Fintech's transformative power

Fintech is ushering in an era of structural change in financial services. Here are some promising themes and insights on how one may sift for winners

ROUNDTABLE PANELLISTS:

- **Matt Lipton, senior managing director and portfolio manager, Wellington Management**
- **Gareth Nicholson, CIO and head of discretionary portfolio management, Nomura**
- **Brad McCarthy, Apac head of alternative investment sales, Citi Global Wealth Management Investments**

Moderator: Genevieve Cua, wealth editor, *The Business Times*

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FINTECH is slowly and surely disrupting and transforming the financial services landscape. Investing in this segment of the technology sector has proved both rewarding and challenging.

In this roundtable, our panellists share their views of the major fintech themes for the short and long term, and principles that will help investors sift for potential winners.

Q: What do you see as the major and most transformative technologies, with the greatest long-term impact on the way financial services are used and delivered?

Matt Lipton: While the first half of 2022 was certainly challenging for the fintech market, my long-term view is that we're at the beginning of a decades-long cycle of disruption and structural change in the financial services sector, fuelled by 3 key drivers/technologies:

- Adoption of big data and cloud computing. This may be a universal theme across many sectors, but it's early days for financial services. Based on our research, we estimate that 5 per cent of banks can open an account online for a customer from end to end, and that big data and the cloud will unlock a solution for a much larger customer base. The online mortgage process is one area with far too many manual steps still required and many opportunities to digitise the workflows as new technologies take hold. Fraud and risk management remain stumbling blocks for most incumbent financials to digitise their business, which cloud and big data can help overcome. In time, we should see a near-total rewiring of the financial infrastructure, including the service providers and back-office software companies serving financials.
- Democratisation of financial services. Many around the world still lack access to good financial services such as credit and checking. But apart from digital banks – an extension of traditional banks – neobanks and tech companies can use digital and mobile technologies to create better user experiences, access to credit, and investment capabilities. Neobanks, which are exclusively online, can acquire a customer at about a third of the cost of a traditional bank but still potentially derive the same lifetime revenue per customer. The ability to do it all faster and cheaper is driving market-share shifts in deposits, lending, and brokerage assets away from incumbents.
- Financial inclusion in emerging markets. We're seeing fintech-related disruption in the US and in other big population centres such as Brazil, India and Indonesia. It's creating a more level playing field for the "under-banked" and helping to reprice financial products. Fintech companies are offering more reasonably priced products to emerging market consumers and taking share away from incumbents.

Gareth Nicholson: The future of investing as will be largely quantamental investing – the combination of human and machine. It's the best of both worlds.

Well-trained human analysts can understand how the future may look different than the past – think of changing industry structures, emerging technologies, shifting company positions or new industry regulations. In these situations, machines focused on historical data are at a disadvantage.

On the other hand, well-developed computer models are unmatched in automating tasks, analysing how the past may predict the future and identifying anomalies (ie, automation, prediction, detection). No human can match an algorithm's ability to vet millions of data points in such a manner. Uniquely integrating both presents a logical opportunity.

The common challenge in big financial institutions is legacy tech – or more specifically, integrating new disruptive technology into traditional banking platforms.

There are huge opportunities for tech integration over the next decade, but banks will likely need to collaborate extensively with non-bank partners to offer new value propositions that are integrated across journeys, technology platforms, and data sets effectively.

As it stands, it is niche financial sub-sectors that are most adept at harnessing technological innovations to launch applications, generate value, and shape the competitive landscape.

In future, traditional financial institutions will need to accelerate partnerships or bring their considerable resources to bear to stay on top of the gathering wave of financial industry disruption.

The greatest long-term impact on financial services: Artificial intelligence (AI) will drive massive value creation. In investing, automatic factor discovery, or the machine-based identification of the elements that drive outperformance, will become more prevalent, helping to hone financial modelling across the sector.

As a key application of AI semantic representation, knowledge graphs and graph computing will also play a greater role. Their ability to assist in building associations and identify patterns across complex financial networks, drawing on a wide range of often disparate data sources, will have far-reaching implications in the years to come.

Brad McCarthy: Change has always been a constant in financial services. In many ways, the global pandemic forced the adoption of digital services by individuals and companies that had long been resistant to embracing significant change.

This has emboldened financial providers to invest heavily in digital innovation, including the adoption of blockchain technology, to strengthen their operations.

One such example of innovative change is the proliferation of fractional trading capabilities that have enabled the growth of discount brokerage firms that rose to prominence during the pandemic.

By enabling retail investors to gain more democratised access to many of the largest stocks in the world, we witnessed a surge in the number of new investors who participated in markets for the first time. A greater number of market participants with greater access than before will only help to strengthen and deepen these markets.

The digital transformation of financial services remains in its early stages as cutting-edge companies are pursuing innovation in the very foundations of finance, including payments, contracts, settlements and regulatory compliance.

In short, the infrastructure of money is being redefined and strengthened in ways unimaginable just a few short years ago, and we expect this new trajectory to accelerate in the years to come.

Q: More investors are seeking out private market investing in today's low-return world, and fintech is helping to widen access. What do you see as the most important private investing trends within the fintech sector going forward?

Lipton: The large addressable market size of financial services, including trillions in dollars of deposits, payment volume, and lending activity annually, makes fintech an attractive investment opportunity for private markets (venture and private equity) investors.

Growing capital formation in both private markets (by our own estimates, US$200 billion in fintech venture funding in 2021) and public markets (over 200 initial public offerings, or IPOs, in the last 24 months) is creating increased competition and investment opportunity.

However, I believe we are witnessing a convergence between public and private markets that is creating a more integrated ecosystem of public and private companies, and broadly altering the investment landscape – giving rise to hybrid managers and hybrid strategies.

- Hybrid managers may benefit from having access to capital during periods of market dislocation, when dedicated private market managers are experiencing a more challenging capital raising environment. Further, hybrid strategies allow investors to be fully invested at inception, potentially minimising J-curve drag in the portfolio. This is valuable for building out private market programmes.
- Given their unique attributes, hybrid strategies may warrant a standalone category within a diversified alternatives allocation. These strategies have the flexibility to benefit from compelling opportunities across structural winners and losers, both via long/short and public/private positions.
- Depending on their exposure and liquidity objectives, allocators may consider using specialised hybrid strategies to amplify exposure to innovative areas or to fill in gaps. For example, putting more capital behind structural megatrends impacting fintech.
- Hybrid strategies can also employ shorting and hedging techniques in the public markets to take advantage of the information edge and market volatility created by an increasingly competitive market.

Fintech and financial services are particularly relevant to this convergence theme as the massive disruption across the global financial system driven by new technologies – cloud, AI, digital platforms – is creating intense competition among incumbents and disruptors.

In fact, many large incumbent financial firms are also heavily investing in private fintechs through their investment or venture arms.

Nicholson: Two areas of particular interest with regard to more private or alternative markets are access to traditionally illiquid markets and transparency. I think 2 technologies offer great opportunities in solving these challenges:

- Blockchain will disrupt established financial products. Technologies such as smart contracts, zero-knowledge proof, and distributed data storage and exchange – which are key to existing fintech innovations such as digital wallets, digital assets, decentralised finance (DeFi), and non-fungible tokens (NFTs) – will continue to play a prominent role in allowing better access to private markets
- Internet of Things (IoT) will drive a new era of trust in finance/transparency. From the financial applications perspective, consider the fact that environmental, social, and corporate governance (ESG) considerations now govern many investment strategies and regulatory policies. For instance, several major countries have committed to achieving peak carbon emissions and carbon neutrality. Aside from broader use of renewable energy, success in achieving these goals will be predicated on the effective monitoring and management of industrial energy and power efficiency. This presents a perfect scenario for IoT applications. Carbon trading, for example, will be increasingly indexed to IoT measurements, opening new opportunities for astute players.

McCarthy: There are 2 key areas where we have seen a surge in interest within the private fintech space: data aggregation and cybersecurity.

In an increasingly connected world, such as one powered by Web 3.0, the explosion of data created each day is truly breathtaking.

According to Statista, prior to the start of the pandemic, there were roughly 44 zettabytes (44 billion terabytes) of new data produced each day around the world.

In 2022, that number has jumped to 97 zettabytes each day, and by 2025, it is expected to double again.

There is an enormous amount of insight on many fronts that can be gained by combing through this data, and what we see today in private markets is something of an arms race to find new applications that can help to do so.

The other side of the same coin is the growing concern about the safety and security of this data. Unlike physical assets where visible deterrents such as lights or cameras can help deter bad actors within their proximity, digital assets, such as data, require rapidly evolving security measures to protect from new threats from all corners of the world.

For this reason, cybersecurity will remain one of the fastest growing areas within private markets for many years to come.

Q: An environment of higher interest rates, higher inflation and lower growth has caused a valuation reckoning in the fintech sector. What principles do you pursue in discerning between potential winners and losers in the fintech space?

Lipton: The current market notwithstanding, we think every financial institution will face decades of disruption from both existing competitors and new fintech entrants; investors may expect dispersion and volatility to remain for some time.

The reason for this is that the global economy has been over-served with stimulus, and central bankers globally are now making adjustments. Fintech was at the epicentre of a move to low interest rates, unprecedented stimulus and wild valuations.

In fact, there were over 200 fintech IPOs in the last 24 months, with share prices down over 50 per cent on average from last year.

While that may look enticing to many, I think the party is over, because general projections miscalculate the challenges of financing and credit costs for many fintechs.

As financial services specialists, we search intently for the intersection of incumbent weakness and entrants with strong models; and I believe amazing financial change is right in front of us, but having the right bottom-up company calls is key to success.

Going forward, there will be a greater emphasis on businesses with moats and winning unit economics.

There are a couple of areas to watch:

- The new environment is one where long/short stock picking is potentially beneficial. We are now seeing companies in the payments and challenger bank space with entry points back at 2018 levels, despite the business being 3-5 times larger. There are also compelling short opportunities as well – companies with poor fundamentals that may burn through their liquidity in the next 12-24 months amid a difficult capital markets environment.
- In the private markets, embedded finance infrastructure and platforms are of interest, whereby financial services will become more intuitive and ingrained in our daily workflow, prevalent across every main street business. Owners can manage their checking account and loans in the same application they order inventory and manage payroll. Similarly, consumers can shop, save, borrow and pay on single applications.

Nicholson: Success will require more than hiring some people and telling everyone to get to work with the tech. To be successful, each firm faces a similar but distinct challenge: discovering how to best integrate new technologies with their human talent pool given their unique objectives, skills and experience.

No-code and low-code will redefine application development and are particularly attractive.

No-code development platforms, and their close relation low-code platforms, allow programmers and general users to develop applications through graphical user interfaces and configurations (for example, drag-and-drop) instead of traditional computer programming. This opens up great synergies for traditional investors to share skills and enhance traditional methods to cater for the huge increase in data and scale required.

McCarthy: Despite the market conditions experienced this year, we maintain a strong conviction that fintech is an unstoppable trend.

In considering investments, it remains paramount to consider factors such as a company's total addressable market, rates of adoption, and the potential to become category leaders.

The key principles that will drive important long-term process improvements for consumers include the need to offer greater convenience, lower costs and better profit margins for users, while maintaining the high-trust environment expected from financial services.

Quality of capital structures as well as quality of business will also matter. We have observed a bifurcation in private markets between businesses with strong and weak balance sheets and capital needs.

In prior years, when capital was more abundant, management teams that had foresight enough to raise excess capital would enable their companies to survive and likely thrive.

This will come at the cost of companies whose management teams were not as proactive and whose balance sheets and funding positions are weaker. The more proactive management teams will also benefit from the potential to make acquisitions of other private market firms and further strengthen their competitive positions.

The current valuation environment would provide investment opportunities across all fintech segments.

In this environment, an investor should be able to find opportunities to match their technology risk appetite from established companies to untested transformative technologies.

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