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ZEO QUARTERLY LETTER: 2Q2016

Dear Clients:

We are living in curious times. We have more data at our fingertips than ever before, and we have more computing power to analyze that data as well. Yet, we also appear to have more uncertainty in our economy and financial markets than even before. As an example, the Fed has demonstrated an admirable focus on data-dependent decisions in their continual effort to manage the money supply. But they appear to have run head first into the intersection of two realities: (1) economic data points don't always draw a straight line, with new measures often contradicting previous ones even if there is a long-term trend; and (2) today's investors and consumers seem to lack the patience to draw long-term conclusions from short-term data, leading them to overreact to each slightly positive or negative economic metric. In short, despite best efforts to be transparent and objective, the Fed has inadvertently continued to nurture a culture of uncertainty.

Mind the Gap[1]

One explanation for heightened uncertainty even in an era of unprecedented financial sophistication is that the democratization of data access and analysis has enabled a widespread complacence – an enormous amount of faith is placed in the erroneous assumption that one's analysis has taken into account all risks when in fact it has only taken into account all foreseeable risks. After all, with so much data at the investor's fingertips, how is it possible he or his favorite experts missed something? For this reason, when that investor is faced with the unexpected, his reaction is likely to be similarly unexpected and, in turn, often more pronounced.

The reason is grounded in a financial theory of relativity. That is, investors individually and markets as a whole react not to an absolute outcome (i.e. rates rising or falling) but to that outcome relative to their expectations. If one enters the markets believing there are hidden risks, the appearance of one, however unpleasant, is more likely to be met with disappointment than panic. However, as has been observed often during corporate earnings season, the opposite is also true: if a company announces strong results that don't meet expectations, the consequences are usually not positive. Or, in the category of current events, there was a widespread expectation of data-driven pundits that the United Kingdom would vote to remain in the European Union despite indications that public opinion was wavering. Even when investors had reason to doubt their expectations, the reaction to a different outcome was striking.

1 *Every passenger on the London Underground hears this warning several times per ride – if only every risk in the United Kingdom was so well identified.*

The active acknowledgement and management of this gap between expectations and a subsequent reality underpins the effort to manage portfolio risk. Even so, it is a difficult task to be confident in one's view of either side of this equation – aggregate expectations of market participants or what will actually happen in the future. In lieu of a crystal ball, the most honest approach to a risk management objective, therefore, is one focused on the uncertainty itself. Where there is significant uncertainty around the outcomes of a particular situation with meaningful potential negative impact to one's portfolio, we can see a high potential for an expectations gap. Especially as it pertains to those investors focused on capital preservation, we believe the goal of protecting against unexpected losses is best pursued by seeking to identify through careful analysis where such expectation gaps may exist with the express purpose of avoiding them.

Most readers of this letter are considered risk managers – hired by clients or self-directed to apply risk management principles while investing in strategies, asset classes or managers through careful analysis and deliberate selection. As active fixed income portfolio managers, we at Zeo are hired to do the same for a portfolio of corporate debt. However, we don't rely too heavily on an opinion of what will happen to interest rates in the future. Rather, we embrace the uncertainty inherent in the environment at hand. Our goal is to identify those investments where the dispersion among potential outcomes is small regardless of what happens. For example, a company with a strong credit profile may have many paths, but the fundamental analysis may still give us a high degree of confidence that none of them result in a failure to repay its debt. Of course, there are no certainties, which is why we also apply a disciplined approach to portfolio construction and maintain a well-diversified set of holdings, but by viewing uncertainty as a risk we seek to manage rather than just as an opportunity for a directional trade, we aim to help our clients be better protected from risks that don't come with warnings.

Buyers Beware

When we speak of uncertainty, however, we are not indulging in theoretical pursuits. Many fixed income investors have felt like cats with nine lives over the last two years. The significant decline in oil prices that roiled credit markets beginning in mid-2014 threatened many portfolios that relied on broad-market high yield exposure to earn income. That threat appeared to subside in early 2015, only to be met by a fear of a slowdown in the Chinese economy. This gave the markets another push downwards as the demand for commodities from one of the world's largest buyers over the last several years seemed to be waning. The resulting widening of credit spreads[2] fueled the worst down market we've seen since the financial crisis in 2008-2009. Fortunately for many investors, this most recent dramatic decline was met with an equally dramatic recovery, but just as the markets were recovering from the whiplash, the United Kingdom cut the party short by voting to leave the European Union[3].

When combined with an unpredictable election year that is remarkable for a rise in anti-establishment populism that transcends traditional ideological boundaries, we seem to be faced with a surprising and uncertain outlook for the previously unquestionable truth of globalization. Even so, economic data being released as we write this letter appear to have given the markets confidence enough in a continued economic recovery to overlook the strong US dollar and weak

2 *A credit spread is the difference in bond yields between a Treasury security and a non-Treasury security that are identical in all respects except for quality rating.*

3 *In addition to creating volatility in the financial markets, this event also has the dubious distinction of adding the term "Brexit" to the financial lexicon for generations to come.*

economies overseas. Given the circumstances, we certainly won't deny an investor being proud of remaining upright in these highly uncertain and volatile times. But…

…Nowhere is the "caveat emptor" doctrine more applicable than in the financial markets. Any additional risks lurking below the surface of the water remain the investor's responsibility to identify and evaluate. In our conversations with various active market participants, we believe there is one risk in particular that is belied by the relief spreading across the markets that the worst may be behind us. Lost in the market advances of recent months and the ups and downs of short term rates, driven by bets on whether the Federal Reserve will raise their benchmark rate at one of several upcoming meetings, is the fact that while short-term Treasury rates are higher, *long-term* rates are actually lower. Even on significant up days for the credit and equity markets, the interest rate on the 30 year Treasury has *declined*.

We believe this observation of simultaneously higher short-term and lower long-term interest rates, referred to as a flattening yield curve, is the direct result of the unintended uncertainty being underwritten by the Federal Reserve. Even as market participants gain confidence that the Fed will indeed raise overnight rates, presumably due to stronger economic fundamental data, they lack confidence that this will translate into the long-term growth necessary to drive healthy inflation and higher rates for longer- term borrowed money (mortgages, loans and corporate debt to name a few examples).

There are many consequences of this disconnect, any one of which could upset the fragile low growth/low inflation pace of an economy dependent on consumers. For example, even in a strong economy, the many small businesses that make up the heart of the US economy are heavily dependent on loans from banks to fund their operations and underwrite hiring and growth. But the banking business operates using a very simple business model – borrow as cheaply as possible from short-term sources (including deposits) and make loans which typically have longer timeframes and higher rates. Plainly put, a flatter yield curve is less profitable. When we also consider that banking regulations have placed additional restrictions, often for good reason, on the amount of leverage a bank can use to increase the profitability of many types of loans, the flatter yield curve takes capital away from small businesses. In light of the recent global market turmoil caused by the Brexit, which has presented headwinds for larger corporations, it's unclear to us who will pick up the slack in hiring and spending to keep the economic recovery moving.

That said, despite the preceding discussion, we don't presume to know the full impact of expected events (e.g. interest rate hikes), nor do we claim to know what unexpected shocks lie in wait around the corner, if any. But the tension among investors is palpable, and we believe it's reasonable to expect more uncertainty in the months and years ahead. Here at Zeo, we aim to capitalize on that potential volatility even as we target consistency in the current "hold-your-breath" environment, but even more aggressive return-seeking buyers in today's market may be well-advised to be cautious. We're not sure how many of those nine lives are left, but we believe one or two more may yet be needed.

With Great Milestones Comes Great Responsibility

Milestones are points of pride for any organization, and we are no exception – when they are in the future, one can't help but look forward to them with an eager anticipation. However, once they are reached, there is a risk among asset managers that the hubris of success overwhelms the humility necessary to remain consistent and serve clients well. As of this quarter, we have been fortunate to have served some of you since the inception of our fund five years ago (and others even longer). In reaching this point, we have been presented with a wonderful opportunity to set aside the usual self-congratulation that tends to characterize the fund management industry in favor of a reflection on what got us here in the first place.

Our business was built on a strategy designed to address a specific need for our early investors. Since then, we have focused on fit with our clients with the goal of making sure that we remain consistent for our investors – we believe that however we fit into the portfolio today should remain the same for as long as we have the privilege of managing those assets, and we take pride in the performance and risk profile that we are able to deliver to achieve those ends. Like the fiduciaries that invest with us, we work for the benefit of the clients that have hired us. We are always grateful when a prospective client sees the value in the portfolio we manage and engages in a dialogue with us, but we do not attempt to win the business of prospective investors who are not aligned with the goals and objectives of the portfolio as it is. This is evident in the intentionally deliberate trajectory of our firm to date.

Maintaining this consistency is the greatest challenge for a growing asset manager. After all, the biggest impediments to growth are size and length of track record, so when those hurdles are overcome, there is a tendency for many managers to shift strategy to capitalize on achieving milestones even if doing so compromises their ability to manage the portfolio in the same manner as had been the case before. However, consistent with our DNA as risk managers, we view maintaining consistency, not capitalizing on momentum, as Zeo's greatest strategic responsibility. While we cannot predict when we will reach our next milestone, we do know this: the future of our business looks very much like its past – rooted in the dialogues we have with our clients, responsive to the needs of investors and disciplined in our business decisions with a focus on a long-term fit with those who hire us.

It has been observed recently that, in choosing to manage our business in this way, we appear to have more in common with our clients than our peers. More than reaching any traditional milestone, we take great pride in this observation. We look forward to the next five years and beyond with a commitment to our clients that we intend to continue to manage our business with these same values.

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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