

Reap the benefit of lives in your hands

Trading in life policies is gaining ground in the race to ride out uncertainty and poor returns in other classes

The market in traded life policies has not always enjoyed the best press – particularly in Europe where advisers are sometimes wary of recommending investments in policies sold by those seeking to unlock benefits before they die. However, with equities performing poorly, interest rates still relatively low and the property market uncertain, investment in an uncorrelated low-risk asset class which produces annual returns in the region of 7 to 8 per cent has to be worth a look.

When these products were first launched in the late 1990s take-up was slow. However, today volumes are increasing as investors take a keener interest. Last year, institutional money managers invested more in life settlements than in the previous seven years, around \$10bn to \$15bn in face value, with particular interest coming from Germany.

Private studies estimate that this equated to around 19,000 policies sold – a figure which is expected to rise to 26,000 this year. On current progress, it is expected the global market will be worth around \$125bn by 2015.

As interest has grown, so the number of European providers has increased. There are now believed to be around 10 players, the majority of which have launched funds in the last 18 to 24 months. With more institutional money coming in, the industry will continue to expand, especially as regulatory moves increase the transparency of the market.

Policies are most often sourced in the US, where they are seen as something of a status symbol for the wealthy. Most have a face value of between \$1m to \$5m and are generally taken out as a form of inheritance tax planning, since in the US there is no seven-year rule. As portfolios mature, individuals, who are generally 70 or older, often sell the policy because they have safeguarded the future of their inheritors through trusts or other means and are now seeking to fund a comfortable retirement. These products are known as senior settlements and are not to be confused with viaticals, which generally have a lower face value, and are policies sold by those who believe they have less than two years to live and often need to release equity to fund medical expenses.

Life policies are sold to fund managers either through specialist brokers or licensed providers and, under US legislation, once they are more than two years old, they cannot be revoked by the issuer, even if policy-holders smoke, drink, participate in dangerous sports or commit suicide.

Most policies are also whole of life, rather than term assurance – as is common in the UK. It is this combination of high face values, favourable legal conditions and established infrastructure which fuels the market.

Risk

Policies are purchased at a discount on the face value and payment of the premiums is taken over by the fund manager. Essentially, a profit is made when the cost of purchase, plus the cost of maintaining the policy, is less than the final payout. The risk comes in estimating how long it will take for the policy to mature – a risk which is mitigated by careful assessment of individuals' medical data and actuaries' life expectancy tables.

Good fund managers are able to make money on these policies because in the years when they were first taken out – the 1970s and 1980s – the insurance companies which provided the policies priced them too cheaply. As medical science has progressed and life expectancies have been extended, so these policies have come to represent increasingly good value when life expectancies and premiums are re-evaluated with the benefit of hindsight.

Perhaps not surprisingly, rumour has it that the American Council of Life Insurers may soon require those taking out policies now to hold for a minimum of five years, or pay tax on 100 per cent of the

gain, which means the window for this investment opportunity is definitely closing.

US providers selling to US investors are subject to regulation in the state where they are sold. Offshore funds, in which Europeans can invest, are subject to the regulation pertaining in the local jurisdiction. In the UK, life settlements are regulated by the FSA in that the advice given by the IFAs and providers selling them is regulated, though the underlying investment is not.

At the wholesale end, policies are bought by hedge funds, pension funds, European private banks and fund managers. Historically, it is the banks which have made the running in this market and which are now increasingly prepared to lend to fund managers seeking to extend their offering. German investors have also been very active in recent years, pushing up prices and raising interest in the class, though their interest has now peaked following a change in the tax laws.

At the retail end, the asset is sold to high net-worth individuals, either in the form of individual policies, or more usually as an investment in a managed fund, through an IFA or private bank. Fund managers also purchase from specialists to increase the variety in their fund of funds.

Minimum investments tend to be relatively high – around \$50,000, or the equivalent in sterling or euros, with top-ups purchased in \$5000 tranches.

For those wishing to make a smaller investment, purchase is usually made through an insurance wrapper offered through an institutional investor – the individual or IFA can then elect to have an element of their investment in traded life policies.

Generally, it is recommended that the investment period should be around seven years.

While there are many providers in the US, selling exclusively to a US customer base, the number of European providers is smaller – estimated at around 10, most of which have come to the market within the last two years.

Funds are based off-shore, typically in the Cayman Islands, Isle of Man or Lichtenstein.

Investors should look for a number of features when selecting a traded life investment:

- n Size of fund – it should contain at least 100 policies;
- n Good returns record;
- n Longevity;
- n Bank interest;
- n Appropriate fee structure;
- n Good total cost ratio;
- n Transparency;
- n Independent life expectancy estimates.

Viable funds have between 100-150 policies. It is essential that the number is relatively high in order to enable the manager to spread the risk.

In a market where both product and provider are relatively new, a good returns record is essential. Investors should ask: How have mature policies performed? Has the provider been able to sell on a proportion of policies above accrued book value? If so the value of the investment is strong. For those who have been established longer, how has the fund performed quarter by quarter, year on year?

Experience

Banks are probably the most experienced investor in this asset class. So a good marker of quality is the level of bank lending to the fund. Any sizeable investment will have needed to pass the scrutiny of the bank's lending committee. If it is good enough for Deutsche Bank, or ABN Amro, for example, it should also be good enough for most IFAs.

As always, reasonable fees, a good total cost ratio and transparency are also essential and will have been carefully vetted by experienced institutional investors. But perhaps most important of all, investors should satisfy themselves of the quality of life expectancy assessments.

While assessing life expectancy used to be something of an art, it is now definitely more of a science. Four companies now have a well-established reputation based on a sound track record. Better funds will rely on a minimum of two estimations of life expectancy and compare results from two methods of estimation – probabilistic and deterministic. Sometimes, a more conservative life expectancy will still provide a greater return coming in early, than a more aggressive life expectancy coming in late, which is why it is important that funds use a variety of evaluation techniques.

As Benjamin Franklin said in a letter to Jean-Baptiste Leroy in 1789: "In this world nothing can be said to be certain, except death and taxes."

While investments in life policies are based on the first certainty, the challenge for investors is to minimise the second while picking the provider which offers the best returns for the lowest risk.

David Rawson-Mackenzie, managing director of Centurion Fund Managers

<http://www.ftadviser.com/default.aspx?m=11200&amid=98401>

Powered By Digimaker

© Copyright Financial Times Business Limited - 2006.

"FT", "Financial Times", "Money Management", "Investment Adviser" and "Financial Adviser" are trademarks of The Financial Times Limited and their associated companies. No part of this publication may be reproduced or used in any form without prior permission in writing from the editor.

[Privacy Policy](#), [Terms and Conditions](#).

Developed by Digimaker, The .NET CMS.