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Life Settlements – where does the Performance come from?

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Abstract

An investment in life settlements needs to be profitable, the **income needs to exceed substantially the expenses**. Life insurance policies need ongoing premium payments, thus there are significant expenses on top of the usual asset management cost. Therefore, a positive cash balance depends on the collected death benefits substantially exceeding the cost which allows the repayment of the funds used for the initial purchase of the portfolio and the surplus being the return for the investors. An investment leads to a partial or total loss if the collected death benefit does not exceed, or does not exceed enough, the cost.

Appreciations and depreciations of a life settlement portfolio influence the NAV curve of an investment. However, **appreciations and depreciations are irrelevant for the performance** under a buy and hold perspective. Irrespective of any appreciations or depreciations the collected death benefits need to exceed the cost substantially. A life settlement fund showing an upward sloped NAV curve may lead to a partial or total loss for the investors if the collected death benefits don’t exceed substantially the cost.

Trading can provide gains for investors. A fund with a particular focus on trading should show the portfolio turnover ratio. Furthermore, just realized gains from closed sales should be activated in the NAV calculation, and not potential, unrealized gains.

Motivation for this White Paper

We recognized in our discussions with investors that there is **no clear understanding where the performance of life settlement investments is coming from**. This fact can be attributed, at least partly, to the fact that life settlement asset managers don’t adhere to performance presentation standards that would allow to understand where the performance is coming from. Furthermore, the general lack of knowhow about the performance of life settlement investments leads to the effect that investors don’t ask the right questions when assessing an asset manager (‘due diligence’).

The **marketing of life settlement investments** bases to a significant extent on the level of projected IRR and the NAV curves of life settlement investments. However, neither the advertised IRR nor the shown NAV curves are reliable measures to base on for an investment decision.

What is a Life Settlement?

What is a life settlement?

US Life settlements are transactions in which unwanted or unneeded in-force life insurance policies are sold to investors for a lump sum. The seller remains the insured person, while the buyer, i.e. the investor, becomes the new owner and the beneficiary of the death benefit proceeds. Furthermore, the investor is responsible for the payment of future premiums to keep the policy in force. The profit for the investor in US life settlement is the difference between the death benefit ('cash-in') and the expenses ('cash-out'; acquisition cost, premium payments, fees etc.).

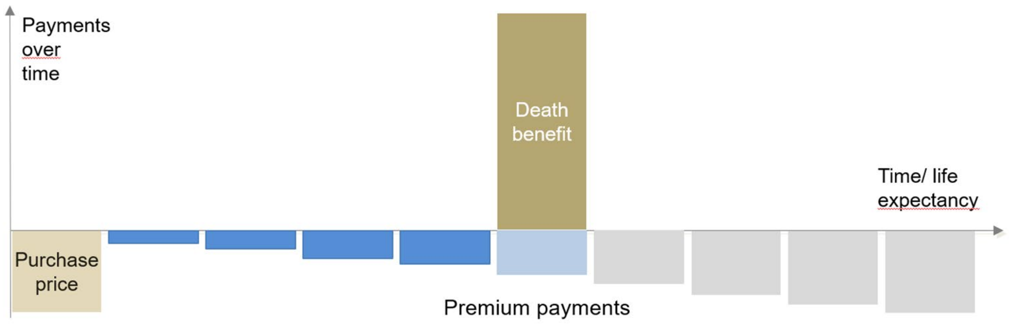

Figure 1 Schematic description of a life settlement from the view of an investor. *The expenses consist of the purchase price and the ongoing premium payments. The premiums[1] ('cost-of-insurance', COI) increase with increasing age of the insured person. Therefore, the premium burden increases over time if the policy does not mature, and consequently the expenses increase.*

Secondary and tertiary life settlement market

The life settlement market consists of two different sections: the secondary and the tertiary market. In the secondary market a policy owner sells a policy to a buyer. If the buyer resells the policy such a transaction is classified as a tertiary market transaction.

The secondary and the tertiary market interact since the underlying investment is the same, and accordingly the prices of the two markets can deviate however they can't completely decouple from each other. The tertiary market is relevant for the ongoing mark-to-market valuation of portfolios.

How does the market work?

In general, the market works via auctions where buyers bid against each other for single policies or portfolios.

[1] There are also other possible premium streams (i.e. level premiums, combinations of COI and level premiums and so forth) but in general the COI streams are used in the life settlement industry.

WHERE IS THE PERFORMANCE COMING FROM?

Generally

The value proposition of an investment in life insurance policies is simple: purchase life settlements, pay the necessary premiums and collect the death benefits. This basic mechanism can be summarized as the 'cash-on-cash' performance. It describes the true, unmasked performance of life settlement investments under a buy and hold perspective.

The net asset value ("NAV") performance of a life settlement portfolio is different to the cash-on-cash performance, as various appreciations and depreciations of the portfolio are included in the NAV as well as the changing cash account.

THE CASH-ON-CASH PERFORMANCE

What does 'cash-on-cash' performance mean?

An investment starts with the deployment of the capital. The invested capital needs to be returned to the investors, and the investment starts to yield a positive return once this has been achieved.

In order for investments in life settlements to be profitable, the sum of collected death benefits needs to exceed the cost (i.e. premium payments, fees etc.). Unlike other investments, a life settlement portfolio needs ongoing premium payments to keep the policies in force ('cash-out'; compare Figure 2). The balance of expenses and of collected death benefits ('cash-in') needs to be positive to repay the money which was necessary to purchase the portfolio. Once this has been achieved, a positive return for the investors is earned.

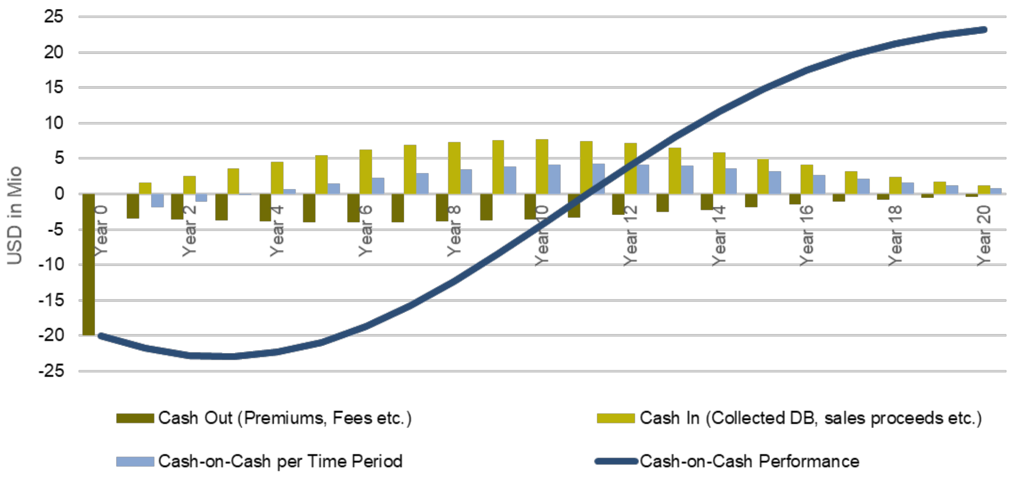

Figure 2 The development of an investment of USD20 million in a life settlement portfolio with USD100 million face amount. *The expenses ('cash-out') are higher than the earnings ('cash-in') in the first years which increases the financial exposure of the investors beyond the initial USD 20 Mio, compare the J-shape of the blue line. The balance of expenses and collected death benefits starts to be positive in year 4. The positive balance is then used to repay the initial investment. The*

investors have their initial investment back after about 11 years, and a positive return is earned afterwards.

The most significant risk to the success of life settlement investments is if the life expectancies ('LE') are, on average, too short. If this is the case, then (1) there will be increased premium payments due since ongoing premium payments are required and since the premiums increase over time with the increasing age of the insured persons (compare Fig. 1), and (2) the sum of collected death benefit lags behind.

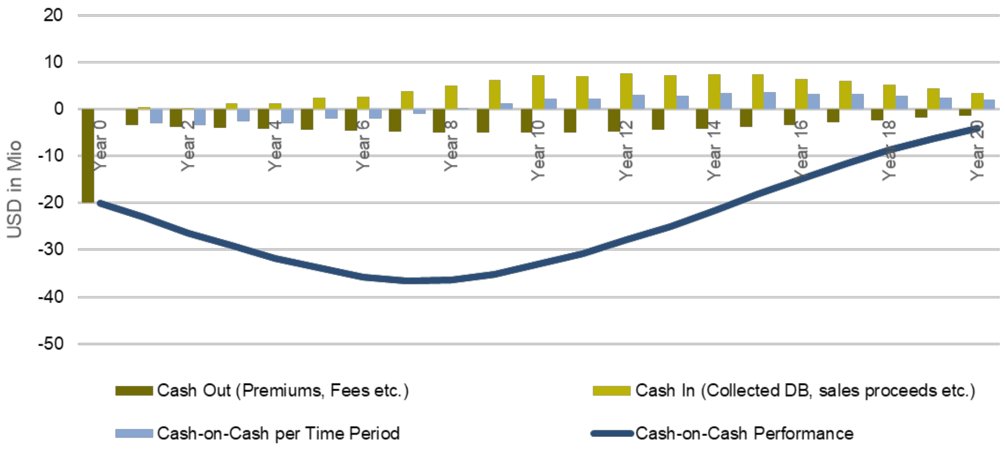

Figure 3 Partial or total loss for investors in case the LEs are significantly too short on average.*[2] The expenses ('cash-out') exceed the collected death benefits ('cash-in') until year eight, the portfolio starts to be cashflow positive around year nine. The positive balance, however, is so small that not even the initial capital can be repaid. The investment is a partial loss for the investors.[3]*

LEs that are too short can lead to a partial or a total loss for the investors. This is because the cash realized from maturities is 'burned' to meet the ongoing costs of the remaining portfolio, being the premiums that remain due (which, often, are increasing) and all fees. So, the proceeds from collected death benefits 'disappear' as time goes on[4]. Cash from collected death benefits over cost is not sufficient to repay at least the initial investment, it leads to a partial loss of the invested capital for

[2] The accuracy of LE is measured using the actual/ expected ratio ('A/E ratio') or the Difference in Temporary Life Expectancy ('DTLE'). The A/E, and if available the DTLE, should be included on every fact sheet and in every presentation. Though, A/E and DTLE are difficult to understand and to verify/ check. Therefore, the cash-on-cash performance is the most important measure to be provided by the asset managers and the most important figure to look at and check from an investor's perspective.

[3] The purchase IRR is largely irrelevant for the final outcome of an investment under a buy-and-hold perspective. A higher purchase IRR may come with a lower average purchase price, i.e. the purchase price is USD 18 Mio in the example instead of USD 20 Mio. However, the effect of the lower purchase price is low overall. The cash-on-cash performance is decisive for a successful investment and not the purchase IRR.

[4] Life settlements are self-liquidating, there is no portfolio left (hold-to-maturity) which can be sold at the end. A policy 'disappears' from the books of a fund when it matures, and instead the cash is increased by the face amount (a swap on the active side of the balance sheet, a policy is swapped into cash). The cash, in turn, is used to meet the ongoing cost (i.e. premium payments, fees etc.). Therefore, there is nothing left on the active side of a balance sheet if the collected death benefits are 'burned' for meeting the running expenses.

investors. A total loss for the investors results if the collected death benefits do not exceed the expenses.

APPRECIATIONS AND DEPRECIATIONS

What are the sources for appreciations and depreciations?

The value of a life settlement changes over time. There are various factors which influence the value of a life settlement which feeds into the NAV curve of an investment:

- Asset-inherent appreciation: the value of a life settlement is increasing over time. This reflects the probability of a death benefit payout increases over time, which leads to an increase of the value of the life settlement. The more time that passes, the closer comes the time when the death benefit is potentially paid out (if a policy is still in force).
- Appreciations and depreciations linked to an insured person's health: a decline of an insured person's health leads to an appreciation of a respective life settlement since the respective LE shortens, and vice versa.
- Appreciations and depreciations due to market movements: the market price for life settlements is not static, but constantly changing. The link between market movements and the valuation of life settlements in a portfolio are the discount factors that are used for the discounting of cash flows.
- Appreciations and depreciations due to changed premium streams.

It is important to recognize that the cash-on-cash performance, compare the previous section, and not appreciations, are decisive for a successful investment.

- An investment needs to be profitable, i.e. the collected cash needs to exceed the cost. An investment will fail if the collected cash does not exceed the cost irrespective of the shown NAV performance or eventual appreciations.
- The NAV performance of a life settlement investment can look appealing since appreciations can lead to an upward sloped NAV curve which can attract new capital which in turn allows to purchase additional policies which can be appreciated[5], and so forth. Appreciations therefore can be the ingredient which fuels the growth of a fund since the NAV curve serves as a marketing tool, albeit a portfolio may have never been profitable from a cash-on-cash performance standpoint.

It is therefore important that asset managers report which part of the NAV performance stems from appreciations respective depreciations ('performance presentation standards'). Furthermore, it is important that appreciations respective depreciations from newly acquired inventory is reported separately.

[5] The IRR in the life settlement market vary widely. Policies are sold for IRRs as high as 20%, 30%, 40% or even higher, depending on the features of the policies, the riskiness and so forth. If a fund uses a discount factor of for instance 13% for the valuation and if it does not account properly for the features and the riskiness of the policies, it can acquire policies with IRRs greater than 13% and mark them up on the books by applying the 13% discount factor, which leads to appreciation gains and an upward sloped NAV curve, which in turn attracts new investors which allows to acquire further inventory and so forth. This mechanism can lead also to false incentives since the steady demand for policies can eventually incentivise market participants to suppress rightful auctions and thus sellers not receiving a fair price for their policies.

GAINS AND LOSSES FROM TRADING

Gains and losses from trading

In almost every asset class, asset managers can pursue trading strategies. The measure for such funds is the turnover ratio. The turnover ratio refers to finalized trades, i.e. the percentage of assets that has been replaced on the balance sheet over a given time period. The purchase of inventory onto the balance sheet does not qualify as 'trading'.

Trading can lead to gains or losses, being the difference between purchase price and sell price of the traded assets. It is only realized gains or losses on the finalized trades that should be treated as gains or losses for the calculation of the NAV.

- The activation of unrealized gains/ losses can offer false incentives to asset managers. The activation of unrealized gains can lead to an upward sloped NAV curve of a fund which in turn attracts new investors which allows the purchase of additional inventory on which unrealized gains can be activated, and so forth.
- Asset managers can earn management fees and incentive fees on the unrealized gains.

Life settlement funds pursuing a trading strategy should report the turnover ratio on the fund fact sheet and in marketing material. Furthermore, trading funds should report in a transparent way about the realized gains and losses from trading.

SUMMARY

Summing up and conclusions

The performance of a Life Settlement portfolio stems from three sources: the cash-on-cash performance, changes of the value of life settlements on the books and trading.

The most important source of performance under a buy-and-hold view is the cash-on-cash performance. Just a positive balance from inflows and outflows allows a repayment of the initial investment and, ultimately, a positive performance. Thus, **the cash-on-cash performance is the most important information from an investor's perspective, and at the same time it is the most reliable measure whether an asset manager is in fact able to repay the initial investment and to generate value for the investors**.

Appreciations and depreciations occur as with every asset. However, under a buy-and-hold view an investment can become a partial or total loss irrespective of the valuation if the portfolio does not provide significant positive cash flows. Furthermore, the valuation can be 'influenced' by the asset manager. Therefore, the **contribution of the valuation to the NAV performance should be looked at separately by investors**.

Trading is a separate source of income. Just realized profits from trading should be considered in the NAV. And the **performance contribution from trading activities should be looked at separately from other sources of performance**.

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