SFG INCOME FUNDS

WHAT TO LOOK FOR WHEN SELECTING A MORTGAGE FUND INVESTMENT

A few simple components make all the difference

An investment in a well underwritten mortgage portfolio can be one of the smartest fixed income tools within one's portfolio. When properly selected, a mortgage fund investment can synergistically provide portfolio stability, reasonable liquidity, and a highly productive return with modest correlation to the volatility of the financial markets. i.e., it offers peace of mind.

Today however, with the extended rise in real estate values and the pervasive, almost ubiquitous nature of mortgage pool offerings, it is imperative for one to consider critical benchmarks that separate the wheat from the chaff. This article is your guide to better fund selection.

When constructing a portfolio (pool) of mortgage investments, quality is king. Not all mortgages are created equal. This was proven in spades during the financial crisis of 2007-2010. Mortgages were packaged and sold as if they were all the same, with little regard to sound underwriting. It was an emperor's-new-clothes era, and we all know how that ended.

Although it can be difficult for the average investor to notice the difference between a best-in-class mortgage fund and the many touting "us too," there are a few key components that define quality.

Let's take a look at the key elements to consider for prudent fund selection.

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1. TIME

> "THE TRUTH IS INCONTROVERTIBLE. MALICE MAY ATTACK IT, IGNORANCE MAY DERIDE IT, BUT IN THE END, THERE IT IS."
>
> ***Winston Churchill***

Since about 2011, post Great Recession, real estate values have been on an unfettered steady rise. Over this time, many major West Coast cities have seen double digit appreciation throughout most market segments. Business has been robust, buyers plentiful, and values elevated. The current market can make mortgage investing seem easy – so easy even a cave man can do it. Or, two or three guys with big grins, nice suits, and a website. But like anything else, the truth comes out in time.

Most mortgage investment funds operating today have never seen a down market. They have never had to play defense or been tested by an economy in reverse. If a mortgage fund started after 2010, chances are it is the robust market that has kept them going, not disciplined underwriting. In fact the eight-year bull run in real estate has likely led to underwriting complacency for those without down market experience. Be aware of this. Nothing exposes the truth like time…. especially in mortgage investing. ***Recognize the importance of a firm that has navigated a variety of economic conditions, not just rising markets.***

2. TEAM

> "TEAM SYNERGY HAS AN EXTRAORDINARY IMPACT ON BUSINESS RESULTS"
>
> ***Patrick Lencioni***

Seattle Funding Group and SFG Income Funds have an exceptional team of proven individuals who have been working together, on average, 15 years or longer. This level of synergistic longevity is unheard of in our industry.

Jointly, we have successfully navigated multiple markets over decades, including the dot-com implosion of the new millennium and the financial crisis of 2007-2010. The value of "proven" cannot be overstated. Working collectively through difficult markets refines skills and unifies risk awareness for future transactions.

When it's summertime and business feels effortless, you need fund managers who have seen the dark side of the moon making decisions to protect your capital from down markets yet to occur. The skill in lending is limiting your downside as lenders are not positioned to capitalize on "home runs" to compensate for losses. A proven, time-tested team makes all the difference in the world when protecting capital and producing sustainable investment results.

It is through challenging times that one learns of a team's character and adherence to appropriate discipline. Rough waters make better sailors. Be sure to check the:

- ☑ ***history***
- ☑ ***quality***
- ☑ ***longevity***

of the fund managers' team before investing..

THE SFG *Accounting Team*

Jan Jeffery
Senior Accounting Administrator
with SFG since 1993

Eric Benzel
Funds Administrator
with SFG since 1999

Karin Case
Controller
with SFG since 1997

Reid Wagner
Loan Progression Manager
with SFG since 2015

Xiameng Wu
Administrative Assistant
Accounting Department
with SFG since 2016

Lisa Larsen
Construction Draw Accounting
with SFG since 2017

Additionally, they should have a strong, proven accounting department within the organization, not just polished sales people. Quality sales people are a huge asset to any enterprise; however, when managing money, a solid, highly skilled accounting team, with appropriate checks and balances, is a must.

A key question to ask is:

"where was the organization in 2007-2010?"

If they were not an organization at that time (most weren't), where were the key individuals working? Check their individual track records during those years. The years 2007-2010 were the last time fund manager tests were given. How did they do? Were they even in business? Most want to forget those times. You should not.

3. DESIGN

> "WHEN IN DOUBT, CHECK IF YOUR ACTIONS ARE ALIGNED WITH YOUR PURPOSE."
>
> ***Azim Jamal & Brian Tracy***

Ensuring alignment between one's investment goals, the structure and features of the target mortgage fund, and the underlying loan origination business is essential. All too often you see investment offerings touting features that just don't seem to match, such as:

- *abnormally high yield with assurances of quality and safety*
- *generous liquidity options, yet the fund is invested in illiquid properties*
- *promises of value stability, yet there are front-end loads and investments in long term assets.*

All these are recipes for disappointment. Make sure your investment objectives and those of the investment funds are squarely in alignment with the underlying business and assets. Be aware of the risks of chasing yield. Just because you may "require" a certain yield doesn't mean the market will give it without significant risk that may be unrealized and masked by strong market conditions until reality hits you hard.

At SFG Income Funds, an investor-first mentality is our mantra. The integrity among our fund features, business model, and underlying assets is well considered. Our foundational principles of a secure, stable investment with liberal liquidity features providing a very productive yield are in alignment with our time-tested conservative underwriting of short term mortgages. And our no front-end load fund structure is rife with checks and balances, vetted by some of the largest independent financial firms in the nation. ***Always remember, if it sounds too good to be true it most likely is.***

4. TERRITORY

"BEFORE YOU START TRYING TO WORK OUT WHICH DIRECTION THE PROPERTY MARKET IS HEADED, YOU SHOULD BE AWARE THAT THERE ARE MARKETS WITHIN MARKETS."

Patrick Clitheroe

Watch out for mortgage funds that lend "nationally" with just one office and a few employees. Private lenders with one small office and a big website, lending nationally, will likely experience substantial losses in a down market.

Remember, everything works during rising markets, but when the economy slows, a portfolio of collateral scattered across the country, managed by just a few people 1,000 miles away, is a recipe for disaster. A disaster we have seen many times.

With current technology it is amazing how much real estate underwriting information can be gleaned from sitting at the computer. Satellite imagery, street view, ownership data, sales comparables, value estimates…the list goes on.

Access to all this information can be very valuable and efficient, but when evaluating real estate loan opportunities, data culled from computers comes with the risk of complacency. There is no replacement for intimately knowing the nuances of a local market, all the way down to the specific neighborhood.

"Location, location, location"

is paramount and the one thing that can't be changed. Local traffic patterns, school district boundaries, customs, crime, hazards, development patterns, etc. come into play, not to mention specific knowledge and understanding of the local lending laws, legal climate, and culture.

So, be wary of a single office, small staff, "desk jockey" lender who reaches far and wide though computer analysis and third-party appraisals. Check their website. It can be revealing when a private lenders' website shows off recent deals that range from a small hotel in Chattanooga, Tennessee, a development deal in Sacramento, California, and a small commercial building in Louisville, Kentucky. Really?

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Fund Manager
with SFG since 1988

Greg Elderkin
Fund Manager
with SFG since 1992

Steve Ludeman
V.P. of Capital Markets
with SFG since 2017

While it is possible to scale with the proper infrastructure, remember there is no replacement for having "boots on the ground" and deep-rooted, time-tested knowledge of the markets you lend. We could write a whole article on the ridiculousness of this business strategy, but we will spare you. However we will leave you with this:

During the aftermath of the Great Recession, SFG took back and managed dozens of properties in the territories we lent in. It was just that kind of an economy. For a few years we facetiously felt more like property managers than lenders. It was an arduous task, but fortunately we knew our lending market nuances well, had strong connections with real estate agents and contractors committed to helping, and our legal teams were already in place. If these properties were scattered across the USA, in areas we didn't know well, the challenges would have compounded exponentially.

Stay with mortgage funds that know their markets well, have circumscribed territories, and have a team in place to solve inevitable challenges when their loans are tested.

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5. DISCIPLINE

> **"DISCIPLINE WEIGHS OUNCES...REGRET WEIGHS TONS."**
> ***Jim Rohn***

Sound underwriting is the primary skill to investment success. However, even sound underwriting can be dissected into three components:

1. Skill
2. Experience
3. Discipline

Discipline is the primary component to a fund's sustainable performance. Saying "yes" to a loan request feels good. Saying "no" doesn't. Saying "yes" brings in more money today. Saying "no" doesn't. It is very easy for undisciplined individuals and corporations to respond to immediately positive sensations. It is for this reason experience and discipline are so critical. Skill is obviously important, but without discipline, it's meaningless. Life is built this way. The nine year old boy who eats too much candy is later tested at the dentist. The boy may have great potential, but it will not be realized until he learns to exercise appropriate self-restraint. Likewise with investing. Knowledge and skill do not equal success, only potential success. Discipline is the bonding agent that makes skill and knowledge effective.

The difficulty lies in the fact that discipline does not show up neatly on a fund manager's resume. One has to look for it indirectly, through a firm's history of performance during unfavorable conditions. Again the importance of "time", mentioned throughout this article, is in play. ***Be mindful that lack of discipline takes a while before it is revealed.***

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with SFG since 1998

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SUMMARY

When you, the investor, are armed with all this data about a fund's managers (who they are, what they have done, and where they were during the financial crisis of 2007-210), you are better prepared to compare apples to apples. The statement "one should never value their investment returns until they fully understand the risks assumed to achieve it," holds very true here. All mortgage funds are not the same, any more than all real estate is the same, all security systems are the same, or all software is the same.

*SFG has proven itself in the areas of **time, team, design, territory,** and **discipline**. There are very few mortgage funds in the nation (if any) with the history of proven performance like the SFG Income Funds and our thirty years of performance in a variety of markets.*

We are very proud of this fact and grateful for the many of you who have been with us for decades. As SFG investors and investment representatives, you are a large part of our collective success. The SFG team will continue to serve you with the highest levels of investment skills and discipline. We are all positioned for a very bright future.

Well secured loans on relevant real estate with responsible borrowers are requisite to a mortgage fund's sustainable productivity and resilience. The challenge investors face when making an investment decision amongst various mortgage funds is knowing the difference between good, not so good, and terrible. A best-in-class mortgage fund, such as SFG, will help stabilize investor portfolios, deliver resiliency during difficult markets, and produce very productive returns along the way. Poorly underwritten mortgage portfolios may also perform nicely during up markets, but they typically lead to disaster as soon as real estate markets weaken even slightly. SFG

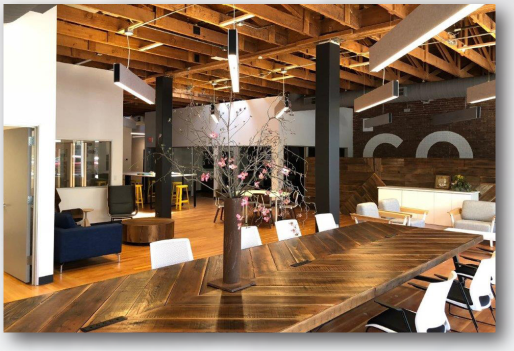
SUCCESS STORIES

Spectacular Oceanfront Lot
$3,100,000
60% LTV
Dana Point, CA

Modern Custom Home
$2,640,000
63% LTV
Denver, CO

Fully Remodeled 28 Unit Apartment Community
$1,500,000
65% LTV
Phoenix, AZ

122 Pad Mobile Home Park on 22 Acres
$4,550,000
60% LTV
Black Diamond, WA



Two Well Located Commercial Properties
$2,400,000
56% LTV
Petaluma, CA

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