

Analysing liquidity in a life settlement fund

In this turbulent market, cash is king and prudent liquidity management is vital in the viability and success of any investment fund. In an asset such as life settlements which is often characterised by many as an illiquid class, the challenge is not only to understand how to manage liquidity but also to generate it.

In an investment fund holding traditional assets such as equities and bonds, liquidity is typically met by selling an asset in an open market where the price is readily available. For life settlements, assets are priced either “mark-to-market” or “mark-to-model”. Mark-to-market records the value of the asset at the current market value while the mark-to-model prices an asset based upon a financial model and its inherent assumptions.

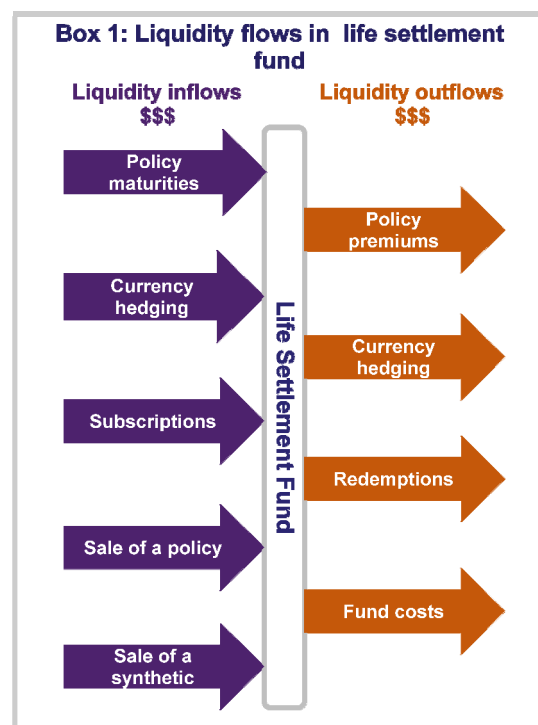
The factors which impact the market value of a life settlement asset include:

- Availability of current up-to-date life expectancy reports – These need to be as recent as possible and certainly no more than 3 months old. If a fund updates its life expectancies on a regular systematic basis, then this will be reflected in the fund’s valuation of the assets
- Quality of origination documentation – Did the investment fund buy policies that did not comply with today’s standards? The life settlement market has evolved dramatically over the past few years and old documentation often needs to be brought up-to-date before policies can be sold into the market
- Policy origination – Was the policy premium financed or a STOLI (Stranger/Investor Originated Life Insurance) arrangement? These policies were bought cheaply at the time but today are traded at heavy discounts where the effective discount rate very often are not reflected in the valuation of the investment fund
- Credit rating of insurance carriers – If the carrier’s rating has been downgraded, this has an impact on the discount rate and hence the price of the asset
- Market conditions – as with most markets, the life settlement market is driven by supply and demand and where there is an excess in supply, the prices tend to be driven down impacting the value of the asset

For investors, these factors are often not transparent and their answers difficult to establish. The lack of any of these elements has a severe impact on the marketability of the asset but this may not be apparent in the net asset value of the fund.

Fund managers who rely solely on subscriptions to meet redemptions may run into liquidity issues if certain constraints are not put in place. As there is a long lead time of between 2 and 3 months involved in the sale of a life settlement, a redemption notice period is necessary in order to manage the liquidity flow. When selling a life settlement, there is the cost of the brokerage fee which is based upon the face value of the policy and not the asset value. By putting in place a redemption penalty, this helps not only to cover the transactional cost but also to prevent investors from using the fund as a money market investment.

If the market conditions are such that it is not advantageous to sell an asset, one option available to fund managers is to arrange a bridging facility with a bank. In any such arrangement a “haircut” is applied in valuing the assets for collateral purposes. Depending on the state of the life settlement documentation and the bank’s familiarity with this asset class, the haircut can often be as high as 70% of the asset value which may make a fund become vulnerable to collateral calls should there be a downturn in the market.



So how do we at Centurion manage our liquidity?

For a life settlement investment fund, liquidity is not just about meeting redemption requests. The fund needs to have sufficient cash to meet premiums obligations on policies as well as any currency hedging requirements. So how do we manage this balancing act?

Firstly, we recognised early on that to price this asset class based solely on a mark-to-market valuation is extremely difficult as it would be impossible to establish on a month-on-month basis the market discount rate used to determine the market value of the assets. Keen to ensure equitability to all shareholders, we have put in place a valuation reserve which is used to buffer the vagaries of the market such as modifications in life expectancy underwriting, changes in the market discount rate or delays in policy maturity. Built over the past 5 years, our reserve today, in what is our fund's 8th year, stands at between \$15 million and \$20 million, well in excess of our target 3% of the net asset value of the fund.

Today, if we should find ourselves in a situation where we need to raise \$30 million for liquidity purposes, we have the "luxury" of selling our assets at 50% of their book value, funding the losses through the use of our reserve and still not having a negative impact on the net asset value of our fund. It is unlikely that we will need to do this but it is comforting to know we have it.

Life settlements increasingly form part of an emerging asset class known as micro-longevity. Micro-longevity is defined as the longevity of a subset of the general population (macro-longevity), typically comprised of between 300 and 1,000 lives of individuals ages 70 and above, in the case of life settlements. As this asset class continues to develop, there are increasingly more financial products available from investment banks that address the issues specific to this asset class. At Centurion, we realised that these longevity products such as swaps, notes and indices can not only help us as fund managers to better manage the liquidity of our investment funds, but also to overcome some of the intrinsic constraints of the life settlement asset. We started looking at using swaps in 2006 and concluded our first transaction in 2008. From a liquidity point of view, the fund manager can sell a portion or the whole of the swap back to the investment bank and the transaction can normally be concluded in 30 days, well

short of the 2 to 3 months required to conclude a sale of actual policy in the market.

We set out to bring to the market the concept of a defined return. Over these past 8 years, we have continually striven to improve our products for the benefit of our shareholders. We believe our cautious view on valuation methodology, in particular the updating of life expectancies and the incorporation of reserves into our valuations, make us a notable leader in the longevity fund market. By being cautious, some may say overly cautious, we will meet our goal of being one of the recognised specialist longevity managers in the years to come – A longevity manager with a longevity track record.

The key points in our liquidity strategy are:

- Updated life expectancy reports – In the past 6 months, we have updated 28% of our life expectancies in our portfolio, far exceeding our target of 20%. This allows us to value our assets using the most updated and current life expectancy reports
- Valuation reserve – This helps ensure that even if there is fluctuation in the discount rate, this provides a safety margin to help us buffer any adverse movement. Today our valuation reserve is in excess of the target 3% of the net asset value of the fund
- General liquidity – To ensure that all our obligations are met, the fund aims to keep between 5% and 10% for general liquidity requirements such as premium and currency hedging. Today, our liquidity level is upwards of \$15 million across all our life settlement funds with a premium obligation of under \$7.5 million over the next 6 months
- Longevity products – We have in excess of 15% of our funds' assets in longevity products such as swaps. These products are more liquid than traditional life settlements
- Shareholder diversification – we have no single investor with more than 2.5% holding in our funds. This helps to avoid huge redemption request from a single shareholder causing liquidity issue within the fund. Furthermore, we have not enticed shareholders into our funds by offering special penalty-free redemption terms.

For more articles and presentations on longevity please go to www.centurionfundmanagers.com.

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