INVESTING IN FRACTIONAL LIFE SETTLEMENTS ARE YOU LEVERAGING THIS UNIQUE *Alternative Asset Class?*

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Has anyone ever told you that it isn't the destination that matters, it's the journey? They probably weren't talking about retirement planning or investing. The saying certainly can and does apply. If you have read anything at all about behavioral finance you know that it is human nature to want to do the wrong thing at the wrong time when it comes to investing. Buy high and sell low, anyone? I bet you know more than one client who has been that route. Helping clients make it comfortably to and through retirement is what matters. That is the destination. But what if the journey is so rough that it causes them never to reach that destination? Enter the concepts of asset allocation, diversification, and correlation—all central ideas of Modern Portfolio Theory (MPT). Don't panic: This isn't an article about MPT.

With that said, proper investment portfolio construction does matter. Asset allocation matters. Diversification and investment correlation matter. However, if you have been in the business for any length of time, I bet you would agree that clients tend to care more about bottom-line performance. You also know that your clients must survive the journey for you to deliver the destination. As a licensed California insurance agent, why not offer your clients both? Thanks to some legislation unique to California, you can take advantage of the asset class of fractional life settlements.

LIFE SETTLEMENT HISTORY AND BASICS

When an insured senior (usually 65 or older) no longer needs, wants, or can afford their life insurance policy (universal life for our purposes discussed here), they have only three real options:

- Keep it and let the cost of insurance eat up the cash value until the policy lapses, potentially leaving them nothing.
- Cash it in to the issuing insurance company for the surrender value.
- Sell it to a third party, in what is known as a life settlement, often for three to five times what the cash-surrender value is, but for significantly less than the face value.

If you are newer to the business, or otherwise unfamiliar with the last concept, you may be asking yourself, "Is that legal? Can a person sell their life insurance policy?" Yes, yes they can. In fact, it is legal per the highest court in the land, and it was ruled on a lot longer ago than you might suspect.

In 1911, the Supreme Court case of Grigsby v. Russell (222 U.S. 149) established that a life insurance policy is considered private property, which may be assigned at the will of the owner. Justice Oliver Wendell Holmes, Jr. stated in his opinion that, "Life insurance has become in our days one of the best recognized forms of investment and self-compelled saving." This decision placed the ownership of life insurance on the same legal footing as more traditional investments, such as stocks and bonds, and therefore represented an asset that a policy owner may transfer without limitation.

So, once a senior sells their policy, how does that help your clients with their investment portfolio? Fractional life settlements are a relatively new development in the life settlement space. With the emergence of these vehicles, clients can now gain exposure to an asset class traditionally reserved for institutional investors. In 2000, California approved the right of "qualified" investors to purchase (for their own account and not with a view to resell) fractional shares of one or more life insurance policies via California Senate Bill 1837, September, 2000. The legislation defines a qualified investor as someone with $250,000 in investible net worth, excluding their home, home furnishings, and car. Another way to qualify is with a combination of 2 years of $100,000 or more of income and at least $150,000 of investible assets.

CORRELATION AND PERFORMANCE

The problem with most non-correlated alternative asset classes is this: Many of them don't perform that well much of the time even if they are otherwise serving their purpose to be non-correlated to stocks. Despite a stomach-churning ride at times, over the long haul, equities are likely to do their job reasonably well for an investment portfolio. Therefore, if an asset class is negatively correlated to equities, it won't do so well in all those good stock years. If an asset class has a low correlation, it may or may not do well in those years when equities perform well. What seems ideal is an asset class that generally performs well in a steady fashion, and is not correlated to equities. Hence, this explains the general popularity of bonds and bond mutual funds.

But what is the state of affairs with fixed income? We are still experiencing historically low interest rates and we see occasional hints that one day soon we may finally be in that rising rate environment that we keep hearing about and so many have been expecting for so long. In mid-February, the *Wall Street Journal* reported that 16% of global government bonds have negative yields. Central Banks around the world are still cutting interest rates and the European Central Bank (ECB) has initiated quantitative easing (QE) by purchasing 60 billion Euros of bonds a month. We won't even talk about Greece. On the corporate bond front, large companies such as Apple, Microsoft and many more, are issuing long-term debt with rates below 1%. In fact, the Swiss-based food conglomerate, Nestle recently issued debt that matures in just over one year with a negative yield. This means that investors are paying Nestle for the right to lend Nestle their own money!

You can use bonds and bond funds and the fixed income arena to fill that slot in your portfolio to try and hedge some of the risk of equities, but they aren't paying that much, and bond funds can certainly carry risk of loss in a rising rate environment.

With equities, let's not forget that the game is buy low and sell high. Stocks have made it back to all-time highs, and therefore probably do not exactly represent a bargain at this time. It used to be that an investor could look to the international equity markets to provide some strong performance with low correlation to the domestic markets, but not so much anymore. With the rapid exchange of information and the global economy, so goes one continent's markets, so go them all it seems these days. As you go to bed in the West you can get a hint as to what is likely to happen the next day by watching the Asian markets, or you can watch the after-effects in their markets from what occurred here earlier in the day. According to Guggenheim, in the past decade, correlation of International Equity to the S&P 500 has risen to 0.89.

What is an investor to do if stocks are relatively expensive; international isn't the answer; bonds don't pay much in terms of yield; bond funds may give seriously negative total returns; and rates may rise in the near future?

THE OPPORTUNITY

Fractional life settlements are a compelling long-term proposition and can offer double-digit return potential. According to an 11-year empirical study done by the London Business School, purchasers across their sample could have expected to earn average annual returns of 12.5% from 2001 to 2011, with a low of 11% from 2005 to 2007 and as much as 18.3% in 2011. The study looked at more than 9,000 policies representing more than $24 billion in life settlement policies. Another important fact to consider is that life settlements were one of the few assets that weathered the 2007 to 2009 economic crisis unscathed.

Knowing this, it should come as no surprise to learn that large institutional investors like Warren Buffet, Goldman Sachs, Credit Suisse and many more have been quietly using the asset class of life settlements for years. With markets at all-time highs, and interest rates not likely to go lower and more likely to someday soon go higher, one could hardly imagine a better environment for many clients to be open to repositioning some of their assets into fractional life settlements.

With such strong performance possibilities and attractive investment characteristics, there are risks to life settlements, of course. One of the most significant is lack of liquidity. An investment into life settlements is illiquid until the policy matures. This is one reason only qualified investors are able to purchase fractional life settlements and investment should generally be limited to no more than 10% of net

worth. Longevity risk is another significant factor. If an insured lives past the life expectancy, premiums will still need to be paid until the policy matures. When this happens, premium calls may happen, and the net return of the investment will be negatively affected. This should make it obvious that getting the best life expectancy estimates you can is very important when considering an investment into the asset class of life settlements. There are other risks unique to life settlements, so be sure to do adequate due diligence before investing or recommending life settlements to clients.

HOW TO LEVERAGE FRACTIONAL LIFE SETTLEMENTS

If you are just learning about the unique asset class of fractional life settlements, congratulations! You now have a new tool to help qualified California clients add true diversification that doesn't sacrifice performance potential and has a relatively modest risk profile. If you are an independent life agent, fractional life settlements give you the chance to work with clients' assets that you probably otherwise would not ever have been able to work with.

Start by thinking about whom you know who would be a qualified investor who probably holds stocks, bonds, mutual funds, annuities, and probably some real estate in their investment accounts. Do they hold any other alternative investments? Ask them also about any positions they may have in commodities, precious metals or currency plays. Share with them the fractional life settlements story and see if reallocating 5% to 10% of their portfolio makes sense to them. In about the past four years, gold is off by more than a third and silver more than two-thirds! These are good examples of what many people see as non-correlating alternative assets, but it will be an easy conversation with them to demonstrate that performance matters along with non-correlation. With a chance at double-digit returns with no stock market risk, clients will clearly see the benefits of this historically institutional investment that you can now offer to them as individual investors.

Consider incorporating the investment concepts covered in this article in your marketing efforts. You are likely to find that there is substantial interest from the public in an alternative investment that provides non-correlation to a portfolio while also giving a real chance at highly competitive returns.

The need is real. The opportunity is significant. The time is now to explore this unique investment for your clients and your practice. ★

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