

The Emerging Alternative Investment – Life Insurance Assets¹

Edward S. Adams²

Abstract

The Emerging Alternative Investment – Life Insurance Assets outlines alternative investment options with the emergence life insurance secondary market of for investors seeking asset diversification to mitigate and diversify risks. Traditional asset classes no longer provide the diversification that investors require. Specifically the paper examines asset diversification through uncorrelated, alternative asset classes – real estate investment trusts (REIT), equipment leasing, energy exploration, and life insurance assets found in the life insurance secondary market. Life insurance assets should be considered within this stable of alternative asset classes because of their ability to add further diversification from other assets classes – both alternative and traditional. Because life insurance assets are tied to mortality statistics, these assets are uncorrelated to other asset classes. Thus, investors should consider a holistic approach to their investment portfolio including alternative investments. Life insurance in particular may provide greater asset diversification for investors seeking asset classes that are uncorrelated to the volatility of other assets in order to mitigate and diversify risks.

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² Edward S. Adams, J.D., M.B.A., Howard E. Buhse Professor of Finance and Law, University of Minnesota Law School

Professor Edward S. Adams specializes in commercial, bankruptcy, and corporate law. He teaches bankruptcy, creditors remedies/secured transactions, commercial paper, corporations, and corporate finance. Professor Adams served as Associate Dean for Academic Affairs from 1997 to 2000. He was honored with the Stanley V. Kinyon Teaching and Counseling Award in 1994 and 1996, and was a co-holder of the Julius E. Davis Chair in Law for 1999-2000.

Professor Adams earned his B.A. degree, magna cum laude, from Knox College, where he was a member of Phi Beta Kappa. In the fall of 1984, he studied at the University of Freiburg in West Germany as a European Studies and NATO Conference Scholar. Professor Adams received his J.D. degree, cum laude, from the University of Chicago Law School in 1988. He was Managing Editor of the University of Chicago Law Review. Following graduation, Professor Adams clerked for Judge J. Harvie Wilkinson III of the United States Court of Appeals for the Fourth Circuit. He then practiced law with Latham & Watkins in Chicago. Before joining the University of Minnesota Law School faculty in 1992, Professor Adams was a Visiting Professor at Albany Law School of Union University. At Albany, he was the faculty founder of the Albany People's Law Program, which provides free legal advice to members of the community. In 1997, Professor Adams graduated with an M.B.A. with highest honors from the Carlson School of Management at the University of Minnesota.

I. Introduction

The historical volatility of the equity and real estate markets, coupled with historically low interest rates, suggest investors more than ever need to consider diversification into alternative classes of assets, or non-traditional asset classes. Investors are frustrated by the failure of traditional diversification and portfolio construction theories to provide returns and prevent losses.³ Nearly sixty-nine percent of U.S. investors concur that traditional techniques should be replaced with new asset allocation and diversification strategies.⁴ Additionally, seventy-five percent say that the traditional bond and stock portfolio allocation no longer best manages returns and risk.⁵ Moreover, forty-six percent of investors regularly consider whether returns that are uncorrelated to the markets can be achieved by an investment.⁶ To meet retirement objectives, investors should use a broad range of asset classes, incorporating stocks, bonds, and alternative investments. This can help an investor mitigate short-term volatility and pursue long-term growth from asset classes with different market cycles.

One particular alternative asset class worthy of investment consideration is life insurance policies purchased in the secondary market (“life insurance assets”) through a process known as a life insurance settlement. This Paper explores the operation, advantages and potential disadvantages of life insurance asset investing. In doing so, the Paper first surveys differing categories of investments that are available to investors and concludes that life insurance assets should be included as an alternative investment. The Paper then considers how life insurance functions and how the life insurance policy may be sold as personal property. Third, the Paper provides a brief history of the life insurance secondary market and who are likely candidates for life insurance settlements. Finally, the Paper concludes by advocating why life insurance assets may offer a viable alternative investment for an investor to diversify his or her portfolio as part of a holistic investment approach.

II. Categories of Investments

Systemic risk, or the risk of the entire economic system in which we invest, affects all of us. Avoiding systemic risk is impossible unless one changes economic systems—in other words, moves from investing in the U.S. equity markets to the other markets such as the European or Asian equity markets, unless those markets are

³ *U.S. lags Europe, less affluent nations in retirement security, according to new worldwide index developed by Natixis Global Asset Management*, Natixis Global Asset Management, March 7, 2013, http://ngam.natixis.com/docs/95/788/Global_Retirement_Index_R.pdf.

⁴ *Investors Worried About Reaching Retirement Goals, but Paralyzed by Fear of Losses in Volatile Markets*, Natixis Global Asset Management, October 17, 2012, http://ngam.natixis.com/docs/200/144/NGAM%20US%20Individual%20Release%20&%20Highlights_10%2010%2012%20FINAL.pdf.

⁵ *Id.*

⁶ *Id.*

correlated. In addition, one faces the systemic risk inherent in the new system regardless of correlation. Non-systemic or unsystemic risk is risk inherent in any particular investment: for example the risk unique to an investment in Microsoft includes risks inherent in management decisions, new technologies, or the introduction of competing products. Experienced investors minimize unsystemic risk and stabilize the returns from investments by allocating resources among different asset classes and subclasses and diversifying investments within each class of assets by the differing degrees of risk. These investors look to further diversify their risk through investing in asset classes that are not correlated. Investing in multiple asset classes including alternative investments helps achieve an optimal balance of risk.

A. Traditional Asset Classes

There are numerous asset classes an investor should consider. The range of asset classes include stocks, bonds, mutual funds, cash and cash equivalents, futures and options, and direct investments. A traditional investment portfolio includes a combination of stocks, bonds, cash or cash equivalents, and mutual funds that invest in these asset classes.⁷ Asset allocation is an important consideration in determining the asset classes of an investment portfolio, which depends on the objectives and risk tolerance of the investor. Increasingly, it is clear that an investor's determination of objectives and risks should also include the consideration of alternative investments.

Stocks are equity investments in a corporation, giving an investor proportionate ownership to the number of shares owned in the company. The price movement of the stock determines how much gain or loss an investor may realize. In addition, income from the corporation may be paid out in the form of dividends.

Bonds are a loan (with a claim to the assets of the corporation) and a fixed income security paying interest over a fixed time period. Fixed interest payments provide a steady, regular, stream of payments until maturity. In the secondary market, bond prices vary depending on the rate of interest the bondholder receives and the credit quality of the bond issuer.

Mutual funds use the assets of a large pool of investors to invest in a collection of stocks, bonds, or other securities. Mutual funds that invest in stocks are similar to the stock asset class in terms of investment allocation. Mutual funds that invest in bonds are equivalent to the bond asset class. Income is earned for investors from dividends, fixed interest payments, and on the sale of investments that have appreciated in price.

Cash and cash equivalents include bank accounts, money market funds, certificates of deposit, and treasury bills. Because of inflation the value of cash and cash equivalents decreases over time. However, cash and cash equivalents provide the most liquidity and when guaranteed by a government-related entity can promise the most safety.

⁷ Virginia B. Morris and Kenneth M. Morris, *Guide to Understanding Direct Investments*, Lightbulb Press (2009).

Futures and options represent an asset class of financial products called derivatives. Derivatives derive from, and their prices reflect, the value of the financial product underlying the futures or options contract. Derivatives do not involve an ownership transfer. Instead a contract states the terms for which the underlying product will be purchased or sold at a future date.

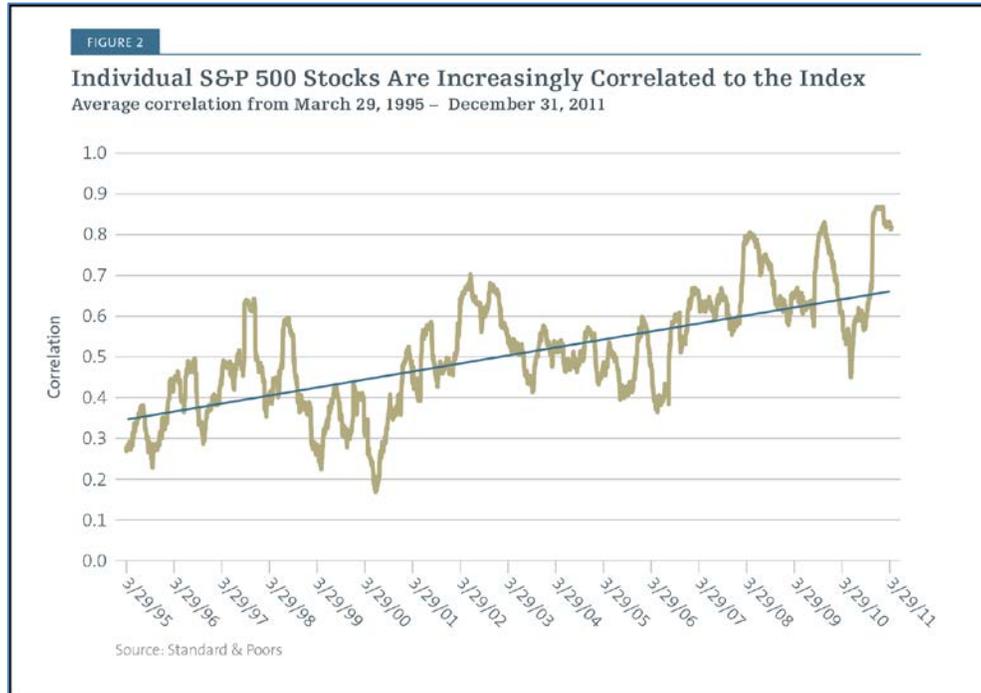
Direct investments differ from other asset classes because they utilize limited partnerships or corporations to invest in businesses that own alternative assets such as real estate, equipment leasing, and energy exploration and production. A direct investment allows the investor to become a part owner in the assets of the enterprise. Direct investments are usually income investments and often include equity participations. The investor realizes income from the business and at the end of the investment term may receive ordinary income or capital gains on sale of their interest. Direct investments may also provide a tax benefit such as tax deferral on a portion of the regular distributions paid to the investor, tax deferment for depreciation, depletion allowances, and other deductions. However, no formal secondary market is available and direct investments are not usually traded. Thus, direct investments are typically illiquid long-term commitments and usually last between seven and twelve years, although terms differ.

B. Alternative Investments

Increasingly, investors like Harvard University's Endowment Fund and the California Public Employees' Retirement System have elected to consider and ultimately, add alternative investments to their portfolio mix because traditional diversification is simply not working as it has historically.⁸ Traditional diversification functions under the assumption that investing in a variety of businesses and differing market capitalization sizes should result in diverse stocks increasing and decreasing in value in dissimilar patterns. However, the correlation between stocks has increased due to index funds and the ease of access to company information (see Figure 1 below).

⁸ Nathan Rowader, *Managing Correlation Risk With Alternative Investments – Breaking the Back of High Correlations*, Forward Investing Management, LLC (2012), <http://www.forwardinvesting.com/wp-content/uploads/managing-correlation-risk.pdf>.

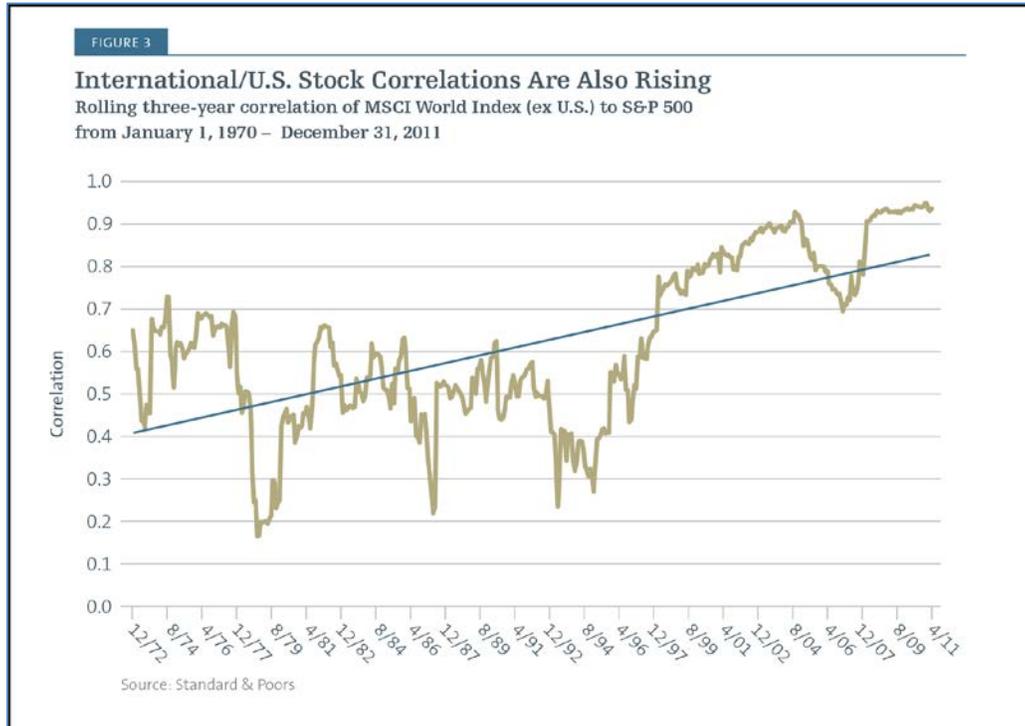
Figure 1⁹



Geographic diversification also appears to be waning in relevance. Geographic diversification utilizes international stocks to diversify investor portfolios. However, the benefits of geographic diversification may be diminishing because the correlation between international stocks and U.S. stocks has continued to increase (see Figure 2 below).

⁹ *Id.*

Figure 2¹⁰



With the possible diminishing value of traditional and geographic diversification, alternative strategies are needed for portfolio diversification. This is where alternative investments, including real estate investment trusts (REIT), equipment leasing, and energy exploration and development may fit into an investor's asset mix. For example, thirty percent of high net worth investors (investors with more than \$5 million in investable assets) are inclined to consider alternative investments.¹¹ Among the investments that these high net worth individuals consider are private equity (35%), managed futures (32%), REITs (28%), hedge funds (23%), and venture capital (17%).¹² Alternative investments can provide portfolio diversification and offer other sources of return not available from traditional asset classes like stock and bonds.

Life insurance assets found in the life insurance secondary market should also be considered within this stable of alternative asset classes because of their ability to add further diversification from other assets classes – both alternative and traditional. This is a relatively new longevity based asset class that has matured and is worthy of investment. What are life insurance assets? What is the life insurance secondary market? What is a life insurance settlement? Why does it make sense to invest in life insurance assets? These questions and their answers are explored later in this Paper.

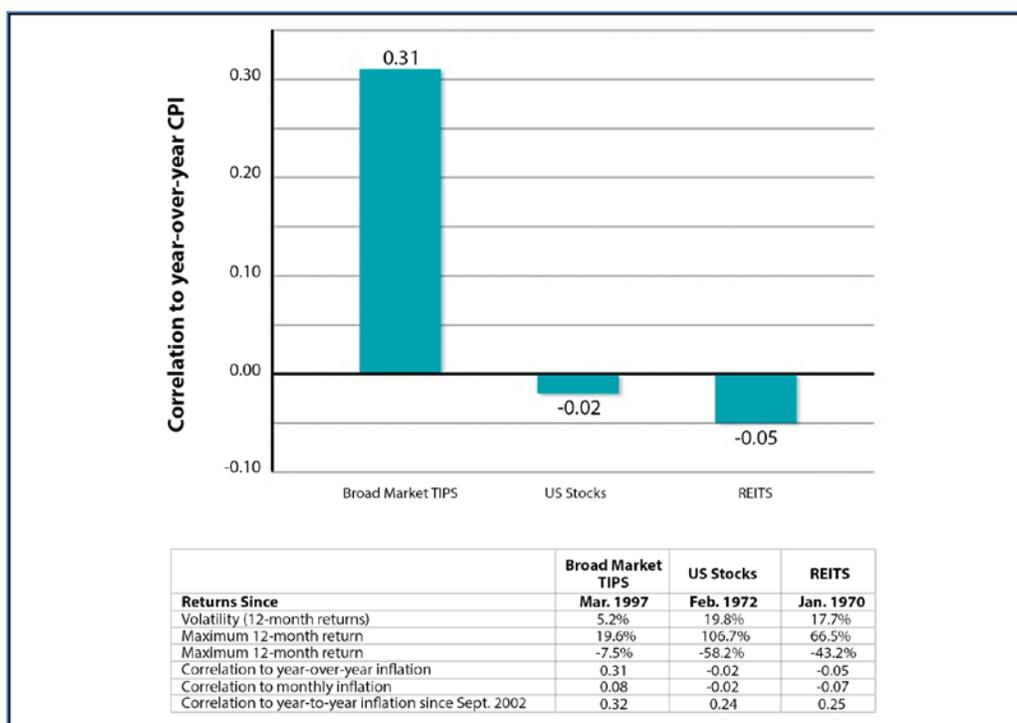
¹⁰ *Id.*

¹¹ *More Wealthy Americans Turn to Alternative Investments*, The Wall Street Journal, March 21, 2013, <http://online.wsj.com/article/PR-CO-20130321-909620.html?mod=crnews>.

¹² *Id.*

The most traditional alternative investment sold in the marketplace is participations in commercial real estate.¹³ The most common method of investing in commercial real estate is through REITs, a corporation whose only asset is real estate. There are two ways to invest in REITs. The first is to invest in a private, nontraded REIT offered as a direct participation program. The second method is by purchasing shares of a public corporation listed on a national exchange. Nontraded REITs are available only to investors who meet certain eligibility criteria. There is no formal secondary market for nontraded REITs and the shares are rarely traded. Generally nontraded REITs are not correlated with traditional investments – meaning that they are usually not affected by changes in interest rates or corporate earnings reports, which affect other securities. Nontraded REITs could still have correlation to the larger market because increases in the market may correlate to increases of REIT values, and vice versa. Further REITs do not tend to act as an inflationary hedge (see Figure 3 below).

Figure 3¹⁴

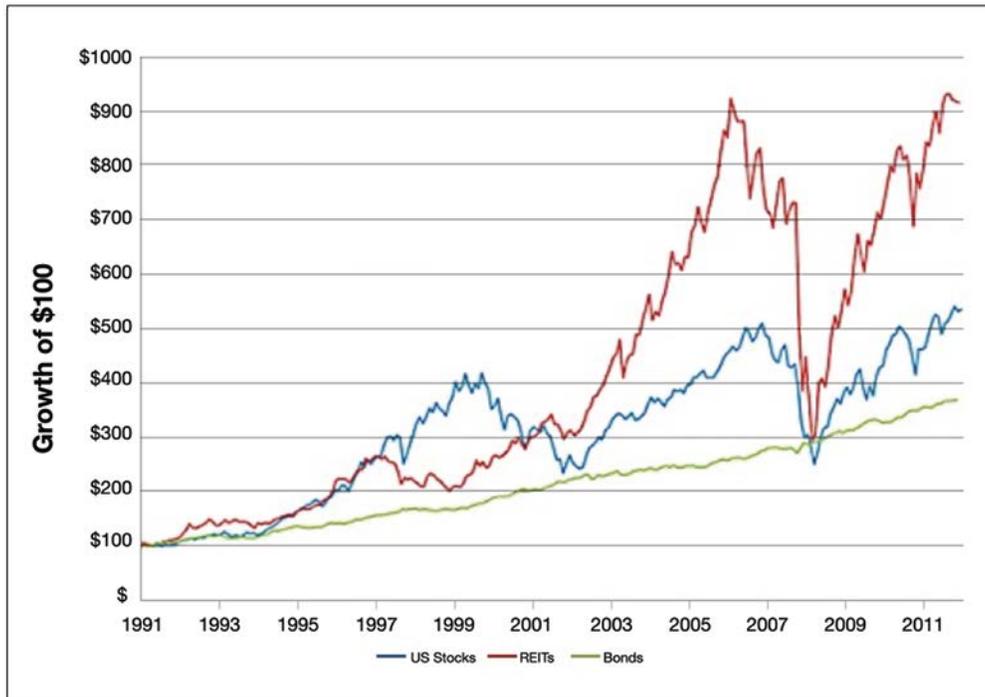


However, most REITs are publicly traded and are subject to market forces. Traded REITs have an active secondary market, but a publicly traded REIT is subject to meeting short term expectations, like other traditional listed investments such as stock. Price fluctuations of publicly traded REITs tend to be driven by changes in economic conditions. Thus, publicly traded REITs’ values generally rise and fall with other equities in the market instead of providing risk mitigation (see Figure 4 below).

¹³ Virginia B. Morris and Kenneth M. Morris, Guide to Understanding Direct Investments, Lightbulb Press (2009).

¹⁴ Joe Davis, *REITs: A word of caution*, The Vanguard Group, Inc., January 10, 2013, <http://vanguardblog.com/2013/01/10/reits-a-word-of-caution/>.

Figure 4¹⁵



Sources: Vanguard calculations based on data from Dow Jones, MSCI, FTSE, and Barclays. U.S. stock returns represented by Dow Jones Wilshire 5000 from 1991 through April 2005 and MSCI U.S. Broad Market Index since May 2005; REITs returns represented by FTSE NAREIT All Equity REITs Index; and bond returns by Barclays U.S. Aggregate Bond Index.

Another alternative investment, equipment leasing, allows investors to invest through direct participation programs (DPP).¹⁶ Equipment leasing provides an investment in equipment that is leased, resulting in steady income generated by the lease. When investing in the DPP, an investor generally does not know in advance what type of equipment will be offered for lease although most DPPs invest in a range of equipment types to add diversification and limit the risk of concentrating on a specific or limited number of industries and market segments. Because the DPP is not traded, this can help separate an investor's portfolio from market volatility.

Further, equipment leasing is often used as a hedge against both inflationary and recessionary periods. During inflationary periods, assets from expiring leases may be resold at higher prices and exceed expected returns. During recessions, companies leasing the equipment tend to hold onto leases instead of purchasing new equipment, increasing lease renewals. There are risks to an equipment leasing DPP from the costs involved in terminating leases. Additionally, when interest rates are low, equipment leasing DPPs may provide an alternative

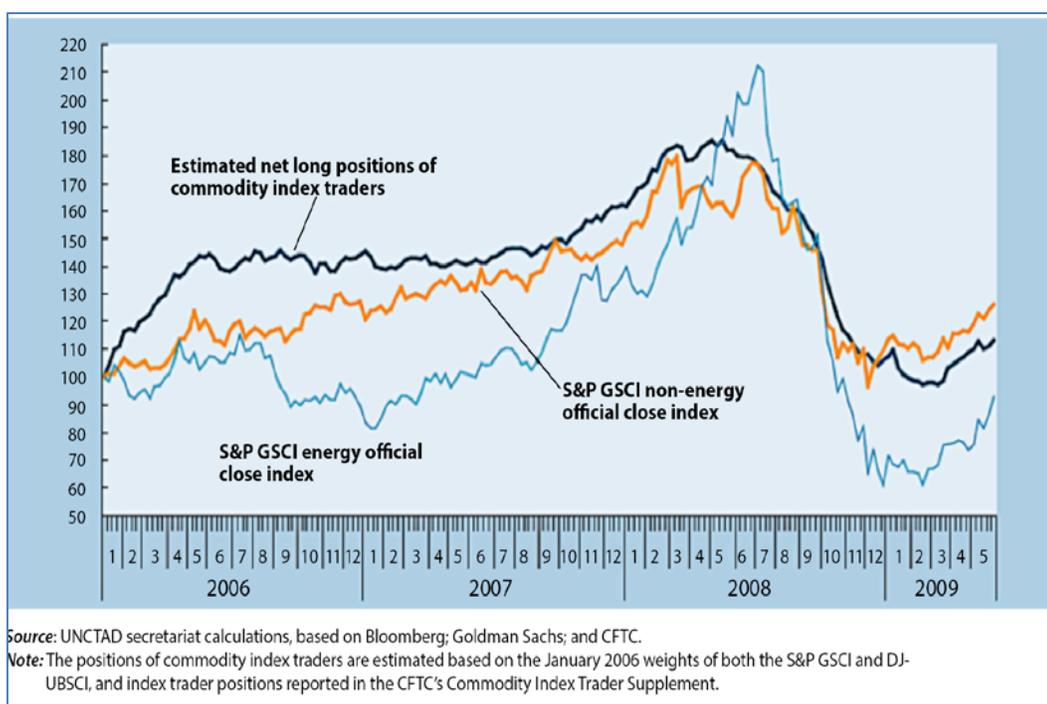
¹⁵ *Id.*

¹⁶ Virginia B. Morris and Kenneth M. Morris, *Guide to Understanding Direct Investments*, Lightbulb Press (2009).

to fixed income securities. However, equipment leasing DPP investments may be substantially more difficult to liquidate than bonds or other interest bearing investments.

Similarly, an investor may want to consider energy exploration and production partnerships in petroleum or natural gas drilling projects.¹⁷ Energy investment programs may provide diversification through partially sheltered revenue streams from depletion and depreciation allowances. Additionally, because energy DPPs are nontraded, long-term investments, oil and natural gas DPP returns are generally not correlated to the stock and bond markets, and their value usually isn't affected by the securities market pressures. However, there are three factors that affect income distributions from oil and natural gas direct investments: production volume, operating expenses, and commodity market prices. There is the risk that a well will not produce enough to cover the exploration costs or yield no return. Additionally, high operating costs limit possible returns. Importantly, oil and natural gas prices tend to fluctuate with external factors such as oil importation from OPEC countries, which expand or restrict production in accordance with political or economic events. Natural gas DPPs are less affected by international economic or political pressures, but are more affected by demand than supply chain problems. However, energy DPP investment options are dramatically impacted by volatile commodity prices (see Figure 5 and Figure 6 below).

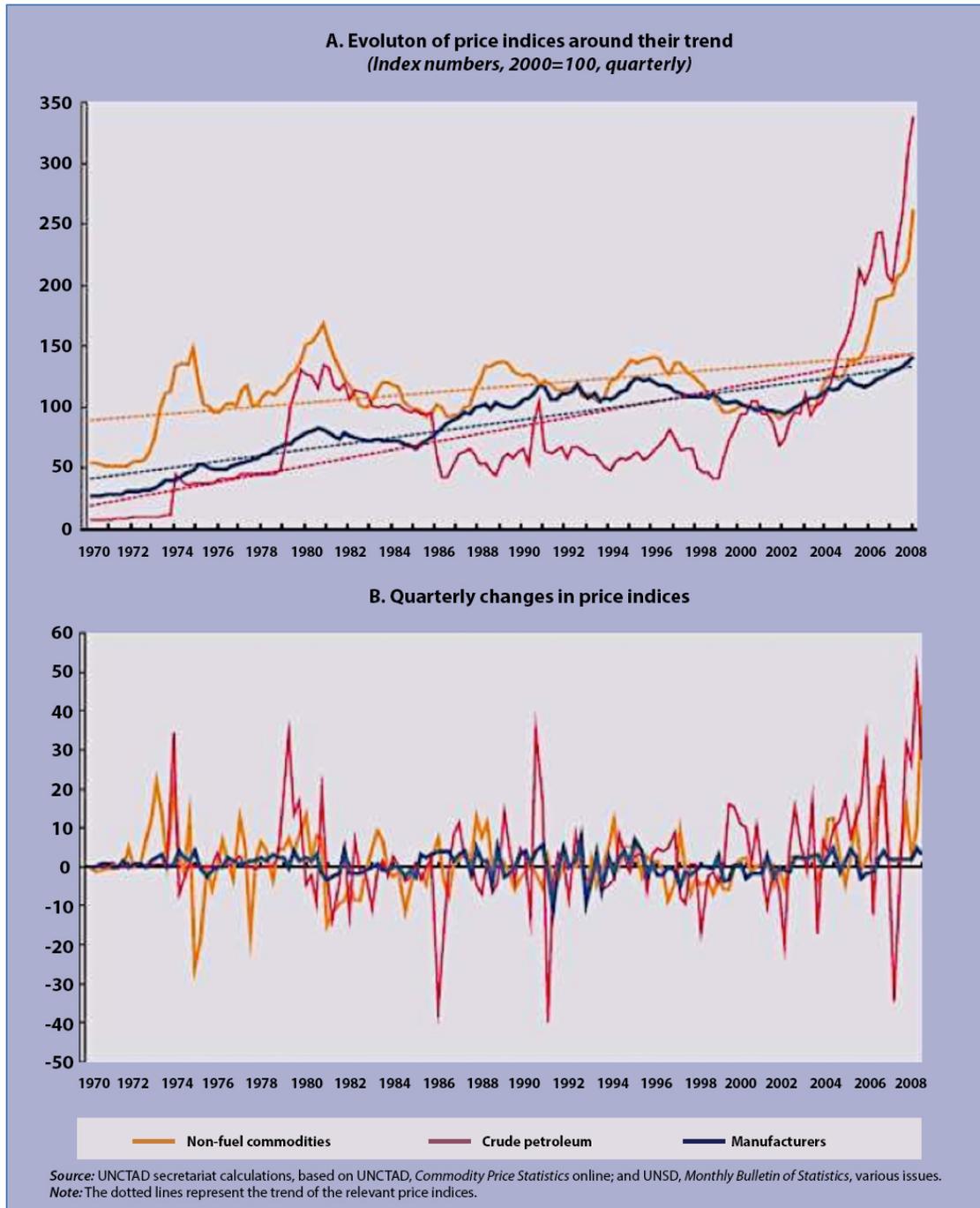
Figure 5¹⁸



¹⁷ *Id.*

¹⁸ Estimated Index Trader Positions and Commodity Prices, January 2006-May 2009, UNCTAD Trade and Development Report, 2009, Chart 2.2.

Figure 6¹⁹



Life insurance assets, as further describe in the next section of this Paper, are like REITs, equipment leasing DPPs, and energy investment DPPs in that they allow an investor to diversify from risks traditional asset classes face. However, life insurance assets may also give an investor the added benefit of almost no correlation,

¹⁹ Price Trends and Volatility of Non-Fuel Commodities and Crude Petroleum vis-à-vis manufactures, Chart 2.4, UNCTAD (2008b).

if any, to other asset classes. REITs, equipment leasing DPPs, and energy investment DPPs tend to have limited correlation to the stock and bond markets, but may still have correlation to the same pressures that the stock and bond markets face. Alternatively, life insurance assets follow the mortality experience and because it is relatively predictable over large groups of individuals, the mortality market generally does not correlate to other markets, nor is it influenced by political or economic pressures the other alternative investments discussed here experience. Thus, life insurance assets may offer an investor the opportunity for more diversification than many of the other alternative investments described above.

III. How Life Insurance Functions and Why It's Sold

Life insurance is a contract with an insurance company. Life insurance typically comprises all policies of insurance where the payment by the insurer is contingent on the mortality of the specified individual.²⁰ A life insurance contract provides that the insurer will pay a fixed lump-sum payment, called the mortality benefit, upon the occurrence of the inevitable death of the life that is covered by the contract.

A. Life Insurance Company Business Model

Life insurance companies build their business models and economics on several primary pricing practices. One of the primary aspects of the life insurance business model is the “voluntary surrender rates,” e.g., the number of policies sold which will never result in the payment of a benefit because consumers stop paying the premiums. The voluntary lapse rate results from consumers lapsing or surrendering their policies back to insurance companies. . Lapsed policies provide windfall profits to insurance companies.

According to the American Council of Life Insurers Fact Book 2011 (ACLI), individuals owned over \$10.48 trillion of face value of life insurance policies in the United States in 2010. This figure includes all types of policies, including term and permanent insurance known as whole life, universal life, variable life, and variable universal life. According to the ACLI, the average annual lapse rate and surrender rate of life insurance policies for the ten years ending 2010 was 7.2%, or over \$712 billion in face value of policy benefits in 2010 alone. These figures do not include group-owned life insurance, such as employer-provided life insurance, whose market totals over \$7.83 trillion of face value of life insurance policies in the United States in 2010, and whose policies exhibit similar lapse and surrender rates according to the ACLI.

Owners of life insurance policies generally allow them to lapse or surrender for a variety of reasons, including: (i) unrealistic original earnings assumptions made when the policy was purchased, combined with higher premium payments later in the term of the policy than initially forecasted; (ii) increasing premium

²⁰ Peter Nash Swisher, *The Insurable Interest Requirement for Life Insurance: A Critical Reassessment*, 53 Drake L. Rev. 477, at 478 (2005); *See, e.g.,* Bowles v. Mut. Benefit Health & Accident Ass'n, 99 F.2d 44, 48 (4th Cir. 1938) (*quoting* Mut. Reserve Life Ins. Co. v. Dobler, 137 F. 550, 553 (9th Cir. 1905)).

payment obligations as the insured ages; (iii) changes in financial status or outlook which cause the insured to no longer require life insurance; (iv) other financial needs that make the insurance unaffordable; or (v) a desire to maximize the policy's investment value. Rather than allowing a policy to lapse as worthless, or surrendering a life insurance policy at a fraction of its inherent value, the sale of a life insurance policy in the secondary market can bring significant value to the policy owner. The life insurance secondary market often pays policy sellers amounts ranging from two to ten times the surrender value that would otherwise be offered by the insurance company.

B. Types of Life Insurance

The various types of life insurance include whole life insurance, variable life insurance, universal life insurance, joint life insurance, term life insurance, credit life insurance, industrial life insurance, and endowment life insurance. However, the most common types of life insurance are term and permanent insurance. Universal life is the most common of permanent life insurance policies.

1. Term Life Insurance

Term life insurance is the most affordable type of life insurance when initially purchased because of low payments. However, term life insurance premiums generally increase with age. Term life insurance only provides insurance for a specific time period (the term which may be renewable) and pays a benefit only if mortality occurs during the term. This type of insurance is mostly used for coverage that will cease at a specific time when the coverage is no longer expected to be of value, such as after a mortgage is paid off or children have completed education. Premiums are generally lower than permanent (universal) life insurance when initially purchased. However, there is no cash value for term life insurance. Most term life insurance policies offer the owner with the opportunity to convert the policy into permanent universal life insurance during the term of the policy

2. Permanent Life Insurance

In contrast to term life, universal life provides lifelong coverage as long as the premiums are paid, which may be paid from accumulated cash values. Assuming the policy is in good standing, the face amount of the life insurance will be paid upon the death of the insured, less premiums due and outstanding loans. Withdrawals and/or partial surrenders may reduce the death benefit. Depending on the amount of premiums paid, universal life insurance may accumulate cash value over the course of the coverage on a tax-deferred basis. Policy owners may pay more or less premiums, but not less than the minimum amount required to cover the "cost of insurance" and administrative costs. Minimum premium payments for universal life will generally about equal the cost the same death benefit under a term life insurance contract. If greater amounts of premiums are paid, cash values will accumulate on a tax deferred basis at growth rates stipulated in the contract, or at rates being paid at that time by the insurance company. The key advantage for universal life insurance is lifelong protection so long as

the premiums are paid. However, due to historically low interest rates, most of the universal life insurance policies sold have not performed up to the projected growth illustrations upon which they were sold²¹ – making them ripe for life insurance settlements.

C. Sale of Life Insurance Policies

Life insurance policies are transferable property that may be sold by their owner. The right to sell was established by the U.S. Supreme Court in 1911. This process is today most commonly known as a “life settlement” and is regulated by forty-five states and Puerto Rico, of which five states additionally mandate that insurers advise policy owners of the life settlement option when policies are being lapsed. By their terms, life insurance policies provide the right to name policy beneficiaries, change beneficiaries, assign the policy as collateral, borrow against the policy, and sell the policy to a third party. Under law, persons not having an insurable interest in an insured may not purchase life insurance on such person. However, a person having an insurable interest in an insured and having legally purchased a life insurance policy on that insured may later sell that policy to someone who does not have an insurable interest in the insured. Thus, holders of life insurance policies may sell their policies at will to an investor, providing a unique investment opportunity for investors.

IV. History of The Life Insurance Secondary Market

The life insurance secondary market has its genesis in the viaticals market of the 1980s.²² The viaticals market developed from the sale of life insurance policies by terminally or chronically ill individuals, typically suffering from HIV, who no longer needed the life insurance policies they owned.²³ A “viatical settlement” occurs when a third party purchases a life insurance policy of a terminally or chronically ill insured individual, typically facing less than two to three years of life expectancy.

Similar to viatical settlements, life settlements are the purchase by a third party of life insurance policies from policyholders. However, life settlements involve policyholders where the insured is at least 65 years or older and not terminally or chronically ill. In either case, the original policyholder commonly receives an amount more than the cash surrender value the life insurance company offers. Under both viatical and life settlement transactions the purchaser continues to pay the premiums on the policy and benefits by collecting the mortality benefit when the policy matures.

²¹ Leslie Scism and Joe Light, *Draining Away!*, November 16, 2012 <http://online.wsj.com/article/SB10001424127887324595904578121484233279270.html>, accessed April 21, 2013.

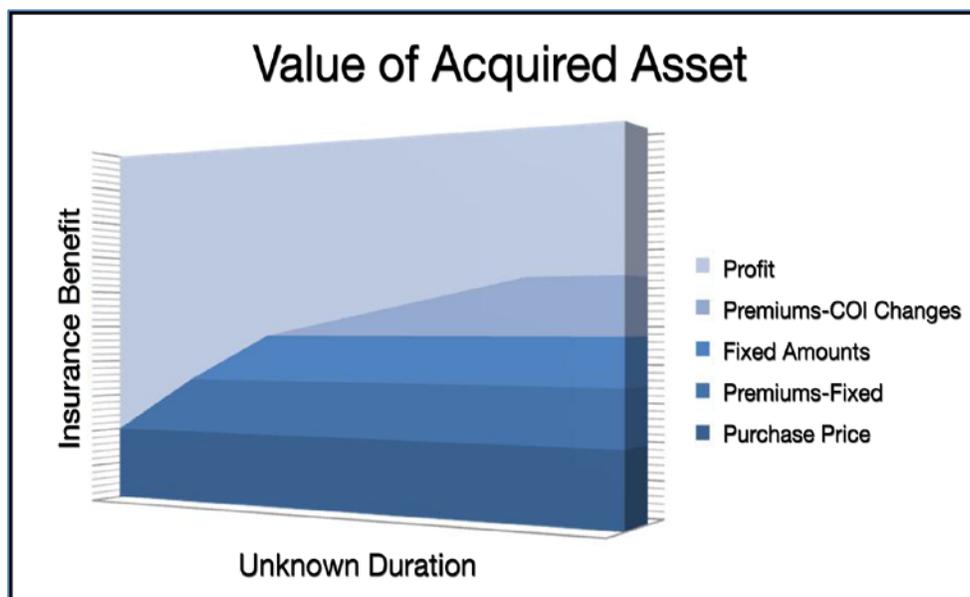
²² Sam Rosenfeld, *Life insurance assets: Signposts to a Principal Asset Class*, Working Paper, Wharton Financial Institution Centre, at 4 (2009); *Life Settlement History*, Life Insurance Settlement Association, accessed March 10, 2013, <http://www.lisa.org/content/51/Life-Settlement-History.aspx>.

²³ *Life Settlement History*, Life Insurance Settlement Association, accessed March 10, 2013, <http://www.lisa.org/content/51/Life-Settlement-History.aspx>.

A. The Basics of Life Settlements

The goal of life settlements is to extract the unrealized value that is normally lost when a life insurance policy is surrendered directly to the insurer (see Figure 7 below). Consumers who sell their life insurance policies to a third party investor unlock a valuable cash asset by entering into a life settlement. There are no restrictions to the seller on the use of life settlement proceeds.

Figure 7²⁴



Life insurance company pricing practices, described in Section III above, create a profit opportunity for the life insurance secondary market. The profit opportunity is the difference, or “spread,” between (i) the cost of purchasing and maintaining a life insurance policy over the insured’s lifetime; and (ii) the policy’s benefit that will be paid upon the insured’s mortality. The secondary market for life insurance policies has also been driven by the creation of life insurance policy pricing tools and actuarial modeling techniques developed by investors.

A myriad of service providers are available to assist consumers with accessing the value that is lost if a life insurance policy is surrendered directly to the insurance company. In doing so, they may also offer investors the opportunity to share in the value of life insurance assets by offering investors the chance to invest in a portfolio of life insurance assets. Such policies may be found in private portfolios which may include trusts, partnerships, individually held, etc. They may also be found in investment structures available to investors such as: bonds and notes, mutual funds, partnership or limited liability company shares, common or preferred stock in companies holding life insurance assets, fractional policy ownership, etc. Once transferred into the secondary

²⁴ Sam Rosenfeld, *Life Settlements: Signposts to a Principal Asset Class*, Working Paper, Wharton Financial Institution Centre, at 10 (2009).

market via a life settlement, these policies may be resold or traded among investors in private tertiary sales. There is today no public market in which to sell life insurance policies in the life insurance secondary market.

B. Who are Good Candidates for a Life Settlement

A good insured candidate for a life settlement meets one of the following criteria: (1) a male or female 70 years old or older, or (2) a male or female 65 years old or older with some health problems. There are other considerations including: future needs for life insurance, credit worthiness of the insurer, size of the policy, life insurance policy terms and history of the policy's ownership. Typically, a life settlement broker is the first contact in the life settlement process who determines a candidate's eligibility.

Almost all life insurance policies are eligible for life settlements. Generally, a life insurance policy must be in place for at least two years before it can be sold, but some states stipulate up to a five year holding period. Additionally, the most attractive life insurance policies for life settlements are convertible term life and universal life. Further, in order to be eligible for most life settlement opportunities, the life insurance policy must have a face value of at least \$250,000. Life settlement brokers also prefer a policy with a cash surrender value of less than twenty-five percent of the net policy benefit. They also prefer policies that have not been previously owned or financed by a third party that may not have had an insurable interest in the life of the insured.

V. Alternative Investments in Longevity Based Assets

Longevity assets include life insurance policies, pension funds, annuities, long-term care contracts, and reverse mortgages. The Social Security Administration provides benefits keyed to longevity, as do families funding parents' retirement and care. In all of these, when an individual benefiting from the assets lives longer live longer the asset value decreases ... and in extreme circumstances ... the plan or contract can become underfunded. This is the current issue with Social Security and the current focus of concern for many pension, annuity, long term care and retirement plans.

A prudent investment in longevity assets is keyed to averages based on long established mortality statistics accumulated by the U.S. Government, the Society of Actuaries and other specialized institutions. A prudent investment seeks assets that are of such size and diversity that the performance of the investment relies on historical averages applicable to the cohort group of lives representing the asset. This investment principle is based on the "Law of Large Numbers". The law of large numbers is a statistical axiom that states that the larger the number of units independently exposed to an event, the greater the probability that actual event experience will equal expected event experience. In other words, the credibility of data increases with the size of the data pool under consideration.

Investments in longevity assets that are not of sufficient size to expect the "average" or law of large numbers can result in very high risks of financial loss if the lives on whom the assets are based live longer than

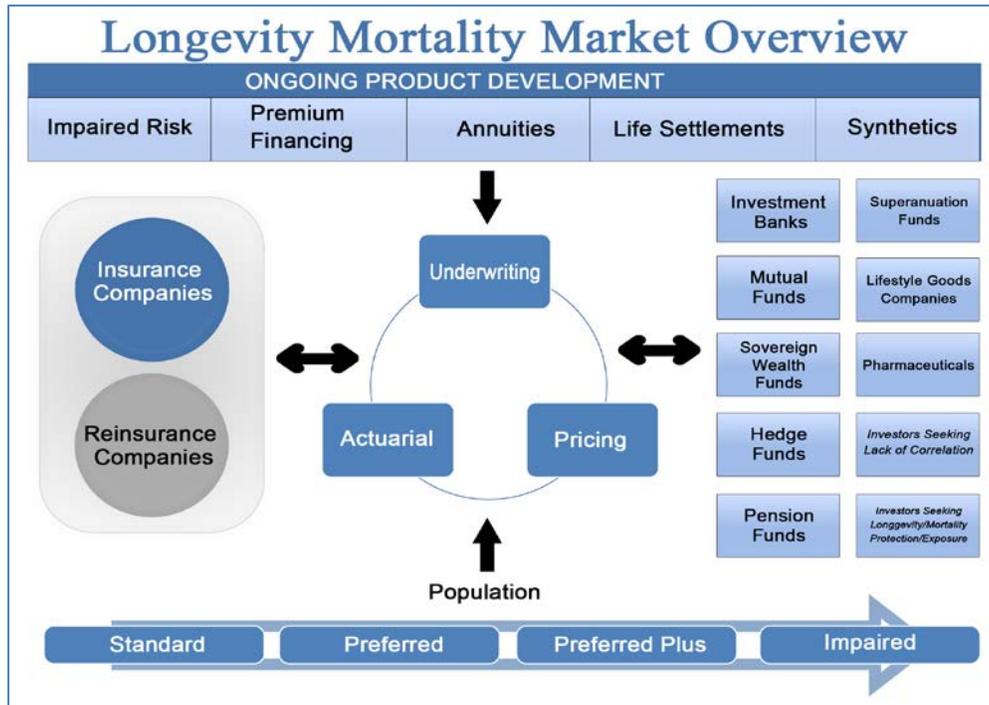
expected. Similar situations, perhaps to a lesser extent, exist in other alternative asset classes including oil & gas, real estate, equipment leasing, mortgages, to mention a few.

Insurance companies use the “Law of Large Numbers” and probability to determine the chance of an event occurring. If the chance of someone incurring an insured loss one in one thousand, then insurance companies seek similar coverage on 1,000 risks and expect to pay the claim on the one insured claim. This is called “spreading the risk”. It is important for insurance companies to adequately gauge the hazards (items that increase the chance of loss) of a risk before insuring it. If they don’t research and know a business or the habits of an individual and they guess wrong in predicting the chance of something happening, the insurance company could lose money. If they do this often enough then the company suffers. The term “Law of Large Numbers” was introduced by S.D. Poisson in 1835 as he discussed a 1713 version of it put forth by James Bernoulli, in other words it is well established and understood by most investors.

As applies to life insurance assets, utilizing mortality tables derived by recording and studying the number of claims over a very large population, the number of 80 year old men, for example, who will die in a particular year can be fairly predicted. However, this does not say the year a particular person will die can be predicted. It only says that in a given year there is a high probability that X number of men who are 80 will die. Accordingly, with enough data, a statistician can comfortably predict the number of persons of a given age who will conceive a serious illness in a given year. With enough data, the statisticians can assemble all of this information into tables. For deaths, the tables are called mortality tables and for sicknesses they are called morbidity tables.²⁵

²⁵ [Asset Protection: Concepts & Strategies](#) (McGraw-Hill 2004); Chris Riser and Jay Adkisson

Figure 8²⁶



VI. Life Insurance Assets are a Viable Alternative Investment

Life insurance is a longevity asset that can act as an important component of an investment portfolio. Life insurance assets provide an alternative investment class that offers significant risk mitigation through portfolio diversification, possible securitization of life insurance assets, the growth and size of the underlying longevity-mortality market (see Figure 8 for an overview of the longevity-mortality market), and other benefits.²⁷ Life insurance policies in the LISM have now become recognized as an “alternative” asset class that can provide investment returns higher than most mainstream assets, that is not correlated with most mainstream investments or other alternative investments, and that has unique investment risk considerations.

A. Benefits of Life Insurance Assets as an Alternative Investment

The life insurance secondary market is huge and growing. From \$87 billion in 2011, the market is expected to grow to \$151 billion by 2020.²⁸ Life insurance assets represent a viable alternative investment because the longevity-mortality industry underlying life insurance assets is uncorrelated to traditional financial

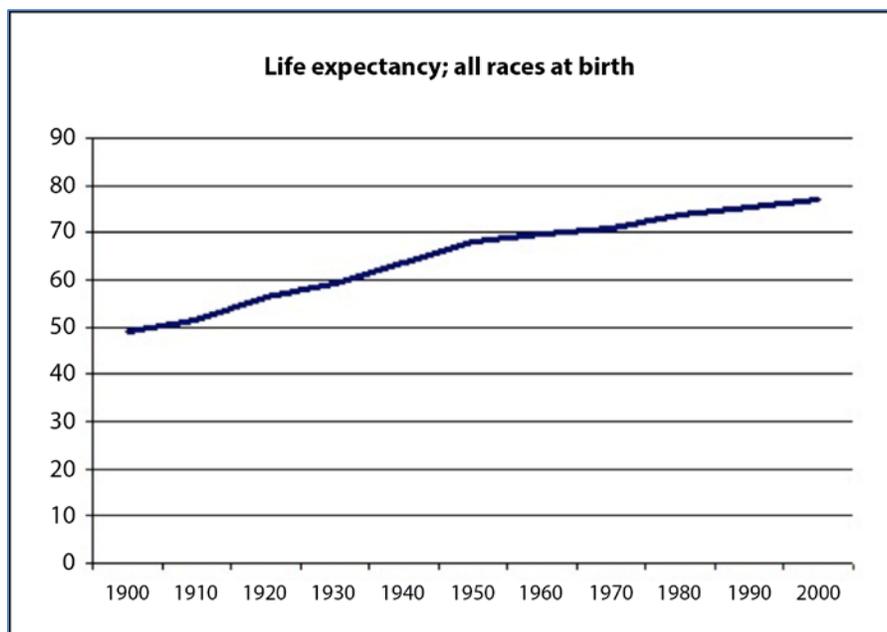
²⁶ *Id.* at 39

²⁷ Sam Rosenfeld, *Life insurance assets: Signposts to a Principal Asset Class*, Working Paper, Wharton Financial Institution Centre, at 3 (2009).

²⁸ *Id.*; see also, *LISA 2nd Annual Institutional Investor Life Settlement Conference*, accessed March 14, 2013, <http://www.mlflexserv.com/lisa-2nd-annual-institutional-investor-life-settlement-conference>.

instruments. In addition, the historical predictability of U.S. mortality has been very predictable over the last century (see Figure 9 below).

Figure 9²⁹



This provides diversification away from other asset classes like stocks, bonds, commodities, and property. Another benefit of life insurance assets as an asset class is that the investments in the assets are often securitized (i.e., debt or equity securities offered which are backed by life insurance assets). Such securitizations are accomplished through careful consideration and selection for inclusion in the asset pool based upon factors such as life expectancy, age, face amount of the life insurance policies, disease, and other meaningful attributes. By pooling into portfolios and then securitizing life insurance assets, investors have a greater ability to determine what level of risk and which life insurance attributes the investor prefers by selecting the desired pool in which they wish to invest.

Life insurance assets can be found in private portfolios which may include trusts, partnerships, individually held, etc. They may also be found in investment structures available to investors such as: bonds and notes, mutual funds, partnership or limited liability company shares, common or preferred stock in companies holding life insurance assets, fractional policy ownership, etc. Once transferred into the secondary market via a life settlement, these policies may be resold or traded among investors via private tertiary sales. There is today no public market in which to sell life insurance policies in the life insurance secondary market.

Not only is the market for life insurance assets growing, but recent legislation has developed to create transparency within the industry. The regulation of the life insurance secondary market now exists in forty-five

²⁹ Elizabeth Arias, United States Life Tables, 2001, National Vital Statistic Reports 52, No. 14 (2004), table 12, available at http://www.cdc.gov/nchs/data/nvsr/nvsr52/nvsr52_14.pdf.

states.³⁰ Further, institutional investors increasingly participate in the life insurance secondary market. For example, current and prior market participants include Goldman Sachs, JP Morgan, Deutsche Bank, Morgan Stanley, Credit Suisse, Gen Re, AIG, Phoenix Life, and TransAmerica.³¹ The presence of large institutional investors in the life insurance assets market has increased and promises to continue to increase the liquidity of the market and the market's stability.

B. Risks of Life Insurance Assets as an Alternative Investment

Although there are numerous benefits to an investment in life insurance assets as an alternative investment, there are also several risks. These risks include the longevity risk described above, adverse selection, operational risk, counterparty risk, market risks, and regulatory risks.

Longevity risk concerns the risk that rate of maturity within a portfolio of life insurance assets will be slower than projected by the actuarial and underwriting modeling.³² However, this risk may be mitigated by use of longevity reinsurance or synthetics for a portfolio wide hedge against the asset performance. Alternatively, a hedge may be used on an asset specific basis determined by individual life insurance policies.

Related to longevity risk is adverse selection risk. This is the risk of insureds who sell their policies to represent themselves to be less healthy than they really are and/or after selling their policy they engage in living and health practices designed to lengthen their living. This risk is minimized, to the extent possible, by obtaining multiple medical records, obtaining life expectancy evaluation by experienced experts, interviewing the policy seller, and applying a mortality improvement factor in the insured's life expectancy. If misrepresentation appears to exist, the policy will not be purchased. However, there is nothing anyone can do to prevent an insured from engaging in living and health practices designed to lengthen their lives.

Another risk involves operational risks inherent in a portfolio design and the management of the portfolio of the life insurance assets. Due diligence and transparency provide investors with the best opportunity to evaluate this risk. Things to consider are experience of management, evidence that policy pricing practices include sufficient margin to cover risks, frequency and clarity of reporting practices, updating of life expectancies of the insured, and considerations included in the modeling of the portfolio's projected performances. The portfolio business model should include provision for premium payments and policy maintenance during the early years when policy maturities may be lumpy and may be less than expected. Further, management of a carefully controlled portfolio of life insurance assets will constantly monitor the performance of the assets and if appropriate, sell off underperforming policies. Counterparty risks are also a consideration. This risk involves both the issuer of the life insurance policy and the constituents to the life

³⁰ *State Document Report*, Life Insurance Settlement Association, www.lisa.org/state-document-report.aspx.

³¹ Sam Rosenfeld, *Life insurance assets: Signposts to a Principal Asset Class*, Working Paper, Wharton Financial Institution Centre, at 34 (2009).

³² *Id.*

settlement. The danger is that the underlying life insurance policy may become worthless if the issuer of the policy fails or the acquisition and maintenance of the life insurance policies is not conducted properly. However, the counterparty risks are limited by diversification of highly rated insurance carriers and due diligence and transparency before the acquisition of the life insurance policy to avoid both the allegations of fraud and the failure of the life insurance issuer.

Market risks are fundamental to the trading of all assets, including life insurance assets as alternative investments. The value of a life insurance policy may rise or fall, but the diversification of a portfolio reduces the extent of the volatility. Thus, as with all asset classes, market risk may be mitigated by asset diversification.

Finally, regulatory risks result from legislative environment surrounding life settlements and life insurance assets. Although the legislative environment may create uncertainty, similar to any asset class, prudent financial practices and due diligence help mitigate the risk. Additionally, transparency of the acquisition of the life insurance policy is essential to assist in the mitigation of the regulatory risks surrounding life settlements and life insurance assets.

The benefit to an investor in investing in or with a company that pools and manages life insurance assets is manifest. Foremost, such parties help mitigate longevity and counterparty risks. Such entities often have portfolios of numerous life insurance assets with different longevity studies by major ratings companies have shown that the longevity risk can be mitigated by diversifying larger portfolios of life insurance assets. Further, because such entities purchase life insurance policies from numerous parties, the counterparty risk is mitigated through diversification of the parties to the life settlement. Finally, as discussed above, investing with a professional aggregator of life insurance assets assures that investors mitigate their longevity and operational risks while investing in a vehicle that avoids the risks inherent in the stock and bond markets.

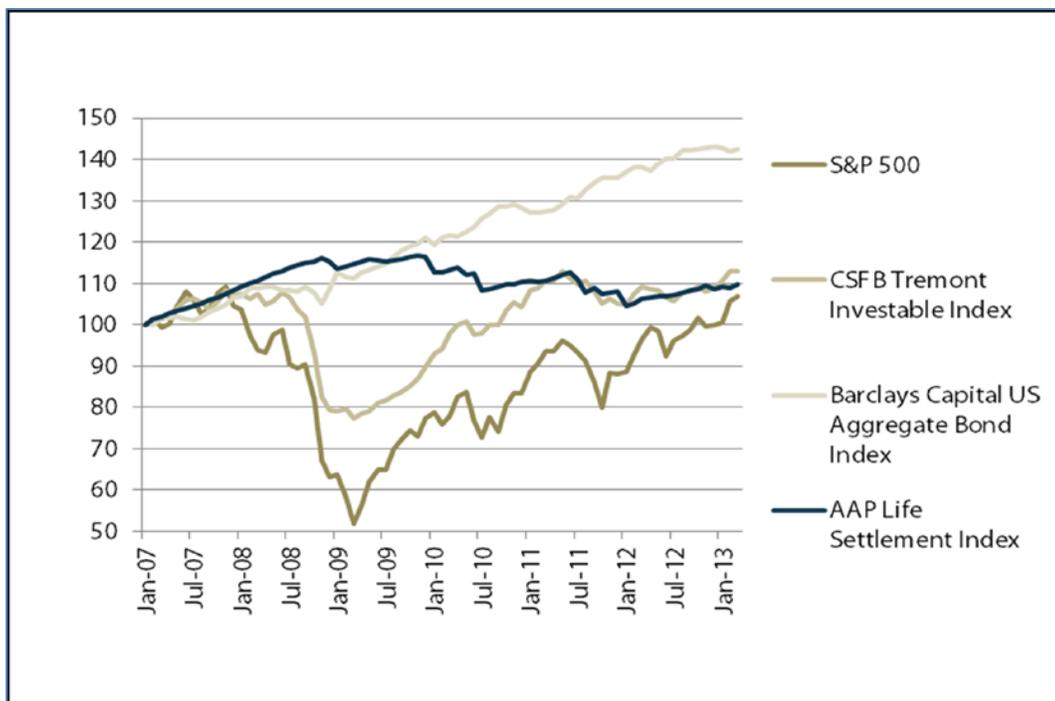
VII. Conclusion

Investors should consider a holistic approach to their investment portfolio. This includes consideration of alternative investments to mitigate and diversify risks. An investor should contemplate life insurance assets, REITs, equipment leasing DPPs, and energy investment DPPs among their stable of alternative investments. Among the names that investors should consider in REIT investments are: Baron Real Estate Fund, American Residential Properties, Inc., Hines Global REIT, Inc., and Wells Core Office Income REIT, Inc. Further, investors should consider the following names in equipment leasing DPPs: New England Securities, Cypress Financial Corporation, and Berthel Fisher & Company Financial Services, Inc. Additionally, companies involved with energy DPPs investors may want to consider are: Texas Coastal Energy Company, TRUExploration LLC, and Red River Securities, LLC. However, life insurance assets in particular represent a potential alternative investment that an investor should consider as part of a holistic view for their investment portfolio. The goal of

all investors is to mitigate risks and traditional diversification no longer meets this goal. The use of life insurance assets represents one alternative investment that may provide greater asset diversification for an investor searching for an asset class that is uncorrelated to the volatility of other asset classes (see Figure 10 below).

Figure 10³³

AAP Life Settlement Index Performance
Comparison to Stocks, Bonds & Hedge Funds: January 2007 – July 2012



Among the names that investors should consider in this space for further information and to explore an investment opportunity in life insurance assets are the following: GWG Life Settlements, LLC, Coventry First, LLC, CMG Life Services Inc., and Habersham Funding, LLC.

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³³ AAP Life Settlement Index, AA-Partners Ltd., accessed March 14, 2013 <http://www.aa-partners.ch/aap-ls-index/>.

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Consider, for example, the potential benefits of an investment in a diversified mix of life insurance assets. Such an alternative investment represents the opportunity to diversify asset classes by buying life insurance settlements as an alternative investment. A diversified portfolio of life insurance assets also represents risk mitigation from buying merely one life insurance settlement policy. Moreover, life insurance assets provide diversification apart from the type of mitigation afforded in the context of traditional and geographic diversification because, significantly, life insurance policies are not correlated to the equity market. Instead, the underlying life insurance policy asset is based purely on mortality experience. Finally, by investing in a multitude of life insurance assets, investors limit their risk of investing in only one life insurance settlement.