Zeo Capital Advisors

investor.relations@zeo.com | 415.875.5604 | www.zeo.com

ZEO QUARTERLY LETTER: 2Q2017

Dear Clients:

Many wise and accomplished people, much wiser and more accomplished than we would give ourselves credit for being, have made some grand statements about the debate between active and passive management in the last few months. Indeed, the volume of this argument has reached deafening levels recently, and while we won't name names, there are some prominent, well-credentialed people planting new, highly visible stakes in the ground. Depending on who you ask, these experts argue that as few as 10-20% of active managers outperform their benchmarks. What, they ask, are investors paying for?

Logic Puzzles

We can see some readers are already getting riled up and preparing for a fight. So, at this point, we'll encourage everyone to take a deep breath and remain introspective. The question above is a good one and should be asked by anyone who takes their responsibility as a fiduciary seriously. However, the conclusions often drawn from this question tend to be full of false assumptions and logic errors.

Consider the following syllogism[1]:

> 90% of your food options are not good for you.
> To be healthy, you must eat food that is good for you.
> Therefore, you cannot be healthy.

This is obviously bad logic. While all three statements may individually be true[2], the argument is invalid. Yet, this is analogous to the first and most common argument for why investors should invest in passive index funds. Since a large majority of active managers don't outperform their benchmark, investors are best off buying passive index funds. The logic underlying this conclusion is just wrong, plain and simple.

To be fair, this is an imperfect analogy. It's not terribly difficult to identify nutritious foods, but it does take some effort to find the active managers worth investing in. And you may very well live a long life if you just eat a little bit of everything edible. But as the analogy breaks down, it

1 Google it. It's a real thing. We swear.

2 You might argue the third of these statements is not true, but we at Zeo would beg to differ for as long as our willpower is under attack from a constant supply of M&Ms in our office pantry.

doesn't necessarily favor the investor (or his trusted advisor, the nutritionist) – eating an "index" of foods may not cause irreparable harm, but being on the losing end of a large one-sided market move, especially in a fixed income portfolio meant to be the safer part of an allocation, could have harmful and lasting consequences.[3]

In the case of the trusted advisor, being a fiduciary is first and foremost about suitability. We at Zeo believe there are appropriate uses for both active and passive strategies, and we have routinely argued that comprehensive allocations should use both. But suitability is not determined based on fees or performance alone. Not every client need is well-served by picking investments based on historical performance of market average returns or by choosing strategies which require low levels of effort, and therefore cost, to implement.

Yes, some funds perform objectively poorly; some funds likely don't earn their fees; and some funds fit both groups. But to use these factors as the sole decision-making criteria cynically ignores the fiduciary's suitability obligation. Worse, it is replaced by deniability and a culture of low expectations designed to reduce the chances of getting fired by the client. The index fund's promise of market average avoids questions of strategy selection entirely[4], while a focus on fees instead of net results[5] avoids questions of due diligence failure.

In one form or another, everyone reading or writing this letter is a fiduciary: we are the nutritionists of our own, our families' or our clients' portfolios. While we would not necessarily advocate investing only in the top 10% of actively-managed funds, it's hard to believe they aren't worth including in our diet at all. That's neither a logically valid nor a responsible conclusion.

But Is It Worth The Effort?

Regardless of the conclusions, however, the argument isn't complete without a direct answer to the question. So let's take it on more directly: What are investors paying for if they choose active managers?

Surprise! It's a trick question. Active managers don't fit neatly into a single category the way index funds might. It's been a long-term challenge of the investment community to slice and dice investment strategies in meaningful ways to enable apples-to-apples comparisons. Whether in the form of asset allocation pie charts ("Alternative? Alternative to what?"), fund categories or style boxes, many methods have emerged from the well-intentioned goal of evaluating just how well a manager is doing relative to *something*. Then why not evaluate a manager relative to your portfolio goals?

3 Some will take issue with this. But, with even many former active managers using index funds now, there are fewer investors on the other side of the passive trade. If and when index funds turn into sellers, those remaining active managers may be setting the prices – to their advantage of course.
4 For the sake of simplicity, we gloss over many nuances with this statement. For example, index funds don't actually deliver market average performance – the truly passive portfolio is guaranteed to underperform the index by the amount of fees and transaction costs. Second, the use of passive funds does not insulate an investor from falling short of market average returns. Instead, tactical rebalancing becomes the primary driver of performance deviations.
5 For the purposes of this discussion, net results are results after all fees and expenses.

Most investors have been conditioned to focus exclusively on performance relative to a benchmark index. On the surface, this makes sense. It's an easily observable comparison. But does it really align with the goals of the portfolio? Financial plans have internal targeted rates of return, but those targets aren't defined relative to an index. For those readers who are financial planners, when was the last time you told a client they would be able to afford to retire in ten years no matter where you ended up, just as long as you beat the S&P 500? Why do we continue to insist on judging our portfolios solely by relative return measures?

This gets to the heart of the answer to the original question: choosing active managers offers an opportunity for investors to decide what objectives matter and select for strategies that seek to achieve those objectives. The metrics vary based on the goals, but they tend to boil down to three key categories: pure performance measures (yes, it's still important), pure risk measures and risk-adjusted performance measures. It is important to note that these measures may be absolute or relative – despite our skepticism of relative performance comparisons for every portfolio objective, some portfolios explicitly seek to outperform market indices and should be measured as such. In addition, applying relative metrics for both performance and risk simultaneously can be revealing.

To that end, we can use readily available tools to demonstrate. According to Morningstar.com, there are 1,146 distinct taxable bond funds that have at least a 3-year track record.[6] We can further filter these funds by both performance and risk metrics relative to the most prevalent fixed income benchmark index – the Bloomberg Barclays Capital U.S. Aggregate Bond Index[7] (Figure 1).

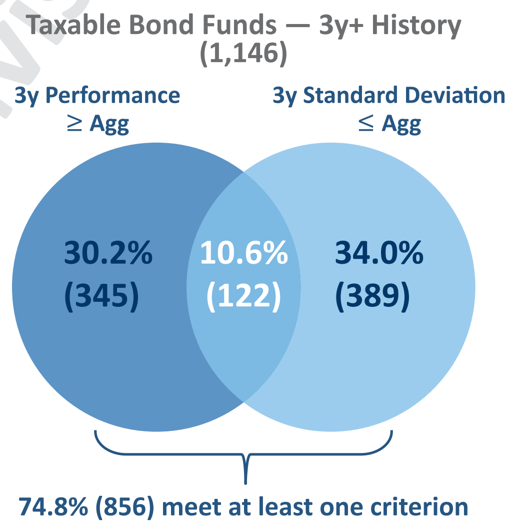

Figure 1 (*Source: Morningstar.com*)

What can we learn from this quick and simple exercise? To start, we can see that the funds that emerge from a relative performance comparison have very little overlap with those that emerge from a relative risk comparison. This has important implications for the portfolio whose goal is to preserve capital, which is primarily a risk objective. Also, it's worth noting that nearly 75% of these funds fit at least one of these two criteria, but the overlap of the two is barely over 10%. Once again, this tells us that fitting strategies to portfolio objectives is unlikely to be effective if we limit ourselves to judging funds by relative performance. But it tells us something else also.

6 Since Zeo is a fixed income manager, we will limit this discussion to fixed income markets, but the principles apply across asset classes. We use trailing 3-year data as of 6/30/2017 because of the ease of availability at Morningstar.com. However, we encourage readers to analyze other timeframes if possible.

7 The Bloomberg 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. You cannot invest directly in an index.

For the portfolio seeking to preserve capital and minimize account value swings without compromising on relative performance over a market cycle, not a single fund in the 10.6% of fixed income strategies in the intersection is an index fund. And remember that both metrics are based on results net of all fees. For the performance-focused, one might say these funds paid for themselves, and the beneficial risk profile came for free; for the risk-focused, one might say that investors didn't have to compromise returns to pay for lower volatility.

Either way, it almost doesn't matter. The objective we've just described, common to many fixed income portfolios, cannot be achieved without active management. In this sense, we agree with the experts that only a minority of active managers differentiate themselves. Where we disagree is whether investors should look for them or give up. In our view, it's the difference between achieving a portfolio's goals and having to artificially change them to prove a point that has nothing to do with suitability.

What Really Matters Anyway?

"Check it –
"Can I be real a second?
"For just a millisecond?
"Let down my guard and tell the people how I feel a second?"

George Washington[8]

We are willing to entertain the possibility that we are outliers. To us, the previous discussions seem reasonable, logical and intuitive, which leaves us a little baffled by the intensity of the debate between active vs. passive investing. From the perspective of a fiduciary, this is surely a false choice, no? Nowhere in the debate does there seem to be patience for the consideration of a strategy's objectives, risk profile or cost to manage. Yet, these three characteristics comprise many of the reasons why results might deviate from a broad market index or why expenses might differ from those of an index fund.

It's very easy to get caught up in the active vs. passive rumble. After all, we at Zeo are active managers, and we believe our results demonstrate a clear value-add from our active investment efforts. We look to our clients to confirm this belief, including at a gathering of a group of our investors at a recent advisor conference. But what struck us most about that evening was the diversity of the group. No two people saw the world or their investment approaches the same way. For some, Zeo is one of many active managers; for others, Zeo is the lone exception in a portfolio of index funds. But they were all members of the same club.

What they had in common was an understanding of what Zeo does for them and why we make the case that no exchange-traded fund delivers what we deliver. The discussion wasn't

8 As written by Lin-Manuel Miranda in the Broadway musical Hamilton. For those who empathize, Venk would welcome your membership in the club: http://amzn.to/2ubxjHN.

about how passive investors "don't get it", and it wasn't an impassioned defense of all things active. The conversation centered around Zeo's fit within their portfolios – it is why we believe we are hard to replace, addressing a need for which there are few options, active or passive.

And that is what really matters. We at Zeo don't worry too much about how we compare to an arbitrary index or a passive strategy *unless that index or strategy is intended to achieve the same objectives:* low volatility, absolute return fixed income aiming first and foremost to preserve capital. That we do it in a labor-intensive way – deep fundamental analysis on individual companies in a capacity-constrained strategy – sets us apart from most *active* managers as well. We focus on risk-adjusted net performance that fulfills our clients' objectives consistently, and we run our business to serve our clients in the most cost-effective manner possible without compromising the integrity of our investment strategy or our approach to client service.

When you hire us, that is what you get. This same philosophy is what sets the financial advisor apart from the robo-solution. We can't speak for other active managers, but at Zeo, it's what sets us apart from an index.

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 is not 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.