GARVAN
FINANCIAL PLANNING

Guide to…

Mortgage Funds

What are Mortgage Funds?

Investing in mortgage funds can most easily be thought of as you taking the place of a bank in a normal mortgage arrangement. That is, instead of the bank making the loan, by investing in a diversified mortgage fund which comprises many individual mortgages, you are indirectly lending money to another person and charging them interest via the fund manager who manages the portfolio of mortgages.

Within a mortgage fund, a portfolio of mortgages on income producing real estate (i.e investment properties) typically secures your investment. These mortgages secure your loan by placing a charge over the specific properties. The mortgage fund may have a first mortgage over each property, which means that the debt owed to you (via the mortgage fund) has priority over other debts that may be claimed against these properties in the event of a default in payment. It is important to note that not all mortgage funds hold first mortgages. Some funds may hold mortgages that are less secure than first mortgages and this may lead to different risk characteristics in funds. Also, some mortgage funds may invest in one single mortgage or a single sector of the property market, whereas most of the mortgage funds managed by large fund managers tend to have a diversified portfolio of many individual mortgages spread across a range of property sectors. Mortgage funds that invest in single mortgages or single sectors are generally likely to be more risky than diversified mortgage funds. To compensate for this higher risk, these tend to offer higher rates of interest.

When investing in a mortgage fund your money is pooled with other investors. As the size of most mortgage funds is quite significant the number of mortgages that are held can be large. This means that the fund will have lent money to a large number of borrowers, which helps to reduce the risk associated with one borrower not being able to meet their obligations.

Why invest in a Mortgage Fund?

Generally, mortgage funds may exhibit the following basic features which may appeal to some investors. Note the features below may not apply to all mortgage funds:

- Regular income payments
- Competitive rates of interest compared to cash and term deposits
- Lower volatility of returns than fixed interest/bond funds
- Investment secured by a mortgage over income producing real estate (i.e investment properties)
- First mortgages which gives the investor (via the mortgage fund) first right over the asset should the property need to be sold

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What are the Risks?

One risk within a mortgage fund is that one or more of the borrowers will not be able to meet their interest repayments (i.e default risk) and the property securing the loan may need to be sold. If the property sells for less than the loan amount the fund will produce a loss. This loss can reduce the income received and can also reduce the capital value of your investment. This is an important issue for investors to be aware of as it is possible to experience a capital loss on your investment within a mortgage fund.

Liquidity risk is also an issue for mortgage funds given the underlying assets over which the mortgages are secured is direct property and this asset class can be illiquid.

The degree of risk for an investor in a mortgage fund depends upon several factors including:

- The margin of safety by which the property valuation exceeds the loan secured by a mortgage. This is usually expressed as a loan to value ratio (LVR).
- The accuracy of the valuation in relation to the current market price.
- The capacity of the borrower to honour obligations under the loan arrangement.

How are these risks managed?

Mortgage funds try to manage, or reduce, these risks by considering several aspects of the loan before lending their investors' monies.

Many mortgage funds:

- do not lend more than 70% of the value of the property (or properties) offered for security, also known as the loan to value ratio (LVR)
- require a current valuation for any property being considered for security
- assess the income and cash flow position of the borrower before lending any funds
- manage potential concentration of exposure to one geographical region i.e have geographical diversification requirements which must be met
- have maximum allocations of the mortgage fund assets that can be lent to one borrower

Mortgage funds, as with all investments, have potential benefits when used as part of a diversified portfolio as well as risks which need to be understood. As with all investment products, your financial adviser can assist in ascertaining which investments are appropriate for consideration within your portfolio.

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