Better Than Bonds:

A Special Report Examining Bonds and Mortgage Notes

Alternative Investment Series

Eric Scharaga

Bonds in 2020

Facing a COVID-19–created liquidity crisis, the bond market in 2020 looks different from prior years. No longer offering the same stable safety that investors want during a time of massive financial insecurity and economic upheaval, bonds must be replaced as the low-risk go-to for securing an investor's yield.

> Bonds are debt instruments that represent a loan the investor gives to a government or municipality. Through the bond, the issuer promises to repay the loan by a set maturity date and pay interest at the coupon rate.

In March it was reported that many investment-grade bonds were already trading as if the companies, which included Delta and Marriott, were distressed.[1] At the same time, even

[1]https://www.barrons.com/articles/delta-marriott-investment-grade-companies-bonds-distress-51584628415

energy bonds were struggling, after having already extended their maturity dates by ten years back in 2014.[2] In July Moody's had its highest number of speculative bonds rated B3 or lower (to put this in perspective, B3 is a full six ranks lower than investment-grade ratings). This means there are now a higher number of low-rated speculative bonds than we had during the Great Recession in 2008.[3] Further, for the first time in forty-eight years, high-grade corporate bond yields fell below 2 percent.

Even traditionally low-risk municipal bonds are in trouble when tied to projects such as convention center buildings.[4] Entire business sectors, including airlines and hospitality, aren't sure when they will be back to prepandemic business levels, with some anticipating that it might not happen until 2024.[5] Where does that leave their bonds?

While the current pandemic casts a very specific pall over bonds, this asset class has some significant problems even in the best of times. The problem most investors have found with bonds is that unless you are willing to purchase higher-risk junk bonds, it is hard to obtain low-risk yields above 5 percent.[6]

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[2]https://www.bloombergquint.com/business/everything-goes-wrong-at-once-for-distressed-energy-debt-issuers

[3]https://finance.yahoo.com/news/bond-traders-aim-separate-distress-100008210.html

[4]https://www.nytimes.com/2020/04/14/business/convention-hotels-municipal-bonds-coronavirus.html

[5]https://finance.yahoo.com/news/airline-hotel-industry-reps-both-say-their-rebound-depends-on-the-return-of-business-travel-180251163.html

[6]https://www.thinkadvisor.com/2020/08/14/low-rates-arent-going-anywhere-heres-what-that-means-for-retirement-planning/

Another risk with bonds in the current ultralow yield environment is that investors essentially have two choices: commit to hold the bond to maturity for a very low interest rate, or sell it early. If you sell early during a rising yield environment, which we are undoubtedly entering, you can end up having to take a huge loss on your investment.

> For example: You buy a thirty-year bond at 2 percent, and rates go up to 4 percent any time during your ownership period. If you decide you want to sell that bond, you would have to take a loss of up to 50 percent to match the yields in the bond market at the time you want to sell. I don't know about you, but that's not a loss I can stomach.

Finally, keep in mind that committing to a long-term, low-yield bond for income will not keep up with inflation, which means that investors will likely lose money over the term of the bond.

What if there was a fixed-income option that offered both higher yields and the safety of spreading risk over many homeowners across the country? The answer may be a mortgage loan fund.

Alternatives to Bonds

Bond investors nervous about the current bond market might not think that alternative investments offer a worthy replacement for the stable, passive income they expect with bonds—but they are wrong.

Alternative investments are becoming increasingly ubiquitous in the portfolios of investors all over the country. It's likely that by 2023, the global market for alternative investments will reach or exceed $14 trillion, with investors seeking a higher level of control and greater yields from this asset class.[7]

The stigma that alternative investments are "too risky" to recommend makes little sense when you consider that with high-yield corporate bonds, you have to rely on the company to make the coupon payments and pay back the

[7] https://docs.preqin.com/reports/Preqin-Future-of-Alternatives-Report-October-2018.pdf

principal, something studies show might not be as reliable as you've been told.[8,9]

In the midst of the 2020 COVID-19 pandemic and resulting recession, we're seeing a lot of fear and turmoil surrounding the markets, where there was already a void in stable, low-risk, income-producing investments. Because of this, investors are left seeking yield in a falling bond market when more of them should consider turning to noncorrelated alternative investments, such as mortgage loan investing.

Mortgage loan investing is probably the one alternative investment most similar to bonds, since the motivation between both bonds and mortgage loans is stable, low-risk, completely passive income that an investor can receive over time.

SPECIAL NOTE:
The mortgage loan investments covered in this report are NOT Mortgage-Backed Securities (MBS), which were responsible for the 2008 Financial Crisis.

Mortgage Loan Investing Overview

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

[8]https://www.brookings.edu/blog/up-front/2019/07/15/muni-bond-defaults-more-common-than-rating-agency-tallies-suggest/
[9]https://www.nber.org/papers/w15848

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.[10] 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.[11] 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.

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[10] https://www.cnbc.com/2017/05/01/7-insights-from-legendary-investor-warren-buffett.html

[11] 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.

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. 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 accounts to grow exponentially.

Mortgage Loans	Bonds
Secured by real property	Represent a promise by the issuer to pay back principal
Income based on set payments	Income paid when bond issuer can afford to
Payments typically don't change	When a bond issuer runs into trouble, they may miss a coupon payment
Investor decides yield at purchase	Yields determined by bond issuer or seller
Additional liquidity by selling loan or partial	Additional liquidity through sale of bond

Mortgage Loan Funds

If bonds are in trouble, then it's reasonable to expect that bond funds might be too. 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.[12]

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.[13] 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

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

[13] 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.

Your Mortgage Loan Fund Questions Answered

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.

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.

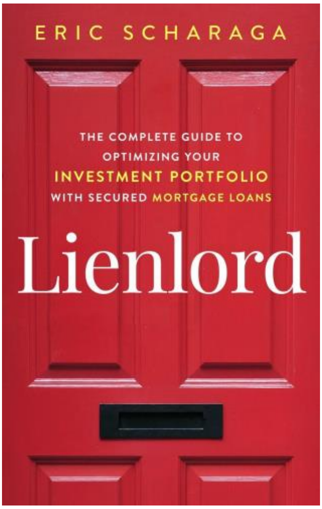
Are there any sales loads?

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 invest by using the same secrets that banks use?**
- **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 investment product that offered both high yields and the passive security of bonds?**

Author Eric Scharaga

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.

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.

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

Collateral custodian: Business that handles all mortgage loan collateral–related needs for investors.

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

Creditor: A bankruptcy term for the party that is owed money.

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

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

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

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

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.

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.

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

Investment to value (ITV): The amount of money invested by an investor to purchase a mortgage loan, divided by the value of the property.

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 sale agreement (LSA): The formal contract used to sell a mortgage loan between parties.

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.

Nonperforming loans (NPLs): Mortgage loans that have gone at least ninety days without payment.

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

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.

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-servicing: A mortgage loan that is serviced by an individual investor; not recommended.

Seller financing: A loan provided by the seller of a property to the purchaser.

Servicing transfer: The process of transitioning a loan between servicers in accordance with applicable state and federal laws.

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

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.

Unsecured loan: Loan issued only based on the borrower's credit worthiness, without any collateral.

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.

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