Structured Credit in Modern Portfolio Management

Clayton Triick, CFA®
January 2016

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Clayton Triick, CFA®
Portfolio Manager
Angel Oak Capital Advisors

- Serves as a Portfolio Manager for Angel Oak Capital Advisors and of the Flexible Income Fund where he focuses on portfolio analytics and fixed income strategies.
- Manages specific strategies within the mutual funds, private funds, and SMA’s, specifically within structured credit and non-agency mortgage bonds.
- 7 years of investment experience across multiple sectors of fixed income.
- Degree in Finance from the Farmer School of Business at Miami University in Oxford, OH, also holds the Chartered Financial Analyst (CFA®) designation.

For more information on our strategies, please contact:

Robert Razzolini
Managing Director, Southern Region
robert.razzolini@angeloakfunds.com
Phone: 770.843.4208

Lu Chang, CFA®, FRM, CAIA
Chief Risk Officer
Angel Oak Capital Advisors

- Chairs the firm’s Risk Management Committee and Valuation Committee, as well as serves as the secretary of the Investment Committee.
- Before joining Angel Oak, she spent over 10 years at Wells Fargo (and legacy Wachovia) across multiple risk management and investment research functions. Her most recent role was a finance manager at corporate treasury focusing on corporate-wide liquidity risk.
- Previously, she served as a senior research analyst at Evergreen Investments, performing fund due diligence for fund of hedge funds, managed futures, real estate, and commodity funds on a $5 billion alternative investment platform.
- Ms. Chang holds a B.A. in Finance from Wuhan University, an M.A. in Sociology from University of Oklahoma, and an M.B.A from College of William and Mary, where she graduated with distinction, Beta Gamma Sigma. She holds the Chartered Financial Analyst, the Financial Risk Manager, and the Chartered Alternative Investment Analyst designations.
Angel Oak Overview
Angel Oak Overview

Potential Competitive Advantages of Our Firm

Experience Across Varying Market Cycles

- Relative value fixed income specialists with successful seven-year track record in structured credit management
- Disciplined investment focus on a high quality subset of the non-agency RMBS, CMBS, and CLO markets
- Experience managing traditional multi-billion dollar RMBS, CMBS, and CLO portfolios
- Investment experience in the post-crisis cycle (distressed and opportunistic)

Pragmatic Approach

- Flexibility to customize portfolios to target investor-defined investment objectives
- Expertise across the mortgage-backed spectrum of origination, servicing, securitization, credit analysis and portfolio management
- Qualitative and collaborative approach to investment decision-making
- Strong, diverse industry relationships to facilitate security sourcing and trade execution, supporting alpha creation

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<th>Year</th>
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<th>Event</th>
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<tr>
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<tr>
<td>2009</td>
<td>$87 M</td>
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<td>2010</td>
<td>$145 M</td>
<td></td>
</tr>
<tr>
<td>2011</td>
<td>$200 M</td>
<td>Jun '11: Launched Angel Oak Multi-Strategy Income Fund</td>
</tr>
<tr>
<td>2012</td>
<td>$1.3 B</td>
<td>Aug '12: $310MM SMA</td>
</tr>
<tr>
<td>2013</td>
<td>$3.2 B</td>
<td>Aug '13: Successfully closed Series A $300MM SMA</td>
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<tr>
<td>2014</td>
<td>$4.4 B</td>
<td>Nov '14: Successfully closed Debt Recovery Series B</td>
</tr>
<tr>
<td>2015</td>
<td>$6.0 B</td>
<td>Nov '14: Launched Angel Oak Flexible Income Fund</td>
</tr>
<tr>
<td>Feb '15</td>
<td></td>
<td>Crossed $4.5 Billion in Mutual Fund Assets</td>
</tr>
<tr>
<td>Aug '15</td>
<td></td>
<td>Flexible Income Fund Crosses $400 Million in Assets</td>
</tr>
</tbody>
</table>
Angel Oak Overview

As of 9/30/15

Agency MBS, Corporate and ABS
$630 million (11%)

CLOs
$1.3 Billion (22%)

CMBS
$915 million (15%)

Whole Loans
$190 million (3%)

Cash
$135 million (2%)

Non-Agency RMBS
$2.8 billion (47%)

Angel Oak Overview

Mutual Funds
$5.1 billion (85%)

Limited Partnerships
$270 million (5%)

Separately Managed Accounts
$600 million (10%)

Agency MBS, Corporate and ABS
$630 million (11%)

As of 9/30/15

Angel Oak Capital Advisors, LLC
Current Landscape
**TIGHTER SPREADS AND INCREASED RATE RISK**

Spreads on traditional fixed income are back to pre-crisis levels
- Traditional fixed income offers investors minimal protection from an increase in interest rates

Lower rate volatility and all-time lows in interest rates and company’s costs of capital have increased interest rate risk across traditional fixed income
- Lower prepayment speeds on agency mortgages has extended current coupon durations

**Spreads Back to Pre-Crisis Levels**

Source: Bloomberg

**Interest Rate Risk on the Rise**

Source: Bloomberg
TIGHTER SPREADS AND INCREASED RATE RISK

Global search for yield has pushed investors out the risk curve.
- High yield spreads are flirting with historically rich levels
- HY corporate net issuance has increased substantially in the post-crisis period
- Total HY corporate bonds outstanding increased from $890 billion to approximately $1.4 trillion
High Yield Credit – Implied Losses

Source: JPMorgan
Average Pro-Forma for Large Corporates

Source: BofA Merrill Lynch Global Research
As of 3/31/15

Debt/EBITDA
Senior Secured/EBITDA
EBITDA-Mainten. Capex/Cash Int.
EBITDA-Capex/Cash Interest

Source: BofA Merrill Lynch Global Research
As of 3/31/15
Tightening Cycles & Longer-Term Rates

Period: 1/31/94 - 2/28/95
Length: 14 months
10 year Treasury: 156 bps higher
Fed Funds: 300 bps higher

Period: 6/30/99 - 5/31/00
Length: 12 months
10 year Treasury: 49 bps higher
Fed Funds: 150 bps higher

Period: 5/31/04 - 6/30/06
Length: 26 months
10 year Treasury: 49 bps higher
Fed Funds: 425 bps higher

Source: Bloomberg
As of 12/31/15
Structured Credit
Securitization is the process of pooling financial assets to create tradable securities. The first financial products to be securitized were home mortgages, followed by commercial mortgages, credit card receivables, auto loans, student loans and other financial assets.

Bonds backed by financial assets fall into a broad category called asset-backed securities (“ABS”); bonds backed by mortgages are a subcategory called mortgage-backed securities (“MBS”). For the purposes of this paper, we refer to both types of bonds inclusively as “securitized products.”

Structured credit is a subsector of securitized products that are credit-intensive and normally have more complex structures. Structured credit originations are usually placed in the private market, unlike agency MBS, which are always issued as public securities. Chart 1 shows the typical structure of a structured credit instrument.

Structured credit instruments typically have three types of tranches:

1. Senior tranches, which provide the best credit quality but typically offer the lowest yield
2. Mezzanine tranches, which are subordinate to the senior tranches but superior to the equity tranches, and tend to fall somewhere in the middle with regard to both credit protection and yield
3. Equity tranches, which sit at the bottom of the subordination waterfall, paying the highest yield but bearing the first risk of loss
Growth of the Securitized Market

Even though the first securitized product was created in 1987, the sector remained fairly obscure until 2000. In the subsequent decade, this market experienced substantial growth as origination and demand steadily increased. Since the beginning of 2000, the face value of the securitized product market has more than tripled, as shown in Chart 2.

Several factors were responsible for much of this impressive growth including:

**Inherent advantages of securitization:**
Securitization may allow entities to reduce their financing costs, diversify their funding sources, originate additional loans and accelerate earnings.

**Strong global demand for fixed income investments:**
From 2000 to 2007, the amount of money invested in worldwide fixed income investments roughly doubled, yet the supply of traditional fixed income investments did not increase in step with demand, leading to higher bond prices and lower investment yields. Investment banks on Wall Street answered this demand with financial innovations such as MBS and CDOs, to which credit rating agencies then assigned ratings.

**Low interest rates:**
Because U.S. Treasury bonds have had such a low yield, global investors demanded alternative investments that offer a higher yield with what they perceived as a similarly remote credit risk (AAA rated). Subprime mortgage-backed CDOs were among the investment products created to fill this need. Investors’ search for yield led many of them to purchase structured credit securities.

**Pricing models:**
More sophisticated pricing models allowed for rapid pricing of structured credit and improved the liquidity of these securities.
US Structured Credit Markets (Excluding Agency RMBS) are $2.4 Trillion In Size:

Chart 3: Size of Select U.S. Fixed Income Market as of 11/30/2015
- Securitized Product: Agency RMBS/CMOs: $5.2 T
- Securitized Product: HY Corporate Bonds: $1.4 T
- Securitized Product: Leveraged Loans: $0.9 T
- Securitized Product: Structured Credit (ex-Agency RMBS): $2.2 T

Chart 4: Structured Credit Market as of 11/30/2015
- ABS: $439.1 B
- CDOs: $177.3 B
- CLOs: $418.9 B
- Non-Agency RMBS: $668.5 B
- Non-Agency CMBS Fixed: $466.9 B

Source: Bank of America Merrill Lynch Global Research

Finding value and dislocations across the structured fixed income markets:

→ Non-Agency Residential Mortgage-Backed Securities (RMBS)
→ Collateralized Loan Obligations (CLO)
→ Commercial Mortgage-Backed Securities (CMBS)
Fixed income is a core component of institutional investment portfolios, such as insurance companies, endowment funds and mutual funds. However, not all fixed income is created equal. In response to the 2008 credit market crisis, the Federal Reserve (“Fed”) intervened in many fixed income markets through a variety of programs, including quantitative easing (“QE”), which focused on the U.S. Treasury and agency mortgage markets. The Fed’s support, coupled with the subsequent market recovery, has resulted in historically low yields for government-issued and government-backed securities.

The search for alpha is one of the reasons why active managers tend to underweight government bonds in favor of nontraditional sectors. Experienced portfolio managers generally see more opportunities to generate alpha in the following fixed income subsectors:

- More credit-intensive asset classes
- Issues with complex structures
- Private markets

Angel Oak Capital Advisors, LLC (“AOCA”), is a structured credit specialist that embraces and applies the above investment thesis to identify and pursue investment opportunities within structured credit. AOCA’s flagship fund, Angel Oak Multi-Strategy Income Fund (“ANGLX”), is a multi-strategy portfolio that encompasses many structured credit asset classes, including non-agency RMBS, CMBS, CLOs and ABS. Chart 5 is a snapshot of the fund’s asset allocation as of Nov. 30, 2015.
The application of Modern Portfolio Theory (“MPT”) became more widespread in the late 1970s and throughout the 1980s, resulting in balanced portfolios of equity, fixed income, and cash. In this context, fixed income provided coupon income and dampened the volatility associated with equity markets. Thus, many institutional investors adopted the classic 60/40 equity/fixed income allocation.

Over the recent years, structured credit has had a low correlation to both equity and fixed income (see Chart 7). As such, we hypothesize that structured credit is not a fixed income subsector but rather a separate asset class within a portfolio allocation model.

<table>
<thead>
<tr>
<th></th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
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<tbody>
<tr>
<td>ANGLX</td>
<td>1.0</td>
<td></td>
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<tr>
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<td>0.4</td>
<td>1.0</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>IG</td>
<td>0.4</td>
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<td>0.1</td>
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<td>0.2</td>
<td>0.9</td>
<td>-0.2</td>
<td>1.0</td>
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</table>

*calculated monthly
Structured Credit in an Equity/Fixed Income Portfolio

Chart 8: Efficient Frontiers A and B

Portfolio B:
60% Stock, 24% Bond,
16% Structured Credit

Portfolio A:
60% Stock,
40% Bond

Based on data: 6/30/11 – 11/30/15

Performance quoted is past performance and is no guarantee of future results. Current performance may be lower or higher than the performance data quoted. The investment return and principal value of an investment in the Fund will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance to the most recent month end can be obtained by calling 855-751-4324.
## Structured Credit in an Equity/Fixed Income Portfolio

### Efficient Frontier A: Equity and Fixed Income Only Portfolio

<table>
<thead>
<tr>
<th>Portfolio Allocation:</th>
<th>Historical Return</th>
<th>Standard Deviation</th>
<th>Sharpe Ratio</th>
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<tr>
<td>S&amp;P 500</td>
<td>Barclays Agg.</td>
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<tr>
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<td>0%</td>
<td>3.3%</td>
</tr>
<tr>
<td>10%</td>
<td>90%</td>
<td>0%</td>
<td>4.4%</td>
</tr>
<tr>
<td>20%</td>
<td>80%</td>
<td>0%</td>
<td>5.5%</td>
</tr>
<tr>
<td>30%</td>
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<td>6.6%</td>
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<td>7.7%</td>
</tr>
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<td>50%</td>
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<td>0%</td>
<td>8.8%</td>
</tr>
<tr>
<td>60%</td>
<td>40%</td>
<td>0%</td>
<td>9.9%</td>
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<tr>
<td>70%</td>
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<tr>
<td>80%</td>
<td>20%</td>
<td>0%</td>
<td>12.1%</td>
</tr>
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</table>

### Efficient Frontier B: Equity, Fixed Income and Structured Credit Portfolio

<table>
<thead>
<tr>
<th>Portfolio Allocation:</th>
<th>Historical Return</th>
<th>Standard Deviation</th>
<th>Sharpe Ratio</th>
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</thead>
<tbody>
<tr>
<td>S&amp;P 500</td>
<td>Barclays Agg.</td>
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<tr>
<td>0%</td>
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<tr>
<td>80%</td>
<td>2%</td>
<td>18%</td>
<td>13.2%</td>
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</table>

Based on data: 6/30/11 – 11/30/15

Past performance does not guarantee future results.
Structured Credit in a Fixed Income Only Portfolio

Chart 9: Efficient Frontier C

Historical Return

Portfolio C:
60% Bond,
40% Structured Credit

Standard Deviation

Based on data: 6/30/11 – 11/30/15
Past performance does not guarantee future results.

Angel Oak Capital Advisors, LLC
### Efficient Frontier C: Fixed Income and Structured Credit Portfolio

<table>
<thead>
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<th>Barclays Agg.</th>
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<th>Historical Return</th>
<th>Standard Deviation</th>
<th>Sharpe Ratio</th>
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<td>3.9%</td>
<td>2.7%</td>
<td>0.63</td>
</tr>
<tr>
<td>80%</td>
<td>20%</td>
<td>20%</td>
<td>4.5%</td>
<td>2.7%</td>
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<tr>
<td>70%</td>
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<td>60%</td>
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<td>40%</td>
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<td>6.9%</td>
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<td>100%</td>
<td>9.3%</td>
<td>4.7%</td>
<td>1.53</td>
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</table>

Based on data: 6/30/11 – 11/30/15

Past performance does not guarantee future results.
The Next Opportunity
The Next Opportunity

Non-bank lenders can fill the void:
• Banks no longer have the skill set required to underwrite non-agency mortgages
• Good credits are left behind because they fall outside the current credit parameters
• Opportunities exist to offer credit to strong borrowers at very compelling risk/return parameters

New origination focus has a very favorable risk profile:
• Credit driven underwriting
• High current coupon fixed rate and hybrid mortgages
• Not reliant on underlying property appreciation and recovery – low LTV at current home prices
• Emphasis on short duration mortgages

Specialized investor skill set requirements:
• Deep understanding of mortgage markets and associated regulatory constraints
• Proprietary default / pre-payment analysis
• Models based on 400,000 vintage home loans, to estimate default rates, voluntary prepayments and loss severities of non-agency residential mortgage bonds; purchases / origination in the program will be analyzed with this proprietary model
The Next Opportunity

SAMPLE ORIGINATION – “JUST MISSED JUMBO”

<table>
<thead>
<tr>
<th>Loan Size</th>
<th>DTI</th>
<th>FICO</th>
<th>LTV</th>
<th>CLTV</th>
<th>Coupon</th>
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</thead>
<tbody>
<tr>
<td>$1,021,650</td>
<td>25.99%</td>
<td>690</td>
<td>64.25%</td>
<td>72.47%</td>
<td>6.56%</td>
</tr>
</tbody>
</table>

- A large number of requests for jumbo loans from “well-qualified” borrowers are not fulfilled because the borrower credit profile falls just outside of today’s tight credit box.
- Common reasons they fall outside of today’s requirements are:
  - Credit score; and
  - Income documentation required for self-employed borrowers
- Mortgage loans are 30-year amortizations and can be offered as 30-year fixed or a 5 or 7 year ARM.

SAMPLE ORIGINATION – THE NEW ALT-A / SUP-PRIME

<table>
<thead>
<tr>
<th>Loan Size</th>
<th>DTI</th>
<th>FICO</th>
<th>LTV</th>
<th>CLTV</th>
<th>Coupon</th>
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<tr>
<td>$224,147</td>
<td>36.67%</td>
<td>655</td>
<td>72.48%</td>
<td>72.48%</td>
<td>9.55%</td>
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</table>

- The most common borrower profile for this product is an individual with a one-time credit event (Bankruptcy, Foreclosure, Short Sale) that prohibits them from qualifying for conventional or government financing due to the waiting periods associated with the credit event. Waiting periods typically range from 3-7 years depending upon the individual circumstances.
- Typically structured as a 30-year fixed rate mortgage.
Traditional fixed income valuations are back to pre-crisis levels

Current opportunity set heading into a rising interest rate environment: Wide spreads and relative value are available within the structured credit markets.
- Non-Agency RMBS
- CLOs
- CMBS
- ABS
- Agency RMBS toward the latter end of the interest rate cycle

The Next Opportunity: Private securitization in housing will return in the US but will look much different than the prior cycle
Portfolio Construction in the Current Environment

- High current income; 4-6% potential current income yield
- Low duration and low volatility; can position a portfolio with a rate duration of 1-3
- Positioned for a rising rate environment; low rate duration with potential spread compression
- Taking advantage of an improving credit economy
- Investment with upside

- Seek potential protection from an inflationary spike
- Seek to benefit from improving refinance activity (especially in Adjustable Rate Mortgages)
- Asset Allocation
  - Overweight NA CMO over CMBS and CLOs
  - Overweight floating over fixed
  - Overweight Alt-A over prime and subprime

NA CMO Collateral Type

- Prime: 68.5%
- Alt-A: 26.3%
- Subprime: 5.2%

Floating vs. Fixed

- Fixed: 60.8%
- Floating: 39.2%

Asset Allocation

- NA CMO: 62.6%
- CMBS: 19.7%
- CLO: 12.7%
- ABS: 2.8%
- Preferred: 1.6%
- Cash: 0.1%
Index Performance

Multi-Strategy Income Fund Performance:

<table>
<thead>
<tr>
<th>Fund Type</th>
<th>Total Returns (as of 12/31/15)</th>
<th>4Q 2015</th>
<th>YTD</th>
<th>1 Year</th>
<th>3 Years</th>
<th>Inception</th>
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<tr>
<td>Class I</td>
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<td>2.01%</td>
<td>2.01%</td>
<td>3.88%</td>
<td>8.95%</td>
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<tr>
<td>Class A at NAV</td>
<td>-0.40%</td>
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<td>3.69%</td>
<td>8.75%</td>
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<td>Class A at MOP</td>
<td>2.63%</td>
<td>-0.64%</td>
<td>-0.64%</td>
<td>2.90%</td>
<td>8.20%</td>
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<tr>
<td>Barclays US Agg Bond TR USD</td>
<td>-0.57%</td>
<td>0.55%</td>
<td>0.55%</td>
<td>1.44%</td>
<td>2.94%</td>
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Angel Oak Multi-Strategy Income Fund Expense Ratios by Share Class

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<tr>
<th></th>
<th>Class A</th>
<th>Class I</th>
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<tbody>
<tr>
<td>Gross</td>
<td>1.65%</td>
<td>1.20%</td>
</tr>
<tr>
<td>Net</td>
<td>1.24%</td>
<td>0.99%</td>
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*Gross expense ratios for the A Class and the Institutional Class are reported as of the 5/31/15 prospectus. The Adviser has committed contractually to waive fees and/or reimburse expenses so that net annual fund operating expenses do not exceed certain levels through 5/31/16 and may be discontinued at any time by the Fund’s Adviser after 5/31/16.

References to other funds should not be considered and offer for these securities.

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

Mutual fund investing involves risk. Principal loss is possible. The Funds can make short sales of securities, which involves the risk that losses in securities may exceed the original amount invested. Leverage, which may exaggerate the effect of any increase or decrease in the value of securities in a Fund’s portfolio on the Fund’s Net Asset Value and therefore may increase the volatility of a 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. Derivatives involve risks different from and, in certain cases, greater than the risks presented by more traditional investments. Investments in asset-backed and mortgage-backed securities include additional risks that investors should be aware of, such as credit risk, prepayment risk, possible illiquidity and default, as well as increased susceptibility to adverse economic developments. Investments in lower-rated and nonrated securities presents a greater risk of loss to principal and interest than higher-rated securities. A non-diversified fund, may be more susceptible to being adversely affected by a single corporate, economic, political or regulatory occurrence than a diversified fund. Funds will incur higher and duplicative costs when it invests in mutual funds, ETFs and other investment companies. There is also the risk that the Funds may suffer losses due to the investment practices of the underlying funds. For more information on these risks and other risks of the Funds, please see the Prospectus.

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

Fund holdings and allocations are subject to change at any time and should not be considered a recommendation to buy or sell any security. Opinions expressed are as of 12.31.15 and are subject to change at any time, are not guaranteed, and should not be considered investment advice.

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

Angel Oak Capital Advisors, LLC
Angel Oak Capital Advisors is located in Atlanta, GA and New York, NY. To learn more about the Angel Oak Funds, speak with a member of our investment team, receive monthly investor updates, or schedule a face-to-face meeting, please contact us at:

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