Ep #296: Kevin Fechtmeyer - Business and Investment Strategies in the New (Post-Election) Economy - Part 2

Full Episode Transcript

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Dr. David Phelps

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David Phelps: Hi, it's David here. This is part two or week two with my ongoing discussion with Mr. Kevin Fechtmeyer. If you missed last week's episode, you'll definitely want to go back and catch that one. This week, Kevin and I will go into some depth on the investment opportunities that the retail public never sees. That's about alternative investments, what we do in Freedom Founders. How to know how to do it, who to invest with, what their experience levels are, and how you deal with asset bubbles, like we have right now in both the stock market and in alternatives like real estate. How do you know? What do you do? How do you hedge against the unprecedented moves that the federal reserve has made, the uncharted waters that we're in today? Enjoy the session with Kevin. I know you'll love it.

I'm going to take some of your experience and knowledge and turn it a little bit more towards what I tend to focus on just in my world and my experiences, which has been real estate, and one of the things you said in your newsletter is ... Well, let me take it here. Who are your investors? What's an ideal investor? What are the qualifications to invest with Cave Creek Capital, for instance? What does that look like?

Kevin Fechtmeyer: Well, that's a good question. They're long time friends and CEOs and members of our past boards of directors. They would be generally Reg D, high net worth qualified individuals, almost every single one. There are 58 of them right now. They invest ... Again, everyone's different, whether you invest $50,000 or five million, everyone's got a different financial profile, but A, they're helpful in the sense that they show us deals and they think about us and they're very smart people that are plugged into the network of businesses that allow us to see your deals and learn about new deals, and that's been very helpful. We've got everything from former governors to former senators to former groups that were very visible private equity groups, where the managing partners are looking to do smaller transactions personally, and then there's mostly CEOs, mostly executives that bring a skill set that help us. No offense, but it's not a hundred dentists who are passive investors. We're generally looking for other business owners and executives who can bring our intelligence level up on certain industries.

David Phelps: No, I get it, and that's why I want to get some clarity, because access to the network that you have is not something you can just write a check to have. You want some participation, you want to, you said, raise your level of intelligence and your access points. That's what gives you the firepower, along with the capital you have, to do vet the number of deals you have to bring it down to the best of the best. You want to be able to cherry pick in any environment. The more deals you have to look at, the more access points you have make sense.

Kevin Fechtmeyer: That is correct in theory. In practice, let's just say every week is different and you never know what deal is going to end up happening when you think it's all lined up, and then other times, things come out of the blue where we don't have any experience or relationships, and we end up doing it.

David Phelps: So in your newsletter, you talked about the best approach today is to have an opportunity, as an investor, to be able to target specific investments versus blind pool funds. So I need some help with that, because I look at blind pool funds, and specifically, I talk about real estate, my area, with a "good fund manager", which is critical to the conversation, the diversification the blind pool fund allows seems to be a positive. Certainly I also invest in targeted deals, typically syndications in our world, that are facility-specific. So help me with that a little bit. Why targeted specific investments versus the blind pool?

Kevin Fechtmeyer: Well, it's really what our investors like. I don't necessarily think it's the best way every time for everybody, but people like to look at things and make their own decisions. I encourage people not to second guess. We've had people, they've got a couple of kids going to college and they can't invest quite as much. So if they had, say, committed a million or five million dollars to a private equity fund over a 10 year period, I don't know many people who could predict their liquidity over the next 10 years. That's not easy.

So what our method allows people to do is to say, "Hey, I really like this area, so I'm going to, let's say I put

$500,000 in this deal." He's very excited about this area. Let's say a typical high net worth person. We encourage never to put more than, say, two to five percent in any one deal. So they may say, "You know what? I'm not as thrilled about this area, but I trust you that it's got some merit to it, so I'm going to put a hundred thousand dollars into this one."

Essentially, we encourage everyone to invest at least a certain amount that they're comfortable with and to go up from there, and usually there's a couple large investors that are kind of leading it, and then historically, me and my two or three partners, depending on the deal, will put in one third of the equity capital ourselves. So we generally, in all cases, are the largest individual investors. So it's really not necessarily you trying to supersede another investment to a manager's judgment. That's a very good question, because I couldn't second guess a tech investor. They tell me that a cloud-based software company is better than another cloud-based software. I would have to trust their judgment. So part of it is picking the manager, but part of it is just understanding where you personally are comfortable in size and timing and all that. A lot of people, they commit to a year fund and then they get divorced or there's a terrible event, they can't continue to fund it, they're stuck. They forfeit a lot of value because of that.

David Phelps: Is there a secondary market and private equity for buying those interests of people who need liquidity, but are tied up? Is there a play there?

Kevin Fechtmeyer: Yeah, there is an LP, an active LP secondary market the funds themselves. So a fund may have 10 positions in different companies, and there are people who buy those LP interests. The area we want to get into and are more interested in is actually buying individual companies out of the LP portfolio, so we think that's the next phase of private equity, which ultimately gives it more liquidity and more credibility and more transparency over time.

David Phelps: Going back to what you said earlier about the Fed sugar high, central bank policies have taken interest rates down to historic lows, close to zero, in some cases, negative interest rates. The fact that that's going to reduce the expectations for yield, both in the public markets, for sure, and also in private equity. You believe that we really become kind of embedded or addicted to these low interest rates. What could potentially, in your opinion, move interest rates? How could they move and head back up again? What factors could lead to that, if anything?

Kevin Fechtmeyer: Well, this is venturing into an area in economics that really smart people still don't have answers to, but I do know that the very worst case is if we continue to screw up our own budget deficit and the dollar ceases to become a reserve currency, then we become like any other developing nation who's balanced payments are out of whack, and we have inflation, depreciation and all the rest. A lot would have to happen for that to occur, but my long-term concern is that the dollar loses credibility in the international markets, and we've got a rare case where the US can control a lot of its own interest rates.

A lot of the world's trade and debts denominated in dollars, and the federal reserve has unprecedented power to set rates. There's very few entities in the world that have that power. The EU, ECB and us. We're in the world now managing these rates, independent of real market forces, and I think there's more risk and more volatility that we don't see that is embedded in this, and that's concerning to me. When rates go up, that's a good thing or a bad thing, depending on whether you're a borrower or a lender, but if you're trying to run a business ... I've been in countries where you don't know what the currency's going to do next year, and it's very hard to have long-term contracts, to plan, to get long-term capital, so I hope to god the US never gets there, but we're running some risks here that are really much bigger than what people realize.

David Phelps: With those risks ... Again, in your newsletter, you mentioned that general partners are forced to focus on return of capital today more so than growth, which is what private equity typically has looked for past the growth, which diminishes their value as an entrepreneurial partner that's changed the character of a vast majority of private equity funding groups from capital gains driven principles seeking to multiply money, to fee-driven asset managers seeking to grow assets. I think I see the exact same thing in real estate, with the bubble right now, is where's the value play? When you have a bubble here, where do you find it? So there's a tendency, in many cases, for people just to be driving the base of acquisition. Is that what we're talking about here?

Kevin Fechtmeyer: Yeah, unfortunately it is, and the more zeros, the more temptation there is to do that, the less, you have an alignment of interest with the investor and the manager, it just snowballs, not because they're doing anything illegal, but the incentives become misaligned, and this can happen anytime, but it just gets much more acute in a low interest rate environment, where you suddenly are getting most of the capital, and the manager's extracting most of the gain. That's never, long-term, a good thing, and again, it doesn't mean that you have to restructure how managers manage investments, probably over time, it's happening very, very slowly. I don't ultimately know how quickly this alignment and how this alignment will get back into gear. We just, unfortunately, have to be ready for lower rates. We're in a lower return world, and either you save more or you accept that you're going to have to work longer, or a combination of both.

David Phelps: Lower yield environment combined with potentially higher taxes in some form or fashion? Yeah, it does bode for having to work longer and harder. It's hard to grow your equity and ... Potentially harder to keep it.

Kevin Fechtmeyer: Yeah, that's another way to look at it, absolutely.

David Phelps: A couple of other points you made in the newsletter, which I think people miss, but you said, again, this is lessons from your 25 years of experience. What lessons have been you learned that you're looking at for the future, and number one was boring can be beautiful. It's really my mantra in real estate. I'm not a speculator. It's more of a trading position. The short term arbitrage in markets that are more volatile, east coast, west coast in real estate, I tend to stay more mid-west in investments and really focus on the boring, the cashflow. If there's going to be appreciation or inflation in the marketplace, then yes, I'd like to capture that, but again, give me a little bit more on that statement of boring can be beautiful.

Kevin Fechtmeyer: Well, in the business world, just having long-term relationships becomes an incredible asset, because that becomes a more dependable source of revenue, and if you have reasonably predictable margins, you can plan your business. I don't know about real estate, I'm not an expert in real estate, but you generally have a sanity check of where a property is overvalued or undervalued, and so you want to go down right in the middle of the plate. If you're going to speculate, know when you're speculating. I think a lot of people don't know when they're speculating. I can't tell you how many people, the hard money lenders, they want me to participate in these loans and, "Oh, Kevin, it's 20% loan to value!", and I say, "Is the property occupied? Is there a rent?" "No, but the appraisal has it ..." Oh my god. That, to me, is they don't know their risk. They have assumed a level of risk that may be far, far different than what the reality is.

David Phelps: Yeah, well said. We had a discussion early on when the COVID shutdowns were happening, I think, back in March, and we were talking about some things there. We're not through with COVID. We don't know what portends for the fall. We've had massive stimulation in the unemployment sector and loans, cares act loans to many business sectors that ... I think, to a degree, artificially pump things up. Generally speaking, I know every sector is different. There are sectors that are killing it right now, there's sectors that have climbed through the last five months and seem to be back on a run rate, and there's others that obviously are not doing well at all, but in general, Kevin, what do you think? Is there going to still be more aftershocks from COVID that we need to look for for the next several quarters based on whatever sectors we're looking at?

Kevin Fechtmeyer: Yes. I think the way some of my smarter friends on Wall Street described it, they call it the 80% economy. I call it the 90% economy, because we bounce back fairly quickly, but there's a significant segment of the economy that's not bouncing back, that the rigidity of the sector and the unemployment ... I don't know who's going to hire all these pilots that are unfortunately laid off. There's a lot of talent now that was dislocated in less than a year that would have been a five or 10 year shift. So how quickly that last 10% of the economy bounces back is going to be a big question mark.

So right now, the market is bouncing all over. It's overvaluing some of the tech plays, and I think they're underestimating the rigidity or the structural unemployment that's been created by the pandemic, and the resulting shortfall and consumer demand and so forth. So I do think that there's going to be little shockwaves for a period of time, and we, in my view, did not handle this well, in many dimensions, but it's going to be at least a year before we know even where the last 10% is coming back, and the hope is that some of these growth areas will compensate for the 10% of dislocated employees, and that is a functioning adjustment that we can help either with government assistance or with just being there with the capital markets and funding good companies. We're looking at two companies, interestingly one in cleaning solutions, which is an innovative way to ship cleaning products, and then there's another one, believe it or not, in the cannabis space, which has now gotten a lot of attention, so it's adjacent to that area. So there are sectors that are hiring and there are sectors that are going to grow. So I'm not totally negative, but a lot of the valuation of assets today assumes a perfect recovery in a short period of time, and that will not happen.

David Phelps: Great insights, Kevin. Last question for you, and maybe I'm going to take this, again, down to the niche of the people that are primarily listening to this, small business owners, doctors, dentists. Anytime there's disruption in the marketplace, any sector, there are business owners, founders that decide, for various reasons, they're done. I've seen this already happened in our industry. Dentists in their fifties and sixties, after the COVID shutdown, they say, "I'm done," and hopefully financially they're in a place where they could do that, but, "The decision's been made, I'm out, it's over," and then there's others that financially won't come back, can't come back. Too much debt, too much leverage, can't make it through, never had those operations in place and in the margin in the first place. So my question to you, in any sector, including medicine and dentistry, there's opportunity for those that are strong and positioned well to take more market share. Would that be a fair statement?

Kevin Fechtmeyer: Oh, very much so. Yes. Yeah, we see that in all of our companies.

David Phelps: So basically, whoever you are, whatever your priorities are going forward, where you are in your career or your financial position, there's opportunities ahead, but you've got to have a network, you have to have your eyes open, you need to have the capital-based ability to take advantage of it, but if you can do that, there's opportunities coming out of this.

Kevin Fechtmeyer: Yeah. I definitely believe that, and it's happening, as you well know, in many sectors already. Meal delivery to online delivery that replaces what was a traditional grocery shopping trip or a restaurant visit. As you well know, the fitness industry is rapidly going online. So there are all of these hybrid consumer models evolving, and people who are smart and quick witted and satisfy customer demand, they're going to make it work, and we're going to see some real success stories out of this.

David Phelps: Innovation is the key to solving current problems. That's what makes this country as strong as it's always been. The entrepreneur on the street figuring out solutions, reducing friction for consumers in any way they can is where markets grow.

Kevin Fechtmeyer: Absolutely, and we're seeing it, we'll continue to go. As you know, I worry that if you end up with a swing politically in the extreme direction the other way, just don't ever make over $400,000 or sell your business for more than $400,000, or you're screwed. You've got to be careful.

David Phelps: Well, as you said, these policies, tax policies are in place in other countries currently and the past, we can learn lessons from them. That's a discussion for another day, but Kevin Fechtmeyer, I appreciate your time today. A lot of great insights. I think our discussion today will be very valuable to our listeners, so I appreciate your time.

Kevin Fechtmeyer: Great. Well, thank you very much. Bye-bye.

David Phelps: See you, Kevin.

All right. That concludes my two week discussion with Mr. Kevin Fechtmeyer. I hope you enjoyed it. I will have Kevin back again, especially after the election end of the year, starting 2021, just because of his knowledge base and experience. We'll peel back the layers more and more and give you some insights that probably you won't get anywhere else. Thanks again for listening. I'll see you next week.

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