Dez Capital

BALANCED PORTFOLIO GUIDE

USING PASSIVE
RELIABLE
REAL-ESTATE
INVESTMENT

BALANCED PORTFOLIO USING PASSIVE RELIABLE REAL-ESTATE INVESTMENT

Summary

When the economic outlook is positive and we are in a Bull market, it is easy to lose sight of the need for a balanced portfolio. Stock market returns are attractive, news media creates a buzz around the markets, and there is an urge to invest everything in the stock market. However, the current, unprecedented state of the market can clearly demonstrate the need for a balanced portfolio; inflation is well above targets, central banks are raising interest rates, unemployment is low and GDP growth has slowed. Add a slowing worldwide pandemic and a major power in a hot war with its neighbour to the mix, and you have a lot of uncertainty regarding the economic outlook, and thus, a substantial downturn in the stock markets. The future is far from clear; the resultant volatility could be around for some time. A balanced portfolio is all the wiser when facing such unpredictability.

The traditional wisdom in balancing a portfolio is to combine asset classes to balance the risk and reward. A balanced portfolio combines capital preservation and growth, with income generation and long-term return. This balancing act inevitably depends on the individual, encompassing many factors such as risk appetite, stage in life, level of current income, level of monitoring and other factors. Traditionally, this type of a portfolio consists of stocks (growth and long-term return) and bonds (capital preservation, and fixed income). The allocation can be equal or favoured in either direction depending on the aforementioned factors.

Growth and Long-Term Return

The growth portion of a balanced portfolio may consist of different asset classes and can thus require knowledge and perhaps a high level of continued monitoring. Simply calling this portion ‘stocks’ cannot provide an accurate risk assessment because different stocks carry different risks. An index fund does not carry the same volatility as a single technology stock; different technologies vary in their risks, etc. For example, the S&P/TSX composite index has a much lower volatility than Shopify (a well-known Canadian technology company) as seen in Figure 1.

Index Funds and Exchange Traded Funds (ETF) pool together a number of stocks in a given market sector, allowing investors to participate in a larger number of stocks more easily while reducing the cost of investing, since trading individual stocks can be expensive. ETFs and Index Funds have become very popular over

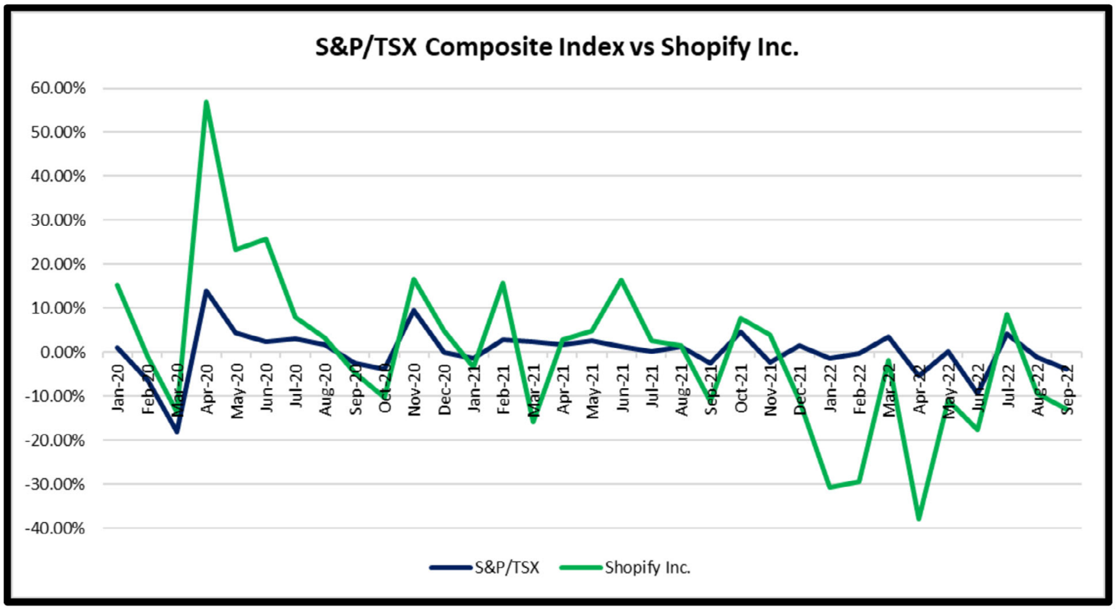

Figure 1 - Data sourced from: https://www.marketwatch.com/

the last few decades with their variety and low fees. There is much to be said about this portion of a portfolio, however, the aim of this paper is to focus on capital preservation and fixed income.

Capital Preservation and Fixed Income

Traditionally, bond products have been and will remain the backbone of capital preservation and fixed income investments. Government bonds (federal and provincial) carry low risk, lower return and are widely used. Corporate bonds have higher risk associated with them but generally have higher returns. Bonds are considered low risk investments, and for good reason as they have a very low default rate, and thus generally do well to maintain one's principal. However, there are other considerations pertinent in this market. Bonds have an inverse relationship to interest rates, as interest rates rise, the price of a bond falls. Furthermore, there will be a loss of principal if liquidity becomes a priority, and the bond is cashed before reaching maturity. Corporate bonds will be affected by market volatility and the corporation's liquidity during a market downturn. While bonds have their place in a portfolio, alternatives are worth considering when faced with both rising inflation and interest rates. The returns of various banks bond are shown in figure 2. These portfolios are made up of Canadian government and provincial government bonds as well as Canadian corporate bonds. The impact of rising interest rates is clearly visible in the value of bonds.

Mortgage Investment Funds (MIFs) offer an option as an asset class for capital preservation and fixed income. This is particularly true in a reliable robust real-estate market, which can balance out a portfolio.

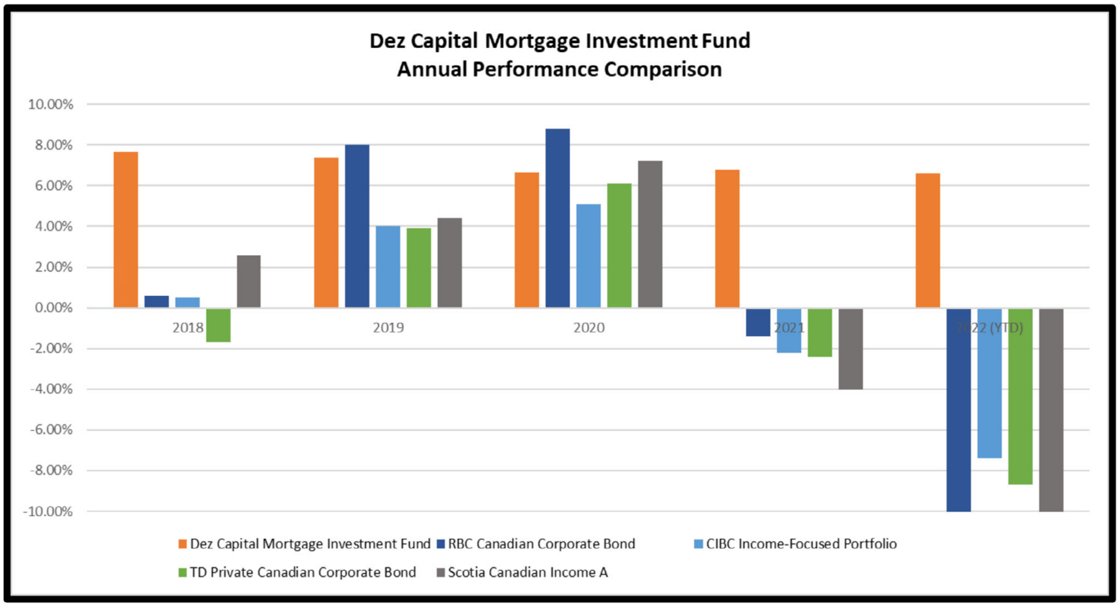

Figure 2 - Data sourced from: https://citywire.com/selector/

What is a Mortgage Investment Fund?

A mortgage investment fund (MIF) is typically offered by a private lender to compensate for the shortfalls of traditional institutional mortgage lending. Bank financing can be limited for borrowers who wish to assemble land, tear down an old home and build a new one. Such a "pre-development mortgage" is extremely common for developers and builders, and in demand in geographic areas that are highly sought after. Private lenders generally offer loans to borrowers that are active in the development process which typically are not covered by institutional mortgage lenders such as banks. Private lenders have more flexibility in financing programs, typically offering structures that can be customized to the borrowers' needs. A custom mortgage will benefit these specific borrowers by providing (a) the ability to execute quickly on real estate investment opportunities, and (b) loan terms that are in line with the real estate investor's business model and/or needs. As a result, borrowers are generally willing to pay higher interest rates for such short-term customized mortgages.

Private lending is asset-backed, meaning that the underwriting team will focus more on the asset than a bank typically would while considering the loan. Assets that are highly marketable are more desired by the lender because their liquidity decreases risk.

Mortgage investment funds tend to offer returns between 5% - 10% or more, depending on the level of risk an investor is willing to accept. Most MIFs also offer liquidity within 30 to 90 days, without sacrificing principal. Additionally, most MIFs are registered account eligible (i.e., RRSPs, RESPs, etc.)

MIFs benefit from the diversification that large amounts of capital provide, and as the size of the fund increases, the quality of the deals does as well. However, as with most things, the marginal benefit of additional size doesn't increase forever; there are diseconomies of scale, and medium sized firms are poised to offer the benefits of scale, while maintaining their own strict underwriting principles and developing relationships of trust with their investors.

How to Choose a Mortgage Investment Fund

Several parameters differentiate mortgage investment funds from one another. These parameters reflect the risk and the return of a particular fund.

The real-estate market in which the fund is active, or the composition of different real-estate markets that make up the portfolio, have a large influence on the fund's ability to withstand an economic downturn. Geographic areas that have a high demand tend to fare better during economic slowdowns. Historical data shows that the Greater Golden Horseshoe (GGH) area has done very well compared to Alberta, Quebec, or Saskatchewan, or even compared to large sectors of the United States. Factors such as immigration and the availability of jobs play a major role in making an area an attractive real-estate investment.

Another important parameter of mortgage funds is the Loan to Value (LTV) of the portfolio. This ratio indicates the loan amount compared to the value of the underlying asset. The lower the LTV, the safer and more resilient the portfolio will be. To illustrate, a portfolio that has a 65% LTV can withstand a 35% drop in the value of the assets and still preserve the principal capital of the fund. The value of the housing market would have to drop 35% in this case, for the principal to be affected.

Another important consideration with MIFs is the position of the mortgages within the fund, specifically the number of mortgages positioned second or third. The potential risk increases as the number of second mortgages within the fund climbs, however, the returns are higher. If a mortgage is in default, managing it from a second position is more difficult, and costly.

Finally, it is important to consider the main concentration or mix of the portfolio—whether the product is residential or commercial real estate. Residential real estate is typically less risky, and more liquid compared to industrial/commercial real-estate, therefore making the portfolio less risky.

The above-mentioned points are some of the parameters to consider when investing in a mortgage investment fund. These will affect the liquidity, return and the risk of the MIF. Speaking to the fund manager about these parameters will provide insight into the fund's strategy in managing the specific portfolio. Comfort in how the fund's investment strategy and risk tolerance align with your own comfort level is paramount.

Golden Horseshoe Real-Estate Market and Risk of Mortgage Defaults in Canada

Just as the type of bond and the originator of the bond dictates the inherent risk associated with the asset. Similarly, the real-estate market that forms the mortgage pool is important in assessing the risk of the asset. For example, Argentina's government bonds vs. Switzerland government bonds. The golden horseshoe which encompasses the area around the western section of Lake Ontario is one of the most stable and sought-after real-estate markets in North America.

The Greater Golden Horseshoe (GGH) has one of North America's diverse and vibrant economies, generating upwards of 25% of Canada's GDP. It is Ontario's main economic engine and will continue to fuel the economic growth of Ontario and Canada for the foreseeable future[1].

Immigration is set by the Federal Government, and after the pandemic related travel restrictions caused a slump of newcomers in 2020, the Federal Government ramped up the arrival of new immigrants in 2021, ending the year with a record breaking 405,000 newcomers. There is expectation that the number of newcomers for 2022 will exceed 400,000. Ontario's share of Canada's Immigration is 44% and most of this pool is forecasted to settle in the GGH[2].

GGH is home to several top Universities and is an attractive destination for both national and international students. All these factors contribute to a large demand for rental and residential housing for the foreseeable future, therefore creating a stable real estate market.

Other Risks Associated with MIFs

MIFs are not safeguarded from risks completely, as interest rates rise, borrowers may have a harder time servicing their debt. A month of significant missed payments can alter the monthly return of the investment by shifting potential return to future months. Investors relying heavily on fixed monthly income need to be aware and cautious regarding this risk. Additionally, as interest rates rise, the turnover in the real estate market tends to fall affecting liquidity for the fund. In a weak real-estate market, an economic down-turn can cause prices to collapse which results in a liquidity squeeze for the fund. Factors such as LTV, geographic location of the fund, and the percentage of first position mortgages play a big factor in the resilience of the fund in difficult economic circumstances. Speaking to the Fund manager to understand their strategy is critical when choosing a MIF.

1 A Place to Grow: Growth plan for the Greater Golden Horseshoe | ontario.ca
2 HEMSON-GGH-Growth-Outlook-Report-26Aug20.pdf
Canada is on track to welcome a record 431,000 immigrants | Canada Immigration News (cicnews.com)

Advantages

- ➡ Investors have flexibility as to their risk profile and return rates
- ➡ 30-90 days liquidity in most cases
- ➡ Benefit from diversification into numerous mortgages

Risks

- ➡ Macroeconomics and real estate trends can affect your return, liquidity and in extreme cases your principal
- ➡ Fund managers can restrict liquidity in certain cases
- ➡ Security of asset is dependent on quality of the Fund

Investing in Mortgage Investment Funds

MIFs can be used in two distinct ways within an investment portfolio; with sufficient capital invested, the monthly income generated by an MIF can provide a relatively stable income. As an alternative, monthly income can be reinvested to benefit from compounding returns thus exponentially increasing the returns. Either way, MIFs can help to increase the returns in the low-risk portion of your investment portfolio.

MIFs are also well poised to face the challenges of the current market. Generally, the rates of the funds' follow those set by the central bank, which ultimately determine the return. As seen, high inflation leads to high interest rates, and high interest rates increase an investor's return.

Summary

A balanced portfolio will not only deliver a suitable solution in the short term but will also provide the necessary growth capital in the long term. It is possible to customize the portfolio, according to risk tolerance and position in life. Mortgage investment funds are a good option for fixed income and capital preservation. MIFs can provide income and safeguard the capital in a balanced portfolio.

Dez Capital

CONTACT

416.519.9090
info@dezcapital.com
brokerdeals@dezcapital.com
investor.relations@dezcapital.com

ADDRESS

Dez Capital Corporation
12 Bruce Park Avenue, 2nd Floor
Toronto, Ontario
M4P 2S3