**YOUR GUIDE TO**

**SMART TRUST DEED INVESTING**

**1. Small Loans Are Much Less Risky**

You have $25,000 to invest. Your hard money broker offers you two different loans, both yielding 8%. One is a $1 million loan on a shopping center. The other is a $100,000 loan on a little real estate office (converted house). For my money, I will choose the smaller just about every time.

Why? Small loans have small payments. You've go to remember that banks are charging just 5.5% on commercial permanent loans. That shopping center could probably easily debt service a $1 million loan at 5.5%. However a $1 million loan at 9.9% (the gross interest rate before loan servicing fees) might produce a negative cash flow of $2,800 per month for the borrower.

Now let's look at that converted house. If the little office building cash flowed at 5.5%, a 9.9% loan produces a negative cash flow of only $275 per month. Now which negative cash flow is easier to carry - $2,800 per month or $275 per month?

When making high interest rate loans, you have to be sure that the higher hard money monthly payments don't slowly grind the borrower into the dust. The wise trust deed investor wants his borrower to succeed.

**2. Second Mortgages Can Quickly Become Alligators.**

An alligator is a property with a negative cash flow, and alligators will quickly eat you alive. Picture this... Sicily, 1948. Ha-ha! Seriously though, picture this... You make a $50,000 second mortgage behind a $500,000 first mortgage on a house worth $1 million. The borrower then becomes an opioid addict and stops making payments.

You get notice from the bank that the first mortgage is seven months in arrears, and you are facing another eight months to foreclose and to get relief from the borrower's inevitable Chapter 11 bankruptcy. Fifteen months worth of first mortgage payments equals another $50,000 - not counting another $20,000 in foreclosure and legal costs. And what about the cost of the repairs and the renovations that will inevitably be necessary?

You are going to have to shell out all of this new money - approaching $100,000 - just to protect your original $50,000. And there is no guarantee when the bankruptcy judge will finally grant your Petition For Relief From the Automatic Stay. The borrower might be able to postpone the sale for another full year.

Alligators are a dangerous thing. When there is no definite end in sight, and when you are shelling out big money every month, six months feels like six years. Alligators simply drive investors mad. They tend to lose all sense of economic reason. Do you know what usually happens - at least sixty percent of the time? The second mortgage investor ends up walking away from his original $50,000 investment, even though there is tons of equity in the property.

Moral of the story: Avoid second mortgages unless you are richer than Crassus.

**3. Foreclosed Property Will Never Sell or Lease Until It is Renovated.**

You foreclose on a property. You are reluctant to throw good money after bad. (Some of the most foolish words ever uttered.) "Let's just sell the property as is and get whatever we can get." You list the property for sale with a real estate broker "as is", and then the property just sits and sits and sits. The roof starts to leak, mold grows, and vandals - after seeing no activity on the property for months - break in and steal the appliances and the copper pipes. Vandalism insurance only cover your losses if the property is at least 20% occupied.

Heed these words of warning: Foreclosed property never sells or leases until it is renovated. The wise trust deed investor, on the morning of the foreclosure sale, immediately sends in his locksmith and his renovation contractor. You don't have to turn the place into the Taj Mahal, but you do have to immediately renovate it.

Observable facts of nature: Apples fall out of trees. Water flows downhill. Foreclosed property never sells or leases until it is renovated. Been there, learned this (many times over 37 years).

**4. Invest More Aggressively During Recoveries and Vice Versa**

Four and a half years from now (2/17/18), this once-in-a-lifetime economic recovery will be getting long in the tooth. At that time, you will want to start paying more to get superior quality first trust deeds. The way you "pay more" is to accept a lower yield. For example, your hard money broker may be offering two different loans. Loan number one is yielding 10% and is 75% loan-to-value. Loan number two is is yielding 7%, but it is only 60% loan-to-value. Four and a half years from now, you need to start choosing deals like loan number two.

Recessions always follow recoveries. You therefore want to be invested exclusively in superior quality first trust deeds by the time the next recession starts. The good news is that the next recession will probably be just a regular one, the type where real estate only falls by 20% to 25%. We can be fairly sure of this because the Great Recession already cut most of the fat (buggywhip manufacturers holding on by a shoestring) out of the U.S. economy.

On the flip side, you can be much more aggressive during recoveries. When real estate is appreciating at 1% per month, a loan made at 75% loan-to-value will be less than 63% loan-to-value within one year. Therefore, if the subject property is attractive and less than 40 years-years-old, go ahead and be aggressive on your loan-to-value ratio right now, if this is what it takes to win the deal.

For the first time in 15 years, I believe that we are about to enter a big-time bull market in real estate - perhaps almost a mania. It has to do with the trillions of dollars injected into the economy by the Fed during the Great Recession. When Americans start borrowing and spending like normal again, inflation has the potential to go ballistic.

**5. Good First Trust Deeds Are Very Hard To Find These Days, So Move Fast**

It is no longer easy to find good first trust deeds in which to invest. Because banks are paying just 1% and trust deeds are yielding 8% to 9% (and even higher on riskier deals), tens of thousands of accredited investors nationwide are pouring hundreds of millions of dollars into first trust deeds. Hundreds of brand new hard money shops have opened up over the past two years, so the competition for good loans is immense. This is by far the most competitive market for hard money loans that I have ever seen in my 37 years in business.

If your hard money broker offers up a good new loan, you need to call him instantly. You are in a race with the other investors on his list. After you have dilly-dallied a few times, only to find that you called too late, you will learn this lesson.

Cold, Hard Fact: There is far-far more investor demand for good-quality first trust deeds than there are good loans available.

**6. Most Painful Trust Deed Losses Take Place During Recessions**

Let's face it. You are going to foreclose on more properties during recessions. During regular recessions, real estate typically falls by 20% to 25%. During great recessions - like the S&L Crisis, the Dot Com Crisis, and the Great Recession - real estate seems to fall exactly 45%. (Remember that number - 45%.) Don't panic and try to sell the property during a recession. You will only end up taking a painful and unnecessary haircut. In the case of great recessions, you'll end up taking an outright scalping. Instead, simply rent the property out and wait for three and a half years. By then real estate will probably be approaching new highs again, and you'll likely end up making a handsome profit, instead of taking a painful haircut.

Not convinced? I could make a good argument that one of the best investments on earth is real estate purchased at the very bottom of a recession. Historically, real estate pops around 30% to 35% in just the next three and half years, as it bounces off its nadir (low point) and recovers to new highs. Therefore, rather than sell (your foreclosure) at the bottom of a recession, hold at the bottom of a recession.

**7. Will Your Hard Money Broker Survive the Next Bad Recession?**

Here's a wake-up call for you. There were around 400 hard money mortgage companies in America when the Great Recession began. By the end, maybe a dozen of them survived. (Actually the real number may even be lower than that.)

When a hard money broker files for bankruptcy, really bad things happen to the trust deed investors. The court appoints an expensive trustee ($$$), who immediately hires a receiver ($$$), who brings in a CPA firm as an auditor ($$$) and an attorney ($$$) to represent the investors. Then they hire property managers ($$$) for the properties. Guess who gets to pay for all of these expensive jackels. You guessed it. The trust deed investors.

To make matters worse, there is no capitalist around to say to the jackels, "Hey, that little report couldn't possibly have taken you eight billable hours to complete!" "What's this $26,000 invoice for copies at 42 cents per copy?" The jackels feed and feed, with no one to rein in their spending. I would not fall off my chair in surprise if some of the trust deed investors with some of these bankrupt hard money brokerage firms recovered less than 40% of the face value of their accounts.

How did Blackburne & Sons survive the Great Recession (and the S&L Crisis and the Dot Com Crisis)? We charged very low points (loan fees) and charged a loan servicing fee of 1.9% annually. What did most of our competitors charge for loan servicing? Most of them charged 0.50%.

When the Great Recession hit and new loan originations tumbled by 80%, Blackburne & Sons was able to fall back on its loan servicing revenue (after cutting our staff to the bone). Our competitors had just a tiny fraction of our loan servicing revenue. They had lived for years off their big loan fees on newly-originated loans. When that source of income virtually disappeared - poof - so did they - poof.

About a decade ago, there was a hilarious claymation (animation using clay characters) kiddie movie entitled, Chicken Run. The movie was about a bunch of chickens who escape from a massive chicken-raising facility. There is a line from the movie that still tickles my wife and me ten years later. When the chickens discover their likely fate, a cute little chick pipes up, "I don't wanna be a chicken pot pie!" So if you don't want to be a chicken pot pie or jackel food, make sure you invest with a hard money broker with the cash flow to survive a recession.

I could make a good argument that 90% of the newbie hard money shops opening up these days closely resemble Ponzi schemes, all but pre-destined to collapse in the next recession.

**8. No one ever bids at foreclosure sales.**

You have probably seen the reality show, Fix or Flop, about the guy who flips houses. Juicy gossip: The couple is divorced now, and that beautiful wife is now (before?) dating the poor hero's general contractor. Yikes.

Anyway, our hero in Fix or Flop would go to foreclosure sales, and there would actually be competitive bidding at the foreclosure sale.

Yeah, but this does not happen very often in real life. When you bid at a foreclosure sale, you have to bid all-cash. There is not an infinite number of people in the world with the financial horses to bid $500,00 or more all-cash at a foreclosure sale.

In Lesson 2 we talked about a trust deed investor who had made a $50,000 second mortgage, behind a $500,000 first mortgage, on a $1 million house. In real life, that second mortgage investor would probably choose NOT to advance another $100,000 in new money, just to protect his $50,000 investment. The good news is that someone might bid $550,000 for this $1 million house at the foreclosure sale. If it happened, the second mortgage investor would be rescued.

Unfortunately, in real life (almost) no one ever bids at foreclosure sales. The all-cash requirement is one big hurdle. The second hurdle is that most bankruptcy judges are bleeding hearts. The bankruptcy judge is unlikely to grant the first mortgage lender's Motion For Relief From the Automatic Stay in a Chapter 11 bankruptcy, until the accrued interest on the first mortgage loan has eaten up almost all of the junkie's equity in his house.