The reliability of investing in TLPs (For FundAIM)

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Transplants, open-heart surgery, wonder drugs, etc: the list of medical achievements that improve life expectancy is a long one. The general assumption, quite rightly, is that such advances are prolonging life expectancies year after year. So given we never know what new life-preserving technological or biological development is just around the corner, does this mean any investment that depends on the reliability of mortality tables will be fraught with uncertainty?

This might seem a fair observation, for example, in relation to funds that invest in traded life policies (TLPs). TLPs are United States-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.

TLP funds buy a number of policies on the second hand market and continue to pay the premiums on the policies until the life assured dies. When the fund managers buy policies they have to price them based on expectations of how long the life assured will live using mortality tables and medical information, factoring in a steady return. Provided a portfolio of policies is sufficiently diversified and the tables are reliable, managers of TLP funds should be able to predict returns in the region of 8-10% with a high degree of accuracy.

But could the sellers of policies confound the managers of TLP funds by living substantially longer than expected because of medical advances? This is what happened when the TLP market began to grow substantially in the 1980s as a result of the AIDS epidemic. HIV sufferers sold their policies to raise cash for medical treatment then new drugs extended their lives beyond original expectations.

These days, the lives assured on the policies are almost invariably 65 or over, which tends to make the exercise a much less risky one. But mortality risk is still there, so how do managers of TLP funds deal with it? It is certainly the case that the longer the life expectancies, or LEs, on a portfolio of policies, the more risky they are to manage. If for example, a sample of 1,000 lives had an average LE of 10 years, then 50% of them could be expected to die before the 10 years and 50% thereafter. It would be very hard to predict what technological and medical advances would happen to prolong life over the next decade. But there would be every reason to expect they will occur and that people will live longer as a result. Fund managers can reduce this risk substantially by buying policies with LEs of around five years, an optimal period for the risk-return trade-off.

While LEs generally do tend to rise with remarkable consistency, it is still essential to take account of updated mortality tables on a regular basis. It is also essential to closely monitor the LEs of the lives assured in a portfolio of policies, for the longer someone survives, the longer their LE becomes and the valuation of a portfolio has to be adjusted. MPL regards it as prudent to conduct this exercise on a monthly basis, with the help of a professional actuary.

For many investors, both retail and institutional, direct investment in TLPs is too complicated to manage themselves. But by investing in mutual funds, they can have their investments managed by professional managers who, with prudent actuarial analysis and diversification, can deliver steady, incremental returns, every year, of around 10% per annum. What is more, these returns are uncorrelated to the financial markets - an extremely attractive proposition.