Ep #260: Jeffrey Watson - Investing Due Diligence in a Low-Yield Environment

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Dr. David Phelps

Dentist Freedom Blueprint with Dr. David Phelps

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David Phelps: Good day, everyone. This is Dr. David Phelps of the Freedom Founders Mastermind Community and Dentist Freedom Blueprint Podcast. Today with a really good buddy of mine. We've known each other for quite some number of years and circulate around different groups and masterminds and really all things real estate. But even more specifically in this topic today we'll be talking about real estate, the current environment and also certainly into some areas a little bit about tax, the federal tax savings through the self-directed IRA especially of this gentleman and I have today, It's an honor to have him, my good friend Mr. Jeffrey Watson. Jeff, how are you, Sir?

Jeffrey Watson: David, I am doing better and better and it is a genuine pleasure to have this time with you. I know we saw each other face to face on Sunday, a few days ago, and that was good, but I always enjoy chatting with you, man.

David Phelps: Well, Jeff, I'm going to give a little bit more of your bio, but just on a conversational basis, Jeff, I know you, number one, to be a practicing attorney for 27 years, but like many people that we circulate with, you have over the years found your niche highly in real estate. You've done other things in law, but real estate is something we both love. You love it, and you've taken some unique approaches and your expertise is highly valuable in these areas. So, I'm going to give a little bit more of your overall bio, so people know what we're talking about and who you are.

David Phelps: So, Jeff Watson is an attorney. He's been practicing active trial and hearing practice for more than 27 years. As a trial lawyer, he has a very unique perspective on real estate investing, wealth building and asset protection. He's tried over 20 civil jury trials, has handled thousands of contested hearings. In Ohio, where a lot of his practice time has been, he has changed the law five times via litigation or legislation. He's also been an active real estate investor since 1994, investing in both residential and commercial properties.

David Phelps: He currently represents established real estate investors in commercial and residential matters when the transaction has evolved to self-directed retirement accounts. This is a passion that Jeff has. He's really gotten deep and understands the laws and the right way, the wrong way to do things. If you need any help with setting up self directed IRA accounts and how to invest the right way with real estate, Jeff would be definitely your guy. He's also a frequent popular guest speaker, teaches on stages and webinars, a recognized thought leader and innovator in the field of real estate investing, wealth building, self-directed retirement transactions.

David Phelps: He's also done a lot of work state and national levels regarding regulatory concerns. Besides things, he's done in Ohio, I mentioned earlier in 2010 going forward, he has led lobbying efforts in Washington DC on behalf of real estate investors nationwide to bring about several changes in both government regulation and policy on distress, property purchases, resales. He was instrumental in bringing about the change in the US tax code and helped reinstate the Mortgage Debt Forgiveness Act. Since 2015, he's also worked on behalf of all of us investors to secure passage of these Seller Finance Enhancement Act. I could go on and on. He's coauthored several books and I'll give you the website where you can find him. In addition to those books, he has as an email newsletter goes out twice a week. I get it. I'm on the list and maintains a blog at www.watsoninvested.com. Everything about investing in business and entrepreneurship.

David Phelps: Tons of people are on that list. So Jeff, I shortened it as much as I could, but you really, you brought so much value to me and to the people we circulate with him. Really what I want to touch on today, what's something that you and I, we both in different ways have talked about it. You've spoken about it, you write it, we both write about it, but it's kind of the environment we're in today as investors overall. We talked about a little bit last weekend where we saw each other in Dallas and it says, "Low yield, low interest rate yield and a deal starved environment we live in today".

David Phelps: Let's brush that up a little bit, Jeff, and talk about... some people say, well, the low interest rates, that's a good thing. That's a good thing. And other people say, no, that's a terrible thing. So, dive into this. Give us some overview as maybe a little bit, why we're here in this environment and where we're going and what we have to be aware of as investors in this... lot of territory to cover. But jump in and we'll have a conversation.

Jeffrey Watson: Yeah, let's try and break it into three segments. I think we're in a low interest rate environment because of two factors. Number one, the central banks across the world have been engaged and they race to the bottom as to who can devalue their currency to try and enhance their foreign trade. So, that means they've got to keep their interest rates low.

Jeffrey Watson: I think we also have another reason why we're at a low interest rate environment and that is we have needed low interest rates to come out of the calamity of a dozen years ago and the stock market absolutely will throw a temper tantrum. The moment there's even the thought of a small return to normalcy or small step towards normalcy of interest rates. And then the last thing, and David, correct me if I'm wrong, but I think another reason why we've got low interest rates is because our tax and spend-a-holics in Washington, D.C. need it be cheap. They need to be getting as cheap of money as they can from the Fed, from bond holders, from investors, because we just have politicians that spend with no thought of tomorrow.

David Phelps: Yeah, you're 100% right. The Fed has to keep to the extent that they can to keep the interest rates low, artificially low, subsidized low so that the government can maintain that continuing excessive debt burden that as you said, the politicians keep piling up as if there is no tomorrow. It's like we never have to pay it back. And of course politicians don't care because they're here today. They get what they want out of D.C., go home with their massive retirement plans and everything else that they aggregate during those years. And unfortunately, they don't care as long as they get theirs, they don't care. It's a sad state of affairs. But that's where we are. So, I think you nailed it as far as why we have this low yield environment. All right, I'll let you to let you take the next step with this.

Jeffrey Watson: Well, the next step is that means that we've got to be smart about how we invest. Okay? We've got to be incredibly smart about how we invest. We've got to be thinking about two things. All that glitters is not gold. And in a YieldStar environment, the next Bernie Madoff is getting a big head of steam right now. I don't know who it is, I don't know where they are, but I guarantee you the next Bernie Madoff is on the scenes piling up victims that don't even know it's happened to them yet. And the other thing that scares me, David, is in our real estate investing world, in our culture, there are a lot of people who are falling for this notion of higher yields on these deals that... if you and I looked at him, we'd run away screaming, but the way they're camouflaged or misrepresented an unsophisticated investor's going to be lured in by the high yield and the charms of the promoter and they're going to lose the principal, let alone not get a return on the principal. That's my biggest fear.

David Phelps: So Jeff-

Jeffrey Watson: I mean it's scaring me.

David Phelps: So you and I and a lot of people that we spend time with have seen the cycles and certainly the last one, 2008 which now is 12 years ago and coming out of that say 2011, 2012 since then we've had a run now of good solid eight years where the markets, all markets have risen. And a lot of it, as you said already, it's been driven by the federal reserve doing the big bail out, forcing interest rates down, down, down to salvage the company to open credit markets back up again because credit, the ability to finance our lives, our consumption businesses, investments, that's what drives the economy. So without credit everything does dry up. So, it comes to a screeching halt. So, they forced the rates down a year or so ago, they started to try to reverse their quantitative easing and try to tighten things back up on their balance sheet.

David Phelps: They tried to raise interest rates a couple quarters of point and then they had to reverse course again. We won't go into the details there, but we're going back again and so many people, Jeff, who went through 2008 or maybe didn't go through 2008 really, hit on in business or investing, they don't remember or they don't know. And we're to a Bernie Madoff type environment because everybody wants to get that yield. They want to get the return. And because of low interest rates over this period of time, and the fact that it's been so much money digitally pumped into the economy by the federal reserve, you've got these dollars chasing, where do I make my money earn? Because the problem for conservative people, which is what we're taught to do, is save our money and then put it in something conservative like a CD or a money market or a treasury bill.

David Phelps: Very, very typically, very, very safe. Well, it doesn't generate you any yield. So, everybody's money, including seniors who should be conservative, are having to gamble their money either in the stock market or any kind of have a deal today that shows the pretense of producing a higher yield return. And that's where the scary part comes in because as you just said, I don't know who the next Bernie Madoff is, but you and I both see in traveling the country, talking to people, we see a lot of brazen, younger investors who feel like they can do nothing wrong and the market just goes on and on and that's the bigger fool theory, "I can buy X for this and someone else will buy it from me later. I'm all good. I'm all good". Speak to that a little bit. What do you see out there?

Jeffrey Watson: Well, David, you and I are reading from the same playbook even though we're not in the same room this decade, the decade of the twenties is not going to be anything like the decade we just came through. Okay. You and I have been friends for most of the last decade. Okay. Seeing each other work together, collaborated often in the last decade. This next decade is going to be probably the most challenging for investors that we've ever seen. And I'm going to tell you why, because we're going to get whipsawed and we're in a low interest rate environment. Asset prices keep climbing and we're going to stay that way for a while longer. And then something's going to happen. And David, I have no idea what it's going to be. I have no idea when it's going to be, but something's going to happen and we're going to hit a bump. We're going to hit a bump. Everybody is going to catch their breath, look around and go, "Hmm".

Jeffrey Watson: And collectively we're going to have as a society and a country decide in the world economy decide, was that a bump or is that a dip? And I believe we'll treat it as a bump. We'll try and get rolling back again. But I think in the next 10 years we are going to have to address this massive amount of debt that is out there and growing. I mean, David, you and I are scared to death of some of the stuff we see out there and I think some of the scariest stuff I see is the corporate borrowing for the purpose of repurchasing shares of stock. That causes me a great deal of concern.

David Phelps: So, for our listeners benefit, explain a little bit why that should cause people to have concern.

Jeffrey Watson: Because what a company's doing is, it's taking liquidity out of the capital markets out of the bond market and so on. It's taking that money and it's then adding it to its balance sheet in exchange for buying back stock. So, it's literally sending the money to shareholders and pushing the value of the shares of stock up. It's not being used to generate productivity. You're not seeing plants built, you're not seeing products developed, you're not seeing things ship. You're not seeing innovation launched and developed. No. What you're seeing instead is we're just propping up the price of our company's stock and some of them are going to get away with it David, but there's going to be a bunch that won't. And when the dike starts to sprout more than a couple of weeks, we're going to be worried about the whole wall caving in and everybody getting flooded out.

David Phelps: That's the problem Jeff, as you said, we don't know exactly what the trigger point is going to be for a reset because the markets are always going to try to get back to an equilibrium. We can, the government can, the Fed can artificially try to interfere. And they do, they interfere a lot, but eventually they can't keep it propped up. So something will trigger. And then it's like a domino effect, it just starts to fall. The house of cards starts to fall and maybe as you said, maybe they prop it up, but eventually we got to deal with the debt. And until that happens, to me it's all very scary. So, let's talk a little bit, Jeff, about about any lesson. I already read your bio. You are... Just like I and a lot of people we run with, we invest in capital assets, tangible assets. We love real estate, we love real estate.

David Phelps: We know that we can be as active as we want to be. We can be boots on the ground and find deals where we can be semi-active and invest people, co-venture joint partnerships. We can invest in syndications, there's all kinds of ways to be involved. But the problem again is because we have all this money chasing yield and we have a lot of investors out there, whether they're doing direct ownership, single assets like single family or maybe in getting involved in some syndicating money to put it into apartment house or a self storage or there's people that have real estate funds where they're investing a pool of money to a diversified set of assets.

David Phelps: There's all these opportunities, but the price points of the assets that anybody's investing in have been pushed up and up and up. So, it means the margins or any equity, which is typically what we're investing in, gets slim. And the availability of the debt. So people that want to buy real estate at whatever level can typically, if they've got decent credit scores, the money's very accessible today and it's low interest rate. And so it's just like money flowing and people can't help themselves but to go buy it and then they have the equity on top, which is what we invest in typically. And so as equity investors, we're getting thinner slice of the pie and it's a scary place to be. So, what do we need to do as investors to be more savvy, more sophisticated? What kind of due diligence should we exercise? Should we be exercising before we just toss our money into the pool with everybody else?

Jeffrey Watson: Oh David, when you said due diligence, you said the two most important words that I have been speaking about on stage after stage, after stage. In fact the next three presentations I'm scheduled to give this month are all about due diligence because that is the most important thing. Okay. And like you, David, I want to get a good deal. I like equity because when equity grows, I'm making and growing my wealth without paying taxes. I like that, but I'm also like you and I love this thing called cashflow. Okay. I want money coming in because that's the whole purpose of investing is to get cashflow coming to me as well as equity going up. But it all hinges off of due diligence and David, I spend more time now doing due diligence than I have ever done before. I do due diligence on the asset.

Jeffrey Watson: I do due diligence on the transactional structure. I do due diligence on the tax arrangements and consequences. I do due diligence on the counter parties to the deal. I do due diligence on where other investors are coming in with me on how good are they, how stable are they, how predictable are they? I look at all of these things and David, I dig in more and more and more and we ask questions and this is something I do for a lot of clients, is doing very intensive due diligence on assets and because I've developed a network and resources and places to go get information that's not readily available, but that's so important to always be asking this question, "What happens if the deal goes sideways? How do I get my money back"?

Jeffrey Watson: And if you do a good job underwriting the deal, if you do a good job on due diligence, it's a deal where you'll get your money back or maybe even more if the deal goes sideways, you make a good loan with good LTV and for some reason your rehabber, borrower babbles the deal, whatever reason, and you end up having to take the house back, you can finish the deal, whatever, and you end up making the same or more money. Yeah, you get some more headache, but you make more money for it. That's what I look at. That's the stuff I look for.

David Phelps: Yeah. It's something that is so overlooked by so many people and there's different levels of due diligence and yeah, somebody like yourself can look at due diligence or underwriting the deal, the asset and also the operators deeper than most people because you do have that network. You've been doing this for well over 20 years, so you've developed a network so you can dig deeper and you've got the legal expertise to do that. A lot of people don't have that much and we can't on this call make people experts in due diligence, but we want to maintain the importance of that doing it or finding people like you, Jeff, or other people that they're in a group with to help them ascertain the things you just talked about. So, a lot of times Jeff, we look at the track record of the person that we are investing with are true.

David Phelps: So, we might be lending money just on... you said a rehab deal, lending money to someone who we've maybe known for a number of years so far up today, they seem to have a good track record. They seem to put together a good operating system. All things are checked. But again, we know we're still in a marketplace, an economy that maybe it's topping out, but it certainly isn't dropping down. Credit is still widely available and stuff is still selling retail. So, so far so good.

David Phelps: You talked about a deal going sideways or not working out. Now, that could be because of the ineptness of an operator. But here I'm talking about an operator who's done a number of deals, whether it's small deals or larger syndications or maybe they're managing a fund. So, I'm not talking about someone who doesn't have some track record in the industry. But what else could make a deal go sideways that maybe isn't totally under the control of the operator, Jeff. What things can happen that's really not their fault, but just it can happen? Give us a few instances.

Jeffrey Watson: Yeah. I'll give you a very specific incidence because a lot of this, as you know, is local. All the due diligence in the world has to be done. You have to look at the local conditions and I'll give you an example.

Jeffrey Watson: Right there, North of where you are there a whole subdivision that all the houses are paralyzed in their pricing because the Feds swooped in and shut down a commercial development right next door because they called it a Ponzi scheme and it's been thrown into bankruptcy courts. It's been thrown into federal court on criminal charges. This whole commercial area that was 90% completed, David, is now fenced, boarded and locked with huge signs on it and 24 hour flood lights and so on. And so anybody driving in that neighborhood's like, "Oh, Oh". And it's crushed the values of hundreds of houses in a quarter half mile radius. Now, anybody doing a rehab in that area, they're just caught in the downdraft.

David Phelps: Right.

Jeffrey Watson: But it's stuff that happens. And so, before you make a loan in an area that you don't know really well, spend some time looking for news stories in that area.

Jeffrey Watson: Something happened recently. Like I said, we'll, we don't know who the next Bernie Madoff is, but I guarantee you he's out there. So you guys got to be looking for stuff. The other thing I'm going to tell you, and David, this is to my chagrin, is trust your gut. Make sure your gut and your brain are aligned. And if you've got a partner, if you've got a spouse, get their input as well. There's a deal that I did years ago that my ex did not want me to do. And I went ahead and did it and I landed up losing about a $100,000 and to her credit, she only said, "I told you so" twice. To her credit, she only said it twice and you know what? I deserved it. I really did deserve it. But if I would've listened to her gut, I would've been $100,000 ahead.

David Phelps: Jeff, I have a similar story. I won't give you the details but to your point, oftentimes females, they have an instinct that we don't have and it's it's more about the character of the person or persons who are operating. Now they can have expertise and looking at the deal structure as well. I'm not saying they can't, but in this case, someone very close to me also... warning signs came up. I ignore them and yeah, came down later that the person that I was doing business with... things fell apart and like you considerable time and money lost and not looking deeper at those things. We all can become susceptible to just wanting things to happen, right? We want to feel like everything's good and you just have to be prepared for when things don't go well.

David Phelps: I think the other side of looking at a deal or investment, Jeff, no matter what you're investing in or who you're doing it with and say everything... you check all the boxes, check, check, check, check. You want to know that there are multiple exit strategies, right? There's different ways to go. There may be A plan, a plan A is to take and add value to something and an exit by refinancing or selling the property of the project and everybody gets their money back in return. Okay, great, plan A. What if plan A doesn't work? Again, not because of ineptness of the operator, but because other conditions that you've already alluded to that happened. Is there a plan B that we as the investors and the operator can ride through and still come out at some point later, at least getting our principal back and hopefully still some return. Is that not a good way to look at how we potentially invest?

Jeffrey Watson: Absolutely. Absolutely, David. And if it's possible, construct a plan C as well. And I want to back up because knowing the character and makeup of most individuals that are going to be listening to us, highly educated, very successful, extremely intelligence.

Jeffrey Watson: And guys, I'm talking to you, you're like check, check, check on the three things I just laid out. Yes. Some highly educated, yes, I'm very successful. Yes I'm intelligent. Yes, I've got a good business, I've got a good practice. I got you. Dude, you got to check your six for your blind spots because you've got them, you've got them. And you need to just by asking, what are and where are my blind spots? You're going to start to become more aware of them. So, you've got to do that because

David, you and I have seen this many, many times over. I'm thinking of one particular individual, and I'm not going to mention any identifying information about him, but an incredibly gifted surgeon just over and over and over again. Bad business ventures.

David Phelps: Yeah.

Jeffrey Watson: Okay. Brilliant man. Brilliant man. But over and over and over again, bad business ventures. And here's a due diligence question that I always would ask somebody else is, "Tell me about your most recent failure and what did you learn from it"?

David Phelps: Yeah. That's very smart.

Jeffrey Watson: It is. And I had a deja vu moment the other day, David, I'm on a plane and sitting two rows in front of me is a former business colleague who still owes me a chunk of money, who has just ghosted me, disparaged me, ghosted me and so on. And they owe me a chunk of money and I made sure I said hello to him, wished him a happy new year, shook their hand the whole bit and talk to them. And they didn't want to talk to me. But I thought about all the interactions I had with them in the warning sign I just kept missing was nothing was ever their fault. Everything that went wrong was always somebody else's fault. And I'm like, "Watson, how could you have been so blind"? You know? Because if you tell me you don't make a mistake, I'm sorry. You're not obviously too good for me.

David Phelps: Yeah, way too good. So, you're right. I think in concluding, in looking at the person is we're not looking for perfection. It does not exist. We're looking for someone who will admit to openly talk about, as you said, lessons learned. I want to know what they've gone through and more importantly, how they work themselves back out and how they took care of the people that were investing in them with time or capital, whatever it might be. I don't know how they came out. I am not looking for perfection because I don't have it either, but are you the kind of person who will persevere and in the end do the right thing? That's what I want to know and I think that's what you're really saying is, you've got to dig down and ascertain that character of the person and of course the due diligence on the actual asset, the structure, many areas there.

David Phelps: We can spend a lot of time on this, Jeff. I think it was so important we get this message out because again, we're at the top of the cycle and there's just money being thrown hither and tither without really any due diligence being done at all in many cases. I want people just to hopefully wake up and be a little bit more cautious about it. I'd love to do more of these wicked dig down some different topics at a deeper level. So Jeff, I'm going to fall back up with you and we'll pick some additional topics. It's always fun to talk to you. You bring so much experience and expertise to the table and you are the real deal. So, people can find you... best place to find... I mentioned www.watsoninvested.com, what's the best way for people to do further connect with you Jeff?

Jeffrey Watson: That would be the place to go. Go to www.watsoninvested.com. There's a link there on where they can then get in touch with my office and go through the process of setting up a time to have a consultation. And I'll just tell you David, my passion is showing people how to structure investments, transactions, deals, whatever you want to say it in using self-directed retirement accounts, IRAs, Roth IRAs, 401ks, HSAs and so on. And trying to do it in a way that is simple, safe and secure. I love to hit those three S's. I don't want to over complicate it. But I want to make it safe and I want to make it secure and I don't want the IRS to have anything good out of it.

David Phelps: I'm with you hundred percent. We love doing that. So, we'll follow back up and we'll do that topic. How about that? Let's make that our next one. We'll do that topic coming up hopefully soon. We'll schedule it. All right?

Jeffrey Watson: Sounds excellent, David. Always enjoy it. And I'll be back in your neck of the woods in a couple of weeks, man. Okay?

David Phelps: Very good, Jeff. Thank you so much your time today.

Jeffrey Watson: All right, my pleasure, David. Have a great time. Thanks. Peace.

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