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Non-Bank Lending: A New Asset Class That Should Be Part of Your Portfolio

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By Jan Brzeski

Most wealth managers today advise investors to maintain a diverse portfolio of stock and bond funds. However, there is one glaring problem with this advice: neither type of investment generates much income.

Let's use an example of a couple that wants $150,000 per year of after-tax income in retirement, without selling assets to cover their expenses. Depending on one's tax bracket and state of residency, the effective tax rate might be 35%, meaning you can keep 65% of your investment income. The pre-tax income needed is $150,000/65% = $231,000.

A typical portfolio today generates about 2% per year in income. To generate $231,000 of pre-tax investment income, one needs a portfolio of $231,000/2% = $11.5 million. Only a very small number of people can hope to save this much. As a result, investors must choose among a few options, and most will pursue some combination of the following:

- Keep working for much longer than was typical for past generations. According to a recent Gallup poll, 74% of Americans plan to keep working part-time or full-time after turning 65.
- Adjust your lifestyle expectations for retirement. Plan on less luxury travel and more meals at home.

- Spend some of your savings during each year of retirement. The risk of this approach is that with increasing life expectancy and improving medicine, one can easily outlive one's savings.

- The final option—which investors should approach with caution but not ignore—is to find a higher-yielding income investment to supplement what traditional wealth managers can offer.

The search for yield and the risk of the "sucker yield"

As of late November 2017, the dividend yield on the S&P 500 stock index stood at 1.85%; the yield on the broadest U.S. bond index, the Barclays Aggregate, was 2.65%. For a typical portfolio of equity and bond funds, the blended yield is a little more than 2%. Consider that for older generations, investment income of 4% or more was very achievable.

Today's investors face the most challenging environment in memory for generating investment income, and they need to go outside of mainstream investments to find attractive current income or yield. However, they need to be careful not to go too far into the unknown.

A "sucker yield" is an investment with such attractive income that it lures in unsuspecting investors, only to result in a loss of principal. This could happen because of a dishonest investment manager such as Bernie Madoff. More often, losses result from the structure of an investment which sacrifices safety in order to create an unusually high income stream—in short, by using leverage.

To understand this concept, imagine buying a house and then renting it out. Borrowing 70-75% of the purchase price for an income property may be prudent and can increase returns; borrowing 99% of the purchase price (if you could) might enhance returns even further, but it also greatly increases the risk of the investment. With only a 1% down payment, one could theoretically buy 25 rental houses with the same amount of cash required to buy a single house with 25% down. But just because one can do this doesn't mean an investor should.

Why non-bank lending

Fortunately for investors, at the very time they need new income-producing investment alternatives, our financial system is offering up a solution of sorts. Since the financial crisis, banks have avoided making many types of loans to appease regulators. For example, before the crisis—as depicted in the excellent movie *The Big Short*—people with no steady income were able to borrow money to buy new tract homes and condos speculatively in hopes that the value would increase quickly. Today, even prudent investors who own rental

homes will be challenged to find banks or other conventional lenders willing to provide loans like this.

Sophisticated investors are starting to take note of non-bank lending opportunities. For example, Goldman Sachs recently purchased mortgage lender Genesis Capital, which makes loans to real estate investors who buy, renovate, and resell single family homes. It also started a company making loans to ordinary consumers, of whom many are trying to pay off credit card debt.

Individual investors can also invest a portion of their savings into non-bank lending strategies. There are regional companies which make loans to real estate investors and developers, and pass on the interest income to investors in the funds they manage.

Strategies such as this can make a big difference to an investor's overall portfolio yield, even if only a smaller portion of the portfolio is invested this way. Consider a portfolio of $1 million. If $200,000 is invested in non-bank lending earning 8%, it generates $16,000 per year in income. If the other $800.000 earns 2%, it produces the same income. In other words, just 20% of a portfolio invested carefully into lending strategies can generate as much income as the other 80% invested in a mainstream investments.

Top risks for investors seeking high income

At this point, you're probably thinking, "This sounds too good to be true." Being skeptical when something generates so much income is healthy. Some of the main risks to look out for when evaluating a high-yielding investment strategy include:

Dishonest investment manager. This is far and away the largest risk for investors who want to step outside of the mainstream to find higher yields. High income is the bait most often used by white collar criminals to steal from unsuspecting investors. The television series *American Greed* does a good job of profiling the many schemes used by these criminals.

If you're considering investing in a non-bank lender, make sure you ask lots of questions and get lots of details about how the lender's strategy actually makes money for investors. For example, if a fund makes loans on houses being renovated for resale, ask for a complete list of addresses and go visit some or all of the houses. If you can't get a complete list from the manager, don't invest. If you get a list and the homes aren't being renovated, or if anything else doesn't add up, just pass. Also, always make sure you meet the fund manager in person and if anything doesn't feel right, don't invest.

Sucker yield. Some strategies may have a nice recent track record of generating income, but there can still be huge risks lurking just under the surface.

For example, consider two funds that both lend money to real estate developers. One fund lends 75% of the project cost and requires the investor to bring a 25% equity down payment for each project; the other lends 99% of the cost and only requires a 1% down payment. The risks are very different, so you'll need to ask enough questions to really understand the strategies for producing returns, and then use common sense to determine whether there is a sufficient margin of safety.

Other risky strategies that achieve a high yield include making junior loans which can be wiped out in a foreclosure, making loans on volatile properties types such as land, and lending on properties far from job centers.

Style drift. This term refers to an investment manager who sets out pursuing one strategy, but changes the strategy over time—and sometimes without clearly communicating the changes to the investors. Adjusting strategies as market conditions change is not necessarily bad. However, the key is letting investors know if the margin of safety is changing significantly over time, and to give them a chance to redeem their investment if they're not comfortable with the changes. Managers whose funds are growing dramatically, or who invest in markets that are becoming much more competitive, may be more susceptible to style drift.

Why Vanguard can't offer this strategy

Vanguard is a wonderful company and it takes in about $2 billion per day from investors. But it's hard for large investment managers to offer compelling yield and to execute on non-bank lending strategies. The best yields come from smaller loans originated by expert local and regional lenders who know their borrowers. Companies such as Vanguard cannot place enough money in these strategies to satisfy clients, and they also wisely stay away from strategies where they can't add value.

A few larger investment managers try to participate in non-bank lending; however, they too face challenges. They can pursue and directly originate large loans of $20 million to $50 million plus, but these loans offer much lower yields for a given level of risk or loan-to-value (LTV).

Alternately they can try to work with lots of smaller regional originators, but then the investor ends up paying two layers of management fees–one to the actual loan originator/servicer, and one to the investment management company that aggregates the

loans. Sometimes to compensate, the larger investment manager will dial up the leverage to try to deliver an attractive yield, but this also dials up the risk.

This combination of factors explains why non-bank lending continues to offer compelling yields, while almost every other investment sector is flooded with far too much capital. There is no easy way for the giant aggregators of investor funds to deploy money efficiently into the best non-bank lending niches. As a result, diligent investors must forge their own way to identify solid managers who can find compelling, specialized lending opportunities.

Conclusion

Non-bank lending opportunities offer a valuable complement to traditional investments, and may be suitable for a portion of an investment portfolio. The best managed funds of this type can provide a lot more income than stock and bond indexes, while maintaining a reasonable margin of safety.

An investor must be willing and able to perform due diligence on fund managers to avoid some of the pitfalls mentioned in this article. Over time we expect a growing number of savvy investors will incorporate non-bank lending strategies into their portfolios. And finally, as the market cycle evolves, investors will learn to differentiate the best managers from those offering a "sucker yield."

About the Author

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