



Dear Clients:

Are we having fun yet? The high yield bond market experienced its first calendar year decline since 2008. Since mid-2009, high yield bonds did not see a decline over any twelve consecutive months until mid-2015. We believe that, with the exception of possibly real estate, no asset class has benefited more from the era of “free money” characterized by the Federal Reserve’s near-zero interest rate policy. Among other reasons, the expectation of rising interest rates led many investors to seek refuge in high yield bonds, which tend to exhibit less sensitivity to rate moves than similarly-yielding<sup>1</sup> bonds with higher credit ratings<sup>2</sup> and longer durations. But 2015 wouldn’t cooperate, and with the end of this Federal Reserve policy upon us, there would seem to be a lot of opportunity for reflection.

## Holy Backfire, Batman!

Low interest rates over the last several years led many investors to reposition their fixed income portfolios. Many replaced exposure that more closely tracks the most widely accepted fixed income benchmark, the Barclays Capital U.S. Aggregate Bond Index (the “Barclays Aggregate”)<sup>3</sup>, with investments in broad market high yield bonds. While it is easy to point out as we did above that such a shift didn’t work out in 2015, it would not be fair to dismiss this decision entirely without some comparison beyond just year-end performance.

We find particularly revealing the upside and downside capture ratios<sup>4</sup> Morningstar calculates for funds and categories. For a portfolio being compared to the Barclays Aggregate, we find the capture metrics to be a useful way to understand its role in a fixed income portfolio. For example, for funds that finished the year with a return comparable to this index, we might ask whether the managers achieved those returns in differentiated and diversifying ways that benefited their shareholders. On the other hand, for funds whose performance differed materially from the index, we might instead wonder if those differences persisted

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<sup>1</sup> Yield is the return an investor will realize on a bond purchased at the market price and held until its expected redemption date.

<sup>2</sup> A credit rating is an assessment provided by a nationally recognized statistical rating organization (NRSRO) of the creditworthiness of an issuer with respect to its debt obligations. Standard & Poor’s ratings are measured on a scale that ranges from AAA (highest) to D (lowest), with ratings of BBB- and above considered investment grade; ratings are subject to change without notice. “NR”, or Not Rated, indicates the issuer or specific security has not been rated and does not necessarily indicate low credit quality.

<sup>3</sup> The Barclays Capital U.S. Aggregate Bond Index: covers the USD-denominated, investment-grade, fixed-rate, taxable bond market of SEC-registered securities. The index includes bonds from the Treasury, Government-Related, Corporate, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS sectors. The U.S. Aggregate Index is a component of the U.S. Universal Index in its entirety. Unmanaged index returns do not reflect any fees, expenses or sales charges.

<sup>4</sup> Upside capture ratios for funds and categories are calculated by taking the monthly return during months when the benchmark had a positive return and dividing it by the benchmark return during that same month. Downside capture ratios are calculated by taking the monthly return during the periods of negative benchmark performance and dividing it by the benchmark return. A negative upside or downside capture ratio means the fund or category has moved in the opposite direction of the benchmark (i.e. up when the benchmark is down or down when the benchmark is up).



throughout 2015 or if they were due to one or two large deviations in an otherwise correlated year.

Referring specifically to Morningstar’s High Yield Bond category<sup>5</sup>, with annual returns falling significantly short of the Barclays Aggregate, how appropriate was the decision to reposition a fixed income portfolio with exposure to broad market high yield bonds?

High Yield vs. Barclays Aggregate
2015 Upside Capture: -14.86%
2015 Downside Capture: +107.40%

The short answer is “not very”. On days the index was up, the category was *down* on average 14.86% of however much the index was *up*. On days the index was *down*, the category was also down on average 7.40% *more* than however much the index declined. Put another way, investors who sought to protect against rising rates by replacing the duration risk of the Barclays Aggregate with broad market high yield funds got more than all of the downside and less than none of the upside.

## Comparing Apples to Oranges

However, we caution investors not to paint all corporate debt portfolios with the same brush. We have long been proponents that credit may be a reasonable alternative to duration in fixed income portfolios as rising interest rates become a reality. But the question remains: how does one differentiate among corporate debt strategies?

We believe the answer to this question lies in the driving factors behind portfolio decisions of the various styles of corporate debt portfolio management. In volatile markets such as those we observed in 2015, the underlying thesis behind a strategy was able to tell us a great deal about how to interpret both performance and volatility. While it can be difficult to see the forest for the trees when the tree in front of you is on fire, a broader perspective that takes into account a manager’s investment process and casts both the short-term and long-term in a less tactical light can be helpful in determining if a strategy is truly delivering something additive and diversifying to your investment allocation.

For the manager aiming to track a broad market high yield bond index, there is little in the way of an investment thesis. Material deviation from the benchmark index, also known as tracking error, is considered a failure of the portfolio, so any active management of the underlying holdings is typically limited to overweighting and underweighting certain

<sup>5</sup> The Morningstar High Yield Bond category consists of funds with at least 65% of assets in bonds rated below BBB.



industry sectors or individual companies while maintaining general index-like characteristics. While such decisions can result in relatively better results, it seems that the primary driver of performance is the level of demand for the underlying asset class.

On the contrary, our actively managed portfolio is based largely on two main tenets: (1) each debt purchase we make is based on a specific fundamental investment thesis that supports the value of the holding as a stand-alone instrument; and (2) our risk profile is the result of marrying this fundamental investment selection with a carefully maintained short-duration profile and deliberate position sizing. While we are not immune to moves in the underlying asset class, we rely almost entirely on fundamentals and portfolio construction to drive our results.

To make this distinction tangible, below are the one-year capture ratios of our flagship fund as calculated by Morningstar for 2015.

ZEOIX vs. Barclays Aggregate
2015 Upside Capture: +31.49%
2015 Downside Capture: -21.96%

In our case, performance exceeded that of the Barclays Aggregate by a margin this year. While we are certainly proud of this fact, we take greater pride in doing so in a differentiated way that we believe has been consistent with our objective to deliver low volatility absolute returns as evidenced in part by these capture metrics: on average, we were up whether the index went up or down. Specifically, the negative downside capture means our strategy gained when the index declined and therefore didn't have to capture all of the upside in order to outperform.

How did we do it? In short, we aim to mitigate short-term sensitivity to the markets with our disciplined, risk-managed approach to portfolio construction while expecting fundamentals to drive long-term performance. We believe that the relentless dual-focus on fundamentals and portfolio construction that characterizes our investment process better enables us to cut through the fog of uncertainty and clearly hone in on the key fundamental theses underlying our investments to determine if actions need to be taken.

To the external observer, a reliance on fundamentals can seem convenient. We will be the first to admit that there are many managers who represent themselves as fundamental investors who are anything but. However, in our opinion, the ability of a company to repay its debt is one of the few analyses in which one can have confidence even during times of unexpected market volatility if the manager is sincere and disciplined in the effort. In taking this approach, we welcome discussions of how we differ from both the Barclays Aggregate and the broader High Yield Bond category reported by Morningstar.



## The Myth of the Wall Street Dealer Bid

As readers may be aware, pricing of corporate debt tends to be determined more by the indications of the dealers than by actual trades. This is very different from equities, which are typically priced using the last sale on an exchange. This is notable because, in today's regulatory environment, dealers are less willing to provide liquidity to their customers using their own balance sheet and capital than was the case a decade ago. As a result, this tradition of providing indications no longer reflects trading levels but rather just the dealers' opinions of where a bond might be, often without any intention of trading at those levels.

To avoid appearing uninformed, however, dealers often try to set these indications to bid/offer levels where they don't risk having to provide liquidity if they are wrong. In a down market, this means skewing their indications lower, and in an up market, it means skewing their indications higher. By doing so, it is less likely that a customer will try to sell bonds at those lower bids or buy bonds at those higher offers, thereby saving the dealer from having to admit that his levels were not real. This behavior is not victimless: pricing services pick up these skewed levels and value their indices and funds accordingly.

Such observations suggest that investors should be cautious in watching broader markets and implying the behavior of any specific portfolios. In December, for example, there were many days during which prices were indicated higher. But, that higher *pricing* was not necessarily indicative of trading activity at higher *prices*. Investors who wanted to make sales into the higher valuations being presented often didn't have the opportunity. Our empirical observations during the month suggested there were a lot of managers who still had bonds for sale across the board and a number of people that needed to raise cash even in upward market moves. We have no reason to believe this is not still the case heading into 2016.

It has been our experience in the past that, in general, when bond investors need cash, the first bonds they sell are those they believe to be safest and most liquid. These tend to be the bonds which exhibit less price volatility, usually because they have shorter durations or are viewed as being higher credit quality. So while the non-transactional pricing levels of riskier high yield bonds may drift around due to dealer indications, the transactional pricing levels of these particular bonds may not move in lockstep on a day-to-day basis. In other words, when evaluating some debt strategies, daily comparisons of portfolio valuations to broader market movements may introduce more noise than clarity into an investor's decision-making process. This phenomenon has certainly been true in this most recent sell-off, but with a twist....

## Aren't We Supposed to Buy Low?

At the moment, it is our observation that bond investors who are looking to raise cash interpret any sign of strength in the markets as an opportunity to make sales, and they



typically offer out what they view to be their most liquid instruments, as we described above. These are exactly the types of bonds we seek for our portfolio. In our effort to do what's best for our shareholders, though, it makes little sense for us to pay their offers when we can try to be opportunistic and take advantage of motivated sellers by bidding them down one or two points. That better pricing for our shareholders will necessarily impact our net asset values as the third-party pricing services give weight to actual trades taking place. We believe the potential medium-term benefits to our shareholders outweigh the short-term optics. It is for this reason that we strive so hard to engage in a dialogue with you, our clients, and we are grateful for your response in kind.

This is the point in this discussion where we cut to the chase. We at Zeo invest in a fundamental portfolio of corporate debt instruments. While the prices of our investments might move, sometimes because of our own investment decisions in an effort to get our clients the best possible prices, at no point in recently volatile markets has our confidence in the underlying fundamental value of our holdings wavered. As we noted earlier, this may differ from the broad market high yield fund manager whose underlying investment process does not necessarily distinguish as firmly between stronger and weaker credits.

Given that we're typically not the only buyers for the bonds we target and that there are some we haven't even been able to buy in a down market, we can add one additional observation to the contrast between the transactional price changes we've seen in our portfolio and non-transactional price changes that have characterized the broader corporate debt markets. Actual trades are an affirmative sign of our portfolio's liquidity and our ability to be opportunistic in what continues to be a very difficult market. That isn't to say demand won't resurface and catch up with the dealer levels (i.e. we are not planting a stake in predicting more downdrafts), but we much prefer the sandbox we play in where actual trades are taking place and where, though we have experienced some price declines, we have done so purposefully to be on the opportunistic side, rather than the fearful side, of those trades.

What is the end result of this analysis? We will let our actions speak for themselves: in December alone, we bought over \$52m worth of bonds, taking advantage of a conservative positioning coming into the month for exactly this opportunity to buy what we believe to be good credits at attractive prices. We do run the risk of buying too much too soon, but we will be the first to say that we are not experts at calling market bottoms. Rather, we believe the more reasonable approach is to maintain capacity in each holding so that we can average down if we see bonds offered at prices that are more attractive than what we paid a few days earlier. But our investment team didn't just make sizeable bond purchases for the portfolio; we made sizeable additional long-term purchases of our flagship fund ourselves. We believe there is no stronger sign of a management team's confidence in its portfolio in difficult markets.



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

Bradford Cook  
Portfolio Manager

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ZEO STRATEGIC INCOME FUND (Ticker: ZEOIX)											
	NAV	1M	3M	6M	YTD	1Y	2Y	3Y	5Y	10Y	Since Inception (31-May-2011)
<i>Month End (31-December-2015)</i>											
<b>Zeo Strategic Income Fund</b>	9.82	-0.60%	-0.57%	-0.50%	1.99%	1.99%	2.10%	2.80%	n/a	n/a	2.82%
<b>Barclays Aggregate Bond Index</b>	1925.40	-0.32%	-0.57%	0.65%	0.55%	0.55%	3.22%	1.44%	3.25%	4.51%	2.87%
Total Fund Net Assets: \$215.7m											
<i>Last Quarter End (31-December-2015)</i>											
<b>Zeo Strategic Income Fund</b>	9.82	-0.60%	-0.57%	-0.50%	1.99%	1.99%	2.10%	2.80%	n/a	n/a	2.82%
<b>Barclays Aggregate Bond Index</b>	1925.40	-0.32%	-0.57%	0.65%	0.55%	0.55%	3.22%	1.44%	3.25%	4.51%	2.87%

ZEOIX – Total Annual Operating Expense Ratio: 1.30%

The performance data quoted represents past performance net of all fees and expenses for the Zeo Strategic Income Fund (“the Fund”). Current performance may be lower or higher than the performance data quoted. Investment return and principal value will fluctuate, so that shares, when redeemed, may be worth more or less than their original cost. Past performance is no guarantee of future results. A fund’s performance, especially for very short periods of time, should not be the sole factor in making your investment decisions. For performance information current to the most recent month-end, please call toll-free 855-936-3863.

The Barclays Capital U.S. Aggregate Bond Index: covers the USD-denominated, investment-grade, fixed-rate, taxable bond market of SEC-registered securities. The index includes bonds from the Treasury, Government-Related, Corporate, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS sectors. The U.S. Aggregate Index is a component of the U.S. Universal Index in its entirety. Unmanaged index returns do not reflect any fees, expenses or sales charges.

**Investors should carefully consider the investment objectives, risks, charges and expenses of the Fund. This and other important information about the Fund is contained in the prospectus, which can be obtained by calling 855-936-3863. The prospectus should be read carefully before investing. The Fund is distributed by Northern Lights Distributors, LLC member FINRA/SIPC.**

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Mutual Funds involve risk including possible loss of principal.**

The Fund can invest a percentage of its assets in derivatives, such as futures and options contracts. The use of such derivatives may expose the Fund to additional risks that it would not be subject to if it invested directly in the securities and commodities underlying those derivatives. The Fund may experience losses that exceed losses experienced by funds that do not use futures contracts and options.

Typically, a rise in interest rates causes a decline in the value of fixed income securities. Overall fixed income market risk may affect the value of individual instruments in which the Fund invests. Lower-quality fixed income securities, known as “high yield” or “junk” bonds, present greater risk than bonds of higher quality, including an increased risk of default. As a non-diversified fund, the Fund may invest more than 5% of its total assets in the securities of one or more issuers. The Fund’s performance may be more sensitive to any single economic, business, political or regulatory occurrence than the value of shares of a diversified investment company. Securities of small and medium capitalization companies may be subject to more abrupt or erratic market movements than those of larger, more established companies or the market averages in general. Market risk results from adverse changes in exchange rates in foreign currency denominated securities. Investing in securities of foreign issuers involves risks not typically associated with U.S. investments, including adverse fluctuations in foreign currency exchange rates, adverse political, social and economic developments, less liquidity, greater volatility, less developed or less efficient trading markets, political instability and differing auditing and legal standards.