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ZEO QUARTERLY LETTER: 4Q2020

"The only thing necessary for the triumph of evil is for good men to do nothing."

— Edmund Burke

What a difference a year makes. Our society is in a knife fight with a virus that, this time last year for most people, was a little-noticed headline in a distant country. Our economy has lost millions of jobs in the last year, many permanently, and families everywhere are wondering when they will recover their income and when their children will be able to return to school full-time, which for many is its own economic issue. Conversely, our markets are higher than they were a year ago (at all-time highs in fact), bolstered by an understandable loose monetary policy by the Federal Reserve; the perception (however tone-deaf) that inaction by a divided government is beneficial; and a growing disconnect between Main Street and Wall Street, in part due to a decades-long bipartisan marginalization of large swaths of our country.[1]

Usually in these pages, we work hard to help investors identify market risks based on economic and corporate risks, but increasingly, that causal relationship between fundamentals and market prices seems more theoretical than ever. This is surprising to us given the many events we just went through as a nation in 2020, any one of which would be enough to place the year that just passed in the history books as a case study in unexpected risks. But this disconnect has also helped to reveal what may be the biggest risks of all hidden in plain sight: apathy and complacency.

Just Because You Can Doesn't Mean You Should

For just over 14 years, I have tried to instill some basic rules of life in my children. One of those principles is understanding the difference between what one is technically allowed to do and what one actually should do. This principle can be interpreted as part of a personal code of ethics, or it can be interpreted as risk management – reducing potentially negative consequences of behaving in a way that may be viewed by others as inappropriate even if not forbidden.

There is a framework from the field of psychology for these two interpretations: The former is intrinsic motivation; the latter is extrinsic motivation.[2] Put simply, intrinsic motivation occurs when one's own values and goals drive a particular behavior. Extrinsic motivation occurs when earning rewards or avoiding punishments drives the behavior. It is not uncommon for behaviors to start off with extrinsic motivators, but it takes more to turn those behaviors into habits. The trick is to train oneself so that the

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1 This is not entirely without reason. The poorest 50% of our country holds a mere 5.6% of total assets as of Q3 2020 according to Federal Reserve data. It makes sense, then, that this group might get ignored, as their impact on the overall economy in aggregate is small. But this is also why Fed Chairman Jay Powell has repeated continuously since March that a sustained recovery requires a fiscal solution (i.e. requires legislation from Congress); monetary policy cannot help people who don't have access to capital in the first place, and investors acting in their financial interest are not incentivized to favor more inclusive policies. Only those in our leadership charged with the well-being of all citizens and who (should) have no profit motive are in the position necessary to address this growing chasm.
2 If you are interested in the research, we suggest you start with the following paper and run head first down the rabbit hole that it opens: *Cerasoli, C. P., Nicklin, J. M., & Ford, M. T. (2014, February 3). Intrinsic Motivation and Extrinsic Incentives Jointly Predict Performance: A 40-Year Meta-Analysis. Psychological Bulletin. Advance online publication.* http://dx.doi.org/10.1037/a0035661.

motivation becomes intrinsic. This isn't easy, but it is necessary if one values consistency and longevity.[3]

Yet everywhere we turn, we seem to be faced with behavior which models a different message: If you can get away with it, you should do it. This amoral acorn doesn't fall far from the Machiavellian oak tree, which extolls that the ends justify the means. In today's world, the ends are almost always some form of personal gain, whether money, power or some other modern-day metric of success.[4] Moreover, we don't just see this behavior modeled; it seems to be deliberate much of the time. And investors have not been immune.

While there are investors who send this "win at all costs" message to their managers intentionally, we believe the conventional wisdoms and traditional methods of asset allocation may be inadvertently and erroneously making this a rule of the markets. A focus on performance in and of itself, without an analysis of how and why it happened, sends this message. Overemphasizing relative results between materially different strategies sends this message. Short-term comparisons to broad-market indices and passive portfolios send this message. And the asset management community has heard this message loud and clear: A majority of allocators want managers to prioritize returns regardless of what risks they must take to get them. In turn, a majority of managers appear to have complied because that is the path to the most robust asset growth. In practice, this means tactical asset class exposures have eclipsed security selection as the primary risk drivers of many fund portfolios as this is the only way to reliably deliver on the demand for short-term relative outperformance over passive indices. As it turns out, the hardest thing for a manager to do in today's investing environment is to stay disciplined.

As a result, just within our subset of the investing universe, fixed income managers who are hired for security selection have shifted into buying broad market ETFs, SPACs and equities in pursuit of performance. This has been going on for years; most managers have the flexibility to deviate from their mandate to some extent, and while some hide such deviations, others go to great lengths to argue that such deviations are within their mandates. And to be fair, for those managers to whom their investors have clearly sent the message to prioritize performance regardless of risk, returns (the ends) do indeed justify the style drift (the means). In our experience, however, most investors care very much about the risk they are taking on a forward-looking basis. And those investors should care that this undisciplined behavior was particularly prevalent in the depths of the 2020 market decline precisely because it was so easy to miss.

The problem lies in the tendency of investors to hold managers accountable only after the fact for the risk they take <u>and</u> only if the performance was disappointing. This has given many managers a free pass in 2020 that leaves unsuspecting investors at risk. After all, who can argue with the recovery many portfolios showed from the market lows in late March? Does anyone really want to know how that recovery was achieved? Is anyone really interested in comparing recoveries across managers and discovering who stayed true to their mandate and who did whatever they could get away with? Who really cares if a manager took a Machiavellian approach or a principled one?

The rest of this discussion is for that subset of investors who care about risk <u>and</u> reward. Not everyone will fit into that category, and that is ok. As we have said for many years, investing in managers is an exercise in finding the best fit for the goals of a portfolio. Some portfolios value consistency of risk profiles, while others prefer returns regardless of the risk required to achieve them. Many investors accept that they will only learn about risks in the portfolio after they have had a negative impact.

For these very reasons, Zeo has been committed to transparency since our founding. 2020 was no exception. We provided deep dives into our decline and recovery in three client letters, one webinar and two town halls over just the past ten months. Through those discussions, we were able to highlight that the decline in March of our portfolio of high yield bonds resembled that of most investment grade

3 For those of you who made New Year's resolutions, take note!
4 [Enough said.]

portfolios, which we believe validates our view that deep fundamental analysis can result in a risk profile that is better than ratings indicate. We were also able to isolate the primary source of performance drag to a single position, our first credit event in 12 years and over 400 credits (and a record we would put up against any credit manager). We explained the thesis of that position in detail and showed that, despite the unfortunate outcome, it was consistent with our reputation for rigor and depth of analysis. Perhaps most importantly, we were able to show that the recovery of our portfolio has kept pace with or outpaced most of our peers even inclusive of the impact of this unexpected headwind and without compromise to our stated mandate and risk management principles.

We are proud of the strength and consistency of our investment process, which was certainly tested in 2020. We did not need to style drift as the large majority of our peers did. We didn't buy ETFs. We didn't stray from our core asset classes or justify another asset class as "fixed income like" to capitalize on a market trend. We remained true to the risk profile we have always aimed to deliver regardless of the market environment. In a year where there were many opportunities to choose performance over process, we rejected that false choice. On March 24, at the lowest point of the market dislocation, this was much easier said than done. But we stuck to discipline, and without dismissing the other emotions that 2020 elicited, we look back at our transparency and consistency with pride.

What we and other similarly disciplined managers have in common is intrinsic motivation in both our business and our portfolios. Our investors will recognize, over years not months, that we hold transparency and consistency to be foundational values, not just client-relations tactics. That is what keeps us pointed at true north even when buffeted by a pandemic-induced storm.

We have welcomed the questions from our investors who have dug deep into our 2020 experience. As a result, we begin 2021 with renewed confidence that our clients recognize the strength of our process and our portfolios. We encourage every investor to ask their managers the same questions and to take the time not just to look at performance in 2020 but to understand how and why it happened and where it came from. We believe it is in every investor's best interest to find out if a manager did what you thought they were doing. Not all managers took the Machiavellian path in 2020, but many managers strayed from the principled one. Investors would be wise to ferret out if there is some unexpected exposure that they may have inadvertently benefited from in hindsight but that they don't want going forward (or never wanted in the first place).

Bank Loans Are A Thing Again! So Are Their Hidden Risks.

In my new favorite television show of the Great Quarantine,[5] the lead character claims that the happiest animal on earth is the goldfish. Why? Because, according to him, the goldfish has a 10-second memory. By that measure, the happiest investors on earth must be the people rushing back into bank loan funds right now.

To be clear, we are not arguing that bank loans are not a good investment. After all, we invest directly in select bank loans in our own portfolios. Nor are we arguing that investors should avoid all bank loan funds. There are some managers that take a careful approach to credit selection who present an opportunity for those who appreciate the differences between a selective credit portfolio and an indexed one. These are the managers that warrant a less tactical allocation within a fixed income portfolio. But

5 If you haven't had the pleasure of watching the series Ted Lasso on AppleTV+, put down this letter right now and go binge watch the ten-episode first season. William Haemmerle of Wiss & Company (an accounting firm with which we have no relationship) wrote the following on the company's official blog: "There are certain people we meet throughout our lives that we know will change us forever. They encourage us to become a better version of ourselves. I recently met one of those people while watching the first season of Ted Lasso on AppleTV." He is spot on. Seriously. Put down this letter and go watch it. Now. (But maybe not with your kids. Fair warning that it can be a little bawdy.)

make no mistake: Bank loans are credit instruments, and they have often-misunderstood risks which can undermine the very reason they are so popular in the first place.

Regular readers will recognize that this isn't the first time we have highlighted hidden risks in the bank loan market. Previously, we have written about various reasons to be cautious in our investor letters [Q4 2017, Q1 2018 and Q3 2018]. Shortly thereafter, in Q4 2018, the bank loan market experienced a correction which spooked many investors who didn't appreciate those very risks and which set in motion a correction in the credit markets as a whole. Notably, many of the risks that went unappreciated at that time are back with a vengeance today.

Bank loans are popular in large part because they are perceived to be floating rate instruments, meaning that if interest rates increase, they are not expected to exhibit the same price declines typical of fixed income securities. In most floating rate securities, when rates go up, the coupons paid to investors also increase. However, as was the case prior to 2018, many loans being originated today have provisions that place a floor on the coupon that will be paid. Often, coupons are reset quarterly, usually at a rate equal to 3-month LIBOR[6] plus a fixed credit spread. To protect against a LIBOR rate that is near zero today, many credit agreements stipulate that, if the LIBOR reset rate is below a certain threshold (typically 0.75% or 1%), the reset will use the threshold rate instead of the actual market LIBOR rate. This is, of course, an investor-friendly provision, as the interest paid is higher due to the LIBOR floor.

Let's take a moment to think about what else this means. Until 3-month LIBOR exceeds 0.75% (at least), the loan will have a fixed coupon rate and behave more like a typical fixed income instrument when interest rates increase for at least that fixed rate portion of the loan's life. As of the time of writing, 3-month LIBOR is not projected to exceed 0.75% until June 2024. You read that right. More than three years away. To be fair, the markets are not expecting the Federal Reserve to raise their benchmark interest rates for the next two to three years, so this may not be a risk that manifests itself. However, if the goal of loan exposure in a portfolio is to protect against both expected and unexpected increases in interest rates, this is a risk most investors are not aware they are taking.

The hidden risks don't stop there, and not all of them are as tied to the current market environment as the one we just discussed. Regardless of where interest rates are, many investors forget that bank loans are credit instruments that regularly have long maturities. New loans typically have maturities between 5 and 10 years, and since the credit spread component of a loan's coupon reset is fixed, the sensitivity to credit spread moves always resembles that of typical fixed income securities. This is referred to as the credit spread duration. Anyone completing due diligence on any credit portfolio should ask the manager for both the interest rate duration and the credit spread duration to fully understand the risks.

In a market where credit spreads have snapped back near their all-time tightest levels, taking on longer-term credit spread duration requires caution. Zeo believes it is irresponsible to take this risk indiscriminately by buying an index fund of bank loans where the underlying credits owned are not proactively chosen by a manager doing fundamental analysis on the issuers. Even many CLOs expose investors to less selective credit portfolios. What is worse, companies can typically repay loans at 100% of their face value at any time. This means that if credit spreads tighten, bank loans do not benefit from the same price appreciation that can be observed in longer-term bonds. In short, the credit risk in loans is not only longer-term than many investors realize, but it is asymmetric to the downside as well.

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6 LIBOR is the London Interbank Offered Rate. This is the average rate at which banks in London are willing to lend in US dollars to one another. It is determined by surveying contributing banks daily, throwing out the highest and lowest quartiles and averaging the remaining surveyed rates. Due to a price fixing scandal resulting from collusion among the traders who supply these rates across multiple banks, LIBOR is scheduled to be fully phased out by 2023. The loan market is still trying to figure out how best to handle this. At the moment, the final decision in many credit agreements lies with the issuer and the bank which acts as the administrative agent for the loan. That the lenders themselves don't seem to be part of this determination strikes us as yet another risk, albeit a small one, that investors should at least be aware of.

What can investors do if they still want a portfolio that is less sensitive to interest rates without taking on a suboptimal and possibly lopsided credit exposure? We at Zeo believe there are two good answers to this question. On the one hand, if the investor is only concerned about the credit risk itself and can accept some price movement due to interest rate fluctuations, look for a carefully researched portfolio rather than an index or a passively managed fund. Fundamental analysis can help mitigate credit risk by reducing the impact of poor-quality credits, which are often disproportionate drivers of credit indices. Such a portfolio could be all loans, but for a bit more diversification, we believe credit strategies such as Zeo's can help to further reduce the asset class idiosyncrasies of the bank loan market; in the case of our unconstrained sustainable credit portfolio, the native consideration of ESG factors in our firm's investment process (which are core credit factors in our view) further elevates the underlying credit quality in our view even without a duration constraint. That said, in our opinion and experience, it is important that any approach to credit is a deeply fundamental one, with the resulting holdings limited in number and truly held to a higher credit standard, not just an index by another name.

For those investors seeking both lower interest rate sensitivity and credit spread exposure, we believe Zeo's short duration strategy provides the profile investors are seeking from bank loans without the hidden risks we discussed above. Our short interest rate duration profile limits the interest rate risk in the portfolio naturally, without relying on interest rate resets that may not happen for structural reasons. Meanwhile, we explicitly manage our short duration portfolio to avoid an unexpected mismatch between credit spread exposure and interest rate exposure; the credit spread duration in this portfolio is naturally limited by shorter average maturities. Keep in mind that, since this strategy does not have a long-term sensitivity to credit spreads, our short duration portfolios will not behave like longer-term high yield portfolios. This applies to the exposure in both directions, up and down, which we believe is more appropriate than the unexpected asymmetry present in many index-like loan funds.

We are all watching assets flow into passive loan portfolios today at a rate not seen since 2017. Investors would be well-served to remember the last time the overlooked risks of the bank loan asset class reared their heads. In life, it sometimes helps to be a goldfish; a short-term memory can be the key to resilience and longevity. This is emphatically not the case with investment portfolios.

Prioritizing Diversity Is Easier Than You Think

Diversity and sustainability have always been a part of our DNA. At Zeo, we do more than talk about diversity and ESG; we represent it. We believe this results in more inclusive perspectives and is a necessary component of our genuine commitment to sustainable credit investing. It is who we are as a firm and how we invest every single dollar on behalf of our clients. On July 28, 2020, Zeo Capital Advisors was certified as a Minority Business Enterprise (MBE) in the state of California. We made the decision to pursue this verification not just because we could (which has been true since our inception) but because the events of 2020 brought into clear focus the importance of proactive leadership and prioritization of an issue that plagues financial services with no end in sight. It doesn't have to be this way.

We were heartened to see that a number of large institutions started programs in 2020 to survey all of their managers to assess their diversity. This is a great first step; we encourage these institutions to go one step further and hold each manager accountable. This cannot be just a check-the-box exercise, where any plausible explanation for a lack of diversity satisfies the diversity due diligence item just the same or where only a few very large diverse managers receive an overwhelming majority of token allocations.

The problem with this thinking is that asset allocation is a zero-sum game. Handing out free passes for managers is not an innocent exercise; this effort requires intentionality and a new incentive structure, which can only come from the allocators. Increased allocation to an ever-growing number of diverse managers will likely result in decreased allocations to managers that don't share this priority. Some will view these moves as unjustified and unfair, and some of them may indeed go too far. But it's always worth remembering that the fairness pendulum has been so far to one side for so long that, when it is finally left to swing freely, it's unreasonable to expect it to stop right in the middle. It's ok if it swings just a little bit in the other direction before finding the ever-elusive equilibrium of perfect inclusivity.

Meanwhile, there is no shortage of excuses for why financial services companies don't prioritize gender and racial diversity. The most common center around difficulty finding qualified candidates or pointing to a token past hire as absolution. In particular, boutique managers already have difficulty finding just the right hires who can wear multiple hats. Even Zeo, with our small team, could easily hide behind such excuses if we didn't find them so inaccurate. In reality, when done right and intentionally, prioritizing an inclusive candidate pool and redefining what it means to be qualified can be expanding rather than limiting. In many ways, it is exactly the boutique managers that are in the best position to effect the change we need to see in our industry. Zeo has been proactive in our diversity efforts from day one, and we have had success with these priorities over the past 12 years. To those managers who might instinctively react with excuses and justifications, we'd like to offer a more inclusive path drawn from our experience.

First and foremost, it is essential to remember this one important truth: Just because someone hasn't done the job doesn't mean they can't do the job. In a small firm like Zeo who prioritizes technology and automated processes as superior alternatives to manual processes and headcount, every role is multi-faceted and can often have responsibilities that would otherwise be compartmentalized in larger companies. As a result, we spend more time evaluating candidates by their core skillsets rather than just by their work experience. Skills are transferable if a candidate is a lifelong learner who is intellectually curious. There is some specific baseline of experience certain roles require; we're not advocating for avoiding domain expertise. However, dismissing candidates for a role because they haven't had that exact same role elsewhere will naturally exclude exactly those underrepresented groups who don't get the opportunity to fill those roles in the first place. Here is one area where boutique firms have an advantage. In our experience, smaller fund managers often prefer less-experienced candidates right out of college or business school with the intention of molding them into the perfect employee for a given role. In that case, the focus is on skillsets and mindset, which are often the only qualifying characteristics for a job.

This brings us to our second observation, which is a natural extension of the first. We have found that there is little value to a growing business in hiring people who have fully realized their potential (or believe they have). If we cannot offer a potential hire not just a job but an opportunity for personal growth, we are not doing our job as an employer. We expect employees to be self-aware enough to recognize not just their strengths but their areas for support and improvement. If a candidate is motivated mainly by monetizing their current resume without an eye toward where they can grow and learn, we find that to be a limiting and ultimately unproductive mindset.[7] When we view our candidate pools through this lens, we find that privilege can often be a disqualifying factor. By considering skillsets and mindset, we have found that the candidate pool is naturally more inclusive without having to do much more than rethink what it means to be qualified.

Third, and for this letter, the final topic we will focus on is that of candidate sourcing. Many boutique managers will recognize traditional methods of finding candidates. These include but are not limited to: networking by hiring managers or by those who will be the new hire's future co-workers; using third-party recruiters; posting jobs with college or postgraduate career offices; and using job posting opportunities that reach a broader audience (whether industry-specific or general). All of these methods run the risk of

7 In an elegant example of thematic consistency, this dichotomy can be viewed with the same extrinsic vs. intrinsic motivation lens that we discussed in the context of investing earlier in this letter. The candidate who is seeking to monetize is extrinsically motivated, while the candidate who is seeking self-improvement is intrinsically motivated. Anyone who has managed people should recognize these two mindsets and will probably agree that the latter is the employee that tends to have the stronger work ethic and longevity.

reaching a less inclusive audience, which will naturally limit the candidate pool and result in an artificially low representation of already underrepresented groups.

Even posting jobs with industry groups, at industry-specific locations (such as Bloomberg's JOBS board), or on general sites (such as Indeed.com) requires intentionality on the part of the hiring manager. Though these candidate sources can reach appropriate audiences, using them still requires the same redefinition of what it means to be qualified that we have just been discussing. Furthermore, expanding this effort to include groups that are demographically-focused (e.g. professional groups for women or minorities) takes little extra work but does require proactive intent, as doing so is often only natural to those firms where diversity is already present.

However, the approach to networking may be the most insidious culprit behind undermined diversity efforts, even if unintentionally so. Experienced hiring managers tend to network with more experienced candidates (i.e. those who are already doing the job). As often, they outsource networking to less-experienced members of the team. But without a deeper professional context, less experience comes with a tendency to apply a personal filter which prioritizes candidates one relates to or wants to socialize with and a professional filter that naively focuses on existing responsibilities rather than skillsets and mindset. The result is homogeneity in the workforce, which at a smaller firm is very hard to undo until there is turnover. The consequences of apathy are long-lasting.

So what are the results of intentionality at Zeo? Our team consists of 33% people of color (67% of our investment team), 50% women, and 83.5% ownership by underrepresented groups within our industry. 100% of our senior management team is staffed with underrepresented groups as well. We haven't gotten here accidentally, and we never felt that our options were limited by our emphasis on inclusivity. The reality is quite the opposite, but it takes confidence and commitment. In short, achieving diversity in financial services is easier than many firms make it out to be. What seems to be hard is finding the will to do so.

Edmund Burke was onto something. It would be dramatic to refer to Machiavellian investors as evil. Machiavelli himself is viewed by many as a seminal and positive contributor to the history of political science. But a bad actor isn't necessary for bad things to happen when good people do nothing. The challenge of our day isn't good vs. evil. The challenge of our day is awareness and intentionality, whether that applies to what allocators ask of their managers, diversity or investment risks. Even with the best of intentions, it takes extra work to be aware, and it's work we believe is worth doing. This philosophy is foundational to both Zeo's business and our portfolios. We believe these priorities result in better outcomes and a better fit for our clients.

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

Sincerely,

Venkatesh Reddy
Chief Investment Officer

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