Investing in Mortgage Loans with an IRA: Creating a Perfect Synergy

Eric Scharaga

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Selecting Your IRA

Since their introduction in 1974, individual retirement accounts (IRAs) have proved a formidable tool in the effort to get people saving for retirement. While originally created for workers who didn't have a pension, by the 1980s, IRAs could be opened by any worker (sometimes within income limits) and their spouse. By the late 1990s, IRA options were expanded to include Roth IRAs and to diversify the allowable investments within self-directed IRAs.

Which IRA Is Right for You?

IRAs can be broadly divided into two categories. Roth and traditional.

> **Traditional IRA:** Funds deposited are tax-deferred, meaning assets grow without taxation in the IRA. When the owner begins taking qualified distributions, they are taxable based on the owner's current income. The IRA has no income limits; however, the amount of the deduction given for contributions may vary based on income.

> **Roth IRA:** Funded with after-tax dollars, but qualified distributions are nontaxable. If you believe tax rates will be higher when you are ready to retire, you should strongly consider a Roth IRA. Roth IRAs do have income limits that change yearly.

Investors can have both a Roth and a traditional IRA, but the combined contributions cannot exceed the annual limit ($6,000 in 2020 with a $1,000 catch-up contribution for those over fifty).

One crucial question you must ask yourself before choosing between opening a Roth or traditional IRA and choosing how to fund them is whether you think tax rates will increase in the future. If you believe that taxes will go higher, then a Roth IRA with its tax-free qualified distributions could be the more advantageous choice.

If, however, your income exceeds the limits for a Roth IRA, you may want to talk to an advisor about a "**Backdoor" Roth IRA**. In this strategy, you would fund a traditional IRA, which has no income limits. Then, you'd move the money into a Roth IRA using a Roth conversion, paying the applicable taxes up front at the time of conversion. Keep in mind that Roth conversions are permanent and cannot be reversed once completed. Also, there are many rules that need to be followed for the conversion to be legal, so complete the conversion under the guidance of a custodial bank, financial advisor, or brokerage.

The IRA Custodian

The financial institution or trust company that holds your IRA account and handles annual reporting is called the *IRA*

Custodian. When choosing a custodian, you must first decide whether you want a regular custodial IRA or a self-directed IRA.

> **Self-directed IRA:** A type of traditional or Roth IRA offered through select custodians that allow specified alternative and nontraditional investments. Custodians for self-directed IRAs will allow the IRA to hold assets such as mortgage loan investments, mortgage loan funds, real estate, multifamily buildings, raw land, tax liens, oil and gas, and more. Investors can invest in funds and syndications that pool capital in these investment niches, if they don't feel comfortable or aren't interested in making the individual investment decisions themselves.
>
> **Regular custodial IRA:** A more traditional IRA structure in which the custodian has advisors who can carry out trades for the account and the investments are limited to positions such as stocks, bonds, CDs, and mutual funds.

Self-directed IRAs allow more options and flexibility for investors who don't want to turn over 100 percent of their retirement to large companies where they have no control over what happens. There are at least fifty different self-directed IRA custodians that help investors set up these accounts, and they make sure the investments and documentation are compliant with IRS regulations. One thing these custodians cannot do, however, is provide any advice on individual investments. It's also important to note that you can use a self-directed IRA for a portion of your retirement savings and keep the rest with a regular custodian. Just remember that the contribution limits are cumulative.

> Some self-directed IRAs are checkbook IRAs, meaning that the IRA custodian is not involved in any of the investing processes, giving the IRA owner direct control and fewer fees.

When choosing a custodian for a self-directed IRA, there are several questions to ask, including:

- What alternative assets do they permit in their IRAs?
- Will they set up a checkbook IRA?
- Is the custodian IRS approved? Consult the IRS website for a list: https://www.irs.gov/retirement-plans/approved-nonbank-trustees-and-custodians
- Do they have the appropriate SEC and state regulatory licensing?
- Are there complaints online from other account holders?
- What are their business hours and how is their response rate?
- What are their policies about providing account assistance/guidance to customers?
- Do they offer multiple methods of contact, including online chat, phone, email, and text?

In 1993, roughly 8 percent of eligible workers had IRA accounts. By 2016 that had grown to 44 percent.’ Not only has usage grown, but so too has allowable contribution amounts. From 1982 to 2001, the maximum contribution was $3,000 per year. Today, that amount has increased to $6,000 with an added $1,000 catch-up contribution for those over fifty.

But with the rise in allowable contribution amounts comes an important question: What, exactly, should we be investing in?

Feel free to contact me with any questions or for more information about mortgage loan investing.

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Should You Have Real Estate in Your IRA?

The self-directed IRA gives investors the freedom to invest in real estate to provide fixed-income solutions, a major plus once these investors have reached retirement. The problem is, while real estate *offers* a fixed-income solution, it doesn't always actually *provide* that solution—and when it does, it can come at a huge price.

Since 2013, real estate has been the most popular investment in America.[1] Whether flipping, residential rentals, commercial rentals, or vacation rentals, real estate draws in passive-investment-seeking investors like few other investments do. But no matter what you've read in the countless real estate investing books available, owning real estate and renting it, for any reason, is not a passive investment unless you invest in a REIT, syndication, or fund.

[1] https://news.gallup.com/poll/309233/stock-investments-lose-luster-covid-sell-off.aspx

Don’t Become A Burned-Out Landlord

I learned the hard way over 13 years as a landlord that being a real estate investor was a grueling business, even more volatile than the stock market. There’s an old expression in real estate: *You make your money when you buy, not when you sell.* Let’s take a look at some of the reasons why:

- Purchasing discounted properties is harder than picking winning lottery numbers. The ever-growing number of real estate investors, many inexperienced, increases competition and drives up prices for properties to irrational levels. It’s not uncommon for discounted properties to have over thirty bids from investors.
- Rehabbing older properties is challenging and risky, including latent defects and hard-to-estimate expenses.
- Tenants are especially hard on rental properties, and every tenant turnover cost me an average of $5,000. This includes often-forgotten costs such as vacancy expenses and advertising for and finding a qualified new renter.
- During financial downturns (or, as we see now, pandemics), many tenants lose their jobs and can’t pay their rent. Spreading risk between more units fails to provide any type of hedge against loss; it just amplifies the risk.
- Laws are overwhelmingly designed to protect tenants (and they should be), but they create an untenable model for most landlords. Trying to create a stable, passive income from tenants who are frequently struggling from paycheck to paycheck in an

environment that views landlords as the enemy isn't a practical business model.

- Expenses go up every year, and because of the stiff competition locking area rent rates in place, there is often no way to recoup those higher costs. A single major setback could blow up your entire cash flow for this year and sometimes even the next.

The National Apartment Association's research supports what a low-margin business rental housing is. According to their 2019 findings, each dollar in rent received is broken down in the following ways[2]:

$0.39	Mortgage payment
$0.10	Capital expenditures
$0.27	Maintenance, utilities, insurance
$0.14	Property taxes
$0.09	**Profit**

Figure 1

IRAs: Compounding the Real Estate Problem

All the issues discussed in the last section were for real estate investments in general. Now let's look at how problematic real estate is once you buy it in an IRA.

[2]https://www.naahq.org/sites/default/files/naa-documents/dollarrent_v3.pdf

- Real estate investors regularly rely on leverage to build their portfolio. Purchasing properties with just 20 to 30 percent down through commercial loans is the goal, allowing a bank to finance the rest. In an IRA, however, you have to finance the entire purchase from the IRA, unless you can secure nonrecourse financing, which is more expensive and more difficult to obtain. Worse, when you finance an entire real estate purchase out of your IRA, you have less available to purchase other investments and diversify holdings. Not to mention the amount of money you've exposed to risk.
- All expenses for the properties need to be paid for by the IRA. This includes repairs, which you cannot legally do yourself. It also includes:
    - large capital expenditures
    - routine maintenance
    - pest control
    - unit rehab between tenants
    - management and contractor fees
    - evictions
    - lawsuits
    - fires/floods/natural disasters
    - increasing costs for property taxes
    - increasing costs for hazard, liability, and umbrella insurance
    - utilities
    - city fines/inspections
    - closing costs

All these expenses can massively derail profits, offsetting any appreciation. They drive down the net gain and impact the investor's liquidity along the way.

And what if your IRA doesn't have enough to cover a necessary expense? You risk lawsuits, fines, and even foreclosure.

- Unpredictable appreciation and liquidity. IRAs are generally used for income in retirement. When you're invested in real estate, not only can your liquidity be unpredictable as rental units remain empty and tenants suffer financial issues, but you can't even take out the equity since you can't secure an equity loan within an IRA. As for appreciation, there is a real risk of values dropping during a recession. During the 2008 recession, home prices fell 33 percent.[3] In 2020 we're seeing real estate values falling in some markets due to the financial pressures brought on by the pandemic.
- Loss of depreciation and tax benefits. Taxes are a consideration for every investor. Real estate investors, in particular, have some advantages in the area of taxes. These advantages are not generally present, however, when the real estate investment is within an IRA. Real estate investments made with IRA accounts **cannot** be depreciated and have a long list of restrictions and potential taxations (including UBIT) that you should review carefully with your IRA custodian and CPA. You may find that investing in rental properties in an IRA can actually result in you paying *more* in taxes.

Let's face it—owning property comes with huge liability risks. In order to profit, most landlords are forced to manage their properties at a substandard level, which devalues the property over time and increases the risk of lawsuits— in this

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[3]https://www.washingtonpost.com/news/business/wp/2018/10/04/feature/10-years-later-how-the-housing-market-has-changed-since-the-crash/

case, all aimed directly at your retirement savings. Speaking of which, the amount of insurance landlords require is staggering. From hazard to liability to umbrella to workers' compensation, it's not just about protecting the property but also tenants, guests, and workers.

In a very serious event, such as a fire, there is a high likelihood the owner's coverage won't be enough to pay out the totality of claims. Since most investors underinsure to maximize profits, they face the risk of attorneys going after their IRA balances, and possibly other personal assets when the IRA isn't enough.

What if a tenant brings something onto the property—a pit bull or a trampoline, for instance—and someone is seriously injured? Who is the attorney going to recoup damages from? The tenant? Or the property owner and their IRA? Even if the owner didn't know about the dog or the trampoline and didn't give the tenant permission to have them, the owner is still liable for the damages.

Or, what if the handyman the landlord uses frequently for repairs gets hurt while working on the property? An investor may think the handyman is an independent contractor, but a judge will likely rule under workers' compensation laws that the property owner is responsible for the injuries and/or disability.

There's no way around it. Rental real estate—a supposedly passive investment—is easily one of the most time-consuming, expensive, and troublesome investments available. **And when investing with an IRA, most people are looking for passive investments, not active headaches.**

A Different Kind of Real Estate for Your IRA

Rental property income is neither stable nor consistent. But that doesn't exactly mean you should cross real estate off your list of possible IRA investment options. Believe it or not, there is a *truly passive* real estate investment without all the headaches and risks: mortgage loan investments.

Mortgage note investing involves buying secured home loans (mortgages) that banks have already underwritten and approved. Mortgage loan investors count on monthly loan income for profits and since they don't originate the mortgage

loans, they don't need to evaluate debt-to-income ratios, collect required disclosures, or deal with compliance. Instead, they simply purchase loans through what's called the secondary market.

> Mortgage loans are *secured* loans in which a borrower's property (home) is pledged as collateral. A lien is recorded against the property to secure the lender's interest, and if the borrower ever defaults, the lender has the right to foreclose the collateral and sell the property in order to satisfy the debt.

Why don't more investors consider mortgage loans as investments? I don't see any reason why, other than lack of knowledge. It makes sense to avoid investing in something you don't know much about or don't understand. That's certainly what Warren Buffett suggests.[4] But here's the interesting point: If you have ever had a mortgage, then you know enough about mortgage investing to create a solid knowledge foundation.

> "Never invest in a business you cannot understand."
>
> —Warren Buffett

As of 2019, there was $15.8 trillion in mortgage debt in the United States.[5] Home ownership *is* the American dream, and you don't need to be a massive bank or financial institution to enjoy the benefits of mortgage loan investing. Everyday investors like us can invest in that dream.

[4] https://www.cnbc.com/2017/05/01/7-insights-from-legendary-investor-warren-buffett.html
[5] https://www.housingwire.com/articles/u-s-mortgage-debt-hits-a-record-15-8-trillion/

How Mortgage Loan Investing Works

Investors can buy loans secured by multifamily properties, commercial properties, vacation homes, and single-family primary residences. When you purchase a residential mortgage loan as an investment, you are simply buying a debt obligation for a set number of payments from an existing loan that has already been originated, usually by a licensed financial institution. Once originated, the loan terms cannot be changed unless both parties agree.

> Mortgage loan investments are a truly passive real estate investment without all the headaches and risks associated with landlording, flipping and managing vacation rentals.

Originating mortgage loans is a completely different endeavor from buying and owning them. Origination is a tightly regulated business requiring licensure and compliance with myriad laws on the state and federal level.

While the borrower is the rightful owner of the property and is allowed all the rights and responsibilities of ownership, that ownership is subject to the lender's lien on the property, which must be paid in full before the borrower completely owns the home. What the borrower builds in the meantime is *equity*, or the difference between the value of the property and the amount of debt owed to the lender. Over time, equity grows as the value continues to rise and the amount of debt is paid back to the lender.

> The types of loans discussed in this report are referred to as *performing loans*, and there's a good reason for that. In a performing loan, the borrower is current and making regular payments. This is

> something that can help an investor feel confident about their investment, but I want to be clear that tracking billing and payments is not part of the job of a mortgage loan investor.

Almost all investors hire a *loan servicer* to manage their mortgage loans. Servicers are usually licensed in the states in which they service loans and charge a flat monthly fee per loan for servicing. This involves:

- notifying the borrower of any changes in loan ownership
- sending monthly mortgage statements
- collecting monthly payments
- keeping track of the payments and loan balance via payment history
- communicating with the borrower
- paying property taxes through an escrow account
- collecting proof of hazard insurance on the property
- disbursing monthly payments to the lender
- following up on any delinquencies
- handling payoffs
- sending out year-end tax statements to the borrower and lender

Part of the beauty of mortgage loan investing is that the lender has no other responsibilities for the collateral property; that is entirely up to the homeowner. And while economic downturns almost certainly contribute to falling home values, they do not necessarily trigger high rates of foreclosure, which is good news for mortgage loan investors. Ultimately, mortgage loan investing is a simple business. Money was lent, the borrower needs to pay it back in monthly payments, the investor buys the lender’s rights to the

repayment, and the rest is an opportunity for our IRA accounts to grow exponentially.

Doubling Your Money

The restrictions and disadvantages of buying real estate in an IRA make mortgage loan investments the perfect alternative. Further, IRAs give us a perfect place to amplify the power of our investing capital because investing within an IRA allows an investor to enjoy tax-deferred or tax-free growth, making it even easier to double our money.

The Rule of 72

Every month that your IRA receives mortgage loan investment payments from borrowers, you have the opportunity to reinvest those funds. And when the homeowners pay off the loan early, those funds get reinvested, too, often back into a new loan. Thanks to the Rule of 72, you can figure out at what interest rate you need to reinvest those funds to double them during the timeline you choose.

The Rule of 72 is a mathematical formula that allows you to estimate the time it will take money to double at various investment rates. In general, you can expect money invested with a 1 percent return to double in seventy-two years. A 2 percent return doubles money in about thirty-six years. A 3 percent return doubles money in about twenty-four years, and so on.

If you earned 9 percent annually on your portfolio, it would take you eight years of compounding interest before your portfolio doubled in value. The formula for the Rule of 72 is:

((72/interest rate) = number of years to double)

The key for mortgage loan investors who aren't using their returns for current income is to continue reinvesting the earnings, keeping in mind that consistency over time beats a couple of great years over the long run.

Too often, I hear from people who keep their funds sitting in their IRA account because they're waiting for an astronomical investment return. What these folks don't understand is that, thanks to inflation, money not invested decreases in value each month, and accurate portfolio performance measurements must average in the amount of time investment funds went undeployed.

> With potentially higher yields than bonds and bond funds, mortgage loan funds within a self-directed traditional IRA mean investors can enjoy a high-yield, lower-risk investment with deferred taxation—ensuring their growth compounds continually.

Slow and steady growth wins the race. It's much better to keep your money working for you consistently over time than it is to have it sitting on the sidelines decreasing in value, hoping that some "home run" investment comes along. Few of us would be shocked with a 9 percent return, but when you consider that it can double your money in eight years, it certainly sounds better than leaving those funds doing nothing in your IRA or risking their loss with that "sure thing" investment.

As a mortgage loan investor, all I own, literally, are two signed documents that give me the ability to collect a set number of payments, and the right to a residential property as collateral. It's well worth the trade-off because mortgage loan investing is a much more scalable business.

Before making any decisions about what to do with the funds in your IRA, it's critical that you first meet with a CPA, attorney, and financial advisor. Only with this team of experienced professionals will you get a full picture of the potential benefits and pitfalls of the investments you're considering based on your individual retirement timeline and objectives

Mortgage Loans in IRA	Real Estate in IRA
Secured by real property	Can't mortgage property
Income based on set payments	IRA must cover all costs to maintain
Payments typically don't change	No DIY projects or maintenance
Investor decides yield at purchase	Must maintain insurance and expenses
Additional liquidity by selling loan or partial	Illiquid, with no equity loan availability
Maximum risk is the amount paid for note	Must pay all associated expenses for maintenance, liabilities, repairs, and more

No future expenses for maintenance	No depreciation and may need to pay UBIT
No insurance requirement	Because the IRA must fund full real estate purchase, it’s harder to diversify
Homeowners very rarely default on payments	May lose tenant income

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Recession-Proofing Your IRA

Risk is a part of every investment experience. There are no investments that are completely risk-free and few that combine low risk with a decent return that can beat inflation.

When considering mortgage loan investment risks, it would seem as if borrower default is the biggest risk you run, especially during a recession. After all, your income comes from the homeowners making their monthly mortgage payments and eventually paying off their homes.

But as it turns out, this risk might not be something that needs to strike fear in an investor's heart for three reasons:

1. Homeowner default is statistically rare.
2. Mortgage loan investors can provide options for borrowers to help them get over short-term financial issues.

3. If no agreement can be made, mortgage loan investors retain the right to foreclose on a defaulted loan's collateral.

Now, let's talk about each of these factors in more detail.

The Statistics of Mortgage Default

In a normal economic time, during a "normal" year, delinquency rates on single-family homes are low. In fact, the delinquency rate for mortgages ninety days or more past due fell from 4.9 percent in January 2010 to 0.8 percent in December 2019.

Of course, as the Great Recession and the COVID-19 Recession have taught us, normal is a gift we don't always get to enjoy. But a deeper look at actual delinquency and foreclosure rates during these events shows us that homes seem to be the last asset people are willing to lose.

It's been estimated that between 2007 and 2010, there were just 3.8 million foreclosures in the United States. In quarter one of 2010, the delinquency rate for single-family residential mortgages reached its highest point, 11.54 percent. At the time, the unemployment rate was around 10 percent. In quarter two of 2020, after months of a pandemic and lockdown orders and with an unemployment rate of 11.1 percent, the delinquency rate for single-family residential mortgages was just 2.49 percent.

In part, the drastic difference between delinquency rates today versus around the Great Recession is likely due to changes in loan underwriting standards and lending regulations as well as government intervention in the form of

automatic forbearance—factors that will continue to benefit mortgage loan investors throughout the future years and potential economic upheaval.

Contrast this to the experience that stock and bond investors have during a recession. In 2008, investors lost an average of 25 percent of their retirement account values, and ten years later, many still hadn't recovered.[6,7] Meanwhile, bond interest rates fell from 5 percent to 2 percent, and are even lower than that today.[8]

During the Great Recession, a common concern was that borrowers would abandon their homes as property values plummeted, and by March 2011, almost 30 percent of them were underwater or very close to it.[9] The term *strategic default* was coined by lenders to identify borrowers with negative equity who decided to just lock the doors of their home and walk away. Financial institutions were concerned that millions of homeowners would strategically default since there was no financial incentive for them to stay.

As it turns out, the concern over strategic default was overblown, which should give today's mortgage loan investors some additional confidence. J.P. Morgan Chase conducted a study in 2017 to learn about borrower behaviors

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[6]https://www.theatlantic.com/business/archive/2015/10/the-recession-hurt-americans-retirement-accounts-more-than-everyone-thought/410791/
[7]https://money.cnn.com/2017/12/01/news/economy/recession-anniversary/index.html
[8]https://www.marketplace.org/2020/03/09/bond-yields-lower-than-during-financial-crisis/
[9]https://www.corelogic.com/news/new-corelogic-data-shows-23-percent-of-borrowers-underwater-with-750-billion-dollars-of-negative-equity.aspx

and motivations during the financial crisis, and what they found was astounding.

Strategic default never happened.[10]

The study followed almost a half-million homeowners who received a home loan modification and found that in virtually every single case, the only borrowers who lost their homes were borrowers who had no financial ability whatsoever, either through themselves, a spouse, or family members, to continue to pay. In other words, default was tied to a fundemental drop in income, rather than a drop in property values or size of payments. Underwater borrowers stayed in their homes, continued to pay, and just waited for the housing market to rebound.

Why would they do this? Overwhelmingly because they loved their homes and wanted to stay in them! In 2018, when almost two million homeowners still had negative equity, New York Fed found that the primary reason underwater homeowners hadn't even considered strategic default was simple: they liked their homes and didn't want to lose them.[11]

Modifying Payments

Chances are good you've heard about banks offering mortgage loan modifications to borrowers dealing with short-term financial issues. With these modifications, they reduce the payment borrowers are expected to make and they add past-due balances to the principal amount owed.

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[10]https://institute.jpmorganchase.com/content/dam/jpmc/jpmorgan-chase-and-co/institute/pdf/institute-mortgage-debt-reduction.pdf
[11]https://www.marketwatch.com/story/why-do-underwater-homeowners-keep-paying-the-mortgage-2018-04-19

Banks do this because it works. Between 2007 and 2016, more than 24 million nonforeclosure solutions were offered by the mortgage industry, rescuing millions from foreclosure, keeping families in their homes and keeping payments rolling in.

Our goal as lenders is simply to keep the loan payments coming in on a monthly basis, so common alternatives to foreclosure can include:

- short-term forbearance
- loan modification
- selling the house
- refinancing the house
- deed in lieu of foreclosure

These foreclosure alternatives are usually brought on by short-term financial hardships that prompt defaults. This can include difficult events such as:

- death in the family
- divorce
- job loss
- illness
- overwhelming debt, frequently due to medical bills

The key here is short-term. Federal law prevents lenders from filing a foreclosure until a borrower is 120 days delinquent on their loan, so this usually gives a loan servicer time to reach out to the borrower, assess the borrower’s situation, and offer potential solutions.

Since loan servicers collect loan payments and communicate directly with the borrowers, investors should not get involved. In many states, calling borrowers directly can be considered debt collection, which would require a state license. Personally, as an investor, I want as large a distance between myself and the borrower as possible.

Why do these alternatives work so well with homeowners? If you're used to dealing with tenants as a landlord and have had to evict—or threaten to evict—tenants, then you might not understand. As a landlord, I found that tenants generally viewed renting as a financial transaction. Their goal was to get the best unit for the lowest price, with the lowest amount down, and they were willing to move, even on short notice, for a better deal.

Also, the rental market was competitive. Many landlords would upgrade units and offer incentives like free rent to attract tenants; they'd even lower prices out of a need to fill units. Thus, many tenants aren't concerned about an eviction, in my experience, because they could always move to another rental.

Homeowners, however, are a completely different breed. Just think about how the process of buying a home starts—usually with a big down payment. People save money for years, handing over more money than they may have for any other purchase in their lives, to buy a home. They move in, they personalize and put money into improving the space and yard, they expand their families, get pets, and make memories. A homeowner's connection to their property is referred to as "**emotional equity**", and it has proven to be even more powerful than financial equity. Bottom line, homeowners don't want to move, *even when* their home is

underwater. Overwhelmingly, they choose to stay, pay, and wait for values to increase as they pay down the balance of their mortgage loan. As the data shows, homeowners almost never walk away.

Besides that, over time, their financial equity in the property can grow to hundreds of thousands of dollars, making their home the most important investment they have. In fact, as of 2018, the average homeowner had more than $113,000 in tappable equity.[12]

Foreclosure

While it doesn't happen often, there are borrowers who become so behind on mortgage payments that their lender files foreclosure. But, as I mentioned, this is infrequent, even during times of financial stress such as the Great Recession, when about 25 percent of homeowners were underwater, yet only 3.8 million ended up in foreclosure.

Because mortgage loan investors are secured lien holders, mortgage loan investors retain the right to foreclose on a property to reclaim the balance of the loan. As a lender, I am willing to provide alternatives to foreclosure if I see a clear resolution in sight. I don't want to displace borrowers unless absolutely necessary and all alternatives have been exhausted. But if no solution can be found, then sometimes foreclosure is the only answer. Just because a foreclosure case is filed doesn't mean that it will be completed; among the statistically small percentage of cases that are filed, even fewer actually make it to a foreclosure sale.

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[12] https://www.blackknightinc.com/black-knights-may-2018-mortgage-monitor/

This is yet another reason I suggest that investors stick with owner-occupied, primary residences; homeowners are much less likely to allow them to go into foreclosure than they might a vacation or investment property.

The key in mortgage loan investing is to have a large portfolio diversified over many borrowers in many markets in order to withstand any financial storm. One of the most powerful advantages of mortgage loan investing is geographic diversification, or the ability to purchase loans in multiple markets in multiple states. Real estate investors tend to purchase properties only in one local market, which can expose an investor to tremendous risk during economic recessions. Since not all markets will be affected the same way during recessions, the ability to create geographic diversification further reduces portfolio risk.

In addition, thanks to this level of flexibility, investors can choose to only invest in loans secured by owner-occupied homes in the markets they choose. Investors can even choose collateral properties that show a clear pride of ownership and are located in low-crime neighborhoods.

IRAs are designed for totally passive investments, and that is what notes provide, at a much higher yield, without the volatility or headaches of real estate. And at the end of the day, the most the investor risks is the price paid for the note.

Small Steps to Mortgage Loan Investing

By now, you probably have a much better idea what role mortgage loan investing might play in your IRA and future income plans.

Now, let's go a step further and talk about two ways to invest in mortgage loans without a large capital commitment. As I walk through these steps, please remember that my goal is to introduce you to these concepts and expand your understanding of what's possible in your portfolio. Please

consult with a CPA, attorney, financial advisor, and IRA plan custodian before taking action and making any investments.

Baby Steps: Partial Loan Purchases

What if you're not ready to purchase a whole loan? Whether you're concerned about concentrating that much capital in a single investment or you simply don't have enough money in your IRA to take such a big step, you might instead start by purchasing just part of a loan.

A *partial loan purchase* is a great way to test the mortgage loan investing model with a lower capital contribution while learning the fundamentals. A partial loan purchase contract has three parties: the seller, the buyer, and the borrower. Partial loan sales occur when a seller wants to raise capital from a mortgage loan investment, but doesn't want to sell an entire loan. Let's take a look at how it works.

Example

Recently, I purchased this mortgage loan located in California:

Purchase price	$21,000.00
UPB (unpaid principal balance)	$27,376.22
Monthly payment	$351.84
Payments remaining	104
Yield	14.18%

Total collected over life of loan	$36,591.36

Figure 2

If, after buying this loan, I found that I needed to raise $10,000 and didn't want to sell the entire loan, I could sell a portion of the payments to another investor at an agreed-upon yield.

For example, let's say I am willing to give the purchaser a 9 percent yield. With a financial calculator, I can figure out how many payments I need to sell to the buyer to return a yield of 9 percent:

N: number of payments	PMT: monthly payment	I/YR: desired yield	PV: purchase price
Unknown	$351.84	9%	-$10,000

Figure 3

By entering the data and then pressing the N key, you will get an answer of thirty-two. That means I need to sell the buyer a total of thirty-two payments to provide a 9 percent yield. Let's look at an actual amortization schedule to provide even more detail.

Partial purchase price	$10,000
Monthly borrower payment	$351.84
Buyer's yield	9%

Number of payments required to yield 9%	32
Total amount collected by buyer	$11,258.88

Figure 4

Compounding Period: Monthly

Nominal Annual Rate: 9.000%

Cash Flow Data - Loans and Payments

	Event	Date	Amount	Number	Period	End Date
1	Loan	07/14/2020	10,000.00	1		
2	Payment	08/14/2020	351.84	31	Monthly	02/14/2023
3	Payment	03/14/2023	381.49	1		

TValue Amortization Schedule - Normal, 365 Day Year

	Date	Payment	Interest	Principal	Balance
Loan	07/14/2020				10,000.00
1	08/14/2020	351.84	75.00	276.84	9,723.16
2	09/14/2020	351.84	72.92	278.92	9,444.24
3	10/14/2020	351.84	70.83	281.01	9,163.23
4	11/14/2020	351.84	68.72	283.12	8,880.11
5	12/14/2020	351.84	66.60	285.24	8,594.87
2020 Totals		**1,759.20**	**354.07**	**1,405.13**	
6	01/14/2021	351.84	64.46	287.38	8,307.49
7	02/14/2021	351.84	62.31	289.53	8,017.96
8	03/14/2021	351.84	60.13	291.71	7,726.25
9	04/14/2021	351.84	57.95	293.89	7,432.36
10	05/14/2021	351.84	55.74	296.10	7,136.26
11	06/14/2021	351.84	53.52	298.32	6,837.94
12	07/14/2021	351.84	51.28	300.56	6,537.38
13	08/14/2021	351.84	49.03	302.81	6,234.57
14	09/14/2021	351.84	46.76	305.08	5,929.49
15	10/14/2021	351.84	44.47	307.37	5,622.12
16	11/14/2021	351.84	42.17	309.67	5,312.45
17	12/14/2021	351.84	39.84	312.00	5,000.45
2021 Totals		**4,222.08**	**627.66**	**3,594.42**	
18	01/14/2022	351.84	37.50	314.34	4,686.11
19	02/14/2022	351.84	35.15	316.69	4,369.42
20	03/14/2022	351.84	32.77	319.07	4,050.35
21	04/14/2022	351.84	30.38	321.46	3,728.89
22	05/14/2022	351.84	27.97	323.87	3,405.02
23	06/14/2022	351.84	25.54	326.30	3,078.72
24	07/14/2022	351.84	23.09	328.75	2,749.97
25	08/14/2022	351.84	20.62	331.22	2,418.75

	Date	Payment	Interest	Principal	Balance
26	09/14/2022	351.84	18.14	333.70	2,085.05
27	10/14/2022	351.84	15.64	336.20	1,748.85
28	11/14/2022	351.84	13.12	338.72	1,410.13
29	12/14/2022	351.84	10.58	341.26	1,068.87
2022 Totals		**4,222.08**	**290.50**	**3,931.58**	
30	01/14/2023	351.84	8.02	343.82	725.05
31	02/14/2023	351.84	5.44	346.40	378.65
32	03/14/2023	381.49	2.84	378.65	0.00
2023 Totals		**1,085.17**	**16.30**	**1,068.87**	
Grand Totals		**11,288.53**	**1,288.53**	**10,000.00**	

ANNUAL PERCENTAGE RATE The cost of your credit as a yearly rate.	**FINANCE CHARGE** The dollar amount the credit will cost you.	**Amount Financed** The amount of credit provided to you or on your behalf.	**Total of Payments** The amount you will have paid after you have made all payments as scheduled.
9.000%	**$1,288.53**	**$10,000.00**	**$11,288.53**

Figure 5

Here’s a simple breakdown of the process:

- The buyer wires the seller the $10,000.
- The seller assigns the loan to the buyer and sets up the partial contract with the loan servicer so the next thirty-two payments of $351.84 are paid directly to the buyer.
- The seller then has the $10,000 they need for their investing purposes, and the buyer has a short, inexpensive introduction to mortgage loan investing with a 9 percent yield.
- After the thirty-two payments are made, the loan reverts back to the seller, who has the right to collect the remaining seventy-two payments.
- If the loan is paid off early, all the payments received by the buyer are amortized along with the buyer’s

interest rate and the total amount the buyer invested to determine the refund due to the buyer. This is tracked by the loan servicer.

Partial loan purchases are a win for both parties: the seller gets a cash infusion and still gets to keep the tail end of the loan, and the buyer gets a solid yield on a lower-risk investment, since the seller isn't going to do anything, or allow anything, to jeopardize their investment in the remaining loan payments.

With that said, it's still important to do the same due diligence on a partial loan purchase as you would a full loan purchase. The difference with a partial is that there is no competitive bidding process. The seller will review all the data with you, explain all aspects of the loan purchase, and allow you to ask as many questions as you need to feel comfortable with the investment.

Partial Loan Purchases FAQ

Who owns the loan during the partial sale period?
The loan will be assigned to the buyer during the period that the buyer is collecting payments, and will be assigned back to the seller once the buyer receives their entitlement.

What happens if the borrower defaults during a partial?
Most partial loan sale contracts allow the seller to do one of the following in case of a borrower default:

- Buy back the loan.
- Continue to make the payments to the buyer.
- Begin legal proceedings at the seller's expense.

Remember, the seller retains the right to many tail-end payments in the loan, so they have a vested interest in making sure the borrower keeps the loan current.

How is the loan serviced during the partial sale period?
Once the contract is signed and forwarded to the loan servicer, the loan is set up as a partial in the servicer's system. The servicer tracks the balance of the buyer's partial payment entitlement.

Which party pays the servicing fee?
The net monthly payment, after servicing, is used for the buyer yield calculations.

What paperwork is required?
The seller and buyer sign a contract that covers the partial loan purchase, which includes amortization schedules for both the buyer and the borrower, covering the number of payments sold.

What if the loan is paid off early?
All the payments the buyer already received would be entered into an amortization schedule, along with the buyer's interest rate and the total amount the buyer invested to determine the refund due to the buyer. The loan servicer tracks this data on a monthly basis and would distribute the correct amounts between the buyer and the seller.

What if the borrower makes irregular payments (pays more each month than they are required to)?
Additional principal payments reduce the amount owed to the buyer, since the principal amount is paid back faster. The loan servicer tracks the amount due to the buyer each month during the partial contract.

What are the advantages of partial note purchases?

- Seller provides all due diligence for the buyer's review.
- Seller steps in and rectifies the situation if the borrower defaults.
- Buyer legally owns the loan during the partial.
- Capital commitment is reduced.
- Investment term is reduced.
- It's a relatively simple process with high yields and lowered capital needs, making it great for IRAs.

Mortgage Loan Funds

For investors who prefer funds and who aren't interested in learning the business of mortgage loan investing, but still want to profit from the mortgage loan investment model, I'd like to introduce the mortgage investment fund. They are even more passive than actively purchasing individual loans, and return similar yields.

> Mortgage loan funds pool investor capital in order to purchase larger quantities of loans, and they usually pay a preferred return to investors, which means the investors receive their returns first, before the manager(s) realize any profit.

Unfortunately, many mortgage loan funds that are allowed to advertise are restricted to only allow *accredited* investors, but there are some funds that accept *sophisticated* investors.

Accredited Investors

The SEC defines an accredited investor as a person who either has an annual income of $200,000 per year ($300,000 for joint income) for the last two years or a net worth of $1,000,000 or more, excluding the value of their primary residence. Because of their net worth and/or income, the SEC believes these investors are capable of making their own investment decisions, without restriction.

Recent changes to the SEC's definition allow for the inclusion of knowledgeable employees of a fund, spousal equivalents, and certain people with relevant credentials and certification from accredited institutions.[13]

Sophisticated Investors

A sophisticated investor may not meet the accredited investor income/net worth status, but is believed to possess superior knowledge of business and financial matters, enough to weigh the merits and risks of an investment.[14] There are certain types of funds that accept a limited number of sophisticated investors, even though they do not meet the income or net worth requirements to be considered accredited.

Qualifying a Fund

It's not just the investor who must qualify for the fund, but the fund that must qualify for the investor. After all, mortgage investment funds hold all the same risks as individual

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[13]https://www.sec.gov/news/press-release/2020-191

[14]https://www.sec.gov/fast-answers/answers-rule506htm.html

mortgage loan investments, and if they are not properly diversified, vetted, or managed, investors run the same risks of loss as they would investing in individual loans.

> It is crucial that you complete a thorough due diligence review of a mortgage fund before agreeing to invest. Just because a fund manager seems like a nice person does not mean they are a good fund manager.

The following questions are absolutely critical to review with a sponsor during the vetting process. The answers to many of these questions will probably be included in the fund offering documents, so be sure to look there as well. If you have any questions about how to review those documents and identify important information, you should speak directly to the fund manager. **It is your money; don't be afraid to ask the tough questions.**

Who is/are the fund's manager(s)?

Keep in mind that you are investing in the people even more than the model. I like to see that the leadership has a great depth of knowledge in the field, as well as a successful track record. I always ask the manager how much of their own capital they have invested in the fund. That shows how personally vested they are in the fund's success. Additionally, I strongly recommend doing a background check on the manager(s).

What is the strategy of the fund?

Funds can have many strategies. For example, some might want to focus on single-family residential first liens. Others might focus primarily on commercial real estate. Investors

should generally look for a focused, singular strategy organized by a manager with plenty of related experience. If a fund is going to buy both residential and commercial real estate plus anything else appealing that comes along, there may not be enough expertise and focus in one field, which greatly increases the risk. It is very rare that a management team is a market leader in all those fields.

What is the fund’s yield?

Most mortgage funds pay investors a preferred return ranging from 8 to 10 percent, depending on the types of assets the fund purchases. The riskier the fund’s strategy, the more yield an investor should expect.

What happens if a mortgage within the fund defaults?

Mortgage funds should be set up to absorb a 15 percent default rate and still pay investors.

When are investors paid?

If an investor is counting on the fund for reliable income, they may want to look for a fund that pays a monthly distribution. Also, make sure to note if there is a delay between when the funds are invested and the preferred return distributions begin.

What fees does the fund charge?

Ideally, a well-run mortgage loan fund will have no fees. Some investment funds, however, charge a management fee of 2 percent or more per year, which is payable to the

managers regardless of fund performance. Funds are also known to charge myriad additional administrative and management fees that can really add up and could affect distributions to the investors. A fund ***without*** fees demonstrates that the sponsors are very confident in their model, because they will not be paid anything for their hard work unless the fund does well.

What costs does the fund incur?

Even if the fund charges a low fee, the costs of running the fund can impact profits and yield. I suggest that investors look for a fund that balances these costs against the cash flows of the fund. If there isn't much of a buffer between the monthly net income and investor-preferred return obligations, the fund could get into trouble down the road, unable to pay its costs and/or investor-preferred returns.

What is the fund's lockup period?

Many commercial real estate funds have a minimum commitment of five to ten years, which means investors may not redeem their shares during that period. A lot can happen in that span of time, so investors should look for funds with as short a required commitment as possible. Once the lockup period has passed, there should be a clear procedure for redeeming shares and exiting the fund.

In which states do you own loans, and how many loans are owned in each state?

It's critical that investors find funds with adequate geographic diversification. If all the loans are held in one city or state and

that area sees a major employer move or a natural disaster, the investors could be in big trouble.

What is the fund’s current delinquency rate?

If the strategy of the fund is to invest in performing loans but it has a troubling percentage of loans (more than 5 percent) that are nonperforming, I would be concerned.

What is the fund UPB vs. invested capital?

This is an important liquidity issue that tells investors how much debt the fund owns in relation to the amount of investor capital they have accepted. If the fund were ever to be liquidated, would there be plenty of money left over to pay back investors? The more debt the fund owns in relation to invested capital, the more confident investors can be that the fund could survive a financial downturn or a spike in delinquency.

What are the monthly cash flows of the fund?

This is a measure of the monthly payment income versus its preferred return obligations to investors. The fund should be taking in plenty of excess capital monthly that should be invested in more loans to increase the financial health of the fund and strengthen its safety net.

How high a delinquency rate could the fund withstand in order to still pay preferred returns to borrowers?

Under a preferred return model, the fund managers know exactly what their monthly obligations are to investors. If a catastrophic downturn occurred and 25 percent of a fund's loans became delinquent, could the fund still pay investors? As an investor, I want safety and security more than flashy promises of astronomical returns. After all, the first key to investing is to not lose money.

Has the fund ever missed a payment to investors?

If the fund has, I would want to know why, and what changes have been made to ensure that never happens again.

What are the tax implications of fund participation?

When buying into a fund outside a qualified account, make sure there are no tax surprises, such as managers issuing capital gains distributions for proceeds from sales within the fund. Additionally, I like to see that the fund has a licensed CPA handling its forms and filings, both with the IRS and investors.

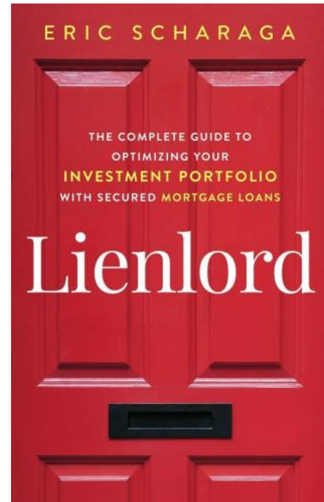
Are there any sales loads?

Ideally, the fund should have no sales loads or commission charges for buying or selling your interests outside of the lockup period.

Choosing between investing in a fund and purchasing individual loans or partials should be a time versus reward consideration. How much better do you think you can do on your own after investing all the time and taking the risks to learn the business and develop a network? Also, are you able to spend the capital to diversify your loan portfolio properly? While an individual investor may only be able to buy five to ten loans at a time, a fund might have three hundred in its inventory, providing a far better hedge against risks.

In my opinion, investing in a mortgage loan fund is really the only totally passive, high-yield, secured real estate investment available.

Learn More



- **What if there was a way to own a truly passive real estate investment?**
- **What if you could benefit from the security of real estate without all the risks and headaches of ownership?**
- **What if there was a fixed-income real estate investment product that offered both high yields and passive security?**

Over the last twenty-five years, I have invested in traditional Wall Street investments and real estate in my search for financial freedom, and have discovered a simple alternative that has been so much more powerful: **mortgage loan investment.**

This discovery was the motivation for writing *Lienlord*, my book on mortgage loan investment.

I created this e-book series simply to provide information on an investment I'm passionate about, and I hope it provides you with valuable insight. I'm dedicated to helping investors understand and get started investing in mortgage loans.

Author Eric Scharaga

I hope you have gained some insight on how mortgage loans can create an amazing synergy for any investment portfolio, without the volatility of the markets or the headaches of real estate ownership.

If you are interested in learning more, feel free to contact me for a free copy of my book, *Lienlord: Secrets to Creating MASSIVE Passive Income with Secured Mortgage Loans*.

If you found the information in this report helpful, I'd be eternally grateful if you took two minutes to write a review on Amazon. When you leave a review, it helps other investors find my e-books.

Feel free to contact me with any questions or for more information about mortgage loan investing.

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Glossary

Accredited investor: Investor that is allowed to purchase securities by satisfying SEC requirements regarding their income, net worth, and/or professional experience.

Amortizing mortgage loan: Mortgage loan that requires scheduled payments of principal and interest, with the majority of the interest paid at the beginning of the loan.

Assignment of mortgage/deed of trust (AOM): Recorded document that transfers ownership interest of a lien to a subsequent lender.

Balloon payment: A one-time payment required to fully pay off a mortgage prior to its full amortization.

Borrower: The party who pays back a mortgage loan in equal installments in accordance with the promissory note.

Collateral file: All the required documents relating to a mortgage loan.

Collateral property: The property that the lien is filed against and pledged by the borrower as security for a mortgage loan.

Debtor: A bankruptcy term for the party who owes money.

Deed: Legal instrument used to transfer property ownership from the old owner to the new owner.

Deed of trust: A recorded instrument securing a loan to the collateral and used mainly in nonjudicial foreclosure states.

Default: Occurs when a borrower stops making required payments on a mortgage loan.

Discount: A mortgage loan sale price for less than the full UPB.

Due diligence: The steps taken by an investor to determine whether a mortgage loan is a proper investment.

Equity: The current value of a property minus any debt owed by the owner.

Financial calculator: A specialized calculator used to calculate yield to maturity.

Financial institution: A banking entity that lends depositor funds to borrowers.

First lien: The mortgage recorded first; retains right to first priority for payoff.

Forbearance agreement: A short-term agreement that allows a borrower to temporarily pause or reduce their payments during a time of hardship.

Foreclosure: A legal process in which a lender attempts to recover the balance of a loan from a borrower who has stopped making payments to the lender by forcing the sale of the asset used as the collateral for the loan.

Health Savings Account (HSA): A tax-advantaged medical savings account available to individuals who are enrolled in a high-deductible health care plan.

Home Equity Line of Credit (HELOC): Usually a junior lien mortgage in which the lender provides a mortgage loan and the collateral is the borrower's equity in their house.

Individual Retirement Account (IRA): A tax-advantaged account designed for retirement savings.

Interest rate: A fee charged by a lender in exchange for a loan, usually payable in installments.

Judicial foreclosure: A foreclosure action required to go through the court system.

Lender: An individual or business that lends money.

Lien: Provides a lender a legal claim on a property until a debt is paid off.

Loan modification: A written agreement that changes the original terms of a mortgage contract agreed to by the lender and borrower.

Loan servicer: Private company that collects payments and handles administrative responsibilities required for a mortgage loan in exchange for a fee.

Loan to value (LTV): The amount of money owed by a borrower, divided by the value of the property.

Maturity date: The date on which the final payment is due on a mortgage loan.

Mortgage: A recorded instrument securing a loan to the collateral and used mainly in judicial foreclosure states.

Owner occupied: A property that is a borrower's primary residence.

Partial loan purchase: The sale from an existing mortgage loan of a specified number of payments at a specified yield to a third-party investor.

Pay history: A servicing record used to verify the existing balance and monthly and late payments for a mortgage loan account.

Performing loan: A mortgage loan that is current and in good standing with its lender.

Primary residence: The dwelling where a borrower personally lives the majority of the time.

Principal: The amount of debt a borrower owes; also a noninterest portion of a monthly mortgage loan payment.

Promissory note (note): A legal instrument in which a borrower promises in writing to repay a loan under specific terms.

Reperforming loans (RPL): Loans that were previously delinquent but have resumed performing status, frequently under modified terms.

Roth IRA: Type of IRA in which deposits are made from post-tax income, in which future growth is tax-free.

Second lien (junior lien): The mortgage recorded second; retains right to second priority for payoff.

Secondary market: The market in which whole mortgage loans are sold after origination.

Secured loan: A loan in which collateral is promised to guarantee the repayment of the loan.

Self-directed IRA: An individual retirement account that allows alternative investments for retirement savings.

Sophisticated investor: An investor who is deemed to have sufficient experience and industry knowledge to understand an investment offering.

Traditional IRA: Type of IRA in which taxes are deferred until the funds are accessed in retirement.

Underwrite: Formal steps taken to determine the risk profile of a loan.

Unpaid Principal Balance (UPB): The portion of a mortgage loan at a certain point in time that has not yet been repaid to the lender.

Whole loan: An individual loan issued to a borrower in which the lender retains 100 percent ownership interest in the debt owed.

Yield: An investor's annual return over the life of an investment.

About the Author

Eric Scharaga is the founder of Damen Capital Management, an investment firm that purchases residential mortgage loans nationwide.

Before focusing full-time on mortgage loan investing, Eric worked for twenty-three years as a public high school teacher. In 2001, after reading *Rich Dad, Poor Dad*, he began investing in rental properties, with the dream of leaving his job to become an investor.

Unfortunately, after thirteen years dealing with the constant stresses and unpredictability of landlording, he came to the realization that he would never achieve his goal of financial freedom through rental properties. He found the business of landlording even more volatile than the stock market, and developed a strong understanding that most investors should not invest in their own rental properties.

In 2016, while still teaching, Eric transitioned to the more stable and passive cash flow of mortgage loan investing, which ultimately allowed him to leave his full-time job in 2019.

In his book, *Lienlord*, Eric gives an introduction to the power of investing like a bank in owner-occupied mortgage loans. He resides in the suburbs of Chicago with his wife and two children and is passionate about personal finance and financial freedom. His goal is to continue introducing investors across the county to the power of reliable investment yields.