Alan Greenstein, Zagga

Alan Greenstein is the CEO of Zagga, a new, alternative asset class in Australia, using real property as security. Alan has extensive experience in credit, risk management, executive management and investments, having led a number of banks and financial services businesses in South Africa.
He co-founded a family office in Sydney, and consulted extensively in banking and financial services. Most recently, Alan conceived, built and managed a direct mortgage originator for an Australian direct insurer, in association with a well-known Australian banking group.
Alan is a member of the Zagga Compliance Committee and the Zagga Credit and Risk Committee.

THE CREATION OF AN ALTERNATIVE ASSET CLASS

Why Australians need a new approach to income investments

Alan Greenstein

Foreword

I've been fortunate enough to have a career in which I've spent considerable time in a wide range of senior roles in the banking and financial services industry in Australia and New Zealand.

Increasingly, I've been drawn to businesses borne out of the fintech industry – broadly defined as technologically enabled financial innovation – which have been at the forefront of nothing short of a revolution in the financial services industry in recent years.

At Zagga, we're extending this revolution. A number of environmental factors – such as the tightening of bank regulations post-GFC; low interest rates for investors; and unmet demands of quality borrowers, have contributed to the genesis of Zagga; a new asset class for investors which is set to flip the marketplace lending arena in Australia as we know it on its head.

Our platform is disrupting both the traditional investment and lending markets, which is a tremendously exciting business in which to be.

Peter Clare - Chairman, Zagga Australia

Introduction

The Australian investment market of 2017 is evolving rapidly.

Low interest rates and global monetary policy have pushed yields to record lows. Property prices have reached "bubbly" proportions in many locations. Exchange-traded funds (ETFs) and listed investment companies (LICs) are attracting fans for their lower fees and higher liquidity. More Australians are eschewing the confines of a pooled superannuation and going it alone.

And against this backdrop, a wave of baby boomers reaching retirement age is creating huge demand for income-producing assets.

How will the investment industry respond to these trends? How will it meet the demand for transparency, control and income that today's sophisticated investors demand? And what are the risks to the system, to the industry and to individuals if they don't?

This paper explores a number of trends among self-directed and wholesale / sophisticated investors, and looks at why a new asset class is needed to reduce risk and increase returns among income-focused investors in Australia.

The rise and rise of the "selfie"

Self-directed investors are on the rise, driven in large part by the growth of self-managed super funds (SMSFs), which now account for almost one-third of the superannuation pool in Australia. These 'selfies' are driving a do-it-yourself ethos in the wealth management industry, and it's distinct from the traditional strategies of institutional investors.

SMSF investors represent the largest group of 'DIY' investors, with significant investable assets and defined investment goals (accumulation ahead of retirement or income during retirement). However, there are many other independent investors, with the ASX reporting that 60 per cent of Australian adults hold investments outside of super.

It should be noted that, while they are self-directed, these investors are not always unadvised - 60 per cent use professional advice to make investment decisions, such as financial planners, accountants, stockbrokers and lawyers.

One force shaping the investment market is the 1.1 million Australians who use a SMSF to manage their super, collectively holding $656 billion. Their behaviours and preferences are influencing the products developed by the wealth industry, and the allocation of capital in Australia.

The trends outlined in this paper aren't exclusive to this group, although it's worth noting that 30 per cent of investors who do not currently use a SMSF intend to set one up in the future, indicating it is set to continue growing.

Many SMSFs also fit within the category of 'sophisticated investor' (annual income of $250,000 and above, or $2.5 million in assets, or able to make a single investment of $500,000 or more), able to access products and schemes not usually available to retail investors. In fact, more than 13 per cent of SMSFs already hold enough assets to fit this criterion.

A different approach to portfolio construction

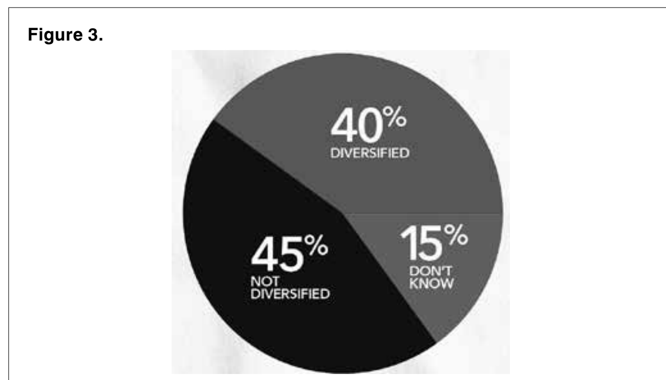
Most of the selfies' portfolios don't look like the 'strategic asset allocation' assets of pension and superannuation funds. Rather than a carefully balanced set of weightings and ranges for a standard number of asset classes, self-directed portfolios are clustered around three asset types, with a strong domestic bias.

The figures below show how this works for key investor groups:

Figure 1.

Figure 2.

Figure 3.



Spreading risk is a key challenge for Australian investors: 40 per cent say they are diversified, 45 per cent say they aren't and a further 15 per cent don't know.

Just under half (48 per cent) of SMSF trustees aim to have a fully diversified portfolio, yet more than 50 per cent of their portfolio is invested in just one investment type (outside of managed funds) and 30 per cent have over half their portfolio invested in direct equities alone.

Yet despite this, Australian investors have a risk-averse outlook: nearly 70 per cent are seeking stable, reliable or guaranteed returns from their investments, and compared to the rest of the world, only 29 per cent of Australian investors are prepared to increase their risk profile for the opportunity to earn more income, compared to 66 per cent of investors globally.

As a result, many investors have built barbell-style portfolios: low-return cash investments to stay safe, balanced by higher-return equities, further up the risk spectrum, to increase returns.

This raises the question: why are they studiously avoiding the middle ground?

Prices are up. Yields are low. What next?

In a low-interest-rate world, income investors are keener than ever to get returns above the cash rate.

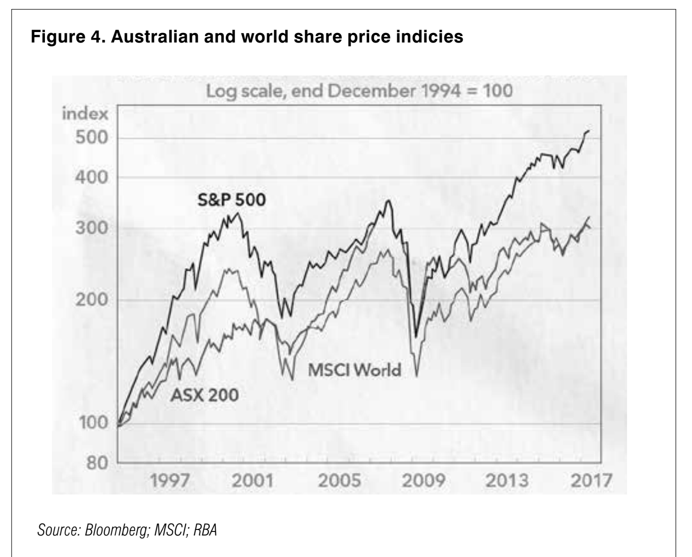
But as they flock to income-producing assets, it has pushed valuations up, and perversely, pushed yields ever lower. Capital growth is good for overall returns but poses problems for investors, especially those in pension phase, seeking income.

Property prices have increased by up to 70 per cent in a five-year-period, while rents lag behind, leading to record-low yields. This yield dilemma is true for both residential and commercial property.

Similarly, in the equities market, valuations and PE ratios are high, relative to historical trends (prompting one professional fund manager to 'sell everything' at what he is calling the top of the market). The income-focused investor must pay a high price for bond-proxy stocks in this situation.

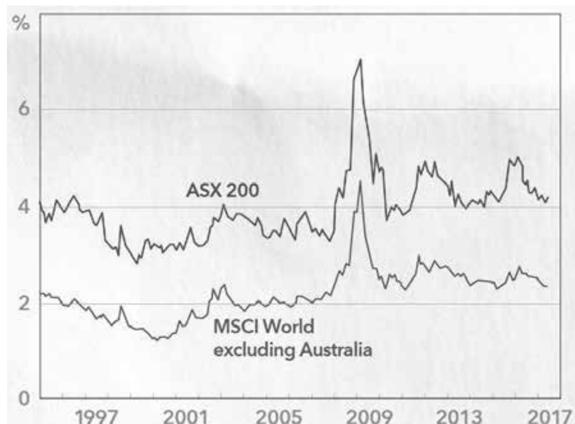
The Reserve Bank of Australia's charts reflect this price trajectory and the dilemma for today's investors, where 'nothing is cheap'.

Figure 4. Australian and world share price indicies



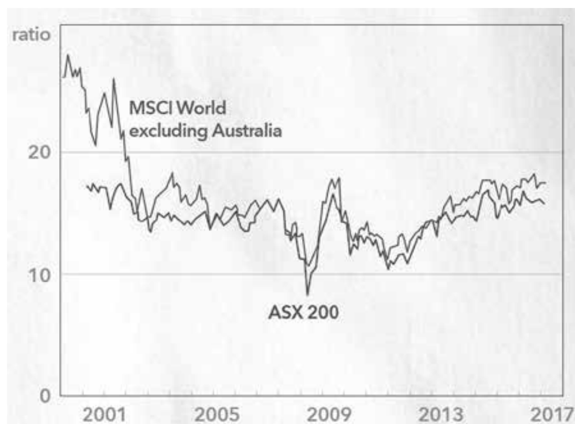
Source: Bloomberg; MSCI; RBA

Figure 5. Dividend yields



Source: Bloomberg; MSCI; Thomson Reuters

Figure 6. Forward PR ratios



Source: Bloomberg; MSCI; Thomson Reuters

The bondification of shares

Their high allocation to cash suggests that for Australian investors, consistent income and capital preservation are top of mind.

Except when it comes to equities – where the search for growth and yield trump capital guarantees.

This has been called the 'bondification' of shares - turning to equities for the consistent income - as The Financial Times explains it: *Investing in stocks "with good dividends, fewer debts, strong pricing power, free cash flow and high return on equity — factors that make them more bond-like."*

However, shares are not bonds, and they have two crucial differences: their dividends are discretionary and they rank last in the capital stack.

In contrast to debt products, where borrowers must make repayments (for example, paying coupons), companies are only permitted to pay shareholders if they are in good shape. And unlike fixed income securities, equities come last in the capital structure. In other words, if the company is liquidated, bondholders get paid ahead of equity holders.

The creation of a new asset class

Australia is unusual in its low allocation to fixed income investments at both institutional and individual investor levels. According to Mercer, local super funds have an average of 25 per cent allocation to fixed income (including cash), compared to 40 per cent for the USA and Canada, 65 per cent for Sweden and 80 per cent in China.

These are professionally managed investment portfolios. According to Franklin Templeton, when we look at SMSFs, as an example of self-directed investors:

The allocation to fixed income is alarmingly low at one per cent.

There are a number of possible reasons for this bias among investors, who favour share ownership ahead of fixed income:

Familiarity with equities

Shares became mainstream in Australia during the late 1990s / early 2000s, particularly after the public floats of institutions like Commonwealth Bank, Telstra and NRMA. By 2005, more than half of Australian adults (53 per cent) directly owned shares. This subsequently fell to 37 per cent, however, more than one in three adults are share owners today.

Share prices movements and trends also dominate investment commentary. A cursory read through the financial and business media reveals that news about listed companies is the most prevalent content, and share price movements a key news item.

Dividend imputation

The ability for investors - especially retirees in a tax-free super environment - to boost their returns with franked dividends, essentially 'supersizes' stock-market returns. As investment manager Dr Don Hamson explains, "For the pension investor, $1 of pre-tax capital gain (short or long term) or unfranked income (interest, rental, overseas dividend, unfranked dividend) is worth $1. However, $1 of fully franked dividend is worth $1.43, since the pension investor gets a $0.43 franking credit refund."

While this is good news from an income point of view, equities are among the riskier asset classes, from the perspective of price volatility as well as potential for capital loss.

Price volatility not only affects overall returns, it opens up the prospect of sequencing risk – that the order and timing of investment returns is unfavourable, resulting in less money for retirement. So the additional returns need to be considered in the context of additional risk.

Definition: Sequencing risk

A combination of market volatility and cash flows produces sequencing risk. Whenever there are cash flows into or out of an investment, such as in retirement, the sequence will matter. Two investors might experience average returns of eight per cent over a 20-year period and yet have materially different balances, depending on when losses or gains are made in that time. It is therefore important to manage volatility in portfolios at every stage.

Transparency and control

For 56 per cent of SMSF trustees, having control over their investments is the key driver for setting up the vehicle.

And compared to the self-service approach of direct equity investing, the debt market in Australia has been somewhat opaque. Most corporate bonds have been traded by institutions, in large parcels (until the introduction of exchange-traded bonds (XTBs) in 2014).

Otherwise, exposure to bonds and credit products has been through managed funds, where the investor has no control over asset selection. This also comes at a cost, with the investor forced to pay management and/or performance fees for access to fixed income products.

As such, investors have the opportunity to increase their exposure to debt products, as long as they can increase their familiarity with them, understand the need to balance risk with reward, and have a sense of control and visibility.

Democratisation of lending

Australian investors are comfortable with being owners and borrowers. They take out mortgages for their homes, negatively gear their investment properties and take limited-recourse loans to buy property in their SMSFs. They take equity stakes in companies.

And yet they are missing out on a key opportunity: to be a lender.

While the opportunity to lend money has been around as long as bonds, the advent of marketplace lending has made it more accessible for individual investors.

There are a number of models in this sector, the underlying concept is that borrowers can access capital being lent by individual (or institutional) investors, rather than just banks.

It's a democratisation and disintermediation of the traditional banking role.

Definition: Marketplace lending

Marketplace lending generally describes an arrangement through which retail or wholesale investors invest money (seeking to earn a return), which is then lent to borrowers (consumers or businesses). Marketplace lending arrangements commonly involve the use of an online platform, such as a website, on which loan requests are made. The loan requests may then be matched against offers to invest. Investors either select the loans they wish to invest in or they are matched with loans that meet specified criteria, such as a prescribed or desired interest rate and loan term. In some arrangements, investors may also be exposed to a loan or a pool of loans. Multiple investors may also fund a single loan.

A range of factors have seen banks pull back on lending both globally and locally. Post-GFC regulation and capital requirements are key factors, but in Australia this has been magnified by efforts to dampen the housing boom.

Macroprudential policy has forced the banks to reduce their lending to property investors and foreign residents.

This has had the result of credit essentially being rationed, even to quality borrowers. It creates a significant gap - and opportunity - for lenders who don't have the same restrictions.

A new approach to income generation

The marketplace lending model provides exposure to the debt asset class, but for an investor focused on capital preservation, the solution needs to be safe as well.

Most existing players offer unsecured loans, meaning that the risk profile of their products may not align with the needs of investors, especially those in retirement.

Zagga flips the concept of a traditional marketplace lender on its head with a secure, fully-licensed offering suited to wholesale / sophisticated – including self-directed – investors, in a safe environment. By providing only high-quality loans backed by real mortgages, the risk of capital loss is very low, offering a better investment overall.

Zagga uses a technology platform and custom-built credit assessment algorithm, and overlays this with the input of real people: expert credit assessment professionals.

Zagga's investors fund loans to borrowers, with each deal assigned a credit score according to its risk profile and offered only to investors whose risk appetite and personal preferences for investment opportunities matches it.

Transparency is key in this process: the investor sees all the documentation that Zagga sees, not only the headline items, but the detailed specifics. The investor can determine how much they wish to invest, funding either a portion of the loan, or the entire amount.

This ability to 'fractionalise' their lending means Zagga's wholesale / sophisticated investors can further diversify their risk across multiple loans. It's akin to building a portfolio of bonds or equities.

Based on current market conditions, Zagga expects its loans will generate a net return of at least 8.5 per cent a year, with each investment priced on its own merits. This represents, if not a higher yield than many competing income investments, certainly a very competitive one, but the risk is mitigated by the fact that loans are secured by mortgage over real property, each is housed in a separate bare trust within Zagga's trust structure, and all are subject to extensive credit and risk assessment.

The benefit that Zagga, as an alternative asset class, brings to investors is that they are able to add a 'middle ground' to their portfolios, providing regular, consistent income. Yet they benefit from greater capital protection than equities and higher returns than traditional bonds or fixed income products.

Zagga believes this new type of income-producing asset will appeal to a growing class of wholesale / sophisticated investors, who want transparency, control and returns from their investment products.

In a rapidly evolving investment landscape, Zagga is turning the traditional way of investing and lending on its head. FS