P2P LENDING

FOR INSTITUTIONAL INVESTORS AND WEALTH MANAGERS: AN OVERVIEW

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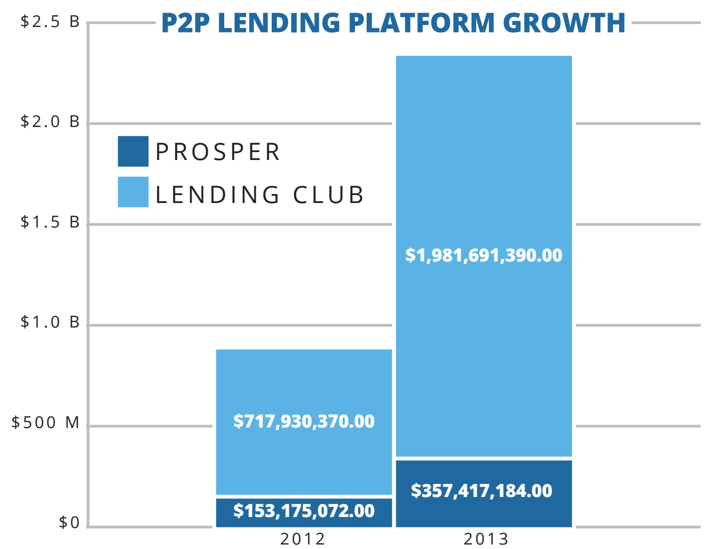
P2P lending (or peer-to-peer lending) is a fast growing space in which any individual or organization can lend money directly to another individual through an online p2p lending platform such as Prosper or Lending Club. The transparency, ease-of-use, and ability to quickly make a loan request or fund a loan at competitive interest rates make P2P lending attractive for both borrowers and lenders. The passing of the Jumpstart Our Business Startups or JOBS Act in 2012 created additional interest by formalizing rules around crowd funding—an off shoot of peer-to-peer lending. This growth has attracted institutional and investment advisors to P2P lending to invest in this fast growing space typically through a P2P lending fund. What follows is a look at P2P lending for professional investors.

P2P LENDING INDUSTRY OVERVIEW

In 2013 two of the largest platforms in the United States, Lending Club and Prosper issued $2.4 billion in loans nearly triple the $871 million issued in 2012. Growth in P2P lending is not confined to the US, Britain exceeded £1 billion in P2P loan origination in 2013.[1] Despite these numbers, the P2P lending industry is still relatively small. About $5 billion of P2P loan origination has occurred since inception of the industry in the U.S. relative to the current U.S. consumer debt of $3.11 trillion according to the Federal Reserve estimates.[2]



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There are a growing number of online platforms around the world offering borrowers opportunities to seek online funding for personal or business needs. More recently real estate and student loan P2P lending platforms have emerged. The P2P average loan size tends to be relatively small, ranging from $2,000 up to $35,000. Don't be surprised if the term micro-financing comes to mind, the concept of P2P lending is similar.

When P2P lending began in the mid-2000s, the lenders tended to be individuals. The last several years have seen a large increase in the number of institutions, professional traders, and investment funds acting as lenders. The entry of investment funds gives lenders (investors) two ways to participate P2P lending: 1) an individual lender to borrowers. 2) an investor in investment funds where the funds lend to the individuals.

The Federal Reserve Bank of San Francisco notes P2P lending is somewhat of a misnomer as platforms do not allow borrowers to receive the funds directly from the lenders. The mechanical aspects of the P2P lending platforms include: "(1) broker loan reimbursements through interest-free investments; (2) broker the sale of securities backed by their issuers; or (3) facilitate the origination of loans which are sold as securities to P2P lending investors who behave like lenders (and who may not even realize the nuance)" [3]

RISK AND RETURNS OF P2P LENDING

The loans are usually unsecured and if a default occurs, the lender's notes are not covered by FDIC insurance. In the U.S. the platforms are regulated by the SEC and the lending notes are registered with the SEC and include a disclosure. The platforms usually require the standards of several credit score metrics to be met for a loan to be accepted onto the platform and to determine the loan's interest rate. These standards may reduce the potential for loan defaults. The platforms can and do reject the majority of loan applications.

As risk management and diversification are key components of portfolio management, the same portfolio concepts are utilized when investing in P2P loans. Equity investors tend to invest in many stocks to reduce correlation risk and tail risk of their equity portfolio. P2P lenders will also invest across the space of the industry by lending to hundreds or thousands

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of borrowers. By doing so, the default of a single borrower should be no more than a marginal negative impact on the P2P portfolio to reduce the portfolio's volatility. According to Lending Club, about 99.9% of investors will sustain a positive return if they lend to more than 100 notes and any allocation to a single note is not greater than 1% of the P2P portfolio. [4] It is similar to a portfolio allocation risk pool.

P2P loan interest rates tend to range between 7% to well over 20% and compare favorably against credit card rates and other unsecured consumer loans. According to Prosper, a seasonality factor based on the age of the note increases the variance of default. For example, notes become "seasoned" after 10 monthly on time payments, thereby decreasing the risk of default thereafter.

ADVANTAGES OF P2P LENDING FUNDS

As P2P lending origination grows, P2P lending investment funds will have the ability to grow with the industry offering ongoing liquidity and invest across hundreds or thousands of loans simultaneously. This allows for greater diversification and potential to reduce return volatility.

P2P lending investment funds have the expertise for proper due diligence and analysis of the loans as notes are issued. P2P lending funds such as the Prime Meridian Income Fund (www.pmifunds.com) leverage this expertise by making loan allocations automatically using a custom algorithm executed through a P2P lending platform's API. Fully automated systems have the ability to identify borrowers that meet the algorithms lending criteria and allocate accordingly and "instantly".

"We manage tens of thousands of loans at speeds of up to 20 pings per second," says Don Davis, Managing Partner of the Prime Meridian Income Fund, "The combination of access, expertise and technology allow us to provide our institutional investors with better than average risk adjusted returns."

SUMMARY

P2P lending is growing in assets for both individuals and institutions as an attractive alternative investment option for many portfolios. It is a growing disruptor in the traditional methods of banking. While P2P lending is accessible to anyone, institutional and high-net worth investors are particularly attracted by a favorable risk/reward ratio. P2P lending funds can provide the professional management and automation required to properly allocate to several opportunities at once thereby creating the opportunity for scalable, risk adjusted returns.

As with any investment, the investor should always do their due diligence and understand the product and how it may add value to a portfolio. Past performance is no guarantee of future results.

[1]http://www.economist.com/news/finance-and-economics/21597932-offering-both-borrowers-and-lenders-better-deal-websites-put-two "Banking without Banks" March 1, 2014
[2]http://www.federalreserve.gov/releases/g19/current/ As of January 2014
[3]Federal Reserve Bank of San Francisco, "Peer to Peer Lending and Community Development Finance"
[4]https://www.lendingclub.com/public/diversification.action

MARK SHORE has more than 25 years of experience in the capital markets and publishes research, consults on alternative investments and conducts educational workshops. Mark is also an Adjunct Professor at DePaul University's Kellstadt Graduate School of Business, where he teaches the only known accredited managed futures course in the country, and a Board Member of the Arditti Center for Risk Management at DePaul University.

Prime Meridian Capital Management is an investment management firm specializing in online Peer-to-Peer (P2P) lending strategies.

Our flagship Prime Meridian Income Fund provides investors low cost access to short-duration, high yield loan portfolios by taking advantage of the efficiencies in the burgeoning Peer-to-Peer (P2P) lending space.

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