INTEGRIS WEALTH MANAGEMENT

Gifford Lehman, CFP | Michael A. Leavy, CFA | Douglas M. Roesser, CFP

Technology Bust Redux

May 2008

If you are a reader of the local Monterey Herald, you have no doubt seen numerous front page articles recently about a local investment firm, Cedar Funding. This firm collects money from investors and then lends that money primarily to builders as construction loans, secured by the properties in the form of first or second deeds of trust (mortgages).

Cedar is currently in the press because they are, for all intents and purposes, imploding. While there is some uncertainty regarding all the underlying facts, what is clear is that they have cut interest payments to investors, investors are currently unable to get their original investment back, some investors have filed lawsuits, and the regulatory authorities have suspended Cedar's ability to operate independently. Nobody is sure whether investor principal will be completely recovered or not.

If you have been following our newsletters, you know we like to seize upon "teachable moments" when they present themselves and to treat such moments in a lighthearted way to make the lesson more enjoyable. However, this is happening in our community, and too many people reading this have been investors with Cedar or know someone who has. This is not a moment to have fun, but there are lessons to be had.

Point One - Diversification. In the world of investments there is a relationship between return and risk; and the only reliable way to manage risk is to diversify your portfolio. This is the closest thing to a "free lunch" that is available. For example, if you buy 10 investments, each with an expected return of 10%, the risk of that portfolio of investments is lower than the risk of any one of those investments. That is because you are "diversifying" away what investment professionals call "specific risk" – the risk specific to each individual investment, such as the risk of owning an Enron or a WorldCom (or a Cedar). With Cedar, most investors did not appreciate or think through the implication that they were:

1.) Concentrated in one tiny sector of the financial markets – deeds of trust;

2.) Concentrated in one or two geographical areas - Central and Southern California; and

3.) Concentrated with one money manager - Cedar Funding, run primarily by one person.

That is a TON of specific risk. It is a lot like investing all your money in one or two stocks, and hoping that that investment does not become the next Enron or WorldCom. A properly diversified portfolio should limit the concentration in any one security, industry, or geographical location.

Point Two – No free lunch. Cedar offered its investors 10.75% interest, which is fine. The sad part is that many of these investors regarded Cedar as a risk-free or nearly risk-free investment. Higher return investments are always higher risk investments. Think about it. If someone is willing to pay 10% or more to borrow money, it is typically because they can't get a loan for a lower rate. And the reason they can't get a lower rate is because lending to them is risky. So if Cedar was truly able to invest at interest rates of 10% or greater, they had to be investing in higher risk loans.

Point Three - Liquidity. Liquidity means you can get your money out at any time at a fair price. Private mortgages, just like direct investments in real estate, are inherently NOT liquid. The person borrowing the money from you is not obligated to, or even expected to, return those funds until either the property sells, or the mortgage ends. And if the borrower can't return the funds when the mortgage is due, you either renegotiate or foreclose on the property, neither of which gets you your money back right away.

For investors in Cedar's pooled mortgage fund, Cedar has historically been able to accommodate investor liquidity needs by using new investor money to return money to investors who wanted to get out. This probably lulled investors into thinking they had ready liquidity, but this was an illusion. If there are no new investors, as is the case now, then there is no liquidity.

Conclusion. There is nothing inherently wrong with investments in deeds of trust. The failure is that some of Cedar Funding's investors thought they were getting a high rate of return with nearly complete liquidity for almost no risk – a "free lunch" – and given this false sense of security, placed too much of their wealth in a single undiversified investment.

This is not the first time investors have underestimated or misunderstood the risk of an investment. The most recent example that comes to mind is the technology stock bubble of the late 1990's. Unfortunately, many investors believed there was a "free lunch" there – that tech stocks would go up dramatically forever with minimal risk – and as a consequence, they failed to diversify properly.

Integris Wealth Management, P.O. Box 6322, Carmel CA 93921 | 831-620-1717 | integriswealth.com