

Getting more out of life

Life settlements have been in existence for over 20 years and form part of the micro longevity asset stable which also includes reverse mortgages and life tenancies



David Rawson-Mackenzie, director, Centurion

The life settlement industry is now worth over \$16bn with market analysts predicting further growth over the next two years to \$21bn (‘Life Settlements – A Buyer’s Market For Now 2009’ by Conning Research & Consulting). The recent turmoil in the financial markets demonstrated that many of the more traditional alternative investments, such as hedge funds, failed to provide investors with adequate portfolio diversification. Consequently there has been increased interest from financial advisers and asset managers looking for a different alternative investment product that will deliver low volatility and uncorrelated returns.

This article aims to provide a brief overview of how life settlements work as an investment tool and to demonstrate how they can help to diversify an investment portfolio and both improve performance and diversify risk.

Modelled p’folio asset allocation (cautious)

	Existing	Remodelled
Cash deposits (Base rate less 0.5%)	35%	35%
Giilts (UK Gilt Index)	30%	30%
Guaranteed life bonds (Average price of UK life bonds)	25%	15%
Corporate bonds (Moody’s Corporate Bond Index)	10%	10%
Property (FTSE Real Estate Index)	–	–
Equities (FTSE 100)	–	–
Life settlements (Avg price of Centurion longevity funds)	–	10%

Source: Centurion Fund Managers

Why invest in them?

Compared to other alternative asset classes, life settlements can provide attractive and predictable returns with low volatility and market correlation, which appeals to a wide range of investors, particularly those targeting inflation-beating returns and capital preservation.

By relying on the duration of the life expectancy of the insured and not on the market prices of a fund of stocks and shares, for example, a life settlement fund is not subject to the same vagaries of the financial markets, and so is more predictable. This predictability can be a particularly useful tool for financial planners when they are planning for education or retirement funding.

How they work

A life settlement is the term used to describe a life insurance policy that has been traded in the secondary market. These traded policies are bought from their original owners, usually US seniors aged 70-plus who receive a cash sum which is worth considerably more than if the policy was surrendered. Life settlements are mainly purchased by institutional investors such as banks, pension funds and life settlement funds.

A life settlement fund holds a portfolio of individual policies with varying longevity expectations, which, when combined in a portfolio, aim to deliver consistent returns with little market volatility.

The key risks inherent in life settlements are complex and need to be thoroughly understood by both potential investors and their advisers before investing. In particular, understanding the intricacies of managing exposure to the various types of risk within a portfolio is critical to a successful investment in this asset class.

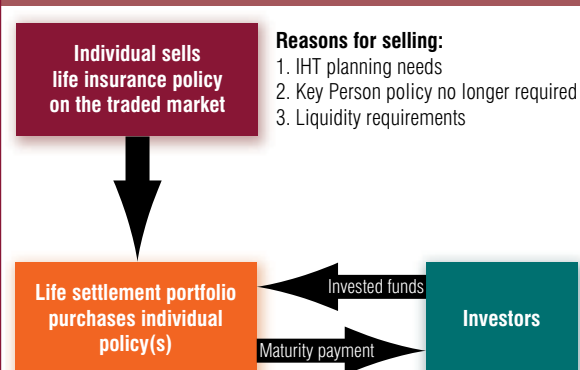
While the principal risk is that of longevity and the policyholders living longer than expected, requiring the fund to pay out additional premiums and therefore having to wait longer for the maturity values, other risks such as origination and liquidity risk also need to be considered when evaluating a portfolio of life settlements.

Introducing life settlements into an investment portfolio can increase performance.

Investment portfolios

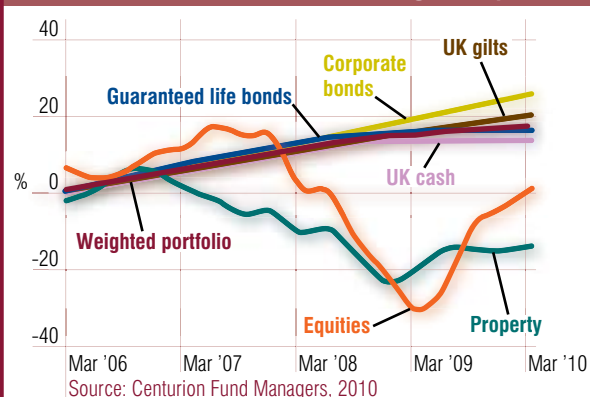
Introducing life settlements into an investment portfolio can increase performance.

How a life settlement works



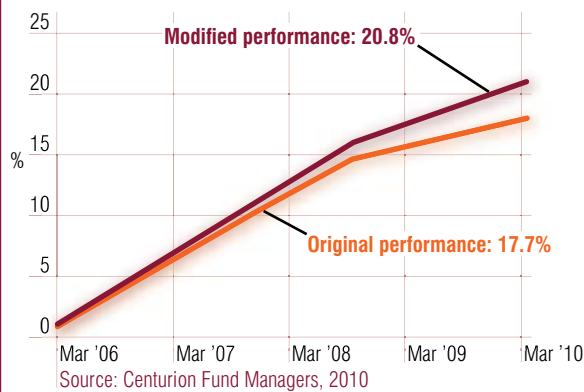
Source: Centurion Fund Managers, 2010

Overall individual asset vs weighted p’folio



Source: Centurion Fund Managers, 2010

Weighted perf: P1 original vs remodelled



Modelled p'folio asset alloc (opp balanced)

	Existing	Remodelled
Cash deposits (Base rate less 0.5%)	20%	20%
Gilts (UK Gilt Index)	15%	15%
Guaranteed life bonds (Average price of UK life bonds)	10%	10%
Corporate bonds (Moody's Corp Bond Index)	20%	20%
Property (FTSE Real Estate Index)	15%	10%
Equities (FTSE 100)	20%	15%
Life settlements (Avg price of Centurion longevity funds)	-	10%

Source: Centurion Fund Managers

ance without increasing the risk profile. For financial advisers, the key issues to consider are what is the optimum asset allocation to meet their client's investment objectives and what effect is this going to have on the portfolio's performance and risk profile.

So, how does this work in practice? The sample investment portfolios below have been modelled to demonstrate how life settlements can be incorporated into an asset allocation mix to obtain different results depending on the investor's risk profile and investment objectives.

The asset allocation models contain the asset classes that typically would be held in a balanced portfolio with a relative risk rating attached to each as follows: Level 1 – cash and gilts; Level 2 – life/longevity; Level 3 – corporate

bonds; Level 4 – property; and Level 5 – equities. The individual risk ratings are then weighted depending on the asset allocation to provide an overall risk rating for the portfolio.

The asset mix is based on different assumptions depending on the risk profile of the investor with more cautious investors holding a larger proportion of low volatility assets than a more opportunistic investor for example.

Portfolio 1: Cautious

Our first type of investor is either approaching retirement age or has already retired and is looking primarily to protect his capital or, at the very least, to minimise any risk to his capital with a view to generating income either immediately or in the near future. So the investment portfolio is

heavily weighted towards low volatility with a smaller element put into corporate bonds to mitigate the effects of inflation.

The performance chart on the opposite page shows how the actual performance of the existing portfolio on a weighted basis can mitigate the effects of a downturn in an individual asset class performance.

By definition, the asset mix of a cautious investor will not provide a significant opportunity to reduce the risk profile, so to introduce life settlements into the asset allocation, the exposure to guaranteed life bonds has been reduced, as these have a similar risk profile, to create a life settlements holding of 10%. The result is that while the conservative risk profile of the portfolio has remained unaltered, the performance has been improved by over 3% when back-tested over the past four years.

Portfolio 2: Opportunistic balanced

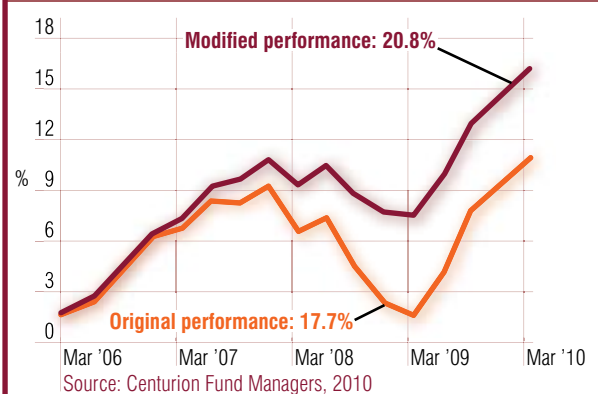
The second model portfolio has been structured for a less risk-averse type of investor. Typically they are looking for investment opportunities based on market timing and so hold a higher than average level of liquidity. In this scenario, introducing life settlements into the asset allocation and reducing the exposure to property and equities (the asset holdings with the highest potential volatility) has resulted in an increase in performance by over 5% when back-tested over the past four years, and has reduced the overall risk profile.

Whatever the investor's profile, these examples illustrate that life set-

tlements are not merely another two-dimensional asset class but a multi-faceted investment option that, like any other new asset class, can add an element of diversification to an existing portfolio. At the same time they can provide a serious alternative whatever the overriding economic climate; outperforming cash while keeping risk profiles down or offsetting the turbulence of the more traditional equity and property options while maintaining portfolio performance.

As recent experience has taught us, investors are more risk-conscious than ever before but still demand performance; life settlements, along with other longevity assets, should not be overlooked when planning a portfolio's asset allocation. IA

Weighted perf: P2 original vs remodelled



Risk rating

