Episode 89

The Takeaway with Troy Gayeski: Putting cash to work

Chief Market Strategist Troy Gayeski shares the latest in economic trends and market strategy, including why (and how) he's redeploying cash.

[00:00:00] **Harrison Beck:** 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.

[00:00:28] **Troy Gayeski:** Hey, how are you, Harrison?

[00:00:29] **Harrison Beck:** Doing good. How are things up in Connecticut?

[00:00:32] **Troy Gayeski:** Ah, it's a little gloomy day today I must say, but it was nice weather recently, so I'm not complaining.

[00:00:38] **Harrison Beck:** Well, Troy, given the continued growth in the U.S. economy, but also the halting progress against inflation, high interest rates, and the current outperformance of risk assets like equities as compared to cash, there is a lot for investors to respond to.

But spring is in the air, as you say in the title of your latest strategy note. So many investors may be thinking about a little portfolio spring cleaning. So, let's talk about what they may want to consider. Let's start with performance. How are key alternative investment strategies performing in the first quarters of 2024? And how does that compare to traditional investments like equities?

[00:01:16] **Troy Gayeski:** Yeah, it's a great question, Harrison. So, if you think about how this year's progressed, just very simplistically from an economic standpoint is the economy continues to do better than most expected. Inflation continues to trend higher.

In fact, there's been some alarming reacceleration of certain inflation metrics. And so, what this has led to is meaningfully better performance for equities, vis a vis expectations. You know, think high single digit type returns, low teens. Fixed income has done what I lovingly refer to as the fixed income thing and found new ways to lose money for investors.

So, another tough start to the year for bonds, down north of 1%, in some cases north of 2%, depending on the index. And then cash is doing the cash thing, right? It's making you a no volatility, no risk, marginal return, only marginally above, let's call it, one to one and a half percent, depending on what type of cash instrument you're in.

And then alternatives, depending on the strategy, have either comfortably outperformed cash, or are right in line with cash. So, I think that the whole premise of this like spring cleaning argument for portfolios is the number one challenge for investors today in whether these are institutions, individual investors, financial intermediaries like advisors or consultants is, these massive cash piles have been built up over the last several years after the pandemic. And it's a challenge to figure out the best way to put that to work without exposing yourself to undue risk. So, the way we look at it is, are there strategies out there that can meaningfully improve your return potential without driving your risk level to an uncomfortable level?

[00:03:11] **Harrison Beck:** Well, and that's one of the big themes you've been talking about, the risk that cash holds for investors. Can you describe those risks?

[00:03:19] **Troy Gayeski:** Yeah, so I don't think of it, in terms of risk. I think of it more in terms of opportunity cost, or return potential that you're leaving on the table. Because A, you haven't been able to access alternatives before because they've been mainly for large institutions. Or B, they tend to be more complex strategies.

You know, let's say you're making five and a quarter in cash right now. Isn't it better if you don't need that liquidity tomorrow or the next week or the next month? Meaning you can trade off liquidity. Isn't it better to make 9, 10, 11, 12 percent. More than likely most people would agree, but if you're quintupling your risk or you're taking much more risk where you could allocate that 10 percent of your portfolio away from cash into something else, and that's something else could drop by 10 or 15 percent the next six months, that probably doesn't make sense.

[00:04:11] **Harrison Beck:** So, it sounds like the issue with holding on to cash is the potential opportunity cost of what you could be missing someplace else. But is that the only risk with cash?

[00:04:22] **Troy Gayeski:** The risk, and again, this is not our base case, but there's this concept of real yields.

Where you have what the risk-free rate is paying. And then how much of that you're getting taxed through inflation. So, if risk free is zero and inflation's two, your actual purchasing power is going down over time. Well, really in the entire post global financial crisis period, up until very recently, real yields have been negative the whole way.

So, holding cash, you're actually getting debased. For a little while now, we've had real yields going higher and higher and higher, and why? Because the Fed hiked to five and a quarter, five and a half percent, kept rates there, and inflation was dropping, dropping, dropping, so real yields were going higher and higher and higher.

Well, we've seen the last two or three inflation numbers is a resurgence in inflation. So, you're once again going through a short-term period where your real yields dropping. Again, the risk of inflation exceeding the Fed's risk-free rate is low. But if you're going to use the term risk, probably the one true risk is that we wake up at six months and you thought you were getting a real yield that was positive, but it turned out that you once again have inflation that's at least slightly higher than the risk-free rate. Not our base case, but certainly conceivable.

[00:05:39] **Harrison Beck:** And certainly, that's the reason to diversify what you're holding on to and to not just sit with something that feels safe or that felt safe last year.

[00:05:47] **Troy Gayeski:** Yeah, exactly. And, also furthermore, like, hey, if you're starting out at a 10 percent number and you think you're giving back, three and a half from inflation.

Okay, you're at six and a half, but if inflation turns out to be five, again, not our base case, but let's just do the math, turns out to be five. Well, hey, you're still making 5 percent above and beyond the purchasing power eroding nature of inflation. So, you know, five is not six and a half, but it's still better than zero, right, or something that's slightly negative.

[00:06:16] **Harrison Beck:** I like that strong math that you're bringing to the conversation. It's important to ground ourselves.

[00:06:21] **Troy Gayeski:** I'm good with back of the envelope math. You know, I haven't done many derivatives in a while, but I can still do addition and subtraction.

[00:06:26] **Harrison Beck:** Well, and when we talk about balancing appetite for risk with a desire for returns, we usually reference the efficient frontier.

But one of the things I really enjoyed about your recent strategy note is the way you simplified this. In terms of two powerful investor emotions, greed on the one hand and fear on the other. So, what might balancing greed and fear look like for investors today?

[00:06:50] **Troy Gayeski:** Yeah, thanks for the compliment Harrison, appreciate it.

So, the whole efficient frontier argument for investment professionals is pretty straightforward. As you take more risk, you should have more return. But how much risk do you want to take right now, given that equity markets are 21 times forward earnings and bond yields have gone up a lot? It's very hard to argue in this inflationary environment where the Fed is in no rush to cut, that fixed income looks incredibly attractive.

So that's one angle, but the whole greed and fear concept is typically when investors talk about greed, what comes to their mind is you're in a very strong bull market and people are really getting bulled up and taking higher and higher levels of risk to generate higher and higher returns.

And sometimes that can lead to significant losses if there's a bear market or a pullback. And then the fear side is typically staying invested at the bottom of market cycles and not exiting at the totally wrong time before market rebounds.

[00:07:50] **Harrison Beck:** So then how might greed and fear apply to what investors are seeing today?

[00:07:54] **Troy Gayeski:** When you think of it as it applies to the current environment, the greed side is that, almost every rational investor understands that the returns from cash are meaningfully better than they've been for a long, long time. You're finally getting a real yield, meaning income after subtracting the pernicious effect of inflation.

But you have to be greedy enough to understand that, cash returns are probably not going to cut it from a standpoint of achieving your life goals. Whether it's retirement or whether it's endowment, trying to support a college, four, five, five and a half percent just isn't enough. So, you want to be greedy enough to start looking at thoughtful ways to deploy that capital that can meaningfully increase your return. So that's the greed aspect.

The fear aspect though is, again, if you think of where we are in this cycle, even though recession risk has gone down dramatically in equity markets, it's not zero, right? You could always have an exogenous or endogenous shock, or a surprise recession. I think more challenging is just where valuations are.

They're extremely elevated relative to history. They have only been more expensive twice, in the dot-com bubble and in what we refer to as the green light go environment in 21. When the Fed was doing everything they could to reflate the economy. So you want to be fearful enough to understand that maybe going from a 10% cash allocation to zero and plowing that all into equities might not make a lot of sense.

And then at the same time, when you objectively look at fixed income, it's more attractive than it was in 21 and in late 2020. So it's not the definition of return free risk like it was then, but you can certainly experience higher degrees of volatility and the potential for loss, particularly as the inflation data continues to be very, very robust.

So, the fear side is: Hey, is there a way to balance that greed of knowing you need a little bit more return, or in some cases meaningfully more return, with the fear of, it probably isn't the smartest thing to take this cash pile and instantaneously deploy it into higher risk assets, whether they're driven by duration, or they're driven by beta. Beta is for equities, duration is for fixed income.

So, that is really where alternatives come in to really solve that pressing problem. And we think this is going to be an issue probably for years. And how do you thoughtfully put that capital work? So as people are going through their own asset allocation, we are obviously happy to help out in that thought process of balancing between greed and fear.

[00:10:32] **Harrison Beck:** I think that's another part of your strategy note that worked very well. There was this place where you talked about the beauty of portfolio construction, and you seem to be touching on this idea that especially when exploring a new allocation or, even a totally new strategy or asset class, there was room to still be careful even while avoiding opportunity cost.

[00:10:54] **Troy Gayeski:** Yeah it's a great observation, Harrison. So you think about it, everyone is in a different period of their life cycle for embracing alternatives as a compliment to fixed income, as a compliment to equities. And now as arguably the most optimal place to put cash to work.

Again, if you have any fear in your heart, makes sense. If you have any greed in your heart, makes a lot of sense. Because you're increasing returns substantially and not forcing you to take uncomfortable levels of risk. So if you're an investor that has never embraced alternatives at all, your portfolio may look something like 10, 15 percent cash, maybe even higher 20, 30 percent fixed income.

And then the balance being in equity is just one generic example. We always say you have to do enough to move the needle. Meaning if you make a 0. 1 percent allocation anything like almost, what's the point? It's not going to change the outcome. So we always think of increments of five percent or as little as two and a half percent on one extreme.

And then of course you have larger institutions that have been very active in alternatives for years. Whether it's middle market private equity, or private credit , or senior commercial real estate lending. And their question is a little bit different. It's, all right, so if I already have 40, 50 percent in alternatives, I'm happy with my allocation. Ooh, I got this seven, eight percent in cash and I haven't owned fixed income in a long time because there's been no point. I don't like volatility, so I don't really like that much equity beta.

So how do I rebalance my existing alternative exposure, upgrade managers, upgrade strategies, perhaps instead of focusing on mega cap LBOs, focus more on middle market private equity. Or instead of going with older vintage private credit, focusing on a newer vintage private credit vehicle with an emphasis on asset-based lending. And then again, with that 5 percent to 7 percent cash over the next year, making sure that's deployed. In areas that, once again, can increase return potential without taking uncomfortable levels of risk.

[00:13:00] **Harrison Beck:** That idea of rebalancing is a really strong one, and I almost wonder if we thought about it as greed on the one side and fear on the other. Maybe there's a third idea, and that's rebalancing.

This idea of thinking not about how am I going to swing really far towards being risk averse, or how am I going to swing really far the other way of being really aggressive, but where am I going to find opportunities to complement what I'm already doing.

[00:13:26] **Troy Gayeski:** Yeah, complimentary is a good way to think about it, Harrison, because every asset class, every strategy has pros and cons. And look, there are certain times where it's obvious that asset class is challenged. Like you think about bonds at the end of 20 and 21, when yields were so low and there was so much duration risk.

If the Fed tightened at all, it was going to be a problem. And obviously they tightened a ton. And then it was also pretty clear for equities going into 22, given elevated multiples and a Fed tightening campaign, not so good. But we say in this environment, it's more muddled than usual. We don't think there's much upside in fixed income, but hey, if there's a recession, at least you can make a little bit of money.

Unfortunately, the probability of recession is very low. If you look at equities, even though they're expensive, we're sympathetic to the argument that given how the equity markets are made up these days in terms of the heavy, heavy emphasis on highly profitable mega cap tech and the really diminished number of companies and the diminished footprint of public equities that multiple should be higher.

So, it's not always an either or. Right now it's really more, how do you compliment? And even again with cash, if you have 10, 15 percent cash, like there's nothing wrong with a year from now going from 15 to five and still having five. Cash has looked better for a while than it has in 20 years.

So that's an interesting point you bring up Harrison, you got greed, you got fear, and then you have rebalancing or complimentary exposures.

[00:14:57] **Harrison Beck:** Well, let's synthesize our conversation so far with a hypothetical. Say an investor puts you in charge of their portfolio right now. What strategies might look attractive to you?

What strategies might you try to avoid?

[00:15:09] **Troy Gayeski:** In general, it's a really interesting time for private lending strategies. You almost couldn't design a better opportunity, at least in theory. And what I mean by that is, remember what any lending strategy is, you're providing money to a corporate entity or a real estate borrower, and you just want to be paid the income and not lose any principle.

And so a lot of the income streams in private lending are tied to risk free or were fed funds or the term that used to be LIBOR and now it's SOFR. But basically, where fed funds is plus a spread. So most private lenders, including ourselves, since the end of 21, early 22, we've been rooting for the fed to hike as much as possible and keep rates as high for as long as possible without cratering the U.S. economy. Because if you crater the economy, you start to give back some of your income through defaults and losses of principle, which clearly you don't want to do.

And so we came up with this whole thesis last August of “Dare to Dream”, where again, it wasn't necessarily a dream, but the probability of the U.S. economy avoiding recession was arguably lower than the probability of the U.S. economy entering a recession. And when you think of where we are today, it's like we've gone through that period where the Fed is jacked up rates a ton, they haven't cut them, they're not cutting meaningfully anytime soon and the economy stays incredibly robust.

So that is a wonderful environment for private lending. Whether it's the corporate entities, whether it's asset-based loans where you're financing receivables or whether you're lending against real estate.

[00:16:51] **Harrison Beck:** That makes sense. What other strategies look interesting to you?

[00:16:55] **Troy Gayeski:** Now, real estate, of course, in the major metro office area is having some problems, but most of the sectors, multifamily, industrial, are in really good shape.

So we really like that a lot. More income, less risk in terms of leverage on individual deals. And then on top of that, you have a banking system that was forced to retreat meaningfully once the failure started, which opened up some new opportunities. Although we're starting to see that mean revert back.

The only negative right now, or it's not a negative, but if I could draw my perfect environment for private credit. I wish spreads were a little bit wider, maybe 100, 150 wider where they were May of last year. But if you could make high single digit, low teens returns, very little volatility, very low risk of loss. That looks very, very competitive.

[00:17:44] **Harrison Beck:** It certainly does. I know we touched on equities before, but how are equities looking to you?

[00:17:49] **Troy Gayeski:** When you think of ways to achieve growth, most people already own U.S. equities and they're obviously dominant. A handful of companies that are awesome companies and will probably continue to do great, but you already got that covered.

So, you probably want to be in the US, but you already got mega cap tech and mega cap equities covered. And then as you look at other options, whether it's venture capital or extremely large leveraged buyouts or private equity. When you think of the spectrum, what really jumps off the page, is this concept of middle market smaller private companies in the U.S. Private equity, where there's a lot of stats and a lot of complexity to it, of course, but it's really very basic that the vast majority of companies in America are private. The vast majority of them are smaller. The growth prospects are very strong. And if they're already well managed companies that are purchased by an investor that specializes in increasing operating efficiency of companies.

If you can grow earnings or the term is EBITDA, roughly at 20 percent consistently, not in a recession, of course, but in nine out of 10 years, as an investor, you're going to have very good outcomes. And one of the beauties of the middle market is you don't have the leverage that a lot of larger corporate entities have, meaning in terms of borrowing.

And that means you have more free cash flow to invest in growth. The other is, they're just cheaper, and of course they should be cheaper. Smaller companies should be cheaper than larger, more established ones because they're more fragile. But coming in at a cheaper valuation and growing the business. To more earnings, more revenue, more EBITDA and potentially commanding a higher valuation.

Smaller companies have grown from 25 million of earnings to 75 million. It's much easier to sell them to mega cap buyout shops that have over a trillion dollars. Some studies put it as high as two and a half trillion dollars of dry powder. So very attractive opportunity in middle market private equity. Very attractive opportunities in private credit, both on the real estate side, as well as on the corporate side. So those are the two things we really like.

[00:20:06] **Harrison Beck:** So private lending strategies, CRE, and private equity with an emphasis on middle market all look interesting. What strategies are giving you pause?

[00:20:15] **Troy Gayeski:** In terms of things we don't like, we brought this up before. It's not that we don't like cash. We recognize that cash is an attractive place to be relative history. It's just, can you do better? Right? We think the answer is definitely yes. And again, I'm not picking on fixed income permables here. I really am not trying to give them a hard time, but there's just been so much overenthusiasm for every time yields go marginally higher in fixed income. It’s like “This is the greatest buying opportunity ever.” “No, no, no, this is the greatest buying opportunity.” Well, but I thought you told me the last one was the greatest buying opportunity ever.

And again, we recognize that yields have gone up and they've gone up meaningfully with stronger inflation numbers. And it's not like the risk reward is terrible, but you have to be honest that if you just earn your income the next several years... And as an example, in the 10 year treasury, it's about four and a half percent. ...That'll be a good outcome. Don't expect capital appreciation from yields dropping and be very mature and understand that between now and the next recession, which might not be for five years. You could really take substantial mark to market or valuation pain if the 10 year yield goes to 5 or even higher.

[00:21:30] **Harrison Beck:** It sounds like this is another situation where there's maybe more room for things to get worse than there is for them to get better.

[00:21:37] **Troy Gayeski:** The other part of that is this concept of yield curve slope.

Let's say the Fed cuts by 100 basis points the next year. Okay, so risk-free will now be four and a quarter to four and a half. So down by one percent. What's an appropriate level for the 10 year treasury at that point? Well, based on history, it sure isn't meaningfully lower than it is today. In fact, some would argue it should be higher as we go through a reflationary period.

So fixed income, again, we're not hating on it. We just think as we hear these investment rationales for different asset classes, there's just a lack of recognition that the risk order fixed income, it's improved, but you can't convince me that duration is a bargain.

[00:22:20] **Harrison Beck:** So finally, as we wrap up this episode, it's the name of the podcast, The Takeaway.

I think it's a great way for us to finish our time together. What's one takeaway you want listeners to have from our conversation today?

[00:22:32] **Troy Gayeski:** Yeah, the number one takeaway, without a doubt is there has been nothing wrong with building up much higher cash balances, money markets, T-bills than you ever expected four years ago. Because guess what? Everyone's done it. Large institutions, huge family offices, smaller investors.

The question now is how do you balance that greed and fear, to put that capital to work where you can meaningfully improve your return outcomes without taking uncomfortable levels of risk.

[00:23:05] **Harrison Beck:** Thank you so much, Troy. This has been a pleasure.

[00:23:06] **Troy Gayeski:** Thanks Harrison. Thanks everybody for listening.

[00:23:14] **Harrison Beck:** 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.