How Volatility Ruins Retirement: A Special Report

Alternative Investment Series

Eric Scharaga

With

Derek Diemer

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The Current Volatility Crisis

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

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

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

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

According to Fidelity, almost 40 percent of their clients between the ages of fifty-six and seventy-four had more stock in their portfolios than they should, based on their ages. Even more concerning, Fidelity found that 7 percent of baby boomers had retirement accounts with 100 percent of the assets invested in the stock market.[1] Few people, at any age, would enjoy watching their retirement account balance whip back and forth between lows and highs on a weekly, or even daily, basis. But once you're nearing retirement, it's especially stressful—and damaging—to expose your assets to the volatility inherent in traditional investments.

Avoiding Volatility: It's Not Just About Equities

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

For example, bonds are generally promoted as a low-volatility investment. As you age, advisors often suggest taking more and more out of equities and shifting assets into

[1] https://finance.yahoo.com/amphtml/news/many-boomers-still-own-too-much-stock-132236022.html

less risky bonds. This year, however, the US bond market hit its highest level of volatility since 2009.[2]

Real estate is another investment opportunity promoted as having lower volatility than equities. But this year, with four months of COVID eviction relief built into the CARES Act, an extension of that timeline possibly on the horizon, and many pushing for all-out rent forgiveness, landlords are finding their previously predictable incomes getting slashed while their expenses remain the same.[3]

Even the usually dependable commercial real estate market is readying for future volatility, as the pandemic-led, work-from-home trend depresses demand for commercial leases and stay-at-home orders leave brick-and-mortar retailers struggling, leading to reduced rents and a higher rate of unoccupied units.[4] In November Simon Properties reported revenues on mall rental falling 25 percent.[5]

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

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[2]https://www.ft.com/content/a8cb729e-6772-11ea-a3c9-1fe6fedcca75

[3]https://www.marketwatch.com/story/joe-biden-has-called-for-rent-forgiveness-during-the-coronavirus-pandemic-heres-how-that-would-work-2020-05-26

[4]https://commercialobserver.com/2020/11/what-will-a-second-covid-19-wave-do-to-u-s-cmbs/

[5]https://finance.yahoo.com/news/mall-landlord-simon-propertys-revenue-212407083.html

Volatility and Returns: Not Just a 2020 Problem

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

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

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

Figure 1

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

Figure 2

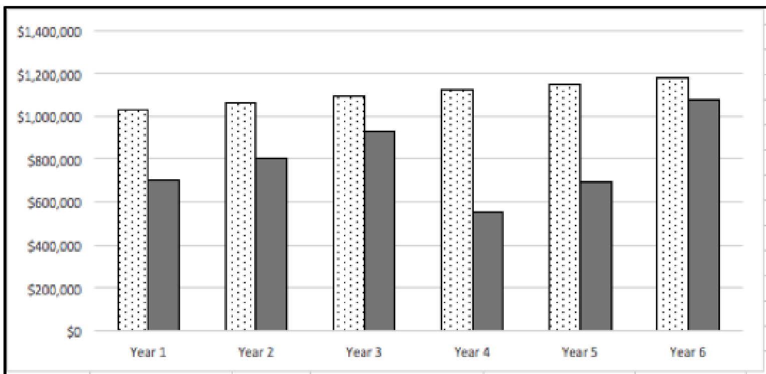

Figure 3

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

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

Example: Dollar-Cost Averaging

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

Figure 4

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

Volatility and Income: Recipe for Disaster

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

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

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

2007, the cell phone has been replaced by a Blackberry, and our investor has a portfolio balance of $366,427 the day they retire.

Almost two years after retiring, in February 2009, just as our investor needed to start liquidating their portfolio to take some income distributions, the stock market crashed and the value of all their investments fell to $220,841.[6] Now, our investor has to liquidate a higher number of shares early on in their retirement just to get the amount they need for a distribution. This leaves fewer shares in their portfolio, which means less opportunity for recovery and growth when the market rebounds.

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

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

[6]https://www.portfoliovisualizer.com/backtest-portfolio

Figure 5

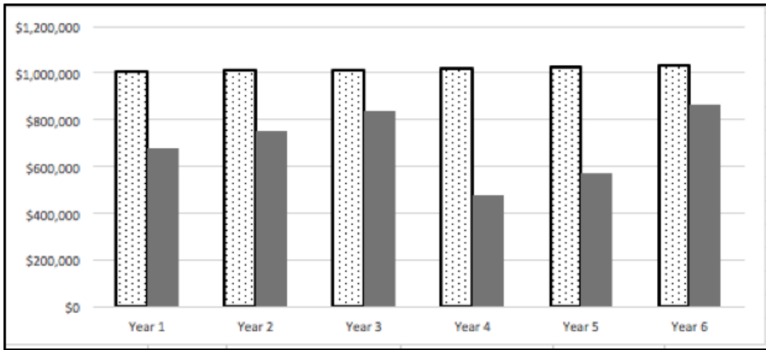

Figure 6

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

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

Where can you look to escape volatility in an economic landscape none of us have ever encountered? It might be time to consider alternative investments.

Included in the universe of alternative assets are traditional assets like gold and silver, but as highlighted in the 2020 Prequin Global Hedge Fund Report[7], this asset class has grown in both size and scope. Hedge funds, real assets such as timber or farmland, and private placement investments each comprises a significant portion of the growing alternatives space. Just as with traditional equities, the fundamental drivers of returns differ greatly, and thus the prudent investor will consider the risk profile that matches his needs.

Traditionally, hedge funds seem to receive attention as the most dapper and desirable guest at the alternatives house party. Some of the early hedge funds actually were created to offer a hedge against the broad equity markets, yet in the past 15 years we've seen a proliferation of unrestricted funds, whose policy statements allow for broad authority to select investments and utilize leverage. The best way to consider their performance is to review an aggregation of data.

If we take a closer look at hedge funds courtesy of The Barclays Hedge Fund Index[8], which tracks more than 1,700 funds as of November 2020, we see that returns to date have lagged the broader S&P 500, but with less volatility.

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[7] https://docs.preqin.com/samples/2020-Preqin-Global-Hedge-Fund-Report-Sample-Pages.pdf
[8] https://portal.barclayhedge.com/cgi-bin/indices/displayHfIndex.cgi?indexCat=Barclay-Hedge-Fund-Indices&indexName=Barclay-Hedge-Fund-Index

	2020 YTD Return	Annual Volatility of Returns (as measured by standard deviation from the mean)
Hedge Fund Index	7.3%	6.5%
Gold	14.3%	15.8%
S&P 500	12.1%	11.7%

**YTD return data is through Nov 30*
***as measured by standard deviation from the mean; Gold & S&P 2009-present, Hedge Fund Index 2016-present*

Furthermore, cumulative returns data from 2015 through present will show the S&P 500 produced nearly 3x the returns of the Hedge Fund Index (92% for the S&P vs. 32% for the hedge fund index) although as we see above the volatility is historically nearly 2x.

Another consideration the prudent investor must consider when considering alternative investments is liquidity constraints. Hedge funds, for example, will often mandate a 2 or 3 year “lockup period”, which restricts withdrawals to protect other investors, and charge annual fees ranging from 1-2% of the amount invested as well as 10-30% of the annual gains. Farmland and other real assets like timber, will often require an investment horizon as long as 7-10 years. Which option is most preferable? Which is appropriate? Our intent here is not to make an investment recommendation, but rather to provide the data needed for you to consider modifying or crafting your own investing narrative.

Of particular interest to the savvy investor may be the risk profiles of a lesser-known asset such as mortgage loans and mortgage loan funds. These two investments can be a great complement to a portfolio because they are not correlated to the stock market. They can also strengthen an income-focused portfolio by reducing volatility and offering more control over yield.

Embracing Stability

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 multi-faceted asset class.[9]

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

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

Mortgage Loan Investing Overview

Mortgage loan investments are a truly passive real estate investment without all the headaches and risks associated with landlording, flipping and managing vacation rentals. Mortgage note investing involves buying secured home loans (mortgages) that banks have already underwritten and approved. Mortgage loan investors count on monthly loan income for profits and since they don't originate the mortgage loans, they don't need to evaluate debt-to-income ratios, collect required disclosures, or deal with compliance. Instead, they simply purchase loans through what's called the secondary market.

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

Why don't more investors consider mortgage loans as investments? I don't see any reason why, other than lack of knowledge. It makes sense to avoid investing in something you don't know much about or don't understand. That's certainly what Warren Buffett suggests.[10] But here's the interesting point: If you have ever had a mortgage, then you know enough about mortgage investing to create a solid knowledge foundation.

> "Never invest in a business you cannot understand."

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

—Warren Buffett

As of 2019, there was $15.8 trillion in mortgage debt in the United States.[11] Home ownership *is* the American dream, and you don't need to be a massive bank or financial institution to enjoy the benefits of mortgage loan investing. Everyday investors like us can invest in that dream.

How Mortgage Loan Investing Works

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

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

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

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

equity grows as the value continues to rise and the amount of debt is paid back to the lender.

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

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

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

Part of the beauty of mortgage loan investing is that the lender has no other responsibilities for the collateral property; that is entirely up to the homeowner. Ultimately,

mortgage loan investing is a simple business. Money was lent, the borrower needs to pay it back in monthly payments, the investor buys the lender’s rights to the repayment, and the rest is an opportunity for our accounts to grow exponentially.

Borrower Default Data

In these turbulent times, it might seem as though borrower default is the biggest risk you run. After all, your income comes from the homeowners making their monthly mortgage payments and eventually paying off their homes.

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

1. Homeowner default is statistically rare.
2. Mortgage loan investors can provide options for borrowers to help them get over short-term financial issues.
3. If no agreement can be made, mortgage loan investors retain the right to foreclose on a defaulted loan's collateral.

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

The Statistics of Mortgage Default

In a normal economic time, during a “normal” year, delinquency rates on single-family homes are low. In fact, the delinquency rate for mortgages ninety days or more past due fell from 4.9 percent in January 2010 to 0.8 percent in December 2019.[12]

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

It’s been estimated that between 2007 and 2010, there were just 3.8 million foreclosures in the United States.[13] 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.[14] 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.[15]

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

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[12]https://www.consumerfinance.gov/data-research/mortgage-performance-trends/mortgages-90-or-more-days-delinquent/#mp-line-chart-container
[13]https://www.chicagofed.org/publications/chicago-fed-letter/2016/370#:~:text=As%20a%20result%20of%20the,were%20approximately%203.8%20million%20foreclosures.
[14]https://tradingeconomics.com/united-states/unemployment-rate
[15]https://fredblog.stlouisfed.org/2018/11/the-lowdown-on-loan-delinquencies/

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.

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.[16] 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

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

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.[17]

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

Why would they do this? Overwhelmingly because they loved their homes and wanted to stay in them! In 2018, when almost two million homeowners still had negative equity, New York Fed found that the primary reason underwater homeowners hadn't even considered strategic

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

default was simple: they liked their homes and didn't want to lose them.[18]

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.

The 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?

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

Mortgage Loan Funds

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

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

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

Accredited Investors

The SEC defines an accredited investor as a person who either has an annual income of $200,000 per year

($300,000 for joint income) for the last two years or a net worth of $1,000,000 or more, excluding the value of their primary residence. Because of their net worth and/or income, the SEC believes these investors are capable of making their own investment decisions, without restriction.

Recent changes to the SEC's definition allow for the inclusion of knowledgeable employees of a fund, spousal equivalents, and certain people with relevant credentials and certification from accredited institutions.[19]

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.[20] 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.

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[19]https://www.sec.gov/news/press-release/2020-191
[20]https://www.sec.gov/fast-answers/answers-rule506htm.html

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

Your Mortgage Loan Fund Questions Answered

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

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

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

What is the strategy of the fund?

Funds can have many strategies. For example, some might want to focus on single-family residential first liens. Others might focus primarily on commercial real estate. Investors should generally look for a focused, singular strategy organized by a manager with plenty of related experience. If a fund is going to buy both residential and commercial real estate plus anything else appealing that comes along, there may not be enough expertise and focus in one field, which greatly increases the risk. It is very rare that a management team is a market leader in all those fields.

What is the fund's yield?

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

What happens if a mortgage within the fund defaults?

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

When are investors paid?

If an investor is counting on the fund for reliable income, they may want to look for a fund that pays a monthly distribution. Also, make sure to note if there is a delay

between when the funds are invested and the preferred return distributions begin.

What fees does the fund charge?

Ideally, a well-run mortgage loan fund will have no fees. Some investment funds, however, charge a management fee of 2 percent or more per year, which is payable to the managers regardless of fund performance. Funds are also known to charge myriad additional administrative and management fees that can really add up and could affect distributions to the investors. A fund ***without*** fees demonstrates that the sponsors are very confident in their model, because they will not be paid anything for their hard work unless the fund does well.

What costs does the fund incur?

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

What is the fund's lockup period?

Many commercial real estate funds have a minimum commitment of five to ten years, which means investors may not redeem their shares during that period. A lot can happen in that span of time, so investors should look for

funds with as short a required commitment as possible. Once the lockup period has passed, there should be a clear procedure for redeeming shares and exiting the fund.

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

It's critical that investors find funds with adequate geographic diversification. If all the loans are held in one city or state and that area sees a major employer move or a natural disaster, the investors could be in big trouble.

What is the fund's current delinquency rate?

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

What is the fund UPB vs. invested capital?

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

What are the monthly cash flows of the fund?

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

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

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

Has the fund ever missed a payment to investors?

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

What are the tax implications of fund participation?

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

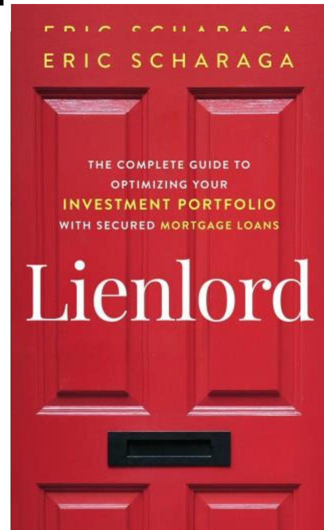
Are there any sales loads?

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

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

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

Learn More



- **What if there was a way to 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?**

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

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

I created this e-book series simply to provide information on an investment I'm passionate about, and I hope it provides you with valuable insight. I'm dedicated to helping

investors understand and get started investing in mortgage loans.

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

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

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

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

eric@damencapital.com
www.mortgageloaninvesting.com

Glossary

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Lender: An individual or business that lends money.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

About the Authors

Author Eric Scharaga

Eric Scharaga is the founder of Damen Capital Management, an investment fund manager 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.

Author Derek Diemer

Derek J Diemer is the co-founder of FinTech Ranger and Regiment, a boutique digital investment bank serving investors seeking opportunities to invest in private placements and alternative assets. He holds a B.A. in Management from Greenville University and an MBA from the Kelley School of Business at Indiana University. He holds the FINRA Series 7 and Series 63 securities licenses.

Feel free to contact Derek Diemer with any questions about private placements and alternative asset investing.

(812) 671-0313
linkedin.com/in/derekjaydiemer/