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Achieving Strong Returns
In an Uncertain Investing Environment

A look at minimizing risk through mortgage investments, an often-overlooked alternative investment option

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Talk of an overheated stock market, as evidence by recent pullbacks, is growing louder. This is giving investors and those who advise them reason to seek alternatives that can deliver strong returns, while keeping risk in check.

With a relaxed regulatory environment, major changes to the U.S. tax code and an overall recovery from the Great Recession, equities have surged in recent years. Although this has been a boon for investors in most categories and the economy as a whole, nothing goes in the same direction forever. The signs are getting clearer that the stock market could be due for a significant correction, or at least an extended period of sideways trading.

On the fixed income side, there is uncertainty as well. In a May 2018 Guggenheim Group report, Scott Minerd, the firm's Chairman of Investments and Global Chief Investments Officer, said he's recommending clients be "positioned for choppier waters," noting the recent rise in interest rates and predicted the Fed will increase rates through 2019. CNBC's Andrew Osterland echoed this sentiment about bond market uncertainty. In an April 2018 story on the business news site he wrote, "After decades of generally declining rates and capital gains on bonds, investors may actually experience losses in 2018."

For high net worth investors, family offices, family foundations and endowments, where wealth preservation and producing a source of higher income while protecting against downside risk is a priority, the investing environment today presents a conundrum. If both the stock and bond markets are emitting warning signs (not to mention the economy, which some believe is headed toward a recession), what are some viable, short-term options for investors who seek to increase their cash positions for wealth preservation as well as position themselves for a resetting of asset valuations? Additionally, for those who are looking to manage their cash on a short-term horizon, what are some possibilities that have the potential to deliver meaningful, risk-adjusted returns, especially in an environment where the returns on cash positions are at near historic lows?

The answers to these questions vary, not surprisingly, based on investment objectives and risk tolerance. They can range from the traditional to the more unique, and even involve sectors that might not have been previously considered. Let's look at these opportunities and weigh their pros and cons:

- Bank Accounts: While investors can be as certain as possible about the security of their money with a traditional bank account, the opportunity to make any money is practically nonexistent. At the 0.1 percent interest rate that many major institutions offer, "Your money will double in 6,000 years," according to Mike Geri, financial advisor, at RBC Wealth Management. Even the 1.75-1.90 percent offered by some banks is not an attractive return to investors. The only benefit is the FDIC protection, although that only covers $250,000 per depositor. Based on current low inflation rates of about 1.90 percent, investors will lose money on an inflation-adjusted basis by putting cash in a bank account.

- Money Market Funds: Obviously with a return rate of somewhere between 1 – 2 percent, the money market fund is a low risk/low reward investment opportunity. Money market funds barely beat inflation, and in some cases, may not even do that. Because they focus on short-term government bonds (a few even hold triple A-rated corporate debt), the risk remains low. While they are insured for up to $500,000, should the brokerage firm fail, they do not protect against market loss.

- Government Bonds: Government bonds are essentially risk free because they are backed by Uncle Sam. Additionally, they are a highly liquid investment, so selling them and getting fair market value is a relative certainty. Not surprisingly, they offer a low rate of return, with the 3-month Treasury just crossing over 2 percent, and the 1-year is at just over 2.4 percent.

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- Investment-Grade Corporate Debt: With corporate debt, investors benefit from the predictable outcome of knowing what and when they'll get paid, provided the company doesn't default on its bond payments. Even if the business does fail, bond holders come ahead of shareholders in any applicable payouts. The rates of return are a function of the firm's overall credit rating, plus there's the issue of the bond 's term. Depending on how much time remains till the bond's maturity, that yield (currently about 3.9 percent for 1-year AAA corporate debt, which is low compared to the historical average of 6.92 percent), barely exceeds inflation.

- High-Yield Corporate Debt: The junk bond sector has been outperforming their investment-grade counterparts in recent months. John Lynch, chief market strategist for LPL Financial, said in a June research note that this is because these firms are "more domestically focused" and less likely to see significant impact of any trade war. However, the downside risk for this debt remains high because of potential default and insolvency.

- Mortgage Investments: Mortgage investments offer a risk/reward scenario that's designed to appeal to high net worth investors, family offices, family foundations and endowments. Mortgage investments can deliver regular returns of 7 percent or more annually, and because they're uncorrelated to the market and collateralized by real estate, risk and volatility are significantly mitigated.

About Mortgage Investments

Senior mortgage loans on commercial real estate deliver an investment alternative that provides the capital preservation investors seek during possible times of market volatility, along with a potential short-term return that is far more than traditional fixed income vehicles. To further the appeal, they do so with a well-collateralized offering, mitigating a sizable portion of risk, especially if the loan is in a senior lien position.

Investors benefit in many ways, including that these loans are secured by the underlying value of the property, be it an office building, shopping center, apartment complex, or industrial facility. The loans may be purchased in their entirety or as a participation interest within a loan syndication, which allows the investor to spread risk over a number of loan investments.

First mortgage loans are designed with capital preservation in mind when secured by quality real estate. By way of comparison, corporate bonds are reliant on the solvency of the company. Government bonds, CDs and other fixed incomes offer low risk, but with a rate of return that may not even exceed that of inflation.

First mortgage loans can deliver returns of more than 7 percent on a typical 12-month offering, and such returns can even rise to double digits if the loan is levered. Further, the risk is kept in check when the loans benefit from a low loan-to-value (LTV) ratio — generally at or below 65 percent, which helps ensure that the investor is protected in the event of a foreclosure. At a low cost basis in the underlying collateral, there would be enough equity in the property to cover foreclosure costs, repayment of capital, accrued interest, default interest, late fees, and potentially a return of profit in a fire sale scenario.

During any volatile economic period, investors focused on capital preservation flock to the fixed income markets as a way to guard against any major movements in a typically unpredictable market. But alternatives exist, and senior mortgage loans on marquis, commercial real estate deliver the desired mix of collateralized and uncorrelated lower risk with a potential return that far outpaces traditional, fixed income vehicles. It also helps a capital preservation strategy because these mortgage investments are short term in nature, typically 12 months or less, in order to reduce market risk.

As a generally under-the-radar investment that doesn't get as much attention, these select opportunities arise only in a proprietary climate within the sphere of an experienced and trusted private mortgage lender, providing a safe, differentiating investment opportunity that is as close to an ideal solution in the world of fixed income as one can get.

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