Peer-to-peer lending special
Your guide to the major funds and platforms
Tempted by booming peer-to-peer lending?

Hello, welcome to the new edition of Income Investor! This month we are taking a look at the boom in peer-to-peer (P2P) lending. The sector has been growing at breakneck speed in recent years, fuelled by yield-hungry investors and borrowers denied lending by the banks.

And it’s set to get even bigger, thanks to chancellor George Osborne’s plans to allow the investments to be held in ISAs. Jennifer Hill has taken a look at prospects for the sector, and some of the reasons behind its strong growth in chapter one. Fund managers have been among the most enthusiastic backers, and explain why, while we also highlights some of the risks involved.

If you are keen to take part in the P2P boom, getting involved can seem a daunting prospect. There are a plethora of different platforms on the market, and picking the right one may appear a daunting task. We’ve reviewed some of the major players, and it reveals more differences than you may expect – in the type of borrowers lent to, rates offered, and the way in which loans are repaid. Crucially for income investors, not all make it easy to take the interest while leaving the capital untouched.

An alternative to doing it yourself can be to find a fund to pick P2P loans for you. In the last year a number of investment trusts focused on the sector launched, with some more to come. Robert St George has reviewed what’s on offer.

Daniel Grote, Editor
Peer-to-peer lending prepares for lift-off
We examine the prospects for a sector that has been growing at breakneck speed.

Which P2P fund should you trust?
After a series of big investment trust launches last year, there is plenty of choice.

Getting started with P2P
There are dozens of P2P platforms to choose them. We’ve reviewed the major players.
Booming peer-to-peer lending prepares for lift-off

By Jennifer Hill
Peer-to-peer (P2P) lending, the product of savers’ struggle for a decent return on their cash and borrowers’ search for alternative loan sources following the credit crunch, is garnering a growing following among income-seekers, including professional fund managers.

Also known as ‘social lending’ or ‘lend-to-save’, P2P lending is the name given to a financial transaction which takes place directly between individuals, or ‘peers’, without the use of a traditional financial institution like a bank.

The sector has been handed a huge boost by the government’s announcement in this year’s summer Budget that a new type of ISA – the Innovative Finance ISA – will launch next year to house P2P investments.

P2P lending websites, of which there are three main ones in Britain – Zopa, RateSetter and Funding Circle – unite people who want to borrow money at competitive interest rates with those who want to lend and earn interest on their capital.

Instead of putting cash on deposit, income-seekers can lend to borrowers (either individuals in the cases of Zopa and RateSetter or small businesses in the ...)
Peer-to-peer lending is here to stay as a very small but growing part of the overall UK lending market

Richard Staveley, Majedie Asset Management

case of Funding Circle) at an interest rate of their choosing, with the money being repaid over a set period of time. The higher the deemed risk, the higher the potential rate.

The industry has grown exponentially since the longest-running site, Zopa, was established in March 2005. The most recent figures from the Peer-to-Peer Finance Association show the industry has lent more than £2 billion with more than £1 billion of new lending advanced during 2014 alone.

With bond yields at rock bottom – and fears growing over the impact of a rise in interest rates, which some experts believe is imminent across the Atlantic – and concerns that valuations of high-yielding blue chip shares have been pushed to unattractive levels, fund managers are casting their nets wider in search of income.

Fund managers grab a slice

Citywire AA-rated Richard Staveley, manager of the Majedie UK Smaller Companies fund, added P2P Global Investments to his portfolio when the investment trust launched last May.

The trust initially raised £200 million to invest in loans on peer-to-peer platforms in the UK, US and Europe and now has a market capitalisation of £233 million. Demand has pushed the shares to a 3.1% premium to net asset value.

‘Peer-to-peer lending is here to stay as a very small but growing part of the overall UK lending market, disintermediating the banks through lower costs, a lack of legacy issues, systems and processes and better use of technology,’ said Staveley.

‘This vehicle not only benefits from the high yields available in this global market, but by having first mover advantage in bringing institutional capital to the European market has also negotiated excellent terms with the very best platforms and modest
equity exposures to some of the likely long-term winners.’

George Luckraft, manager of the AXA Framlington Monthly Income fund, is another fan of the sector. He also invested in P2P Global Investments when it made its market debut and has more recently added VPC Specialty Lending, another investment trust tapping into P2P lending. The £204 million trust is trading on a 0.6% premium. Luckraft also holds GLI Finance, a small business loans provider quoted on the Alternative Investment Market.

Direct lenders on P2P websites typically net rates from 5%, with the sector able to boast yields of between 7% and 15%, according to Luckraft.

These, however, won’t always stay at such lofty levels: as the sector matures, the risk/reward profile will change and yields will eventually come down – something that the Citywire AA-rated manager is keeping a watchful eye on.

Staveley also sounded a note of caution: until the sector has been stress tested, investors won’t know where the real dangers and risks lie.

‘The current lending environment is benign,’ he said. ‘However, this will not always remain the case and, thus, the real test for the entire space will be the next impairment cycle.’

While the industry became regulated by the Financial Conduct Authority from 1 April 2014, it is not covered by the government-backed Financial Services Compensation Scheme, which pays £85,000 per person per financial institution if the institution goes under.

Adrian Lowcock, head of investing at AXA Wealth, said: ‘It’s an interesting industry and great example of disruptive technology, but the sector is still very new and, as such, there’s still a lot that’s not known. It has yet to have a major crisis. What happens if your peer-to-peer lender hits financial problems? ‘Sectors which experience rapid growth with many competitors frequently suffer from this overexpansion with a few companies not reaching profitability or remaining viable.’
P2P platforms: a guide to help you get started

By Daniel Grote
One of the attractions of peer-to-peer lending is its apparent simplicity. For investors keen to earn a better income than available from the meagre interest rates on bank savings accounts, direct lending can appear a simpler concept to grasp for those who may be hesitant to dip into the stock market.

Lend to a business, individual or landlord and, should all go to plan, receive a return that has been agreed at outset: it seems much more straightforward than subjecting yourself to the uncertainty of investing in shares.

But when it comes to deciding who to put your money with, things can get a fair bit more complicated. There are a plethora of lenders to choose from, focusing on different types of borrowers, structuring loans in various ways and offering varying levels of charges and protection.

Filtering the market
To try and make things a little simpler, we’ve confined our review of lenders to those that form part of the Peer 2 Peer Finance Association (P2PFA), although we excluded MarketInvoice, as its offering is targeted more at institutional investors.

Members of this trade body have to submit to its rules, which cover aspects of their businesses such as segregating client funds, how much operating cash they should set aside and how they handle complaints. Members are also required to provide lending data to the association, including their respective default rates.

That’s not to say lenders that are not part of the association should be ignored, but we had to limit our review somehow.

Among the nine P2PFA members three stand out as by far the biggest: Funding Circle, RateSetter and Zopa. Zopa recently became the first UK peer-to-peer lender to reach £1 billion in loans, while RateSetter has lent £756 million and Funding Circle £784 million. •••

<table>
<thead>
<tr>
<th>Platform</th>
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<th>Provision fund</th>
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</tr>
<tr>
<td>Lending Works</td>
<td>Pooled</td>
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Picking out individual borrowers requires more work to assess each of them and, if you lend too much to each one, could be riskier. Funding Circle highlights on its website that diversification is the best way to manage risk, and claims that every investor who has lent to at least 100 businesses, with no more than 1% of their capital devoted to each one, has earned a positive return.

Picking loans
Should you want to pick out the businesses you lend to yourself, Funding Circle categorises them into six risk bands, with A+ the ‘safest’, then running from A to E as the loans become riskier. Average interest rates for each risk band rise from 8.9% to 18.3% in line with the increasing risk of default on loans. This compares with the headline 7.2% return the lender quotes, after fees and bad debts, for the last 100 loans accepted.

Funding Circle estimates that £12 of every £1,000 lent to A+ borrowers won’t be repaid, but that rises to £207 for E borrowers.

In addition to this risk rating, lenders are given a series of other details about borrowers. This includes its ‘Delphi’ score from credit checking company Experian, the nature of the business, filed accounts and a facility to ask the borrower...
questions about the loan. While some borrowers are anonymous, others give names, meaning the research could be supplemented by a few checks on Companies House.

Lenders decide the interest rate they want to lend at, with borrowers accepting the lowest rates on offer. Loans can range from six months to five years, with an average term of three years.

Lenders are able to sell the ‘parts’ of a loan before the end of the term however, for a 0.25% fee, provided there are buyers, and can offer them at a premium or discount of up to 3%.

LendInvest operates a similar model to Funding Circle, albeit focused specifically on property. Investors lend their money to residential landlords taking out mortgages, as well as to those borrowing against commercial property. As with Funding Circle, there is an ‘autobid’ option, but you can also lend money to specific borrowers.

Variety of rates
These borrowers will state the rate they are offering on the loans, which are more short-term than those offered on some of the other platforms, running from between one and 12 months, with rates of between 5% and 9% a year. Unlike other platforms, there is no sale facility – once you buy loans, you hold them for their duration.

Madiston LendLoansInvest is another peer-to-peer platform allowing investors to both lend to individual borrowers or lend to a variety that will meet the interest rate they require. Lenders submit their bids to borrowers – in Madiston’s case, consumers - with the final rate of the loan set at the average of the winning bids. They are given the potential borrower’s credit score, obtained from credit reference agencies Equifax, Callcredit and Experian, and details of their stability of employment and residence. Lenders can also ask additional questions of borrowers.

Loans last between 12 months and five
years, and lenders are able to sell on their loans for a flat fee of £1 plus 1% of the value of the loan being sold.

ThinCats is the most geared of the platforms we are reviewing to individual loans. Unlike the others, it does not offer an automatic lending facility, and its system of rating borrowers differs from those of its rivals.

Instead of relying on credit scores, ThinCats accredits ‘sponsors’, who prepare reports for potential investors on a loan required by a borrower. Currently 13 business finance firms sit on its panel.

As with most of the platforms offering individual lending, it operates a ‘reverse auction’ facility, with lenders setting ‘bids’ based on the interest rate they want to receive.

ThinCats positions itself as a platform for more sophisticated lenders with more assets at their disposal, and as an alternative to bank lending for businesses. Borrowers include a wide range of businesses looking for funding for a variety of resources, such as property, or even wind farm financing.

Loan lengths range from six months to more than 10 years, with an average of three years, with rates on longer loans tending to be index-linked, accounting for inflation.

**Selling on loans**

Lenders are able to sell the loans, provided there are buyers, either at ‘par’ – at the same rate they bought it for – or at a premium, although unsurprisingly this can lengthen the sale process.

RateSetter and Zopa lie at the opposite end of the spectrum. If you lend money on RateSetter, you don’t get to pick the borrowers, or even find out who they are. You simply accept the RateSetter market rate for your money, which rises depending on how long you tie up your cash for, or set your own rate, which you’ll receive if there is demand from borrowers. • • •
Zopa operates a similar system, with your money automatically spread between multiple borrowers, with a maximum of 2% of lender portfolios exposed to any particular borrower.

Likewise Lending Works, which allocates your money between different consumer borrowers. Landbay is a more niche platform that focuses solely on lending to buy-to-let landlords. It has so far lent £8 million through 42 mortgages, and lenders gain exposure to a selection of these when they invest.

These four platforms also operate provision funds, intended to protect lenders if borrowers go bust. It’s worth noting too that while Zopa, Landbay and Lending Works spread money between different borrowers, RateSetter does not operate similar diversification rules.

It argues that its £15.4 million provision fund does the job of mitigating risk and that the actual risk you are taking on as an investor is of the fund being able to fulfil claims, rather than to the individual businesses themselves.

Madiston LendLoanInvest also offers lenders protection from a compensation fund, although it is optional and, unlike those of the other three platforms, carries an explicit charge for lenders. This is set at £4.95 a month and an additional monthly percentage fee, based on the amount of loans made and the credit score of borrowers lent to, which ranges from 0.2% to 1%.

Platforms that do not feature compensation funds urge lenders to adopt a diversification strategy in order to mitigate risk. A spokeswoman for Funding Circle said that it did not believe in the compensation fund model. ‘Either you’re capital isn’t fully invested or, when the credit cycle turns, there is not enough in the fund,’ she said. It promotes the ‘100 club’: investors lending to at least 100 different businesses. With £20 the minimum that can be lent to a single business, it would take a £2,000 investment to achieve this using the ‘autobid’ facility. •••
How much do you get?
This question is easiest to answer for RateSetter, Zopa, Lending Works and Landbay. As these platforms do not allow loans to individual borrowers, there is less variety in the returns offered.

RateSetter’s headline rates at the time of writing were an annualised 3% for its one-month product, 3.8% for its 1-year product, 5.3% over three years and 6.1% over five.

How you receive your payments depends on the type of product you pick. For the monthly or one-year product, your money is locked up over that period, with your capital, and interest, returned at the end.

For the three and five-year products, you will receive the interest monthly, alongside repayments of your capital in instalments. It’s worth noting that the headline rates quoted by RateSetter for these rates are based on that interest and capital being reinvested as you receive it. You don’t have to do this – you can choose to withdraw your payments as you receive them or, for pure income investors, just draw an income from the interest. This will, however, result in a lower headline return over the period.

Zopa is currently advertising average rates of 3.8% on two- and three-year loans, and 5% on four- and five-year loans. For Lending Works, the rates are 4.8% over three years and 6.1% over five. As with RateSetter, those rates are based on reinvesting monthly repayments.

On Zopa and Lending Works, lenders receive interest and portions of their capital back in monthly instalments, and there is also the option of withdrawing the instalments as they come in, or drawing just the interest from the repayments and reinvesting the capital.

Repayment methods
RateSetter, Zopa and Lending Works allow long-term lenders to sell their loans before the end of the term of their product, provided a buyer can be found. Zopa charges a 1% administration fee for this.
Landbay offers a fixed-rate three-year product currently offering annualised interest of 4.4%, and a ‘tracker rate’ product offering the Bank of England base rate – currently 0.5% - plus 3%.

Unlike with Zopa and RateSetter, you only receive your interest back each month, with the capital paid back at the end of the term – although the loan can be redeemed before this if a buyer can be found. Headline rates assume interest is reinvested, but this can also be withdrawn as it is received. LendInvest operates the same system of returning capital at the end of the loan.

It’s hard to be as precise about returns on the platforms that also allow you to pick individual borrowers, although most tell you the average return on loans. For Funding Circle it is 7.3%, for LendInvest 7.2%, while ThinCats boasts an average of 9%.

On Funding Circle, lenders receive interest monthly, and their capital is repaid monthly in instalments. As with the other platforms, their headline rate depends upon this monthly cash being reinvested. You can choose to withdraw the repayments, but unlike some of the other platforms, there is no option to withdraw just the interest and reinvest the capital. So for a pure income investor, it may be less suitable.

On ThinCats, loans can vary more widely – some will be ‘amortising’, where chunks of the capital are returned in instalments along with interest, while with others the capital is only returned at the end of the term.

Madiston lenders will receive their interest and capital back in instalments, although there is no automatic reinvest facility and loans are typically made with rates of around 10%.

**Differences abound**

If nothing else, our review has served to highlight the variety of approaches offered by the peer-to-peer lending platforms.

They differ not only in the sort of borrower you will be lending to, but in the degree of diversification you are able to secure as a lender, and the research involved over who is receiving your money.

Just as crucial is the method for receiving your money back. For all that peer-to-peer lending has been touted as an income investment opportunity, not all return your money along traditional ‘income’ lines.
Which P2P fund should you trust with your money?

By Robert St George
incomeIQ: Empowering investors through intelligence

Do you spend more in the supermarket when you’re hungry? Would your friends describe you as someone who always takes an optimistic view of a situation? Have you ever made an important financial decision based on a hunch?

We all like to think we make decisions based on logic. In reality, many of the decisions we make are skewed by our inherent tendencies to think in certain ways, known as ‘behavioural biases’.

Behavioural finance is an area of academic study which examines these biases by applying cognitive psychology to economics and finance, helping to explain why we are prone to making irrational financial decisions.

Maybe you are over-confident in your investment ability? Our recent global research found that 95% of investors are confident in their ability to make sound investment decisions, highlighting the prevalence of ‘overconfidence bias’.

Or perhaps not planning far enough ahead is stopping you from realising your goals? Of the investors we surveyed, 46% favoured a short-term approach that generates returns in under two years, while only 12% preferred a long-term approach. This demonstrates how often ‘present bias’ leads investors to focus on the here and now rather than the future.

Imagine how much your finances could benefit if your decisions were influenced more by insight than by instinct –incomeIQ is designed to help you achieve just that.

In collaboration with Joe Gladstone, a behavioural scientist and PhD researcher at the University of Cambridge, we have...
Projection bias is the tendency to make decisions about your future financial requirements without considering how your life will change. An example is estimating your retirement income needs based on your current lifestyle.

developed a simple online test that aims to uncover your own behavioural biases and provide tips on how to overcome them when making income investment decisions. This insight will be invaluable when discussing your investment plans with your financial adviser.

Understanding your behaviour
Based on Joe Gladstone’s research, we have worked to identify those behavioural biases most likely to influence your investment decisions.

Projection bias is the tendency to make decisions about your future financial requirements without considering how your life will change. An example is estimating your retirement income needs based on your current lifestyle.

Present bias refers to a person’s preference for a reward now rather than a larger reward later. This short-term view can make it difficult to save for the future.

Over-optimism can give you an unrealistic view of your future financial well-being. By altering your perception of market risk, it can lead you into making irrational investment decisions. Watch the video.

The incomelQ test will assess you for these and a range of other biases in 10 simple questions, empowering you to be a more informed investor.

Please remember, the value of investments and the income from them may go down as well as up and investors may not get back the amount originally invested.

Take the incomelQ test now. If you do not currently have a financial adviser, one option is to search for a local independent adviser at www.unbiased.co.uk. You may also find it useful to visit www.vouchedfor.co.uk, where members of the public rate and review advisers they have used.
Joe Gladstone: incomeIQ behavioural bias: Projection
From famine to feast, investors are now spoiled for P2P investment trust choice.

Although investors have been able to make direct P2P loans over platforms like Zopa since 2005, the first P2P investment trust launched only in May last year.

Seizing first-mover advantage to call itself P2P Global Investments (P2P), it attracted £200 million initially but has now swelled to £865 million thanks to two further fund raisings backed by prominent investors including Citywire AAA-rated Neil Woodford.

Such successes are rarely ignored by investment firms and so it was joined this year by two more P2P trusts, VPC Specialty Lending Investments (VSL) and Ranger Direct Lending (RDL), which pulled in £200 million and £130 million respectively.

Although ostensibly all very similar funds, investors convinced by the sector should bear in mind the subtle differences between their approaches.

Also last year, Guernsey-based trust GLI Finance (GLIF) shifted away from investing in niche debt like collateralised loan obligations towards alternative finance platforms.

More launches
GLI plans to launch a new trust, GLI Alternative Finance, investing in non-bank business loans. And one of the UK’s largest P2P platforms, Funding Circle, also plans to launch a trust.

Also last year, Guernsey-based trust GLI Finance (GLIF) shifted away from investing in niche debt like collateralised loan obligations towards alternative finance platforms.
**WHICH P2P FUND SHOULD YOU TRUST WITH YOUR MONEY?**

**HOW THE FUNDS STACK UP**

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<th>Ticker</th>
<th>Launched</th>
<th>Total Assets</th>
<th>Current Premium</th>
<th>12-month Average Premium</th>
<th>Target Annualised Net Total Returns</th>
<th>Target Yield</th>
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<td>P2P Global Investments</td>
<td>P2P</td>
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<td>£864m</td>
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<td>10.9%</td>
<td>5-15%</td>
<td>6-8%</td>
<td>Feb, May, Aug, Nov</td>
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<td>Apr, Jun, Sep, Dec</td>
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<td>VPC Specialty Lending</td>
<td>VSL</td>
<td>Mar-15</td>
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<td>Mar, Jun, Sep, Dec</td>
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**SOURCES: AIC & NUMIS**
WHICH P2P FUND SHOULD YOU TRUST WITH YOUR MONEY?

VPC is the more reliant on the US, though, with the country accounting for 85% of its portfolio; almost all the remainder is with UK borrowers, but VPC intends to become more internationally diversified in time. P2P Global’s loans are more widely dispersed through Europe.

VPC also has more allocated to business loans, representing around a quarter of its portfolio, whereas P2P has closer to 20%.

The two diverge further in how they transmit money to their borrowers. P2P Global makes what are known as ‘marketplace’ loans: it identifies loans through other platforms like Zopa, to which it pays small fees, but owns the loans itself directly.

VPC mixes that approach with ‘balance sheet’ loans, whereby it lends money to a platform that in turn distributes it to borrowers. If the end borrower defaults, this means that the platform rather than VPC bears the loss – the platform still has to pay VPC back, although of course if there are too many defaults the platform may itself have to default.

The youngest of the three, Ranger Direct, has the least mature portfolio. At the end of July it had deployed just 26% of its capital, whereas the others are fully invested. Yet Ranger Direct’s young portfolio is distinct in its own ways: it is entirely in the US, although it is exploring international opportunities; it is just 19% exposed to the consumer; and the bulk of its business loans are secured against assets like property or equipment. •••
The two likely newcomers will each add something different too. Funding Circle will adopt a ‘no fee’ structure: although as with other such lenders there will be an underlying 1% service charge at the platform level, there will be no extra management or performance fee. It will lend primarily to UK businesses.

GLI Finance – which currently invests in the equity of lending platforms, in theory a higher-risk, higher-return approach – is also planning a P2P trust with a diversified portfolio and tiered fee structure starting at 0.75% on the first £100 million of assets, dropping to 0.5% thereafter, with no performance fee.

So with these options, should investors spread their bets or back just one?

David Hambidge, Citywire AA-rated director of multi-asset funds at Premier Asset Management, invests in two – P2P Global and VPC – to gain exposure to the asset class.

### Diversified approach

‘It is less fund specific, albeit that the two we invest with do things differently and have different risk-reward characteristics,’ he explained. ‘I would suggest that at the moment the best approach is to have a diversified approach to what is a very new area.’

However, Charles Stanley investment analyst Stephen Peters observes that not all investors will have the luxury of being able to hold several P2P trusts. ‘They aren’t going to be a big problem for a large, diversified portfolio if one goes wrong. That’s not the case for a smaller portfolio.’

On the question of whether these trusts have raised too much money to allocate efficiently, Hambidge is sanguine. ‘We spoke to P2P Global and they suggested that perhaps they have a little bit more in the US than they ultimately would like, but we believe they have done the last C-share issue now and we’re happy with that.’ He added that expanding the trust also improved the liquidity of its shares.
## THE TEAM

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