# ZEO QUARTERLY LETTER: 2Q2019



Dear Clients:

The Greek myth of Daedalus and Icarus is a timeless tale. To refresh your memory, the story starts with King Minos of Crete, who commissioned Daedalus to build an enclosure to hide the Minotaur, a half-man/half-bull creature who also happened to be the king's step-son.[1] Instead of simply designing a cage, Daedalus chose to get creative and built a giant maze called the Labyrinth, which King Minos used to his advantage by imprisoning enemies inside for the creature to eat. Anyone who went inside would be unable to return to tell the world of what dwelt within.

To further ensure that no one would find out about the Minotaur, King Minos imprisoned Daedalus and his son Icarus in the walls of the Labyrinth. But Daedalus was a crafty fellow, and using some wood, wax and feathers, he was able to fashion wings with which he and his son could fly to safety. Luckily, and somewhat implausibly, their prison cell contained a window through which they could climb, most likely either an oversight by the king or a necessary detail storytellers inserted so they could get to the moral of the story. Cautioning Icarus not to fly too close to the sun, Daedalus flew to his freedom, only to watch in horror as his son failed to heed his warning. Enamored of the feeling of soaring through the air, Icarus melted his wings in the sun's heat and plummeted to his death.

This myth is obviously very old, but its lessons are no less valid today. So perhaps we should reimagine it in a more modern setting.

## A Labyrinth of Financial Engineering

In the years preceding the financial crisis in 2008, the country was lost in a maze of subprime lending and adjustable-rate mortgages. These structures were tempting, but once people got trapped in them, confusion reigned. And this confusion was, in many cases, intentional. These labyrinthine structures were meant to obfuscate risk, both for the benefit of packaging and selling them to Wall Street investors as structured products and to hide the risk of overextending oneself from the borrowers themselves, who didn't want to question their ability to afford a house in a market that seemed too good to be true.

1 We couldn't make this stuff up if we tried. We definitely can't fault the storytellers of ancient Greece for a lack of detail in their backstories.

To some extent, the creation of this labyrinth was the doing of lax regulatory policy, with a corresponding failure to protect the consumer from (at best) negligent, if not predatory, financial services.[2] And it's not entirely clear whether the maze or the monster represents the financial system's relationship with the average consumer. I suppose each person who was affected will have her own opinion on the most appropriate analogy: Was she trapped or eaten? Or both?

This is where reality diverges from myth in our retelling. In the original Greek story, a Hunger Games-like offering of fourteen young Athenians to King Minos and his creature took place every seven years as a tribute to his kingdom of Crete. Theseus volunteered to take the place of one of the tributes, and with the help of King Minos's daughter Ariadne, he navigated the Labyrinth and slayed the Minotaur.[3] But the 21st century version of this story does not have a Theseus-like hero, and it seems to us that both the maze of financial products and the hidden creatures within them are still very much with us today.[4]

To be clear, Wall Street learned a lesson from the financial crisis. It's just not the lesson one might have expected. Today, we continue to see creative ways to sell leverage to market participants, but often, that leverage is harder to see, and the risk is harder to assess. We've discussed some ways this has been true in previous letters. For example, structured products, such as CLOs, have dominated the syndicated loan market. The first order effect of this demand for loans is the erosion of covenant protections for investors, a hidden and potentially severe risk which we don't believe most managers of loan portfolios are incentivized to avoid and which we don't believe most investors in those managers are aware of. But the second order effect is just as destructive: Just as they did in 2008, such products offer investors the option to use leverage to purchase already leveraged investments, all in the form of a security (hence the term "securitized products") which appears unleveraged on account statements.

A plethora of other headlines corroborate this view that Wall Street keeps innovating on ways to market labyrinthine products to unsuspecting consumers. Creative mortgage structures have reinserted themselves into dinner table conversations, though admittedly in a less pervasive way due to the reduced willingness to lend to the average consumer by banks who got tripped up a decade ago. Structured products packaging auto loans and credit card balances have gained in popularity as well. Though, the more insidious way these higher risk consumer loans have invaded investor portfolios is through suspiciously high CD rates from online banks whose primary source of net interest margin is the much higher interest rates charged on credit card balances and other forms of shorter-term consumer lending. While some might cite FDIC insurance to offset the risk of loss (up to a limit), the



2 Whatever you think of Senator Elizabeth Warren as a politician, her 2007 paper "Unsafe at Any Rate" was on point with its foundational question: Why does the government have regulation to protect consumers from unsafe tangible products but not from unsafe financial products? In this paper, Warren proposed just such a regulatory agency as a professor at Harvard Law School which she later created as the Consumer Finance Protection Bureau (CFPB) at the direction of President Obama in 2010.

3 Ariadne fell in love with Theseus when he arrived in Crete and so decided she would help him. In yet another demand for a willing suspension of disbelief by the ancient Greek storytellers, however, she apparently gave him a ball of thread to tie to the door of the Labyrinth (so he could follow it to find his way back out) and a sword with which to slay the creature. It seems the guards who escorted the tributes to the maze may have missed the sword one of their prisoners was carrying or that he tied a string to the door of the Labyrinth before heading inside. After he emerged victorious, Theseus added insult to injury, leaving for Athens with King Minos's daughter Ariadne (take that, King!) before abandoning her during the journey back to Athens. But the joke's on him; she soon met and married Dionysus, the Greek god of wine, who we assume was way more fun to spend time around.

4 What about the Dodd-Frank Wall Street Reform and Consumer Protection Act, you ask? Didn't we just highlight the CFPB in an earlier footnote on this very page? We thought about that. And without taking a side on the effectiveness of the Dodd-Frank Act, it seems to us that its supporters should be disappointed that it has been somewhat defanged since passage (e.g. loan securitization sponsors are no longer required to retain risk in their securitizations); and critics might argue it was never effective in the first place (e.g. mortgage securitization sponsors were never required to retain risk in their securitizations) or placed undue burden on market participants without sufficient impact. Either way, it's hard to argue that the Dodd-Frank Act slayed the financial beast which ate so many unsuspecting consumers.

additional risk of not having access to one's savings while the FDIC figures it out is rarely considered.

But the headline that most intrigued us recently is near and dear to our own efforts to identify and invest in strong corporate credits on a daily basis. In the last couple of years, another form of securitized lending called "whole business securitization" (WBS) has become increasingly popular in the corporate debt markets. Here's how it works, in short: A company moves all of its cash-generating assets into a bankruptcy-remote special-purpose entity and issues debt directly from that entity. The bondholders have priority on those assets and their cashflows. Meanwhile, the company can no longer use those assets as credit support or collateral to raise other debt capital.

Such a structure is particularly interesting to the restaurant industry, where the steady cashflows from franchisees can be isolated for the benefit of lenders. The company benefits because, if the structure is set up correctly, these bonds can get an investment grade rating where unsecured debt issued from the parent company would not. How, you ask, is that possible? It's a good question, and the answer is not at all satisfying or easy to understand. But we will do our best to explain.

The willingness of ratings agencies to assign higher ratings to the WBS structures is based on a couple of factors that differentiate them from unsecured debt issuance: (1) the franchise cashflows and related intellectual property is held within the special-purpose entity and pledged to the WBS; and (2) the covenants of the WBS are typically somewhat tighter (for now) and often have provisions for using cashflow to paydown the debt well in advance of maturity. But don't get too excited about this second point: Often, these maturities are 30 years away, and the provisions we reference require the company to use all excess cashflow to whittle away at this debt if it isn't able to be refinanced in a timeframe that is relatively shorter (say, 10 years) but not absolutely short. Investors, then, can look at these securities as shorter instruments while the ratings agencies can give them a benefit of the lower risk of defaulting at their much-longer stated maturity. But would these investors really lend on an unsecured basis to, say, Domino's Pizza (issued in 2018) or Massage Envy (issued last month) for 30 years? Put simply, it's ratings arbitrage, not risk mitigation.

In reality, these WBSs are still dependent on the parent company's ability to protect the brand and manage the franchising operation, and they are still dependent on the sensitivities that the underlying franchises have to the economy and the brand (including headline risks of mistakes or controversies at other franchises). To the extent the parent companies want to leverage the intellectual property beyond franchises, they would need to strike agreements with the special-purpose entities to reacquire the rights to do so. And if the parent companies run into financial trouble due to their other business units, they no longer have access to their most valuable cashflow-generating assets to shore up their liquidity. To be fair, this may not bother the WBS holders since they are isolated from a parent company bankruptcy and can take control of the intellectual property and keep earning the franchise fees; this is the very thesis everyone in this WBS ecosystem is counting on.

However, the parent company does have a management agreement with the WBS entity, and any financial trouble would likely get in the way of making good on that contract. For this reason, WBS structures include a backup manager arrangement so the lenders can take control of the entire operation even if the parent company fails and can no longer serve as the manager of the assets. While we haven't looked through every WBS in existence, a quick survey of recent deals shows that backup managers are mostly strategic consulting firms rather than experienced operators. For the sake of the investors seeing more and more exposure to this type of structure in their portfolios, we hope consultants are up to the task.

At this point, we should clarify that we are not highlighting these securities as the next hidden risk. But they are indicative of a bigger picture which we believe readers have vaguely been aware of for some time, but maybe without fully considering the consequences. Such financial engineering is not just alive and well but growing and prospering. The risks are more deeply buried, and intentionally so (again). If mathematicians on Wall Street, even those with good intentions, can argue that the likelihood of a loss is low, then the severity of that loss can be catastrophic and still not affect their ability to package, price and sell these risks to investors.[5] If we're lucky, those tail events won't happen. But as we've said many times before, risks don't *not* exist simply because, in hindsight, they didn't manifest themselves.

It's through this lens that we encourage all readers to view the current focus on our economy's own personal Daedalus, the U.S. government. Yes, they are the ones who helped King Wall Street build the maze in which so many consumers (and the entire economy) got lost during the 2008 financial crisis. But they also responded to their own horrible creation by building wings to the best of their abilities, using the tools and materials at their disposal at the time: industry bailouts, new financial regulations and, of course, lower interest rates. But what happens when using those wings proves too enticing? Investors don't seem eager to take them off anytime soon.

**The Intoxicating Rush of a High-Flying Market**

ALL. TIME. HIGHS.

Seriously?

If there was ever a sign that the stock market is a measure of so many factors at once that it ends up being a measure of nothing, this would be it. Let's recap.

The market is reaching all-time highs, in large part because the Federal Reserve has indicated a willingness to lower interest rates. Why? Because they are seeing weakness in the economy, which is threatening the recent pace of growth. Should the economy strengthen, they may be less inclined to cut rates and would likely return to the more hawkish stance of just a couple of quarters ago, when rate *increases* were more likely. If that were to happen, it is probably not controversial to say the markets would retreat from their current levels. This indeed may be an understatement, as we would expect the shift in expectations and resulting volatility to be sudden and significant.

So, in summary, the stock markets are at all-time highs because the economy appears weak. Should the economy strengthen, the stock markets would likely decline, and in our opinion, would do so in dramatic fashion. Is this dynamic unnerving to anyone else? And this simple cause-effect excludes two outcomes which would be even worse: deleveraging and inflation without growth. While some might argue that economic growth would boost corporate earnings and provide some level of support to otherwise lower valuations caused by rising interest rates, we believe those arguments fail to recognize the impact which deleveraging and tariff-driven consumer price increases would have



5 Meanwhile, philosophers on Wall Street may wonder how much the structures have really changed. For centuries, scholars have argued whether replacing the underlying components of one object over time leaves you with the same object or a different one. Originally, this concept was contemplated with respect to the very ship our hero Theseus sailed home to Athens. To preserve the ship, planks and other parts had to be replaced over time. But at what point was it no longer the same ship? Today, the same question is essentially being asked about these structured products, and some on Wall Street are hoping we will conclude they are different. But, from our vantage point, it seems the more they change, the more they stay the same.

on the markets. Some market participants (including us) see the recent market rally as a symptom of an environment in which capital is cheap and short-term returns are being prioritized irresponsibly.[6]

But the Federal Reserve isn't wrong. We should remind ourselves that their mandate is not to minimize volatility or maximize market prices. Investors are doing that all by themselves. The Federal Reserve's statutory goals for monetary policy, as established by Congress in the Federal Reserve Act, are "maximum employment, stable prices, and moderate long-term interest rates."[7] Higher rates keep inflation in check by reducing the money supply and encouraging saving, while lower rates spur spending, and as it relates to businesses, presumably hiring. Unemployment is low at the moment, and the argument is that this metric shows it may be time to raise rates.

It seems to us that what the Fed is really saying when they talk about the risk of a weaker economy is that, to some extent and with all due respect, they are confused. The loose monetary policy and the resulting low unemployment has brought with it two hard-to-explain observations: inflation remains below the 2% target, and wages aren't increasing as would be expected if the low unemployment was the result of a supply/demand imbalance in the workforce. So the subtext in the messaging around lower rates seems to be that wages need to go up (i.e. employers need to compete more for workers) and inflation won't run rampant in the meantime; after all, consumer spending is traditionally viewed as a key driver of price inflation, and if it hasn't happened with rates as low as they have been to this point, maybe it won't happen until people are getting paid more, or at least until they are feeling more confident.

Enter Mario Draghi. The outgoing European Central Bank (ECB) chief recently painted a not-so-rosy picture of the European economy and broadcast in much more direct terms the likelihood of renewed quantitative easing in Europe. So how does this affect the Fed? A weaker European economy with lower interest rates for those holding Euros likely means a stronger U.S. dollar as assets seek safer havens, especially with Brexit (and the British pound) still facing uncertainty. In turn, a stronger dollar likely means lower intermediate-term and potentially long-term interest rates here in the U.S. as investors would be willing to earn less in exchange for feeling their money is safe, not to mention the U.S. trade deficit would likely increase as imports become relatively cheaper. This effect could somewhat offset the tariff threats facing the U.S. economy, but if the government continues to take a protectionist approach to industry, this outcome would not be desirable, potentially leading to an even more isolationist policy mindset (or at least rhetoric),[8] which would in turn threaten to

6 In our view this has happened, at least in part, as a result of the well-meaning but misunderstood use of passive asset class indices. Much of the research surrounding the active vs. passive debate is centered around a probabilistic conclusion of underperformance: Over time, the argument goes, active managers are less likely to beat their benchmarks based on a statistical analysis of historical periods. But this argument breaks down when outperformance is inadvertently defined narrowly as a beta-oriented performance goal, and then only over inappropriately short timeframes. The insistence that active management has no value ends up being a misguided conclusion counterintuitively driven by the irresistible urge to invest actively by the very advocates of passive investing. Even if risk-unaware performance is an investor's goal, which we argue is not the case for most, rather than position a passive portfolio for the long-term and trust that it will outperform over time, investors have intentionally misinterpreted the research to claim they are investing passively. Meanwhile, they tactically rebalance (i.e. actively manage) asset class exposures way more frequently than is appropriate in an attempt to "outperform." At best, it's an unintentional outcome of human nature; at worst, it's an intentional and cynical marketing ploy designed to create institutional job security. After all, a "long-term hold" portfolio no longer needs a professional manager, but a portfolio that requires frequent tactical action does.

7 In service of these goals, the Federal Open Market Committee (FOMC) has long held that their mandate is consistent with a 2% inflation target. This target was made explicit in 2012 and clarified in 2016, but some have argued the Fed has managed to such a target implicitly for over two decades. There is some debate about whether it is time for the Fed to revisit whether a more relaxed inflation policy is in order. In another case of needing to examine incentives, these arguments almost always seem to come with the reasoning that the Fed should keep rates lower for longer from those that would benefit from them doing so. We have yet to see a prevalent argument for the Fed to alter inflation target policy to accelerate an increase in interest rates. Go figure.

8 To be fair, the current administration has said they have decided against taking any action after having a meeting about ways to weaken the dollar. Wait, what? They already met about it? We'll file that under "no action… for now."

destabilize what appears to be a rather counterintuitively confident consumer at the moment (given the weakness in wage growth and the Fed's aforementioned concerns for the U.S. economy).

Fed Chairman Jerome Powell made this point directly when, in his recent testimony to Congress, he incorporated a noticeable theme: The ubiquity of such "uncertainties" are giving the Fed pause even in the face of some positive economic indicators. (Translation: "We're not sure what's going on yet.") For us, herein lies the confusion. Uncertainty, in our experience, is the primary driver of market volatility. And yet, the market is acting as if risk is only something that exists in cautionary bedtime stories to scare kids into behaving. Volatility is very low even as uncertainty is very high. This is a perplexing formula, and to be clear, it does *not* point to a market crash. But it also does not *not* point to a market crash. The problem with this paradox is that the market will only reconcile it after the fact. In the meantime, market participants are faced with the need to manage a risk which seems impossible to avoid but is admittedly intoxicating to ignore. Maybe, just maybe, the sun won't come out today, and they can fly just a little… bit… longer….

We will be the first to admit that we aren't economists and that there are so many variables in economic forecasting as to render most opinions moot the moment they are spoken aloud. But in our experience, the philosophical principle of Occam's razor has proven correct time and time again: When faced with competing hypotheses for a given potential outcome, the explanation which relies on fewer assumptions and less complexity is generally correct. There is a lot of uncertainty, certainly way more than is being priced into the markets. If a rationalizing of the economic outlook and the markets is something one is concerned about, a reset to the downside is easier for us to understand; it makes sense to us to err on the side of caution and protect against just such a correction. The alternative is to err on the side of complacency and expect the U.S. economy to grow its way out of and emerge unscathed from this jumble of offsetting and sometimes contradictory factors when the dust settles. In our view, to do so is to fly in the face of common sense. Despite all of the warnings, investors may be at serious risk of melting their wings.

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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