



Dear Clients:

It's been six years since we started Zeo Capital Advisors. A lot has changed in that time, but one thing that hasn't is our focus on consistency. It is our belief that the repeatability of an investment strategy that seeks to preserve capital requires an approach to risk management that doesn't rely on a directional view that may turn out to be wrong. Rather, repeatability is, in our opinion, a by-product of consistency of an investment process that is applicable regardless of the market environment. We believe the longevity of a business is similarly dependent on consistency in both our portfolios and our business decisions as judged by our clients.

## **Our First Quarterly Letter**

For those readers who are clients of Zeo, you will recognize our philosophy that fit with our clients is paramount. From that principle have come a plethora of business decisions which have shaped our firm. It is our view that the truest path to a long-term business is to know who you serve and to serve them well. As applied to a growing firm, there is a corollary mandate that the objectives of new clients be compatible with those of existing clients. Furthermore, we believe our firm should engage with our clients in a way that is consistent with how we manage our business and our portfolio.

We take pride in the fact that our clients use our strategy in a variety of ways which are aligned with the long-term focus of our investment approach. Our portfolio is designed to behave independently of daily, weekly or even monthly headlines. That is not to say our strategy is immune to market movements, but those movements in short timeframes don't usually alter the underlying fundamentals of the companies in which we invest.

The same holds true for our perspectives on the markets. In our previous commentaries, we have frequently pointed out that most market activity observed on a monthly basis is not an indication of how one should position to profit from the direction of markets. Rather, the only conclusion we can reach with confidence is that capital preservation comes from positioning a portfolio in an effort to achieve its goals regardless of the uncertainty that surrounds us. More conclusive and actionable analysis requires that we identify patterns in these market observations, but that in turn takes more time.

In an effort to strike a better balance between the longer-term nature of our thoughts and the more frequent access, insights and transparency for which we are known, we are transitioning to provide our commentary as a quarterly letter to our readers. We are constantly striving to achieve consistency across our firm, from business management to portfolio strategy to client engagement. We believe this is one more step in doing so. We look forward to hearing your thoughts and feedback.



## Saying “No” to Good Companies

Managing a portfolio of shorter duration<sup>1</sup> bonds means we are often looking to reinvest the proceeds from redeemed investments into new positions. Sometimes we are able to roll our old investment into another bond or loan of the same company. Once we find a company that we like, why not stay invested? Alliance Healthcare and Mueller Water are two recent examples of companies for which we carried out our due diligence and bought debt, and when the company refinanced our holding, we reinvested into new securities of each company.

However, this has not been the case this past quarter. New issuance of corporate bonds remained strong. High yield bond investors continued to be price takers, unafraid of increasing levels of financial leverage in the average deal. Two of our recent holdings, DAE Aviation (aircraft engine repair and overhaul) and Blue Coat Systems (cybersecurity software), were in the market with new syndicated loans to refinance existing debt. We have been invested in both of these companies for some time. We believe they are good, stable companies that had manageable levels of debt compared to profitability and cash flows.

The refinancing for each company resulted in such meaningful increases in financial leverage that we could not justify buying the new deals. In the case of DAE Aviation, the leverage as measured by the ratio of debt to cash flow increased from 4x to over 7.5x under the new debt package. Blue Coat leverage went beyond 8x depending on how many adjustments you want to make to pro-forma earnings – a discussion for another day.

We passed on the new versions of these loans because of the obvious increase in risk associated with the balance sheets. The market digested these new deals with exuberance, probably with the rationale that the higher leverage is not a risk since there is significant “equity cushion” behind the bonds. “Equity cushion” is measured based on equity valuation multiples prevalent in today’s market. We can leave it up to the reader to decide if equity values are fairly priced at the moment. But as long as stock markets retain their existing valuations, deals like these will continue to be financed.

We have a choice not to accept this risk. It pains us to have to pass on what we strongly believe are great companies just because of aggressive financial leverage. However, sometimes, one has to say “no” to good companies. It’s perhaps the hardest decision a fundamental investor makes.

## Our Approach to Volatile Markets

We continue to believe that there will be significant volatility in the markets in the near future. Just when that will happen is best left to the managers with clearer crystal balls than ours, but we are already seeing signs of volatility that could prove systemic rather than temporary. But what does one do with such an outlook? Volatility to some investors is an

<sup>1</sup> Duration is a measure of the sensitivity of the price of an investment to a change in interest rates.



opportunity to react to fluctuations in the market. For the strategy that makes tactical market decisions on a daily or weekly basis, it is entirely appropriate and likely essential to evaluate short-term market behaviors with the explicit goal of reaching an actionable conclusion.

However, that is not the way we manage our strategy. In our approach to achieving longer-term stability of capital, such an effort is unnecessary at best and harmful in many situations. That is not to say that we don't evaluate the impact of the additional data on our holdings, but we explicitly avoid the mindset that each data point is a call to action. Our objectives mirror our experience that, to deliver a true fixed income risk profile, a portfolio must embrace uncertainty and should not hinge on being on the right side of a directional view on interest rates or any other market factor. What happens in any given week or month, while interesting and additive to our overall investment process, is less relevant than the effort to maintain a consistent risk profile, an effort that is inherently subject to less frequent revision.

When considering that we don't alter our portfolio approach based on economic factors, understanding how our expectations of increased volatility will affect our strategy becomes a question of opportunity and risk management rather than one of portfolio trading. Our portfolio is one that is always in need of securities to purchase due to the short-term nature of our holdings – we are always receiving cash for bond maturities and redemptions. Despite recent volatility, we have noticed fewer bond offers than we saw during previous periods of similar movement, possibly due to an aggressive rotation into short duration credit by ETF investors. We are reinforcing our usual focus on off-the-run securities (including syndicated loans and non-benchmark bonds) to mitigate these challenges.

In doing so, even in recent market choppiness, we have seen interesting entry points for the bonds we seek to buy, but yields have not yet widened much, so our participation is cautious. We are targeting a slightly-higher-than-usual cash balance to have dry powder when those entry points become the rule rather than the exception. With the markets continuing to whip around, we expect that opportunity may be right around the corner.

As always, we are available for your questions, comments or feedback. We thank you for your continued support and confidence in our management.

Sincerely,

Venkatesh Reddy  
Chief Investment Officer

Bradford Cook  
Portfolio Manager



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