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Back to School: *Public vs. Private – Financial Edition*

It's hard to believe it's back to school season already. It's also hard to believe that it's been 10 years since the start of the financial crisis that brought about the Great Recession. A decade later, we find ourselves in the nation's second longest economic recovery and expansion (FYI: the average duration of a bull market is 3.5 years). Yet while stocks continue to push to new record highs, corporate earnings have failed to keep pace with prices, resulting in stock valuations that now sit near all-time highs. If you remove the tech bubble as a one-time anomaly, stocks have historically never been more expensive (based on a number of different metrics) than they are today.

Recent History

The good news is that after two years of relatively flat earnings, we finally reached an inflection point late in 2016. Year-over-year earnings are now growing 10% compared to the first half of 2016 when energy prices acted as a significant drag on the economy. A rebound in corporate earnings and a pickup in economic activity (Q3 GDP is projected to be greater than 3% as of this writing) combined with the possibility of fiscal stimulus and tax reform in late 2017/early 2018 lessens the likelihood of a recession occurring anytime soon.

However, the bad news might come in 2018 when double digit earnings growth becomes much more difficult as the year-over-year comparisons get harder when measured against the strong growth of the past ten months. Corporate earnings may be locked into a best-case scenario of mid-to-high single digit growth for the foreseeable future. With stock valuations already elevated, stock gains might be limited to the level of earnings growth (mid-to-high single digits) or even less if valuations begin to revert towards their historical averages. And that's if everything goes right! Tax reform is far from a slam dunk, geopolitics is increasingly on the front page, a potential government shut-down and debt ceiling debate looms, not to mention the Fed is looking to unwind their massive balance sheet.

Philosophy (Get rich or stay rich?)

The risk of recession and an ensuing bear market is always elevated this far into a market cycle; current high valuations and the heavy use of leverage will act as fuel should a negative spark hit the markets. Pundits point to a perceived lack of euphoria in trying to draw distinctions between today and the latter stages of previous bull markets. But the 2017 version of market euphoria is out there just expressed differently as witnessed in the valuations for private tech companies, ultra-high end residential real estate prices and the incredulous price action in cryptocurrencies. While Bitcoin may personify the 'get rich' ideal of this generation, at this stage of a cycle we encourage a shift in your mindset to more of a 'stay rich' mentality.

But where should investors turn their attention to? In times past, one could take stock profits and reallocate into 6-8% yielding treasuries – sacrificing little in portfolio return since the mid-to-high single digit returns were similar to what was project for stock gains in the remainder of the business cycle. And if rates were to fall in the

ensuing recession, investors would get the added kick of capital appreciation (falling yields = rising prices). However, we live in interesting times and that's not a viable option this cycle. With stocks at all-time high valuations and treasury bonds yielding next to nothing after taxes and inflation, we must work harder and dig deeper to find value.

Econ 101 (Seek out value)

There is a herd mentality to the market. An initial investment thesis in a quiet part of the market catches fire and prices start to rise. Other investors catch on and pile into the trade—pushing prices higher still. The thesis turns into gospel when more and more investors pile in. The cacophony reaches a fever pitch as the herd chases the recent winners and pushes prices and valuations way beyond what any well-informed, reasonable investor would deem appropriate, not to mention the original thesis. When this happens, savvy investors need to check their emotions at the door, take profits and look elsewhere for shunned assets that are generally under-owned, unappreciated, and unloved.

This is hard as often assets are shunned for good economic reasons. But not always.

Look no further than our January newsletter article highlighting unique opportunities in emerging markets (EM) despite the anti-China/anti-Mexico rhetoric coming out of Washington DC (EM stocks are one of the best performing groups in 2017). In this case, the government caused investors to flee an asset class. In other times, assets may be under-owned (and therefore cheap) because they aren't well known or readily available to the average investor. In both cases, the supply of investors is artificially smaller which limits the herd factor and keeps prices rationale.

On very rare occasions, investors can uncover these unloved assets in a sector of the economy that's improving. When both influences align (an asset class has a limited supply of investors/investment capital and an economic tailwind driving demand higher) one of the first rules of economics begins to take shape. When demand exceeds supply, prices tend to appreciate and investors have an opportunity to reap meaningful profits.

Applied Math

Theory is great but can investors actually allocate to such investments? Private Alternatives may currently offer this rare combination. Because these assets are illiquid and not available to everyone (generally limited to institutions and high net worth individuals), they are considered Private. And by definition, because these assets aren't publicly registered securities like stocks and bonds, they are classified as Alternatives—thus Private Alternatives. Some options include the following;

- **Private Lending (in the Real Estate sector)**
  The Great Recession and ensuing government overreach (e.g., Basel III, Dodd-Frank, capital ratios, etc.) left a void in the banking community. No longer are banks allowed to lend to real estate projects outside of their pre-approved box (i.e. 800 FICO score, W2 income, etc.). Fortunately for real estate developers, private capital has stepped in to fill the void. Investors can lend money on these illiquid real estate

projects and command a hefty return because the demand for housing and other real estate project financing is booming and the banks aren't able to fill it (high demand with no supply of loans). We as investors can "Be the Bank" for these projects and reap mid-to-high digit returns, all while interest rates are stuck down near 2%. If and when the banks do come back, we can reposition into other assets to avoid the oncoming herd.

- **Private Lending (in the Corporate sector)**
  The exact same "Be the Bank" opportunity also plays out in corporate lending. While larger companies can access the bond market, the middle market (companies that generate between $10MM and $100MM in annual revenues) is starving for attention. The number of middle market companies is exceptional, and without banks in the lending mix (high demand with no supply of loans), yields and returns are similar to that of private real estate loans.

- **Private Insurance (in the Real Estate sector)**
  While perhaps not as attractive as the above lending opportunities, insurance-linked securities are an alternative asset class that should certainly be explored. Because it's a relatively newer asset class, it benefits from a lack of awareness and over-ownership that prevents overvaluation. The thesis here might be called "Be the Insurance Company." As investors, we can step in and replace capital constrained reinsurance companies and reinsure the world's most prized real estate assets – collecting the premiums and paying out on any catastrophic claims (think hurricane, earthquake, tsunami, etc.). While catastrophic events are impossible to predict, the benefit is that investors have the opportunity to earn stock-like returns (with stock-like risk) with zero correlation to any business cycle. Recessions don't trigger hurricanes! Certainly, the investment introduces a new risk to your portfolio but it's a diversifiable risk that provides another return profile and profit engine.

- **Private Ownership of Key Assets (Farmland, Timber, Infrastructure & Real Estate,)**
  In any investment plan, diversification is the only free lunch and having three legs of the stool is a good rule of thumb. While the previous examples center on Lending and Insuring, direct ownership of private real assets remains attractive vis-à-vis public markets. Owning mission critical assets such as Amazon warehouses, FedEx distribution centers, and sea/airports for growing global commerce, food/lumber production for an increasing population, and skyscrapers in major metropolitan areas (perhaps excluding the financial sector of London) all serve not only as good portfolio diversifiers but as a safe harbor in case another global storm hits the equity markets.

Conclusion: Private or Public?

While we are by no means calling for a top in global public equities, it now may be a prudent time for investors to focus on increasing the 'stay rich' side of their portfolio ledger via private alternatives. These strategies should not only appeal to the typical bond investor but also the stock investor as well as yields are greater than those that can be found elsewhere and total returns are likely to rival domestic stocks.

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