Episode 180: The Secret Life of Private Investments

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Private equity, private credit, accredited investors, venture capital, growth equity, buyouts, liquidity risk, carried interest, private debt, institutional investors, portfolio diversification, investment returns, financial sponsors, market cycle sensitivity, alternative investments.

SPEAKERS
Alex Murguia, Speaker 1, Briana Corbin, Wade Pfau

Briana Corbin 00:00
The purpose of retire with style is to help you discover the retirement income plan that is right for you. The first step is to discover your retirement income personality. Start by going to risaprofile.com/style, and sign up to take the industry's first financial personality tool for retirement planning. You I'm sure by now you might think that Wade and Alex have joined a private equity firm. Don't worry, they haven't, but they are breaking down what you need to know about private equity credit and whether these alternatives have a place in your retirement plan.

Wade Pfau 00:56
Hey everyone, welcome to another episode of retire with style. I'm Wade. I'm here with Alex, and we're continuing our alternative investments. In particular, we've got this episode today, Alex, where you'll be talking about private equity and private credit, and we'll have one more in this series on real estate, and then we'll be getting into some other topics after that, but alternative investments, if you've been listening the past few weeks, you know the basics. We're talking about investments that are available to accredited investors. And as Alex likes to emphasize, we're not either advocating for or against any particular investment. We're really just trying to provide background and education so that you can make the right decision for your situation. Anything to add on that point? Alex, no,

Alex Murguia 01:46
no, you're right. Then why do we choose to do this? After all, this is a retire with style podcast, and sometimes, you know, we'd like to keep the focus on retirement income. But the reality is, there's many ways to generate retirement income, and while traditionally it's it's usually thought of as a stock to bond inquiry, we realized over the last few years there's been significant interest on the consumer end for alternatives. And it's not necessarily because there's interest you should do it, but we felt it important to help everyone become more informed consumers, especially as a lot of these solutions are being brought to the general public through the advent of, frankly, technology that is able to facilitate these transactions a lot more efficiently. The other piece is just, so you know, when we say accredited investors, what does that mean? And Wade,

since I'm going to be doing a lot of the talking, maybe you want to just, you know, give a little check the box on what technically is an accredited investor?

Wade Pfau 02:50
Yeah, yeah. So there's a few different characteristics that we're looking at for that. On the wealth side, you do need to have an believe it's an investable net worth, so excluding your primary residence and other non investment assets. So an investable net worth of at least a million dollars, either individually or jointly with your spouse,

Alex Murguia 03:12
you have that in meme coins, right? So

Wade Pfau 03:16
yeah, and I think this is a case of either or not, not both, but yeah, the other one is with income, individual tax filer with $200,000 of income, or 300,000 for married filing jointly over the past two years, I guess an average of at least that amount over the past two years, with an expectation of similar income in the future. Or there is another way to become accredited, and that's through to demonstrating investment knowledge. But that would be more if you're an investment professional, so if you hold different licenses, such as a series seven, series 65 or series 82 license, or you just have that work experience with companies that are active in the area of these types of accredited investments, that may be another way to qualify.

Alex Murguia 04:09
I believe too correct me if I'm wrong, but I think you're working on one more qualification of an accredited investor being there, subscribe to retire with style. Is that accurate, or is that an apocryphal to have that one included?

Wade Pfau 04:25
I guess it's probably the SEC that decides this sort of thing.

Alex Murguia 04:28
Yeah, honestly, maybe a mixture of SEC, FINRA, IRS, I have no idea. I just know a credit investor. That's what you need. And there it is the powers that be who decide, off the top of my head, I can't remember. It's from the mountaintop. How's that?

Wade Pfau 04:51
That's a good yeah.

Alex Murguia 04:54
And so today, we just did a thing on hedge funds, where we just describe hedge funds, what they are. Are, what different themes are hedge funds using with their investment strategies? We ran the gamut of that today. We want to do a little bit of that with private equity, and then we'll get into private credit, which is different in and of itself. Now private equity could mean a lot of things. Could be a lot of different styles, and so with that, we want to break those out a little bit. But ultimately, some of the key takeaways for private equity is, you know, they're they, they serve different purposes. Some of them are for starting up a company. Some of them are you some private equity funds concentrate on startups. Some of them are mid tier companies, and they need that growth capital. Some of them are kind of turnaround distress pieces as well, all

right. And so they all have different risk return profiles and different liquidity issues that come with them, and it's good to know them, simply because I we do think a lot just based on anecdotal evidence that we've gotten from prospects over at McLean and individuals that are part of our community retire with style. A lot of folks are asking this, this more than usual, and so our spider senses were like, Hmm, let's, let's talk about this in, you know, in a more structured manner. So that being the case, private equity. Effectively, you know, take the word private and equity. So it involves directly investing in private companies, right way. How's that?

Wade Pfau 06:37
Everybody is private? Yeah, that

Alex Murguia 06:39
sounds like those. You know, when you're in third grade and you get asked this quiz question, what is whatever? And you just kind of like, just spit back the same word in that manner, but yeah, it's invest at its basic essence. You're investing in private companies rather than in public stocks. All right now, unlike public equities, that you can buy and sell at the win at your whim, although that's not encouraged by any means. These investments are often long term and require active management, not by you as an investor, but by the general fund that's investing in these companies specifically, right? And it's seen significant growth as institutional and high net worth investors are simply looking for alternatives and potentially higher returns to serve as a point of departure from just public equities, more so that, if you've been reading the news, there are immensely large private companies right now that are going public, and frankly, you don't see them going public anytime soon. Now, I may date myself if you listen to this podcast a year from now, but you have stripe, which is probably over $100 billion private, you know, private company. You have OpenAI, which is, I think their last raise was at a $300 billion valuation, and they're private. And so you're just seeing, after the 2008 financial crisis and a lot of these sort of hurdles that companies started to face, you know, to go public, and some of them being good, I'm not. I'm not saying this as a negative. I'm just sort of pointing it out. A lot of companies were like, You know what? I don't need the aggravation. I'm just going to stay private, and I can get funding from quote, unquote private equity funds. So I don't, you know, I don't need to live in that quarterly earnings. Rigmarole, right? And so you see, you're seeing a lot of this, and hence, you're seeing a lot of consumers say, Hey, how can I invest in these companies, and when there's demand, technology finds a way, as opposed to nature finds a way, I guess so with regards to private equity, just effectively think of them as they're just private they're companies just like anyone else. It's just they're not in the public markets, so you can't just buy and sell at their whim. Now there's three basic types, venture capital, growth equity and buyouts. Venture capital, those are early stage companies with high growth potential, right? And you can even say frontier capital in terms of, there's Minimum Viable proof of concept, if that, and just raising money, that kind of thing, that they're beyond the friends and family round, and maybe beyond the angel seed round, and they're they're getting out there. And those are the that's what you see. With regards to venture capital, growth equity, they're funding expansion stage companies. Growth equity would be like, let's take McLean Asset Management. That's a fairly you know, Wade and I are principles of wealth. McLean Asset Management a wealth management company. And let's say we wanted to jump start this growth, because retire with style is doing great, which it is, by the way, right, Wade, but retire with style. Doing great. It's providing so much exposure to McLean that we have plans to go national. You know, we want offices in every major city right Wade, and I can fund that ourselves. We can ask, you know, our uncles for her money, for growth, whatever. We can ask friends, or we can seek institutional money to

get us to that next stage. We're not early stage high growth, you know, a proof of concept company. We're an established company that wants to get to that next level. We've proved the business model. We just need money for scale at this point, right? And so that would be more growth equity buyouts. Those are leveraged buyouts, distressed assets. That's where companies are flailing a little bit. And you know what we need, effectively, a bridge, cash bridge or something, to get us over the hump. And potentially, you know, we get there, if we don't get there, then you're looking at leveraged buyouts, where we effectively sell ourselves to the private investment company. And they they do what they did in the movie Wall Street. Effectively, they sell us for the parts, you know, if you will, all under the name of greasing the wheels of capitalism. That being the case, you have three types of private equity, venture capital, growth equity and buyouts. What happened? Wait, funny,

Wade Pfau 11:27
he's selling for parts,

Alex Murguia 11:28
kinda right. What was, uh, airline company rate? I forget the name of the I'm sure somebody will write it in uh so private. Equity. Now, a lot of times within private equity, there's a life cycle to that. They're meant to be seven, eight years, let's just say life cycle. And so what effectively happened is private equity,

Wade Pfau 11:55
specifically, I'm not sure if you've made the real distinction. So there's private equity, just companies that are private, and then there's a now you're talking about a private equity fund. Okay,

Alex Murguia 12:04
perfect. Yeah, thank you for saying that. So how does a private equity fund go through this process of investing in, let's say startups, or investing for growth companies, or an LBA, a leveraged buyout fund, right? How do they do this? Where do they get this money? Is it out of their own pocket. What they effectively do is, you know, they work for, they work for an established company, a bulge bracket type of investment banking company, develop a name for themselves, and they go, they go out on their own. Now they have a roller decks. I think I'm dating myself by just using the word Rolodex. I don't know what people would be saying 30 years from now, they have a lot of LinkedIn profiles. They have a lot of LinkedIn associate I don't know, LinkedIn network or whatever, but they have a huge Rolodex. And so they want to raise capital, and they want to raise $500 million so they can then invest in companies. They hit up all their investors, all potential investors. They give them the premise of what they're going to do with the fund, and they raise the money. They have $500 million sitting there to be, to be now invested. So let's call that the fund formation stage, if you will. All right, you with me so far, wake and so in this fund formation stage, they're just establishing, you know, they're getting their investors. They're establishing the legal and operating foundations of the fund. From there, they raise capital, hence the story I was just saying. And then they go through what's called an investment period, they begin to find they have a theme. They usually have a theme that they're following. And they begin and theme could be, let's take our industry right now, the wealth management industry, which is right, it's just full of these types of firms, especially within the roll up stage. But they, they're saying to themselves, okay, I'm going to bet on the demographic, that many independent advisory firms and advisors, the average age is, is 65 years old there,

and they have no transition plan in place. Aha. There's an opportunity here where we can effectively roll all of these up. And this would be like the growth part of the venture of the private equity, not necessarily the venture capital part. And so I'm going to raise $500 million across investors, and this is going to be my theme, and I'm off to the races. So then they have this money. There's an investment period. Within the investment period, what they're effectively doing is one offering these companies and investing in what they think are the the best opportunities within that right now, mind you, investors, the clock is ticking, right? Because they gave these folks, they raised $500 million $200 million whatever have you. The clock is ticking for these folks that invested in them to get a return on that capital. So it just can't sit there forever. They got to put that money to work. That's the balance, right? How much do you put to work? How much you keep in cash? Are you charging? Etc, etc. They make their investment. Sense, if your VC there, if you're a venture capital, the money that goes into these, these companies, through the VCs, are being used to build the business. They have proof of concept. They want to take proof of concept to that next stage, right with the idea that it could be another funding round for that company later on. But for the purposes of this one, they just want to help to take it to that next stage and see if they can get they went from zero to one in terms of customers, but now, can they get from one to 1000 right? And that requires capital. They can meet the higher sales team, et cetera. And so the VCs will help with all of that. If it's a venture capital, if it's a growth investment, then what they're doing is they're just trying to find other other companies that they can help, you know, get to that next level. From, you know, the McLean version, from, let's say, eight digits to 10 digits of revenues, right? What can you get there? Right? And so they're focused then, as they identify the companies, this value creation and operational improvements, right? Once they've achieved that, think about it, their original investment has actually grown, because the company is technically worth more, and so then they're readying themselves for the IPO, for the sale into the secondary market, secondary market being going public, right? What's happening now is sometimes, because there's so much money in private equity, they'll sell, they'll the, you know, seven years are up, they want to return assets, they want to re they want to provide investments to their investors. They start up another fund. That other fund maybe buys this, or they just go public. And so effectively, that's why you have that, that sort of life cycle, and it's more of a j, j ish curve, if you will, where there's an initial fund formation, that money, you're going to be at a loss. They need to put capital to work. It's not quite getting up there. But then during that investment period, when they're creating value and operational improvements, quote, unquote, that's when you start seeing the pop in. You see, you see something very similar in the venture capital side of things, in the in the growth stage side of things, and in the leverage buyout side of things, right? It follows that structure, and that's why a lot of times you know people, you know you can say those small companies. They they take in private equity money, and then shortly thereafter, they're complaining five, six years later, because even though they got handed a lifeline, they're like, man, they're they have this short term attitude, whereas I have this long term attitude for the business. Well, there are, there are opposing dynamics here, right? The Private Equity folks are looking to get a return on their investment, for their investors, you know, plain and simple. Whereas the time horizon for that company may be limitless, private equity doesn't have that limitless. I'm not saying that's the case for everyone, but that's generally the trend. There's some folks that are very hand on, and they'll keep it forever, because they'll go, they'll put it in one fund, to the next one, to the next one to the next one. They'll keep on rolling them over. But this is kind of the vibe that you're getting when you're looking at the private equity life cycle across VCs, growth equity and buyouts now again, VCs, that's early stage, high growth potential. That's why venture capital, they're venturing out new ventures, things along those lines, growth equity again, funding expansion stage companies that would be like McLean if Wade and I had had aspirations to take over the world in the wealth management business, right? We just like our little podcast here, right way.

Wade Pfau 18:42
I'm just wondering how much of this is hypothetical versus your actual plans. No, no,

Alex Murguia 18:49
no, no, I'm I'm too busy with pickleball right now and then and then buyouts. Buyouts would be obviously a distressed company. We need a lifeline. We take it because we just rent, let's say, you know, we just ran into a hurdle. We take that lifeline. We're able to turn the company around, but we're on a clock no matter what, because the folks that gave us a lifeline need to see a return on that investment, and that's where you get all these like opposing dynamics between the quote unquote bean counters and the quote unquote strategic entrepreneurs. All right, now, what's the return profile? Because of the risk that you're taking on there's naturally going to be a higher return profile than public equities. But what tends to happen with venture capital, though, is that the returns come from. You know, there's a Pareto Principle 8020 where 80% of the profits come from, 20% of the of the of your customers. This is probably more like 98 to where 98% of your returns come from. From 2% of your of the companies, they're going for home runs, and they fully expect a majority of their investments to fail, right? But you just need one Google. You just need one Nvidia to really, you know, bring home the returns. And so you have more of that profile growth equity. They're looking to hit a lot more because these are established companies. They're not betting on the business model they're betting on. Can we scale this and leverage buyouts? Think about it. The risk is this company is going to go bankrupt. Why would you invest in a bankrupt company? Unless you can, you can give yourself a higher rate of return, because the cost of capital is so high, and so you do that by effectively taking over the company and really getting involved and participating and looking at it just from a pure dollars and cents standpoint. And so all of these have higher return profiles than what you would find in public equities. In aggregate, results vary, but this is a this, I said it kiddingly, but to a large extent, in addition to the IPO market, this is what wheel is, what greases the wheels of capitalism, to a huge, to a huge extent. All right, are there volatility considerations? Absolutely, but because these are private structures, you're just not seeing the volatility mark to market on a daily basis. You just don't but that being the case, how does the structure of these look like? Right? If you were to invest in this, how does it work? So imagine here, imagine a world. There's two types. There's general partners. Those are the folks that are working in these fund structures. And there's limited partners. Limited Partners are quote, unquote, the investors, right? These are private, private things, and so effectively, your limited partner, as an investor, these will largely follow that 2% and 20% profit fee structure, and there's carried interest. And this is a political thing, that you see a lot carried interest in the tax rates. And I'll discuss that a little bit. And so with regards to the private equity structure, be it event VC fund, a growth stage company or or an LBO, what you largely see is a financial sponsor, Goldman, Bridgewater, what have you you see a financial sponsor, and you have and they look for investors, right? The financial sponsor is a fancy way of saying, you know, the admin part of it, the back end, the back of the house, admin, right? You have a financial sponsor. They bring in investors. Within the financial sponsor, you have the management company, and they get paid through the management fees, which is the 2% if you will. They deal with it like that. And you have the general partners. The general partners take a piece of the management piece, but they also get paid through carried interest, and I'll talk about that afterwards, right? And the and then the

investors, right? They get paid through the capital, quote, unquote appreciation. So the management company with the general partners under the financial sponsor, create this private equity fund. The money of that private equity fund is funded by investors, right? And the private equity fund takes that, and the general partners decide we're going to invest in this company, this company, this company, this company and that company, right? And if it's venture capital, they're going to do their darndest to not just throw in money. The best VCs are actually helping these companies grow, they're using the wisdom of their network, the and by wisdom of the network they've seen everything, so they know what's going to work or not work, hopefully, with regards to their specific niche and with regards to the companies that they're funding. But they they also are able to provide ancillary services such as bookkeeping, finding space, knowing, knowing where to go to, making connections with with folks that can really expand their business, putting them together with other companies that they may have previously funded that are doing something similar, in which one plus one equals three. Now you have that type of the great the VCs are doing that, and what happens is you end up getting a lot of the deal flow. And so a lot of people start funneling to them simply because of their success. But that being the case, they start they support those companies. The same thing with the growth, the growth type of private equities, and the same thing with the leverage prior folks, right? So as those companies that they're investing in rise in value, effectively, the fund grows when, when it gets sold, it needs, it needs a liquidation event. And liquidation is either somebody needs to replace them the original either somebody needs to replace the private equity fund and buy them out and they're going to buy them out at a higher valuation than what they invested in, or. To go public, and by going public, that's a capital event in which they effectively sell the shares, all right? And so that's what you have there, and that's how the money is is bandied around. Now you can ask, what is carried interest? Carried interest is a share of the profit that the general partner of a private equity or venture capital fund receives as kind by or venture as, just say, private equity as the private equity receives as part as compensation for managing the fund and generating returns for investors. So if you think about it, the profits, though, are only there through the company rising in value. And so what's interesting is, you know, this is where the 20% of the funds profits come from, right? And it's only paid after that high watermark that we talked about earlier, when we're talking about hedge funds. That's usually, you need at least a seven or 8% return or something like that. But unlike a salary or management fee, that's, this is a performance based fees, and because of that, they pay capital gains on that. Now, an argument could be made that says that shouldn't be a capital gains tax, that should be income. It's almost like an incentive income plan, which, frankly, I subscribe to that. I think somehow they have this loophole in there and, you know, maybe somebody want that's into this may say you don't know what you're talking about, and maybe that's the case. But the reality is, it just smells like it should be treated as an income tax form of, uh, treatment, not necessarily a capital gains rate. But that's, that's me, not saying anything other than that. So there you have it. That's really how the structure works for these companies and for these funds. And again, this is prep, this is private equity. And under private equity, we are talking about VCs, venture capital. We're talking about growth equity. Parts of it, that's, that's, if you want to invest, like the McLean kind of companies, or, you know, large or even, you know, pre public, you know, why didn't you get that little next bump? And that's how buyout funds are, are, you know, are structured as well. You're, you would be as an investor, you would be a general partner. So that means you will be getting canines, and, you know, not Kane, you'd be getting Kane hangs dogs. You be getting K ones and the sorts come come tax time, because you are a limited partner within that fund, which that in itself can be a hassle. I mean, these are one of the nuisance things, because those k ones don't come. You'd think they come January the first second, you know, the first in January.

Sometimes you get them April the 12th. And there you have it. It becomes, it could be a nuisance sometimes. Now, again, another key concern, general partners, the liability is unlimited. Limited partners, you're limited just to the extent of the investment in the LPS fund, so you can you know that investment could go to zero. Now, private equities roll within a portfolio. Again, there's diversification benefits, because it's just different types of companies that you do you tend not to see in the public markets, although that's becoming less and less, not more, and more, low correlation with the public markets, hence the diversification benefits, but there's an enhanced long term growth potential. Because investing in these folks, I still don't think there are magicians out there, but the reality is, they're getting they could be great businessmen, as opposed to stock pickers, because they're getting involved in the nuts and bolts of the company and turning things around in a way that a fund manager just doesn't have access to or isn't expected to do. They're rolling up their sleeves and getting involved in a very cold, calculating manner in the success of the company. Wade Any questions so far as I've been speaking that may make sense to ask

Briana Corbin 29:03
if you're looking for more personal advice, please note that our show is sponsored by McLean Asset Management. Learn more at McLean am.com that's m, c, L, E, A, n, a, m.com McLean Asset Management is a wealth management firm where we help you design and implement the right retirement plan for you.

Wade Pfau 29:26
Well, just done. Kind of what are there special risks associated with these that may differ from traditional, just public equity, I

Alex Murguia 29:36
think the long Well, I think we discussed this earlier, but more so than in the hedge funds. There's liquidity risk here, in the sense that you're this is a long term investment these funds have, they run, let's say, seven years. So whatever you put in, you shouldn't expect to get out, unless you have that type of holding period. It just is what it is you. The fees are high and the valuations are somewhat opaque in the sense of, what is OpenAI really worth, right? What is it really worth? What was WeWork really worth when it was private, right? Remember, WeWork? WeWork was this darling. I forgot the high peak of the valuation, let's just say 100 billion, which I don't think I'm too far off at the end of the day. I mean, they were raising capital at extraordinary valuations. Private equity money was put, I mean, I don't know, Softbank put over, easily, over $5 billion I just don't know off top my head, but a significant amount of money into these things at these crazy valuations. It wasn't until they started, they started making inroads to go public, and they put their their financials out to the public, that people were like, This is no different than any like Office sharing space scenario. You can call it we work, and say, you're going to change the world. But at the end of the day, the numbers are the numbers, and then, and the math just doesn't add up for $100 $100 billion valuation, I don't care what they were in the public equity markets, you know, and if you want to go public, people are going to start really asking questions. And so that's not an example of opaque valuations in the sense of who was, who's pricing these, you know where, where the valuations going up and up because the previous valuations were were lower. And so, if for no other reason, if we valued it last week at 50 billion, it has to be valued this week at 55 billion. You know why? Because I'm going to invest again in this, and I need to show my investors in the previous fund that this, that this company is still going up in value, so I can mark it on my books. I mean, there's a game that that folks play with

that, and so that's you got to ask yourself, Is that worth the headache if you're, if you're a masses of the universe, and you have your pick of the litter in terms of the fund that you can invest in and things along those lines, then you're probably not listening to this podcast. If you're listening to this podcast, then you're probably, you know, a normative to high net worth investor. And you know, probably you're, you know, not more than 20 million in asset, investable assets. And if that's the case, the portion of your portfolio that you would allocate to this is probably such that you would have to live with having opaque valuation models, you know, with some of these companies, because simply, you're just not going to have velvet rope, relevant rope access to the manner that large institutions are that being the case, you know, part of the theme was, you're starting to see democratization through retail products. Less so with ETFs, but more so with, you know, platforms such as icapital and CAIS, that through advisors as an interlocutor of sorts, they're able to provide access to the higher level private equity funds that are available. That's not saying just because it's available you should get it, but you're seeing this beginning to trickle down more and more, not less than less. And you're also seeing technological advancements in deal sourcing and execution that are allowing people to have access to this, such as there's pre IPO marketplaces that are now available, where you can buy shares of, let's say, strike before it goes public, things like that. Now that's also a good segue towards private credit, credit, which is that's an area where you are seeing those available to, you know, direct investors, you know, to a larger extent.

Wade Pfau 33:46
So what? What's the difference between private credit and private equity?

Alex Murguia 33:51
Private credit is, is just a different other than the word private you know, they're different. Effectively, think of it as peer to pure lending. You had that, you know, a few years ago, lending tree or Lending Club and prosper were all the rage, right where you can, wow, I can, I can. I have $10,000 I want to put to work, and I can lend $1,000 to 100 different people, and you know what? And I can get for that 7% return, all right, that kind of thing. And you that that was the, the genesis of really institutionalizing private credit. And effectively, what that is, is you're, you're, you're lending money to individuals, you're and you're seeing this a lot now, access is improving, but due diligence was still critical. And what you had before is, you know, it's different than bonds, because now you're, you know bonds as a company, you know your corporate credit, government credit and the like. This is individual credit, right? You're lending them to individuals. And this has blown up so much so that what used to. Peer to peer to peer to peer. Peer to Peer is no longer really in existence. What you find is like the Lending Club, or, you know, whatever, prosper in those companies, the loans that they were lending directly to individuals like me, where, hey, I could lend, wait, wait, if you wanted to borrow 1000 bucks, I can lend you that money. What happened is that institutions said, You know what, I'm going to be the ones that take over all these loans, and I'm going to manage these books, and like prosper, it's probably easier for prosper to manage one institution lending money to all of these individuals, as opposed to managing 1000 people lending money to 1000 people. And so this has facilitated this huge growth in private credit market, because these institutions got in, and what they're doing is effectively packaging all these loans, you know, in the form of funds to individuals.

Wade Pfau 35:54
But it's corollary is bond markets. It's yeah, it's corollary traded.

Alex Murguia 36:00
It's corollary is more bond market, bond market. And you're seeing this increasing demand because of all the again, going back to the trickle effects from oh eight and the like, even during COVID, you saw like freezes here and there. Banks reduce lending the moment. Banks reduce lending. Technology finds a way, if you will. And so there's been a huge institutional retail adopt, retail investor adoption, with regards to private credit. In fact, I'm seeing this more and more as an advisor. I'm getting bombarded. Bombarded is too strong a word, but I'm getting tons of emails about these kinds of funds that are starting to proliferate in terms of, have you thought about private credit for your clients and the like? And I do think, personally, there is something to this, from that vantage point as an alternative asset class. Now, I don't consider it a bond, per se, because when I think of bonds, I always think of, from a retirement income standpoint, 100% secure government bonds, right? This is not, this is not that. This is loans to Johnny and Jimmy, if you will. But if you're able to diversify those away, you know the individual risk away, and through a fund you have, you're effectively loaning to 100,000 Johnny's and Jimmy's. Then it could become more interesting, because you're diversifying that that individual risk away, you're getting the aggregate, mind you, but at that point, you can kind of assess the risk reward a lot better. Now, within the private credit, there's, there's three types, right? There's direct lending, and that's the examples that I've been talking about, the private loan, you know, the peer to peer. But there's also private loans to companies such as a company like cabbage, I think, you know, a company lending McLean money indirectly, directly. As opposed to McLean going to the bank, we go to a company to get direct lending. There's mezzanine finance, which you know, not to dissimilar from growth stage private equity only. They're just doing that. They're not interested in involving themselves, in helping me run the company and getting it to that next level. They're just interested in lending me the company. So it's a little bit of a hybrid of debt and equity financing, and there's distressed debt, where I'm financially troubled and I'm going to get a loan from somebody, but they're not going to be actively involved in the company, right? They'll take it over if, if I fail, but it's not in your best interest to do that either. So you had those types of private credit investments that are proliferating a lot more to individual investors than you could get previously. Now why would investors look at this again? It's higher yield than traditional fixed income. Usually they're floating rate structures. They're not necessarily locked in, so there's an inflation hedge to it. And again, if you're looking for more of an equity play, even though it comes in the form of credit bonds, if you're looking for more of an equity play, this is where you would have it, because you're going to demand a higher rate of return than you would if this was a straight up uh bond from, uh, from, you know, short term bond year, from uh, from the government, if you will.

Wade Pfau 39:11
So what about the risks relative to,

Alex Murguia 39:13
well, again, it's similar to anything that has to do with private in their title. Again, because it's private liquidity risk, there's longer lockups in these and in public bonds, and there's some market cycle sensitivity. Because think about it, if you are lending to individuals similar manner, that if you own real estate and your money was largely through rental income, if there is a recession, then it stands to reason that many of these individuals aren't going to be able to pay back their $1,000 loan, right? And if they can't, if all, if I don't know, 40% of your client, 40% of the funds underlying book can't pay back their small loans, it's going to have an effect, right?

And so there's strong market cycle sensitivity to. Is but to me, if you diversify that away, you get the normal credit and default risk. What stands out more so is the liquidity risk, you know, relative to public bonds. But that being the case, there are higher yields in the private markets. Hence, you're getting compensated for that liquidity. You know, it's think of it a premium, a liquidity premium, if you will. That so go on.

Wade Pfau 40:31
Well, who invests in these? And these would be great credit investors. But more broadly, yeah, what

Alex Murguia 40:38
used to happen is, like investors could invest in some of these because they had marketplace platforms for this. But I you know, it seems that was more trouble than what it was, and frankly, institutions wanted to get in on this because these were successful. But institutions, like institutional funds that wanted to promote these, they're not going to invest $10,000 they're going to invest $50 million and so they effectively flooded this market. And like I said, like prosper and those people, they just end up going directly to institutions to help fund the loans, as opposed to trying to play matchmaker with 1000s of potential loaners, if you will. And so largely, you see pension funds and insurance companies investing in these and again, they do this in 10 million plus increments, not in $10,000 increments. So they needed to have these fund structures to it. And so P to P became P to B. I guess at some point, a lot of institutional and high net worth investors do this. And again, it's not quite there to the degree of the other alternatives that we spoke about earlier. But there's growing retail access through some interval funds. There's also in the private credit world, there are some closed end private debt funds, some closed end funds that are dealing with this as well. So if you wanted to look into this, closed end funds, there's some interval funds that do this as well. And as an aside, there's some business development companies that that sort of traffic in this as well.

Wade Pfau 42:21
Okay, so bringing this back around to the idea of people building portfolios, either pre retirement or post retirement, I guess the broad question of with alternatives more generally, but like with private credit, what kind of role would it play in a portfolio? The

Alex Murguia 42:40
role that I would see, it's, it's a little bit of a hybrid between contractual income and and a probability based kind of vibe. And by that, I mean, look, you are getting, you know, income generation, and there's contracts because loans are being made out. But the reality is, the credit quality of these folks is significantly less. So you are. You are trying to grasp a higher premium in exchange for bearing that extra risk, because you're bearing that extra risk, and there's an imputed extra return within that, to me, it's a bit of a hybrid between an expected return of some sort of public equity and and and public credit, it's in, it's in that range now, because they are sensitive, especially with private credit, to economic cycles. You know, I think there is an expected healthy dose of volatility, so you have to just make sure it complements your other holdings. Because an argument could be made. Look, do you need something that's in the middle? Because at the end of the day, if you want to be safe, be safe. If you want to be risky, just be risky. And if you have a blend of those two, you are effectively getting something in the middle anyways. And so that's the key here. And this is where I use the color analogy, Wade, where, if you want a portfolio that's straight on green, you can do it by getting certain mixtures of

yellow and blue, right. Blue being, let's say public markets, and yellow being, say bonds, right. In a 6040, portfolio, you are getting some sort of shade of green if, if you're happy with that shade of green, you don't need to do anything else. You don't have to worry about hedge funds or anything like that. What's the point? Now, if you're not quite happy with that, and you want to shade a little bit more towards yellow, or you may want to shade a little bit more towards the blue, then you can throw in little, little influences of these kind of holdings to get you there. Because I, again, I always view any investment within the contract of a portfolio of other holdings, and so I don't view these just independent of themselves as an independent holding. I think it's a very viable consideration. Yeah. Yeah, but within the portfolio, it just depends how it interacts with everything else. You know, sometimes you don't need salt in the meal. You have enough other spices to get to get your palate to find the meal Delicious, right? And so that's kind of how I'd answer it. Did that make sense? Wade, or do you want to say it in another way, just in

Wade Pfau 45:19
case? No, no, I like the salt analogy,

Alex Murguia 45:24
right? And I think that's the case for a lot of things. Don't you think, Wait, even with all these different types of you know, I'll take annuities, right? Sometimes you get asked, Hey, should I have every different type of annuity? And your answer is

Wade Pfau 45:38
probably not. I haven't heard that specific question I'm

Alex Murguia 45:40
at here right now. No, I have, I had some, I have an index annuity now. I want, okay, why? What do you think? You know, you're like,

Wade Pfau 45:49
variable annuity to the mix. Or should, yeah, exactly.

Alex Murguia 45:53
And you're like, No, not really. Or how? Sometimes people in 401, K plans, when they have investment menu, they just 10% everything.

Wade Pfau 46:01
Oh, right, yeah, that's common the one over in strategy. Just why you doing investment equally? And

Alex Murguia 46:07
so I strongly suggest Think of it like that, like you're making a meal. And sometimes you don't need every single ingredient that you could possibly think of. And salt is great, right? But you may not need it. You know, I love sugar, right? I'm not going to put it in my whatever, in my chicken noodle soup. So that's, yeah, that's how I would answer that. So wait, and you thought we were we're over. So what's the question? We had a question

Wade Pfau 46:40

of the day, and it's somewhat related to this theme, I think it's more a little bit more investing, but a question of the week here at retire with style is in the data and research, do more volatile assets outperform less volatile assets, for example, small caps or small cap value? Or is it that more volatile assets have the so I think, or I'm not, the question seems to be like, can you really expect more volatile assets to outperform or is it more the case they have an opportunity to outperform that or may not be realized

Alex Murguia 47:13
all you listeners here, because we're probably going to cut this into a Short Can you repeat that question? So for easy editing for Amber, so she'll be coming to me tomorrow and say, What the heck's going on here? I can take two.

Wade Pfau 47:27
So our question of the week in the data and research, do more volatile assets outperform less volatile assets, for example, small caps and small cap value? Or is it that more volatile assets only have an opportunity to outperform.

Alex Murguia 47:45
Okay, I'll start it off by saying this. This is the whole point of investing. To some extent, you want to be compensated for the systematic risk that you're taking on. And I'm using that word systematic versus unsystematic, very specifically, but that's for another day. You want to be compensated for the risk that you're taking on. And many times, the parlance of risk becomes volatility. Some would argue that's not risk, but let's just just humor me here and assume it is at the end of the day you don't want to take on more risk without getting a commensurate return. That's usually above and beyond the risk that you're taking. The beauty of a portfolio is, when you're putting all these different asset classes together, you're getting the only free lunch that's available, which is, you're able to kind of increase returns relative to the risk that you're taking more so in aggregate than you can with all those individual components isolated. That's the beauty of portfolio construction. That being the case, there are many things that are volatile, that have a terrible return profile. So theoretically, so technically speaking, many things can off. Can be extremely volatile, but have terrible returns. To me, gold comes to mind, right? So just because it's volatile doesn't mean that you're expecting a higher return. But the point is, if you're gonna experience this level of volatility, which, to me, that's kind of a proxy for uncertainty. What's going to happen next, especially when you're trying to structure income, right? And so if you're going to have this higher level of volatility, it better come married with a higher expected return. That's my answer. Wade,

Wade Pfau 49:40
yeah. Oh, absolutely. Just because something's more volatile doesn't mean it's going to have a higher expected return. Specifically with the small caps and small cap value, you do see that in the historical data that, like with the Morningstar data, you can kind of list the investments with as the expected return, historical, I should say historical. Average return increases, the volatility increases, like with Treasury bills and then intermediate term bonds and then long term government bonds, long term corporate bonds, large cap stocks, small cap stocks and small cap stocks in that data set had higher average returns and higher volatility. And even that led Bill Bingen with the research he did on the 4% rule, idea that when you disproportionately invest in the small cap, despite the higher volatility, that could increase that safe, historical, sustainable

withdrawal rate, because the higher expected returns more than compensated and the lack of correlations with the rest of the portfolio, and you see that, especially

Alex Murguia 50:40
with small cap value, as opposed to just small caps, I would say, over the last investment cycle, the last few investment cycles, the small cap premium has become a subject of strong debate, and that's something we'll get into in the in the podcast at some point, but Continuing, it really just

Speaker 1 51:00
needs to be a theoretical justification for why, if an asset does outperform, why that's happening. Like, does that make sense? Is there some premium that the market's been neglecting and so on and so forth? So I guess really, then the answer to the question is, there's no, no guarantee, or anything like that, that more volatile asset classes outperform, but you've got to have an expectation it's associated with risks, but at least an expectation that it would outperform. If you're a risk averse investor, you wouldn't invest in something more volatile unless it had the expectation it could also provide a higher expected return over the long term, 100%

Alex Murguia 51:43
another way to think about this is, why would you invest in stocks versus bonds? And the analogy works for you know, riskier things within the stock universe, right? You would only invest in stocks versus bonds because there's a higher expected return. If stocks, you know, they're more volatile, right? Stocks, I don't know, 10% return, 17 standard deviation. Bonds, significantly less, depending on the maturity that you use, or whatnot, but let's just say four or 5% return, 5% return, and standard deviation within that range, six, seven for why would you invest in the market if it wasn't going to give you a higher return and more volatility. If that was the case, you if it was going to give you the same returns as bonds, you would just return. You would just put it in bonds. But if stocks gave you a higher return every year, you know, you would just if it gave it to you every year, you would just put it in the market, and there would be no volatility. But eventually that would go away, and it would go back to the returns of bonds, because everyone would consider stocks to be safe at that point. So you need that uncertainty. You need that implied uncertainty to capture that higher return. But because it's uncertainty, it doesn't guarantee you a higher return at all.

Wade Pfau 53:00
Yeah, most people are risk averse, so They at least need an expectation that something will earn a higher return if it's otherwise more volatile to justify. And yeah, you're right. Like, if it earned a higher return and was less volatile, people would push into that and subsequently, the expected returns would have to drop

Alex Murguia 53:21
at something they would go down. It's just how markets work. All right, anything else? Wait. No,

Wade Pfau 53:28
think that solves it for the week. We do have the YouTube Live coming up. That'll be June 2, at 2pm Eastern Time, and we hope to see you there. And if you can attend live and ask questions,

great. If you'd also like to send a question in advance for that you can do so@retirewithstyle.com

Alex Murguia 53:46
Take it easy, everyone. Thanks for listening in and catch you next week on retire with style.

Briana Corbin 53:56
Wade and Alex are both principals of McLean Asset Management and retirement researcher. Both are SEC registered investment advisors located in Tysons, Virginia. The opinions expressed in this program are for general informational and educational purposes only, and are not intended to provide specific advice or recommendations for any individual or on any specific securities to determine which investments may be appropriate for you consult your financial advisor. All investing comes with the risk, including Risk of Loss past performance does not guarantee future results.

54:30
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