

Volume

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**THE ALLIANCE PORTFOLIO**

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Industry White Paper Series

FINANCIAL PLANNING INNOVATION:

*Alternative, High  
Yield Investments*

FINANCIAL PLANNING INNOVATION:  
**Alternative, High Yield Investments**

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## Introduction

As part of our ongoing commitment to providing the financial services industry with innovative products, services and educational content, *The Alliance Portfolio* is pleased to introduce the first in a series of industry white papers that have been specifically developed for financial planning professionals.

This paper is a detailed analysis of why now is the time for financial planners to consider alternative investments in their financial planning recommendations, and how an innovative product – private real estate financing – can be a key solution to provide a high yielding investment that is not correlated with typical investments to enhance overall portfolio performance.

Developed in partnership with Nexus Strategy, LLC, a leading consulting firm to the wealth management industry, this report will highlight the current market environment for alternative investing, analyze the features and benefits of private real estate financing investments, and suggest ways financial planning professionals can use these innovative tools to solve various financial planning situations for individual investors.

## The Case for Alternative Investing

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We invite you to learn more about how you can take advantage of this type of investment program by logging on to [www.arbingerfund.com](http://www.arbingerfund.com) and sign up for one of our regular webinars.

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As markets become more challenging, advisors seeking to insulate client portfolios from market volatility are following the advice of sophisticated institutional investors, by increasingly turning to alternative investments. Defined as any investment outside of stocks, bonds and cash, alternatives are generally uncorrelated to the general market and are well-known for their potential to enhance portfolio returns and diversification.

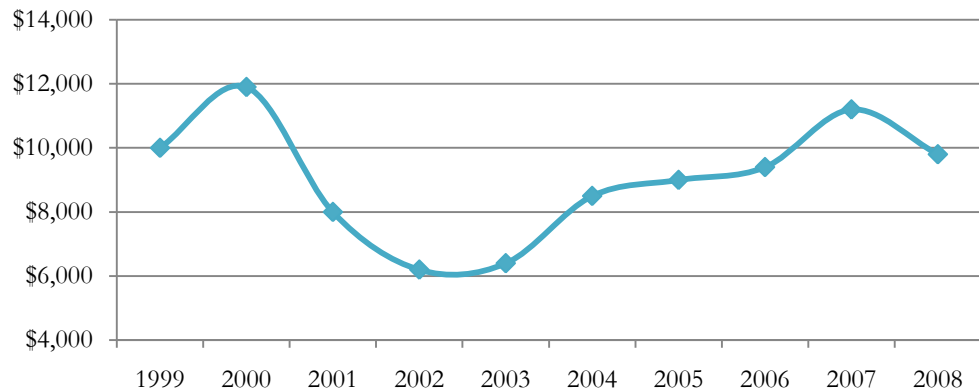
It's no surprise that advisors are increasingly using alternative investment products to enhance returns and mitigate risks, given recent market volatility. In fact, more than half (55%) of advisors estimate they will increase their use of alternatives by up to 25%, while 13% believe they will boost their use of alternatives by more than 75%. (*Investment Advisor*, January 2008)

One key factor driving this trend is the quest for income generation in retirement which has many investors looking to invest in alternative assets such as real estate and private equity. These kinds of investments offer the potential both for diversity as well as for high returns, and increasingly, advisors are offering their clients the ability to invest in them with a self-directed IRA.

To see why alternative investments are making more and more sense, advisors only have to look to the current state of the equity markets. What is being called the “lost decade” in stocks by the *Wall Street Journal*, dating back to before the peak of the internet bubble, equity returns have been flat over that period. As the staple of investment advisor recommendations for growth, equities have not lived up to their historical expectations, creating a need for alternative solutions.

## “The Lost Decade” in the Equity Markets

Total Return on \$10,000 invested in the S & P 500



April 1999 through March 2008 (Source: *Wall Street Journal*, March 26, 2008)

## Correlation Concerns

Correlation is a statistical term that describes the relationship between two investments in terms of the rise or fall of those investments relative to each other. A positive correlation means that the two investments tend to rise and fall together over time. A negative correlation indicates that the investments act differently, and when one investment is rising, the other tends to fall. Correlation value is on a scale from 1 to -1. A value of 1 indicates perfect positive correlation, or poor diversification, since it means that the two investments behave exactly alike.

A correlation of -1 indicates perfect negative correlation, or good diversification, since this means that the two investments behave exactly opposite to each other. Similarly, a correlation of zero means they act randomly with respect to one another, which is to say there is no correlation.

The domestic equity asset classes that most investors recognize as the norm for allocating assets are the following:

- Large capitalization (cap) growth stocks
- Large cap value stocks
- Mid-cap growth stocks
- Mid-cap value stocks
- Small cap growth stocks
- Small cap value stocks.

## ALTERNATIVE, HIGH YIELD INVESTMENTS

Over the past 20 years especially, these equity asset classes have become highly correlated.

### CORRELATION OF STANDARD DOMESTIC EQUITY CLASSES \*

	Large Growth Stocks	Large Value Stocks	Small Growth Stocks	Small Value Stocks	Midsize Growth Stocks	Midsize Value Stocks
Large Growth Stocks	1.000					
Large Value Stocks	0.799	1.000				
Small Growth Stocks	0.822	0.653	1.000			
Small Value Stocks	0.689	0.792	0.853	1.000		
Midsize Growth Stocks	0.924	0.720	0.944	0.772	1.000	
Midsize Value Stocks	0.754	0.953	0.712	0.888	0.739	1.000

\*Correlation Coefficient Dec-1986 to Jun-2007 (Morningstar)

Additionally, for many investors, international equities have been identified as a potential solution to correlation convergence. However, even the addition of this asset class is seeing its correlation advantage go away, due to many factors such as globalization.

Time period	Correlation of S&P 500 to MSCI EAFE
1980 – 1989	0.58
1990 – 1999	0.75
2000 – 2006	0.84

Source: Phoenix Investment Partners, Dec 2006

So what is a financial advisor to do?

## Private Equity Real Estate Financing

One innovative solution that is rapidly growing in use by sophisticated financial advisors is alternative, high-yielding investments that are backed by individual trust deeds on residential and commercial properties. Known as “private money lending” or “hard money lending”, these types of investments are a niche market for borrowers and properties that do not meet typical institutional lending requirements. Billions of dollars in these types of loans are made every year and represent roughly 13% of all real estate loans in the US. Due to the structure and demand for private money loans, these trust-deed investments typically offer a high yield.

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Given the slate of issues recently with “sub-prime” mortgages and collateralized debt securities based on sub-prime loans, it is important to note the clear differences with private money lending.

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Private money lending is based on direct lending on individual deeds of trust, so there is a direct line of sight to foreclose if the borrower defaults.

Private money lending is NOT a derivative security, therefore not similar to the problems that large banks are facing as the underlying assets of those securities do not perform. Additionally, the recent sub-prime loan problem was caused by the lack of foresight of banks, offering 100% financing to questionable borrowers, poorly underwritten and ultimately with no recourse should the borrower default.

Given that private money loans are based on direct lending, owned by a local, community-based firm with low loan to value ratios, there is very low risk of principal loss due to borrower default. This is due to the very conservative underwriting on properties in highly desirable, excellent locations that have historically maintained their values, even in declining markets, along with a short-term focus, typically under 3 years duration in term.

## Demand for Private Money Loans

Due to the reaction of the credit markets to the current “credit crunch”, demand for private money loans is expected to increase. Typically, borrowers use private money as “bridge loans” to solve a timing issue, such as emergencies, real estate purchase financing falls out at the last minute, and other reasons. These other reasons include property issues, such as the property in question does not meet standard guidelines, including non-owner occupied property, mixed use or high land to improvement ratios. In these cases, institutional lenders will not allow a borrower to finance cash outs, creating a very good opportunity for private money lenders to step in and offer a solution.

One of the more common reasons driving demand for private money loans is that even well-qualified people find themselves in various situations that prohibit them from accessing institutional financing. These common situations include divorce, where one spouse wants to stay in the house, but needs a cash out re-finance to pay off the other spouse. Other situations include liens and judgments from the IRS, which will prohibit institutions from financing. Additionally there may be investment opportunities that a borrower would want to take advantage of and need to access equity in their properties quickly. Private money lenders are flexible enough to be able to quickly arrange financing, sometimes in less than a week, while institutions often require several months. Lastly, the borrower may not meet standard guidelines, such as citizenship issues, changes in career or gaps in employment history.

There are many situations that arise on a daily basis that make private lending a very viable opportunity. Additionally, with many lenders adopting more conservative underwriting standards due to the mortgage market displacement, demand for private money loans is expected to increase dramatically, many industry experts agree.

## **Pooled Investing**

The most common methods for private money lending are individual trust deeds and mortgage pools. Individual trust deeds carry a higher level of risk due to the concentrated nature of a single borrower, while pooled funds of trust deed investments offer more diversification and therefore have a lower level of risk. Because of this, financial planners often prefer the pooled investing route.

Pooled funds, similar to mutual funds, are accessed by investors purchasing shares in the fund, often an LLC or private partnership. The fund then originates and/or purchases qualified trust deed investments, which provide a high-yield return to the fund. The fund distributes proceeds to investors through the cash flow of the fund or through re-investment.

Because these investments are in the “alternative” category, financial advisors should conduct appropriate due diligence to ensure that they are optimally allocating their clients’ assets. Some considerations are to ensure that the fund manager has a strong track record and extensive experience in managing mortgage pools. Additionally, it is important to validate that conservative underwriting criteria are being used, such as low “loan to value” ratios to ensure the investment is protected should there be any incidence of default.

The underlying trust deeds should be in excellent locations, such as southern California beach-front, that have historically held their value in down markets and increased in up markets. Lastly, a strong compliance culture within the fund manager along with regular reporting and transparency into the fund are important to ensure the long-term viability of the fund.

## **Financial Planning Uses of Mortgage Pools**

Financial planners are using pooled mortgage investments as alternative, high-yielding, non-correlated tools to enhance portfolio returns and provide diversification.

Some common approaches include:

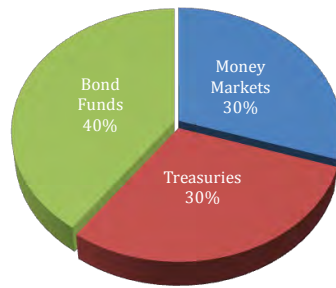
- Enhancing fixed income portfolios
- Diversifying and enhancing performance of growth portfolios
- Strategic income vehicle for retirement income planning

The following case studies illustrate some potential uses of mortgage pool investments that many financial advisors are now considering as an advanced approach to solving various financial planning situations.

**NOTE**

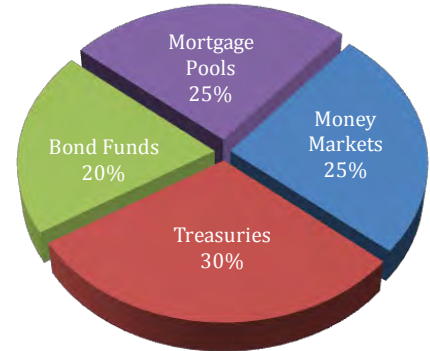
Please note that the following are for illustration purposes only and are hypothetical examples that are general in nature and do not take into consideration individual circumstances, tax, legal or other issues. Past performance is no guarantee of future results.

**Enhancing fixed income portfolios**

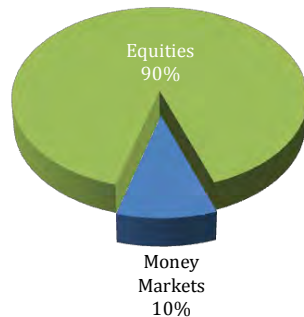


In today's low interest rate environment and volatile bond markets, financial planners are constantly looking for new tools to enhance income. In the case of a \$1 million fixed income portfolio made up of 40% bond funds, 30% money markets and 30% Treasuries, this portfolio might yield in today's markets roughly a 4% blended rate of return or \$40,000 in income.

By re-allocating 25% of the portfolio to mortgage pools, the new expected blended rate of return is increased to 6.25% or \$62,500 in income. Not only did this alternative investment enhance returns, it also provided diversification, while maintaining liquidity.



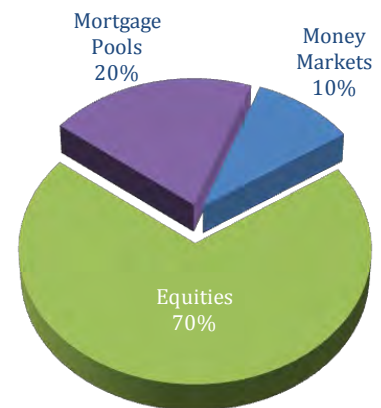
**Diversifying and Enhancing Performance of Growth Portfolios**



Given the "lost decade" we've seen in the equity markets, many financial advisors are looking to alternative solutions to provide performance for their equity and growth portfolios. In the case of a highly aggressive \$1 million growth portfolio, over the last ten years, it has only returned roughly 1%, something that will not meet the needs of the investor who was

looking to fund their long-term goals. Additionally, with the concentrated equity portfolio, the investor was taking on added risk.

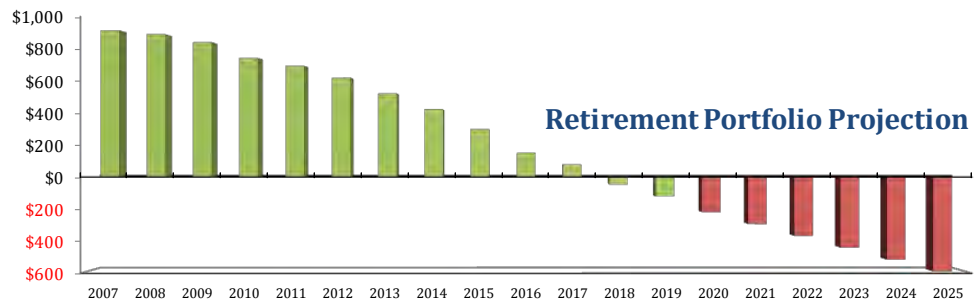
By re-allocating 20% of the portfolio to mortgage pools, the new expected, blended rate of return increased, the overall portfolio risk was lowered, while still maintaining an aggressive growth profile.



### Strategic income vehicle for retirement income planning

As the massive baby boomer generation cycles it’s way towards retirement, many are looking for income solutions to finance those golden years. This makes retirement income planning more and more important, particularly for retirees facing possible health care issues or increased longevity.

Consider the case of a married couple, with one spouse, 78 experiencing health care issues, while the other spouse, 70, is in excellent health. Due to the unexpected increase in healthcare costs, and their conservative retirement portfolio, their assets are expected to be depleted within the next 10 years.



By re-allocating 30% of the portfolio to mortgage pools, the overall expected portfolio blended rate of return has increased. This enhanced return now enables the portfolio to be stretched out to 2025, when the surviving spouse will be 88. Additionally, the portfolio is more diversified.



### Conclusion

In today’s ever changing investment environment, the one thing that has remained constant is the continued innovation in products, services and methodologies to help professional financial advisors provide the highest level of service to their clients. As equity markets have entered a potential flat phase and ever increasing globalization has increased correlation in markets world-wide, alternative assets are becoming more useful and important in helping financial advisors enhance portfolio returns and better manage risk. Financial advisors owe it to themselves and their clients to continue to learn more about how they can take best advantage of the continued innovation in the industry.

## **About The Alliance Portfolio**

*The Alliance Portfolio, a private equity real estate financing company based in Orange County California, is a leading provider of pooled, privately financed real estate investments. By combining well underwritten and well secured trust deed loan origination with the flexibility of private money lending in a highly desirable local market area, The Alliance Portfolio has consistently created opportunities for both borrowers and investors. [www.theallianceportfolio.com](http://www.theallianceportfolio.com)*

## **About Nexus Strategy, LLC**

*Nexus Strategy, LLC is a leading consulting firm to the wealth management industry. With over 15 years of experience working with the industry's leading institutions and hundreds of independent investment advisors, Nexus Strategy is uniquely positioned to bring the latest thinking, industry knowledge, and creativity to create wealth management marketing and distribution opportunities. [www.nexus-strategy.com](http://www.nexus-strategy.com)*