



Caveat Emptor

One of the first lessons I learned in Contracts class in law school was *caveat emptor*, buyer beware, the principle that the buyer alone is responsible for evaluating quality and suitability before making a purchase. In theory, this principle should not apply to financial services when a consumer is working with a fiduciary. In practice, however, it often does. And if Wall Street gets its way, it will apply even more forcefully to a new category of investments being introduced into 401(k) plans: private equity (PE) and private credit (PC).

At its core, PE and PC are simply investments in private companies, equity ownership or debt lending. Private companies make up more than 80% of the U.S. economy, and individuals and institutions rely on investment firms to create PE and PC funds that provide access to these opportunities. Historically, these firms focused on the largest private companies and raised capital from the most connected investors: major institutions and ultra-wealthy individuals. In exchange for locking up their money for many years, investors were rewarded with higher returns than those available in public markets, largely due to the illiquid nature of these investments.

As the industry matured, attractive deals became harder to find. Investment firms first moved down-market to middle-market companies, where deal flow remained strong. More recently, they have been pushed even further, investing in very small businesses, think of your local HVAC company. At the same time, these firms needed more capital, so they expanded their investor base, welcoming smaller institutions such as local universities and, eventually, any accredited investor. When the Federal Reserve lowered interest rates to near zero, the present value of future cash flows surged, and PE and PC firms deployed enormous amounts of capital.

Fast forward to today, and many of these firms are effectively stuck. The companies they acquired are often worth less than what was paid for them, and the companies that borrowed money must now refinance at significantly higher interest rates. There are few remaining institutions or accredited investors willing to absorb these investments. So, where does the liquidity come from?

According to the Federal Reserve, roughly \$10 trillion is currently held in 401(k) plans. The executive order titled “*Democratizing Access to Alternative Assets for 401(k) Investors*” created the regulatory pathway to open this pool of capital to private investments. While there may still be select opportunities in this space, individual investors should not assume that their 401(k) plan fiduciary will protect them. When Wall Street, or any investor, is aggressively trying to sell you an investment, it’s worth taking a long, hard look before buying. If these investments were truly as attractive as advertised, would they really be offered to you inside your 401(k)?

Best,

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