

When return on investment seems too high – beware

By Don Martin

Many people think buying bonds will serve as protection from a stock crash. To get a better yield and enhance the returns further, they buy risky junk bonds, which pay about 3.5 percent more than U.S. Treasury bonds.

Some investors consider buying “B” second mortgage notes, which may yield up to 12 percent, 7 percent more than

Treasuries. Since interest rates range from 0.75 percent over Treasuries for “A” paper companies to 3.5 percent for junk bonds issued by “B” paper companies, it seems suspicious that second mortgages offer a yield of 12 percent to investors.

Why doesn't competition force rates down to the level of junk bonds, so that “B” paper mortgages would be about 7.75 percent? The reason is that the

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private party second mortgages are simply too risky. It is similar to the situation when bonds issued by a South American country paid 23 percent interest

– then the nation defaulted and bondholders were paid off at 38 percent of face value, losing 62 percent of the principal.

Whenever a borrower pays an absurdly high rate of interest, the “invisible hand” of the economy is telling you that the risk is very high. There is no way to be properly compensated for taking on these risks.

In recent years banks have lent money to applicants with

only one month's work experience, instead of the 24 months usually required. Banks have lent mortgages with no income verification and no down payment.

My point is that lending today is riskier than in previous cycles so when you are offered a 12 percent return on a second mortgage, it is probably a zero down payment, no income verification type of loan.

When a borrower goes into foreclosure, the note holder can't get a deficiency judgment if it was a purchase transaction loan. The note holder now becomes the owner and if it was a no down payment transaction, the note holder will lose money selling a foreclosed property.

If a second mortgage at 100 percent Loan-to-Value (LTV) was foreclosed on, often the entire loan becomes worthless because it is too expensive to foreclose and resell the property, and the first mortgage holder has the right to get paid in full before any money goes to the second mortgage holder. A bank loses money in a foreclosure unless there is a 23 percent down payment (a maximum 77 percent LTV). That implies a second mortgage, lent for 100 percent of the value of a house that already has an 80 percent mortgage, would become worthless if the borrower decided to go into foreclosure.



Typically every decade there is a real estate crash, which causes homes to drop 20 percent to 30 percent, wiping out the value of a high LTV second mortgage. And who borrows those type of loans? People with shaky jobs, bad credit, no emergency savings, no 401(k), no nothing tend to borrow them. So when they lose their jobs, they lose the houses that they bought for zero down. One banker sarcastically called such mortgages a "put option" on real estate.

If you buy just one note instead of a large pool of notes, you have introduced an additional problem because you have no diversification, which makes the risk of losing your entire investment even greater.

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