ALTERNATIVE OUTLOOK

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The changing face of longevity investing

To continue our drive towards transparency and compliance within the longevity asset class and in order to protect our shareholders, Centurion has recently made a number of strategic changes to its longevity funds.

We believe that Longevity as an asset class needs to move towards a more market led strategy where assets are valued at market and can be more easily traded to provide liquidity as and when required. We have therefore made the strategic decision to move to a "Mark-to-Market" methodology as opposed to the current "Mark-to-Model" basis we previously used, and which is prevalent in the industry today.

The mark-to-market technique enhances liquidity by ensuring that returns incorporate the current market discount rate to accurately reflect the asset values, and are linked to actual mortality experience. Shareholders will benefit from this new and more equitable approach, as firstly all investors are treated equally by entering and exiting at market price and secondly new fund subscribers are not subsidising the value of those investors redeeming.

We have also launched two new share classes called DRF Longevity Select and LSSF Managed Growth, both of which will benefit from the mark-to-market methodology.

As it was not practical to switch the older legacy funds onto the new structure, to protect existing investor holdings, all shareholders have been transferred to a closed end fund structure. Existing assets were transferred at current valuation to the structure and have been ring fenced to ensure equity across all fund classes.

I believe that the longevity asset class has an enormous future given the asset rich and cash poor "baby boomers", who will start to retire this year. These individuals will greatly benefit from the liquidity that we as professional asset managers can provide them - the ability to liquidate illiquid assets and release the value in formally locked up assets.

In this issue of Alternative Outlook we explain more fully the rationale behind the recent change in our new fund strategy and answer some questions about the mark-to-market valuation model. Additional information including FAQs, more details on the new valuation model and fact sheets on our new funds is available on our website at www.centurionfundmanagers.com or on our financial intermediaries' portal at https://portal.groupcenturion.com/client/Login.aspx

D. Rawson-Mackenzie

David Rawson-Mackenzie
Director

Centurion was founded in 1995 and has over $500m in longevity funds under management.
We specialise in alternative investments including life settlements and longevity derivatives and also offer a range of bond, equity and liquidity funds.

Longevity investing: A 100 year old asset class comes of age

David Rawson-Mackenzie is director of Centurion Fund Managers Limited (Cayman Islands), part of the Centurion Group. Rawson-Mackenzie launched one of the market's first life settlement funds, the Defined Return Fund, in 2002, followed by the Life Settlement Strategy Fund in 2006, which was one of the first longevity funds to include synthetics.

The concept of longevity investing can be summed up quite simply by looking at a life policy: you, the investor, buy a policy for a lump sum from the insured, and when the policy matures, you receive the sum insured. The value of the investment is a function of the sum insured, less the purchase price of the policy and the premiums paid to maintain it (this is an insurance policy, after all). For some, it is akin to a glorified, high yield deposit account with an unknown maturity date.

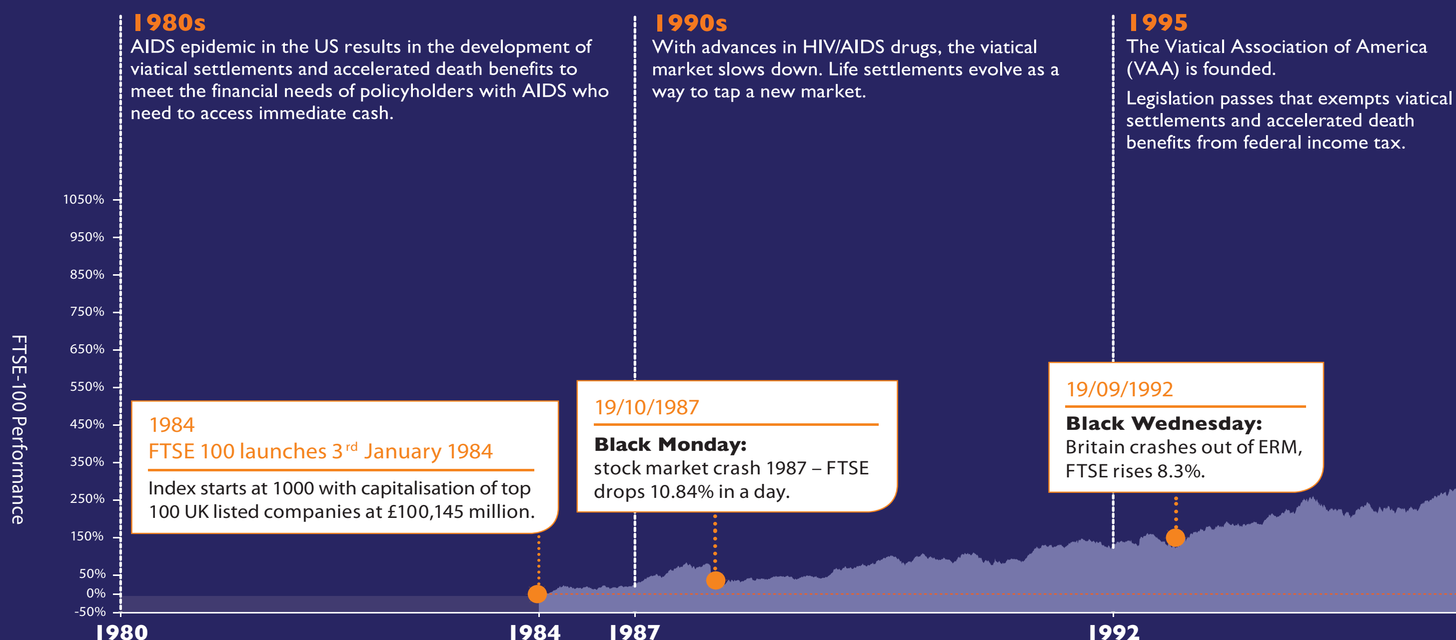
Obviously, it is more complex than that.

Longevity is a long-term investment where benefits are collected upon the death of the life insured. Traditionally, investors have recognised that this type of investment required time to mature and create value, typically several years. Pricing assets on a hold-to-maturity basis was therefore considered appropriate.

The current economic backdrop appears to have changed investor behaviour fundamentally. Portfolios have been re-balanced to place a greater emphasis on liquidity and investment horizons seem to be shorter. In essence, this means that longevity as an asset class needs to move towards a more market-led strategy where assets are valued at market and can be more easily traded to provide liquidity as and when required.

At present, most longevity funds value their assets using a discount rate based on either the rate at the time of the policy acquisition or a historical model. The disadvantage of this approach is that one retains the discount regardless of what is happening in the market. In addition, the historical model is based on a series of assumptions that may not reflect the market rate, where the discount can vary and longevity estimates can change.

This traditional approach to valuing longevity assets has meant that managing liquidity has proven to be the Achilles heel of this asset class, and one of the



biggest tasks facing a longevity fund manager. Prudent liquidity management includes managing a fund's outflows such as policy premiums and currency hedging requirements. Planning the fund's cash flow is achieved by diversification of the portfolio's projected mortality exposure and then adjusting this to manage the fund's liquidity. A longevity fund manager also needs to manage the origination of the fund's assets to ensure that they are tradable should additional liquidity be required.

The real problems begin when a fund has redemptions. In practice, funds try to match their outflows with inflows - new money and policy maturities. It is, of course, well nigh impossible to match outflows with policy maturities. It doesn't work that way except in a closed end fund.

That means that outflows have to be matched with new money and this could lead to new investors overpaying.

Mark-to-market also provides a better indication to prospective investors and their advisers of the risks associated with this asset class as a true and relevant value will be reflected in the monthly share price. Investors will no longer witness a share price which ticks up at the same rate month-on-month, based on a model discount rate and policy maturities; rather they will observe a price driven ultimately by longevity but subject to market price. Finally, there exists an established and active market for longevity instruments. These assets can be traded to realise asset values, if required, without any undue loss to all shareholders.

Given the long term predictability of this asset class compared to others, longevity is a useful tool for investment managers when deciding on portfolio asset allocation as it can add an element of diversification whilst helping to improve performance and reduce risk and market exposure.

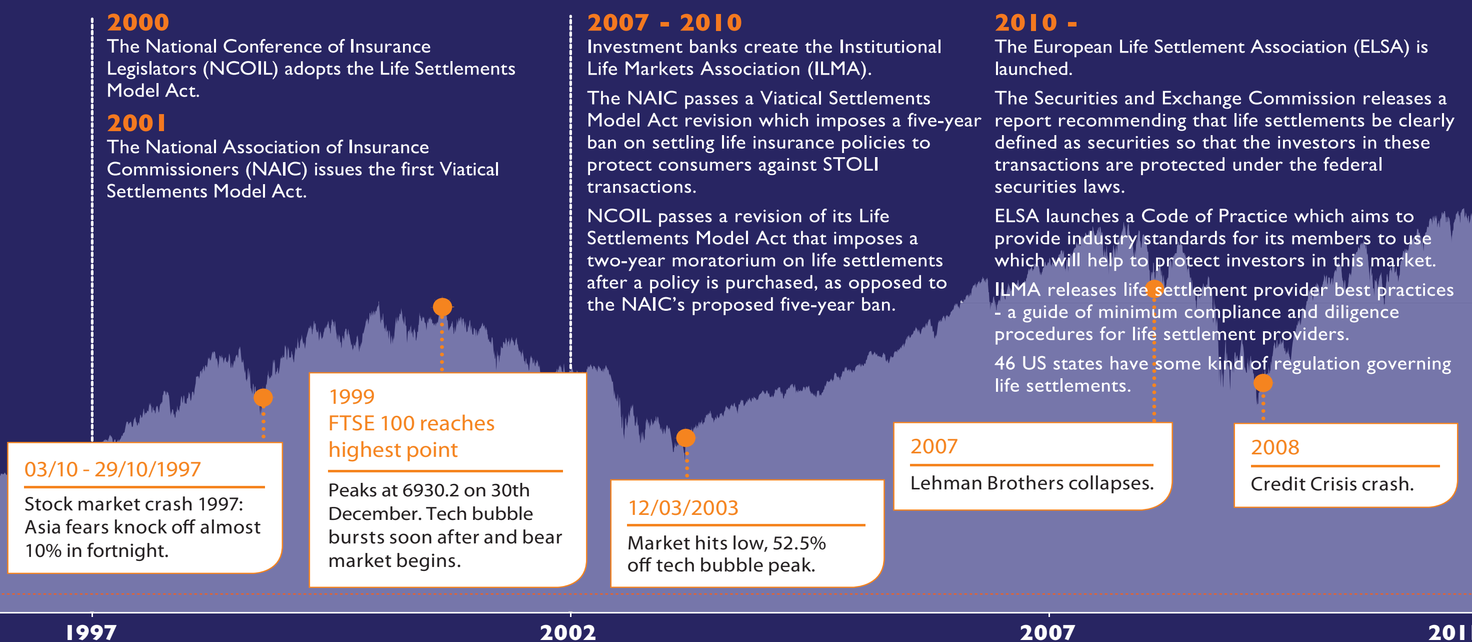
> **"Mark-to-market addresses investor demand for greater liquidity, diversification and transparency in longevity products..."**

What longevity fund managers are facing is a switch from mark-to-model to mark-to-market - when the assets are valued at the current market price. Because there is not a high degree of fluctuation in this asset class, the market value can be determined by surveying the principal brokers in the industry, of which the largest players are two investment banks. The advantages of a mark-to-market approach include the equitable treatment of all investors, as the holdings of those investors departing the fund and those remaining or entering the fund are all priced at current market value, rather than a model price.

To this extent we have effectively put all existing shareholders into a closed end structure where they will be paid each time a maturity occurs and the death benefit is received. In this way their investment is truly linked to longevity.

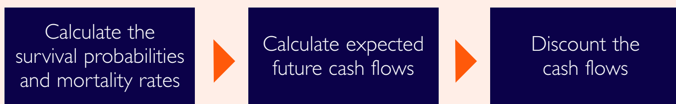
The paradox of longevity is that the concept is simple to explain but hard to understand. High net worth investors with sophisticated investment advisers have the resources to analyse the risks of - something that retail investors lack - and consequently understand how longevity can be used in an investment portfolio.

This article was first published online in International Adviser on 12th July. The article can be downloaded from our website at: http://www.centurionfundmanagers.com/longevity-media-coverage.aspx.



How is an individual policy valued, using a mark to market model?

The input factors for the model are the life expectancies ("LEs") provided by the major life expectancy underwriters (such as AVS and 21st), the market discount rates and the premium stream as calculated by MAPS (which is the standard software in the industry). The valuation itself then comprises three steps:



How is the discount rate derived?

Traditionally the discount rate at point of acquisition has been used to value the policy on an on-going basis irrespective of market movements. Going forward, the market discount rate will be used to value the policies.

Market discount rates as a function of the policy risk profile will be provided on a quarterly basis by independent third parties. These will be major life settlement participants (e.g. providers, servicers, etc) with a thorough knowledge of current life settlement yields gleaned from the volume of transactions they conduct each month.

All policies will be divided into 3 different categories of risks:

1. Universal or converted term policies with face value of $5m or less and with no origination issue (non premium financed and no beneficial interests). The average LE is between 36 months and 120 months or if the LE is lower than 36 months, then the age of the insured must be greater than 85 years. The carrier is rated BB+ or better by AM Best and the policy has low sensitivity to LE extension.
2. Policies, which could be universal, converted term, term or whole life, with a face value of between $5m and $10m and which may have originated from carrier approved premium financing programmes (no beneficial interests). The average LE is less than 36 months (and the age of the insured less than 85 years) or greater than 120 months. The carrier is rated BB+ or better by AM Best and the policy has medium sensitivity to LE extension.
3. Any policies that do not fit into the two categories above.

The life settlement participants will provide us with discount rates for policies in categories 1 and 2 above and we will compute the average of the provided quotes for both categories and use these two rates to value our policies. Policies in category 3 will continue to use the discount rate at time of acquisition. These policies represent a small percentage of the portfolio and are typically opportunistic buys.

Is the valuation methodology and process audited independently?

Yes. The valuation will be independently verified by Lewis & Ellis and the model and process will be audited by BDO International.

How much volatility will the portfolio pick up from the new valuation technique?

With all actuarial methods of valuing longevity assets, the volatility is primarily a function of the number of policies held. The new fund classes aim to have a greater number of policies, hence the volatility will reduce, although reviewing the market discount rate on a quarterly basis, may potentially increase the volatility. Diagram A below compares the volatility in share price on a portfolio of 500 policies, based on using a market discount rate and a constant discount rate.

A balanced asset mix will hold asset types producing different levels of return with varying degrees of volatility to ensure that the overall fund objectives are met whilst mitigating potential risks. Diagram B illustrates that the relative low volatility of premium financing "smoothes" the higher volatility of trading whilst maintaining overall fund performance.

Diagram A

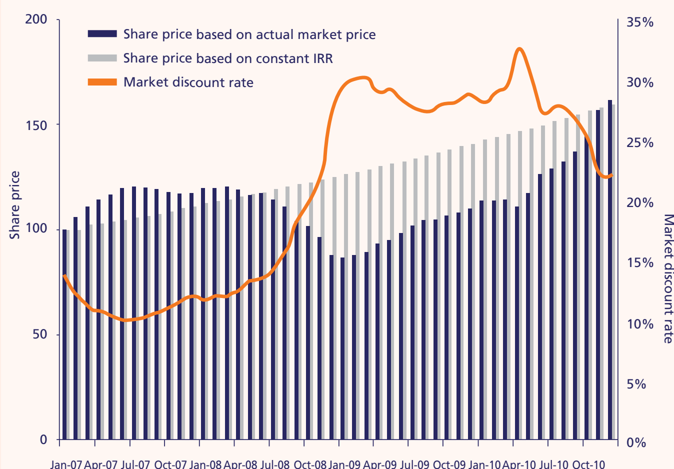
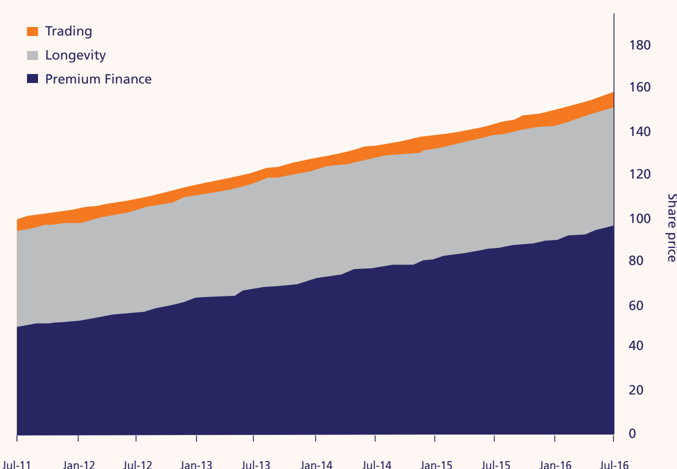


Diagram B



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