

2024

Best Practice Advice for Investors

## 10 key questions to ask life settlement fund managers



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# Top 10 questions investors should ask life settlement fund managers

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## A growing market

The secondary market in US life settlements has steadily grown over recent years as awareness of the asset class and its benefits have become more widely established. With it being increasingly difficult for investors to find attractive yields in traditional capital markets, and with global interest rates continuing to remain low, capital has continued to flow into life settlement investments.

## Increasing policy supply

In 2023, the American Council of Life Insurers<sup>1</sup> estimated that in the US there were 259 million in force life insurance policies representing \$21.8 trillion of maturity benefits. With trading in the life settlement market estimated to have been around \$42bn<sup>2</sup> in the 5 years to 2022, there is huge potential for market growth as public awareness of the life settlement option continues to increase.

Sustained direct-to-consumer campaigns by members of the life settlement industry will help to support increased supply to the market. In addition, some US States have started to encourage individuals to consider a life settlement to compliment the use of Medicaid to fund long term care.



*“Investors are attracted by the minimal correlation with traditional markets and higher projected returns”*



*“Investors in life settlements should ensure that they have satisfactory answers to ten critical questions from their Investment Manager.”*

## Ageing population

Members of the baby boomer generation are now heading into their 70s and a life settlement will more commonly become a useful source of retirement income for them. Data from the US Census Bureau indicates that 16.8% (55.8m people) of the US population was aged 65 and over in 2020<sup>3</sup>. This represents a 38.6% increase since 2010<sup>3</sup>.

In its annual study in 2023 Conning estimated that the average annual net market potential will be \$224billion<sup>4</sup> of face amount in the 10 years to 2032. In addition to the secondary market there is a vibrant tertiary market where policies can be traded. Conning project that the face amount of in-force settled policies in portfolio by the end of 2032 will be in excess of \$39bn<sup>4</sup>.

## What are life settlements?

Life settlements are life insurance policies issued by US life insurance companies insuring mainly US lives, which are traded in the secondary market.

Investors buy the legal rights to the policy and pay premiums before making a return by collecting the death benefit of the policy upon the death of the life insured.

Policies are purchased at a price above the cash-in value offered by the life insurance company, but at a significant discount to the final fixed maturity value (death benefit). Policyholders are typically aged 65 years or older.

## Delivering investor returns

The basis of value for an investor is the surplus in future death benefit for the policy, over the acquisition price, premiums paid and any expenses.

The primary determinant of investor return is accurately estimating the life expectancy of the insured. Life settlements are a longevity risk-based investment and accurately assessing the ‘right’ price for each policy acquired is fundamental.

Using actuarially robust policy pricing and portfolio valuation methodologies is vital to generate an attractive investment performance.

1. ACLI 2023 Life Insurers Fact Book;  
2. SL estimate of combined secondary and tertiary market trades by maturity benefits;  
3. US Census Bureau - Age and Sex Composition 2020; (published May 2023)  
4. Conning Research and Consulting Inc 2023;



## 10 Key Questions

When selecting a life settlement Fund or a fund manager, SL Investment Management recommends that investors always ask ten critical questions during their due diligence process to ensure a sound choice is made.

### 1. Is the manager or fund regulated? If so - where?

The regulatory environment provides investor protection by enforcing certain behaviours on the manager; and in some instances can give additional reassurances to investors through compensation mechanisms. Knowing the regulatory environment your manager is operating within is important. Investors should look for funds that are managed or advised by regulated investment companies.

### 2. How are policies valued?

There is no standard methodology for the valuation of life settlement policies and this can provide managers with the potential to distort valuations in an attempt to suggest 'better' performance. The biggest driver in the valuation of a policy is the life expectancy duration as this will determine the projected amount of premiums payable before the death benefit is received.

Investors should understand how a prospective manager uses life expectancy estimates and ensure that actuarial models are appropriately used in the valuation process. Additionally it is important to consider how much a valuation basis may deviate from a realisable value – particularly with open-ended funds where redemptions may require gate-keeping measures to be applied should policies be overvalued.

A fund that has a historical valuation chart showing smooth straight line growth since launch is likely to be marking their valuation solely to a model ('Mark to Model') and not updating their life expectancy estimates regularly - avoid these, especially if the manager has performance fees relating to unrealised portfolio gains.

Finally, just because the policies are valued by an independent valuation party and/or audited does not necessarily mean they are appropriately valued. Therefore investors are best served undertaking their own due diligence to satisfy themselves that the valuation is reasonable.

### 3. What due diligence does the manager perform at acquisition?

Some past life settlement transactions have included cases of dubious legality. From outright fraudulent activity to so-called 'wet paper' transactions - which fall under the more common terminology of Stranger-Originated Life Insurance (STOLI). These are policies that are effectively manufactured for a quick sale in the secondary market, and as a result have no insurable interest.

Furthermore, incomplete documentation may prevent policies from being sold at their full value in the tertiary market at a later date. It is important that the manager performs its own due diligence on policy packages; or that it delegates this function to a suitably qualified third party to review cases.

### 4. How are mortality and longevity dealt with?

Mortality in the elderly population has been improving. It is important when assessing policies to consider how their likely mortalities are going to emerge. Life expectancy is a statistical term which, in basic terms, means the average future duration for which an individual will survive. Some people will die before this time and some will die after. It is important that a fund manager is aware of this and allows for this effect both in the valuation, and in any performance or liquidity planning forecasts.

Investors should look for funds that have a policy of regularly updating the life expectancy estimates on the policies they own – every two years is a reasonable guideline for doing this.

### 5. How is performance measured and rewarded?

Investors should always look at the historical performance of a fund or a manager they are considering investing with. In a market where there is very little uniformity in valuation methodology - and as a result there is considerable scope for abuse - this is of paramount importance.

Avoid funds that have performance fees that are linked to unrealised gains. Look for those that charge performance fees only on realised gains - or do not charge performance fees at all. How the performance fees are calculated is a key consideration. Front-loaded performance fee structures are best avoided.

### 6. How are parties remunerated?

It is normal for funds and companies to disclose in detail the fees on a fund structure. It is worthwhile comparing these stated fees against the outgoing fees in a company's reports and accounts. Origination fee arrangements are typically disclosed in much less detail and it is worthwhile exploring how the fee process and controls work for the origination process. In particular it is worth asking what proportion of the origination price goes to the manager, the provider, the broker, adviser, and ultimately to the policy owner.

Funds that remunerate advisers should provide full transparency on their remuneration structure. Avoid funds that are not prepared to openly disclose their fees and remuneration packages.



## 7. How does the manager approach liquidity provision in its funds?

Life settlement portfolios generally require liquidity to meet premiums and expenses. Failure to pay premiums will result in a loss of value due to policy lapse. Liquidity provision is therefore key to the operation of a successful life settlement fund - there needs to be a combination of a liquidity facility and non-policy liquid assets in the fund.

Liquidity is especially important to open-ended funds. Maintaining liquidity when a fund is receiving subscriptions is straight forward - it is a different matter when a fund begins to suffer net redemptions.

For example, SL Investment Management operates a liquidity management process whereby action is triggered should cash and facility levels fall below a pre-determined threshold and where investment is capped based on holding sufficient assets to withstand sustained periods of limited income. The fund's liquidity is stress-tested using both stochastic and deterministic models.

## 8. How does the manager approach operational risk?

The legislation, licensing and practical realities of running a life settlement fund means that there will be numerous third parties involved. Investors are dependent upon all of these functions operating properly. Tracking the status of the insured lives, renewing documentation, payment of premiums and other less glamorous functions need to be performed. The manager needs to ensure that these third party functions are continuously monitored - and where necessary - remedial action taken to mitigate operational risks. The impact of policies lapsing can be quite dramatic.

## 9. How are conflicts of interest managed?

Some funds may combine certain functions in one. For instance, some managers also provide sourcing services and may have their own internal valuation services. The life settlement market is a relatively new market. Therefore, specialist providers of such services are not always available.

It is neither uncommon nor unethical for such conflicts to exist. It is important, however, that parties involved in the transaction disclose such conflicts and can explain how they are managed.

## 10. How is the fund taxed?

In 2009 the IRS issued new guidance on the taxation of life settlement transactions. This brought much-needed clarity to the market - but also created a number of problems for funds and companies that held such policies in countries that did not have a suitable tax treaty with the United States of America. Some funds have yet to solve these issues - and for those that have the complex solutions employed may prove to be more costly than the tax savings achieved.

## Make Contact

Our life settlement team would be delighted to discuss any of the topics discussed in this document - or to answer any additional questions you may have. For more information please contact:

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