Episode 95

The Takeaway with Troy Gayeski: Is it too good to be true?

Our Chief Market Strategist shares the key takeaways from his latest strategy note on why fear of a "GFC Part II" is a poor reason to hold on to cash.

Troy Gayeski (00:00):

Yeah, I think, look, it's really important to differentiate between where things appear too good to be true and when they're just factually true.

Harrison Beck (00:12):

This is The Takeaway with Troy Gayeski, a podcast from FS Investments. We sit down with Chief Market Strategist, Troy Gayeski, to get at the key insights in his latest strategy note—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 (00:40):

Hey, Harrison. How are you buddy?

Harrison Beck (00:42):

I'm doing good. How are you?

Troy Gayeski (00:43):

I'm doing great.

Harrison Beck (00:44):

Troy, you've been traveling around the country, you're talking to advisors and financial professionals. What's a conversation you've had recently that really stood out to you?

Troy Gayeski (00:52):

Yeah, I've probably spent more time the last six to eight weeks reviewing advisor asset allocation models than probably the prior three to six months combined. And I think one of the things that keeps coming up as we meet with advisors and talk about the strength of middle market private equity, particularly in comparison to mega cap buyout or LBO or how our solutions compare and contrast to others. It's really trying to figure out if you're going to make an allocation to a core middle market private equity holding, how do you best compliment that? Is it with mega cap buyout? Is it with a secondary only focused fund? Should you go international or still lean more heavily into the U.S.? So that has been a big component, really the last six to eight weeks is like, "Hey, Mr. And Mrs. Advisor gets that you should have middle market private equity as a core holding," and then the question is how do you build around that? So that's been really fun to focus on, and it's really interesting to see the different solutions that advisors come up on their own right. Some may lean towards brand name, mega cap buy shops, others may lean to more venture capital or secondary focused funds, or those that are a little more upper middle market, but still not make a cap LBL buyout. So that's been really fun to work through the last couple weeks.

Harrison Beck (02:21):

That's fabulous. And I feel like I want to drill down into the word complimentary because that's something that we talk about and something that you talk about a lot as well, when advisors either are enthusiastic or are familiar with alternatives or maybe they're new to it, understanding that they're not supposed to replace everything in their portfolio, but they're supposed to pick something that's going to play well with what they already have.

Troy Gayeski (02:47):

Yeah, it's a really important part. I mean, that's the core point of asset allocation, and that's why sometimes, for instance, if we're doing media appearances and people are hyper fixated on 25 basis point cut here, not cutting there, the whole point of asset allocation is that you don't know the future with perfect certainty. And so as you're building out a portfolio, we've never said, flush all your stocks, flush all your bonds, put it all into alternatives. Not at all. It's just trimming your equity risk at a time where you're at very elevated multiples. And then of your current holdings, what makes the most sense to trim based on the market and economic cycle and the subtle differences between different strategies? Well,

Harrison Beck (03:33):

And speaking of trying to understand market conditions both in a positive way and a negative way, in your recent strategy note with the really great title too Good To Be True, you talk about how as you've been reviewing these client asset allocations, you've been running into a new investor concern. What is it?

Troy Gayeski (03:51):

Yeah. And by the way, Harrison, I think you came up with that title. So two thumbs up on that. Well done, well done. But no, it's really interesting. I think what's happened two or three times over the last six weeks is we have a range of clients, some less sophisticated new users to all, some incredibly sophisticated, been around the block in markets for years and have seen and studied every market cycle. And one thing that almost surprised me when it came up is the reference to the echoes of the global financial crisis in that it sort of felt like a lot of the same conditions were in place now that were in place pre global financial crisis. And I was kind of taken aback by it because when you're in the weeds every day, there's so many incredibly powerful differences, which is why we think there's less than a 5% probability if maybe less than a 1% probability that happening anytime soon.

(04:52):

But the heart of the question, I think was less about, yeah, I think the GFC is really going to happen, which is why I'm sitting on 20% cash instead of two or three and more in certain asset classes. It almost feels too good to be true as opposed to this meaningful risk of the GFC. And there we definitely hear folks that in some asset classes it does appear too good to be true, but sometimes what appears to be too good to be true is actually factually true. And that's a really important point that we will flush out in our conversation today.

Harrison Beck (05:30):

Well, and let's dive into it. So what are forward indicators telling us? Is there a real reason to think that we are headed towards another 2008 style global financial crisis?

Troy Gayeski (05:41):

No, I mean, that's an incredibly low probability right now. And if you think of some of the key metrics to analyze, you remember, the global finish crisis was really driven by an overlevered consumer and a housing market that was due to have quite a doozy of a debacle, and then it just spread and metastasized to other asset classes. But just if you look at headline numbers, US consumer debt to GDP going into or as a Q 4 0 7 was 102.5%. Most levered US consumer had really ever been. Now it's 73.4%, so meaningfully lower leverage consumer debt to DPI, which stands for disposal personal income was 1 37 0.3. Now it's a hundred mortgage debt to disposal personal income, because remember, the GFC was started as a housing bubble collapsing was a hundred 0.4 versus 63.6, and the aggregate home mortgage loan to value was 46.1. At that point is now 29.

(06:45):

That includes those that own their home entirely without a mortgage that have a hundred percent equity. And then if you look at the interplay between leverage on a balance sheet and cashflow going out the door to service that debt rates have gone up a lot, but the consumer financial obligation ratio is still only 14.2%. It is off the lows we experienced recently, but that compares to 18.2% going into Q1 of oh eight. And so very, very clear contrast. Whatever happens to markets, it's not going to be consumer led. And then the flip side, or in tandem I should say, is if you look at the US banking system, and this gets back to the, there's echoes of the GFC where you had banks failing. Well, we obviously have had some weaker links in the banking system crack under a duration mismatch and overnight liquidity from their deposits.

(07:44):

But the two metrics that I think people forget about is going into the global financial crisis, we had only had 43 and a half billion of total reserves in the US banking system, which at the time seemed like a big number, but now we have 3.4 trillion of total reserves. So orders of magnitude higher, no problem in the system. That's not to say we won't have a few more weak banks fail, but system level, no problem at all. And then even after the book value hits that the banking system took from a lot of their duration sensitive treasuries and agency RMBS, we still have 13.7% tier one capital in the banking system compared to 8.25 pre GFC. So yeah, the risk of A GFC just is, it's not zero, but it's so low that you should not hoard cash because of that fear, which again gets back to the central point. I think when sophisticated investors are articulating that, what they're really talking about is certain asset classes appear like things are just too good to be true, there must be something wrong when in fact there might not be.

Harrison Beck (08:57):

If listeners want to take a look at this data that you are referring to, there's a really wonderful table, really useful table in your strategy note, they can find it on our website, fs investments.com/insights. My really big takeaway I think, in looking at that table, but also in listening to you talk through it now, is that there are big changes in economic conditions from now in 2008, and there's also really big changes in how the government has positioned itself and how regulators have positioned itself to put us in a stronger place now. That's

Troy Gayeski (09:28):

Right. Yeah. And look, I think regulation at times can maybe go a little bit too far. We've often talked about this mega trend in markets where more and more companies are staying private as opposed to being public. And part of that did start with the sarbanes oxley reform coming out of the.com bubble collapse. That wasn't the only reason, but it's really where things started to accelerate. But in this case, I think the regulators have done a wonderful job making sure that the banking system has adequate tier one capital, adequate total reserves. It still didn't stop the banks from turning back into pro-cyclical lenders, which they always tend to do, which by the way, place the strength of private credit. But yeah, that was between Basel three and Dodd-Frank. Very, very important reforms that I think the regulatory bodies, the Fed, the OCC and the

FDIC with clearly the help of Congress and the Senate and multiple presidents have gotten far more right than wrong.

Harrison Beck (10:30):

So now moving away from looking at regulators and looking at the economy, looking at what's coming up, let's turn back to investor perception. So when an investor goes to their advisor and says, Hey, these market conditions, they look too good to me, it looks like we're headed for a fall. What are these investors seeing and then how are they responding?

Troy Gayeski (10:53):

Yeah, so I think first of all, whenever people are articulating things seem too good to be true, they're really honing in on US equity markets, particularly market cap weighted indices like the s and p 500 or the nasdaq, and then more specifically the magnificent seven minus Tesla plus Eli Lilly, or begins to think like magnificent six plus Eli Lilly. That's one area. And then the other area was would be private credit, which is enjoy and has enjoyed and is enjoying arguably the best macroeconomic environment you could ever dream of. I think a

Harrison Beck (11:30):

Useful exercise might be if maybe we imagine that I'm an investor and you're my advisor, and I say maybe going through equities and private credit and saying, Hey, first of all, I'm worried about concentration in public equities. I'm worried about how expensive everything is. I think I should have more cash in my portfolio. I think we should hold onto the cash we have. What's your response to that?

Troy Gayeski (11:55):

Yeah, and we would say there's nothing wrong with cash, especially in an environment like this. It's not that cash is bad or evil or toxic or anything like that. It's just what used to be maybe two to 5% of investor portfolios has grown to 15 to 20% in many cases. Most of the major broker dealers, wealth management firms are hovering right around 20%. So there's been a lot of TBI rolling, a lot of money hoarded in money markets, CD balance has have grown, preferred savings have grown. And so it's not that you shouldn't be concerned about the potential for loss in different asset classes, it's just that if you can take five or 10% of that cash, or roughly I should say five or 10% of your overall portfolio, which is roughly 25 to half of your cash balance, understand that you're going to concede liquidity and allocate that to a private credit strategy, particularly one that has clean vintages and is focused on asset-based lending.

(13:01):

Well, you're going to take your total return and income from roughly five and a quarter to let's call it 10 and change. Some funds will do nine, some will do 11 and a half, but let's just call it 10. So you're basically coming close to doubling your income and total return. Now you are sacrificing liquidity. You're going to lock up your money for at least a quarter. And as a reminder, all these funds have gating mechanisms, so no guarantee you can get all of your money out at a particular quarter if there's some type of market debacle. So you're definitely sacrificing liquidity. But another conversation I had really was around, well, we really don't need alternatives at all because we don't worry about mark to market volatility and everything works out in the end. And it's like, well, I mean, I've yet to meet a client that doesn't care at all about Mark to market volatility.

(13:56):

I mean, think about 2022, think about the global financial crisis. And it is true that in US equity markets kind of like a unicorn market globally over time. We've had this incredible bull market from oh nine to today, but that came after a last decade. And over that time horizon, you had many extended periods of pain. And I just questioned the logic that every client can tolerate egregious levels of volatility through any market cycle. If that were the case, then people would be levered long equities and not have any fixed income exposure or cash. And we obviously know that's just not how this industry operates.

Harrison Beck (14:39):

I think that's a really great thing to keep in mind that as confident as an advisor may be at the end of the day on the other side of the table as an investor, and their concerns may be a little bit more grounded in their experience.

Troy Gayeski (14:51):

A hundred percent. And by the way, when you think about, obviously a 40-year-old client's going to behave differently than a 7-year-old client and someone in a massive liquidity position on the margin can take more risks than someone that doesn't. And there was also, and this has been bandied about for years, that institutions, they're thinking over the next 30, 40, 50, 60 years, and they never redeem. They never have cash shortfalls. Well, look, the whole reason there's a secondary market for private equity right now and a developing secondary market for private credit is institutions care about volatility too. And if you're an endowment and you have a contribution shortfall, or if you're a defined benefit plan that's being retired or you have a change of CIO with a whole different viewpoint, volatility matters and risk matters. That's the whole point again, of embracing asset allocation with alternatives as a key cog in that machine.

Harrison Beck (15:56):

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

Troy Gayeski (16:07):

Yeah, I think, look, it's really important to differentiate between where things appear too good to be true, and when they're just factually true. And as a reminder, there's a lot of areas of markets that things have almost been too bad to be true. Fixed income and duration be one, owning and operating blue city office towers would be another shorting any equity at all, particularly growth equity. So it's not like everything's too good to be true, right? But in the case of private credit, we're the first admit that we wish spreads were wider today like they were 18 months ago. But if you're picking up close to 500 basis points of extra return and you're lending at today's values at a materially lower loan to value and debt to EBITDA level, then prior to the fed hiking, you're earning more income in total return while taking material less risk.

(17:07):

That's a very, very rare combination, right? That in fact violates the whole premise of the efficient frontier. But in certain periods of time, you do have that opportunity. So lean into it and don't be overly frightened of market concentration. Understand that it is going to leave a mark at some point, but most of what you read in the press or you hear from long only equity managers is just their desire to find something that's wrong or could go wrong, and also to explain their dramatic underperformance versus market cap weighted indices. Which again, is why if you look at a lot of sophisticated institutions for beta, they just go with the indices because they're cheap, they're liquid. You let the market figure out which companies succeed or fail, and then you focus on alpha or where there's meaningful value added by a manager in alternatives, whether it's private credit, private equity, liquid, multi strategy, liquid credit, et cetera. That's where you get your alpha. That's where you get your diversification. That's where you can meaningfully increase total return in income without taking uncomfortable levels of risk.

Harrison Beck (18:17):

Makes a lot of sense. Well check out Troy's latest strategy. Note two, good to be true, why fears of GFC Part two are a suboptimal reason to hold onto cash. You can find it on our insightsPage @ at fsinvestments.com/insights. The note has some really useful data for shaping a conversation around this kind of investor perspective, contextualizing what's happening in the market and articulating why they may want to deploy cash into appropriate alternatives. Two, good to be true. FSinvestments.com/insights. Troy, thank you so much.

Troy Gayeski (18:51):

My pleasure, Harrison. Looking forward to next time already.

Harrison Beck (18:54):

Same here. Take care. 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.