KEY POINTS

- After disappointing results since 2008, the life-settlement market may be recovering and could become a buyer's market, in particular for institutional investors.
- Life-settlement funds are complex vehicles suitable only for investors who can adequately evaluate the risks.

Settle for More?

The life-settlement market may provide opportunities for institutional investors

BY RHEA WESSEL

Worth roughly US$12 billion dollars at its peak in 2007, the life-settlement market is rebounding as more financing becomes available, particularly from Asian pension funds and European hedge funds. The industry has regrouped after disappointments starting in 2008 that were linked to frozen credit markets, the economic decline, and revised life-expectancy tables that caused a sudden downward revision to the value of life-settlement contracts. (For more background, see "A Brief History of the Life-Settlement Market" on page 30.)

The prospects in this subset of the longevity market could be promising for institutional investors because experts say the market is likely to remain a buyer's market for some time. An increasing number of individuals in the U.S. who own policies with a high face value are interested in selling their policies in order to finance their retirements or pay for medical care, and the amount of capital chasing those deals is still less than at peak times as a result of some investors taking a more conservative approach. "We're able to generate better yield and be more effective in our life-settlement portfolio construction at the moment," says Sam Rosenfeld, the chief operating officer of the Atlanta-based, longevity-focused investment firm Carolus Capital Advisors.

A life settlement takes place when an individual sells his policy onto the secondary market via life-settlement "providers," such as the Coventry Group or Magna Life Settlements. The policy owners receive more than the surrender value of the policy but less than the face value to be paid out upon death. The investor becomes the owner and beneficiary of the policy and continues to pay policy premiums, keeping the policies in force and assuming the longevity risk. If the insured lives longer than expected, the investor's return will decline. If the opposite is true, the returns will go up.

Given the potential investing and ethical pitfalls of this alternative investment, to which some people object on the moral grounds that strangers have no insurable interest in others' lives, investors likely will want to ensure thorough due diligence and consider following best practices championed by industry associations—such as the European Life Settlement Association (ELSA), which is developing standards across the market, particularly in Europe.

Patrick McAdams, CFA, current treasurer of ELSA and a former chairman, says he is optimistic about the market and its outlook, despite the earlier lack of standards and the poor construction of certain pools of investments that caused some investors to have bad experiences. "We strongly believe in the asset class and its ability to generate low-correlation and low-volatility returns for investors, as long as life settlements are structured properly and the investor is aware of the risks," he says.

In the recent past, negative outcomes have generated headlines. For example, in 2004 and 2005, Deutsche Bank collected more than €550 million from investors in two tranches and then discovered that its life-expectancy estimates were too low and the cost of its policies too high. In 2009, the bank offered to buy back investments from its clients at 80 percent of their value and scaled back its operations.

Still, Rosenfeld shares McAdams' positive outlook. "Structured correctly and funded correctly, this is an uncorrelated asset," he says. "But you have to surround it with the correct risk management methodology, and you cannot treat life settlements as liquid investments. You've got to buy and hold them to realize value."

Some institutional investors work directly with "providers" of life settlements to access pools of policies. Others choose to go through an intermediary, such as a fund or an investment firm that structures pools of life settlements.

Both open-end and closed-end funds are available, and boutique shops will help clients develop their own pool of policies so that institutions can white label the products and resell them to other investors or keep them on their books as a proprietary position. Buyers may be hedge funds, offshore funds, banks, or occasionally pension funds, and transactions are typically private placements of unregistered securities. Sophisticated individual investors who want to get in on the market typically go through agents or brokers representing the providers of life settlements.

According to McAdams, who works as the investment director at SL Investment Management (a U.K.-based firm that pools settlements on behalf of institutional investors), having an intermediary between the institutional investor and life-settlement providers, such as an investment manager or fund, can provide a needed buffer, because providers of life settlements receive a spread or fees on each sale and therefore have an incentive to sell high volumes of policies to investors. Investors, on the other hand, want to obtain only those policies that fit their investment goals (i.e., those policies that will pay out or "mature" as expected at the time of acquisition).

"You would never want to see cross-ownership or similar conflicts between the investment manager and the policy provider," says McAdams. "Those two should be at arm's length. Effectively, it's a completely independent counterparty relationship."

Typically, the pool for which SL Investment Management facilitates investments contains policies on the lives of 300–500 U.S. citizens and is worth US$200 million or more. But it has put together pools as small as US$50 million and as large as US$700 million. The investment of US$700 million was the acquisition value of a pool of commingled policies structured for a group of investors McAdams declined to identify.

"We would generally tell any institutional investors who are considering building their own pool and not entering into a commingled or fund vehicle that they would need to put to work at least US$150 million to cover the acquisition value of enough policies to achieve reasonable diversification and to cover a prudent level of reserves for ongoing premium expenses," says McAdams. "If the institutional investor puts money into a pool with others, investments can start as low as US$250,000."

Rosenfeld, the author of a seminal report on longevity-based financial instruments,[1] also points to proper diversification as a critical best practice for institutional investors. "The key to investing in longevity-based financial instruments like life settlements is to ensure that you have effective diversification and proper risk management, which is normally gained through portfolio construction," he says.

Another point to consider is the average face value of policies in the pool. "Diversification really depends on the number of policies rather than the amount of money invested," says Jörg Finsinger, a professor of finance at the University of Vienna and the head of the Life Settlement Institute. "If policies in the pool are small, a US$10 million investment could be diversified. If policies are big, US$50 million–US$80 million dollars would be a better choice."

Intermediaries, funds, and institutions that are working directly with life-settlement providers and want to conduct their own due diligence, or brokers representing the sellers of policies often outsource to multiple third parties the review of the medical records of the insured people in the pool. Specialty firms in the business include Fasano Associates, AVS Underwriting and 21st Services. Such firms typically review the underwriting of the life-settlement provider for each insured life and come up with a life expectancy.

1 "Life Settlements: Signposts to a Principal Asset Class," Wharton Financial Institutions Centre working paper.

Finsinger warns investors to choose their life-expectancy providers with utmost care and to consider the firms' incentives or motives because the independence and accuracy of estimates play such a huge part in the overall value of an investment in a life settlement.

SL Investment Management, for example, undertakes an annual rating-agency style assessment of its approved underwriting service providers and then weights the use of life expectancies in its pricing and valuation models based on the level of confidence it has in the providers' underwriting methodologies, systems, and controls.

Jeremy Leach, the managing director of Managing Partners Limited (MPL), a Cayman Islands company that specializes in setting up and managing traded life policies, agrees that how policies are valued is a key question for most investors.

"Life-settlement funds are inherently complex vehicles to manage and only suitable for sophisticated investors who have the ability to assess the risk," says Leach. "A portfolio manager must demonstrate now more than ever before its ability to manage risk in challenging market conditions. The primary risk considerations for the asset class are longevity risk, including the accuracy or mortality predictions, and currency risk (i.e., how non-USD portfolios are hedged, liquidity risk, and the accuracy of valuation methodology)." With an open-end portfolio, a firm would typically apply a "mark-to-model" valuation, according to Leach, because a "mark-to-market" method is simply not equitable to investors with a buy-and-hold strategy. With a mark-to-model methodology, every policy should be revalued on a monthly basis, and for every month that passes, each person is expected to live longer than was assumed the month before. By moving out the life expectancy in this way and recalculating the future premium liability, a portfolio manager is able to make regular valuation adjustments that will deliver smooth, predictable investment returns for the investors.

Leach adds that constant repricing will keep investors from being disappointed the next time the Society of Actuaries issues new life-expectancy data or valuation basic tables. Leach said the average life expectancy on policies owned by MPL is six to seven years—any longer and the "mortality expectations would be less quantifiable." And with shorter policies, even small variations in life expectancy create a significant difference in value and risk.

Rosenfeld says his firm's best practices for life-expectancy estimates include pricing the curve rather than relying on a single figure from set actuarial tables. "The commonly accepted practice for a long time was that a life-expectancy report would produce a number, which was the median. The nomenclature was 'the median life expectancy for 1,000 lives.' And it would be a number of months, such as 48 months or 96 months." This number is then used as the basis for computer calculations. "To me," adds Rosenfeld, "it is a basic precept of finance that if you're working off a probability curve, which is what ❯❯

a mortality curve is, you price the curve, you don't price a single number. I've been advocating this for years."

If estimates are off—even slightly—the risk for institutional investors is overpaying for policies or, if they are using an open-end fund, they may not be able to redeem funds as expected. For these reasons and others, the Life Settlement Task Force indicated in its 2010 report to the U.S. SEC that the market needed more significant and consistent regulation of life-expectancy underwriters.

"In light of the crucial role that life-expectancy underwriters play in the settlement process," states the report, "the Commission should consider highlighting to Congress and state legislators that investors and market participants could benefit from more significant and consistent regulation. Such regulation could cover areas including licensing and qualifications of underwriters, privacy of customer information, and physician review standards."

Other risks faced by institutional investors include so-called headline risk (or the chance that an investor may receive negative press for participation in a life-settlement investment). This risk may have been one reason some investors, such as Goldman Sachs, pulled out of the market altogether. To mitigate that risk, some investors ensure a minimum amount of the investment goes to the policy seller. They can then argue that the investment was a win–win situation for both the policy seller and the investor.

Plus, the definition of a security under U.S. federal securities law could be changed to include life-settlement instruments. In fact, a recent SEC report recommended such a change, a move that could have tax ramifications.

In addition, some observers, such as Chris Kaplan, CFA, managing member of SLK Advisors, are concerned that life-settlement investments could cause capital market volatility. In other words, the longevity risk and other risks inherent in the investments could be overlooked as the policies are repackaged and resold. They argue that a breakthrough in medical technology that caused people to live longer could suddenly cause the investments to implode, possibly leading to declines in capital markets.

"In my opinion," says Kaplan, "the markets for securitized products, whether life settlements or subprime mortgages, are under-regulated and few people understand these exotic multiasset securitizations."

Institutional investors would like to put an end to the life-settlement industry's high fees. Fees have decreased since 2002, and McAdams believes they can come down even more. According to Finsinger, in the past decade, providers typically took 4 percent of the face value of a life policy to cover their own expenses, such as licensing costs in multiple states, and to pay agent commissions. Management fees are often expressed in terms of the death benefit and can become a substantial portion of the net asset value of the investment.

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A BRIEF HISTORY OF THE LIFE-SETTLEMENT MARKET

Having gained experience in the process of buying and selling life policies but lacking a supply of appropriate policies, some market players began in the 1990s to develop a market based on the policies of healthy people who held insurance policies with a high face value. This market became known as the life-settlement market. As the market grew, expected returns were high, sometimes reaching 20 percent a year.

But in 2003, a viaticals company with 28,000 investors, Mutual Benefits, was declared a Ponzi scheme and was shut down by the U.S. SEC. After underestimating life expectancies, the company, which used its own doctors for mortality estimates, began to take money from new investors to pay premiums on existing policies of older investors, thereby depleting new premium funds.

In 2004, returns on life settlements dropped significantly after European investors began to flood the U.S. life-settlement market, thereby driving up the prices that policy sellers were paid for their policies and driving down the rates of return that investors received. From 2004 to 2006, the expected annual return dropped to around 7 percent as a result of the additional investors' capital and a lack of supply, which pushed up the prices paid to policy owners.

Beginning in 2007, mortality rates were revised upward, putting out of business some players that had guaranteed results to their investors and were not indemnified. In addition, questions arose about the independence of providers of life-expectancy estimates, and some people speculated that some firms may have been getting kickbacks from life-settlement providers who wanted to persuade investors with short life expectancies.

"Looking back, we now understand why reputable underwriters failed to provide reliable data on life expectancies," says Jörg Finsinger, a professor of finance at the University of Vienna and head of the Life Settlement Institute. "Underwriters relied on the mortality tables of the insurance industry, which were designed to be conservative and project a high number of people dying, and they often based their mortality estimates on average population samples, while those people who sold their policies were instead the healthier bunch."