Note Investing Introduction

Why Owning the Loan Is the Better Real Estate Investment

Eric Scharaga

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Why Consider Alternative Investments?

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.[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.

Investors frequently look to real estate to provide fixed income solutions, many in retirement. What they

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

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*. This is my motivation for writing this report—to introduce more investors to the concept of becoming 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 report 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

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

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

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 report, the focus will be on the latter—single-family, owner-occupied, primary residences—which I believe to be the safest mortgage-related investment.

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

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

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 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

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.

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

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The Real Estate Investing Myth

Since 2013, real estate has been the most popular investment in America.[4] Whether flipping, residential rentals, commercial rentals, or vacation rentals, real estate draws in investors like few other investments do. Many look to real estate to fulfill their dreams of passive investment income, when really, they should be looking at mortgage loan investing.

No matter what you've read in the countless real estate investing books available, owning real estate and renting it, for any reason, is not a passive investment unless you invest in a REIT, syndication, or fund. The thirteen years I spent as a landlord taught me that owning a rental property is the furthest thing from passive investment you can get.

Ironically, the number one candidate for mortgage loan investment is the burned-out landlord looking for a

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

less stressful and more passive real estate investment option.

Becoming the Burned-Out Landlord

Real estate investment wasn't on my radar until 2001 when I read *Rich Dad, Poor Dad*. The book's message convinced me that the secret to financial freedom was cash flow obtainable through real estate investing: owning rental properties that would bring in stable monthly income.

Every real estate investing book I read told me that cash flow from real estate ownership was the number one path to wealth in America. I took that to heart and earnestly learned everything that I could about rental investing. I found a mentor who was an attorney, became a licensed real estate broker, and started my own single-person brokerage. I scaled a real estate business that allowed me to purchase and flip homes for profit while accumulating thirty-eight rental properties in the Chicagoland market.

Dream come true, right? ***Wrong.*** Because after thirteen years, my fantasy of leaving my teaching job and being financially free seemed even further away than when I was investing in mutual funds.

I learned the hard way that being a real estate investor was a grueling business, even more volatile than the stock market. Unfortunately, purchasing discounted properties was even harder than picking winning lottery numbers. The ever-growing number of real estate investors, many inexperienced, increased competition and drove up prices for properties to irrational levels. It was not uncommon for discounted properties to have over thirty bids from investors. Rehabbing older properties revealed latent defects and hard-to-estimate expenses. Tenants were especially hard on the properties, and every tenant

turnover cost an average of $5,000. This would include often-forgotten costs such as vacancy expenses and advertising for and finding a qualified tenant. I even hired several property management companies to help me with my business, only to see my problems, costs, and oversight increase.

The downturn of 2008 proved especially challenging. Many of my tenants lost their jobs and couldn't pay their rent. Spreading risk between more units failed to provide any type of hedge against loss; it just amplified the risk. As a landlord, I found there weren't really any laws working in my favor. Laws were overwhelmingly designed to protect tenants (and they should be), but they created an untenable model for me. 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.

Then there was the interpersonal aspect of the job. I've never met anyone who enjoys dealing with tenant drama, demands, excuses, and problems. I loathed it.

I tried everything I could to trim expenses and run a nimble business, but in thirteen years, I never made anywhere near what I projected. I could not support my family as a full-time investor when I was always just one roof replacement, trashed unit, or lawsuit away from insolvency. While the public perception is that landlords make tons of money, I sure didn't. The bank, the county, the contractors, and the attorneys all got paid before I did, and there was very little left over each month for me to reliably count on.

Expenses went up every year, and because of the stiff competition locking area rent rates in place, there was no way to recoup those higher costs. A single major setback (which I discovered over time was pretty much

guaranteed) could blow up my entire cash flow for that year and sometimes even the next.

The National Apartment Association's research supports what a low-margin business rental housing is. According to their 2019 findings, each dollar in rent received is broken down the following ways[5]:

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

Figure 1

I remember sharing the details of my business with a financial analyst who was interested in real estate investing. He asked me if I could quit my teaching job and rely on my properties for income. My lack of an answer made it crystal clear to both of us that it was time to accept the obvious: this was not the business I had been hoping for.

Looking back on those years as a real estate investor, the biggest and most expensive lesson I learned was **real estate investment wasn't worth the constant stress**. You can't put a dollar amount on being interrupted every holiday with a repair catastrophe or a furnace failure when you are trying to enjoy time with your family. I began

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

feeling like I was on call twenty-four hours a day, providing high-quality housing to tenants, but receiving very little financial incentive in return.

None of the gurus that promoted real estate investment as the secret to financial independence ever addressed any of these issues, drawbacks, or the guaranteed burnout that comes with landlording. They were too busy convincing me how I would be a multimillionaire within ten years. It made me wonder if the gurus gained much more from the *promotion* of real estate investment rather than the actual *practice*.

There is no question that serious wealth is made in real estate. However, based on my own experiences, I wouldn't be surprised to learn that much of that wealth is skewed toward large investment companies rather than mom-and-pop organizations like mine. Either way, being a landlord or running a vacation rental is not going to be a good fit for every investor, which is why we need to consider a new way of making money in real estate—a way that's truly passive and truly profitable.

Recovery through Mortgage Loan Investing

Needless to say, after more than a decade, I realized real estate investing and landlording weren't going to get me the financial success and independence I wanted. Still, I thought that real estate might hold the key to realizing my future goals, but how?

I discovered the answer to this question in 2016, during a chance meeting at a real estate conference. An investor I met had transitioned out of rental investing and into mortgage loan investing. His story, which was very similar to mine, blew my mind. The difference was that as a mortgage loan investor, he ran a profitable, low-stress

business from anywhere in the world. Payment collection and borrower communication were handled by a third-party loan servicer. Best of all, he was able to invest in loans secured by real estate without the myriad risks and complications that came with owning the property. It sounded too good to be true—but in this case, it wasn't.

Soon after I began purchasing mortgage loans as investments, I started selling my rental units, most of them at a loss from what I paid a decade earlier. I was so glad to walk away from the stress and headaches, I was willing to accept the loss.

With mortgage loan investing, I found I was better able to expand and grow in diverse markets across the country, without having to spend my weekends inspecting rentals and paying contractors, without the worry of flooded basements during every heavy rainstorm. Mortgage loan investing gave me a manageable way to enjoy the inflation resistance of real estate while ensuring I received regular distributions, rather than having appreciation locked up in equity. Even better, the distributions were ongoing, which meant I could live on or reinvest the income steadily, at the buying power of today's dollar.

As a real estate investor, I felt like I earned every dollar I ever made by dealing with stressful situations every day. This is not the case with mortgage loan investing, a truly passive method of secured lien holding with predictable payments. Part of the reason for this is that mortgage loans allow investors to leverage the traditional banking model—and if there's one thing banks are experts at, it's making money.

Considerations	Real Estate Investing	Loan Investing
Leverage	Purchase with only 30% down	Must pay cash
Appreciation	Appreciates over time	Depreciates as payments are made
Depreciation	Great tax benefits	No tax benefits
Transfer costs	$30,000 or more	Approximately $100
Headache factor	Tenants are difficult, demanding	No contact with borrowers
Capital expenditures	Frequently costly repairs	Not the lender's responsibility
Vacancy	Repairs, loss of rents	Paid in full when borrower sells home
Legal	Laws favor tenants	Laws protect lenders
Market diversification	Usually a single market	Nationwide
Liability	High risk, requires expensive insurance	Own the lien, not the property
Management	Requires staff, contractors	Can passively manage thousands of loans
Emotional equity	Tenants move for cheaper rent	Homeowners emotionally tied to homes
Financial sophistication	Tenants living paycheck to paycheck	Homeowners more financially sound
Wear and tear	Tenants hard on properties	Homeowners protect their #1 investment

Figure 2

Profiting with Mortgage Notes

While both banks and mortgage loan investors own loans and count on monthly loan income for profits, the mortgage loan investing business model differs from the bank's in one key way: investors don't need to originate mortgage loans. They don't need to evaluate debt-to-income ratios, collect required disclosures, or deal with compliance.

Instead, investors purchase loans that banks have already underwritten and approved. They do this in what's called the *secondary market*. And that's critical to how mortgage loan investors make money.

Loan Origination and the Secondary Market

When a person first buys a home, refinances a home, or gets an equity loan from a lender, it's a transaction within the primary mortgage market. Sometimes, lenders in the primary market want to sell off the loans they've originated

or are servicing. One way to do this is by offering the loans for sale in the secondary mortgage market.

Think of it in the same way you would traditional public equity purchases. If an initial public offering (IPO) is a primary market offering, after that, stock purchases and sales take place in the secondary market.

Mortgage banks and nonbank lenders, which do not engage in the business of retail banking by accepting deposits from borrowers, originate mortgage loans from huge lines of credit, and immediately sell the loans on the secondary market, mainly to the government-sponsored enterprises (GSE) Fannie Mae and Freddie Mac. These loans, which have strict and extensive underwriting guidelines, are frequently packaged into securities, sold as bonds, guaranteed by the GSEs, and backed by the US Treasury. While these bonds are very safe investments, their yields are usually quite low—barely above US treasuries—and may not even beat inflation.

Depository institutions, a.k.a. traditional banks, are not in the business of creating securities from their mortgage holdings. Instead, they sell their loans in pools on the secondary market to recapitalize.

Entire loans sold in the secondary market are referred to as *whole loans*, because the bank sells the rights to the entire loan, not just a securitized piece of a loan pool.

There are many risk-reducing benefits to investing in whole loans through the secondary market, but one of the most important is that you can select loans on which borrowers have been making consistent payments.

Banks take something of a leap of faith when they originate a mortgage, especially with low down-payment loan programs. Will the borrower pay? When you invest in mortgage loans through the secondary market, you are

able to review extremely detailed information about the pay history, with a tracking of payment dates, amounts, and late fees, sometimes going back for years. From that information, investors can select loans that have an established, on-time pay history.

Investing in financial institution–generated secondary mortgage market loans means gaining an inherent stability and security because investors know that

- loan documents and procedures adhere to all applicable state and federal lending guidelines and servicing histories and data are accurate;
- there is usually no need to interior appraise or visit the property;
- loan servicers collect any payments and keep track of tax records;
- the payment terms cannot be changed unless the lender consents;
- borrowers are required to continue making payments and maintain insurance to retain their property. This is important because history shows that even in times of economic hardship, borrowers protect their homes. According to the Federal Reserve, foreclosure rates on residential mortgage loans during the financial crisis of 2008 to 2013 never exceeded 11.54 percent.[6] The truth is, Americans have, on average, more wealth in their homes than in their savings and retirement accounts combined.[7] Most Americans' greatest source of wealth is the equity in their homes.

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[6]https://www.federalreserve.gov/releases/chargeoff/delallsa.htm

[7]https://www.federalreserve.gov/publications/files/scf17.pdf

According to Black Knight, the average homeowner with a mortgage has $113,900 of equity in their home.[8] That's a powerful motivator, but besides the financial equity, they also have emotional equity. What's the likelihood a homeowner will pack up and leave a home they have equity in and that they have invested their time and money into upgrading? In my experience, it virtually never happens. Borrowers fight to keep their homes, which is what mortgage loan investors want; and

- mortgage loan investors don't own the property, just the *lien* on the property. I spent thirteen years as a real estate investor, an experience that taught me that owning and managing property as an investment is a high-risk, high-stress responsibility to be avoided. As a mortgage loan investor, the collateral pledged as security for the primary loan secures your investment. To the homeowner, the underlying collateral is more than just a means to mitigating investment risk; it's the homeowner's prized possession. It's their biggest investment, and the place where they keep their families happy and safe. It's also up to them to maintain and repair it. For an investor, this can be the best of both worlds. You don't own the property, but you have the right to foreclose and sell the property at auction to recoup your investment if the borrower defaults.

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[8]https://investor.blackknightinc.com/investors/press-releases/press-release-details/2018/Black-Knights-Mortgage-Monitor-Despite-Record-Setting-Tappable-Equity-Growth-Share-of-Total-Equity-Withdrawn-Hits-Four-Year-Low-in-Q1-2018/default.aspx

Your Investment, Your Choice

When banks are in the business of lending, they have certain guidelines they need to follow to ensure they are meeting the investment needs of the communities they serve. The Community Reinvestment Act (CRA) requires banks to lend to a variety of different borrowers for a multitude of property types throughout their community.

Mortgage loan investors reviewing offerings on the secondary market for opportunities are not held to the same standards. We have the power to choose the types of properties and markets we invest in. This offers a level of diversification that can go far in further reducing risk and improving returns.

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 natural disasters or 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.

Mortgage loan investing is a very passive, scalable, diversifiable, low-stress business. In mortgage investing, all the major responsibilities are outsourced to experts. My main responsibilities as an investor are

- finding new sellers of loans that meet my criteria; and
- reviewing loans for purchase.

I even outsource my bookkeeping and accounting responsibilities. But there's more to the reasoning that the simplistic model makes mortgage loans the gold standard of alternative investments. There is the financial component. In other words, it comes down to yield.

Securing Your Yield

An investor's annual return over the life of an investment is called *yield to maturity,* or just *yield.* I always purchase on yield, and I firmly believe that buying on yield, based on the individual risk assessment of each loan, is the wisest strategy.

There's a common misconception that yield and return on investment (ROI) are the same measurement. They are not. ROI is a measure of an investment's return relative to its cost. To calculate the ROI of an investment, one simply divides the net profit by the amount of the investment. ROI is more appropriately used once an investment is exited.

Yield, on the other hand, represents the ongoing future income on an investment. Yield includes the element of duration and is better used for measuring future investment returns.

Rate of return (ROR) is another factor that often gets confused with yield. As with ROI, ROR will depend on the total amount earned over the life of the investment, versus the asset's cost and accounting for inflation.

Calculating Yield

Calculating yield is quite simple, but requires a financial calculator. The financial calculator I use is called 10bii, and I have it on my smartphone. For the purposes of basic yield and pricing calculations, I only use four keys at the top of the 10bii calculator:

N	I/YR	PV	PMT

N: number of payments remaining
I/YR: interest per year, or yield
PV: present value (purchase price, entered as a negative number)
PMT: monthly payment

Here's an example of a simple yield calculation to help you understand the process. Let's say you were reviewing a loan that had the following characteristics:

- 132 payments (11 years) remaining
- 8 percent note interest rate
- $43,285.21 unpaid principal balance (UPB/PV)
- $494.12 monthly payment

If you pay a flat $43,285.21 for the loan, your yield, or future ongoing income on the investment, would be 8 percent. Few would argue that an 8 percent yield is too low, but what if you wanted more? What if you wanted a yield of 12 percent each year over the remaining eleven years of the loan? This can be accomplished by reducing the amount that you pay for the loan. Using a financial

calculator, you would solve for the desired purchase price at a 12 percent yield by entering the following data:

N: number of payments	I/YR: desired yield	PV: purchase price	PMT: monthly payment
132	12	Unknown	494.12

Figure 3

By entering the data and then pressing the PV key, you will get an answer of -36,125.48. PV is expressed as a negative, because this is what you are paying; it is money out of pocket. Therefore, our simple yield calculation returned that we should offer the seller of the loan $36,125.48.

By reducing our purchase price to $7,159.73 less than the total amount owed by the borrower, we pay a discounted price for the loan and drive up the yield so it exceeds the interest rate of the loan. Therefore, the purchase price must be discounted for us to achieve our desired yield. This brings up the important term of *par*, something you might have heard if you've traded bonds.

When a bond is sold at par, it means the sale price is equal to the bond's face value. When mortgage loans sell at par, it means they sell for 100 percent of the UPB. In the initial example, a loan selling at par would be selling for the full $43,285.21.

I decide my minimum yield when I purchase a loan. By calculating the monthly payment, the number of payments remaining on a loan, and the purchase price, I can determine exactly how much I will make each year over the life of the loan. Since I am buying the full unpaid principal balance (UPB) at a discount, if the loan is paid off

early (most are), my yield will increase even more. And if I decide to sell the loan, I can sell the remaining payments to another investor.

This, however, is where that balance I mentioned earlier between yield and risk comes in. Because the messier the characteristics of a loan are, the greater it will be discounted. If the borrower has missed or been late on a couple of payments since origination, or the owner of the loan is missing a loan document, or when the borrower has just filed a bankruptcy, it introduces additional risk (most of the time negligible) into the scenario and, as a result, increases the discount and the yield.

Ultimately, potential yield means nothing if you never collect any money. I would rather have a lower, yet still competitive yield and on-time payments than a huge potential yield that I never collect on. Remember, lending is based on risk. We can mitigate this risk with our lien, but we want to choose deals that keep us in the payment business, not those that push us into the litigation and eviction business.

Not all loans sold at a discount are high risk, however. Why would a seller of a perfectly low-risk mortgage loan accept less than the full amount owed for a loan? Because of the *time value of money*.

Time Value of Money

Due to its earning potential, one dollar today is worth more than the same dollar will be in ten or twenty years—because today that dollar can be invested and compounded in value year after year. Factor in inflation, and the future value of one dollar drops even more.

When banks originate a mortgage loan, they have two choices. They can wait a maximum of thirty years to

receive the last payment and get all their money back at a future value with cash that's worth less than it would be today, or they can sell the loan to another investor during the first few years of the loan and capitalize on the fees they charge on newly originated and amortized loans.

Inflation alone causes the value of every mortgage payment to drop. That $494.12 payment? Today, during year one, it's worth a lot more money than it will be by year twenty after inflation drags down the spending power of each dollar. For banks, mortgages are depreciating assets.[9] If they hold these assets for the full thirty years, they will likely be worth significantly less than they are today.

And remember that amortization example we looked at before? Banks can only originate those thousands of loans when they have the available capital to do so. Divesting some older mortgage assets means freeing up capital today and putting the time value of money back on their side.

Let's look at an example of a discounted mortgage loan purchase to understand why a bank would agree to sell at discount.

Loan amount	$50,000
Borrower's interest rate	8%
Monthly payment	$366.88
Amortization	30 years

Figure 4

[9]https://www.econlib.org/archives/2003/09/mortgage_deprec.html

After five years of consistent payments, the bank decides to sell this loan as part of a pool to an investment fund needing to earn 11 percent on its money.

Original loan amount	-$50,000
Origination fees	+$2,500
Principal and interest collected over 5 years	+$22,012.80
Discounted sale of loan	+$37,432.42
Bank profit after five years	**$11,945.22**

Figure 5

Keep in mind that the profit in Figure 7 does not include the yield spread for the bank's cost of capital. When we take that into consideration, their profit is much higher. Selling this loan allows the bank to make more in fees by originating a new loan, constantly recycling their capital.

Selling mortgage loans at a discount allows banks to avoid the deleterious effects of inflation and lost earning potential. It makes mortgage loans more attractive to investors and much more liquid for banks.

Investor versus Bank

If it's in a bank's best interests to sell some mortgage loans, you might be wondering why it's in an investor's best interest to buy them. After all, don't you have to worry about the time value of money too?

First, you have to consider the benefits of mortgage loan investing against that of other forms of investment you

can make. Whereas a bank has that potential to originate thousands of loans when they have the available capital, retail investors like us might not have the same financial wherewithal. Further, because most of us don't want to spend our investment principal, we are happy to receive monthly cash flows that provide us with a combination of return of our principal, along with interest income at a predetermined minimum yield.

Investors are generally focused on yield for the part of their portfolio they allocate to mortgage loan investing. Mortgage loan yields are generally much higher than bonds. It's not unusual to see yields of 8 to 10 percent on mortgage loans, which is really hard to do with bonds or annuities. And unlike annuities, the mortgage loan's payments don't stop when an investor passes away.

Investors are also in a more favorable position than banks in terms of capital outlay. When a bank originates a mortgage, it lends 100 percent of the loan balance, and is limited to the interest rate on the note. Mortgage loan investors purchase loans at 50 to 90 percent of what is owed, which means if the loan is paid off early, our yield will *dramatically* increase.

Investor versus Bank, Part 2

We've focused a lot on yield in this chapter, but there is actually another way investors can profit in mortgage loan investment, and that occurs when they've purchased a loan at a discount and that loan is paid off early.

While yield calculations assume all payments are made to maturity, purchasing loans at a discount can create a huge ROI gain if a loan is paid off early, and they

usually are. *The average mortgage loan is paid off within ten years.*[10]

Consider the following example on a second lien loan I just purchased in California:

Purchase price (for investor)	$21,000.00
UPB (unpaid principal balance)	$27,376.22
Borrower's interest rate	6.99%
Monthly payment	$351.84
Payments remaining	104
My investment yield	14.18%
Total collected over life of loan	$36,591.36

Figure 6

If this loan is paid off after twelve months, the investor would receive a total of $29,216.96 on a loan they paid just $21,000 to own.

12 monthly payments of $351.84= $4,222.08
Payoff balance after 12 payments at 6.99% interest= $24,994.88

$4,222.08 + 24,994.88= $29,216.96

This would result in realizing an additional 19 percent ROI, not including the twelve payments received before the early payoff. If we include the $4,222.08 in

[10]https://www.colliers.com/-/media/697C933563184B1183435095CAB54459.ashx

payments received over the twelve months, our total yield due to the early payoff is 39 percent! The investor could then take the $24,994.88 payoff and purchase another loan, or possibly two! It doesn't take very long for income to compound in mortgage loan investment.

While this section may seem complicated, the basic point here is that buying a mortgage loan as an investment is like buying a neat, packaged set of payments. It's highly defined and measurable, and far fewer variables occur than in traditional real estate investing.

The loan you may be considering buying might not be the only lien on the underlying house. A property's *first lien* is the loan secured earliest, which has the priority repayment position in the event of a sale or refinance. The *second lien* is the next loan secured after the first lien and has second priority for repayment.

Don't let this discussion overwhelm you. When we calculate yield for our investment purposes, we are not concerned about what percentage of each payment is principal versus interest. Our yield calculations are based simply on the number of payments and the amount of each payment required, which makes our lives and investments that much easier.

If borrowers pay extra each month, that's great for us; our loan will be paid back even quicker than we originally calculated, and our yield will increase even higher than we originally expected. The only downside to an early payoff? We will have to go back out to market and find a replacement loan, but chances are the replacement loan will have a higher monthly payment and a higher UPB. If not, we can likely buy two loans! Think about how quickly

this strategy can multiply, and you're starting to understand the benefits of mortgage loan investing.

Now that we are on the topic of doubling our investment portfolios, let's examine how compounding interest can double an investment portfolio.

Compounding and the Rule of 72

If you are starting to get excited about investing in mortgage loans because of their simplicity and profitability, hold on to your hat, because it gets better.

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

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

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

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

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

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

> I am a firm believer that returns are based on risk. Be very cautious of any offering that touts both double-digit returns and low risk. These types of offerings could end up costing you your entire investment.

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

Downsides of Mortgage Note Investing (Or Are They?)

Every investment has risks, limitations, and drawbacks that impact its appropriate level of asset allocation in each investor's portfolio. It's important to learn about these potential downsides for a couple reasons.

First, doing so helps you determine the appropriate weight for that investment within your portfolio. Second, learning about the downsides can sometimes give you an insight into ways they become upsides.

Full Cost Up Front

Real estate investors regularly rely on leverage to build their portfolio. Purchasing properties with just 20 to 30 percent down through commercial loans is the goal, allowing a bank to finance the rest.

As I've mentioned, mortgage loan investors, on the other hand, pay the full amount the loan is being sold for.

There is no leverage in mortgage loan investment, meaning banks will not finance mortgage loans. This can mean that an investor's funds don't go as far—if an investor has $100,000 to invest, they might be able to buy four $100,000 rental homes, but only four $25,000 mortgage loans.

Leverage sounds like a pretty big advantage given to real estate investors, but it can get risky. In every loan transaction, the lender puts themselves in the best position to secure their capital. In other words, they will set themselves up to collect their money whether you can afford to keep paying or not. Banks require most investors to personally guarantee commercial loans, which means that if the borrower defaults, the lender can make a claim against the borrower's, or in this case, investor's personal assets.

Let's say that after you buy a multi-unit building with bank financing, there is a severe economic downturn. Your tenants can't afford to pay their rent because they are out of work. You're collecting only 50 percent of the monthly income you expected and, frankly, depend on, and you're unable to continue to meet the large mortgage payment and pay for repairs, insurance, utilities, and real estate taxes. You have burned through your cash reserves trying to keep the building afloat and now have to come up with extensive legal fees in order to evict tenants who cannot pay rent.

After a long eviction, you are faced with staggering expenses to rehab the units to get them ready to re-rent. Do you expect the bank to cut you some slack and allow you to not make loan payments for twenty-four months while you try to get back on your feet? Or how about asking them to loan you more money to pay the legal fees, fix up

the units, and re-rent them? You might hope that, but they won't do it.

Eventually, the lender will file foreclosure and seek a deficiency judgment against you personally, which would allow them to recover the amount you owe the bank from any personal assets you own. At this point, to save your personal assets, you will have few options other than filing bankruptcy.

In my experience, most real estate investors vastly overleverage and don't maintain the massive reserves needed to survive an economic downturn. They want to put their cash to work as quickly as possible by purchasing more units. Unfortunately, too many real estate investors are financially destroyed during downturns and lose not only their credit, but also all the cash down payments they invested as well.

It's just too risky for my appetite, and instead of holding on to huge cash reserves to offset the risks in real estate, I would rather place those in an investment that returns less volatile income.

This accelerated risk for real estate investors taking advantage of leverage is, in actuality, a downside. It means that mortgage loan investment's lack of leverage is a benefit for the investor. Since we have paid cash for a loan, we know our maximum downside risk: the price of the loan. We needn't worry about considerable additional expenses piling up on us when we can't afford to pay them, or having those expenses jeopardize our ability to maintain ownership of our assets.

Appreciation

The biggest advantage to real estate ownership is appreciation. Because real estate investors own their

properties, they participate in the growth of its value. They can realize the profits from this growth by selling the property for a higher price than they purchased it for or by pulling cash out through loans. How significant an advantage is this?

Well, between 1969 and 2016, the average appreciation rate was 5.4 percent.[11] During the eleven-year period of January 2009 and January 2019, the average home price appreciated more than 50 percent.[12]

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.

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[11] https://escholarship.org/content/qt31q9h8m0/qt31q9h8m0.pdf
[12] https://fred.stlouisfed.org/series/MSPUS

But wait—not so fast. This example doesn't take into consideration any of the following potential losses absorbed by the investor:

- large capital expenditures
- routine maintenance/repairs
- pest control
- vacancies
- unit rehab between tenants
- overcharging contractors/property managers
- evictions
- lawsuits
- fires/floods/natural disasters
- increasing costs for property taxes
- Increasing costs for hazard, liability, and umbrella insurance
- utilities
- increasing competition flattening rent increases
- city fines/inspections
- break-ins
- closing costs
- Agent/property management fees

All these expenses 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.

Let's face it—owning property comes with huge liability risks. In order to profit, most landlords are forced to manage their properties at a substandard level, which devalues the property over time and increases the risk of lawsuits. Speaking of which, the amount of insurance landlords require is staggering. From hazard to liability to umbrella to workers' compensation, it's not just about

protecting the property but also tenants, guests, and workers.

In a very serious event, such as a fire, there is a high likelihood the owner's coverage won't be enough to pay out the totality of claims. Since most investors underinsure to maximize profits, they face the risk of attorneys going after their personal possessions and accounts, which a simple LLC won't prevent.

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

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

And, as I briefly mentioned, none of this considers the risk that the property will lose value either because of mismanagement, vacancy, neighborhood, or economic factors. Remember, only investors purchase commercial buildings, not homeowners, so the purchasers don't fall in love with room sizes or colors or appliances. They only fall in love with the numbers and cap rate, and only buy when they can get a deal. It's no secret that tenants are hard on rentals, and owners must project very generously for ongoing building repairs.

Furthermore, not all properties appreciate equally. I held single-family rentals for over ten years that actually

depreciated in value from what I invested into them, between acquisition and rehab costs.

Many investors choose lower-value (under $150,000), single-family rentals because of the higher cash flows and perceived stability, like I did. Yet, in my experience, these are speculative investments, mainly driven by investor demand during real estate market upswings. Unfortunately, markets with numerous single-family rentals are considered less desirable, tend not to be well maintained by the investor owners motivated by profits, and attract fewer homeowners.

I have also watched investors move into markets betting on gentrification, only to see those markets drop in value during market corrections. In some cases, the investors have trusted city- or county-wide plans for improvement that seemed to be pointing the area in one economic direction, only to see plans change, funding fall through, and improvement projects scrapped.

Leverage is helpful to real estate investors who want to grow a portfolio quickly, but it still takes time to make a portfolio of rental buildings appreciate. During this time, investors are exposed to a multitude of risks that just grow, which for me, at least, begs the question: *Is it worth it?*

For mortgage loan investors, however, the value of the loans we purchase slowly decrease over time as we collect payments and the loan is paid back, because there is no underlying physical asset.

This definitely represents a difference compared to real estate investing, but remember that we determined our minimum yield when we purchased the loan. Since loans are usually paid off prior to the maturity date and we purchased at a discount, we will get a nice additional return on our investment when that happens.

In addition, rather than pay interest on a loan to extract value out of a property, like a real estate investor must do if they don't want to sell, we get capital back every month that we can continue to reinvest, allowing us to increase our cash flow dramatically over time.

While we all like to focus on the appreciation of real estate, which is certainly a benefit for real estate investors, it's also important to consider that there is a real risk of values dropping during a recession. That is a risk real estate investors are exposed to, but mortgage loan investors are not. During the 2008 recession, home prices fell 33 percent.[13] In 2020, we're seeing real estate values falling in some markets due to the financial pressures brought on by the pandemic. And, while economic downturns almost certainly contribute to falling home values, they do not necessarily trigger high rates of foreclosure, which is good news for mortgage loan investors.

Personally, I would much rather buy a set number of payments from a mortgage loan and not have the responsibilities and headaches of property ownership, even if I miss out on the potential property appreciation. While appreciation is nice—when it happens—it usually requires a decade or more, and for investors with rental properties, it's always offset by large capital expenditure requirements.

I hear stories of investors buying rental properties with cash flows of only $100 after fixed monthly expenses. I shudder when I hear that because I can guarantee that person they will lose money over time due to all the

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

variables involved with real estate investment. Whether it's a new roof, foundation, concrete, porches, sewer, plumbing, electrical, HVAC, tuckpointing, siding, and/or windows, you can always count on properties breaking down, ultimately offsetting gains in appreciation.

For me, going into an investment knowing exactly what I'm buying, what I'm getting, and what my expenses will be has proven to be a much faster route to financial freedom than dealing with tenants, toilets, termites, and trash.

Depreciation and Tax Benefits

Taxes are a consideration for every investor. Real estate investors, in particular, have some tax advantages that those of us investing in mortgage loans do not get. Like many things, however, these advantages do have a darker side.

One of the most notable tax benefits enjoyed by real estate investors is depreciation. Certain investors, including those with rental property, can write off the loss of value that comes from wear and tear since this use depreciates the property over the years. Depreciation adds a great tax benefit to the bottom-line income of real estate investors, but there is a hitch.

The fact that depreciation is a write-off shows that the IRS knows rental properties break down quickly and require consistent, expensive repairs. That's why the tax code gives such generous depreciation allowances, allowing investors to depreciate the building over a twenty-seven-and-a-half-year period (thirty-nine years for commercial properties). But that write-off ends even quicker when the property is sold. It's at that point that the depreciated value is considered "recaptured" and is then

taxed as ordinary income, with a current cap of 25 percent.[14]

Real estate investments made with IRA accounts **cannot** be depreciated and have a long list of restrictions and potential taxations (including UBIT) that you should review carefully with your IRA custodian and CPA. You may find that investing in rental properties in an IRA can actually result in you paying *more* in taxes.

Another potential problem is that we don't know if and how these tax breaks will continue. Tax laws in the 1980s allowed for first-year depreciation of 11.7 percent. Today, first-year depreciation is capped at 3.63 percent. Who knows what the future brings for this and other aspects of real estate investment taxation?[15]

For these reasons, I am very comfortable guaranteeing you that taxes in the future will be higher than they are now, and the government may target tax breaks and incentives for real estate investors. If the tax breaks go away, what benefits will be left?

The problem with depreciation and loss is that for underwriting purposes, banks routinely only credit investors for 75 percent of their rental income. This helps them account for expenses related to vacancies and repairs. Unless an investor has huge cash flows or a huge W2 income, they run the risk of not being able to qualify for continued mortgages. In fact, the more units you have, the more likely it will appear to banks that you are operating at a loss.

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[14]https://www.irs.gov/publications/p544#en_US_2019_publink100072564

[15]https://mf.freddiemac.com/docs/tcja-report.pdf

Other tax benefits given to real estate investors include:

- cost of repairs
- maintenance and upkeep expenses
- property taxes
- management fees
- legal fees
- advertising costs

Sure, a deduction for all these expenses is helpful, but consider the fact that real estate investors have to keep the capital on hand to pay for all those expenses, whenever and however often they arise, and you can see how quickly the downsides of real estate investing outweigh the tax advantages.

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

Evaluating the Risks of Mortgage Loan Investing

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.

While we all interpret risks in different ways and we each have our own risk tolerance, I tend to categorize mortgage loan investments as one of the few investments that has minimal risks with great potential returns. Let's take a look at some of those risks so you can see for yourself.

Borrower Default

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

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 through short-term financial difficulties.
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.[16]

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

[16] https://www.consumerfinance.gov/data-research/mortgage-performance-trends/mortgages-90-or-more-days-delinquent/#mp-line-chart-container

States.[17] 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.[18] 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.[19]

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.

Modifying Payments

Chances are good you've heard about banks offering mortgage loan modifications to borrowers dealing with resolvable financial issues. With these modifications, they can reduce the borrower's monthly payment and/or interest rate, extend the loan's maturity date, and add past-due balances to the principal amount owed.

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

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[17]https://www.chicagofed.org/publications/chicago-fed-letter/2016/370#:~:text=As%20a%20result%20of%20the,were%20approximately%203.8%20million%20foreclosures.
[18]https://tradingeconomics.com/united-states/unemployment-rate
[19]https://fredblog.stlouisfed.org/2018/11/the-lowdown-on-loan-delinquencies/

foreclosure, keeping families in their homes and keeping payments rolling in.[20]

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

[20]https://www.housingwire.com/articles/36455-hope-now-145-million-solutions-available-to-homeowners-in-2015/

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 weren'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 ever have before, to buy a home. Once they move in, homeowners personalize their home and yard, and they expand their families, get pets, and make memories.

Besides that, over time, their equity in the property can grow to hundreds of thousands of dollars, making their home the most important investment many of them have. Homeowners have both a financial and emotional connection to their homes (even when they are underwater on value) and almost never walk away.

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.[21,22]

Because we 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.

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.

Lending is a business. One of the biggest lessons I learned during thirteen years of real estate investing is that decisions should always be made based on the numbers,

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[21] https://cnsmaryland.org/2020/05/19/a-decade-after-great-recession-home-values-in-some-communities-remain-underwater/

[22] https://www.chicagofed.org/publications/chicago-fed-letter/2016/370#:~:text=As%20a%20result%20of%20the,were%20approximately%203.8%20million%20foreclosures.

not on how I feel about a situation or my desire to shape an outcome. I strongly believe that I have a responsibility to the portfolio of loans I manage, and that means making sure timely payments continue to come in during the life of each loan.

While I want to help borrowers whenever possible, it's unreasonable for anyone to think they can stay in a home for a year or longer without paying a mortgage, taxes, or insurance. Sooner or later, everyone needs to face the reality of their situation, and delaying the inevitable just makes situations worse for everyone involved.

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.

Falling Property Values

When you invest in real estate as a landlord or flipper, falling property values can be a great concern. After all, selling the property or leveraging the equity can be an important means of accessing capital and gaining profits. Falling property values threaten to undermine that completely.

From that perspective, mortgage loan investors don't need to be as concerned about falling property values. While I always look for equity in my purchases, since I don't own the property or need to use its equity as leverage or liquidity, the value of the property itself plays little role in my overall business model.

Instead, mortgage loan investors need to be concerned with how homeowners will react to falling property values. 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.[23] 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 and motivations during the financial crisis, and what they found was astounding.

Strategic default never happened.[24]

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

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[23]https://www.corelogic.com/news/new-corelogic-data-shows-23-percent-of-borrowers-underwater-with-750-billion-dollars-of-negative-equity.aspx

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

2018, when almost two million homeowners still had negative equity, The 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.[25]

When you think about it, everyone needs a place to live. Whether you're paying a mortgage or rent, you're paying living expenses. The extensive research done after the Great Recession shows us that homeowners would far prefer to keep paying for their homes rather than give them up to pay rent on a temporary dwelling they have no stake in, control of, or emotional tie to.

This data perfectly illustrates the importance of emotional equity in home ownership, which has proven to be even more powerful than financial equity. The mindset of a homeowner is completely different, because it involves *ownership*. Homeowners do not make rational, data-driven decisions about their homes. Their decisions are overwhelmingly emotional.

Furthermore, humans are essentially creatures of habit and familiarity who don't like change. Moving is difficult and expensive, and most people try to do it as rarely as possible. How could you find an investment that is better than this, with borrowers who are motivated to keep their mortgage current and in good standing, regardless of what happens in the economy and markets around them?

Interest Rate Changes

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[25]https://www.marketwatch.com/story/why-do-underwater-homeowners-keep-paying-the-mortgage-2018-04-19

Interest rate risk is inherent with many investments. It describes the risk that when a fixed investment, such as a bond or CD matures, an investor may not be able to reinvest their principal at a similar rate if rates have fallen.

Real estate investors face a different type of interest rate risk, as their expenses are driven up when they invest in properties by taking out mortgages during a high, or rising, interest rate environment.

Most commercial loans are balloons of about five years, meaning that investors are required to refinance their debt (and pay bank fees) upon the balloon's maturity, at the bank's discretion. If rates are increasing, investors could find themselves with a nasty surprise: increasing leverage costs that they cannot absorb by raising the rents. If banks sense systemic risk, they could decide not to refinance the loan at all, forcing the investor to either find a new bank or sell the property in the current market conditions. In a declining market with a neglected property, an investor could find themselves—pardon my language here—totally screwed.

For mortgage investors, interest rates, whether high or low, play no role in our ability to profit, even if we're reinvesting our principal when loans are paid off early and interest rates are extremely low. The reason we don't need to be concerned about interest rates is that we generally buy loans based on *yield*, not interest rate.

When mortgage loan investors calculate investment yield, we don't pay attention to the *borrower's* interest rate. Our only concern is *our yield*, which is based on the amount of each payment, the number of payments remaining, and the purchase price. Discount allows us to increase our desired yield to meet our investment requirement.

In addition, when rates fall, homeowners are more likely to refinance their loans, meaning investors get paid back early. Depending on our purchase discount, an early payoff can drastically increase our investment ROI.

Out of the hundreds of billions of dollars of mortgage loans originated each year, there are wide varieties in the interest rates.[26] I review countless loans every year originated by smaller lending institutions or credit unions as far back as 1995, at or above 10 percent interest. Higher interest rates don't necessarily mean a higher-risk borrower, and they don't equal a higher yield. When a mortgage loan investor looks for a specific minimum yield, the calculation revolves around the cost of the loan and the remaining payments.

Let's take a look once more at the example we discussed in the Calculating Yield section. As you can see in Figures 15 and 16, the yield of the investment changes not because of interest rate, which isn't even a factor in the calculation, but based on the purchase price of the loan itself.

Number of payments	Monthly payment	Yield	Purchase price
132	$494.12	8%	$43,285.21

Figure 7

[26]https://www.consumerfinance.gov/data-research/consumer-credit-trends/mortgages/origination-activity/

Number of payments	Monthly payment	Yield	Purchase price
132	$494.12	12%	$36,125.48

Figure 8

No matter what interest rate homebuyers are paying, you can maintain the same yield with every new investment.

Risk may be an unavoidable reality of any investment worth having. Understanding the true nature of the risks associated with mortgage loan investing gives you the power to create hedges against them, such as diversifying the locations for your mortgage loans. Often, however, the very nature of this type of investment and its focus on yield create a far more hospitable environment for investors seeking low-risk and comfortable returns for a portion of their portfolio.

Ways to Invest in Mortgage Loans

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

Now, let's go a step further and talk about some alternative ways to invest in mortgage loans and some different types of loans to invest in. As I walk through these steps, please remember that my goal is to introduce you to these concepts and expand your understanding of what's possible in your portfolio. **Please consult with a CPA, attorney, financial advisor, and IRA plan custodian before taking action and making any investments.**

Baby Steps: Partial Loan Purchases

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

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

Example

In Figure 8, showed you this loan I bought in California:

Purchase price	$21,000.00
UPB (unpaid principal balance)	$27,376.22
Monthly payment	$351.84
Payments remaining	104
Yield	14.18%
Total collected over life of loan	$36,591.36

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

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

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

Figure 9

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

Partial purchase price	$10,000
Monthly borrower payment	$351.84
Buyer's yield	9%
Number of payments required to yield 9%	32
Total amount collected by buyer	$11,258.88

Figure 10

Compounding Period: Monthly

Nominal Annual Rate: 9.000%

Cash Flow Data - Loans and Payments

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

TValue Amortization Schedule - Normal, 365 Day Year

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

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

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

Figure 11

Here's a simple breakdown of the process:

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

- If the loan is paid off early, all the payments received by the buyer are amortized along with the buyer's interest rate and the total amount the buyer invested to determine the refund due to the buyer. This is tracked by the loan servicer.

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

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

Partial Loan Purchases FAQ

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

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

- Buy back the loan.
- Continue to make the payments to the buyer.

- Begin legal proceedings at the seller's expense.

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

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

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

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

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

What if the borrower makes irregular payments (pays more each month than they are required to)?

Additional principal payments reduce the amount owed to the buyer, since the principal amount is paid back faster. The loan servicer tracks the amount due to the buyer each month during the partial contract.

What are the advantages of partial note purchases?

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

Buying Second Liens

When buying a loan, investors can choose whether to buy a lien in the first or second position. Title companies use the old title expression, *first in time, first in right,* to decide which lien gets paid off first when a property is sold or liquidated. This means that, with some exceptions, liens recorded first are paid off first, while second and third liens are paid off with any remaining funds.

There are two reasons investors traditionally believe that second liens are riskier:

- If the borrower defaults, either lender can foreclose, but the lender in first-position lien will be paid first. If the first lien forecloses, it can unsecure the second-position lien at foreclosure sale.

- Owning second liens can pose a risk when markets fall and home values drop, potentially unsecuring the second lien due to loss of equity.

In theory, both of these concerns are valid, but in my experience, due to the power of emotional equity, they have proven to be unfounded. Let's explore why.

Busting the Second Lien Danger Myth

The most common type of second lien loan today is a home equity line of credit, or HELOC, which allow borrowers who have equity in their homes to go to a financial institution and take out a second mortgage on their home.

For example, let's say a borrower has a $150,000 first mortgage balance on their home worth $250,000. In order to add on an extra bedroom to their home, they take out a $40,000 HELOC. The borrowers will now have two mortgage payments each month, usually to two different lenders.

HELOCs tend to be structured differently, with an initial draw period, during which the borrower can use the credit line like a checkbook and only pay interest on the amount of money they use. At the end of the prescribed draw period, the loan converts to a repayment period, during which borrowers usually make regular monthly payments to repay the balance with interest.

HELOCs are primarily used for home improvements.[27] This is not generally a move made by someone who is ready to lose their home. In fact, second

[27]https://www.housingwire.com/articles/43830-heloc-use-is-on-the-rise/

liens can be preferable to buying a first lien. Why? Because second liens usually are characterized by:

- higher property values
- more financially sophisticated, higher-income borrowers able to withstand recessions
- lower loan purchase prices
- more frequent refinancing
- less competition from other buyers/investors

Other benefits of second lien purchases include:

- taxes and insurance escrowed/monitored by the first lien servicer
- the ability to monitor the status of the first lien
- risk can be spread amongst many more loans
- higher yields and greater discounts

Because of my experiences in real estate investing during the 2008 recession, I expected my inventory of second liens to have a higher default rate during the COVID-19 recession of 2020. I was shocked when that didn't happen. Not only did it not happen, I found that the few defaults I had were on first liens! I suspect this is because the borrower's income is usually tied to the value of the home, and because I don't want to invest too much into just one loan, most first liens I purchase are on properties with values under $150,000.

So while most people think that second liens are riskier, lower-income borrowers are more often living paycheck to paycheck and are more likely to run into financial trouble during economic downturns.

Another benefit I have found to investing in second liens is that first lien servicers are usually handling tens of

thousands of loans, and they are usually understaffed and slower to react to borrower default. If I keep an eye on the first lien status, it allows me to act first to best control the outcome if there is a first lien default. Better yet, there are many ways an investor can protect a second-position lien, and to date, I have never lost a second lien to foreclosure.

Even if you don't want to monitor the performance of the first lien, you will be notified of any adverse actions because in most states, first lienholders are required to notify second lienholders in the event of foreclosure action.

With second liens, time is on the investor's side. Following every scheduled payment, the first lien balance is reduced as principal is paid back; at the same time, the value of the property is increasing. This creates a constantly increasing equity position that benefits the borrower and protects the second lien lender.

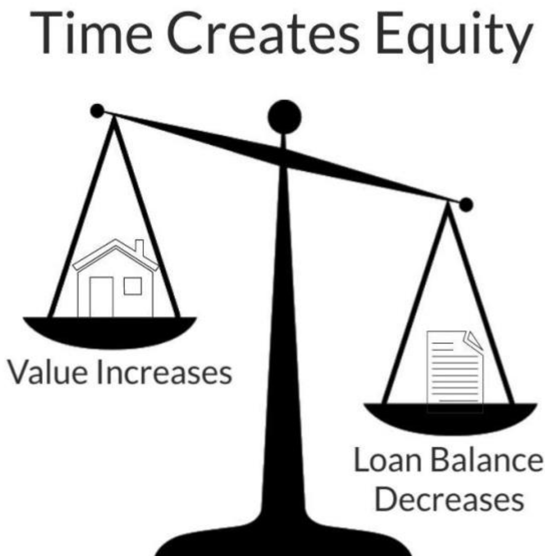

Figure 12

From Nonperforming to Reperforming Loans

Financial institutions originate billions in loans each year, yet foreclosure numbers average less than 1 percent.[28] Within that gap lies a special opportunity for some mortgage loan investors who want to turn nonperforming loans (NPLs), those which have gone at least ninety days without payment, into reperforming loans.

Why Banks Avoid Foreclosure

Financial institutions are in the lending business, not the collections business. These companies have a massive number of loans to service, and in my experience, they are not designed to effectively collect on delinquent loans. In most cases, they don't have employees with the knowledge and abilities needed to handle delinquencies.

Compounding this issue is the negative public perception issues facing banks that foreclose on borrowers, especially during times of recession. Most financial institutions don't want the bad publicity or legal and political scrutiny that comes with filing foreclosures and potentially evicting borrowers from their homes.

Finally, foreclosure is an expensive, lengthy process that in some states can take years if contested by the borrower. In many cases, especially with second liens, it is preferable for financial institutions to write down these loans as loss against their profits and sell them off at discount on the secondary market to a private fund that is

[28]https://www.attomdata.com/news/market-trends/foreclosures/attom-data-solutions-2019-year-end-u-s-foreclosure-market-report/

willing and able to spend the time and money to file a foreclosure case and ultimately solve the delinquency problem.

Buying NPLs

Banking regulations typically require financial institutions to identify nonperforming loans on their books after ninety days of nonpayment.[29] Once they write the loan down as a loss, they don't continue to try to collect on the loan. Instead, they frequently sell off the loans to recoup what money they can and put those funds back into circulation, making new loans and generating new fees.

In my experience as an investor in defaulted loans, by the time these loans are sold after being written down, the homeowner is frequently in a better financial situation and motivated to keep their home. I'm not the only investor with this experience, since there are many private investment funds that specialize in purchasing these NPLs and working with borrowers to modify the loans.

Although I have extensive experience in NPL investment, it is a much riskier investment model reliant on complex litigation in a constantly changing legal landscape with no guarantee of any profitable outcome. For that reason, I **strongly discourage** NPL investment for beginning investors who cannot handle the risk of a total loss of their invested capital.

The motivation behind filing a foreclosure case for an NPL is NOT to displace the borrower; it is simply to get

[29] http://pubdocs.worldbank.org/en/314911450690270267/FinSAC-LoanClassification-Provisioning-Paper.pdf

them to resume paying. A foreclosure action requires the borrower to make a decision and address the debt prior to the foreclosure sale. About 60 percent of the time, these nonperforming loans end up with a borrower requesting and agreeing to a loan modification. Prior to modifying the loan, the lender requires the borrower to submit a detailed financial application.

The lender's goal in a modification is to create a loan that the borrower will not redefault on, so it's in the lender's best interest to modify the loan to terms that the borrower clearly can afford. Because the investor has purchased the loan at a significant discount, they can afford to pass on these savings to the borrower in the form of a favorably modified loan, creating a positive solution for all parties.

Once these loans are modified, they are commonly sold in the secondary market as *reperforming loans* (RPL). I regularly purchase RPLs, both first and second liens, and have found them, over time, to be strong investments. Here's why:

- Foreclosure is a very stressful experience for borrowers. It forces them to face the reality that they could lose their home, and once they resolve the foreclosure, they don't want to experience the stress of a foreclosure again.
- A foreclosure filing is embarrassing, since the publicly recorded foreclosure filing is reflected on websites like Zillow, which all of their neighbors can see.
- The bigger the down payment at loan modification, the larger the statement from the borrower that they want to stay in their home and the lower the likelihood of a redefault.

- Since NPLs are purchased anywhere from 20 to 65 percent of UPB, the sellers can afford to sell them with higher yields and deeper discounts since their business model involves flipping the loans to reinvest their capital.
- Borrowers tend to refinance these loans more frequently, due to the higher interest rates, rolling the balance of the second mortgage into just one loan. When that happens, the ROI skyrockets.

Mortgage Loan Funds

Not interested in learning the business of mortgage loan investing, but still interested in profiting from the model? Mortgage investment funds could be a more suitable option. They are even more passive than actively purchasing individual loans, and return similar yields.

These funds pool investor capital in order to purchase much 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 can 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.[30]

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.[31] 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 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 absolutely 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.

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

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

The following questions are absolutely critical to review with a sponsor during the vetting process. The answers to many of these questions will likely 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. Some might want to focus on single-family, residential first liens. Others might focus primarily on commercial real estate. Still others could choose nonperforming first or second liens. 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, performing and nonperforming first and second liens, and anything else that comes along that looks appealing, 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. For example, in my experience, purchasing nonperforming loans is a much riskier investment model than performing loans. I do think there is a place for NPL funds, but I also believe the investors should share a much larger portion of the profit, not just a preferred return, to reflect the risks involved.

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.

Does the fund have any broker-dealer affiliations?

A broker-dealer, licensed by FINRA, is in the business of buying and selling securities. While this is not a requirement, a fund's affiliation with a broker-dealer represents an additional measure of confidence, because broker-dealers complete very rigorous analyses and reviews of fund offerings before recommending them to their clients.

What is the current distribution between first and second liens?

If the fund invests in first liens, investors need to know either their policy for minimum property value or their current average property value. I would be wary of funds that purchase loans or have an average value under $75,000 because lower-value properties have lower-income owners and typically have more problems and higher default rates.

If the fund invests in second liens, I want to know what percent of their loans has a combined loan to value (CLTV) under 100 percent. This answer will tell me how many of their loans have full equity coverage between the first and second lien, which is an additional measure of conservative investing.

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.

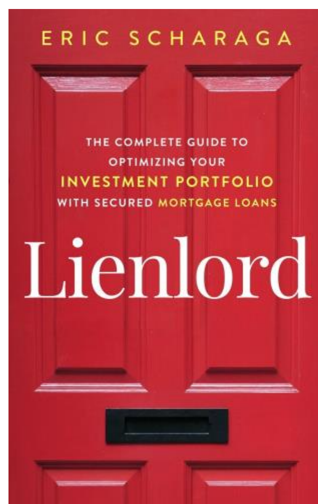
Are there any sales loads?
Ideally, the fund should have no sales loads or commission charges for buying or selling your interests outside of the lockup period.

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 special report 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 special reports.

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.

Arrears: Unpaid interest during a period of mortgage loan default.

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

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.

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

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

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

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.

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

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

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

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

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

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.

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 management firm. He serves as the manager of Damen Capital Fund, an income fund for accredited investors 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.

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

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