Part 2 – Risk? What Risk? Mortgage Investment From the "Buy Side"

Residential mortgages in Canada, compared to various other possible investments, are not usually considered to be particularly risky. And, they're not. But they do carry more risk than government bonds do and they are therefore priced at a spread above government bonds. What risk is there – particularly with insured mortgages? In terms of credit risk (the risk that some portion of the principal advanced or interest owing may be lost due to borrower default) there is very little. For conventional loans with an LTV of 80%, credit losses would arise only in the event of a "perfect storm" scenario which would include a mortgage default, a steep drop in home values, property tax arrears and delay. This rare scenario could easily erode a lender's 20% security cushion but investors also consider two other types of risk always associated with mortgages: Reinvestment Risk and Liquidity Risk.

Credit Risk is the risk that that some portion of the principal advanced or interest owing may be lost due to borrower default.

Remember Mary and her government bond? When Mary sold her 10% government bond (and earned an impressive capital gain because rates had decreased from the time she first invested), she decided to consider taking on a little more risk and she looked at investing in a fund of fixed rate residential mortgages. The fund manager explained to her that the fund's yield would not be constant because amounts of principal are repaid to the fund every day – either through regular amortized borrower payments or full payouts. The fund would then reinvest the repaid principal in new mortgages which could have lower rates than the older repaid mortgages. Mary now understood the concept of Reinvestment Risk. Her bond had paid a constant rate of return until maturity. An investment in mortgages was going to provide a less certain return, but she invested in the fund anyway because she was comfortable that she was being compensated for this risk by the yield she would earn, which includes a spread above the yield of government bonds.

Reinvestment Risk is the risk that the mortgage principal may be repaid prior to maturity (without the appropriate interest penalty) and reinvested at a lower rate.

A couple of years after she invested in the mortgage fund, Mary decided to sell all of her investments and open her own business. Over that two year period, her mortgage fund had performed well but there had been widely reported problems in the American mortgage and housing market which were threatening to spill over into Canada. Mary was not the only investor in the fund wanting to sell and the fund manager was having great difficulty finding new investors as investments which contained the word "mortgage" had fallen out of favour in the market. Mary had come face to face with Liquidity Risk and, although she was able to sell her investment in the mortgage fund and open her own business, it took longer than she had expected – especially compared to how easy and fast it had been to sell her government bond two years earlier.

Liquidity Risk is the risk that, in the event that an investor needs to sell some or all of its mortgage portfolio , it could take some time to find a buyer and to go through the review process and close the transaction.

Mortgages are priced at a spread over government bonds to compensate investors for Credit Risk, Reinvestment Risk and Liquidity Risk. But how big does the spread need to be? Look for the answer in the next edition of MCAP's Monday Morning News.