A Guide to Investing in Traded Life Policies

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Investors can be forgiven for feeling a little shell-shocked after the rocky ride they have had over the last two years or so. The more money they had then the more they are likely to have lost as financial markets went south. Lawyers, tending to be among the richer echelons of society, will have been among the biggest losers unless they had a financial adviser that told them to sell their equity, bond and property investments about two or three years ago.

Many investors and their advisers are understandably looking at whether there are alternatives to these traditional asset classes. Some might look at hedge funds or other ‘absolute return’ products. But even these have been disappointing. And what about the ‘with profits’ policies that promised steady, incremental returns for several decades? The failure of these products to deliver on such promises has been well documented.

The good news for investors though is that there has been one asset class that has managed to deliver steady, predictable returns even amid the financial catastrophes of the last two years. This relatively new asset class is known as 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. The old adage “don’t put all your eggs in one basket” applies here because 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 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. Companies insure their staff but those staff might leave the company, the company might become unable to pay the premiums or a new owner takes over and changes the staff benefits. For all these reasons and many more, thousands of policyholders in the US decide unsolicited that they want to sell their policies each year.

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. As part of the life settlement, inheritors have to approve the transaction before it can take place. It should also be borne in mind that 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.

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. Some years on, the 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 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 currently estimated to be $500 billion.

There is still much room for expansion in the TLP market, too. One reason for this is that life policies traded constitute a small proportion of the policies surrendered each year. This suggests a lack of awareness by policyholders of the secondary market. There was an average annual growth of 42.9% in the value of life settlement transactions over the five years from 2000 to 2004, yet their value as a percentage of sales of life policies was just 0.2% over the same period.*

The factors are all in place for a much larger secondary market. As life expectancy in the US rises over time, the chances are higher that people will outlive the usefulness of their life policies, especially with regards to income protection for dependents, who are more likely to become independent as the subject of the life policy changes. Awareness of the life settlement industry will increase as people realise they can get more for their policies than if they were to surrender them back to the insurance companies. Suneet Kamath, writing in the 'Bernstein Research Call' in March 2005 estimated the TLP market could grow to $161bn by 2030.

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 and make regulations to protect investors even tighter.

All of this is encouraging for those investors looking for steady, predictable returns in the region of 8-10% year in, year out. TLPs offer the kind of risk-return combination that with profits once promised but eventually failed to deliver. If investors ever wanted proof of TLPs' ability to deliver they could not have asked for more testing conditions than those seen over the last two years. If TLPs can produce double-digit returns in what has been the most difficult conditions seen on western markets in living memory then it is hard to imagine an environment in which they would fail to do so. TLPs have certainly earned the right to be regarded as a significant asset class in their own right and investors would add some stability to their portfolios by including TLP funds.

*Source: ACLI/Bernstein Research, march 2005