Episode 118

The Takeaway with Troy Gayeski: Replacing fixed income

[00:00:30] Harrison Beck: Welcome, Troy.

[00:00:31] Troy Gayeski: Good to see you, Harrison. Happy holidays to everyone in advance.

[00:00:35] Harrison Beck: Happy holidays to you. Happy holidays to all of our viewers and listeners. Troy, your new strategy note is called "Replacing or Complementing Fixed Income with Alternatives." It examines one of the most attractive investment themes of the past six to seven years, using appropriate alternative strategies to replace or complement fixed income.

This note does a great job of kicking the tires on bonds and duration, and then articulates why alternative strategies like commercial real estate lending, corporate private credit and liquid multi-strategy offer a compelling way to replace or complement fixed income. So let's get into it. You paint a great and very funny picture of long only fixed income managers talking up bonds and duration.

What's the argument that investors are hearing for why they should drop everything and buy bonds? And how good is that advice?

[00:01:29] Troy Gayeski: So it's pretty funny because everybody talks their book to some level in this industry. And that's kind of understandable if you're a fixed income manager, you almost always like duration. The question is, do you like it? Do you love it? Or do you really, really love it?

Because that's what you do, right. I once said on Bloomberg that I've never seen a fixed income manager not love duration. And to be fair, as the listeners probably know, there was a brief period at the end of '21, early '22, where a manager that typically had seven years average duration might have shortened it to six-and-a-half or six.

Right. It's like, yeah, look at us. So I get that. But kind of what I don't get is when objective people that have no inherent bias make a rational argument to go long fixed income in size. And look, I also get the concept of trading, and trading ranges. You know, when the tenure hit 5%, there was clearly much more value than when it was at one-and-a-half.

And you had, you were set up for our counter-trend rally, but the cacophony of voices that I would hear either on panels or just meeting with investors and financial advisors about how all these guys are talking to fixed income. And look, I get it as a trade. Watching the tenure drop from five to four, but once we got sub four and the yield curve got incredibly inverted, the thing that really shocked me is how much or how little awareness there was of what historical yield curve slopes have looked like and what they more than likely will look at going forward.

And that's assuming that the Fed cuts rates. Because the whole argument for the fixed income guys are yeah, the Fed's going to cut, you got to lock in your yields. And all this nonsense. And it's like, well guys, look, if the 10-years at 3.6 or 3.8 or four and the Fed is gradually cutting the front end to three over time—and perhaps they won't even get to three—the typical slope between a 10-year and a Fed funds rate over an entire cycle has been around 130 to 140 basis points. So you just start right there and say, okay, 3% front year, sorry, 3% Fed funds, you should probably have, let's call it 4.2 to 4.4. However, in the economic expansionary periods, it's often that you get a two, three, or even as high as 400 basis points slope historically.

So you start doing the math on that. You're like, wow, 3% front end, 5% back end, 6% back end, I mean, 7% back end. And so it was just a really odd period where you'd have people articulating that as the Fed cut rates, the yield curve would remain as inverted as it was prior to the first Fed rate cut.

And clearly, we did our best to articulate that was bad advice. I'd like to think some people listened and saved themselves some ugly mark-to-market price action. But it's terrible advice. That's not how yield curve works. And it's just shocking again, that this is not something that we pulled out of a crystal ball or out from left field. It's just looking at historical yield curve behavior over 40 years.

[00:05:01] Harrison Beck: Well, so if someone's telling you to chase duration, it sounds like it's a function of both not understanding what's happened historically, but then also maybe not having a wide enough view of what's happening in the economy or what may happen in the next couple of years.

[00:05:14] Troy Gayeski: Yeah, that's probably fair. I mean, there were some people still holding on to recession fears in the run-up to the election, which again, it made no sense to us really since August of '23. And then furthermore, I'd say we're not really even touching upon the horrific Ford supply situation for Treasuries.

If you think of asset classes, there's a simple metric, it's really more popular in gold and crypto community of stock to flow or flow to stock. And basically what it looks at is how much new issuance there's going to be relative to existing stock that's out there. Unsurprisingly, U.S. equities have the best flow to stock or stock to flow of any asset class.

Maybe surprising to some, Treasuries have the worst in...you start thinking about the magnitude, 20 trillion of issuance the next 10 years, in the event that we don't have another major shock like a pandemic or a hot war, and then it will obviously be larger. That's like 73, 74% of all the issuance ever that's held by the public.

So roughly, and it actually tracks the budget deficit pretty closely just by happenstance in terms of math. But roughly for the next 10 years, 7% of all Treasuries ever issued will come out as new supply, so huge, huge number. And then you think of who's going to buy it. Well, last I checked, the Fed is still shrinking their balance sheet.

They've tapered QT, but they're still draining their balance sheet. They're knocked out unless there's an absolute calamity. If you think of the Chinese, they were huge buyers for a long period of time. I think most importantly, even before you get into the geopolitical situation, if you think of their trade surpluses, they're just not what they used to be in terms of size and magnitude. So they really don't have the fiscal buying power they used to. Furthermore, their demographics are absolutely egregious. So don't count on the Chinese to be buying, even if there is a Kumbaya moment, which no one expects in terms of geopolitics. You know, Japan's got its own challenges. So it's really going to be up to U.S. individuals and banks to absorb that supply and it'll get absorbed, just at higher yields.

[00:07:26] Harrison Beck: Well, we talked about China, we talked about Japan, bringing things a little closer to home. When thinking about solutions for fixed income, some investors might say something like, Troy, what about munis, or municipal bonds? They're considered to be a low risk investment, fixed income, a good option for diversifying a bond portfolio. Why don't I stick with munis?

[00:07:46] Troy Gayeski: Well, yeah, look, there's nothing wrong with munis. But the thing to remember always is when you're talking about longer duration munis, the number one driver of performance outcomes over the short to intermediate term will be duration. So you do have a higher yield, which shortens your length to some extent, and makes you slightly less interest-rate sensitive than say Treasuries, but not dramatically so. And if you were to buy a bond at par with eight years duration and interest rates—particularly in the back end of the curve—went up by a hundred basis points. That's a painful mark to market that you can suffer. And I think what a lot of people unfortunately learned the hard way in 2022 was everybody says they're going to hold every bond to maturity.

And that is the theory. But in reality, the statement Navarist that you have and you can carry for years is very, very painful. Now let's be clear. We're not talking about a repeat of 2022. We're just talking about the fact that if you're moving from Treasuries to munis and you think that's somehow going to protect you from back-end rate damage, that's a very naive, naive point of view.

And so I think the point of all that is as you remember from the strategy notice, very few advisors or high net worth clients actually own Treasuries in size at the long end of the curve. They tend to own it more in munis, but longer-dated munis certainly have the same or a similar degree of duration risk that longer-dated Treasuries do.

[00:09:22] Harrison Beck: Interested to think then about the contents of investors' portfolios and what they're thinking of.

[00:09:30] Troy Gayeski: Exactly.

[00:09:31] Harrison Beck: You mentioned investors considering some potential exogenous shocks. Long duration fixed income does offer some hedge protection in case an exogenous shock hits markets and the economy. Isn't that a strong argument to include long duration fixed income in an investor portfolio?

[00:09:47] Troy Gayeski: So again, I think to be fair in all this conversation, long duration fixed income is no longer the definition of return-free risk like it was at the end of '21 and early '22. Yields are higher, so you're getting more income and there is material hedge protection. You think about a repeat of a pandemic. Fed brings the front end to zero, a 10-year has a one-handle on it. That's meaningful duration upside. You think about Treasury yields from this point drop in, let's call it 250 basis points, eight-year duration. That's really 20 points of upside, which helps hedge some of the other pain.

So that is fair. And we would never articulate that people should completely flush that exposure if they're concerned about exogenous or endogenous shock risk. I just can't see any endogenous shocks right now, and clearly there could be some exogenous that are almost unpredictable by definition.

When you think this through, if you're focused on growth and compounding wealth over time, you still have alternatives like private credit as an example, where even if you got that outcome tomorrow, and you went through a repeat of '08, over a five-, seven-, or 10-year period, you would still have much better outcomes, owning private credit versus long duration Treasuries. But again, to be fair, having some duration from a hedge perspective does have some value depending on a client's risk tolerance and their focus on protecting wealth versus compounding wealth over time.

[00:11:24] Harrison Beck: Well, and that's a perfect transition talking about potentially better outcomes and alternatives, why that's a reason to at least complement fixed income. Let's get into it. With all of what you've just said about bonds and duration, you wrote in this strategy note one of the most compelling use cases for alternative strategies since 2017 has been as a fixed income complement or replacement. What are the alternative strategies you're talking about here?

[00:11:51] Troy Gayeski: Yeah. And even before we get into that, remember the history of alternatives for the primary use case has evolved over time. So you go back for the last decade, really 2016, most folks invested in alternatives as a way to diversify away complement substitute for equity risk.

And so much of that was driven by the outcomes, the terrible outcomes of the last decade in U.S. equities and recent experience. By '16, '17, it really flipped because then there was more consensus that yields couldn't continue dropping from the levels that we're already at. And then of course you had the pandemic, which brought yields even lower. And since then it's been a one-way train upward in terms of yield.

So I think that use case, and the way I described it is the more things change, the more they stay the same. And so that use case had been powerful for years. And I think it went on a brief hiatus again when the tenure briefly hit 5% and then rallied back to 3.62. But it's really come back with a vengeance now. Hopefully, some of our work has helped people understand the risk/reward at duration and yield curve slopes and common bond stuff. And in terms of strategies, look, I think it really depends upon where you want to sit in the efficient frontier.

If you historically think of commercial real estate lending, senior commercial real estate lending, that certainly has less yield than middle market corporate private lending, but over full cycles, less risk. In fact, if you think of what we've just gone through, we've gone through the second or third worst commercial real estate downturn since the Great Depression.

So it was a doozy and you can barely see the orange bar of realized losses, which, by the way, does include office just for everyone, every listener, office is included. You can barely see the orange bar realized losses offsetting your income. And then if you want to have higher yield, and can tolerate a bit more risk and to put numbers around it, senior secured commercial real estate lending sub one ball, middle market, private corporate lending, without an asset-based lending focus has been roughly four, depending on three-and-a-half to four-and-a-half, depending on your look back.

So if you're going to take a little bit more risk, you can increase your return by several hundred basis points from where senior secured commercial real estate lending is. Those clearly have higher yields than fixed income. Clearly have less volatility. Clearly have ability to compound capital after tax in a much greater rate.

And you're basically taking very modest economic sensitivity risk in private credit. In the term we use to describe that, it's typically beta. So sensitivity to S&P. So I think of commercial real estate lending as a sub, basically a zero beta, unless you have a repeat of the GFC, then it might go up to 0.1 and corporate, private credits like 0.3, depending on the time horizon. So you're flushing duration risk, which again does have hedge protection, but a lot of all very paltry income for something that has much more income, much more total return, arguably less fall, but you are taking a bit of economic sensitivity risk just to be fair and balanced on the risk/reward profiles.

[00:15:18] Harrison Beck: Well, so keeping all of that in mind, let's synthesize it. Let's imagine an advisor conversation with their investor. How might they present the potential opportunity in these three alternative strategies as a replacement or a complement for fixed income?

[00:15:33] Troy Gayeski: Yeah. So again, it's pretty straightforward. It's how much income would you like to earn Mr. or Mrs. Investor? Are you comfortable with four, four-and-a-half over a very long period of time, or do you like a reasonably high probability of making above eight tax equivalent in CRE, real estate lending or right around 10ish in middle market corporate lending?

If you want more income, which is going to lead to much better compounded annual returns over time, particularly after taxes, particularly after inflation, not to segue back to cash, but even at the high point in the Fed funds rate, after taxes, after inflation, you still weren't making any money.

Sometimes we always talk about gross or returns. Gross of taxes, gross of inflation, but you have to factor in inflation and tax as well. If you want more income, you want less change in your statement like month to month, you want a much lower probability of making an investment decision and then waking up in six months and staring at a down 10% net asset value, which you certainly get in a long duration fixed income. What you have to sacrifice, however, is a little bit of liquidity. Your money is going to be locked up for at least a month or a quarter. And there are gating mechanisms in these funds to size up that asset liability mismatch.

But as we talked about before, if the theory behind fixed income is to buy it and never sell it, and hold it to maturity, that's what everyone tells me. Are you really giving up liquidity? Probably not, but at least you have the option to receive that liquidity in the event of a life change, or you have to send your kid to college, or you want to rebalance your portfolio into some other asset. That the whole marriage between these user-friendly democratized solutions and illiquid assets. There's the push and a pull, give and a take. But net, most clients like more income, more absolute return, both pre- and post-tax, pre- and post-inflation versus less with a lot more statement risk.

[00:17:43] Harrison Beck: That's a super useful way to think about it. Touching back on the Fed, you write that as the Fed cuts rates, the absolute level of income will drop to some extent for floating rate income strategies. Keeping that in mind, how concerned are you about the forward trajectory of the front end of the curve?

[00:18:00] Troy Gayeski: Look, I think it's not that I'm indifferent to it. But I kind of am indifferent to it because the way these strategies work is when the Fed cuts rates, your absolute income total return drop to some extent. However, your spread to the risk free rate actually expands. So let's say the Fed takes the front end to three by the summer of next year, which they're not going to do by the way, but let's just stylize that.

Okay. So yes, your income will drop to some extent and depending on the strategy, the beta or sensitivity to the front end is somewhere between .2, .3 and .5. But your spread to the risk-free rate, which is very, very important to clients. Think about all the capital that's been built up in T-bills or money market funds or preferred savings accounts at large wealth management firms.

As that front end drops, your spread expands. Let's use another scenario, which is not going to happen either. The Fed never cuts rates again. They keep rates here from now till you and I collecting social security. And unfortunately I'll be collecting it sooner than you, Harrison, but it'll probably be solvent. Fingers crossed. But, for me, maybe; for you, I don't know. Anyway, so, if you think about that scenario, the spread to risk-free is not going to expand, but you're going to enjoy more and more income and absolute return, total return for longer. So again, it's not that I'm completely indifferent, but I guess I kind of am.

So I'm not really concerned at all from a use case standpoint, but investors should be aware that as the Fed cuts the front end, your absolute level of income will drop, but your spread-to-risk-free will expand. And then, by the way, not to expand on this too much further, but one of the principal tailwinds that has developed for senior lenders in floating rate securities of all stripes, syndicated bank debt, senior secured commercial real estate lending, middle market corporate is, we all had this headwind for years of the Fed not hiking, then barely hiking, then whoops, we hiked too much.

Got it cut by 75, taking rates to zero, keeping them there too long coming out of the pandemic, that has become a sustained tailwind. We are in a stronger economic environment for longer. We are in a higher inflationary environment for longer. We are in a higher rate environment for longer, which means more income and total return for longer.

And then, as you know, from October '22 to, really, let's call it late spring, super early summer of '23, there were concerns that I agreed with at the time that some of that income could be given back. That excess income could be given back by a recession-driven default hangover. And clearly that risk has receded again. Recession risk is never zero, but it's very, very low. Very hard to see what force is powerful enough to crack the U.S. labor market enough, to crack a consumption service economy enough, to cause a recession anytime soon.

[00:21:12] Harrison Beck: Well, Fed cuts are on everyone's mind, so that's a really helpful answer for allocators to have in their back pockets. Finally, as we wrap up this episode, it's the name of the show and a great way to summarize our conversation. What's the takeaway you want listeners to have from our time together today?

[00:21:30] Troy Gayeski: Yeah. I think the takeaway is again, the more things change, the more they stay the same. And if you think about portfolio asset allocation, if you think about use cases for alternatives, one of the most profound continues to be a substitute or complement to fixed income exposure. And that's going to be with us for quite some time.

I think it'll take a 10-year, at least at 5%, if not higher, or at that point, you're finally going to have roll down the curve. You're finally going to have non-paltry income. At that point, the Fed will be closer to stopping cutting, which could tends to cause yield curves to steepen. So that's going to be with us for a while. Not that there won't be ranges.

And then I guess the last takeaway is remember the newest use case for alternatives, which really started 18 months ago is how do you take capital parked in cash? And there's now over $7 trillion in U.S. money market funds. How do you take that cash, meaningfully increase income and or total return without taking uncomfortable levels of risk? I think if you just focus on those two, we'll talk about substitution for small mid cap with middle market private equity later. We'll get to that in the next podcast, maybe. But those are the two takeaways. Substitute complement for fixed income. How do you put cash to work? Meaningfully increase income and total return without taking uncomfortable levels of risk.

[00:22:57] Harrison Beck: That's great. Check out Troy's latest strategy note, "Replacing or Complementing Fixed Income with Alternatives." You can find it on our Insights page at fsinvestments.com/insights. This note is a really succinct and actionable articulation of why investors may want to complement or replace fixed income with alternatives and which alternative strategies they may want to consider. That's "Replacing or Complementing Fixed Income with Alternatives" on fsinvestments.com/insights. Thanks for a great conversation, Troy.

[00:23:30] Troy Gayeski: Happy holidays again. Hope everyone enjoys it.

[00:24:00]