

Longevity investing turns to mark to market

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

BY DAVID RAWSON-MACKENZIE

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.

■ What is longevity?

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 rebalanced 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.

■ Mark to market

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.

■ Changing models

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.

Mark-to-market also provides a better indication to prospective invest-

tors 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.

■ Predictability

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.

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 this complex asset class – something that retail investors lack – and consequently understand how longevity can be used in an investment portfolio.



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