Alternative investing strategy:

Income trust fund

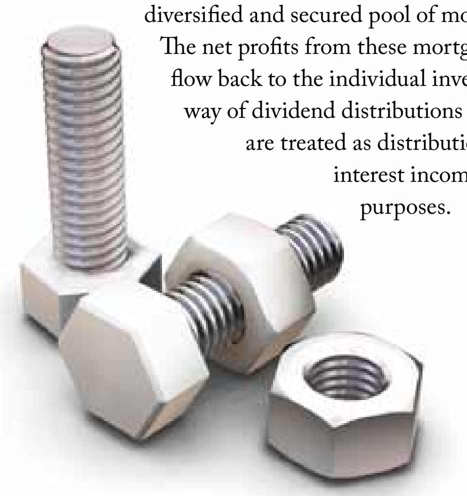
Tim Wittig explains the nuts and bolts of investing through an income trust fund, and how you can make money from it

'Pooled Mortgage Investment Funds' – the undiscovered alternative to the fixed income asset class.

Even though this type of investment has outperformed many other vehicles in terms of capital preservation and returns, 'Pooled Mortgage Investments' are less widely known than other income-producing vehicles. As a result, Residential Income Trusts and Mortgage Investment Corporations (MIC) remain relatively undiscovered. They are, however, a simple and effective way for individual investors to participate in the lucrative mortgage industry traditionally dominated by all major Canadian banks.

How does it work?

Pooled Mortgage Investment Funds allow individual investors to group their finances collectively, to lend out on a pool of mortgages, all of which are secured by Canadian real estate. For a minimum investment, investors can purchase units (or shares) in a non-taxed, flow through entity, such as an Income Trust or a Mortgage Investment Corporation (MIC), which then manages a fund with a diversified and secured pool of mortgages. The net profits from these mortgages flow back to the individual investors by way of dividend distributions which are treated as distribution or interest income for tax purposes.



The investment objective of Pooled Mortgage Investment Funds is to deliver stable cash flow to their investors, while protecting invested capital. The best managed funds have been able to achieve this, generating yields of 7–10% with little correlation to major stock indices. This satisfies an investor's hunger for yield, while at the same time leaving them feeling comfortable that their money is secured by housing inventory – a tangible asset that they can 'touch and feel'. Moreover, their risk is tempered by the fund manager's stated policy of not exceeding a percentage of the appraised value of the real estate security, commonly referred to as the 'loan to value ratio'.

How you can profit from it

Pooled Mortgage Investment Funds are a viable addition, or alternative, to Bond Funds, REITS and Term Deposits for the fixed income portion of your balanced portfolio. Fixed income products should be part of a properly diversified portfolio that includes the three major asset classes: fixed income, real estate, and equities.

Most Pooled Mortgage Investment Funds provide financing for residential housing, and are generally focused on lending to Canadian homeowners. Conversely, REITS predominantly invest in commercial property, (or mortgages on larger commercial property) and distribute returns based on income or capital appreciation in good to moderate economic cycles. Commercial real estate is generally more susceptible to the ups and downs of the economy, as well as to fluctuations in business cycles. The residential sector, however, is less susceptible because homeowners tend to have an emotional attachment to their property, making them less likely to walk away from this investment.

Home are people's havens

With interest rates in term deposits at historical lows, bond funds seem a viable choice, and they can be a very useful way to generate income as long as rates stay relatively flat. However, your initial capital investment may be subject to volatility when interest rates inevitably rise, which is anticipated over the next 3–5 years.

In contrast, Pooled Mortgage Investment Funds generally move with the market, which creates a cushion for your returns and capital. Because the mortgages in these pooled funds are typically short term, (24 months or less) this provides some protection against rising interest rates. In a rising rate environment, older mortgages that are paid out are renewed or replaced by new mortgages that are funded by correspondingly adapting rates, thereby minimizing interest rate risk.

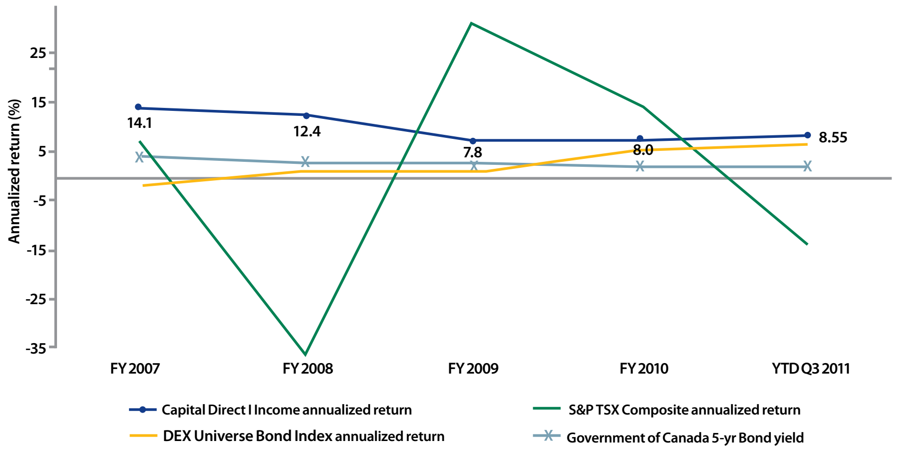
Most Pooled Mortgage Investment Funds offer a distribution reinvestment plan (DRIP) where the investor's distribution is automatically reinvested to purchase more units in the fund. As most of these funds are similarly qualified for registered investments such as an RRSP, TFSA, RESP, RRIF or LIF, they allow investors to benefit from the magic of compounding interest.

Growing popularity

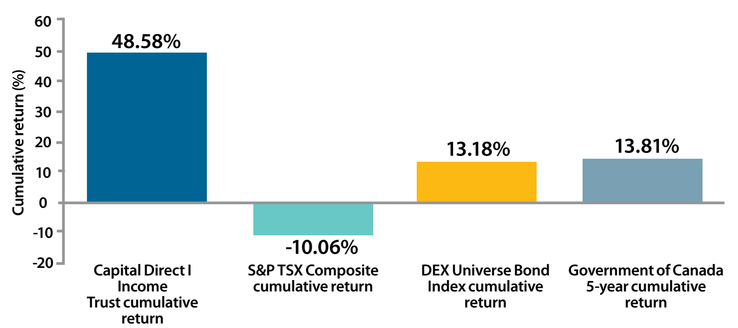
The number of borrowers who require pooled mortgage lending is increasing. There is an ever growing number of Canadians whose borrowing appetite does not meet the strict lending guidelines that the Schedule A Chartered Banks in Canada must now adhere to. Between April 2010 and April 2011, the Canadian government made three significant mortgage regulatory changes:

i) Stricter qualification requirements
ii) Higher income requirements

Capital Direct I Income Trust annualized rate of return vs. alternative asset classes



Cumulative investment return vs. traditional investments (2007–Q3 2011)



Source: Bloomberg, Capital IQ, Bank Financial Statements, and Company reports

Income trust performance

Below is an example showing how Capital Direct I Income Trust fared against Alternative Asset Classes during the period of 2007 to Q3 2011, and some highlights that it has to offer.

Highlights of Capital Direct I Income Trust:

- 8.18% Annualized return for 2011*
- Five-year average historical yield of 10.4% distributed to investors
- Average loan to value of 59% in current portfolio
- Geographically diversified mortgages within 90km of major urban areas of Ontario, Alberta and British Columbia
- Quarterly distributions, Distribution Reinvestment Plan available
- Registered Investment qualified (RRSP, TFSA, RESP, LIF)
- Term of mortgages limited to two years maximum
- Trustee: Computershare Trust Company of Canada
- 100% residential
- Historic complete portfolio available online

** Annual ROI based on 2011 distribution*

iii) The government withdrew its CMHC insurance backing on lines of credit

These stricter regulations mean more homeowners are looking for an alternative to their primary bank. This includes good credit, self-employed and commissioned workers.

These regulatory shifts do not apply to lenders who specialize in Pooled Mortgage Investment Funds. This provides a significant opportunity and long-term growth potential for the customized lending that Pooled Mortgage Investment Funds offer.

Factors to consider

When it's time to choose which Pooled Mortgage Investment Fund to invest in, there are certain characteristics to think about:

- How or where does the fund acquire new mortgages?
- Has the fund been established for a reasonable length of time?
- What is its track record i.e. what has been the average return to investor?
- Does the mortgage pool offer geographic diversification?
- What is the average loan to value in the current holdings?
- Does the management team have sufficient industry experience?
- What is the historical loan loss percentage of the fund?
- Do they act as their own trustee, or does the fund have an independent trustee?
- What is the average term of the mortgages in the fund's current portfolio?
- How much bank borrowing does the fund use to leverage?
- How often are distributions made?
- Is the fund qualified for registered investing (RRSP, TFSA, RESP, RRIF, LIF, etc.)?
- Is investment in the fund restricted to accredited investors?
- Ensure the properties being lent on match your risk profile.
- Is the fund 100% residential, or does it include a commercial mix?
- Is the fund fully transparent with its current portfolio and financials readily available? ■

TIM WITTIG is vice president and a director of both Capital Direct I Income Trust and Capital Direct Lending Corp. He has 25 years of experience as an owner, has been an investor in private mortgages for 14 years, and is a licensed mortgage broker. For information on Pooled Mortgage Investment Funds, visit incometrustone.com.