Need Income? Go Private

As investors, we must constantly reassess the opportunities that are available in the public markets and beyond. Collectively, we tend to focus on the public markets as the primary destination for our capital. Both the public debt and equity markets are on constant display, providing immediate feedback and apt benchmarks against which to measure our performance. These markets have worked exceptionally well over an extended period and will likely remain the measuring stick for our investment performance.

As we embark on a new year and a new venture we have the gift of starting with a blank canvas. We are not bound by benchmarks, an investment committee or a fixed asset allocation. We have the flexibility to look at all alternatives and to allocate capital to those that offer the best risk/return characteristics and to those that most closely align with our investment objectives, which are:

- Preserve capital
- Generate an attractive level of income
- Produce long-term capital gains

You will note that there are two notable omissions from our statement of objectives; no reference to volatility or to liquidity.

Regarding volatility, our preference for low volatility is reflected in the other statements, notably the focus on capital preservation. We have worked long and hard to acquire our capital and we want to put it to work, not at risk. That said, nothing ventured, nothing gained, so we seek investments that have a low probability of loss and backed by either real assets or clearly identifiable cash flows.

We also state that we want investments that can produce long-term capital gains. This indicates our focus on the terminal value of an asset rather than an intermediate valuation. This is critical when considering private investment opportunities alongside public. Too often, investors look at public investments as too volatile because the valuation is real time and subject to the whims and moods of the markets. Private investments are often considered less volatile because they are not subject to daily valuation. We discount both conditions and instead focus on the risk of loss, the amount of income we can generate over the holding period and the value of the investment at the end of the investment horizon. These considerations reduce the importance of volatility in our view.

Likewise, we discount the liquidity of the investment. We believe that long-term investors should commit capital to investments for the long-term. Liquidity can and should be derived from short-term, not long-term portfolios. We are apparently in the minority here as the reward for accepting illiquidity today is generally greater than for other risks; notably default, prepayment and term structure risks.

Given our investment objectives and our views on volatility and liquidity, we are now able to look across a broad range of investment opportunities and allocate capital to those that we believe are most consistent with our risk and return targets and our long-term investment objectives.

Today's Opportunities

We believe that the best opportunities to deploy capital today are in the private markets. There are significant supply and demand imbalances that can be exploited to enhance return at the expense of reduced liquidity.

When looking at corporate equity opportunities, we believe that a significant portion of the value creation is now occurring before a company goes public. In addition, we believe that current tax policy limits the amount of capital available for distribution to investors and subjects these distributions to double taxation. We prefer direct, private real estate equity to corporate equity (public or private) as we participate pro rata in the net income of the property and the income is generally tax advantaged.

In the debt markets, we have a clear preference for private debt over public. There are significant opportunities for enhanced yield with limited risk of loss. The risks that we take have more to do with lack of liquidity and the timing of cash flows. Further, private debt is often subject to risk based capital restrictions for large institutional investors such as banks and insurance companies, limiting demand. Public pension funds and other investors are often averse to these opportunities as liquidity tends to rank high on their list of objectives and the debt portion of their portfolios is often used to meet short-term liquidity demands. Our view is that long-term investors should not demand liquidity from long-term investments as the opportunity cost for liquidity is just too high.

Looking Back

We have been professional investors in the public markets for nearly 35 years. This period has been extraordinary as the S&P 500 experienced nearly a 22-fold increase and as the yield on ten-year US Treasuries declined from a high of nearly 15.7% to a low of 1.35%. Looking forward, is it reasonable to expect that kind of performance over the next 35 years? We don't think so.

Source Bloomberg - The S&P 500 hit a low of 103.71 on 8/6/1982 and rose to a high of 1527.46 on 3/24/2000 for the period January 1, 1982 through December 31, 2000

Source Bloomberg – The peak yield on the Generic 10-year US Treasury Note was recorded on 9/25/1981 and the low yield recorded on 7/8/2016 for the period January 1, 1979 through January 20, 2017

When looking at the equity markets, we see that the 35-year gain was largely driven by the period from August 1982 through March of 2000. This was a truly exceptional period as the index gained nearly 16.5% per year, exclusive of dividends. This gain was driven by many factors including globalization, deregulation and technological innovation. Add to that a positive demographic, as the baby boomers came of age, and a secular decline in interest rates that accompanied a marked decline in inflation and a marked increase in real economic growth. This combination of factors was so extraordinary that we are unlikely to witness a repeat of this performance anytime soon, if ever.

To support this view, we need to look no further than the performance of the S&P 500 since the end of this bull market. Since March of 2000 the price index (which excludes dividends) is up a cumulative 49%. While this sounds reasonable, it equates to annual price appreciation of only 2.4%, even though the S&P achieved a new all-time high (as of 1/25/2017). We would also like to point out that dividends on the S&P 500 are low by historical standards at 2.01% and well below the long-term average of 3.03%. Earnings yields are also low by historical standards at 4.86% versus an average of 6.73% over the same period, representing a payout ratio of 41%.

When looking at the fixed-income markets, we see a similar situation. The peak in rates was directly attributable to the efforts of the Volker Fed to wring inflation out of the economy. The Federal Funds Rate target peaked at 20% in March of 1980. We then witnessed what amounted to a sustained march toward zero as the Greenspan Fed lowered rates to 1% in 2003 and the Bernanke Fed took us effectively to zero following the financial crisis. Despite the end of quantitative easing in 2014 and two subsequent increases in the Fed Funds Rate, it will be impossible to repeat the dramatic declines in rates we witnessed over the last 35 years.

The financial crisis (2007 to 2009) also led to many changes in the banking sector and in the markets. Dodd-Frank effectively restricted risk taking by banks which in turn led to a structural reduction in the availability of credit. While this initially led to a reduction in the potential growth of the economy, it subsequently led to the emergence of alternative sources of credit. This largely explains the recent growth of the private credit market.
Source FRED - Real Gross Domestic Product was 3.74% per annum over the period Q2 1982 through Q3 2000 with only 2 negative quarters Q3 & Q4 1990

Looking Ahead

Today, we are seeing a significant number of opportunities to invest in private credit (debt) at rates that are determined by the borrower's potential to create economic value rather than on prevailing market rates. While the ten-year US Treasury is currently yielding 2.5% (as of 1/25/2017), we are seeing opportunities to invest in private debt at rates ranging from 8% to 15%. The rise in US Treasury rates following election day (65 basis points as of 1/25/2017) has had no impact on these rates. If anything, there has been downward pressure on these rates as the availability of credit has increased due to an expansion of the private credit market and the perception that the restrictive impacts of Dodd-Frank will subside as the new administration alters and implements policy. This suggests that there will be little if any correlation between these rates and US Treasury rates unless and until there is a major shift in interest rates.

The yield levels available certainly qualify as high yield opportunities. Most investors, however, tend to associate the term high yield with 'junk bonds', implying that the yield is solely indicative of the likelihood of default and, subsequently, loss. We have observed that many of the private debt opportunities we have reviewed and invested in do not have a significant risk of loss. Rather, the compensation provided is reflective of the lack of available credit (significant demand and limited supply) and the lack of liquidity associated with these investments. Simply said, there is a supply and demand imbalance in the debt markets, specifically for debt that would require significant risk based capital reserves on the balance sheet of a bank or an insurance company.

Will this change with the new administration? It is certainly possible that deregulation or at minimum a re-think of existing regulation could allow banks back into these types of loans resulting in a dramatic increase in the supply of capital and a corresponding decline in rates. We do not believe that this will be either easy or quick, but there is a reasonable probability that it will happen in time.

What Does This Mean for Investors?

We believe that returns in the public markets will be muted. In public equities, the bulk of the return will need to come from price appreciation as dividend levels are off their historic lows, but are still depressed by historical standards. For prices to rise, earnings will need to rise and/or multiples will need to expand. Looking at the positives, changes in tax policy could result in an increase in dividend distributions. This coupled with repatriation of foreign profits could increase both the amount of capital available for distribution and the propensity for corporations to make those distributions. For public debt, whether Treasury rates rise, fall or go sideways, we are unlikely to see attractive returns as we are starting from very low yield levels by any historical measure.

We have invested equity capital in real estate versus corporate equity for a variety of reasons. First and foremost is the distribution of income. In real estate, we participate pro rata in the net income of the property. In public and private equities, it is generally up to the issuer to declare a dividend, meaning they have discretion over the portion of income that is shared with investors. If we are going to own a pro rata share of a business, we would like to have access to a pro rata share of the income. Second is the taxation of the income. For the moment, the net income from real estate investments offers certain tax advantages that we find very compelling.

It has been pointed out that real estate valuations have come a long way and that there is risk in acquiring properties at these levels. We could make the same argument about the public equity markets. We believe that if one adheres to stringent valuation and underwriting criteria, attractive properties in various markets around the country can still be found that offer exceptional risk/reward characteristics.

In the private debt markets, we have deployed capital across multiple opportunities that provide yields of 8 to 13% with limited risk of loss. Is there default risk? Yes, but the loans are generally secured by a first lien position on the underlying property or cash flows. Is there market risk? Yes, but as capital increasingly flows to alternative lending solutions, we believe the pressure will be on lenders to lower rates as competition increases. Further, we believe that these rates will demonstrate little correlation to US Treasury rates.

Conclusion

We believe that the best opportunities to deploy capital today are in the private markets. We also believe that the public markets will continue to be the benchmarks against which all investment performance will be judged, but performance in these markets will likely fall short of long-term expectations. In the private markets, there is significant reward available to long-term investors that are willing to accept complexity and forego liquidity in exchange for incremental yield and return.

Notes:

1. Source Bloomberg – The S&P 500 hit a low of 103.71 on 8/6/1982 and rose to a high of 1527.46 on 3/24/2000 for the period January 1, 1982 through December 31, 2000
2. Source Bloomberg – The peak yield on the Generic 10-year US Treasury Note was recorded on 9/25/1981 and the low yield recorded on 7/8/2016 for the period January 1, 1979 through January 20, 2017
3. Source FRED – Real Gross Domestic Product was 3.74% per annum over the period Q2 1982 through through Q3 2000 with only 2 negative quarters, Q3 & Q4 1990
4. Source Bloomberg/ NYU – Dividends averaged 3.03% for the period January 1, 1960 through December 31, 2016. The low dividend yield on the S&P 500 was recorded in 1999 at 1.14%
5. Source Bloomberg - Federal Funds Target Rate – Up Index – The high rate was recorded on March 7, 1980 at 20.0%, the low was recorded on December 19, 2008 at 0.25%
6. ACC/Deloitte survey – "The private credit market has grown from $440 billion last year, to $560 billion today." (July 28, 2016)
7. Risk based capital regimes include those recommended by the Bank for International Settlements (BIS) and the National Association of Insurance Commissioners (NAIC)
8. Source S&P Dow Jones Indices – as of December 30, 2016, trailing 12-month p/e ratio was 24.34