Investing in the post-COVID era: Why mortgages have a place in every investment portfolio

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CMI

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1. INVESTING IN THE POST-COVID ERA

The COVID-19 pandemic brought the world economy to a halt in March 2020, as nations implemented drastic measures to contain the spread of the disease. An aggressive, coordinated response from all levels of government appears to have negated the generational recession many economists had feared. But these same measures have laid the groundwork for a new global financial order that no longer adheres to more established approaches to portfolio construction. Now more than ever, investors need to be creative to achieve their longer-term horizon investment goals.

2. THE RISE OF ALTERNATIVE INVESTMENTS

Much has been written about the shift in the so-called "60/40" investment portfolio, which advises investors to allocate 60% of their holdings to stocks and 40% to fixed-income assets like bonds. Although the rationale for a 60/40 portfolio split remains relevant today—namely, its broad diversification and volatility-reducing benefits—traditional fixed-income assets aren't holding up their end of the bargain from a rate of return perspective.

Collapsing real yields in the wake of the 2008-09 financial crisis have made government bonds far less predictable and attractive than before. And with the Bank of Canada expected to keep interest rates low following the pandemic through to at least 2024, government bond yields are struggling to keep up with inflation.[1] The same outcomes are being observed in the United States, Europe and Asia, with central banks in these regions continuing to suppress interest rates to aid in the post-pandemic recovery.

Against this backdrop, alternative investments have carved out a strong presence. This asset class, which includes financial products that typically fall outside of conventional assets like stocks, bonds and cash, topped $10 trillion in 2020, an increase of 55% over the previous seven years.

While definitions vary, alternative assets usually include private equity, venture capital, hedge funds, real estate, private mortgages, commodities, tangible assets and, more recently, cryptocurrencies. Alternatives are expected to reach over $17 trillion by 2025, although this projection predates the COVID-19 pandemic.[2]

Within the alternatives category, real estate and mortgages have become a popular option for smart money investors. By 2018, these investors had allocated a quarter of their portfolio to alternatives, with real estate accounting for the second-largest category following hedge funds, according to Ernst & Young. Despite the record-breaking bull market in stocks, major institutional investors are saving plenty of room in their portfolios for real estate.

Figure 1: Current and projected assets under management of alternative assets. | Source: ▶ Prequin

3. MORTGAGE INVESTMENT ALTERNATIVES

Direct ownership of real estate isn't the only way investors are gaining exposure to the lucrative property markets. Private mortgages, which offer a fixed-income alternative to government bonds, have grown in popularity over the past ten years. Shifts in the country's mortgage lending practices have created higher demand for private lenders—a category that the Bank of Canada calls "non-bank financial intermediation."

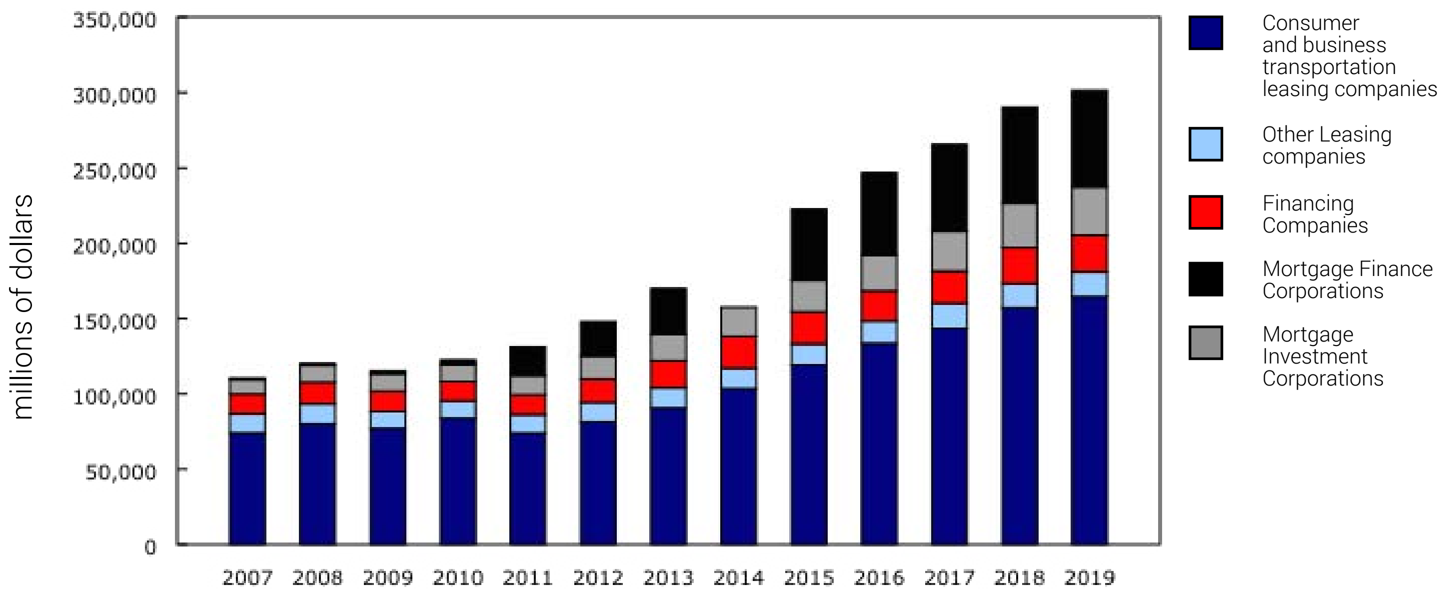

Figure 2: Total financial assets of non-bank credit intermediaries have grown steadily over the past decade. | Source: ▶ Statistics Canada

Non-bank financial intermediation is one of the fastest-growing segments of Canada's lending market. Today, these lenders account for roughly 1% of the overall mortgage market and a much higher percentage of secondary mortgages in major jurisdictions like the Greater Toronto Area. [4]

Recent changes in federal mortgage guidelines that seek to tighten qualification rules are likely to compel more prospective borrowers towards private mortgages. In April 2021, the Office of the Superintendent of Financial Institutions announced it will raise the benchmark to qualify for uninsured mortgages to 5.25%, up considerably from the posted rates of Canada's six largest lenders.[5] Similar measures have been enacted recently—all of which drove higher foot traffic to private lenders.

In Canada, Mortgage Investment Corporations (MICs) are one of the easiest ways investors can gain direct exposure to the private mortgage market. MICs are pooled investment funds that invest in private mortgages on behalf of investors. A MIC is structured similarly to a mutual fund or exchange-traded fund, but instead of stocks and bonds as the underlying asset, the MIC consists of a pool of carefully selected mortgages that generates income through the collection of fees and interest charged to the borrowers. In Canada, MICs can be incorporated into registered investment portfolios, such as a TFSA, RRSP or RESP.

By definition, traditional portfolios composed of equities and bonds lack sufficient exposure to private real estate and mortgages. These portfolios are less resilient to extreme market shocks like the one we saw in 2020 when the entire global economy shut down due to COVID.

On the other hand, private mortgages exhibit no correlation with public markets, which means they aren't exposed to the same volatility as stocks or bonds. Even during the worst of pandemic-induced stock-market volatility of 2020, Mortgage Investment Corporations were relatively unaffected. These portfolios continued to benefit from a resurgence in housing market demand following the first wave of the pandemic in March 2020.

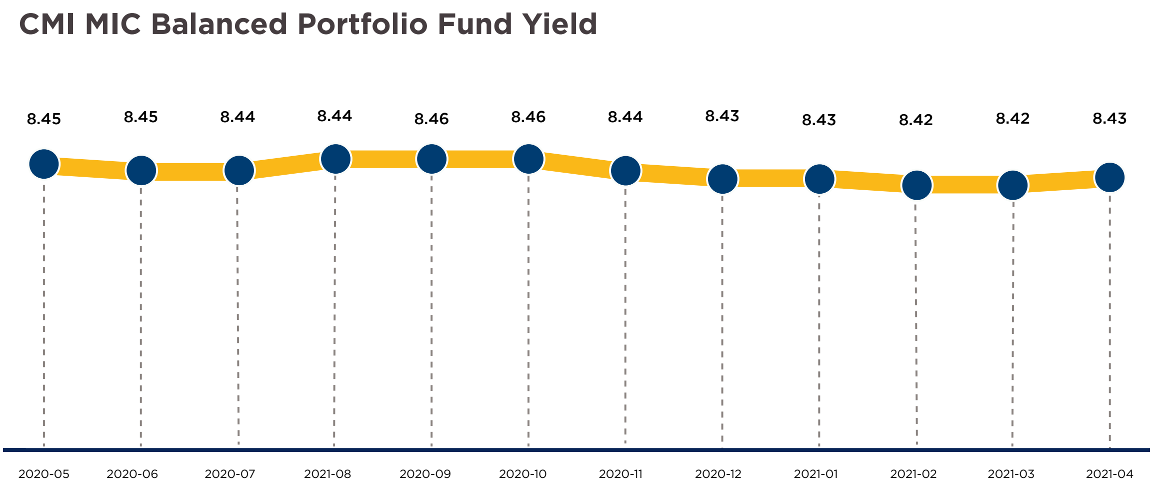

Figure 3: CMI's Balanced Portfolio Fund met its yield targets every month during the pandemic.

As short duration fixed-income assets, private mortgages have historically generated higher yields than other fixed-income assets such as government bonds. Although government bonds are generally considered to be among the most risk-averse assets, declining yields have made these bonds less competitive over time, especially when compared with leading private mortgage portfolios that have produced consistently higher returns. However, it's important to point out that the potential rate of return on a private mortgage portfolio is highly dependent on how the fund is managed and structured. Some MIC portfolios target higher rates of return, which means they take on loans that are perceived to be slightly riskier. Others adopt a more conservative approach that produces lower, but more predictable, yields.

CMI MIC Funds is comprised of three funds that are tailored to various investor risk profiles. As of April 2021, the net annual yield for the CMI MIC Funds was between 6% and 10.5%, with higher yields corresponding with slightly higher risk profiles. However, each fund maintains a strong focus on capital preservation by adhering to strict loan-to-value ratios.

With access to a broad deal flow, CMI's fund managers can be more selective in terms of which mortgages are included in their MIC portfolios. CMI's private mortgage portfolio is national in scale, seeking geographic balance with a strong focus on diverse first and second mortgages. CMI Mortgage Investments also administers a whole mortgage investment program that includes origination, underwriting and servicing components.

4. INVEST WITH CONFIDENCE

Successful mortgage investing usually begins by selecting a reputable investment partner. Several MIC providers have sprung up in recent years to capture the growing popularity of private mortgages. Many of these funds are narrowly concentrated in the Greater Toronto Area. Given the short duration of mortgage portfolios and the need to deploy capital as quickly as possible, many GTA-focused MICs have seen their yields stagnate or decline. That's because increased competition in dense urban markets has placed downward pressure on interest rates and compressed the yields of several leading MIC funds. Therefore, one of the most important factors when selecting a reputable MIC provider is geographic distribution. Funds that lend to geographically diverse regions often generate higher and more stable yields and have more attractive investment prospects.

In addition to geographic distribution, experienced MIC providers with a proven track record of success are better positioned to serve investors. Experience doesn't just include years in service, but total assets under management (AuM).

The most reputable Mortgage Investment Corporations have proper risk and due diligence processes in place. MICs with in-house capabilities to review submissions, conduct pricing analysis, fulfill commitment issuances, complete due diligence processes and advance and administer mortgages are in a better position to provide investors with the highest level of sophistication needed in a portfolio manager.

With over $700 million in successful mortgage placements, CMI Financial Group has become one of the fastest-growing private mortgage providers in Canada. CMI's MIC Family of Funds continue to meet investment objectives thanks to our rigorous and geographically diversified lending approach.

5. THE BOTTOM LINE

Alternative investments have played an increasingly vital role in portfolio construction over the past decade. It comes as no surprise that smart money investors have focused on real estate holdings as a hedge against volatility and a buffer against other forms of financial uncertainty.[6]

Canadian investors in search of broad diversification and insulation from the volatility of public markets are starting to pivot towards private mortgages to boost portfolio returns. Like physical real estate, private mortgage investing provides passive income and exposure to stable residential markets—only without the risk and costs associated with home ownership or title ownership.

The CMI Financial Group is committed to working with investors to provide solutions for their specific needs. Contact us today for more information on our MIC Funds and whole loan program.

Endnotes

1 Pamela Heaven (September 4, 2020). "Posthaste: Bank of Canada could keep interest rates super low for next 4 years, if these economists are right." Financial Post.

2 Prequin. The Future of Alternatives.

3 Mike Lo Parrino (November 19, 2018). "How disruption is reshaping alternative asset management." Ernst & Young.

4 Guillaume Bedard-Page (March 26, 2019). "Non-Bank Financial Intermediation in Canada: An Update." Bank of Canada.

5 Theophilos Argitis (April 8, 2021). "Canada Regulator Eyes Tougher Mortgage Rules Amid Bubble Fears." BNN Bloomberg.

6 John J. Pizale. "Why The Wealthy Favour Real Estate Investing." Fundscraper.

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