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Dear Clients:

"The four most expensive words in the English language are 'this time it's different.'"

Sir John Templeton[1]

Some words don't need an introduction.

Myth #1: Low Volatility Is Here To Stay

There is no shortage of people warning that more market volatility may be just around the corner. We include ourselves in that camp. So far, however, many investors who have ignored these warnings have been rewarded. But what are they being rewarded for, savvy or complacency?

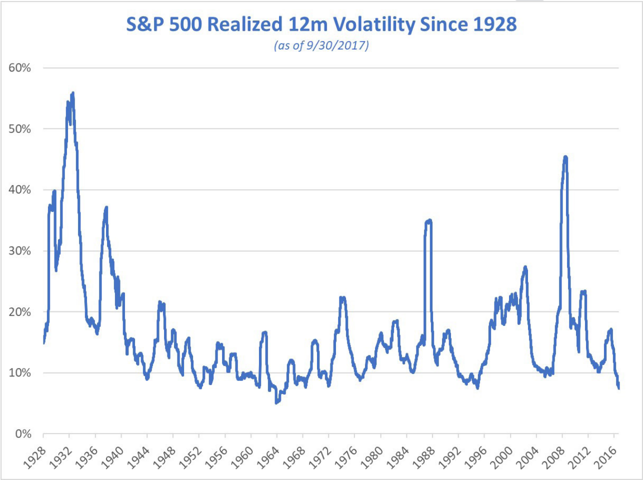

Figure 1 ***(Source: Zeo, Bloomberg Finance LP)***

Figure 1 argues for the latter. The chart shows the rolling 12-month realized volatility of the S&P 500 Index since 1928. We don't need to overcomplicate the picture to draw one simple conclusion: it's a good bet that volatility won't stay as low as it is. There is a plethora of market participants that will no doubt disagree with this statement, citing structural market changes as supporting a permanently lower equilibrium of volatility going forward. Indeed, this argument is not new, as it is the same reason often given to explain why markets today can support higher levels of leverage.

1 As quoted in *The Four Pillars of Investing: Lessons for Building a Winning Portfolio* (2002) by William Bernstein

Figure 2 offers one way to view this leverage effect, by showing NYSE margin debt balances relative to those from 40 years ago, adjusted for market moves[2]. Some structural changes cited for this permanent change in equilibrium leverage include the greater use of derivatives and other structured "distributed risk" products; the repeal in 1999 of the Glass-Steagall Act, which separated US commercial and investment banking activity; and the democratization of market access due to technological advances. We recognize that there may be some validity to these arguments and to the case made that structural changes have enabled higher leverage as part of a permanent new investing paradigm. But somehow, looking at the chart, that explanation doesn't really calm the nerves, does it?

Figure 2 ***(Source: Zeo, Bloomberg Finance LP)***

We aren't arguing that volatility won't remain stubbornly low or that every spike in market volatility is accompanied by a widespread loss of economic wealth. But a rise in volatility, as well as many more subsequent valleys and peaks, seems all but inevitable in our view. What doesn't seem obvious is who among the investors in this game of musical chairs will be left standing when the low volatility tune stops playing. Nor is it obvious how many chairs there are – who amongst us would claim a repeatable skill to time the market? Yet that appears to be the claim to skill being made, and with suboptimal tools for doing so, no less. Read on.

Myth #2: Market Timing is Easy

Ok, so maybe not. No one really believes this, right? We would venture to guess that no one reading this letter has ever uttered these words – not out loud anyway. Perhaps few even among the broader investor community would be so brash. But how else are we to interpret the overwhelming bias toward indexed portfolios that has dominated the markets in the last decade?

Let's start with the simple observation that if an investor chooses to invest in an index fund, it is likely for one of two reasons: Either the fund is a long-term hold based on the belief that short-term fluctuations can be disregarded; or the fund is a tactical bet on shorter-term gains in a particular asset class with the expectation of exiting the investment before that asset class declines or as soon as it begins to do so.[3]

2 The chart starts at 1.0, representing the ratio of the level of margin debt on the inception date (9/30/1967) to itself. We then adjust each month's growth in margin debt for the growth in the NYSE Composite Index to eliminate the portion of increases due to price appreciation. Finally, we express that adjusted value as a ratio to the inception date margin debt level to show the relative change over time.

3 We should note that this expectation has been made harder by the complacency noted earlier in this letter. As investors are conditioned more and more to ignore volatility and market declines that have turned out to be temporary bumps in the bull market road, it becomes less and less likely that those investors will recognize the beginning of a sustained market correction until they find themselves just one member of a herd heading for the exits. Unfortunately, in a frightening case of self-referencing, the group think of these very investors is the precise reason for this conditioned behavior, which we believe will make it even tougher to spot when the tides shift – and will magnify the spikes in volatility when they occur.

But therein lies the problem. Passive index investments must be part of an active investment strategy if the goal is to avoid the potentially large losses that come with a market correction.[4] And while rational hindsight may argue that markets eventually recover, most investors are not quite so rational in the thick of a decline, nor is there any visibility into how long the recovery will take – otherwise, they wouldn't be selling on the way down and creating the volatility in the first place! The many retirees that found themselves back in the workforce in 2009 can attest to the material difference between theory and practice in this respect.

With ETFs multiplying like rabbits, we now have passive vehicles for every manner of asset class, including many that track such instruments as syndicated bank loans and broad market high yield bonds. We at Zeo obviously invest in these asset classes, and we find the idea of ETFs tracking these particular markets curious to say the least. The underlying instruments do not lend themselves to indexing or to the scale required to support a capacity-unconstrained ETF structure for a few reasons. First, these asset classes are traded over-the-counter (as opposed to on an exchange), and there is significant friction to tracking an index. Second, to satisfy the scale and diversification requirements of an ETF, a fund must compromise on credit quality, in a credit-focused investment no less. And third, these asset classes do not represent broad market economic indicators, which relegates them primarily to tactical usage and eliminates the "next marginal buyer" support that often mitigates volatility.

Let's dive into this last point a bit more. A "next marginal buyer" effect depends on the existence of multiple groups of investors in the same asset class with different investment theses. Each thesis may cause that investor to enter or exit the market at different times and different prices, but typically, the exit prices for one investor group will be the same as the entry prices for another investor group. The result of this is a "win-win", not unlike when a company buys a business for strategic reasons (e.g. to capitalize on synergies) from a current owner who originally purchased it for financial reasons (e.g. a private equity sponsor) – the business is worth more to the corporate buyer than to the private equity owner.

But when one investment thesis dominates an asset class, as is the case with bank loans at the moment[5], prices can get inflated when that investor group begins buying and selling to itself or buys largely from primary rather than secondary market participants. Buyers pay higher prices to take the other side of sellers who no longer believe in their shared thesis or to buy securities directly from an issuer who won't provide a bid if the market declines thereafter. But we are missing a buyer in the secondary market with a different thesis (e.g. non-tactical) to backstop the last investor standing when the music stops. Or, more accurately, that "next marginal buyer" exists but has an entry price that is at a significant discount to where the current market is trading. Once the exit begins, look out below.

This happened in 2008 to the convertible bond market when hedge funds inflated the prices of convertibles using leverage and increasingly-complicated derivative valuation models. When these funds all looked to the exits, they found that the next marginal buyer was the fundamental credit investor, who set the exit price so far below current market that the entire convertible market ended up in a vicious cycle of margin calls and asset price declines. While we

4 "Not true!", said the passive indexer, right before he made an active decision to shift passive index exposures.
5 Interest rate risk, anyone?

aren't predicting that a similar effect is imminent, we do seem to have many of the ingredients for this recipe on hand today.

This is not to say that bank loans, high yield bonds or other similar markets are not worth investing in. On the contrary, they often present some of the best opportunities for volatility-mitigated, less-correlated strategies. But these strategies are typically fundamental in nature, with managers selective about the types of risks they take within these asset classes. These strategies are typically capacity-constrained as a result, focused mainly on that subset of the investments for which there are marginal buyers. And these strategies are often miscategorized because their risk profile, their asset class and their return profile each seem to fit a different category.

If it sounds like we're describing our own strategy here at Zeo, this is not a coincidence. In our case, we aim to invest in a subset of corporate credit which tends not to be of interest to index investors in bull markets. This enables us to have an investment approach that does not try to be on the right side of market moves but rather seeks to perform as expected regardless of the direction of any given asset class. We do this while actively positioning to be the buyers setting the prices in bear markets.

How? By being the fundamental investor in a market full of timers. We view the purchase (or sale) of corporate credit not as a tactical trading decision based on whether we think an entire asset class will go up (or down). Instead, we view our investments for what they are: Each position represents Zeo lending to an individual company and evaluating whether that company will pay their debts. As such, our thesis is completely different from the passive strategy, and we aim not to change the mind of the indexed ETF evangelist who has great confidence in his ability to time the market. We wish him well in his effort. But when he comes to sell, we will be ready and waiting as the next marginal buyer to provide him the liquidity he needs…*at our price*.

Myth #3: Mutual Funds Should Have Low Fees

We're hitting a little close to home, aren't we? It's hard to read everything that is being written about mutual funds and not acknowledge that everyone is thinking about it, right? So let's unpack this myth, starting with a few simple analogical questions to get the discussion started:

Is an attorney worth $500/hour?
Is a doctor worth $500,000/year?
Is a financial plan worth $15,000?

The only honest, non-ideological answer to any of these questions is: "It depends." It depends on whether the attorney did a good job, perhaps by limiting or recovering damages even after considering his fees. It depends on what kind of doctor and how impactful the service, perhaps by performing a life-altering reconstructive knee surgery. It depends on the plan itself, what goals it sets out and how practical it is (see Figure 3).

After all, there *are* attorneys who charge less, doctors who earn less and personal finance options that cost less. And perhaps they are better service providers by some metrics. For example, what if the $500/hour attorney doesn't win you at least enough in damages to cover his fees? And before you answer, did you first ask whether he was even hired to win a damage claim?

Figure 3

If we judge every attorney by whether he wins money, no one would hire any legal counsel other than litigation specialists and whatever they can get for free or flat fee on the internet.

This is not to say there aren't overpaid attorneys, undeserving doctors and bad financial plans. These things almost certainly exist, and in large numbers. But if we don't start by understanding what services they are offering and how effective they are at delivering *those* services (and not some generically broad service that may not be related to their practice, such as damage awards), we cannot possibly determine if their price is worth paying, i.e. their "value-for-money".

The real and unexpected downside comes when one decides this is not worth figuring out and instead falls into the trap of *the denominator effect*: "If I hire the lowest cost option (i.e. lower the denominator in the value-for-money relationship), then even a bad job is good value-for-money." In other words, aim low and you will never be disappointed. Except, you very well could be, and sometimes, the consequences are irreversibly bad.

By now, the analogy to mutual funds is likely not lost on any of our readers. But the questions remain: Why are the services of investment managers not evaluated based on what the manager is trying to achieve? If the goal is risk-adjusted returns or loss avoidance, as is the case in many long-term savings portfolios, shouldn't their worth be measured based on risk metrics such as volatility, return-to-risk ratios and max drawdowns/recovery periods? Moreover, their value would seem to also depend on a demonstrated likelihood of consistency in these metrics. Of course, if an investor doesn't value those objectives, then he shouldn't hire the manager regardless of the fees. But to argue that a portfolio designed to manage risk falls short because it doesn't achieve a certain return is comically dissonant logic.

Unfortunately, the best intentions are often undermined by an inability to act. Making the case for a "value-for-money" environment is the easy part; acting on the approach is much more difficult. Investors just don't have the tools they need to evaluate managers in a goal-based framework nor form even a qualitative opinion of value-for-money that isn't denominator-focused. Worse, they don't even have the tools to identify potential investments based on an alignment of investor and strategy goals. This is fine if the only goal of a portfolio is to outperform some index over short periods of time – there is a multitude of ways to find that, though even those tools are largely dependent on hindsight. But for most people, investing is not about winning but about achieving goals and taking as little risk as possible to do so – objectives that are rarely consistent with index tracking. Where does an investor go to evaluate the value-for-money of a fund for which deviation from an index is part of the strategy to achieve those goals? The answer is simple: at the moment, nowhere.

Without the proper tools to align goals with an investment portfolio, one is forced to fit a square peg into a round hole. How does someone manage their savings when the investment vehicles offered are explicitly focused on generating market-correlated returns based on some broad market measure which, by its very definition, represents unmanaged risk? If a financial advisor believes in the opportunities presented by actively managed strategies, how can she measure her success against more aligned benchmarks that capture both the performance goals *and* the risk goals within her portfolio? Are investors really doomed to repeat the failures of the past because they lack the necessary support to improve upon them?

To be fair, despite the theme of this letter, this is technically not a mistake at risk of being repeated, because “value-for-money” is not a lesson the financial markets seem to have learned yet. But given what is at stake, it seems irresponsible not to recognize the similarities to other high-cost-of-failure service providers. Rather than look elsewhere for guidance, however, many in the investment management community seem perfectly content to focus on self-preservation rather than innovation. In doing so, their investors are being poorly served, with a smile.

The good news is that a value-for-money framework isn’t out of reach for investors interested in choosing the best possible strategies for their many portfolio goals. Even better, doing so does not require a change in investment approach, even if the current methodology has a strong bias toward low-cost, passive options – many of those options are likely appropriate value-for-money themselves. But it does require a willingness to think about one’s true objectives and what metrics would best measure success in each. It’s not always obvious, but in our one-on-one consultations with financial advisors on this though process, we find that it’s usually intuitive, actionable and impactful.

We’ve seen this movie before, friends. Following the conventional wisdom and accepting risk which is not consistent with one’s goals because it’s the path of least resistance isn’t a new phenomenon invented by the post-crisis investor. It’s the painful legacy of generations of investors who have repeatedly confused ideology for reason. Throughout the years of sharing our ideas, philosophies and approaches at Zeo, we have been careful not to steer our readers toward a particular ideology. We have aimed to explain underexposed points of view so that they could complement your own hard-earned views. Like our many letters before, this one is not case-closed *against* passive management, ETFs or cost-consciousness. And it’s not case-closed *for* active management, contrarianism or paying for premium services. But it is an impassioned plea for the opportunity that value-for-money analysis and fundamental investing may offer to those investors whose goals aren’t neatly served by the loudest voices in the room.

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

Venkatesh Reddy
Chief Investment Officer