A Monthly Market Letter *November 2023*

The Soundview Landmark Group at Morgan Stanley

Where We're Going

Private Credit! That's one of the hottest topics in the investment world these days. Think of Private Equity, it's kind of the same set up, but in Private Equity the private equity fund manager takes a company over and runs it, while a private credit fund manager simply lends money to the company. A private credit fund is like a bank. It raises funds from investors just like a bank raises funds from savers. A bank usually takes the deposits from a saver and lends some of it to various enterprises in hopes of earning a rate of interest income above what it pays to the depositor. Likewise, the private credit fund takes the funds it raises from investors and lends it to various enterprises in hopes of earning a rate of interest above the average run-of-the-mill bond fund. Private Credit really got going post the Great Financial Crisis. As we all remember, a lot of large financial entities got caught up lending a great deal of their depositor's savings to people looking to buy a house. Eventually, the financial entities were so enthused with the business that they started lending money to people that literally had no chance paying them back. As we all know, it didn't end well. As a result, banks were targeted for sterner regulatory measures. In short, they had to conserve enough capital to make doubly, even triply, sure that they maintained enough funds on hand to cover their customer's savings, lest said customer came a knockin' requesting a withdrawal. Having to hold onto more money, meant banks didn't have as much money to lend out to various enterprises. Also, post the crisis, banks became far more risk averse. They lost their appetite for making loans to hopey/changey type ventures. The result? A void in the credit markets. Banks stopped lending to a lot of worthwhile businesses. That's where this whole private credit thing comes in handy. These funds have stepped in to fill the lending role that the banks no longer can, or decline, to fill. Awesome, right? Well, maybe not so awesome, or awesome up until it isn't. Ask Tom Horn.

Tom Horn was born in 1860. His parents were deeply religious people and believed strongly in dishing out God's wrath upon their own children to keep them from straying too far from a righteous path. Accordingly, at the age of fourteen, young Tom skipped out on the family and headed west for Arizona. There, after trying his hand briefly at prospecting, riding for the Pony Express and cow herding, he ended up as a mule packer for the U.S. Army. No dummy, Tom learned to speak Spanish and even Apache. Within a year, he rose to chief of scouts in the Army's campaign to capture Geronimo. From there he headed to Mexico, but came back to the states after killing his first fellow human, an officer in the Mexican army, in a duel over the amorous affections of a prostitute. Upon his return to Arizona, Mr. Horn built his own ranch. In short order, he acquired over 100 head of cattle and 26 horses. Then, in even shorter order, a gang of cattle thieves stormed his ranch and stole the entire herd. Tom had to file for bankruptcy and came away from the entire incident with a deep, deep disdain for horse thieves and cattle rustlers.

After a brief stint on the rodeo circuit as a steer-roper, Horn took an interest in pursuing a career in law enforcement. He took a job as a deputy sheriff in Pleasant Valley, Arizona. There, a war broke out between cattlemen and sheep herders. Tom promoted himself around the region as a mediator of the conflict, and all his self-promoting eventually caught the attention of the Pinkerton Detective Agency. They hired Horn to head up their Denver office, handling investigations in Colorado and Wyoming. In his autobiography, Horn claimed the Pinkerton job was just plain boring, and that the formality of the organization prohibited him from performing his job effectively. Perhaps, but records show he took it upon himself to kill 17 men before they were ever provided their day in court. He also came under scrutiny for being involved in a bank robbery in Reno, NV. In any event, it was all adding up to a public relations nightmare for the Pinkerton agency, and consequently they suggested Tom resign. He did. For the next venture in his career, he put himself out for hire as, what he termed, a "range detective." Basically, if someone stole a horse or head of cattle from you, you could hire out Tom and he would search the surrounding territory to find the guilty party and get your cattle, or horse, back to you. If said thief was not cooperative with Tom, Tom would take further steps to recover your livestock. If he had to shoot and kill the suspected thief in order to return the stolen property, then so be it. Range detective? How about vigilante. He charged $500-$600 for each cattle rustler he shot. Not surprisingly, Tom found and killed a lot of cattle rustlers. "Killing men is my specialty," he once said, "and I think I have a corner on the market." Then, in the summer of 1901, a feud broke out between a sheep rancher by the name of Kels Nickell and Wyoming cattle rancher, Jim Miller. Miller claimed Nickell's sheep were grazing on his land and quickly hired our friend Tom to enforce his property rights. A few weeks later, Nickell's son, Willie, was found shot dead a mile from his home. Law enforcement immediately focused on the "range detective." Unfortunately for Tom Horn, he liked to brag about his accomplishments and in an interview for a phony "range detective" job set up by a U.S. Deputy Marshal, he laid out his fine work in the Nickell's-Miller feud, unaware that a court reporter was listening in and taking notes. Tom Horn was sentenced to death for the murder of Willie Nickell and hanged on November 20, 1903.[1]

Just as a guy can come along and call himself a "range detective," even though he's just a vigilante, a guy, or group, can also come along and call themselves a "private credit" investor, even though they're really just a bank, and a largely unregulated bank, at that. The private credit market has performed quite well over the past few years. As Barron's noted in a recent article on the industry, "Private debt funds," they write, " have returned 4.2% in 2022 compared with declines of 18% for the S&P 500 index and 15.7% for investment-grade corporate bonds."[2] Such performance draws attention. As such, a vehicle that was primarily the purview of large institutional investors is now attracting investments from wealthy individual investors. Of course, those that work in the industry tout the advantages of private credit. First, they are largely focused on issuing floating-rate debt. This, of course, offered up a lot of protection for holders of the debt once the Fed and other global central banks went into full-on hiking mode. With the Fed now apparently in "pause" mode in anticipation of a slowdown in the economy, the industry pundits are highlighting defensive aspects of private credit. For instance, most of these private credit funds make senior secured loans to midsize companies. When a borrower runs into trouble the senior secured loans are the first to get paid back in default. Also, the midsize corporate market is big and broad. Lenders are able to diversify across industries and largely avoid lending to those susceptible to the vicissitudes of the normal business cycle. Finally, if a company were to run into trouble, the private credit lender has the ability to negotiate with the borrower to work out a reasonable solution that might offer better returns than forcing the entity into default. So how does that really differ from the advantages that a bank holds when they make a corporate loan? We think what separates a private credit fund from a bank has to do with regulation. First, the bank raises funds from depositors, and those depositors are free to spend that money if they so choose. Private credit raises funds from investors, and they are free to put "gates" up, keeping investors from accessing their money. Credit funds tend to permit only quarterly withdrawals and they don't have to permit those, if too many want their funds back at the same time. Banks don't have that luxury. Furthermore, banks have to report non-conforming loans and regulators require them to hold capital to cover such loans. Private credit funds are not as fully obligated as banks to disclose their holdings, how they're performing, or how they're valued.[3] Yet, like banks, private credit funds are run by human beings. Just like bankers, we suspect private credit fund managers enjoy making money, too. We'll bet that they eventually get overly excited about lending to a particular industry (Electric Vehicles? Midtown Manhattan Office Real Estate maybe?) and end up thinking they "have a corner on the market" That's when the gallows await!

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David Boudreau, Vice President, Financial Advisor, Portfolio Management Director

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[1] https://www.legendsofamerica.com/we-tomhorn/
[2] https://www.barrons.com/articles/private-credit-funds-alternative-assets-carry-risks-12ab8a09?mod=past_editions
[3] https://www.bloomberg.com/news/articles/2023-10-27/what-is-private-credit-and-how-does-it-work