Article for WealthBriefing: What makes a good TLP fund?

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Traded life policies (TLPs) attracted increasing attention during the financial crisis because they stood out as an asset class that could deliver positive returns even as equities and bonds were going south.

However, TLPs have attracted controversy, not least because as a relatively new form of investment they are still deeply misunderstood. So what should investors and wealth advisers know in order to differentiate the ‘good’ from the ‘bad’ funds that invest in TLPs?

TLPs are US-issued whole of life policies sold before their maturity so that the original owners can enjoy some of the benefits in their own lifetimes. Funds that invest in TLPs are effectively buying assets at a deep discount from what is a fixed maturity value. There is a risk in that the fund managers do not know how long before the policies mature, and therefore how many more premiums will have to be paid on the policies.

Given these risks it is essential that TLP funds carry out correct actuarial analysis and portfolios are sufficiently diversified. The types of policies being bought are also an issue: it is better to buy the policies held by more senior individuals with life expectancies averaging three years or less rather than policies from younger individuals for whom it is much more difficult to manage longevity risk.

Fund managers and other investors must bid to buy policies on the open market so TLPs are keenly priced. Hence investors should look very closely at the charges in a fund because the only way to gain alpha performance is by lower charges.

Initial charges on some TLP funds, for example, are as high as 10% and investors need to pay particular scrutiny to such products. But they should be particulary wary of products that impose performance fees.

Managers of TLP funds may either value their units using a mark to market or a mark to model basis. The former values the funds based on what the underlying policies would fetch at any given time on the open market whereas the latter does so by giving each policy a present value based on the assumption that they will be held to maturity.

If the latter is applied then some degree of subjectivity is involved based on the actuarial model used. A performance fee creates a moral hazard in that a fund manager can “skew” the fund valuations to create short term performance that is not really justified. For this reason, investors should shun funds that apply performance fees.

Investors and wealth advisers should look at the track records of funds to ascertain the performance/charges trade-off and to check that what might look like outperformance is not really down to the manager over-estimating the valuations of a fund.

Analysis of the track record should also expose how good a fund manager is at managing currency risk. TLPs are dollar assets and if managers are to offer share classes in their fund in currencies other than dollars then they have to be able to hedge effectively. This is especially relevant now with FX rates likely to remain volatile for some years to come.

Finally, investors should pay particular attention to the regulatory aspect of a TLP fund. Research presented at a recent roundtable debate sponsored by Managing Partners Limited revealed that five of the six product providers selling TLP funds into the UK were not using UK-regulated subsidiaries to do so.

The advantage of having a locally regulated fund promoter to sell a fund is that there is more accountability with regards to the marketing material. Russell Golledge, an adviser with Essex-based Crystal Financial Management, told the debate that he took comfort from working with a provider regulated by the FSA because they would be adhering to the same rules.

Wealth advisers need to understand a great deal about a lot of products. Clarity and transparency in the marketing material can only help them and their clients to understand better this exciting asset class and the benefits it can bring. But those benefits can only be delivered when TLPs are handled in the right way.