

## Opening the private real estate debt market to individual investors

*Ed O'Farrell, managing director of Real Assets Adviser, recently sat down with Steve Kirschner, senior vice president – National Institutions at Redwood Investment Management, to talk about how the firm is making private real estate debt markets accessible to individual investors. Following is an excerpt of that conversation.*

### **Tell me a little bit about Redwood.**

We are an investment manager focused on delivering risk-focused outcomes to advisors and their clients. Our mission is to democratize sophisticated investment solutions and deliver high-quality risk management to the individuals and families that need it the most. Today, we are primarily focused on doing this through an evergreen private real estate debt fund that seeks to simplify access as much as possible. Most of our industry seems to thrive on keeping things overly complicated – clinging to an air of exclusivity. But we believe the benefits of private real estate debt can be attained in a straightforward way open to all. Sometimes exceptional outcomes can be achieved through simplifying the complex – delivering the consistency of outcomes that investors expect.

### **How is Redwood different from other firms?**

Redwood is focused on protecting the investor's assets. Throughout the major market drawdowns of the past couple of decades, we became acutely aware of sequence of returns risk, where if you have a considerable downturn at the wrong time in your investing career, it can have lasting impacts for the rest of your life. So, we developed what we call our RiskFirst® process. It's a core principle that asserts that successful investing requires managing risks, specifically drawdown risk, before thinking about returns. Everything we've built starts with that.

During the last major market downturn, traditional assets were not providing the diversification benefits that they once did. Fixed income has long been used as a diversifier for equity. Historically, when there was an equity problem, fixed income picked up the weight and carried it.

But starting in 2018, and then specifically in 2022, that relationship changed. We set about looking for other assets that could help stabilize a portfolio and began looking at private markets. We primarily wanted to be in the safest part of the private world that we could be. Our research led us to short-duration, first lien,<sup>1</sup> very conservatively underwritten private real estate bridge lending. These are short-term loans that are made to developers who are transitioning properties. They may provide a very durable, consistent income stream that can enhance public fixed income and act as a ballast in a diversified portfolio.

### **Is your firm doing the lending, or are you investing in portfolios of loans?**

One of our competitive advantages is the way that we've structured our portfolios. We lend directly to borrowers, but we partner with multiple originators with deep relationships and differing approaches to the market. During the past 15 years, the lending environment has shifted away from regional banks, which were the ones that would have the expertise and relationships in those markets. Instead of local banks, we now have an ecosystem of regionally specific, private lenders who have stepped in as the lenders of choice. They have very deep relationships and are hyper-focused in regions or sectors. If you only have a single originator, however, you're limited to whatever their focal point is. Bringing multiple originators together gives us a wider opportunity set to choose from with greater diversity throughout our portfolio. It allows us to deploy capital faster. It also allows us to think from an overall portfolio perspective: Where do we want to add and redeploy capital as the markets are shifting and evolving?

### **How exactly does that work?**

One of our originators is based in New York. They focus primarily on multifamily and multi-use large projects in the 30 largest metropolitan areas in the country. We pair that expertise with another group that focuses primarily on the residential space across the nation. That allows us to take advantage of changing tailwinds.

For example, currently, the conversion of warehouses into condos in the Northeast might be a great project for us to invest in. But at other times, tailwinds in the supply/demand dynamics in residential real estate might make that a more attractive place to be. We want to see as many different types of deals as we can and then build a portfolio around that. We're putting all of that together, managing liquidity – which is important in the private markets, especially with retail investors – and using our RiskFirst® philosophy and mindset to put different types of loans together to diversify risk as best we can, while still providing a premium level of income potential.

### **How does Redwood add value?**

In addition to tapping into the expertise of our origination partners, we also focus in the lower end of the commercial real estate (CRE) loan market, where competition is lower, and spreads remain higher. That allows us to provide higher income for our shareholders. The largest private credit managers in this space, generally speaking, can't look at loans below \$50 million. It just won't move the needle, so it doesn't make sense. So, we like to go where they aren't. We have this trademark saying, "Size is the enemy of alpha." And in private markets, I think that's true and we're seeing that proven today, where a lot of capital has flooded the direct corporate lending market, and you're starting to see the spreads come down there. Our approach is meant to preserve spreads and deliver premium income.

### **Do you focus on specific sectors and geographic markets?**

Having multiple originators allows us to diversify across several dimensions. We want to be geographically diverse, and our approach is doing just that. We also want to diversify across industries and sectors. And we want to be somewhat opportunistic. One of our origination partners focuses specifically on opportunistic projects that can provide high levels of income while also being a great portfolio diversifier. We're looking at the breadth of the real estate market, and

we're looking for areas where there are tail winds. Today, one of those tailwinds is the lack of housing supply and positive impacts for lending in the residential and residential-adjacent markets.

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Regulation is also something that can drive opportunity. Some jurisdictions are trying to address the limited supply of housing through the rezoning of real estate. This is allowing for projects that may convert warehouses or industrial properties into forms of housing like multifamily properties. We completed the execution of the funding of a project in Brooklyn doing just this. Having a lot of different inputs lets us pick and choose those projects that add value to our portfolio and provide income to our investors.

So, while we are not solely focused on any sector or any geography, we are looking for projects in areas across the United States that are additive to our portfolio from both a risk and return

perspective, while maintaining disciplined and conservative underwriting.

#### *How do you define conservative opportunities?*

Initially, we focus on three core aspects: Short duration, first lien and low loan-to-value ratios are the minimum criteria. The average maturity of our fund is less than eight months right now, creating a portfolio with liquidity that is well suited to the evergreen fund structure. We like to be the first party that gets paid on any cash flows, so we focus on loans in a first lien position. We also want to ensure that there's a relative cushion in every loan that we underwrite. We tend to focus on loans with loan-to-value in the 50s. This means the borrower owns an equity position of at least 35 percent, but usually closer to 50 percent of the property. This equity generally protects against a level of drawdown in the value of the property, and when you combine this with the short-term nature of our lending, we believe we are well protected against volatility in the real estate markets.

#### *Is today's economy affecting your loans?*

The underlying loans are all referenced to very short-term rates. They often use the SOFR (secure overnight financing rate) as their primary reference rate, and that usually moves with the Fed's rates. So, as we've seen inflation spike, rates went up. As we've seen inflation come down, those reference rates have come down. The overall rates may go up and down,

but the spread above the public short-term fixed-income rates tends to be durable. We've been successful at maintaining this spread throughout both higher and lower inflation environments. By remaining focused on lending assets with protection for shareholders in loan sizes that keep us below where some of the big players want to play, we can maintain that spread and maintain that income for our investors.

#### *You mentioned earlier that this doesn't have to be complex. What do you mean by that?*

When you start talking about capital stacks, spreads and collateral, private credit can look complex. However, investors inherently understand mortgages, which can help them easily understand our investment process. Like a mortgage but on a private basis, we lend money to real estate owners looking to upgrade or modify the property to improve the income-producing capacity of the property. Because of that simplicity, it has had good uptake across the wealth channel. And as I said earlier, we specifically built these to be available to everybody. So, opening the market to investors that may not have had access to any private markets a couple of years ago is critical and dramatically increased the market opportunity for our solutions.

<sup>1</sup> 1st Lien (or first lien) debt is a type of legal debt secured by collateral, such as real estate. 1st lien debt holders are paid back before all other debt holders. If the borrower defaults on the loan, the lender can seize the collateral to recoup their losses until the loan has been repaid.



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#### CORPORATE OVERVIEW

Redwood Investment Management brings institutional-grade investment processes to all individual investors through its RiskFirst® solutions. By prioritizing risk management, Redwood believes investment success naturally follows. These innovations include democratizing access to private debt secured by real estate with a single ticker symbol and offering turnkey asset allocation models that blend public and private investments. Redwood partners with financial advisers to deliver these solutions via Redwood mutual funds, LeaderShares® ETFs, and Engineered Risk-Budgeted Model portfolios. With no minimums, accreditation, or paperwork, investors gain access to short-duration, first lien secured real estate loans – making sophisticated investing available to all.

#### Important Information

The Redwood Private Real Estate Debt Fund ("CREMX") is registered as a non-diversified, closed-end management investment company that is operated as an interval fund. The Fund's investment program is speculative and entails substantial risks. There can be no assurance that the Fund's investment objective will be achieved or that its investment program will be successful. The Fund is an appropriate investment only for those investors who can tolerate a high degree of risk and do not require a liquid investment. The Fund does not intend to list the Shares on any securities exchange and the Fund does not expect a secondary market in the Shares to develop. Because you will be unable to sell your Shares or have them repurchased immediately, you will find it difficult to reduce your exposure on a timely basis during a market downturn.

Investors should carefully consider the investment objectives, risks, charges and expenses of the Redwood Private Real Estate Debt Fund. This and other important information about the Fund are contained in the prospectus, which can be obtained at redwoodmutualfunds.com or by calling 888.570.0805. The prospectus should be read carefully before investing.

The Fund invests in commercial mortgage loans subject to risks of delinquency, foreclosure, and loss. Additional risks include reliance on participation interests that depend on lead lenders' decisions, exposure to fixed-income market fluctuations and liquidity constraints, as well as sensitivity to inflation or deflation affecting property values and borrower repayment capacities. Secured debt is not guaranteed and may still be insufficient if collateral values decline. Holdings in subordinated debt may suffer greater losses during defaults. SOFR interest rate benchmarks are variable and may affect income and borrower costs. Operational challenges such as sourcing quality loans and competitive pressures can impact portfolio performance.

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