

Evaluating risk in a life settlement fund

As with a lot of alternative investment funds, it is often difficult for outside investors to evaluate all the risks, and a life settlement fund is no exception. Whilst certain risks such as the policy origination process, external service providers or extended longevity are common to both open-ended and close-ended funds, the former is subject to greater market risks and thus the fund structure and liquidity are also important elements to consider.

Common risks to both open-ended and close-ended funds

When procuring a life settlement, it is easy to establish whether there are obligations such as liens on a policy and any experienced US purchasing agent will be able to do this. However, it is harder to determine insurable interest on a life settlement as the concept of insurance interest is more like a legal definition that varies depending on the state in which the policy owner lives. Insurance carriers are unlikely to challenge on the insurable interest aspect until the policy matures so it could potentially be years before the issue rears its ugly head unless the fund tries to sell the policy to raise liquidity. For the investor, the practical solution is to ensure that the fund procures from numerous policy providers, that the policies are independently verified and that the time span between the issue date and the acquisition date is as long as possible.

Once acquired, a life settlement policy requires maintenance such as meeting regular premium payments, verifying the insured is alive (tracking), updating medical records to obtain updated life expectancy reports (if the fund wishes to have the ability to sell assets), and optimising premium payments to minimise the cash outflows. The fund also requires a sub-custodian in the US to hold these assets, which can be in the form of a trust or a securities intermediary who will be responsible for claiming death benefits and for withholding any US taxes. An investor therefore needs to understand not only the experience of the policy maintenance team, but also any tax implication and potential US reporting requirements if, for example, the fund is set up as a partnership.

The key risk in this asset class is extended longevity which can be mitigated in a number of ways. The most costly is to purchase some form of stop-loss

insurance, which was originally provided by the likes of Lloyds of London though now it has become the domain of investment banks. The alternative is to use a prudent longevity valuation methodology to value the policy. Life settlements by their very nature deal primarily with a subset of the standard population and therefore standard mortality assumptions are a mere starting point. Obtaining multiple life expectancy estimates from reputable underwriters, applying rules on maximum deviation and using the fund manager's own prudent mortality assumptions to stress test the performance of the policy when subjected to any extended longevity are all additional steps that should be taken to help minimise any extended longevity risk. It is imprudent to rely on one's own life expectancy estimates as that will not correlate to market assumptions and thus will make the policy very difficult to sell should the fund need to raise liquidity. Investors



should be looking to see who is providing the life expectancy estimates, the number provided, the frequency with which they are updated and the deviation between life expectancy estimates.

Carrier default risk is seldom priced into the physical market primarily due to the regulatory environment in the US where insurance is regulated at the individual state level. This means that even if the parent company goes into liquidation, it is unlikely that its subsidiaries in each state will run into financial difficulties.

Open-ended versus close-ended funds

An open-ended fund is subject to more market risks than a close-ended fund. As investor sentiment influences market changes, subscriptions and redemptions as well as currency movements will affect a fund's liquidity. Extended longevity can also impact liquidity levels as the premiums required to keep the policy in force increase. Investors therefore need to know what a fund's liquidity management strategy is as this can be addressed in several ways.

In a traditional equity or bond fund where assets are priced to market, assets are simply sold when liquidity need arises. However, in life settlements, where it is necessary to update medical records and life expectancy estimates before a policy can be disposed, this is difficult to achieve. Even if the disposal process can be shortened, there is the question of how the policy is priced in relation to the market. If the manager needs to sell the policy in the open market at a substantially reduced price in order to raise liquidity, this will have a detrimental effect on all the investors in the fund. The key to liquidity management in a life settlement fund is to have the right balance – having excessive liquidity leads to underperformance while not having sufficient liquidity necessitates policy disposal at the market value with any associated costs.

Any successful longevity fund needs to have earlier than anticipated deaths. However, early deaths are by no means an indication of good management. Actuaries can project the number of early deaths required for a fund to be sustainable without new subscriptions and the need to sell policies. The effectiveness of this actuarial projection is shown by the actual-to-expected mortality. A conservative fund manager will take into account actual-to-expected mortality experience and liquidity requirements and have at least a percentage of the portfolio priced to market rather than to model. A line of credit or holding more liquid longevity assets such as synthetics are additional tools a manager can use to meet any liquidity requirements. Investors should evaluate how liquidity is managed and should take note of liquidity management that substantially relies on using subscriptions to meet premium obligations or redemption needs.

The fund's legal structure can go some ways to alleviate this liquidity management issue. Unlike a close-ended fund, an open-ended fund has regular inflows and outflows so redemption restrictions have to be put in place to stop investors from using the fund as a type of high yield bank account. Investors therefore need to understand the fund's legal structure to ensure that larger investors are not given special liquidity terms (e.g. no redemption penalties) to the detriment of other investors.

Of particular relevance to an open-ended fund is the need for investors to evaluate and understand the valuation methodology. Is this a fund whereby investors should aim to be first-in-first-out or is there a more equitable solution? For a longevity fund to work, it must experience early deaths as these generate higher returns than anticipated at the time of purchase, whilst policies maturing later than anticipated generate lower returns. Consequently this leaves the investor having to time both entry and exit into the fund relevant to the volume of subscriptions, new policy acquisitions and the portfolio's weighted average life expectancy. An alternative solution is for investors to select a fund where the valuation methodology uses a debit and credit system for the early and late maturities thereby treating all investors equally, irrespective of when they buy into the fund. More so than any other asset classes, good past performance may be detrimental to future and past performance!

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