The rise of traded life policies – but IFAs and investors must appreciate the risks

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Equity and bond markets are once again beset by fears of another financial crisis. Equities are volatile and have fallen significantly since the beginning of the year while several observers think another crash is due. Investors are looking hard for investments that are uncorrelated to the main asset classes. One such asset class is traded life policies (TLPs), which are also known as life settlements.

TLPS are US-issued whole of life policies sold before their maturity date so that the original owners can enjoy some of the benefits in their own lifetimes. Life expectancies do not depend on whether share or bond prices go up or down and as such, TLPs constitute an uncorrelated asset class.

However, while this might suddenly look like a free lunch, the reality is that there are several risks that must be understood by advisers and investors before they invest in what is a sophisticated investment.

Before looking at the risks, how does the theoretical lack of correlation with equity and bond markets work out in practice? There is a lack of market wide data relating to the funds that are distributed in the UK. However, analysis of the performance of the Traded Policies Fund, which was launched in July 2004, shows that it was negatively correlated to both equities and bonds over the one and three years to 1 May 2011, a period that has seem some of the worst turbulence ever seen on financial markets.

Using the Traded Policies Fund's UK Growth share class as proxy for TLPs and the S&P 500 as a proxy for equities, the share class had a correlation of 67% over the three years to 1 May 2011. The correlation over one year to 1 May 2011, when equities performed strongly, was significantly higher at 89%. The Growth share class had a correlation of 76% with the JP Morgan Global Aggregate Bond Index over the three years to 1 May 2011 but over the one year to that date – when bonds saw significant losses – the correlation was negative at -45%.

This illustrates the upside to TLPs. The downside is that there is a whole range of risks.

Investors should take a close look at the charges in a fund, and be particularly wary of performance fees. Second hand policies in the US are sold at auction and the market is highly competitive as a result. This means the only real way to gain alpha is through lower charges. This creates a significant moral hazard in funds in which the Net Asset Values are determined by the managers themselves using their own valuation models.

Those fund managers who significantly outperform their peers may be taking unwarranted risks. The actuarial models used to value policies held within a fund vary among fund managers. If a fund manager values policies too aggressively in the early years of holding them and factors these high values into a fund's returns, this can lead to volatility and underperformance in later years if the policies fail to deliver the expected performance. It is much more accurate and fairer to all investors over time if managers factor in smoother returns from policies when valuing their funds' unit prices.

While a buyer of a TLP knows from day one what a policy will be worth at maturity, it is impossible to know when it will mature and how many premiums must be paid upon it. This means that it is crucial to buy a diverse range of policies and to carry out prudent, actuarial analysis to assess life expectancies. Veering too far from buying policies with average LEs of between five to seven years does raise the risk level in a fund. It also helps if the policies purchased are more reflective of the average American on which LE tables are based rather than the more affluent end of society, which enjoys longer LEs. Allowance must also be made for the fact that LEs improve over time. This might seem obvious but it is not unheard of for fund managers to only adjust their estimates every seven years when the LE tables are actually published.

TLPs are US dollar-denominated assets. However, any fund with non-US dollar share classes can be hedged to reduce currency risk. Currency hedging is a complex exercise and carries risks that individual may find hard to understand or quantify. When considering a non-US dollar TLP fund one should therefore assess a fund manager's experience in currency hedging. If a fund manager has at least a five year track record – especially over the last five years that have seen a lot of volatility on currency markets – then that should be comforting. But fund managers should also be able to articulate the process by which currencies are hedged.

The TLP market is similar to most other financial markets in that assets are freely traded. However, the time needed to settle a trade is longer than in many markets, due to the specialised nature of the asset class. For this reason, liquidity risk may arise if the sale of one or more policies takes longer to complete. It is important for investors to understand that while investment returns are quite smooth and predictable, TLP funds are not as liquid as some other asset classes and investors must have medium term horizons. Sufficient cash reserves must be maintained in order to meet a fund's cashflow requirements, which includes those created by currency hedging techniques and to pay premiums on policies until they mature.

One risk that has seen extensive coverage since the Lehmans collapse is counterparty risk. The insurance company that issues a policy may default on its obligation to pay out at maturity. This risk can be reduced by holding policies from a diverse range of companies. Each US state also operates a compensation scheme that indemnifies policyholders against insolvency of the issuer. In the US, contestability law prohibits an insurer from repudiating a claim on any grounds once a policy has been in force for at least two years. This risk can be avoided by not buying 'contestable' policies.

So TLPs can be a very risky asset class in the wrong hands. However, if handled correctly then can have a stabilising effect on portfolios because of the steady, incremental returns they can generate. It is up to advisers to select for their clients those funds that have proven their ability to address all the risks outlined above.

Please see graphics below:

Fig 1: Correlation of the Traded Policies Fund (USD Institutional Share Class) versus equities and bonds

Time period (years) to 1 May 2011	S&P 500	JPMorgan Global Aggregate Bond Index
One	0.89	-0.45
Three	0.68	0.76
Five	-0.35	0.93

Fig 2: Correlation of the Traded Policies Fund (GBP Growth Share Class) versus equities and bonds

Time period (years) to 1 May 2011	FTSE 100	JPMorgan Global Aggregate Bond Index
One	0.89	-0.45
Three	0.67	0.76

Fig 3: Performance of USD Institutional share class versus S&P 500 and JPM Global Aggregate Bond Index