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THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

Looking to U.S. Structured Credit Markets for Higher Current Income

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SECTOR — GENERAL INVESTING

TWST: Can you briefly describe the Multi-Strategy Income Fund (ANGIX) and how you are making allocations to it at the present time?

Mr. Dunlap: The Angel Oak Multi-Strategy Income Fund is a unique strategy focused on identifying the best relative value within the U.S. structured credit markets, predominantly mortgage credit. The areas in which we focus are also predominantly in the non-agency subsectors within U.S. structured credit.

The non-agency U.S. structured credit markets in which we focus are approximately $3.1 trillion in size. The way that the Multi-Strategy Income Fund team allocates is based on identifying the best relative value from a top-down perspective within the individual subsectors that include non-agency RMBS, ABS, CLOs, and CMBS.

Once we identify where the best risk-adjusted return and the best relative value within U.S. structured credit space is, it is up to individual portfolio managers and their product disciplines to allocate accordingly based on a formal target set by the investment committee. Our formal investment committee meets each month, but we also meet each morning. Subsector targets are set formally each month, but they can change quickly as we navigate environments like we experienced in March 2020. We have a very nimble approach and react quickly in times to identify relative value opportunities.

TWST: Are you making adjustments to this fund at least monthly then?

Mr. Dunlap: We set formal strategy targets on a monthly basis, but targets can change daily when we meet each morning. Again, we have a very nimble approach, but we do set formal targets monthly based on where we see the best relative value within the U.S. structured credit markets.

TWST: Can you describe the assets under management presently and also the type of investor who is best served by the fund? Where would he or she view it within a portfolio?

Mr. Dunlap: Angel Oak Capital Advisors manages approximately $10.8 billion in fixed income. We focus on the U.S. structured credit markets and predominantly in mortgage credit. This fund from a strategy perspective is approximately $7.4 billion in size. We also have a UCITS version of this fund as well, the Angel Oak Multi-Strategy Income UCITS Fund.

What we seek to identify within the U.S. structured credit markets provides a unique allocation for investors seeking high current income and a unique allocation away from traditional fixed income in the U.S. structured credit markets. This fund has a unique allocation and an overweight to non-agency RMBS and predominantly legacy non-agency RMBS — bonds that were issued prior to the global financial crisis. It has over approximately 65% of the allocation towards non-agency RMBS.

The allocation seeks to provide investors high current income, with a relatively short effective duration profile, which we think is unique given the current environment of historic fiscal and monetary stimulus. Here, at the zero bound, we are seeking to provide investors high current income, with low interest rate sensitivity.

TWST: Explain how you view the zero bound policy that the Fed set as a CIO? Also, can you speak to how it impacts and will impact this particular fund?

Mr. Dunlap: Heading back to the zero bound, well, we have been here before. Unfortunately, we do think it's one of the consequences clearly of the pandemic and challenges all fixed-income investors to find high-quality income and/or yield in the current environment. The Fed is committed to being at the zero bound until 2023, and QE4 in quarters ahead.

It is increasingly hard to find high-quality income opportunities that we view to have short effective duration profiles. Historic monetary and fiscal stimulus are going to be very supportive for growth in 2021. Something has to give in this environment, and we think it will be the long end of the risk-free curve. We are positioning this fund to identify high current income that U.S. structured credit offers today with relatively short effective duration profiles. That allocation, in our view, given the zero bound, is a favorable one.

Also, within the U.S. structured credit and the assets in which we target, we are still, from a spread perspective, wide on a year-to-date basis. We think those have room to continue to tighten, which should add potential additional total return through price appreciation as spreads and the asset classes we target potentially tighten in the coming year.

Highlights

Sam Dunlap discusses the Angel Oak Multi-Strategy Income Fund, which is focused on identifying the best relative value within the U.S. structured credit markets, predominantly mortgage credit. He says they seek to provide investors high current income with low interest rate sensitivity, favoring relatively short effective duration profiles. He says the fund has a unique allocation and an overweight to non-agency RMBS, predominantly legacy non-agency RMBS. According to Mr. Dunlap, the Fed's commitment to the zero bound and buying mortgages has been hugely supportive for U.S. housing, which improved the credit risk profile of the bonds they target within non-agency RMBS. He states that within the U.S. structured credit and the assets they target, spreads have room to continue to tighten, which could increase total return through price appreciation as they potentially tighten in the coming year.

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TWST: I've heard you mention that the RMBS — residential mortgage-backed securities — which are dominant in this fund are not accessible in ETFs or other funds that have structured credit. Why would this be so unique in terms of access?

Mr. Dunlap: The allocation is unique given our focus on U.S. structured credit specifically. To your point, these asset classes are typically not in traditional ETFs. The historical allocation and the predominant focus we have had on mortgage credit allows the fund to give investors a concentrated allocation towards U.S. structured credit in mutual fund form. As the hunt for yield continues here at the zero bound, we find, traditionally, that most investors are under-allocated to U.S. structured credit and especially non-agency structured credit.

It is a very large marketplace, as I mentioned. The U.S. non-agency subsector is approximately $3.1 trillion in size. It offers high-quality current income, but, given the size and fundamentally positive credit attributes that the asset classes we favor typically exhibit, it can give investors unique diversification that they otherwise might not have within their traditional fixed-income allocations, as in non-agency RMBS, consumer-backed ABS, CMBS, and CLOs.

TWST: Let's argue for a moment that there might be more volatility going forward in the U.S. economy for various reasons. Might you shift into other subsectors of credit? If so, what might they be?

Mr. Dunlap: As far as volatility is concerned and to your point on volatility within the U.S. — whether it relates to capital markets or U.S. growth ahead, for example — we do think that the Fed and the recent commitment to the zero bound and QE4 is an incredible volatility suppressant, particularly for risk assets. Hence the mortgage allocation, as I mentioned, is the overweight within the fund at over 65% of the allocation.

Given how profound the Fed's commitment is to QE4 and buying agency mortgages, we've seen interest rate volatility collapse just as you've seen volatility collapse across all the risk markets, including the VIX. We believe this is hugely supportive to continue to suppress volatility, which is supportive for mortgage credit, generally speaking. We think our volatility outlook for the years and months ahead bodes well for the mortgage allocation.

Our goal is to provide investors with the best relative value that will pay over the long run credit cycle, and in addition to low volatility, the U.S. mortgage credit market has been benefiting from positive fundamental credit attributes. The Fed's commitment to the zero bound and buying mortgages, as well as collapsing interest rates has been hugely supportive for U.S. housing, which from a fundamental perspective, improved the credit risk profile of the bonds we target within non-agency RMBS.

There were some questions to your point on volatility in the U.S. economy surrounding unemployment and rising delinquencies in RMBS due to the pandemic. As we took a step back and reflected on the post-COVID environment from a top-down standpoint and what it meant for RMBS, we were reminded we were very bullish towards U.S. housing and non-agency RMBS going into COVID due to the incredible supply and demand dynamics supporting U.S. housing. There's just a general shortage of supply and rising demand. We became even more bullish towards U.S. housing and non-agency RMBS post COVID. We have been pleasantly surprised to say the least with what has transpired post COVID as it relates to housing and RMBS.

It was not immune to what we saw with the volatility during the March period. As all credit products were particularly hard hit, mortgage credit was not immune to similar spread widening, but the fundamental credit aspects that back the bonds we target have improved dramatically post COVID. I don't anticipate potential volatility ahead to change our current outlook and backdrop to the macro tailwinds that benefit mortgage credit over the medium term. One of the things that we have shifted towards post COVID are more areas of consumer ABS — that is an area that has benefited from similar macro tailwind to mortgage credit.

Rates obviously collapsed on the front end and improved financing costs has really benefited areas like auto ABS. Additionally, U.S. consumers were in solid shape going into COVID, and in our opinion, U.S. consumers were very well positioned to stave off the worst from the pandemic.

Personal savings rates as a percentage of disposable income were rising going into the COVID crisis, and they subsequently spiked to post-WWII all-time highs. We and other market participants took note. We believed there were some excellent opportunities within the consumer ABS space, particularly auto ABS coming out of the COVID environment. That has, again, been a pleasant surprise given our outlook, as used car prices increased dramatically — similar to the dynamic for U.S. houses.

We know there are depressive effects, as in people not traveling and people being worried about their jobs and/or being laid off or having already been laid off. Can you speak to what might be undergirding the U.S. borrower, but also why you might feel optimistic about the U.S. economy in general?

Mr. Dunlap: We are optimistic looking ahead into 2021. We view the recovery as continuing to be shaped after what we saw in November. We thought the effectiveness of the vaccine was profound for all risk assets in November, in that it points towards a more normalized economy and a resumption of a lot of pent-up demand. The vaccine coupled with historic monetary and fiscal policy will be very supportive for growth in the U.S.

The fiscal and monetary stimulus we feel has been profound, but the U.S. consumer and mortgage credit was in really good shape going into the pandemic. Never in a million years would we imagine this happening, clearly. But if the U.S. consumer were the braced for a potential shock, they certainly were much more prepared than they were going into the last global financial crisis. They had delevered quite a bit, and as you saw in our outlook, consumers were saving a lot. The recent fiscal stimulus further bolstered U.S. consumers and their propensity to save. They haven't necessarily gone out and spent those dollars, and in our view, there is a tremendous amount of pent-up demand from U.S. consumers.

In 2021 we expect 4%-5% GDP growth to further improve the labor market recovery and potentially full employment by the end of 2021. So, as quickly as this crisis began, we see it coming back in a V-shaped fashion. We view the fiscal stimulus as enough to get us to the finish line of herd immunity and getting the U.S. economy back on track to rival growth that we saw in the late 1990s.

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We felt, even if the U.S. consumer were to fall under more undue pressure by not passing additional stimulus, the collateral value that backs the auto ABS were improving in a dramatic V-shaped fashion. Consumers not only bought homes to escape the ills of the COVID crisis, but they also bought cars. Our allocation targets were consistent going into the COVID crisis, but that gives you a sense of how we thought of it coming out.

CMBS is an area we actually decreased the allocation after the COVID-related volatility. Commercial real estate is a sector where we have concerns about the integrity of the long-term leases in areas like retail, which was a concern for us prior to COVID; office, given the acceptance of the work-from-home environment; and hospitality, which has been particularly hard hit. Prior to COVID we were biased towards being up in quality in CMBS. Post COVID we not only maintained our up in quality bias, but we have predominantly targeted agency-backed CMBS in the post-COVID environment.

TWST: I was looking at your mid-year review, and I believe you mentioned that one of the things bolstering U.S. borrowers was monetary policy, including forbearance programs. Can you elaborate more on what's bolstering the U.S. borrowers?

Additionally, there were a whole host of mitigants and programs we feel really helped stave off the worst. A lot of credit goes to Chairman Powell and other policymakers who utilized some of the tools built after the global financial crisis. They implemented a lot of these tools, not only swiftly but immediately.

For example, it took years to implement foreclosure moratoriums after the global financial crisis, whereas during the COVID crisis they were implemented immediately. This has been very supportive to U.S. housing. In addition to foreclosure moratoriums, accommodative Fed and fiscal policy has allowed consumers to restructure their debt obligations and servicers to immediately apply battle-tested loss mitigation strategies learned after the global financial crisis. We think it is going to be hugely supportive for consumer and mortgage credit as we look forward into 2021 beyond the pandemic.

TWST: Are the investments you have in the fund helped by the fact that many lending institutions had to change their ways post-financial crisis, as in the banks having had to be stress tested and so forth? How much is that a factor in your analysis?

Mr. Dunlap: Absolutely, as a result of Dodd-Frank, risk-retention was required for most structured credit products. That's otherwise known as “skin in the game.” If you are going to sponsor a securitization, you need to have “skin in the game” or ownership of a percentage of a sponsored deal. This is very important to maintain the integrity of the collateral underwriting process, which clearly had problems in the last global financial crisis.

If you look specifically at mortgage credit, the Dodd-Frank Act improved the integrity of residential mortgage origination, not only requiring risk-retention, but restructuring the entire mortgage origination process. We felt as bondholders this was very important, as it dramatically improved the quality of the underlying collateral. Not only were the actual mortgage loans higher quality from an underwriting perspective, but there was a tremendous amount more of credit enhancement and/or protection that came as a result of the last global financial crisis in areas like RMBS, ABS, CMBS and CLOs.

Bond investors clearly learned from prior mistakes in the last crisis, and regulators really homed in on improving the integrity of the underwriting in areas like RMBS and ABS, and we believe bond investors are going to be pleasantly surprised with how well areas of RMBS and consumer ABS perform throughout this COVID crisis.

TWST: Is there anything else you wanted to say about the macro trends you see going forward, even any contrarian views you might have about them as the CIO of the firm?

Mr. Dunlap: A big theme for 2021 is growth will be brisk in the months ahead, and the perennial fear of rising long-term rates is now actually becoming much more realistic. With the Fed on hold until at least 2023, high-quality income opportunities are becoming scarce. Not only will areas of high current income within U.S. structured credit be an excellent income complement for investors, but they often come with much less interest rate sensitivity. They are shorter duration products, which we think will be critical in 2021.

We think long-term interest rates are susceptible to rising even with the Fed’s commitment to QE4. That is going to pressure traditional fixed income, particularly areas in investment-grade corporate bonds with a tremendous amount of interest rate sensitivity. In fact, duration for the Bloomberg Barclays U.S. Corporate Bond Index is at historic highs while its yield is near all-time lows.

What is unique about structured credit is you still have a higher current income opportunity, with much less interest rate sensitivity. We believe that profile is going to be critical from a performance perspective in 2021. We would encourage investors looking for income to seek the higher quality alternatives and shorter duration products which U.S. structured credit offers.

TWST: Thank you. (KJL)

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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.

CBOE SPX Volatility Index (VIX): A key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices.

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.

It is not possible to invest directly in an index.

Diversification does not guarantee a profit or protect from loss in a declining market.