Traded Life Policies for the UK investor

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In the last few years a whole new asset class has gained prominence in the United States, prompting growing interest from retail and institutional investors around the world. That asset class is Traded Life Policies (TLPs).

TLPs are US-issued, whole-of-life assurance policies sold before the maturity date to allow the original owner to enjoy some of the benefits during their lifetime. The transaction by which an existing life insurance policy is sold to third parties is known as a life, or traded, settlement.

There are many reasons why the holders of life policies might wish to sell them before their deaths. The premiums may become unaffordable or they might need ready cash. But no-one can dispute that a second-hand market gives them the option to get a better deal rather than just surrendering them back to insurance companies.

The TLP market first took off in the 1980s during the AIDS epidemic, when a substantial number of people required ready cash to pay for care. When these policies were sold they became known as viatical settlements, or policies sold on lives assured that have been designated as having a terminal illness or to be in terminal decline, with a perceived life expectancy of less than three years. Brokers would offer policyholders prices and find buyers, or ‘funders’, who were primarily private individuals, aligned with finance companies.

Investment in viaticals during this period turned out to be a bad investment because new drugs extended the life expectancy of AIDS victims and life expectancy opinions became notoriously inaccurate.

Some years on, the TLP market has now become much more focused on policies written on the lives of seniors, or over-65s, where life expectancy opinions are much more consistent. While the TLP market is still quite young in many respects, it has grown at a phenomenal rate from a mere $50m in 1990 to a staggering $10 billion in 2006. The potential is for further growth. Unlike the UK, where the market in traded endowments have a limited life span because people do not buy with profits policies so much any more, people continue to buy life insurance policies in the US. The total value of life policies held by the over-65 age group in the US is currently estimated to be $500 billion.

The market is now starting to display signs of its maturity as a major investment class because large financial institutions are showing clear appetite for market share. The introduction of adequate regulatory codes covering the TLP market in an ever-growing number of US states is also likely to contribute to that growth potential by providing an environment in which the market can flourish even further.

The main reason TLPs have come to the attention of investors is that it is possible to use them to deliver steady, predictable returns. This appeals to both retail investors in the UK looking for a replacement to the steady returns once promised by with-profits as well as pension funds looking to match their future liabilities with predictable investments.

The key point about TLPs is that the value of a policy is known: what is not known is when that policy will actually pay out. But by calculating backwards from that known value, with careful actuarial analysis and sufficient diversification it is possible to deliver secure, incremental returns to a high degree of accuracy.

What is more, it is possible to secure a high level of gearing with such investments because financial institutions are happy to lend on assets that have a definite value. This facilitates enhancement of returns, which is very attractive to those UK investors looking to switch out of their poorly-performing with profits funds and go some way to making up for the substantial surrender penalties they will pay for doing so.

TLPs are not without risk, of course. While it is possible to know from day one what a policy will be worth upon maturity, it is not possible to know exactly when the life assured will die and how many premiums will need to be paid before that date. This risk is more pronounced the smaller the number of policies invested in. Therefore it is essential to buy a large number of policies across a wide range of insurance companies, reducing the risk that any companies going bust will have a devastating impact on a fund.

Keeping track of the policyholders and their state of health might also be seen as a risk. In practice, this is easily achieved by writing into the purchase contract for a TLP that anyone who is caring for the policyholder must provide information on them. It is also possible to check public death records easily on the Internet in the US, where it becomes publicly available within two weeks of a death.

The TLP market raises some emotive issues. Firstly, these policies are linked to the deaths of individuals. Secondly, individuals are selling assets at a deep discount that they could otherwise pass on to inheritors. However, it is worth bearing in mind that the TLP market allows policyholders to benefit from policies they have paid for themselves, rather than having to pass those benefits on to anybody else. The creation of a ‘secondary’, or second-hand market means policyholders can get a higher price for their policies than if they just surrendered their policies back to the insurance companies.

There are many reasons why someone may wish to sell a policy. People’s insurance needs change throughout their lives, for example, a young couple might take out insurance to protect each other or their children against their premature deaths, but they might divorce or outlive their children. Premiums can also become a burden or unnecessary expense and they might need ready cash to pay for care. Companies insure their staff but those staff might leave the company, the company may become unable to pay the premiums or a new owner takes over and changes the staff benefits. There is already a range of funds available to retail investors in the UK. As well as MPL’s own range of Oeics, Traded Policies Limited and Corinthian Growth, there exists the Fortress, Integrity, Utopia, Aurora Select High Security and Defined Returns funds. Minimum investments tend to start around £25,000, but this falls to £5,000 if an investment is made via a wrap such as a SIPP, a portfolio bond issued by some insurance companies, a trust or a fund platform.

While the declining interest in with profits in the UK points to a finite life for the traded endowment policy market, the fact that whole-of-life policies continue to be sold in the US, combined with an aging population, point to a continued and thriving TLP market. This strengthens the case for TLPs to be regarded as an asset class in their own right. Their benefits deserve more recognition and as investors' appetite for alternative asset classes develops and more attention is focused on those assets that can offer more predictable returns.

It should also be remembered that many retail investors never lost their appetite for the steady growth that with profits promised, it was just that with profits failed to deliver. These investors should be encouraged by the continued development of the TLP market and the unique risk-reward combination it offers.