Q&A

ANGEL OAK CAPITAL ADVISORS

Q&A with Brad Friedlander

Non-agency RMBS: Finding Value

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Q Where do you believe the best values in fixed-income investing are today? Do you feel they are more inherent in interest rate or credit-focused assets, and why?

Friedlander: We've seen quite a rally in the bond market through the first half of 2014. Much of the move has been in response to geopolitical and economic softness in the aftermath of a punishing winter climate. Both "risk free" and credit-focused bonds have benefited in the flight to quality within the greater context of a global quest for yield. This has bailed out even the most traditional low-yielding sectors, like U.S. Treasuries. Although an understandable reaction, I view this dynamic as ultimately fleeting as the year progresses and market anxiety subsides under the weight of continued U.S. labor and growth improvement.

It's with this mindset that we favor non-agency mortgage bonds and allocate a large portion of our strategies to this space. At this point in the business cycle, I believe investors are being rewarded for taking a moderate degree of credit risk in certain sectors and these mortgage-related securities are well-positioned as fundamental tailwinds in housing continue to gain strength. We favor this sector above any other because fundamentals such as delinquencies, home values and prepayments are expected to continue to improve. Non-agency MBS are yielding approximately 5-6% on a loss-adjusted basis and offer hundreds of basis points more income than many other sectors that we view as comparable credit risks.

As a quick reminder, non-agency RMBS are securitized bonds backed by residential mortgages from across the U.S. They differ from the Agency RMBS market because these securities do not have the implicit guarantee of the federal government (i.e., Fannie and Freddie). From a practical standpoint, the majority of the non-agency RMBS market consists of seasoned pools that are priced at a discount. Lastly, they provide fixed income investors access to an improving housing market and a healing consumer with less interest rate risk since the majority of the asset class is floating rate.

BRAD FRIEDLANDER

Since 1999, Mr. Friedlander has been involved in the capital markets and asset management across the fixed income product spectrum. Prior to Angel Oak, he spent five years as a portfolio manager with Washington Mutual Bank in Seattle, Washington, where he managed over $8 billion in RMBS, ABS, and U.S. government and agency portfolios. Mr. Friedlander's previous experience includes four years on the trading desks at J.P. Morgan in New York.

Fund Industry Intelligence named Mr. Friedlander one of the 2013 Rising Stars of Mutual Funds. He was featured in Barron's and has been quoted in The Wall Street Journal, Bloomberg and Reuters. Mr. Friedlander has also appeared numerous times as a guest on CNBC and Fox Business.

Mr. Friedlander earned his bachelor's degree in economics from the University of Rochester.

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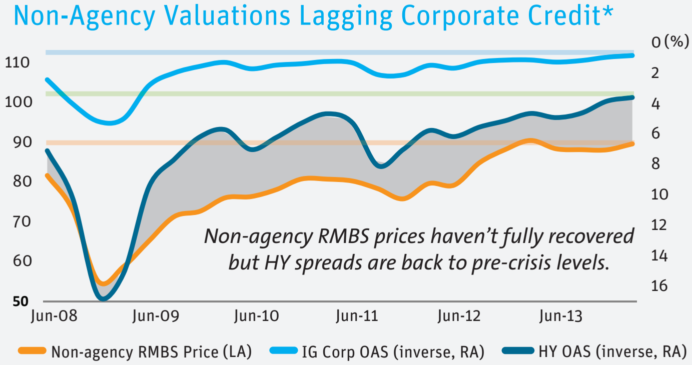
Q Given the performance of non-agency MBS since the crisis, how much more can the sector improve?

Friedlander: Nearly six years removed from the credit crisis, many markets have not fully normalized. One look at the still accommodative Fed policy confirms that point. I prefer to take a step back and compare investments from a higher level when thinking about asset recoveries in the broader markets and where values still remain (Figure 1). Asset prices in the non-agency sector, though partially recovered, still reflect a sentiment that is residually spooked even years following the crisis. Compare this to equities or other credit markets, such as investment grade and high-yield corporate bonds, that are approaching pre-crisis levels.

Figure 1:
Non-Agency Valuations Lagging Corporate Credit*



An obvious question one would ask is: What is holding non-agencies back? Despite some volume upticks and minor notoriety in recent years, it is still an inefficient market. It has yet to draw significant investments from the biggest legacy players, such as banks, since the majority of the asset class was downgraded. Compare that to more heavily followed spaces that have rallied past pre-crisis levels as they have experienced a resurgence of capital (Figure 2).

I am optimistic about the upside in non-agencies largely because they are still available at deep discounts. While prices do not sit at the absolute lows we saw in 2009, we now know more about this recovery than we did during the depths of the crisis. Fixed income investing in 2014, 2015 and 2016 does not have to be all defense. I do not think investors should settle for parking money in lower-returning hiding spots because there are still prudent opportunities out there. We believe some of the best opportunities are in floating rate credit assets, which may position investors well through an eventual Fed tightening.

Q In the past, you said the non-agency market was pricing in conservative assumptions for the bonds you hold in ANGIX. Is that still the case, and how do you and your team quantify that?

Friedlander: Punitive loss assumptions and the extreme stressing of securities are still very much the case in the non-agency market. We have seen a gradual shift in assumptions to meet the improving fundamental reality over time, but the disconnect remains in a few key metrics:

1) When investors are evaluating home prices, the assumption is that home values flatline or actually decline in value as compared to the actual home price appreciation that the market and the economy is currently experiencing with each month of improving data.

Figure 2

	Index/Price Level		
Asset Class	**Pre-Crisis Dec. 2006**	**Current July 2014**	**% Change**
Investment Grade Corporates	1,601	2,549	59%
High-Yield Corporates	884	1,658	87%
S&P 500	1,418	1,978	39%
Non-Agency MBS[2] (Price Level)	100[1]	87*	-13%

*Average price of non-agency holdings across a set of portfolios managed by Angel Oak Capital Advisors

[1]Average price at issuance

[2]Source: Amherst Securities

2) Voluntary prepayment rates, another key metric for investors, are assumed to fall in some cases approximately 50% below current levels. There is no benefit given to the fact that borrowers are in a better equity position in their homes and are also in better income positions. In general, borrowers and consumers are in much better positions from a personal balance sheet and debt load standpoint than they have been in a couple of decades.

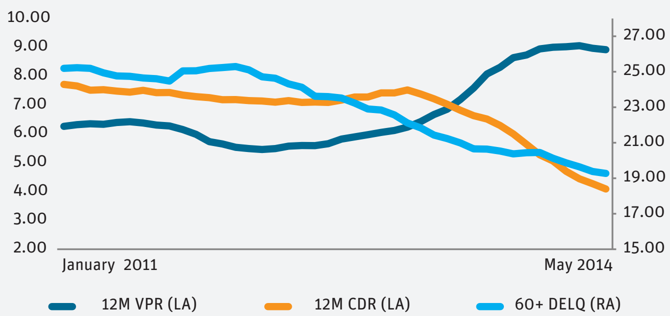
3) Last, the market is still assuming that defaults will meet at least 1 to 1.5 times the 60-plus-day delinquent loans. We have seen delinquent loans fall by over 40% in the past few years.

We believe assumptions are far too onerous, especially when you assume home values will not increase over the remaining life of these investments, approximately 5-10 years.

Q Generally speaking, what are the prepayments, delinquencies and modifications across prime, Alt-A and subprime?

Friedlander: We are continuing to see voluntary prepayment speeds increase. Prime mortgages are approximately 10-15%, Alt-A is a bit slower at approximately 5-10% and subprime, being the most credit-hampered right now, approximately 1-5%.

Figure 3: Large Improvement in Credit Fundamentals*



**Prepayment speed data of non-agency holdings across a set of portfolios managed by Angel Oak Capital Advisors*

Default rates continue to moderate. We are seeing annualized cumulative default rates approximately 2-4% for prime, Alt-A approximately 3-6% and subprime approximately 4-8%. The precursor to default is that delinquencies continue to fall. Prime is approximately 11% delinquent, Alt-A approximately 21% and subprime approximately 30%; but all of those figures represent significant improvements over the past several years (Figure 3).

Modifications are another important metric. We continue to see prime modifications of approximately 13%, Alt-A approximately 26% and subprime approximately 54%. The modifications are mostly rate modifications, but they can be composed of principal modifications or loan term extensions.

Q Angel Oak was founded in mid-2008 to capitalize on the opportunities you and your partners saw in housing, and specifically non-agency mortgage-backed securities. The sector has added many market participants as it has evolved from distressed to opportunistic. In such a competitive environment, what do you see as Angel Oak's edge?

Friedlander: There are a number of seasoned non-agency managers, but there are definitely new participants who have entered the space in the post-crisis period. One of the differentiators for Angel Oak is that we have been ingrained in the housing market, and in loan analytics, for approximately 20 years, far before the sector became attractive to many pre-crisis money managers. We have been participants in this particular space during the best and worst of times. This experience tends to reveal itself not just through performance over the years, but in a manager's ability to effectively manage liquidity in stressed environments. All managers make mistakes. It is how you learn from mistakes and refine your views and investment strategies that make a stronger, time-tested investor.

Additionally, our team prides itself on not being a consortium of statisticians analyzing credits from afar, but rather a team that has worked as mortgage originators serving in pivotal roles in underwriting individual loans. We have worked for servicers and understand the subtleties of servicer behavior that may lead to either an absence or abundance of bond cash flows for investors. It's this practitioner approach that helps shape our analytics and models every day.

Q Today we are seeing improving loan-to-value ratios in almost all parts of the country and I know there are many inherent risks in subprime, but are you seeing any value in that segment of the non-agency market?

Friedlander: We feel investors are generally rewarded by stepping into the non-agency sector, but not dipping too far down in credit because we believe the credit curve is quite flat.

Subprime, like so many other parts of the mortgage credit markets, is experiencing some broad and widespread curing of credits. To a certain extent, the rising tide of home price appreciation and a recovering economy has lifted all boats, but to different degrees. Some of those boats are more susceptible than others if we were to once again experience a soft patch in the economy.

However, there are circumstances when the yield pickup for a subprime bond can offer upwards of 50 to 100 basis points versus a cleaner-quality bond or, in an upside scenario, can offer upwards of 200 to 400 basis points of incremental yield. We feel those warrant our attention. Otherwise, on a near equal yield basis, we are less interested. We monitor all credits and pay particular attention to subprime as it can often prove to be the canary in the coal mine during market challenges. As well, the volatility in subprime is typically higher than that of prime and Alt-A.

Q How does Angel Oak underwrite servicers?

Friedlander: Servicers and servicer behavior have become ever more important in the past few years. There has been a sustained trend of the traditional servicers transferring their servicing rights to newly emerging private servicers. Post-transfer, there is often a shift in servicer behavior. Bonds can experience a spike in modifications, a change in timing from delinquency to liquidation, and even the shutting off of principal and interest payments for an interim period. Modifications, whether they are rate modifications or principal modifications, tend to be the primary driver of cash flow disruptions. As a result, we actively track the behavior of individual servicers over time, which allows us to have a view of any future disruptions that may occur.

We monitor the aggressiveness or the passiveness of certain servicers versus one another, how they approach delinquent borrowers, their modification programs, and the patterns noted in the advancing of principal and interest, because all of these factors directly impact the cash flow of the securitization. Servicer actions on delinquent loans by definition are more impactful to higher delinquency pools. This is one of the reasons we opt to focus on higher-quality collateral, where the impact is more muted. However, we work to actively manage our exposure to certain servicers, currently underweighting Nationstar versus Ocwen.

Q How granular does Angel Oak get when looking into specific mortgages and the individual loans in its portfolios? Specifically, how does your team filter through loan-level data to analyze mortgage-backed securities and underwrite collateral?

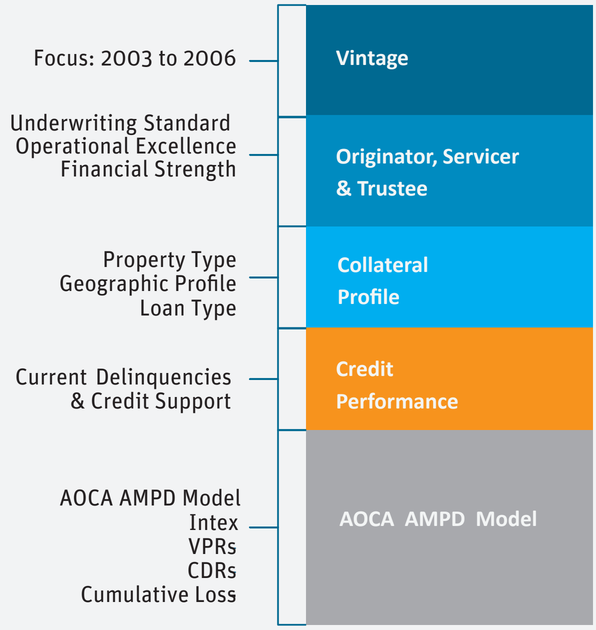
Friedlander: There is a tremendous amount of specific loan-level data that is available and probably more than most people would realize. Being a nimble investor, we screen through hundreds of securities every day. We are particularly selective in analyzing and underwriting various residential, commercial and a number of different types of asset-backed securities.

We initially screen based on the vintage year the loans were originated and look closely at the originators, servicers and trustees to make sure that they are demonstrating a solid track record from an underwriting perspective. We examine the credit scores of the borrowers, home price adjusted loan-to-values on particular properties, the interest rates that borrowers are paying, the principal and interest payments per month in whole for those individual borrowers, and the geographic location of the property. Additionally, we want to know whether the loan was a refinance or a purchase loan and if it is an owner-occupied home or a vacation or investor property. All these factors have an impact on expected defaults over time.

Once a particular bond meets all the rigors of that screening process, we then analyze the security through our proprietary model known as Angel Oak Model for Prepayment and Default* (AMPD). AMPD helps us estimate defaults and voluntary prepayments, as well as loss severities, on non-agency mortgage securities. The model itself is looking at a wide array of information and data to help predict prepayments and defaults over time.

While we are not wholly reliant on models to determine our buying process, we have been very pleased with the high degree of accuracy that we have experienced in analyzing and predicting these types of defaults through a disciplined process.

Figure 4: RMBS Market Analytics*



**Angel Oak has created proprietary models to estimate default rates, voluntary prepayments and loss severities of non-agency residential mortgage bonds. The models analyze loan-level data and then aggregate them at the security level. The empirical analysis is based on a sample of more than 400,000 older vintage home loans from a sample of over 300 mortgage bonds. The models provide preliminary default rates, prepayment rates and expected severities on any pool of mortgage loans or securities and have provided a good linear relationship between predicted values and the real cases. Portfolio managers and analysts merge the model outputs with their own views on future market and economic conditions to provide more qualified pre-purchase assumptions.*

About Angel Oak Capital

Angel Oak Capital Advisors, LLC, is an Atlanta-based, SEC-registered firm currently managing investments on behalf of public, private and institutional clients. Founded in April 2008, the firm has grown to over $3.5 billion in assets under management (AUM), predominately in non-agency residential mortgage-backed securities (RMBS).

We seek to provide compelling fixed income investment alternatives available in today’s challenging market. Our viewpoints, both opportunistic and contrarian, help us identify what we believe are the best opportunities.

This material has been prepared solely for informational purposes. The views and opinions expressed within are solely those of the authors and may or may not be accurate over the long term. While we have a reasonable basis for our appraisals and we have confidence in our opinions, actual results may differ materially from those we anticipate. These opinions are current as of the date of this material but are subject to change. It is not an offer, recommendation or solicitation to buy or sell, nor is it an official confirmation of terms. It is based on information generally available to the public from sources believed to be reliable. No representation is made to its accuracy or completeness or that any returns indicated will be achieved.

There is no guarantee that this or any investment strategy will succeed; the strategy is not an indicator of future performance; and investment results may vary.

The strategy invests in high-yield securities and unrated securities of similar credit quality (commonly known as junk bonds), as well as derivatives of such securities, and therefore is likely to be subject to greater levels of interest rate, credit and liquidity risk than strategies that do not invest in such securities. These securities are considered predominately speculative with respect to the issuers' continuing ability to make principal and interest payments. An economic downturn or period of rising interest rates could adversely affect the market for these securities and reduce the strategy's ability to sell these securities (liquidity risk). If the issuer of a security is in default with respect to interest or principal payments, the strategy may lose its entire investment.

The value of some mortgage-backed securities may be particularly sensitive to changes in prevailing interest rates, and although the securities are generally supported by some form of government or private insurance, there is no assurance that private guarantors or insurers will meet their obligations.

No investment strategy, including an absolute return strategy, can ensure a profit or protect against loss. Additionally, investing in an absolute return strategy may result in underperformance during a bull market.

Past performance is no guarantee of future results. The investment return and principal value of an investment in the strategy will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost.

Definitions

Agency RMBS: The purchase of mortgage-backed securities issued by government-sponsored enterprises such as Ginnie Mae, Fannie Mae or Freddie Mac. The term is most commonly used to refer to the U.S. Federal Reserve's $1.25 trillion program to purchase agency mortgage-backed securities, which commenced on Jan. 5, 2009, and was completed on Mar. 31, 2010. (This definition is from Investopedia: Agency MBS Purchase.)

Non-agency RMBS: Mortgage-backed securities sponsored by private companies other than government sponsored enterprises such as Fannie Mae or Freddie Mac. (This definition is from the NASDAQ website.)

LTV: A lending risk assessment ratio that financial institutions and others lenders examine before approving a mortgage. Typically, assessments with high LTV ratios are generally seen as higher risk and, therefore, if the mortgage is accepted, the loan will generally cost the borrower more to borrow or he or she will need to purchase mortgage insurance.

Loan Servicing: The administration aspect of a loan from the time the proceeds are disbursed until the loan is paid off. This includes sending monthly payment statements and collecting monthly payments, maintaining records of payments and balances, collecting and paying taxes and insurance (and managing escrow and impound funds), remitting funds to the note holder, and following up on delinquencies.

Barclays U.S. Corporate High-Yield Index: The U.S. Corporate High-Yield Index measures the market of USD-denominated, non-investment grade, fixed-rate, taxable corporate bonds. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below, excluding emerging market debt.

Barclays U.S. Investment Grade Corporate Index: The U.S. Corporate Index is a broad-based benchmark that measures the investment grade, fixed-rate, taxable, corporate bond market. It includes USD-denominated securities publicly issued by U.S. and non-U.S. industrial, utility and financial issuers that meet specified maturity, liquidity and quality requirements.

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