About Mortgage Trusts

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A mortgage mutual fund trust ("**mortgage trust**") is a diversified pool of mortgages that consists of conventional mortgages that are secured by residential, industrial, and commercial properties. In the case of the Tri City Group Monthly Income Mortgage Trust ("**TCGMIMT**"), the vast majority of the properties are residential. The objective of mortgage trusts is typically to provide greater yields than investment grade bonds, while maintaining predictability of returns and preservation of capital.

Depending on the asset mix, mortgage trusts can sometimes offer lower-risk/volatility and more stabilized returns than many equity funds. They provide a means to participate in real estate markets without directly investing in property, while providing the safety of a registered charge in front of the owners' equity position. This concept is known as loan-to-value. We favor this form of income over equities because, once the mortgage is registered in the name of the mortgage trust, it becomes a debt registered by the Province on the specific title of the investment. This is distinctly different than equities in so far as one is never quite sure what the underlying assets of a company are and what the value would be in a volatile market. Also, common stockholders are the last to receive value if a company is liquidated, being preceded by mortgage holders first, and then bondholders, followed by preferred shareholders. In effect, a mortgage trust, such as TCGMIMT, takes positions on title (when doing 1st mortgages) much like banks and credit unions do.

Benefits of a mortgage trust

In short, the benefits of investing in mortgages are that the holders of the mortgage are secured by the land and buildings and are in a position where the mortgage holders are paid in order of their charge. Failure to do so by the owner starts a process of foreclosure whereby the court orders that the property be put up for sale and sold by the court to the highest bidder. The ranking of the mortgage, commonly referred to as first, second or third, dictates who gets paid the proceeds of the sale first. Thus the equity in the property, which is referred to as loan-to-value, becomes a key factor as to whether all mortgage holders get paid. As long as loan-to-value protects the value of the mortgage, the lenders usually get paid their interest and principal.

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One other benefit to keep in mind about mortgage lending is that the laws of foreclosure in Canada are very well defined and there is an established procedure for a lender to recover its debt.

It has not been uncommon for private individuals to lend their money on mortgages. While there are pluses and minuses to all investing plans, here are some of the advantages of investing with others in a mortgage trust or a Mortgage Investment Corporation, commonly referred to as a MIC. By pooling funds, individuals can invest in a diversified portfolio of mortgages managed by experienced underwriters and mortgage professionals who understand this business inside and out. In contrast, when people act on their own behalf as private mortgage lenders, they are exposed to both regulatory complications and the considerable infrastructure it takes to engage in the business. In addition, there are substantial capital requirements which most individuals do not have. Most individual investors are not able to invest in a large enough number of mortgages to benefit from diversification, and therefore have greater risk. Furthermore, with first mortgage amounts in Vancouver climbing, on average, towards a million dollars, most people do not have enough money to even fund one first mortgage, let alone a diversified portfolio of mortgages. In effect, by pooling funds, small investors are given an opportunity to invest in higher yielding investments, such as mortgages, than they would normally have access to.

The other reason why it makes sense to be in a pool of mortgages is the ability of the manager of the pool to create a flow of mortgages to look at and pick from. At Tri City, we looked at 750 mortgage proposals on average in order to fund one in ten mortgage opportunities. Mortgage brokers do not want to be bothered calling a number of one off investors attempting to get a mortgage funded, when they can call a mortgage pool which generally has funds available.

RRSP eligibility and tax treatment

Our mortgage trust is 100% RRSP-, RRIF-, LIRA-, RESP- and TFSA-eligible. Outside of a registered fund, distributions are received as interest income for tax purposes.

Comparison of real estate investment trusts (REITs), mortgage investment corporations (MICs) and mortgage trusts

Most REITs are publicly-traded shares of a company whose primary business is buying, owning, and managing groups of income-producing properties, such as apartment buildings, hotels and shopping malls. Income received in the form of rent or leases is distributed to investors. In effect, an investor is placing himself in the position of the owner, as opposed to the debtor. In terms of investing, this is a much riskier position than holding the mortgage because the first loss is to the investor in the REIT. There is no longer the protection of the equity in front of the debt held by the investors in the mortgage trust.

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Mortgage trusts have what we believe is one major advantage over MIC's. In the event of a downturn, mortgage trusts can hold real estate whereas MICs cannot. Unlike stock investors, mortgage trusts can (in certain circumstances) seize the underlying asset, i.e. the real estate. At that point, they can choose to rent it, hold it or sell it. In a 1930s type depression, this could be a major advantage in preserving and even profiting on the mortgage investments made by the trust. This one feature strongly distinguishes investing in a mortgage trust over a stock portfolio.

In addition, Mortgage Investment Corporations are similar to mortgage trusts, but have additional restrictions with respect to the types of mortgages MICs can invest in. At least 50% of the assets of a MIC must be invested in residential mortgages. While a mortgage trust focuses on residential mortgages, there may be points in the market whereby the trust manager feels it is better to invest in another asset class. In the market place, it is harder to finance other asset classes generally and thus, at certain times it may be advantageous to the trust and the investors to pick mortgages securing other types of buildings.

Consideration before investing in a mortgage trust

Before investing in a mortgage trust, the following trust information should be reviewed and evaluated:

- What is the maximum loan-to-value ratio on any one property?
- What is the maximum percentage or dollar value that can be invested in any one mortgage?
- What are the lending guidelines for commercial and industrial mortgages?
- Where are the mortgages located?
- Do the managers have their own equity in the fund?
- How experienced are the managers in identifying mortgages?

These details are published in a trust's Offering Memorandum.

The risks of mortgage trusts

The main risks associated with mortgage trusts are credit and interest rate risks. Credit refers to the borrowers' ability to pay and can change with borrower circumstances. Fluctuating interest rates can affect how borrowers repay or refinance their loan. Trusts that carry mortgages with shorter terms are less affected by interest rate risk. The loan-to-value ratio of a mortgage when advanced by a lender is also a significant factor in the risk profile of a particular mortgage.

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The yield of a mortgage trust also depends in part on the trust manager finding quality mortgages that meet the trust's investment and risk criteria. An experienced lender, with an excellent track record and established relationships with brokers and developers, would be in a better position to originate these mortgages than a less experienced lender. Trusts with the managers' money in them may cause those analyzing the loan requests to be more cautious about funding than those managers who only manage other people's money.

Finally, investments in mortgages are affected by general economic conditions and local real estate markets. Different classifications of mortgages are affected differently. Residential mortgages are generally considered the safest of the property classes. Commercial and large development mortgages generally are higher risk and, therefore, garner higher fees and interest rates. Such factors as demand for leased space, fluctuations in occupancy rates, time delays and operating expenses can all be huge factors with respect to many commercial mortgages.

Mortgages are relatively non-liquid investments as compared to stocks, mutual funds, and some GICs. However, a trust that invests in short-term mortgages provides the trust manager more flexibility to respond to market conditions and provide liquidity. Another advantage of a mortgage trust investing in short-term mortgages is that it offers a better opportunity to repatriate investors' money than those with longer term loans. In effect, mortgage trust units are more akin to a bond or an investment certificate, which are cashable but only with a penalty in the near term. A mortgage trust that is functioning in normal times and invests in short-term mortgages should have the capital available to pay out investors who want to use their money elsewhere for a variety of reasons. As with many GIC's, early withdrawal penalties apply with many trusts and MICs.

Summary

This brief explanation of some types of investment vehicles is by no means an exhaustive analysis of where one can invest. The mortgage field, trusts, MICs or other forms of alternative investments are all complex and cannot be explained in full in a few short pages. This explanation is meant to be a very simple overview of why a person might want to consider investing in a mortgage trust, a MIC or a REIT.

This document is for general information purposes only. Prior to making any decisions about where to invest, individuals should do their own investigation and should always consult an investment advisor.

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