FOR PROFESSIONAL ADVISERS ONLY

DIRECT LENDING AS AN ASSET CLASS

REPORT PARTNERS:

TRIPLE POINT, FORESIGHT, BOVILL & SHAKESPEARE MARTINEAU

28 SEPTEMBER 2018

AKG

Accessible – Comparative – Independent

Analysis by AKG Financial Analytics Ltd

CONTENTS

1. INTRODUCTION

1.1. BACKGROUND

Report background

AKG has produced an independent report for a financial adviser audience on the theme of giving due consideration to the potential relevance and suitability of direct lending within or amongst wider consideration of alternative asset classes.

Report brief and content

There was a key requirement for this report to be both educational and practical in its nature, contributing towards unstructured continuing professional development (CPD).

Market research

AKG was keen to underpin the report with fresh market research insight and has thus carried out quantitative market research with both consumers and financial advisers to support the delivery of this report. These exercises were carried out during March and April 2018 via online survey.

The consumer research was conducted on AKG's behalf by Consumer Intelligence and the research with financial advisers was conducted on AKG's behalf by Pollright. Findings from these research exercises are incorporated and referenced throughout the report.

Report partners

This AKG report is sponsored by the following partners; Triple Point, Foresight Group, Bovill and Shakespeare Martineau.

Both Triple Point and Foresight Group offer investment solutions in this investment area, while Bovill and Shakespeare Martineau offer professional compliance and legal expertise and services, respectively, to companies operating in this investment area.

Triple Point

Triple Point is an independently owned alternative investment manager established in 2004 and currently managing over £1 billion of private and institutional capital.

The Group offers a range of investment strategies in asset classes such as real estate, infrastructure, energy, private equity and private debt.

Triple Point currently manages over £360m of assets across its private debt and direct lending strategies, providing finance to over 100,000 SME businesses across a variety of sectors and industries in the UK.

www.triplepoint.co.uk

Foresight

Foresight is a leading independent infrastructure and private equity investment manager which has been managing investment funds on behalf of institutions and retail clients for more than 30 years.

Foresight has over £2.5bn of Assets Under Management across a number of funds, including Listed Vehicles, Limited Partnerships, Enterprise Investment Schemes (EISs), Venture Capital Trusts (VCTs) and Inheritance Tax Solutions using Business Property Relief (BPR).

Foresight was voted 'Best VCT Investment Manager' at the 2017 Growth Investor Awards, having been previously awarded 'VCT House of the Year' at the 2016 Unquote British Private Equity awards.

Foresight is headquartered in London with regional UK offices in Manchester, Nottingham, Milton Keynes, Leicester and Guernsey and international offices in Sydney, Rome and Seoul.

www.foresightgroup.eu

Bovill

Bovill is a specialist financial services regulatory consultancy, established in 1999 and headquartered in the UK with offices in London, Singapore, Hong Kong and Chicago.

'Our sole activity is the provision of high-quality, technically-focused advice and consultancy services on all aspects of financial services regulation. We aim to develop effective solutions to the complex problems of our clients, and do not offer commoditised advice or services. Bovill has experts spanning all aspects of financial regulation in the UK, EU and Asia.

Our specialists in the private equity and venture finance space work with a range of alternative fund managers, corporate finance houses, business angel networks and venture capital trusts.'

https://www.bovill.com/

Shakespeare Martineau

Shakespeare Martineau is a leading law firm that brings creativity, commerciality and clarity to complex challenges.

'It's our business to understand our client's business. That's why we're committed to being just as driven, dynamic and diverse as our clients. Our multi-disciplinary team combines pragmatic advice and deep sector expertise for businesses of all sizes. That means experts that collaborate to think bigger about your strategic goals and how to get there.

Investment funds has been a long standing chosen sector of the firm. The sector has seen substantial changes over the last decade. From increased regulation and tax changes to investor appetite and global market influences, the landscape continues to evolve. Investment funds, managers, investors and the companies that they support need advisers who can help them manoeuvre through this changing environment. That's where we come in.

Our investment funds team is made up of lawyers across a variety of disciplines, each with specialist knowledge and interest in the sector. Our understanding of regulatory and legal issues affecting the sector is coupled with market experience and commercial approach. Using this depth of expertise, we collaborate with our clients, providing bespoke, tailored solutions, often working from an initial concept or developing new products.
Our approach is to think beyond just legal solutions. As long-term partners, clients continually trust us to advise on what's possible, what's prudent, and what's coming around the corner. It's our energy and entrepreneurial flair that have helped us become one of the country's fastest growing legal services providers.'

http://www.shma.co.uk/

Partner contributions

Insight and comment from the report partners has been sought by AKG during the production of this report and is referenced within the report.

Reference material

As with all asset classes, there is a lot of reference material available in the public domain relating to investment strategies which provide direct funding to SMEs. AKG's report includes a reference library (Appendix 1: Resource Links) for those readers of the report who wish to carry out further research and interrogation of the subject matter.

1.2. RELIANCES AND LIMITATIONS

This report has been produced for the Report Partners. AKG is happy for the Report Partners to reproduce all or part of this report in any internal or external published material, subject to prior written agreement of the content, context, duration and volume of such reproduction and of any reference, explicit or implicit, to AKG's involvement in producing this report.

The information upon which AKG's report and comments are based has been in part supplied by the Report Partners and otherwise researched by AKG from a variety of publicly available sources.

AKG has made every effort to ensure the accuracy of the content of this report and to ensure that the information contained is as current as possible at the date of issue, but AKG (inclusive of its directors, officers, staff and shareholders and any affiliated third parties) cannot accept any liability to any party in respect of, or resulting from, errors or omissions. AKG personnel are available to expand upon the comments in this report, if required.

Whilst many aspects underlying AKG's comments are likely to change only slowly, the financial services industry is a competitive and dynamic marketplace, with new products/funds and developments being announced regularly. As a result, AKG cannot guarantee that any particular comment will remain appropriate at any future date. Future developments in the market could have a significant impact upon the comments.

AKG information, comments and opinion, as expressed in the form of its analysis and ratings, do not establish or seek to establish suitability in any individual regard and AKG does not provide, explicitly or implicitly, through this report and its content, or any other assessment, rating or commentary, any form of investment advice or fiduciary service.

Specifically, AKG's report is not an endorsement of this asset class or the suitability of investment strategies in this area for financial advisers, their clients or any other consumers and investors.

2. EXECUTIVE SUMMARY

Background – Direct Lending is an evolving asset class

- Private (non-bank) debt has been a long standing component of the market albeit for many years it was really only accessible for institutional businesses.
- SMEs (small and medium-sized enterprises) have historically been unable to access the bond market and have experienced a funding gap; this worsened since the 2008 financial crisis and non-bank finance providers backed by private and institutional investors have found opportunities to obtain competitive yields for providing investment propositions in this market.
- The market has evolved over the last decade, with more opportunities now available for retail investors to put money in fund vehicles which lend to SMEs.
- Compared to some investment themes or trends that have been seen in the past in the alternatives area, this does not feel like a 'fad'.
- There is a lot of academic material showing why direct lending strategies are growing, albeit much of the prior research has been directed at the US and Europe markets and towards institutional investors.
- Big investment houses that are managing multi-asset solutions in the UK are more regularly considering alternatives in their asset allocation mix. Exposure to alternatives would appear to be growing and likely to grow further in future.

Background – the evolving advice market

- Commonality is now being seen across key research, due diligence, compliance and PI considerations.
- Processes within adviser businesses will need to be comprehensive across these disciplines for things to work out. They will need help from providers, independents, specialists etc. while retail market in its infancy.
- MiFID II product governance requirements seem pretty sensible in terms of designing solutions for proven customer needs and then delivering them to the right audience. And proving that this is happening via MI, reporting etc. on an ongoing basis. It does feels like this will generally become best practice.

Market research – key findings/themes

Attitude to, and appetite for, alternative investments

- Strong indication from advisers surveyed that clients are willing to consider different asset classes, in order to achieve higher yields.
- This is backed by apparent expression of willingness for consumers to invest in investment/savings products outside the traditional equity or cash-based solutions.

- With many consumers indicating that this change in attitude to investing in investment/savings products outside the traditional equity or cash-based solutions has come about due to long-term low interest rates and rising inflation.

More specific items relating to direct lending

- Just under two-thirds of advisers surveyed state that they are familiar with SME Credit/Direct lending as an asset class.
- 39% of advisers surveyed would consider investing their own money in products exposed to SME Credit/Direct Lending while 10% of advisers state that they have already done so.
- Two-thirds of advisers surveyed are concerned that savers and investors in general do not understand direct lending products.
- 53% of advisers surveyed have been asked by clients about products exposed to SME Credit/Direct Lending.
- One-half of advisers surveyed have clients who are investing in alternative debt products such as Direct Lending, Peer-to-Peer loans, or crowdfunding without adviser involvement.

Expectations and requirements from investment products

- One-half of advisers surveyed aim to achieve a target yield of 3% to 5% for clients investing cash in fixed income products.
- Advisers flag *RPI plus a percentage target*, *CPI plus a percentage target* and *BOE rate plus a percentage target* as the investment performance benchmarks which are deemed most appropriate and which resonate most strongly with clients when assessing debt instrument returns.
- Advisers selected *Expected returns*, *Clarity on where money is invested*, *Higher returns*, *Guarantees (that investments are covered by compensation schemes)* and *Tax-free allowances* as most important attributes for investment products.
- Consumers selected *Level of risk*, *Guaranteed returns*, *Expected returns*, *Guarantee that investments are covered by compensation scheme*, *Clarity on where money is held and invested* and *Understanding of the product/investment area* as most important attributes for savings/investment products.
- Consistency of preferred attributes displayed between both research audiences.

Barriers and hurdles to further engagement with SME Credit/Direct Lending products

- The top barriers to advisers recommending SME Credit/Direct Lending products to their clients were: *Am not familiar with the products*; *Concerns that they are not covered by compensation schemes*; *Concern over regulatory issues*; *Our compliance department*; *Lack of liquidity*.
- The top items that would deter consumers from investing in products that lend direct to SMEs were: *Too risky*; *Lack of clarity about what you are investing in*; *Don't understand the market*; *High/unrealistic returns*; Lack of access to cash; *Concern about compensation schemes*.

- Commonality between engagement barriers/hurdles for advisers and consumers and clear areas of focus for providers of solutions in this area who are seeking to increase engagement and market share.

Risk / Reward Considerations

- Fixed Income investments are considered, as an asset class overall, to be relatively low risk and have historically produced fairly stable, low to medium levels of return.
- Direct lending-based investment falls within this Fixed Income class and therefore would be expected to share this risk / return profile, to some extent.
- Direct lending as an investment asset does appear to be offering opportunities across a range of risk / return and maturity profiles, and with a relatively positive yield compared to other investments in its class with a similar risk profile.
- Private debt was stated by a global investment manager as having 'emerged as an asset class with potential to improve portfolio risk-adjusted returns by offering higher yields in exchange for illiquidity, better diversification, and lower volatility'.

Summary of Report Findings

- While the AKG report looks more broadly at direct lending as an asset class, advisers then need to understand how providers of retail solutions in this space are bringing products to market if they would like to investigate potential relevance and suitability of such solutions for clients.
- There is evidence that direct lending is becoming established as an asset class and product set in the financial advice market.
- For instance, a multi-asset managed fund in the retail sector reported 'an increase in the allocations to these asset sub-classes over the past few years, leading to better returns and diversified risk, within fixed income, being made available through those managers who have taken this approach'.
- There is evidence of increasing demand from clients for alternative asset classes to include direct lending.
- These solutions are newer to the retail market and hence more bespoke/specialist research is likely to be required in the short-term.
- The products are unlikely to fit neatly into standard research processes in adviser businesses at this stage, i.e. be represented in desk-based research tools, be mapped into risk profiling tools.
- Advisers need to acquaint themselves with the Base Prospectus and Investor Memorandum made available by potential solution providers
- There will be a heavy responsibility on research, paraplanning and compliance teams within adviser businesses to 'get across' these solutions.

3. RISE IN OPPORTUNITIES FOR THE PROVISION OF DIRECT LENDING INVESTMENT SOLUTIONS

3.1. DIRECT LENDING AS AN EVOLVING ASSET CLASS

The rise of opportunities for alternative, non-bank providers

Direct Lending, Private Debt Investment, SME Credit, SME Financing, Private Debt, Debt Based Investments are all amongst the terms applied to what is essentially non-bank lending to corporate and SME businesses or for asset-backed finance.

3.2. DEFINITION OF DIRECT LENDING

Definition of Private Debt and Direct Lending

For context, we'll start by confirming a definition for both Private Debt and Direct Lending.

Private Debt (or Private Credit) is debt that is provided to companies or projects on a bilaterally negotiated basis. Private Debt instruments are generally illiquid and not traded on organised markets in the way that many corporate bonds are. It takes various legal forms including loans, bonds, notes or private securitisation issues.

Private Debt typically comprises; mezzanine, private placements, direct lending, leveraged loans and syndicated loans.

Provision of private debt has been long standing albeit historically only at the high end of the market and so available for predominantly Institutional businesses through, say, private placements, where a bond might be made available to a small pool of sophisticated investors.

The market has evolved over the last decade, with lending to smaller, mid-market (SME) companies becoming more prevalent and this narrower market for debt provision is what is being referred to here as the direct lending market.

Direct Lending therefore is a form of Private Debt in which lenders other than banks make loans directly to companies. The borrowers are typically (larger) small or mid-sized companies, also called SMEs, rather than large, listed companies, and the lenders tend to be asset management firms or non-bank lenders.

Peer-to-peer (P2P) lenders are sometimes considered part of the Direct Lending market, but tend to mainly be concerned with funding micro businesses, although some also serve small companies.

3.3. DEFINITION OF SMES

Definition of SMEs (small and medium-sized enterprises)

As per the European Commission, whether an enterprise is defined as an SME is determined using the following two factors:

1. Staff headcount
2. Either turnover or balance sheet total.

Such businesses have historically been unable to access the bond market but have experienced a funding gap in terms of requirements for core business asset funding or for growth opportunities, for instance.

Non-bank finance providers backed by private and institutional investors began to investigate this underserved market and found opportunities to obtain competitive yields for such investment propositions, subject to appropriate significant due diligence, structuring and ongoing monitoring/maintenance (through financial and performance covenants for example) of such contracts and pricing to reflect the risks involved.

Institutional private debt funds have more commonly focused on the middle market, which consists of approximately 35,000 companies employing a total of 4.2 million people. The micro and small business sector represent a larger market without access to the funding that they require.

SMEs have been underserved from a funding point of view - 47% of SMEs have used a personal credit card to cover their business needs and 19% do so regularly, while 26% of SMEs have used overdrafts to grow their businesses. 540,000 businesses in the UK are unsure about being able to access the finance they may need to grow or even survive.

For these reasons, non-bank alternative lenders are essential in providing the finance to keep the economy thriving.

What are the risk characteristics of SMEs?

Although each business is very different, and the SME definition covers such a wide variety of business sizes and types, SMEs are nonetheless generally considered to be more risky counterparties than large corporates simply because of factors such as the ability to cope with changes in economic factors such as interest rate, inflation, political, regulatory changes, as well as marketplace or company-specific risks which they face.

However, these factors have a much greater impact on small and micro businesses than on true mid-market firms, which can often be better placed than larger corporates and listed companies in terms of their agility and ability to respond to such change factors.

Range of debt funding options for SMEs

SME's have a wide range of options through which to seek funding for working capital, purchasing core equipment and other assets, or for progressing strategic plans for business growth objectives be it organically or via merger and acquisition activity:

- traditional debt finance, asset-based lending, factoring and leasing (from bank and non-bank lenders)
- alternative debt such as direct lending; corporate bonds; debt securitization; covered bonds
- crowdfunding activities including P2P
- hybrid debt: subordinated debt; participating/silent participation; convertible debt and warrants; mezzanine.

Direct lending to SMEs

(from Triple Point paper "Private Debt: The opportunity for diversification and risk management with illiquid assets")

Private debt funds that focused on the SME market were virtually non-existent in Europe in 2005, yet by 2015, there were 31 Europe focused direct lending funds. As at June 2016, private credit providers had US$595 billion in assets under management globally, of which US$153 billion was dedicated to direct lending to SMEs.

The UK remains the largest market for private debt funds with 45% of the transactions in Europe, followed by 23% in France and 13% in Germany.

Whilst not as large as the institutional direct lending funds, the online alternative finance providers are an active and growing part of the alternative finance market.

By the third quarter of 2017, online alternative finance cumulative lending volume for UK SMEs reached £4.4bn, with total lending across all sectors growing 84% between 2016 and 2015.

These debt funds and alternative lenders offer borrowers more flexible terms on debt than banks and are filling some of the funding vacuum created by the withdrawal of traditional lenders.

SMEs are vital to the UK economy. There were 5.7 million private sector businesses at the start of 2017, of which 99.3% were small businesses and 99.9% of these are classified as SMEs. The total number of people employed by SMEs was 16.1 million, representing 60% of all private sector employment in the UK. The combined annual turnover of SMEs was £1.9trn, 51% of all private sector turnover in the UK. Since the start of the global finance crisis, the importance of SMEs to the economy has markedly increased. There are 29% more SME businesses trading today than in 2007.

SMEs have created 73% of all new jobs since 2010. In this time, SME turnover has grown by 17%, increasing their contribution to GDP.

Triple Point further analyse the position in their Advancr Bond Base Prospectus dated 26/4/18:

There has been an acknowledged "funding gap" for small and medium-sized enterprises ("SMEs") since the 1930s, but this has worsened in the aftermath of the 2008 financial crisis. Structural shifts in regulation and sterner capital requirements for banks have led to the retrenchment of traditional lenders from the SME sector.

Whilst larger corporates have been able to turn to the corporate bond market for financing, taking advantage of record-low interest rates to raise debt directly from the markets, SMEs do not have this option. Their borrowing needs do not reach the scale required to access the bond market cheaply. This has created demand for additional sources of funding and created space for non-bank lenders and asset managers to operate in.

UK bank SME lending volumes stood at £164 billion at the end of 2016, down from a high of almost £189 billion in 2018 suggesting there is currently a funding gap of circa £25 billion in the UK. Adjusting for the expansion of real UK GDP since 2011 this loss of funding is approximately £47 billion. It should be noted that SME lending levels were significantly higher pre-2009, and SME finance was already said to be scarce before the financial crisis, and that therefore the real funding gap is likely to be significantly larger.

There has been an influx of asset managers, institutional investors and alternative finance providers into the direct lending space since 2008, attracted by both the positive real yields and diversification opportunities, which combine to give solid absolute risk adjusted returns. Whilst this rise of alternative credit markets may be a more recent trend in the UK and Europe, non-bank lending accounts for 75% of total corporate lending in the US and is an established component of the market. The view in the market is that there is significant scope for the continued growth of this sector in the UK.

To summarise, the current trends of traditional lenders participating less in the SME sector, coupled with the increasingly vital contribution of SMEs to the UK economy, support the continued growth of the alternative finance market and the importance of non-bank lenders.

P2P Lending

Britain has one of the biggest P2P lending sectors in Europe, with established online platforms introducing borrowers and lenders. Over a fairly short period (less than 10 years) the UK sector had lent out (as at February 2016) £4.4bn, which is very little compared with the high street banks but nonetheless a considerable figure.

P2P lending is the practice of lending money to individuals or businesses through online services that match lenders with borrowers. Also known as *market place lending* or *crowd-lending*, many peer-to-peer loans are unsecured personal loans, though some of the largest amounts are lent to businesses.

The growth of the sector has only been possible with the internet and in some ways is typical of a modern internet business with the development of a platform, an online marketplace, which borrowers and investors can register with and they are then matched – lenders introduced to borrowers against a list of required criteria. P2P websites work by linking up savers who want a better return on their cash, directly with people (or small businesses), who are looking to borrow at competitive rates.

The P2P sector is regulated by the FCA but investors' cash is not protected under the Financial Services Compensation Scheme (FSCS), which would safeguard the first £85,000 of funds if they were held in a bank or building society which ceased to trade.

Lending is managed by the platform, with borrowers being credit-checked, assessed and underwritten by the P2P provider. The creditworthiness of the underlying borrower is a significant element of the assessment and ultimate interest rate offered and this requires expertise in assessing - small businesses for example are risky enterprises with hugely different finance requirements, needing an understanding of business plans and management.

The platform handles all the administration related to credit assessment, drawdown and repayment – the P2P businesses behind the platforms are of course businesses themselves and so aim to make money. As an investor then, there are various fees paid in respect of this work undertaken, sometimes directly to the platform / provider but sometimes built into the interest rates being made available.

Differences between P2P Business Lending and Direct Lending to SMEs

P2P lending platforms are sometimes considered to be part of the direct lending market but tend to mostly lend to micro companies, whereas direct lending is focused on larger, more established, small and middle market SMEs. This is reflected by the typical loan size offered by P2P lenders. For example, Funding Circle, the largest P2P platform in Europe, offers a maximum loan size of £500,000, whereas this often tends to be the starting loan size for many Direct Lenders. In 2015 NESTA reported that the average loan size for non-real estate businesses via P2P platforms was only £76,280.

P2P platforms initially were aimed at, and attracted, retail investors and matched the requirements of investors with that of private and smaller business borrowers, the platform acting as a broker to feed the funds through.

Direct lenders structure their funding differently, by acting as a balance sheet lender (like banks) or acting as investment trusts; or through listed vehicles such as bonds or funds set up for investors to access, with those vehicles providing the lending lines to SMEs and other borrowers. This means the direct lender is therefore taking the credit risk and subject to losses if the loans default. Whereas the P2P platform is acting as an intermediary and not taking any credit risk; and therefore they are not subject to losses in the event of loans defaulting.

The key difference is P2P platforms operate an origination model and are rewarded for throughput. Whereas Direct Lenders operate a balance sheet lending model and are rewarded for the performance of their underwriting.

3.4. USE IN MULTI ASSET PROPOSITIONS IN THE OUTSOURCED INVESTMENT CONTEXT – PART OF THE MATURING OPPORTUNITY

Growth in the availability of and investment in multi-asset managed fund solutions in the retail investment market has been significant. It includes propositions from the largest retail providers such as Prudential and Aviva Investors. Where advisers are using these types of investment solution the responsibility for strategic asset allocation, tactical asset allocation and portfolio implementation and ongoing management resides with the asset manager.

AKG discussed this with the multi-asset team of a large provider, with responsibility for setting the overarching strategic asset allocation framework for its multi-asset fund range and for managing asset allocation.

Q1: Are you actively seeking out alternative investment options compared to 3 years ago, and how has your allocation percentages changed if so?

Given the yield compression in traditional (western) developed markets fixed income and high valuations in some other asset classes, the investment sector has been looking for niche opportunities both within the public and the private asset classes space which can offer potentially attractive risk-adjusted returns and diversification benefits. This has led to an increase in the allocations to these asset sub-classes over the past few years, leading to better returns and diversified risk within fixed income, being made available through those managers who have taken this approach.

Q2: Do you consider strategies linked to direct lending to SMEs/SME Credit as part of your holdings in alternatives?

Within these there has been some inclusion of Direct Lending strategies. In framing our asset class characteristics, multi asset managers look through to the underlying risk and returns drivers. Hence for our analysis we treat them as private credit and position them along the risk return spectrum depending on the underlying risk drivers for the sub-asset class.

Q3: How would you describe the risk/return profile for direct lending to SMEs/SME Credit strategies?

The starting point for understanding the risk/return profile would be the public credit instruments with a similar credit rating and maturity profile. We would then adjust for the illiquidity and complexity of the asset sub-class, while making adjustments for mandate-specific characteristics like sectoral composition and geographical composition, as well as potentially origination premium.

Such managers carry out their own investment research and due diligence of the asset sub-class, evaluating the risks and returns and assessing if it fits with their overall portfolio. Once they reach an asset sub-class view, the implementation is subject to established appropriate due diligence on the manager and vehicle.

Making use of this approach can be a comforting route into consideration of the asset class by advisers, looking to bring some diversified exposure and other characteristics to clients' portfolios.

Advisers should note though that, as with most private asset classes, the divergence of returns between different managers can be significant and hence manager due diligence is an important part of the investment process.

3.5. IMPACT OF DIRECT LENDING WHEN INCLUDED IN A PORTFOLIO

Nuveen LLC has published various papers in 2017 including one entitled 'Private Debt: the opportunity for diversification with illiquid assets' in which it modelled and analysed the effects of including private debt investments (replacing other investments) within a portfolio:

"Overall, results supported diversifying stock/bond portfolios with middle market loans, which have potential to improve returns and reduce risk by replacing a portion of allocations to equity, high-yield bonds and other asset classes with less attractive risk/return profiles."

"Private debt has emerged as an asset class with potential to improve portfolio risk-adjusted returns by offering higher yields in exchange for illiquidity, better diversification, and lower volatility. Institutional investors who are less concerned about liquidity have the potential to earn above-market returns with lower risk.

Several categories of private debt historically have offered particularly attractive risk-return characteristics, including middle market direct loans and mezzanine debt. With track records offering higher yields and lower default and loss rates, they can serve as alternatives for traditional asset classes, including public corporate and high-yield bonds, and equity.

Investing in private debt — a complex market lacking transparency — requires due diligence in selecting managers with specialized expertise, a network of industry relationships, and a track record of success in developing diversified private loan portfolios."

Note the research and analysis was undertaken in the US market and was directed at Institutional investors but looked nonetheless at middle market loans i.e. direct lending assets as investments.

Subject to a clear understanding of the investment proposition and appropriate due diligence there are positive reasons for considering direct lending strategies for sophisticated HNW/UHNW investor portfolios.

3.6. DEVELOPING A RETAIL SOLUTION

Legal and Structural considerations

Report partner Shakespeare Martineau identifies numerous regulatory and structural issues facing providers seeking to structure debt lending propositions to SMEs as an alternative lending vehicle:

Regulation and Product Structure

- There is a general prohibition on carrying out regulated activities under section 19 of FSMA 2000 without the requisite permission. The type of product and target investor base (professional investor or retail) dictates the regulatory regime that must be complied with. Providers therefore need to carefully consider their own regulatory permissions and the structure that will best suit the type of investors being targeted (as many investors/intermediaries will not, or cannot, invest in certain types of product). It also depends on who is going to make the investment decision (the investor or the manager) and whether the structure gives access to the Financial Services Compensation Scheme (FSCS).
- Some products can look very similar, but the underlying structure and regulatory regime and implications can vary materially. Shakespeare Martineau recommends that product providers carefully consider what may work for them and that advisers research the product structure to ensure they understand what they are, and can advise on what's right for their client.
- The main problem is the variety of structures being used and, in some cases, lack of transparency (or adviser understanding) as to whether it's a fund, an individual investor managed service, or something else; and who makes (or can make) the investment decision. This does give everyone a headache because it's difficult to directly compare products (or they lack sufficient understanding of what the implications are of the various products).

Crowdfunding and platforms

- Operating a loan based crowdfunding platform is regulated under article 36H of FSMA 2000 (Regulated Activities) Order SI 2001/544 ("RAO") where the relevant regulated activity is "operating an electronic system in relation to lending".
- Firms operating a loan based crowdfunding platform facilitate loans where a corporate borrower enters into many individual loan contracts with lenders. The platform organises the KYC on the lenders, the suitability of the lenders to enter into such loans, the receipt of funds from lenders and the on-payment to the borrower when the loans complete. The platform organises the due diligence on the borrower, the collection of interest from the borrower and on-payment to all the lenders of the loan proceeds as well as the mechanics of repayment of the loans on maturity. In order to undertake these payment functions, the firm operating the platform must also obtain client money permission from the Financial Conduct Authority.
- A firm with permission to operate an electronic system in relation to lending, by virtue of becoming an authorised person, should be able to communicate the terms of the loan offer to a retail client and therefore should not fall foul of the restriction on making financial promotions under section 21 of FSMA 2000.

- Platforms cannot make direct offer financial promotions except to certain classes of lenders. For example, the offer must be limited to professional clients, high net worth investors, sophisticated investors and restricted investors.

Fund Vehicles (Corporate, LLPs, LPs etc)

- Fund vehicles tend to be the most commonly utilised structure in the sector, albeit these funds typically tend to only be available to institutional investors, with very few offers available to retail investors due to the regulatory regime. The fund vehicle pools assets and onward invests, which usually denotes that the structure is an alternative investment fund. If so, these products (and their providers) need to comply with the provisions of the Alternative Investment Fund Managers Directive (and related regulation).
- The majority of funds operating in this sector are closed ended funds, although there are a small number of open ended funds also operating, and may be considered to be unregulated collective investment schemes (UCIS), which can introduce an additional overlay of obligations/restrictions (in particular, marketing alongside the financial promotion restrictions under section 21 of FSMA 2000).
- Financial advisers may require additional levels of PI cover to advise on UCIS.

Management Services

- Certain providers set up their product offering by way of a management service. These might involve individual investor management arrangements, or alternatively a pooling of individual arrangements and assets and onward investment. The regulatory regime is very complicated and very much depends on how the product is categorised based on the structure.
- Where the structure is considered an alternative investment fund (despite there not being an actual fund vehicle), these products (and their providers) need to comply with the provisions of the Alternative Investment Fund Managers Directive (and related regulation). In addition, the product may also be a UCIS (see above).
- Where the product offering is an individual investor management service, the arrangement is likely to fall under the provisions of the Markets in Financial Instruments Directive (MiFID).

Corporate Bonds

- There are then those providers who have gone down the option of launching bonds for companies who carry on lending activities.
- This type of products may not be a ‘fund’ from a regulatory perspective, but would be subject to normal corporate law (for example, the UKLA prospectus and, if relevant, listing rules).
- It should also be noted that single securities, such as bond and shares, whilst common place, are not considered retail investment products. As such, advisers may require additional levels of PI cover and financial qualifications to advise on them.

4. WHERE DOES DIRECT LENDING SIT FROM A RISK PERSPECTIVE?

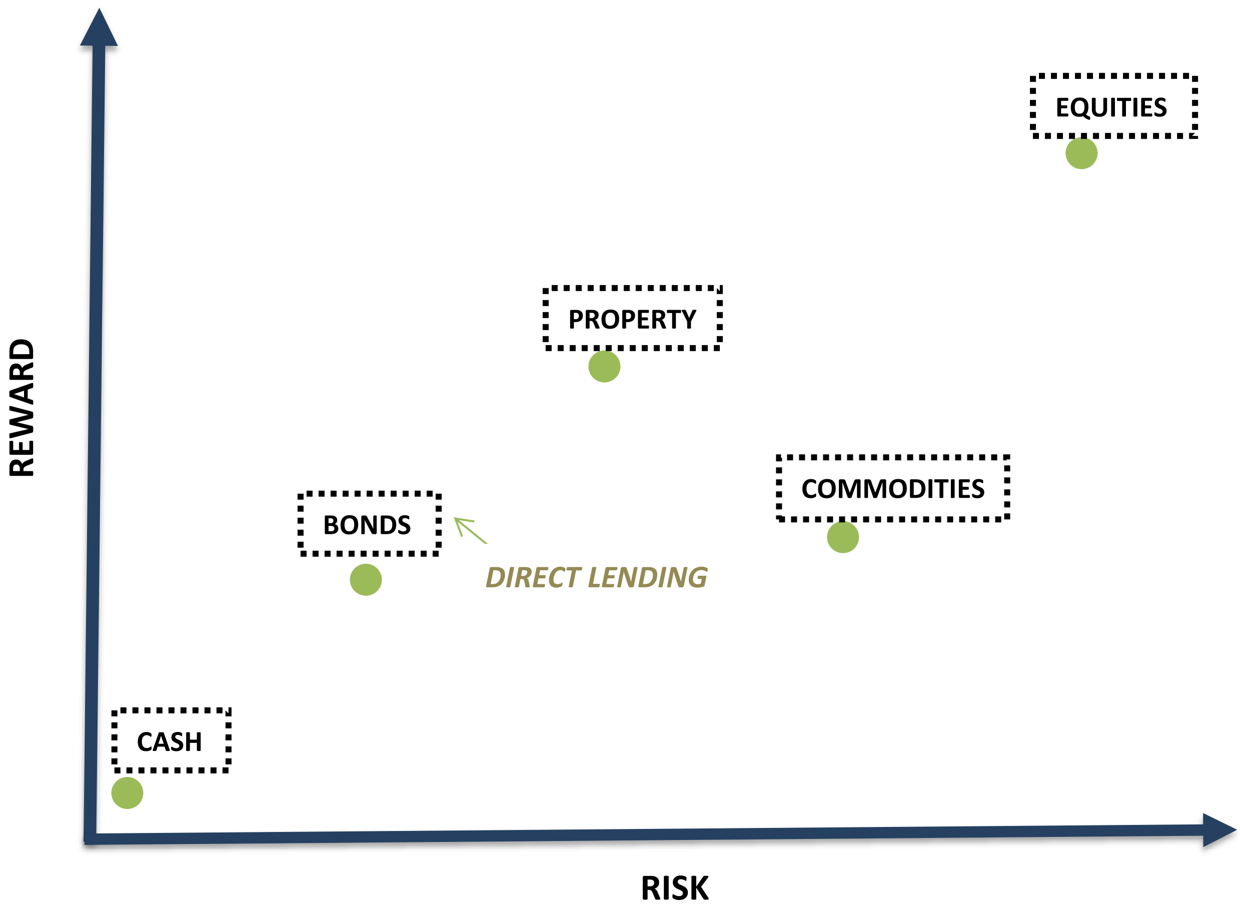
4.1. RISK PROFILE OF DIRECT LENDING?

AKG has considered the risk profile of this asset class for investors, using various sources and underlying metrics of risk and return comparisons (such source data including some level of performance data) to consider more fully where Direct Lending (and SME /Mid market lending) sits relative to the range of other asset classes.

4.2.1. RANGE OF ASSET CLASSES

Investable assets can be viewed across a range of classes, each of which reflect similar characteristics or behaviours:

The risk and reward properties of asset classes:



4.2.2. RELATIVE CHARACTERISTICS BETWEEN ASSET CLASSES

Cash

- Simple / familiar
- Liquid / portable / convertible
- No loss of (notional) capital value
- But in real terms, inflation reduces value (purchasing power) over the long term
- Low return as an asset class historically

Risk = lowest of main asset classes

Bonds / Fixed Income (WHICH ENCOMPASSES DIRECT LENDING)

1. Familiar to many investors but less well understood than cash
2. Investor returns are based on a debt-centred structure - i.e. someone is being lent money at some point within the model - with interest being paid / received. This is not necessarily (and generally not) paid directly to the investor, but drives the return paid to investors – many different structures exist though.
3. Fairly liquid given secondary market
4. Gilts / government bonds less volatile than equities - lack of correlation can be useful protection against stock market fluctuation
5. Returns are generally low-medium - better than cash but less than equities
6. But there are many sub-classes of bonds with different risk profiles including high yielding bonds available for higher risk

- If not index-linked then capital value can be affected by inflation and interest rate fluctuation

Risk = Lower than equities generally; higher than cash

Property / Real Estate

- Feels familiar but needs specialist investment knowledge to understand and manage as an investment asset
- Ultimately relates to ownership of physical assets from which income and/or development growth and capital growth can be derived.
- Generally illiquid, whether held directly (buy-to-let) or in a fund (through REITS - real estate investment trusts, or ETFs - exchange traded funds)
- Returns can be wide-ranging but generally mid-range against other assets – over the longer term the asset class has lagged equities
- Property values historically have kept ahead of inflation – but there have been bubbles with value lost rapidly in times of market stress
- Global property returns have demonstrated a moderately low correlation to UK equity so can act as a good portfolio diversifier

Risk = Higher than bonds or cash, but lower than equities

Equities (stocks & shares)

- Familiar to many investors, but risks not always well understood, and regularly underestimated; investors known to act irrationally
- Investment directly into business ownership with returns directly or indirectly linked to business performance
- Shares listed on major stock markets considered very liquid in fair trading conditions – other stocks /circumstances may see significantly reduced secondary market
- Over the long term, equities have historically delivered returns above any other asset class and have outstripped inflation – significant capital gains can be made but there are no guarantees of capital growth, or income.
- Significant loss of capital can feature

Risk = Higher than bonds, property or cash

Commodities

- Speculative investment requiring specialist market knowledge to capitalise on this asset, which is complex and difficult to assess competently
- Based on ownership of physical assets which are extracted, mined grown etc with value based on some further manufacturing process or end use
- Mainly invest via commodity funds providing exposure to price movements of commodity future contracts
- Liquidity overall good given well established trading markets
- Returns can be more limited than other asset classes but are likely to be realised in a shorter term
- Positive attributes include diversification risk as low or negative correlation with equities; and a hedge against inflation as spot prices tend to rise accordingly.

Risk = similar to equities albeit along the lines of FTSE large cap companies.

4.2.3. SUB-ASSET CLASSES

Sub asset classes are derived bringing the assets together within smaller less divergent groups of characteristics.

The Direct Lending sub asset class within Fixed Interest as shown above is known by various names depending on where you are viewing it from (so it could be direct lending, private debt, credit investments, alternative credit, illiquid credit etc) but it has some common characteristics within the definition / focus of this report.

However, it is also important to note that whilst lumping together various providers and propositions suggests some unity across the sub-asset class, this is not the case at all, they are each very different.

SME or Mid-market Credit 'sub' sub asset class

Even amongst those focused on SME credit within the direct lending sub asset class, a wide range of structures, returns and operating models are offered.

- Whilst closely related to the more established institutional investor / corporate borrower type of structure and within the direct lending / illiquid credit class of assets (where the majority of published data is focused), the underlying nature of investment asset and investor is pools of SME borrowers (multi-purposed but largely collateralised debt) and where the investor is (not exclusively but largely) sophisticated private HNW/UHNW.
- The underlying structures are sometimes balance sheet lending but always non-bank; and can be funds or bonds established by the investment management companies; and we are considering this to be distinct from the P2P end of market (platforms connecting retail investors to retail or small business borrowers) notwithstanding some small elements of cross over and similar structures utilised in this market by some players.

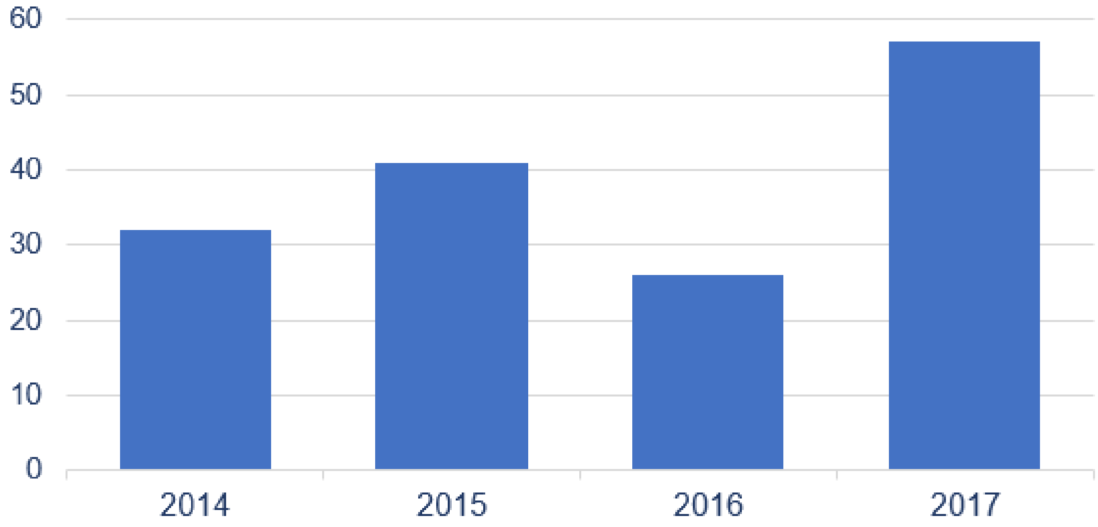
4.2.4. DIRECT LENDING ASSET CLASS INVESTMENT PERFORMANCE

Direct lending fund raising by investment groups doubled in 2017, with 75 funds raising US$56.7bn, according to data provided by Preqin. Growing regulatory pressures on banks has made them reluctant to lend whilst companies have continued to shore up balance sheets.

In those European funds with direct lending strategies the trend was also upwards with €20bn was raised across 27 funds in 2017 (in 2014 this was €9bn raised from 16 funds).

SMEs, too small to enter the bond market directly, have found loans originated by asset managers and other private equity groups to fill the gap.

Money flowing into private debt funds
Global annual direct lending fundrasing ($bn)



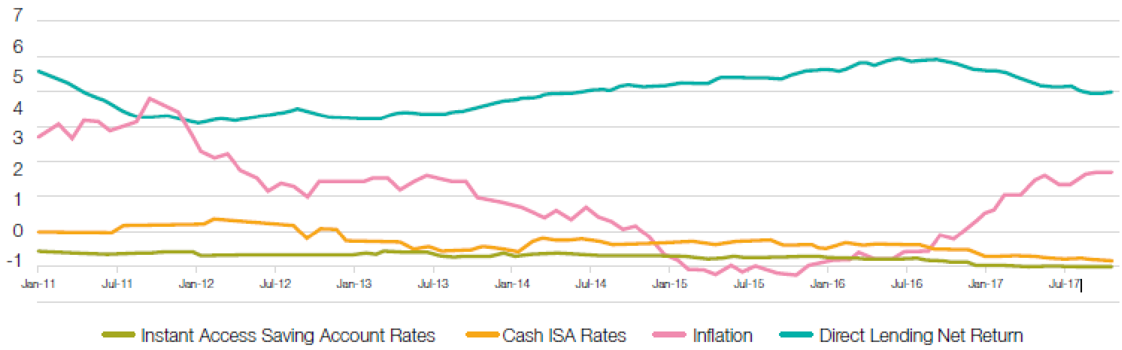
Source: Preqin

© FT

Since 2006, the Altfi Returns Index (ARI) has tracked net annualised returns ranging between 4.5%-7% (average 5.7%). This comes at a time when fixed income and savings yields are at historic lows.

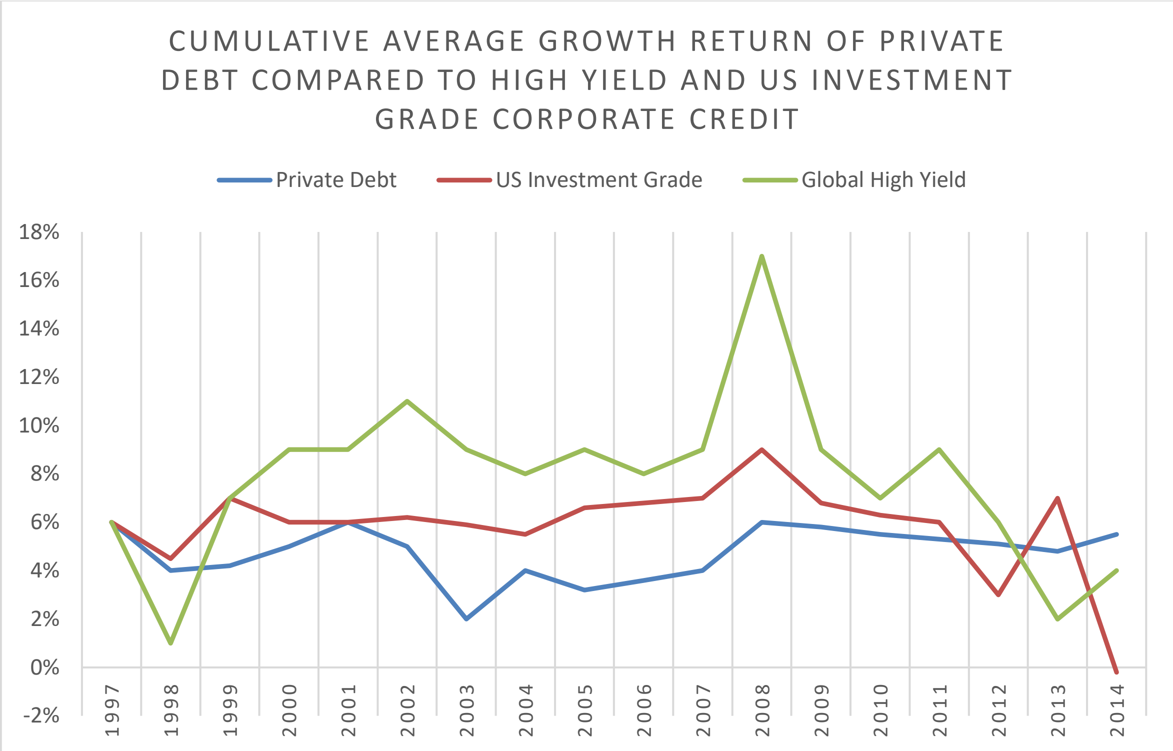
Source: AltFi Data 2018

DIRECT LENDING NET RETURNS VS. KEEPING MONEY IN THE BANK AND INFLATION (% RETURN)



Please note that past performance is not indicative of future returns.

Since data has been available, private debt has outperformed two key fixed income indices, Global High Yield and US Investment Grade (Figure 1) from an absolute returns point of view:



Source: Preqin and Create Research 2015

Past performance of course cannot indicate future returns but there is clearly potential being shown in evidence from many sources that Direct Lending has the potential to offer a high steady annualised return; this is what has made it interesting to institutional investors in the US and Europe and the reason structures to make the asset class available to retail investors have been developed.

4.2.5. RISK CHARACTERISTICS OF DIRECT LENDING INVESTMENT ASSETS

In AKG's view, having considered the range of opportunities within the asset class and available research material regarding their risk and return characteristics, a simplistic or blanket indication of risk for this asset class could be problematic, given the spread of variants within it.

Therefore, rather than seeking this potentially misleading shortcut, advisers and clients should look to more fully understand the specific characteristics and ingredients of the different offerings within the asset class and gain an understanding of and comfort with each risk profile in this way.

Fixed Income investments are considered, as an asset class overall, to be relatively low risk and have historically produced fairly stable, low to medium levels of return.

Direct lending-based investment falls within this Fixed Income class and therefore would be expected to share this risk / return profile, to some extent.

Direct lending as an investment asset does appear to be offering opportunities across a range of risk / return and maturity profiles, and with a relatively positive yield compared to other investments in its class with a similar risk profile, in AKG's opinion.

However, quality is important to achieve a positive outcome, so the asset manager / adviser / investor need to undertake significant due diligence in all cases - this is discussed further in Section 6, Best Practice Considerations.

Pricing can be misaligned if risk is not thoroughly considered, and of course, there is an uncertainty of outcome which means that if higher expected returns were anticipated, these may not be realised in any case.

Risk assessment

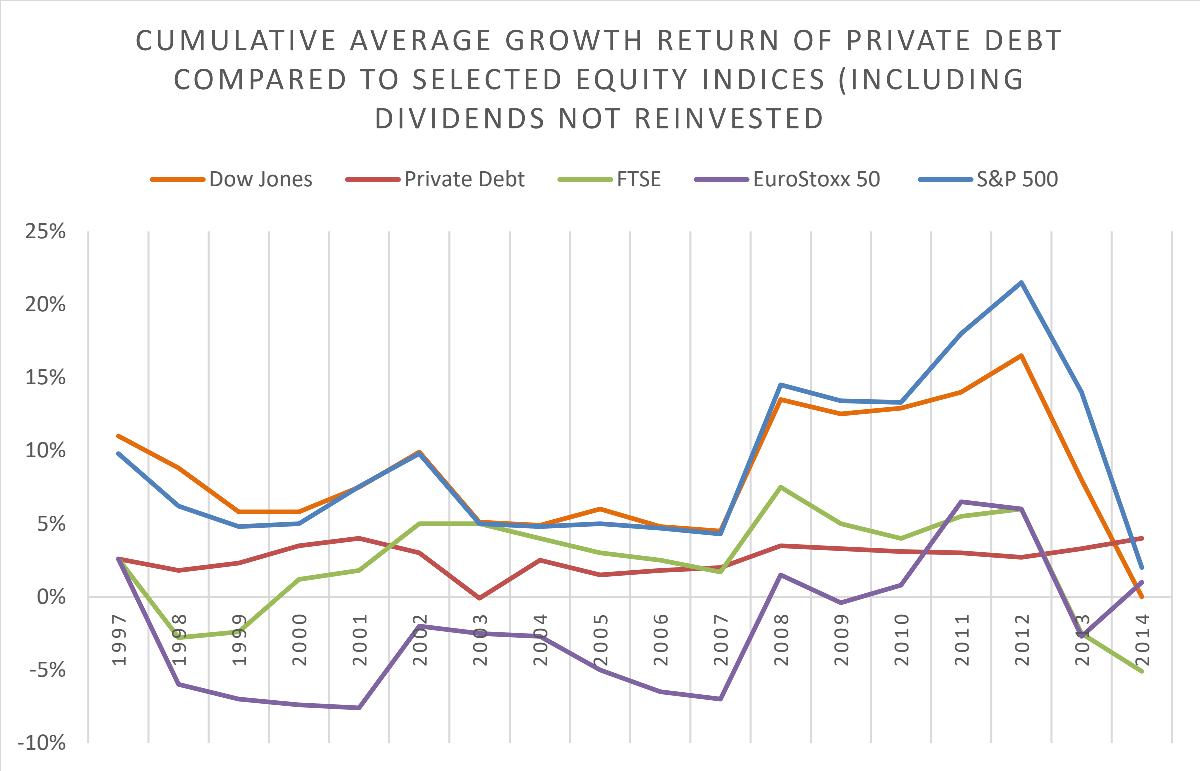
Risk is inherently difficult to assess and quantify, being based on many factors. For any asset class, historical performance is the start point for an assessment of its future risk.

It takes time to establish this in respect of new classes of investment assets – and this applies to Direct Lending (in the context of sophisticated 'retail' investors) and even more so when the underlying asset is SME borrowers.

The expected returns on any investment usually provide a good guide towards the level of risk being taken on - investments that carry more risk typically offer a higher level of expected returns, by way of compensation for the greater uncertainty from investing in them.

There are some core risk characteristics of direct lending as an investment, and specifically those with an underlying mid-market / SME targeted approach include:

- Credit risk – it depends on the category of direct lending but credit risk (in terms of a track record / lending default record / investor returns record) remains a key element of the assessment of risk for an investor
- Collateral / lending secured on assets – within the lending side of the transaction, assets may be taken as security and so form part of the credit assessment. The assessment of asset value and asset type, realisation in event of default etc all falls upon the credit provider to assess and so becomes part of the track record of the lender; but it is important for an investor to understand how (or in fact, if) any asset-backing impacts on the investment proposition offered and how that fits with the structure of the investment proposition and pricing
- Illiquidity – a lack of secondary market, or lock-in periods / contractual terms that impact on liquidity may be an issue. But this is perhaps less important (or indeed an actual positive) to those investors with a buy and hold strategy who should be 'closing their eyes'
- Interest rate risk – the ability for servicing the underlying credit may be impacted by changes in the prevailing interest rates
- Volatility of performance – from a risk point of view, there is a relative lack of volatility in private debt when compared to equity indices:



Source: Preqin and Create Research 2015, Bloomberg

- Transparency – the due diligence process will highlight a wide range of transparency, with some providers being very clear about the risks and protections associated with their propositions whilst others will make it hard work to establish these.
- FCA/FSCS protections – it is important to be clear about what protections exist. These will depend on the provider and the nature of the structure of the proposition – it is incumbent on the adviser to assess clearly any statement about FSCS protection for instance – it is NEVER going to extend to investment under-performance.

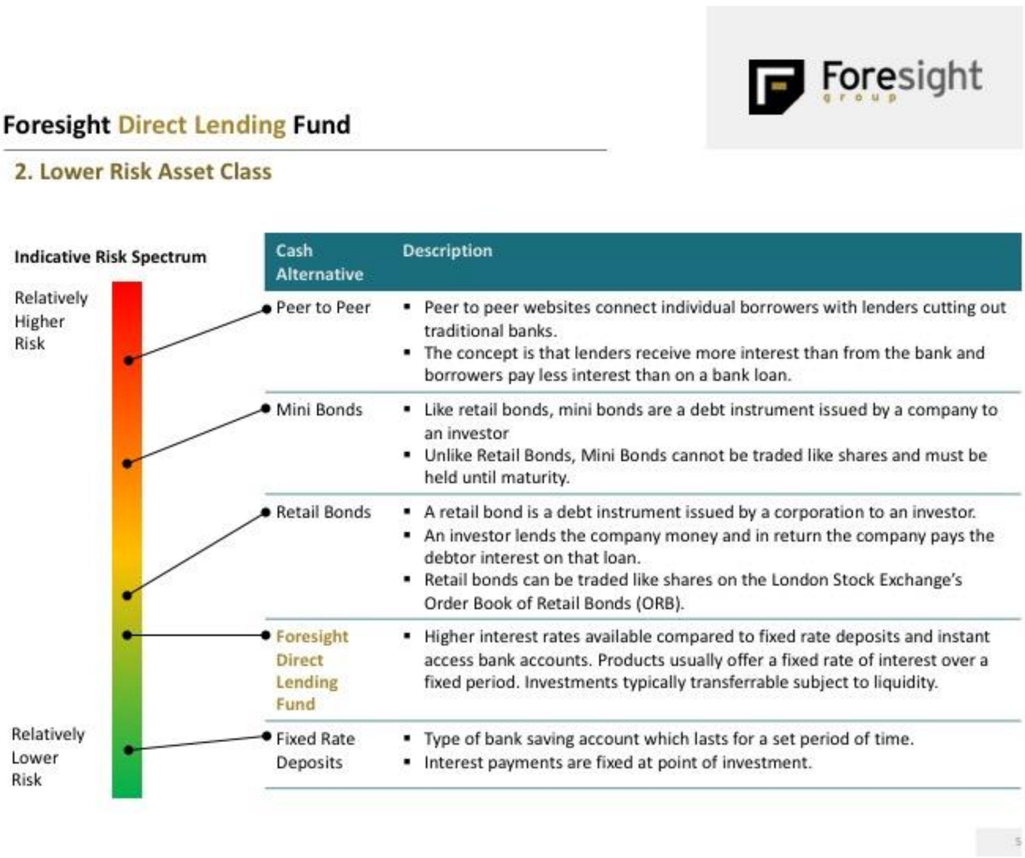
4.2.6. DIRECT LENDING WITHIN THE ASSET CLASS

There are good quality direct lending investment propositions available and subject to strong due diligence these can provide potential value for advisers of wealthier clients who look to their adviser to act as a conduit for all financial activities.

Many products are available and AKG's research with both consumers and advisers highlights that some clients are going direct to P2P or direct lending products, outside of the advice process, as advisers are not aware (or are nervous about providing) advice on direct lending alternative strategies.

An appropriate approach can potentially give advisers opportunities for further client engagement and to consider propositions that are arguably more robust – than say direct to client offerings of P2P - enabling advisers to carry out due diligence on the underlying risk of the asset / asset class.

Report partner Foresight provides an indicative risk spectrum for its Direct Lending product, outlined in the following diagram, which AKG considers to be reflective of Direct Lending to established SME borrowers, compared to other alternative types of the asset class available.



Cash Alternative	Description
Peer to Peer	▪ Peer to peer websites connect individual borrowers with lenders cutting out traditional banks. ▪ The concept is that lenders receive more interest than from the bank and borrowers pay less interest than on a bank loan.
Mini Bonds	▪ Like retail bonds, mini bonds are a debt instrument issued by a company to an investor ▪ Unlike Retail Bonds, Mini Bonds cannot be traded like shares and must be held until maturity.
Retail Bonds	▪ A retail bond is a debt instrument issued by a corporation to an investor. ▪ An investor lends the company money and in return the company pays the debtor interest on that loan. ▪ Retail bonds can be traded like shares on the London Stock Exchange's Order Book of Retail Bonds (ORB).
Foresight Direct Lending Fund	▪ Higher interest rates available compared to fixed rate deposits and instant access bank accounts. Products usually offer a fixed rate of interest over a fixed period. Investments typically transferrable subject to liquidity.
Fixed Rate Deposits	▪ Type of bank saving account which lasts for a set period of time. ▪ Interest payments are fixed at point of investment.

AKG also agrees with report partner Triple Point in its view that private debt has emerged as a credible (and increasingly popular) asset class along with other alternatives such as, infrastructure, real estate, energy, and private equity as part of a balanced investment risk.

Private debt is perceived to be particularly attractive whilst interest rates remain depressed. As excess liquidity has heightened the correlation between historically uncorrelated asset classes, investors have ramped up their search for other asset classes with good diversification potential.

Valuations of most asset classes have hit all-time highs due to Quantitative Easing, and as interest rates are expected to rise and fears of correction lie in the background, private debt remains well protected.

5. WHY MIGHT ADVISERS NOW CONSIDER PRIVATE DEBT INVESTMENT?

5.1. OPPORTUNITY

Along with the customer factors outlined previously which have driven the requirement to look beyond 'traditional' assets such as equities (the aspirations for yield, reduced volatility, diversification away from highly correlated equity and bond markets, referred to earlier) which advisers seek to satisfy, key to why advisers might now consider Private Debt Investment are two factors:

- Changes in the advice environment, notably post RDR
- The growth of an alternatives investment context.

Both are explored below.

Focus in on the RDR and post RDR Landscape

The original key regulatory drivers of the RDR initiative were aimed at addressing perceived shortcomings in the advice market by improving the clarity with which firms describe their services to consumers; by addressing the potential for adviser remuneration to distort consumer outcomes; and by increasing the professional standards of investment advisers. These key drivers could be grouped under headings that reflected the concerns of the Regulator: professionalism, adviser charging and market definition.

In the context of this report, the evolution of the market definition post-RDR, and its associated requirements, is pertinent. A wider definition of whole of market was introduced, meaning that advisers who wished to operate as 'independent' needed to consider a wider range of products than previously, and the definition of 'packaged products' was extended to 'retail investment products'.

'Retail investment products' now being defined to include:

- structured investment products
- all investment trusts
- unregulated collective investment schemes (albeit not available to the general public and restricted investors)
- any other investment vehicle that offers exposure to underlying assets in a packaged form rather than as a direct holding.

Advisers who have adopted independent, whole of market status therefore need to illustrate that they are considering this broader range of potentially applicable 'retail investment products' when carrying out financial planning exercises for their clients.

The advice sector evolution since RDR has therefore contributed to an environment which is more suited to the consideration of alternative investments, including Private Debt investment.

It has allowed alternative investments to become an option within the range of other more traditional asset/product opportunities considered by intermediaries in meeting client needs.

This is because an emphasis on financial planning and the greater consideration of client outcomes, via adding value through more sophisticated expertise and more robust processes, best practice and governance including better research and due diligence, have all contributed to a more holistic investment environment, which is no longer any sort of 'default product sale'.

Focus on the Alternative Investments Context

The primary traditional asset classes are cash, equities, conventional bonds and property. Alternative Investments is a catch-all phrase for non-traditional asset classes.

Examples of Alternative Investments include:

- Private Debt, i.e. non-listed debt investment (Direct Lending)
- Private equity, i.e. non-listed equity investment
- Commodities (precious metals, stones and resources such as oil and gas)
- Currencies, i.e. speculating in the movement of foreign exchange movements
- Hedge funds

Notably advisers' clients might well be less familiar with these asset classes compared to more traditional ones and longstanding investment structures. The AKG research underscores this.

See following extract:

Q5C: WHICH INVESTMENT/SAVINGS PRODUCTS ARE YOU FAMILIAR WITH?	
Cash ISAs	78%
Bank/building society accounts	74%
Stock and shares ISAs	68%
Individual shares (listed on an exchange)	47%
Bonds (listed on an exchange)	40%
Investment trusts	39%
Unit trusts	37%
Life insurance bonds	34%
Bonds (not listed on an exchange	29%
Private equity funds	29%
Individual shares in unquoted companies	22%

Gilts	22%
Direct lending/SME credit	**16%**
VCTs/EIS	7%

*Source: AKG **Consumer** Research 2018*

One rationale for investing in Alternatives is their expected low or negative correlation with the traditional asset classes.

This helps increase the diversification within a portfolio such that the poor performance in the core portfolio may be protected - when prices there go down, it is expected that the prices of the Alternative investments either do not fall as much or may even counter the losses with gains. Equally, when traditional investments rise in value the Alternatives may not rise as much or might fall in value. This is tantamount to an insurance mechanism.

In some cases the investment in Alternatives is for pure gain (even speculation) purposes, rather than hedging or insurance against losses. The different features of these investments and hence differing response to micro/macroeconomic, political and supply/demand drivers may give a skilled investor an opportunity to make profits which are not expected to materialise in traditional investments. In some cases the gains (and possibly losses) of a portfolio may be geared through Alternatives such that a small investment can achieve the returns of a larger commitment in traditional assets.

Crucial to any exposure to Alternatives is a full understanding of their dynamics, appreciation of the magnitude of the potential losses and accepting that different market participants have various intentions undermining the rationale of other investors. These latter issues are not necessarily unique to Alternatives; they are also present in traditional asset classes to some extent. However, the volatility is often not easy to measure or forecast, nor is it always well understood. In some cases the investment models are extremely complicated and hypothetical. The investment outcomes can consequently be surprising in their direction and magnitude.

Investment in Alternatives can sometimes be expensive as the management and holding fees can be higher than for traditional investments. In addition, the lower liquidity may mean converting the investment into cash may not be easy in the short term.

Intermediaries are increasingly finding that in order to provide their clients with a holistic service, at a reasonable cost, they are looking to outsource one or more elements of this investment activity.

When they do this, they need confidence in the processes and competencies provided by the third party. In the eyes of the regulator, the intermediary, not the third-party provider, has the ultimate responsibility to the end client.

As above, investment management is increasingly seen as a sector where intermediaries are turning to third party solutions, model portfolios, guided architecture etc. This encompasses not only 'main stream' asset classes such as equities and bonds but increasingly extends to asset classes, such as Private Debt, with which the intermediary is less familiar.

The proposition fits in as an appropriate component of this overall evolving 'intermediary market investment processes norm'.

Its process is made a particularly important part of its proposition due to the simple fact that intermediaries are indeed less familiar with the asset classes to which it delivers exposure. In this regard the growth of multi asset propositions is particularly relevant.

5.2. CUSTOMER ENVIROMENT CONTEXT

5.2.1. BACKGROUND – AN EVOLVING ADVISORY SECTOR

Introduction

It is valuable in establishing the context in which Private Debt Investment propositions sit, to set the scene in terms key environmental drivers.

In particular those which have shaped the current UK intermediated advice sector, through which Private Debt Investment propositions are now in part delivered. And even more so in understanding the conditions, evident in the market and which will impact on the opportunity or otherwise for further development growth of this asset class and mechanisms for its delivery via financial advisers, to individual end consumers, their clients.

Circumstances change and the consequent requirement of this intermediary market and of the underlying customer/client segment it serves are particularly pertinent in to the consideration of Private Debt Investment, its 'fit' and the appetite for it. In addition, such cognisance is key to understanding any challenges to and resultant requirements (general or specific to the Private Debt asset class and propositions).

Growing Professionalism and 'Value-add' in the Advice Sector

The UK intermediary market increasingly looks to deliver a more sophisticated offering, particularly to a client segment considered as high net worth or similar and particularly since a shift in the regulatory landscape under the Retail Distribution Review (RDR).

It does so in the context of a 'new world reality' of fee charging. Although it should be noted some intermediary firms had made this transition some time ago, it was previously only a fraction of the market.

Indeed the more explicit nature of cost and revenue apportionment along the value chain has put real pressure on competitiveness for each entity in the relationship, as well as giving the intermediary a growing focus on adding value to the advice offered, in part through a more sophisticated approach and wider constituents, all overlaid with appropriate governance and scrutiny.

Cost pressure has further contributed, along with a desire to enhance propositions (inclusive of governance and improved client outcomes), to the greater use of technology and tools. This includes the increased adoption of platform (wrap) technology, DFM and multi manager solutions and the use of tools/techniques in areas such as risk assessment, performance comparison and model portfolios. Investment components that are available via outsourced arrangements need to fit with these other components. And the growth of these is relevant to the opportunity for Private Debt Investment and its route to market.

Further and out with the RDR, other regulatory change and ongoing pressure has meant that intermediaries' own thirst for robust process, clear competencies and clarity of governance has increased. Indeed, delivering such a 'defined investment process' has become something of a hygiene factor for intermediary investment operations.

5.3. BACKGROUND – CHANGING CUSTOMER REQUIREMENTS AND CONTEXT

Search for yield

Market conditions, largely since the financial crisis, have proved challenging for customers or investors searching for yield.

Difficulty in deriving attractive yield from fixed interest securities and from an ability to map equity investment in uncertain markets, have meant that investors have questioned whether other sources of return might be available to them.

This yield question has been further emphasised in recent times by growing concern of rising inflation.

These market and economic factors are very visible for investment customers and thus translate into the broad investment and advice 'conversation'.

This set of circumstances is evident and has been articulated in press and commentary over recent years and is also encapsulated in the findings of the AKG consumer research undertaken for this study.

Is there customer appetite to look outside of traditional investment options?

QIC: ARE YOU WILLING TO INVEST IN INVESTMENT/SAVINGS PRODUCTS OUTSIDE THE TRADITIONAL EQUITY OR CASH-BASED SOLUTIONS?	
Answer Choices	*Percent*
Yes – Depending on returns	53%
Yes – Definitely	22%
No	13%
Don't know	12%

*Source: AKG **Consumer** Research 2018*

The results from the initial question illustrate a consumer appetite for considering investment in investment/savings products outside the traditional equity or cash-based solutions.

22% said that they would definitely be willing to do so while the majority, 53%, said that they would be willing to do so, depending on the investment returns available, i.e. in line with the search for yield which has been such a feature of the market backdrop since the financial crisis, and continues to be so given current uncertain conditions.

This clearly shows an appetite by customers to look for greater returns beyond traditional sources. To try to achieve these higher returns aspired to by some clients, advisers may need to look beyond investments such as fixed interest, as indicated by the research findings further on.

This perception of this client view is, as would be expected, picked up in adviser views of their clients. As indicated below.

Q3A: ARE YOUR CLIENTS WILLING TO CONSIDER DIFFERENT ASSET CLASSES, IN ORDER TO ACHIEVE HIGHER YIELDS?	
Answer Choices	*Percent*
Yes, if yields are substantially higher than average	20%
Yes, if yields are slightly higher than average	21%
Yes, in general	42%
No, they generally prefer standard asset classes	12%
Don't know	5%
All yes	***83%***

*Source: AKG **Adviser** Research 2018*

What yield are advisers looking for in fixed income products?

Q1A: WHAT TARGET YIELD DO YOU AIM TO ACHIEVE FOR CLIENTS INVESTING CASH IN FIXED INCOME PRODUCTS?	
Answer Choices	*Percent*
Up to 3%	23%
3% to 5%	50%
5% to 7%	23%
More than 7%	4%

*Source: AKG **Adviser** Research 2018*

Customers (a significant proportion) emphasise their willingness to explore niche areas to meet this aspiration of higher returns (the 5%+) which advisers are unlikely to be able to consistently deliver from allocation to investments such as fixed interest.

Is the economic backdrop driving interest in exploring alternative investment solutions?

Elaborating further the following research response is noteworthy:

Q2C: HAS YOUR ATTITUDE TO INVESTING IN INVESTMENT/SAVINGS PRODUCTS OUTSIDE THE TRADITIONAL EQUITY OR CASH-BASED SOLUTIONS CHANGED DUE TO LONG-TERM LOW INTEREST RATES AND RISING INFLATION?	
Answer Choices	*Percent*
Yes – I am more willing to try alternatives	32%
Yes – Depending on circumstances	49%
No	13%
Don't know	5%

Source: AKG ***Consumer*** *Research 2018*

From the above question, the research indicates that consumers are more willing to try something outside of traditional equity or cash-based solutions due to the prevailing economic and market conditions.

Indeed, amongst many commentators there is a view that current market uncertainties will see alternatives as a growing beneficiary as investors search for yield and a reduction in volatility.

As referred to above inflation concerns are also part of this narrative and again the AKG consumer research illustrates this.

See below extract.

Q3C: ARE YOU CONSIDERING SWITCHING MONEY OUT OF CASH SAVINGS GIVEN THE EXPECTED RISE IN INFLATION?	
Answer Choices	*Percent*
Yes	31%
No	31%
Don't know	38%

Source: AKG ***Consumer*** *Research 2018*

With nearly a third of respondents going as far as to say they are considering switching from cash due to inflationary pressure.

Search for lower volatility

Allied to the search for yield in investment customer demands is a search for reduced volatility.

Indeed, the natural extension of diversification between different equities is to incorporate other asset classes, such as bonds and cash, property and alternative investments.

This is expected to help dampen the returns from time to time. The investor is giving up the extreme highs of the returns sometimes seen in equities in exchange for avoiding the extreme losses that occur from time to time.

Search for Diversification

A further understood corollary to improving yields is to improve the diversification of the asset mix and sources of risk and return held by investors.

Again, this is about understanding the correlations between assets and markets, including the risk of self-referencing markets that can be overpriced.

Understanding illiquidity

Liquidity or lack of it has always been a key concern for investment customers. However, it was further brought into focus during the financial crisis and since then it has remained a heightened consideration.

In a certain respect this has helped in raising the profile of consideration of liquidity / illiquidity and the potential, once understood, for investment customers to consider the illiquidity premium, whereby a higher yield might be derived from giving up the characteristic of being able to sell and asset quickly if required.

AKG’s research results placed liquidity relatively low in the mix of investment attributes. Although it should always be stressed that understanding the consequences and having the ability to cope with illiquidity is a necessity. See following extract.

Q4C: WHAT WOULD YOU CONSIDER TO BE THE MOST IMPORTANT ATTRIBUTES FOR SAVINGS/INVESTMENT PRODUCTS?	
Level of risk	51%
Guaranteed returns	42%
Expected returns	41%
Guarantee that investments are covered by compensation scheme	36%
Clarity on where money is invested	35%
Understanding of the product/investment area	34%
Flexibility	28%
Tax-free allowance	26%
Instant access	24%
Familiarity	13%
Liquidity	13%

*Source: AKG **Consumer** Research 2018*

A Proven path trodden by institutional innovation – but with the need for more information

A final contextual element from the perspective of investment customers is the fact that Institutions have been investing for some time in a wider range of assets. In particular, of relevance here, Private Debt.

They have done so for many of the same reasons as outlined above that constitute the context for individual customers, as well as some specific to their requirements, which can have additional complexities and required characteristics.

Thus, there is some useful cutting of a path by heavier weight investment entities that provides an element in the backdrop for individual investment customers.

Innovation by institutional investors may well contribute some comfort to individual investors that such asset classes are viable and provide lessons in requisite research and due diligence to provide an understanding that might otherwise seem to be out of reach, and which is certainly necessary, to participate in such market areas.

This is further underlined and augmented in terms of accessibility by the further development of multi asset propositions in recent years by providers. Such propositions have also actively sought out different asset classes as existing fixed income has seen yields compressed and other asset classes have suffered from worryingly high valuations.

Certainly, the requirement for information to facilitate consideration of Direct Lending by consumers via their retail advisers is clear. It is something that was underlined in AKG's adviser research.

Q4A: ARE YOU CONCERNED THAT SAVERS AND INVESTORS IN GENERAL DO NOT UNDERSTAND DIRECT LENDING PRODUCTS?	
Answer Choices	*Percent*
Yes	67%
No	26%
Don't know	7%

*Source: AKG **Adviser** Research 2018*

Patently more information (not necessarily complex and voluminous, but sufficient to clearly inform) is required to enable growth and consideration of Direct Lending investment in this market segment, where there would appear to both demonstrable and justifiable pull from environmental drivers.

Currently this asset class (along with other currently niche areas) form only a small part of what advisers recommend within portfolios and consequently only a small part of what consumers say they currently hold.

Asked 'IN WHAT ASSET CLASSES DO YOU CURRENTLY ADVISE CLIENTS TO INVEST FOR INCOME?' 7% of adviser respondents in AKG's research indicated Direct Lending.

Though interestingly this is higher than VCTs/EISs, at 5%.

A slightly lower figure was evident amongst the consumer research population. With 4% indicating a holding of Direct Lending investment. VCTs/EISs again was lower still at 2%.

Extending this further to the broader familiarity front, there were no major surprises here with the top three indicated by AKG's consumer research being Cash ISAs, Bank/building society accounts and Stocks and shares ISAs.

This current relatively low level of use, and greater but still relatively modest level of familiarity is clearly relevant to the opportunity for Direct lending within a balanced basket of asset types and is commented on further in this report.

Also, for a sample of 'regular investors' there is healthy awareness of core investment componentry - Individual shares (listed on an exchange), Bonds (listed on an exchange), Investment trusts and Unit trusts. See below for the full list from the research.

Q7C: WHICH INVESTMENT/SAVINGS PRODUCTS ARE YOU FAMILIAR WITH?	
Cash ISAs	78%
Bank/building society accounts	74%
Stock and shares ISAs	68%
Individual shares (listed on an exchange)	47%
Bonds (listed on an exchange)	40%
Investment trusts	39%
Unit trusts	37%
Life insurance bonds	34%
Bonds (not listed on an exchange	29%
Private equity funds	29%
Individual shares in unquoted companies	22%
Gilts	22%
Direct lending/SME credit	16%
VCTs/EIS	7%

*Source: AKG **Consumer** Research 2018*

Customers seem to be considering Direct Lending options outside of Advice – a challenge?

There is perhaps a timing question to be considered in the evolution of the investment sector in its consideration of Direct Lending and possibly alternatives more widely.

Some of AKG's research indicates that customers might be running a little ahead of advisers in their attitude to the asset class.

This is something of a challenge for advisers, although not an unwelcome or unnatural one. in fact, it is understandable and probably what market would want from a responsible advisory constituent, given prior issues with some alternative investment funds/ unregulated collectives.

The two questions from AKG's adviser research are notable in illustrating this facet of the market evolution / potential further evolution.

Q9A: HAVE YOU EVER BEEN ASKED BY CLIENTS ABOUT PRODUCTS EXPOSED TO DIRECT LENDING?	
Answer Choices	*Percent*
Yes – and have recommended them	22%
Yes – and have not recommended them	31%
No – and would not recommend them	28%
No – but might recommend them	19%
All yes	***53%***
All no	***47%***

Source: AKG ***Adviser*** *Research 2018*

Q7A: DO YOU HAVE CLIENTS WHO ARE INVESTING IN ALTERNATIVE DEBT PRODUCTS SUCH AS DIRECT LENDING, PEER-TO-PEER LOANS, OR CROWDFUNDING WITHOUT YOUR INVOLVEMENT?	
Answer Choices	*Percent*
Yes	50%
No	36%
Don't know	14%

Source: AKG ***Adviser*** *Research 2018*

A final interesting revelation was that some 50% of advisers had knowledge of clients investing in alternative debt products, and a further number who did not know if their clients were. There seems therefore be potential for many advisers to be able to benefit from advising and managing this instead.

5.4. INVESTOR CASE STUDIES

The Report partner Triple Point has provided some case studies to illustrate how clients of their Triple Point Income Service have incorporated the investment within their portfolios:

Profile 1	The investor is a 55 year old man who previously worked in the investment industry, specifically advising institutional investors on fund selection. He is an active investor with a portfolio that is predominantly invested in shares and ETFs. However, he is concerned with the current highs of the UK and US stock markets and holding off on making any further equity investments until there is a correction. He believes diversification is genuinely important.
Amount Invested	£660,000
Investment details	He has purchased a variety of 1 year investment terms with differing maturity dates, all paying interest at the date of maturity, rather than receiving it monthly as he does not need the income generated by the investment. Some of the investments are held within ISAs to maximise tax efficiency. He chose a 1 year investment term because liquidity is important to him and whilst he will not require funds within 12 months he would like to take a view of the available investment opportunities at maturity, including additional investments in the product, as opposed to being invested for a longer term. During this initial period he wants to put his funds to work and generate a higher return than merely remaining in cash. He is using the Triple Point Income Service as a savings tool rather than a pure investment, although he treats it as and evaluated it as an investment. For example, he recently sold his house and none of those funds are invested in this product. Those funds are in a bank account and treated as cash. His savings however are invested in the product. He felt the product offered a far more attractive risk reward profile than any fixed term deposit account or corporate bond he was able to find elsewhere. He also chose a 1 year term over 3 years because he felt 3 years was a significant period in terms of credit risk and a lot can change over such a period. He was comfortable sacrificing the more attractive return for ease of access. He typically reinvests the money returned at maturity into another 1 year investment. Although this may change should a financial requirement arise and he needs to use those funds to meet it.
% of entire Investment Portfolio	15%
% of available cash at the time	30%

Profile 2	The investor is a family owned UK LTD company that owns and lets residential properties in the South East of England. The Finance Director was concerned with the large amounts of cash on the company's balance sheet that were not earning a return. The client is heavily exposed to the UK property market already through the day to day operations of the business. He did not want to increase this exposure further as he is weary of the current property market, and was therefore seeking alternative homes to put this capital to work. Money markets and Gilts would have been an option in the past but the interest rates are not attractive enough at this current point in time.
Amount Invested	£3,000,000
Investment details	He made a series of 3 year term investments, some paying interest monthly to generate additional income for the business and the remaining balance paying a compounded return at maturity. By taking monthly income on part of the investment, it also allows him to spread the tax liability rather than incur it all on maturity. He chose a 3 year time horizon as the business has no immediate need for the capital and preferred to take the higher return in exchange for tying up funds. As a corporate, the lack of volatility of the investment was an added attraction because he did not want to expose the company to the movements and risk of the capital markets.
% of entire Investment Portfolio	30%
% of available cash at the time	70%

Profile 3	The investor is a 68 year old ultra-high net worth individual, who has invested via his SIPP. He has a financial adviser that he works very closely with, particularly with regard to his SIPP holdings. Currently outside of his SIPP he has investments in a range of VCT, EIS and BR investments to mitigate his personal tax liability. He has previously invested into direct lending products upon the advice of his financial adviser. Both the adviser and the client like the credit risk of the asset class because of the structures in place to mitigate risk at the underlying transaction level. The client is seeking income producing investments to be held within his SIPP to produce tax free income. Additionally, if he were to die before he is 75, the SIPP would be exempt from inheritance tax and the beneficiaries could draw upon the income produced free of tax.
Amount Invested	£120,000
Investment details	The client (via his SIPP) selected 1 year investment paying monthly income, although he retains the income within the SIPP. Upon maturity of the investment, he intends to reinvest into the same product. Upon the advice of his financial adviser, his investment comprises 10-15% of his overall SIPP value.

	Prior to investment the SIPP was heavily weighted towards equity holdings. As a result his adviser recommended that his client reduce this allocation in favour of alternative asset classes which are uncorrelated to the stock market and consequently should show less volatility. The investor's adviser chose direct lending as it shows these features.
% of entire Investment Portfolio	1%

5.5. BACKGROUND CONCLUSIONS

To sum up the background context, in the UK market the level of advice available to retail investors is now more professional, and advisers have the ability, tools and infrastructure to facilitate a more sophisticated investment advice offering.

This is welcome because customers responding to changes in the environment have new aspirations in terms of their investment portfolio.

To date, Direct Lending opportunities are not a prevalent part of the investment mix for retail customers or those coming through retail advisers. But customers appear open to it and whilst advisers have (rightly) not rushed in, they are moving forward with their clients (the retail customer) to address this opportunity.

Subject to appropriate information and transparency, a place for Direct Lending, amongst a broad basket of investment and asset options, appears compelling.

The opportunity is nicely summed up by advisers in the following general question from AKG's research.

Q11 WOULD YOU INVEST YOUR OWN MONEY IN PRODUCTS EXPOSED TO DIRECT LENDING?	
Answer Choices	*Percent*
Yes – I already have	10%
Yes – I would consider it	39%
No	37%
Don't know	11%
All yes	**49%**

Source: AKG ***Adviser*** *Research 2018*

6. BEST PRACTICE CONSIDERATION FOR ADVISERS

6.1. AKG'S APPROACH TO APPRAISAL OF ALTERNATIVE INVESTMENT PROVIDERS

Key considerations for AKG when assessing providers of alternative investment propositions

AKG has experience in assessing Alternative Providers in the context, specifically, of understanding the proposition and how this might be affected in the event of failure or other untoward event and the onward impact on investors.

In the context of Direct Lending as an Alternative Investment, some key points would need to be evident and positive from AKG's assessment:

- A significant track record of the target business within the sector – i.e. experience of lending to SMEs, a substantiated background in lending and minimal levels of bad debt/problematic lending would demonstrate a good history of credit assessment and lending governance / control
- Trading profitably and well capitalised, meeting any internal or external solvency requirements and with a good regulatory record as appropriate
- Good internal governance, transparent criteria and strong underwriting to ensure adherence to lending principles are maintained
- Experienced credit staff and management
- Transparency of business model.

And in respect of the proposition, it is good to establish:

- Investor protection – clarity on whether investors are covered by the Financial Services Compensation Scheme which operates in the UK or whether no explicit investor protection is available.
- Nature and extent of any underlying guarantees, third party / counterparty risk.

The nature of direct lending investment propositions is such as to require individual investors to be "well informed". There is a clear need for advice and a full understanding of the risks involved. Products of this type carry a number of inherent risks, whilst not having the explicit fall back provision of investor protection. These include:

- Investment risk – There is the risk that the investment will not provide the returns expected; past performance should not be taken as a guide to the future

- Liquidity / illiquidity – essentially an illiquid asset, direct lending can have some level of limited liquidity depending on structure, availability of a secondary market or on-selling capability etc
- Process risk – Administration needs to be carried out by a competent and experienced organisation, and this will usually be managed in-house; but may not be.
- Misappropriation of monies/assets – where are investor monies held at various stages on transaction and are all appropriate regulatory conditions met and mandated control procedures governing transfer of monies adhered to. Are Property assets registered at HM Land Registry / share certificates deposited etc etc

What are the hurdles for using such alternative providers?

Providers need to work hard to understand customer requirements and also to find out what motivates them and what might deter them from engaging with a particular type of investment solution.

For example, AKG asked consumers:

Q5C: WHAT WOULD DETER YOU FROM INVESTING IN PRODUCTS THAT LEND DIRECT TO SMES?	
Too risky	39%
Lack of clarity about what you are investing in	38%
Don’t understand the market	32%
High/unrealistic returns	28%
Lack of access to cash	22%
Concern about compensation schemes	21%
I wouldn’t be deterred	6%

*Source: AKG **Consumer** Research 2018*

What this illustrates is that there is always likely to be something which might hinder engagement, with only 6% saying that they would not be deterred. While providers might not be able to square-off all of these potential concerns they can seek to help customers understand the positioning of a solution when considering potential push-back items.

In particular, the buck stops with providers to invest in the time, resources and material to better communicate and educate (directly or via the intermediary channel) those customers for whom there is a lack of clarity about what they are investing in (38%) and/or who don’t understand the market (32%).

Advisers were also questioned about barriers to recommending direct lending products:

Q10A: WHAT ARE THE BARRIERS TO YOU RECOMMENDING DIRECT LENDING PRODUCTS TO CLIENTS?	
Answer Choices	*Percent*
Am not familiar with the products	28%
Concerns that they are not covered by compensation schemes	23%
Concern over regulatory issues	23%
Our compliance department	22%
Lack of liquidity	21%
No demand from clients	16%
Wide range of alternatives so no need to recommend them	15%
Concern about impact on Professional Indemnity cover	13%
Our para-planning/research department	10%
Yield rates are not high enough to justify	3%
Other (please specify)	1%
None	3%

*Source: AKG **Adviser** Research 2018*

In essence, there was not one overwhelming barrier, but a range of smaller hurdles for providers to consider and tackle.

Familiarity can be tackled over time with awareness/education campaigns and longevity of solutions in the market can help, i.e. these are still pretty new solutions in retail market.

The next three significant barriers are then linked to regulatory/legal/risk and compliance issues, which seem inevitable, as AKG has seen in other situations.

6.2. COMPLIANCE CONSIDERATIONS

Report partner Bovill provided some expert input in this respect.

For providers / asset managers:
Why should anyone be interested in an investment manager's compliance function?

A well-run investment manager will have a robust governance framework and sensible compliance culture. Firms that follow the FCA's treating customers fairly principles really do place investors' interests at the heart of their business, which is good for the investors and good for intermediaries.

Bovill has been working with cutting edge investment managers for nearly 20 years now and in our experience the managers with strong risk and compliance functions have the best investment processes.

What does good look like in terms of rigorous, comprehensive internal compliance?

The short answer is: it depends. Firms are encouraged to take a risk-based and proportionate approach to compliance – there is no one size fits all solution. A compliant investment manager will have an engaged management team setting the right tone from the top. They will take a long-term view of the business and keep a close eye on the constantly shifting regulatory landscape to make sure the firm is ready to adapt to any changes.

The best investment managers understand that compliance should be at the heart of their business and not just a back-office concern. In practice this will mean well planned and executed compliance monitoring, regular staff training, using reputable service providers and frequent monitoring of distribution channels.

So advisers should not be put off when an investment manager requests data or documents from them – this is a sign that the manager is doing their job properly. Advisers should have more concerns about the investment manager who never asks them to provide or update information – they will have weak controls and run the risk of enforcement action from the FCA.

Of course, taking compliance seriously takes time, money and expertise, which is why most investment managers have a relationship with external compliance consultants to help with the heavy lifting or to access advice on best practice.

Are there any areas which are of specific importance for providers of specialist investment solutions?

Many providers will be subject to AIFMD and will need specific governance structures and processes in place to manage the risks and liquidity of their funds, as well as having a specialist depositary in place. These things come at a cost, but the upside is increased protection for investors.

The product governance rules brought in by MiFID II require providers to have tighter controls around product design and oversight of their distributor channels. The aim is to produce high quality products with a clearly defined target market in mind.

Advisers can expect responsible providers to request detailed information on the adviser's distribution strategy and the type of investor being targeted, so there will be a clear audit trail to demonstrate that the product is ending up in the hands of the right audience.

What recent regulatory initiatives and compliance developments are affecting this type of provider?

There has been a big shift in the regulatory landscape recently. MiFID II and PRIIPS have come into force, as well as changes in the anti-financial crime regime with the Money Laundering Regulations 2017 and a new corporate tax evasion offence being introduced in the autumn of last year.

As well as the new product governance rules, MiFID II has introduced enhanced standards that affect most product providers, such as increased levels of disclosure for investors and extending 'retail' levels of protection to professional investors.

Advisers will have seen that providers now need to produce Key Information Documents (KID) for their alternative investment funds. These documents are very formulaic and alternative products are always going to be categorised as high risk under the methodology that must be used. The PRIIPS rules weren't drafted with alternative assets in mind, so 'risk indicators' and 'performance scenarios' don't always translate well for these products. Bovill encourages advisers not to dismiss products as too risky simply on the basis of the KID!

For financial advisers / planners:

Having looked at this from a provider's viewpoint, here Bovill considers some adviser business compliance considerations.

Where advisers would like to factor in due consideration of specialist investment solutions, how should they go about designing robust, comprehensive compliance structures and processes?

a) What should research and due diligence look like when assessing the propositions or providers in this space?

A good product should in theory be easy to spot. If the provider has written clear product literature which demonstrates its investment due diligence process, advisers can take comfort from that. Good providers will also have a helpful and knowledgeable sales team on hand to answer any questions advisers may have on the product.

Bovill encourages advisers to consider the investment manager's experience in the sector they operate in. This might include looking at the historic performance data for the manager's product range to see whether that performance has matched or exceeded the performance objectives described in the literature.

There are some independent research houses that cover some of these products, who are worth investigating by advisers. However, just because advisers can't find research on a product, doesn't mean it is not worth considering.

b) How should financial advisers tackle client recommendations or suitability exercises?

Diligently! A well performed suitability assessment protects both the client and the adviser. Before recommending investments in the SME sector, Bovill recommends that advisers need to document their rationale for making the recommendation carefully. Advisers should bear in mind that whilst such investments are not for everyone, they can have an important role to play in a diverse portfolio.

In Bovill's experience, many suitability assessments are sub-standard, often because they fail to take proper account of the clients' financial needs. Alternative investments may be quite illiquid for some time and this needs to be considered by advisers. And, of course, the availability of certain tax breaks will depend on the characteristics of the investor.

If the client is unfamiliar with the investment being proposed, it may be possible to educate them, always keeping in mind the overriding principle of treating your customer fairly; providing access to suitable investments, rather than preventing access, is the job of a good adviser.

Bovill recommends that advisers refresh their suitability assessments regularly because investors' circumstances can change quickly: this affects what advisers can and cannot recommend. The FCA has given lots of guidance over the last few years and punished many firms for getting it wrong, so there's plenty of information around to help advisers with key suitability considerations.

Suitability

As part of the 'gauging suitability' process, advisers need to be aware of which type of customer is being targeted by the provider bringing the proposition to market. The types of consumer that such propositions will be most suitable for include:

- Clients of financial advisers who have maxed out the ISA allowance and have significant cash on account
- Professional Investors (including high net worth, sophisticated)
- Corporate Investors
- Institutional Investors
- Charities / Trusts

Overall it tends to be investors that are seeking income and are looking for an alternative to their current yield products which are producing historically low returns.

Additionally, investors who are sitting on large amounts of cash (potentially in ISAs or SIPPs) that want to put this capital to work to beat inflation.

6.3. PROFESSIONAL INDEMNITY COVER

Concern about the impact on Professional Indemnity cover

AKG asked advisers, 'What are the barriers to you recommending SME Credit/Direct Lending products to clients?'

Concern about impact on Professional Indemnity cover was stated as an answer by 13% of advisers.

Professional Indemnity (PI) cover - the bigger picture

While these factors might not be directly linked to a product/fund type being distributed by some providers such as Foresight or Triple Point, they are relevant in terms of considering the broader PI cover theme.

- A lot of focus and resource is being taken up by matters relating to the provision of advice for clients/members who are considering Defined Benefit (DB) to Defined Contribution (DC) pension transfers.
- This is similarly the case in relation to pension freedoms, insistent clients, pensions/investment scams and fraud etc.
- There is currently concern in the market that this might create more hurdles for adviser businesses when engaging with PI insurers and/or push up PI cover premiums for financial adviser businesses.
- There have also been lessons learnt in recent times from some types of alternative investments held within Self Invested Personal Pensions (SIPPs).

What will PI insurers want to know and see?

To consider PI cover submissions insurers are going to want to see robust structure and rigorous processes in place when it comes to compliance, risk management, research and due diligence functions. Their considerations are likely to include some of the following:

- Why does the adviser business want to access the alternative asset class/type?
- How will it fit within their range of product/fund solutions?
- How much money do they envisage investing in the alternative asset class/type?
    - What % of total business or AUM per annum is this likely to represent?
- Which clients or client segments is this alternative asset class/type suitable for?
- What processes/systems do they have in place to test and prove suitability of the alternative asset class/type for clients?

- What level of knowledge, awareness and experience do they have in the business about the alternative asset class/type?
    - Have you invested in a product/fund in this area before?
- What level of knowledge and awareness do they have of the fund managers/product providers offering solutions in this area?
    - Have you worked with fund managers/product providers in this area before?
- What is your approach to research and due diligence of these products/funds?
- What is your approach to research and due diligence of fund managers/product providers in this area?
- Do you carry out research and due diligence processes in house or outsource these functions to a third party?
- What is your approach to risk management and governance within the business, i.e. key roles, structure, processes, systems etc?

APPENDIX I RESOURCE LINKS

AKG list of resource links & reference items

Below are some links to data, research, statistics etc. relating specifically to direct lending to SMEs or more generally to SMEs and alternative debt solutions.

M&G Institutional

How direct lending is opening up new opportunities for private debt investment
http://www.mandg.co.uk/institutions/articles/private-debt-investment/-/media/0A116147236044E78AE8BDD254FCA856.pdf

Nuveen

Private Debt: The opportunity for diversification with illiquid assets

https://www.tiaa.org/public/pdf/Private-Debt-White-Paper.pdf

British Bankers' Association (BBA)

SME statistics

https://www.bba.org.uk/news/statistics/sme-statistics/

The Federation of Small Businesses (FSB)

http://www.fsb.org.uk/media-centre/latest-news/2017/01/11/small-business-confidence-bounces-back-to-pre-referendum-level

FSB VOICE OF SMALL BUSINESS INDEX

https://www.fsb.org.uk/docs/default-source/fsb-org-uk/fsb-sbi-q4-2017.pdf?sfvrsn=0

BDRC

SME finance monitor

https://www.bdrc-group.com/products/sme-finance-monitor/

The Insolvency Service

Insolvency Statistics – April to June 2017 (Q2 2017)

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/632527/Insolvency_Statistics_Q2_2017_-_web.pdf

Prequin

2018 Preqin Global Alternatives Reports

https://www.preqin.com/item/2018-preqin-global-alternatives-report/0/20101

2018 PREQIN GLOBAL PRIVATE DEBT REPORT SAMPLE PAGES
http://docs.preqin.com/samples/2018-Preqin-Global-Private-Debt-Report-Sample-Pages.pdf

Deloitte

The changing world of SME lending

https://www2.deloitte.com/uk/en/pages/financial-services/articles/changing-world-of-sme-lending.html?id=gb:2sm:3tw:4fintech:5awa:6fsi:20170825100000:duk3&linkId=41391542

The Deloitte Alternative Lender Deal Tracker Q3 2017

https://www2.deloitte.com/uk/en/pages/financial-advisory/articles/alternative-lender-deal-tracker.html

ICG

ICG is a specialist asset manager investing in private debt, credit and equity

The Rise of Private Debt as an Institutional Asset Class

http://www.icgam.com/SiteCollectionDocuments/Rise%20of%20Private%20Debt%20as%20an%20institutional%20asset%20class%20Amin%20Rajan%20GENERIC.pdf

Lombard Odier Investment Management

A New Paradigm In Fixed Income,March 2017

https://www.lombardodier.com/files/live/sites/loportail/files/images/AssetManagement/Campaign/2017/FI/Roofstory%20A%20new%20paradigm%20in%20Fixed%20Income%20markets_14Mar17.pdf

Arbour Partners

Private Capital Market View – H1 2017

Direct Lending 2.0 Is Here - How Platform Lenders are Accelerating the Evolution of Credit Markets

http://www.arbourpartners.com/Private-Capital-Market-View-2017.pdf

Willis Towers Watson

Global Alternatives Survey 2017

https://www.willistowerswatson.com/en-GB/insights/2017/07/Global-Alternatives-Survey-2017

PWC

Asset Management 2020 - A Brave New World

https://www.pwc.com/gx/en/asset-management/publications/pdfs/pwc-asset-management-2020-a-brave-new-world-final.pdf

Pavilion Alternatives Group

PRIVATE CREDIT: IS NOW A GOOD TIME TO INVEST?

https://www.pavilioncorp.com/wp-content/uploads/2017/10/Private-Credit-Is-now-a-good-time-to-invest.pdf

EBA (European banking Authority)

http://www.eba.europa.eu/

(SME paper March 2016)

https://www.eba.europa.eu/documents/10180/1359456/EBA-Op-2016-04++Report+on+SMEs+and+SME+supporting+factor.pdf

P2P:

Alt-Fi Data – measurer of P2P / tech enabled lending in UK

http://www.altfidata.com/marketdata/

http://www.altfi.com/article/3381_direct_lending_the_making_of_a_market

Investin

https://www.investitin.com/p2p-lenders-uk/

Below are some links to press coverage/features on the subject:

The Economist

Direct-lending funds in Europe

https://www.economist.com/news/finance-and-economics/21735622-smaller-firms-they-offer-alternative-bank-lending-direct-lending-funds

Bloomberg

What's Direct Lending? Bank Loans Without a Bank

https://www.bloomberg.com/news/articles/2017-09-19/what-s-direct-lending-bank-loans-without-a-bank-quicktake-q-a

BNP Paribas

BNP Paribas Investment Partners announces successful €500 million final close of newly launched European SME Debt Fund
https://docfinder.is.bnpparibas-ip.com/api/files/BB02B6F6-D24C-4B40-886C-0360E4330DD3

This is Money

RM Secured Direct Lending looks to raise £100m as it tempts with promised 6.5% dividend yield

http://www.thisismoney.co.uk/money/investing/article-4025160/RM-Secured-Direct-Lending-tempts-6-5-dividend-yield.html

P2P Finance news

http://www.p2pfinancenews.co.uk/2017/06/16/sme-guide-to-p2p/

Prestige Funds - Commercial Finance Opportunities fund

https://www.privateequitywire.co.uk/print/2018/03/21/262413/prestige-funds-uk-sme-direct-lending-fund-passes-usd100m-aum

Credit Funds

https://www.ipe.com/reports/special-reports/credit/asset-allocation-credit-where-credits-due/10013128.article

APPENDIX 2 MARKET RESEARCH EXERCISES

Adviser research

Independent research agency Pollright interviewed 100 financial advisers using an online methodology between April 3rd and 22nd 2018. The questions posed were:

Q1 What target yield do you aim to achieve for clients investing cash in fixed income products?

Q2 Which of the following investment performance benchmarks are most appropriate and resonate most strongly with your clients when assessing debt instrument returns?

Q3 Are your clients willing to consider different asset classes, in order to achieve higher yields?

Q4 Are you concerned that savers and investors in general do not understand direct lending products?

Q5 What are the most important attributes for investment products?

Q6 In what asset classes do you currently advise clients to invest for income?

Q7 Do you have clients who are investing in alternative debt products such as Direct Lending, Peer-to-Peer loans, or crowdfunding without your involvement?

Q8 Are you familiar with SME Credit/Direct lending as an asset class?

Q9 Have you ever been asked by clients about products exposed to SME Credit/Direct Lending?

Q10 What are the barriers to you recommending SME Credit/Direct Lending products to clients?

Q11 Would you invest your own money in products exposed to SME Credit/Direct Lending?

Consumer Research

Consumer Intelligence interviewed 1,018 adults who are regular investors willing to consider alternatives to traditional cash and equity based products aged 18+ on March 9th using an online methodology. The questions posed were:

Q1 Are you willing to invest in investment/savings products outside the traditional equity or cash-based solutions?

Q2 Has your attitude to investing in investment/savings products outside the traditional equity or cash-based solutions changed due to long-term low interest rates and rising inflation?

Q3 Are you concerned about the risk of a fall in equity markets from current record highs?

Q4 What would deter you from investing in products that lend direct to SMEs?

Q5 What would you consider to be the most important attributes for savings/investment products?

Q6 Which investment/savings products are you familiar with?

Q7 Which investment/savings products do you currently hold?

Q8 What annual rate of return do you believe is achievable for long-term savings and investments?

Q9 What annual rate of return do you estimate you are receiving from your long-term savings and investments?

Q10 Are you considering switching money out of cash savings given the expected rise of inflation?

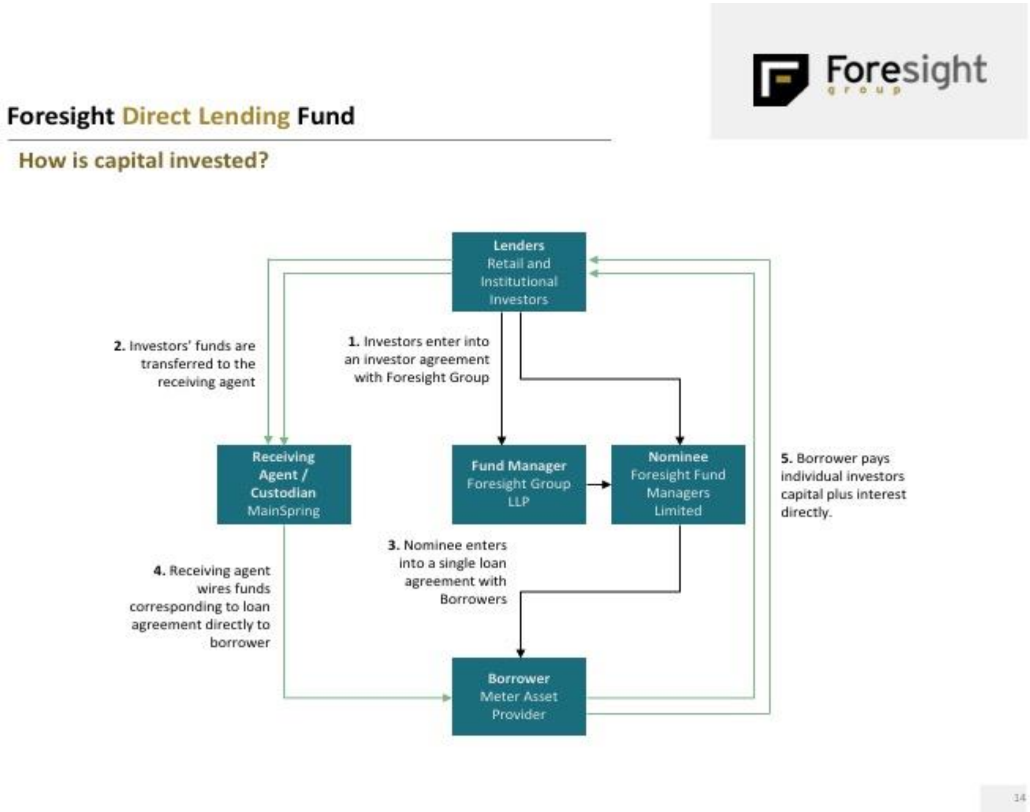
Q11 Would you consider investing in products which lend directly to SMEs?

APPENDIX 3 PROPOSITION STRUCTURES

Foresight & Triple Point – Structuring of propositions

How have your designed/structured your Direct Lending proposition for advisers/clients?

Foresight Proposition

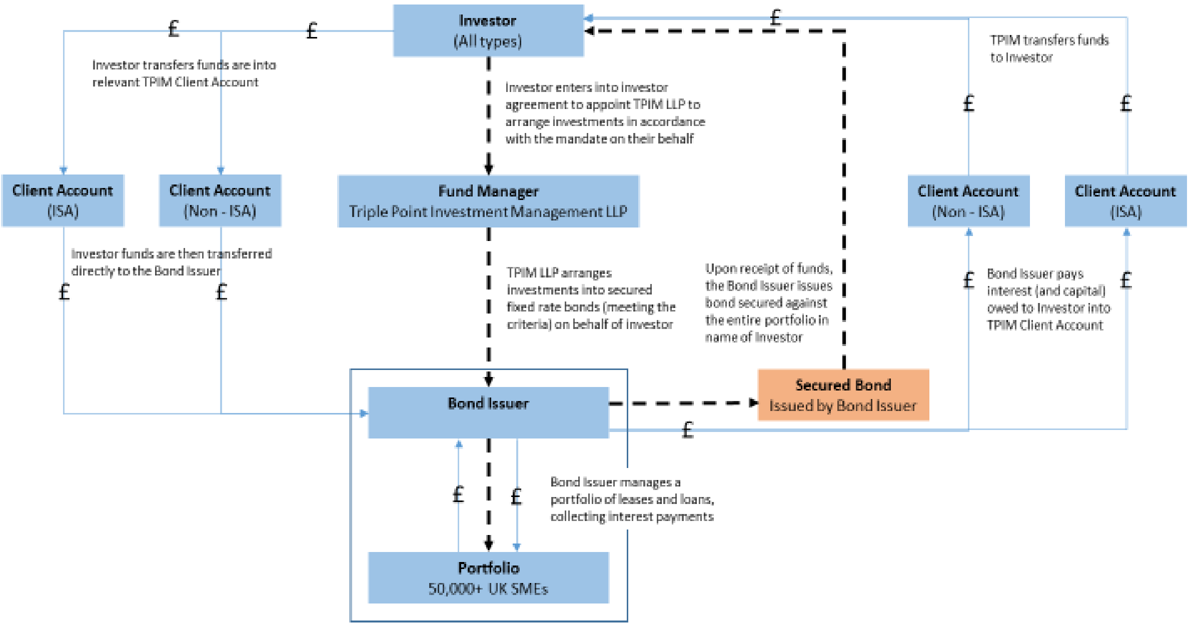


Fund Structure and Investor Criteria

- The Fund is structured as an Alternative Investment Fund (AIF)
- It does not constitute a collective investment scheme (CIS) or a non-mainstream pooled investment (NMPI)
- The Service is also classified as a Retail Investment Product (RIP)
- An individual investor enters into an investor agreement with Foresight
- The investor agreement appoints Foresight to invest monies on behalf of the investor in a specified category of loans and to manage the investment
- Foresight makes the loans and manages the investments collectively on behalf of all investors
- The structure is similar to Foresight's Inheritance Tax Solution structure
- Foresight has been advised that this should be considered an Alternative Investment Fund (AIF) / Collective Investment Undertaking (CIU)
- Foresight will make decisions as to which loans investors are put into, with loans be held by a nominee – Foresight Fund Managers Limited
- Distribution of the product is restricted to retail clients who are high net worth / sophisticated investment professionals and advised clients (i.e. the same distribution rules as the ITS fund)
- FSMA financial promotion rules apply.

Triple Point Proposition

Triple Point
INCOME SERVICE



Fund Structure and Investor Criteria:

- In terms of regulatory classification, the Triple Point Income Service is a managed service, which is an Alternative Investment Fund (AIF) and a non-readily realisable security
- It does not constitute a collective investment scheme (CIS) or a non-mainstream pooled investment (NMPI)
- The Service is also classified as a Retail Investment Product (RIP)
- An individual investor enters into an investor agreement with Triple Point
- The investor agreement appoints Triple Point to invest monies on their behalf in a specified category of secured bonds in line with the investment strategy and to manage the investment
- Triple Point makes investments into secured bonds held in the name of the investor.
- Distribution of the product is available to both retail and professional clients, including;
    - Advised clients
    - Restricted investors
    - High Net Worth Individuals
    - Sophisticated investors
    - Per se or elective professionals
- FSMA financial promotion rules apply.

INFORMATION ABOUT AKG

AKG is an independent consultancy specialising in the provision of ratings, information and market assistance to the financial services industry.

A wide range of Clients

Within a specialist focus on the financial services industry, AKG has developed a broad, complementary range of clients including: Intermediaries (Financial Advisers and EBCs), Life Companies, Friendly Societies, Adviser Networks, Regulators, Fund Managers, Trade Bodies, Service Providers, Banks, and Building Societies.

Support for Product Providers

AKG assists Providers in:

- Financial Strength Analysis and Presentation
- Data and Information Provision
- Technical Consultancy
- Distribution Consultancy

Assistance to Financial Intermediaries

AKG assists Intermediaries in:

- Financial Strength Analysis and Ratings of Product Providers
- Best Advice Panel Services
- Data and Information Provision
- Technical Support

Regular Reports

AKG publishes the following reports to assist providers and intermediaries:

- **Financial Strength Assessment Reports - Provider**

  (Covering UK life assurance companies, friendly societies and other similar providers)
- **Financial Strength Assessment Reports - Platform**

  (Covering Platform companies)
- **Financial Strength Assessment Reports - Offshore**

  (Covering Offshore life assurance companies)
- **Financial Strength Assessment Reports - DFM**

  (Covering Discretionary Fund Managers)
- **AKG UK Life Office With Profits Report**

  (Providing further depth in the assessment of with profits funds)

For further details on any of the above please contact AKG:

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