Zeo Capital Advisors

Dear Clients:

Observing the markets in the first quarter of 2016 has felt a little like stopping into the local Irish pub on vacation – you know you're in a different place, but it looks awfully familiar.[1] As was the case in 2015, we are beginning the year with significant market volatility, with declines and subsequent recoveries whose magnitudes evoke comparisons to 2008. As was the case in 2015, the energy sector is front and center in taking blame for destabilizing markets. As was the case in 2015, interest rates have started the year in decline, with the 10 Year US Treasury today yielding even less than at this time last year, despite a long-awaited Federal Reserve interest rate hike in December. And as was the case in 2015, even as investors start the year expecting the Federal Reserve to raise interest rates, the timing of a raise is highly unpredictable.[2] In light of these observations, investors will be forgiven for their feelings of déjà vu.

~~Trading~~ *Investing in* Fixed Income

So what have fixed income investors done with the discomforting familiarity of today's environment? Many have reverted to their same outlooks from one year ago. Bulls argue that market declines are buying opportunities. Bears argue that the recent rally in corporate debt is a head fake with the next leg down just around the corner. This rhetoric could very easily pass for a debate about equity markets – the focus on which direction the bond markets are going seems to have as much to do with capturing gains as avoiding losses.

It's important to acknowledge that this behavior is not necessarily sinister. Rather, it is likely the result of a well-meaning if misguided evolution in the way fixed income portfolios are judged. Over the last 30 years, there has been a systemic shortening of time horizons over which investment performance is measured. This trend can be attributed to a variety of factors. For example, the democratization of financial technology has enabled a wellspring of short-term tactical trading strategies that previously were the domain of a handful of well-connected and well-financed broker/dealers. In the equity markets, we can point to the technology boom/bust in 2000 as just one of many market events that caused investors to emphasize short-term gains over long-term fundamentals when measuring equity portfolios.

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1 This comparison only goes so far. After all, we like *Irish pubs.*

2 Despite near certainty by economists and analysts that the Federal Reserve would increase interest rates in 2015, investors suffered through nearly a full year of "will they or won't they" anxiety before the sole interest rate hike of 2015 took place at the last Fed meeting of the year in December. Moreover, the Federal Reserve Board made clear that it did not feel obligated to provide a timeframe or trajectory for future rate increases, leaving the markets with as much uncertainty after the first rate increase as there was before.

And sometimes, a manager's self-proclaimed objectives justify shorter-term metrics, as with hedge funds targeting positive equity-like returns over short timeframe regardless of whether their benchmark indices are up or down.

On further examination, many such examples of shorter time horizons are due to a short-term relative comparison, sometimes as little as one quarter or less, to a target return, a benchmark or an alternative market segment. Such comparisons require that investors prioritize a trader's mindset over an investor's mindset. That is, this trend favors those who make shorter-term trades to profit from directional market moves over those who make longer-term investments in securities whose underlying fundamentals may not be as highly correlated to the market benchmarks. Such lower correlations have even been vilified through the use of the term "tracking error" to describe deviation from a passive index benchmark as a flaw rather than a potential benefit, even when the deviation is due to lower volatility.

Returning to the topic at hand, we question whether this trend toward trading is aligned with the primary objective of most fixed income portfolios. Are short-term benchmark comparisons which drive tactical directional bets helping investors achieve their core fixed income goals? In our conversations with investors, we hear this concern often. The investment thesis behind buying an individual bond is typically to earn a coupon until the bond matures with the expectation that the price will fluctuate but remain relatively stable. A diversified portfolio of bonds, often achieved through a mutual fund, should target the same with the potential for offsetting price fluctuations to deliver even more stability. The next logical extension of this would be a portfolio of bond portfolios (or a portfolio of mutual funds). But why does the success metric change for these latter fixed income allocators? Why does the emphasis shift away from stability in favor of short-term comparisons to a benchmark?

For those who prioritize stability in their fixed income portfolios, in our opinion, the answer lies in the same principle of diversification that investors apply on an almost daily basis to their overall allocations. By seeking to diversify risk profiles within the fixed income funds that they use, investors have the potential to mitigate the impact of any one market move on the overall portfolio, thereby reducing the need to make short-term tactical trades to avoid difficult-to-recover losses. At this point, readers may find this discussion sounding familiar – we discussed a similar topic at exactly this time last year.

Déjà vu indeed.

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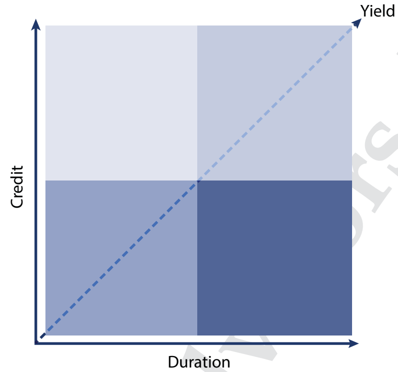
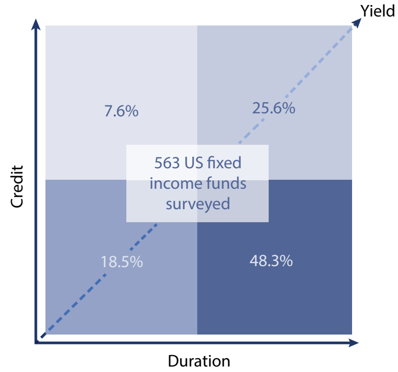
The Risk Less Traveled

Within fixed income, there are two primary risks that drive yields – duration and credit:



In the diagram, the vertical credit axis progresses from investment grade at the bottom to high yield at the top, and duration increases along the horizontal axis. As yield increases along the diagonal, one can expect that additional return comes with additional risk, and in choosing investments, investors are implicitly assorting a portfolio of specific preferred exposures.

To diversify risk, we must first decide which risk factors are overrepresented and which are underrepresented in a given portfolio. To help in this effort, we did a simple analysis of fixed income funds found in the Morningstar database.[3] Of the funds we surveyed, the distribution across the two risk axes presented was as follows:



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3 For simplicity and consistency, we limited our analysis to U.S.-focused taxable funds with traditional fixed income characteristics. We started with all Taxable Bond funds that report duration and credit quality to Morningstar. We excluded Emerging Market Bond funds, World Bond funds, Preferred Stock funds, Stable Value funds and Nontraditional Bond funds. We further narrowed the results to exclude funds that had a negative 3-year performance, which we take to be a sign of a risk profile less consistent with fixed income, and we narrowed the results such that each fund was represented by a single share class. This analysis was done as of 12/31/2015.

Of the four quadrants on the chart, the bottom-left quadrant is where one will find traditional short- and ultrashort-duration strategies that, in the current low interest rate environment, may be having trouble keeping pace with inflation; we believe this makes them suboptimal as core fixed income options. The top-right represents longer-duration, lower-credit-rating high yield bond funds, whose historically high correlations to equities usually limit their presence in fixed income portfolios. The remaining two quadrants represent the most common choices for fixed income investors seeking capital preservation and income.

From these results, it seems reasonable to conclude that shorter-duration high yield bonds tend to be underrepresented among the fixed income options available to investors. We believe the reason for this is because such strategies tend to be fundamentally focused and capacity constrained. Put another way, the average manager has little interest in managing funds that cannot scale. Our continued analysis supports this observation, with over 90% of the funds with a core fixed income profile falling into the bottom-right quadrant (higher credit rating, longer duration) and just 19 of the original 563 funds fitting the bill for core fixed income in the top-left quadrant.[4]

We at Zeo take pride in managing an underrepresented strategy, as we consider our competitive advantage to be one of differentiation. If an investor is seeking to diversify a fixed income portfolio, we suggest a similar exercise to identify if the current holdings are concentrated in one particular fixed income exposure. If so, it may make sense to find those fixed income strategies that seek to deliver comparable core fixed income results in less trafficked ways.

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Avoid Becoming a Fashion Victim

We understand that accepting a portfolio of shorter-duration high yield bonds as an appropriate diversifier for core fixed income is not an easy task for some investors. After all, conventional wisdom assigns a significant increase in risk to bonds rated below investment grade. We feel it would be helpful to provide an example of why such generalizations present opportunities.

Throughout the high yield bond universe, there are examples of companies that have somewhat volatile earnings streams. In the retail apparel sector, for example, there are

4 It is notable that more than half of the remaining 19 funds were dedicated bank loan portfolios, with additional risk factors that may give investors cause for concern due to significant differences between interest rate sensitivity and credit spread sensitivity.

many companies that can be classified as fashion businesses. These are companies whose merchandise is assorted each season according to what they believe is in fashion. If they are wrong about what will be popular, earnings will suffer. This contrasts with basics businesses, which are companies that produce basic clothing for which demand is less volatile. Such companies would include Hanesbrands, Inc.[5], a manufacturer that specializes in underwear,t-shirts and socks. Such apparel has a less elastic demand profile. There is no denying that such a business may still exhibit some cyclicality, and low product costs tend to come with lower margins, but the consistency of the underlying customer (the low cost is less of a deterrent for the jogger who just wore a hole through his running socks) produces a steady and healthy level of cash flow.

Of particular interest are those businesses that contain both fashion and basics characteristics, and we find these patterns throughout the landscape of high yield issuers, not just in the retail sector. One notable example is Lions Gate Entertainment Inc.[5], which has an avid following among equity analysts as a surprisingly consistent hit-maker among film and television production companies. Due to their small size, they have just over $300m in outstanding bonds, which means the company is less followed by credit analysts.

The consequences of this notable difference in analyst attention are meaningful. Lions Gate is a company that appears to be a fashion business, with each quarterly management conference call focused on the success of its latest film or television show. Indeed, this is a fair characterization for the equity investors in the company, as earnings are impacted by hits and misses – a successful box office opening can contribute significantly to the company's short-term bottom line.

However, for the bond holder, a deeper dive into the company reveals a basics business that tends to get ignored by fashion-obsessed equity analysts. From a credit perspective, the impact of a given quarter's movie releases is muted by the significant amounts of high-margin revenue generated by licensing a formidable library of movies and television shows. The net effect: Lions Gate as an overall business has been able to demonstrate consistent profitability, through good times (Hunger Games) and bad (Gods of Egypt). This stability is the foundation of a fundamental investment thesis that favors the reality of credit quality over the optics of credit ratings.

This discussion does not do justice to the depth of analysis required to get past the superficial appearance of risk in an otherwise defensive high yield company, but it should

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5 See important disclosures at the end of this letter.

be an indication of what is possible. Especially in companies whose analysis is dominated by equity analysts whose concerns and sensitivities differ from those of credit analysts, we see an interesting dichotomy. Equity investors in businesses with fashion components tend to be traders, looking to buy or sell in anticipation of a hit or a miss. Fixed income investors in businesses with basics components tend to be investors, seeking to earn a well-supported stream of income from a bond until it matures or is redeemed by the company. The opportunity for investors in companies like Lions Gate lies in uncovering the investment hidden by a trade that is getting all the attention. Sounds a little like the challenge of fixed income investors in today's markets dominated by traders, doesn't it?

Sometimes, familiar feelings are not just déjà vu. Sometimes, they are patterns worthy of further analysis and consideration.

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

Sincerely,

Venk

Brad

Venkatesh Reddy
Chief Investment Officer

Bradford Cook
Portfolio Manager

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Issuer	Security	%
Hanesbrands Inc	HBI 6.375 20	2.9%
Lions Gate Entertainment Corp	LGF 5.25 18	8.4%

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