Houston AAII - Retirement SIG

Life Settlements

Presented by John Swallow of Laureola Investments
Introduced by Rohit Millstein

August 13, 2020

Our Retirement SIG

- Participate, participate, participate
- We will continue SIG meetings on the 2nd Thursday of the month
- Walter's presentation – on the impact of costs is available on our chapter page
- We're all doing things – let's share them
  - Write us at aaiichapter_Houston@yahoo.com

My Life Settlements Experience Thus Far

- Invested in Life Settlements last year
  - Sought a truly non-correlated asset
  - Sought a decent, reliable return
    - i.e. an income asset in an income-less world
- Return for 2019 – 7.14%
- YTD 2020 – 4.24% (through June)
- Result: LS was 7.6% of my portfolio when I invested; it's now 8.8%
  - And that's before I added to it on July 1

Disclaimer

Many of you know I am a Registered Investment Advisor Representative of Millstein Advisors, LLC, a Registered Investment Advisor.

I share with you my experience with Laureola as an investor, a lifetime member of AAII, not as an advisor.

The investment is working for me as part of my personal portfolio. It is up to you whether you think it will improve your portfolio

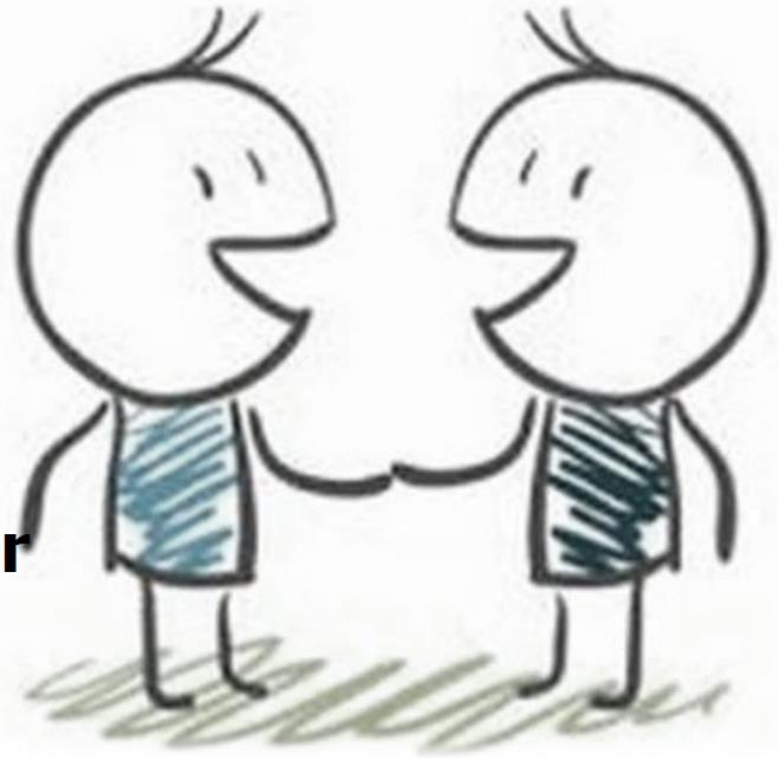
LAUREOLA ADVISORS

Life Settlements

An attractive asset class,
un-correlated to financial markets

What are Life Settlements

The Sale in the USA of a Life Insurance Policy to a 3rd Party.



Legal

Highly Regulated

Both buyer and seller profit

Is this socially responsible investing?

- 90% of Americans do not have savings sufficient to pay their living costs for more than 2 months
- What about health insurance costs, especially in retirement?
- 1/3rd of Americans couldn't pay their housing costs in June 2020
- Right now there are 16m unemployed in the US
- For many Americans a life assurance policy which is no longer needed for the purpose it was originally intended is an asset which can be monetised to meet these needs
- Many seniors cannot afford higher premium costs associated with universal life policies
- Insurance carriers may offer $x if the insured wants to surrender the policy.
- The investor market will often pay 4, 5 or 6 times $x to the insured.
- The insureds are willing sellers and the sale of their policy provides much-needed liquidity.

A Repeatable and Sustainable Investment Thesis

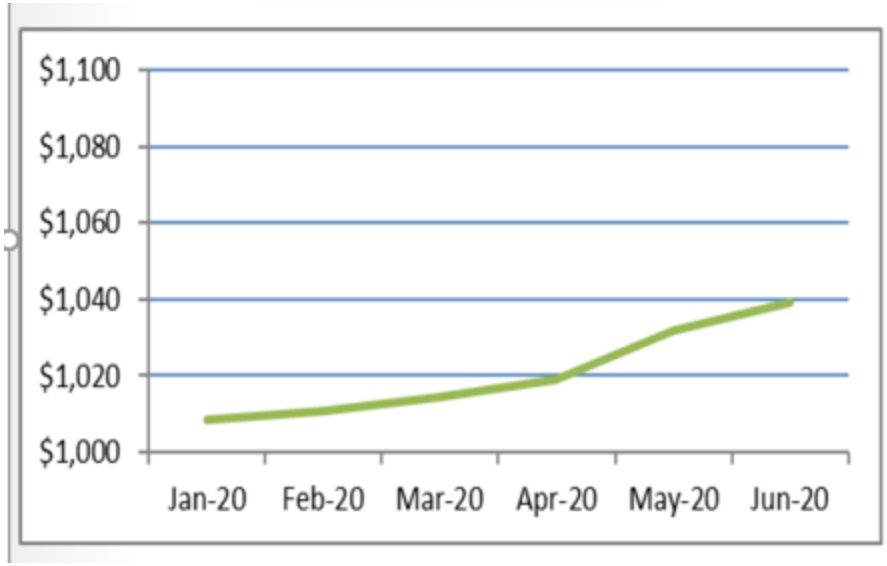
- We buy a policy today with a projected net return of (e.g.) 10%
- The insured dies in 5 years
- We reinvest the money into a policy with a projected net return of 10%
- Etc

- It's not how the stock market works

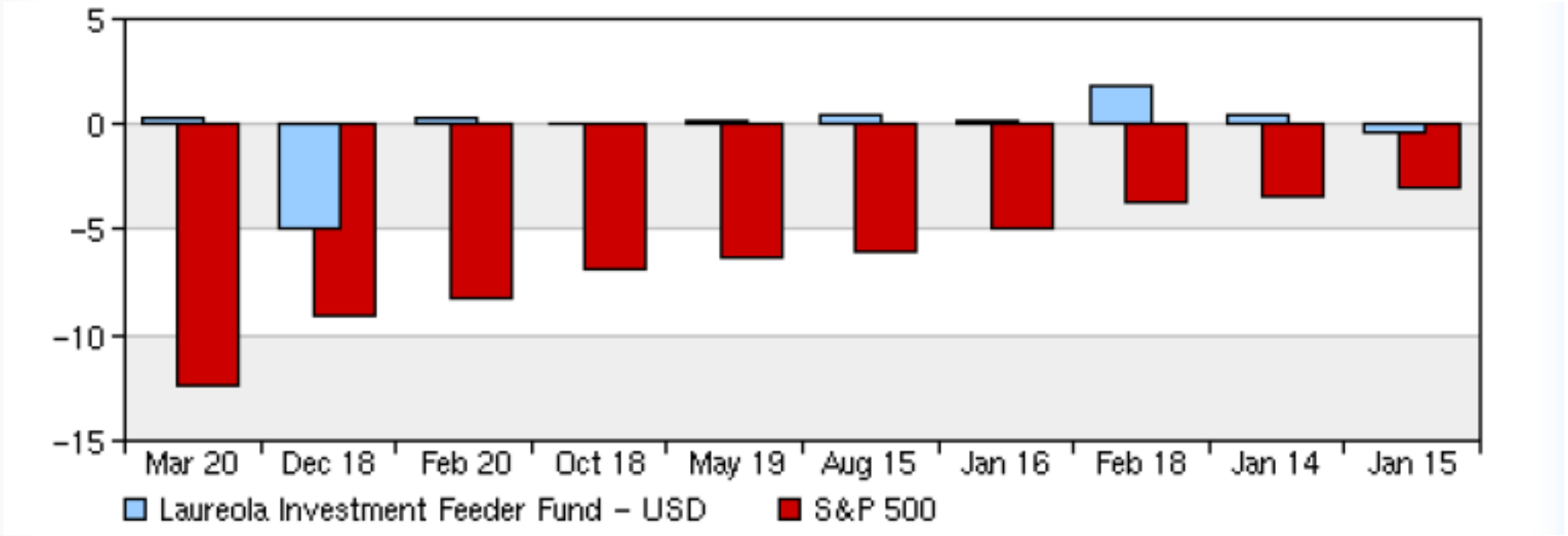
Non-correlation in H1 2020

S&P 500

Laureola Fund



The worst 10 months for the S&P 500 (to June 2020)



** Data for the Laureola Fund*

The Tortoise vs the Hare!

Period	Laureola Fund	S&P 500
Ytd *	3.90%	-4.00%
1 year	9.60%	5.40%
3 years	30.40%	27.90%

** Performance to 30 June 2020*

Life settlements can give equity-like returns
with fixed-income characteristics

What does the Life Settlement market look like?

Secondary Market Structure

- $20.4 trillion of life insurance in force in the US
- 90% of policies lapse without payment of the death benefit
- $1.2 trillion lapses every year
- $600 billion lapsed by Seniors annually
- <$2bn is sold annually to the investor market
- Life Settlements are quietly encouraged by Government Regulation on Medicare eligibility
- 20%+ year on year growth in the supply of new policies
- Policies are sold one by one

Tertiary Market Structure

- Policies typically sold in blocks by one investor to another
- $15bn to $20bn market size (estimated)

Only 0.1% has come into the Life Settlement Markets in the history of the asset class

Life Settlement Market Structure

Secondary Market

	3 months	12 months
Number of policies	**117**	**542**
Total Face Value ($m)	**121.6**	**686.7**
Average Face Value ($m)	**1.0**	**1.3**
Average Age	**74.3**	**77.5**

Tertiary Market

	3 months	12 months
Number of policies	**150**	**757**
Total Face Value ($m)	**340.1**	**2014.7**
Average Face Value ($m)	**2.3**	**2.7**
Average Age	**82.6**	**83.4**

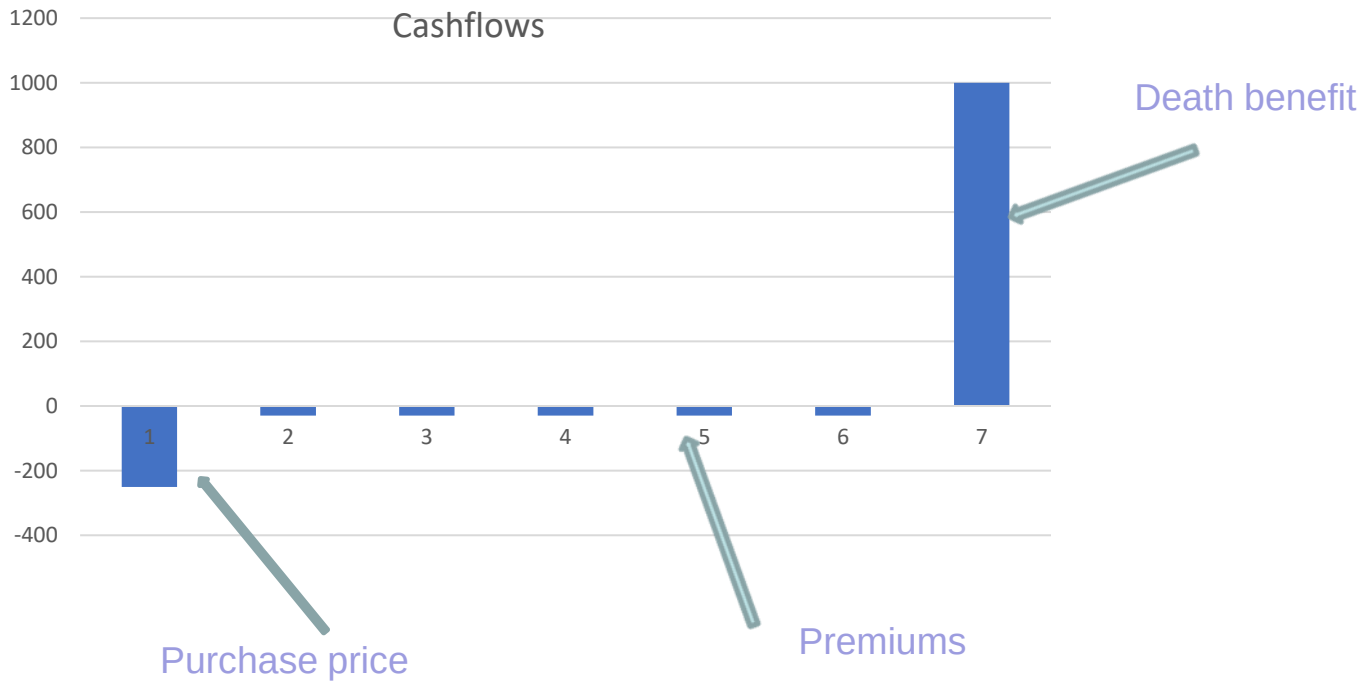
**Figures from AA Partners for 2018*

Conclusions?

The Life Settlement Market is tiny!

Understanding a negative cashflow asset?

Life settlement is a negative cash flow asset



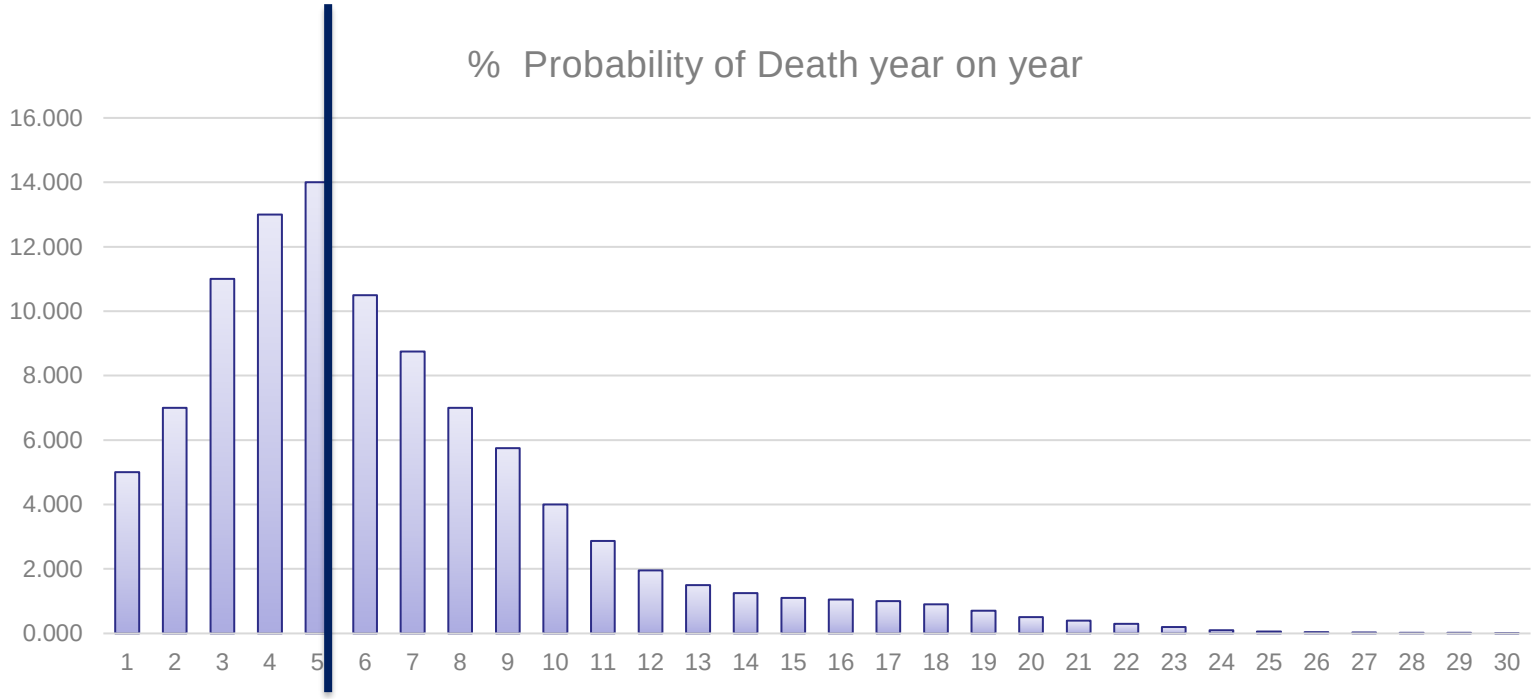
How are policies priced for sale?

Price is calculated on discounted cash flows,
i.e. premiums to be paid and death benefit to be received.

Metrics for calculating the price are

- Final payment (death benefit) which is fixed and certain
- Premium payments (the values of which are largely known or can be reasonably estimated)
- The time before receipt of the death benefit and the number (and therefore amount) of premiums to be paid, but…. **LIFE EXPECTANCY IS UNKNOWN!** Investors rely upon Life Expectancies (LEs) provided by (typically) two of the six actuarial firms that service this industry
- The desired investment return on the purchase price and premium payments – the discount rate.
- The market trades at a ***purchase irr*** of 12% to 14% with wide dispersion around this range.

What does a 60 month Life Expectancy mean?



60 months is the mid-point (median) on a probability distribution curve

This means that out of 1,000 individuals of the same age, gender and with the same health issues, 500 are expected to die before 60 months and 500 after

A review of purchase *irrs*

The Secondary Market

Age	75	76	77	78	79	80	81	82	83	84	85	86
No of transactions	31	22	13	15	22	15	18	16	12	13	16	17
Average Face Value ($m)	2.2	1.2	0.9	1.3	1.5	1.1	1.1	1.4	2.5	0.8	0.9	1
Average LE in months	108	100	92	96	81	82	78	74	63	69	59	61
3rd quartile irr	18.8%	21.0%	16.6%	15.2%	29.6%	18.6%	35.2%	24.2%	20.2%	19.8%	18.5%	23.1%
1st quartile irr	14.2%	14.4%	12.6%	9.3%	13.5%	12.2%	17.8%	14.3%	13.0%	14.4%	12.0%	13.3%

**Figures from AA Partners for 2018*

The Tertiary Market?

Figures are not easily found but the market is tighter at around 12% to 14% (buyers and sellers are both knowledgeable)

What are the strategies?

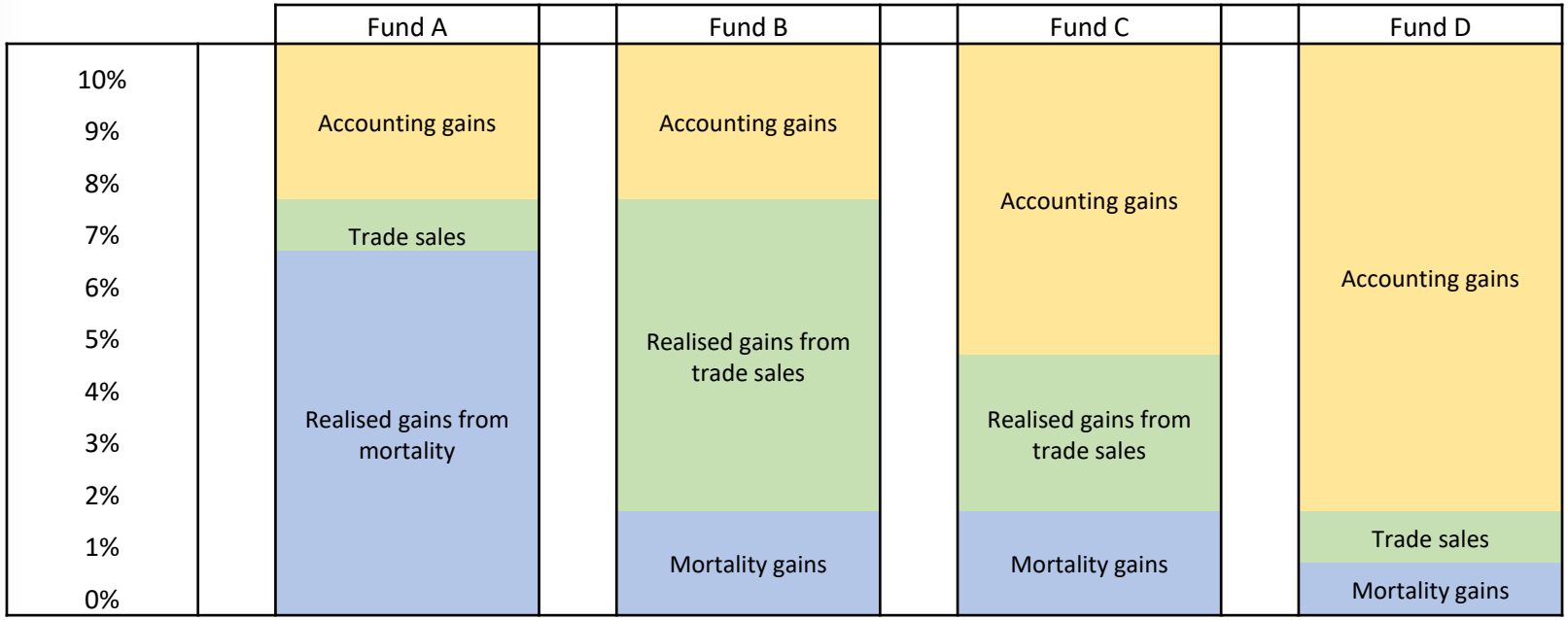
You might expect, given the nature of the asset, that the manager's focus in on making money through mortality.

And you might expect that most of the published performance was derived from mortality

You might be surprised that many make money through trading policies and/or through accounting adjustments.

Understanding published performance

A life settlement fund publishes 10% return in the year.
How is that performance attributed?



Understanding accounting gains

There will always be accounting in an open-ended fund*

The fund has to publish a price on any Dealing Date

The fund will always have policies so these need to be valued.

Purchase *irr* and valuation *irr*

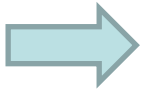
Value on the books of a $1m policy
with a 5 year LE and $30,000 annual premium

Assume the policy is bought at an *irr* of 14%, a purchase price of $353,000

Assumed discount rate	Value on the book	Valuation change with change in the valuation *irr*
16%	$312,000	-11.61%
15%	$332,000	-5.95%
14%	$353,000	0%
13%	$375,000	6.23%
12%	$399,000	13.03%
11%	$424,000	20.11%
10%	$450,000	27.48%

These are all accounting adjustments

Valuation *irr*

A 1% change in valuation *irr*  3.5% change in value on the books

So it's easy to "generate" return if you move the valuation *irr* lever.

Nobody would do that would they?...

Who decides which valuation *irr* to use?

And what if the manager charges performance fees on accounting gains?

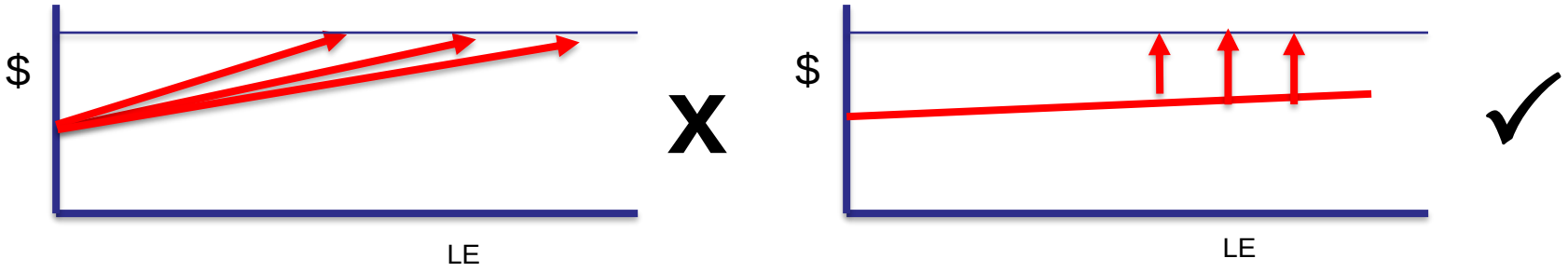
(Most managers do)

Valuing a policy over time in the portfolio

We have to pay premiums every month

We have to wait an indeterminate time to receive the death benefit

How shall we value the policy each month in the meantime?



The only way to have a policy increase in value once it is on the books and before it matures is to change the valuation *irr*

Many managers do this

Understanding trading gains

Some funds rely upon being sell a policy for more than they bought it

Problems?

- The tertiary market trades in a narrow range (12%-14%) so any “large” number of policies will get done in this range reducing the opportunity to profit.
- You can trade opportunistically for sure but as a strategy??
- You are relying upon liquidity in the market. If you are correlated with the liquidity market you will be correlated with all financial markets if there is a market dislocation – as we saw in the years following 2008
- (As an aside – this is a danger for closed end funds too which rely for a lot of their return on being able to sell off the book at the end)

Understanding mortality gains

When a policy matures we are no longer dealing with life *expectancy.* We have *certainty* and we can measure the actual performance of the asset in terms of the *irr* delivered. This can be uncomfortable!

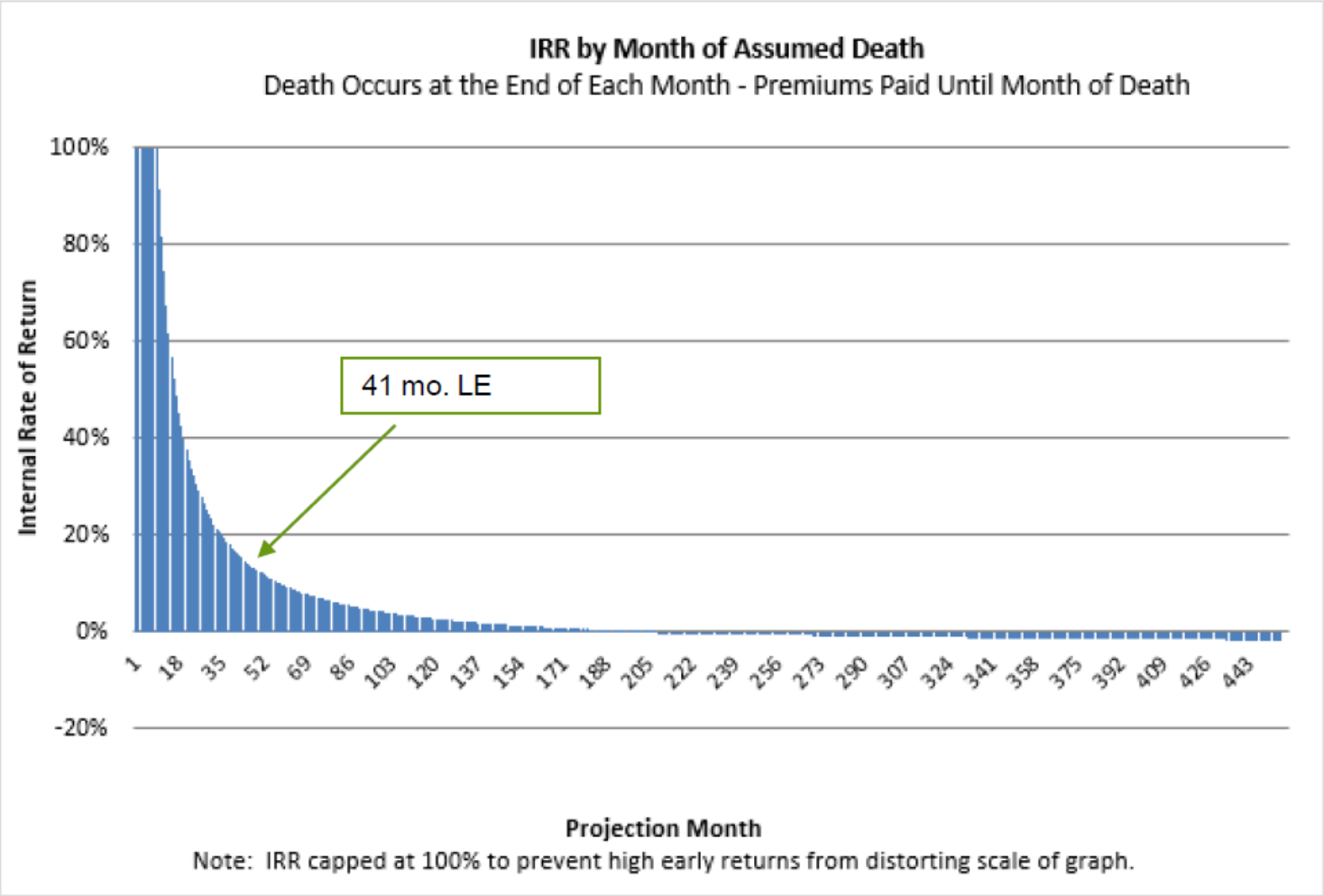
If maturity is one year later than LE…

> ***irr* actually achieved is as much as 6% to 12% per annum less than the purchase *irr***

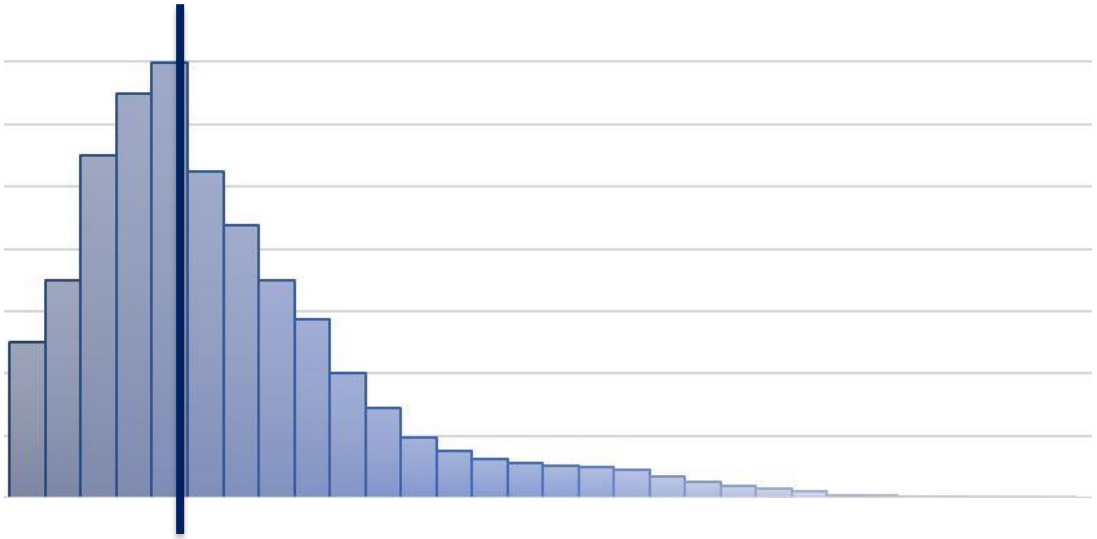
The Actual to Expected (A/E) ratio:

- If the A/E is 100%, the (gross fund returns) will be the same as the purchase *irr*

The *irr* you <u>actually</u> get



Mortality strategies:-
1. The law of Big Numbers



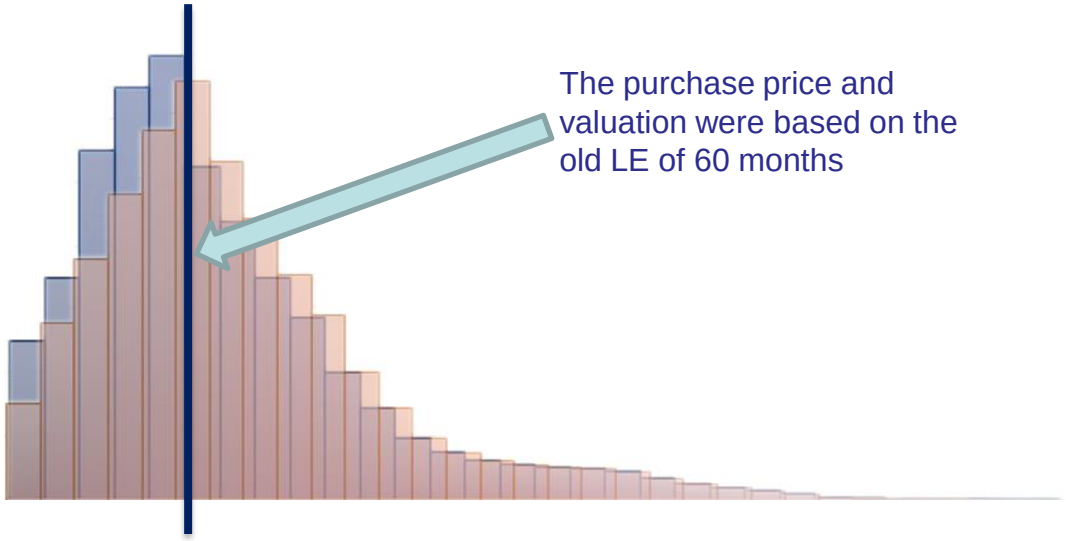
Remember this? 500 people are expected to die before 60 months and 500 after….

To get statistical “certainty” you need how many policies? … 150,.. 300,… 1,000?

Whatever the number, bearing in mind the size of the market we saw earlier, you will be forced to be a *beta* manager (12%-14% less management fees, fund costs and performance fees = 6% to 8%)

What if the Life Expectancy is wrong?

Law of big numbers

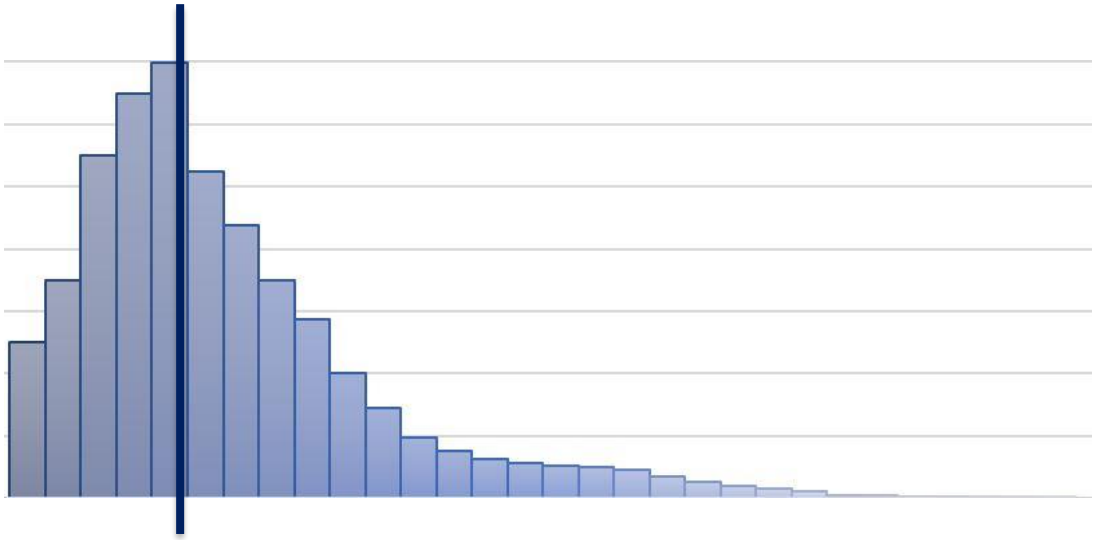


Many more will die **after** 60 months than before

If the life *expectancies* are extended by 1 year by the LE providers (as we saw in December 2028), we should expect to see a 20% reduction in value.

And as we saw earlier, if the *actual* mortality experience is 1 year later than expected, we lose between 6% and 12% of **annual** performance.

Mortality strategies:-
2. Stock picking



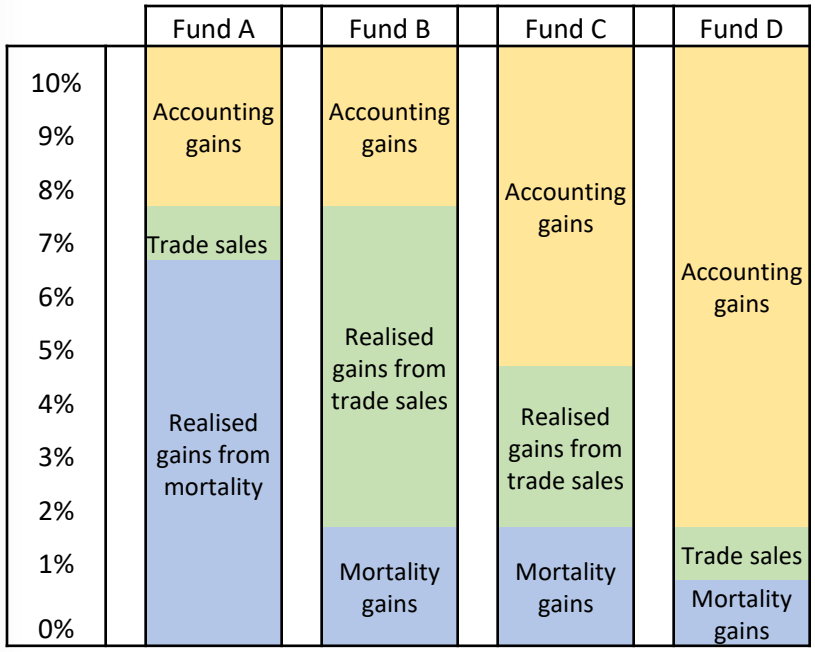
500 people are expected to die before 60 months and 500 after….

If you can weight your portfolio towards the first half of this probability distribution curve you will do well for your investors. So how can you get a better than average chance of picking an insured who will be one of the first 500?

- Understanding the strengths and weaknesses of the LE underwriters
- Picking low face value policies – the wealth effect
- Picking highly impaired lives
- Getting a better understanding of the health of **this** insured

Another look at published performance

A life settlement fund publishes 10% return in the year.
How is that performance attributed?



- Mortality gains make the fund “safe” and ensures non-correlation
- Trade sales are real dollars but rely upon being able to sell assets at the price you carry them and at the time you need to sell them – this increases correlation with liquidity markets
- What are the drivers for accounting gains?
  - Life expectancy
  - Discount rate
- What are the incentives for accounting gains?

  - **PERFORMANCE FEES!!**

What are the risks?

- There is no material credit or counterparty risk – insurance companies have not failed to pay a legitimate death benefit claim since 1864.

The principle risks in this asset class are:

- Longevity
- Liquidity
- Valuation

- What about a cure for cancer?

The effects of COVID19

Short term:

- There is no doubt that mortality has “improved” for life settlement funds (at least for those with a focus on mortality)
- The demographic of the life settlement market is insureds over 70 and often with co-morbidities – exactly the people recognised as being most at risk of succumbing to the virus.
- There is also the secondary effect for these insureds not attending hospital appointments for their existing conditions.

Long term:

We expect to see an increase in the supply of policies – pushing prices down, *irr*s up.

Conclusion

- Uncorrelated if liquidity risk is managed correctly
- The investment thesis is repeatable and sustainable
- Risks exist in some strategies more than others
- It is not enough to buy policies, traditional asset management principles and skills need to be applied
- Fixed income alternative with equity-like performance
- Beta is 6% to 8%
- Alpha is possible if the manager is small and competent!

Disclaimer

This Presentation Document is neither an offer to sell nor a solicitation of an offer to buy any securities described herein.

Finally..

Thank you for listening

Any questions?