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Bedrock investments can liberate a portfolio's capacity to take risks in a post-pandemic landscape

A message from Tony Bremness, Managing Director of Laureola Advisors Inc.

The potential of stable and uncorrelated investment returns might have led you to the life settlements asset class. The return from life settlements has historically been in the 6-12% range and can be attractive to investors seeking uncorrelated returns*.

Life settlements are resold insurance policies and can be thought of a form of financing extended to the policyholder secured by the person's life insurance policy. Life settlement transactions convert illiquid life insurance policies into cash that can be used by the policyholders while they are still alive.

The investor in life settlement (usually via a fund) then earns a return for paying the policyholder upfront and for taking up the obligations of any outstanding premiums due on the policy until maturity.

Life settlements' raison d'etre is to address a societal need for better retirement provision by giving policyholders choice. Researchers from London Business School estimated in 2013 that the value unlocked by the life settlement market for policyholders is on average about four times greater than that of the surrender value offered by insurance companies.

Despite the existence of life settlements since 1911 and its growth during the 1980s, this asset class is not widely known by investors. We hope to de-mystify life settlements by taking the reader through the following:

1. How life settlements work from the perspective of investors and policyholders

2. The investment and societal benefits of life settlements

3. Risk considerations for a life settlements investor

On a personal note, I founded Laureola Advisors to tap into the life settlements opportunity with my own portfolio. Over the last 8 years, we have built an experienced team with strong investment and administrative skillset in extracting the returns from life settlements.

Welcome to the life settlements world. We hope you find it as interesting and meaningful as we do.

Sincerely,

Tony Bremness

Managing Director
Laureola Advisors

*Past performance might not be indicative of future performance

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Who is Laureola?

Laureola Advisors Inc ("Laureola") is a boutique specialist life settlements investment manager. Its flagship fund, the Laureola Investment Fund, was launched in 2013 to extract life settlements' attractive and uncorrelated long-term returns.

Laureola is helmed by experienced managers with a combined total of over 200 years of experience in life settlements. The fund has experienced the risks of life settlements first hand and have systematically mitigated these exposures with robust investment processes built over 8 years of operation.

Laureola is one of the few vertically integrated managers – vertical integration provides the fund with tools and insights to better manage its portfolio and to settle transactions and claims efficiently. The design of the fund also promotes alignment between the manager and investors, and between investors. The investment team is also supported by a panel of medical and scientific experts who have decades of experience in their respective fields. The team's developed expertise and access to scientific medical opinion enables the fund to add alpha through security selection.

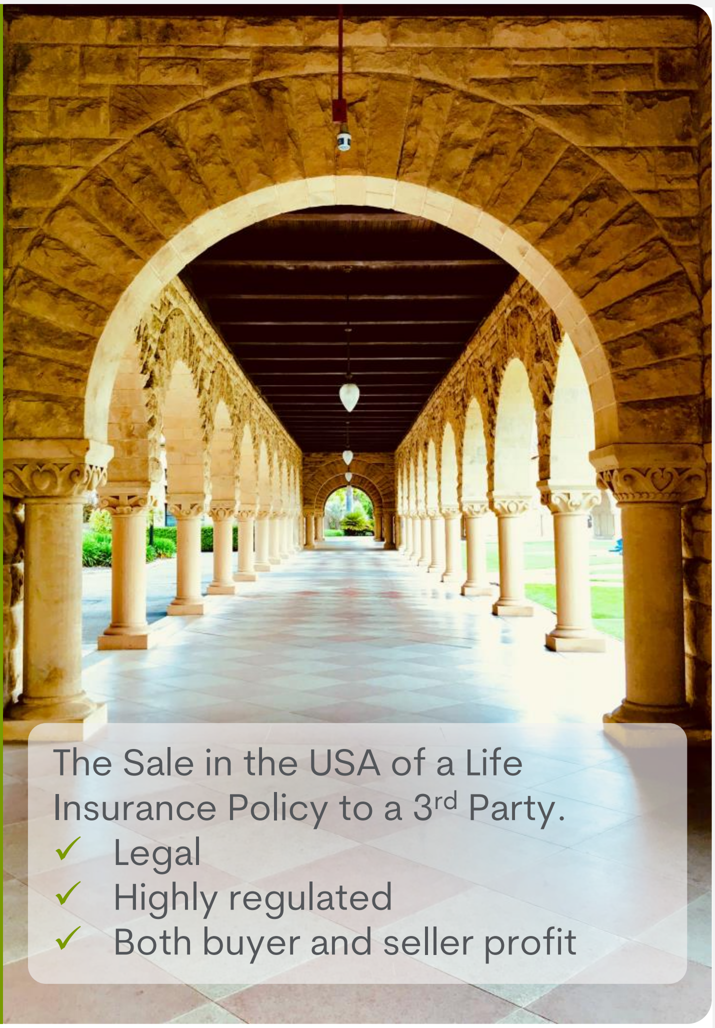
Who can invest with Laureola in Australia?

Laureola has established the Laureola Australia Feeder Fund ("Australian Feeder"). This feeder fund feeds into the same master strategy as the flagship fund. The Australian Feeder has an AUD hedged class (FX risk is hedged at cost) and an USD class.

The Australian Feeder is open to investors who are classified as wholesale investors under Australian regulations. The Responsible Entity of the Australian Feeder is Quay Fund Services Limited (AFSL No 494886).

The Australian Feeder provides the opportunity for SMSF trustees, self-directed investors, family offices and institutional investors to gain exposure to life settlements in an Australian regulatory-friendly manner.

1. What is a Life Settlements investment?



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

- ✓ Legal
- ✓ Highly regulated
- ✓ Both buyer and seller profit

Imagine having the ability to benefit from the diligent financial habits of middle America.

Like most residents of advanced countries, Americans have a tradition of establishing a life insurance policy as they start a family, take on a mortgage or build their own business. Over a period of responsible financial discipline, the children become independent, and debt is paid off. The need for insurance cover diminished.

Some policyholders realise that their life policy is a financial asset and would seek to cash in its value. Unfortunately, there is a low level of understanding of the options available to cash in life insurance policies. This resulted in over 90% of life policies being terminated in the US without paying a death benefit in 2018.[1]

To provide a better outcome, the life settlements market was formed to match policyholders wishing to sell their unwanted cover to investors looking for a non-correlated asset class with the potential for stable returns. A life settlement market will give policyholders additional options in obtaining a higher value of their policies.

[1] The American Council of Life Insurer's 2019 Life Insurer Fact Book.

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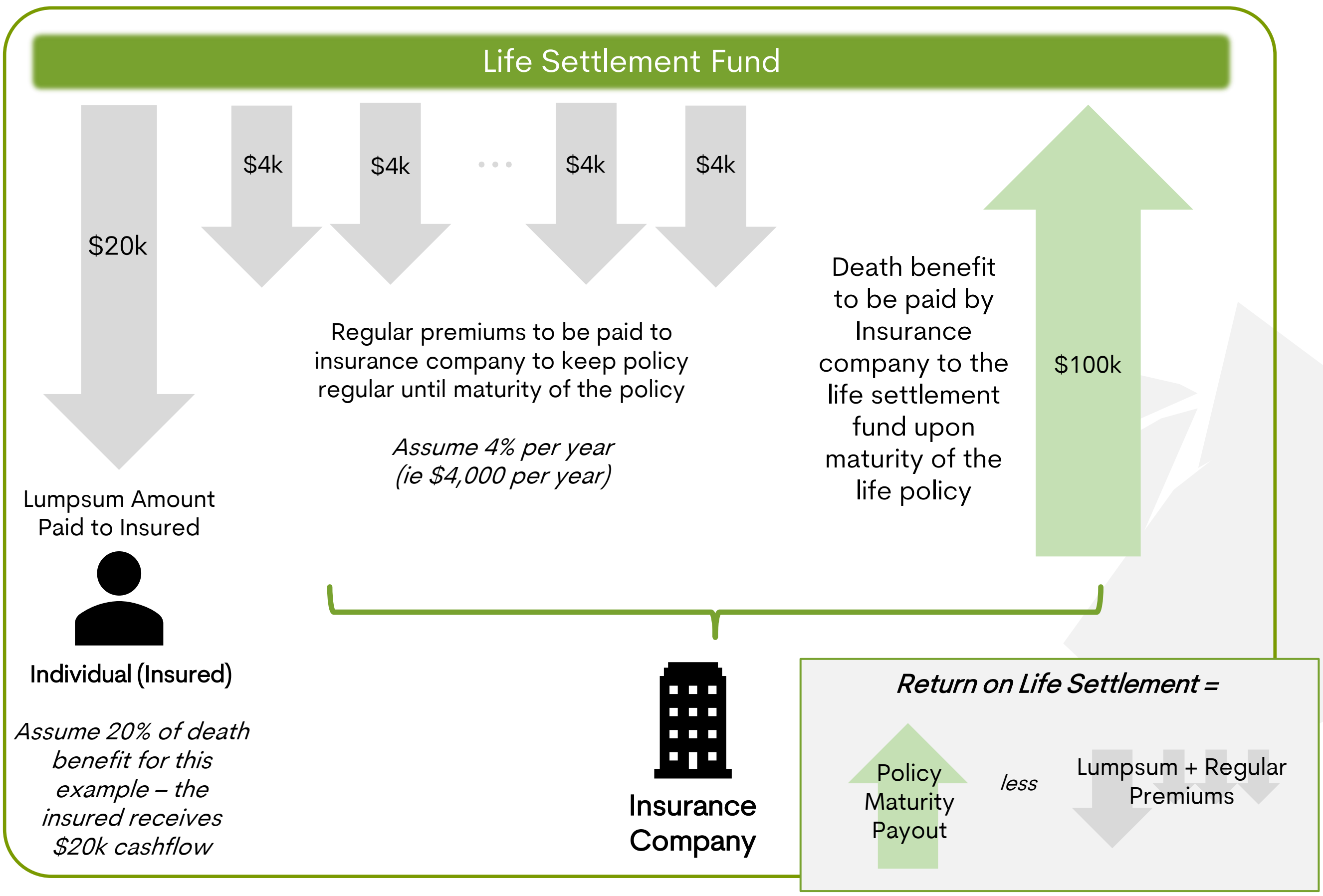
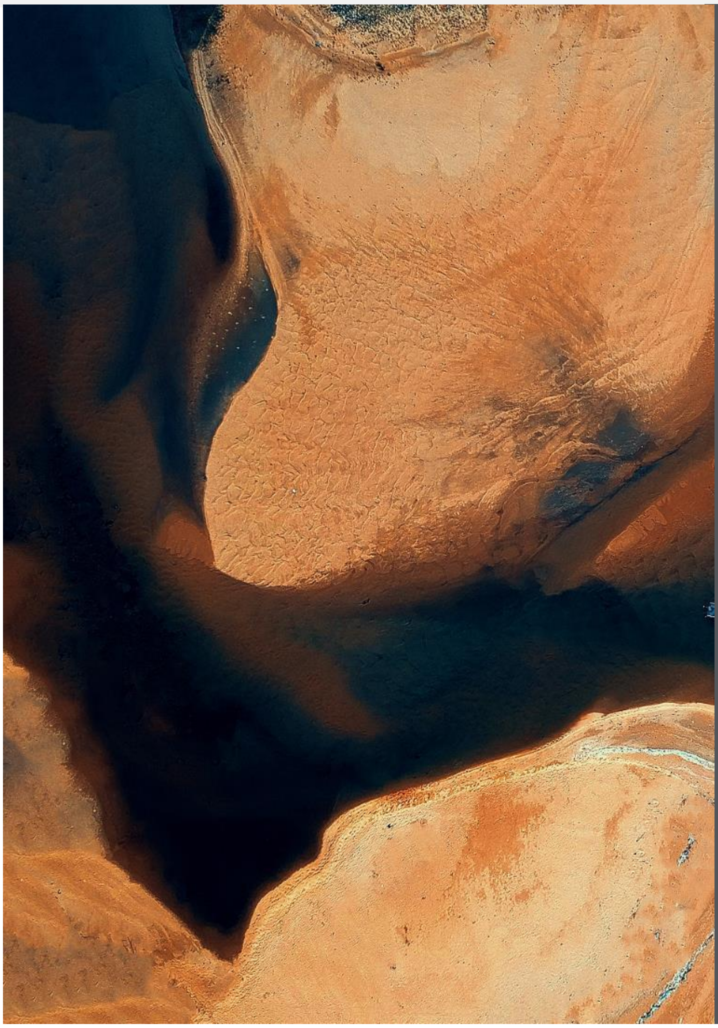
A life settlement transaction starts with a policyholder selling their life insurance policies to an investor (usually a fund). The life settlement investor buys the life insurance policy from the policyholder and commits to paying future insurance premiums until the insured person dies. The investor then collects the death benefit payout from the insurance company as the concluding repayment of the life settlement transaction. The path of an illustrative policy is shown below.

Illustrative example – assume a life settlement transaction backed by a policy with a death benefit of $100k:



Hence, a life settlement transaction can be understood as a form of financing extended to an individual secured by that person's life insurance policy. The returns to the investor are embedded in the benefit payout collected upon the maturity of the policy. Most market observers estimate a long-term range of 6-12% p.a. as potential returns going forward.



2. What are the benefits of Life Settlements for the Investor?

Investors in life settlements obtain a defensive asset that generates consistent stable returns regardless of market movements or changes in government economic policies. A 2013 study of gross projected IRR's in the life settlements market showed a range of 11.0 to 18.9% p.a. over periods of differing economic conditions.[2] More recently, the Laureola approach to Life Settlements has averaged double digit returns over the past eight years. Current research also confirms the lack of correlation between Life Settlements and other financial markets, especially during periods when traditional markets experience losses.

Such uncorrelated stable returns have attracted notable investors in life settlements such as leading US Endowment and Pension Funds (State of Michigan, Alaska Permanent Fund) and Warren Buffett's Berkshire Hathaway.

There are two common applications of life settlements in an investment portfolio –

I. as a fixed income alternative; and

II. as an uncorrelated safe asset in a portfolio.

[2] Januario, Afonso Varatojo and Naik, Narayan Y., Empirical Investigation of life settlements: The Secondary Market for Life Insurance Policies, (June 10, 2013).

I. A FIXED INCOME ALTERNATIVE–
looking beyond term deposits and bonds for fixed income

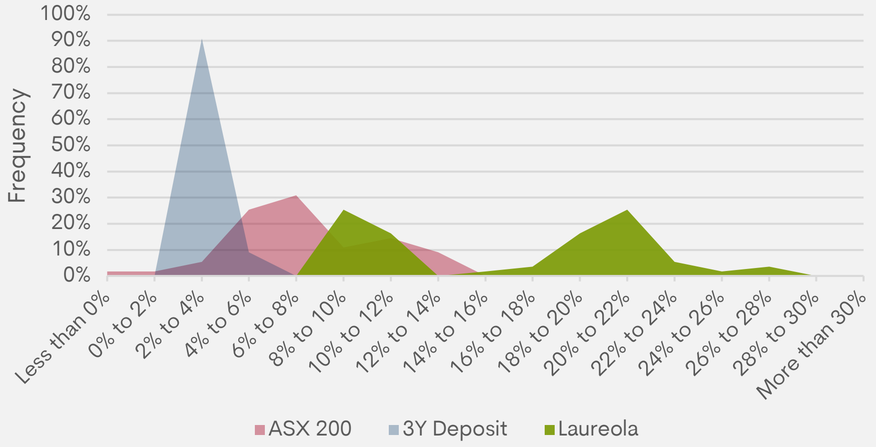
Today's fixed income investors face a real dilemma. Traditionally, bonds could be relied upon to provide capital protection with low default risk, returns greater than inflation, noncorrelation with equity markets and the economy, and, most importantly, the ability to sleep at night.

However, bonds and most fixed income instruments might be struggling to live up to their traditional strengths. Interest rates of zero are observed in most of the developed world. Current pricing of speculative high yield bonds implies investors might have to accept worse-off conditions – lower rates with higher risk of default. Credit Suisse analysts also reported that bonds might no longer offer diversification from equity risk.

This is potentially where a well-managed life settlements fund can step into the traditional role of bonds. Some policy payouts are protected by the government. The life insurance company must pay out to the policyholder when the policy matures, regardless of the state of the economy or market performance. The US life industry has paid out 100% of all unterminated policies in the last 150 years. A portfolio of life settlement investments can potentially provide meaningful returns in excess of current inflation while not being correlated to traditional markets and economic conditions. All these features combined can enable life settlements investors to sleep well at night.

In the absence of a recognised life settlements index, the following charts use the Laureola Investment Fund as a proxy for life settlements.

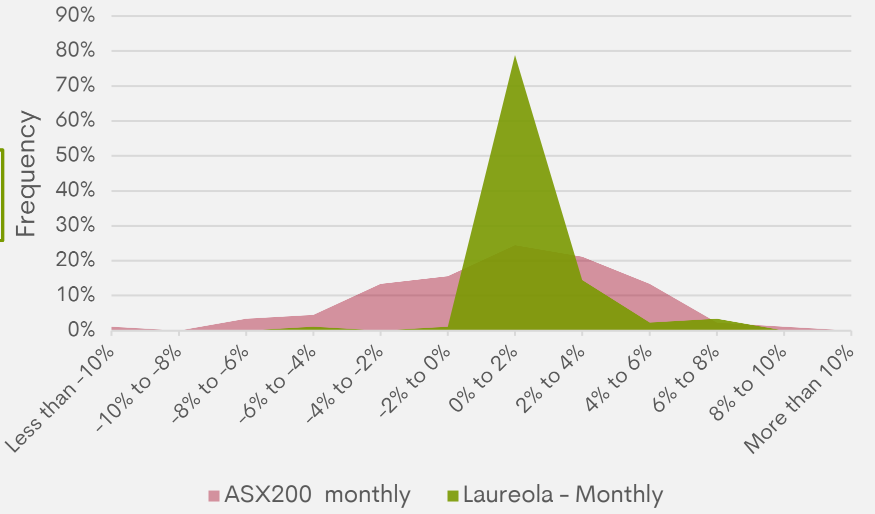
Life settlements' returns over 3-year periods (a test of consistency) often match that of equities, but with tighter dispersion of monthly returns.



Distribution of Annualised Returns over 3-year Period: May 2013 to Oct 2020

The fund's returns tend to be higher than that of the ASX200 Index and 3-year bank term deposit rates since May 2013.

This highlights the consistency of performance over a 3-year timeframe.



Distribution of Monthly Returns: May 2013 to Oct 2020

The narrow range of returns for a life settlement fund suggests returns volatility closer to that of fixed income when compared to ASX200's wide dispersion of returns.

With reference to the charts above, life settlements' returns over 3-year periods (a test of consistency) often match that of equities, but with tighter dispersion of monthly returns. The fund's returns tend to be higher than that of the ASX200 Index and 3-year bank term deposit rates since May 2013. This highlights the consistency of performance over a three-year timeframe. Stability can be measured through how widely dispersed the returns of the asset are. The narrow range of returns for a life settlement fund suggests returns volatility closer to that of fixed income when compared to ASX200's wide dispersion of returns.

Source: Laureola Advisors, Reserve Bank of Australia, Standard & Poors.
The charts use the Laureola Investment Master Fund ("Laureola") as the representative for life settlements. There is no widely used asset class benchmark available. The Laureola Investment Master Fund is denominated in USD. Performance numbers here ignore FX effects. For an investor in the AUD class of the Laureola Australia Feeder Fund, the AUDUSD exposure will be hedged at prevailing market rates which is likely to reduce annualized returns.

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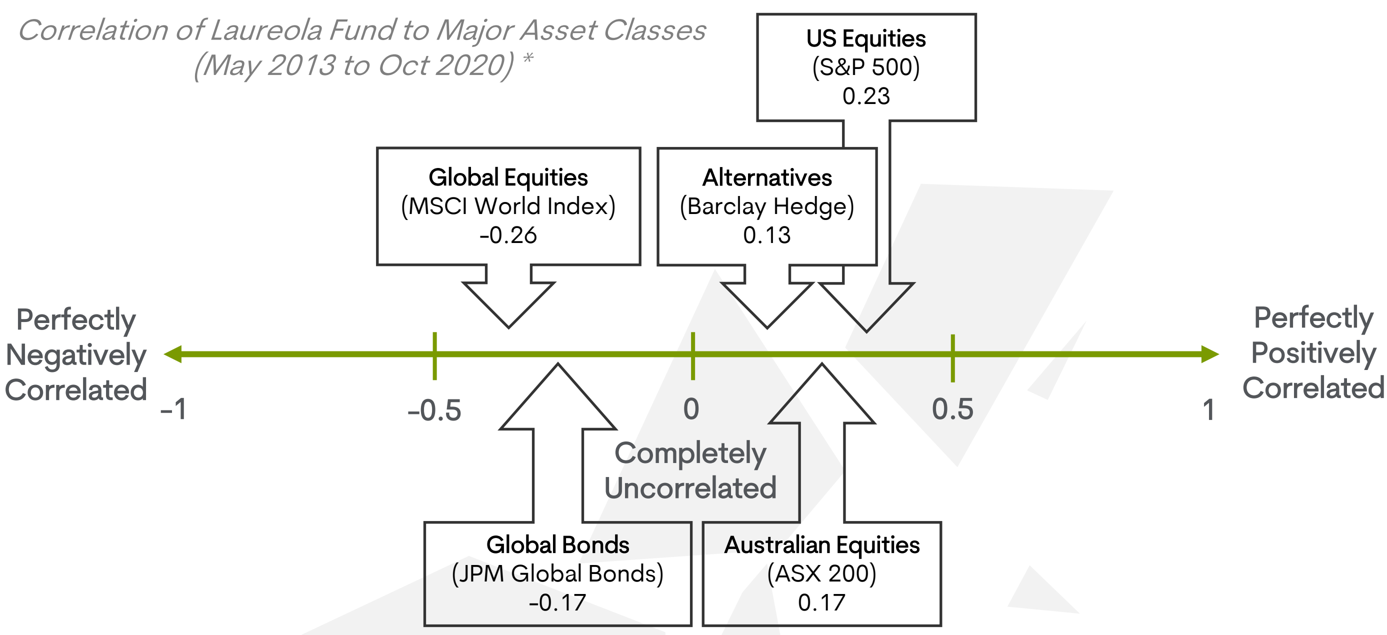
II. UNCORRELATED ASSETS–
Close to zero correlation with other investment markets

Historically, life settlements have close to zero correlation with other investment markets and that might be rare even within the fixed income arena. Many investment strategies claim to be non-correlated to equities or other popular investments. However, such strategies can decline along with the general market in a major downturn – the very outcome investors try to avoid.

Using the Laureola Investment Fund as the life settlements proxy again and with reference to the following charts, life settlements has recorded low levels of correlation with other asset classes. Of note are the low correlations to equities. In addition, the worst 10 months of ASX200 would have caused an average monthly decline of -7.0% while life settlements would have produced an average of +0.9% return

*Correlation of Laureola Fund to Major Asset Classes (May 2013 to Oct 2020) **



Life settlements sit in the sweet spot of correlations around -0.25 to 0.25 which means its returns are not linked to the performances of equities, bonds or alternatives. This independence is useful as a portfolio stabilizer during periods of poor performance in the risky assets, while not being a drag during periods of good performance.

Source: BarclayHedge, Standard & Poors.

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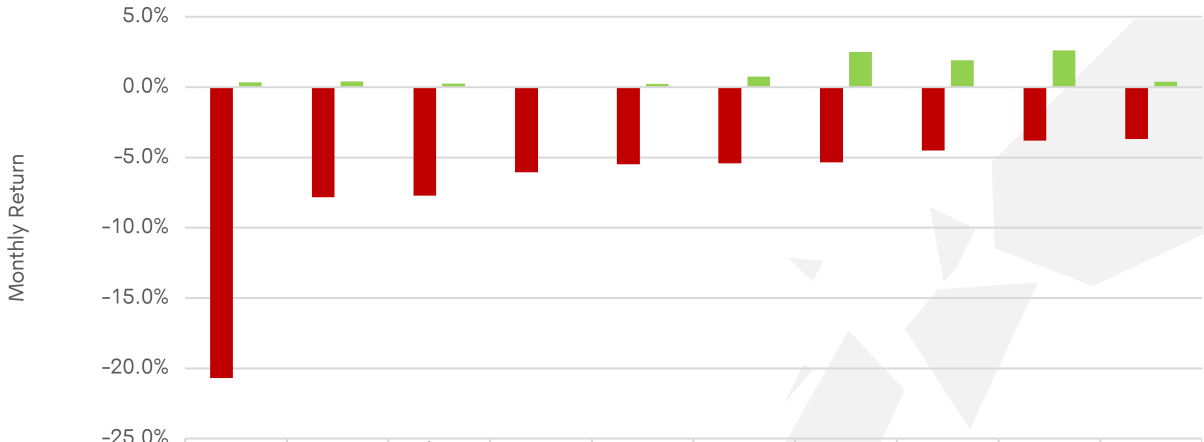
*Performance of Laureola Investment Fund vs ASX 200 in worst 10 months for ASX 200 **



	Mar-20	Aug-15	Feb-20	Oct-18	Jan-16	Sep-14	Jun-15	May-13	Mar-18	Sep-20
ASX200	-20.7%	-7.8%	-7.7%	-6.1%	-5.5%	-5.4%	-5.4%	-4.5%	-3.8%	-3.7%
Laureola	0.3%	0.4%	0.3%	0.0%	0.2%	0.8%	2.5%	1.9%	2.6%	0.4%

Worst 10 Months of ASX 200
(May 2013 to Oct 2020)

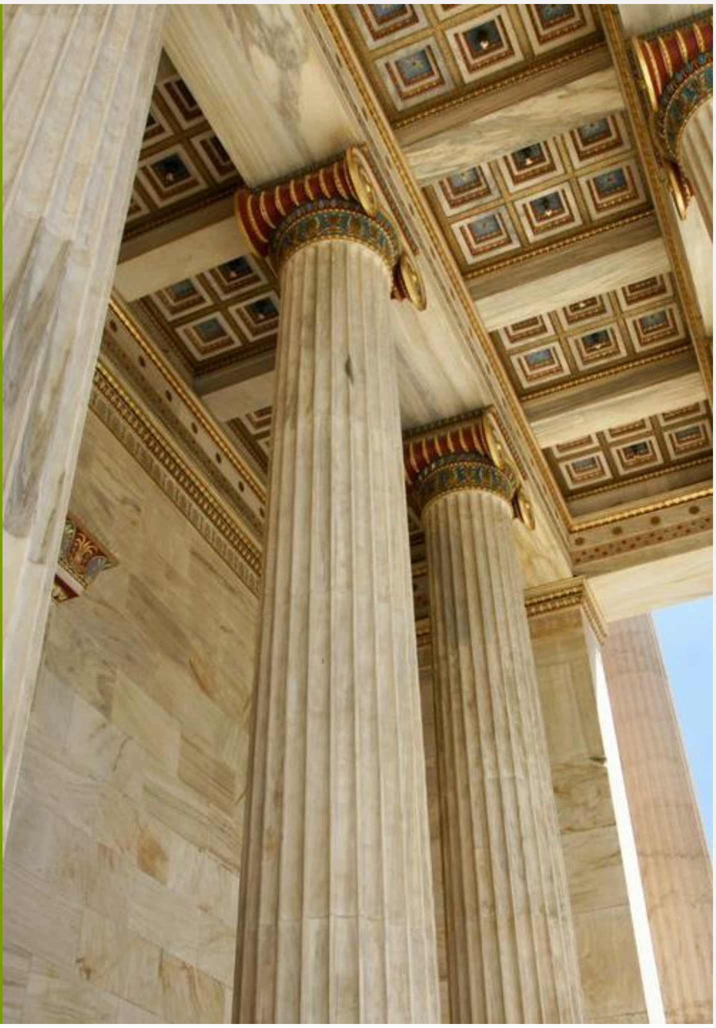
ASX200 Laureola

The life settlements sector, which can be considered a form of financing to individuals secured by that person's life insurance policy, is one of the very few assets not impacted by equity market movements. The primary reason for this non-correlation might be due to how life settlements transactions are constructed. If one follows the cashflows of a life settlements transaction, one might observe that the usual economic and financial factors such as interest rates, crude oil prices, and equity index levels do not affect life settlement returns.

This fundamental delinking potentially highlights non-correlation in practice, not just in theory. Life settlements has historically provided non-correlation when needed. It is a "sleep comfortably at night" fixed-income alternative which can potentially generate returns matching equity markets.

** The charts use the Laureola Investment Master Fund ("Laureola") as the representative for life settlements. There is no widely used asset class benchmark available. The Laureola Investment Master Fund is denominated in USD. Performance numbers here ignore FX effects. For an investor in the AUD class of the Australia Feeder Fund, the AUDUSD exposure will be hedged at prevailing market rates which is likely to reduce annualized returns.*

3. What are the benefits of life settlements for society?



Alignment with ESG principles is becoming imperative in investment management. A majority (86%) of Australians expect their super or other investments to be invested responsibly and ethically. In addition to the expectation of returns not being compromised, investors also expect these investments to have a real environmental, societal or governance impact, not just "ethics washing."

Due to slow-changing legacies, popular investments such as equity and bonds, funds usually start their ESG journey through implementing negative screening to exclude investments whose activities are considered harmful. However, it is still difficult to directly link the remaining assets to having actual positive ESG impact. These assets might just be less harmful.

Positive ESG impact assets are not immediately obvious because most investors are not used to the idea that assets that service a societal need can be profitable. The opportunity in life settlements shows how helping others can be profitable too.

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How can an investment in life settlements, where returns are made when the insured dies, be a social good?

The positive impact that can arise from an investment in life settlements is improved physical and financial wellbeing of senior citizens in the US (where the most active life settlements transactions market operates). An investment in a life settlements fund can help vulnerable retirees and tackle three ESG-related issues in the US:

There is a shortfall of retirement savings in the US

The National Institute of Retirement Security estimates that approximately 44% of people born between 1944 and 1979 are at risk of having insufficient income to meet basic day-to-day expenses in retirement.

Due to the savings shortfall, seniors cannot access long-term care

The average middle-class senior citizen does not have sufficient savings to cover the cost of long-term care. When accounting for long-term care costs, 69% of households are at risk of being unable to maintain their standard of living in retirement.

Instead of helping to ease this shortfall, life insurance policies add to the burden with regular ongoing demands for insurance premiums while the senior is alive.

Every year since 2009, over 33 million life insurance policies terminate prematurely which means the policyholder does not realise a benefit from the policy despite paying premiums for decades. The American Council of Life Insurer reported over 90% of life policies terminate without paying a death benefit in 2018.

Life settlements provide a solution to these issues by providing a cash payout to the seniors and by shifting the burden of the insurance premium to life settlements investors. By investing in this asset class there is potential for:

Retirees to use life settlement proceeds to replace pre-retirement income and help maintain a dignified standard of living.	Frail and disabled persons to use life settlement proceeds to pay for long-term skilled nursing, subsequently reducing the burden on the shoulders of family or government programs.	The benefit of decades of premiums paid on a policy to be realised by an individual in need rather than forfeited to insurance companies.

Researchers from London Business School estimated in 2013 that the value unlocked by the life settlement market is on average about four times greater than that of the surrender value offered by insurance companies.[3]

While life settlements might not look like a candidate as a force for ESG-aligned investing, its fundamental raison d'etre is to address a societal need for better retirement provision. In return for such social good, life settlement investors can obtain stable, uncorrelated returns which has historically been in the teens.

Strong regulation assists in building suitability for ESG principles-aligned investing

The US government recognises the social good that life settlements provide, and US regulators and legislators have supported life settlements for over 100 years. Like any asset class with a long history, it is highly regulated in the US which is to the benefit of policy owners selling (often elderly or ill) and the acquiring specialist company. An example of favorable regulation is a bipartisan bill (the proposed Senior Health Planning Act) introduced in early 2020 would provide better tax treatment for seniors by allowing them to sell their policies to the life settlement market.

As life settlements provide better financial outcomes for seniors and promote better corporate governance within insurance companies, regulations were introduced not to limit life settlements transactions but to promote and encourage responsible behaviour amongst participants. A strong transparent secondary market helps keep insurance companies in check.

[3] See footnote 2.

4. What are other considerations when investing in life settlements?

What are the regulatory risks associated with life settlements?

Life settlements is a highly regulated market with clear protections and process developed over the last 100 years. Honest investors and operators in this industry should face minimal regulatory risks.

This market has been supported by US regulators and legislators for over 100 years. The following are key legal precedents that accelerated and codified life settlements as a legitimate asset class:

- In 1911, a Supreme Court ruling gave birth to life settlement as a concept in the US.
- In 1996, the Health Insurance Portability and Accountability Act codified the ability of an insured to transfer ownership interest to a third party.
- In early 2020, the proposed Senior Health Planning Account Act is a bipartisan bill introduced to provide better tax treatment for seniors to engage in life settlement.

Can life settlements be banned as an asset class?

The life settlement industry is seen by regulators and legislators as a social good by providing choice to seniors who want to liquidate their insurance policy. Such support for life settlements suggests a minimal probability that the US government will reverse decades of precedent and ban life settlements as an investable asset class.

Is there any credit risk?

There is minimal credit risk to the insurance companies due to the ranking of benefit payouts above senior debt. Death benefits must be paid before any other creditors. It is the most senior relative to other claims to the assets of the insurance company.

Furthermore, in the event of insolvency, death benefits are guaranteed by many local State Insurance Boards to a maximum which varies from state to state, typically USD 300,000.

There is also implicit demand by competitors for an insurance company's policy portfolio in the event of a life insurance company bankruptcy. With someone in the industry always willing to step in, there is no credit risk to the death benefit.

The death benefit due under a life policy in the US has always been paid for the past 150 years.
There is no credit risk to the insured individual.

What are other risks that an investor should consider when investing in a life settlement fund?

An investor should also consider operational risk – life settlement transactions are documentation and administration heavy. Policies could be lost. The insured's family might not inform the fund of his or her death. Investors should review the administrative setup of any fund before investing.

For life settlement funds, there is also cashflow risk. The buyer of a life settlement commits to paying the premiums on the policies for as long as the insured is alive and hence must have the cashflow to make those premium payments. A cashflow crunch can occur if there are not enough matured policies and/or not enough new subscription money. This risk is acute in large funds where large amounts of cashflow might be required to keep policies active – a lapsed policy is an immediate loss.

What investment horizon should an investor assign to life settlements?

A longer timeframe (3 or more years) is preferred so that the fund's investment horizon can match that of the asset class. The risk trade-off of higher and yet uncorrelated returns from life settlements is acceptance of the uncertainty of when a policy would mature. While experienced life settlements fund managers can manage this longevity risk to a certain degree, investors should allow for a longer investment horizon so that policies have time to mature.

What are the investment styles in life settlements?

Most funds adopt the equivalent of a "buy-and-hold" approach whereby policies are purchased with the intent of holding until maturity to earn the return of the asset class. Some policies might be traded prior to maturity due to new information on the insured or if there is excess demand making certain policies more valuable (even after high transaction costs).

The investment approach taken by investors in life settlements should be constrained by the characteristics of the life settlements market. The life settlements market is a private market with each policy having its own unique set of circumstances. Each human being is one-of-a-kind after all. Transactions can take longer to execute, compared to equities or bonds. Hence, there is less active and frequent trading of policies because of the higher costs to execute such trades.

What are key performance metrics to determine if a manager is performing well?

A key indicator of performance is percentage of returns that comes from realised gains, as opposed to paper gains. Realised gains come from matured policies or actual sale of policies and there would be an actual cash inflow to the fund. On the other hand, paper gains are accounting gains which reflects a hypothetical valuation. Some managers are aggressive in their valuation of paper gains, while others are a lot more conservative. For "buy-and-hold" approaches, realised gains are preferred because more realised gains reflect good asset selection and management by the manager.

How are life settlements compare to other insurance-linked strategies ("ILS")?

The similarities are that both life settlements and ILS are linked to insurance payouts. However, the directions of payouts are different. Life settlement pays premiums and collects the policy payout, while ILS generally takes the opposite side. ILS receive premiums and pay the policy payout during the occurrence of an insurable event.

Closing Thoughts

Bedrock investments can liberate a portfolio's capacity to take risks in a post-pandemic landscape

Australian-based Laureola representative, Alex Lee, highlights the role of bedrock investments in a portfolio:

"

The stable core of a portfolio consists of 'bedrock investments. Their role is to generate stable, consistent returns over time. Ideally, the returns are not correlated to the returns of the risky asset. With this stabilising force, the portfolio can then take greater levels of risk in its growth asset allocation.

Traditionally, fixed income instruments have played this role. Bonds provide the stability and consistency to preserve a portfolio's returns while the riskier equities hunt for higher returns. However, unfavorable changes in correlation between equities and bonds over time nudged investors to evaluate the suitability of other potential bedrock investments.

We suggest life settlement as a strong bedrock candidate based on the following historically observed attributes. The returns in life settlements are stable and consistent over time. When risky assets dive in value, life settlements behave independently and are not directly affected by the correcting markets.

Hence, life settlements exhibit characteristics of a bedrock investment - stable consistent returns over time with its returns uncorrelated to a wide range of risky assets. With a bedrock in the portfolio, an investor can liberate his/her portfolio to take on risk. This is especially meaningful navigating the rich but risky platter of opportunities in the post-pandemic investment landscape.

"

Alex Lee – Melbourne, June 2021

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