

Investment Week

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FEATURE - INVESTMENT

Will longevity be the next innovative retail asset class?

David Rawson-Mackenzie

Longevity as an asset class has typically appealed more to institutional investors but it will start appealing to retail investors too, writes Centurion's David Rawson-Mackenzie.

Investing in longevity is certainly not for the unsophisticated investor and we would be foolish to think otherwise. However, it would also be untrue to believe that it is only suitable for investors with a Masters degree in quantum finance and nerves of steel.

Enabling knowledgeable retail investors to benefit from investing in longevity is a view that is beginning to permeate the industry but first the dilemma facing this asset class needs to be resolved: the dichotomy is that longevity is a simple concept to explain but hard to understand and this is mainly due to a lack of standardisation in the longevity market.

The lack of industry standards is particularly true for macro longevity, which relates to the general population and is generally represented by a sample size in the tens of thousands of lives: it is based on derivatives such as swaps, longevity linked notes and longevity indices.

The International Swaps and Derivatives Association (ISDA) has set industry standards for many of the over the counter (OTC) global derivatives markets, but to date there has been no standard documentation or contract for longevity derivatives.

This looks all set to change with the announcement that the ISDA is working on a standardised contract for longevity swaps as a response to the increased interest in this relatively new market sector. It is early days but a new industry standard for longevity derivatives will help transparency and mitigate risk.

The concept of a derivative can also be difficult to grasp as there is no actual "physical" asset. However, the increasing number of longevity swaps being arranged by investment banks in recent years is helping to bring longevity more into the mainstream investment markets.

The most recent one was completed by BMW with Deutsche Bank in February 2010 for \$4.6bn and market analysts predict that in 2010 the longevity swap market for UK pension funds alone will reach £10bn.

The introduction of longevity indices will also help increase transparency and raise standards. The newly formed Life & Longevity Markets Association is dominated by the top investment banks including Deutsche Bank, JP Morgan, Morgan Stanley and UBS and aims to provide a consistent and transparent set of standards for developing, producing and publishing longevity indices.



“ Investing in longevity is not just for investors with degrees in quantum finance ”

Currently there are three main indices in operation: the CSFB Longevity Index launched by Credit Suisse in December 2005; JP Morgan's LifeMetrics Longevity Index released two years later and the latest entrant into the market - the Xpect indices developed by the Deutsche Börse – the German stock exchange.

Micro longevity is a different animal; it references a much smaller pool of lives – typically between 200 and 1,000 – and includes investment products such as life tenancies and life settlements. Being based on physical assets such as property and life insurance policies, micro longevity is relatively easy to explain but there are still a number of standardisation issues.

For example, in the case of life settlements, there are limited standards of policy origination so it can be difficult to ascertain the rationale and condition under which the policy was taken out in the first instance: if this was with the sole purpose of seeing as establishing a market price is not as simple as looking up the price on Bloomberg or Reuters. For example, for life settlements, if we assume that on average a life company has five different products and then multiply that by the number of life companies in the US – currently over 1,000 – then it is easy to comprehend the impossible task of getting a daily price for all the assets held in one life settlement portfolio.

Life settlements in a synthetic format could be attractive to the retail market if they were made available via a “symposium” of investment banks whereby the banks take on both the origination risk and pricing the life settlements.

There would also be more data available to generate the life expectancy estimates as the banks would use their own mortality tables. In this way, the less quantifiable risks associated with life settlements disappear and the process becomes far more transparent thus making them far more attractive to the retail investor.

The investment banks would also provide the liquidity, which is a key ingredient in any retail product, but like all good things this comes at a price: lower yields, so investors expecting returns in the double figures will be disappointed.

Yet a longevity product with low volatility and minimum correlation to the financial markets should have a place in an asset allocation model and as we move forward, the next decade will see longevity filtering into investment portfolios.

With the aid of asset allocation simulation tools, investors and their advisers will be able to remodel the historic performance of their investment portfolios to introduce different levels of longevity and demonstrate how it can affect a portfolio's performance and risk profile.

Up until now longevity as an asset class has typically appealed more to institutional investors such as pension funds, insurance companies and investment banks rather than sophisticated retail investors.

However, with the development of more innovative products combined with increasing regulation and standardisation, it is highly probable that in the next decade we will see a longevity investment product specifically aimed at the sophisticated retail market. Watch this space!

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