Diversifying Through Reinsurance and Marketplace Lending Interval Funds

By Larry Swedroe

Article Highlights

- By placing restrictions on the frequency and amount of withdrawals, interval funds can invest in assets that mutual funds and exchange-traded funds (ETFs) cannot.
- Reinsurance is purchased by insurance companies to manage risk; it is uncorrelated with most other assets because it is tied to natural disasters like earthquakes and hurricanes, not the financial markets.
- Financial intermediaries have largely replaced individuals on alternative lending platforms, leading to more stable capital, less information risk and more structured payments.

Editor's Note: Alternative investments that restrict purchases and redemptions to set intervals are being made available to so-called mass affluent investors who work with advisers. (The minimum investment and portfolio size vary.) These investments can offer diversification, but must be analyzed individually and are not suitable for every investor. To provide you with examples and give you a framework for what to consider if pitched such an investment, I asked Larry Swedroe to discuss two interval funds his firm uses in some client portfolios.

With equity valuations at historically high levels and bond yields at historically low levels, investors are searching for alternatives to the traditional 60% stock/40% bond portfolio.

Unfortunately, the evidence shows that the usual suspects, such as private equity and hedge funds, have delivered poor risk-adjusted returns.

Thanks to recent innovations in finance, specifically the development of closed-end interval funds, there are now certain alternative investments that my firm, Buckingham Strategic Wealth, is including in some client portfolios. Unlike mutual funds and exchange-traded funds (ETFs) that offer daily liquidity (that is, the ability to redeem shares for cash daily), interval funds provide for limited quarterly liquidity (generally a minimum of 5% per quarter). This feature allows interval funds to invest in assets that mutual funds and ETFs cannot—investments that provide exposure to different sources of risk, including illiquidity. Recognizing that they have only a limited need for liquidity each year, institutional investors have long taken advantage of their ability to invest in less liquid assets, earning an illiquidity premium while gaining exposure to different sources of risk.

While illiquidity—the inability to access your investment dollars without restrictions—is a compensated risk, if an investor prudently designs their portfolio, it is likely rare that they would need to raise cash by selling all, or even most, of their assets at the same time. Thus, most investors could prudently expose at least some of their portfolio to liquidity risk. In fact, if you hold assets in tax-advantaged accounts and you are not taking retirement withdrawals, you would not want to withdraw those assets if you needed liquidity anyway. Instead, you would prefer to use assets in taxable accounts. Even when an investor reaches the age for required minimum distributions (RMDs), illiquidity would not be an issue for most, as the RMD at age 90 is not even 10% of the total balance of a traditional IRA, SEP IRA or similar type of account. (Plus, interval funds generally allow investors to withdraw a minimum of 20% a year.) Finally, one should not put all of their assets in illiquid investments.

Among the interval fund alternatives my firm recommends for consideration are reinsurance and marketplace (alternative) lending.

Note that prior to making any investment, an investor should evaluate all offering materials and other documents

Investing Terminology

Here is a brief glossary of the some of the investing terminology used in this article.

Amortizing Loan

A loan whose balance can be fully repaid through a series of equal payments consisting of both interest and principal (e.g., a 30-year mortgage).

Interval Funds

These closed-end funds only allow investors to sell back shares they currently own at predetermined intervals, typically once every three, six or 12 months. The limited number of opportunities for shareholders to transact allows the fund to follow strategies that would be harder to use if shareholders were able to redeem shares on a daily basis, as traditional open-ended mutual funds allow.

Liquidity (and Illiquidity)

The ability to buy or sell an investment quickly at quoted prices. Large-cap stocks are highly liquid because they can be bought or sold—usually within seconds—at or very close to the prevailing quoted price. An investment in a privately held business is illiquid because it is difficult to sell the ownership stake quickly at a fair price.

Quota Shares

An agreement in which a reinsurer company receives a certain percentage of a premium in exchange for agreeing to cover the same percentage of any losses incurred. If 50% of the ceding company's book is being reinsured, the reinsurer will be responsible for covering any losses on that portion of the book.

Term Risk

The annual average return of long-term (20-year) U.S. government securities minus the average annual return of one-month Treasury bills. This factor helps to explain the return of bonds. Interest rates for longer-term bonds tend to be higher because investors want additional compensation for committing their money over a longer period of time.

associated with the investment. Interval funds involve a higher degree of risk and an investor should refer to the applicable prospectus for complete information on risk factors and risk of loss.

Reinsurance as an Investment

While nobody likes to buy insurance, every year consumers spend trillions of dollars on insurance policies that protect against the possibility of rare, unpredictable downside events—such as premature death, disability or destruction of property from a fire, earthquake or hurricane—that are too risky to bear on our own.

The price that the insurance company charges to bear the risk of extreme events, which can lead to large losses, decomposes into three parts: origination and underwriting costs, an expected payout and a risk premium to compensate the seller for the uncertain nature of any payout, which may be sudden and dramatic.

In other words, when individuals buy insurance, they anticipate that, on average, the insurance company will generate a profit.

Reinsurance

Reinsurers are an important part of the overall insurance industry. However, while most people are familiar with at least a few of the largest insurance companies, reinsurers generally aren't household names because they don't deal directly with consumers.

Reinsurance is insurance that an insurance company purchases as a means of risk management, allowing it to service its clients (by selling more insurance than it has capital to otherwise support) and to diversify risks. The "ceding company," which issues insurance policies to its own policyholders, pays the reinsurer a reinsurance premium.

Investment Opportunity

Investing in the reinsurance industry presents an opportunity to add an asset with equity-like returns uncorrelated with the risks of other portfolio assets (stocks, bonds and other alternative investments). Stock market crashes don't cause earthquakes, hurricanes or other natural disasters. And the reverse is also generally true. The combination of the lack of correlation and equity-like returns results in a more efficient portfolio.

Diversification Benefit

Consider that there is no logical reason to believe losses from earthquakes should be correlated with returns to stocks, bonds, commodities or currencies, or to any factor in which you can invest (such as momentum or term, which is the difference between the average annual return of 20-year U.S. government securities and the average annual return of one-month Treasury bills). A well-run reinsurance fund should diversify across types of events whose losses are also uncorrelated. For example, a well-diversified reinsurance fund might write policies covering losses from fires, tornados, earthquakes, hurricanes and political risks and fine art losses while goods are in transport (marine and on land). Each of these risks should be uncorrelated—there is no reason to believe that losses from earthquakes correlate with losses from hurricanes.

What's more, insurance companies are now developing innovative new products that protect against losses from hacking, business interruption, concert cancellations and even lack of sufficient snow for ski resorts. Such offerings present further diversification opportunities.

The equity-like expected returns associated with the risks of an investment in reinsurance are compensation for the risk of occasional large losses. As is the case with equities, writing insurance against extreme (but rare) events comes with accepting the negative skewness (the possibility of an extreme, unpredictable loss) of returns. Because investors dislike negative skewness, they demand a large premium (resulting in a high expected, but not guaranteed, return). A well-structured reinsurance fund can minimize the risk of negative skewness by diversifying across many different types of risk and across the globe.

Summarizing, reinsurance diversifies the risks of a traditional stock and fixed-income portfolio. Reinsurance also offers the potential for equity-like returns but with less volatility and less downside risk than equities. The most effective method to gain exposure to the reinsurance premium is to partner with large reinsurance firms through the purchase of quota shares, which reduces the risk of exposure to equity market fluctuations (market-beta risk) that an investor would incur simply by owning insurance company stocks, and it minimizes the concentration risk associated with catastrophe bonds.

One option to access the reinsurance premium in a highly diversified way is the Stone Ridge Reinsurance Risk Premium Interval Fund (SRRIX), which is the vehicle my firm recommends. The fund is only available through a small group of registered investment adviser (RIA) firms (less than 150). Each advisory firm sets its own minimum investment requirement. (My firm, for instance, does not impose any minimum.)

Table 1. Stone Ridge Reinsurance Risk Premium Interval Fund (SRRIX)

Year	Return (%)
2013	(0.10)
2014	11.00
2015	7.90
2016	6.40
2017	(11.40)
2018*	1.00

*Through April 30, 2018.
Source: Stone Ridge Asset Management LLC.

Table 2. Pioneer ILS Fund (XILSX)

Year	Return (%)
2015	9.90
2016	8.00
2017	(6.30)

Source: Pioneer Investments.

The Stone Ridge Reinsurance Risk Premium Interval Fund provides direct exposure to reinsurance risk mostly through quota shares. In a quota-share arrangement, which transfers risk from the reinsurance company to Stone Ridge, investors receive a specified percentage of the premium of a defined book of reinsurance business and also pay that same percentage of the losses.

We estimate the fund's expected return to be about 6.5% above what could be realized by investing in riskless Treasury bills. As of May 2018, that is currently about 8.25%. Adjusting for the possibility of an extreme, unpredictable loss, we expect volatility to be about 12.5%.

The fund's inception date was December 8, 2013, and Stone Ridge data shows its annualized return from inception through April 30, 2018, as 3.0%. Table 1 shows its annual returns.

The year 2017 was the worst year for the reinsurance industry since 2005, as the U.S. was hit with three major hurricanes. In addition, California experienced the two worst fires in its history. Years such as 2017 should be expected as the "price" for earning equity-like returns. With that said, as is typically the case, losses lead to hikes in premiums and expected returns increase.

The Stone Ridge Reinsurance Risk Premium Interval Fund has an expense ratio of 2.40%.

The other public reinsurance interval fund is the Pioneer ILS (Insurance-Linked Securities) Fund (XILSX). This fund has an expense ratio of 2.10%. Its returns are listed in Table 2.

Marketplace Lending

Given the current low-interest-rate environment, many investors are looking far and wide for strategies to supplement the yield on their fixed-income investments. One specific alternative investment strategy that has piqued the interest of many investors is marketplace, or alternative, lending.

Over the past several years, we have witnessed a fundamental shift in the fixed-income landscape. Banks have been central to the creation of credit, driven by their ability to take in low-cost deposits and loan money at higher rates. While non-bank loan channels have always existed parallel to traditional banking, these channels were historically small niches in the overall economy.

However, a new breed of lender has emerged to become a significant presence in the market. Initially, they were known as "peer-to-peer lenders" or "marketplace lenders." The first was Zopa Ltd., a U.K.-based platform founded in 2004, which matched consumers who wanted to borrow money directly with individuals who wanted to lend money.

Growth in the space hit an inflection point after the 2008–2009 financial crisis, driven by a severe contraction in bank lending and acceleration of online financial services. Today, these technology-based lending businesses are disrupting the lending markets and have gained significant market share.

Cost Advantage

Because alternative lenders are not burdened with the substantial infrastructure costs of traditional banks, or the same level of regulatory oversight, they are able to offer loans at significantly lower rates. Alternative lenders have been able to leverage their superior operating efficiency to offer more attractive pricing to consumer and small business borrowers while delivering a superior service experience.

Alternative lending is not just a U.S.

phenomenon. There are now hundreds of alternative lending platforms around the world. This allows investors to build globally diversified portfolios, reducing idiosyncratic country risks.

Source of Capital for Alternative Lenders

There were two significant hurdles for the industry. The first was that borrowers want their money quickly, but the platforms first had to find willing lenders. The matching process was not conducive to good service. The second problem was the information asymmetry between the individual borrower and the individual lender. Specifically, the lender did not know the borrower's credibility as well as the reverse. Such information asymmetry can result in adverse selection.

Fortunately, financial intermediaries began to replace individuals as lenders, buying loans from well-known alternative loan originators such as Prosper, LendingClub, Square and SoFi. Today, institutions are the predominant source of funding for alternative loans. For example, LendingClub, the largest U.S. platform, had shifted from 100% retail funding in 2008 to 84% institutional funding by 2015.

Alternative lenders prefer institutional capital because it makes the loan funding process faster from the borrower's perspective. From a strategic perspective, dedicated institutional capital is more stable, allowing the platforms to grow responsibly. Institutional investors provided funding by creating investment products—specifically, the aforementioned closed-end interval fund—that individual investors can utilize to access the market.

This type of financial intermediary can help reduce asymmetric information risk by setting strong credit standards (such as requiring a high FICO score), performing extensive due diligence on originators (to make sure their credit culture is strong), structuring repayments in ways that can improve performance [such as requiring that all loans be fully amortizing, meaning the loan is paid off through a series of equal and regular payments, and that automated clearing house (ACH) repayments are made on individual loans, thereby eliminating the choice of which loans to pay off, as with credit card debt], and requiring the originator to buy back all loans shown to be fraudulent. Intermediaries can also require that business loans be repaid directly from sales receipts. Additionally, they can enhance credit quality by requiring the use of social media to confirm information on the credit application. By improving transparency, they also facilitate the flow of capital to borrowers in a more efficient and dependable manner.

In addition to higher yields relative to traditional fixed income with relatively short durations, these loans also provide diversification benefits because the correlation of their returns to those of equity markets tends to be low, except during periods when unemployment rises dramatically (such as during the global financial crisis of 2008). For example, equity markets experienced significant losses over a six-week period in December 2015 and January 2016. However, there was no concurrent downturn in the economy that would have caused consumer defaults to rise. Investors saw something similar immediately following the Brexit vote in June 2016. In both cases, while equity markets were falling, the performance of these loans was unaffected. Thus, there are times, though not all times, when an investment in these loans will help to dampen portfolio volatility.

Until recently, most investors have not had direct access to the consumer, small business and student loan credit risk premium. The alternative lending industry is bringing benefits to both borrowers (by reducing the high cost of bank credit, credit card debt and payday loans, as well as by providing better service) and investors (by providing

Allocating to Alternative Investments

In simple terms, alternative investments are those that are not traditional equity and fixed-income securities and funds. Such assets typically have different return and volatility characteristics. These different characteristics enable alternative investments to play the role of diversifying agents in a portfolio.

In their book, "Reducing the Risk of Black Swans," Larry Swedroe and Kevin Grogan suggest that investors seeking to use alternative investments allocate between 10% and 30% of their total portfolio to alternative investments. When deciding how much to allocate, consider the potential tax impacts—most alternatives are not tax efficient.

When considering more than one alternative investment, consider splitting the total amount you are intending to allocate to all of them equally among each investment. If you were planning on allocating 20% of your portfolio to alternative investments, for example, and you intended to buy four different alternative investments, you would allocate 5% of your portfolio to each investment. The math is 20% of the portfolio divided by four investments. The actual percentages depend your preferences, goals and financial situation.

As to where the money for the allocation should come from, it depends on your current allocation and the type of alternative investment purchased. An investor with a heavy allocation to equities (e.g., 60% or greater) who is targeting alternative investments with similar returns as stocks can shift the money out of their current equity holdings. An investor with a heavy allocation to fixed income (e.g., 60% or greater) who is targeting alternative investments with lower levels of volatility can shift the money out of their current bond holdings as long as they consider the possibility of ending up with a comparatively more volatile portfolio.

opportunities to earn higher yields).

Today, with the proper controls in place, investing in these alternative loans can complement a fixed-income portfolio. While they do entail more credit risk, alternative loans also currently provide sufficiently high yields to allow for high expected returns relative to other alternative investment strategies. At the same time, given that the average duration on a portfolio of alternative loans generally is only about one-and-one-half years, they significantly reduce term and inflation risk relative to a typical intermediate-term bond portfolio. Thus, there is a trade-off—lower term and inflation risk but more credit risk.

Accessing Marketplace Lending

Historically, the consumer and small business credit risks underwritten by banks were not shared directly with outside investors. Now, investors can directly access these products. One option is through the Stone Ridge Alternative Lending Risk Premium Fund (LENDX), which is the vehicle my firm recommends that investors consider using.

Stone Ridge employs the same approach in this fund that it has been using for several years in the Stone Ridge Reinsurance Risk Premium Interval Fund, bringing long-term committed capital and partnering with leading global alternative platforms to package loans into an investable portfolio. The approach is to buy a pro rata share (like the quota shares it buys for SRRIX) of the loan originator's entire book of business, as long as it meets Stone Ridge's underwriting standards, which only allow for the purchase of prime (not subprime) loans. This strategy avoids agency issues (misaligned incentives) and cherry-picking.

Risk and Return

We estimate expected return for the Stone Ridge Alternative Lending Risk Premium Funds to be about 5% above the return earned on riskless one-month Treasury bills. That puts the expected return currently at about 6.75% as of May 2018. Adjusting upward to account for the potential of a large loss, we estimate the volatility of returns to be about 5%.

The fund's inception date was June 1, 2016. Stone Ridge data shows that the fund returned 8.6% in 2016. In 2017, it returned 6.4%. In 2018, through April, it returned 2.0%. The fund's expense ratio is 1.94%.

The other public marketplace-lending fund available is RiverNorth Marketplace Lending (RMPLX). It has an expense ratio of 1.50%. The fund's return since inception on September 22, 2016, through April 2018 was 5.2%.

Summary

By adding unique sources of risk and return, such as reinsurance and alternative lending, as well as by taking advantage of the liquidity premium, investors can improve the efficiency of their portfolios. The expectation is that adding these alternatives will also reduce downside risk—the risk of large losses that occur in traditional stock and bond portfolios.

For those interested in learning more, my book, the 2018 edition of "Reducing the Risk of Black Swans" (Buckingham, 2018), co-authored with Kevin Grogan, goes into detail on the strategy behind reducing such risks. It also includes a discussion on reinsurance and alternative lending, as well as on three additional alternative investments. ▲

Disclosures

Buckingham Strategic Wealth, where Larry Swedroe is director of research, recommends Stone Ridge funds in constructing client portfolios.

Discussion of SRRIX, XILSX, RMPLX and LENDX is provided for informational purposes only and is not intended to serve as specific investment or financial advice. These funds were shown as the only registered funds investing in reinsurance and marketplace lending, respectively. This discussion does not constitute a recommendation to purchase a single specific security and it should not be assumed that the securities referenced herein were or will prove to be profitable. Prior to making any investment, an investor should carefully consider the fund's risks and investment objectives and evaluate all offering materials and other documents associated with the investment.

Expected return forecasts are hypothetical in nature and should not be interpreted as a demonstration of actual performance results or be interpreted as a target return. It is important to understand that forward-looking return expectations/expected returns are the mean of a very wide potential distribution of possible returns. Thus, they are not a guarantee of future results. Expected returns are forward-looking forecasts and are subject to numerous assumptions, risks and uncertainties, which change over time, and actual results may differ materially from those anticipated in an expected return forecast.

Larry Swedroe is director of research for Buckingham Strategic Wealth and the BAM Alliance and co-author with Kevin Grogan of the expanded edition of "Reducing the Risk of Black Swans" (Buckingham, 2018). Find out more about Swedroe at www.aaii.com/authors/larry-swedroe.