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ZEO QUARTERLY LETTER: 3Q2018

Dear Clients:

During the course of hundreds of conversations we have in any given year with our clients, prospective clients, friends and colleagues, we often see patterns in the fears and concerns that weigh on your minds. In this letter, we dive into several of the worries we've seen bubble to the top as they relate to our own short duration credit strategy to help our readers wrap their heads around low credit spreads and "covenant lite" loans. We agree that both of these are areas of concern deserving of focus – but not for the reasons you might think.

Rising Credit Spreads Won't Sink All Boats

Low credit spreads are obviously impactful on both the past and future performance of any strategy which invests in corporate debt, such as ours.[1] But what gets lost if we stop with a discussion of performance is the importance of the actual strategy and the investment process that implements that strategy. That is, we cannot stop at a discussion of observations at the asset class level. We must dive deeper to investigate how different managers approach the asset classes strategically and what process drives the actual security selection within an asset class.

In today's environment of passive index investing, it's often hard for investors to understand that an investment strategy can be greater than the sum of its passive credit and interest rate exposures. The errant conventional wisdom is simple: high yield indices go up when credit spreads go down, and intermediate term high grade fixed income indices go down when interest rates go up. This, the thinking continues, is why credit-oriented strategies have done so well and broad market fixed income indices have done so poorly this year. But, won't the music stop?

This logic ultimately reaches a flawed conclusion: Because credit strategies invest in bonds with credit spread exposure, they will have principal losses when credit spreads rise. So why do we believe this is incorrect? In short, this thought process fails to distinguish between a carefully selected portfolio of short-duration bonds (such as the portfolio we construct in our own strategy) and a broad market passive index of high yield debt.

1 This is also true of any strategy intended to track an index which has corporate debt constituents. The Bloomberg Barclays U.S. Aggregate Bond Index, widely used as a benchmark for fixed income portfolios, is just such an index.

First, let's look at the impact of fundamental analysis, which has historically been associated with equity portfolios. While one can debate the benefits of stock picking due to the long-term nature of equity analysis, we believe the impact on debt is much more straightforward. Here, fundamental analysis typically has one aim: mitigate default risk. In our case, we have a second aim related to our dual mandate: mitigate portfolio volatility. It is our view that, by focusing on businesses with barriers to entry and defensive positioning, we can deliver a portfolio with materially different behavior characteristics than a passive index. Why? Because indices are intended to be comprehensive snapshots of the markets they represent. High yield indices include all levels of creditworthiness *by design*.

If one imagines two portfolios, one that is indiscriminate regarding creditworthiness and one that aims to select only issuers that the analysts believe can repay their debts, it becomes easier to understand why a comparison would be apples to oranges. This may not be the case for a portfolio aiming to replicate or always outperform the index, as the incentive to select higher volatility credits or riskier credits becomes a primary (if not *the* primary) driver of decisions. But for a capital preservation portfolio, this should not be the case, especially when the investment process is designed not just to identify creditworthiness but also to screen out volatility catalysts.

Second, we should not discount the impact of short durations beyond their dampening impact on passive bond math sensitivities. Evaluating creditworthiness is a function of several factors: size of debt (leverage), ability to service the debt (cash flows) *and borrowing term* (credit duration/maturity).[2] Put simply, shorter borrowing terms make the evaluation of repayment easier. But, it's important to note that *not all short-term debts are creditworthy*. This is, in our opinion, why many short duration high yield portfolios do not live up to the bond math expectations. It is specifically the combination of shorter terms and fundamental credit selection that drives the potential to be less sensitive to broad market movements when they happen.

But we shouldn't stop with the theoretical discussion. Those among our readers who are invested with us are already aware of our strategy's performance profile. For those who are not, suffice it to say here that our strategy has never been down over any 12-month period since our inception.[3] We believe this shows that concern about rising credit spreads impairing a portfolio like ours is unwarranted. Rather, our strategy and investment process has delivered positive results on a rolling 12-month basis even during those periods of time when credit spreads increased substantially. During these same periods, broad market high yield indices and many short duration high yield strategies posted negative performance. Meanwhile, we aim to be positioned to reinvest into higher yields and credit spreads if such a widening were to happen. In our opinion, this asymmetry is one of the unheralded benefits of our strategy.

2 This is not the same as interest rate sensitivity, which is the most common form of duration discussed in most investment conversations. Low interest rate duration is on everyone's mind these days due to the specter of rising interest rates, but bond math doesn't care which input moves. Bond prices decline when either interest rates or credit spreads increase. Especially for floating rate portfolios, a darling of the risk-aware investor nowadays, the credit spread sensitivity can be many multiples of the interest rate sensitivity. We encourage readers to contact us anytime to understand this issue in more detail. It's important and timely.

3 In fact, the performance hasn't been negative over any 6-month period either. However, we believe a 12-month period is a more appropriate timeframe for investors who are considering hiring Zeo as part of their fixed income portfolios, as we discourage short-term tactical uses of our strategy. Note that our strategy inception was just over nine years ago, so there are potential market environments we have not managed through in that timeframe. Also note that past performance is not an indicator of future results.

We share the concerns of many that credit spreads may be at unsustainably low levels (see Figure 1). We also share concerns about rising interest rates, though we believe the risks are more due to complacency toward leverage (as evidenced by the indiscriminate euphoria surrounding syndicated bank loans) rather than excess duration, which is largely understood in our view. We believe we are well-positioned both in the portfolio and by our investment process and strategy to benefit our clients if these concerns are manifested in the marketplace. Meanwhile, if they do not, and we have no visibility to predict markets will rationalize anytime soon (recent volatility notwithstanding), we believe we are also well-positioned for the waiting game until this happens – by our reckoning, it's only a matter of time. What we aim to provide our investors is an approach with which they don't have to know when it will happen to be positioned for it.

Figure 1: 20-Year History of Bloomberg Barclays US Corporate High Yield Average Option Adjusted Credit Spread (Source: Bloomberg Finance LP)

Covenant Lite: Yields Great, Less (Ful)Filling

A lot has been written in the financial media about the return of "covenant lite" loans. Many market participants remember correctly that there was a spike in such loans before the last financial crisis in 2008, and this trend was cited then as a sign that the syndicated loan market, a once sleepy and supposedly safe corner of fixed income, had become unsustainably risky. When characterized this way and given what eventually happened to the capital markets, who could disagree?

Strictly speaking, the term "covenant lite" specifically refers to the absence of a specific restriction on a company's ability to issue debt. Depending on the type of debt issued, including the level of risk perceived by debtholders, a bond (or loan) would have either an incurrence or a maintenance covenant. The incurrence covenant places a restriction on the amount of leverage a company can have when it issues a new debt instrument. Put another way, if the company's leverage was, say, 3x EBITDA[4], an incurrence covenant might say the company can only issue new debt if that debt resulted in leverage at the time of incurrence was below, say, 4x EBITDA. However, once the debt was issued, if EBITDA subsequently declined in a future year so that the company's leverage exceeded 4x EBITDA later on, this would not constitute a default under the debt's covenants.

4 This means that the company's total debt outstanding can be no more than three times its reported earnings before interest, taxes, depreciation and amortization (EBITDA). Companies can often have ways to adjust these numbers before calculating leverage, so a detailed credit investor will often look for the loopholes in the definitions of both debt and EBITDA before trusting a number provided by an issuer.

If this 4x EBITDA requirement was written as a maintenance covenant, the company would be required to maintain that level of leverage at all times. Even a single instance of leverage exceeding the covenant, whether due to the incurrence of new debt or due to a decline in EBITDA in a subsequent period, would constitute a default. Such maintenance covenants have traditionally been standard in debt issued by companies with high yield credit ratings. Because the risk of excess leverage is one associated with the issuer itself, not the type of debt it issues, the credit agreements governing syndicated bank loans issued by high yield companies[5] have historically also included maintenance covenants. Until they didn't. The trend in the years leading up to the 2008 financial crisis and again now of dropping the maintenance covenants from loan documents is the specific meaning of the "covenant lite" label.

However, the absence of maintenance covenants doesn't mean that the loans are not without protections. A variety of secondary covenants, such as explicit limits on increased borrowing or restrictions on paying dividends to shareholders, often do a better job of getting to the true heart of the question facing credit investors: Are there restraints on cash exiting the business in a way that puts the ability to repay debt at risk? If such restrictions exist, the creditworthiness of a particular loan may be validated regardless of the existence of a maintenance covenant. On the other hand, the existence of maintenance covenants don't necessarily add value or protection to a weak credit; they may simply serve to accelerate a default.[6]

That said, the renewed focus on "covenant lite" loans is not misplaced, but not because the loans are missing maintenance covenants. The indiscriminate buying that has characterized the loan markets in recent times has created a seller's market for such securities. As a result, issuers are able to whittle away at even the more meaningful cash flow restrictions elsewhere in the loan documents. Why? Because the intersection of the overwhelming trend toward passive investing and the huge demand for a place to hide from rising interest rates has created an unprecedented volume of demand from investors (and the managers they hire) who buy securities in bulk without reading the governing documents. The need for exposure to the asset class as a whole irrespective of issuer creditworthiness has drowned out the more selective loan investors who view creditworthiness over time as a prerequisite to making an investment.

Unfortunately, we don't see this trend subsiding without a significant correction at some point, but in keeping with the theme of this letter, the conventional wisdom dominating the headlines isn't the real story here. "Covenant lite" isn't why investors should be worried about the loan market. The credit risk in the current market is driven by the lack of attention being paid to other credit protections because investors are treating the entire loan market as one homogenous asset class.

Even so, the fact remains that the general characteristics of syndicated bank loans are as advertised. In particular, they have lower interest rate durations while offering reasonable yields. One can benefit from this profile by recognizing loans as the credit instruments they are, and a responsible use of such securities requires at least some level of credit analysis to inform security selection. It is no more valid to throw out the entire loan asset class for a general trend toward

5 Note that most of the bank loans dominating the marketplace today are issued by high yield companies, in part because they are the highest yielding and in part because investment grade loans are not often syndicated beyond lender pools consisting solely of banks.

6 Accelerating a default before things get worse has its benefits to debtholders, to be sure, but making a badly-run business creditworthy is not one of them.

weaker covenants than it would be to exit all equity investments because trade tariffs threaten a subset of stocks. On the other hand, it would make no more sense to buy the entire asset class indiscriminately and then wonder why it didn't do what it was supposed to do when interest rates and credit spreads increased. Weaker covenants in general don't impact all loans equally, and not all loans are being undermined by weaker covenants. But to be able to make this differentiation is an exercise in security selection, not asset allocation. In other words, only the fundamental debt buyer is doing what it takes to spot the difference.

We are encouraged every day by the thoughtful and informed discussions we have with our readers, and we invite you to view this letter as an invitation to engage with us further. We are hopeful that our perspective is helpful and, more importantly, actionable. We believe it is essential not just to know that risks exist but also to understand why they are risks in the first place, and by extension, to consider how one might prepare for them. After all, there is no free money: Achieving any return is an exercise in choosing to take some risk. It is this understanding of the "why", not just the "what", that enables investors to act with clear heads and rise above the emotional reactions that plague so many and can be so costly in times of volatility.

As always, we are available for your questions, comments or feedback. We thank you for your continued support and confidence in our management.

Sincerely,

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