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# ZEO QUARTERLY LETTER: 4Q2017



Dear Clients:

With another Happy New Year wish to our clients and friends, we humbly reflect on the opportunity we have had over the last 8½ years to develop a dialogue with you, our readers. On and off these pages, we have shared our views on fixed income markets, portfolio risk allocation, due diligence and a variety of other topics. We have described our own approach to the portfolios we manage at Zeo, directly and indirectly, with our well-worn emphasis on caution and vigilance, market-independent risk profiles and longer-term investment horizons. We have had welcome feedback from these letters – a handful of you even agreed with what we had to say or found our thoughts helpful!

And yet, as we end another year of very low volatility in the markets, the conversations we are hearing in the marketplace tell us we and those who agree with us are still in the minority among the broader investment community. But therein lies the opportunity for us and our clients. We realize we won't change everyone's mind, but we're not trying to. We work for those investors who share our view of fixed income; who value our emphasis on strong risk-reward metrics and low volatility; and who don't mind joining us in the minority who prefer portfolios which can help them achieve their goals independent of market direction and volatility. And there's no place we'd rather be.

**Running With The Bulls Can Get You Trampled**

> *John Maynard Keynes said in his masterful* The General Theory*: "Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally." (Or, to put it in less elegant terms, lemmings as a class may be derided but never does an* individual *lemming get criticized.)*
>
> *Warren Buffett*[1]

To be fair, running with bears can also get you trampled. But the observation is the same: It has been our experience that long-term wealth is neither created nor preserved by following the conventional wisdoms of the majority. With so many investors lining up to board the "index fund" train, can there be any doubt that these investors are all on the same side of the market, advancing when the indices go up and declining when the indices go down?

1 Excerpted from his Chairman's Letter in the 2004 Annual Report to Berkshire Hathaway shareholders

As important, who do they expect will lessen the pain of the decline when it does happen? It is unlikely to be another index investor, as they will be rushing for the exits alongside one another. Rather, they are likely counting on the investor who, to paraphrase another of Mr. Buffett's maxims on investing, was fearful when they were greedy and will now be greedy when they are fearful. Whether this comes in the form of long-term value investors like Berkshire Hathaway or tactical traders who actively trade index funds to express their short-term views on market direction, these are the pipers being paid by the subscribers to conventional wisdoms.

While this argument is often given as a defense of active managers who invest in equities, these issues are magnified when considered in a fixed income context. After all, while equity is a game of yards, fixed income is a game of inches. While an equity has the potential to gain as significantly as it can lose, bonds are asymmetric to the downside – large potential price declines with gains coming mostly from a relatively modest coupon and limited potential price appreciation. If an investor finds himself on the wrong side of a fixed income market decline, as may happen if interest rates spike in the coming years, it will be quite some time before the interest he is earning would recover the loss he experiences at the outset. In this sense, the argument we present against the conventional wisdoms that have driven investors into index funds is arguably even more valid for bonds.

But for fixed income portfolios, the risks aren't limited to the majority of investors who invest in indices. First, the markets are awash with capital. If a majority of those investors seeking to mitigate the risks we describe above pursue the same opportunity to do so, they too expose themselves to a herd mentality. Since they are all generally aiming to mitigate the same risks, this is highly likely to happen when paired with our second observation.

Fixed income asset classes, because of the broad expectation that they are safer than equities, have managed to evolve in a way that obscures risks in order to appear in accordance with the conventional wisdoms investors hold dear. This is not always intentional and is as often the result of an over-application of long-held but well-intentioned assumptions as it is the result of intentional malpractice. But, regardless of the cause, what has resulted is a plethora of alternative strategies designed to satisfy the risk mitigating appetite of a subset of fixed income investors, which in turn, exposes them not only to the same groupthink as index investors but also to additional unintended risks created by an adherence to old-fashioned assumptions.

Especially in the context of discussing our own strategy, we hear a lot of conventional wisdoms, most of them in the form of reasons not to buy our fund of course. Most often, we hear bank loan funds cited as a better alternative. Just as often, we hear a preference for high income short term investment-grade bond funds. In both cases, investors are swayed by commonly held assumptions whose validity is limited in scope, exposing them to unintended risks and creating opportunities for those who wade into the less correlated world of exceptions to the conventional wisdom rules.

We consider ourselves and our strategy in this category of less-trafficked opportunities. And by the metrics we are aiming for, we believe we compare favorably to these more popular alternatives and set ourselves apart from our peers. We manage our strategy with a priority on the depth of our analysis, a transparent fit with our investors and long-term consistency. In our view, the conventional wisdoms we hear often fall short by one or more of these measures – they may be majority opinions, but they are misguided at best and potentially dangerous if misused.

**Bank Loan Funds: You Are What You Eat**

When we started the Zeo journey, we remember having to explain to prospective clients why they might want a shorter duration fixed income strategy in a long-term portfolio. Nowadays, financial industry conferences resemble a Baskin Robbins store of short duration: there seem to be 31 flavors of "we aim to protect your portfolio when interest rates go up". But, like with ice cream, the ingredients, and how you make it, matter. How a strategy gets to its short duration, and even whether it actually is short duration, is often a function of understanding the component risks of an asset class, what might go wrong and how the manager is mitigating that downside. Most important, it should be simple enough to understand and repeat.[2]

Take bank loans, for instance. There is no shortage of mutual funds offering bank loan portfolios as the panacea for all that ails a fixed income portfolio. After all, loans are floating-rate instruments, meaning their coupons increase if interest rates increase. What this means is, as interest rates increase, the value of a loan stays the same because the usual negative impact of a rate rise on bonds is offset by the higher coupon. Sounds great, doesn't it? We think so – bank loans have been a small portion of our portfolio for years.

True to their billing so far, bank loan funds have performed well over the last few years as well. As rates stabilized and started to inch upwards, the demand for loans has spiked. Loan prices have gone up (and yields have gone down) as a result. Companies have borrowed from loan investors at record levels with some of the least restrictive lending terms the market has ever seen. This, in turn, has contributed to near-zero corporate default rates. But, it's a seller's market, and investment banks have noticed. The credit spreads investors are earning for loans has never been tighter, resulting in some of the lowest coupons for corporate debt in history. This has been great for companies and their equity, as stockholders have been among the most rewarded beneficiaries of this historically cheap cost of capital.

What has happened as a result is a noticeable decline in the underlying credit quality of the average outstanding loan. Many loan investors don't care. After all, loans tend to be the senior-most part of a company's debt, so the risk of principal loss is perceived to be low regardless. But this is a mistake. Even if the risk of principal loss due to default is low, which is debatable for some of the more popular loans in many large funds, the risk of large price movements is not. Most loans, despite their low interest rate sensitivities, have very high sensitivities to credit spreads, some as long as 5 to 7 years. This is because the coupons of floating rate instruments do not increase when credit spreads increase the way they would for interest rates. The same bond math that has prompted some to flee intermediate- and long-term funds exposes investors in bank loan funds to a rude awakening if credit spreads widen. Unless an investor is willing to commit to not having access to her capital when that happens, any sale during such a decline is as real a principal loss as one caused by a corporate default.

This is not to say that we believe bank loans are too risky for a responsible fixed income allocation. We at Zeo invest in loans as part of our overall corporate credit portfolio. But it does matter that investors know the risks and investment process of the strategy in which they are investing. Our approach to loans is deeply fundamental, as it is with every security we purchase.



2 Sugar or high-fructose corn syrup? We thought so.

Put another way, we are highly selective and tend to focus on the small minority of debt instruments and issuers whose strong credit profiles offset the supply/demand impact of the overall market. As many of you have heard us say before, it has been our experience that in portfolios that invest in credit, it matters what credits you pick. Sometimes, this requires that we avoid overlap with broad market index mutual funds and ETFs. Such portfolios of bank loans selected using non-fundamental factors or which take an index approach may seem similar, but they are an entirely different flavor with a risk which may be unwelcome – and unnoticed until it's too late.

Compare that to our approach at Zeo, in which we select individual companies, evaluate their ability to repay their debt and aim to buy the best among them. In short, we aim to be the vanilla of short duration fixed income, simple and intuitive. Don't be fooled – great ice cream of any flavor is hard to make, and ours is no exception. But it should have ingredients you want and a repeatable recipe. Does anyone really know how they get tutti frutti to taste that way anyway? When it comes to fixed income risk, it may be best to stick to the flavors which are easy to understand and explain.

**Short-Term Bond Funds: This Rose By Any Other Name Would Be Something Else**

Wall Street has a long history of convincing investors that something complicated is the same as something simple, not always intentionally and usually with a smile and a claim of innovation in risk management. One of the more egregious examples of this was the advent of asset-backed structured products. With the help of sophisticated mathematical risk models, banks could convince credit ratings agencies that a pool of riskier loans, if purchased through structured derivatives, could theoretically be shown to have lower risk in aggregate, low enough in fact to be assigned investment grade credit ratings.[3]

There are many short duration mutual funds which invest solely in investment grade securities, so many in fact that Morningstar has an entire category just for them. Those with the highest income tend to invest heavily in mortgage-backed securities (MBS) and other asset-backed securities (ABS). It is no secret why these funds tend to outperform their investment grade peers who only use corporate debt. Whether intentional or not, these portfolios are effectively able to use structured products to get paid for taking risks in excess of what would normally be considered investment grade. But due to the aggregate portfolio risk models (which assume a certain level of diversification and duration), they can do so through instruments that have investment grade ratings. Pretty neat, huh?

We are not trying to make a case that all mortgage products are bad, and we are not even arguing that investors have been misled to invest in funds which use these products. But if we dive deeper into the models used to justify the investment grade ratings, we realize they are dependent on a handful of factors. Among those are correlation of mortgage defaults; the value recovered by the lenders during a foreclosure process; and the rate at which borrowers tend to prepay their loans. If we learned anything during the 2008 financial crisis, it was that pools



3 The math and modeling behind this is beyond the scope of this letter. Suffice it to say here that the risk reduction is dependent on certain assumptions of the correlation of defaults and other characteristics of the underlying pool of loans. Where the models, and the ratings that depend on them, fail is if actual observed correlations exceed those used in the models (which are typically taken from historical levels). A textbook example of this failure would be mortgage-backed derivative securities during the 2008 financial crisis.

of mortgages on houses from the same market tend to be much more highly correlated than is typically assumed by these models. Furthermore, for any given foreclosure, the higher default correlation results in much lower recovery values as there are typically few buyers in a housing market crash.

In our view, though, the biggest risk to these securities in the current market is that investors may be taking on more duration risk than they think. Mortgage borrowers have a tendency to prepay their mortgages, either when they sell their homes or when they choose to refinance. The rate of prepayments directly impacts the average duration of a mortgage pool – the higher the prepayment rate, the more loans get paid before their maturity and the lower the duration.

The long stretch of low interest rates we have just experienced saw a wave of refinancings that is unlikely to be replicated and may cause prepayments to be lower than expected for years to come. An upward trending rate environment would also deter homeowners from refinancing their mortgages even if they hadn't done so recently. In addition, any hiccup in the economy or a drop in housing purchases (as some predict may happen due to recent tax law changes) would further reduce prepayments. All of these risks point to a duration extension in the average mortgage pool.

To be fair, experienced mortgage traders monitor these factors constantly and are skilled at choosing the securities which are least susceptible to these risks. But that's just the point, isn't it? The value here comes not from the obfuscation of a risky asset by hiding it in an asset that appears less risky. The value here comes from the careful selection of fundamentally strong loans. While we find it difficult to imagine making such evaluations based on aggregate metrics (e.g. average FICO scores or average prepayment rates), we don't doubt there are those who can. And we have no doubt that they can find value and opportunity even among those borrowers that have been labeled as risky.[4]

Put another way, it's the in-depth evaluation of individual borrowers that mitigates the default risk, not the designation of some credit rating agency. It is our experience that the more directly an investor can isolate this effort as the driving force behind a credit-oriented portfolio, the more confident he can be that the risk he is trying to take is in fact the risk he is getting. We aim to be that consistent fundamentally-focused short duration strategy with a more straightforward portfolio of long-only corporate credit. Through our bonds and loans, we lend directly to the companies who issue the debt we buy. We don't use structured products. We don't invest based on aggregate portfolio risk metrics. We simply evaluate if, in our view, a company can repay the short-term debt we are considering, and if so, we buy and hold it. Pretty neat, huh?



4 This argument is not restricted to mortgage-backed securities. The same is true of more subtle complacency as well. An over-reliance on credit ratings agencies in general leads investors to have a strong bias toward longer-duration portfolios which are highly rated while vilifying credit risk as "bad". In truth, investors who have this bias may not be de-risking but rather simply trading one risk (credit) for another (duration). We believe it's harder to determine the direction of interest rates than it is to determine the creditworthiness of a borrower, but both exposures require some level of skill to evaluate and manage. The challenge we are setting forth is for investors and managers to be honest and transparent about the risks they are taking and how they manage them, rather than highlighting the risk they are reducing and hiding (intentionally or not) a different risk they are taking instead.

At Zeo, we do not aim to appeal to those investors who hold steadfast to the outdated conventional wisdoms prevalent in the fixed income markets. We don't consider deviations from common fixed income indices to be a flaw of our strategy. We are transparent to a fault about the loan positions we own, both with respect to their durations and in our effort to avoid rather than tactically profit from temporary demand. We don't try to hide the fact that we invest in high yield issuers. We much prefer to engage in an open dialogue with our clients and friends rather than pretend to be something we are not. In doing so, we may be an exception to more than a few prevailing assumptions about fixed income investing. And there's no place we'd rather be.

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

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