Income Investment

Cash Flow Comparison

How Mortgage Notes Compare With Real Estate, Stocks, Bonds, and Annuities

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Landlord versus Real Estate Investor

Almost every single day, I field calls and emails from people who want to invest in real estate. In talking with them, I hear about their desire for passive income and the safety of an investment secured by an underlying property. You know what I don't hear? I don't hear about people wanting to become landlords. And I certainly don't hear anyone talking about the inherent burnout that comes with real estate ownership.

Since 2013, real estate has been the most popular investment in America. 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.

Why 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. Let's take a look at some of the reasons why:

- 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. Some of these expenses include:
    - 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.

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

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

Cash Flow Comparison

Figure 1

The true goal of those who reach out to me is to find a way to invest in real estate with all the benefits of a secured investment but without the headaches and risks of real estate ownership. **For these investors, I strongly recommend investing like a bank: in mortgage note investments.**

Mortgage Loans	Real Estate
No contact with borrowers (loan servicer's responsibility)	Tenants are difficult, demanding
Lender owns lien, not property	High liability risk, requires expensive insurance
Lender not responsible for property	Frequent costly repairs
Loan is paid in full when borrower sells home	Vacancy means extensive expenses, loss of rents
Laws protect lenders	Laws favor tenants
Spread risk nationwide	Usually a single market
Can passively manage thousands of loans	Requires staff, contractors to scale
Homeowners emotionally connected to homes	Tenants move for cheaper rent
Homeowners build substantial financial equity	No financial incentive for tenants

Cash Flow Comparison

Homeowners more financially sophisticated	Tenants usually living paycheck to paycheck
Homeowners protect their #1 investment	Tenants hard on properties
Costs $150 to transfer loan	Costs $10,000 or more to transfer property
No appreciation	*Potential* for appreciation, not guaranteed.
No tax depreciation	Can't depreciate within an IRA; too much depreciation can prevent further loan approval

Real estate investing's two greatest benefits, appreciation and depreciation, are certainly not guaranteed. Real estate profits can be realized by selling the property for a higher price than it was purchased for or by pulling cash out through loans. But how significant an advantage is this?

Well, between 1969 and 2016, the average appreciation rate was 5.4 percent. During the eleven-year period of January 2009 to January 2019, the average home price appreciated more than 50 percent.

The problem with counting on appreciation, besides the fact that you don't know the property will have appreciated by the time you want to sell it (just ask investors who retired and wanted to sell property in 2009), is that leverage makes potential appreciation look way better on paper than it is in real life.

Let's look at an example. An investor purchases a six-unit building for $500,000, making a 25 percent down payment of $125,000. Leverage allows the investor to count on the $500,000 purchase price as the basis for the asset's appreciation, not just their down payment.

If that $500,000 building appreciates at 3 percent per year, then in ten years, it should be worth $650,000. Because the investor has only invested 25 percent of the purchase price as the down payment, in theory the asset can produce a cash-on-cash return of over 100 percent ($125,000 costs, $150,000 profit).

On paper, it seems like a no-brainer, right? Especially when you compare it to a similar mortgage loan investment, which has a cash-on-cash return of 10 percent.

But wait—not so fast. This example doesn't take into consideration any of the potential losses absorbed by the investor, listed in the last section. Losses created by normal expenses that can massively derail profits during that ten-year period, offsetting any appreciation. They drive down the net gain and impact the investor's liquidity along the way.

Shouldn't it be alarming that one of the most popular ways that mentors teach to find discounted properties is to look for *burned-out* landlords? If that is the case, maybe we should be talking about landlord burnout isn't a case of *if*, but *when*.

Personally, I have come to the conclusion that investing in American homeowners is one of the safest investments available.

Understanding Mortgage Loan Investments

Alternative investments, like mortgage loans, 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.[1]

This information, while definitely compelling, comes as little shock to me. As I write this, the country is in the midst of the 2020 COVID-19 pandemic and resulting recession. As a result, 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.

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

Investors frequently look to real estate to provide fixed income solutions, many in retirement. What they learn, like I learned, is that rental property income is neither stable nor consistent. What if I told you that you could benefit from a *truly passive* real estate investment without all the headaches and risks?

It’s difficult to sit on the sidelines, watching investors flounder when I know there’s a better way. After all, I’ve been there myself. As a landlord, I struggled, which is what drove me to become a *lienlord* by investing in secured mortgage loans.

Of course, this all starts with a question: *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.[2] But here’s the interesting point: If you have or have ever had a mortgage, then you know enough about mortgage investing to create a solid knowledge foundation. Hopefully, this book will round out that knowledge so you can determine whether mortgage loan investing is a suitable option for you.

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

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

What Is Mortgage Loan Investing?

Investing in mortgage loans has provided me with a level of financial freedom I failed to achieve through my job and *two decades* of real estate investing. The numbers for the mortgage industry are staggering. As of 2019, there was $15.8 trillion in mortgage debt in the United States.[3] 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.

When I purchase a residential mortgage loan as an investment, I am 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.

Investors can buy the loans secured by multifamily properties, commercial properties, vacation homes, and single-family primary residences. For the purposes of this book, the focus will be on the latter—single-family, owner-occupied, primary residences—which I believe to be the safest mortgage-related investment.

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[3]https://www.housingwire.com/articles/u-s-mortgage-debt-hits-a-record-15-8-trillion/

Mortgage loans are *secured* loans, meaning that the borrower's 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.

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 covered in this book 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

I use several servicers, and find that their monthly servicing fees range from $15 to $30 per month, per loan. Considering the amount of work, regulation, licensure, and responsibility it takes to service a loan, this is a bargain.

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.

Optimizing Your Portfolio with Mortgage Loans

You now know what mortgage loans are and why they might be a superior real estate investment than rental property. Now let's look at them as part of your non-real estate portfolio.

I want to make it clear that I'm not in favor of mortgage loans replacing traditional investments in an investor's portfolio. Every investor has a complicated combination of risk tolerance, time horizon, accumulation goals, net worth, and income needs. Therefore, every investor, with the help of a seasoned advisor, needs to find their own appropriate and effective asset mix.

My goal in this section is not to tout mortgage loan investing as a superior option to any other kind of investing, but to help the reader understand how mortgage loan investments stack up against more traditional investments. Doing this will allow more investors and their advisors to determine the appropriate place for mortgage loans in their portfolio.

I view mortgage loan investing playing a complementary role in a portfolio. These assets help improve diversification and are noncorrelated, meaning they are not affected by swings in the stock market. They add balance for many investors and a source of strong, predictable income for those who need it. But again, I want to stress that mortgage loans are just one component of a diversified, well-balanced portfolio.

> Noncorrelated assets are those with a performance that's not tied to that of the stock or bond market. Having them in your portfolio hedges against the volatility and massive downward movement of an unstable market.

Too many financial advisors are discouraged or even prevented from researching alternative investments such as mortgage loans or mortgage loan funds. The pool of what they offer clients is a tiny slice of the investable universe. It often consists only of Wall Street–related investments too volatile for a large stake of client assets and which often don't address the need for high-yield income generation.

The stigma that alternative investments are "too risky" to recommend makes little sense when you consider that stock investing success relies on a combination of consumer confidence, investor demand, and the willingness of corporations to act in their investors' best interests. Switch over to high-yield corporate bonds, and you have to rely on the company to make the coupon payments and pay back the principal, something studies show might not be as reliable as you've been told.

Let's take a closer look at some often-promoted investments to see how they stack up against mortgage loan investing. I'll kick it off with the big one—stocks.

Stocks

I was first introduced to stocks, which represent shares of ownership in an underlying company, when I was sixteen. My grandfather, who was retired during my entire youth, was an active stock market investor before the internet age. He introduced me to *Value Line*, an equity research company with a series of hard-bound research and ratings books at the library, very similar to a set of encyclopedias.[4] He taught me what to look for in stocks and how to integrate a stockbroker's advice. I still remember our experiments of picking stocks, pricing them out per share, and tracking our portfolios.

Trading stocks seemed, to me, overly complicated with no real assurance of success. The whole process seemed more like throwing darts at a board than it did controlled research resulting in successful returns. Essentially, it is a practice in speculation. You form an "educated" opinion (which is just a fancy guess) about which stocks will do well over your investing timeline and you invest in them—- completely ignoring the fact that you may not be able to pull income out of this asset class when you need it. But my biggest problem with the market was that I didn't like the stress of having to accept losses.

Take a look at almost any generic asset allocation pie chart and you will see that stocks are pushed as the primary

[4]https://www.valueline.com/

investment for most people during their younger, income-earning years. Why? Because conventional wisdom tells us that stocks grow. And grow. Did you know that if you invested $100 in Amazon back in 1997, it would be worth about $196,635 today?[5] If you invested $100 in Microsoft in 1986, it would be worth about $26,100. That same $100 in Apple in 1980? It would be worth about $106,391 today!

These numbers aren't untrue, but they are pretty optimistic. Because for every one Wall Street unicorn that's grown exponentially in forty years, there are thousands of companies that have gone bust. So, sure, $300 spread between Amazon, Microsoft, and Apple between 1980 and 1997 could have given you more than $300,000 today, but $300 in Enron, Compaq, and WorldCom might have given you losses or, worse, nothing at all.

The Problem of Picking Winners

There's no bright, blinking neon arrow flashing over the stocks that are going to grow over the years, and there's no specter of doom standing over those that will not. As of 2020, there were roughly 2,800 stocks listed on the New York Stock Exchange and 3,300 on the NASDAQ.[6,7] Which of the thousands are worth investing in? Probably not many. Just five stocks on the S&P 500, which lists 500 tech stocks, are pulling up the average of the whole index.[8] I don't know about you, but when it comes to being an individual investor trying

[5] Yahoo! Finance. Prices accessed 8/30/2020.
[6] https://www.advfn.com/nyse/newyorkstockexchange.asp
[7] https://www.advfn.com/nasdaq/nasdaq.asp
[8] https://www.washingtonpost.com/business/2020/08/19/tech-stocks-markets/

to pick winners out of pools that big, I don't like my odds. And that inclination isn't just a feeling—it's backed by facts.

For fifty-five years, the Center for Research in Security Prices (CRSP) has maintained a database tracking historical security prices and returns.[9] Studies analyzing that database have found that between 1926 and 2016, the median length of time securities stayed listed was just seven-and-a-half years before disappearing into obscurity, taking investor cash with them.[10] That's overwhelming to think about, so let's go smaller and look at the S&P 500. Between 1980 and 2014, 320 listings had been removed from this list due to "business distress."[11] And according to J.P. Morgan, a steady stream of these companies faced their distress during times of economic expansion, not recession. The year this book was written, we saw massive volatility thanks to an election, a pandemic, and massive unemployment. Imagine trying to pick a winner with this level of volatility.[12]

All this should help you see that the odds are against you when you try to pick stocks, but I want to throw one research paper quote at you to help drive this point home. When

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[9] http://www.crsp.org/

[10] https://poseidon01.ssrn.com/delivery.php?ID=586024090004104077089103018119114105036053067045062087091089084119013068085098082104033016012031048048013081085017099088114018009094094009064094095018102026036012097127107111109120126086096127069015089067029090067021065005008124085024025000&EXT=pdf

[11] https://www.jpmorgan.com/cm/BlobServer/Eye_on_the_Market_September_2014_-_Executive_Summary.pdf

[12] https://www.forbes.com/sites/sergeiklebnikov/2020/09/30/stocks-close-a-dismal-september-as-investors-prepare-for-an-even-rockier-october/#50e1caf7e4b2

researching whether stocks outperform treasury bills, researchers found that:

> *"… the best-performing 4% of listed companies explain the net gain for the entire US stock market since 1926, as other stocks collectively matched Treasury bills."*
> —"Do Stocks Outperform Treasury Bills?" Department of Finance, W. P. Carey School of Business, Arizona State University, May 2018

It doesn't take a virus, housing market collapse, or dotcom bubble burst to create losses for individual investors like you and me. Attempting to pick winning stocks is like betting against the house in Vegas. The odds are not in our favor, and most people are going to lose, most of the time. So much so that even highly trained, experienced financial professionals have a poor record of picking stocks that beat the market.[13]

Maybe It's All In the Timing

Another current stock investors fight against is timing. Let's look at a portfolio at the tail end of 1997 holding Microsoft, Bank of the Ozarks, and Mattel, all purchased from a broker, using a cell phone with a retractable antenna. But let's up the ante. Let's say the investor was fifty-five years old, just ten years away from retirement, and threw $100,000 into those positions. Now, we reach the year 2007, the cell phone has

[13] https://www.aei.org/carpe-diem/more-evidence-that-its-really-hard-to-beat-the-market-over-time-95-of-finance-professionals-cant-do-it/

been replaced by a Blackberry, and our investor has a portfolio balance of $366,427 the day they retire.

Almost two years after retiring, in February 2009, just as our investor needed to start liquidating their portfolio to take some income distributions, the market crashed and the value of all their investments fell to $220,841.[14] Now, our investor has to liquidate a higher number of shares early on in their retirement just to get the amount they need for a distribution. This leaves fewer shares in their portfolio, which means less opportunity for recovery and growth when the market rebounds.

The above situation is an example of *sequence of returns risk*, and it causes lasting damage. Just as compounding interest and returns can drive accumulation, selling a large chunk of shares at a low price (or a loss) early in your retirement can devastate your ability to maintain distributions and live out a comfortable retirement.

Time is touted as a great friend to the stock investor, when it can just as easily be the enemy. Proponents of stock market investing hold out 10 percent as a reasonable expectation for returns, a number that's often based on growth of an entire index during a historical period.[15] Please tell that to investors who lost their savings with WorldCom, Pets.com, Enron, and the thousands of delisted stocks removed from the NYSE over the years.

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[14]https://www.portfoliovisualizer.com/backtest-portfolio
[15]https://www.investopedia.com/ask/answers/042415/what-average-annual-return-sp-500.asp#:~:text=The%20S%26P%20500%20index%20is,since%20its%20inception%20through%202019.

Stocks may have a place in your portfolio. That's for you and your advisor to determine. For my part, I am uncomfortable with the idea that hardworking Americans can have a large portion of their retirement savings wiped out during one major market correction, and it can take years to regain those losses—if they can at all.

While we *do* know where the market has been, we *don't* know where it's headed. Of the crashes that have occurred during my lifetime, the one thing they all had in common was that very few of us saw them coming. The stakes are too high to take chances when an investor's retirement is at risk.

Can we—or *should* we—expect an average 10 percent stock market return in the future? I don't know, but if there's any doubt, I would argue that investors should look at putting a small amount of their portfolio into alternative investments, such as mortgage loans, both to hedge against loss and to provide some steady income security.

Let's look at yet another not-so-nice gift that time brings to stock investors: volatility.

The Current Volatility Crisis

For risk-averse investors, 2020 has been a rough year. After watching the Dow Jones Industrial Average (DJIA) reach an all-time high of 29,398 in February 2020, the COVID-19 pandemic introduced a spate of panic selling that left the DJIA and S&P 500 tumbling to lows we hadn't seen in years. In fact, in a single month, the DJIA fell from 27,960 to 18,591—quickly erasing 100 percent of the gains made since July 2017.

Now, eight months later, we're finally seeing the market rebound toward February highs, but between election insecurity, potential lockdowns, and vaccine reporting that prompts more questions than answers, who knows how long that will last.

Still, this level of roller-coaster movement in stock prices hasn't seemed to prompt enough preretirees to adjust their asset allocation and move toward safer, less volatile investments.

> Volatility is the movement of an asset's value, measured by amount, frequency, and deviation from a benchmark.

According to Fidelity, almost 40 percent of their clients between the ages of fifty-six and seventy-four had more stock in their portfolios than they should, based on their ages. Even more concerning, Fidelity found that 7 percent of baby boomers had retirement accounts with 100 percent of the assets invested in the stock market. Few people, at any age, would enjoy watching their retirement account balance whip back and forth between lows and highs on a weekly, or even daily, basis. But once you're nearing retirement, it's especially stressful—and damaging—to expose your assets to the volatility we've seen this year.

Avoiding Volatility

Whenever you mention volatility, people immediately think of the stock market. While it's true that traditionally, equities are one of the most volatile investments, this year, all bets are off in terms of what investments feature retirement-undermining instability and volatility.

For example, bonds are generally promoted as a low-volatility investment. As you age, advisors often suggest taking more and more out of equities and shifting assets into less risky bonds. This year, however, the US bond market hit its highest level of volatility since 2009.

Real estate is another investment opportunity promoted as having lower volatility than equities. But this year, with four months of COVID eviction relief built into the CARES Act, an extension of that timeline possibly on the horizon, and many pushing for all-out rent forgiveness, landlords are finding their previously predictable incomes getting slashed while their expenses remain the same.

Even the usually dependable commercial real estate market is readying for future volatility, as the pandemic-led, work-from-home trend depresses demand for commercial leases and stay-at-home orders leave brick-and-mortar retailers struggling, leading to reduced rents and a higher rate of unoccupied units. In November Simon Properties reported revenues on mall rental falling 25 percent.

As a concept, volatility is intriguing. It creates fear for some and excitement for others as they expect to find deals and profit from short-term moves. But when you see it playing out across your portfolio, volatility becomes a devastating reality undermining your retirement.

Volatility and Returns

It doesn't take a pandemic, contested election, or nationwide protests to create volatility, and volatility isn't just damaging during these historically unstable times. In any normal, non-pandemic year, volatility diminishes returns.

If I asked you whether you'd rather have an investment that had a fixed annual return of 3 percent over six years or a volatile investment with an average annual return of 6 percent over six years, you'd probably choose the more volatile but seemingly higher return. But let's look at the overall performance of both investments:

	Steady Return		
Year 1	$1,000,000	3%	$1,030,000
Year 2	$1,000,000	3%	$1,060,000
Year 3	$1,000,000	3%	$1,090,000
Year 4	$1,000,000	3%	$1,120,000
Year 5	$1,000,000	3%	$1,150,000
Year 6	$1,000,000	3%	**$1,180,000**

Figure 2

	Volatile Return		
Year 1	$1,000,000	-30%	$700,000
Year 2	$700,000	15%	$805,000
Year 3	$805,000	15%	$925,750
Year 4	$925,750	-40%	$555,450
Year 5	$555,450	25%	$694,313
Year 6	$694,313	55%	**$1,076,184**

Figure 3

Cash Flow Comparison

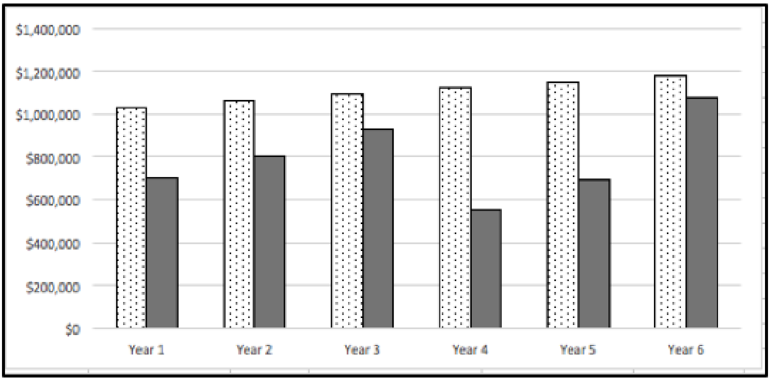

Figure 4

As you can see, the more volatile investment earns far less than the slow, steady, lower-return investment. By the end of the six-year period, the volatile position has earned just $76,184, while the steady return has earned $180,000.

Most people accept volatility as a natural, unavoidable part of investing. Some even embrace it, under the strategy of *dollar-cost averaging*. This strategy involves investing a specified amount periodically into a certain stock, ensuring that the investor buys both when the stock price is up and when it's down. Since the market is impossible to time, dollar-cost averaging ensures the investor buys both during highs and lows, thus averaging out their cost basis and better managing volatility.

Example: Dollar-Cost Averaging

Cash Flow Comparison

	Q1	Q2	Q3	Q4	Avg price p/s
20 shares ABC	5.75 p/s	5.00 p/s	6.00 p/s	5.80 p/s	**$5.64**
80 shares ABC			6.00 p/s		**$6.00**

Figure 5

It might sound like a great approach, but the truth is that the more volatile an investment is, the less successful a portfolio will be over the long term. Especially as a retiree begins taking an income.

Volatility and Income

Volatile investments are not ideal for income generation. What makes them particularly harmful to retirement planning is that you can't control how the market is doing when you start liquidating volatile investments for income. That is when sequence of returns risk becomes a very big problem.

> Sequence of returns risk is the risk that the timing of income withdrawals from a portfolio will coincide with a fall in the market, resulting in the liquidation of a larger portion of a portfolio. This lessens the amount left in the portfolio to grow and recover and can reduce the overall value exponentially.

Let's look at a portfolio at the tail end of 1997 holding Microsoft, Bank of the Ozarks, and Mattel, all purchased from a broker, using a cell phone with a retractable antenna. But let's up the ante. Let's say the investor was fifty-five years old, just ten years away from retirement, and threw $100,000 into those positions. Now, we reach the year 2007, the cell phone has been replaced by a Blackberry, and our investor has a portfolio balance of $366,427 the day they retire.

Almost two years after retiring, in February 2009, just as our investor needed to start liquidating their portfolio to take some income distributions, the market crashed and the value of all their investments fell to $220,841. Now, our investor has to liquidate a higher number of shares early on in their retirement just to get the amount they need for a distribution. This leaves fewer shares in their portfolio, which means less opportunity for recovery and growth when the market rebounds.

In the last section, we talked about the difference between a steady return and a volatile return. Let's see how that same $1 million investment is impacted when the investor needs to take a $25,000 annual income from it.

		Steady Return		
$1,000,000	3%	$1,030,000	-$25,000	**$1,005,000**
$1,000,000	3%	$1,030,000	-$25,000	**$1,010,000**
$1,000,000	3%	$1,030,000	-$25,000	**$1,015,000**
$1,000,000	3%	$1,030,000	-$25,000	**$1,020,000**
$1,000,000	3%	$1,030,000	-$25,000	**$1,025,000**
$1,000,000	3%	$1,030,000	-$25,000	**$1,030,000**
		Volatile Return		
$1,000,000	-30%	$700,000	-$25,000	**$675,000**
$675,000	15%	$776,250	-$25,000	**$751,250**
$751,250	15%	$863,938	-$25,000	**$838,938**
$838,938	-40%	$503,363	-$25,000	**$478,363**
$478,363	25%	$597,953	-$25,000	**$572,953**
$572,953	55%	$888,077	-$25,000	**$863,077**

Figure 6

Cash Flow Comparison

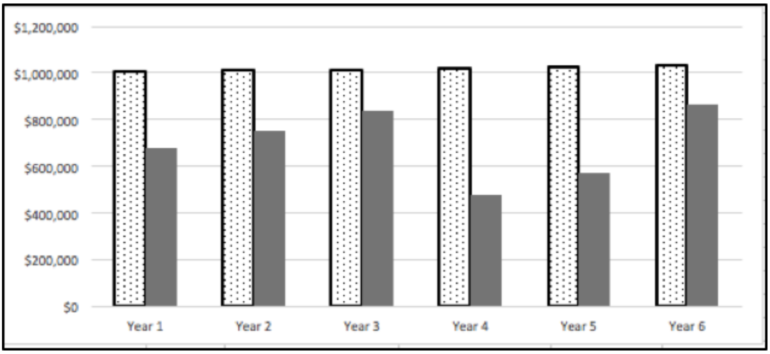

Figure 7

You can see that while we still have our $1 million principal in our “steady” investment and we’ve been taking out $25,000 in income, we’ve also been accumulating an additional $5,000 per year. Yet in our volatile investment, we’ve tapped into the principal and our balance has dropped below $900,000, despite an average annual return of 6 percent.

At this rate, how many more market dips can this investor sustain and still have funds available to provide an income for retirement? Instead of making that guess and hoping for the best, investors planning their retirement need to find less volatile investments in an increasingly volatile world.

Where can you look to escape volatility in an economic landscape none of us have ever encountered before? It might be time to consider alternative investments, such as mortgage loans and mortgage loan funds. These two investments can be a great complement to a portfolio because they are not correlated to the stock market. They can also strengthen an income-focused portfolio by reducing volatility and offering more control over yield.

Dangerous Dividends

But, you may be thinking, what about stocks that pay a dividend? Wouldn't those be good for income? Well, that depends.

One of the biggest issues I have with dividends is that companies are not required to pay them and can revoke them at any time. For many years, Microsoft was under fire for deciding not to offer a dividend, despite having a profit.[16] While they reinvested this money into the business and the value of the stock grew, investors who were hoping for a dividend were out of luck. Not only are dividends not guaranteed, but dividend-paying stocks can go bust, or companies can simply suspend dividends, like Dunkin' Donuts and General Motors did in 2020.[17]

When investors look for dividend stocks to create regular income, they often change the parameters around their assessment of a stock. Instead of measuring risk and potential the same way they would a growth stock, they instead consider only the dividend potential. Worse, evaluating stocks this way can actually hurt overall returns as dividends can reduce stock prices.[18]

The most common way for investors to make money in the stock market is to sell shares for a higher price than the price

[16]http://pages.stern.nyu.edu/~adamodar/New_Home_Page/articles/Microsoftdividends.htm
[17]https://www.nasdaq.com/articles/here-is-a-list-of-companies-that-have-suspended-dividends-or-stopped-stock-buybacks-in
[18]https://finance.zacks.com/dangers-buying-highdividend-stocks-1419.html

at purchase. Sounds simple enough, but without the ability to time the market and without any meaningful control over company decisions, we have no way to create a positive environment for stock ownership. Worse, we, just as everyone else, are victims of the whims of the market—which means that even if a company is doing well by all measures, if consumer sentiment is against it, the price of its shares can plummet, just when we most need them to rise.

Stocks have their place in the portfolios of many. They offer opportunities for growth, intermittent income, and—when you're lucky—meteoric rises, if you're willing to take on some pretty major risks. Mortgage loan investments, on the other hand, remove the instability and costs of volatility while generating a predictable income/yield, with no exposure to market risks.

Mortgage Loans	Stocks
Represents a lien secured by real property. Lienholder is the	Shares represent ownership in a company. In a bankruptcy,

primary interested party.	preferred stockholders take priority.
Income is based on set payments with predetermined yield.	Income based on corporate profits (when companies pay dividends). Growth is based on share appreciation, reliant on investor interpretation.
Payments typically don't change.	Share price changes constantly.
Risk can be spread over many borrowers in many markets.	Risk is mitigated by diversification in industry, sector, and company.
Can control loans in portfolio.	Outside of voting rights, no control over the company.
Investor decides the yield at purchase.	Timing for buys and sells relies on predictions and advisors.

Bonds

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.

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.

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In March it was reported that many investment-grade bonds were already trading as if the companies, which included Delta and Marriott, were distressed. At the same time, even energy bonds were struggling, after having already extended their maturity dates by ten years back in 2014. 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. 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. 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. Where does that leave their bonds?

A Problem of Yield

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.[19] As of the writing of this book, bond yields are averaging only 2 percent.

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.

Bonds are probably the most similar investment to mortgage loans, and the motivation between both bonds and mortgage loans is stable income that an investor can receive over time that is completely passive. Both are considered lower volatility (even though bonds are certainly not without risk), and the risk profile can be judged at purchase.

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

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Mortgage Loans	Bonds
Secured by real property	Represent a promise by the issuer to pay back principal
Income based on set	Income paid when bond issuer

Cash Flow Comparison

payments	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 (in secondary market)
Additional liquidity by selling loan or partial (explained later in the book)	Additional liquidity through sale of bond, at a discount if interest rates have risen, potentially resulting in a loss of principal

Annuities

Another investment that has followed bonds in popularity during recent years are annuities, contracts issued by insurance companies that guarantee a specific fixed income to annuitants after principal is paid to the insurance company. Let's take a closer look at how they work.

Guaranteed Income: When and for How Long?

Annuities designed for ongoing income can pay that income in different ways. Some pay a guaranteed income for a limited term, some pay a guaranteed income until death of the annuitant, and some pay an ongoing income until the death of the last surviving joint annuitant.

The payment of this income comes after the annuity owner pays a premium, which is a lump sum of money paid in either a single contribution or in multiple payments.

In many ways, annuities are similar to mortgage loan investment, in terms of getting a steady, ongoing income. But unlike mortgage loan investments, annuity yields are very low and payments can vary, based on when you trigger them. For example, when you have a guaranteed minimum income benefit rider, the longer you wait to start the income, the higher your periodic payments will be.[20] Annuities also have administration and investment management fees as well as commissions.[21] Finally, annuity payments only occur when the insurance company is able to fulfill its promise of payment, a risk that some investors might not be willing to take.

Annuities have many built-in protections, such as inflation riders, which help to increase your future income to combat inflation. But many of these benefits come at an additional cost, which lowers the investment power of your principal.

Annuity Investments

Unless you buy a fixed annuity with a guaranteed return, you're likely to choose either a variable annuity or an indexed annuity. A variable annuity allows you the choice of an underlying mutual fund for your annuity premium to be invested in.

[20]https://www.annuity.org/annuities/riders/gmib/

[21]https://www.fidelity.com/viewpoints/retirement/shoppers-guide-to-annuity-fees

An indexed annuity requires you to choose an index, such as the Dow Jones Industrial Average or the S&P 500, and will credit your account with a return based on the performance of that index.[22]

General Liquidity

When buying an immediate annuity, payments can begin as soon as one month after purchase. Should you need more money from the annuity, you could find yourself paying a penalty if it's during the annuity's *surrender period.* With a mortgage loan, however, you could get additional liquidity either by selling the loan or by selling a partial interest in one or more of your loans.

Mortgage Loans	Annuities
Secured by real property	Relies on insurance company fulfilling terms
Payments start immediately	Payments might start immediately or may be deferred

[22]https://www.investor.gov/introduction-investing/investing-basics/investment-products/insurance-products/annuities

Cash Flow Comparison

Able to be sold in full or partial to access principal	Can be surrendered, at a penalty
No ongoing fees	Ongoing fees for investment management, riders, administrative expenses, and more
Can control loans in portfolio	No control over underlying investments, other than selecting a fund or index
Payments don’t vary	Payments may be higher the longer you wait before taking them

Recession-Proofing Your Portfolio

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.[23,24] Meanwhile, bond interest rates fell from 5 percent to 2 percent, and are even lower than that today.[25]

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.[26] 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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[23] https://www.theatlantic.com/business/archive/2015/10/the-recession-hurt-americans-retirement-accounts-more-than-everyone-thought/410791/

[24] https://money.cnn.com/2017/12/01/news/economy/recession-anniversary/index.html

[25] https://www.marketplace.org/2020/03/09/bond-yields-lower-than-during-financial-crisis/

[26] 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.[27]

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 fundamental 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.[28]

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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[27] https://institute.jpmorganchase.com/content/dam/jpmc/jpmorgan-chase-and-co/institute/pdf/institute-mortgage-debt-reduction.pdf
[28] 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.[29]

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.

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

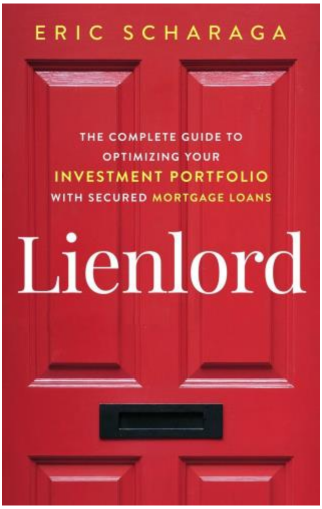
This is yet another reason I suggest that investors stick with owner-occupied, primary residences; homeowners are much less likely to allow them to go into foreclosure than they might a vacation or investment property.

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.

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 you were able to avoid the risk and volatility of traditional investments and get a stable, fixed return that beats bond rates?**



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.

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.

Allonge: Paper attached to a promissory note that transfers ownership of the note to a new lender.

Allonge chain: All of the endorsements/allonges required to transfer the note from the original lender through to the current lender.

AOM chain: All of the mortgages/deeds of trust required to transfer ownership of the lien from the original lender through to the current lender.

Automated Valuation Model (AVM): A sophisticated modeling software that determines property values by combining property data with recent sales transactions.

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

Bankruptcy: Legal process through which individuals or entities who cannot repay debts to creditors may seek relief from some or all their debts.

Bankruptcy discharge: Upon completion of a bankruptcy case, an order that releases the debtor from personal liability for certain specified types of debts.

Bankruptcy dismissal: An order prior to bankruptcy discharge that closes the bankruptcy case without any legal protections for the debtor.

Bankruptcy lien strip: A bankruptcy filing that eliminates a junior lien without equity.

Bankruptcy trustee: Party responsible for overseeing the debtor's estate in a bankruptcy case.

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

Broker Price Opinion (BPO): The estimated value of a property as determined by a real estate broker or other qualified individual or firm.

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

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.

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

Cutoff date: The date after which all borrower payments will belong to the purchaser of 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 in lieu of foreclosure: An agreement in which a borrower agrees to transfer ownership of a property to the lender in exchange for dismissal of a foreclosure action.

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.

Deferred balance: Usually occurring in a loan mod, the postponement of a portion of a loan balance to a later date and without any regularly scheduled monthly payments.

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.

Endorsement: A stamp on the original promissory note that is used to transfer ownership of the instrument to a new lender.

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

Escrowee: A third party used to oversee a mortgage loan purchase between parties.

Estoppel affidavit: Typically used for self-serviced loans; a notarized statement from the borrower agreeing to certain stated loan terms, usually the UPB.

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.

Forced-placed insurance policy: An insurance policy placed by a lender when the property owners' insurance is canceled or has lapsed.

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.

Funding date: In an LSA, the date that the funds are due to the seller.

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.

Indicative bid: An initial bid placed by an investor on a mortgage loan subject to certain conditions.

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.

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

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

Lender: An individual or business that lends money.

Lender's title policy: A policy that protects the lender from problems or claims against a property's title.

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 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.

Lost note affidavit: An affidavit filed to justify the loss or destruction of a note secured by a deed of trust or mortgage.

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.

Nonjudicial foreclosure: A foreclosure action that is not required to go through the court system.

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

Notarization: The witnessing of a legal signature by a licensed third party.

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

Par: A mortgage loan sale price for 100 percent of the UPB.

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.

Representations and warranties: In an LSA, statements and promises of good faith from a seller to a buyer.

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

Schedule A: An addendum to the LSA listing the loans being sold and their individual data, including UPB.

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 creditor: A bankruptcy term for a creditor whose loan is guaranteed by some form of collateral.

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.

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.

Tape: An industry term for a spreadsheet that contains data on mortgage loans for sale.

Title report: A researched document that outlines the legal status of a property and related information on its ownership.

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.

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

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.