Introduction

Alternative investments are becoming increasingly ubiquitous in the portfolios of investors all over the country. It’s likely that by 2025, the global market for alternative investments will reach or exceed $17 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. When I wrote the first edition of this book, the country was in the midst of the 2020 COVID-19 pandemic and resulting recession. At that time, we saw a lot of fear and turmoil surrounding the markets, where there was already a void in stable, low-risk, income-producing investments. The years that followed introduced mounting geopolitical instability that rattled the market. In fact, increasing numbers of younger investors are seeking above-

[1]https://www.preqin.com/insights/research/reports/future-of-alternatives-2028

average returns with risky alternatives such as crypto—not realizing that there is a much less risky option.[2]

As post-pandemic interest rates have risen, so too have bond rates. This is good for fixed-income investors, especially those who want a fixed-income solution for a portion of their portfolio. But higher bond rates aren't helpful when corporate default rates are rising.[3] Even bonds issued by the United States government have experienced rating downgrades.[4]

Investors frequently look to real estate to provide fixed income solutions, many in retirement. What they learn, like I learned, is that rental property income is neither stable nor consistent. What if I told you that you could benefit from a truly passive real estate investment without all the headaches and risks? It's difficult to sit on the sidelines, watching investors flounder when I know there's a better way. After all, I've been there myself. As a landlord, I struggled, which is what drove me to become a *lienlord*. This is my motivation for writing this book—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

[2] https://ustrustaem.fs.ml.com/content/dam/ust/articles/pdf/2022-BofaA-Private-Bank-Study-of-Wealthy-Americans.pdf

[3] https://www.schwab.com/learn/story/what-happens-when-corporate-defaults-rise

[4] https://www.fitchratings.com/research/sovereigns/fitch-downgrades-united-states-long-term-ratings-to-aa-from-aaa-outlook-stable-01-08-2023

Warren Buffett suggests.[5] But here's the interesting point: If you have or have ever had a mortgage, then you know enough about mortgage investing to create a solid knowledge foundation. Hopefully, this book will round out that knowledge so you can determine whether mortgage loan investing is a suitable option for you.

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

What Is Mortgage Loan Investing?

Investing in mortgage loans has provided me with a level of financial freedom I failed to achieve through my job and *two decades* of real estate investing. The numbers for the mortgage industry are staggering. As of Q3 2023, there was $12.49 trillion in mortgage debt in the United States—up from $10.22 trillion in 2020.[6] 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.

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[5]https://www.cnbc.com/2017/05/01/7-insights-from-legendary-investor-warren-buffett.html
[6]https://www.newyorkfed.org/microeconomics/hhdc

Origination is a tightly regulated business requiring licensure and compliance with myriad laws on the state and federal level.

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

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

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

The types of loans covered in this book are referred to as *performing loans*, and there's a good reason for that. In a performing loan, the borrower is current and making regular payments. This is something that can help an investor feel confident about their investment, but I want to be clear that tracking billing and payments is not part of the job of a mortgage loan investor.

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

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

I use several servicers and find that their monthly servicing fee average around $25 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 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.

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My Story: Seeking Freedom

I'm often asked what led me into mortgage loan investing, and I point to an incident that occurred when I was thirteen that really shaped my view of money.

I grew up the oldest child in a single-parent home in Hoffman Estates, a suburb about forty minutes northwest of Chicago. Hoffman Estates was where my family had our first home and first mortgage.

I was lucky enough to attend one of the top high schools in the state, filled with students split between my middle-class town and a much more affluent town next door. Many of my affluent friends' parents were executives, business owners, or doctors, and it was not uncommon for my friends to drive brand-new Porsches and Mercedes to school.

One day after riding my bike home from a baseball game, I saw my mom talking to a city inspector. Our main sewer line kept backing up, and the city inspector said that our only option was to hire a plumber to run a camera down the pipe and diagnose the problem. He pointed down to a section of our yard, right before the sidewalk, that was sunken.

"That's likely your problem there," he said. "If the crack is on the street side of the sidewalk, the village is responsible for the repair. But if the crack is on the homeowner's side, you'll have to repair it." He estimated the cost for the repair at $5,000 to $10,000.

I recognized the panicked look on my mom's face. I knew enough to know that we didn't have the money to pay for the repairs; my mom was a teacher, and we lived paycheck to paycheck my entire upbringing.

I felt totally helpless standing there next to her, with no knowledge of plumbing and no ability to get anywhere near the amount of money required to pay the repair bill. I grew frustrated with the situation, embarrassed, then angry, and made a silent vow to myself that day to never be in that position again.

From that point forward, for me, money represented freedom. Freedom from having to worry. Forget the material possessions; money meant complete control over my own life.

Ten years later, I found myself training to become a high school teacher in the same district I attended as a student. For twenty-three years, I went to work every day out of a sense of responsibility. I believed in the mission of public education in our society as the great leveler, and I believed I had a responsibility to inspire and guide my students, many of whom struggled at home.

But midcareer, I found myself struggling daily with the sheer weight of the profession. The days were long and intense, and the workload was never ending. I spent many days hiding an immense sense of frustration and feeling completely overwhelmed, seeing firsthand what my students had to struggle through.

Regularly, I came home from work and hid. All my energy was spent, and I had little to nothing left for my own children. I would get depressed and stressed out Sunday nights thinking about the week ahead. Honestly, there were many days that I would arrive in the parking lot and just sit there, not ready to get out of the car. I was no longer satisfied with the predictable repetition and craved a new challenge that would force me to grow.

This is the problem too many people find themselves in, regardless of their profession. Stuck, too tired to figure a way out, and resigned to unhappiness. As a teacher, I learned that most of my coworkers felt like they had no choice but to stick it out for thirty-six years for the pension, for the promise of future happiness.

Looking for a way out, I invested in traditional investments and real estate, but nothing met my need for stability, passive income, and scalability until I found mortgage loan investing in 2016. It represented everything that real estate investing wasn't.

By 2019, after twenty-three years of service, I retired from teaching. I entered into the great unknown of entrepreneurship with a wife and young kids who depended on me to provide for them. I knew it was time. I knew that if I stayed, I would regret being unhappy and unchallenged more than if I failed.

As of the date of this book, I have purchased over 400 individual loans totaling over $6 million in purchase price. I am by no means rich, but I am financially self-sufficient, and I am able to pay my bills using my investment income, which was my original goal. Material things still don't matter to me, and as I get older, the more I think about what I am building and what I am passing on to my children, in lessons and in legacy.

I am grateful for all the people I met in my early years in mortgage loan investing as well as my mortgage loan mentor, because they all taught me lessons that have turned me into the investor I am today. I am still learning about mortgage loan investing every day, and I enjoy passing on my knowledge to others.

I made a promise to my mentor early on in our relationship that in exchange for his help, I would teach someone else this business. I see this book as a means of fulfilling that promise, and sincerely hope you learn something valuable by reading it.

This book is not a complete educational program in mortgage loan investing; it is considered an introduction, designed to pique your interest and to make a case for a real estate-based, passive supplement to traditional investments.

I understand that not everyone will be as driven as I was for change, and most people are generally satisfied with their careers. But I believe there are many more investors who would choose mortgage investing for a part of their investment portfolio, because it is such a simple model. I strongly believe that we all should have the opportunity to control our financial futures and create the lives we desire.

Mortgage loan investing has allowed me to do that—I hope it can help you too.

The Real Estate Investing Myth

Since 2013, real estate has been the most popular investment in America.[7] 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 wealth, 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 less

[7]https://news.gallup.com/poll/505592/real-estate-lead-best-investment-shrinks-gold-rises.aspx#:~:text=When%20real%20estate%20or%20stock,estate%20and%20stocks%20are%20down.

stressful and truly passive real estate investment option. Remember my experience as a child, standing in the front yard, overwhelmed by the cost of the massive repairs sometimes required in real estate ownership? That was merely an introduction of what was to come.

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 was the number one way to wealth in America, and 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. There's an old expression in real estate: *You make your money when you buy, not when you sell.* 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, even in high-crime communities, 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 me an average of $5,000. This would include often-forgotten costs such as vacancy expenses and advertising for and finding a qualified new renter. 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 everyone thinks 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.

Today, it's even worse with home insurance costs in some states rising as much as 26 percent—a cost that landlords quickly pass on to renters.[8]

The National Apartment Association's research supports what a low-margin business rental housing is. According to their 2023 findings, each dollar in rent received is broken down in the following ways[9]:

0.46	Mortgage payment
0.02	Capital expenditures
0.27	Maintenance, utilities, insurance
0.11	Property taxes
0.07	**Profit**

Figure 1

I remember sharing the details of my business with a financial analyst who was interested in real estate investing.

[8] https://mynews13.com/fl/orlando/news/2023/09/13/renters-likely-to-feel-pains-of-florida-property-insurance-crisis
[9] https://www.naahq.org/breaking-down-one-dollar-rent-2023

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 feeling like I was on call twenty-four hours a day, providing high-quality housing to tenants, but receiving little to no 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 about 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.

I will be exploring my experiences in real estate investment more fully in an upcoming book.

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

Leveraging the Traditional Banking Model

In a post-Great Recession world, banks are leaders in safe lending. With the introduction of the Dodd–Frank Act, financial institutions have stiff regulatory compliance standards to maintain and rigorous capitalization requirements.[10] In short, banks that survived the financial crisis are stronger than they've ever been and new regulations, no matter how begrudgingly followed, are keeping them there.

Of the major changes the Dodd–Frank Act introduced to banks, two of the most interesting are the stricter requirements for mortgage lending and better safeguards for banks that follow them. One such change is found in the eight underwriting factors lenders are asked to consider when determining a borrower's ability to repay.[11] Another is found in the legal protection offered to lenders who keep borrower loan payments from going above 43 percent of their income.[12]

Sounds good for banks, right? But what about for investors? Well, if you're investing in mortgage loans that have been originated by banks under these stringent guidelines, it results in an inherent risk mitigation that might not exist with other investments.

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[10]https://www.bankrate.com/banking/banks-safe-healthier-now-coronavirus-shock/
[11]https://www.federalregister.gov/documents/2013/01/30/2013-00736/ability-to-repay-and-qualified-mortgage-standards-under-the-truth-in-lending-act-regulation-z
[12]https://www.consumerfinance.gov/about-us/newsroom/consumer-financial-protection-bureau-issues-rule-to-protect-consumers-from-irresponsible-mortgage-lending/

It's not just newly originated loans that have risk-adjusted benefits for investors. Even loans originated before the 2008 Great Recession can have tremendous value with limited risk. Because these loans were issued to borrowers who kept up their payments, even while underwater during the financial crisis, most of them have already regained the equity lost during that stressful time.

But beyond safety, mortgage loan investing offers an opportunity for alternative investors to find high profits—similar to those that banks secure for themselves. How? By taking advantage of the spread and amortization intrinsic to the traditional banking model.

Traditional Banking: The Net Interest Spread

When I talk about traditional banking, I'm referring to depository institutions, such as commercial banks, savings and loans, and credit unions. These are "banks" in the traditional sense; they accept deposits from borrowers and part of their business is lending out their depositors' funds to borrowers in the form of mortgage loans. In the next chapter, I'll talk more about other types of mortgage lenders.

The traditional banking model is surprisingly simple. In its most basic sense, it works like this:

ABC Credit Union accepts deposits from customers, paying interest of 2 percent on their deposits.

These deposits are pooled and funds are used to originate a mortgage loan to Joe Customer at 8 percent.

The bank requires a 20 percent down payment from Joe Customer, allowing them to finance 80 percent of the home's value.

The credit union's net interest spread is roughly 6 percent, which is the difference between what they receive in interest on home loans and their cost of funds, or what they pay in interest to their deposit customers.

Banks are in the business of money. Loaning it, securing it, and earning it. This is clearly seen from the simplicity and net interest spread built into the traditional banking model. While these factors lay the foundation for why mortgage loan investing can be low risk and profitable, there's a lot more to it than that.

Traditional Banking: Fees and Amortization

Another way that banks profit in mortgage lending is through the fees involved in originating a mortgage loan. If financial institutions can keep recycling their capital and charging borrowers fees that total 3 percent of each mortgage loan amount, it would make more sense to sell loans as quickly as possible.

If a financial institution originates only $20 million in loans per year and makes 3 percent of that total just in fees, that equals $600,000 profit per year! When you further consider that home buyers routinely finance their closing costs as part of the overall mortgage, the profits grow exponentially.

Banks also profit on lending through amortization. If you've ever taken out a home loan, you have seen the required Truth in Lending disclosure in Figure 3. Did you get sick to your stomach when you saw that making each minimum required payment over the life of the loan would drive up the total amount paid back on your loan *almost three times what you originally borrowed?*

Consider the following example for a $50,000 loan at 8 percent over thirty years:

ANNUAL PERCENTAGE RATE The cost of your credit as a yearly rate.	**FINANCE CHARGE** The dollar amount the credit will cost you.	**Amount Financed** The amount of credit provided to you or on your behalf.	**Total of Payments** The amount you will have paid after you have made all payments as scheduled.
8.000%	**$82,076.80**	**$50,000.00**	**$132,076.80**

Figure 3

You might think that this means a bank would want to hang on to your loan as long as possible to get all of that 300 percent markup, but thanks to amortization, which requires the largest percentage of interest at the beginning of the loan, banks don’t need to. Because in addition to earning money from the spread we talked about in the last section, banks are earning most of the interest on your loan up front, in the first several years of payments.

Take a look at the amortization schedule for the loan discussed in Figure 3:

Payment #	Date	Payment	Principal	Interest	Balance
1	Aug 12 2020	$366.88	$33.55	$333.33	$49,966.45
2	Sep 12 2020	$366.88	$33.77	$333.11	$49,932.68
3	Oct 12 2020	$366.88	$34.00	$332.88	$49,898.68
4	Nov 12 2020	$366.88	$34.22	$332.66	$49,864.46
5	Dec 12 2020	$366.88	$34.45	$332.43	$49,830.01
Year 1	**2020**	**$1,834.40**	**$169.99**	**$1,664.41**	**$49,830.01**
6	Jan 12 2021	$366.88	$34.68	$332.20	$49,795.33
7	Feb 12 2021	$366.88	$34.91	$331.97	$49,760.42
8	Mar 12 2021	$366.88	$35.14	$331.74	$49,725.28
9	Apr 12 2021	$366.88	$35.38	$331.50	$49,689.90
10	May 12 2021	$366.88	$35.61	$331.27	$49,654.29
11	Jun 12 2021	$366.88	$35.85	$331.03	$49,618.44
12	Jul 12 2021	$366.88	$36.09	$330.79	$49,582.35

Figure 4

The first monthly payment of $366.88 only applies $33.55 to principal. In fact, one year in, at your twelfth payment, you're still only paying $36.09 toward that principal balance—for a total of $417.65 paid toward your principal. In a YEAR! During that same time, you've paid $3,984.91 in interest. And that's only for *one loan*! Multiply that by a thousand loans, and you can see what money machines banks are.

Finally, banks cannot just continue to lend endlessly. They are bound by reserve ratios, or the amount they are required to keep liquid. If a bank is approaching their lending limits, but still wants to originate loans, it may decide to sell some of their older loans, or least desirable loans in pools in order to create liquidity and continue lending and collecting origination fees.

And that's where you come in.