Insights – Distressed Assets Q1 2015

Life settlements – marked-to-myth

A common feature of illiquid assets is that price expectations of sellers and buyers do not match, with these wide spreads resulting in non-functioning markets. Whilst there are many reasons for this to happen, often this is due to the assets being valued by pricing models using stale or overoptimistic input values. Some market participants call this valuation approach "mark-to-myth". In this brief note we discuss why this is the case in particular for many life settlement funds.

By way of background, life settlements are existing life insurance policies in the US that were sold by their original policyholders to a third-party. Typically such policies are sold to life settlement providers when the policyholder no longer needs or wants the policy for personal reasons or where future premium payments become unaffordable. The life settlement providers then often sell the policies on to investors, often wrapped in specialized investment funds, looking for attractive and uncorrelated investment opportunities. The marketplace can therefore be characterized as follows.

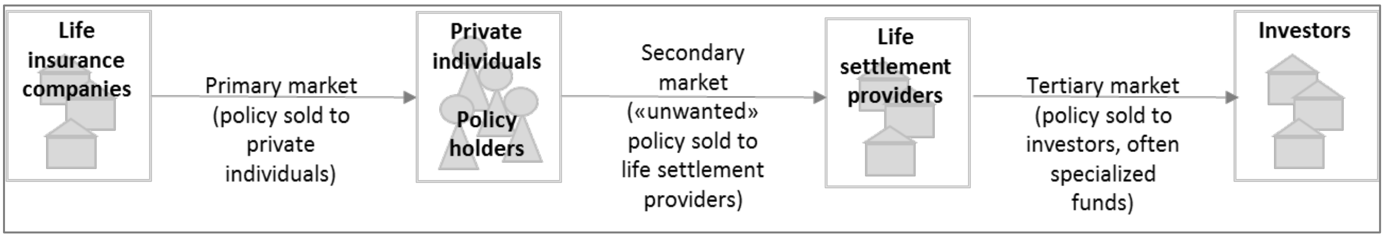

Figure 1: Illustrative description of life settlements market

While the primary and secondary markets take place in the US, many investors in Europe have acquired life settlement funds or structured life settlement products and might be interested in seeing an increased liquidity in the so-called tertiary life settlement market.

Let us now continue with an illustration on the economics of life settlement investments and how the actual outcome diverges from investors' initial expectations.

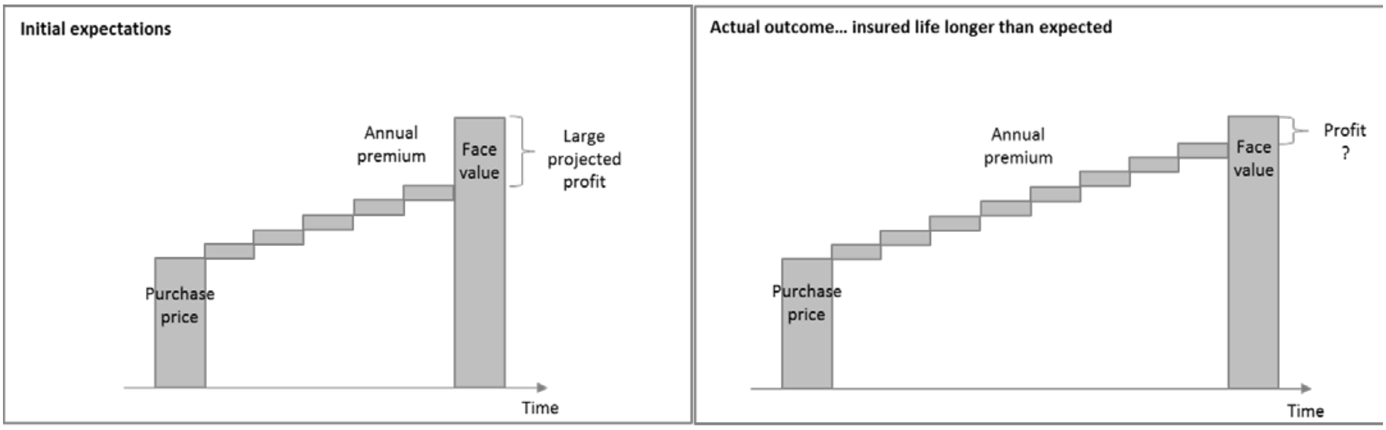

Figure 2: Illustrative cash flow profile of life settlement investments

As it turned out, many life settlement providers were selling policies with unrealistically short life expectancies used in the pricing models. In particular, during the years just before the significant life expectancy table methodology revisions in 2008, many life settlements were acquired by dedicated life settlement funds in Europe that are affected twofold. Annual premiums have to be paid for much longer periods than initially expected and receipt of the policy face values will occur much later than anticipated, materially eating into realizable profits. Making matters worse, investments funds that do lack the liquidity or financing to continue premium payments risk for the policies to lapse, may be forced into a fire sale or even end up insolvent.

Turning to valuation now. Ever since IFRS 13 accounting standards on “Fair Value Measurement” have been introduced in 2013, it is evident that most life settlement funds or products should mark their books on the basis of an “exit price” as a market-based pricing must be used wherever possible. As many data providers are now able to deliver market-based input values for life settlement portfolios, there is no reason to hold on to discounted cash flow models that can justify any valuation, leaving investors at the will of the fund manager. Fund managers tend to inflate or at least keep valuations inflated, as a) fees are linked to the fund’s net asset values and b) write-downs seriously affect the potential for raising new assets. It is therefore time for investors to start pushing their investment managers to finally use market-based input data in their valuation models that is sourced from independent data providers. Also, investors should demand from their managers to disclose the ratio of actual/expected deaths to assess the quality of the chosen life expectancy model inputs.

Secondary market pricing for many life settlement funds is currently characterized by extremely steep discounts to their applied mark-to-myth valuations. As soon as life settlement funds start using a market-based valuation, we expect the liquidity in the tertiary market to pick up substantially allowing investors to exit their investments near the official market valuations, even if that means crystallizing unrealized losses currently not reflected in the valuation.

Please do not hesitate to contact us if you wish to discuss exit options for your life settlement investments.

Thomas Ritter is a founding partner of Multiplicity Partners. He is responsible for the firm's distressed assets business and has more than 17 years of experience in alternative investment industry with focus on secondary markets, portfolio management and structuring. Prior to founding Multiplicity Partners, he held various roles at Horizon21, Man/RMF and Credit Suisse. Thomas holds a MSc in Finance from the ICMA Centre, University of Reading, and is a CFA and CAIA Charterholder

About Multiplicity Partners

Multiplicity Partners is an investment boutique specialised in providing liquidity solutions to holders of private market funds and distressed assets. The firm also offers a range of advisory and governance services across alternative assets.

Multiplicity Partners has been an active participant in the secondary market for fund interests and distressed assets since 2010, acting as buy- and sell-side advisor, investment manager and principal investor. The team has successfully completed dozens of transactions across a wide range of illiquid and complex financial assets and established a global network of industry contacts. Each partner contributes more than 15 years of relevant experience, giving us the collective capabilities to effectively identify, analyse and execute attractive investment opportunities in hard-to-value assets.

Multiplicity Partners is an independent and management-owned company. Personal accountability of senior professionals ensures quality of work, reliability and attention to details.

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