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Ethics:

Paying Referral Fees

By Peggy Cabaniss

Last year, NAPFA's Board of Directors approved a revised version of the Code of Ethics and reaffirmed the organization's commitment to a high standard of ethics for our members and all financial advisors. We also committed NAPFA to taking a leadership role in educating its members, as well as the public, on the importance of ethical behavior by financial advisors. Part of that education consists of presenting ethical issues to our members through our publications several times a year. This is our first Ethics column, and it covers Referral Fees, a recent topic of enthusiastic discussion on NAPFA's online Discussion Forum.

To review for a moment, NAPFA's

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Should You Add Individual Mortgages to Your Clients' Investment Portfolio?

By Edward Brown, CEO, Equity Bancorp, Inc.

Investing in mortgages should not be looked at with trepidation. They can be profitable and safe cash flow investments, similar to corporate bonds, government notes, or money market funds. If you choose your investment intelligently, individual short-term mortgages (which I define as first deeds of trust on real estate with 65% loan-to-value (LTV) ratios, maturing in 3 years) are a bit more risky than money market accounts or US Treasury bills, but they offer yields at the level of corporate bonds, or even higher.

How can I come to that conclusion? I define risk in terms of loss of principal, taking into consideration opportunity costs if interest rates rise. Generally, individual mortgages do not trade in the open market; thus, the principal is not subject to market fluctuations, as compared to US Government Treasury Notes, Treasury Bills, or corporate bonds. In addition, mortgages that have a 65% LTV enjoy some protection if the underlying property declines in value. Government Notes and Bonds have no collateral behind them, although they are backed by the "full faith and credit"

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of the US government. Corporate bonds usually have no specific collateral and are based upon the full faith and credit of the issuer.

The grid on this page shows the comparative advantage of mortgage investments over alternative income-producing investments.

For purposes of this article, we have defined the following:

• Gov't T-Bills – 1 yr obligations guaranteed by the US Government

• Gov't T-Notes – 5-10 yr obligations guaranteed by the US Government

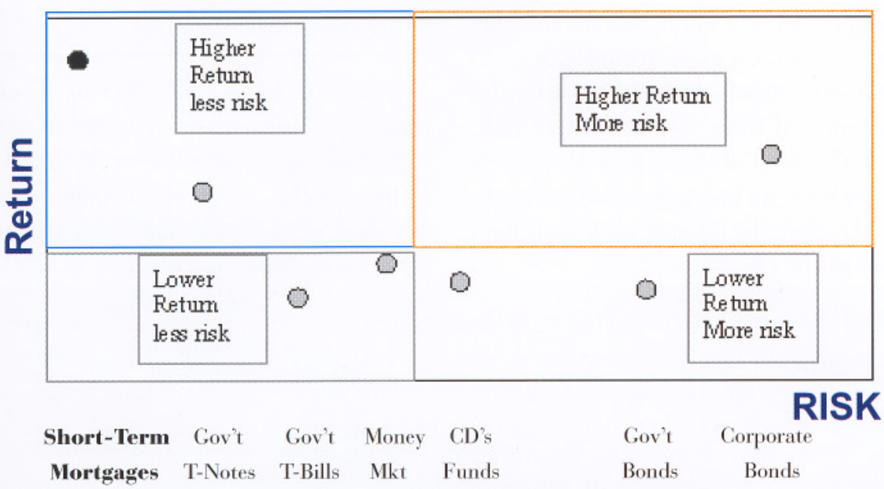
• Gov't T-Bonds – 15-30 yr obligations guaranteed by the US Government

• CDs – 1 yr FDIC insured

• Money Market Funds – liquid mutual funds maintaining a $1 share price

• Corporate Bonds – 15-30 yr obligations guaranteed by a US corporation rated AA

• Mortgage Investments – 1st deeds of trust on real estate with 65% LTV, maturing in 3 years.



While the risks might be lower, it is important to acknowledge that the risks in direct mortgage investments are different than those that advisors might be more familiar with, and more due diligence is required. First of all, unlike CDs or US government obligations, mortgage investments are not FDIC-insured and have no government guarantee. Do not confuse these types of mortgage investments with GNMAs, the pooled investments created by the quasi-governmental mortgage company Ginnie Mae and sold to the public. GNMAs are mortgage-type investments and have a quasi-government backing. By contrast, the mortgages used in the above examples are individual mortgages; thus, the principal is fixed and does not fluctuate unlike GNMAs, which return a portion of principal with each interest payment and trade in the open market and are subjected to market volatility. The mortgage investment's backing is primarily going to be the underlying real estate on which the mortgage is recorded (specific versus blind pool), and almost all short-term mortgages will pay interest only, thus keeping the principal intact.

However, all income-producing investments carry some risk – and this fact is often misunderstood, even by sophisticated financial advisors. For example, money market funds generally are only backed by the mutual fund's integrity to honor the $1 share price because all it is are holding are short-term obligations, both government and corporate. In the early 1990s, when many corporate bonds went sour, investors suddenly learned that their $1 share price was not guaranteed; they could actually lose principal. The mutual fund families that sponsored the money market funds paid out of pocket to subsidize the share prices, thereby preserving the sacred cow.

Corporate bonds carry the risk of the strength and integrity of the corporation that issued the bonds. Independent rating services such as Standard and Poors and Moody's have been shown to misjudge the security of many corporate bonds – whether through conflicts-of-interest or simple mistakes. Even without misjudgments, the price of a corporate bond fluctuates based on the performance of the company, its industry, and the economy overall. In addition, as interest rates rise, the value of the bonds decrease.

The risks that a mortgage investor faces primarily involve the borrower and the underlying real estate. An investor may choose to work with a borrower with less than perfect credit if there is sufficient equity in the property that it is worth the risk. Alternatively, a property may be marginal, but the borrower has excellent credit. These are the main factors determining the interest rate that an investor can expect on his mortgage investment.

There is another factor that has been prevalent in recent years; competition from conventional banks. During the savings and loan scandals in the early 1990s, most banks were apprehensive about lending money to weaker borrowers for fear of government scrutiny of loans that did not fit exactly in "the box." At that time, mortgage investors fared well, achieving higher than normal yields for the same risk.

However, when interest rates declined some years later and money was abundant, banks loosened their guidelines and competition for loans became fierce. Then money became even more readily available when the stock market corrected, as investors parked their money in safe havens like banks. Banks were suddenly willing to go as high as 80% LTV in order to land the deal. Many banks also lowered the points charged to borrowers and covered many other costs ordinarily borne by borrowers.

During this time (years 2001-2003), individual mortgage investors had a difficult time finding loans to invest in that would give them an acceptable yield. They either had to sit on the sidelines with their money (in liquid accounts

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yielding a paltry 1% or less), or they had to take on potentially more risky loans. In 2003, the stock market started to rebound, and some investors shifted back into the stock market to try to recoup the gains lost during the downward spiral after 9/11. Others, still remembering the pain of losses in the stock market, moved money toward higher-yielding income investments, some short term, some long term. These investors will face a different type of risk: opportunity risk.

Holders of long-term government or corporate debt do not encounter the risk of failure as much as the opportunity cost during rising interest rates. As interest rates rise (as we are slowly starting to see now), the investor is caught holding investments that are losing principal, albeit temporarily. Sure, these investors can hold on to lower-return investments until maturity, but the price they pay in the lack of opportunity to participate in higher-yielding instruments usually outweighs the wait. Of course, in times of declining interest rates, one would be better served to be in the longest-term bond possible and to sell just as interest rates begin to rise. The question then becomes one of using a crystal ball in which way interest rates are headed.

One solution for the risk-averse investor is to look to short-term mortgage investments (no more than 5-year maturities) for relatively high current monthly income (approximately 8% as of this writing). The shorter maturities guarantee the investor will not get caught holding low-interest investments if interest rates rise as the mortgages mature and new ones replace the old ones at whatever are then-prevailing rates. In addition, if loans are 65% LTV or less, then the value of the underlying property could decline by one-third, and the investor's mortgage is still covered. The investor needs to examine the underlying real estate and ask himself if he would be willing to own it for the mortgage he is considering. For example, if the property appraised for $100,000, would the investor be willing to own it for $65,000 (his investment in the mortgage)?

Where do investors (and their advisors) find these short-term real estate mortgages? There are lenders called "hard money real estate lenders" who provide private financing to borrowers who may not be able to obtain conventional loans for a variety of reasons. One main reason is there are instances when banks cannot work fast enough to provide the needed loan for the borrower. These borrowers are then forced to obtain alternative financing (at usually higher rates than a typical bank would charge). Some mortgage brokers may have leads to these private lenders. These lenders may allow investors to participate with them in funding a loan to a borrower. The reason the lender may allow participants is that the lender keeps the points charged to the borrower. In addition, the lender might earn a spread on what it charges the borrower and what it pays the investor.

Advisors should deal with lenders who have some of their own money at risk, record the deed of trust, and do not service the loan; an independent third party should collect the interest each month on behalf of the client.

Although short-term mortgages are not the "end all" investment, they can have a place in portfolios of investors looking to provide high yields for relatively low risk. Preservation of principal is a key role for many clients, and advisors would be smart to consider short-term mortgages for their clients.

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A few notes about investing in first mortgages

Three NAPFA members with extensive experience in mortgage investments offered a few observations and cautions to financial advisors who are interested in pursuing first mortgage investments for their clients. We thank Chuck Cencibaugh, Richard Crum, and Michael Joyce for providing these ideas:

·Know your state. Different states have different laws about lending and titling. For example, some states prohibit equity loans. Others restrict the fees or the annual interest rate you can charge.

·A clean title is critical. Don't just rely on the borrower's assertion. The title assures your investors that they are in the position they want to be, especially because they have no control over the debt that is incurred at a later time by the borrower.

·Do not rely solely on an appraisal. Do your own homework on the property; it's easier to do than you might think.

·Liquidity risk. Do a reality check on the property: Can you really re-sell it if the borrower walks away?

·Never, ever buy a mortgage in which the borrower has a high LTV ratio. In those situations, you are making the dangerous assumption that you are loaning to a "good borrower." Don't do it. One should only lend against the equity value of a given property. This is your only security. The 65% maximum LTV suggested in the article by Ed Brown is appropriate, though usually you should seek to be closer to 50% to 60%, or less.

·Having investing partners in any deal raises complexity.

·Adjustable rates. You can do adjustable rates on many loans, especially longer-term ones. This can help you avoid "negative convexity," the situation in which you are receiving less in interest than borrowing will cost you.