

Hanging out for your investment

With many mortgage funds still frozen, investors are impatiently waiting for the thaw. What does the future hold for mortgage funds?

Mortgage funds have been a popular source of income for many years, combining the advantages of having funds at call with returns that are generally higher than term deposits.

Australian mortgage funds provide loans to small commercial borrowers on terms that have an average maturity of about three years. This means their assets have a medium-term maturity while their commitment to meet redemption requests is relatively short term.

In times gone by, these funds had sufficient liquidity from a combination of new money coming in and loans paid out to meet all redemption requests. That all changed last year when investors started to take their money out of what was fundamentally still a sound investment.

The knock-on effect

It all started when the sub-prime crisis in the US brought about the collapse of some established US financial institutions. The panic spread worldwide and investors started to worry that their money was no longer safe in the bank.

The Australian government responded by introducing a guarantee on deposits held by banks and other approved deposit-taking institutions to help safeguard the Australian banking system. However, this guarantee didn't cover mortgage funds.

The fact that mortgage funds were not guaranteed prompted many investors to move money out of mortgage funds into a guaranteed deposit. The result?

Mortgage funds didn't have enough cash to keep up with redemption requests. The managers were forced to restrict or freeze redemptions altogether.

This move was an attempt to treat investors fairly, trying to strike a balance between selling the fund's assets to create liquidity for those who wanted to redeem, while at the same time not accepting depressed prices for those who wanted to remain in the fund.

Mortgage funds today

Australian mortgage funds generally lend on conservative loan-to-valuation ratios and actively manage any loan arrears. Morningstar data shows funds have paid returns in a range between 5.5% and 7.8% for the year to March 2009.

So apart from its current liquidity problems, in general, the mortgage fund sector appears to be in surprisingly good shape.

Although many funds are still frozen, most are offering quarterly redemptions paying out their available cash on a pro rata basis. Many larger funds are still paying distributions.

...and tomorrow?

At a recent briefing held by Investment and Financial Services Association (IFSA), managers said their structure of funds was under review.¹

It seems likely that the structure of mortgage funds will change and we could see them offered as a fixed-term

investment in the future. In the meantime, IFSA is trying to get government support for the sector, lobbying Canberra to make temporary investments in mortgage funds through the Australian Business Investment Partnership.

1. Source: Sydney Morning Herald 10 June 2009.

To help people hardest hit by the freeze, the Australian Securities & Investments Commission has amended the law so that investors meeting hardship guidelines can make up to four withdrawals per calendar year to a maximum of \$100,000 for the year. Contact your adviser if you have any questions or concerns about any mortgage fund.