

## Life Settlement Funds

January 2008

### **Attractive at first glance, but they don't sit well with our investment philosophy.**

At BFP we continually review new investment opportunities to see whether they have the potential to contribute beneficially to our clients' portfolios by improving the trade-off between risk and return. In this brief note, we review life settlement funds, an investment opportunity that is increasingly being considered and used by some wealth managers.

As part of our ongoing portfolio management process which seeks to deliver the highest chance of success for our clients, every investment building block that we use is judged against the specific criteria that must be met for it to be included in client portfolios. This systematic review of each investment opportunity helps to ensure that both its characteristics and the risks inherent in it are clearly understood and that it fits closely with our investment philosophy.

### **What are life settlement funds?**

The chances are that you may not have heard of life settlement funds, perhaps not surprisingly since they are a relatively new concept in the UK. Something that will be familiar to you however is life insurance, on which they are based. In the USA, where life settlement funds originate, there are two types of life insurance: first there is 'permanent' life insurance which has a cash surrender value (CSV) and secondly there is 'term' insurance, with which we are more familiar in the UK, where there is no CSV, just a death benefit during the term of the policy.

According to Milliman and Robertson, an international actuarial firm, 90% of universal life policies (the most common type of permanent life insurance sold in the United States) never result in a death claim. The policies are either surrendered or worse, allowed to lapse. When you add in term insurance, according to 'Tax Planning with Life Insurance' by Zaristky and Leimberger, there is less than a two percent probability that term insurance bought 20 years before an insured's death will be in force. On average, 93% of all life insurance policies sold never pay even \$1 in death benefits – the life insurance companies keep all of the premium dollars, while the insured or his heirs get nothing in return! Enter the life settlement fund.

### *An example of a life settlement transaction:*

Imagine that you have set up and paid premiums on a universal life policy that will pay out \$500,000 on your death – you then decide that you no longer want to pay into this policy and would prefer to cash it in. You contact your insurance company who offers you a cash surrender value of \$55,000; before life settlement funds came along that was the only exit option. These funds – in reality an aggregated group of investors – calculate that the cash surrender value offered by your insurance company is well below the likely value of your policy, given your age and state of health, and offer \$150,000 to buy it from you. In effect they are betting that you will die earlier than the actuarial calculations, on which your policy is based, suggest. You take the cash and assign to them the benefits and responsibility for paying the premiums.



Everyone is superficially happy: you get \$150,000 instead of \$55,000 and the investors are happy because they think that they are going to benefit from your death and have paid you a sum for your policy that will allow them to make a large profit i.e. up to \$350,000, being the \$500,000 death benefit less the \$150,000 they paid you and the cost of any future premiums.

In practice, most policies purchased by life settlement funds have a death benefit of at least \$250,000 (the US is the main market for this type of investment), although sometimes policies with death benefits as low as \$100,000 are considered. Policyholders need to be at least 65 years old and have a life expectancy at the time of the purchase of at least two but no more than 12 to 15 years, depending on the buyer's criteria. Obviously, it is in the investors' interest to keep the purchase price low. They also would prefer if you died sooner rather than later! So, a policy from a policyholder who is in declining health, or, for example, is an active smoker, could be worth more than a comparable policy from someone who is healthy.

From the investor's point of view, the pooling of the acquisition of policies allows each investor to own a diversified holding of policies. Until life settlement funds, which allow individual investors access to a diversified pool of policies, came along, this investment opportunity was only available to large institutional investors, by whom it has been used for some time.

#### **Putting yourself in the investor's shoes**

Looking at average annual historic rate of return of 15% or so from life settlement funds over the past few years, it is perhaps not surprising that they have caught the eye of wealth managers and their clients. Add to this the fact that returns appear to have been relatively stable and that they are not related to how the equity or bond markets perform, but on the longevity (or preferably otherwise from an investor's point of view) of the original policyholders, they appear to be a great risk diversifier and return generator. What more could you ask for in your portfolio? However, the astute investor looks beyond the obvious.

#### **Watch out for the pitfalls**

Nothing in investing is ever a free lunch and something that looks too good to be true usually is. Life settlements have a number of significant potential pitfalls.

- **Are sellers getting a fair deal?** The most serious aspect is that it is extremely difficult for sellers of a policy to know whether they are getting the best deal possible. As a result, life settlements have been drawing the attention of regulators who allege backroom dealings and predatory sales tactics by brokers who source the policies for life settlement funds. In addition, recent research by Deloitte Consulting indicates that in almost all cases, the original owner (or their heirs) gain considerably more value by continuing to pay the premiums on the policy and taking the death benefit, rather than surrendering the policy to the insurance company or selling it to a life settlement fund, obtaining liquidity, if it is required, by borrowing against the surrender value, or using dividends (or family members) to pay the premiums. Future class actions against the life settlement industry could have repercussions for future returns and damage the reputation of the industry, as well as those of investors who have invested in them.



Questions have already been raised about collusion among buyers and brokers; former New York Attorney General Eliot Spitzer filed a lawsuit against one of the largest life-settlement buyers, Coventry First, accusing the firm of bid-rigging with one of its competitors that significantly short-changed sellers. In this alleged scheme, Coventry would make payments to brokers in exchange for them tilting the bidding process to ensure that Coventry was able to purchase the policies at lower prices. Emails presented as evidence showed Coventry officials haggling with brokers over what Coventry would have to pay to win the auctions. In one instance, Coventry is alleged to have paid a broker \$200,000 in exchange for not presenting to the policyholder a bid that would have topped Coventry's bid on a \$10 million policy by \$425,000. Coventry denied in court filings that the firm did anything wrong, saying that it did not have to disclose the payments to policyholders. This is not the sort of transparency and integrity that we like when selecting investments.

- **The arbitrage of the profit opportunity:** As ever in the financial services sector, any profit opportunity is identified quickly and as more profit-hungry competitors enter the marketplace, they risk bidding up the price they pay policyholders to buy the policy – while this is good for the seller, it is not so good for the investor, as returns are likely to fall.
- **Returns are reliant on the skills of the fund manager:** Each policy and policyholder needs to be scrutinised closely upfront in order to decide how much 'value' there is in the transaction; buy the wrong policies and the fund could fail to make the expected returns. A major medical breakthrough could have return repercussions, although a good fund will hold a diverse pool of policies, whose policyholders will have different impaired life circumstances. This sort of analysis, both upfront and on an ongoing basis, along with broker commissions (6% to 20% of the purchase price) make this an expensive process, taking up to 50% of the total return – costs tend to be opaque in the life settlements industry – again, not something on which we are keen.
- **Benefiting from other people's misfortune:** When dealing with returns derived from longevity, you are betting on other people's circumstances; while this is also the underlying principle of annuities, some investors feel uncomfortable with the notion that they are to benefit, perhaps handsomely, from another's misfortune.

### **Our conclusion: not for our clients**

On balance, while the broad investment properties appear to be favourable, we feel that we do not wish to include life settlement funds in our client portfolios due to the pitfalls outlined above. In essence, we are seeking investments that have a strong economic rationale for a market-based return for the risk taken, rather than relying on manager skills to generate returns. Consequently we look for products that capture the characteristics that we are seeking, structured and priced in a transparent way and that deliver the bulk of the returns generated to our clients. We do not believe that life settlement funds do so, at least in their present form. We will continue to monitor the industry and will revisit the case in the event of material and favourable developments.



**Exhibit 1: Life settlement funds do poorly against our criteria**

**Criteria for inclusion**

Return based on market risk factors	✗
Return history provides adequate insight	✗
Functional attributes will contribute to the portfolio	✓
Products exist that cleanly replicate these characteristics	✗
Products have low Total Expense Ratios and other costs	✗

**Included in model portfolios** ✗

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