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ZEO QUARTERLY LETTER: 2Q2021

Credit spreads are at historically tight levels. Short-term interest rates (and therefore interest income) are likely staying low for the foreseeable future. The rate curve is poised to steepen to potentially unprecedented levels as inflation fears grip the markets. The global pandemic has not gone away and may be accelerating toward a second (though probably less severe) public policy reaction. And fixed income investors aren't getting sufficiently compensated for taking on longer-term or equity-like risks.

But today's investors have been convinced by market professionals to focus not on risk but relative performance; not on strategy but fees; not on fit but trends. As a result, situations which might seem obvious in retrospect, such as the unsustainability of an indiscriminate bull market, become "doh" moments as investors belatedly realize their mistakes, only to repeat them over and over again. What these situations have in common is a fear that reducing risk will be punished in the form of relative underperformance if the risk doesn't manifest itself. We suppose there's logic to this thought process. After all, don't we all regret buying homeowners insurance if our house didn't burn down last year? Oh wait. No. We don't. But we do generally sleep better at night.

Not All High Yield is Junk

As a value-oriented credit manager, we bristle at the term "junk bonds" to describe debt with high yield ratings. In reality, issuers and bonds may be rated below investment grade for a variety of reasons.

First, it is important to recognize that the credit rating agencies have certain immutable criteria which weigh into rating assignments. It is true that there are some companies that have significant risk. They may have too much leverage. They may have unsustainably low margins. They may be cyclical. For these reasons, the agencies have tended to use metrics such as leverage, margins and business cyclicality as proxies for risk. But this is imperfect and results in many babies being thrown out with the bathwater. Businesses such as Hanes Brands (BB+ rated) have low margins but a strong market position which enables them to control prices and pass costs through to customers. As a result, they can demonstrate a level of stability that even many investment grade companies cannot match. Acquisitive companies such as Hyland Software (B rated) often increase leverage for mergers and then use strong cashflows to reduce debt until the next target company comes along. They may appear on average to carry more leverage than a rating agency might want to see, but a disciplined strategy and cashflow resilience can point to a lower risk level than ratings would imply.

Second, rating actions tend to be reactive to good or bad news. That is, the agencies rarely if ever make a rating change because they expect something to happen. The only scenario in which we have seen regular exceptions to this rule is when an investment grade issuer assumes large amounts of leverage for an acquisition and promises the agencies they will bring leverage back down if they can keep their investment grade rating. (AT&T, we're looking at you.) Regardless, we won't fault the agencies too much for being reactive. In our experience, corporate CFOs have a knack for pulling rabbits out of hats and foiling market expectations (in both directions). Notably, this is one reason why we focus our portfolios less on being "right" about the direction of a credit and more on companies whose resilient profiles give us high degrees of confidence that they will repay their debt regardless of what happens. That said, this reactive approach to credit ratings is not a reasonable way to develop an investment strategy. Who would want to invest in a strategy which buys bonds after they have been upgraded or sells them after they have been downgraded? Anticipation is the key difference between investment analysis and ratings analysis.

Lastly, agencies tend to issue ratings at the issuer level, meaning they are assigning a rating which will be assigned to all bonds in a company's capital structure whether they mature in one year or ten years. It seems obvious to us that the inherent credit risk in these two bonds would be different, and the market tends to treat them differently (shorter-term bonds tend to exhibit lower volatility than longer-term bonds even during times with stable interest rate outlooks). But the ratings agencies treat them the same. The only time a ratings agency tends to rate individual issues is if they are being paid by the issuer to do so, a conflict of interest we have written about before. At times, if an issuer is too small to warrant a regular reevaluation of its ratings, the ratings assigned to debt at issuance will persist even if the issuer's underlying fundamentals have changed.

We share these observations not to complain but to highlight the significant potential for mispricing in credit ratings. And make no mistake about it: market mispricing is the bread and butter of value investors. We spend our days looking at companies, understanding business models, evaluating resilience factors and forming views on creditworthiness so that we may identify those issuers who are misunderstood by the market and the rating agencies. We believe that long-term success comes from a simple investing rule: If you buy good things, good things will happen. Some investors outsource what is good and bad to ratings agencies, and some do the work themselves. We are in the latter category.

But why should investors want managers who do the work themselves? Because the devil is in the details. It is rare to find that a simple screen of publicly reported metrics results in a portfolio which achieves its goals. To understand this, we will dive into three categories of credit factors which together allow us to determine an issuer's creditworthiness: financial (quantitative), business (qualitative) and sustainability (ESG). Financial factors tend to be the most commonly analyzed, though most credit investors tend to be more focused on projections which support a directional bet on a bond price (e.g. will a credit spread narrow). We at Zeo spend our time in a less crowded room, looking at the same metrics such as liquidity, cashflow and leverage but with an eye toward evaluating a company's resilience.

However, evaluating resilience cannot be done with numbers alone. We must also evaluate qualitative factors such as business model and management team. This is an area where we feel we have an advantage as a team which cuts across all sectors. Where many analysts are focused on their primary sectors and limit their risk evaluations to those which they deem most relevant to the industry, we have learned over the course of our careers that the risks inherent in issuers cut across an industry classification. What matters more than sector is business model, and by having a team which evaluates companies of all shapes and sizes, we believe we have more experience in drawing these parallels between companies who would otherwise not be considered similar in a way that identifies mispricings.

The same applies to sustainability factors, and it is no less important. Last quarter, we highlighted research being done at the Wharton School which concluded that only those strategies which integrated ESG factors into their investment analysis demonstrated a positive alpha when compared to traditional benchmarks. And yet, investors are directing assets mainly toward approaches which have negative alpha instead. These include strategies in which the primary approach to ESG factors is to screen out certain unacceptable sectors. Similarly, outsourcing ESG evaluations to a third party, which may or may not contradict a different third party, means the manager simply does not fully know the risks in the portfolio, which in our opinion is unacceptable. Rather, just as with relying on credit ratings, the manager is relying on someone else's conclusion as to whether a company is "good" or "bad." Setting aside the possibility that they are wrong and the manager would not know, or that their definition of "good" differs from her own, there is a bigger problem with these approaches. Put simply, they avoid those companies which are most likely to have the biggest impact with respect to ESG issues. Only by doing the work ourselves can we assess a company's room for improvement and its intentionality to make progress.

We take pride in aiming to deliver a portfolio which invests in high yield issuers but is not full of the types of risks which are typically associated with the high yield markets. Zeo's strategies are deeply rooted in a rigorous and intentional approach to evaluating creditworthiness as impacted by all three of these categories of credit factors. We show in the last section of this letter what can result from doing so. But first, we wanted to turn the tables and discuss what we believe is most at risk in the current fixed income markets. Spoiler alert: We don't think it's high yield.

Not All Junk is High Yield

Junk may be a strong choice of words to describe asset classes poised to decline in the current market environment, but there are plenty of exposures much more common in many fixed income portfolios today which we would consider way more concerning than a fundamental approach to high yield. So what is the current environment?

As we wrote in May, we believe the Fed is unlikely to raise rates for an even longer period of time than the market is assuming already. Just in the last two months since we first published this opinion, the Fed has been vocal that any calls for it to act sooner because of unexpectedly strong recovery data are premature. We think that there may be some volatility on the horizon even as rates stay low as the trickle of critics now becomes a flood of pressure on the Fed in the future.

We also suggested that the Fed would not be terribly upset by the consequences of standing its ground, namely a steep upward sloping yield curve. We continue to believe this is the most likely scenario. However, we also recognize that the pandemic is far from over, and the actions of public officials are unpredictable (in most cases – some are depressingly predictable). Renewed concerns about the economy would have the opposite effect on the yield curve. That said, we don't see the economic shock of 2020 repeating itself for two main reasons: (1) No two crises are the same, and it is the unexpected that triggers dislocations; (2) there seems to be little appetite anywhere for renewing policies which might risk recreating the economic and educational crises of the last 16 months. That said, we think there is risk of at least some public policy reaction, and we cannot predict how the markets might react even to a less severe set of restrictions.

Meanwhile, the corporate credit yield curve (i.e. interest rates + credit spreads) is remarkably flat. Issuers are not just refinancing debt at historically low yields; they are able to raise new debt and increase leverage at those same record low rates as well. Notably, many issuers already took advantage of the pre-pandemic low rate environment to refinance much of their debt and shore up liquidity, decisions which proved to be prescient as much of that liquidity was essential to weathering the brief 2020 economic seizure. As a result, today, it is not common to find issuers who feel the need to refinance debt for liquidity reasons. More often, we are seeing debt issuance for strategic reasons (e.g. acquisitions) or to lower a company's cost of capital.

This means we are not seeing companies acting as aggressively to refinance their secured debt. Yields on secured debt are already lower than unsecured debt, and by our observation, are currently around the same levels as the yields available in the new issue market. This is why some might have observed that our portfolio statistics have skewed up the capital structure to the secured layer. This has not been a tactical risk decision (which we typically do not do anyway), but rather the result of our portfolio construction process, which places a heavy emphasis on evaluating not just volatility and credit risk but also opportunity cost.

Opportunity cost, put simply, is what you give up in opportunities in the future by making a decision today. As it pertains to corporate debt, this explains why we aren't aggressive about purchasing newer bond issues even in our Duration Unconstrained Credit Strategy. If we are not getting paid an appropriately higher yield to take on the longer-term risk, we prefer to earn that same yield for a shorter term and reinvest the proceeds at the time of maturity. There is risk to doing so, namely that yields may be lower in the future. First, we don't believe a bet today on yields being lower three to five years from now is prudent, though perhaps we will be proven wrong. Second, we believe that the best risk to take in the fixed income markets right now is reinvestment risk.

In the case of our Duration Unconstrained Credit Strategy, we have positioned the portfolio with this in mind. When we include longer durations in that strategy, they tend to be particularly strong credit profiles and often in floating rate securities in which we can isolate the credit risk without taking on interest rate sensitivity. In the case of our Short Duration Income Strategy, selecting reinvestment risk is in many ways the inherent decision being made by our clients. That portfolio does not have a flexible duration mandate, so we will always position short and reinvest, regardless of the interest rate and credit spread environment.

In our opinion, investors should choose the shortest durations which allow them to achieve their income goals. In our experience, we have never been disappointed that we didn't lock up our clients' capital for longer. We have always found that having capital to deploy over time due to a continuous calendar of maturities and repayments over short timeframes has worked to our strategic advantage based on the portfolio we aim to deliver.

Unfortunately for many fixed income investors, we believe these risks expose broad market fixed income portfolios with longer durations, especially the intermediate term investment grade and mortgage-backed strategies found in most core fixed income portfolios. Even so, where one can take credit risk without interest rate risk, it must be done carefully and selectively given the potential for an unexpected economic hiccup. But yields are unlikely to rise, making it necessary for investors to seek higher income sources that are not materially exposed to inflation, the shape of the interest rate curve or the equity markets. Lastly, we believe it's imperative that a portfolio be designed to mitigate rather than take risk if pandemic fears reemerge.

Balancing all of these potential outcomes and constructing a portfolio which can perform as expected regardless of the market environment is exactly the goal of our focus on reinvestment risk and rigorous fundamentals. We do not need to style drift to include asset classes outside of our core competency. We do not need to add hidden equity, SPAC or illiquidity exposure to our portfolios. We don't need to expand our mandate and convince our investors the risk is the same when it is clearly not. To us, in this environment, that would be sign of junk in a portfolio.

Are Risk and Reward Inversely Related?

At Zeo, we have often been asked how our investment approach can mitigate volatility when we invest in high yield bonds. Of course, one way in which we do so in our Short Duration Income Strategy is by carefully controlling the portfolio duration. But even in our Duration Unconstrained Credit Strategy, where we have the flexibility to take on additional duration, the portfolio has shown a knack for being relatively boring, and we say that with pride. We have always made the case that, aside from duration, it is our fundamental analysis which has a significant impact on the underlying risk and volatility of the portfolio. We started to address this in terms of our approach in the previous section, but we can also put some numbers behind this claim.

For the following discussion, we will ask readers to set aside the impact of lowering duration by focusing on only the broader high yield market. Lowering duration would only further mitigate volatility, but we wanted to isolate the impact of just our security selection. One of the outcomes of our careful focus on issuers, business models and sustainability is that we find there are certain industries which rarely find their way into our portfolio and others which are regularly represented. Because we manage our portfolio with a goal of delivering attractive risk-adjusted returns, we tend not to favor those sectors which contribute disproportionately to high yield market volatility. In this letter, we decided to show that this is the case and help our readers understand the consequences of this outcome.

Our analysis was done using data from Bloomberg Finance LP run through their own analytics on their own Bloomberg Barclays US Corporate High Yield Index over the last three years, as illustrated in the chart below. Those three years contained a market decline (late 2018), a significant rally (late 2019), a market dislocation (early 2020) and a recovery and continued rally to new all-time highs (late 2020 until now) (see Figure 1). Start to finish, the high yield market is at its highest levels, with credit spreads and interest rates flirting with all-time lows, again, as illustrated in Figure 1.

High Yield Total Return	High Yield Spreads
6/30/2018-6/30/2021	

Figure 1: High yield total return and high yield spread represent the Bloomberg Barclays US Corporate High Yield Index. Data source: Bloomberg Finance LP.

Exhibit A in the Appendix to this letter contains a table which shows the standard deviation of the index, as well as the standard deviations of each sector in the index in the same period. We have sorted the sectors by standard deviation (greatest to smallest), separating those which had greater volatility than the index into the left column and those which had lower volatility than the index into the right column.

We can quickly see which sectors contribute most to the volatility of the high yield market. Some will not come as a surprise. We have long shared our view that the price of oil, for example, is a reasonable indicator for the high yield market, and the material impact of the energy sector is evidenced in Figure 2, as “Energy – Integrated”, “Energy – Independent” and “Oil Field Services” are the three most volatile sectors in the high yield index.

Standard Deviation of Sectors in High Yield Index	
Sector	**3-YR Standard Deviation**
Energy – Integrated	28.67
Energy – Independent	16.66
Oil Field Services	16.29

Figure 2: Represents the three most volatile sectors in the Bloomberg Barclays US Corporate High Yield Bond Index based on three-year standard deviation. See the Appendix for the full table.

What may come as more of a surprise, however, can be found in Exhibit B in the Appendix. When we compare the annualized performance over these three years of the sectors with above average volatility to the sectors with below average volatility, we get a counterintuitive result. The lower volatility sectors actually *outperformed* the higher volatility sectors, and this during a bull market for high yield! Furthermore, those sectors make up less than 40% of the index.

The implications of these observations are significant. As it turns out, mitigating volatility may not have a materially detrimental effect on performance over time, if at all. In addition, it may not be necessary to analyze all of high yield in order to identify a portfolio which can outperform the index if one knows how to narrow the universe to reasonable investment candidates. Indeed, we’ve long held that not trying to “boil the ocean” with representation from every sector can deliver a more consistent and attractive risk profile.

One important caveat here is that Zeo does not rotate between sectors based on economic views. We are not deciding to invest in sectors first and companies second. We invest in companies first and always. As a result, as readers who have watched our portfolio for a long time will recognize, our sector representation tends to be fairly consistent. Even so, it also tends to be fairly low volatility. Exhibit C and D in the Appendix show the concentration of our portfolio in each sector found in Exhibit A. What these tables show is that, regardless of our duration mandate, our fundamental research naturally prefers those sectors which have below average standard deviations.

Unfortunately for those readers who have already started looking into launching a high yield bond fund by just filtering out high volatility sectors, this is not the full story. There is still a significant amount of risk in a filtered broad market portfolio with unmanaged duration, and there is a lot of work which must go into security selection to separate the wheat from the chaff. But an approach which aims to mitigate volatility and deliver strong risk-adjusted returns is not necessarily making a performance trade-off relative to unmanaged indices. Even so, it can potentially deliver a risk profile which might be most appropriately labeled a HYINO – High Yield In Name Only.

As much as everything else we have shared in this letter, we at Zeo believe to our core that our clients are better off if we remain true to our foundational firm philosophies: to be consistent, transparent and intentional. Many of you have been reading our writing for some time now. We have discussed throughout the years the dynamics of our strategies. We have been forthcoming about the scenarios in which our approach may outperform and when one should expect it to be “good enough” so that we may lie in wait for the environment in which our strategies can shine. We believe the current environment, now and looking forward for the next several years, is that time.

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

Sincerely,

Venkatesh Reddy
Chief Investment Officer

APPENDIX

Exhibit A

Broad Market High Yield 3-Year Standard Deviations By Sector

Index 3 Year Standard Deviation		6.47	
Sectors with Above Average Std Devs		Sectors with Below Average Std Devs	
Energy - Integrated	28.67	Media/Entertainment	6.42
Energy - Independent	16.66	Supermarkets	6.18
Oil Field Services	16.29	Food and Beverage	6.13
Airlines	14.75	Consumer Cyclical Services	6.09
REITs - Retail	14.61	Lodging	6.06
Energy - Refining	12.00	Banking	5.85
Tobacco	10.76	REITs - Healthcare	5.66
Aerospace/Defense	10.50	Insurance - P&C	5.52
Energy - Midstream	9.95	Other Financial	5.49
Leisure	9.54	Packaging	5.42
Automotive	8.63	Railroads	5.37
Gaming	7.89	Consumer Products	5.29
Pharmaceuticals	7.84	Brokerage/Asset Mgrs/Exchanges	5.18
Transportation Services	7.81	Chemicals	5.06
REITs - Office	7.71	Other Industrial	5.05
Restaurants	7.37	Technology	4.99
Communications - Wireless	7.28	Electric	4.78
Insurance - Life	7.21	Building Materials	4.48
Finance Companies	7.07	Other Utility	4.33
Retailers	6.98	Home Construction	4.01
Healthcare	6.96	Environmental	3.73
Construction Machinery	6.95	Paper	3.67
Communications - Wirelines	6.72	Diversified Manufacturing	3.64
Cable/Satellite	6.68	Cash	0.00
REITs - Other	6.67		
Insurance - Health	6.65		
Metals and Mining	6.48		

Exhibit A: 3-year standard deviation by sector in high yield market based on Bloomberg Barclays US Corporate High Yield Bond Index from 6/29/2018 to 6/30/2021. (Source: Bloomberg Finance L.P.)

Exhibit B

	# of Sectors	*3y Ave % Weight*	*3y Total Return (Annualized)*
Overall Index	**50**	**100.0%**	**7.4%**
Sectors with Above Ave Std Devs	**27**	**60.9%**	**7.2%**
Sectors with Below Ave Std Devs	**23**	**39.1%**	**7.9%**

Exhibit B: Overall and filtered statistics represent aggregated data based on actual weightings and performance for the same period.

Exhibit C

Zeo Short Duration Income By Sector (as of 6/30/2021)

% of Portfolio in Above Std Dev Sectors		% of Portfolio in Below Std Dev Sectors	
Energy - Integrated	0.0%	Media/Entertainment	15.8%
Energy - Independent	0.0%	Supermarkets	3.7%
Oil Field Services	0.0%	Food and Beverage	14.2%
Airlines	0.3%	Consumer Cyclical Services	8.2%
REITs - Retail	0.0%	Lodging	0.0%
Energy - Refining	0.0%	Banking	0.0%
Tobacco	0.0%	REITs - Healthcare	0.0%
Aerospace/Defense	0.0%	Insurance - P&C	0.0%
Energy - Midstream	0.0%	Other Financial	2.8%
Leisure	0.0%	Packaging	0.0%
Automotive	1.7%	Railroads	0.0%
Gaming	0.0%	Consumer Products	0.0%
Pharmaceuticals	0.0%	Brokerage/Asset Mgrs/Exchanges	0.8%
Transportation Services	0.0%	Chemicals	2.6%
REITs - Office	0.0%	Other Industrial	4.0%
Restaurants	0.0%	Technology	15.4%
Communications - Wireless	0.0%	Electric	0.0%
Insurance - Life	0.0%	Building Materials	3.0%
Finance Companies	2.1%	Other Utility	0.0%
Retailers	11.3%	Home Construction	0.0%
Healthcare	0.0%	Environmental	0.0%
Construction Machinery	0.0%	Paper	2.9%
Communications - Wirelines	0.0%	Diversified Manufacturing	2.2%
Cable/Satellite	0.0%	Cash	9.3%
REITs - Other	0.0%		
Insurance - Health	0.0%		
Metals and Mining	0.0%		
Total	**15.3%**	**Total**	**84.8%**
# of Above Std Dev Sectors:	***4***	***# of Below Std Dev Sectors:***	***13***

Exhibit C: Current portfolio breakdown of Zeo Short Duration Income Strategy by sector, grouped by broad market high yield 3-year standard deviations (Sources: Zeo Capital Advisors, Bloomberg Finance L.P.) [Note: Portfolio data taken from largest account managed according to the strategy.]

Exhibit D

Zeo Duration Unconstrained Credit By Sector (as of 6/30/2021)

% of Portfolio in Above Std Dev Sectors		% of Portfolio in Below Std Dev Sectors	
Energy - Integrated	0.0%	Media/Entertainment	13.5%
Energy - Independent	0.0%	Supermarkets	3.1%
Oil Field Services	0.0%	Food and Beverage	12.5%
Airlines	0.6%	Consumer Cyclical Services	7.9%
REITs - Retail	0.0%	Lodging	0.0%
Energy - Refining	0.0%	Banking	0.0%
Tobacco	0.0%	REITs - Healthcare	0.0%
Aerospace/Defense	0.0%	Insurance - P&C	0.0%
Energy - Midstream	0.0%	Other Financial	2.9%
Leisure	0.0%	Packaging	0.0%
Automotive	2.8%	Railroads	0.0%
Gaming	0.0%	Consumer Products	1.4%
Pharmaceuticals	0.0%	Brokerage/Asset Mgrs/Exchanges	0.0%
Transportation Services	0.0%	Chemicals	2.4%
REITs - Office	0.0%	Other Industrial	3.7%
Restaurants	0.0%	Technology	18.5%
Communications - Wireless	0.0%	Electric	0.0%
Insurance - Life	0.0%	Building Materials	3.9%
Finance Companies	1.8%	Other Utility	0.0%
Retailers	13.8%	Home Construction	0.0%
Healthcare	0.0%	Environmental	2.6%
Construction Machinery	0.0%	Paper	6.8%
Communications - Wirelines	0.0%	Diversified Manufacturing	3.0%
Cable/Satellite	0.0%	Cash	-1.1%
REITs - Other	0.0%		
Insurance - Health	0.0%		
Metals and Mining	0.0%		
Total	**19.0%**	**Total**	**81.0%**
# of Above Std Dev Sectors:	***4***	***# of Below Std Dev Sectors:***	***13***

Exhibit D: Current portfolio breakdown of Zeo Duration Unconstrained Credit Strategy by sector, grouped by broad market high yield 3-year standard deviations (Sources: Zeo Capital Advisors, Bloomberg Finance L.P.) [Note: Portfolio data taken from largest account managed according to the strategy.]

investor.relations@zeo.com | 415.875.5604 | www.zeo.com

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