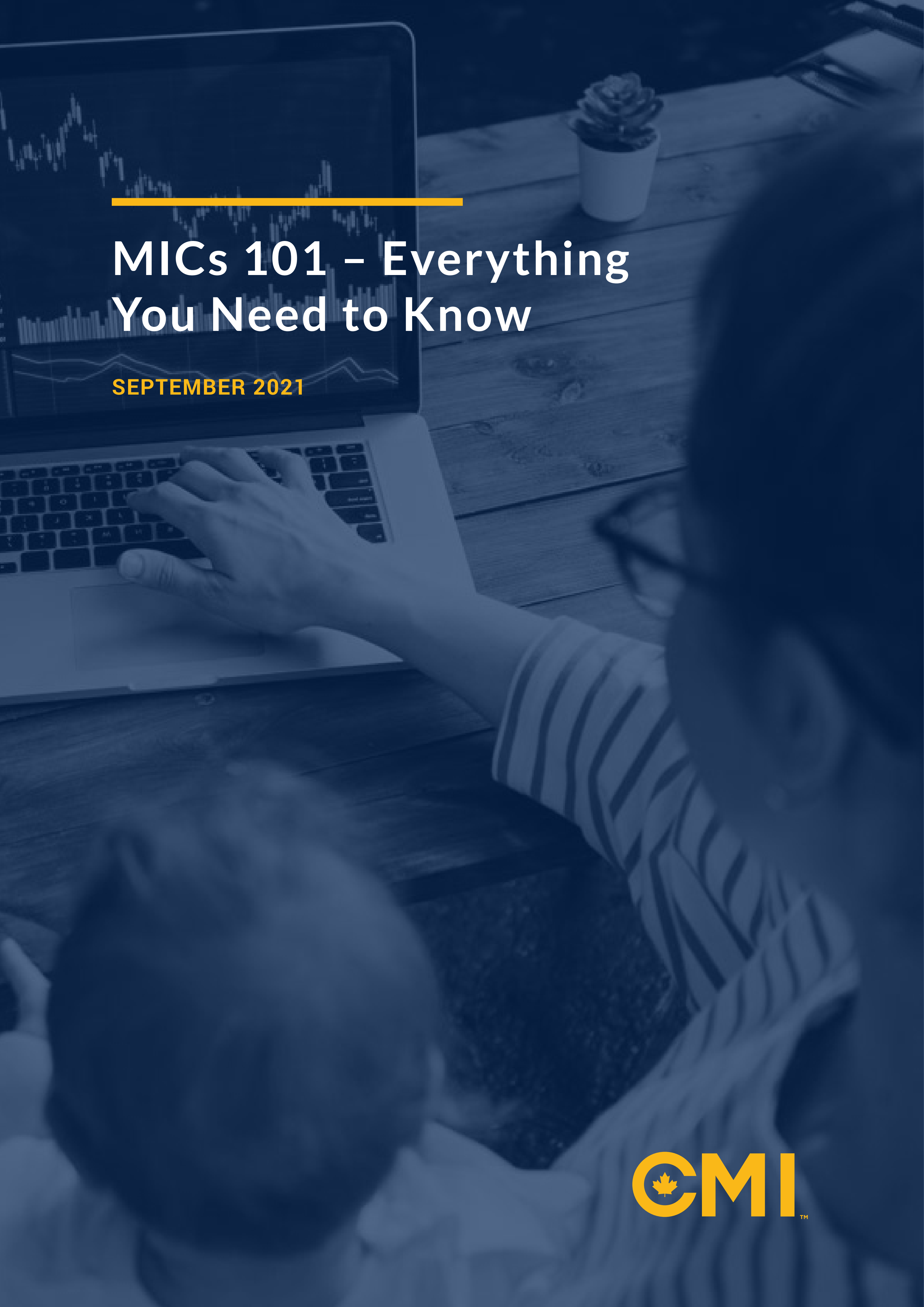

MICs 101 – Everything You Need to Know

SEPTEMBER 2021

CMI™

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INTRODUCTION

Since the 2008 financial crisis, alternative investments have emerged from the periphery of the global financial landscape into the mainstream. Structural changes in the economy, declining real interest rates and, more recently, a protracted pandemic have created new obstacles for today's investor.

Alternative investments – a broad category that includes equity, venture capital, hedge funds, real estate, private mortgages and commodities – topped $10 trillion US in assets in 2020, according to Preqin[1]. This figure is expected to rise to $17.2 trillion US by 2025, as fund managers continue to pivot away from the traditional portfolio of stocks and bonds.

Within the alternatives landscape, mortgages have become one of the most popular options for investors seeking exposure to residential housing markets without the risk of home ownership or title transfer. Mortgage Investment Corporations, or MICs, are the most accessible entry point for investors into this potentially lucrative market.

1. WHAT IS A MORTGAGE INVESTMENT CORPORATION?

While Mortgage Investment Corporations have only recently garnered mainstream attention in Canada, the origins of the asset class trace back to the Residential Mortgage Financing Act of 1973. Eight years later, in 1981, Canadian Parliament estimated that more than $5 billion in mortgage financing would be required to keep pace with the country's rapid population growth. At the time, the annual gap in mortgage financing was estimated to be $2.3 billion. Thus, the government issued a mandate to support MICs to increase mortgage financing at a critical time in the nation's evolution.[2]

MICs represent a unique opportunity for investors to participate in Canadian mortgages and, by extension, the Canadian real estate market. A MIC invests in mortgages, not real estate, which means funds deposited into the MIC are used by borrowers to purchase or refinance their property. Typically, MICs finance the short-term financing needs of borrowers over a period of six to 24 months.

For the investor, MICs provide access to a diversified pool of mortgages. In exchange for financing private mortgages, investors receive income and dividend payments that accrue monthly. The returns generated by MICs have historically outperformed traditional fixed income securities such as government bonds and Guaranteed Investment Certificates, or GICs.

Under Canadian law, a MIC is structured as a tax-exempt corporation and investors who deposit money into them are considered preferred shareholders. As MICs do not pay income tax, they distribute all their earnings to investors, usually through regular dividend payments. MICs typically hold most of their assets in higher yielding, uninsured residential mortgages. The structure of the funds may differ based on the mortgage position (first, second or third) and loan to value (LTV), which impacts the risk profile of the fund, as well as the geographic diversification of the underlying mortgage assets.

Recent history has demonstrated that MICs tend to offer higher yields than traditional bond investments because borrowers who deal with private mortgage lenders are subject to higher interest rates and fees. These borrowers turn to private lenders either because they're unable to qualify under the stricter lending guidelines required by traditional banks and credit unions, or because private lenders offer more customized and flexible terms and conditions.

Private lenders are also not bound by strict income verification and debt servicing requirements that exclude many new immigrants, the self-employed and anyone who doesn't have traditional employment, such as gig workers.

To be eligible to invest in a Mortgage Investment Corporation, investors must meet minimum contribution requirements, which vary based on each MIC provider. Although mortgage investments are usually marketed to high net-worth investors, MICs often provide a much more accessible entry point for the average client. In the case of CMI MIC Funds, the minimum investment required to gain access to a diversified pool of carefully selected mortgages is as little as $5,000.

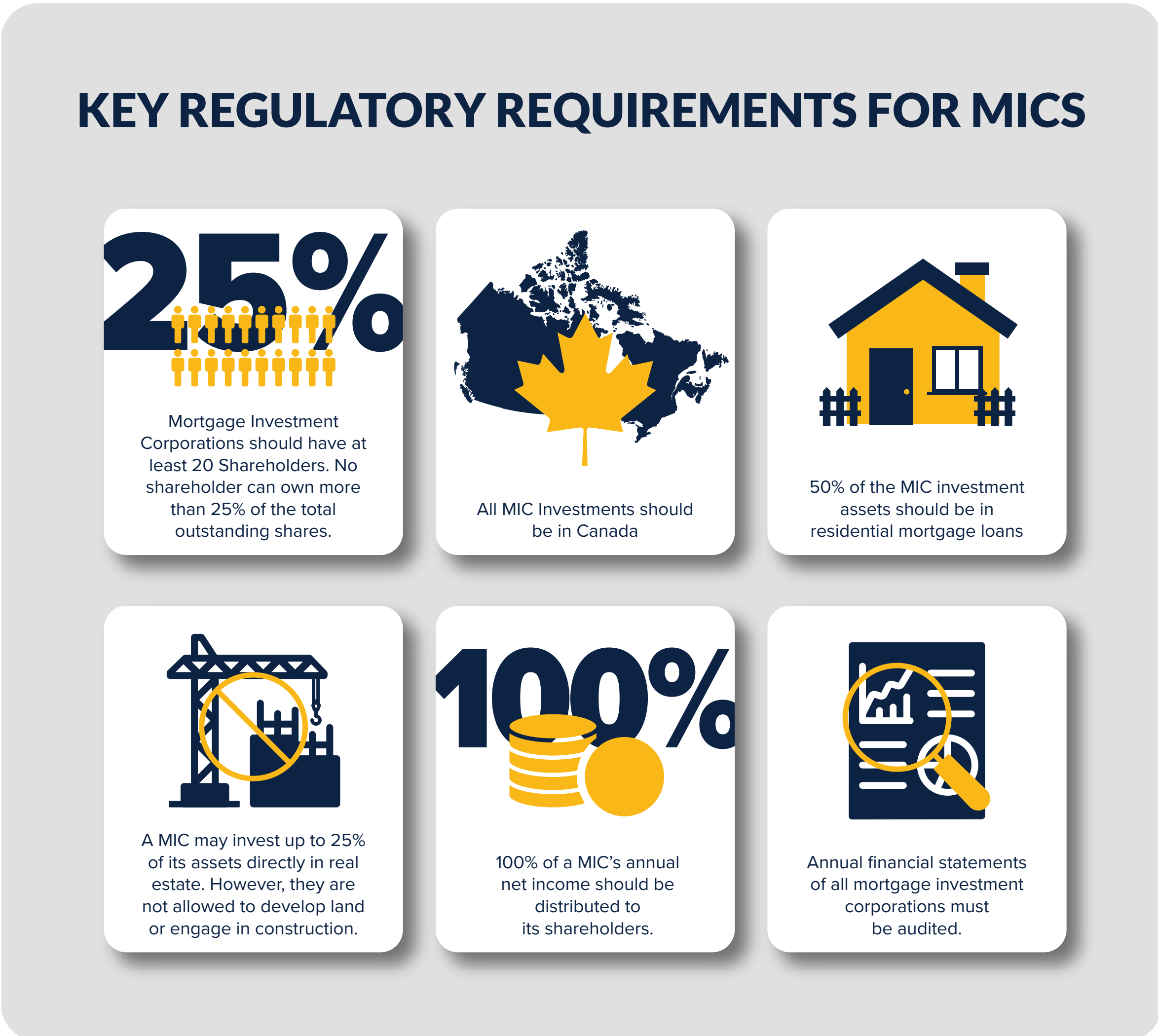

Figure 1: Key regulatory requirements for MICs

2. WHY MICS HAVE A PLACE IN THE MODERN INVESTMENT PORTFOLIO

There are at least three reasons why mainstream investors should consider adding MICs to their portfolio. Each of these reasons reflects underlying shifts in the investment landscape which have made mortgage investments more attractive to the average investor:

1. Demand for private mortgages in Canada is growing
2. Returns on traditional fixed income securities remain at historic lows
3. Mortgage portfolios have the potential to outperform traditional bond portfolios

1. Demand for private mortgages in Canada is growing

Although Canada is home to one of the world's most stable housing markets, the federal government has instituted several important changes to mortgage eligibility requirements, which has had a cascading effect on housing affordability. In 2020, the Canada Housing Mortgage Corporation, or CMHC, implemented new mortgage insurance requirements that capped the gross debt servicing ratios (GDS), thereby impacting the maximum amount homeowners are eligible to borrow.

During the height of the COVID-19 crisis, the Crown corporation asked banks to reduce their exposure to higher-risk mortgages.[3] In April 2021, the Office of the Superintendent of Financial Institutions (OFSI) said it would raise the benchmark for qualifying for uninsured mortgages to 5.25% – a level that was much higher than the one set by the major banks.[4] The increase took effect June 1, 2021.

However, these changes have had minimal impact on housing demand, as Canadian homeowners continued to prioritize residential real estate ownership over other accommodations. In fact, housing demand increased during the pandemic, with sales and listing activity setting multiple record highs in 2020 and 2021. While the market experienced a pullback in the second quarter of 2021, it remains elevated compared with the historic average.

During this period, more borrowers began to rely on private mortgage lenders – a category of lenders that the Bank of Canada refers to as "non-bank financial intermediation." According to Statistics Canada, between 2007 and 2018, assets under management held by Mortgage Investment Corporations more than tripled to reach nearly $30 billion. The recent tightening of federal mortgage guidelines suggests this trend could continue. Non-bank financial entities currently account for roughly 1% of Canada's mortgage market,[5] though this figure is considerably higher for mortgage refinances.

2. Returns on traditional fixed-income securities remain at historic lows

The growth of alternative investments reflects investors' need to think outside the box when it comes to portfolio construction. For decades, the traditional portfolio allocation of 60% stocks and 40% bonds was the benchmark for creating a well-balanced portfolio. That all changed after the 2008 financial crisis when central banks embarked on an unprecedented stimulus campaign, which included lowering interest rates to record lows and implementing novel stimulus programs.

The legacy of zero interest rates and quantitative easing remain with us to this day. Central banks around the world doubled down on their stimulus programs during the onset of the COVID-19 pandemic. Now, it's not entirely clear if, when and to what extent monetary policy will ever be "normalized" again.

Figure 2: The yield on the Government of Canada 10-year bond has collapsed throughout the decades. | Source: ▶ **TradingEconomics**

In this environment, bond portfolios with exposure to government and corporate debt have faced what many describe as an "income famine" due to the decline in real yields. Government bonds, Guaranteed Investment Certificates (GICs) and other fixed income securities have seen their yields decline both nominally and when measured through an inflationary lens. By comparison, Mortgage Investment Corporations have the potential to generate significantly higher returns, particularly when geographic diversification strategies are employed.

3. Mortgage portfolios have the potential to outperform traditional bond portfolios

With fixed income securities providing such low returns, especially relative to inflation, investors are increasingly diversifying into mortgage investments. The following chart provides a high-level breakdown of yield expectations for the Scotiabank Canadian Low Volatility Index, the RBC 5-Year Non-Redeemable GIC, the 10-Year Government of Canada Bond and the CMI MIC Balanced Mortgage Fund.

The relative outperformance of the CMI MIC Balanced Mortgage Fund is due to several reasons. Most significantly, higher target yields are a function of both a risk premium, as private mortgages are typically higher risk loans, as well as an illiquidity premium. MICs are considered illiquid investments due to redemption restrictions. Funds maintain minimum cash reserves as investors' capital is fully deployed in mortgages. MICs vary in terms of redemption provisions, but it is not uncommon for a MIC to allow redemptions after 24 months and with 90 days' notice. In return, investors receive a significant yield premium relative to more liquid fixed income investments, such as bonds, GICs or money market funds.

Asset	Average Yield (August 2021)
Scotiabank Canadian Low Volatility Index	0.35% - 3.50% (max)
RBC 5-Year Non-Redeemable GIC	1.45%
10-Year Canada Bond Yield	1.20%
CMI MIC Balanced Mortgage Fund	8.43%

In addition to their proven track record of outperforming traditional bond portfolios, MICs provide a passive income stream in a domain that is largely uncorrelated with public markets. Low correlation with stocks, bonds and other public markets usually means lower portfolio volatility.

Investing in a MIC also provides many of the same benefits of physical real estate, only without the challenges of tenant management or the risks of negative cash flow, illiquidity and maintenance expenses. MICs are also registered account eligible, so they can be included in an RRSP, RRIF, LIRA, RESP, RDSP or DPSP. MICs can also be included in the highly coveted Tax-Free Savings Account (TFSA), which means monthly cash flow can be withdrawn without any tax liability.

3. CMI MIC FUNDS: A CANADIAN INDUSTRY LEADER

Mortgage Investment Corporations have become a formidable asset class in Canada - and one of the fastest growing. Once the domain of high net-worth individuals, MICs are now offered to a wide array of investors with few barriers to entry.

CMI currently offers three MICs that cover a broad spectrum of risk and return characteristics. The Balanced Mortgage Fund provides a passive investment opportunity in a diversified pool of first and second mortgages. The High Yield Opportunity Fund has a slightly higher risk profile, with the aim of generating above-market returns. The Prime Mortgage Fund employs a more conservative asset allocation using a risk-mitigated portfolio composed almost solely of first mortgages. While stock and bond markets experienced significant volatility over the pandemic, mortgage investments remained relatively stable, as evidenced by the performance of the CMI MIC Funds.

Fund	Net Annual Yield Target	Actual (Aug 2021)
CMI MIC Prime Mortgage Fund	6% to 6.5%	6.33%
CMI MIC Balanced Mortgage Fund	8% to 9%	8.43%
CMI MIC High Yield Opportunity Fund	10% to 11%	10.43%

CMI Financial Group is committed to working with investors and our advisor partners to provide compelling mortgage investment solutions. Our industry-leading MIC funds are designed to help everyday investors gain access to high-quality mortgages in a well-diversified portfolio. To learn more about our mortgage investment solutions, contact us today to speak with one of our Investment Managers.

Endnotes

1 Prequin. The Future of Alternatives.

2 CMI (December 17, 2018). The Mortgage investment Corporation (MIC): A Canadian Guide.

3 Pete Evans (August 12, 2020). “CMHC urges lenders to stop offering so many high-risk mortgages.”

4 Theophilos Argitis (April 8, 2021). “Canada Regulator Eyes Tougher Mortgage Rules Amid Bubble Fears.” BNN Bloomberg.

5 Guillaume Bedard-Page (March 26, 2019). “Non-Bank Financial Intermediation in Canada: An Update.” Bank of Canada.

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