Traded Life Policies as a new asset class

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The UK pensions market has a rather pleasant surprise in store. Too few people in the industry realise it yet, but a whole new asset class is gaining prominence in the United States that offers investors steady, predictable returns. This new asset class, which is prompting growing interest from retail and institutional investors around the world, 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.

The TLP market began in the 1980s, when the AIDS epidemic meant a substantial number of people needed ready cash to pay for care. Many of them sold their policies, which became known as viatical settlements. The term ‘viatical’ signified these were policies sold on lives assured designated as having a terminal illness and a perceived life expectancy of less than three years.

These days the TLP market is focused on policies written on the lives of the over-65s, where life expectancies can be predicted with much higher degrees of accuracy. While the TLP market is still quite young in many respects, it has grown from a mere $50m in 1990 to a staggering $20 billion in 2006*. The potential is for further growth: Americans continue to buy whole-of-life insurance in ever greater quantities and the number of over-65s rises by the year.

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 several 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. These appeal 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 a diversified portfolio of policies, 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 must 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, cutting the risk that any companies going bust will have a devastating impact on a fund.

TLPs raise emotive issues because of the link to people's deaths. But investors should realise there are many reasons why holders of life policies wish to sell them. Insurance needs change throughout people's 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 an unnecessary expense, while as part of benefits packages companies might insure staff who subsequently leave. What cannot be disputed is that a second-hand market gives people the chance of getting a much better deal than they might otherwise get by surrendering their policies back to insurance companies.

There is already a range of funds available 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, available to both retail and institutional investors.

The case is certainly growing for TLPs to be regarded as a new asset class. The unique risk-reward combination they offer deserves recognition, especially among investors looking for an alternative to equities and bonds in the current market conditions but provides a better return than cash.

*Source: Credit Suisse estimate