MASECO™
PRIVATE WEALTH

Loans against Life Insurance

The asset class discussed here is designed for Sophisticated and Certified High Net-worth investors only and will not be suitable for all investors

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Portfolio Construction

As a Portfolio Manager one is constantly searching for investments that generate positive expected returns but are not correlated with each other. The problem with this is that most investments are actually correlated to some degree to the global equity market and interest rates. Therefore during times of falling equity markets one's equity investments will suffer and during times of rising interest rates one's fixed income holdings will suffer. The good news is that these two macroeconomic factors don't always move hand in hand. Even with these two important levers at the Portfolio Manager's disposal it is still important to constantly research the marketplace in search of alternative opportunities where the risk involved is not correlated with equities or interest rates.

The Funding Dilemma

Currently healthcare costs in the US are prohibitively expensive and it is an unfortunate reality that some people will contract terminal diseases and as a result, suffer pre-mature death. These individuals will have healthcare needs and if they choose to fund their healthcare costs personally it could push them into a situation where they go bankrupt. Most life insurance policies only pay out when the life assured passes away and do not pay out whilst they are still alive when they need it most. Many individuals need funds for medical or living expenses and are thus forced to look to using their 401(k) or selling property to pay for the care they need.

In respect of the inefficient policy situation identified above and as is quite often the case when a gap in the market is identified, the private market stepped in to fill the gap.

As a result of this funding shortfall firms set themselves up using private capital to provide loans to individuals with terminal illnesses requiring immediate access to capital. The firms use an individual's life insurance policy as collateral against the loan made to the individual. At the time of death the proceeds of the policy are first used to repay the loan and interest and the balance is paid to the individuals beneficiaries.

The industry has continued to develop and now many more people with late stage illnesses can monetise value from their life insurance policy and also provide capital for their family with any residual amount when they pass away.

This new Alternative Credit strategy has become increasingly popular as it provides liquidity to the family during their time of need. Typical net returns have ranged been between 10-14% per annum. [1]

Risks of the Strategy

From a portfolio management perspective the risk of investing in a pool of life insurance contracts is that the collective lives insured may live for significantly longer than expected. This risk is similar to that of a life insurance company whose risk is that the pools of insured lives live for a significantly shorter time. Like all risks these are managed but the correlation to traditional sources of return (equities and bonds) is very low.

There is an origination cost to the loans as the structuring of the transactions is complex. From an investor's perspective therefore a high turnover of loans would be undesirable as the cost of origination would weigh on the portfolio return. The investor's objective is for the collective loans to have a maturity that falls within the normal distribution range.

The market risk of the strategy is that the life insurance contracts have no value left because the life assured lives longer than expected and the loan and interest eradicate the policy worth. The major credit risk of the strategy is the credit worthiness of the life insurance carriers and ensuring that they pay out as per the policies.

The most significant risk factor of this strategy is illiquidity. After the loans are made there is no secondary market for these investments and the terms of the investment are the average lives of the insured. This asset class therefore will not appeal to those who demand liquidity or to those who might believe they will demand it in the near future.

As with all portfolio management, diversification is important. Ensuring that there is diversification across the types of conditions that the individuals are suffering from will help mitigate systemic risks. Finally ensuring that there adequate number of loans in the portfolio and they are adequately diversification will reduce the idiosyncratic nature of individual loans.

Summary

The investment world is dominated by correlated returns in the fixed income and equity arena. Unearthing uncorrelated return streams is challenging. Those investors who can accept the illiquid nature of the asset class could benefit from the illiquidity risk premium and the risk premium within this inefficient market. Like all inefficient markets the opportunity is there for investors to plug the gap and as more participants enter the market the risk premium narrows. This is expected to be the case for this asset class but currently this risk premium is in its infancy.

As such, if constructed properly and for those who can afford the illiquidity, adding life insurance loans could be a good source of risk adjusted returns to traditional portfolios.

Risk Warnings

1. Nolex Capital LP