A Guide to Investing in Traded Life Policies

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This feature will look at investing a lump sum in traded life policies as an alternative to investing a lump sum in equities or bonds. What returns can investors expect in the way of returns and security? How does lump sum investing work, what sort of clients should Financial Planners be directing such funds at?

Bullet Points:

- Assets offering steady, predictable returns are best for lump sum investment because of the risk involved in investing a substantial amount at one particular time. The losses seen on financial markets over the last two years illustrate how easy it is for investors to have lost a large amount in a short period if they mis-timed investments.
- Funds that invest in Traded Life Policies (TLPs) can deliver steady, predictable returns of the order of 8-10% if they are managed using the right actuarial analysis and diversification. This makes them an ideal replacement for with profits, which have failed to deliver on promised returns.
- Many financial planners are allocating 10% to 20% of their clients' portfolios into TLPs because of their stabilising effect. TLPs are particularly useful in low risk portfolios, such as post-retirement pension pots.

The dangers of lump-sum investment have been dramatically illustrated by the tumultuous markets seen over the last two years. Lump-sum investors could quite easily have lost half of their investment in a short period by getting the timing wrong. But if equities and even bonds present a risky proposition to the lump-sum investor, is there another asset class that offers them a safer option?

The technique of pound-cost averaging, whereby investments are drip-fed into the market, usually each month over many years, is an ideal way to benefit from the long-term returns offered by equities. This spreads the risk over time and means investors might also 'buy on the dips' at many points in time. However, the ideal investment for a lump sum is one which offers steady, incremental returns because of the higher risk of losses involved with timing.

For many years, with-profits offered such returns but their eventual failure to deliver on promises has been well-documented in recent years. One asset class that has proved it can deliver, however, even when equities, bonds and even cash funds have made losses, 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. Under the transaction, the buyer of the policy becomes the new beneficiary.

The fundamental advantage of TLPs for investors is that the face value of a policy is known; what is unknown is when the life assured will pass on and that value will be paid out. The premiums will have to be paid until that date.

Some large institutions, such as banks, buy TLPs directly and build up their own substantial portfolios. But there is another way to invest in them that is available to ordinary investors: there is a growing number of collective investment schemes, or funds, that invest in TLPs and which are managed by professional fund managers.

These fund managers must use actuarial analysis to buy TLPs at the right discounts, calculating backwards from the known face value, and carry out sufficient diversification to control the risk. A manager should not buy policies issued by just one company in case it goes bust. Thankfully, this has not been a problem, even in the current financial climate.

It is also important to have a high number of policies because while it is known from day one what a policy will be worth upon maturity, it is not possible to know exactly when the life assured will pass on and how many premiums will have to be paid before that date. The higher the number of policies that are held, the greater the chance that the actual maturities converge towards the standard life expectancies used to manage the fund.

Clearly managing TLP funds is a complicated task. But with the right investment process and actuarial analysis 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. These returns are largely unaffected by what is happening on financial markets because people always want to sell their policies at all stages of the economic cycle, if not more so in downturns when they might need to raise cash.

Last year was particularly good for TLP funds. The sterling share class in MPL's own Traded Policy Fund, which is available to retail investors, delivered 10.56% net of all charges over the year to 1 January 2009. The credit crunch was in fact beneficial for TLP investors, who were able to buy them at discounted prices towards the end of last year from cash-strapped institutions with substantial portfolios that were selling TLPs at a discount to raise money.

TLP funds are becoming popular. A report by Professor Merlin Stone of the Bristol Business School, published in December, estimated that investment in TLP funds by both retail and institutional investors rose by more than 50% over the year to 1 November 2008.
One of the reasons that Professor Stone believes that TLP funds are likely to grow in popularity among retail investors is that they can be a good replacement for with profits-based investments because they offer steady, incremental returns with relatively low risk.

The sensitive nature of TLPs in being linked to the lives of individuals does raise emotive issues. But investors should have a clear conscience about investing in them. 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.

Another contentious issue is the fact individuals are selling assets at deep discounts 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. Also, a second-hand market exists only because it offers policyholders much better prices than they would get from the insurance companies, which offer zero or near-zero surrender values.

So what sort of clients should financial planners be directing funds offering steady, predictable returns in the region of 8-10% year in, year out, even in the testing conditions seen over the last two years? The key point about TLPs is that they can add stability to portfolios. It is this attribute that has meant many advisers have put between 10% and 20% of their clients' portfolios into them to provide stability. This is particularly true of post-retirement pension pots. After all, few people want to take risks with their pensions. While the minimum investment in TLPs funds is still quite high, making it the preserve of higher net worth clients, they can be accessed at much lower minimum investments via insurance bonds and SIPPs. Over time, we can expect TLPs to become accessible to a much wider range of investors, who will be grateful for the steady returns offered by this burgeoning asset class.