FRIDAY, DECEMBER 9, 2022

Hello and welcome to the Dividend Cafe. I am extremely excited to talk to you today about a topic that has all of a sudden dominated the media. And it isn't about the Fed directly, it isn't about the economy directly, it's not going into the public stock market and yet has become one of the dominant stories of the last week or so. And a quick context, and I'm going to spend most of my time explaining why this context matters to the broader principles we're here to talk about, but there's a couple of what's called non-traded real estate investment trust that have gotten a lot of attention in the press this week. And there's a lot of questions right now about illiquid assets, particularly real estate and how an investor may be impacted by how it is marked and what the real value is and could the marks go lower and can people get access to their money.

There's this whole discussion about liquidity valuation in the world of real estate and yet we're talking about in some cases asset managers that have been some of the greatest wealth creators in history inside of capital markets. And then you look at the other story that it's competing against for headline and for media time around this FTX crypto implosion where there's DOJ investigation, house investigation. It seems to most analysts inevitable that there's significant criminal charges coming and just billions upon billions of dollars of eroded wealth. And these

two stories don't quite seem to be comparable to me. So if you're not familiar with all of it, don't worry about it. Just if you know what I'm talking about and you already have a little context, great. If you don't, you're not going to need it because I'm just starting fresh with some ABCs of investing that I think are going to be incredibly important for us.

Basically, I've written several times over the years, it's a huge theme at the Bahnsen Group in our portfolio management about the world of private investing. What do you mean by private investing? It could be a reference to real estate, it could be a reference to equity, it could be a reference to debt where it is not traded, it is not readily accessible. So what do you mean by a private equity, a private company? Well, I happen to be the managing partner and lead and majority owner of a private company. The Bahnsen Group is one, you can't buy it, you don't know what it's worth. It's a private business. Most businesses in America are private now public businesses end up trading, subjecting themselves to more regulation by being able to be traded on an exchange and have shares or equity of their company available to the public.

That's the trade-off. And so you have a very robust private market for debt, a very robust private market for equity and for real estate as well. Certain investment vehicles have been put

together people to buy real estate with professional management, but it isn't, you're not being able to sell the whole fund. So there are publicly traded REITs that might focus in a particular aspect of real estate, but it trades like a stock. You can buy and sell it day by day. Even though the underlying assets are shopping centers or apartment buildings or office buildings, those buildings can't sell, but you can buy and sell stock because they publicly trade one investor for another. The private side doesn't do that. So I've talked about the pros of private investing, the cons of private investing, why we like it, how we go about doing it, why it matters in past Dividend Cafe's and so forth.

Well the issue in the world of private investing is that for all the good, all the bad, one element I'm well aware of that I think is very valuable just economically is this concept of price discovery and it's sort of a Hayekian notion. The great 20th century economist freedom Kayak talked about the importance of information that is sort of signaled in prices that we learn a lot by seeing prices. And I agree that as a general rule of thumb price discovery is really beneficial to just the overall calculation one does economically their decisions is an investor decision buying and selling and so forth. As you say, well how could you like private investing, you don't necessarily get the same price discovery. And this is a very important reality because first of

all, how does one get price discovery on a public or traded stock?

So I used in my written Dividend Cafe, Microsoft as an example, but you could use any company you want. It just trades a ton. Microsoft trades about 23 million shares a day. And so there's no question about what its price is at any given point in time. There's such a high volume of people buying and selling. And what does that mean, buying and selling? That's called a clearing price. So we know what the price is because a buyer and a seller agreed together. Why is that harder with a private company? Because there's not even a remote indication, generally speaking of an agreeable price at which a buyer and seller may transact. Now I suppose in theory you could have someone say, I'm willing to pay X for the Bahnsen Group and someone who runs the Bahnsen Group would say, I'm willing to sell it for you for that.

Now we're not going to do it, but I would sell for that and you would buy for that. So we do know a price, but we're just not going to do it. I mean you could have that happen, but when do you really know a price? Let's use another example. You're probably all familiar with a home. Do you know what a home is worth when you put a sign up in front or when you close escrow? So the clearing price is the moment at which there's

price discovery. So by definition, one of the downsides to private investing is a lack of price discovery. This is essentially now where we talk about the subject of liquidity. Liquidity. Microsoft trading 23 million shares, someone who closes a sale on their house on your street. That liquid moment becomes the price discovery and short of liquidity, price discovery becomes a much more ambiguous area.

Now, why would anyone want to be invested in something that you can't get? Price discovery me when the reason is because you can't get liquidity. In other words, the question comes about because when you word it this way, it sort of makes more sense. Why would you want to own something you can't sell? The answer is because that's where an awful lot of money gets made in this world. Illiquid investments, when you think about the lion share of wealth creation in human history, but to just avoid apples to oranges, analogies, just in modern financial history, concentrated stock that you can't sell along the way. Stock options, you can't sell along the way. Private equity starting your own business, you don't know what the Bahnsen Group's worth because I'm not selling and if I knew a price, I wouldn't tell you. So you don't know. And yet we have this understanding that some companies are doing well, other companies are not.

And I use the example all the time, a lemonade stands, no one's probably going to want to go buy your neighbor's kids lemonade stand. But if you did just drive by and want to make an offer, you don't know what it's worth. You probably assume it's not worth very much, but it's the illiquidity that is creating the lack of price discovery and illiquidity is often exactly why people want to be invested. Probably not in your neighbor's kids lemonade stand, but certainly for a business owner, entrepreneur like myself, I'm very grateful for the illiquidity of Bahnsen Group. I've built a very successful business without needing to worry about price transparency as I go. And so things like real estate, things like closely held businesses, entrepreneurial endeavors, that's why people want to be invested in things that they can't sell right away because they generally can build an awful lot of wealth that way.

So the fact of the matter is that your question is not why would you want illiquidity, it's why would you care about price when you do have illiquidity? And the first thing I have to say is I just know it's going to be taken by some as me being condescending. And I don't mean it condescending to you, I mean it condescending to someone else. Okay? The re reason I think I have a lot of experience in this and observation throughout the personalities and realities of human nature is I think a lot of

people have a blend of both ego and insecurity that is important to them to be able to say, I have this value. You write a check for a hundred thousand dollars to some private investment and you think it could be worth 500,000 in the future, but you couldn't sell it the next day for anything and it could go to zero and it could go up a lot.

You have no idea. So you can tell yourself, it's called mark to market, you can market to purchase value, which is what most would probably do. And just tell yourself, I wrote a check for a hundred thousand, it's worth a hundred thousand, but if you were to market to sale value, what you could sell it for, it would be worth zero. So I figure anything between zero and a hundred thousand, you can tell yourself what's what it's worth, but do you tell yourself on day one it's worth 200,000 because you think it's going to sell for that in the future? Maybe you do. It makes you feel richer. I don't know what people have done over the years with telling themselves different private companies, different dot coms, different even their expectations of sale values of real estate. There's a lot of shall we say, hope as a strategy embedded in it.

And so that may not be a material, but I do think it's helpful to identify some of the human nature realities here. But see ego and insecurity and behavioral human nature, things are not the only

reasons. Price may matter, price may matter to other practical reasons that are not yet going to be fundamentally important to our investment theme about liquidity versus illiquidity. Getting some idea of what a price is on something that is technically illiquid may be useful. If your bank needs an understanding of what your total financial picture is, they know it isn't necessarily a saleable asset, but they want to have an idea of your net worth where they consider you as a credit worthy borrower for other things, you're borrowing money against estate planning, it could matter, right? You need to be able to plan for what your liquidity is when you die, for what your tax liability may be, how you're going to divide up assets to spouses, kids, grandkids, things of that nature.

And so some idea of a reasonable value of illiquid assets could matter in estate planning. Look, the particular asset you have that is illiquid. It may be being run by a money manager, like I mentioned the example at the top of our show a non-traded real estate manager may be charging fees and how do they charge fees unless there's some sort of appraised value to charge 'em against. And then of course getting some idea of a price range could matter when even though you may be wanting to convert it to liquid, you may have a plan to sell. And so if all of a sudden you have abc company and you've done a real good job, you've

grown earnings and there's some private equity companies out there or investment bankers sniffing around that might want to buy you it, it's helpful to get an idea of, well, what are we talking about here?

And you don't know an exact amount like we already said, until a transaction closes, a clearing price at the point of liquidity provides perfect price discovery. But along the way it's helpful to start hearing some companies say like, Hey, I think we'd be looking at around 10 million for you guys and someone else would say, now we may think it's only eight and a half million, but we want to look at your numbers more so you start at least getting this general ballpark. So those are some examples of why someone may care about price a little. But fundamentally, the investment reality is that there are illiquid investments that are intended to be illiquid and that price discovery that is not perfect can be used for one of those other aforementioned needs. But the problem becomes forcing liquidity into an illiquid asset. So all of a sudden someone, the great example is when you have an illiquid asset like a bunch of real estate in a eliquid asset, so now publicly traded REITs, the asset inside of them is not liquid.

The shares of stock of this fund is liquid. So that's great. You get people buying and selling back and forth, but you don't really

get a price transparency of the underlying asset. You're getting a price around liquidity need. So I know the cash flows, let's say of the Bellagio Hotel in Las Vegas where I like to go when I go on trips there and I feel real confident I could sell that building in a year put the right deck together, put the right book together, get the right institutional investors on the line, and I think I could sell that hotel for 6 billion. But if you said you gotta have it sold in the next hour, you're going to be selling it for real cheap and yet is that price that is forced out of liquidity real accurate price discovery. So see that's the problem is you can get bad price discovery and illiquidity when people are marking something to fantasy, oh, I just put in a hundred grand and I think that's worth 200 grand already.

And because there's no liquidity, no, you can't falsify the information. So those things can be overly marked just out of hope and maybe even good intentions. But again, it's somewhat in fantasy land. Then you could have a forced sale. Something was an illiquid asset that had a liquid need and then it gets priced to something that reflects other extraneous circumstances. So the problem with price discovery is when the liquidity and illiquidity of the underlying amount, in other words, the liquidity of the investment and the illiquidity of the underlying asset don't match. All right? So if you have an illiquid underlying

investment inside of a liquid vehicle, that mismatch of liquidity can create real problems with price discovery. People go, okay, well this doesn't sound good, and I would suggest to you that there's three people involved in this and it could be bad for two of 'em and that there's one of the three, but I don't think it's bad for at all.

So who are the three people I'm talking about? Number one is someone who bought illiquid investments in a liquid vehicle and they need their money back and per why is it bad for them? Maybe there's going to be a sale at a really inopportune price. Maybe they're not going to be able to get their money back. They thought it was liquid, but they're not going to be able to produce what was promised the liquidity won't be. There are any number of things that could happen that could be bad for a person who went into illiquidity expecting liquidity. Number two, it could be the asset manager or who has sort of made or sponsored the product or the strategy, the asset manager, portfolio manager, and now all of a sudden they have promised someone liquidity around something that has illiquidity attached to it, and hopefully they did in a smart way.

They provided a gate meaning, Hey, we're going to allow some money to be sold every month, but we're going to cap it at a certain number. Or they can do it on a best efforts basis, but

they're not legally allowed. Now this could be legally useful, but it doesn't necessarily mean it's reputationally useful because if you start making liquidity available that is unrealistic to illiquidity. Then even if somebody signed documents saying they understand it, they start coming back saying, I didn't read this giving back my money. You could be in a position where there's reputational damage, even if not legal, and it could force people to start selling assets in opportune prices. Now, what is the scenario by which the third person is not impacted? That's the scenario where they bought illiquidity and are totally content with illiquidity. In other words, there's a long-term investment objective.

They understand it. They're not looking to try to mismatch liquidity and an underlying illiquid investment structure. In that case, I think we're talking about the types of investors we are, the types investors that we're working with where there's an understanding of what's going on. The long-term objectives of a certain pocket of capital are aligned to an appropriate strategy, and you want time for real genuine operating income to grow real, real genuine wealth creation and trying to magically extract liquidity outta something that can't create it is not on the horizon. So to the extent that there becomes liquidity, illiquidity mismatches for another investor the investor who continues to

own those assets that we're assuming for the sake of argument or high quality are going to grow over time, are generating good net operating income and we expect to continue doing so, are well managed, well cared for, that investor doesn't have to care about this other drama.

So in other words, this whole entire subject comes down to either investors being misinformed, miseducated or an asset manager perhaps not aligning the liquidity that they promised investors with the illiquidity of the annoying investments. I think that that happens very rarely. I think most of the time the asset managers are quite aware that what they can and cannot do, and now what we're dealing with is category one, that investor who has mismatched their behavior and expectations with the nature of what they may have invested in and then a media that wants to run with it. Well, you go, yeah, I get it. Now you're not about ftx, you're not about crypto. No, I'm not talking about people who put money into an asset that has no value and then that asset has been moved away or is gone or they don't, or it was lent somewhere else against their knowledge.

I'm not talking about any fraud, I'm not talking about any corruption. Now those stories, that's a ill liquidity of sorts, but it's totally different kind of a liquidity. That's an illiquidity that comes about because the thing you invested in has no value. It's

not simply that you're in a really beautiful piece of real estate, but you can't go out and sell it right away. The Bellagio Hotel is my example I'm using doesn't trade like a baseball card on the playground. What I'm referring to in this other example is speculation that blows up. That was real wealthy evaporation. That wasn't a liquidity problem, it was a solvency problem. So how do you go about investing in illiquid assets, trying to get them investment benefits to certain levels of illiquidity and still maintain some hand on liquidity? Well, look, if you're investing in a privately business, you really want to assume no liquidity.

I mean, if they have a really, really clear path to a sale, a really clear path to public markets that there's different things that people might be expecting, but none of those outcomes are ever assured. With real estate, you always know there's brick and mortar and dirt that can be sold if it's diversified real estate, you may say you may be comfortable with a certain element of quarterly liquidity is better than daily. Daily is just absurd. Monthly is pretty absurd. Quarterly gets a little less absurd, annual gets much less. So there's a continuum, a sliding scale of reality around potential fair expectations of liquidity with these illiquid assets.

I think that what we're dealing with in the world of private investments, of illiquid investments is that when it comes to

being able to determine what the price is, that we can't get it perfect without a querying print transaction. We use valuation models that are reasonable and tested, but not necessarily a reflection of a final sale, but they're based on inputs. They're not marked to fantasy, but they are not the same thing as full price discovery. That comes from liquidity and you tolerate that. In fact, you even want that because within the illiquidity, you're getting an investment outcome that you want greater returns over time from real estate, from private credit, from private equity, from partnering in your friend's business, from venture capital, from those types of things, from a privately held business that is giving you restricted stock and then one day they're going to go public.

There's all kinds of advantages with risk around private investing, but the obsession on what the valuation may be right now is only important if it's that ego point or some of the legitimate points are brought up with the banks and estate planning, or if you're trying to create a liquidity function outta something that doesn't have liquidity, and in that case, I think the problem is with the investor. Sophisticated investors should not be investing for liquid liquidity out of illiquid investments. When you say, I know what this investment is, I know there's either limited liquidity, quarterly, annual what have you, but I

have a longer term horizon, and there is a fundamental investment thesis in what you're doing as opposed to simply trying to trade as opposed to trying to speculate and you don't have an illiquid investment tethered to a lot of leverage position of debt exposure.

You have liquid debt combined with an illiquid asset. That can be a very dangerous position. But again, the liquid debt and illiquid asset in these crypto explosions was still fundamentally about the fact that the underlying asset was worthless or close to worthless or what have you. That's basically a night and day story of what we're talking about. I say to the world of illiquidity in well run high quality assets. You continue to do what you're doing with illiquidity. I say to the investors who are buying it, make sure you are buying and understanding and expecting illiquidity. Do not believe that magically entire hotel buildings, apartment buildings can be sold at one day's notice, one hour's notice when you see things that you know to be underlying illiquid that are trading daily, they're going to have more volatility because why their trading is not reflecting the underlying value or cash flows or any kind of clearing transaction price of the underlying asset.

They're reflecting the sentiment of the market. It's one of the reasons the publicly traded wreaths go at big premiums to their

value underlying value or big discounts to their net asset value because they're really trading off of the sort of emotional highs and lows of the underlying investors with illiquid assets. You get to be removed from that kind of story and focus entirely on what you want to be focused on, which is the fundamentals of the investment building long-term wealth. It requires you to behave. It requires you to be educated about what illiquidity is and hopefully to be aligned with a high quality manager. That also takes this seriously. If someone's out there saying, you can have all the benefits of illiquidity with daily or monthly or whatever liquidity you have to understand now, perhaps they've put very fair, very realistic. Some of these stories are in the news this week.

There's very, very clear limitations around what the liquidity may look like that are not protective of the asset manager, the protective of the investor. It doesn't help the investor to say, oh, good news, I have full liquidity. If the underlying assets illiquid, that can deteriorate wealth. So some of the necessary guardrails being in place is a good thing to protect the investor. So look for those things. Look for quality, reputation, long-term wealth creation, and all of a sudden you totally change the whole story around liquidity versus illiquidity. It becomes an investor behavior story. Investors behave doing well and investors that

are actually believing the never ending please for things that don't exist for I use in different cafe analogy of Lima beans that tastes good, or ice cream that doesn't have calories or that the french fries without sodium. I use food examples all the time.

I guess you could tell where my mind is. You don't these things until we don't exist, but when it comes to investing, we want the illusion of safety and we want to believe that things that can't possibly exist do exist and will tell ourselves whatever we have to. In the world of illiquidity, invites such delusions, resist delusions, resist amiss, a mismatch of liquidity and illiquidity that comes down to a behavioral commitment that will lead to better outcomes. I swear to you that we are committed to this each and every day at the Bahnsen Group, getting these things properly aligned. We want to optimize illiquidity opportunity for investors, but we never want to do that by facilitating delusions. To that end, we work. Thanks as always for listening to and watching the Dividend Cafe. I really hope you'll also take the time to read Dividend Cafe. I think you'll find this week's commentary perhaps even more enjoyable of a read than a listen. In the meantime, I have a wonderful weekend and we look forward to being back with you again next week.

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FRIDAY, DECEMBER 9, 2022

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