



A Terrific Opportunity That Might Be Flying Under Your Investment Radar **Tom Anderson, President & CEO, PENSCO Trust Company**

I have known many investors who have done nothing more than invest in one asset type over the years, content to get a steady 9-12% annual return, virtually without fail. This asset is not purchased through, nor does it correlate with, the publicly traded stock market. While the investment certainly has its own vulnerabilities to risk, if properly managed, investors have the potential to see these sorts of returns on a consistent basis. What is this mystery investment? Sometimes called mortgages, but more often called trust deeds or 'hard money' loans, these are secured investments consisting of loans made to borrowers that are typically secured by real estate (e.g., the primary residence of the borrower). In other words, they resemble the kind of loan a bank makes to you when you buy a home, with the exception that they are generally sub-prime, and they exist and yield higher returns because most banks won't do them. That's because banks extend loans based on the creditworthiness of the borrower supported by the appraisal on the property. Banks do not want or expect to force the property owner through a foreclosure, a generally messy, protracted and expensive process. Hard money lenders essentially ignore the credit situation of the borrower and focus primarily on the owner (borrower's) equity in the property, and supporting appraisals.

This article will explore these investments in more detail, explaining how and why they work and what to look out for to decrease your investment risk. You are probably well aware of the demise of a number of institutional lenders in the sub-prime marketplace that got caught between falling real estate values and borrowers who were suddenly unable to pay on ARM mortgages whose rates began to rise. To avoid the same mistakes, hard money lenders follow some basic rules--primarily not to extend loans with a loan-to-value (LTV) ratio exceeding 70%. As you've probably noticed, banks are often willing to loan up to 100% LTV because they are 'banking' on the borrower's good credit and the expectation that the property will appreciate in value, but they don't like to make loans to a borrower with poor credit. Ironically, this reasoning is exactly what makes these secondary market loans work for private investors, because the terms of these loans tend to mitigate any down-side results. For example, a bank may be willing to make a 95-100% loan (0-5% down) to a borrower who has a good credit score today, only to find that their borrower gets laid off, forcing the bank to foreclose. With only 5% equity, especially in a declining real estate market, the bank will be fortunate to get out without losing money. On the other hand, a hard money lender (e.g., investor) may be willing to extend a first or second mortgage to an individual with very poor credit and who might even be unemployed. Why? Because the borrower might have 40% equity built up in the property that is securing the loan. This not only means that the borrower has a vested interest in making the payments (retaining his equity), but that if he should not, there is a decent cushion built in to soften the lender's fall. In fact, if such a borrower failed to make payments and a foreclosure resulted, the hard money lender might actually earn more after the sale of the foreclosed property than he would if the investment had functioned as planned to maturity.

You may wonder whether this kind of lending could be considered predatory because of the higher interest rates, yet in many cases, just the opposite is the case. In fact, the existence of these secondary market loans and lenders is often the only recourse some borrowers have to actually save their homes during an economic crisis such as a medical emergency, temporary disability or workplace displacement, etc. The loan, for this type of situation, provides the temporary funding to allow the borrower some time to recover by paying off the primary lender (the bank), thereby forestalling foreclosure. Sometimes used in conjunction with a land trust, these borrower- or demand-driven scenarios can actually prevent the bank from foreclosing. Thus, done correctly, trust deeds serve the capital markets as another important source of funds through a win-win relationship between the borrower and the lender/investor.

I can personally attest to how a “hard money” loan can effectively serve both the lender and the *borrower*. Many years ago, when I was just starting my business, I needed a hard money loan to help me out. I didn’t have a paycheck yet, as I was still in the start-up phase waiting for IRS approval to operate as a non-bank custodian. I had just about burned through my savings, and was seriously considering going back to a corporate job. I told one of my customers about the situation, and being a sub-prime mortgage broker himself, he recommended a hard money second mortgage on my house. I had sufficient equity to attract lenders and soon the resulting loan gave me enough staying power to get my business on its feet. As a borrower with substantial equity at stake, and with a high-interest rate loan to boot, the first payment I wanted to make every month was on my hard money loan. After a year or so, I refinanced my first mortgage with the bank and then paid off the hard money loan from the CPA who had extended it. I wonder today what would have happened if I didn’t get that loan. (Would PENSCO Trust Company exist?)

A long-time client of mine, Stuart Boren of Lafayette, California, says “I’ve been doing trust deed investments using personal funds for 20 years in total, and for the last 12 years through my 401(k) rollover IRA at PENSCO Trust Company. I service all my trust deeds myself, preferring to work closely with the borrower in case they have difficulty making payments. I have limited my IRA-held trust deeds to single family homes in suburban areas of California. To ‘spread the risk’, I usually have 8-10 loans of moderate size rather than a few larger loans. While banks typically focus on borrower credit, my loans are strictly ‘equity loans’, focusing on the home’s loan-to-value ratio. Even though these loans are obtained through a mortgage broker, I do my own ‘due diligence’ to confirm that the security of the loan is sufficient. I use resources on the Internet like zillow.com and realtor.com as well as online county public records and title company property profiles to determine property values before investing. Overall, I have had excellent success with trust deed investing and I have received yields of 9-13% year after year - for 20 years! The results have helped me sleep well at night, knowing that I am continuing to build my nest egg.”

So now that I’ve hopefully convinced you that trust deeds serve a legitimate purpose in the capital markets, let’s look at these investments more closely and learn why they are particularly attractive to tax-deferred retirement accounts such as self-directed IRAs. Instead of a Wall Street firm going to the nation’s largest fund (e.g., TIAA-CREF) for a \$100 million loan, an individual borrower taps investors’ IRAs as a source of secondary funding. Investors and IRA owners look at trust deeds as a way to get steady and attractive returns with moderate risk, while helping to protect their portfolio through diversification. Accruing inside IRAs, returns of 9-11% are actually equivalent to similar returns of 12-14% or up to 15%, because they are tax-deferred (or tax-free if within Roth IRAs), unlike similar investments made outside of retirement accounts. These loans typically range from \$50,000 to \$100,000 on an individual basis or, for commercial properties, a \$1,000,000 loan might be divided between four or five investors on the trust deed (deed and note). They tend to mature quickly, like bridge loans, and although the stated term might be five or ten years, they may pay off in six to eighteen months (and sometimes with a pre-payment penalty, which

increases the yield). But from the borrower's standpoint, this may be enough time for him to improve his credit score, allowing him to refinance conventionally and pay off the more expensive debt.

Investors who are familiar with trust deeds and who work with experienced independent mortgage brokers, like the fact that they can stay very close to how their money is being invested by looking at and reviewing each deal the broker presents. Independent brokers do most of the work as well, making the process easier for investors who would otherwise have to do appraisals and service the loans themselves (like Boren above). Brokers tend to add 2-3% to the cost, but investors still get a net yield of 9-12% as the brokers' costs are passed along to the borrower. California is one of the largest states for trust deeds and there are over 300 independent hard-money brokers here, most of whom can be found at www.californiamortgageassociation.com. Or simply search for "private loans", "trust deeds", or "hard money loans" on the Internet. It is very important that investors perform adequate due diligence on any broker(s) they choose to use, and check references and broker policies, particularly their loan-to-value (LTV) tolerance and practices. You will want to fully explore the broker's due diligence process, including their appraisal approach, evaluation of the market, and the credit analysis performed on the borrower, before proceeding to invest.

Once a note is selected and the investment is made, it is essential that an experienced person or entity stay abreast of the payments as they come due. The broker may offer this loan servicing function (that is, the loan accounting, collection and possible foreclosure processing). However, the investor may also choose to sub-contract the loan servicing out to independent firms that solely focus on this service. This provides an objective third-party check on the process and the borrower, as these servicers typically do not also act as brokers. For a nominal monthly fee for each note, they will invoice borrowers, and follow up on late payments and delinquencies until they are satisfied or legal action is taken. A good firm to consider can be found at www.sellerloans.com. Note Servicing Center, Inc. is a national firm that handles the servicing of more than \$1 billion of these types of notes. According to Tom Standen, President of Note Servicing Center, Inc., "Most important to investor clients is the assurance that their note's investment income is being handled accurately and that the yield is being reinvested into their retirement account in a timely fashion. Two other benefits [of using a note servicing company] are the ability to communicate personally with an account representative and being able to review one's account 'online' 24/7. We know this because we've been doing this for 23 years now."

To summarize: for many, trust deeds represent a low-risk, moderate yield investment that may work well to diversify one's portfolio. This is an asset type that does not fluctuate with most other asset classes, with the possible exception of real estate in general. So, for example, when the price of oil goes up, negatively affecting the stock market, there may likely be only a negligible correlation with the performance of trust deed investments. In fact, trust deeds perform much like higher-yielding CDs, when the underwriting and servicing are done correctly, because they are secured by the deed to the property upon which the loan is made. Granted, they are not as low-risk as bank CDs, but they are not as "alternative" an asset type as many might think. So whether you are a borrower or a lender/investor, get to know more about trust deeds as both a source of funds and a potentially sound investment that may yield consistent returns.

The foregoing is a general discussion. It is not intended as, and may not be relied upon as, tax, legal, investment or other advice. Readers desiring such advice should consult their own advisors.