



## FEATURE ARTICLE

---

Date: **31<sup>st</sup> January 2011**

Issued by: **Andrew Gadd, Head of Research - Lighthouse Group**

---

### **Unsuitable For Most Retail Investors?**

As many of you will be aware the FSA has recently issued a Discussion Paper (DP) entitled “Product Intervention.” In this DP the FSA confirm that they are looking at the possibility of producing a list of products that they regard as being generally unsuitable for the mainstream, retail market. Such a list would include, amongst others, Traded Life Policy Investments (TLPIs). Now this is one occasion when I could not agree more with the FSA.

In simple terms traded life policy investors buy whole of life United States assurance policies sold by the life assured to allow the life assured to receive a cash lump sum that is greater than they would receive from cashing in or cancelling the policy (in addition the “seller” benefits because they stop paying premiums on the policy during their lifetime). The purchaser pays a percentage of the eventual payout and factors into the purchase price the premiums that he or she expects to pay before the life assured dies. The purchaser continues to pay the premiums and receives the fixed face value of the investment when it matures (i.e. the life insured dies!). **The final payout is known, but it is not known when the policies will mature.** It is this transaction by which an existing life insurance policy is sold to third parties which is known as a life, or traded, settlement.

Advisers and various other market participants have undoubtedly been attracted to TLPIs by the argument that investing in TLPIs represents a non correlated investment opportunity when compared to investments such as equities, property or fixed interest coupled with attractive published returns in the asset class. **But the fact is that investors need to ensure that such returns are not illusory and understand that such returns do not, in my view, come without significant risks.**

In this respect, in a speech that he made on the 24<sup>th</sup> February 2010, Peter Smith, Head of Investments Policy at the FSA explained that:

“As TLPIs target relatively high returns which are uncorrelated with other asset classes there is significant potential for marketability by intermediaries. However, there is a risk that a lack of understanding by intermediaries may result in unsuitable sales. **If you do not understand the**



**product, you should not sell it.** We have seen far too many market problems arising from advisers selling products they have not properly understood.”

He added that

“We expect advisers to understand the risks inherent in TLPs, to explain these fully to their clients...”

In his speech Smith specifically identified the following risks associated with TLPs:

- ✓ Longevity Risk - The primary risk is simply that the underlying policyholders live longer than expected.
- ✓ Volatility of Returns - Smith confirmed that assuming there is sufficient diversification in a fund and actuarial calculations on longevity are accurate (a big assumption!), volatility in terms of performance should be low. He stated however that experience has shown that there is a real risk of a lack of diversification of policies.
- ✓ Liquidity Risk - Smith confirmed that despite the size of the US traded-life policy market, as a tradable asset class the underlying investments are rather illiquid due to their specialised nature. The underlying policies, by definition, only yield reward over time and the TLPI market is not always completely efficient and there are no set timings in terms of transactions.
- ✓ Counterparty Risk - Smith explained that as with structured products, there is an equivalent counterparty risk if the insurance company becomes insolvent and is unable to meet the death benefit claims.
- ✓ Potential for Loss - Smith specifically included this risk classification in his speech and explained that should actuarial calculations on life expectancy be wrong, there is the potential for significant capital loss where expected returns are not paid on time. Also should an investor require access to capital during the product term, this may lead to a loss of capital.

To Smith’s list one might also add:

- Compensation: My research suggests that U.S. Regulations stipulate that insurance companies must have adequate reinsurance in the event they are unable to meet their liabilities. If they go bankrupt, the authorities are obliged to cover \$300,000-\$500,000 per policy. But the average size of a policy is \$2.5m, implying a recovery rate of, at most, 20 per cent in the event of insolvency for these “average” policies.
- Currency Risk – TLPs are US Dollar denominated assets.
- Regulation - Currently there are no Federal Laws that specifically govern life settlement transactions. Regulations governing transactions and the licensure of life settlement brokers, which represent policy owners wishing to sell their policies and life settlement providers, which



purchase policies (usually on behalf of institutional or fund purchasers) are the domain of each US state with some states not having any rules. Also in the UK the majority of TLPIs are currently structured as Unregulated Collective Investment Schemes.

- Mark-to-model accounting: The argument is that as traded life funds do not sell the policies back into the market, managers avoid assessing them on a mark-to-market basis. It is therefore **vital** to have an appropriate model to determine when the former policyholders would pass away, or overpaying in premiums. Critics of mark-to-model accounting explain that fund managers need to manage their liquidity appropriately so they are not forced to sell mark-to-model holdings when investors redeem, as this would mean revaluing them on a mark-to-market basis. Mark to model also has potential conflicts of interest when performance fees are being paid! With reference to mark to model pricing I have seen the argument put forward that because a TLPI fund has a buy and hold strategy you need to mark to model, i.e. produce a valuation model rather than revalue a policy for what you would be selling it into the market today. If you were marking to market on an open-ended fund you would be bringing new investors in and redeeming investors at the wrong price, which is disadvantageous. With a mark to model you should not, for example, see a massive adjustment in the valuation of a fund just because the Valuation Basic Tables (published every seven years and provide the latest statistics on life expectancies for the United States population) have changed. That's what mark to market does because all of a sudden life expectancy opinions are longer than they were the day before, it means the price of a policy in the market has changed. The argument goes on that that's the danger with mark to market because you're not able to smooth in all of these issues. So for those that run open-ended funds a mark to model valuation basis is equitable no matter when investors want to come in or when they want to exit. Unfortunately for me the problem with this argument is that if, for whatever reason, policies do need to be sold then mark to model pricing is not going to be accurate in terms of valuation – one can never forget that even if actuarial calculations are accurate (which is debateable), financial crises can mean a run on assets of every type – not just those affected by falling markets. Also the market price of a TLPI is likely to be lower than a mark to model estimate due to the allowance for charges and various broker commission on a mark to model basis?
- Taxation Risk – as the proceeds from a Life Settlement are US sourced income, when that income is received by a non-US entity, the proceeds are normally subject to 30% US Withholding Tax. It is therefore important that a Fund is structured to mitigate this liability.

Now I fully accept that various product providers will argue that they are, within their offering, able to mitigate some or all of the risks detailed in this article but the fact remains that a mark to model valuation may look good but is extremely unlikely ultimately to be accurate.



As the FSA has indicated, TLPIs are not something for mainstream investors and possibly not even for sophisticated investors once they understand all the risks?

***Whilst LighthouseXpress Ltd has taken every effort to ensure that the above research is accurate, we cannot accept liability for any errors or omissions. In addition, it should be noted that the research does not constitute advice to invest, or not invest, in any product referred to above. This research is provided in order to assist you to provide your clients with sufficient information on which to make an informed investment decision. The past performance of an investment provides no guarantee as to the future performance of the new funds. The value of unit prices can fall as well as rise and the return of your capital is not guarantee.***

***LighthouseXpress Ltd is a wholly owned subsidiary of Lighthouse Group Plc, the AIM listed largest autonomous IFA and wealth management group in the UK. Full details of the group, including regulatory authorisations, can be found at <http://www.lighthousegroup.plc.uk>, or by contacting:***

***General enquiries phone number: 08000 85 85 90***

***General enquiries email address: [enquiries@lighthousegroup.plc.uk](mailto:enquiries@lighthousegroup.plc.uk)***