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Hello and welcome to another edition of the Dividend Cafe. I am sitting in our Newport Beach office studio, and I don't think I have recorded a Dividend Cafe from here since maybe the second week of January. I mean, it's really been quite a whirlwind. I've been in New York office a lot, and then there's been travel around the last couple of weekends at different hotels and offices and other sites. And so it's nice to be here at the home base and record in the comfort of this beautiful studio.

And it's also nice to be doing a Dividend Cafe for you today on a topic that we don't address a whole lot. We talk about the Fed. We talk about Japanification. We talk about monetary policy. The macroeconomic picture, growth expectations, applying all of this into the orbit of dividend growth. These are things that are pretty frequent topics in the Dividend Cafe, but something like private credit can seem more niche. It can seem a bit more bespoke, yet it's a pretty substantial part of portfolio strategy at the Bahnsen Group. And it's become a very big part of what a lot of high net worth and ultra high net worth investors are looking at generally as a source of return and a source of risk that is outside the conventional elements of stock and bond markets.

That is to say we view it as an alternative investment, which is to say we view its source of risk and reward as non-correlated to traditional investments like stocks and bonds.

And so that broader rationalization as to why we own alternatives at all has always been the diversification benefits that come from non-correlation and the use of private credit within alternatives has picked up just in terms of our view of the opportunity set. It's something we've been mostly very right about for a long time. First of all, not only just in the return sense, targeting high single digit returns in an asset class with lower relative volatility, it's tough to do and it's been happening for quite some time. And frankly, because of the floating rate nature of a lot of private credit, we accidentally got into some low double digit returns. The private credit space saw not only its NAV, its actual underlying value hanging in there but then saw the yields it's paying off increase as a lot of the loans that make up private credit saw their interest rate go higher because of the rate cycle over the last couple of years.

So not only has the return profile been really impressive, but the overall opportunity set has grown a great deal. And I wrote a Dividend Cafe last year where I made the case that this was a tremendously positive thing happening, not merely for investors, not just, oh, there's this new investment opportunity out there, it's doing well, what a great thing for us.

That's all well and good. But I was making the argument that the substantial increase in a host of non-bank lending capital markets was itself a wonderful thing in de-risking systemic contagious risk in the economy, removing some lending risk and default risk and credit risk from the banking system through direct lending, through structured credit that is more asset backed, through private credit that is cash flow backed, that all of these different elements of non-bank lending, different categories and silos, were all things being equal, moving some degree of risk, it never replaces risk, it never lowers, limits, eliminates, it moves. And in this case the movement of risk from the depositor base of the banking system to investors who have a capacity for absorbing losses, I view as systemically a marginally better thing. Now the issue has become one of capacity, that there's only a certain amount of borrowers out there that are high quality doing a certain amount of activities in the production of goods and services that define economic activity. There's always a certain amount that have economic or financial ratios, debt to value, debt to cash flow, the margins within a business to justify a certain amount of credit taken and the capacity for payback.

And it's a large opportunity set, it is like we're talking about a few hundred billion and then it goes away. There's a huge space out there for corporate borrowings and some will go to the bond market and some will still go to banks.

But we have seen a big growth in what we call private credit. And with a big growth in private credit comes two things. One is media incompetence and covering it and the other is legitimate concerns around Johnny Come Lately's and I want to address both things here in the Dividend Cafe.

The media incompetence issue is simply taking headlines from other stories and applying them to this story. Other things formed in a bubble, this thing's doing well therefore this will become a bubble. Other things ended this way therefore this will end this way. As a general rule of thumb, I'm all for trying to find parallels. I myself have drawn certain connections between the dot com moment and the AI moment. Now I try to do a little more detailed and nuanced analysis and commentary around all that but in theory I can understand just wanting to look at the lessons of history. That's not what I mean by media incompetence but not understanding and not properly portraying the reality of what's going on is I think sometimes unhelpful. There's a bit of a hubbub right now about marks, M-A-R-K-S. How a loan, a value of a loan is marked on the books of a fund or an asset manager or a portfolio of loans. So what we refer to as mark to market. You know you with stock in Apple, you don't have to worry about mark to market because it trades a gazillion shares a day and everybody's trading back and forth and it's so liquid and so public that people know what the thing is worth. And then you take your own house and your realtor can guess at price and you can look at what your neighbor sold their house for three months ago and you can put in your mind what you think it's worth because you love your backyard.

But ultimately you don't really know what it's worth until you sell it. And I believe that when we're talking about private assets whether it is real estate, whether it is your own small business that you might work for or might have started yourself or any other private market asset that doesn't have a heavily liquid, heavily traded back and forth what we call a market clearing price.

This applies to private debt, private credit, loans, it applies to private equity, something like my lemonade stand with my son or a very large multi-billion dollar company that nevertheless is not actually traded in the marketplace. And real estate is the greatest analogy. So I wrote this Dividend Cafe last year about the reality of market to market.

I don't believe it's a problem. It's a problem to the extent that people don't understand it or that they think it's supposed to do something it's not supposed to do. That there isn't a readily available price. For something that doesn't have a readily available price is called a tautology. It is what it is. So you don't say hey what do you think about things that don't have a readily available price? Oh I'm a little concerned because they don't have a readily available price.

What you have is either a good intentioned decent attempt to come up with a mark for the sake of having one, a bad intention mark that you have for the sake of misleading someone or you have a well intentioned one that is just simply wrong.

To the extent the investor base of people in private assets is supposed to have a sophistication and awareness that those numbers are make believe to some degree because they're not connected to a clearing price. That's a given. That's part of the deal.

Critiquing private credit saying well those loans may not really be worth what they're saying misses a very fundamental point here. The first one being that all private assets are guilty of this. You could throw the baby out with the bath water on all real estate and by the way real estate is 50 times more guilty of people making up a number out of thin air. But I digress. I've seen some things. With loans you have three issues going on at once. Number one is the probability of a default.

Because the interest rate pricing for a floating rate loan is embedded. If it's a fixed rate like a treasury bond. So now you don't have default risk but you have interest rate risk. You buy a bond at $100 and it's paying you 4%. Then the interest rate in the market goes up to 5%.

Your bond is worth less money. You buy a bond at 5% and the interest rate in the marketplace drops to 4. Your bond is worth more money. So that's just a byproduct of a bond going up or down based on how the change in that reference rate, the risk free rate is moving. In theory private credit is primarily 99%. It might be 97 to 99% floating rate. So it is not trading off of the up and down movements of the interest rate because it's going up itself with rates that move higher and lower. The value is going to be some combination of the probability of a default risk, the magnitude of what that default may be, that impairment, and then the expectation for recovery out of an impairment or distress event, a default.

But see private credit has an average maturity across the asset class of about three years. Some could be five, some are shorter, but this is a lower duration deal. What extends the difficulty of pricing probability of default? Longer maturity. The longer timeline there is, the more unknowables there are. The shorter the timeline, the less unknowables are. So you have an easier situation mathematically with probability than the magnitude of the impairment. How much value deterioration can there be is more known when the loan is senior secured first lien, when you're the top of the stack to get paid back, versus those credits or loan instruments out there that are somewhere junior, somewhere mezzanine, somewhere subordinated. Then it takes a lot more calculation to kind of guess where you are in the totem pole.

And then the recovery rate, where you have more optics around the loan to value, and also different covenants and conditions that a lot of bank loans may not have. But in private credit they have different covenants that kind of provide some awareness of what recovery could look like, as well as a lot of times there are sponsors or asset managers that have a lot of experience doing these workouts.

Doing default events and converting them into turnarounds or equity hybrid or something like that. So the probability, the magnitude, and the recovery are all on the easier side, which is not to say the perfect side, evaluation. They are not on the higher, on the harder end of the curve. In all three categories they're on the easier end of the curve.

But then there's just the proof and the pudding of history. You go under multiple credit cycles, multiple distress periods, and first liens, senior secured loans have more or less done quite well. There have been some defaults.

And these instruments largely trade a couple points off of par value to account for some default risk. But they're all within a very, very tight historical range that has absolutely matched reality. Now you could say, well maybe it gets worse in the future, and maybe it does. But that's predictive. That's not mark to market. That's not valuation oriented. That would just be the other side, saying, well I'm predicting something bad so I want to mark it now. It hasn't happened. I don't know that it will.

So the issue with private credit cannot be just merely in the marks. The issue must be the fundamental quality of the investment, the ability to return high coupon, high cash, and to also return principal as loans mature. And here the argument is one I'm totally sympathetic to in theory, which is this asset class has done so well. There's been so many good operators producing so many good returns that now you're going to get bad investors giving money to bad asset managers for them to loan money to bad borrowers who will use it in bad businesses. And I totally agree that the reality of human nature is that enough good money attracts bad money over time. But this to me is not an argument against private credit.

It's an argument against bad private credit managers. It's an argument for institutional expertise, institutional track record, underwriting, fundamentals, loan to value, covenants and conditions, quality of equity sponsors behind the companies that are being lent to, track record of work throughs when there are distress events at maximizing recovery. There's a whole lot of factors that go in. Now that's our job. I happen to think we do it well. But this should not be coupled to a belief it can be done perfectly.

It's just that the existence of some that will not be good in the space does not poison the well for those that should be good in the space. The analogy I use to close out Dividend Cafe, I'm going to use with you to close now here on the podcast and video, is that there is a really strong economic temptation to start a restaurant based on how well the good restaurants might do. And throughout the course of history, we get a lot of bad restaurants that were driven by the economics that they saw modeled by good restaurants. And at no time when I've gone to a bad restaurant have I ever been tempted to say I no longer want to go to a good one. And by the way, at no good restaurant do you take away the possibility of having some bad meals, some bad experiences. There are going to be some bad loans and defaults within a good asset manager. There kind of hasn't been a ton of that lately, but there could be. But the difference is that you don't view good restaurants based on what the bad restaurants are doing, even though the bad restaurants got their economic incentives from the good ones.

I made up the restaurant analogy as I was writing Dividend Cafe for no other reason than the fact that I've been dieting and I'm really hungry. But the fact of the matter is that the analogy works. Private credit is not a monolithic asset class.

And the desire temptation to mistakenly view any asset class in this monolithic context is okay for the media. It's not okay for investors. Private credit represents not only in my opinion a macro systemic solution that has the value and merit I described a year ago in Dividend Cafe, but I think for individual investors. It represents a wonderful opportunity set that has only grown and that we continue to want to gain exposure due for a portion of a client portfolio where there is capacity for non-bank lenders to provide non-correlated risk with non-correlated return.

That's the idea and I hope this is helpful as you think about a holistic portfolio. Please send questions your way. I'll be doing Dividend Cafe for you next week back in the New York office studio where at least I'll be sitting still for a few weeks. Thank you for listening. Thank you for watching. And thank you for reading the Dividend Cafe.
