Finding Investment Opportunities in Today's Credit and Real Estate Markets

by Timothy D. Welsh, CFP®

The famous economist Joseph Schumpeter wrote in 1951, "Economic life is a unique process that goes on in historical time and in a disturbed environment." No better description for the last few years in the U.S. economy! However, history has shown that when markets become dislocated, opportunities emerge for savvy investors.

Navigating economic and business cycles is nothing new to the financial planning profession. Advisers often show their true value by helping clients understand the inevitable ups and downs of the markets, identifying opportunities along the way, and continually positioning their portfolios to help them reach their long-term goals.

In today's disturbed economic environment, two areas where advisers may find opportunities to add value to their clients' portfolios are in the credit and real estate markets.

Recently, in select markets around the country, we have seen strong activity in real estate transactions, resulting in upward pressure on prices. For example, the Case-Shiller index for home sales for the five-county San Francisco Bay area rose 5 percent in 2009, with further signs of strength across the board in the first quarter of 2010.

Despite these encouraging signs, traditional lenders are not stepping up to offer credit to meet the demand of borrowers for a variety of reasons. According to research conducted by the *San Francisco Chronicle*, more than 22 percent of home sales in the Bay Area in 2009 were all-cash transactions, a remarkable occurrence for *Forbes Magazine's* fourth most expensive city in the United States. Clearly, traditional banks and mortgage lenders are under pressure from increasing capital requirements, troubled loan portfolios, TARP restrictions, and a general risk-averse attitude, making it extremely difficult for them to extend credit, even to highly qualified borrowers.

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Private Mortgage Lending Opportunity

This gap between the supply of mortgage loans and demand creates an excellent opportunity for an alternative solution to traditional lending. Known as "private mortgage lending," this category of mortgage financing offers high returns to investors who make loans directly to borrowers secured by individual or pooled deeds of trust. Borrowers are willing to pay a premium on these types of mortgages to get access to financing they might not otherwise have access to, because of their situation and the current tight credit markets. Another reason borrowers are willing to pay a premium is that private mortgage lending can often be made available in a matter of days, versus the several months it may take for a traditional mortgage to be underwritten, approved, and funded.

Private mortgage lenders raise money from investors—either directly or through investment professionals—to fund mortgage loans. Investors are able to participate in individual loans, fractionalized trust deeds, or in a pooled fund of several loans. Unlike individual or fractionalized trust deeds, a pooled fund of loans provides loans across numerous properties, adding to diversification and lowering concentration risk, in addition to paying out an attractive monthly coupon, typically around 7 percent.

Some advantages to using a professional private mortgage lender are that they provide objectivity in performing the due diligence on the properties and borrowers to ensure that the loan-to-value ratio is low, providing a substantial equity cushion in case of default, along with the industry experience to successfully manage the loans in the portfolio.

Once a loan is funded, a private mortgage lender services the loan and manages the borrower relationship and payment schedule. Although it may sound simple, choosing an experienced, competent private mortgage lender to invest with is essential for successful trust deed investing. This is a niche lending area and advisers should do extensive due diligence on the fund manager to validate his or her track record, compliance culture, experience, and expertise in the industry.

Providing Alternative Fixed Income Solutions

From a financial planning point of view, pooled trust deed investments in particular provide an alternative, fixed income solution to enhance returns and help diversify fixed income portfolios. For many advisers, the current low interest rate environment is creating challenges to finding ways to generate income without moving further out on the yield curve and taking on added risk. And in a rising interest rate environment, pooled trust deeds can provide a hedge against rising rates because new loans are added to the portfolio at higher prevailing rates when older loans at lower rates mature.

With interest rates set to rise—they can't go lower—now is the time to begin re-positioning your fixed income portfolios to take advantage of changes in the markets. Alternative approaches such as pooled trust deed investments are quickly becoming an attractive solution to helping advisers and their clients better manage their portfolios. According to FPA's *2010 Trends in Investing* survey, 50 percent of advisers who currently use or recommend alternative investments plan to increase their use in 2010. And among those who do not currently use alternative investments, 20 percent say they plan to begin using them in 2010. A recent Rydex survey reinforces the growing use of alternative investments, finding that nearly 90 percent of advisers will be increasing their use of alternative investments in the coming year to respond to the challenges and opportunities of the current markets.

The current tight credit markets along with appreciating real estate markets are creating an excellent time to be a private mortgage lender. This dislocation allows private mortgage lenders to be more selective in the loans they make, dictate more favorable terms, and provide a valuable solution for financial advisers to bridge the gap in the current "disturbed environment" that Joseph Schumpeter so eloquently described nearly 60 years ago.

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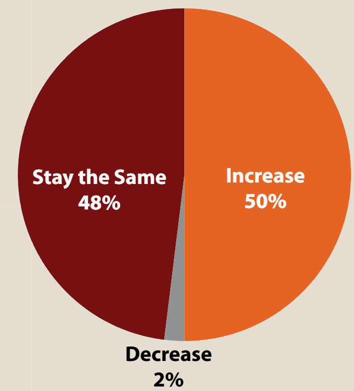
Do you expect your use/recommendation of alternative investments to increase, decrease, or stay the same over the next 12 months?



Source: FPA's *2010 Trends in Investing* survey

What types of alternative investments do you use/recommend?

Commodities	88%
International/global real estate funds	74%
Currencies	40%
Futures	26%
Structured products (including equity-linked notes)	21%
Other*	18%

*Other includes a list of 28 investments, such as private equity, managed futures, and hedge funds.

Source: FPA's *2010 Trends in Investing* survey

Alternative Investments Continue to Gain Acceptance

For the past three years, FPA survey data have shown a growing use of alternative investments among advisers. As advisers search for asset classes and investment vehicles that will perform differently than traditional long-only strategies, what were once considered outside-the-box choices—including international/global real estate funds, futures, commodities, currencies, and structured products—are becoming more mainstream.

In 2008, about 17 percent of adviser respondents to FPA's annual *Trends in Investing* survey were using/recommending alternative investments, allocating an average of 1.3 percent of assets under management to alternatives. In 2009, 32 percent of advisers were using/recommending alternative investments, allocating an average of 5.4 percent of AUM to alternatives. And in 2010, the percentage of advisers who use/recommend alternatives increased to 44 percent, with a slight increase (to 5.5 percent) in average AUM allocated to alternatives.

In 2009, 43 percent of respondents said they expected their use/recommendation of alternative investments to increase, compared to 50 percent who expressed the same expectation to use more alternatives in 2010.

Also, among advisers who were not using alternative investments in 2009, 10 percent said they planned to begin using them in the next 12 months. FPA's *2010 Trends in Investing* survey shows an increase in this cohort as well, with 20 percent saying they plan to begin using alternatives this year.

With economic uncertainty still lingering, investors and advisers will likely continue to demand products that are effective diversifiers, looking to various alternative investments to meet that need.

—Carly Schulaka