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ZEO QUARTERLY LETTER: 1Q2019

Dear Clients:

Several months ago, the world was coming to an end. Remember that? Not long after, not a day went by in March without one or more financial news pundits warning investors of a "melt up" in the markets. And as we write this letter, the markets have shown signs of fatigue again. What changed? Is there really any difference between now and four months ago?

Economic fundamentals don't change nearly as quickly as predictions and projections, which have a way of zigging and zagging in response to every economic headline, big or small. Perhaps the largest material impact on fickle market convictions at the moment is coming from changes in expectations about tariffs on trade with China and Federal Reserve action on interest rates. The Fed seems to have broadcast to the market an expectation that any further rate increases will be put on hold. This emboldened investors to run the equity markets to all-time highs and to put further pressure on credit spreads, driving them back down to what we believe are unsustainably low levels. But the uncertainty around trade has provided offsetting pressure on equity markets, where long-term outlooks are deeply embedded in valuations.

Intertwined in both bullish and bearish arguments is much talk about cash on the sidelines. On the one hand, this is a reason given for a potential continued market rally. On the other hand, this could be a sign that investors are concerned about risks in the markets. So which is it? If the latter is indeed the prevailing view, the once and future market rallies of 2019 may be better explained by a potentially ill-advised fear of missing out (FOMO) than some foretelling of even better economic times to come. If the former, it may be worth trying to understand what it means to have cash on the sidelines in the first place.

The Money Stork

If you are reading this, unless you are a particularly precocious child, you know that babies aren't delivered by storks. However, we cannot deny the simplicity of such an answer to a complicated question when faced with the sincere eyes of a preschooler. Even so, it's hard to shake the nagging realization that all you've really done is kick the can down the road. Someday, this well-meaning delusion will come home to roost. So was the feeling as we asked ourselves partway through the most recent market rebound: "Where is all this money coming from?"

It's impossible to have managed money for the better part of the last three decades and not get the distinct feeling that something has been different this time around. For most of the last six years, every decline in the markets, big or small, seems to have been met with a near-certain recovery, often with a snapback even more violent than the drop that preceded it. Presumably, all that cash on the sidelines was frantic trying to capitalize on each attractive opportunity to take on risk. But then, wouldn't those investors return to cash (and spark a market decline) once the markets exceeded the unattractive levels previously motivating them to be cautious in the first place?

In reality, the amount of cash on the sidelines doesn't change because there is more demand than supply, or vice versa. When one investor buys a security at any price, another one is selling it. The net cash effect of that transaction is precisely zero. This observation, in and of itself, isn't terribly revelatory, both due to its tautologically obvious nature and to the fact that it's well-documented if one does even a cursory internet search for the phrase "cash on the sidelines." A more interesting insight is that what is often mistaken for cash on the sidelines is actually "cash entering and leaving the stadium."[1] In other words, it's as if the cash was conjured up out of thin air with the express purpose of buying the markets. This may seem implausible, but this is basically how leverage works.

But leverage is a vicious cycle when combined with asset value movements. Consider a new homeowner. He may have a mortgage and put 20% of his purchase price down. The bank lends the other 80%, in large part due to the property's appraised value. Presumably, if the appraised value exceeds the amount of the loan[2] and if the borrower's income is sufficient and steady, the lender feels good about getting paid back. Then another house in the neighborhood is sold, this time for a higher per-square-foot price. Now, the value of our new homeowner's house has increased on the assumption that this new transaction has set the market for houses in the area. In fact, this isn't just good news for our friend. One transaction has just revalued the entire neighborhood. Household wealth across all the local residents has increased as a result. Do they actually have more money? No. At least, not yet.

A few neighbors who have owned their house for some time see an opportunity. They can refinance and increase the size of their mortgages, all based on this new valuation of their houses and their history of paying debts on time. And voila. An increase in wealth on paper has turned into an increase in cash in hand, to be spent or invested. This isn't necessarily a bad outcome. Borrowing based on asset values and credit history has been a centerpiece of our economy from the nation's founding. After all, the very existence of a central bank in the United States was based on this notion that credit begets credit.[3] But, let's call a spade a spade: The cash in this scenario was created out of thin air by many measures. And it could just as easily disappear, when the loans are repaid or when asset values drop or borrowers cannot make their payments, forcing the loans to be called by the lenders and assets to be repossessed and sold at a discount, further exacerbating the vicious cycle.[4]

1 It's a tricky metaphor, but we're going to do our best to stay in it.

2 The loan-to-value ratio (LTV) is a common metric for lenders in a variety of industries. An LTV less than 1.0x means the loan is, for the moment, fully covered by the value of the asset. LTVs can change due to borrowings and repayments of loans, of course, but the interesting questions arise when trying to assess the potential changes to LTVs due to changes in asset values in different market environments. For example, mortgage LTVs spiked (i.e. loans exceeded asset values substantially) during the 2008 financial crisis due not to increases in debt but to plummeting home prices. This was not well anticipating by lenders, to say the least.

3 Despite what some believe, Alexander Hamilton was not the original father of US credit. Many know that, as the first US Secretary of the Treasury, he advocated for the federal government assuming debts of the individual states in order to convince foreign nations that the new country was creditworthy enough to lend to – an early form of FOMO in a way. But before he held that role, he was an aide to a man names Robert Morris, who opened the Bank of North America, the first central bank for the newly-freed colonies; Morris was the true originator of US credit. But the fear of foreign influence prevented the bank from operating nationwide. After the US Constitution replaced the Articles of Confederation and once Hamilton became Treasury Secretary, he pushed for a new central bank (the First Bank of the United States) to continue Morris's legacy, and as any fan of early American history, the Broadway musical or Ron Chernow's biography knows, secured necessary support from the Southern states in exchange for moving the nation's capital from New York to a Southern location on the Potomac River. Politics cost the successor to this central bank its charter in 1837, which gave way to a banking system with a series of state and national banks, much as we have now, with one addition early in the 20th century: A central banking structure was finally reestablished when the Federal Reserve System was created in 1913.

4 This is a complex subject, and while we are doing our best to simplify it, we are sure questions will arise. Please do not hesitate to reach out for a deeper conversation on this topic anytime.

But leverage alone isn't the only issue at hand when trying to understand what it means to have cash on the sidelines. It may be a major source of cash entering and exiting the system, but the motivations of investors (i.e. why they buy and sell) have just as large an impact. As we mentioned before, actual cash in the marketplace doesn't change when a trade takes place. The real difference before and after a transaction is that an investor in need of or willing to hold cash now has cash, and an investor for whom holding cash is not an attractive proposition or perhaps is not an option at all has now disposed of cash. There are a variety of reasons why someone would need or want cash. There may be a short-term spending need. Perhaps someone is aiming to repay debt or another liability. Or maybe the investor doesn't mind the opportunity cost of holding cash in order to take advantage of a potential market dislocation later on. On the other hand, the investor deploying cash may be optimistic about the prospects for the market. Or perhaps she simply is not allowed to hold cash and must deploy, regardless of the perceived risk and reward of doing so.

We should note that not every investor who cannot keep a cash balance is risk seeking. It is possible to be concerned about the markets but still feel the pressure to put money to work. In fact, it is this type of investor that woke us up to this observation in the first place. After all, how else can we explain 6-month BBB credit spreads declining in March to their tightest levels since the financial crisis,[5] down nearly 50% from their levels in December. This precipitous drop in short-term credit spreads even during a period in which broader credit risk made money tells us that even cautious investors, piling indiscriminately into bonds they might consider safe, don't always have the luxury of holding cash to wait for better entry points in the markets.

When we combine leverage with this latter observation that some investors are not allowed to hold cash, we get the unfettered market advances we've seen over the last few years. Every dip is met with a fear of missing out, which in turn results in fund inflows to the markets. In recent times, these inflows have been disproportionately allocated to passive index products (ETFs, index mutual funds and passive structured products), which do not have the flexibility to hold cash the way a fundamental strategy or a self-directed investor might. After all, if an individual investing on behalf of herself has cash and feels that the market may be overvalued, there is no investor mandate requiring that she deploy that cash. Then, she has it available to deploy when the markets correct in a much more substantial way. In other words, she is buying when the market goes down (and most likely selling when the market goes up).

Contrast this to the passive investment strategy, which buys when it sees fund inflows and sells when it sees fund outflows. Since inflows drive purchasing, and purchasing drives inflows, there tends to be a correlation between rising markets and allocations to those markets. The opposite is also true. In this case, investors are buying when the market goes up and selling when the market goes down, and the cash being used may even be coming from leverage, which creates a multiplier effect! If this isn't a recipe for increased volatility, we don't know what is. When we see the markets going up indiscriminately, we see a spring getting more and more tightly coiled, every day increasing the risk of a violent decline with few buyers aside from those cautious investors who can and do choose to hold cash, even if it means missing out on risky gains if the market continues to go up in the meantime. After all, nothing in this discussion says when the spring will uncoil. This is, in essence, a decision about acceptable levels of risk in a portfolio.

5 Source: Bloomberg Finance, LP. The average 6-month BBB credit spread since Bloomberg started tracking the data in June 2009 has been about 82bps, roughly where it was in mid-December 2018 as well. The lowest spread in that time occurred on 3/26/2019: 43.5bps.

"Cash on the sidelines," on the other hand, is a very convenient explanation to absolve oneself of the responsibility of making such tough risk decisions and instead justify markets that only go up and to the right. After all, when was the last time we heard anyone say there was too much "cash on the field?"[6] Oh wait. We and others have done exactly that in the past, highlighting the consequences of an overwhelming trend toward indiscriminately investing in asset classes rather than individual securities and an environment in which the cost of leverage is too low. But now we sound like a broken record, advocating for security selection and fundamental analysis in a market all too willing to reward less disciplined approaches for the time being. The problem lies in the hard work it takes to be disciplined. Let's face it folks: It's not easy, quick or convenient, and at times, it can be complicated as there's often no obvious right or wrong decision without hindsight.

So, to all of the like-minded readers out there who are asking themselves the same question with some combination of incredulity, frustration, fear and wonder, we offer this alternative explanation for why markets don't ever seem to go down. Where is all this money coming from? Why, the money stork, of course. And while this may be an obviously false and unsatisfying answer, it does meet the market's requirement for simplicity and a willing suspension of disbelief. The only drawback is, in this case, the consequences of this deception are not as benign as the sad but inevitable realization that our children are not children anymore. In this case, the people investors are intentionally deceiving are themselves.

Redefining Outperformance in Fixed Income

We at Zeo take pride in being fundamental investors. We are grateful that our mandate allows us to pick and choose when we deploy cash. We stay disciplined with respect to the prices which we pay for the bonds in our portfolio. We appreciate and take seriously the responsibility given to us by our clients to seek to earn a fair return for an acceptable level of risk.[7] We believe those among our readers who have invested with us would be happy to know that we do not always buy the highest yielding bonds we see offered. Rather, we seek to buy the bonds which we believe have the best risk/reward profiles. More often than not, this means that if corporate credit experienced a bull market, we would most certainly "underperform." After all, a rising tide lifts all boats, even those which could be on the verge of a restructuring in a less forgiving environment. Meanwhile, in the opposite scenario, we would expect our strategies to "outperform." We believe that both of these observations make one critically flawed assumption: That the goal of a fixed income portfolio is to achieve relative returns.

We've spent countless hours discussing financial plans and asset allocation with financial advisors. We often hear them speak of their clients' goals. Most of those clients are not in "the 1%." They will work until they retire at an advanced age. Their retirement will depend as much on their life decisions as it does on their financial decisions. More often than not, investing their assets in a well-diversified portfolio of mutual funds will not be the most valuable thing their financial advisor does for them. This task is important, however, and achieving their goals will often require a portfolio with

6 Still in it!

7 We aren't naïve or arrogant enough to think that we're the only investors who think this way, however. If an issuer's bonds appear to have substantially different yields than those of other issuers which may be considered its peers, it's more likely than not that other market participants, having done some level of analysis, determined a difference in credit risk or uncertainty to demand a difference in credit spread. It is in the uncertain situations that we find both red flags and our greatest opportunities to differentiate our portfolio through hard work and deep fundamental analysis. The key to our work is enforcing our discipline to reliably identify the babies being thrown out with the bathwater.

a growth profile, which is tricky since a setback due to risks not carefully chosen can be catastrophic. In our opinion, financial advisors understand well that they are being asked for a path, and one of their contributions to the client's journey on that path is the advisor's earnest effort to responsibly manage the investment risk.

As we have written before, unfortunately for those financial advisors and their clients, today's investment environment is not designed to help them live up to this promise. The timeframes over which investors look to outperform indices are getting increasingly short. An investment thesis that may take several years to bear itself out is now judged by whether it beats an overall asset class index in a single quarter. This, in turn, motivates a highly transactional mindset, which plays right into the hands of Wall Street, an industry full of market participants compensated by trade volume and frequency, not trade quality.

The transactional mindset is further instilled by the risk that one might be fired by clients if performance isn't good enough. Often called career risk, this view further embeds a transactional mindset into the psyche, since one way to reduce the risk of being fired is by making oneself essential. A portfolio with a lot of activity presumably has more ongoing need for the financial professional than one that is strategic and low-maintenance in nature. This tactical approach leads to a dependence on asset class exposures through easily-traded passive investment vehicles such as ETFs and index mutual funds rather than careful security selection.

And so investors find themselves spending meaningful amounts of time trying to evaluate whether one asset class or another will go up or down in the short-term. Even if one can reach a conclusion, this effort has only a tangential relationship with the goals of a client's financial plan. That said, most clients still need some growth in their portfolios to achieve those goals. But is that really what the fixed income side of the portfolio is supposed to be doing? Every growth-oriented risk has an offsetting loss potential. While this may be appropriate for equity portfolios, we believe the objective of the fixed income portfolio should complement the equity risk rather than duplicate it; fixed income should not be rooted in a similar outperformance mindset.

The notion that a fixed income portfolio should outperform a fixed income benchmark in a short timeframe is dangerous. Broad market fixed income indices tend to have reasonably long durations. So what does it mean if a portfolio outperforms those indices in a three-month horizon. If, say, an index with an average duration of 6 years is up 3% in one quarter (representing roughly a 0.50% change in underlying bond yields), is a 4% return in one quarter a sign of a good fixed income portfolio or of excess risk? It seems to us a 3% or 4% return in a 3-month timeframe, when annualized, looks more like an equity risk. This performance only represents fixed income risk if viewed in conjunction with performance from other periods over time, and ideally, over a timeframe that more closely reflects the underlying duration of the portfolio. In our view, a fixed income portfolio should be focused on capital preservation. After all, most advisory clients need to know they have something to fall back on if the growth expected from equities doesn't materialize. However, capital preservation is not a return-seeking approach; it is rather an investment philosophy focused on managing risk, not seeking risk.

How, then, do we know if our fixed income portfolio is "outperforming" its benchmark? We believe the key measures of outperformance for a fixed income portfolio are those which demonstrate differentiated risk-adjusted returns. Sometimes, achieving market returns (or slightly below) with meaningfully lower volatility is more aligned with the goals of a fixed income portfolio than achieving traditional outperformance relative to a fixed income benchmark. By prioritizing risk-adjusted returns in fixed income and pairing this capital preservation portfolio with the risk-seeking objectives of equities, we believe investors are more likely to assemble a portfolio of risks appropriate for achieving their long-term goals without placing undue emphasis on relative performance.

Creditworthiness + Volatility Mitigation = Risk-Adjusted Returns

When we evaluate issuers and bonds at Zeo, we are focused on a variety of measures which we believe best deliver on the dual mandate that governs our strategies: creditworthiness and volatility mitigation, which, when combined, drive differentiated risk-adjusted returns. For any fundamental strategy in corporate credit, the metrics we target include appropriate levels of leverage; consistent ability to generate cashflow; and reasonable covenants protecting enterprise value available to lenders. There are many other factors in our deep-dive fundamental analysis; collectively, our approach is designed to comprehensively identify and evaluate the risk factors which are material to an issuer's financial viability and its ability to repay the debt we are considering for the portfolio.

In our short duration income portfolio, just at its ten-year anniversary (eight years in mutual fund form), the creditworthiness evaluation of an issuer is further benefited by the short-term nature of our holdings. Put simply, there can often be less uncertainty in an issuer's credit risk in a short timeframe than there might be over the longer-term. Meanwhile, the fundamental analysis itself can provide a buffer to broad market volatility. If our analysis is able to limit our portfolio to stronger credits within the corporate bond universe, it stands to reason that the asymmetric volatility impact of poorer credits may be avoided in a fundamental approach to short duration credit. This, combined with the favorable bond math of short-term debt, is in our opinion the key driver of our low volatility performance in this strategy since our firm was founded a decade ago.

This same formula is the driving force behind our decision to add to our fund family and pursue a sustainable credit strategy. This decision was the deliberate result of a two-year process in response to interest from our clients in applying our risk management mindset both to a less duration-constrained credit portfolio and to a sustainable[8] fixed income portfolio. When we viewed our long-standing investment process through both lenses, two things became clear: (1) Considering sustainable business factors in our credit analysis was already part of our process informally; and (2) this approach is crucial when evaluating bonds with durations longer than one or two years.

The reason for this gets to the heart of how we think about credit analysis. As we have stated in the past, we view the purchase of bonds not as trading or even investing in securities but rather as lending to borrowers. The "loan" may be in the form of a security purchased through a brokerage. The "borrower" may have incurred the debt through the issuance of the security. But the relationship ultimately is not much different than any other borrower/lender dynamic we see play out throughout the economy, from mortgages to small business loans to a $20 bill lent to a friend. Assessing creditworthiness of a borrower is essentially a task of the lender determining if she believes with a high degree of confidence that the debt will be repaid promptly.

8 For the purpose of this discussion and our new strategy, we use the term "sustainable" in reference to an issuer's efforts to behave in a way that is long-term sustainable for their business. To evaluate this, we include in our credit analysis a review of the ESG (environmental, social and governance) factors material to the company's financial well-being, with the goal of selecting those issuers who demonstrate themselves to be leaders among their peers (i.e. best in class within their industries) or have shown themselves to be actively working to improve their performance when measured by relevant ESG factors.

In general, a bond issuer's creditworthiness is tied to how management operates the business. This much is obvious. But when thinking about credit risk over time, if a company is making decisions which prioritize short-term financial results over longer-term business viability, creditworthiness is compromised even if earnings appear strong. A company that aims to strike a balance between short- and long-term priorities and places strategic emphasis on those factors which make the business more sustainable is the one in which the risk of a credit event is truly mitigated, not just postponed.

Take, for example, Clean Harbors.[9] This company has evolved over the last four decades from a four-person business cleaning tanks in 1980 to North America's largest hazardous waste disposal company today. But this isn't just a story of doing well by doing good. Clean Harbors has become a complicated business, with a variety of services across many industries, including the re-refining of motor oil, environmental remediation, healthcare waste management and emergency response, just to name a few. Most of these business areas also require transportation services, so the company has had to develop a network of facilities to maintain a fleet of specialty trucks in addition to its facilities for the actual waste management services. A company whose livelihood depends on closing sustainability loops and helping companies responsibly dispose of their hazardous waste (or clean up their messes when they don't) cannot last long if it is not as committed to sustainable principles in how it operates its own business as well.

To that end, Clean Harbors makes sustainable business practice a central objective of its operating strategy. The company has adopted a multi-faceted approach to sustainability that goes well beyond the credit it rightly deserves for the socially- and environmentally-conscious nature of its services. It has implemented initiatives around prioritizing health and safety for its employees; managing energy and other resource usage in its own operations; requiring aligned priorities in its supply chain; and engaging stakeholders and communities. In service of these goals, the company has taken actions, big and small. Its employee safety training program has been identified as one of the best in the country by the Occupational Safety and Health Administration (OSHA), earning the company an invitation to present their efforts at OSHA's national conference. It has made a widescale commitment to renewable energy across the organization, including the company's first (of many) self-sustaining fleet refurbishment facility and the use of solar panels to provide power assists and extend battery lives in vehicles. It developed custom trucks to enable the simultaneous collection and delivery of oil to further reduce the environmental footprint of its automotive motor oil recycling services and associated risks. We could go on and on.

A company like Clean Harbors has recognized and built their business strategy around a stated commitment to sustainable business decisions. Such initiatives cost time and money, however, and if you only view these efforts through a lens focused on their impact on investor returns in the short-term, you might disagree with the priority. But we see it differently: The company has aimed to set the table to operate for the foreseeable future without sacrificing its long-term viability, which depends heavily on the alignment of its brand with its actions and on avoiding unexpected (and potentially costly) liabilities that could otherwise be associated with hazardous waste disposal. Clean Harbors uses formal third-party reporting platforms to provide customers and other interested parties with

9 While we may own Clean Harbors securities in our short duration income strategy from time to time for other reasons, this discussion is limited to the sustainable business practices of Clean Harbors as it relates to our view that longer-term creditworthiness is impacted by such corporate priorities. This view of credit over a longer timeframe, exemplified by Clean Harbors, is provided here only as it relates to our forthcoming sustainable credit strategy and does not constitute a comprehensive or actionable analysis of the company's credit. Clean Harbors may or may not be purchased in that strategy when it launches, and this discussion is not a recommendation for any securities issued by Clean Harbors. However, we do see Clean Harbors as a clear example of a company that has committed to sustainable business practices, and we hope this discussion clearly shows why.

clear access to the information necessary to hold it accountable, and the company partners with a variety of environmental organizations and programs to certify its own efforts and to support awareness of and improve on sustainable best practices across industries.

Meanwhile, risk-adjusted returns are as dependent on volatility mitigation as on the long-term sustainable performance of companies like Clean Harbors. Here again, an approach to portfolio construction which includes a company's commitment to sustainable business practices is needed. To be sure, less responsible issuers can still generate meaningful cashflows, a traditional hallmark of strong credit profiles. Vice industries[10], in particular, are good at that. But they also introduce significant headline risk, not to mention policy and political risk. A strategy which seeks to avoid such risks should be a lower volatility one, which in turn should enhance its expected risk/reward profile.

As we were exploring a less duration-constrained credit strategy, and as we considered Clean Harbors and other issuers for a potential portfolio, it became clear to us that including sustainable factors material to a company's financial performance was a necessary component of the investment process. Put another way, for us to deliver differentiated risk-adjusted returns with a less duration-constrained mandate, we believe a good fundamental credit portfolio and a sustainable credit portfolio are one and the same. Zeo's sustainable credit strategy launches on May 31, 2019.

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

Venk Reddy
Chief Investment Officer

10 Vice industries are industries which profit from vices, such as alcohol, drugs, gambling and pornography. Of course, an exhaustive list of mankind's vices would be much, much longer.

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