ALTERNATE INVESTMENT STRATEGY: INCOME TRUST FUND

Tim Wittig demystifies income trust funds and explains why they're a worthwhile addition to your investment portfolio

For the savvy Canadian real estate investor, Pooled Mortgage Investment Funds offer an alternate vehicle for solid and steady growth. Even better, some funds provide the added benefit of tax deferral when held within a Registered Retirement Savings Plan.

Residential Income Trusts and Mortgage Investment Corporations (MIC) offer investors a way to put their funds to work in tangible Canadian real estate interests. These funds manage the combined finances of a group of individual investors, and then lend them out on a diversified and secured pool of mortgages that are generally focused on Canadian homeowners. Although this is a lesser known option for investing, this vehicle has outperformed many other investments in terms of capital preservation and returns. The best managed funds have been able to achieve yields of 7–10% with little correlation to major stock indices.

How it works

For Canadians interested in including this strategy in their RRSP portfolio, they must find an Income Trust or a Mortgage Investment Corporation eligible for investing in registered plans. In exchange for a purchase of units (or shares) in these non-taxed flow-through entities, the investor participates in the net profits from these mortgage pools by way of dividend distributions. Investing within an RRSP allows these distributions to flow back to the investor under a tax deferred umbrella.

Before making an investment with RRSP cash into a Pooled Mortgage Investment Fund, the investor should obtain a copy of either the Offering Memorandum or Prospectus issued by the Fund to determine their eligibility (usually available on their website).

The next step is to open a Self Directed RRSP account with a financial institution that offers mortgage investing within registered accounts. These institutions act as the investor's trustee for the purpose of investing their RRSP contributions into the Pooled Mortgage Fund. Examples of institutions that routinely service this specialized segment are Canadian Western Trust and Olympia Trust. Other select credit unions also provide the service.

Once the account is open and RRSP cash is contributed, the investor is ready to proceed with the fund of their choice. Investors can "self direct" the trustee/institution to purchase units in their chosen Pooled Mortgage Fund using their RRSP funds. Most of the institutions offer online services so the investor can view their account 24/7 in order to monitor their investment once their purchase is complete.

The majority of Pooled Mortgage Investment Funds also offer a Distribution Reinvestment Plan (DRIP) which allows the investor's distribution to be automatically reinvested to purchase more units of the fund. This is particularly effective for RRSP portfolios, which are free to grow in a tax deferred environment, enabling the investor to further prosper from the magic of compounding interest.

Projecting growth

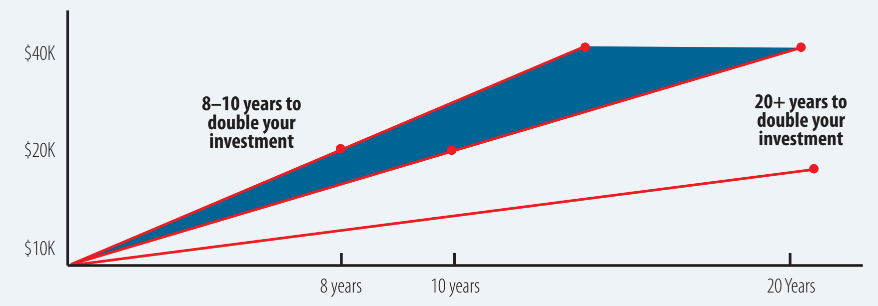
A fundamental way to gauge your RRSP growth potential is to calculate how long it will take to double your investment by employing the "Rule of 72". When you divide the current annualized rate of return of the Pooled Mortgage Fund by the number 72, it will show you how many years it should take to double your investment (assuming the rate stays constant). If rates go up, the number of years goes down, and vice versa.

Chart 1 on this page shows how the 2011 8.18% Annualized Rate of Return* of Capital Direct I Income Trust calculates when applied to the Rule of 72 (where annualized ROI is based on 2011 distribution).

Chart 2 shows how Capital Direct I Income Trust fared during the turbulent markets of 2009 to Q2 2012, and you can see some highlights that it has to offer in the box on page 74.

CHART 1: The rule of 72. How Capital Direct I Income Trust can help you align your investments with your financial goals

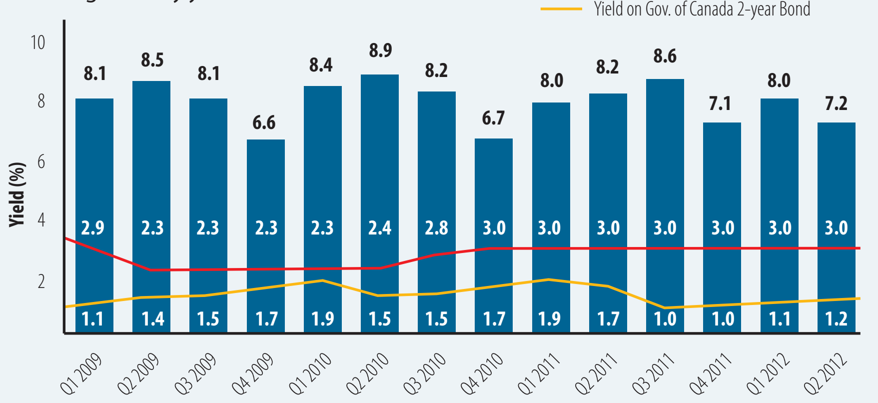
The Rule of 72 says that to find the number of years required to double your money at a given interest rate, you just divide the interest rate into 72. For example, if you want to know how long it will take to double your money at 8.18%, divide 8.18% into 72 and you get 8.8 years! (This assumes the quarterly distributions are reinvested during the DRIP).*



*Actual time to double your investment may vary as the annualized rate of return varies.

CHART 2: Capital Direct I Income Trust Annualised Rate of Return (2009–Q2 2012)

Providing a steady yield in turbulent markets



Source: Bank of Canada, Bloomberg and company reports

Choosing the right fund

Most Pooled Mortgage Funds that are Registered Plan eligible allow investments in RRSP, TFSA, RESP, RRIF and LIF. This means an investor who finds a fund they like can make multiple registered investments.

Before an investor chooses a Pooled Mortgage Investment Fund, here are just some of the factors they should consider:

- Is the fund qualified for registered investing (RRSP, TFSA, RESP, RRIF, LIF, etc.)?
- Is the fund restricted to accredited investors?
- What is the fund's track record? i.e. What has been the average return to investors?
- How or where does the fund acquire new mortgages?
- Is the fund 100% residential, or does it include a commercial mix?
- Does the mortgage pool offer geographic diversification?
- Has the fund been established for a reasonable length of time?
- How often are distributions made?
- What is the average loan to value in the current holdings?
- Does the management team have sufficient industry experience?
- Is the fund fully transparent with its current portfolio and recent financials readily available online?
- Does the fund act as their own trustee, or do they have an independent one?
- What is the average term of the mortgages in the fund's current portfolio? ■

TIM WITTIG is Vice President and a Director of both Capital Direct I Income Trust and Capital Direct Lending Corp. He has 25 years' experience as an owner, has been investing his RRSP funds in mortgages for 14 years, and is a licensed mortgage broker. For information on Pooled Mortgage Investment Funds, visit incometrustone.com.