



Following a difficult year for the life settlements market, hedge funds are once again looking to benefit from the promise of uncorrelated returns and the pick of the best deals in a buyers' market.

BY MICHAEL S FISCHER

The life settlements (LS) marketplace is emerging from a year of turmoil. Throughout 2008, frozen credit markets and a revised upswing in longevity transformed the business from an insurance cash-cow into a buyers' market. A turnaround that may be bad news for cash-strapped global insurers, but which has refreshed hedge fund interest after period of decline.

New and returning managers have been attracted to the genuinely 'uncorrelated' nature of buying life policies. In 2009's brave new hedge fund world, where some promises of alpha have been rendered meaningless by beta results, LS is seen as a refreshing opportunity. Albeit an area that still has to be treated with kid gloves, if managers are to avoid some of the mistakes of 2007's over-inflated boom.

After a period of mistrust, "life settlements has turned out to be an extraordinary diversification tool," says Joe Lucent, president of Settlement Group in Saint Marys, Georgia. "It is uncorrelated to the rest of the investment

world. It doesn't have any ties to real estate, or to the mortgage banking business or to stocks or bonds. A life is a life, and it will not change."

The most common LS strategy involves buying the life insurance policies of aged persons whose average age is 79 to 80, with an average life expectancy of seven to eight years, according to Beat Hess, managing partner of AA-Partners in Zurich. The buyer assumes responsibility for paying monthly premiums on the policy and, at the death of the original policyholder, eventually collects the death benefit.

Sellers may be financially troubled people who need to raise capital or can no longer afford monthly premium payments, or they could be companies that took out policies for a departed key employee. The alternative to LS sales for many sellers is to surrender the policy to the carrier for the cash value, which by one estimate can be 80% less than a LS sale.

A bid-and-offer process goes on in the LS marketplace. "Because there is a lot less money in the market today to buy, you can be choosy and pay a lot less," says Lucent. "I would call it, over the last 12 months and even today, a buyers' market."

Some money is returning, but Lucent doesn't expect the market to reach its 2007 high for a couple of years. He says 2007 saw an unsustainable bubble generated by an LS investment frenzy, as hedge funds and banks charged into

IN APRIL, CARLISLE MANAGEMENT COMPANY, which is headquartered in Luxembourg, launched two funds. Peninsula Long Term Growth is a buy-and-hold fund that was set up in Luxembourg to mitigate the effects of a recent IRS tax guidance, which classes the death benefit from a LS transaction as ordinary income, and therefore subject to a 30% withholding tax. The US tax authority's announcement in May came as a huge blow to LS funds that were set up in non-tax-treaty domiciles, such as Cayman, BVI and Isle of Man.

Those funds, which are now liable for withholding tax, are beating a retreat to Luxembourg and Ireland. "By being in Luxembourg with a transparent structure and raising capital only in countries that have a double tax treaty with the US and Luxembourg, we can mitigate the withholding tax," says Jose Garcia, Carlisle's chief executive. Garcia also wanted to offer investors a fully transparent LS fund. "Everything we do will be disclosed to the client; we're fully transparent."

The new fund also takes into account the major change in medical underwriting last year after the Society of Actuaries revised its mortality table. Life expectancy estimates went up 10% to 15% on average, causing most of the life funds portfolios in the world to be overvalued. "We have the benefit of hindsight," says Garcia; "our portfolios are using

the market without knowing much about it. "Prices dipped to, in many cases, 10% and below," he says. "By that I mean, if you're putting together a financial model, the buy, the discount rate I saw was a low of 8.5%; 9% and 10% was not that uncommon. Today, 14% and 15% is more common."

By 2008, the initial charge had become a trickle. Hedge funds were having difficulty getting new capital to go in, says Scott Hawkins, an analyst at Conning Research in Hartford, Connecticut. As well, some funds were unable to cover premium payments, resulting in distressed portfolio sales. Other hedge fund managers that had lives in a broader portfolios needed to liquidate LS portfolios in order to meet redemption requests from investors who had

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All this has led to the development of a tertiary market for LS policies. "What you've seen is several funders, hedge funds among them, coming in offering to pay the premiums in return for a percentage of the death benefits," says David Rawson-Mackenzie, managing director of Centurion Fund Managers in London. "The investment opportunities today are in the tertiary market."

ANOTHER TREND IN THE LS SECTOR is the development of synthetic products by various investment banks. These financial contracts can be set up in two ways, according to Hawkins, based either on a large group of lives or in a more tailored approach, on specific individuals' life expectancy. The contract holder pays the contract issuer premiums and receives a death benefit when an agreed-on

only up-to-date underwriting."

In addition, the fund stays abreast of rapidly evolving valuation tools. "Back in 2000, we were pricing life settlements with old bond valuation effective yield models; today we use probabilistic, stochastic and stress testing before we buy a policy. Funds created five or six years ago are still using those valuation systems, and they can't change them because the NAV would implode. We wanted to launch a fund that utilised all the new valuation systems."

Garcia says that, to this point, there has not been an open-end fund that has marked to market. "They've all been very good at marking to model, they've all been good at quoting specific deterministic values. "We decided to get real market data on a quarterly basis and actually write our assets up or down according to market changes," he says.

Carlisle's other new product, Peninsula Opportunistic, is an actively traded strategy fund that invests in LS market risk. It buys policies, one at a time, and aggregates them in small portfolios with a face values of \$20m to \$30m. It then resells the portfolios and makes a spread on the trade. "It's an actively traded fund, not for everybody, but something that's an interesting process put together to take advantage of market conditions," says Garcia.

event takes place.

"For the funds that do incorporate synthetics, it allows them to smooth out their portfolio," says Hawkins.

Centurion Fund Managers has already begun combining physical LS policies in its portfolio with synthetic products. "If you look in your portfolio and see that you need, say, more bodies of a certain age with a certain life expectancy and need more of a certain insurer, you can actually structure exactly what you want," says Rawson Mackenzie. "The investment banks are making sort of simplistic notes whose returns are linked to longevity. We're using the investment banks to give us a customised note because we're trying to optimise our physical portfolio."

Frustrated by the lack of an industry benchmark, at the end of last year, AA-Partners launched an index of equally weighted open-end funds that follow a strategy in the LS area. Hess says the response to the index was very positive, and many people asked for an investment product that would replicate the current index one-to-one. But interestingly, only two-thirds of the 19 non-US domiciled funds in the index offer transparency, while one-third provide just enough information to satisfy the inclusion criteria, says Hess.

Now, to meet investor demand, AA-Partners plans to bring out a transparency index to use as the universe of funds for an index fund. "We consider transparency absolutely essential," says Hess.

The fund, which Hess expects to roll out in November, will be calculated such that the most conservatively valued funds will have the largest weight in the index fund. This is overseen by the asset manager, and AA-Partners will act as advisor to that product.

With more funds on the horizon, and earlier problems ironed out, the only snag remains that most commentators believe the buyers' market is already petering out. "I'm seeing it ease up even as we speak," says Lucent.

Hess agrees, describing an uplift in competition that is already driving prices up. "Since the beginning of the year, for each policy that's on the market we see two or three bids at least." ■