Investing in Life Settlements:

Providing greater risk-adjusted returns and portfolio diversification through uncorrelated assets

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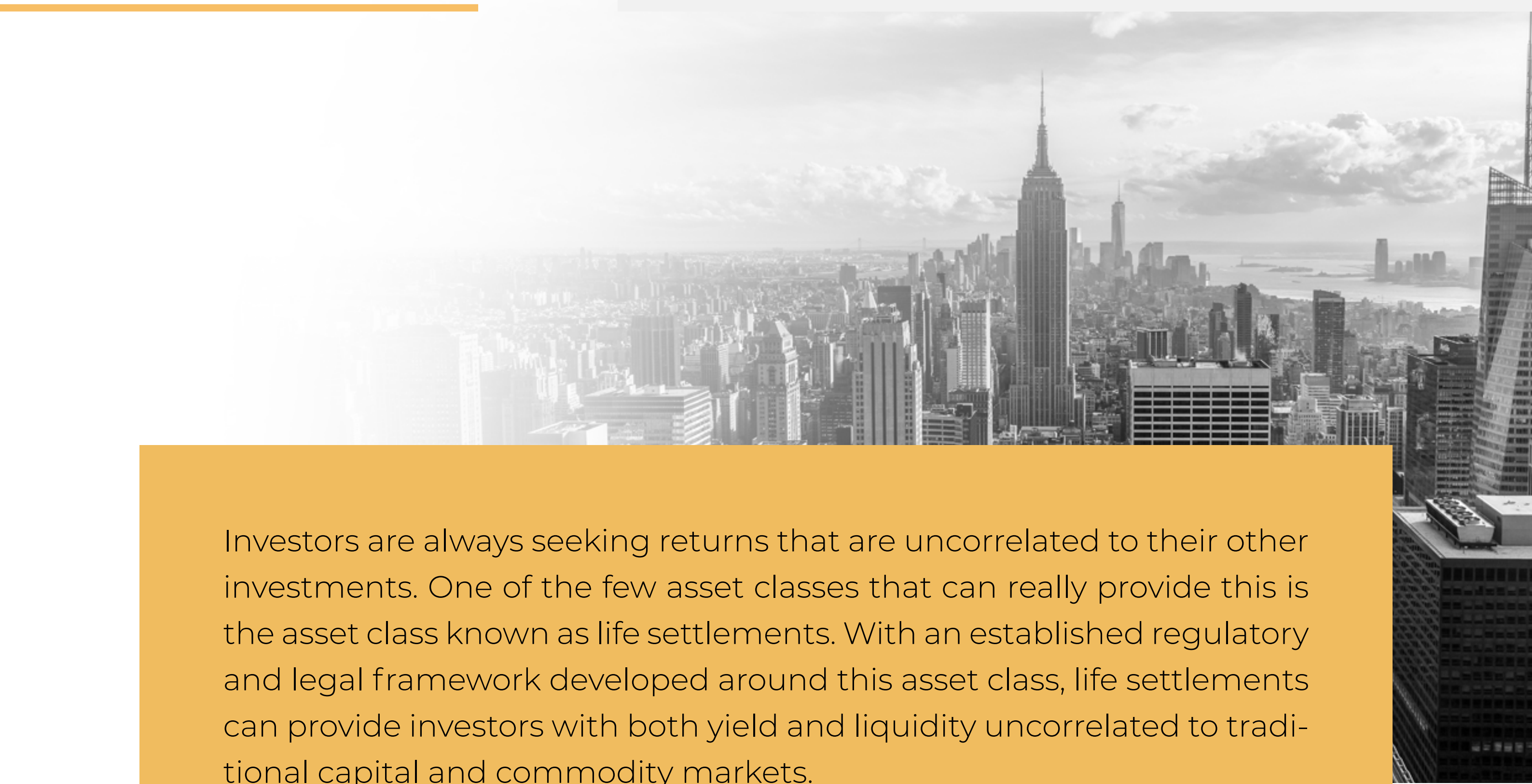
Over the last 20 years well-respected institutional investors such as Deutsche Bank, Credit Suisse, Goldman Sachs Berkshire Hathaway, AIG, Apollo, and Fortress have collectively invested billions of dollars into this little known asset class seeking returns of 12%-20%. But what exactly is it and how does it work?

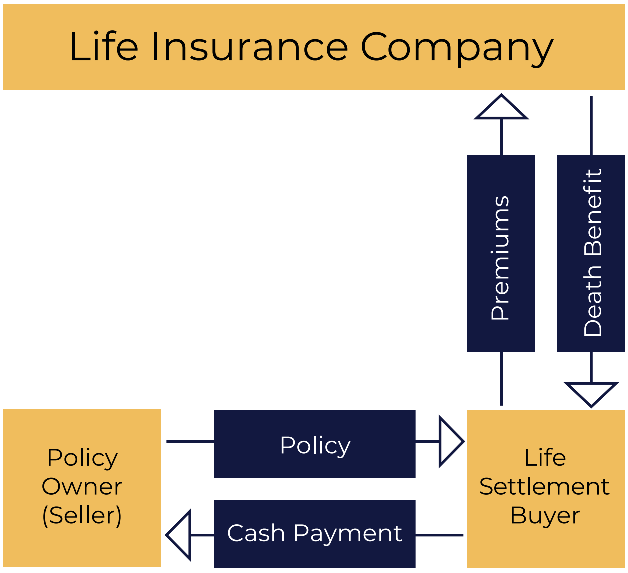
By Rajiv Rebello, FSA, CERA



Investors are always seeking returns that are uncorrelated to their other investments. One of the few asset classes that can really provide this is the asset class known as life settlements. With an established regulatory and legal framework developed around this asset class, life settlements can provide investors with both yield and liquidity uncorrelated to traditional capital and commodity markets.

WHAT IS A LIFE SETTLEMENT?

A Life Settlement is the sale of an in-force life insurance policy to a third party for an amount less than its death benefit, but greater than the policy's cash surrender value established by the insurance provider when the insured desires to terminate the policy. In return for providing the seller with a cash payment, the third-party purchaser (investor) owns the life policy, pays all premium payments going forward and eventually receives the entire death benefit at the time of the insured's death. This transaction then "settles" the life insurance policy – hence the name "life settlement".



In a life settlement the policy owner receives a significantly higher cash payment from the policy than he or she would receive if he were to merely cancel the policy. On the other side of the transaction, the life settlement buyer agrees to purchase the policy and will pay all the premiums owed on the policy in exchange for receiving the death benefit when the insured on the policy passes away. With a priced IRR in the 13%-16% range, the investment is an attractive one if the risks are properly managed.

WHY HAVE SO MANY RESPECTED INSTITUTIONAL INVESTORS INVESTED BILLIONS IN LIFE SETTLEMENTS?

Highly respected institutional investors have invested billions of dollars into the life settlement space. These include:

- Berkshire Hathaway[1,2]
- AIG[3]
- Deutsche Bank
- Fortress[4]
- Credit Suisse
- Apollo Global Management[5]

In addition to the attractive returns that life settlements offer these investors, life settlements also offer a highly valued attribute that such investors have difficulty finding in other asset classes: non-correlation to traditional equity markets.

Most asset classes are tied on some level to the overall state of the economy and the general equity market. For example, when the stock market crashes, typically the housing market declines as well, and credit markets suffer. Therefore, an investor investing in real-estate is implicitly betting on the economy as a whole doing well or relying on monetary policy and credit quality of issuers if they are invested in the bond markets. Life settlements, on the other hand, offer sophisticated investors such as these groups a more robust diversification strategy.

WHY IS A LIFE SETTLEMENT TRANSACTION VALUABLE FOR THE SELLER?

Life insurance is a necessary protection vehicle for individuals who have significant liabilities, but limited assets to pay for them. For example, young parents typically have mortgages and debt obligations but limited assets to pay for them in the event that a primary income earner were to pass away unexpectedly. A life insurance policy helps protect the family against this unforeseen event.

As these parents get older, however, their assets increase as they earn more at their jobs and save for retirement. Their liabilities also decrease as the mortgage gets paid down and kids become adults and move out of the house. Older policy owners no longer need life insurance at that point, but have other life expenses that need to be paid while they're still alive: healthcare, assisted living, etc.

As insureds get older, the cost of insurance on these policies also gets more expensive and often times seniors on fixed incomes can no longer afford to pay the premiums on these policies. Therefore, the ability to treat their insurance policy as an asset and sell it is an incredible benefit for an aging population with increasing costs of living. For senior citizens in the US, the increasing need to monetize their life insurance policy supports the growing life settlement market.

WHY IS A LIFE SETTLEMENT VALUABLE FOR THE BUYER (INVESTOR)?

An investor in life settlements knows that aging insureds on life insurance policies are more likely to be less healthy now than when the policy was originally purchased. Professional investors and asset managers in life settlements confirm this decrease in health through independent third-party consultants that provide life expectancy reports.

Furthermore, life settlement investors know that if they can find specialized actuarial and insurance expertise they can calculate the mortality arbitrage on the policy and determine how to pay significantly less in premiums than the previous policy owner was paying to keep the policy in force. These two factors make the purchase of an individual policy attractive as the life settlement investor typically pays a cash price for the policy at a discount rate (IRR) of 13%-16%.[6]

An investor can expect to achieve two outcomes. The insured could pass away before the life expectancy (in which case the return would be higher than the 13%-16% the policy was priced at) or the insured could pass away after the life expectancy (in which case the return would be lower than the 13%-16% the policy was priced at).

However, the life settlement investor also knows that just buying one policy is extremely risky as the investor doesn't know exactly when the return on investment will be realized. In order for these priced IRRs to materialize and for the investment to be less volatile, investors have to acquire a decent number of policies at attractive prices using a combination of sourcing channels and insurance expertise that properly finds policies, evaluates the risk and then manages the risk post-acquisition.

Hence, while the underlying return on the asset may be uncorrelated to traditional capital markets, this return is very much correlated to the expertise of the asset manager. Therefore, in order for investors to realize stable, high yielding returns in the space that exceed those of traditional equity/bond portfolios they must find highly specialized asset managers that truly understand the space and work on behalf of the investor.

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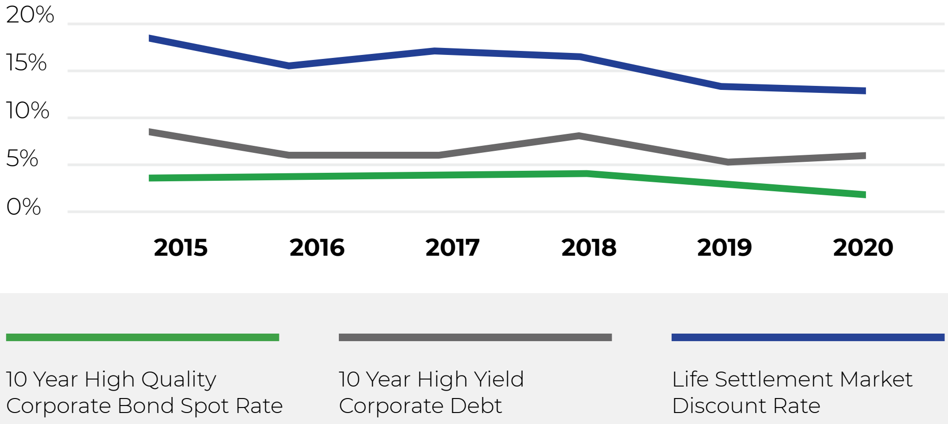
LIFE SETTLEMENT MARKET DISCOUNT RATE VS BOND DISCOUNT RATES



Source:
The AAPartners[6],
Fed Reserve[9]

A diversified life settlement portfolio can provide stable bond-like yields, but with the potential for significantly higher returns over bonds with similar credit risk. In order to realize this additional yield from life settlements, investors need to invest in life settlement funds with qualified asset managers.

The underlying element determining returns in the life settlement asset class is an in-depth understanding of mortality risk and how life insurance policies can be designed and structured to both mitigate risk and improve returns. Neither mortality risk nor life insurance and actuarial expertise is related to the strength of the economy. In other words, whether the economy is doing poorly or doing well, the overall health of the insureds on the life insurance policies is not affected- and neither is the actuarial and insurance expertise of the asset manager of the portfolio. This ability to achieve higher and more stable returns independent of the state of the economy is extremely attractive for institutional investors.

IF I'M INTERESTED IN INVESTING IN LIFE SETTLEMENTS, WHAT QUALITIES SHOULD I BE LOOKING FOR IN AN ASSET MANAGER?

While life settlements are a great asset class for investors looking for both the stability and limited volatility of fixed income and the higher returns of equity classes, it's important to note that not all life settlement asset managers and investment opportunities are the same. Some have extensive experience and qualifications and others merely excel in selling clients on a good idea.

Here are some key qualities you should be looking at when considering an asset manager in the life settlement space:

1. ACTUARIAL AND INSURANCE EXPERTISE:

Life insurance and actuarial expertise and the corresponding ability to manage longevity risk is at the core of this asset class. And yet many in the life settlement space lack this key skillset and instead focus on selling a story.

To draw a parallel analogy, if an investor was looking to invest in a car dealership that was in the business of acquiring undervalued cars and reselling them for a profit, should the investor choose a dealership that has no mechanics on staff but merely excels at convincing the general public to pay high prices for poor quality cars that would later breakdown? Or should that investor focus on the dealership that has highly skilled mechanics that can both identify undervalued cars and rehabilitate them in order to provide the public with a high quality product that will last for the long-term?

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Understanding life insurance and mortality risk is a core differentiator in the space. Any investor looking to invest in life settlements needs to ensure that the asset manager they choose is more than qualified to look under the hood of a life insurance policy, understand how it works, and then use that understanding to structure an investment in the policy that most benefits the investor. Here are two key questions investors should ask of potential life settlement asset managers before investing:

1. How does your team use its life insurance and actuarial expertise to identify attractive policies and mitigate longevity risk?

2. Does your team have direct experience:

a) working with life insurance policies from the origination perspective?

b) reading a policy document?

c) designing and pricing a life insurance policy for a life insurance company and managing the inherent longevity risk with insureds?

2 SOURCING EXPERTISE:

Another key differentiator in the life settlement space is the ability to identify proprietary sourcing channels so that the firm can get a step ahead of the rest of the market. Here are two key questions to ask:

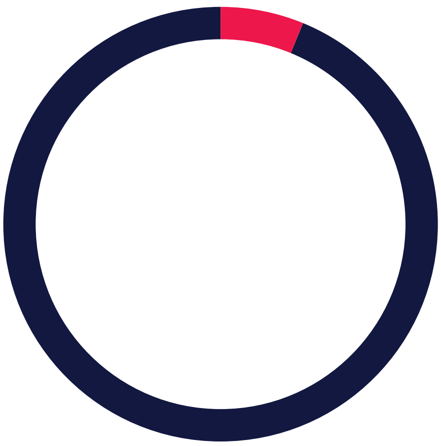
1.

What is your team's experience in identifying and sourcing policies in the life settlement space and what preferred relationships has your team developed to allow your team to get preferential access to life insurance policies in the market? [7, 8]

2.

Only 8% of all policies that would qualify as a life settlement are actually sold in the secondary market. What plans does your team have on penetrating the life insurance space and creating proprietary sourcing channels that will increase returns for investors in the future?

FACE AMMOUNT OF POLICIES ACTUALLY SETTLED IN LIFE SETTLEMENT MARKET VS LOST POTENTIAL ($B)



4,6 **8%**

Actual Face Amount of Policies Settled in Life Settlement Market Each Year

52,4 **92%**

Surrended Face Amount Policies that Could Qualify for a Life Settlement

Of the $57B in life insurance policies that would qualify for life settlements each year, less than $5B are actually sold on the secondary market. With enhanced direct-to-consumer marketing channels, significantly greater penetration can be achieved which would allow for better growth of the life settlement industry as well as higher returns through the reduction of third-party broker costs.

3 VALUATION TRANSPARENCY AND ACCOUNTABILITY:

Gains in the life settlement market consist of two main sources: realized gains and unrealized gains. Realized gains are a result of actual insureds on the policies passing away and a death benefit being paid out or policies being acquired at a lower price and then resold at a higher price.

The remainder of any gains in the market are due to unrealized gains. Unrealized gains occur from policies in which the insureds on the policies have not expired, but have gotten older or less healthy and therefore are closer to their life expectancy date than they previously were. While realized gains are easy to objectively calculate and verify (since there are actual payouts being made), unrealized gains are subjective and are based on each individual firm's calculation of the Net Asset Value (NAV) of the policies that are still active (i.e. the insureds that have not matured).

As one might imagine, the subjectivity of how unrealized gains are calculated can be manipulated by less honorable firms to inflate the investment's overall returns. In order to differentiate firms that are accurately reporting returns from those that are not, here are some key questions to ask:

1.

What percent of the investment's returns are due to realized gains vs unrealized gains?

2.

How are unrealized gains and Net Asset Values being calculated? Are these formulas transparent and able to be critiqued by actuaries not affiliated with valuing the portfolio for the fund? How does the fund validate that the booked Net Asset Values of the fund are reflective of the true market value of these policies?

3.

How does the fund's returns compare with other firms in the life settlement space?

4 TAX-EFFICIENT STRUCTURING:

The returns on life settlements can be enhanced or sheltered through proper structuring of the investment entity. Investments in the life settlement space can be structured through an open-ended fund, closed-end fund or special purpose vehicle. Due to the complexity of US tax regulations, it's important that the life settlement investment under consideration is structured in the most tax-efficient manner possible. Some questions to ask a life settlement asset manager with regards to the efficiency of its structure are:

1.

If it is an open-ended or closed-end fund, what is the domicile for the fund? Why is the particular domicile better for the investor?

2.

How do I receive my distributions and how much, if any, of my gains are withheld to pay taxes?

3. Who are the tax advisors for the fund?

Given the volatility in current equity markets and the low interest rate environment in the bond market, life settlements can be a great investment in today's economic environment. In fact, over the past four years capital has increasingly entered the space as even retail investors are becoming more aware of the uncorrelated and stable returns that a diversified life settlement portfolio can offer. But as with any investment, it's important that the proper due diligence be done on both the asset class and the asset managers running the fund to ensure that any investment risk is minimized and all potential returns are maximized.

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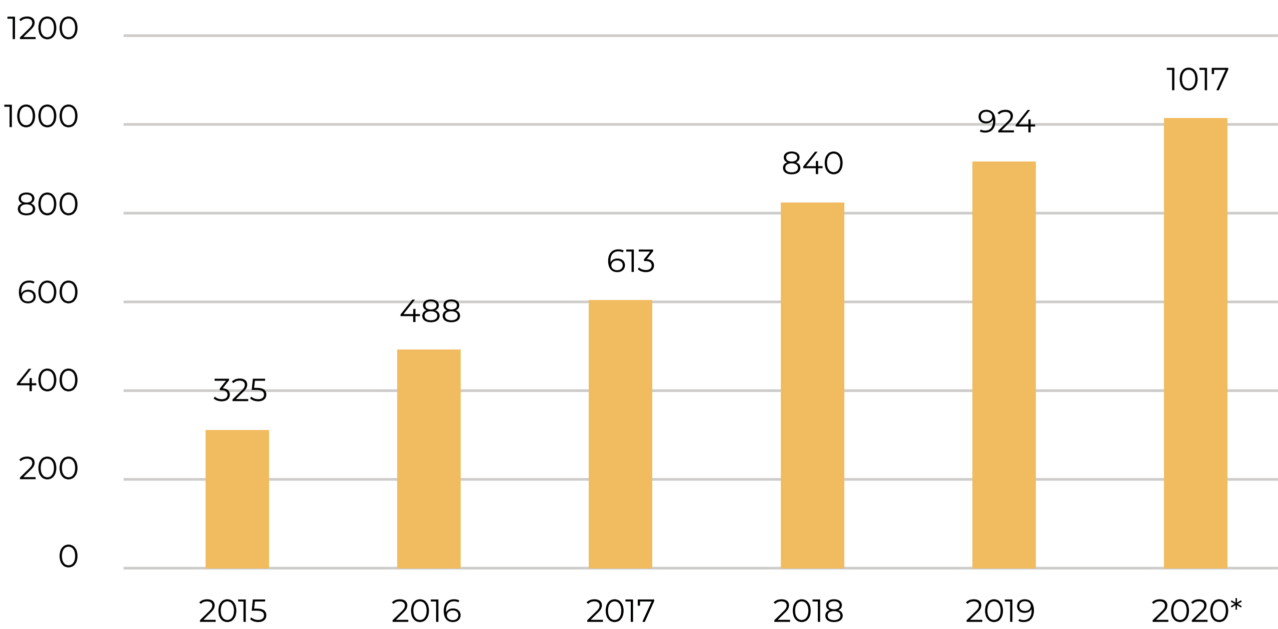
CAPITAL INVESTED
LIFE SETTLEMENT SPACE ($M)



Source:
The Deal[8]

*2020 Totals are Estimated

Over the past six years the capital deployed in the life settlement space in just the secondary life settlement market has more than tripled to over $1 billion in 2020.

Investors are actively seeking to enter the life settlement market in order to diversify their portfolios from traditional stock and bond investments and invest in a non-correlated asset class with the ability to achieve both the stability of bond investments and the higher returns of equity investments.

ABOUT THE AUTHOR

Rajiv Rebello is the Chief Actuary of Colva Actuarial Services. As an actuary he has helped to manage and evaluate thousands of life insurance policies and helped investors save millions of dollars in unnecessary premium payments while structuring investments in the life settlement space to minimize longevity risk and improve returns. Prior to his work in the life settlement space, Rajiv was an actuary for New York Life where he worked on the pricing and design of New York Life's Universal and Variable Universal Life Products and helped make adjustments to New York Life's mortality table based on realized mortality experience. He can be reached at rajiv.rebello@colvaservices.com.

ABOUT COLVA ACTUARIAL SERVICES

Colva Actuarial Services is an actuarial servicing company that helps life settlement investors and wealth management firms properly structure investments in life insurance products in order to minimize premiums paid into these products and maximize client returns.

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