Basic Capital's Big Idea: Bet Your Retirement on Interest Rates

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I just saw a Tweet for how Basic Capital [a] can help you 5x the size of your retirement portfolio by borrowing money.

There's definitely a way to lose all your money.

But more importantly, Basic butchers the entire philosophy of investing for retirement.

So what is Basic offering and should you take them up on it?

- You give Basic Capital control of your 401k or IRA.
- Basic Capital lends you $4 for every $1 in your account. They charge you ~6.25% for this privilege [1].
- Borrowing that $4 costs $0.25 / year but there's a solution to cover that cost!
- Take $4.25 of the $5 available and invest it in bonds [2] that pay you more than the interest you pay Basic.
- Invest the remaining $0.75 in the stock market.
- The money is locked up for five years.

How should you think about this retirement portfolio?

Obligatory disclosure that I'm just some guy on the internet - not your financial advisor!

It's generally recommended (especially for young people) that you should be almost entirely invested in stocks [3]. Investing in American stocks is betting that American companies and the country's economy will be worth more in the future. This has been a really good bet if you have a multi-decade time horizon! I am personally very excited to bet on America - especially on the 40+ year time horizon before I retire.

But Basic is asking us to turn 25% of the money we'd otherwise put in stocks into 425% bonds. How should we think about those?

Let's say interest rates go up 5% as they did between 2022q1 - 2023q3

Your cost to borrow $4 rises from $0.25 / year to $0.45 / year.

If the bonds you bought have a fixed interest rate, you don't make any more money per month. You have a monthly deficit [4] and even worse, since new bonds would be issued at a rate that makes more money, your bonds are less desirable and go down 25% in value [5]. You borrowed $4 to make a $5 portfolio but the whole thing is now only worth ~$3.93 [6]!

This means you've technically lost $1.07 on a $1.00 investment and the interest you're being paid doesn't cover the interest you have to pay each month.

That means one of two things would happen:

SVB fire sale: [7] Your lender watches this start to happen and gets nervous. They force you to sell the bonds and some of your stock to pay them back. This could happen slowly or all at once.

Margin call: Your lender forces you to contribute more collateral to keep them from liquidating you [8].

If the bonds you bought have a variable interest rate it's a little less bad but you'll probably still lose a good bit of money [9].

And those are the two issues with Basic:

You've changed your retirement account to be a bet on interest rates being stable (or decreasing) over the next five years instead of on the American stock market / economy growing over the next 50 years [10].

And you have some large risk of losing all of the money you invest if interest rates climb a lot.

Unfortunately this is the problem with most all complicated consumer financial products — they shift considerable advantage to the company that has 10x more time to think about the transaction [11].

So how do I personally think about how to make an investment in something claiming to beat the market [12]? I ask myself why I'm special — and I better have a pretty good answer!

There's a world of people who spend decades of their lives trying to find and make good investments and even they struggle to beat the market!

There's only a few times when you should be able to make better than average returns:

- The government is subsidizing it [13].
- There's some regulatory arbitrage you're being paid to be a part of [14].
- The investment is too small to be interesting to big investors [15].
- You know something that's both non-consensus and correct about the world [16].
- You have some kind of special access (and be really really cautious about how valuable that actually is...) [17]
- You're being paid to assume some risk that you don't understand very well and it's too good to be true 💔 [18].

For all the clever packaging, the swap Basic Capital's offering is pretty simple:

They wants you to swap a decades-long bet on American growth for a short-term leveraged gamble on interest rates. That's not just risky — it's missing the point of retirement investing entirely.

Notes

1. Technically they charge you SOFR (overnight treasury backed lending rate) + 2%. This is an a pretty good rate. But then they also charge you lots of other fees!
   - 0.50% management fee (maybe on the borrowed money too?)
   - 5% fee on gains
   - $300 annual subscription fee

   Sheel Mohnot modeled the post fee returns profile here [b] and the performance looks even less impressive (4.5% CAGR). In this (optimistic) scenario where interest rates don't change, Basic Capital and its lending partners would make 5x the money you made in fees.

   As an aside there is some risk this structure is not permitted by the IRS and could invalidate your IRA's tax exempt status. The IRS prohibits using these "as security for a loan [c]." Basic tries to get around that by putting the portfolio in an LLC but the LLC sure seems like a "sham entity" that only exists to circumvent the rules. Any profits from the money you borrow might also be subject to a 21% UBIT (unrelated business income tax) rate [d].

2. Matt Levine's article [e] mentions "private credit opportunities" — lending money to other (riskier) uses to receive a 9% interest rate.

3. There have been a lot [f] of [g] articles published about Basic (and featured on Basic's website!) that aren't really about Basic — they're about whether you should borrow money on margin for what you'd normally buy in your retirement account — eg a portfolio of 125% or 150% stocks. This isn't the portfolio Basic wants to sell you. They're offering a portfolio with 75% equities and 425% long-dated bonds.

4. Since the portfolio would probably now have "negative carry," you need to make a contribution each month to cover the difference between what you're paid and what your cost to borrow was. You'd do that by making additional contributions or liquidating some of the portfolio (which probably makes the whole situation worse since you're realizing losses).

5. Price change = -Duration * Interest Rate Change → 5 years * 5% = 25% decrease

6. 4.25 x 0.75 (bonds) + 0.75 (stock) = $3.93 I'm assuming the stocks stayed the same value but their value might also go down when interest rates go up like this!

7. This is the same situation SVB was in. They purchased bonds at low interest rates and a long duration and when the interest rate went up, the bond's value went down and they were technically insolvent (even though they could have just held the bonds to maturity and everything probably would have been fine!)

8. It's unclear if this would even be possible since IRA and 401ks have contribution limits ($7,000 and $23,500 respectively if you're in Basic's young professional target market).

9. It's not much better if the bonds you bought have a variable interest rate. Variable interest rates mean that the person that owes you money now needs to make a payment ~twice as large. If the buyer can't pay you or renegotiates how much they'll pay, your bond is now also worth less than before. Either way, your portfolio is highly levered, worth a lot less, and your lender is very nervous.

10. Stocks will certainly go up and down over this same time horizon but a stock has an indefinite life. Bonds have a fixed duration and you should probably care about what's happening when they reach maturity and expire.

11. You might be able to gain some "edge" by maximizing a system like credit cards that other people don't think about (I literally wrote a guide for this lol). Chase probably lost money on the Sapphire program from 2016-2024 [h]. But even then, the bank probably comes out ahead by winning a large chunk of the financial business you'll do over your life.

12. "Beating the market" here means receiving a return in excess of what could be expected for the given level of risk you're taking. See [18]

13. The Basic Capital team talks about wanting to create an "FHA mortgage for investing [i]." This is an interesting goal (I am directionally in favor of Senator Booker's "baby bonds" / American Opportunity Account proposal) but it misses the underlying aspects of both an FHA loan and the 30 year fixed rate mortgage — they're not viable financial products without a subsidy / guarantee from the government!

14. This is the most charitable possible way to view Basic Capital. The story goes something like:
    - banks want access to this cool new thing called "private credit"
    - regulators told them they should loan money to consumers instead
    - lending to Basic Capital's customers is basically a backdoor to something that the banks think resembles private credit

15. A popular private equity playbook is literally to buy and bundle up very small businesses and sell that bundle to a bigger private equity firm. The bundle is worth more than the sum of its parts because it's (presumably) more resilient than any individual part and it's more interesting to a larger group of investors.

    There's a sweet spot in real estate investing that also rewards small (but not too small) scale since a professional firm has a ton of overhead and would rather invest $100m at an 8% return than $2m at a 12% return.

16. This is possible (especially at a small scale) but really really hard to do consistently. This is what makes Warren Buffett Warren Buffett. We should collectively be skeptical that we or anyone we know is the next Warren Buffett!

17. Bernie Madoff and lots of other frauds started with “special access!”
18. All investments happen on some risk vs return curve but it’s probably a bad idea to pick up pennies in front of a steamroller [j]. The investment tranche that was first to lose money among a series of investors had a name in 2008: toxic asset

Links

a. basiccapital.com
b. x.com/pitdesi/status/1922399841227046944
c. irs.gov/retirement-plans/plan-participant-employee/retirement-topics-prohibited-transactions
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