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FinTech and The Rise of Alternative Investing

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FinTech (Financial Technology) is revolutionizing the financial services industry including the way investors participate in alternative investing. From *Ally* (online banking) to *eTrade* (online discount brokerage) to *Prosper* (peer-to-peer lending), to *HealthiosXchange* (equity crowdfunding), technology is redefining the way we bank, trade stocks, lend money, and invest in companies. Fueling the transition to online marketplaces are tech savvy *Millennials* who find visiting banks and participating in offline investment groups an inefficient use of resources/time and more costly than online alternatives.

One of the most promising FinTech platforms is crowdfunding. Equity crowdfunding (leveraging the Internet to raise equity capital from accredited investors) is projected to raise $700MM in 2014; 7% of the expected $10BLN crowdfunding industry which includes donation, reward, and peer-to-peer lending.

So where will this alternative investment capital come from and is it a zero sum game for incumbents? From Angel Groups? From Venture Capital?

These are the thoughts on the minds of many incumbents as the crowdfunding wave continues to wash onshore and begs the question, will equity crowdfunding disrupt markets (~iTunes to the music industry) or can it be a vehicle for expanding the amount of investible assets? The latter seems more likely given financial markets are highly regulated (protecting incumbent positions and their traditional funding source ~pension funds, insurance companies) and the enormous amounts of untapped capital not participating in alternative investing including $6.5 trillion of IRA assets. However, capital is taking notice of alternatives for good reason.

The attraction of alternative investing (i.e. private equity) cannot be underestimated. Multiple studies (source: Wiltbank) illustrate a managed portfolio of managed early-stage investments (i.e. Angel), in the long run, can produce average annual returns of 25% far superior to the S&P 500 and even hedge funds. In addition, alternatives have emerged as a "go-to diversified tool, capable of dampening volatility and increasing resilience within a portfolio, largely due to their ability to deliver non-correlated performance relative to stocks and bonds" *(New Opportunities in the Alternative Asset Marketplace – Millennium Trust Company).*

But what has limited capital from moving into the alternative sector and how is FinTech improving the risk/reward dynamics encouraging more investment in the space?

Limitations include (1) *lack of education on how to invest in the sector (investors and advisers),* (2) *determining the right mix of alternatives,* (3) *the difficulty of conducting due diligence* (4) *access to top alternative managers/companies and* (5) *understanding the difference between direct and liquid strategies.* FinTech overcomes these constraints by employing technology including online documents and research, social networking, and innovative financial structures assisting investors with diversifying their alternative portfolios.

Crowdfunding

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(1) *How to invest in alternative investments?* Crowdfunding portals are built to assist investors with understanding how to invest in alternatives (~private equity) including educating and providing vehicles (special purpose vehicles) for investors to diversify across multiple companies in an effort to lowering risk/increasing return. In David Rose's (New York Angels and serial entrepreneur) book, *"Angel Investing, The Gust Guide to Making Money and Having Fund Investing in Startups,"* David advises investors to spread allocation of capital (~10% of free cash flow) amongst 25 early-stage companies given the probability of success is low with smaller portfolios; over 50% of private equity investments fail and 20% will barely return investor capital. Like venture capital, the overriding goal when investing in early-stage companies is to select companies that will be acquired or go public at a 10x return ("Hits" based investing), and the best way to achieve this is crowdfunding (encourages/permits low investment thresholds per investor – ability to diversify).

(2) *Determining the right mix of alternatives?* David Rose advises investors to place $15-$25K into 5 carefully selected companies annually for 5 years for the highest probability of achieving 25% IRR's via alternative investing (~private equity, real estate). However this poses a problem for emerging growth companies seeking development financing from accredited investors. Most companies are sensitive about accepting lower capital allocations (~$15 - $25K) per investor since it results in fractured cap structures (multiple lawyers/investors each with a voice) potentially inhibiting future funding rounds (venture capital) and distracting management. Enter the use of Special Purpose Vehicles (SPV's) and Investor Syndicates (online venture funds). Special Purpose Vehicles (LLC's) aggregate investor capital into Limited Liability Corporations (LLC's) that act as single shareholders (more acceptable to follow-on investment sources). Select crowdfunding portals also offer "Investor Syndicates" (*AngelList, CircleUp, HealthiosXchange*) wherein investment capital in SPV's is allocated by a Lead investor (someone with a distinguished track record of investing, exits) into one or more emerging growth companies receiving 15% carry from syndicate investors in return for access to valued deal flow. One type of syndicate allows Lead Investors to invest in multiple companies (discretionary blind trusts) effectively diversifying investor capital across multiple private companies (~HealthiosXchange's "MicroVC's").

And when investors select a mix of alternative investments, crowdfunding portals employ tools assisting users with "digital closings" (efficiency of capital) including online documents/electronic signature, online due diligence (i.e. eDiligence), and eCompliance (i.e.) - verification of Accredited status/suitability and use of CRM's (Customer Relation Management) to store and secure data.

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(3) *The inability/difficulty of conducting due diligence*…Crowdfunding portal functionality improves the ability of investors to perform due diligence including curating deals – team of experts select companies for investment (*CircleUp, RealtyMogul*), scoring (quantitative analysis) and companies meeting qualifications for self-directed IRA investing (*HealthiosXchange*), and "followers"/"Likes" (*AngelList*) – sentiment analysis supporting investment opportunities. Investors now have online access to non/confidential documents, company highlights/deal terms, and management in real-time via Q&A Forums, online events contributing to better deal selection.

(4) *Access to top alternative companies/managers*….Crowdfunding portals give investors access to promising emerging growth companies (institutionally sponsored deals via *HealthiosXchange*), and distinguished managers (500 Startups via portal via *SeedInvest*). Increasingly, the best companies and fund managers are migrating to crowdfunding given the untapped investor base (8.7 million accredited investors in United States of which only 7% have private placements), lower costs of capital associated with direct investing (improved returns), while retaining higher levels of control than traditional financing vehicles (venture capital).

(5) *Understanding the difference between direct and liquid strategies*…Investors have options when investing in alternatives including through venture funds (largely through retirement accounts including pensions), ETF's, and now directly (crowdfunding). Historically, a majority of investors participated via traditional sources (venture capital), however, direct vehicles are increasing in importance fueled by the passage of the JOBS Act (increased shareholder limit to 2,000 investors before going public and permits general solicitation). ETF's have the benefit of being the most liquid followed by direct investing (established secondary markets like *SharesPost*) and lastly venture (employ 10 year locks-ups).

Crowdfunding empowers investors to participate in alternative investing/private equity on a direct basis. The implications of direct investing are enormous for shortening investment cycles and raising investment returns given crowdfunding portals employ advantageous fee structures ("no fee, no carry") and capital is employed when raised. Select crowdfunding portals (*HealthiosXchange*) offer investors low fee structures; do not take management fees (the "2" of "2" and "20") nor carry (the "20" of "2" and "20"), all without employing 10-year lockups. Rather, these portals charge "success fees" from companies ensuring investors are vested 100% dollar for dollar (vs. at $.98¢ on the dollar under venture capital models).

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Select crowdfunding portals also offer "Investor Syndicates" (AngelList, CircleUp, HealthiosXchange) wherein investment capital in SPV's is allocated by a Lead investor (someone with a distinguished track record of investing, exits) into one or more emerging growth companies receiving 15% carry from syndicate investor in return for access to valued deal flow.

Social Media + General Solicitation = Online Funding Goes Viral

A brief word on social media's impact on raising capital from accredited investors. Recent advancements in social media allow companies to reach out to investor on an unprecedented scale. Many users of *Linkedin* enable users to reach out to greater than 10MM first, second, and third-degree connections. Given companies state they cultivate most of their investors from personal connections (people worked with in the past, other investors with whom they co-invested, referrals), the impact of the new fund raising landscape leveraging social media cannot be underestimated. Couple this with the ability to generally solicit (share deal terms without having a personal relationship) and this is a cocktail for viral fund raising. In effect, companies now have the ability to reach the global "total available market" of investors (for now, Accredited) by sharing deal terms from crowdfunding portals with social media contacts.

The demand for alternatives from investors and financial advisors is on the rise and FinTech (equity crowdfunding) is fueling the accent by creating online platforms/portals for broadening access. Equity crowdfunding has the potential to follow the trajectory of Peer-to-Peer lending which recently crossed $5 billion in loan originations since Prosper (2006) and Lending Club's (2007) origins. It looks like equity crowdfunding will be next to leverage technology and rewrite the financial markets.

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