The Benefits of Traded Life Policies

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As every IFA who ever sold a with profits policy knows, the concept of steady, incremental returns was always a winner with clients. The trouble is that in recent years, with profits has failed to deliver. The three-year bear market that followed the TMT crash and the market turbulence seen over the last year, including the problems in the property market, has spurred investors to look for alternatives. And one alternative that is attracting ever more attention is traded life policies.

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 reason why financial advisers should be taking a closer look at TLPs is that they offer steady, incremental returns that are uncorrelated with any other financial market – an attribute that makes them particularly attractive amid the market turmoil we have seen over the last year.

With traded endowment policies, investors know the maturity date and therefore when to expect a payout. What is not known is how much they will pay out. With TLPs the value of a policy is known; what is not known - because they are whole of life - is when they will pay out, and the premiums have to be paid until they do. Managers of funds that invest in them must use actuarial analysis to buy them at the right discounts and carry out sufficient diversification to control the risk. But with the right investment process, it is possible to deliver secure, incremental returns to a high degree of accuracy in the order of 8-10% per annum, year-in, year-out.

Such returns are remarkably similar to those once promised by with profits. Indeed, a roundtable debate staged by MPL recently looked at TLPs as a new asset class and one of the discussion points was TLPs as a replacement for with profits. Gary McLelland, Managing Director of Jersey-based Corinthian Financial Services, told the roundtable Corinthian had promoted with profits bonds in the past but the returns had become increasingly disappointing to a point in 2003 when they felt compelled to look for alternative strategies. Professor Merlin Stone of the Bristol Business School and author of the Merlin Stone Report on TLPs published last October said many investors were now running to cash because they did not want to invest but many of them were unaware of the benefits of TLPs. He said: “TLPs give a better return than cash and do not give any nasty surprises. One can never say the risk is zero but investors are very likely to get their expected return."

Two UK IFAs at the event both agreed that the majority of their clients in pension funds were not looking to shoot the lights out with their investments: they wanted steady returns of cash-plus 2% combined with capital preservation. Nigel Newlyn, Director of Argent Personal Finance Managers said that he was constantly looking for alternative asset classes such as TLPs that could provide an "anchor" to a portfolio. David Chinn, Partner at the Financial Services Division of Oury Clark, said: "Provided we can look to secure an 8% growth rate and not lose capital then clients are very happy with that. That is why TLPs feature as an asset class to us."

TLPs are not without risk, of course. 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. The life expectancies on the underlying policies must also be managed prudently. At MPL, we find that an average expectancy of 5-6 years optimises the risk-return.

Some investors may be unhappy with the fact TLPs are linked to people's deaths and that people are selling their life assurance policies at deep discounts. But people sell policies for many different reasons, and not necessarily out of desperation. Furthermore, 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.

The gradual demise of with profits in the UK means the traded endowment policy market has a finite life. But whole-of-life policies continue to be sold in the US in ever greater quantities. Research in the Merlin Stone Report estimated that the TLP market in the US would potentially be worth $161bn by 2030, from estimates of $13bn in 2005.* The benefits of TLPs certainly deserve more attention among IFAs with clients who still like the idea of steady, incremental returns.

Source: US Census Bureau and Bernstein estimates/Bernstein Research Call, March 2005