Where is the Smart Money in Life Settlement Investing? –

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What the Life Settlements industry has taught us about the Value of Data.

As the industry's top fund managers grapple with a changing regulatory landscape that is ratcheting up costs, one factor remains; no one can seem to agree on what valuations make the most sense for life settlement products.

The disparity in answers and opinions has left a large rift in the life settlement community split between funds that value assets, based on publically available data, versus traditional black-box approaches. As US and European life settlement funds continue to grow, institutional investors are seeking new opportunities and more answers as to which valuations make the most sense.
Every fund shares a common characteristic; there is a calculation that determines how mortality will affect the pricing and valuation of the assets. The truth is, if you put several fund managers in a room and ask them to present their valuation system, I am sure each will make a compelling argument as to why their valuation system works, complete with a dizzying array of charts and graphs.

The smart money investor needs to review the track record of the industry and examine the evolution not only of valuation systems, but also the data that is available to market participants. If one was to review the trajectory that this industry has followed, one can deduce several important factors that would lead us to believe that the closer we get to true market pricing, the better we are.

Viatical Settlements: A Lesson Learned

Policies with short life expectancies, otherwise known as viatical settlements, launched the life settlement industry in the early 1990's. These life expectancies relied heavily on human input. Most of these files involve strong medical impairments where data is scarcely or very recently available, therefore, creating unique challenges for the underwriting process. Often, the health impairments are so acute that the medical records rely largely on the guesswork of doctors, measured in days or months.

These policies were and continue to be much more susceptible to human error based on medical opinions. As a group, viatical settlements were aberrational medical cases with little data that would relate them to one another, unlike those of the current life settlement market. The reading of medical case histories would be based, in large part, on opinions and estimates and not backed up by substantial empirical data.

Much like the fund managers, if you place several doctors in a room and asked for their evaluation of a particular viatical settlement's medical records, they would likely come back with extremely varying results.

Furthermore, many funds also touted internal and proprietary medical reviews. Performing medical underwriting, post independent mortality projections, decreases the process' transparency and yet again increases potential human error.

Investors that were left hurting from viatical settlement investments were a casualty of over-zealous pitch by salesmen as much as they were a result of the lack of industry data and analytics that could have helped the fund managers identify risks and trends.

In addition to the pitfalls of underwriting viatical settlements, there is the issue of liquidity. There are but only a couple of buyers in the market for policies with very short life expectancies. Thanks to the institutional market, however, the number of tertiary volume in the 'Life Settlement' industry was substantially greater than that of the secondary volume. This clearly indicates that the life settlement's marketplace is indeed evolving into a market with liquidity. Many fund managers would agree that in order to achieve liquidity in an efficient way and effectuate more and more transactions in the tertiary market, a mark to market valuation methodology is key.

Looking back to that early slice of our industry, most companies investing in viatical settlements were not very successful.

How Fund Managers Benefit from Mark to Market Valuations

Nobody can predict the future, but the amount of raw data that has been assembled in the last decade by life settlement expectancy firms and independent third parties is staggering. Mortality tables, though criticized, compiled data for over hundreds of years on millions of real mortality events.

Tables like the Carlisle Table (with data starting in 1779) have been used solely for the purpose of calculating and estimating mortality and have offered data that is unbiased by medical opinions.

Fund managers as well as investors can receive significant data as to life settlement market yields. The AAP Life Settlement Market Review actively reports market data of up to ten independent life settlement providers actively buying and selling policies in the life settlement marketplace. This system is growing, improving and providing the market with an independent view of market transaction yields. Which brings us to today; as the life settlement market continues to evolve its participants cannot be appeased with archaic valuation systems that are no longer viable. Market changes cannot be ignored, particularly by investment managers' whose vehicles offer liquidity.

Mark to model valuation systems turn a blind eye to market forces and cannot answer the question that each fund manager should ask; can we sell our life settlement portfolio to the market for the valuation that we are reporting to our investors? If the answer is "no," or "I don't know," or "I think so," then we as fund managers need to evolve as well. Ignoring market forces while reporting fair market values to investors is not only wrong but simply irresponsible. The ingredients for a good mark to market valuation system are now available. We have mortality tables which include hundreds of years of mortality data (not exactly youth), and central reporting mechanisms where fund managers can obtain transactional data. Using mark to market valuation systems must be the market standard and those who do not evolve with the industry will simply become another lesson in the industry's history.

The life settlement landscape has expanded dramatically since its inception two decades ago, as has the data available for fund managers to analyze. The transparency of life expectancy information is so powerful in fact that the industry is poised to revolutionize how investors access this market space.

It was President Ronald Reagan who said, "Admittedly, there is a risk in any course we follow other than this, but every lesson in history tells us that the greater risk lies in appeasement," and we as fund managers cannot be appeased, we must continue evolving.