021 to take advantage of niche opportunities backed by solid fundamental tailwinds, like skilled nursing securitizations. We will also continue to focus on epicenter areas of hospitality in investment vehicles with more patient capital and longer liquidity terms.

> There is approximately $344 billion of dry powder (cash on the sidelines) targeting CRE as of June 2020, which should provide support to CRE prices.

CLOS

After an incredibly volatile year, total returns for IG CLO tranches ended up slightly positive for the year, while CLO mezzanine tranches were flat or slightly negative (Figure 31). Dispersion in total returns was very high, especially lower in the capital structure, primarily driven by the respective performance of each deal. Credit selection was critical in avoiding large market value declines as well as downgrades of the underlying loan collateral. Corporate bonds outperformed CLOs on a total return basis in 2020. However, much of this difference can be attributed to the fixed-rate nature and long-duration profile of corporate bonds.

The pandemic brought the long-awaited corporate default cycle. Market participants were in constant debate on what would be the ultimate catalyst for an uptick in defaults, but none that we are aware of believed it would come as the result of a pandemic and the policy response to shutting economies down. Now that we are in the default cycle, market participants have a clear picture of winners and losers. Loan default rates increased to approximately 4% in 2020, and defaults were concentrated in COVID-19-impacted industries such as energy and retail. Downgrades were much more severe, with S&P downgrading $146 billion of loans held in CLOs, and Moody's downgrading $129 billion after the pandemic. Since late summer, downgrades have subsided, and we expect rating actions to be more muted going forward. We expect loan default rates to remain steady, around the current level of 4%, as certain industries remain challenged. Recovery rates have averaged about 50% in 2020, and we don't expect that to change much, due to weaker loan documentation seen in the 2017-2018 vintage, when the loan market grew to record size.

[6] Smith Travel Research through 12/12/20.

FIGURE 31: ESTIMATED 2020 YTD RETURNS FOR CLO DEBT AND EQUITY

	RANGE OF TOTAL RETURNS
AAA	2.1% to 2.2%
AA	2.4% to 3.1%
A	3.1% to 4.1%
BBB	3% to 5%
BB	2% to 7%
B	0% to 7%
Equity	-2% to +18%

Source: Nomura.

We expect market conditions to be favorable for credit in 2021 as the new credit cycle begins. The zero bound incentivizes fixed-income investors to take credit risk and to avoid interest rate risk with the recovery in action. Risk appetite should also be aided by improving earnings resulting from economic recovery. The supply of corporate bonds is expected to dwindle next year after record issuance in 2020, and the hunt for yield should also push investors down in credit and provide solid demand for high-yield bonds and leveraged loans. Loan issuance is also expected to increase next year as that market normalizes after an anemic 2020.

Similarly, we expect CLO issuance to normalize at around $100 billion of new supply, driven by our expectations of a pickup in net loan issuance and a broadening investor base for the CLO asset class. As credit spreads marched tighter in the second half of 2020, there was much talk of first-time investors in CLOs stepping into the fold. We see this in our own fundraising efforts, and this is an expected by-product of a low-yield environment. Investors are desperately searching for income solutions at the zero bound. Many existing CLO investors have also raised new mandates to buy both debt and equity following a tumultuous year in credit markets. CLO new issuance will also be aided by the never-to-be underestimated desire of CLO managers to increase assets under management regardless of the prevailing arbitrage conditions.

In addition to $100 billion of new-issue CLO supply, we expect at least as much volume in refis (reducing the coupons of existing deals) and resets (extending the maturity and flexibility of existing deals). CLOs typically had two years of call protection before COVID-19, but the typical structure was changed after COVID-19 to only one year of call protection, along with a shorter reinvestment period. As a result, most deals issued this year and almost all deals issued in 2019 and prior will become callable over the course of 2021. This amounts to approximately 95% of the outstanding CLO market. Naturally, not all these deals will be called, but calling even a fraction may result in very large volumes of transactions looking for buyers. As a reminder, neither a refi nor a reset creates any net new supply, as they also mean existing bonds will be redeemed. Regardless, large volumes of deals do give investors fatigue and, in many cases, result in widening pressure on credit spreads, as they increase the amount of spread duration in the market.

Therefore, we are expecting a year of both higher supply and higher demand in 2021, and how those two balance each other will determine the direction of spreads. Our view is the demand side will come out on top, leading to more spread tightening. Existing investors are increasing their CLO allocation, and new investors are coming into the space. This is in line with the general theme of investors' desperate search for yield at the zero bound that should support structured credit more broadly. Ironically, despite the increase in defaults and downgrades in leveraged loans, CLOs performed well in 2020. The CLO structure is now battle-tested by both the GFC and COVID-19, which should give investors more comfort as they debate adding to their CLO allocations in their hunt for yield.

Against this macro backdrop, we favor CLOs that currently trade at discounted prices, as we expect to see a pull to par from both spread tightening and a wave of refi/resets. We like the belly of the capital structure with a bulk of our exposure in single A and BBB tranches still trading at discounted prices. The total return potential in these bonds compares very favorably to other areas of structured credit. There are still risks that defaults can increase with recoveries continuing to track lower, and we expect idiosyncratic downgrades as many businesses face substantial challenges. As a result, we are hesitant to materially increase our exposure to BB CLOs. However, we will make exceptions for pristine deals that have a high likelihood of getting called.

One of the important themes in credit markets has been the growth of private credit. Especially in the aftermath of the GFC, as regulators clamped down on risk taking in bank balance sheets, private lenders started growing their influence. As yields marched lower and institutional investors realized the potential for higher returns, private lenders found success in fundraising. This theme will continue in the post-COVID-19 era, as we are seeing deal flow in the middle-market lending arena recover in the second half of 2020. With ample dry powder and borrowers in need, middle-market lending will continue to be active. This will also likely mean an increase in middle-market CLO issuance, an area where we have been an active participant. Not surprisingly, middle-market CLOs are seeing broadening investor interest. Given the lack of transparency into the underlying loans, manager selection becomes particularly important for middle-market deals. Working with managers who have strong origination networks and can control deal flow and structuring due to their large scale gives us comfort. This played out very well in the aftermath of the onset of COVID-19, as middle-market lenders can sit at the table with their borrowers very quickly and efficiently,

We expect market conditions to be favorable for credit in 2021 as the new credit cycle begins.

re-underwriting these credits and making amendments to the loans to keep businesses operating. Much as we like CLOs backed by broadly syndicated loans, we favor single A and BBB tranches of middle-market CLOs. Even with prices near or at par, the return potential on these positions is attractive due to high current income and very robust structural protections.

CONCLUSION

COVID-19 brought a whole host of unfortunate and tragic events, one of which was a trip back to the zero bound. As we learned in prior years at the zero bound, income will be very important for total return. The good news is we believe there are still excellent alternatives for high-quality, attractive current income without undue interest rate risk: NA RMBS, consumer ABS, high yield, financials, and select tranches of CLOs. Most of these sectors are wider than their pre-COVID-19 spread levels and have much less interest rate sensitivity than IG corporate bonds and other areas of core fixed income. Additionally, as investors reposition for higher income at the zero bound, those target sectors offer the potential for additional total return through spread tightening. As growth continues to accelerate in 2021 on the heels of the vaccine and historic fiscal and monetary stimulus, we believe long-term rates are vulnerable, and U.S. structured credit and high yield are well positioned to outperform in 2021.

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TOTAL RETURNS (AS OF 12/31/20)	1 YEAR	5 YEAR	10 YEAR	SINCE INCEPTION[1]	GROSS EXPENSE RATIO[2]	NET EXPENSE RATIO[2]
ANGIX	-1.77%	3.18%	-	5.88%	1.13%	0.94%
ANFIX	-3.75%	2.27%	-	2.51%	1.10%	0.69%
ANHIX	5.08%	7.95%	6.53%	8.71%	0.90%	0.65%
AOUIX	1.98%	-	-	3.02%	0.60%	0.25%
ASCIX	1.40%	-	-	4.54%	5.45%	0.75%
Bloomberg Barclays U.S. Aggregate Bond Index	7.51%	4.44%	3.84%	-	-	-
Bloomberg Barclays U.S. IG Corporate Bond Index	9.89%	6.74%	5.63%	-	-	-
Bloomberg Barclays U.S. HY Corp Bond Index	7.11%	8.59%	6.80%	-	-	-

[1]The inception dates were 8/16/12 for ANGIX, 11/3/14 for ANFIX, 3/31/09 for ANHIX, 4/2/18 for AOUIX, and 12/26/17 for ASCIX.
[2]Gross expense ratios are reported as of the 5/31/20 prospectus. The net expense ratios are reported as of the 1/31/20 Annual Report and are referenced in the 5/31/20 prospectus. The Adviser has contractually agreed to waive fees through 5/31/21.

Performance quoted is past performance and is no guarantee of future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data shown. Current performance for the most recent month-end can be obtained by calling 855-751-4324 or by visiting www.angeloakcapital.com.

DEFINITIONS

Alt-A: Alternative A-paper.
GSE: Government-sponsored enterprise.
NPL: Non-performing loan.
REMIC: Real estate mortgage investment conduit.
RPL: Reperforming loan.
Alpha: A measurement of the performance of an investment as compared to an index. It is considered to be an investment's active return and is used to understand how an investment is performing as compared to the market as a whole.
Basis Point (bps): One hundredth of one percent and is used to denote the percentage change in a financial instrument.
Bloomberg Barclays U.S. Aggregate Bond Index: An unmanaged index that measures the performance of the investment-grade universe of bonds issued in the United States. The index includes institutionally traded U.S. Treasury, government-sponsored, mortgage, and corporate 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.
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.
Call protection: A period of time during which a bond issuer cannot call, or buy back, a bond.
Cash Flow: The net amount of cash and cash-equivalents being transferred into and out of a business, especially as affecting liquidity.
Consumer Price Index (CPI): An index that measures the changes in the price of a certain collection of goods and services bought by consumers in an effort to measure inflation.
Core PCE Price Index: An index that is defined as personal consumption expenditures (PCE) prices excluding food and energy prices. The core PCE price index measures the prices paid by consumers for goods and services without the volatility caused by movements in food and energy prices to reveal underlying inflation trends.
Duration: Measures a portfolio's sensitivity to changes in interest rates. Generally, the longer the duration, the greater the price change relative to interest rate movements.
Manheim Used Vehicle Value Index: An index that represents the premier indicator of pricing trends in the used vehicle market.
Mortgage Credit Availability Index (MCAI): The MCAI is a barometer of the availability of mortgage credit using guidelines from institutional investors who purchase loans through the broker and/or correspondent channels. Higher index values signal that credit is more available, while lower index values indicate that mortgage credit standards are tighter.
National Association of Home Builders (NAHB) Housing Market Index: A gauge of builder opinion on the relative level of current and future single-family home sales.
Russell 2000 Index: Measures the performance of the 2,000 smallest companies in the Russell 3000 Index.
S&P Energy Sector: The S&P 500 Energy Sector includes all companies in the S&P 500 that are assigned to the Energy sector by GICS. The sector covers companies engaged in the exploration and production, refining and marketing, and storage and transportation of oil and gas, and coal and consumable fuels. Also includes companies that offer oil and gas equipment and services.
S&P Financials Sector: The S&P 500 Financials Index comprises all companies included in the S&P 500 that are classified as members of the GICS Financials sector. The sector includes banks and thrifts, as well as providers of diversified financial services, specialized finance, consumer finance, asset management and custody of securities, investment banking and brokerage services, capital markets services, financial exchanges, data and analytics, insurance underwriters and brokers, and mortgage REITs.
S&P Industrials Sector: The S&P 500 Industrials comprises all companies in the S&P 500 included in the sector by GICS. The sector includes manufacturers and distributors of capital goods such as building products, electrical equipment and machinery, and aerospace and defense. Includes providers of commercial services such as construction and engineering, printing, environmental services, human resource services, research and consulting services, and transportation services.
S&P 500 Total Return Index: The index is widely regarded as the best single gauge of large-cap U.S. equities and serves as the foundation for a wide range of investment products. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.
Spread: The difference in yield between a U.S. Treasury bond and a debt security with the same maturity but of lesser quality.
Tangible Assets: Assets with a physical form and that hold value.
Tangible Capital: An outstanding stock plus retained earnings.
Tangible Common Equity: The common equity listed on the balance sheet minus preferred stock and intangible assets.
Tier 1 Common Capital (CET1) RB Ratio: The measurement of a bank's core equity capital compared with its total risk-weighted asset that signifies a bank's financial strength.
Tier 1 Leverage Ratio: The relationship between a banking organization's core capital and its total assets.
Total Capital Ratio: The percentage of a bank's capital to its risk-weighted assets.
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.
Yield-to-Worst (YTW): The lowest potential yield that can be received on a bond without the issuer actually defaulting.

It is not possible to invest directly in an index.

As of 12/31/20, the securities mentioned in this piece were not owned by Angel Oak Funds.

Fund holdings and/or sector allocations are subject to change at any time and are not recommendations to buy or sell any security.

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 12/31/20 and are subject to change at any time, are not guaranteed, and should not be considered investment advice.

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 nonrated securities present a greater risk of loss to principal and interest than do 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 lead to losses that are greater than the amount invested. The Fund may make short sales of securities, which involves the risk that losses may exceed the original amount invested. The Fund may use leverage, which may exaggerate the effect of any increase or decrease in the value of securities in the Fund's portfolio or the Fund's net asset value, and therefore may increase the volatility of the Fund. Investments in foreign securities involve greater volatility and political, economic and currency risks and differences in accounting methods. These risks are increased for emerging markets. Investments in fixed-income instruments typically decrease in value when interest rates rise. The Fund will incur higher and duplicative costs when it invests in mutual funds, ETFs and other investment companies. There is also the risk that the Fund may suffer losses due to the investment practices of the underlying funds. For more information on these risks and other risks of the Fund, please see the Prospectus.

The Angel Oak Funds are distributed by Quasar Distributors, LLC.

Index performance is not indicative of the Fund's performance. Past performance does not guarantee future results. Current performance can be obtained by calling 855-751-4324.

For more information, or to learn how to invest in Angel Oak's structured credit and corporate credit funds, visit angeloakcapital.com.

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