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FOCUS

LIFE SETTLEMENTS As investors increasingly look for steady returns in an uncertain and potentially turbulent marketplace, life settlements offer reassuring stability

Safe returns in a volatile era from life settlement funds

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In the current market climate, investors are increasingly looking for stable and reliable returns that are not correlated to the market.

As a result, many professional advisers and asset managers are looking at alternative asset classes as a means of providing attractive yet steady returns for their clients.

Hedge funds, exchange traded funds, derivative-based investments and private equity funds are all far more accessible nowadays. Longevity is another such theme that is rapidly gaining interest, mostly in the form of life settlements.

One of the main attractions of investing in life settlements is that they provide returns with low volatility and limited correlation to the financial markets.

Limited risk

The rate of return on investment in life settlements, unlike that of bonds and equities, is linked to the accuracy of the life expectancy estimate of the insured instead of the movement in the financial markets, thus rendering its return lightly correlated to the overall financial market.

The primary risk in life settlements is in the life-expectancy estimate of the insured, who is typically someone aged 70 or above. The estimate is underwritten by actuaries based on mortality curves derived for this sub-population and adjusted for their socioeconomic conditions.

It is this estimate which determines the initial rate of return, and any subsequent deviation will have an impact on the return.

However, it is widely accepted that the longevity improvement in the senior population is expected at best to be modest, which makes the performance of this asset class a non-volatile one.

Life settlements can add diversity to the alternative asset allocation in an investment portfolio, while helping to increase performance and reduce risk and market exposure. They can be incorporated into an asset allocation mix to obtain different results, depending on the investor's risk profile and investment objectives.

A risk-adverse investor deploying capital towards life settlement can enjoy similar returns to that of bonds or property but with less volatility, which will enhance capital preservation.

Similarly, for the more opportunistic investor, investment in life settlements helps to reduce the systemic risk in the portfolio without compromising on the overall return of the portfolio.

It is a common misconception that life settlements are completely non-market correlated. Two market forces that have an impact on the performance of life settlements are capital deployment and foreign exchange movements.

As was clearly demonstrated during the most recent global financial crisis, when the overall liquidity level was low and macroeconomic conditions were poor, investors' appetite, even for alternative assets with low market correlation, was affected, and investors demanded an above-average return.

The situation has since improved and asset prices are beginning to return to normal. As life settlements are a US dollar-denominated asset, investors whose base currency is not the US dollar need to have an effective hedging strategy to prevent them from experiencing any potential foreign exchange losses.

> Longevity as an asset class remains a unique opportunity for investors to gain superior stable returns with little market correlation

The dilemma with life settlements is perception versus reality. Life settlements have been around for over 20 years, though they are often portrayed in the media as the 'new kid on the investment block'.

The dichotomy of this asset class is that the concept is simple to explain but hard to understand. However, investors willing to devote the time to understand its risks will be rewarded by stable, non-volatile returns, which in the current financial climate must surely be seen as an advantage.

One of the main barriers to investing in life settlements is the difficulty for investors to evaluate and understand all the risks involved.

An experienced fund manager will have a robust risk-management procedure in place and be able to demonstrate how these risks are mitigated to ensure investors are treated equitably.

Popular misconceptions

There have been a number of high profile cases in recent months of life settlements being mis-marketed, and this has not been helped by some of the misconceptions and myths that surround this asset class.

Life settlements are a highly specialised and complex asset class and only suitable for sophisticated or experienced investors who, together with their advisers, have the ability to analyse and understand them thoroughly.

Until a life settlement Ucits-compliant product is available, this asset class is only suitable for qualified investors, as defined by Markets in Financial Instruments Directive (Mifid).

Life settlement policy is not a recognised security and as such, in order to establish a Ucits-compliant product, the assets must be held as a financial derivative.

However, until the key hurdles, namely illiquidity and lack of consensus on pricing and valuation, can be overcome, it is difficult for the asset class to attain mass appeal.

It is often easy to forget that life settlement is only one of many assets in the longevity stable. As the western population ages, the opportunities abound for this asset class, whose fundamental risk remains uncorrelated with any systemic or market risks.

Longevity as an asset class remains a unique opportunity for investors to gain superior stable returns with little market correlation.

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Protected: life settlements can potentially keep investments safe from market turmoil

key risks with life settlements

- **Extended longevity:** If policyholders live longer than expected, the fund will have to pay out more premiums, and as a result proceeds from maturing policies will arise later than expected. Consequently, fund performance could be affected
- **Policy origination:** If policies are of dubious origination or the underwriting has been inconsistent, investors' capital could be put at risk. It is imperative, therefore, to make sure that the fund only holds high-quality assets
- **Liquidity:** If the fund cannot meet ongoing premiums and redemption requests, it will need to dispose of assets at a potentially lower price to raise liquidity quickly. This will negatively affect returns to investors
- **Carrier credit risk:** There is always an underlying risk that the carrier (counterparty) behind the policy could become insolvent and be unable to meet death claims. However, insurance policies are viewed as consumer products and death benefits are considered super senior debt and often fall under state guaranteed schemes
- **Fund valuation:** If the assets are not accurately valued, then investors' expectations will not be met and liquidity issues may arise

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