



Centurion Fund Managers

Life settlement funds try to raise their profile among IFAs

Source: FundStrategy (www.fundstrategy.co.uk)

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Demand for traded life policies has soared since the late 1980s and as an uncorrelated asset class it holds attractions for investors - but IFAs are resisting take-up as returns depend on predicting the date of death.

When an asset class promises a return that is uncorrelated to both equities and fixed income it is more than likely an investor's ears will prick up. However, if you tell them the only way to get this return is for someone else to die you are probably set for an interesting reaction.

In America there is a large market for the sales of life assurance policies to third parties. The owners of such policies, which are either whole of life or term assurance, sell the policy to a fund in exchange for a cash payment, which is less than they would get if it matured at death. The fund then takes on the payment of all future premiums during the holder's remaining life and then, at death, collects the full face value of the policy from the insurance company.

The downside is that the inheritors of the estate are left with nothing; the advantage is the policy holder can use the cash received from selling it to pay for medical care, or solely enjoy their last few days. The industry first evolved in the late 1980s in response to the HIV/AIDs epidemic. By selling policies AIDs patients reduced their outgoings and generated capital to pay for medical treatment.

According to Bernstein Research, an investment research firm, about \$50m (£23.8m) of life policies - now known as traded life policies (TLPs) - were traded in 1990. By 2006 Credit Suisse reported that this had grown to \$20 billion and this is now expected to rise even further.

In October, Managing Partners Limited (MPL), a provider of TLP funds in Britain, published a report by Professor Merlin Stone of the Bristol Business School on the asset class. He predicted that over the next few years there will be a surge of money from British retail investors into funds investing in TLPs.

However, for this to happen Stone said that much more needed to be done to raise the profile of the asset class among IFAs. According to research from MPL only 22% of IFAs are familiar with TLPs as investment products.

One of the potential reasons for this lack of awareness is the multitude of names given for these American life policies. In America the policies were initially labelled viaticals or life settlements. However, following a large court case, in which an American viatical marketmaker, the Mutual Benefits Corporation (MBC), was found guilty of fraud, the policies became known as TLPs. The court case lasted two years, with the final ruling in August 2006.

MBC was found guilty of understating the life expectancies of policyholders, which therefore increased the value of their policies. While the directors subsequently pleaded guilty to fraud, there is no doubt damage was done to the reputation of the asset class.

Shepherds, an Isle of Man-based fund management group, which managed a fund invested in TLPs, collapsed in the aftermath of the MBC ruling. This is because the fund, the Shepherds Select Fund, used MBC as its sole broker for TLPs. To compound the problem the fund bought fractions of policies, rather than whole policies.

Jeremy Leach, who joined MPL in 2004, joined Shepherds one year after the Select fund launched in September 2003. Its trading was subsequently suspended in May 2004.

"I came in as a fireman," says Leach. "I never set up the fund, it was set up by a group of directors and they were later taken to court and found guilty of breaching their fiduciary duties. I stayed in the interest of shareholders, but I risked my name being tarnished as a result but the blame for what happened to the fund lies at someone else's door."

That said Leach maintains TLPs remain a new asset class that allows investors to diversify away from bonds and equities. "The complicated part," he says, "is to run a fund that works well to do something that is quite simple. That is to be a few percentage points ahead of the base rate and be a portfolio stabiliser."

Leach notes the biggest mistake the Shepherds' fund made was to buy fractionalised TLPs rather than whole policies. The reason for this was that the Shepherds' fund was Britain's first open-ended fund to invest in the asset class. As such Leach says the management team only expected a small pot of assets to invest at launch.

Given this small pot of assets the fund was not able to buy enough whole TLPs to garner a sufficient spread of risk. Leach says the fund would have only been able to buy eight to 10 policies, where in practice to achieve the right risk spread 100-150 policies are considered necessary.

Leach says it was felt that buying fractions of TLPs, which meant more policies were represented in the fund, allowed for a greater spread of risk. He adds the TLPs were bought solely from MBC because at the time it was the largest marketmaker in America, selling \$1.8 billion TLPs over a 10-year period.

However, by buying fractions Leach concedes the fund was not in control of the pool. "The conclusion and moral of the Shepherds story thus is that correct fund structure is to buy whole policies, not fractions of them."

So what now for the asset class? Three years on from the Shepherds debacle there are several fund management groups offering funds. So what has changed and will it be enough to convince investors and intermediaries to start investing?

Merlin Stone says the benefits of TLP funds is that they offer close to a guaranteed return. This is because of the certainty that the insured will die and that the policy has a definite, nominal value. Together these factors make financial institutions willing to lend money to both TLP funds and their investors.

"This potential to borrow to invest, or gearing an investment, makes TLP funds attractive to UK investors stuck in with-profit funds, says Stone. "Such investors, ever more disillusioned by their diminishing returns, can go some way to making up for the hefty surrender penalties they pay for pulling out of with-profits funds by using gearing to enhance their potential for higher returns. TLP funds will also continue to give them the steady income they sought from with-profits funds."

So what of the new breed of funds? Leach notes the TLP market today is different to how it looked six years ago. He says the Shepherds exercise was an "expensive mistake".

"The industry today is more sophisticated and more regulated," he adds. "You learn more about an asset class by the mistakes you make. What happened at Shepherds was a catalyst for learning more about the asset class. The market is more robust as a result of what happened at Shepherds."

The new MPL fund, called Traded Policies Limited, launched in June 2004. Leach says to date it has dealt with more than 10 American marketmakers to buy policies and invests in whole TLPs, not fractions.

Another product provider is EEA Fund Management. The EEA Life Settlement fund targets annual growth of 8-10% net of fees and John Buttress, sales and marketing director, says that in 2006 the fund achieved a return of 10.56%.

Buttress says: "The asset class works. You won't find anyone from a policyholder perspective who has been ripped off. The main risks are thus that the fund is structured poorly or that the policyholders live longer than expected. In our fund the average life expectancy is three years.

"The fund is run like any normal institutional fund. We have aligned our interests with those of the investor, meaning we only make a performance profit when investors receive 8% net each year. If you take front-end commission there is no incentive for the fund to perform."

The EEA Life Settlement fund, launched in November 2005, employs ViaSource, an independent American-based adviser, to buy from a range of policy providers. To calculate life expectancy it uses a panel of four or five specialist firms and takes the average calculation of two of them.

"If there is a big discrepancy between the expected life expectancy of the policyholder we go to a third firm," says Buttress. "It is a two-tiered process to determine whether we think the life expectancy is correct."

Leach says the process of working out life expectancy is similar on the Traded Policies Limited fund. He says the fund selects from a range of life expectancy companies and uses a panel of medical underwriters. "If the spread is too wide between the life expectancy call we won't invest in the policy," says Leach. "However, if there is an acceptable difference we will buy the policy. The general margin is a 25% difference. We buy policies that will mature within three to nine years and the average life expectancy is 5.5 years."

Similar to MPL fund, the EEA Life Settlement fund invests in whole TLPs, not fractions of them. Another fund provider that does this is Centurion Fund Managers. Centurion's core fund is the Defined Return fund, which targets an 8.8% annual return.

David Rawson-Mackenzie, managing director of Centurion, says good managers make money out of TLPs because in the years when they were first taken out - the 1970s and 1980s - the insurance companies that provided the policies priced them too cheaply. He says as medical science has progressed and life expectancies have been extended, TLPs have come to represent increasingly good value when these life expectations and premiums are re-evaluated with the benefit of hindsight.

Mackenzie notes that having the right tax structure and being transparent are essential, but "all the risk in investing in TLPs is down to the probability of some people dying earlier than expected and others dying late. So investors should satisfy themselves of the quality of life expectations"

Given past events, Rawson-Mackenzie adds it is no surprise that the TLP market was regarded somewhat of a "cowboy industry". However, he says that today the market is much more sophisticated. "The world's five largest banks provide us clients. If it is good enough for them it should be good enough for most IFAs."

The IFAs that Fund Strategy spoke to have yet to embrace TLPs. David Wynn, investment director at Bentley Jennison Financial Management, says more has to be done to educate IFAs about them.

He says: "We have started looking at them, but not enough to have an educated view. We can see the appeal and we always look for uncorrelated assets as they are important for a truly diversified portfolio. At this stage we are open to persuasion, but we won't advise anyone to invest until we understand what all the potential risks are."

Ben Yearsley, senior investment manager at Hargreaves Lansdown, says the asset class has been on the fringe for the past five to seven years, but has never made it to the mainstream. He says: "When you look at TLPs they almost seem to be guaranteeing a profit. When something does this it always makes me slightly nervous, nothing is ever guaranteed."

"I have always thought of TLPs as a speciality asset class. If advisers can't get their heads round them, how will they explain them to their clients?"

As such at this stage in time Hargreaves Lansdown is not recommending the asset class to its investors. Yearsley says that before it does so, TLPs must demonstrate performance over the longer-term. "We need to see how these funds fare over a full market cycle."

Merlin says the purpose of his report is to educate. At this stage, he suggests, with high interest rates affecting cash, property uncertain and shares close to peaking, investors should consider investing a quarter or a third of their portfolios in TLPs.

When deciding on a fund he cautions investors to examine the profiles of the fund managers, including their credibility, reputation, experience and how long they have been in the business.

Tim Cockerill, head of research at Rowan & Co Capital Management, says he has met TLP product providers in the past and notes the performance numbers of the funds were attractive. He also sees them as an uncorrelated asset class,

However, he says Rowan's compliance team ruled TLPs as unsuitable investments.

Cockerill says: "The reason for compliance saying no to TLPs goes back to legal issues in America. Compliance took the view that there was a legal risk that we could not quantify so we decided not to use them, despite the potential returns. This decision was taken two years ago."

The Stone report states: "Most TLP funds deliver growth. There are some income funds, with yields in the 5-6% a year range, but as an asset class, TLPs do not lend themselves as easily to being an 'income' investment because they do not generate income. They must be combined with other assets that do, such as bonds or property."

Critics question the regulation and domicile of TLP funds. Several TLP funds are domiciled in the Cayman Islands, where there are different classes of regulation funds can select.

Buttress says the EEA fund is Guernsey-domiciled and listed on the Channel Islands Stock Exchange. "At launch we felt we needed to adopt a fully regulated structure and Guernsey is a highly regulated market," he says.

In the past, TLP funds were classified as Experienced Investor Funds (EIFs). However, as EIFs were non-regulated, in the aftermath of the suspension of the Shepherds fund they were classed as unsatisfactory.

Rawson-Mackenzie says that in Britain life settlements are regulated by the Financial Services Authority. However, this is in that the advice given by the IFAs and the providers is regulated, the underlying investment is not regulated.

Stone says: "There are no federal laws governing life settlements, but nearly half the US states do now have stringent regulations for the trade of policies. These standards are enforced either by the Securities and Exchange Commission or the State Insurance Regulator. The aim is to ensure that a policy seller is achieving fair market value for his or her policy and that the intermediary's fees are reasonable, so that both the policy seller and the policy buyer get a fair deal."

So given the legal problems in the past and the lack of regulation on the underlying asset, what risk profile do TLP funds sit in?

Stone says: "With judicious diversification and careful analysis of policies and life expectancy tables, a portfolio can be managed to deliver steady returns. There is no such thing as a free lunch. Achieving returns requires expert portfolio management."

However, to do well out of the asset class you have to have faith in the structure of the fund you are invested in, and, just as importantly, what it is actually invested in. "The risk is in evaluating life expectancy," says Buttress. "If you can make this risk minimal, the fund should do well. So if the fund is structured properly we would argue the EEA Life Settlement fund is low risk."

Buttress says EEA has never marketed its Life Settlement fund as an alternative to with-profits. Instead he argues that, given the state of markets, it is an alternative to bond and cash funds. Advisers have yet to agree to this. In terms

of with-profits replacements, the favoured funds seem to be those several asset classes called multi asset funds.

However, even the harshest critics of TLP funds say the asset class itself is not the problem and that they could be a viable with-profits alternative. The sole problem is getting the structure and management right. Shepherds did not get it right and the investors suffered the consequences. Perhaps this time it will be different.

Morality of traded life policies

Despite a rise in retail demand for funds that invest in American traded life policies (TLPs), the asset class always seems to provoke controversy. First, the policies are linked to the deaths of the individuals and secondly individuals are selling at a deep discount assets they could otherwise pass on to inheritors.

Looking from the outside it appears that the TLP funds and their managers are waiting for people to die so that investors and the fund managers can benefit.

John Buttress, sales and marketing director of EEA Fund Management, however, says it advocates its Life Settlements fund as socially responsible. This is because it benefits the original policyholders. "There are many people in the world who are asset rich but cash poor," he says. "By selling their life assurance policy they have the opportunity to release capital for a stated need. This is an option they have never had before."

Professor Merlin Stone, who published a report on TLPs in October, says the creation of a secondary market for policies means policyholders can get a higher price for their policies than if they just surrendered their policies back to the insurance company.

This money can then be put to good use. For example, it can pay for the treatment of an illness, provide for long-term care or perhaps allow the policyholder to live out their final years in comfort or even luxury.

Buttress says: "There is no moral issue. People sell their policies out of a need. No one is forcing them to sell. The majority of the time the beneficiaries of the estate have no objections to the sale. Indeed, we ensure that the beneficiaries of the policy sign to say they are happy with the sale of it before we go ahead and buy it."

The only potential moral question, according to Buttress, is whether funds are buying policies where the holder has a longer life expectancy. "This is a bit more near the edge," he says. "But for people with two to four years to live it is more acceptable."