Ep #160: Mike Zlotnik - Investing in the Age of Stock Market Volatility and Rising Interest Rates

Full Episode Transcript

With Your Host

Dr. David Phelps

Dentist Freedom Blueprint with Dr. David Phelps and Evan Harris

Mike: If you have a mortgage that somehow can be assumable, you can sell the property with that mortgage. That becomes a phenomenal asset. Lock it in. Great interest rates now when the rates are low for long term is a secret to success. You can't go wrong with this.

You are listening to the *Dentist Freedom Blueprint* podcast, with David Phelps. Navigating you through the uncharted waters of a turbulent economy with straight-forward advice to, transform your practice into a self-sufficient cash machine, compound your net worth assets, and multiply, multiply, multiply your passive cash flow streams.

David: Well good day everyone. This is Doctor David Phelps with the Freedom Founders Mastermind Community and the Dentist Freedom Blueprint Podcast. Back to you today with what's going to be a really interesting and very topical interview with a good friend of mine, who is a co member in another mastermind. He is also an elite trusted advisor with Freedom Founders and really brings a wealth of knowledge, experience, to the audience to day in all that he's done in real estate. I'm gonna give a little bit of his background but first let me just welcome our guest today. It's Mr. Mike Zlotnik We also affectionately call him big Mike and I'll tell you why in a minute. Big Mike, how are you doing today sir?

Mike: Hi David. I'm great. How are you? Thank you for having me.

David: It's always great to talk to you. I'll give my listeners a little bit more of your background in a second, but I just always like to take a personal side, and I remember back when you and I first met at the Collective Genius Mastermind. I remember it very, very vividly. We were in Tampa. That was my first meeting. You'd been already a member for a while, and I just remember meeting you and realizing how quickly, how sincere and genuine you were about serving, bringing your experience. You were very, very approachable and I rally appreciated that about you and you haven't let me down since, all the years that I've known you and seen you in different venues, both at Freedom Founders, Collective Genius, all the other people that interact with you and invest in your funds. You're a giver on the front end. You're always bringing your experience to the table, not to sell anything, but just to actually help people and that's what we're going to do today on this interview. Again, I appreciate you being here.

Mike: Thank you kindly, and the feeling is mutual. Your humble approach to everything is a great example and learned it from my mother to be a giver. I don't it any other way.

David: Yeah, exactly. That's the way to do it. Mike, Big Mike, he's been a debt and equity investor in real estate since the year 2000. He started his career and spent nearly 15 years in the information technology field managing risk business intelligence and quality of complex systems, software and processes. He's a strong, analytic, and strategic thinker, focused on improving profitability through data analysis, business processing and engineering, and optimization. While building a successful career in IT, Mike's passion has always been real estate investing because of its predictability of outcome. I'm gonna come back to that. And well understood risk. I think those are two key things that people don't always get. I'm gonna come back to that.

In 2009, Mike joined Temple Funding LSE, which is a mortgage pool fund, as a managing director and vice president of funding operations. Starting from January 2014, Mike has assumed the responsibility of a CEO and has since found his TF Management Group LSE and launching two new real estate investment funds. Under Mike's leadership, the company has seen continuous double digit annual growth delivering strong returns for the fund investors. Mike holds a bachelor's degree in mathematics from Binghamton University. He's a member of multiple real estate and investor mastermind groups such as The Collective genius, Freedom Founders Mastermind Community, Venture alliance, and California Investors, which is a private group.

Mike, you also ... I just want to let listeners know, we call you big Mike because you stand tall. I mean you physically stand tall but you also stand tall in the realm of real estate and your knowledge and experience and you also have a podcast, which is the Big Mike Find Podcast, which people can pick that up I'm sure in all the different platforms, iTunes, Stitcher. Just Google Big Mike Fund Podcast, right?

Mike: Thank you David. Yeah. It's Bigmikefund.com.

David: Dot-com. There it is. All right. You can learn about Mike. People probably listening to your accent a little bit. Where are you from? You're not from Birmingham, Alabama. Where are you from?

Mike: No. From Russia, with love. To be exact. I'm actually from Moldova. The Republic of a former Soviet Union. I am a refugee from the communists. We have a family history. My father was killed by communists and I ran away. My mother, we got away. We are US citizens. We came here in 1989. That's my short story.

David: You were how old in '89 Mike?

Mike: Almost 18.

David: Almost 18. I have to dig in a little bit and we won't spend the whole time ... We could. I really appreciate people's stories, especially people who have successfully immigrated here to the US because of various reasons but many of them, as you said, from communist nations, oppressive nations, and the risk that obviously one takes from family standpoint. Do you stay to do you risk moving, especially if your mom has got to be a very, very strong person, who not only taught you great lessons but with great fortitude, took you on ... I don't know how many siblings you have but how many were with you and your mom when you traveled here?

Mike: We traveled just two of us. My mom is a very courageous woman and she's always given me strength and the gift of giving. I love my mother dearly. She's still around. She's 87. She's having her struggles but she is just a fighter all her life and then she helped my sister come over in 1991. I have one older sister, with her family.

David: Your transition as an 18 year old, coming to the states for the first time, was that difficult for you or did you feel like you were able to assimilate relatively quickly? I'm just curious.

Mike: Fairly quickly. I mean, there's a massive difference between the ex soviet society and the American way. There's a freedom here. Opportunity is here. Over there it's very difficult. Different world. I enjoyed studying mathematics, science, all this stuff was great but life is 10 times more difficult and the freedoms are not there. It's very easy to come to the United States. That's what everybody wants to come here because of freedom and liberties.

David: Something that unfortunately a lot of people take for granted but we won't go deep on that topic today. Thank you for being here. Thank you for being the stand up guy you are and I for one am very happy that you are such an advocate for liberty and freedom that you are in the things you do in the entrepreneurial space. I know you well. As you said in the bio, you're very analytical. You love mathematics, so data analysis, processes, that's what your good at. What was your link to getting into real estate? Where did real estate start hitting you on the radar going, "Hey, I can take what I love and what I'm good at and I can morph this into real estate." What was that transition like for you? When did that happen?

Mike: It happened when I bought my first apartment in the year 2000. This was a primary residence, bought it in a building. I still own a lot of apartments in that building. I'm the president of that co-op but I entered that building in 2000. I love buying the property. I love the fact can get a mortgage, get great financing. I think I actually bought the property originally for cash but then we got a mortgage afterwards. I just thought, living in New York City and the appreciation that real estate has had, it's easy, right? Just buy and hold. You don't have to think about it. For me it wasn't a first investment as a cash flow. It was a primary residence but I was appreciating. So, it was something about real estate that appreciates over time, and New York City is known to appreciate above average. That got me triggered. I spent many years afterwards still in the software development but I've always had a passion for real estate. In 2003, a few years after, I think I picked up one apartment in between and 2003 I picked up eight apartments in the same building.

I started accumulating. It was easy. I govern the board and it was very easy for me, sort of knowing what's going on financially. That was the very basic transition, just seeing that rental properties in the city's apartments is a safe way to invest for some cash flow and for good appreciation. Risk is low. Upside is great. That's the basics. After that I bought houses afterwards and venture into more complicated deals, but the simplicity of real estate, predictability of the cash flow and I guess fairly easy mathematics. You don't have to get complex. I love about it is I have a degree in mathematics but how much of it do you use in real estate? It's basically Excel spreadsheet, mortgage calculators. The benefits of real estate, it's financibility of real estate, predictability of cash flow, the appreciation, all those things combined together make it so attractive.

David: I'm gonna title this podcast interview Mike, Investing in the Age of the Stick Market Volatility and Rising Interest Rates. We know for the last 36 years up until about a year or so ago, we've had falling interest rates. You know, down to and after the mortgage meltdown, and subprime chaos 2008, the federal reserve took rates down next to zero and now they've just been slightly bumping up and there's predictability they'll continue to go up. Of course, where else do they have to go but up, right?

So, we have this falling interest rate environment for 36 year. That's decades and a lot of people listening to this podcast, some weren't born and some were just kids who really didn't know what was going on and so when people then are used to falling interest rates, and relatively low inflation, I'm just wanting to know from your crystal ball stand point, what might we see in the next 36 years, to the nest four decades? If you had to make along term prediction ... I'm not going to hold you to it but do you think interest rates are going to stay low or are they gonna go up and how does real estate fit into the long term for people like us who like to be long term investors?

Mike: You probably heard this from me. My crystal ball broke a long time ago unfortunately but we are living at least in the short run in the age of increasing interest rates and it's been significant stock market relativity just because there's a threat of mortgage rates increases. High interest rates, they bleed bond markets badly. They also bleed stocks. The earnings suffer because financability of corporate debt gets more expensive. In the short run, I mean the next couple of years, it is pretty likely that the rates going to go up and it will put significant brakes on stock market and obviously bond market. Your traditional investment instruments become a lot less attractive. Especially given the run in the stock market. I think we're gonna see some level of correction. Obviously higher relativity and less predictability.

Who knows, the market may continue to keep going up but the laws of gravity in the current PE's, if you follow the basic theory, these are so high that the returns for the next 10 years in the stock market expected to be barely in the single digits, low single digits. That's one aspect of this. In the long run I actually don't think US can afford much higher interest rates. As strange as it sounds because of the huge national debt. The debt is out of control, continues to spin out of control and funded liabilities, entitlements continue to drain US wealth per se. Now, I am neither left nor right. I'm right down the middle. I feel both sides. I'm not taking a political position here. I'm just saying that it's not about politics anymore. It's about what has been done. The debt is so big and continues to grow and US budget just cannot afford to keep high interest rates because the debt service on the growing national debt plus the unfunded liabilities that are turning into national debt every year, going to accelerate.

I think over time the US will go back to the Japan kind of policy, where the rates will crawl back down to low territory, otherwise we're gonna have an acceleration and hyper inflation. It's either back to the low interest rate whom I see acceleration, hyper inflation, with high interest rates and it's gonna be the joke ... It's like Yugoslavia. I use to hold the 500 mil in Yugoslavian bank note. You can't buy a loaf of bread with it. That's sort of my view. It's either hyper inflation or significant slow down and low interest rates and we're not gonna see ... We'll see asset inflation but we're not gonna see as much wage inflation. Wage inflation is obviously going to improve in the short run with low unemployment but who knows what's gonna happen. If that employment turns around, the wage inflation may slow down but asset inflation will continue to take place for many reasons.

One of them is the buying power of the dollar. More dollars in circulation the assets worth more. When the other hand you've got continuous foreign flow of capital. They want to get the money away from Russia, from China, and everywhere else where the governments are communist governments and they have no stability, no predictability. Where they move all their money? To the Unites States. They fell safe and secure here.

David: Yeah, I was gonna say, you talked about rising interest rates can do to the stock market and to the bond markets. What does it do to the real estate that we might be investing in, in long term. What's it gonna do there?

Mike: This is an interesting question. The general theory is that when the rates rise, the cost if financing goes up and the consequence is that the commercial properties, pretty much multi family, any type of commercial office space, industrial, all of them will look a little more expensive from a debt service perspective. From that angle, we can see some level of correction in the real estate markets but on the other side, there's still a lot of capital shifting out of the stock market and gonna shift into alternative assets and that will continuously build the demand. What happens is banks that finance these deals will have a wonderful time sticking to their debt service coverage ratio. Heard of the term DSCR. All it means is that they want to make sure that the properties cash flow well enough to be able to service the debt. The basic solution to the problem is, for equity investors in real estate is, essentially, take less leverage. They bring in more equity, they will bring in partners. They'll take on less debt and the asset prices could still be where they are now. It's a more likely scenario that the prices will collapse.

I would say 50 to 100 basis points raise over the next 12 months is not gonna cause major grief. I don't think we're gonna see a correction. Again, this is just trying to have a crystal ball when I don't have it but the likelihood of serous correction is not there. Although coastal markets are already softening up. I you want to segregate real estate, I would say that good cash flow properties in non coastal markets will do fairly well. The equity investors will have to bring in a little more capital, bring in partners to be able to obtain the assets but we're not gonna see price collapse. I don't think that's happening, not in the next 12 months, but if the rates go up a lot we'll see downward pressure for sure. If it continues for a couple more years ... We're not talking about 100 basis points. We're talking about going back to the norm. So, if the norm is 6%, then we are now into 4%, 200 basis points plus. That might slow down leverage assets to a degree.

David: Yeah, that's good Mike. You said several times, the focus on cash flow. If we're a longer term investor, which is what we're talking about versus speculation, which is speculations people trying to arbitrage the rising markets and that's a whole different game. It's not really what I call investment. It's a game that people that really have their fingers on the pulse of the market may want to play but for the people I deal with and my professional practice owners, we're looking at long term.

With long term, if we focus on cash flow, make sure the cash flow is solid. If were able to leverage and you said we may need to bring in, as rising interest rates may occur over the nest 12, 24 months, may need more capital. So, a little less leverage but still using leverage, which done well, done safely is a good thing. If we're holding long term and we have good long term fixed rate mortgages, financing, then if we do have high interest rates and therefore there may be a decrease in the value of some properties, what's our cash flow likely to do though with higher interest rates? Is that gonna affect ... Is that gonna decrease out cash flow? What happens there usually?

Mike: Well, that's the beauty of ... If you lock in the rates for long term your cash flow is predictable. That point you don't need to worry about everybody else. The new people, the new investors will struggle but you've got a great cash flow. In fact, if you have a mortgage that somehow can assumable, you can sell the property with that mortgage and becomes a phenomenal asset. Lock it in, great interest rates now, while the rates are low for long term is the secret to success. You can't go wrong with this. I'll give you an example. We don't have to go far.

I talked a little bit about that co-op. I'm the president of that co-op, that building. What are we doing right now? We have a 10 year mortgage that is maturing next year in about a year and a half. We know the rates are going up and I thought about the problem and we're essentially taking aggressive action right now to refinance the mortgage because we can lock in 4.1 to maybe 4.1, in that range. 10 year fixed rate on a 30 year amortization that's available through a number of banks here in New York. We will have a prepayment penalty, a little bit of prepayment penalty. It is very well worth to pay a little more to lock in a great rate. In this case it's a prepayment penalty but the long term value of a 10 year mortgage in the low four's is just phenomenal. So, from that perspective that's what people should do, could do, and should do today if they have an opportunity. If they have mortgages maturing in the next year or two, they should be looking into potential refinancing right now, lock it in, great rate, as long as they can and riding the wave up.

David: That's great advice. That's really great advice. Let's talk a little bit about diversification and you have several funds. You put out several funds in the last number of years. They're all doing very well. You've got some that are debt funds. You've got some that are equity funds. We can talk a little bit about the difference here. What I'd really like to talk about is how an investor can diversify. You mentioned to me earlier about lowering the amount of dollars of participation per deal. That gives one more syndication's.

Also, you mentioned west coast or the non coastal areas being less volatile so that we can also stay away from those more cyclically volatile markets. Give us your perspective there because again, I know you can be very prudent about evaluating risk and you talked about earlier about the fact real estate has well understood risks. Kind of bring that together for our listeners because a lot of people think Mike about 10 years ago, 2008, and they may have been dealing with some of the meltdown themselves if they were speculating and highly leveraged or they may know somebody who lost houses or businesses and so they're thinking, "How can you guys talk about volatility but not say that real estates also not volatile?" We talked a little bit about being long term investors and fixed rate mortgages but what else about diversifying and reducing that risk can you give us with your experience and the funds that you do?

Mike: Sure David and thank you for touching on all those great points. Diversification is a general term that applies many dimensions. Folks that invest today, they should definitely look into a few key dimensions. One is geographic diversification. What we do is … opportunity fund is both growth and income fund. Income is we make hard money loans on properties that generated income and equity we invest in the value and equity projects all over the country, but we're trying to do a lot more deals now, believe it or not, in the Midwest, in the boring rust belt, and those areas that are not ... They don't go up and down like a yo yo.

We have investments in the multi family projects with value in Chicago area, even in Michigan. We have projects, conversion self storage in Cleveland, Ohio. These very boring cities but they're steady. The downside is very limited. So, geographic focus in the areas where the real estate it has gone up in the last few years but it's not the same way like we're talking about Southern California and Southern Florida. Staying away from those very hard markets and we're talking about staying away from Las Vegas, from Phoenix, San Diego, LA area, from Miami. Those area's are known to fluctuate significantly. They will have volatility when the market corrects, while rust belt provides significant opportunities.

Going into right geographic regions too, when you diversify, again, you're making assets. So, we make either debt or equity investments. We diversifying between different projects and different sponsors and different syndication. All that means is we're taking investors money, we break it into more smaller pieces across various projects. That's diversification too. If an investor is looking to invest say 1 million dollars for the sake of the argument. So, instead of taking two big chunks of half a million dollars, take four chunks, take five chunks of 200,000 each and less in each project, less in each fund but diversify and look at all angles of diversification.

Diversification among geographic region, project sponsors, types of assets, so we have diversification's between self storage. By the way, self storage, one of the strongest defensive sectors and known to survive recessions fairly well. We taking quite number of oppositions in the self storage because we think it's gonna survive pretty well in any significant downturn. Good multi family value add with forced appreciation equity are very strong projects and with staying away.

This morning I had a deal coming across my desk in Phoenix, ground up construction and I looked at it and said, "You've got to be kidding me." Do I want to put the money in this? Absolutely not because these houses are priced for perfection, if there's a little tremor in the air, suddenly 900,000 is gonna look like 700,000 or 600,000, and you got 30% drop. In those markets it's possible. In Midwest, I seriously, seriously doubt it.

David: That's good Mike. Just for our listeners benefit, I know some people are probably wondering what the difference is between debt and equity investments and then also you mentioned a term that I know well, but it's value at or forced appreciation. Could you just touch on those because I think that will help our listeners today really understand better what you're talking about. Debt versus equity and then also the value at or forced appreciation.

Mike: Sure. Very simple. We make hard money loans and fix and flip projects. We're making a loan, where land, where we van record a mortgage in the property or deed of trust. We're lending money at a fixed rate. Typically, these are double digit rates and it's a short term bridge loans. That's what we do. The long erm mortgages you have also, it's a debt instrument to the bank and an equity instrument for you if you own the property. That's that debt side versus equity.

Equity is when we buy a property or when we buy a part of the equity in the property, for the syndication. An example. We just had an investment in the defensive shopping plaza in Orlando. Orlando is not Miami but making a difference. It's very clos to Disney World. It's a good shopping plaza and a lot of service oriented businesses. The property's purchased for 11.5 million.

The debt is a little over seven and the equity is 5 million. That's the difference. The owners put in 5 million. The banks make a 7 million dollar loan and the property gets bought for 11 with change in the reserves left. That's the basic concept.

What does the value add? The value add ... Give you an example of a multi family project we have. We have two of them actually in the Midwest. Each one is around very similar. One is 343 units in the Chicago area. Essentially it's a A area but the property's a D property. It's a H property. So, when the project sponsor comes in finds a deal, they raise capital from investors to be basically buy the property and have enough capital to renovate every single apartment, or as many as possible in the property. Value add and forced appreciation is created by virtue of doing these renovations, by increasing rent on the renewals. This particular project sponsor has a unique system where he renovates units while people live in them. It's a unique system. The units can get renovated normally when they're empty but he renovates them, he doesn't increase rent, so people get to live in a renovated unit until the renewal time and at time of renewal they feel there so much more value in an apartment that they can tolerate the rent increase. That property, average rent increases 18% at time of renewal.

Either the new people move in or existing folks renew, 18% renewal. We're renovating units, adding a clubhouse to the property, cleaning up, making it look much more attractive. What project looks like ... You're taking a B property and making it into an A property. Two things happen. One is the income has gone up so much that using the commercial valuation approach to value, essentially the commercial property's of multi family trade a cap rate. The property could be bought at an A cap rate and even if it sold at an A cap rate, with 18% increase in net operating income, the value of the property is up by 40, 50% just by that.

Now, if a B property is now viewed as an A property, it's no longer 8% cap rate, it's 6 1/2%, 7%. The value is now up more than 50%. Can this thing go down? Sure. If the economy suffers the vacancy goes up but the value added is so much higher than buying retail. If you bought this property, retail did nothing with it, and the interest rates went up, unemployment got worse, you probably going to take a beating on the value of the property. In this case, okay, it won't go up 50%, it will go up 30% but it's still a significant upside.

David: And that's a huge, I think, benefit but people need to understand that, You know, what usually happens to a lot of investors and Mike, you know this very, very well, is that when a market ... It could be the stock market. It could be real estate market. Any kind of market, crypto currency. There's a lot of people that jump in late in the game, right? They watch these markets go up and up and up and they go, "Wow. I need to get in on that." Let's just talk about real estate. We both know, and you said it earlier, there's a lot of capital looking for a home today, looking for a yield. A lot of it's in the stock market but a lot of it's looking for the alternative investments. When there's a lot of capital chasing deal flow, it's basic economic, supply and demand, right? What happens is a lot of investors knowingly or probably most unknowingly are buying or investing at retail today and they're investing in new development projects at high retail in maybe areas that are more volatile. As you said, all it takes is one tick and that project, the cash flow and the returns can go down.

When you buy an existing project and do, as you said, the value add, renovations, whatever it is you're bringing to the table, that's where your profit lies even when a market may change a little bit. In a more stable market that already has existing performance versus something new that people are saying, "Well it should do this based on we have current market dynamics, the economy is good, there's confidence in business in the consumer markets," yeah, that's great but anything can change on a dime and that's what I think you're so good at because you've seen these markets, you've gone through them, and you know how to position yourself, your funds, and therefore your investors into these safer, with known risks, and therefore ... Really kind of a safety net. You've got the upside there for as long as these markets will run but you've got a safety net, which is all about that cash flow, that predictability of a cash flow.

Mike: David, thank you. I agree with you 100%. Not only that, I wanted to add one more point just to differentiate between value and the value add. There are a number of folks and some of them are mutual friends through CG, brightest guys, they tried some heavy lifting value add projects, meaning that they buy a complex with 30% or 40% occupancy, a multi family complex and they're trying to lift it into high 80's and then it's heavy lifting and high risk and it's hard. The projects I'm talking about is we want to go in with a vacancy in the 80's already. We generally don't want a vacancy ever to drop much below 80% even in heavy renovation. By entering the projects that have occupancy in the 80's into 90's, the downside is fairly low. You have good properties that are already cash flowing and you have nothing but the upside on the cash flow side.

That's the big difference. I'm not talking about any heavy lifting. We have some investments in the ground up developmental self storage and redevelopment. We have one self storage facility project in Houston, Texas, but that are is so badly needs self storage that the likelihood of that success is huge. No only that, that particular project, we're probably going to look for am exit strategy to sell the ground up construction later this year to a REIT. To get rid of it. Not to carry the business for the next few years. We're looking into those projects as potential ways to exit faster but in general, in general, ground up is high level of risk although some sectors like self storage in a wealth guarded area with good market supply index's are much more likely to succeed, and we have another self storage project I wanted to mention in Cleveland, Ohio conversion of an old Macy's to a self storage.

The big value play in that is that, that mall was bought as such deep discount. It's hugely below reconstruction cost. There's so many upsides on that project that it's very hard to go wrong, even if the self storage does not turn a blockbuster. What's funny is in that area in the self storage there's the index, the supply index is known as the equilibrium is around seven. In that area, it was one or two. It's so much below the supply that the likelihood of success is very high. That's what I'm saying. The value add, with very careful selection of the projects in the right areas, you could do ground ups or redevelopments. There's nothing wrong with that but just picking and choosing the battles very, very carefully, where you think the likelihood of success even though heavy lifting project still is very predictable.

David: That's where years of experience and being in different geographic markets and economic cycles provide you with a great deal of the ability to see through these things and again that's where experience pays off. When I want to invest my money and I do it very much the way you talk about. I do it through partners. I call them joint venture partners whether it's in a fund or in one off deals but I love to work with other people because that's where my diversification comes from. If I know that person, I know that they've got the track record, they've been through some battles of the up and down markets, that's where my confidence comes from and just having you talk about that today gives me a lot of additional insights. Lets me know where I'm thinking the right way and maybe where I need to adjust my thinking.

So, big Mike, I really appreciate you being on her today. You brought some great insights to our listeners. Again, you can find big Mike at the bigmikefund.com and jump on if you want to hear some more of his insights. He brings a great deal of experience and expertise to our markets and for those who are wanting to learn more about investing in real estate in all the different ways that are possible. Mike brings a lot of knowledge and background experience to the table.

Mike: Thank you David.

David: Great having you on Mike. We'll talk to you soon.

Mike: Thank you David. I really appreciate it.

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