Episode 92

The Takeaway with Troy Gayeski: Embrace alternatives or be left behind?

Our Chief Market Strategist dives into the latest mega trends, including why exploring alternatives could be essential to staying competitive.

Troy Gayeski (00:00):

There's a reason why large institutions in some cases have 80% of their capital in alternatives, right? They're not doing it for their health. I can assure you of that. They're doing it. They recognize that in certain areas, there are meaningful alpha propositions or excess return above and beyond what you can get in public markets.

Harrison Beck (00:22):

This is the takeaway with Troy Gayeski, a podcast from FS Investments. We sit down with chief market strategist, Troy Gayeski, to get the latest on what's happening in the economy and what investors may want to do about it. I'm Harrison Beck, FS investments content strategist. I'll take Troy through today's top questions so that you can get the takeaway. Welcome, Troy.

Troy Gayeski (00:47):

Hey, Harrison. Great to join you again for, I guess this is our second official vodcast is the term. Now I've learned...

Harrison Beck (00:54):

The second podcast. That's right. Video podcast. Well, Troy, so you've been traveling around the country. You were just telling me a day here and two days there, and it sounds like a lot of traveling, but you're talking to advisors, you're talking to financial professionals. What's a conversation you've had this week that really stood out to you?

Troy Gayeski (01:10):

There's a variety of mega trends going on right now in asset management. One of them affects private credit, which is a strategy of ours, and also affects a short-term theme. Let's call it a medium-term theme. And that is just the fact that we have 10,000 fewer banks in the United States right now than we did in 1990, right? But we had 14,000. We roughly 4,000 now. And there are a lot of reasons for that. But when you step back and you look at that chart and you just see, wow, think about this secular trend, how many fewer banks there are today, and that is really the basis for why private credit is flourished. That on top of the fact that regulatory capital charges for the banking industry make it very difficult for them to lend to non-public middle market companies. Another conversation, a different secular trend, somewhat tied to the rise of private credit is also just this willingness and desire for companies to stay private. So that is another chart that blows one's mind, that we have 35 ish percent more, I think it's 42% more private companies and 36% less public. And one of the advisors actually shared with the audience that there's only a little over 4,000 publicly traded companies left. So those are two mega trends in capital markets, and it's really important as an investor, not only tactically, but strategically to figure out how you can benefit from those.

Harrison Beck (02:37):

And let's dig into both. So going back to companies staying private, walk us through the reasons why are more companies staying private today than did

Troy Gayeski (02:46):

Maybe 10 years ago? When you think about once you go public, you become very exposed to the monotony, but also the pressure of to meet and beat earnings expectations every quarter. And that is the central flaw with the public model in when you think about a company like Boeing, or you think like a company like Intel, not that they're even today is enough capital and private markets for them to have never gone public or had to really overly fixate on short-term profitability. But I got to tell you, you think of what's happened to Boeing without that pressure on quarterly earnings, not that I'm making excuses for management at all, perhaps their quality control would be a lot better. And so when you think about it as a private company, if you're looking to grow a company over years, not quarters, having the flexibility of deep pocket institutions, simply a handful, one to five owners that are experts on the sector, understand pros and cons of strategic moves can help provide capital in a very timely way to grow.

(03:59):

And then the other side of that is the growth in private credit where you don't have to go to the syndicated bank debt market. And the bright side of that is it provides more opportunities for private capital. The negative side, to be fair, is that if you're an investor in an older vintage private equity play, particularly mega cap, it may take you longer to get paid out your capital. So it's not all peaches and cream. But the flip side of that, and we have a huge emphasis on private equity secondaries right now, is if not for that part of the equation, there wouldn't be such a wonderful opportunity for secondary. So all these things, you're trying to figure out what the mega trend is, how to position yourself to profit from that, and then how to be more tactical around the shorter term opportunities. And bottom line is this mega trend to stay in private isn't going away anytime soon, that train's left to station and fortunately to the benefit of our investors.

Harrison Beck (04:56):

Well, and that's why mega trends become mega trends because there's not one reason, there's not two reasons. There's multiple reasons, a hundred percent that are making them happen. And it sounds like within private credit, I mean, it sounds like it's not only regulatory changes, but it's also that private credit can be good for businesses and good for investors. So let's bring it back to advisors. You are having these conversations about private credit, about what's happening with banks and lending. I mean, simply, did they get it? Are the people you're talking to engaged? Are you aware of these ideas or is this maybe a little bit new to them?

Troy Gayeski (05:33):

Intellectually, most people, whether it's clients or advisors, get it, it's just a question of can they break through the inertia and actually take action? I think that's always the most surprising thing to me, is the disconnect between rational thought, rational understanding, and the willingness to then fight inertia and take action.

Harrison Beck (05:58):

Sure. Well, and if I'm an advisor and I'm trying to grow my business too, I mean, I think that there is what could be clear as inertia from the outside might look to me like, well, this has always worked for me and this helped me grow from when it was just me by myself to this office where I've now got 10 guys working for me.

Troy Gayeski (06:16):

Yeah, understand. And look, we've been for the most part in a mega bull market for 40 years. And there's been other strategy notes and discussions about why this current environment's different, mainly because of how sustained inflation is. But that being said, I mean those that stuck with equities over fixed income have seen their capital come back and perform reasonably well courtesy of a handful of mega cap tech companies that have just crushed it on free cashflow growth continually. And sometimes inertia can be your friend if it keeps you from overreacting, if it keeps you from doing, I think selling everything at the bottom of the global financial crisis or maybe buying too much into AI frenzy. Now, given that equity multiples are 21 times four earnings, not saying you won't make money, but the risk reward at this stage of the game is definitely different than it was October of 22.

(07:10):

So yeah, I get that. But I think that when you think of another mega trend in asset management or finance, there's a reason why large institutions in some cases have 80% of their capital in alternatives. They're not doing it for their health, I can assure you of that. They're doing it. They recognize that in certain areas, there are meaningful alpha propositions or excess return above and beyond what you can get in public markets. And that's not to say any individual should go 80% alternatives. You have to do enough to matter. You have to do enough to impact your asset allocation. But at the same time, typically an individual has more liquidity needs, but push comes to shove. If you're not at least embracing alternatives from a thought leadership standpoint or trying to understand the asset class, it's going to be harder and harder to compete. Right? If you don't at least form an opinion and you're not willing to engage on the subject, I suspect your value proposition versus ETF or versus now a bond ETF or mutual fund has gone down dramatically.

Harrison Beck (08:20):

Well, and within the industry. I mean, this is not an opinion that I'm just hearing from you. I remember in your recent strategy note, you were responding to this article that was in the Wall Street Journal. Matt Wetz wrote it, and he was talking about how experts are predicting that by the year 2027, the number of wealthy individuals invested in alternatives as expected to triple, and we're seeing allocations across the industry are increasing in response to this same projection.

Troy Gayeski (08:50):

Yeah. I mean, look, it all gets back to where we are in a market cycle in terms of valuation. S and P is back to 20.6 times forward earnings. And I'm very sympathetic to the argument that given the concentration of market cap in a winner take all environment, that you should have higher multiples than five, 10 years ago or 15 years ago when you had much less return on equity when you had much lower free cashflow. But you can't say equities are cheap, right? There's just no way I could say that. And most would argue they're fair value to a little rich at least. So where else can you get growth in naturally? One would think private equity, but not all. Private equity is the same, right? Mega cap buyout, they're choking on debt service costs, they're choking on exit strategies. They're choking on trying to return capital to inpatient shareholders wish 'em well.

(09:46):

But we're very, very happy. We're focused on the middle market. We're not only do you buy companies cheaper, you don't need leverage to generate returns or what's known as financial engineering because it's more about organic growth. And then as we often say, even though the risk reward of fixed income is much, much better today than at the end of 21, where it was the definition of return, free risk has remained persistent in the Fed is in no rush to cut. So why people have articulated wonderful upside in fixed income for the last six to 18 months is beyond me. I mean, I get it. If you're a long only bond manager and a long only bond manager salesperson, you're going to articulate a lot. But fairly rational people have articulated it in our opinion, and there was never any data to back up an expectation that the Fed would be cutting aggressively at all.

(10:39):

So most high quality bond funds with five, six, maybe seven, maybe 8% type returns in some of the muni indices, that's better than a sharp stick in the eye. But if you could have a similar or slightly better income stream and do it with much less volatility and arguably much, at least somewhat lower risk of loss, that's driving a lot of the allocation to private credit or strategies that are not sensitive to rates going up or down. And so to your point, the question for investors again is as they get educated on alternatives, is which strategies make the most sense? Are you for income? Are you for growth? Are you for diversification? And then of the handful of, let's call mainstream providers of alternatives, whose strategies make the most sense at this given time. And that's where I think as a firm, we're very fortunate to have an embarrassment of riches for our client base right now.

Harrison Beck (11:36):

Absolutely. And to understand that between asset class and strategy and vehicle, there's a lot of options depending on what an investor's goals are. Don't

Troy Gayeski (11:46):

Almost say too many, but we're here to help. We're always here to help.

Harrison Beck (11:50):

It's funny, I read something recently where, and I think the author was being sort of tongue in cheek, and I wish I could remember who the author was, but they were saying institutions have understood that alternatives are an important place to be. Individuals are starting to realize that maybe they have more in common with institutions than they thought they did. And that's kind of tongue in cheek. But in terms of timeline, I mean, if somebody is thinking about retiring in 20 years than a consideration, like liquidity, maybe they do have something a little bit more in common.

Troy Gayeski (12:17):

Sometimes institutions have more in common with high net worth individuals than they thought, but to your point, exactly. I mean, if you're someone my age or younger, hopefully you're younger, and yeah, you need some liquidity, obviously prudently, but why give up three, four, 5% compound returns per year? And that's the magic of compounding, right? If you can compound at 12, basically the old rule is 72, right? Six years to double your money. If it's eight, it's quite a bit longer. Nine years to be precise.

Harrison Beck (12:50):

Well, to bring it back to our conversation about differentiation, bring it back to a conversation about growing advisor businesses. One of the fairly ubiquitous speed bumps in allocation currently is the phenomena of massive cash hos, which we've spoken about before. But I was rereading your note, and I really liked the way you put it. This, while nobody is bashing cash, allocating to cash is hardly a value added service.

Troy Gayeski (13:14):

Yeah. I don't know if the listeners know, but I often like to point to the efficient frontier is in the efficient frontier is just a concept of you have to take more risks to make more money. That's typically how it works. Now, every now and again, it doesn't hold to be true and no one's bashing cash. That is a strategy right now that offers much higher return than is historically. But look after taxes, after inflation, your returns more than likely negative, particularly if you're in the upper tax brackets in states that have income taxes. I was just in Texas, so they have the luxury of not having a state income tax. So God bless Texas, it must be

Harrison Beck (13:54):

Nice.

Troy Gayeski (13:55):

Yeah, I know Pennsylvania I think has one. I live in Connecticut. I'm pretty sure we have one. Most states do. But after tax, after inflation, your return is barely positive, even in tax friendly states. And when you think of as an advisor, it's back to that whole concept of differentiation. How are you possibly adding value for a client? Yeah, man, I can get you an extra 13 basis points in this money market fund or, okay, again, better than nothing, but your whole job, I think, is to help grow wealth for clients, protect their capital. Number one rule, keep a client wealthy is the term. Number two rule. Grow that capital. Trying to add value by articulating that you should have more capital in cash is not a winning strategy by any stretch, the imagination. And so if you're concerned that your business growth has slowed because you're showing people non-differentiated products, the best way to cure that is to at least open your mind to the fact that there are other strategies out there. And again, it's not just our firm, it's, it's a handful of 15 firms that have come a real long way democratizing these strategies.

Harrison Beck (15:14):

That makes a ton of sense. And I think about some of the stories that I hear on one of our other podcasts here at FS Investments head to head, and we'll talk with these advisors and what they'll most often talk about is how emotional and how personal the conversations they're having with their clients are. And performance is obviously key. You show a client a big number that's going to impress them, but to be able to tell them a larger story about why you're able to show them something differentiated, why what you're able to show them is unique, that's got to be compelling.

Troy Gayeski (15:49):

And I'd also say it's important that it's readily explainable, right? When we evaluate strategies at fs, we see a lot of different things. But is it full cycle? Meaning, is this a strategy that can go through economic downturns? Is it overly dependent upon a short-term phenomenon? If it's not full cycle, what's the point? Because by the time you get the idea gestated and scaled up, typically the money comes in too late, nobody wins, then the client doesn't win, the business doesn't win. It's also whether or not it's scalable. Because if you can only manage three or five or seven or $15 million, what's the point of that? And that's what's so fun about, we referred to those two charts before, but the mountains of data and different source material that back up middle market outperformance versus mega cap. LBL Morgan Stanley did a study recently, and I joked around with our team, I'm like, did we sponsor this?

(16:50):

Did we actually pay for this? Because it just tells our story so well. And it basically just pointed out that of the transactions, they looked at over a long period of time in private equity, and they divided it between middle market and large cap LBL or larger. The revenue growth was 2.9 times larger in middle market, and the EBITDA growth was 2.7 times larger. And so that's just one example of all the various data that's out there that demonstrates the relative outperformance of middle market private equity versus mega cap buyout. And then again, just like no one's bashing cash. I'm not bashing public markets. I think there's, in fact, to the point of what many people point to as a negative, the narrowness of narrowness of today's markets has actually been a positive because thank goodness for the magnificent seven minus Tesla, plus Eli Lilly and Nate CapTech is, if not, I can tell you the performance of the s and p wouldn't be nearly as good as it had been the last five, 10 years. Sure. It's just a question of valuation and can you expect continued performance like you've had in the past? I think the answer is clearly no. It doesn't mean you can't expect performance. I like our chances to at least compete or outperform without all the wacky volatility. So yeah, it's a really fascinating time for a handful of select alternative strategies.

Harrison Beck (18:13):

Well, finally, as we wrap up this episode, it's the name of the show and a great way to summarize our time together today. What's the takeaway you want listeners to have from our conversation? Yeah,

Troy Gayeski (18:24):

I think for today, look, we get it. There is a lot of cash on the sidelines. Cash is more attractive than it's been historically, at least most of our investible lifetimes, let's say. But there are alternative options that could meaningfully increase your total return or income without taking uncomfortable levels of risk. And so that is key 0.1. The second key takeaway is we understand everyone's busy. There's a lot of inertia. It takes time to be educated and make meaningful portfolio changes. But if you're a paid financial advisor and you're not at least taking the steps to have an opinion and then demonstrate these strategies to your clients, I guarantee you somebody else will be doing it. We deal with all the major distribution firms, the wealth management firms of many, many different great registered investment advisors, independents. And there are many hungry, motivated people that have no limit to how much time they're going to spend to learn and make sure that they're subject matter experts so they have a higher probability of winning that client and growing their business than someone that is unfortunately succumbing to inertia for whatever reason.

Harrison Beck (19:43):

That makes a lot of sense. Well, thank you so much, Troy. This has been a great chat.

Troy Gayeski (19:47):

Yay. Great. I look forward to the third.

Harrison Beck (19:50):

Same here.

Troy Gayeski (19:51):

Talk to soon, Harrison.

Harrison Beck (19:52):

Talk to you soon. Read Troy's full strategy note and get up to the minute investment strategy research and more at fsinvestments.com. This episode was recorded at the FS Investments headquarters in Philadelphia's historic Navy Yard and in our New York executive office. It was hosted by Harrison Beck and edited and engineered by Aaron Sherman. Video edited by Melissa Venditti. Special thanks to Ellie Zhang and Lara Coleman. Make sure to follow and subscribe to the Fireside podcast wherever you stream. Thanks for listening.