An alternative investment?

US life assurance policies are uncorrelated with bonds, deposits, equities, commodities and crashing property values, and a good choice of investment, says Thomas Dickson

It's becoming more popular for dental clients with disposable cash to invest, to consider alternative investments in a market where even banks don't seem safe.

A model investment portfolio typically includes a variety of equities, securities, bonds, deposit accounts, and gilts (Government-backed investments that were once gilt-edged, hence the name), as well as in some cases, property and commodities. This spread provides a reasonable amount of diversification. However, for any investors reading this, you'll most probably have found that your entire portfolio has fallen in the last few months, and your diversification strategy to avoid your entire portfolio falling has probably not worked as well as you would have liked it to.

US life settlement policies

Since the mid-1990s, we have noted growth in the market for traded US life settlement (life assurance) policies. In Germany and the US, there already exists a thriving traded life settlement policy market, similar in many respects to the traded endowment policy (TEP) market in the UK.

One of the plans we've researched that takes advantage of this market, is Keydata's Defined Income Plan which aims (but does not guarantee) to provide a full return of the initial capital invested at the end of the initial period. With headline yields of 8.25 per cent a year over 10 years, eight per cent over seven years and 7.75 per cent over five years, the investment has obvious appeal for investors seeking an attractive income over the medium term.

You can invest in this asset class through your ISA, as well as in pension arrangements, such as self-invested personal pensions (SIPPs) or directly in unit trusts.

Product structure

The Keydata plan invests in cash and a portfolio of traded US life assurance policies. The cash is used to maintain premium payments on the acquired policies and to pay income to investors. In addition, the insurance companies that issue the traded life settlement policies pay out a lump sum at maturity – that is, when the original life assured dies.

US life settlement policies are quite different from their UK equivalent. In most cases, these are effectively lifetime policies (US universal life contracts are written to age 100) and, therefore, there is a guaranteed payout on death. In the UK, life assurance is generally a fixed term product, with the exception of whole of life policies. The secondary market in US policies developed when it became apparent that many policyholders experienced a trigger event – retirement, for example, or a change in estate planning requirements – that made the protection policy redundant and a cash lump sum preferable. Before the development of the secondary market, the policyholder in this position had no alternative than to accept a surrender value from the issuer.

It is essential to appreciate that the life settlement secondary market is distinct from the earlier viatical settlement market, in which policies of the terminally ill (AIDS victims, for example) were purchased, based on what proved to be flawed mortality assumptions. Life settlement polici-
cies are generally purchased where the lives assured have an expected mortality of between about two and 12 years and where the original policyholder is aged at least 65.

Importantly, the plan allocates about 80 per cent of the portfolio to policies where the life assured is aged 75 or over. This significantly increases the prospect of policies maturing within the term of the Plan, and hence the prospect of a higher yield or growth than is associated with standard portfolios.

The US life assurance policies generally mature on the death of the life assured and so there is an element of uncertainty over mortality assumptions, although Keydata mitigates this risk through its high weighting towards older policyholders in the Plan portfolio. The portfolio construction process

The underlying portfolio aims to contain an appropriate number of policies to create a robust risk pool. The selection of policies, therefore, is based on:

• Diversification across policyholders by age, health, and by region and across issuing insurance companies.
• A minimum policyholder life expectancy of two years which avoids the distressed sales associated with the viatical market and avoids 'contestability' issues on early death, which in the US can arise if the death occurs within two years of the policy being taken out.
• A high portfolio weighting to older policyholders.

Conclusion

The secondary market in life settlement contracts provides a new asset class for UK private investors, which helps to diversify their portfolio. There is a low correlation with traditional income-yielding assets such as bonds, gilts and deposits, and also a low correlation with growth assets, such as equities and property.

How much of your portfolio should be allocated to this new asset class is really decided in a financial review with your IFA, but the institutional market’s rule of thumb is that a five per cent weighting is required for genuine diversification.

It is as applicable to the more adventurous investors with private equity and commodities in the portfolio mix, as it is to those with a more traditional spread of equity and bond funds.

For growth investors, a carefully constructed portfolio would seem to be far less volatile than stockmarket investments. Of course, for both groups there is the inherent risk that medical advances, as yet unknown, could prolong the lives of the original policyholders, while a change in US legislation and regulation could also affect the value of the policies.

However, as the funds are weighted towards the traded policies of the 75-year-old+ market, they would seem to be well immunised against any unforeseen change. Finally, while the investment offers private investors a transparent vehicle and the opportunity to diversify risk with an investment that has a low correlation with traditional markets, it is important to appreciate that the Plan is designed to be held to maturity — that is, either five, seven or 10 years depending on the option chosen. Investors who encash their holding before maturity may get back less than the original investment.

NOTE: The figures in this article are for guidance only and reflect the position at the time of writing. The value of investments can go down in value as well as up. It is therefore important that you understand the risks and commitments.

About the author

Thomas Dickson, director of Essential Money Limited, formerly a partner of Money4Dentists, has a wealth of experience in advising the dental industry. Beginning as a financial advisor, Thomas recently launched Essential Money, providing expert independent financial advice dentists throughout the UK can rely on. For a copy of the Merlin Stone report which explains the attractions, risks and ethical issues of the above investment or for further information, please contact Essential Money on 0121 685 5060 or email thomas@essentialmoney.co.uk