Dear Clients:

You do not need to look hard to find market commentary highlighting fear and worry over liquidity in corporate bond markets. We can understand why. The low interest rate environment has driven new participants into corporate debt and led to record levels of new bond issuance. Some of the new participants are yield[1]-starved investors seeking income. Others are traders that focus on tactical models, momentum and leveraged strategies. It is reasonable to assume that most of these new participants are likely short-term investors. Many will turn seller when central banks raise rates. It is this exodus of temporary high yield investors which is the focus of the worry over the state of the credit markets. We don't necessarily dispute these concerns, but it does seem that liquidity risk has evolved into a culprit of convenience, an attractive red herring to comfort analysts, regulators and media that "The Risk in the Market" has been identified. We caution investors not to be as easily distracted.

What is Liquidity?

When we talk about liquidity risk, we are talking about the loss or haircut that a bond holder will realize when forced to sell. This loss is exacerbated in steep sell-offs, and the resulting volatility is often mischaracterized as illiquidity. In an effort to mitigate this risk, it is a common strategy in credit markets to transact in larger, well known bond issues that trade frequently because they are more liquid. Many investors equate liquidity with large, frequently traded bonds. By this measure, Sprint Corp's $2.25 billion 7.25% notes would be more liquid than, say, Lions Gate's $225 million 5.25% notes. Readers can probably guess which one of these two bonds is held by the large high yield exchange traded funds (ETFs)[2].

We believe issue size and frequency of trades will turn out to be poor indicators of liquidity if the market goes through a dislocation. These are backward looking metrics and not likely indicative of what happens when the temporary high yield investors head for the exits, selling out of passive vehicles like ETFs as they go. Contrary to what pundits say, we believe that these large "liquid" bond issues could be where much of the loss realization will be concentrated. In short, these bonds may not hold their value when the market needs it the most.

Furthermore, just because a bond does not frequently trade does not mean there is a

1 Yield is the return an investor will realize on a bond purchased at the market price and held until its expected redemption date.

2 An exchange-traded fund is a type of investment company traded on an exchange whose investment objective is to achieve the same return as a particular market index. ETF's are subject to specific risks, depending on the nature of the underlying strategy of the fund. These risks could include liquidity risk, sector risk, as well as risks associated with fixed income securities, real estate investments, and commodities, to name a few.

lack of demand. We can point to several bonds where we and other existing holders are keen to own more, and our frustration in recent volatile markets has come not from too much supply but from the fact that no sellers can be found. This is a counterintuitive concept to those not immersed in analyzing and trading such bonds daily. A recent example of this type of supply/demand imbalance can be found in a new bond issue from Scotts Miracle-Gro, maker of fertilizer and poisons. The company, which has a strong credit profile, marketed a new $300 million bond for which there were $2.3 billion of orders to buy. Not all of that demand is likely to be there in a sell-off, but there should be more support than in the case of a company that lets its bankers sell as much debt as the market can digest, regardless of the resulting leverage (see Sprint vs. Lions Gate above).

Further stoking liquidity fears is news that dealers are stepping back from using their balance sheets to hold corporate bonds. Based on statistics from the Federal Reserve Bank of New York, primary dealers' inventory of corporate bonds peaked at $235 billion in October 2007 and decreased to only $13 billion in September 2015. There was a sharp decline in inventories during the financial crisis as dealers joined in on the sell-off, and because of new bank regulations, these inventories continued to fade rather than snap back.

There is a constant stream of commentary from media and prominent fund managers practically shouting about liquidity risks stemming from lack of dealer involvement. We think this commentary is missing the point. From our experience in prior credit default cycles, dealers were hardly ever there to use their balance sheet to support liquidity in a sell-off. They actually made it worse as they sold alongside funds. Low dealer inventories may actually be healthy for the market. Starting from a low point in their inventories, dealers may not be competing with funds to liquidate positions in a meltdown. Maybe, with less cluttered balance sheets, some capacity even exists for dealers to provide a liquidity bid when some need it most. Perhaps we need to consider who is doing the shouting – large funds with large positions in less desirable credits (like energy bonds) that are struggling to find bids as they face investor redemptions.

The Hidden Cost of Perceived Liquidity

Even so, ETFs have become a popular option for investors, especially for those who are looking to invest in bonds but have the aforementioned concerns about bond market liquidity. After all, the thinking goes, what is more liquid than something that trades on an exchange like a stock? However, the growing use of ETFs and their increasing impact on market activity have brought to light another unintended consequence of their perceived liquidity that warrants a closer look.

Typically, when funds that track indices see asset flows, they must immediately transact in the market. There is usually little leeway for managers of such funds to hold cash balances - inflows usually cause traders to lift offers in their underlying securities, while there is rarely sufficient cash to service outflows without hitting bids in the same securities. This differs from more actively-managed funds which often have discretion to be patient and look for better entry and exit points while providing some latitude on which securities to trade and how much cash to hold.

The ease with which investors can move money into and out of an asset class using ETFs has resulted in significant volatility in the total assets of these funds. This has exacerbated the frequency of "round-trip"[3] trading behavior, with ETF managers sometimes lifting offers and hitting bids in the same securities multiple times over consecutive days. For bond funds, this can be costly - in choppy markets, the bid/offer spread[4] that a trader pays when trading on both sides of the market can be high. We estimate a typical spread in recent months was approximately 0.50% of face value!

Each time an ETF grows and shrinks due to investors who take advantage of the exchange-traded liquidity, traders are paying these hidden transaction costs, which can add up quickly. For example, even when normalizing for changes in the value of the underlying portfolio and controlling for long-term fund AUM trends, we estimate high yield bond ETFs may have cost investors over 1% in hidden transaction fees on an annualized basis in 2015.

It's important to note that we are not suggesting that ETFs are bad investments. We prefer to explore for whom they are appropriate, and more importantly, for whom they are not a fit. If an investor is seeking a short-term way to trade in and out of an asset class, it's difficult to imagine any vehicle easier than an ETF. However, for strategic investors seeking to adjust exposures within an asset allocation, they should be aware that they may be the ones left paying the hidden fees triggered by higher frequency traders.

The Importance of Fit

Volatility can shed light on a variety of issues investors face in the ongoing effort to manage a portfolio. One of the more underappreciated areas of neglect revealed by choppy markets is that of investor fit. Professional investors have long had their performance compared to asset class benchmarks, like the S&P 500[5] or the Barclays Aggregate[6]. But sometimes, such comparisons come at the expense of forgetting the goals of the portfolio in the first place and whether the investments fit those objectives, which often are based more on risk mandates such as capital preservation or low volatility over certain timeframes.

A relentless focus on fit is one of the central tenets of Zeo that governs how we approach

3 A "round-trip" trade is one in which an investor buys a security and then subsequently sells the same quantity of the same security, thus completing the "round trip".

4 A bid/offer spread for a security is the difference between where a security can be sold in the open market (the bid) and where it can be bought (the offer).

5 The S&P 500® Index is an unmanaged composite of 500 large capitalization companies. This index is widely used by professional investors as a performance benchmark for large-cap stocks. You cannot invest directly in an index and unmanaged index returns do not reflect any fees, expenses or sales charges.

6 The Barclays Capital U.S. Aggregate Bond Index covers the USD-denominated, investment-grade, fixed-rate, taxable bond market of SEC-registered securities. The index includes bonds from the Treasury, Government-Related, Corporate, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS sectors. The U.S. Aggregate Index is a component of the U.S. Universal Index in its entirety. Unmanaged index returns do not reflect any fees, expenses or sales charges.

our partnership with our clients. In our case, our clients are often concerned about both volatility and liquidity, but no one is immune to either risk, especially in a steep sell-off. We believe there are ways to better approach this risk than those that have thus far accompanied the cacophony of complaints about liquidity. Active portfolio management, knowing your objectives as an investor (or those of your clients as an advisor or manager) and careful security selection based on fundamental analysis may help reduce liquidity risk in ways that may be more effective than the potentially off-target methods that dominate the conventional wisdom.

We believe owning defensive credits that are in demand by other fundamental investors is a better mitigant against liquidity risk than relying on trade frequency. Additionally, it is our experience that companies with strong credit profiles are often a source of liquidity in the form of bond buybacks in all markets. It is our view that, if one focuses on shorter timeframes to improve fundamental visibility, she can take more direct aim at the risks in her portfolio. This is the approach we take at Zeo.

In the previous quarter, the corporate bond markets were, to use the technical term, kicked in the teeth. We take pride in the muted impact of these markets on our portfolio, and we believe this is due to our focus on short durations and fundamentals. Furthermore, while our portfolio did see minor price declines in some bonds, our yield continued to deliver income that overcame those moves as intended. This enabled us to be opportunistic in declining markets – given the choice to pay yesterday's price or try to capitalize on market weakness for the benefit of our clients, we chose the latter. We recognize that this is only possible because of our focus on fit with our investors, who have a clear understanding of our strategy and our firm. We believe this partnership with our clients puts us and them in the best position to take advantage when such opportunities present themselves again and possibly more frequently going forward.

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

Please remember that past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product (including the investments and/or investment strategies recommended or undertaken by Zeo Capital Advisors, LLC), or any non-investment related content, made reference to directly or indirectly in this newsletter will be profitable, equal any corresponding indicated historical performance level(s), be suitable for your portfolio or individual situation, or prove successful. Due to various factors, including changing market conditions and/or applicable laws, the content may no longer be reflective of current opinions or positions. Moreover, you should not assume that any discussion or information contained in this newsletter serves as the receipt of, or as a substitute for, personalized investment advice from Zeo Capital Advisors, LLC. To the extent that a reader has any questions regarding the applicability of any specific issue discussed above to his/her individual situation, he/she is encouraged to consult with the professional advisor of his/her choosing. Zeo Capital Advisors, LLC is neither a law firm nor a certified public accounting firm and no portion of the newsletter content should be construed as legal or accounting advice. If you are a Zeo Capital Advisors, LLC client, please remember to contact Zeo Capital Advisors, LLC, ***in writing****, if there are any changes in your personal/financial situation or investment objectives for the purpose of reviewing/evaluating/revising our previous recommendations and/or services. A copy of the Zeo Capital Advisors, LLC's current written disclosure statement discussing our advisory services and fees is available upon request.*

The material provided herein has been provided by Zeo Capital Advisors, LLC and is for informational purposes only. Zeo Capital Advisors is the adviser to one or more mutual funds distributed through Northern Lights Distributors, LLC member FINRA/SIPC. Northern Lights Distributors, LLC and Zeo Capital Advisors, LLC are not affiliated entities.

5646-NLD-10/20/2015