INVESTING IN MORTGAGE NOTES

ANB FUNDS

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Why should I consider investing in mortgage notes?

Simply stated, investing in mortgage notes can be a great way for investors to create passive, long term income secured by real estate without the hassles of being a landlord. Financial planners stress that diversified investment portfolios provide the best returns given the risk associated with the investments. Stocks can be volatile, and their performance is based on many external factors like the economies strength, political conflicts, conditions of specific industries, recessions, wars and pandemics!

Overall, real estate values are consistent and generally increase over time. Real estate investments have underlying value based on the building and land. Landlords and other people investing directly in real estate deal with what many call the three "T's" — tenants, toilets, and turnover. Investing in mortgage notes lets you have the same security in the property without the hassles of ownership. When was the last time you called your bank to fix your toilet? Besides, if a property's value decreases slightly the mortgage amount is unchanged. The investor still collects the same monthly payment.

Should I invest in a mortgage debt fund or individual notes?

This depends on your personal preferences and goals. If you're looking for a totally passive investment, then a fund is your best vehicle. Buying individual notes can provide higher yields, but they also require that the investor be more involved. Occasionally borrower's fall behind on their payments or a loan needs to be restructured or foreclosed upon. If you own a single note you will need to work with the loan servicer or local counsel to correct the situation. If you invest in a fund, then the fund manager will be responsible for those activities.

There is also the issue of diversity. Investing in a fund means that your return is generated by a pool of loans rather than a single note. If one borrower falls behind on their payments the other properties in the fund will continue to generate income. This makes your return more secure. You have to decide if the increase in yield you get investing in a single mortgage is worth the risk or hassles associated with that type of investment.

Many landlords are burned out and are turning to notes

The COVID pandemic was brutal for many segments of the economy, especially landlords. Property owners were forced to delay rent collection, and evictions were prohibited. Monthly rent checks stopped coming in, but landlords still had to pay their taxes and insurance, keep their properties in good condition and make monthly mortgage payments.

Even before the pandemic hit, many landlords were growing weary of the three "T's" — tenants, toilets and turnover. Based on pre-pandemic statistics provided by iPropertyManagement, 10% of renters were already delinquent on their rents, and one in eight landlords were having to change the lightbulbs in their units. On average it costs approximately $10,000 to evict a tenant. Adding to the list of hassles for landlords, many cities like New York, Washington DC, San Francisco, Oakland, and Portland are rent controlled and restrict evictions. Many more cities are considering rent controls, and some states (like Oregon) are working on measures to control rents in their entire state.

It's no wonder many landlords are getting burned out. Investing in notes is a good alternative.

Some of those who know about note investing are attracted by the benefits, but are afraid of two myths:

Myth #1: Defaults are common, and if the borrower defaults the foreclosure and eviction process is terrible, and you might end up with a house that's been trashed.

Myth #2: Private notes are for borrowers with bad credit, so note lenders are acting as the "lender of last resort" to people who can't otherwise get financing.

Let's talk about each myth.

Myth #1: Defaults Are Common

You might not realize this, but less than 11% of first lien mortgages defaulted during the Great Recession of 2007-2008. This surprising fact has led many people to ask a great question: "How could the Great Recession have been caused by defaults if only 11% of mortgage holders defaulted?"

The truth is that over 45% of the subprime loans were made to unqualified buyers, so these ill-fated loans never should have never been made in the first place. That's what caused the recession.

Here's a surprising fact. According to the Federal Reserve Economic Data, the National Default rate is only 2.39% for the year 2020 (which is their most current data and the year of the pandemic). While default rates are expected to rise due to the pandemic, solid underwriting with thorough credit checks will weed out unqualified borrowers.

Unlike traditional banks and mortgage companies, a private mortgage holder has the flexibility to modify a note to each party's benefit and avoid default. As part of our underwriting, we compare local rents to the borrower's mortgage payment, their financial loss if they default, and the emotional equity they have in a home. The loss of their home would be catastrophic, and they will do everything possible to stay current on their loan and in the house. Most borrowers don't want to trash their homes even if they have to leave. This gives you, the lender, more assurance that they will make their payments.

Here's one more important factor. According to the American Mortgage Bankers Association, 80% of defaults happen in the first two years of most mortgages' terms.

That's why it's smart to invest in funds that buy first lien mortgages and what are called "seasoned" loans; meaning that the borrowers have been paying for at least two years and are beyond the critical default period. While past payment history doesn't guarantee absolute certainty of future performance, it does offer assurance that the borrower is extremely likely to continue making their payments.

Very few investments (such as stocks, precious metals, or cryptocurrency) will guarantee returns. And while investing in notes may have some losses on rare occasions, they are far less likely to occur from factors like oil shortages, etc. that can radically affect stock prices. Even if a home's value drops significantly, the mortgage amount and its payments remain unchanged. If the borrower can't make their payments, the note is still secured by the collateral of the property. If a foreclosure is necessary, the lender can work with local counsel and complete the process within six months or less in most cases. The result is that the investor can end up owning the property at a greatly reduced price than paying full retail.

Myth #2: Private Notes Are for Borrowers with Bad Credit

It's estimated that over $25BB of private long-term loans were originated in 2020. Many of those loans are for people who didn't qualify with traditional banks and mortgage companies, but it's not because they had bad credit.

Many people in the US work for companies and receive paychecks every two weeks or month. When loan underwriters consider someone for a loan, reliable income (verified by a W2) is the first thing they look for. But according to a recent Gallup poll, nearly 30% of Americans are self-employed. That raises eyebrows for underwriters, even though the borrower might have a very high income and great credit rating. While US citizens who are self-employed can get traditional loans, the requirements are much more rigorous than for W2 employees.

Another eyebrow raiser is that many of those who are self-employed aren't American citizens even though they're here legally and have green cards. They may even have an Individual Taxpayer Identification Number (or ITIN), but that doesn't qualify them for a mortgage from a traditional bank. That's because most banks sell the loans they originate to Fannie Mae or Freddie Mac. Those two agencies purchase most of the home loans originated by US lending institutions and they don't accept loans for noncitizens. This means that those who aren't American citizens can't qualify for institutional loans regardless of their employment status. These people hold jobs ranging from highly paid tech workers, plumbers, healthcare providers, freelance gig workers, delivery service people, etc. Most make decent incomes, but the vast majority get rejected by institutional lenders.

These two groups of "penalty box buyers" might have high incomes, great credit ratings, solid pay histories, and they're eager to borrow money; but they get a cold shoulder from traditional lenders.

We're Here to Answer All Your Questions

Most investors don't know much about notes or their benefits. Common myths and misconceptions about notes often prevent Investors from taking advantage of huge opportunities.

I put together this booklet to help potential investors make informed decisions and answer frequently asked questions. You'll find straight information that you need to know before taking your first step as a note investor. This booklet covers the benefits, as well as the pros and cons of different investment strategies for protecting and growing your assets as a note investor. It also covers the most common mistakes new investors make and how those mistakes can be avoided.

While this book is packed with valuable information about the most common issues you may be facing, it doesn't have every single answer to every single question for every single situation. That would be impossible because there's no single right answer for everyone's individual investment goals.

I hope you'll read this short booklet from cover to cover. Then if you still have questions that are not addressed, we'd love to chat with you personally and do our best to address your concerns. Please call us at **317-825-8417** or send us an email at **investors@anbfunds.com**.

We're here to help.

Question (?)

Answer (!)

ANB FUNDS

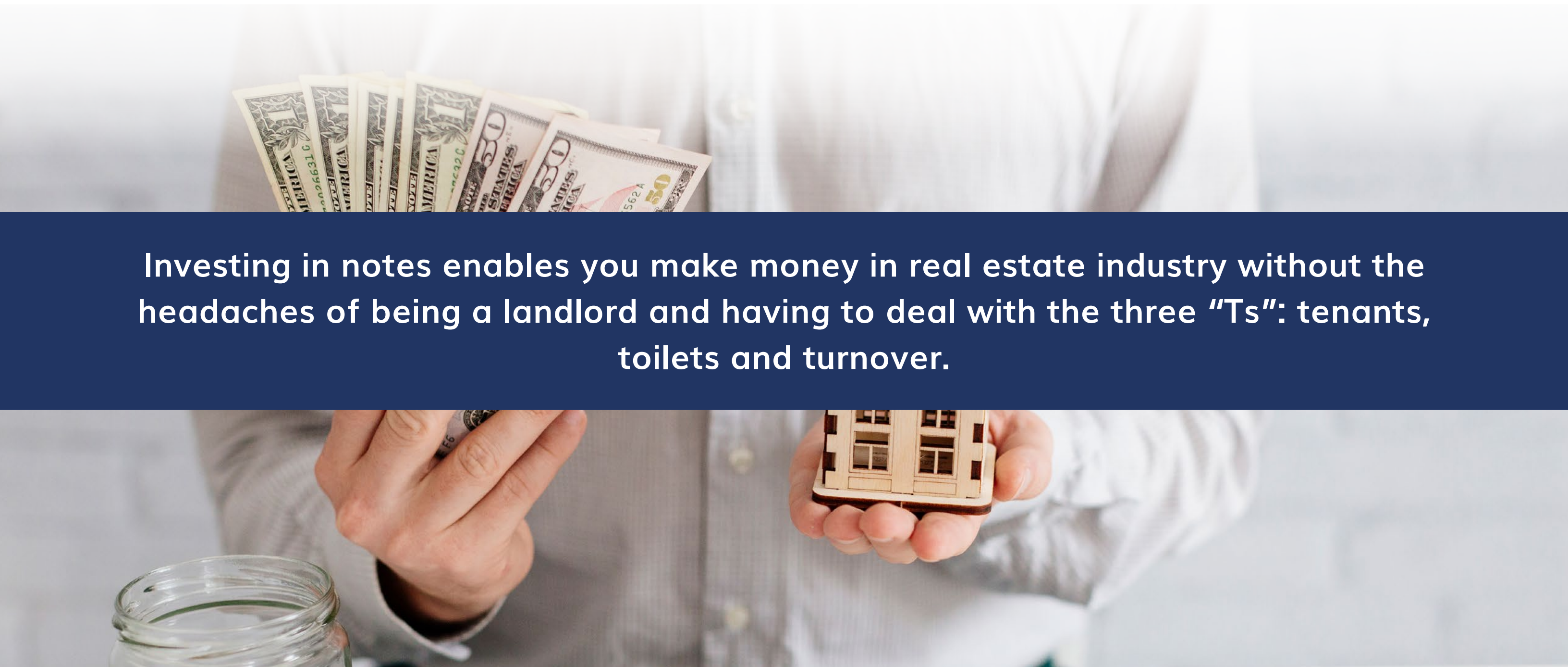
Frequently Asked Questions

Q: Why should I invest in mortgage notes?

As you drive around any neighborhood, about 62% of those homeowners have borrowed money to buy their home. That's a massive investment opportunity you can get in on! You can make passive income every month just like banks do.

Notes provide stable, consistent cash flow with money flowing into your mailbox every month. Plus, they have the huge advantage over other investment vehicles because notes are secured by the home itself as collateral. If the borrower defaults, you have the right to foreclose and take full ownership. As the new owner you can decide to rent the house or sell it to recover your investment. The fact that your investment amount is much less than the house's value provides you with a great margin of safety. Even if the house loses value, the mortgage amount and your cash flow remain the same. Can you say that about stocks?

Sometimes note investors create notes directly with the buyer, and sometimes they purchase existing notes. When we buy existing notes, we look for seasoned mortgage notes of at least two years with a solid pay history. We also look for notes with a favorable loan-to-value ratio, meaning a low loan amount compared to the home's value.



Investing in notes enables you make money in real estate industry without the headaches of being a landlord and having to deal with the three "Ts": tenants, toilets and turnover.

Q: How can private note investors possibly compete against big banks?

Many potential homeowners qualify for conventional mortgages, but huge numbers of buyers don't. Last year, over $25BB of private long-term loans were originated by private investors rather than by banks or traditional mortgage companies. Many of the borrowers are well qualified but couldn't get conventional loans because they aren't US citizens, or they're self-employed, or many other factors.

Private note investors fill the gaps left by big banks. There's a massive pool of "penalty box buyers" who are left behind and can't get a loan from traditional banks. But they have high incomes, solid credit ratings, and are often willing to pay higher interest rates than banks charge.

Q: Would I be investing in a fund or pool of notes?

There are funds that consist of multiple notes, but the vast majority are held by individuals or private companies. Starting a fund requires the creators to meet federal securities rules, have written investment guidelines, custodial agreements, and much more red tape. Our preference is for investors to invest in a fund which provides more diversity and less risk.

Q: What are the advantages of owning notes compared to other alternatives?

We live in volatile times. The economy hasn't fully recovered from being ravaged by the COVID pandemic. The nation is politically polarized. Outbreaks of violence in the Middle East can make oil prices spike and drastically affect the stock market. Fortunately, notes provide stable, consistent cash flow year in and year out, whereas most stocks and other investment vehicles do not. A note is also secured by the collateral of the home's value, which usually exceeds the amount of your investment. To provide added security, we only invest in "seasoned" mortgages, meaning that the borrowers have been making payments consistently for at least two years. Plus, your returns can be tax free if you invest using your self-directed IRA.

Q: How does investing in notes fit into the rest of my portfolio?

Financial advisors consistently counsel their clients to have diversified, balanced portfolios. If all your investments are in stocks and there's a crash, you're in big trouble. Investing in notes can be a great way to achieve diversity while getting consistent, incoming cash flow. Balance can be achieved by investing in notes from different regions of the country, and with notes that are structured to provide either short term or long-term income. Your income can also be tax free if invested using a self-directed Roth IRA.

One of the first things every investor must determine is your risk tolerance. This is usually a factor of one's age, income, and general inclination to take risks. You need to determine what your long-term financial goals are and then create a plan to meet those goals. Notes can provide high returns given their relatively low level of risk compared to stocks. They are also stable and consistent and can offset other higher risk investments.

Q: What is the difference between a mortgage and a mortgage note?

A mortgage is a loan that uses real estate as collateral. Most home buyers do not have enough money to buy a house with cash, so they need a loan to supplement their down payment. Mortgage lenders fund the purchase for approved borrowers who then repay the loan, with interest, over a period of 10 to 30 years. A mortgage attaches a lien against the property until the loan is repaid according to the terms laid out in the mortgage note.

Mortgage notes are not the same as a mortgage, though both secure a loan. When a borrower takes out a mortgage, the lender produces two documents: the mortgage (which is assigned to the homeowner) and the mortgage note (which can be sold to other investors). The mortgage note is also sometimes called a "promissory note." The mortgage note can be seen as a "promise to pay" and lays out the terms and conditions of the loan. The note itself has nothing to do with the property's ownership as the mortgage does. In addition to providing the terms for the loan (such as the interest rate, repayment period, etc.) the mortgage note also gives the lender the right to foreclose on the property if the borrower does not make his mortgage payments as agreed.

Q: What is the difference between a mortgage and a deed?

Many people use the term mortgage and deed interchangeably, but they are actually quite different. A deed (much like a car title) proves ownership of a property. It transfers a property from one owner to a new buyer. Anyone reading a deed will be able to determine who owns the property. Deeds are recorded in the county tax or assessor's office and are returned to the owner or the loan servicer after recording.

The mortgage is a document stating that a lender is holding the property as collateral until the note is paid in full. Anyone who signs the deed for a property must also sign the mortgage. However just because someone is on a mortgage doesn't mean they are responsible for repaying the loan. An example of this is where one spouse has a low credit score, but the other is acceptable. In that case a lender may require that both spouses sign the mortgage but only one will be held responsible for repayment.

Q: Are there different kinds of notes? Of deeds?

While there is only one kind of mortgage note, the form and terms can differ drastically. They range from multi-page documents that are heavily regulated and used by institutional lenders, to one-page printouts that can be found online. In all cases they describe the terms of a loan. They can be secured or unsecured. They should describe the priority of the lien position, 1st, 2nd, 3rd, etc. Notes originated by institutions that intend to sell the loan to Fannie Mae or Freddie Mac must use the forms of notes dictated by those institutions. Private notes aren't required to follow those rigid guidelines but must be written in accordance with the regulations established by the Consumer Finance Protection Board and the Dodd Frank Act.

The various types of commonly used deeds are: Quit Claim, Warranty, Grant, Deed of Trust, Bargain and Sale, and Mortgage Deed.

- **Quit Claim Deeds:** These are used to transfer property between familiar parties or where the seller makes no warranties regarding any liens, or encumbrances that might affect a property's value.
- **Warranty Deeds:** Warranty deeds offer several levels of protection and come in two categories:
  - ***General Warranty Deeds*** guarantee that the seller has the right to sell the property, and that it is free and clear of debts, liens, or other encumbrances.
  - ***Special Warranty Deeds*** protect buyers against issues or claims that might have arisen during the time the seller owned the property.
- **Grant Deeds:** These offer a property at a specific price but don't provide buyers any protection against title defects, incorrect signatures or other problems.
- **Bargain and Sale Deeds:** These offer no guarantee that the property is free of debts or liens. They only state that the grantor is the titleholder.
- **Mortgage Deed:** This type of deed is signed by a buyer and lender and allows them to put a lien on the property if the loan isn't repaid. It secures property as collateral for a loan.

Q: What is a “partial”?

Notes can be purchased as whole notes or partials. When an investor buys a whole note, they are buying all the remaining monthly payments until the note matures, and they are the sole owner of the note. Buying a partial means that they are buying the right to receive a portion of the payments but not the entire term. Partials have shorter terms than whole notes, are usually much lower risk, and have slightly lower yields. For example, if a note holder has a loan with a remaining term of 25 years, he may be willing to sell the first 10 years as a partial. The note would be assigned to the partial buyer for his investment period; and once that period is complete the seller receives all the payments from then on. The partial buyer would receive all his principal and interest over the 10-year term.

Q: Is it better to buy the entire note or a partial?

Whether you should buy whole notes or partials will be determined by your investment goals, the amount of capital you have to invest, and your desired maturity dates. You also need to determine if you want a totally passive investment (where someone else does all the work) or if you want to be active (where you source the loan, architect the terms, raise capital, etc.) Buying a whole note means that you will be somewhat active in its ownership and have a 1-to-25-year term. Partials usually have shorter terms and are more passive, so they offer less work on the part of the investor.

Q: What are the advantages of owning a partial vs a whole note?

One of the biggest advantages of owning a partial compared to a whole note is that when you own the partial your risk level is much lower than if you bought the entire loan. For example, if the full loan amount was $100,000 and you bought a partial on that loan for $25,000 your risk would essentially be 25% of loan's value. If the loan amount was perhaps 70% of the home's value when the loan was granted, then the home would have been worth $143,000 at the time of sale. That means that your actual risk level would only be 17.48% which is very low. If the borrower defaults the partial owner is also in the first position to be repaid. When structured correctly, partials can be extremely secure investments.

Q: I've heard of "hypothecations." What are they?

The Merriam Webster Dictionary states that hypothecation means "to pledge as security without delivery of title or possession." For note owners it means that you can use a note that you own as collateral to borrow more money. In most hypothecations a note holder wants to recoup some of their original investment and is willing to share the monthly payments with an investor for a lump sum. For example, let's say an investor owns ten performing notes and they all cash flow monthly. The balance on those notes might be $500,000. So, the note holder could hypothecate the notes and offer an investor half of the monthly payments in return for a $250,000 lump sum using the notes as collateral. In the case of default, the lender would assume the full payments for the notes until it was paid in full.

Q: What is a note that has a first position vs a second?

The lien priority of a note determines who gets paid first if a borrower defaults. For instance, if someone buys a $100,000 home and gets a $70,000 first lien mortgage and a $20,000 second lien, then he only has to make a $10,000 cash down payment. If he defaults on both loans and the house can only be sold for $80,000, the holder of the first lien will be paid the remaining balance of his lien and whatever is left will be given to the second lien holder. In this case the second lien holder wouldn't be repaid fully.

Q: What is a “performing” vs a “non-performing” loan?

Performing loans have borrowers with proven histories of making their monthly payments consistently every month. For the most part they are passive, long term investments offering high returns given the level of risk. Investors wanting more passive returns with little effort should select performing loans.

Non-performing loans have borrowers who have been making inconsistent, erratic, or no payments for a period of 90 days or more. Investors wanting to be more active and possibly have higher returns should choose non-performing loans. In many cases note holders won't receive payments for months and will need to foreclose on the property. Thus, they should determine if they have the time and are willing to manage those procedures.

Generally speaking, non-performing loans have three exit strategies. The first is to renegotiate the terms with the existing borrower and hope that he will make his future payments as agreed. The second is for the note holder to negotiate a deed in lieu of foreclosure with the borrower. A deed in lieu passes the home's ownership to the note holder and avoids the time and expense of foreclosure. The note holder will often have to pay the borrower several thousand dollars to agree to the transaction but it's much easier and less expensive than foreclosure. If the first two options don't work, the note holder can foreclose and assume ownership. At that point they can choose whether to sell or rent the property. The foreclosure will be administered according to the state's foreclosure guidelines where the house is located.

Q: What are “subprime” loans?

Subprime loans are typically made to borrower's who can't qualify for conventional loans. The borrower's credit scores are often low or there are other factors causing the lender concern regarding the borrower's ability to repay the debt. The fees and interest rate are usually higher than conventional loans and the interest rates adjust after several years. These loans are sometimes "interest only," meaning that none of the monthly payment is applied to the reduction of the principal loan amount. They also can last longer than 30-year terms which lowers the monthly payments but increases the overall interest paid by the borrower.

Q: What are “hard money” loans?

Hard money loans are usually provided by small companies or individuals to others as short-term bridge loans. They are based on a property's value and not the borrower's ability to repay. They are often used by borrower's known as “flippers” so they can purchase, renovate, and sell residential and commercial properties. Since the borrower's credit is not underwritten, and the loan to values are usually high, the fees and interest rates are higher than longer term loans. Hard money loans usually have terms less than 12 months and are therefore not subject to any lending regulations. The lender usually makes the lending decision himself based on his knowledge of the local market and previous business relationship with the borrower; therefore, the approval process can be much faster than with traditional lenders.

Q: How does making hard money loans differ from note investing?

While hard money lenders and note investors both use mortgages and notes to secure loans, the similarity stops there. Hard Money loans have short terms, whereas notes that are purchased by note buyers are much longer term. Hard money lenders are usually actively involved in the transactions. They must know and trust their borrowers as well as the contractors they hire. Hard money lenders need to understand local market trends, values, and construction costs while being able to determine if the projected renovation costs are accurate. Hard money lenders have two primary concerns:

- Can the borrower complete the renovations at the projected cost and time?
- If the borrower defaults, can the lender complete the project himself and recoup his potential losses?

Another factor is that they need a “feel” for general market conditions. Is it heating up? Stable? Cooling down? A borrower may be able to meet the criteria mentioned above but if the market is cooling the renovated property might not sell at the price needed to make a profit. In contrast, note investing can be completely passive, and has much lower risk.

Q: Where do notes come from?

Most notes are originated by sellers who are willing to provide financing when they sell a home. By personally financing the home they are selling to their buyer, they can structure the repayment terms in their favor, receive consistent cash flow, and defer paying taxes on the proceeds.

Another way notes are created is by mortgage companies who specialize in making loans to borrowers who can't qualify for conventional loans. The rates on those loans are usually higher but provide high quality financing to qualified buyers left behind by conventional banks.

Another source for notes is large investment companies who bought the notes at discounts after the last recession when they weren't performing. They worked with the borrower to restructure the notes and reinstate consistent payments or foreclosed on others.

Q: What are the most common reasons for creating a note?

Over the last 3 years , it's been estimated that over $25BB of new private notes were originated annually. Notes are created for many reasons, and here are some of the most common:

- Sometimes landlords want to continue receiving the monthly cash flow they got from a rental but no longer want the hassles of being a property owner. One solution is for them to sell the property and finance the note.
- Some landlords have tenants who have consistently paid their rent on time and taken good care of the property. They may want to help them establish their own credit and buy a house. Selling them the house and creating a note can be a good vehicle for that.
- Some home sellers want to make their property more appealing to a broader pool of buyers by offering seller financing as part of the deal.
- Sometimes the seller carries the financing as a favor to a family member or friend who can't get a traditional mortgage.
- Some home buyers convince the seller to finance the sale, which allows the buyer to pay the seller's asking price and creates favorable terms for the buyer.
- Many notes are created as a way to take equity out of a home without having to sell it.
- Some mortgage banking firms originate notes to serve the large portion of home buyers who can't get conventional financing because they might not be U.S. citizens, they're self-employed, or many other factors.

Q: Why would a seller want to be paid out over time instead of getting a one lump payment?

Many property owners like having the steady income provided by owning rental properties but don't want the headaches of being a landlord. Offering financing to potential buyers increases the chances that a property will quickly sell and ensures the seller of a consistent cash flow without the hassles of managing a rental. A seller might also want to defer paying the required capital gains taxes if all their gains are realized in the same tax year. By offering financing, their tax liability is deferred until the payments are received.

Q: Why don't some banks want to make home loans less than $100,000?

The simple truth is that it's not cost efficient. It costs a bank the same amount of money to originate a $60,000 mortgage as it does a million-dollar mortgage. There are standard costs for originating loans such as paying loan officers, getting a property appraised, closing costs etc. Although some banks will lend slightly less than $100,000, most of them won't. Thus, many of the loans that are less than $100,000 are created through seller financing.

Q: When is seller financing used?

Seller financing can be initiated by the buyer or seller and is very handy as a way to help deals go through so that both parties can get what they want.

When selling a home, seller financing is often used when a rental property is being sold and the seller wants to continue getting monthly payments. Another reason a new note might be created is when the loan size might be too small to meet a lender's minimum threshold and the seller wants to help the deal go through. Or perhaps the property itself is located outside a local lender's standard lending area. Also, the seller may prefer to defer the taxes on the sale while ensuring consistent long-term income. One more popular reason to use seller financing is so the lender (who is selling the house) can make future income on interest as well as income today from the purchase price.

When used in buying a property, seller financing is a way for both parties to get what they want on key aspects of the deal. It's also commonly used as a way to help buyers who have been left behind by traditional banks and mortgage companies. Buyers can be left behind for several reasons even though they are well qualified. As mentioned earlier, the borrower may not be a US citizen and therefore not able to qualify for a conventional loan. Sometimes buyers may not qualify because their credit score is a bit low, or they don't have enough cash for the required down payment.

Q: Can you give an example of how a seller financed note works?

Let's say a seller has someone that wants to buy their property but can't get bank financing. The seller might offer to sell them the home and carry the financing. So, the seller becomes the bank. And just like a bank loan, the buyer would make a down payment when the sale occurs and accept a loan for the remainder of the price from the seller. The buyer would then be obligated to make payments to the seller in accordance with the agreed upon terms until the loan was completely repaid or refinanced. The seller has the flexibility to structure the note using any terms that work for both parties. For example, the buyer may have recently started a new job and doesn't think she will earn enough to make the full payments plus living expenses. In that case the seller could agree to limit the loan payments to the interest only for several years until the buyer has higher earnings. Or, the seller could set a longer term for payoff which also lowers the monthly payments for the buyer. Language that lays out the default process would also be built into the agreement. Overall, there are about fifty tools in the seller financing toolbox. You'll never use all fifty on any one loan, but you probably will use a dozen or so on every loan. There many, many ways loans can be structured.

Q: What advantages does the borrower have with a seller financed loan?

Many borrowers are extremely grateful to get a seller financed loan; especially after they've been turned down for a home loan by their local bank. A common scenario is that a self-employed business owner may not show consistent income from month to month, therefore the bank would reject them in favor of someone with a nine-to-five job and steady paychecks with a W2. Another advantage for the borrower is that seller financing offers faster approval time, and far more flexibility than a bank to craft terms that are favorable to both parties.

Q: Who sells mortgage notes and why do they want to sell them?

When you buy existing mortgage notes, the seller will typically be either an individual or a large investment company. In both cases, the note seller has acted as the bank for a home buyer. Many individuals decide they want to sell a note before it matures. Perhaps they would like to use the money for another purpose like funding their child's education or making another investment. If an investment fund or mortgage company originated the notes, they may need to sell them to use the money for other purposes. Mortgage companies often have limits on the number of loans they can make in specific geographic areas and need to sell them to balance their portfolio and provide funds for making new loans elsewhere. Hedge funds often raise money that has maturity dates; for instance, pension funds might invest with them but need to be repaid within 10 years to meet the payments to their pensioners. Thus, the hedge fund has to sell the loans to repay their investors. The note holder can then sell the loan—which is where we come in. With many years of experience in the note industry we know which loans to buy and which to avoid. We buy loans nationwide and have the expertise to help you invest along with us.

Q: What are the typical yields, terms, and investment size of notes?

Note yields depend on the quality, type and size of the mortgage note you are purchasing. For example, if you are buying a non-performing loan you would expect to get higher returns due to the level of risk. Performing loans offer more moderate returns with lower risk. In addition to your monetary investment, you also have to consider how much time you want to invest.

Buying a portion of a note (known as a "partial") provides a shorter term and much lower risk. Partials usually range from 5 to 10 years, whereas most whole notes mature 10 to 25 years from the date of purchase. The "Investment to Value" (or ITV) which compares the amount invested to a home's value is usually very low. It's common to see partials that are only 20-30% of the home's value. This means that if the borrower were to default the home could be sold at a 70-80% discount and the investor would still recoup their entire investment.

The investment size usually depends on where the loan is located geographically. Homes in Midwestern states tend to be less expensive than the coasts, so the size of the notes are less. Investment amounts are usually in the $30,000 to $70,000 range. In other areas of the country where home prices are higher, loan balances increase proportionally. The current median price for a home in the San Francisco Bay area is $1.06 MM, which makes mortgages much larger.

As we have mentioned before, note yields vary wildly depending on the quality, type, and size of the mortgage. If you call us, we'll be glad to quote you a yield based on the type of note you'd like to invest in.

Q: How much do people usually invest in mortgage notes and how long do the investments last?

Most individual mortgage note investments range from $30,000 to $70,000 per note. Yields vary based on many factors, including the note's age, payment history, loan-to-value, and more. Investments in funds aren't directly related the individual loan amounts the minimum amounts usually range from a $30,000.00 minimum with no maximum. Most funds will increase investor's returns based on the amount invested. Also, most funds provide shorter investment periods. Although they are investing in longer term instruments investors can invest for terms as short as two years.

Your return will depend somewhat on the level of risk you are comfortable with and how actively you want to manage your investment. As the holder of the mortgage or fund investor, the borrower's payments are deposited directly into your account on a monthly or quarterly basis. As you add more notes to your portfolio or increase your investment in the fund your monthly income increases. Depending on your investment goals, you may want to direct these payments to an account that gives you immediate access, or they can go into a retirement or investment account. Each of these options will impact the tax implications of your mortgage note returns. If you invest using a ROTH IRA your returns will be tax free.

Q: Do I have to pay taxes on my returns?

Like most other Investments you'll have to pay taxes on your returns at some point unless you use a ROTH IRA. If the funds you're using to buy your notes are being taken from a bank or savings account, then you will be taxed at your ordinary tax rate. But if you're using funds from your self-directed IRA, then the profits will be taxed according to the rules applying to your account. Cash investors can avoid paying taxes by buying other investments that can be depreciated and provide "paper losses" in excess of the income they produce.

Q: Where are the properties that secure the notes your fund buys?

We buy notes on properties nationwide, but many are located in the more affordable Midwest and Southeastern states. They are in clean, safe, working class neighborhoods in areas that have diverse sources of employment, low to median home prices, and high rents. Buying notes in these well-established areas increases the likelihood that borrowers will be able to continually make their mortgage payments.

The location and condition of the property that secures the note is important to consider, as is the borrower's ability to repay the loan. These factors will shed light on how much risk is associated with a given note and help determine if it is the right investment for you.

When you buy a mortgage note, you are not buying property—you are buying an income stream. When the borrower makes monthly payments on their mortgage loan, you will receive the payments. This payment structure is not unlike the income you receive from rent payments when you own a rental property. However, unlike investing in rental properties, investing in mortgage notes does not saddle you with the administrative and maintenance costs that come with being a landlord. This is because you are "the bank" and not the landlord. Maintenance and upkeep of the property, along with property taxes and insurance, remains the responsibility of the borrower. Your responsibility as a note owner is simply to receive payments!

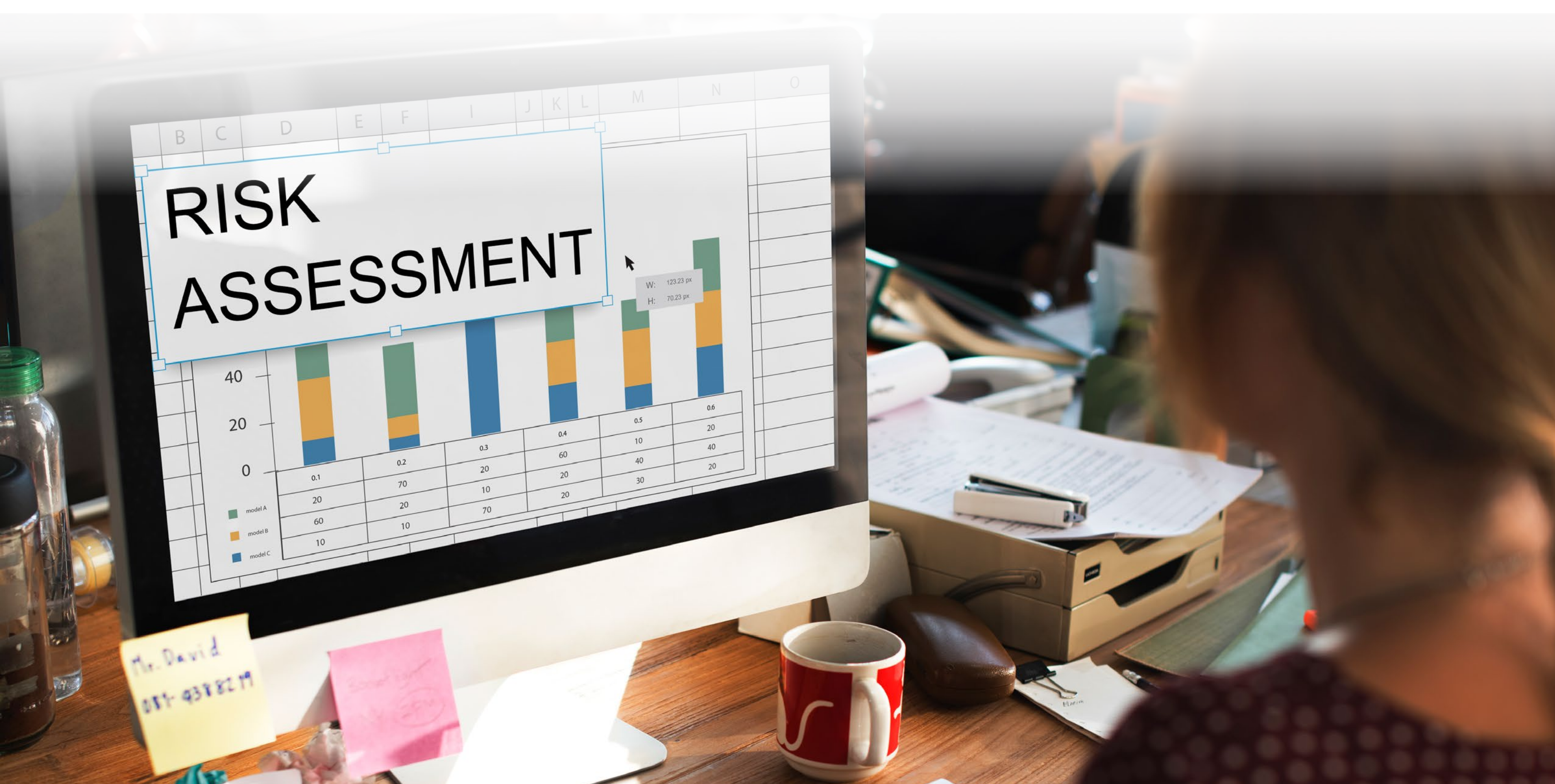
Q: Who are the borrowers repaying your notes?

They are people who work for a living just like millions of other Americans. They work in factories, stores, warehouses, offices, schools, and many other places. These borrowers were approved for a home mortgage and have demonstrated their ability to repay the loan according to its terms.

When purchasing mortgage notes, we do our due diligence and analyze the FMV (fair market value) of the property, review title reports, review the borrower's payment history and credit reports, and take other steps to assess the value of each note as well as its risk. Because of this comprehensive analysis, we are able to project the likely earnings for the life of the note. And because mortgage notes are backed by tangible property, notes offer an added degree of security not provided by stocks, bonds, and other paper securities.

Q: What are the risks of buying mortgage notes or investing in a mortgage debt fund?

All investment vehicles carry elements of risk, and mortgage notes are not immune to this. The biggest risk is that the borrower stops making payments. Fortunately, investing in notes offers a higher level of security for investors than many other options because the note is secured by the property. Investing in a fund provides even more security. The house is usually worth more than the value of the note. If you invest in stocks, you are subject to the market's volatility with no safety net. When the market drops, your investment may lose value. (If you owned stock in Enron or Blockbuster, you know how painful that was.) As with any asset, performing due diligence before you invest is a crucial component of managing investment risk. Most investors are not equipped to analyze the property's location, the borrower's ability to repay the loan, the asset quality, or other factors affecting a notes value. Thus, investing in mortgage notes through a fund makes sense.



Q: What are some common mistakes made by beginning note investors buying individual notes?

There's no substitute for experience but getting experience can be a painful process. When you're buying notes, researching the notes you buy requires thorough due diligence because mistakes can be very expensive. Here are typical mistakes beginning note buyers make who are not guided by experience:

- Not knowing that it's difficult to foreclose in a given state. States have different rules and procedures, and some make it harder than others.
- Not knowing that you have to be licensed as a mortgage lender or register your LLC to own notes in certain states.
- Not assessing the market/exits correctly. (For example, a property might look great and all the numbers work. But you also have to evaluate the town and neighborhood where it's located. If the town is little, has a 20% poverty rate or high unemployment or high crime rate, and it's the best house in the town, you'll have a tough time selling or renting the house if the borrower defaults.)
- Not knowing how to determine that an investor has paid some of the taxes on a property, and if your borrower defaults he has a claim against the property that comes ahead of yours.
- Missing the fact that there are sewer liens on the property.
- Missing the fact that your borrower may be making his payments but has filed bankruptcy.

Knowing how to research these issues helps us avoid unforeseen expenses and losses. Some notes are fantastic investments while others need to be avoided. We have the experience and will research these issues for you. Beginning note investors who go it alone don't know what they don't know.

Q: How do you determine a note's quality?

When we underwrite a note we first and foremost look at the home that secures the note. Does it seem to be in good condition? Is there any deferred maintenance? The quality of the house affects your ability to sell it in case of default, which is your ultimate hedge against the loss of your investment. The property's location and neighborhood are also important. It's difficult to sell a house in a high crime area surrounded by run down homes.

The next thing we look at is the borrower's pay history. If they have consistently made timely payments, there is a very good likelihood they will continue. The loan's documentation is also paramount. Having a compliant loan written on the proper documentation is very important. Are all the terms of the loan correctly stated? Are there conflicts like the maturity date which may be noted as different dates in various documents? We also determine the size of the borrower's down payment and equity in the home. The amount of money the homeowner may lose in case of default is a powerful motivator to stay current on the loan. We must also assess the quality of the borrower. Do they have a full-time job? Is it the type of work that can be easily adapted if the economy changes? Is it steady like a government position? All these factors and more need to be considered in underwriting.

Q: How do I know if the borrower is making payments?

The simple answer is you can always check with a loan servicer. When we purchase loans the seller must provide a written history of the borrower's payments. This proves that the borrower has a consistent track record of making payments, whether the payments were made on time or late, and the amount of each.

Q: What does a loan servicer do?

A loan servicer is crucial to a note investor because they deal directly with the borrower, so you don't have to. They are responsible for collecting payments from the borrower and sending you your money after deducting a small percentage. Loan servicers are bonded, insured, and licensed in the state where your note is located. They maintain the compliance with federal guidelines and track all payments. They are also responsible for paying the taxes and sewer bills out of the money collected from the borrower. They track unpaid balances, check for over or underpayments, and correct adjustments on the principal balance owed. If the borrower misses a payment or if there are any other concerns, they will contact the borrower to resolve the issue, so the note owner never has to communicate directly with the borrower. You can choose your own loan servicer, or we can help you connect with a reputable loan servicer in any state in the US.

Q: What happens if the borrower defaults?

Three things can happen in the case of a default. The first is that the note owner can renegotiate the terms of the note with the borrower. Both parties may agree to a forbearance, or they might lower the monthly payment for a period or extend the terms further. The second option if the borrower can't afford to stay in the home is that the note holder can offer him "cash for keys"; otherwise known as a deed-in-lieu of foreclosure. In exchange for a cash payment, the borrower agrees to leave the house in broom swept condition and avoid foreclosure. The third option is that the note holder can evict the borrower and foreclose on the property and then either sell or rent it. If you invest in notes through a fund the managers will take care of all of this for you.

Q: What if a borrower sells his house while I own the note?

This is actually a great thing for a note holder. When a borrower sells a house, the full unpaid balance owed to the note holder is paid in one lump sum. Thus, the note is cancelled, and the note holder is paid in full. The note holder doesn't have to wait as long to get her money, which increases her yield substantially.

Q: Can I invest in notes using funds from my self-directed IRA?

Many of our clients buy notes using funds from their self-directed IRA funds, which offers many advantages. The most common types of IRA funds used to invest in notes are IRA SEP, Roth, HSA, Coverdell, and Solo 401K. Here is some information on each type.

If you have a 401K plan at your place of employment, most companies allow you to move some of those funds into a self-directed IRA (SDIRA) account without penalty. One of the biggest negative aspects of SDIRA accounts is that account holders are limited to maximum total deposits of $6,000 to $7,000 annually. One way to avoid this limitation is to transfer funds from your 401k account. There are no limitations on the amount of these transfers, and they can usually be accomplished quickly with minimal paperwork. IRA SEP funds are contributed tax free, and no taxes are paid on the investments. Taxes are only due when the funds are withdrawn and when most account holders are at much lower tax brackets.

Unlike an IRA SEP, a ROTH account requires that income taxes are paid on the funds at the time they are contributed. However, no profits are taxed thereafter, even when the funds are removed from the account. Using these accounts to invest in notes is an excellent strategy since large gains can occur over time and they will be tax-free.

Using an HSA Account is a seldom used but excellent method of saving for future medical expenses after retirement. HSA contributions are tax deductible when made, meaning that they reduce your federal and state income tax liabilities and are also not subject to FICA taxes. While they are limited to paying for medical expenses, they do free up other funds that can be used for any purpose the account holder desires.

Coverdell account funds must be put toward education costs, but they can be withdrawn tax free and, just like an HSA account, free up other non-restricted funds that might otherwise be used for your children's education.

Last but not least is the Solo 401K. If you are self-employed, you can contribute 25% or $57,000 of your earnings annually toward one of these accounts. If you're over the age of 50 the maximum limit is $63,500. This is a great way to increase your net worth quickly. All of these programs can be used to invest in notes.

Q: Are there any strategies for increasing my returns?

Yes! One popular strategy involves reinvesting your monthly note proceeds to buy more notes. It works best if you buy notes using funds from a self-directed IRA account. Let's say you start by buying five notes valued at $50,000 each for a total portfolio worth $250,000. By saving the monthly payments, you will be able to buy another $50,000 note within 21 months. By adding that new note to your portfolio and its monthly payments you will be able to buy your next note in 20 months. By repeating this process, you can buy additional notes within continually shorter periods. In ten years, even if you didn't make any more contributions to your account, you will have more than doubled your principal and your original rate of return. Your original investment of $250,000 with an initial rate of return of say 5%, would be worth more than $500,000 at the end of 10 years, with a percentage increase in excess of 10%.

We'll be glad to dig into the numbers with you and explain more about how the process works or answer any other questions you have about the awesome wealth building potential of investing in notes

ANB Funds
investors@anbfunds.com
317-825-8417