SPECIAL FOCUS: INFLUENTIAL WOMEN SHAPING PRIVATE LENDING

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PRIVATE LENDER

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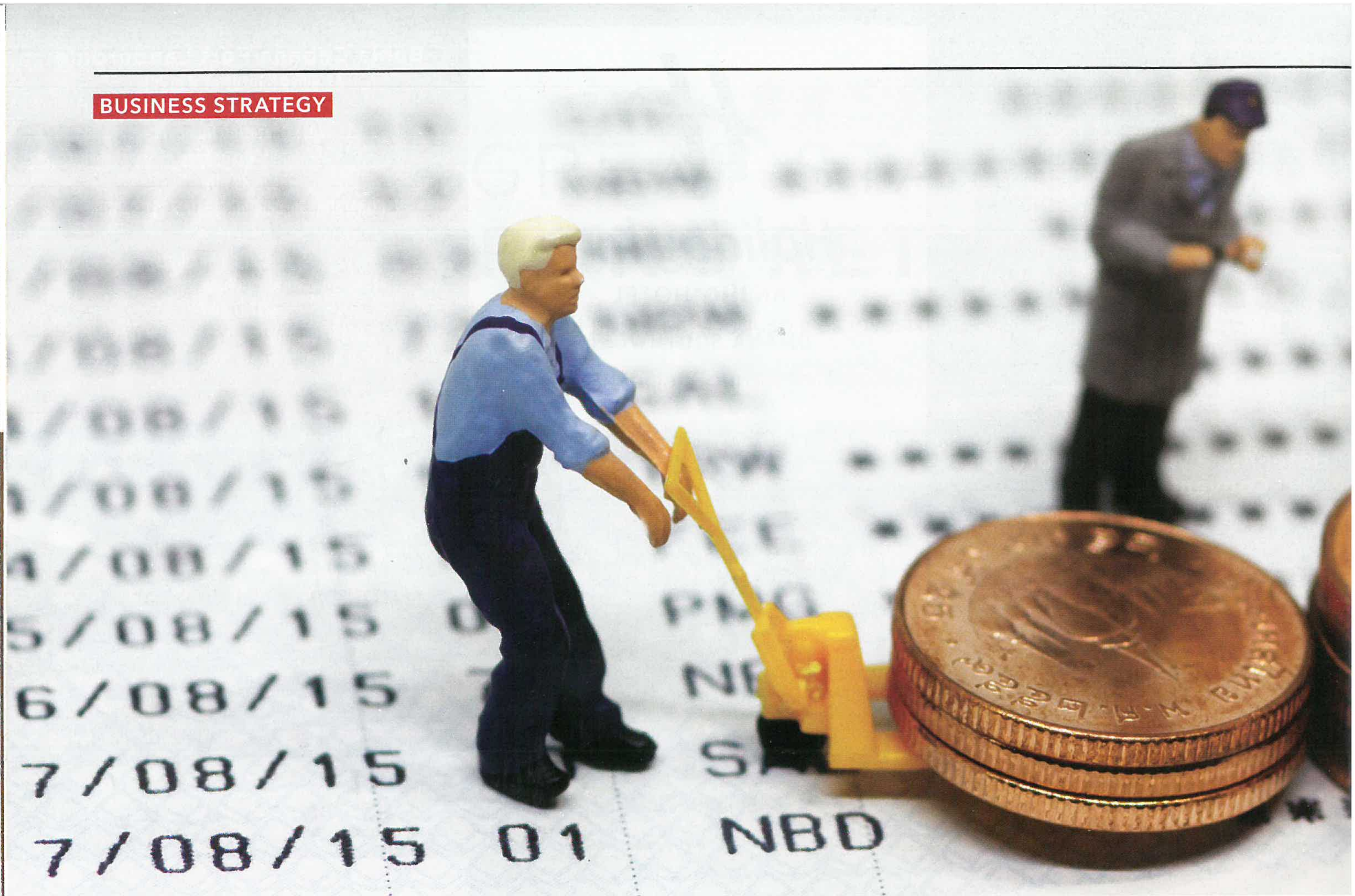

PART 3 OF A 3-PART SERIES

PITFALLS OF TRUST DEED INVESTING: LACK OF DIVERSIFICATION

Trust deed investing is generally considered a safe investment, but there are risks—just as there are for any investment. In this three-part series, we are tackling some of those risks. In the last two issues of Private Lender, we addressed conflict of interest and loan-to-own under-writing. We conclude the series in this issue, with a look at lack of diversification.

by Carrie Cook

PITFALL #3 - LACK OF DIVERSIFICATION

When you invest in the stock market, do you put everything in your entire portfolio into one stock? Would you put your entire life savings into one property? Of course not, it just doesn't make sense.

If you allocated $100,000 of your portfolio in trust deed investments, you should not put the whole $100,000 in one trust deed investment. You need diversification across borrowers, location and asset type.

If you are investing in trust deeds and you are with a mortgage broker who specializes in only one state, that is not diversification. If you invest with a company that only has one borrower, is that good diversification? What if the borrower mismanages funds one year and files for bankruptcy? Or maybe the borrower is only underwriting loans on residential property. Would that be good diversification? No, that is lack of diversification—and that is a huge pitfall.

When you are looking at investing in trust deeds, you do not want to put all your eggs in one basket.

SOLUTION #3 - LACK OF DIVERSIFICATION

If you are investing through a mortgage broker, you want to invest with a company that does not make you put a huge amount of your principal into one loan. A low barrier to entry allows you more diversification. An investment that allows a $10,000 minimum investment provides more diversification within your portfolio than an investment that starts at $100,000. If you do have $100,000 to invest in trust deeds, you want to diversify and put it into several loans.

There are four ways to maintain diversification with trust deed investments.

01 **Investing with several borrowers.** Not just one, not just two, but several different borrowers so that you have options when putting your funds into their projects. Remember, if a borrower has a loan in default, it is not typically one loan, it is their entire portfolio. If you have all your investments with one, you may be in for a long ride should the borrower have financial problems.

> "You need diversification across borrowers, location and asset type."

02 **Market diversification.** This option is probably the least considered, primarily due to location familiarity. When making this decision take into account the last real estate collapse. A well-diversified trust deed investment portfolio weathered the storm, since not all markets reacted the same to the downturn. Some experienced a 90 percent correction, while others only 10 percent. Every market has varying degrees of market drivers and conditions that you must consider. No two markets are the same.

03 **Diversification within loan type.** Your options in this category are the most robust, and you should consider them carefully because market conditions drive demand with loan type. Options may include, but are not limited to, land acquisition, development and construction of single and multifamily residential and commercial office and retail space. This category may also include bridge financing on existing income-producing structures for short durations until bank financing is obtained. Depending on market conditions, not all the options may be appropriate.

Consider the rule of supply and demand when making this decision. You would not want to invest in commercial office

space in a market that has 70 percent commercial office space standing available inventory and the remaining 30 percent at less than 50 percent occupancy. Steer clear of this loan type in that market. On the flipside, a market with one month of home inventory with job creation of nearly 10,000 entering the market in the next 60 days due to a new Google headquarters opening may be a good time to invest in a single-family development project 10 miles from the Google headquarters.

04 **Diversifying in the term or duration of the loan.** You may be asking yourself, why? A typical real estate investment is for many years, whereas trust deed investments are short-term, typically six to 12 months. This is primarily due to the higher rates charged. A borrower cannot afford to pay the higher rates for long periods of time, thus moving through the project quickly or obtaining better financing within short order. If you are strategic with when you invest your funds with trust deed investments, you could create a monthly or even quarterly schedule based on loan maturity dates. Do not get caught in a long-term real estate investment that does not provide flexibility for payoff of redemption for long periods of time, unless you have a crystal ball and know what is going to happen with the value of real estate in the next three to five years.

It is hard enough to find one good mortgage broker, but challenge yourself to find two to accomplish an even better blend that gives you more options to minimize your overall risk and to protect and preserve your principal.

PULLING IT ALL TOGETHER

Now that you know about some of the pitfalls of trust deed investing, you will be acutely aware of what to watch for regarding conflict of interests, loan-to-own underwriting and lack of diversification risks. Instead of falling into those traps, you can look for a mortgage broker who is working on behalf of both the borrower and the investor, who is invested in the performance of the loans they underwrite and who encourage investors to diversify not just within their trust deeds, but within their entire portfolio. ●

Parts 1 and 2 of this series are available at www.aaplonline.com

ABOUT THE AUTHOR

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Carrie Cook is the president of Ignite Funding; CEO of Preferred Trust Company and COO of iManagement Group. Since her appointment at Ignite Funding, Cook has led the team to fund more than $315 million in loans with investor capital. Cook currently manages a capital client database totaling more than $85 million in real estate investments and is a licensed mortgage broker with the Nevada Mortgage Lending Division. As chief executive officer of Preferred Trust Company since August 2014, Cook redeveloped the custodial services business, ensuring clients effectively and accurately utilize their retirement funds to invest in alternatives such as real estate, metals and LLCs. Cook oversees the custody of approximately $250 million in client investments and cash holdings. As the COO of iManagement Group, she specializes in managerial services of investment funds.