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WEEKEND INVESTOR

Would You Lend Money to These People?

Big Investors Are Piling Into the 'Peer-to-Peer' Lending Market. Here's How to Do it—Safely.

By JOE LIGHT

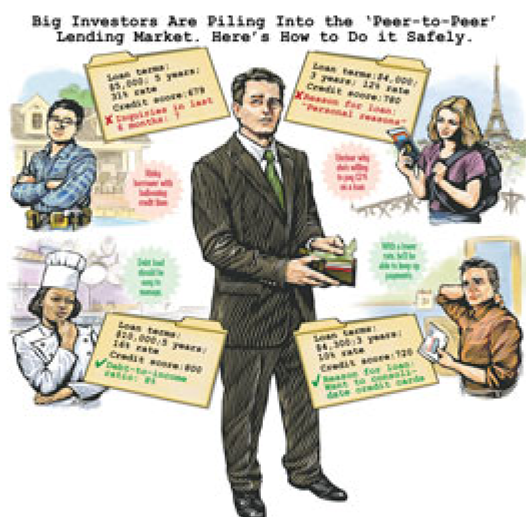
Updated April 13, 2012 9:56 p.m. ET

After years of hype and occasional blowups, the "peer-to-peer" lending market, which connects borrowers with mom-and-pop lenders, is starting to attract professional investors.

The allure? Fat returns. At a time when interest rates are near historic lows, peer-to-peer firms such as Prosper Marketplace and LendingClub Corp. say investors can generate annual returns of 10% or higher by making loans, or pieces of loans, to their fellow citizens.

What's more, the firms say investors who spread their bets wide enough are unlikely to lose money.

But is the market safe enough for ordinary people?



Tim Foley

The short answer: It depends. There are huge risks, but if you can tolerate the uncertainty of lending money to strangers, some with spotty credit histories, you can generate returns much better than can be gotten from most government or corporate bonds.

The choice, experts say, boils down to whether you use the returns on the investments as a key source of investment income or merely a higher-yielding sliver of an otherwise safe bond portfolio. Experts advise the latter.

"It's not something that should be for money that can't handle risk," says William Jordan of William Jordan Associates, an Orange County, Calif., wealth-management firm. "But used properly, you can get much better returns than in other areas of the market." Mr. Jordan last October launched a fund that invests solely in Prosper loans.

Roosevelt Robinson III of Kettering, Ohio, who owns a car dealership, began investing in Mr. Jordan's fund last fall, allocating almost 10% of his portfolio to loans made through Prosper. He says his investment has produced more than a 12% average annual return.

"You've always got risk involved, but given the alternatives, it looks pretty darn good," he says. "There's a zillion banks that do lending to consumers all the time, and they seem to be very profitable."

How it Works

Peer-to-peer lending services such as Prosper and Lending Club launched in the mid-2000s with the idea of letting investors make small loans directly to consumers. Borrowers would pay less interest than they would on typical credit cards, while lenders would get higher returns than they would in other yield-producing assets, such as government bonds.

Other peer-to-peer lenders in the U.S. haven't gotten traction among lenders or borrowers.

Lending Club and Prosper say most borrowers use the services to

pay off high-interest credit-card debt, though they can borrow money for any number of reasons, such as to build a swimming pool. The loans are unsecured, meaning there isn't collateral for lenders to keep if the borrowers don't pay.

Lending Club arranges loans for as much as $35,000 for as long as five years, while Prosper's loans can last up to five years and run up to $25,000.

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The lending experience is much like running a stock screen. After linking a bank account, investors can browse available notes and screen for certain attributes, such as how long the loan would last, the interest rate and the borrower's debt-to-income ratio and FICO credit score, among other attributes. Lending Club and Prosper also assign a rating based on the borrower's credit-worthiness and the size and length of the loan.

Inside each listing, the borrower also can describe what he is planning to use the money for, and potential investors can ask questions. Though the borrower might be requesting several thousand dollars, investors can fund just a portion of the loan. After the loan is completely funded, investors will start to receive their share of monthly principal and interest payments.

Big Players

Until last year, most peer-to-peer loans came from ordinary—and daring—investors. But big institutions are beginning to dabble in the market as well.

In the past 18 months, Lending Club has gathered 30 institutional investors, including hedge funds and wealth-management firms, and boosted its institutional assets from nothing to about $170 million, which accounts for 40% of its outstanding loans, according to the company.

Lending Club announced Thursday that former Morgan Stanley chief executive John Mack has joined its board.

Prosper's institutional assets have grown from $2 million a year ago to about $40 million now, or about half of its total loans, says Joseph Toms, Prosper's chief investment officer.

La Francaise AM, a French asset manager with more than €35 billion ($46 billion) under management, started investing in Lending Club loans last summer and now has around €10 million invested, says La Francaise chairman Xavier Lépine.

Soundpost Partners, a New York-based hedge fund that wouldn't disclose its size, increased its allocation to Lending Club loans twice in the past year and now has more than $2 million invested on the platform, says David Roeske, an investment analyst for Soundpost.

Yield Play

The main driver, the investors say: higher returns. Ultrasafe five-year U.S. Treasurys yield just 0.9%, while, at the other end of the risk spectrum, U.S. high-yield, or "junk," corporate bonds, with a duration of four years, have yields of 7.33%.

By contrast, three-year loans rated B1 by Lending Club, whose borrowers typically have a FICO credit score above 720, pay a 10% average annual interest rate, according to the company. Once defaults are taken into account, the average annual return from Lending Club's B1-rated loans falls to about 8%.

A Lending Club borrower from San Francisco, for example, in early April asked for a five-year, $18,000 loan to pay off his or her credit card debt. The borrower had a FICO credit score between 714 and 749, no delinquent accounts, and a revolving credit balance of $17,770. Other Lending Club investors already had funded 98% of his loan and would earn 12.12% annual interest from the borrower.

On the same day, a Prosper borrower from Georgia wanted a five-year, $15,000 loan for an investment property. Prosper said he had a credit score between 740 and 759, four credit inquiries in the last six months, and $3,047 in revolving credit. Investors would make 17.45% if he kept up his payments. More than 170 investors had contributed to the loan, many offering only $25.

Lending Club and Prosper run individual accounts for wealthy investors with screens of credit criteria—such as credit scores, income and other debt—specified by the investors. Lending Club a year ago also launched two funds with pools of loans that "accredited" investors—those with a net worth above $1 million or income above $200,000 for an unmarried person—can buy into, one diversified among all its loans and one with only its highest-rated loans.

"It's a tough world out there, Lending Club CEO Renaud Laplanche says. "The common theme among our clients is that they want to generate yield."

Big Risks

The downside to the higher yields: much more risk.

Since Prosper and Lending Club are only a few years old, some planners say they are wary of the companies' default projections. The prospectuses note that the rates could change over time.

Lowell Lombardini-Parker, a financial adviser with Seattle-based wealth manager Merriman LLC, says the short history of peer-to-peer loans makes him wonder if investors should make them part of a portfolio. "The high rates they offer are a red flag," he says. "If you're getting something that seems too good to be true, it probably is."

Though executives for Lending Club and Prosper say well-diversified investors in higher-quality loans rarely lose money, institutions that have invested in the loans acknowledge that until the companies have built a longer track record, it is difficult to pinpoint how the loans should be used in a portfolio.

Mr. Jordan, the wealth manager, says most clients look at peer-to-peer as an alternative to junk-bond funds. But unlike high-yield bonds, which sometimes recover some money in the event of a default, Prosper and Lending Club loans offer investors almost no chance of recovery.

So far, the companies have experienced only one recession. According to Lendstats.com, which tracks peer-to-peer firms, Prosper loans issued in 2007 lost 6.8% annually. Mr. Toms, the chief investment officer, says Prosper in 2009 changed its ratings methodology.

Lending Club says its loans issued in 2007 had a 3% average annual return, and that its loans have never had a negative year.

By comparison, between 2007 and 2009, the Vanguard High-Yield Corporate Bond Fund (VWEAX) returned about 12%.

Another risk: lack of liquidity. It is difficult to get your money back before the loans mature, notes Trevor Welch, partner with Praesideo Management LLC, an Ogden, Utah-based registered investment adviser with about $5.4 million invested in Prosper loans.

Online brokerage Foliofn lets Lending Club and Prosper investors buy and sell their loans on the secondary market, but it is thinly traded, Mr. Welch notes.

Building a Portfolio

If you decide to start a portfolio of peer-to-peer loans, its best to test the waters with the company's highest-quality loans, says Kenneth Lemke, publisher of Lendstats.com.

For Lending Club, that means buying only loans that are grade A or B (on an A through G scale). Borrowers with those grades tend to have a FICO score of above 720, on a scale of 300 to 850, and other qualities, such as a long credit history, that make it more likely the borrower will make good on the loan.

On Prosper, the most conservative loans are rated AA or A and tend to have credit scores of 720 and up.

Mr. Jordan says that in a typical portfolio that has a 40% allocation to bonds, investors should devote no more than 10% to peer-to-peer loans. In most cases, investors are most comfortable with a 4% to 8% allocation, he says.

Prosper and Lending Club allow you to fund only a portion of a borrower's request, which means you can spread your risk over hundreds of loans if you wish. According to Prosper, since 2009 investors with at least 100 loans in their portfolio have never lost money.

Investors who have put money into only a few loans, on the other hand, have lost all of their money, according to Prosper.

Mr. Lemke also suggests investors stick to loans from borrowers who have had three or fewer credit inquiries in the past six months and who report that they have credit-card debt that they are looking to

pay off.

"At first, you should start conservatively," Mr. Lemke says. "Don't go for the big money right away. If you diversify into the most conservative loans, it's really hard to screw up."

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