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Mortgage trusts: is there a future?

- Louis Christopher
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IT was just over a year ago that Australia's mortgage trust sector experienced a true, good old-fashioned panic run from investors, forcing many well-known fund managers to suspend their funds.

This panic run was indirectly caused by the financial crisis and directly triggered by the introduction of the government guarantee on bank deposits in late October last year.

The guarantee distorted the risk-return trade-off across investments, undermining the competitive position of the sector.

Unfortunately, this distortion will persist for some time since the guarantee arrangements for deposits of \$1 million and below are only due to conclude in late 2011.

Nevertheless, the sector has survived. Investors' money has remained largely intact. And many managers are now opening their funds once again to redemption requests, albeit on a pro rata, quarterly basis. Some are even writing new loans.

The truth was the sector was always going to at least survive. Managers overall have been quite conservative when it came to writing loans. Yes, it tends to be a riskier borrower that the retail mortgage trust sector services. However, most managers compensate for this risk by demanding a lower loan-to-value ratio when writing loans.

Indeed, that ratio was running at an average of just 60 per cent at the time of the freeze and is even lower today.

This meant that even if a Steven Keen style of housing crash happened, investors still would have had at least a good proportion of their money returned to them, albeit at a slower rate than what is happening today; not withstanding some of the more shonky operators that were happy to lend 100 per cent on the most flimsy of assets.

The sector has also survived due to the fact that mortgage defaults have been far less than what was anticipated this time last year. It has meant that forced sales of real estate have been few and far between and so mortgage trust managers have been able to restructure their books in an orderly fashion.

The sector, though, is still not without its troubles. Funds under management have fallen considerably (the bulk of the decline occurring in October-November 2008). This has made it very difficult for managers in the space to write new loans, which has reduced competition for the banks.

And there is still an issue over the availability of redemptions and the long-term mismatch between what is effectively an illiquid asset versus the demand that these financial products offer redemptions on a daily basis.

Returning to daily liquidity would not be the best outcome for investors over the long term, otherwise we are likely to repeat the past in the next downturn.

Nevertheless, investors still caught up in the freeze have much to be confident about. Soon, the question will be whether they wish to stay in the asset class and take advantage of superior returns compared to term deposits, rather than worrying about whether they will see their money again.

Louis Christopher is head of property with Adviser Edge and Managing Director of SQM Research

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