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Dear Clients:

A lack of discipline appears to be pervasive in today's markets. It is evident in the shortcuts we see in how investors classify "good" and "bad" investments throughout the financial services industry.[1] It is evident in the research we receive from analysts. It is evident in investors' reactions to changes in supply and demand. It is even evident in the volatility we have observed in recent months from the manic back-and-forth between fear and fear-of-missing-out. It is also as understandable as it is concerning – the current markets are certainly not the first to witness undisciplined investor behavior. But it does not have to be inevitable.

While no investor, disciplined or not, is immune to market volatility, we believe prudent investors are the ones who can keep their eyes on the ball and stay focused on maintaining consistent risk profiles. They think critically and aim to avoid oversimplifying shortcuts. They stay true to the metrics that align with their portfolio goals and plan ahead for more than one potential outcome. And they take into account risks rather than depend on investment theses that assume their absence.

In other words, the prudent investor invests intentionally, and consistently so.

Be an Intentional Investor

Returns. Outperformance. Fees.

This month. This quarter. This year.

These are the metrics and timeframes that seem to overwhelmingly dominate the focus of most investors. We find this obsession fascinating even as we are sympathetic to the pressures that have created them. To focus on other metrics and timeframes is hard. We can discuss statistics like standard deviation, maximum drawdown and Sharpe ratio ad nauseum (and we have), and we can try to identify what component of a portfolio should be less volatile or target an absolute return. But to put all of these together in a way that allows an investor to draw a straight line between her goals and her portfolio is among her most difficult tasks.

Instead, market participants start looking at their neighbors. "Since I can't say for sure that I am doing well, can I at least say that I am doing better than him?" This leads investors to fall into the trap of using relative returns over short timeframes as wholly inaccurate milestones to evaluate the likelihood of achieving absolute goals in the more distant future. Unfortunately, we're not writing this letter to provide an easy correction to this misalignment. But we do think it's important for investors to be aware of their biases which may be leading them away from their

1 Regular readers will already be familiar with our view that the separation of investments into "good" and "bad" is usually done in error; the reality is that any investment can be appropriate if it fits the objectives of a portfolio and has a corresponding valuation which makes sense.

goals. In doing so, investors can stay mindful of their intentions and make deliberate decisions.

This is what we refer to as an intentional investor. It is not a new concept. The most obvious example in today's marketplace is what is often referred to as the sustainable and responsible manager. By its very nature, one cannot achieve such a mandate without intentionality. The commonly accepted goal of a sustainable and responsible portfolio is one that requires deliberate decisions, often overriding traditional investment biases. A company may be poised to profit in the short-term, but if it treats its employees poorly, it may be compromised long-term and, from the perspective of the sustainable and responsible manager, should be avoided.

For fiduciaries who invest on behalf of institutions or individuals, investing intentionally has been described for many years as "asset/liability matching" or "goal-based investing," which we even used to frame this very discussion from the start. And yet, while comparatively few end clients have goals that can be accurately characterized in terms of market performance, the industry is inundated with tools and strategies designed to help the allocator track indices. There is even a critical term for deviating from an index: "tracking error." However, for an individual who is just hoping their nest egg grows steadily at a reasonable pace and is available to them upon retirement or a foundation seeking to cover payout requirements without unnecessary risk, matching an index with little deviation is an insufficient way to make investment decisions. It's not wrong – just insufficient without being part of a strategy intentionally designed to achieve goals which rarely change with the markets.

Unfortunately, there are fewer options for investors with a goal-based mindset, which puts more responsibility on financial advisors and other investment professionals to understand the difference between goals and performance and how to target one without compromising the other. This understanding is at the heart of the investing intentionally.

Why are we talking about this? As we said at the start of this letter, there seems to be a particularly acute epidemic of undisciplined behavior in the financial markets. This has put a burden on investors, whether they are individuals or advisors selecting direct investments or investment managers, to seek shelter from a storm they can feel but cannot see. As volatility increases in the markets, the legacy of performance metrics looms large every time the market snaps back from a decline. We caution investors to try to shift mindshare away from such short-term return-focused cycles in favor of making deliberate decisions centered on their portfolio goals. We believe measuring results over longer timeframes and prioritizing risk-adjusted metrics over return-only metrics could help investors strike a better balance between their short-term and long-term objectives in an intentional way.

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Nonsense Masquerading as Foolishness Undermining Discipline

Back in November, a well-known and highly regarded investment bank approved a stunning piece of strategy for distribution to clients. While we are not authorized to reprint the research here, the take-aways are notable for what they tell us about the current investing environment.

As a summary, the authors discussed a potential opportunity for investors in the high yield bond market based on seasonality, with a focus on increasingly warm weather during the month of November in recent years.[2] Using our own research, we can (almost) replicate the observations

2 We wish we were kidding.

of the authors that most[3] of the ten Novembers from 2007-2016 witnessed high yield bond market declines, while most of the 17 Novembers before that period (1990-2006) experienced gains, though we did not then correlate these observations to any particular weather trends – we will just take the authors at their word on this since it really doesn't matter. Based on the data and the analysts' views, the strategy piece argued that, absent bigger factors, seasonal investment strategies may have validity. The actionable conclusion to these observations was to recommend that investors buy the high yield bond market for the colder months of December, January and February due to historically higher returns and lower volatility.

Did you catch it? The unnervingly nonchalant disclaimer injected into a strategy recommendation based on the supposed seasonal trends of the high yield bond market? Absent bigger factors. The authors may ultimately win the argument about seasonality having some validity, but it's a pyrrhic victory if the investment thesis only works "absent bigger factors." Such bigger factors might include the "taper tantrum" in Q2 of 2013; the oil market decline that dominated the second half of 2014 and the start of 2015; the fears over China's economic slowdown that impacted the markets in late 2015/early 2016; and the technology sector decline triggered by a variety of catalysts in Q1 of 2018. Who among us would make the case that this is a market without "bigger factors"?

Perhaps we should be more forgiving. In November, maybe it seemed reasonable to buy the high yield market based on attractive performance during the months of December, January and February historically. Except in 2014/2015, 2015/2016 and 2017/2018. Oops. Being fair, it's worth pointing out that December 2014-February 2015, while not low volatility, ultimately ended in positive territory. Also being fair, December 2017-January 2018 was indeed a positive time period for the high yield bond market. But February 2018 was not, to such an extent that the entire three-month period in question was negative and not anywhere close to being "lower volatility."

So what is our point other than to highlight one singular example of market strategy gone wrong? We have often in these pages made the case for investors to be disciplined and risk-aware. Our foil in the past has been the passive index, which by its very nature is not risk-managed and demonstrates no active discipline. We have further pointed out that the use of index funds is inherently active, as most investors rebalance exposures as market factors and conditions change. And we have argued in various ways that preserving capital, if that is one of an investor's goals, is a direct result of such an active, disciplined investment effort, whether that effort is tactical or fundamental.

But the tactical strategy we've been discussing, making short-term bets on the direction of the high yield market (presumably using index funds) based on seasonality, is not a simple case of discipline breaking down and giving way to foolish behavior out of desperation or a need to outperform. This is sheer nonsense, no more a strategy or evidence of an informed tactical approach to investing than Dr. Malkiel's proverbial monkey throwing darts at a wall. It's no wonder active management has gotten a bad reputation for underperforming benchmarks over time. What investor or advisor invests this way, or chooses managers who do?

The problem here lies once again in the false choice favored by those who would have the incredibly complex financial markets reduced to a one-dimensional "good vs. evil" allegory

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3 We used the ICE BofAML US High Yield Index for our analysis (source: Bloomberg Finance LP). We found 7 of 10 declining months, while the authors found 8 of 10. This is a nitpick for sure, but it highlights the fragility of using such data to underpin investment theses.

– or in this case, "active vs. passive."[4] We are certain there are managers for whom a seasonality thesis like the one discussed above plays heavily into their investment decisions. But, instead of equating this poor excuse for discipline with the many other approaches to active risk selection with desirable exposures not available in passive form, we believe it may be in the investor's interest to recognize that such undisciplined behaviors present opportunities for some of these other managers.

In our view, the lower-hanging fruits are not the indexed alternatives but rather those valuation-based active strategies which may be poised to capitalize on the volatility created both by their less disciplined counterparts and by a potential reversal of index investor sentiment. It is the responsibility of the investment allocator to think intentionally about which strategies best serve the goals of her portfolio before she finds out in a volatile market that her financial well-being has inadvertently become dependent on the weather.

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BREAKING NEWS: Bank Loans Just Got Riskier

In 2014, the SEC and the Federal Reserve applied a rule from the 2010 Dodd-Frank Act to the bank loan market. Simply speaking, the rule required sponsors of asset-backed securitizations to retain a 5% risk exposure to structured products they create. As applied to loans, this means that sponsors of collateralized loan obligations (CLOs) were required to have "skin in the game", and if the loans they selected for their portfolios went bad, they would feel some pain.

The sponsors fulfilled this "risk retention" requirement by keeping ownership of some portion of the securities they were syndicating to finance these asset-backed structures. For example, if a pool of loans was to be securitized, and the issued securities included senior bonds, subordinated bonds and equity, the sponsor might underwrite the equity portion by investing its own capital, thus retaining risk in the securitization.

The effect of this application of the Dodd-Frank mandate was, in short, to limit CLO sponsors to those firms who were capitalized and willing to put that capital at risk. For some banks, there was little appetite to use capital in a way that reduced their financial strength in the eyes of the Federal Reserve since such securities would not qualify as core capital for bank regulatory calculations. For smaller credit managers, the capacity to buy and securitize loan portfolios was limited by how much capital they had to invest in their securitizations, in the same way that an investment fund can only buy as many securities as it can afford based on its assets under management and the capital requirements of its custodians.

So now that our readers have invested some time in understanding the "risk retention" requirements set forth in the Dodd-Frank Act, you will be dismayed to know that the Loan Syndications and Trading Association (LSTA), a trade group representing bank loan market participants, successfully sued the SEC and the Federal Reserve, arguing that the application of the requirement exceeded their authority to impose such limitations on open-market CLOs, i.e. those that purchase bank loans in open-market transactions.[5] On February 9, 2018, the U.S. Court

4 Much of this dichotomy is the result of the combination of two related psychological phenomena, the "illusory truth effect" and "processing fluency." A detailed discussion is beyond the scope of this footnote, but in summary, the takeaways are that people tend to believe (a) what is repeated to them, regardless of whether it is true, and (b) what is easy to process, often made more so through repetition and familiarity (see item a above). It requires intentional effort to stay vigilant and independent when so many businesses depend on these tendencies.

5 It is worth noting that, in the original rule, the regulators already provided some exemptions for certain mortgage-backed securitizations. So there is precedent for exclusions from the rule.

of Appeals for the D.C. Circuit sided with the LSTA, and the deadline to appeal this ruling passed without action by the regulators on March 26. After April 2, the rule will no longer apply to CLOs.[6]

So what does this mean to you? Open-market CLOs purchase the loans in their portfolios either as part of a primary syndication (i.e. new issuance) or in the secondary market. Both have the effect one might expect – to provide support for or a boost to loan prices when a new CLO is brought to market or when an existing CLO (if actively managed) is making additional purchases. Lifting limitations on sponsors means more CLOs, which in turn means more loan buyers. Furthermore, since CLOs, like index funds, are not as concerned about getting the best price as fundamental investors, the marginal loan purchases are more likely to be price indiscriminate. In short, we would expect to see price increases and credit spread compression in the short-term.

Before the loan fund investors in the audience rejoice, we should further clarify what else this means. We may see credit spread compression, but those credit spreads are not compressing due to any fundamental improvements in the credit quality of the underlying issuers. One could argue that easier access to capital is a positive change in a borrower's ability to repay or refinance, but if we were to debate this point with a random sampling of homebuyers in 2009, we suspect we wouldn't end up winning the argument.

Furthermore, we expect new loan issuance will continue to be the seller's market that it has been for the last several years. Issuers are able to mandate their covenants (or lack thereof), their prices (fewer and fewer issues priced at a discount), and their interest payment terms (tighter credit spreads and no more floors on their coupons). This should scare any investors who remember the "covenant lite" era of the bank loan market from 2007. Many have already noticed parallels between that pre-crisis frothiness and what is happening in the loan markets today. Notably, such observations largely pre-dated the loosening of CLO "risk retention" restrictions.

Which brings us back to the overarching question of this letter: as an investor, what are your intentions? If you choose to buy (or hold) a bank loan portfolio because the prices are expected to go up for non-fundamental reasons, you are either expecting to know when to sell before prices come down at some point, or you are not expecting prices to decline at all. The latter is a hold-to-maturity expectation, and it's a common and valid consideration for short duration portfolios. But there is a nuance that can cause problems for investors who are unaware of it.

Unlike short-duration bond portfolios which are short due to the short expected lives of (mostly) fixed-rate bonds, a short-duration portfolio of loans is short due to the floating-rate nature of the securities. But the expected lives of the loans are typically much longer, often more than 5 years, and while interest rate moves may not result in price declines due to the floating rates, credit spread moves would have a significant impact on loan pricing. This makes a hold-to-maturity loan portfolio most appropriate for a longer-term horizon – risky in a market where credit protections for investors are being undermined – unless one takes a deeply fundamental and selective approach, which just isn't possible at scale in a loan-only strategy.

But if not buy-and-hold, then an investor is accepting a market timing mandate as a key component of his investment strategy. Our not-so-positive opinion of market timing has been discussed in previous letters, but even setting that aside, we wonder if this is really the intention of the investor in question anyway. Is he trying to trade the bank loan asset class, riding a short-term demand to a peak and exiting before that one-sided market behavior shifts to the other

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6 The SEC and the Federal Reserve still have one more option: an appeal directly to the U.S. Supreme Court within 45 days. But, since they chose to skip the standard appeals process and the high court leans pro-business at the moment, we view this as unlikely.

side? Or is he trying to stabilize a fixed income portfolio, reduce volatility and make it more likely that he will reach his goals in the long run?

This is the central question underlying many of our discussions with clients. If you take a deep breath, ignore the incessant noise, and re-center on the goals of the portfolio, are you trying to be a trader or a portfolio manager? Which of these is more likely to help you achieve those goals or fulfill your mandate? We ask ourselves this every day, both about ourselves and our clients, and we always reach the same conclusion. Our mandate is to deliver a consistent, low-volatility risk profile suitable for both short and long time horizons. In aiming to do so, we serve those investors with reasonable performance goals which are uncorrelated with short-term swings in any one asset class, up or down.

As we mentioned in our last letter, we've been managing a standalone short-duration credit strategy in one form or another since before it was cool. We've seen a lot of new entrants into this space, but we find it interesting to know that we have little overlap in underlying investments with many of the funds in this peer group. We have often wondered why this is the case. What we realized is at the heart of the theme of this letter: intentionality.

Our business was created to deliver a specific risk profile to address a specific need for our early investors. That is, our revenue has always come from our ability to apply our skillsets to serve clients in a specific way. We carry this mindset with us every day, and it informs every decision we make, both in our portfolio and in our business. What we aim to do, our intentions, are rooted in this founding purpose.

It is not our place to comment on which of our peers may or may not have similar objectives, but we believe our clients should be comforted knowing that our governing philosophy is not one of opportunism, capitalizing on current market trends in investor demand. Rather, it is one of collaboration, seeking to build differentiated solutions to your most pressing problems within our core competencies, even when those problems aren't widespread enough to constitute a market trend. By our next letter, we will have crossed the firm's 9th and our fund's 7th anniversaries. As we head toward year 10 of Zeo (!), we believe more than ever in the durability of this approach in both our business and the ways we may contribute to our clients' portfolios.

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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