Understanding mortgage funds

Client Fact Sheet

July 2012

Mortgage funds offer an alternative to traditional cash and fixed interest investments for investors seeking limited capital volatility and stable income. Primarily, the attraction of a mortgage fund is a relatively steady and reliable income stream.

Mortgage funds generally invest in first mortgages secured by direct property (eg commercial, retail, industrial or residential) - similar to borrowing money from the bank to buy your home. The lender (bank) assesses your suitability as a borrower (and your capacity to service and repay the loan) and the proportion (loan to valuation ratio) it is prepared to advance against your property, based on its assessment of the property's value.

In the case of a mortgage fund, however, a unit trust structure is used, with the mortgage manager receiving the funds from the 'lenders' (investors who are issued units in return) and investing those funds in return for a management fee. The manager applies investment and lending guidelines set out for the fund to its decisions (eg whether to invest in all or selected property sectors, borrowing levels for particular assets/borrowers, etc.). Investors can benefit from achieving, with a relatively smaller outlay of funds, a greater spread of underlying assets in different categories, and professional management, compared to investing in a single property.

Risks of investing in mortgage funds

Some of the risks to be considered when investing in mortgage funds include:

- **Liquidity:** Because cash (deposit) rates are normally lower than mortgage (lending) rates, fund managers may keep a fairly low level of cash within the fund - sufficient to meet expected distribution and redemption requirements. Unexpected or higher than usual withdrawal demands may result in the manager delaying or suspending redemptions.
- **Valuations:** Mortgage fund managers generally obtain property valuations from independent valuers. Valuation methods do, of course, vary depending upon the market perception, underlying assumptions, and formulae chosen (eg cashflow analysis, comparable sales, etc). A property which may well achieve its original estimated value if sold in an unhurried manner, may realise significantly less in a 'firesale' situation. Realisation of a property at less than its security value (plus costs of liquidation) could lead to a loss of capital to the fund and its investors.
- **Capital stability:** Although most mortgage fund values are quoted on a one-dollar-per-unit basis, investors should understand that this does not represent a guarantee of capital. Where borrowers are meeting their repayment obligations, there may be little need to revisit property valuations, despite underlying market fluctuations. However, if borrowers are in default - or wish to renegotiate for a further term - the property value again becomes highly visible. Significant defaults within a mortgage fund would have the potential to negatively impact the fund's capital values, which may then result in a fall in the unit price.
- **No capital growth:** The return from a mortgage fund is primarily in the form of interest repayments from the borrowers, less manager and administration costs. Capital appreciation on the underlying investments accrues to the benefit of the borrowers, not investors in the mortgage fund, who would simply be entitled to return of capital plus costs in the event of a forced sale (the 'profit' belonging to the borrower). Conversely, investors in the mortgage fund bear the risk of capital loss if the property fails to realise its security value – see Valuations above.
- **Risk of interest rate lag:** When general cash rates rise, investors in mortgage funds should understand that such increases may take some time to be reflected in their income distributions. This may occur where the fund holds fixed rate mortgages, or because of a legal liability on the part of the mortgage manager to give appropriate notice to borrowers of the intended interest rate increase.
- **Increasing mortgage fund inflows:** Mortgage funds have experienced significant net fund inflows, due in large part to short-term turbulence in equity markets. A rapid and significant increase in investment flows could have the following potential effects:
  - dilution of returns – the more cash held within a fund, the lower the expected return to investors (due to the differential between cash deposit and lending interest rates);
  - deterioration in mortgage quality (due to a lowering of lending standards in order to place funds); or
  - pressure on mortgage managers to alter investment style or asset selection in order to invest excess cash holdings.

Need more information?

If there's anything else you need to know, please call your financial adviser, or our dedicated Customer Service team on 13 11 55 and ask for 'Super' between 8am and 6pm (Eastern Standard Time) Monday to Friday. We'll be happy to help.

Important note

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