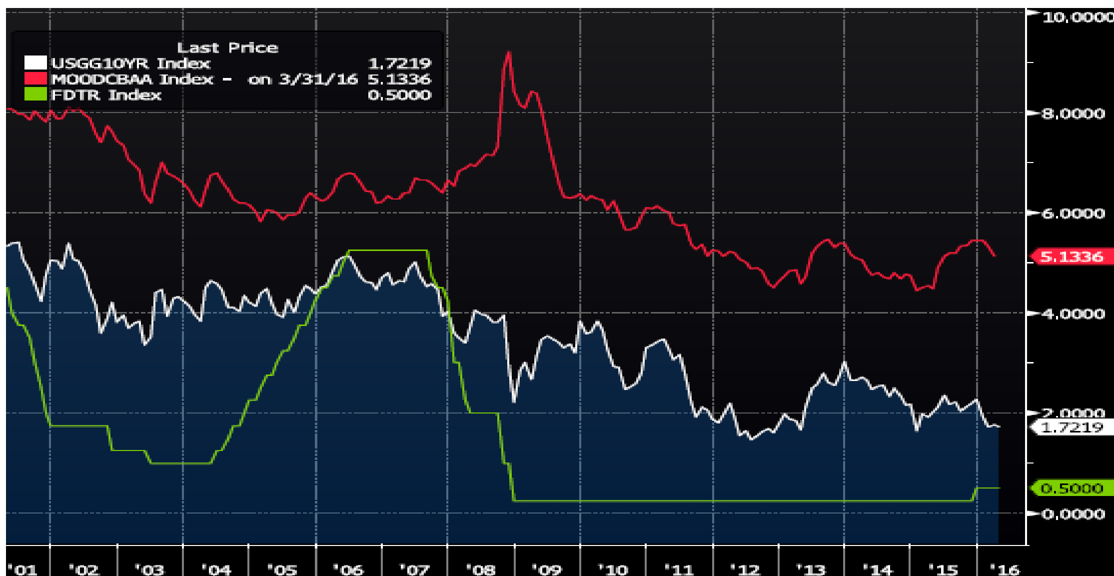
MORTON
CAPITAL MANAGEMENT

Marketplace Lending

Introduction

The fixed income landscape has changed dramatically since the introduction of zero interest rate policies (ZIRP) by global central banks in the aftermath of the credit crisis. In an attempt to avoid a global depression, central banks in the developed countries, led by the US Federal Reserve ("Fed"), reduced short-term borrowing costs close to zero. In the graph below, we illustrate the decline in yields across the fixed income landscape for intermediate government bonds (10-year Treasury–in white), corporate bonds (Moody's Baa–in red) and the federal funds rate (in green) since 2008.

While these central bank actions may have been justified at the onset of the credit crisis, their effectiveness has come into question over the past several years. After all, interest rates represent the cost of capital, and should ideally be set by markets where creditworthy borrowers or seekers of capital are being met by savers or suppliers of capital. Artificially low interest rates encourage the use of leverage in the economy. Also, at these historically low yields, we believe most publicly traded bonds are mispriced and investors are not being appropriately compensated for the risk they are taking. According to JPMorgan, over 60% of the global government bonds are currently carrying yields below one percent, and almost 30% carry negative yields!



US Treasury (10-year) vs. Moody's Baa Corporate Bond vs. Federal Funds Rate (Source: Bloomberg)

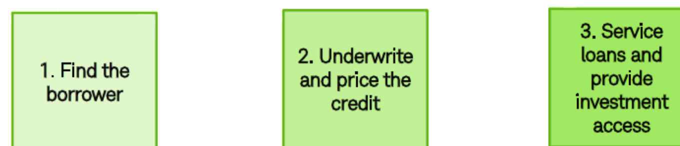
A key differentiator for us has always been our ability to source alternative strategies and incorporate them into our clients' portfolios. In the current environment, with so many pitfalls in traditional assets, we have been searching even more diligently for attractive alternative strategies that we believe can add value in this policy-driven market. We are constantly being shown new and creative strategies, but most fail to survive our rigorous due diligence process. After extended research, one area that we believe holds promise is a new alternative lending strategy.

Private alternative lending strategies—especially first-lien mortgage lending—have been a focus at Morton Capital Management over the past several years. Over the past 18 months, we have been evaluating a new alternative lending strategy called "marketplace" or "peer-to-peer" lending. In this position paper, we will discuss the benefits and risks associated with this space in further detail.

What is marketplace lending?

Marketplace lending refers to investors providing credit to consumers or small businesses without the involvement of banks. This replacement of traditional intermediaries by technology has already become mainstream in the broader economy. Uber and Airbnb are a couple of examples of how technology is disrupting the traditional business models in transportation and lodging. In the case of Uber, people in need of transportation can use their smartphones to connect with people who want to drive them. Uber is simply a middleman and charges a fee for its matchmaking service. Similarly, marketplace lenders find borrowers, conduct credit reviews, and connect those creditworthy borrowers to willing lenders in the marketplace. In return, these marketplace lenders charge an origination fee to borrowers and a servicing fee to lenders. Banks are completely removed from this process, as illustrated below.

Marketplace lending connects lenders directly to borrowers by providing three critical functions:



Source: Sam Hodges, "What Is Peer-to-Peer Lending: And what do Advisors need to know?" Funding Circle, 2015

The first ever peer-to-peer lender was Zopa, a UK-based firm founded in 2004. The largest platforms in the US soon followed with the launch of Prosper in 2006 and Lending Club in 2007. Although these platforms initially followed a peer-to-peer model, institutions have replaced individuals as the predominant source of funding in the space. According to Lending Club—currently the largest consumer lending platform in the US—its source of funding has shifted from 100% retail in 2008 to around 84% institutional funding in 2015. From both the platforms' and the borrowers' perspectives, institutional capital has several advantages over retail investors. First, institutional investors have the expertise and capability to monitor and enforce underwriting discipline. Second, institutions buy whole loans, therefore the funding process can take a lot less time for the borrower. Third, institutional capital is typically more stable than retail capital, creating a more predictable funding source for growth.

Why is lending to consumers and small businesses ripe for disruption?

While the core function of both banks and marketplace lenders is to originate, underwrite and service loans, there are significant differentiators between the two. Marketplace lenders neither take deposits nor use their balance sheets to fund loans. They leverage technology to operate much more efficiently than banks and also operate

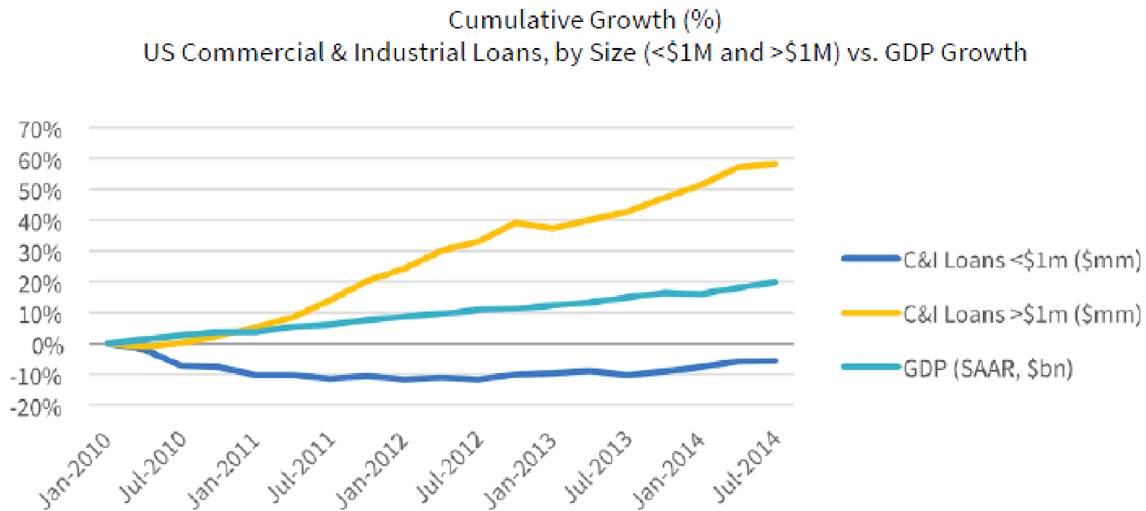
under a less stringent regulatory environment. Therefore, they are able to pass the savings from these efficiencies on to both the borrowers and the lenders.

Banks generally charge high rates on consumer loans or credit cards while paying very low rates to depositors. A prime borrower with a FICO score of 699 pays an average interest rate of 21.8% on credit card debt, while depositors earn very little in the current low-interest-rate environment. In contrast, that same prime borrower would only pay 14.7% at Lending Club, while lenders can earn around 7.9%.

	Traditional Bank	Lending Club
Borrower Pays	21.8%	14.7%
Investor Earns	1.5%*	7.9%

Source: Lending Club, Stone Ridge
* 3-year CD rate: Bankrate.com (12/11/15)

The borrowing environment is even more challenging for small businesses. Following the credit crisis, government regulations such as Dodd-Frank and Basel III have increased banks' compliance costs and capital reserve requirements. One impact of this regulatory burden has been a decrease in bank lending to small businesses as increased costs to the banks have resulted in a heavier focus on larger loans that are more profitable. The chart below shows the recent disparity in lending to small vs. large businesses. Loans of less than $1 million to small businesses (dark blue line) have actually declined since January 2010, while larger loans to larger companies (yellow line) have grown at a healthy clip. This has led to a small business lending market that is significantly underserved regardless of the creditworthiness of the underlying business or business owner.



Source: Funding Circle, FDIC (loans to small businesses, FDIC-insured institutions, 1995–2014)

<u>What is the core differentiator for marketplace lenders?</u>

Marketplace lenders leverage technology in their evaluation and underwriting process resulting in increased efficiencies. Consequently, these lenders can approve a loan in a much shorter timeframe and at less expense than a traditional bank.

Online Application	Initial Contact	Loan Offer	Verification and Final Approval
Less than 10 minutes	24-48 hours	2-3 days	2-3 days
Automated proprietary screen	Loan specialist contacts	Proprietary scoring & human underwriting	Verification & final review
	Discuss funding needs	Analyze financials & 3rd party credit data	Request additional docs
	Determine eligibility		

Application of technology and automation are crucial to creating a more efficient underwriting process. However, the creditworthiness of the borrower is still the most important area of focus. The marketplace lending platforms are typically only lending to borrowers considered "prime," with strong credit histories and credit scores. The entire process is managed by a team of experienced credit experts. Funding Circle, for example, conducts the following due diligence on the small businesses and their owners to which they lend:

	Assets	Cash Flow	Fraud	Other
Business	Discounted asset coverage	Debt service coverage	Authentication calls	Years operating
	Liquidity	Revenue stability	Web presence	Payment history
	Debt & UCC filings	Profitability trend		Use of proceeds
Business Owner	Credit capacity	Debt service coverage	Credit diligence	FICO score
	Equity contribution	Other income	K-1 return	Experience

Funding Circle only approves 5% of the small business loan applications it receives. The approval rate is somewhat higher for Lending Club at around 5-10%. We believe these low approval rates are a testament to the rigorous credit due diligence process employed at the leading platforms.

How can we invest in marketplace lending?

When we conducted our due diligence on this space, we looked at a number of investment platforms and options. We wanted to be able to invest in a diversified program where our clients could get access to several different marketplace lending platforms and strategies. We also wanted the program to be easily accessible from a practical standpoint. We have decided to move forward with a manager, or fund sponsor, out of New York with which we have invested previously in other alternative asset classes. This manager began its review of marketplace lending back in March 2015, and proceeded to identify leading platforms for site visits and one-on-one meetings. The manager's due diligence process focused on the expertise of the teams, the quality of the loan underwriting process, the operational soundness of businesses, and the legal/regulatory/compliance culture of the various platforms. The manager's quantitative research team then conducted extensive analysis on all aspects of the platform, including the history of every loan issued and declined throughout the life of the platform. Only those platforms that offered total transparency were considered. The total due diligence process on each platform generally ran between 6-9 months.

The strategy we have targeted currently has eight approved platforms for its portfolio. The strategy will invest in whole loans, and will be broadly diversified across geography and loan types (consumer and small business). While this strategy has not been launched yet, it is expected that around 55-60% will be invested in the consumer lending space and 40-45% in small business loans. The portfolio will have global geographic diversification, but is expected

to have an overweight to the US (around 60-70%). Within the US, the portfolio of loans will be further diversified, with California currently representing 4% of Lending Club loans followed by New York, Texas and Florida at 2% each.

The below chart illustrates the eight platforms that are currently on the manager's approved list and their areas of focus by loan type and geography:

	US	**UK/Europe**	**Australia/NZ**
Consumer	Lending Club Upstart SoFi CommonBond	Zopa	Harmoney
Small Business	Funding Circle Lending Club Square	Funding Circle	

From an access standpoint, the strategy will be implemented in a mutual fund, specifically in a 1940 Act closed-end interval structure. We have had experience with these structures in the past, and find them appropriate when investing in illiquid or less liquid strategies. While the fund will have a daily price, or net asset value (NAV), it will not have daily liquidity like a standard mutual fund. Instead, investors will be able to request liquidity on a quarterly basis subject to a 5% fund-level gate. The gate is designed to protect investors if there are large redemption requests beyond what the fund has in available liquidity. There is currently no secondary market for loans issued through marketplace platforms, but Duff & Phelps has been hired to act as an independent pricing agent.

What are the current yields in marketplace lending?

When evaluating the potential returns in marketplace lending, it's important to look at the expected net yield to investors. The net yield takes into account estimated expected losses, or charge-offs, that will result when borrowers default on their loans. When evaluating the net yield, most platforms provide their historical annual expected loss rates as base cases. It is important to note, however, that expected losses could be higher or lower than the historical numbers. We have summarized an example of current expected yields, expected charge-offs and defaults, and the net yields for the consumer and small business lending spaces in the table below:

	Current Yield	**Expected Loss**	**Net Yield**
Consumer Lending	13.0%	4.6%	8.4%
Small Business Lending	13.8%	2.5%	11.4%

Source: Stone Ridge, Lending Club, Funding Circle. Data as of 12/31/2015

The strategy in which we will invest will have additional fees and expenses that will reduce the net yields shown above. The strategy is also expected to use some leverage (around 30%), with the aim of increasing the end yield to investors. However, there are also a number of risks to this strategy, as discussed below, that must be considered along with the expected yield.

What do we see as the primary risks to this strategy?

A higher-than-expected default rate is one of the main risks to this strategy. In our opinion, the most likely cause of increased defaults would be an economic downturn or recession. A downturn in the US or the rest of the globe would result in higher levels of unemployment, which would adversely affect the defaults and charge-off rates in the underlying loan portfolios. Another factor that could cause higher defaults would be faulty underwriting. Both Morton Capital and the manager with which we are investing believe that the approved platforms have set up solid underwriting teams and processes; however, marketplace lending is a newer industry and its underwriting consistency will need to be proven out over time. As the industry expands rapidly, there is the risk that platforms will lower their underwriting standards to increase loan volume and market share. While much of the manager's due diligence focused on this, it is an area that will need to be constantly monitored going forward.

It's important to note that a number of the loan features themselves have been designed to mitigate losses. As an example, the impact of defaults would hopefully be lessened by the short-term nature of the loans (typically 3-5 years in duration) and their amortizing structure, where borrowers typically start paying back principal, as well as interest, right away. In addition, most of the platforms set up electronic payments from their borrower accounts so that payments are automatically deducted each month.

As expected with any emerging and fast-growing space, new regulation can be a potential risk. Increased regulation could potentially increase the costs of running the platforms and consequently make the rates and returns less attractive for borrowers and lenders. In addition, there is the risk of negative headlines or news for individual companies having an impact on the overall industry. The industry as a whole has committed to giving the public a high level of transparency, and that transparency will not come without uncovering at least a few missteps. If the industry experienced a high level of turmoil, it's possible that both borrowers and lenders could cut back on their participation, leading to less loan flow and, ultimately, companies exiting the space. While this type of risk would impact the manager's ability to continue growing and investing the fund in the future, it should not have a negative impact on the fund's existing holdings. The manager has structured the fund so that it will be the sole owner of its loans with the ability to bring in a third-party servicer to replace the sponsor platforms if need be. As a result, much of the industry risk that we are concerned with relates more to the viability of this investment on a long-term basis as opposed to our concern that it will threaten our existing portfolio. Our initial allocation to marketplace lending will also be modest as a percentage of a client's overall portfolio.

Conclusion

The question we always ask ourselves when evaluating investments is whether or not we believe we are being paid for the risk we are taking. While there is undoubtedly risk involved in marketplace lending, we believe that the target returns provide fair compensation for that risk. This is in stark contrast to traditional bond markets where we feel that investors today are taking on substantial risk with very little in the way of upside. We also believe that the stock market, given its high valuations, has an elevated level of risk without much hope for strong returns based upon the fundamentals. For a small piece of our portfolios, we feel that marketplace lending is an attractive alternative and diversifier in the midst of a challenging investment environment.

Please do not hesitate to contact your Morton Capital advisor if you would like to discuss this strategy or your portfolio in more detail. As always, we appreciate your continued confidence and trust.

~Morton Capital Investment Team – June 2016

Please see Important Disclosure Information on the following page

Important Disclosure Information

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"Consumer" refers to an issuance weighted yield across Lending Club loan grades. "Small Business" refers to an issuance weighted yield across Funding Circle loan grades. The data includes loan performance information from Lending Club and Funding Circle whose loans have a duration of 2 years. There is no liquid secondary market for these loans. Lending notes are not insured or guaranteed and investors may have negative returns. Individual portfolio results may be impacted by, among other things, the diversity of the portfolio, exposure to any single borrower or group of borrowers, as well as macroeconomic conditions. The expected charge-offs and defaults are based on historical charge off rates by loan grade and loan status over a 9-month period. Historical returns are not a promise of future results.

This position paper includes estimated yields. These results may have inherent limitations, some of which are described below. Estimated yields are provided by the underlying managers and MCM assumes no responsibility for, and makes no representation or warranty, express or implied as to the adequacy, accuracy or completeness of, any such information. Estimates or other forecasts contained herein are based upon subjective estimates and assumptions about circumstances and events that may not yet have taken place and may never take place. If any of the assumptions used do not prove to be true, results may vary substantially from the estimated yield. MCM makes no guarantee that estimates will be achieved. Many factors affect performance including changes in market conditions and interest rates and changes in response to other economic, political or financial developments.
Investments in debt securities typically decrease when interest rates rise. This risk is usually greater for longer-term debt securities. Investments in lower rated and non-rated securities present a great risk of loss to principal and interest than higher rated securities. Investments in Asset-Backed securities include additional risks that investors should be aware of including credit risk, prepayment risk, possible illiquidity and default, as well as increased susceptibility to adverse economic developments.

<u>Past results are no guarantee of future results and no representation is made that an investor will or is likely to achieve results similar to those discussed in this position paper. Inherent in all investments is the possibility of a loss.</u>