

# Lowly Correlated, Long Term Yield Investing

Stockholm (HedgeNordic) – The secondary market for US life assurance policies is estimated to be worth \$3 to \$5 billion of face value per year, which is a drop in the ocean of the total market size of trillions of dollars. “This is partly because many policyholders are unaware that they can sell their policies, and instead let them lapse worthless – producing a windfall profit for the insurance company that has collected premiums, but no longer has to pay out,” says Resscapital AB founder and director, Jonas Martenson (*pictured*).

More well-informed individuals may instead choose to sell policies. Some 45 US states regulate the secondary market, with rules that include requiring the consent of policy beneficiaries and disclosure of all fees; Ress follows the same guidelines when buying policies in those US states that do not regulate the market. (A secondary market for life insurance policies also exists in Germany and some Canadian provinces, but Ress only buys US policies.)

## Forecasting Longevity

In fact, Ress is distinguished by its preference for buying policies from individuals who are both physically and mentally healthy, because Martenson argues that, “it is inherently difficult to forecast life expectancy. We do not believe in short life expectancies, it is very difficult even for doctors to assess that a 78-year old has only four years’ life expectancy, even if they have a number of ailments”.

“We obtain at least two forecasts of longevity and use the longer one in order to be conservative, among other things, as an input for our valuation model. The objective is a gross IRR of 12%, before fees and non-fee expenses” he adds. Other funds using longer or shorter longevity forecasts might project a higher or lower IRR for the same policies.

The return target comes from forecast internal rates of return (IRR) on the life policies, which range from 9-10% on smaller policies and those with shorter longevity projections to as high as 14-15% on larger policies, and those with longer longevity projections. Ress’s average policy size in terms of face value is USD 2 million and the largest is USD 15 million.

Since inception, average annual returns of c.6% in USD have fallen slightly short of the long-term target of 7%, simply because fixed costs were high when the fund first launched in 2011, with around USD 8 million. For instance, the total expense ratio of 5.6% in 2013, has come down to 3.11% in 2018 as assets have grown to over \$120 million.

Policy payouts have actually been running ahead of expectations. So far, Ress does seem to have been somewhat conservative in its forecasts of 24 mortalities, as the fund has received 30 payouts from its 250 policies.

Mortality distributions should not be correlated with equity markets, but Ress assumes a 0.2 correlation to bonds, partly because the payouts from life insurance are nominally fixed. Clearly, rising US interest rates mean that nominal returns now offer a smaller spread over cash, but so far have not forced buyers to pay more for the policies. “Sellers are seeking a dollar amount versus surrender value, and we have been buying policies at an average anticipated IRR of around 12% gross for a number of years,” says Martenson.

## **Selective Investment Criteria**

Ress has reviewed 7,000 policies since inception and bought just under 4% of them. Ress's criteria include credit and counterparty risk guidelines: the insurers must be investment grade companies with a credit rating of A- or above, and the maximum fund exposure is 15% per insurer.

Ress only buys policies that are at least two years old, after which they cannot be contested by the insurance company, nor avoid payouts for suicides. Ress takes advice from a US law firm and believes the prospect of an insurance company successfully contesting a policy, after two years, is remote.

In addition, Ress seeks policies with premiums that are low as a percentage of face value, both initially and in terms of anticipated increases in premium rates. Conceptually, non-guaranteed premium increases could be seen as a type of contingent liability. Premium inflation matters because Ress needs to continue paying the premiums to keep the policies in force, and spends around 2% of the portfolio's face value doing so each year. The rate of premium increases is sometimes guaranteed but not always, in which case Ress has to take a view on the probability of premium increases. Martenson judges that the risk of extreme increases is becoming lower, partly as insurers can only raise premiums on categories or types of policies and cannot jack up premiums on an individual policy.

Ress also keeps a cash buffer of 5-10%, which would probably cover premium costs for at least a couple of years, in the event that insufficient or no payouts occurred. On top of that, Ress has a credit facility of \$5 million that could be drawn on.

These safeguards are potentially important as some funds that miscalculated cashflow forecasts – by underestimating longevity and/or the rate of premium increases – were forced to bring in lenders, who would typically then have the first lien over cashflows from payouts up to certain IRR thresholds. This sometimes resulted in a total loss of value for fund shareholders.

The investment strategy is basically buy and hold, though Ress did sell one policy in 2013 to understand the process involved, and Martenson reckons that the current portfolio of policies could fairly easily be sold to private equity firms (such as Blackstone and Apollo) that have much capital to deploy and tend to buy baskets of policies rather than individual ones. In 2019 the secondary market is reasonably buoyant; Martenson acknowledges that liquidity might dry up if a 2008 Lehman Brothers-type scenario was repeated.

## **Valuation**

Ress has a sophisticated valuation methodology, managed by valuation manager Gustaf Hagerud. They update valuations twice per month based on various factors including mark-to-market adjustments. Ress has listed its fund and net asset values are published on Nasdaq GlobeNewswire. It is also marked to a valuation model because the secondary market for life policies is by its nature fragmented and specific to each individual policy. It would not be practical to ask potential buyers incur the labor-intensive costs of providing indicative quotes without a chance to actually bid for the policies.

Deloitte Denmark's actuarial team, which is separate from the audit business, then review Ress valuations twice a year.

Changes in observed discount rates used for the mark- to market adjustments have also led to valuation tweaks, and increases in observed discount rates explain the negative performance periods. For example, Ress may update longevity estimates in various ways, such as when a

policyholder seeks to sell a second or subsequent policy, or when US mortality tables are updated by the US Society of Actuaries, which happens roughly every 7-8 years.

In some quarters (such as the book *Juvenescence* by Jim Mellon and Al Chalabi) there are high hopes that as yet unseen breakthroughs in medical technology could add decades to life spans. Martenson does not view this as being likely to happen very quickly.

### **Investing and Trading**

In contrast to some closed-end funds in the strategy, Ress has an “evergreen” corporate structure, listed on the Nasdaq Copenhagen exchange. The largest investors are pension funds. Most investors subscribe for new shares at NAV and can give seven months’ notice to redeem without cost, also at NAV, subject to a minimum investment of EUR 100,000.

It is also possible to buy and sell the fund on Nasdaq Copenhagen, with no minimum investment and a typical bid/offer spread of 2-3%. The fund does trade intermittently with some trading most weeks but not necessarily every day. Anyone, anywhere could trade the listed vehicle, but Ress as an AIFM, is only licensed to market to professional investors in most EU countries.