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Dear Clients:

December is fast approaching. One would be forgiven for having a little anxiety, as the last two Decembers haven't exactly been uneventful. 2014's December sell-off was the culmination of a six-month drop in oil prices, while 2015's December decline added general credit spread[1] widening and a broader commodity bear market to the list of triggers. With a nontraditional election and a potential Federal Reserve rate increase looming, it's impossible to say what lies in store for the end of 2016. But, in a year where it seems every asset class is performing well, even those which traditionally move in opposite directions, there appear to be precious few places to hide if one is playing by the traditional asset allocation playbook.

It's time for investors to question some of the long-held maxims of the fixed income market and evolve their playbooks. The fixed income markets of the next 30 years are unlikely to look like the fixed income markets of the last 30 years – certainly getting out of the low interest rate, tight credit spread environment in which we find ourselves is an experience that most of today's investors cannot claim to have been through before. We are in unprecedented times that require investors to approach the markets with a fresh pair of eyes and without preconceived notions. Most investors aim to be risk managers in one form or another, and there is no shortage of risks if one is willing to find them.

Discover Your Inner Skeptic

"It is difficult to get a man to understand something, when his salary depends on his not understanding it." (Upton Sinclair)

An ideologue is someone who is zealously dedicated to a specific point of view, often held out as an ideal – blindly partisan, uncompromising and dogmatic. In many cases, an ideologue has an agenda, a particular self-interest that compromise may hinder. Those involved in the financial markets in particular are confronted by ideologues almost everywhere we turn. The good news is that, while omnipresent and irritatingly visible (not to mention loud and smug), ideologues make up only a small minority among us. The overwhelming majority is made up of investors and advisers just trying to do the best they can for their clients. Of course, everyone acts in their self-interest at some level, but it is not a very fine line to distinguish between those whose services are bought and those whose services are sold.

1 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.

If we've learned anything in our collective decades in the financial industry, it's that we should carry a healthy load of skepticism when confronted with anyone exhibiting an unwavering confidence that they are right and those who disagree aren't just wrong – they must be proven wrong. Within the mutual fund world and especially in fixed income, we see this attitude with frightening regularity. In truth, this isn't surprising. Decades of complacence in fixed income, fed with a steady diet of declining interest rates, cleared the way for investors to draw cause-and-effect conclusions with a misplaced permanence. This laid the foundation for ideologues to prey upon the conventional wisdom unchecked. Skepticism was in short supply during the subsequent maturation of the fixed income marketplace.

So here we are, approaching the end of 2016, a full eight years after the start of the biggest financial crisis since the Great Depression with interest rates still near all-time lows and markets at what many believe are unsustainably high levels, fueled by the aforementioned low rates. The markets are exhibiting unintuitive correlations, and the only people talking are the same ideologues we've been watching on CNBC for years. It's time for investors to dust off their skepticism and question the decades-old conventional wisdom – the messages coming from the television are sounding decidedly quaint, not to mention dangerous.

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The Danger of False Choices

Most popular debates[2] have one thing in common: their very existence requires that the willing participants make a false choice. After all, is it really so hard to imagine a teenager in the 1980s wanting to be both Han Solo and Captain Kirk? The world of financial advisory has been trapped in its own Lucas vs. Roddenberry debate for the better part of the last four decades. And so I will pose the question here for all of our readers to make their choice before reading on: Which is better – active or passive management?

It may come as some surprise to find out that our answer at Zeo is neither, and both. For one, we see merits and flaws in the ideologies of both sides: it is true that many active managers have failed to earn their fees with any form of differentiation, but it is also true that hiring a "blindfolded monkey throwing darts"[3] isn't a foolproof strategy. But, even more practically, an open mind seems wise for investors who aim to build diversified portfolios; it seems of little benefit to eliminate entire collections of risk categories from already limited toolkits. While the active/passive binary is a convenient shortcut to label strategies as "good" or "bad", it's a notoriously unreliable judge. We find that those who view portfolio management as a risk management goal are better served with a taxonomy.

First, it's important to recognize that the terms "active" and "passive" are broad categories of management styles, and they are not mutually exclusive. We prefer to describe these styles by their objectives. A passive strategy seeks to mirror a benchmark index with little to no deviation. To do so, investors must accept that fees will result in a predictable but unavoidable

2 Coke vs. Pepsi, Star Wars vs. Star Trek, DC vs. Marvel, and Tastes Great vs. Less Filling to name a few

3 Burton Malkiel, in his seminal book A Random Walk Down Wall Street*, posited that "[a] blindfolded monkey throwing darts at a newspaper's financial pages could select a portfolio that would do just as well as one carefully selected by experts." We respectfully and vehemently disagree… sometimes.*

drag on performance relative to the index in question. Any attempt to overcome those fees is inherently active. Some managers do so by adjusting the weights of the positions in an index. Some managers go one step further and target further outperformance by adjusting position weightings more dramatically. All of these methods of active management represent a spectrum within a subcategory of active management we refer to as "active beta".[4] These portfolios have the explicit goal of beating their benchmarks while still tracking them over relatively short timeframes. But the risk of underperforming the benchmark limits the deviation a manager can introduce into the portfolio.

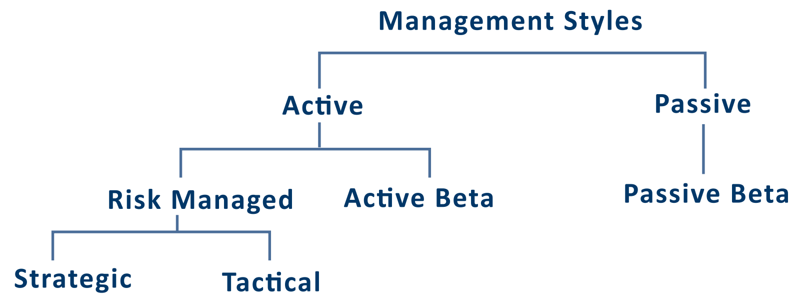

Figure 1: Active vs. passive is about value-for-money, not idealogy.

But what do we make of those strategies which aren't managed relative to a benchmark? Such strategies within fixed income are notoriously difficult to place in today's asset allocation models. On the one hand, they look like alternatives which aim to deliver absolute returns, but they don't deliver the equity-like returns required in most alternative portfolios. Meanwhile, many explicitly target a specific fixed income risk profile, but adapting to intentional deviations from benchmark indices can be hard for many. To give investors a way to think about these strategies, we suggest distinguishing between relative return objectives and absolute return objectives.[5] In practice, this too is a spectrum – of how explicitly a manager is aiming to manage risk. On one extreme is the strategy seeking no deviation from the index (and employing no risk management techniques); on the other is the strategy seeking to deliver positive returns regardless of the benchmark performance (and in which delivering a consistent risk profile is the primary goal). It is our view that a well-diversified fixed income portfolio treats the latter strategy as a different risk profile altogether, offering a consistency that complements more traditional, beta-focused strategies.

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There is a saying among absolute return managers: *you can't eat relative returns*. That is, if a benchmark is down and a manager has outperformed but is also down, one hasn't actually made any money, which presumably would then be used to purchase food for the dinner table. There is some truth in this adage – no one would mistake the Barclays Capital U.S. Aggregate Bond Index[6] for a strategy which intends to make money in all market environments. Indeed, even those actively managed strategies which aim to mimic this particular benchmark are often highly commoditized, and by our research, the value of "active beta" management is limited. However, strategies that target risk-managed outcomes are by definition not commoditized, as there is no "commodity" (i.e. the benchmark) to which they all end up flocking like moths to a flame. Rather, the work they do is not far off from the work of a financial adviser, hired by clients to construct a portfolio which can sustain whatever the market can throw at them. This is labor-intensive due diligence work, not prone to shortcuts.

4 Beta is a measure of the volatility, or systematic risk, of a security or a portfolio in comparison to the market as a whole.

5 Relative return strategies seek to measure their performance relative to a benchmark index. Absolute return strategies seek to deliver positive returns in all relevant measurement periods regardless of the performance of any particular indices.

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. Unmanaged index returns do not reflect any fees, expenses or sales charges.

There are still decisions to be made, such as whether one prefers the risks of strategic or tactical approaches. We at Zeo take a strategic approach to our goal of a risk-managed portfolio (the far left branch of Figure 1), designed to be consistent in our risk profile regardless of the market environment; others attempt to manage risk through tactical trading, shifting from asset class to asset class seeking to be on the right side of directional moves. But these are two means aimed at similar risk-managed ends. For the adviser seeking to construct a resilient portfolio for her clients, it's hard for us to imagine that portfolio exhibiting defensive characteristics if active management is treated as one homogenous group, and in the process, categorically dismissing exactly these strategies that seek to deliver defensive profiles.

The More Things Stay the Same, The More They Change

When you spend as much time looking at individual companies as we do, you are bound to discover little-known businesses that are ingenious in how they have defined and dominated their markets. Hillman Group[7] is the kind of business we don't see every day: it procures hardware products from a highly fragmented global supply base and adds value by managing the distribution of this myriad of "must-have" nuts, bolts, fasteners, etc. in all sizes into hardware retailers' stores as they need them. In the process, the company has to manage acquisition, storage and just-in-time delivery for over 100,000 SKUs – a logistics challenge that gives Hillman Group a nearly insurmountable advantage in its market. Their "fill rate", or the percentage of customers' orders filled directly through Hillman's inventory without having to back-order, is over 95%. That is high and a key reason that retailers prefer not to manage this part of their business themselves. Though the business tends to have low margins and some cyclicality, the high barrier to entry presents a very attractive candidate from a value investor's standpoint.

Due to this profile, Hillman Group has a notably stable leverage and earnings profile. In the twelve months ending this quarter, its leverage, albeit high, ranged from approximately 8x to 9.5x. Meanwhile, its trailing 12 month EBITDA[8] stayed in a tight range of ~$95m to ~$115m. It would stand to reason that the equity and debt of such a company would remain relatively stable as well, right? Figure 2 tells a dramatically different story.

In the second quarter of 2014, Hillman Group was being sold from one private equity sponsor to another. Prior to the sale, the business had been generating stable cash flows and had steadily reduced leverage to a very manageable (and lower) leverage level of under 5x just prior to the transaction. All in all, Hillman Group was a well-run, nicely defensive business. Unfortunately, well-run businesses with steady cash flows have a way of attracting short-term profiteers, and Hillman Group was no exception.

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7 Zeo Capital Advisors holds no positions in any securities issued by Hillman Group on behalf of itself or its clients at the time of writing.
8 EBITDA: Earnings before interest, taxes, depreciation and amortization. This measure of earnings allows for a more consistent comparison of corporate performance before considering varying debt levels, tax rates and non-cash income deductions. Trailing 12 month EBITDA represents a full year's earnings ending with a particular quarter. Trailing 12 month values are used to eliminate the noise inherent in a business that exhibits seasonality within a one year period.

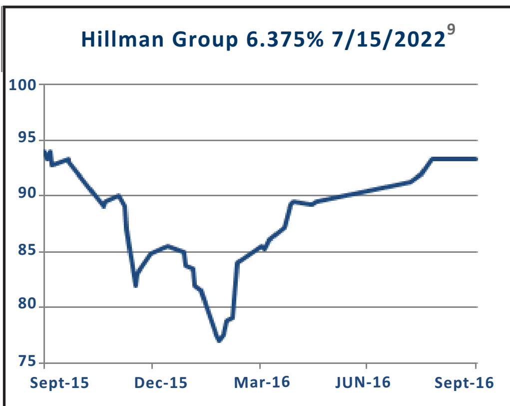

Figure 2: Bonds often exhibit moves unrelated to company fundamentals.

What happened? Theoretically, steady and predictable cash flows can be used to service steady and predictable liabilities (i.e. debt interest). As it happens, the new private equity buyer paid a rich valuation multiple for the Hillman business (some would say overpaid). The financial sponsor's rationale goes like this: a company's capital structure is suboptimal if it generates excess cash after debt servicing costs. Funding as much of the company's purchase price with debt will reduce the amount of the financial sponsor's initial equity investment (and capital at risk if something goes wrong) and boost potential equity returns to offset overvaluing the business up front. If cash flows improve, then debt is serviced, equity value accretes and everyone makes money. Of course, the corollary is also true: if cash flows drop, which would be the case in a cyclical downturn, debt servicing becomes an issue without margin for error. In this instance, the private equity sponsor stands to lose, but the debt holders bear much higher risk from default and potential principal loss. As a result of the 2014 transaction, Hillman Group's leverage was increased from ~5x to the 8x-9.5x level mentioned previously. In a yield-starved environment in which credit risk and return are largely disconnected, bond investors still lined up to invest.

The obvious question to ask those investors is this: do you believe you are getting paid for the risk that you are taking? But we would contend that this question is largely unanswerable. If someone truly believed that these bonds, at that high leverage level, were fundamentally sound investments (we at Zeo did not), the answer is obviously yes when they purchased them at the issue price of 100 in June 2014. Furthermore, given that nothing substantial had changed in the company's underlying fundamentals, the answer would remain yes in February 2016 when those same bonds were trading at 77. But there is no way that both prices represent fair compensation for the fundamental risk in a relatively stable company.

There are many reasons why the price of these bonds fluctuated from the 90s to the 70s and back to the 90s again in one year's time. But none of those reasons are rooted in the underlying fundamentals of the company. The flaw in the investor's thinking in this case is not one of overconfidence in the fundamentals but of a failure of discipline. A true fundamental investor recognizes that the question of being compensated for risk, as posed above, is a trick. If one truly believes in the underlying company, there is no price at which one isn't compensated for the risk since the perceived risk has been theoretically eliminated by the fundamental research.

However, there is still risk. There is risk of price movements unrelated to the underlying fundamentals, and there is risk of changes in the fundamentals themselves. While there is no "right" price for those risks, one can evaluate whether one wants to take those risks. Regular readers will recognize our view that investors cannot choose returns; we can only choose risks, and the market will determine what the corresponding returns will be depending on its level of

9 Prices for Hillman Group's 6.375% coupon bond maturing 7/15/2022 over the last 12 months. (Source: Bloomberg Finance L.P.)

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fear (or greed). Evaluating the level of uncertainty in a company, and therefore, how sensitive it may be to changes in that level of market fear, is among the most important tasks for those investors seeking a low-volatility way to preserve capital. And only a truly fundamental approach to corporate debt would have a fighting chance to identify the uncertainties inherent in the leverage, however stable, that led to the price volatility we saw in Hillman Group in 2016.

Put another way, corporate bonds are securities backed by the full faith and credit of specific companies with varying degrees of creditworthiness. Unfortunately, in today's markets, the prudent corporate debt investor must be skeptical and aim to manage risks if he wants to sidestep deceptive credits as well as poor ones. Despite its stability, Hillman Group was one of a plethora of deceptive credits that have benefited in recent days from a dangerous blend of complacence and impatience exhibited by indiscriminate investors in a market desperate for yield. Reducing corporate debt to indexed asset classes that fail to discriminate between good and bad credits can be very dangerous in its failure to acknowledge the inherent risk selection task involved in managing such portfolios. While this approach may have worked in the fixed income bull markets of the last seven years, with interest rates poised to rise and credit spread moves at best uncertain, we believe cautious investors would be well served to seek comfort in fundamental strategies that focus solely on evaluating an issuer's ability to repay its debt regardless of the overall market environment.

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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