Traded Life Policies as an Alternative to Bonds and Equities

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The Federal Reserve's recent half-point cut in its discount rate prompted by market volatility was hardly a surprise, even though markets had been factoring in expectations of rate rises in the US for most of this year. But this cut, or even one by a full percentage point, won't be enough to resolve the problems in the US sub-prime mortgage market. Equity market turbulence is set to continue for some time and the short term rally seen in bonds will be precisely that – short-term. It is only the forces of supply and demand that has been pushing bond prices up, not the intrinsic value of the assets.

Equities, bonds and property are all under pressure to perform but continued turbulence in these markets is set to continue. The bull run in equities will probably continue for a while because China now permits domestic assets to be invested overseas to ease the pressure on its own overpriced market, but it is widely expected that a correction will occur. Now is a good time for investors to run for cover to an asset class that is not impacted by the global market turbulence. But is there a choice other than cash?

Managers of institutional and pension portfolios with concerns over recent stockmarket volatility and weakening bonds need to consider the burgeoning asset class, traded life policies, which offer steady, incremental and predictable returns. In the last few years TLPs have gained prominence in the United States, prompting growing interest from retail and institutional investors around the world, although there is still a deep education gap in Europe. But any discussion of the merits of this burgeoning asset class must first look at what TLPs are, how they work and how the market for them has grown over the years.

TLPs are United States-issued life assurance policies sold before the maturity date to allow the original owner to enjoy some of the benefits during their lifetime. Funds that invest in TLPs are low risk because the investor has a good understanding of how much profit will be made from each policy in the fund. With careful actuarial analysis and diversification of policies, it is possible to predict returns with a high degree of accuracy.

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 had 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 there 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 generally 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.

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.

So why should such an asset be of particular interest now to UK and European investors? The reason is rising interest rates this side of the Atlantic mean portfolio managers are most likely reviewing their risk/return analyses, raising the hurdle of expectations and looking for assets that will sustain relative yield. They will be scrutinising more harshly their current holdings in equities, bonds and property, which are probably looking less convincing in the face of the returns now available on cash.

One might regard it an investment sin to ignore an asset that is yielding 8-10% in the current environment. Yet that is exactly what TLPs are yielding at present, giving returns several percentage points above cash with a very low level of risk. As an example of this performance, the US dollar institutional share class in Traded Policies Limited, an open-ended investment company managed by MPL, recently chalked up its first three-year track record. It returned 28.35% in the three years to 1 July, 2007, significantly outperforming its benchmark, the 10-Year US Government Bond Index, which returned 8.54% over the period, and the Fed Funds Effective Rate, which returned 12.77%.* The $60m fund’s return represents an annualised return of 8.78%, net of all charges. What is more, the fund did not suffer a single negative return in any quarter during that period.

What is also interesting about the current financial environment is that the divergence between UK/Euro and US interest rates have created a golden opportunity for managers of sterling or Euro-denominated funds to enhance returns with hedging plays.

For example, UK rates are set to rise, with the base rate most likely to be 6% by the end of the year, while the US Fed rate now looks set to fall further than its current 5.25%. Sterling funds can hedge by first placing the sterling on deposit and borrowing in the foreign currency to purchase the investments. A forward cash swap is then purchased for a later date. If US and UK interest rates are at parity, then no gain is made on the interest rate differential. But if UK rates rise and US rates fall, then the differential enhances returns for a neutrally-hedged fund. This means each time UK interest rates rise then hedged sterling funds will see a gain of the same amount.

While waning interest in with profits points to a finite life for the traded endowments market in the UK, in the US whole-of-life policies continue to be sold in ever greater quantities. Together with an aging population and increasing appetite among US citizens to sell their policies, the TLP market is set to continue its expansion. This strengthens the case for TLPs to be regarded as an asset class in their own right. Indeed, the TLP market has been gaining popularity among institutions this year, thanks to their low risk and potential for steady, high growth.

Such investors should be encouraged by the continued development of the TLP market and the unique risk-reward combination it offers. The issue is not that TLPs are superior to bonds or equities, any more than the claim is valid that bonds are better than equities, or vice versa. It is merely that in a volatile market situation with a great deal of uncertainty, there is a compelling argument to reduce the weightings in these particular asset classes in favour of non-correlated ones because of the downward pressures that can be expected to be imposed upon them by economic changes. The risk profile of a TLP fund is not dissimilar to that of a bond fund but an increase in UK interest rates is expected to reduce returns on bond funds and will increase returns on TLP funds, so it makes sense to include the asset class in a balanced portfolio.

*Source: Thomson, including reinvestment of dividends.