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*NOTE: This presentation was made by Wayne Robinson at the Metro Toronto Convention Centre on October 20<sup>th</sup>, during the WorldMoney Show. It has been modified from oral to written format for inclusion here.*

Wayne Robinson has been an advisor and has been managing portfolios since 1983. He is the owner and manager of W. A. Robinson & Associates Ltd which is situated in the Lake District of Eastern Ontario between Ottawa and Kingston. He and staff consider themselves experts in the fields of real estate, mortgage valuation and investing.

**This article talks about mortgages and the pros and cons of investing directly and indirectly in mortgages. Many readers will already know about mortgages and the investment potential but let us review some of the basic concepts and work through the whole subject.**

A mortgage is real estate investing but without directly holding real estate. It provides earnings and cash flow for the investor on a monthly basis.

A mortgage is the transfer of an interest in property (or the equivalent in law – a charge) to a lender as a security for a debt – usually a loan of money. While a mortgage in itself is not a debt, it is the lender's security for a debt. It is a transfer of an interest in land (or the equivalent) from the owner to the mortgage lender, on the condition that this interest will be returned to the owner when the terms of the mortgage have been satisfied or performed. **In other words, the mortgage is security for the loan that the lender makes to the borrower.**

Mortgage comes from the Old French “dead pledge” meaning that the pledge ends (dies) when the obligation is fulfilled.

In most jurisdictions mortgages are strongly associated with loans secured on real estate rather than on other property (such as ships) and in some jurisdictions only land may be mortgaged. A mortgage is the standard method by which individuals and businesses can purchase real estate without the need to pay the full value immediately from their own resources.

Mortgage investing is one of the oldest investment vehicles in the world, people with available capital have been loaning money backed by real estate to people needing to build homes and business for thousands of years. Often it was a business sector controlled by the wealthy merchants or families who wished to leverage their wealth and increase their capital base or to gain cash flow for later years in life.

Mortgage lending did not get into full force on a national basis until the National Housing Act came into play in Canada in the 1940's and Canada Mortgage and Housing started

insuring high ratio mortgages. Over the following 60 years Canada has gone through an economic boom generally and a housing boom specifically as the population grew and Canadian's first choice was to own their home.

Today the mortgage lending business is made up primarily of three groups of lenders: the primary lenders (banks, trust and insurance companies), the secondary lenders (international lenders, finance companies) and the niche players (private lenders, pools such as Mortgage Investment Corporations and other investment funds).

The first group, market leaders such as banks, raises their funds by issuing GICs or like products to individuals or groups who wish to have their deposits insured by governments (e.g. Canada Depository Insurance Corporation or similar guarantors). In turn these lenders find borrowers who have high credit scores, premium properties and a proven cash flow. These lenders make their living by taking the spread between GIC rates and the five year prime lending rate which on average is approximately 2%. This group is by far the largest lending sector in Canada. Michael Porter, the famous economist, would describe them as market leaders.

The second group in the Canadian model are also market followers who function in the one-off market place. Until recently this area was controlled by big US lenders such as GMAC and Wells Fargo. The American companies in this category have been inordinately hurt by the financial crisis south of the border and have effectively exited the Canadian marketplace for at least the short term to get their houses in order.

The third group is the niche players who are required to provide more service to clients. They work harder to find, fund and manage their portfolio. They must generally raise their capital in the market place without the benefit of government guarantees for the investor's deposits. Therefore, on average they must deliver much better returns than GIC rates. These entities must also look at deals that do not ordinarily meet the strict lending criteria of the banks and trust companies. The investors are considered one-off from the person looking for guarantees and the mortgages funded are also one-off in that the borrowers are having difficulty qualifying for bank financing.

**Let us now turn to how mortgages are underwritten or evaluated across the industry; it varies very little from lender to lender so we can speak on a general basis covering most situations.**

Mortgage brokers are registered in Ontario with the Financial Services Commission of Ontario and their influence in the marketplace has increased markedly over the last 20 years. Mortgage brokers now originate over 30% of all mortgage applications in Canada. These mortgage applications, whether generated by the lenders themselves through their branches or mobile employees or through brokers, go to lenders' underwriting departments. Each application is evaluated according to generally acceptable criteria known in the industry as the 4 C's of lending: collateral, credit history, cash flow and character. Most lenders use a scoring mechanism that allows them to rate an application before approving or rejecting the loan.

Once the application is approved, the process is picked up by the lawyer who now assures that the legal description of the property is correct and register able and that the property

has insurance as well as a clear title. This is normally covered by a title insurance company. When all is in place, the money is released to the borrower.

At this point the lender normally starts collecting the mortgage payment made up of a principal repayment component, plus the interest charged on the loan and a municipal tax component. These payments are taken by the lender either through an automated banking process or by post dated cheques.

If the borrower makes all their payments according to the contract, then they get to enjoy the undisturbed benefit of their property and the lenders have no rights except to receive their mortgage payment. If for any reason the borrower fails to meet their requirements under the mortgage contract (not making payments, not maintaining their property to acceptable standards, not maintaining insurance or paying the taxes) then the lender must provide notice that there has been a default in the mortgage conditions. The borrower usually has 15 days to correct the situation but if that does not happen then the lender has two routes to enforce their mortgage. One, which is by far the most common in Canada, is called Power of Sale and the second is to commence a foreclosure action. The process varies greatly in timing from province to province in Canada so I will speak primarily about the rules in Ontario. Under Power of Sale action the borrower has approximately 35 days to repay the mortgage in full. Failing that, the lender has the right to have the property appraised, listed with a real estate company and sold. All debts are then repaid from the proceeds and the balance, if any, goes to the borrower himself. If there is a short fall, then the lender has the right to pursue the borrower for the balance owing and normally does that by way of a court judgment.

Under a foreclosure action the lender is effectively starting an action to take the property for the debt with no further rights to pursue the borrower for any shortfall. The process is more complicated and time consuming in a foreclosure but when the action is perfected the lender is the legal owner of the property and the borrower has no rights to redeem as he would in a Power of Sale.

### **Now why would an investor invest directly or indirectly in mortgages and what are the rewards and risks involved?**

Firstly, it is investing in real assets that one can see, watch, take and sell, if the investment goes bad. A mortgage provides monthly cash flow backed by a real asset. The security is something everyone understands at its basic level – land, with normally a building on it such as a house. Real estate has historically provided real returns that also provide a hedge against inflation. A mortgage is again, as mentioned earlier, investing in real estate but once removed that provides consistent returns and cash flows. A mortgage investment is an investment halfway between a diversified blue chip stock portfolio and a diversified laddered bond portfolio. The historical return reflects that well.

There are many ways for an investor to get into mortgage investing at the lowest possible risk. I suggest the lowest return is to buy a mortgage-backed security sold by one of the large financial institutions. These are securitized pools of mortgages often guaranteed by the financial institutions. These products have had a bad run for the last few years because of the mortgage meltdown in the US.

Investors could purchase units in a mortgage mutual fund which, in most cases, is made up not only of mortgages but also bonds. These two methods are priced according to the principal of mark to market and therefore the value of the pool increases and decreases with interest rates in the marketplace.

An investor could also invest in a mortgage investment corporation generally known in the industry as a MIC, which is a flow through corporation specifically organized to invest in Canadian mortgages. A MIC is normally priced based on cost accounting. Therefore, the value of the mortgages is based on the cost or the balance outstanding and is only adjusted if for some reason the mortgage needs to be written down not because interest rates have moved in the marketplace as one would adjust a typical bond portfolio.

**These are pools that are normally smaller and more regional than MBS or Mortgage Mutual Funds but on average have historically outperformed either investment by a few percentage points.**

One could also invest in mortgages directly by finding a mortgage broker who will connect you and your capital directly with a borrower. This, in most cases, will provide you with the highest return of all three models but the risks are much higher for the individual. You will be your own administrator and you will normally be restricted to smaller mortgages, often second or third mortgages because of the size of your investment funds. When you are part of a pool, then a professional looks after the day-to-day management of the mortgages. And, most often, your capital is spread across hundreds of mortgages rather than a few normally found in a typical private mortgage pool.

**Why would mortgages play a role in a well balanced investment portfolio?**

A mortgage or a pool of mortgages is a loan secured by real property. It provides consistent and long term cash flow with little fluctuation of value of the capital. If the fund is managed well, then it should represent investing in something that has a primary objective of capital preservation with consistent and sustainable cash flow. It would be the position of a good manager that a well diversified portfolio could hold anything from 10% to 25% in mortgages or mortgage related products.

**How would one start investing in mortgages?**

Ask your advisor to get you some information on reputable mortgage pools and find out if he or she has any experience in the area of investing in mortgages. Be sure to read something about mortgages and search out Mortgage Investment Corporation on the net. Make sure that whoever you decide to deal with is registered with the appropriate authorities. In Ontario, that would be the Financial Services Commission of Ontario. They should also be registered under the Mortgage Brokers and Administrators Act. If they are managing a pool of mortgages such as a MIC, ask the company if they are registered with the Ontario Securities Commission as portfolio managers or investment fund managers. Also, ask the business for financial statements and whether or not they use leveraging in their operations. Leveraging exponentially increases risk.

## **Why is the Canadian mortgage business different from that of the US?**

Firstly, mortgage interest in the US is tax deductible and that is not the case in Canada. Secondly, Americans on average are more risk tolerant than Canadians and therefore underwrite mortgage deals more liberally than we do. Over the last 20 years many US firms designed, packaged and sold to consumers and institutions some innovative at best, and bizarre at worst, mortgage investments. Derivatives upon derivatives, so when the housing market cooled in the US, there was an almost full collapse of the mortgage business. This did bring down some of the world's largest financial institutions. The Canadian marketplace has definitely cooled off but has remained relatively robust over the last two years. It now appears that the worst for this recession is probably over.

Canadians will continue to build, refinance and renovate their homes. Business people will continue to expand their physical property and therefore they will continue to borrow money and provide their real estate as security. Mortgage investing allows a normal individual to participate in that sector of the economy and to enjoy some of the rewards of security and cash flow. It is one of the most basic investment vehicles in Canada and should be seriously considered for some portion of every portfolio.

*If you have any questions about this article or on other matters relating to mortgage investing please contact us at [info@RobinsonsGroup.com](mailto:info@RobinsonsGroup.com).*