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Make a Steady 7-10% pa And Avoid the Stock Market

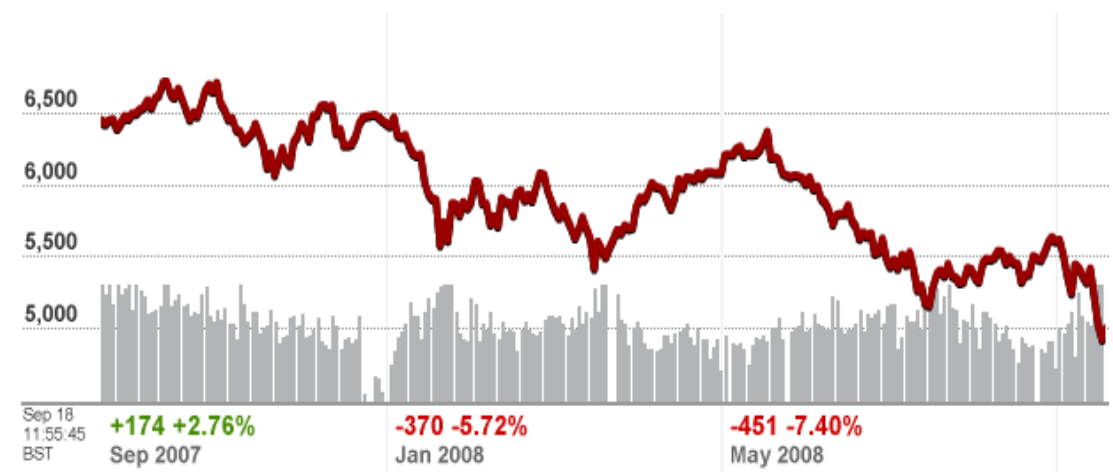
“We are in the midst of a financial depression the likes of which we haven’t seen since the Great Depression.”
[George Soros](#)

The New Paradigm for Financial Markets: The Credit Crisis of 2008

The legendary hedge fund manager outlines the features of this depression. It restricts credit and forces deleveraging - the paying down of borrowed money. This in turn punctures asset prices as the borrowed money which inflated then drains away.

With 70% home ownership and widespread exposure to equities in pension plans, ISAs and the like, few have escaped this bruising deflation since the credit crunch first broke in August 2007.

Figure 1: FTSE 100 1 year performance to Sept 18, 2008



Source: FT.com

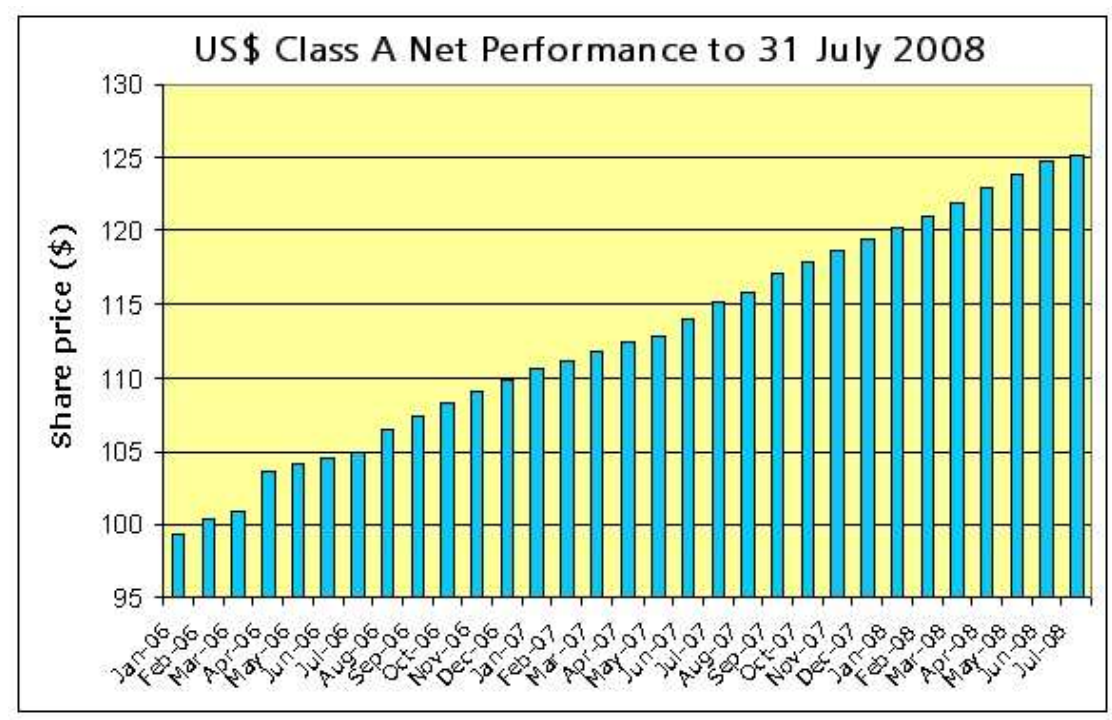
Further benchmark performances for the year to September 18 tell a broadly similar story, albeit with more extreme volatility in emerging markets with the main Chinese stock market index more than halving in value.

Eurostoxx 50	-32%
S&P 500	-21%
Nikkei	-24%
Shanghai Composite	-64%

In addition, commercial property prices are falling and now, as we all know, are house prices too. And then there’s the banks...

But not *all* asset prices have been deflating. The chart below shows the performance of a little known alternative investment over a period when the FTSE 100 has fallen by more than 3%.

Figure 2: Meteor Life Settlement Master Fund performance Jan 06-July 08



Source: Meteor Asset Management Ltd

This alternative investment has been delivering steady low volatility returns of 7-10%pa for investors and, unlike equities, is not derailed in the slightest by greedy bankers or ruthless speculation. Increasingly it is attracting institutional investors – pension funds, hedge funds etc. – as an attractive port in a storm from mainstream financial markets.

“A new breed of asset class”

So what is it? Well, it’s unusual but after something of a false start, it’s proving itself to be an effective investment.

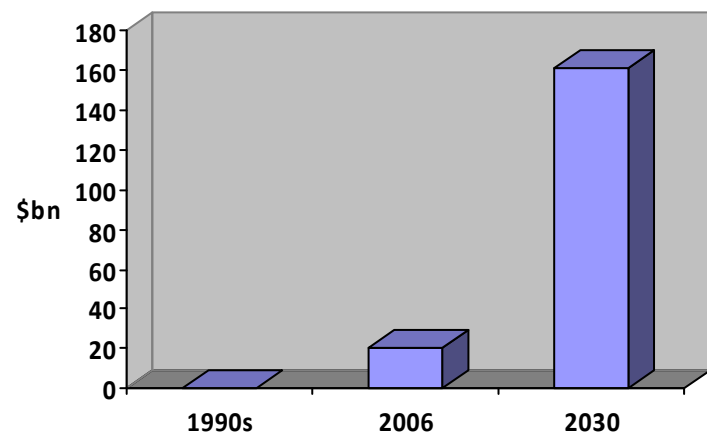
The asset class is based on the hitherto neglected value contained in second-hand American life insurance policies.

These are known in the trade as *Traded Life Policies* (TLPs), ‘*Life Settlements*’ or ‘*Senior Life Settlements*’. We refer to them throughout as TLPs.

We will come on to the details soon but presently, the TLP market is still a relatively small and immature one, which few - even financial advisers - have got to grips with. The potential for growth is significant. Research suggests the market doubled in 2005 and doubled again in 2006. From nothing in the 1990s [Bernstein Research](#) estimates \$5bn worth of TLP business was written in 2004, \$10bn in 2005, and Credit Suisse estimate \$20bn in 2006.

Analyst Suneet Kamath of Bernstein Research anticipates it becoming a \$161bn market by 2030 in an initial market assessment in 2005. A further note a year later said this might be achieved earlier than anticipated as market growth had been “quicker than expected”.

Figure 3: Forecast growth in TLP market (Bernstein Research Call 2005)



Although it is relatively new to the UK, in Germany, a nation renowned for its cautious approach to investment, it is the fourth largest asset class says Gary Flowers of Centurion Portfolio Managers, which manage a number of TLP funds.

An alternative with-profits fund..?

Professional and private investors alike have been hurt in this financial depression but the need for sound investments remains.

The ensuing disenchantment in equity markets is spurring interest in alternatives... The hunt is on for the investors' holy grail of low risk and acceptable performance above cash. This is the promise of investing in TLPs. Specifically they offer an investment with:

1. No correlation with the stock market
2. Consistent 7-10% pa growth
3. Low volatility
4. Dependability

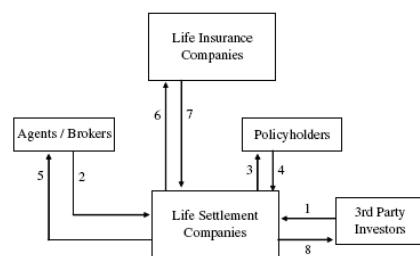
These attributes draw comparison with traditional with-profits style funds which for many years offered investors 'smoothed' returns in the form of bonuses each year.

What's a Traded Life Policy?

Traded Life Policies are life insurance policies issued in the United States where the policy proceeds on death can be assigned by the life assured to a third party in exchange for a lump sum cash payment.

Figure 4: How TLPs are traded

**Exhibit 1
How the Life Settlement Process Works (Flowchart)**



Source: Corporate reports and Bernstein estimates

**Exhibit 2
How the Life Settlement Process Works (Description)**

Steps	Discussion
1.	Institutional investor supplies capital to life settlement firm
2.	Agent or broker refers an existing client for a settlement transaction
3.	Client case is reviewed; life settlement firm makes cash offer for policy
4.	Client reassigns beneficial ownership of the policy to the life settlement firm
5.	Life settlement pays agent / broker a commission
6.	Life settlement firm continues to make ongoing premium payments to the primary life insurance company
7.	Life insurer pays benefit claim upon the death of the original policyholder to the settlement firm
8.	Returns are passed on to 3rd party investors

Source: Corporate reports and Bernstein estimates

Source: [Bernstein Research Call 2005](#)

In a report on the investment potential of TLPs for UK investors, Professor Merlin Stone of Bristol Business School identified two classes of policy which link to the brief history of their evolution as an asset class:

1. Viatical settlements

The sale of a life insurance policy on the 'impaired' life of the life assured deemed to have less than three years to live.

2. Whole-of-Life Policies

The sale of a life insurance policy with no set term other than the death of the life assured whenever it occurs. Whole of life policies typically have an investment element that builds over time over and above the cost of the life assurance.

In both policy classes a pre-agreed sum, the sum assured, is paid on the death of the insured life.

Typically, a person may be attracted to the idea of selling their life insurance policy to a third party when age or infirmity mean life expectancy is short and immediate cash is needed.

The buyers of such policies are unconnected investors. By paying a discounted price to the face value of the sum assured, they calculate to receive the full face value on the death of the life assured.

The purchase price is determined by underwriters based on life expectancy and related factors.

Part of the attraction with TLPs is that, unlike most investments, the return can be clearly determined at outset as the sum assured on a life insurance policy is known.

Why US policies?

The US has a quirk in its insurance law that makes it quite unique. These are its rules on non-contestability.

These rules mean a policy cannot be contested on the grounds of either non-disclosure or suicide once it has been in force for two years. Such rules mean that after this initial period it is a reliable bet a policy, if maintained, has irrevocable value.



The other attractive feature of the US life insurance market is its sheer size. In 2006, Suneet Kamath of Bernstein Research estimated there was over **\$9trn worth** of individual life insurance in the US, making it the biggest in the world. In addition, it boasts \$1trn just in lapsed policies a year. Some 20% of these - \$200bn worth - are deemed suitable for trading.

In a recent report, The Pensions Institute puts low overall market penetration at under 1% presently. Plus an ageing baby boomer generation is expected to see the population of over 65s near double in the next 25 years, so "the number of policyholders willing to sell might also increase," they conclude.

How a health crisis kick-started the TLP market...

According to the Merlin Stone Report:

"The market for TLPs started to grow rapidly back in the 1980s at the start of the AIDS epidemic. A large number of people needed to pay for their care and a substantial market developed to meet those needs."

This group consisted mainly of gay US males, whose need for urgent cash usually exceeded the need to provide for dependents.

Ultimately these deals (viatical settlements) proved bad business for investors as new drugs and treatments extended the lives of AIDS sufferers. This together with notoriously unreliable life expectancy predictions led to investor losses.

Despite this inauspicious start, the concept was shown to have merit and survived by adapting itself to focus on an older age group...so called 'seniors'. These include policyholders aged 65 and over, whose life expectancy can be more reliably assessed. This has proved a more satisfactory business for both responsible buyers and sellers of TLPs. As such, interest in the sector has grown accordingly.

And the contracts now traded have changed significantly from those back in the 1980s. Specifically, the Merlin Stone report identifies three ways life settlements on seniors differ from their viatical predecessor:

1. It is an older demographic
2. The average sum assured on the life insurance policies tends to be higher
3. The anticipated life expectancy of the life assured can be considerable longer than three years. It may be as long as 15 years.

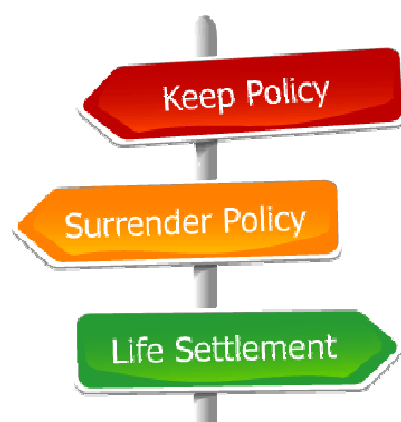
A decent way to turn a profit?

Investing in traded life policies is a bet on the mortality of strangers. A profitable return relies on buying at a deep discount and successfully predicting when people will die. Not without reason have TLPs been dubbed grimly as "death bonds".

Such a gloomy notion stirs the emotions and raises morality issues. It is a question the Pensions Institute addresses squarely - is this an ethical way to make a buck?

Acknowledging it is a matter of personal opinion, they point out it is not the first commercial activity to bet on and profit from mortality. Some examples include the established practices of pooled risk in life assurance, defined benefit pension plans, annuities and equity release schemes.

In addition, the creation of a second-hand market for life assurance policies provides a useful role. It increases liquidity for what has traditionally been a notoriously illiquid asset. Plus it adds a further and potentially better value choice for a policyholder beyond continuing premium payments or surrendering the policy for a modest cash value.



And it is not uncommon for a life insurance policy to come to the end of its useful life long before it has run its full course.

Research by the Hartford 2003 Consumer Survey, found that almost 80% of life insurance policies are bought by people to provide for dependents. This need typically diminishes for "seniors" (TLPs are traded on lives aged 65 years and up) more likely to have grown up children.

Other leading reasons for purchase, include estate and retirement planning and key-man insurance for businesses. Here too the circumstances under which these policies were originally set up are subject to change over time, which may reduce their relevance.

For insurance companies the impact on their business is less clear cut. On the plus side it benefits from lower lapse rates as premium payments continue on unwanted policies via the third party buyer. The industry as a whole may benefit too as more people are encouraged to buy life insurance receive in the knowledge they can get value for it if they don't need it later on. However, the cost to the insurer may be that they will have increased payouts in future as more policies run to an eventual claim. If this happens premiums for senior lives could rise.

Risks of the new

This is by no means a comprehensive checklist, but for a UK investor there are a number of factors to consider when weighing the idea of investment in TLPs.

Immature funds

John Dengate of TLP fund provider MPL describes the development of TLPs as an asset class as "embryonic".

This means TLP funds are young and five-year track records, a significant performance benchmark, rare. As such their ability to perform over a longer economic cycle has yet to be fully tested.

The funds are still small. This raises questions as to whether some can provide sufficient assets to successfully diversify risk for the investor. Experienced practitioner Jeremy Leach of MPL, quoted in Fund Strategy magazine, asserts from the experience of the fund that failed in 2004 - Shepherds Select fund - that "to achieve the right risk spread 100-150 policies are considered necessary". Within the group of companies mentioned in this report, few meet that minimum. However, funds can mitigate this via the development of TLP derivatives or by investing in other TLP funds.

Penalties on early withdrawal

The underlying asset is fairly illiquid and only yields its reward over time. It is, therefore, suited to the patient investor with at least a five-year time horizon in mind, preferably longer.

The fund choices available reflect this in their terms. Structured plans offer terms of 5-10 years with penalties for early withdrawal and other funds charge redemption penalties, which may stretch for seven years. Any investor taking a shorter-term view runs the substantial risk of being penalised on exit.

Offshore investing

At time of writing, the UK regulator has no categorisation for TLAs. This may materialise in due course as the market grows but presently the FSA is more concerned with regulating the sales process and correctly advising the customer than keeping tabs on TLP funds per se and providing a safety net in the event of failure.

Investor choice consists entirely of offshore funds. Though some investors feel a certain reticence investing offshore, each of these funds is regulated in the jurisdiction in which it is domiciled. These include Ireland, the Channel Islands, Luxembourg and the Cayman Islands.

Effective underwriting is crucial

For the investor, a successful outcome depends in good part on the quality of the underwriting. Miscalculation of life expectancy can mean an investor has to wait longer to collect on the policy and pay out more in premium payments. In a worst case scenario says Tim Lock, of XD Management who manages the Utopia TLP fund, "delay in payment can ruin an investment". This can happen where there are questions over the detail in the policy itself, the circumstances surrounding its set up or the fact of its sale to a third party. Fund managers can guard against this risk with longevity insurance, which compensates the owner of a TLP in the event of a delay in payment though adds a further cost to the fund and, in turn, its investors.

No universal regulation

The US regulation of TLPs is uneven. Laws are made State rather than Federal level. Life settlements are not a classified security and not all State's even regulate the market. According to Bernstein Research, in 2005 only 36 of the 50 States had enacted some form of regulation. The Pensions Institute comment:

"...the regulation of life settlements in the US is patchy and inconsistent and concerns are already emerging in the light of evidence of aggressive pricing that incorporates unrealistically low life expectations of policyholders."

In addition, the market relies on the lynchpin of the two-year contestability laws. The Merlin Stone report warns "there is a risk this may be extended to five years at some stage".

Fund gearing

In some cases, among the TLP funds available to UK investors, risk may be increased with borrowing. Some funds do not quantify the limit of gearing allowed within the fund in their offer documentation, though to date those funds that did comment on the matter denied having used the facility. This appears due to a combination of manager caution and the general deleveraging referred to at the beginning. One manager commented that they put no restriction on potential borrowing in their initial offer prospectus as they were unaware at the time as to what extent the banks would lend against them. Given the current state of the banking sector this may not be generous!

Currency risk

The US-centric nature of the underlying investments (ie American life insurance policies) means currency exposure to the US dollar. Non dollar denominated funds can counter this risk by hedging.

Market abuse

Though the market addresses a need, "the potential for market abuses remains" warns the Pensions Institute. The onus is on standards of conduct by agents handling the trades. Suspect practices where third parties have funded life policies on others (so called Stranger originated life policies or STOLI for short) have emerged and on occasion relatives have claimed no knowledge of a life policy having been sold on the death of the family member. Best practice would ensure beneficiary approval prior to the sale of a policy says the Pensions Institute.

Financial institutions are taking an interest:

The Merlin Stone report notes:

"The market is now showing signs of maturity as a major investment class because large financial institutions are showing clear appetite for market share."

Among the developments that have elevated the stature of the TLP market are:

- Cantor Fitzgerald established Cantor LifeMarkets in 2004 and offers an online trading platform – LexNet – to trade TLAs on the behalf of institutional investors. It is licensed in 34 US states.
www.cantor.com
www.lexnet.com
- The Life Exchange was established in January 2005 as an electronic trading platform for life assurance policies.
www.life-exchange.com

- The Institutional Life Markets Association was established in New York in April 2007 as the industry body for TLPs "formed to encourage the prudent and competitive development of a suite of evolving mortality and longevity related financial businesses".
www.lifemarketsassociation.org

- In December 2007, Goldman Sachs launched an index to "measure, manage and trade exposure to longevity and mortality risks". It is based on 46,290 "de-identified" lives over the age of 65 as a representative sample of the US senior insured population over the age of 65. It is the first in an expected series of indices for the sector.
www.qxx-index.com

And other institutions that have participated in the TLP market in some capacity:

UBS
Deutsche Bank
Citibank
GE Capital
The Bank of New York
Dresdner Bank
Merrill Lynch
Gen Re (formerly Berkshire Hathaway)
Zurich
Abbey National
AIG
Source: *Catalyst Investment Group*

How to Invest

Given the expertise needed to source and trade TLPs, the way into this asset class for UK investors is via a professional manager running a fund. In comparison with more mainstream investment sectors, the range of choice in this asset class is relatively modest. Of the nine providers in this report offering TLP funds, four managers are based in the UK. These include **Keydata Investment Services, Catalyst Investment Group and MPL and Meteor Asset Management.**

All the funds identified have a target return. Typically, this falls into the range of 7-10%pa growth. Not all funds have achieved their targets from inception as can be seen from See [the table.](#)

A fund offers straightforward participation in the performance of an underlying portfolio of US life policies. US credit rating agency, A M Best, provides ratings on individual policies on which the overall quality of a portfolio can be objectively assessed.

Funds from MPL and PCP include traded endowment plans (TEPs) too. These are second-hand endowment policies typically running for 25 years. These now discredited savings plans, as with TPLs, may be bought at a discount by a third party investor and continued to maturity. However, unlike with TLPs, the payout at maturity is unknown as it is based on bonuses added to the TEP each year and at maturity. These depend on the generosity or otherwise of the insurer providing the plan. Some have been distinctly stingy in recent years as poorly performing stock markets have cut returns. As a consequence US style traded life policies are preferred. As the sum assured of a US life insurance policy is fixed, an investor knows exactly what return to expect at the time an investment is made.

Open-ended OEIC funds target the more experienced investor and minimum subscription levels reflect that. Generally they are high with \$50,000 (or sterling, euro equivalent) being fairly standard.

Closed-ended (ie with restricted offer periods in which to invest) bond structured products from Catalyst Investment Management and Keydata, however, have lowered the entry bar considerably. Their offerings start with minimum subscriptions from £2,000 and £3,600 respectively, offer high levels of income and are available for investing within an ISA wrapper.

[See [spreadsheet](#)]

Up to 10%pa for income investors...

The nature of the underlying asset is such that it is not a natural provider of income. TLPs pay not interest, coupon or dividend. What's more they actually incur costs to maintain in the form of ongoing premium payments.

But that has not stopped some innovative product development that has seen high income products backed by TLPs be made available. Essentially these funds split monies raised between cash and TLPs to ensure they meet the needs of both income investors and ongoing premium payments. For example, all Keydata's fund series are split 70% TLPs and 30% cash.

	<i>Annual Income (%)</i>	<i>Term (yrs)</i>	<i>Provider</i>
<i>ARM Assured Income</i>	7.5	5	<i>Catalyst</i>
	8.25	7	
	10	10	
<i>Defined Income Plan</i>	7.75	5	<i>Keydata</i>
	8	7	
	8.25	10	

Other funds within the sector may include share classes where regular income can be elected at outset.

Typically, income is paid gross and usually attributable to capital gains tax as opposed to income tax. This is generally advantageous for most investors who can offset it against the annual capital gains tax allowance (£9,600 per person for 2008/9).

Wrap Eligibility – something different for your ISA and SIPP



TLP funds may be eligible to be held within ISA, SIPP and/or personal portfolio insurance bonds. Most funds are structured as OEICs and have a public listing on an international stock exchange such as the Channel Islands, Ireland or Luxembourg exchanges which underscore their eligibility as SIPP investments. However, even those funds without listings may be acceptable to some SIPP administrators.

Where UK investors own a TLP fund outside a wrapper, gains and/or income will be subject to tax. Where income withdrawals are an option, these may be subject to capital gains tax as opposed to income tax. For most, this means they are effectively tax-free if withdrawals do not exceed the annual CGT allowance - currently £9,600 for 2008/09.

“Interest is picking up...”

With, in Soros's words, the “financial depression” upon us, TLPs offers a valuable opportunity to diversify away from equity markets and may be a potential replacement for with-profits policies.

Though this may be a relatively young market, it is developing rapidly assisted by a favourable demographic trend in senior lives. And, though a sombre subject, it is based on mutual need where each participant stands to gain.

For the investor, they promise steady, reliable returns of between 7-10%pa with low volatility completely uncorrelated to the stock market.

For the policyholder, it offers a third choice on an unwanted life insurance policy over and above continuing premium payments and cashing it in with the respective life assurance company.

And for the life assurers, it offers lower lapse rates on policies as more continue in third party hands, so increasing premium income. Plus it gives a general boost to the life assurance market in toto as it encourages buyers, now aware they can receive better value on an unwanted policy at a later date. Against these benefits, however, life companies are likely to be paying out on more policies.

UK investors can access the TLP asset class via a choice of funds. Most funds are targeted at experienced, affluent investors but both **Catalyst Investment Group** and **Keydata** have expanded their appeal by offering relatively low entry level products with subscription levels from £2,000 which can be invested in an ISA.

The funds available to UK investors are young and their ability to hit the return targets set over the long-term has yet to be established – usually between 7-10%pa. Past performance to date has been positive though not all funds have achieved their target performances from launch. In terms of funds under management, the largest providers are **EEA Fund Management** and **Keydata**. Each hold portfolios of 200 or more TLPs in their funds. In the case, of Keydata, in each of their four limited offer period issues to date.

In addition, some of the funds available to UK investors are small and expensive to administer making them costly in comparison to more mainstream UK-based investments. Share classes can carry initial charges up to 9% and an array of annual, performance and redemption fees, Justification for the latter is based on the fact that these assets are fairly illiquid by nature and expensive to manage and administer. Consequently, the funds seek to attract committed longer-term investors (between 5-10 years) and should be seen as such.

The emerging credibility of the TLP is reflected in the attention it merits from institutional investors. Goldman Sachs for one recently launched a longevity index, which it claims will be the first in a series. The challenge is on to commercialise the unfolding phenomenon of living longer.

For UK investors, the demise of once dependable with-profit funds has left a large hole amongst lower risk category savers. The track record of TLPs shows the kind of smooth, consistent and low volatility returns once associated with with-profits and some, such as Professor Merlin Stone, see them as a potential alternative: “Investors looking for attractive returns with the same level of risk associated with with-profits should consider funds investing in TLPs.”

Of late, TLPs have been a beneficiary of the spectacular dislocation of the financial system as investors look for new ways to protect and grow capital. The **EEA Life Settlements** fund has grown from \$40m at the start of the year to \$260m by early September.

TLPs may be an “embryonic asset class” in the words of John Dengate of MPL but interest “is picking up all the time”. Increasingly, they are finding a place in the well-diversified portfolios of forward-thinking investors.

Sources:

- The Merlin Stone Report 2007
- [Financial Times](#)
- [And Death Shall Have No Dominion](#) Pensions Institute Report, July 2008
- Bernstein Research 2005, 2006
- TLP Fund Managers

