# Ep #384: Mike Zlotnik - Stress Testing Your Investments During Uncertain Times

## Full Episode Transcript

**With Your Host**

**Dr. David Phelps**

**Dentist Freedom Blueprint with Dr. David Phelps**

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Welcome to the Dentist Freedom Blueprint, a podcast about freedom—freedom from expectations of society and the traditional path to success that has been ingrained in us from our early years, I'm joined by mavericks, renegades, and non-conformers to discuss an anti-traditional path to financial freedom, freedom of time, relationships, health, and ultimately freedom of purpose. My name is Dr. David Phelps. Let's get started.

David Phelps: Good day everyone. This is Dr. David Phelps of the Freedom Founders mastermind community, and the Dentist Freedom Blueprint Podcast. Today, we're going to have a really great discussion with a good friend of mine, Mr. Mike Zlotnik. Mike, how are you doing, sir?

Mike Zlotnik: Hi, David. I'm doing well. How are you?

David Phelps: Mike I'm well. So, Mike is the CEO and Founder of the Tempo Management Group, which is a company that does a myriad of investments in funds in various aspects of real estate, and we'll talk to him about that because that's where his forte is.

Mike comes from a background of being very analytical. That's what I love about him. We're in a number of other groups together, real estate groups, and Mike is probably the guy that everybody goes to, to say, “Hey, could you analyze the numbers on this particular investment opportunity?”

And Mike's the guy who runs numbers like nobody's business. So, we're really, really honored to have you on here today, Mike, and what I'd like to do is talk a little bit about how you're looking at the market in terms of what I kind of call stress-testing.

When we go through times of economic disruptions and volatility, certainly we have that right now in the market. As an investor, wherever I might be investing, I could be investing in the stock market — I personally don't, but I know a lot of people certainly have money in the stock market.

We talk a lot about alternative investments. That's where our ball game is. But again, we have to say, well, what's going on in the market? Well, we have inflation, which is at a 40-year record highs. And so, the Federal Reserve is coming hard and saying that they're going to commit to raising interest rates. They already have started that, raising interest rates the rest of this year to combat inflation.

Well, what does that do? Well, that increases the cost of money, which means that profit margins across the board for really all companies starts to decrease. Profit margins decrease, stock values come down, people can't afford houses to the extent they could even a few months ago.

So, we see demand decreasing, we see mortgage applications decreasing right now. In fact, a number of mortgage companies right now, this week are laying off employees. I'll stop there and take a breath and let you pick it up from there. What do you see out there as your crystal ball?

Mike Zlotnik: Thank you, David. And yeah, my crystal ball was wonderful, but it broke and I can't find it on sale.

David Phelps: Darn it. I hate when that happens, right?

Mike Zlotnik: That's right. We kind of went through this exercise a couple of years back when COVID started. And I even remember going to the Freedom Founder's Trusted Advisor

mastermind in January. We were doing stress-test discussions then.

So, now, it's another iteration. It's just this recession never really hit. The severe recession never really hit. We had a blink during the first few months of COVID and then things started rolling really well because the very loose monetary policy, major fiscal policy by the U.S. columnist with the COVID spending bills were into trillions and trillions of dollars.

So, we avoided a possible recession. Now, we're coming back, I call it the party is over, from the point of view that the government is not going to spend trillions of dollars on COVID-related expenses. Whatever political side you take, at this point, that's over.

In the Fed, like you said, they are absolutely required, mandated by their charter to raise interest rates because they have dual mandate.

Full employment, which we are already in full employment, we're essentially above full employment. And then they have to maintain stable inflation. We are way above that. So, not to reiterate what you said, but we got to see interest rate going up and that's a stressed driver, a very substantial stress driver.

So, in today's environment, it's really important to look at whatever business you're in, whatever investments you are in, and apply some basic stress-test conditions to essentially prepare yourself for what may happen when the interest rates rise. And if you have a great long-term mortgage at a fixed interest rate, that's wonderful.

But if you're invested in the projects where there's variable cost of capital, this is going to be a substantial stress supplier. It's a variable.

And one thing, just to go back to what happened right after COVID, a bunch of cash flow froze up. Basically, distributions froze so many deals. The reason it happened is because people weren't paying rent or people were asking for rent-deferral. For some amount of time, we saw a very substantial stress from a cash flow perspective.

Now, we're going to see some level of a similar stress, but it's not going to be a short-lived It's going to be ongoing stress because the interest rates that go up, they generate higher debt service, and that's going to stay for a substantial amount of time.

So, that that's kind of what I'm looking at, and as a fund manager, the most basic exercise we do is we look at the portfolio, and we will talk about that. But most investors don't need to panic, just need to take very systematic approach.

Can they look at the portfolio, and look at the points of concern? Where do you have big dollars invested, how those investments will fare or can fare, and just dissect a little bit into that to make sure that you're prepared? You're prepared to deal with potential stress.

David Phelps: Let me throw up just an example that I know you'll have some insights on. There was a large portfolio, large meaning like I think the number was 87. 87 single family houses, a portfolio that was purchased somewhere in Florida. Sorry, I can't tell you exactly where — you may know of this, but this is recent.

This was a Fundrise, which is kind of a crowdfunding source for small investors who aren't accredited and they want to play ball in the real estate market. So, these crowdfunding sources like Fundrise can raise capital in small amount: a thousand, $5,000. And so, they go out and people that are anxious to get in real estate, well, they can do it that way.

What Fundrise did is they used a credit facility like a Wells Fargo, I'm not sure … or actually, I think it was actually Goldman Sachs, in this case, was their credit facility for the debt, underlying debt and they raised a certain amount of capital for this portfolio on the debt side. And then they go to the equity markets and from small investors, they raised another, I think another 45% of the total acquisition.

Well, here's the key. Now, I don't have the numbers in front of me, but I remember looking at this 87-house portfolio, the average bid price or acquisition price of this portfolio, these houses, they bid them up beyond the market norms, about 45% Mike, 45%.

This cheap money — well, cheap at the moment money, allowed them to do that. They're overbidding for these houses and taking houses off the market for owner occupants.

And then now, the comparable sale price goes up. The danger in this case, I would say would be, well, they use cheap money to buy these houses. So, if you got cheap money, you can do almost anything to a point. But most of that money, I think from a credit facility is variable rate, if I'm not mistaken. You would know more than I do.

If it's variable rate, then what's going to happen? These equity investors on top of that capital stack, if things go south a little bit, where's their margin? If you already take a market retail

price that we think is maybe high, relatively high in historical perspective and you bid it up 45% more because, well, you got cheap money, is that necessarily a smart investment?

I'm just going to stand back on that, because again, it's Goldman Sachs, but they're playing in the capital stack down here, these equity investors played up here. Where do they stand? I don't know.

Mike Zlotnik: That's a great example of momentum buy in the hot market paying top price, leveraging with variable rate debt which is highly risky and speculative. Normally, you want to borrow long, you've thought this, borrow 30-year mortgage, buy 15-year mortgage; borrow long, cheap money during inflation, that's wonderful for you as a borrower.

But when you borrow with a variable interest like a line of credit, you expose yourself to substantial risk. And one of the major risks with these portfolio acquisitions, one, is an impact on cash flow. You can actually go from potentially positive cash flow into negative cash flow rather quickly.

So, the simple exercise you could borrow with the interest rates being 4% and with rates going up, and the market adjusting, suddenly the rate goes up to 6% and your payment factor is up 50%. On these leverage investments, you can go from positive cash flow of say 8% cash on cash into negative cash flow situation with negative 8% cash on cash rather quickly when the rate jumps like that.

And that's what we are looking at. So, that's a major risk. Another major risk is actually valuation risk. Like you said, if they overbid and overpay, Florida, especially Southern Florida, Southern California, Phoenix, Las Vegas, they’re known as

union markets. And when the market's correct, those are the markets that take it on the chin.

So, I don't know where this portfolio is, but it's very possible that they overpay. And the retail investors who participated in the Fundrise may wind up losing all their money in essence. It's a very highly leveraged, speculative, not well downside protected type of a deal. I'll give you one hint what institutional investors do.

We've done this on a number of larger deals where you need bridge financing, because you're executing a value as strategy. If they bought this portfolio fully performing new built houses, there is no value. What is the value?

David Phelps: None.

Mike Zlotnik: But if you're buying a distressed or discounted asset and you're executing value at an increasing rent, the reason you go for variable debt is because you want to refinance after a couple of years. You don't want prepayment penalties.

So, one of the insurance policies against that is buying a rate cap, and I don't know whether the line of credit has a rate cap. Hopefully, it does, but if it doesn't have a rate cap, it's a big problem. If it does have a rate cap, at least you know what's the ceiling, what's the worst-case scenario. And that's, by the way, one of the stress tests, if you have variable rate mortgages, find out what is the cap.

So, that's the worst-case scenario, and that can you survive that point? And if you can, at least you can go on and live another day.

David Phelps: So, as a rate cap, as you've defined it, is that available to … who's that available to? Is that available to one-off investors or is that available if someone's going out to finance an owner occupied home today? Is that available in general … as you said, it's like insurance. You're going to pay a premium for that, but it's kind of a premium for a, I'm not going to say a known loss, it's for a known risk protection, so you know what the bottom is.

So, if I have to pay a premium for a rate cap to hold my rate from going above a certain amount, well, at least I know what that is. I've already factored that in versus an unknown. But is that available for across the board or is that in certain lenders? What's that look like, Mike?

Mike Zlotnik: That's a great question. It depends on the type of product. So, if it's an institutional loan … we just did a deal, large multifamily deal in Indianapolis. We went into the deal with a variable rate around 4%, and the rate cap was six.

It was basically an insurance policy. You pay a certain amount of basis points of total amount of loan, and then you have a cap of 6%. So, it is tied to an index. It'll go up at 6%. The insurance company starts paying whatever interest rates spread. So, that is available on large multifamily type of assets.

On residential front, typically you see it in the form of adjustable rate, mortgages are mortgages, have typically a cap. It is part of the disclosure, it's required disclosure, and it typically, off the top of my head, the cap on residentials could be as high as 3 to 4% higher than what the current rate is.

But there is a cap. Most of them have some kind of a cap. It's a substantially higher cap than what you're paying today, but it exists most of the times. Well, lines of credit, it's a conversation

with the bank. Basically, the discussion is if you are borrowing from a line of credit today, what is the cap?

And the challenge with line of credit cap is that at some point, if you hit the cap, the bank just close the line. It's another problem because line of credit is revolving line every year. They can just say, “Hey, we don't want to renew this. Have a nice day.”

David Phelps: Yeah, exactly.

Mike Zlotnik: On the cash, you have 90 days.

David Phelps: Exactly. Well, because what you do as a fund manager of the number of different tempo funds that you help us as investors allocate our capital into, obviously, you're out there in the marketplace all the time with known sponsors that you work with regularly. You're always looking at potentially new sponsors and new opportunities with either known sponsors and kind of deal flow that you're pretty much accustomed to.

I know a lot of things you're doing like is conversion of hotels to workforce housing. That's one area that's been very, very solid this last year. There's a number of other areas. What are you hearing? What are you talking about with your particular sponsors in terms of how they are stress testing the current environment?

What different underwriting criteria, or we could call it a buy box. We talk about a buy box. That means criteria that they're looking at when they make an acquisition. For us as an investor, it would be our investor box, but I want to hear from you kind of what your words are, your language, your conversations are around changing underwriting criteria in the current market.

Mike Zlotnik: So, it's a great question. The number one impact of rising interest rates, obviously, cash flows, if you have a cash flow project. The asset type and the strategy that you mentioned, conversion of hotel to multifamily assets, they don't cash flow. We basically terminate them as hotels and convert them to typically affordable workforce housing multifamily.

So, the cash flow is not really an issue, but the biggest issue is cap rates. So, what typically interest rates do, they increase the cost of financing and the next buyer will probably want to pay a lower price and higher cap rate for the same product. So, that's a critical underwriting requirement. What is the cap rate? What is the cap rate today for this type of a project as completed?

And then you bring it to the market two years from now, what the cap rate might be. So, it's speculative. Right now, cap rates have not gone up, even with rising interest rates, but in theory, there is a correlation. So, the normal stress test scenario in this type of deals, what are you seeing today? What's the cap rate on this type of property?

It's five and a half percent. Well, what are we underwriting it for, what's the exit cap rate? We're underwriting it for six. Well, let's push it to six and a half. Let's push it to seven. Does the deal still make sense? And if it does make sense, you can basically feel strongly about downside protection, because your cost, all-in cost basis, let's just use an example.

Your all-in cost basis is $10 million and you're projecting to sell it at 14 million upon completion over this conversion of hotel-to-multifamily. So, which cap rate change if you go from say six to six and a half, that $14 million price may look like 30 or 12 and a half, is this still acceptable? Is this enough of a return to investors?

So, that's one stress condition. The other stress condition, what happens if the market really takes? Can the cash flow be sufficient to support the asset? So, from an underwriting perspective, you complete the value, and at that point, you're refinancing because you can't really sell. Can you at least have a break even cash flow? So, can you survive with this asset?

These are the type of questions that we look at to make sure that the stress conditions don't put the deal into a problem. The beauty about multifamily, at least the right type of projects is that there is also, besides the cap rate approach, in this inflationary environment, there's a cost basis approach.

What do people pay per door, and each door ramps at every trend. So, at least the strength of this inflationary environment is if you pay the right price per door, that this asset has pretty strong downside protection because the cost to reconstruct the materials, the labor, continue to go up and as the result, at least, you have that protection in the deals.

So, we'll also look on a cost basis what are we in for per door? So, use an example. It's 70,000 a door or a hundred thousand a door, and this thing runs at $900 a month. At 70,000 a door, we know it's going to cash flow really well upon refinance. Even if the interest rates go up a couple hundred basis points.

David Phelps: The cash flow, as you said a moment ago, is what I look at as the key. What is that cash flow? Can we sustain? Everybody comes into the acquisition of an investment with some idea of what the exit's going to look like.

And yes, typically in syndications, there is in exit three, four, five, six, maybe seven years — there's some whole period during the value-added in which the value creation is there. And then the syndicator, the sponsor determines now's a good time

to sell. We've got a good multiple on it, let's make the exit and we'll go to the next deal.

Now, in this marketplace today, we go, well, that time period, it may be extended beyond what the run rate's been in the last three, four, five, six years. So, having that cash flow allows that operator to sustain through a market where maybe the exit timing is not good at three years or four years or five years, whatever is anticipated.

As long as they have that capability, and we, as the investor know that we may need to stay in for a longer ride, as long as we got the cash flow, we're essentially okay. It's those that are tight on cash flow or tight on cash period, that many times in a market where they can't exit on a time basis, that they predicted, then they have to start selling that asset or other assets at discounts, and then you have this domino effect in the market.

So, you just don't want to be one of those. You want to be on the side of those who have predictable cash flow sustainable to get through that and then you're not a seller at a discount. Would that be fair?

Mike Zlotnik: Yeah, for sure. You definitely don't want to be forced to sell. That's the rule number one, you want to sell at your own terms and on your own time. So, from investment perspective today, basically we are looking at the things two way.

One, what do we got in our portfolio and how these assets are progressing through their life cycle? And at which point can they go through a refi?

And obviously, with the rising interest rate environment, we are pushing very hard right now on assets that have gone through

value-add, can they refi as soon as possible. And that's basically one of the things you can do today. You could still try to refi and even though the costs are higher than they were a few months back, it might still be worth going to the exercise rather than waiting another six months and see what's going to happen.

Although I'll mention this point, Fed is raising short term interest rates. Fed can really control their Fed discount rate, and that impacts basically short-term rates. And then they also have their balance sheet as a tool to push long-term rates higher as well by virtue of not renewing maturing securities or selling securities in open market. It's the quantitative tyranny.

What's interesting is what's going to happen to a 10-year treasury in mortgage rates. Depending who you listen to, there are some theories that the 10-year treasuries, which control the mortgage rates may be tapping out in essence. May go up, or it may actually stay where it is, even though the short-term rates will go up. It'll create what is known as inverted yield curve.

And not to speculate on the subject, we need to be prepared for both scenarios. One scenario where these mortgage rates, they've gone up, but they will stabilize. It might hover up and down another quarter point, maybe even 50 basis points, but they're not going to go up from just under 3% now to 5%.

That scenario is pretty extreme. And if we go into recession, that long-term interest rate, it is typically an indicator of a long-term inflation expectation. So, it's very possible that if we go into some kind of recession, long-term rate will not pick up as much as some folks are concerned. And then in that scenario, at least we are dealing with a situation where it's not as much of a pressure.

But on the other side, if the inflation continues to be raging, the Fed may be doing the balance sheet, the leveraging, pushing the long-term rates up as well. So, is a little bit of speculation, but something to keep in mind that we don't panic. We basically prepare ourselves for multiple scenarios.

One of them, by the way, I'm going to just mention this and I'm going to take a step back. The way we look at this, that two probable possible scenarios.

One, I call it stagflation and the other one, is your classic recession, and you got to be prepared for both.

David Phelps: Well, let's talk about that a little bit since you mentioned it: stagflation, that's where we have inflation that continues on but we have an economy that is really kind of, I'd say, anemic, no growth, nothing really happening. So, that would be kind of the basic stagflation.

Then compare and contrast that to, as you said, a kind of conventional recession, what's a conventional recession look like then?

Mike Zlotnik: Sure. So, let me provide a comment first of stagflation. So, stagflation is a high inflation. And by the way, the Feds raising interest rates cannot fix inflation problem because the inflation is driven, at least the bulk of inflation is driven by two things.

One is let's call supply chain problems. When the supply is limited and there's a lot of dollars in circulation, it's 10 apples, $10 when you cut the number of apples to 5 and number of dollars to 20, the price goes up per apple. And then the other element is energy. So, U.S. energy policy unfortunately is not very conducive to curb the inflation. Energy goes into

everything. It goes into transportation, production. So, the result of the current energy policy is that we can't get inflation under control. So, that's a very strong driver of likely inflation.

Now, stagflation is typically, by definition is very slow and possible negative growth. Q1, growth domestic product was a negative 1.4%. It's very possible that Q2 could actually be a negative print which basically signal effectively recession from the GDP perspective, but inflation is still raging. So, that's your classic scenario number one.

And then the typical recession scenario doesn't have this kind of inflation. So, to go into a traditional recession scenario, we need to start seeing inflation curbing down quite a bit. And can this happen? It can. We've seen inflation spike up, hit a high level and then spiked down.

It happened by the way in pre-2008 crisis. There was a spike in inflation, and then all of a sudden, it just kind of fell off, the bottom fell off the floor. Is this likely today? I don't think so, but it is possible that inflation will start slowing down. So, as inflation starts slowing down, also, unemployment has to start showing the signs of worsening.

We are at 3.6% unemployment rate, which is very low. There's almost a great amount of data on the point that at this level, it's probably as low as it'll ever go, which means that we're probably going to see increasing unemployment, and over a period of time, we'll be in a technical recession where we are starting from pretty full employment, at least from that perspective.

So, compare and contrast; one scenario, we continue to have still rapidly … I don't want to call it ravaging inflation in the 8% plus range. Can it go over 10? It can, but the likely scenario, the

reported CPI will start coming down, hopefully, below 8% print. And then we'll be still looking at some form of a stagflation, just not as bad as last couple of months.

David Phelps: Alright, last question, Mike. And we know we're not giving any specific financial advice to anybody here, so we're talking in general.

But I get a lot of questions from people (I know you do too), investors who maybe they're new to investing, they're new to the markets. This is kind of their first rodeo in terms of seeing headwinds like we're seeing right now.

So, there's fear. There's a certain amount of panic out there. What people see in their stock market and 401(k)s have dropped since the 1st of the year. So, there's this new panic in the arena with all that we've been talking about.

What do you do? You've got some assets, maybe you got some cash. Maybe you just had a liquidity event, you sold a business or had some other event that gave you some cash and some people say, well, you better get that cash invested somewhere, because if you don't, the inflation is going to eat it up over time.

Which yeah, over time, it will. I better get it invested somewhere. What do you say about that? The balance between holding onto some cash versus got to get it invested.

Mike Zlotnik: Sure. That's an awesome question. That's a fundamental question. So, let me answer it a few different ways.

So, the first answer is under what circumstance is holding cash is good in the highly inflationary environment? And the answer is there are two scenarios.

Number one, instead of keeping cash, you keep the money invested into something that's falling. The cash is better than a losing investment.

The second scenario is cash is good if you know you're going to get really good deal or better deals coming. That's where the value, even though it's the dollar is losing the value through the inflationary pressures, but it's still not a worse thing in the world.

Now, all that said, you're still better off investing, and what are the great investments in this environment? And without giving any advice, kind of stagflation 101, what's bad? What's bad are growth stocks, and what's bad are bonds.

If the interest rates or rising bonds, zero value in growth stocks, they're taking it from the chin because they have leverage balance sheet, these companies, just their profits are shrinking as a result of this environment.

What is generally good in the stagflation environment; real estate. Real estate is one of the best asset classes where to put them money. There are a couple of other asset classes, what is known as value stocks. So, I'm not a stock picker. I'm not Warren Buffet of the stock market. I do it … I love Warren Buffet, but I love it in real estate. If you can pick the right value stocks, so much power to you.

And then the other asset class is generally commodities. So, energy has been a solid investment in this environment, and probably going to stay solid until … at some point we'll get some more energy production, different political environment.

But stocks … and again, stocks are not good traditional stocks, the growth stocks, and back to real estate. So, real estate is phenomenal. Real estate could be a great hedge against

inflation, and real estate could also provide a safety mechanism but you have to pick the deals. You have to get very, very prudent about picking the deals.

You obviously, are aware of the quadrant methodology that I developed, and then the quadrant methodology, your audience may not know, but we have the investment grade quadrants and speculative grade quadrants. Investment grade quadrants are those deals that basically, or the deals that fall in those quadrants — they are deals with good downside protection.

So, what's really important is to pick real estate deals, but the deals that are typically properly leveraged or lightly leveraged or not leveraged. In addition to that, they have good downside protection mechanism, and these mechanisms need to be well understood and well stress-tested.

And if you go into these deals with a higher degree of confidence that you are well downside protected, then you have the opportunity to still catch substantial hedge against inflation, as well as projects that have value at the component. That's another really important element in investing; are you investing in the projects that are performing today, where you're investing in the project with some value.

And if you're investing with competent folks, and Freedom Founds Network is that, a group of trusted advisors, folks with great abilities to execute value-add strategies. And that makes all the difference in the world because you can create downside protections through forced appreciations, through these projects that build value, regardless of what happens in the market.

David Phelps: Well, Mike Zlotnik, that's golden advice right there. I think you really, you thread the needle on that one so well. I think

that's a good place for us to end this segment, but always a pleasure.

You bring so much wisdom, experience to every conversation we have. I've enjoyed it over many years with you, and we'll continue to go forward during this somewhat tumultuous time. But again, navigating it is what we do. It's fun and we'll continue to carry on. So, thank you, sir.

Mike Zlotnik: Thank you David. Always appreciate your wisdom and grateful for the opportunity to serve the Freedom Founder community.

You've been listening to the Dentist Freedom Blueprint Podcast. If you're tired of trading time for dollars and you want to create more freedom in your life, I encourage you to visit my week blog, freedomfounders.com/blog. I post weekly hard-hitting videos about creating more freedom in your life. Check out my latest book on Amazon, *What's Your Next?: The Blueprint for Creating Your Freedom Lifestyle*, or visit freedomfounders.com to learn more about how we help high income earners create the freedom to buy back their time and create more impact.