

The Role of Life Settlements in a Fixed Income Portfolio

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David W. Miles, CEO
Miles Capital, Inc.

MILES *Capital*
Independent Investment Solutions



Committed to Investing for Client Success

- | | |
|------------------------------|--|
| Founded in 1982 | <ul style="list-style-type: none">▪ 29 year history of helping clients achieve success through integrated investment solutions |
| Independent & Employee-Owned | <ul style="list-style-type: none">▪ Singular focus on investing client assets to meet their needs▪ Highly motivated employee owners |
| Assets Under Management | <ul style="list-style-type: none">▪ \$3.6 Billion as of September 30, 2011▪ Largely fixed income |
| Client Base | <ul style="list-style-type: none">▪ Small Insurers – Life and P&C▪ Foundations▪ Local Governments |

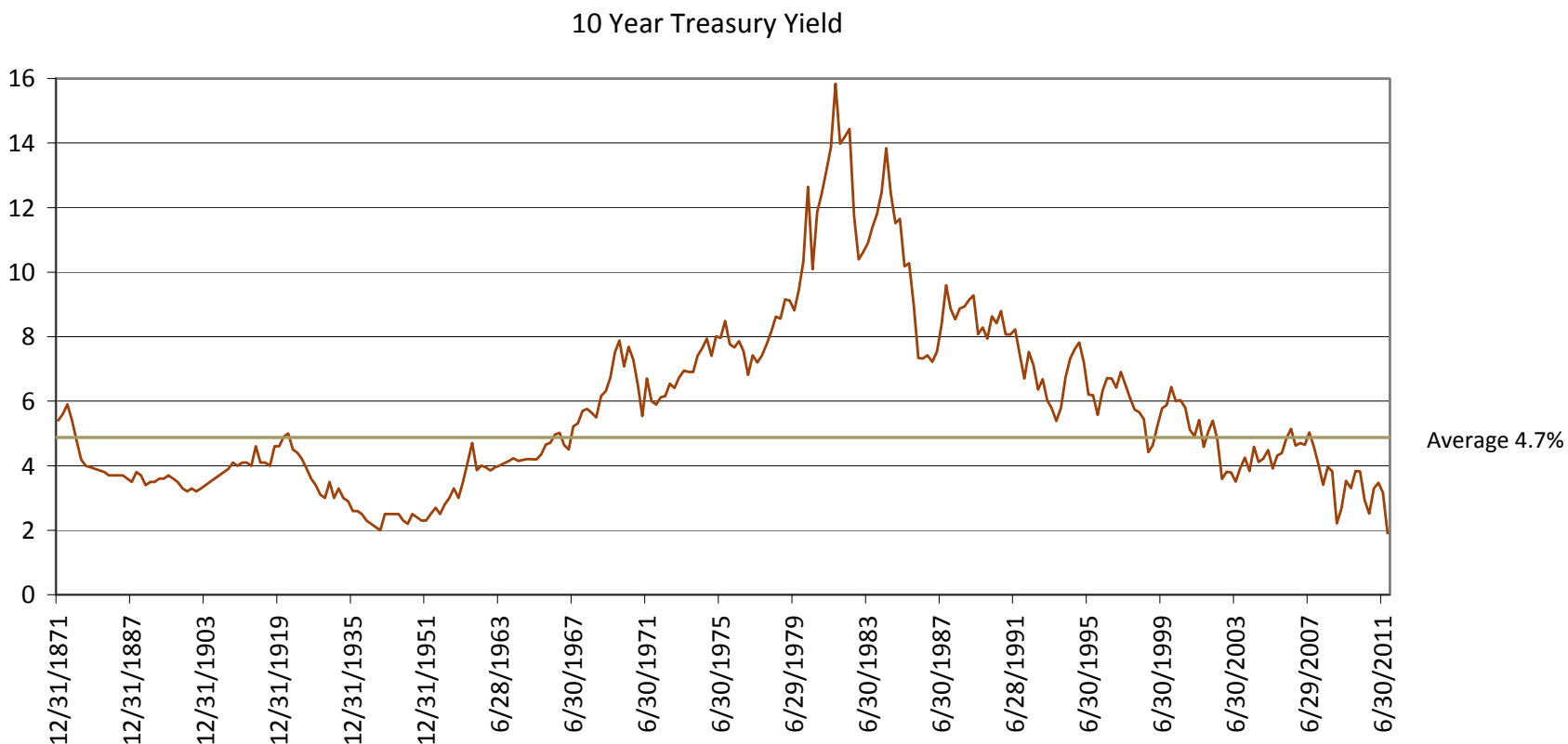
- Generate current income to fund operations
- Maintain/grow real purchasing power
- They value knowing
 - Precisely what investments will return (par); and
 - When principal will be returned (maturity)
- Superior rank of bonds to equities in the capital structure
 - Matches risk tolerance
 - Fits regulatory capital requirements
- Lower volatility than equities
- Lower overall portfolio volatility
- Manage the duration of assets (ALM)

How Bonds Look in the Current Environment

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1 – 5 (Best)
2
2
5
3 – 5
4
5
3 – 5
3
3
4 – 5

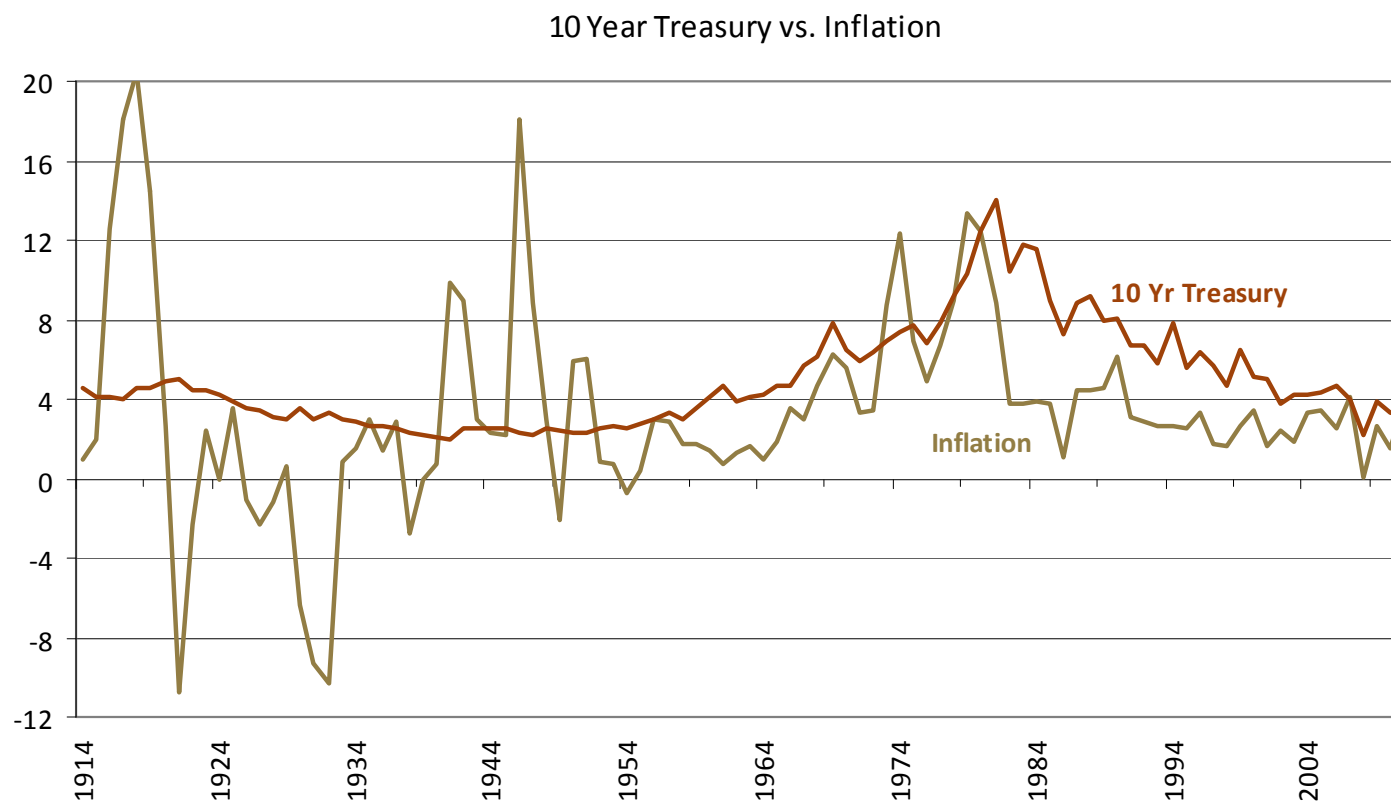
Nominal yields are low...



Source: Bloomberg & U.S. Federal Reserve

Yields are at lows not seen since the 1950s, which makes fixed income returns unattractive.

... and real yields are even more concerning.



Investors are accepting negative real returns in a flight to safety.

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-
- Hedge Mortality Risk

How Bonds Look in the Current Environment

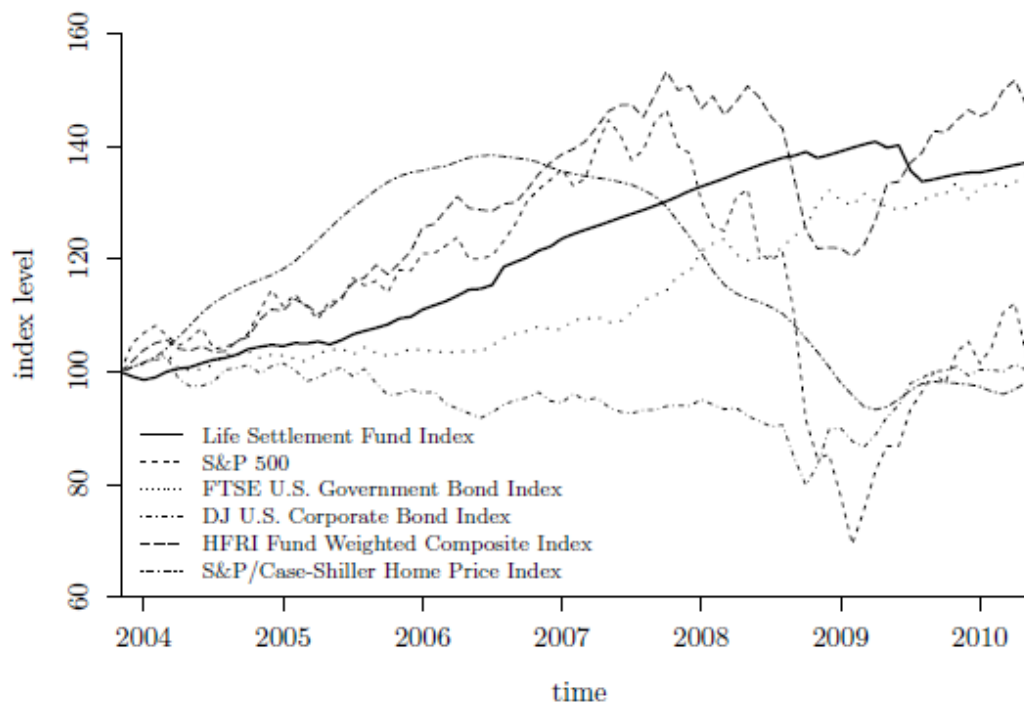
1 – 5 (Best)
2
2
5
3 – 5
4
5
3 – 5
3
3
4 – 5
0

How Life Settlements Look

1 – 5 (Best)
0
2 – 5
5
2
5
??
1 – 3
4
4
3 – 4
4 – 5

At first glance, they are hard to argue with.

Life Settlements in Comparison to Other Asset Classes (December 2003–June 2010)



Source: "Performance and Risks of Open-End Life Settlement Funds," The Journal of Risk and Insurance, 2011
Published online, 11 April 2011

Life Settlements outperformed all but hedge funds over the period, with much lower volatility.

But have they truly lived up to their billing?

	Average Annual Return 1/1/2004 – 6/30/2010
Life Settlement Fund Index	4.85%
U.S. Government Bond Index	4.91%
Average Yield on the 10-Year U.S. Treasury (1872 – June 30, 2011)	4.70%

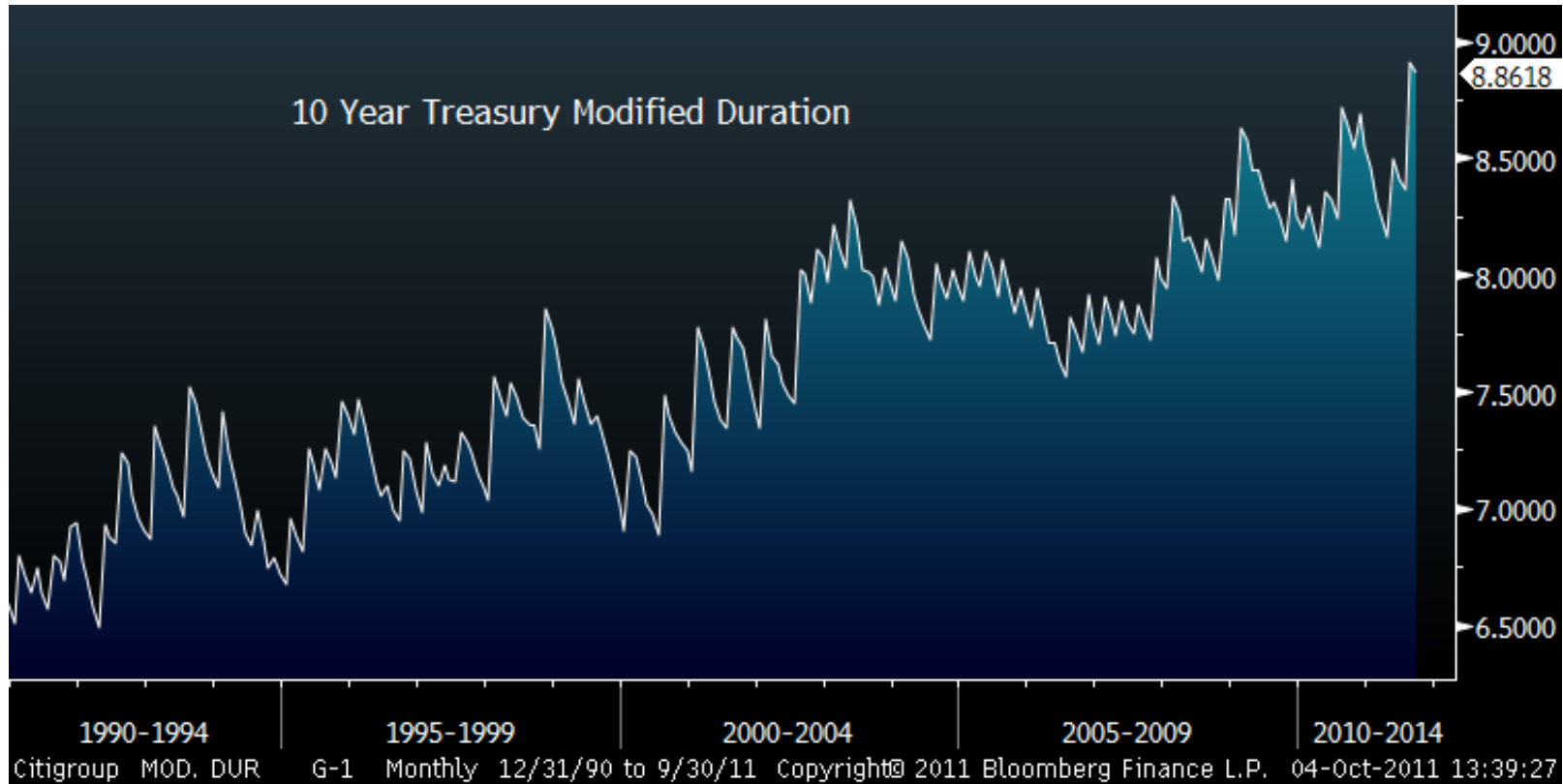
Source: "Performance and Risks of Open-End Life Settlement Funds"

- These are not double digit returns
- Aggregate returns mask wide fund-by-fund variations
- The authors observe that "the solid performance [of the Life Settlement Fund Index]... is likely to be all but a mere by-product of the... valuation methodology...."

- Systemic/Market Risk – the entire asset class loses favor
- Interest Rate Risk – values decline due to rising interest rates
- Purchasing Power Risk – inflation exceeds investment returns
- Reinvestment Risk – declining rates effect reinvestment
- Spread Risk – spreads widen due to market perceptions
- Duration Risk – change in price sensitivity to interest rate changes
- Credit Risk – change in the issuer’s ability to repay
- Operational Risk – loss resulting from failed processes or systems
- Call Risk – issuer prepays when rates decline
- Prepayment/Extension Risk – debt repaid earlier or later than expected
- Liquidity Risk – inability to sell at “fair value” when needed

Bonds in the
Current
Environment

1 – 5 (Best)
3
1
2
5
2 – 4
1
Varies
4
5
4 – 5
3 – 5



Source: Bloomberg

As duration relative to yield has risen, the impact of rising rates on market values is magnified.

	Bonds in the Current Environment	Life Settlements
	1 – 5 (Best)	1 – 5 (Best)
▪ Systemic/Market Risk – the entire asset class loses favor	3	2 – 3
▪ Interest Rate Risk – values decline due to rising interest rates	1	2 – 4
▪ Purchasing Power Risk – inflation exceeds investment returns	2	4
▪ Reinvestment Risk – declining rates effect reinvestment	5	4
▪ Spread Risk – spreads widen due to market perceptions	2 – 4	3
▪ Duration Risk – change in price sensitivity to interest rate changes	1	??
▪ Credit Risk – change in the issuer’s ability to repay	Varies	??
▪ Operational Risk – loss resulting from failed processes or systems	4	2 – 3
▪ Call Risk – issuer prepays when rates decline	5	5
▪ Prepayment/Extension Risk – debt repaid earlier or later than expected	4 – 5	1
▪ Liquidity Risk – inability to sell at “fair value” when needed	3 – 5	1
▪ Systemic “Reset”	4	2 – 3
▪ Regulatory/Legal	4	2

Past performance is not indicative of future results. An investor should consider the investment objectives, risks, charges and expenses carefully before investing as investments may not be suitable for all investors.

- Longevity Risk dominates as the most difficult risk to address adequately
- Liquidity Risk
- Legal/Regulatory Risk
- Expectation Risk – expecting too much from Life Settlements
 - “High” (i.e., double digit) returns – publicly available data do not support the case
 - Low volatility
 - Valuation methods understate
 - Survivorship bias
 - Little market transparency
 - Uncorrelated returns

One of the most-often cited advantages of life settlements as an asset class is the lack of correlation to other financial assets.

The data are supportive

Correlation of Life Settlements to Other Financial Assets
1/1/04 – 6/30/10

	US Stocks	US Govt Bonds	US Corp Bonds	Hedge Funds	Home Prices	Commodities	Private Equity
Life Settlements	-0.12	-0.04	-0.27	-0.06	-0.17	-0.03	-0.08

Source: “Performance and Risks of Open-End Life Settlement Funds”

Our observations

- The performance numbers behind these correlations are based on modeled, not market values, and individual funds differed greatly
- The premise that because mortality is uncorrelated with traditional capital markets, life settlement performance will be uncorrelated to other financial assets misses the mark
- Current low correlations may be due to (1) the immaturity of the market, and (2) a limited number of policies are traded in the normal course
- The more life settlements become established as an asset class, the greater correlations with the bond market will become

- Once you convert life insurance policies to financial products they will be valued against other investment options
- That payment is made upon death – not a market event – will be seen as less significant as the market matures
- Due to their bond-like characteristics, life settlements may price more like bonds
 - Investors will begin to calculate duration of their life settlements as a factor in pricing
 - A recent study calculated a 14.4% duration for a sample of insurance policies
 - Pricing may move from absolute returns to relative spreads
- Whether pricing becomes more “bond-like” or not, changes in the interest rates will impact valuation

As a bond?

“A life settlement can be described as a negative coupon bond having fixed premium payments, a known face value, and variable maturity.”

Life Settlements: Signposts to a Principal Asset Class

“Bond-like characteristics with superior returns.”

Archeron Capital Ltd.

- Life Settlements do have much in common with bonds of different types
- Indeed, we expect correlations between bonds and life settlements to rise
- But, there are too many dissimilarities
 - The negative coupon means life settlements are negative-carry assets
 - The total price of a life settlement is unknowable at the time of purchase
 - Life settlements have no stated maximum maturity
 - The most important investment risks of life settlements differ substantially from traditional bonds

As an alternative asset class?

“[It] is a safe prediction that, by the end of 2012, the key elements of portfolio diversification for sophisticated investors will be equities, bonds, commodities, real estate and longevity.”

Life Settlements: Signposts to a Principal Asset Class

While we wouldn't go quite that far, we think this statement is closer to the mark.

- Life settlements are not necessarily for fixed income investors *per se*
- However, life settlements may well be a very valuable additional asset class for an institution predominantly invested in fixed income that
 - Is not long longevity already;
 - Has a very long (10+ years) time horizon;
 - Is seeking a higher total return on its portfolio;
 - Is willing to buy and hold;
 - Wants to lower portfolio-level volatility; and/or
 - Desires to hedge mortality risk.

How to institutionalize life settlements as an asset class

- As an outsider we perceive some misalignments of interest in the industry
 - Incenting providers on modeled IRRs
 - Paying medical underwriters on a piece-rate basis
 - Conflating the provider and asset manager roles
- Current pools have too few lives
- Changes following the 2008 VBT shook investor confidence
- Vital to build confidence in life expectancy estimates
 - Highlight for investors that LE's are estimates, not certain maturity dates
 - Competition among LE actuaries must not damage industry credibility
- Returns are more than acceptable
 - What is needed is a broader perspective of investor needs
 - Offer a solution, not a product
- Opportunity to benefit from narrowing spreads as the asset class matures
- As the data set of lives examined grows, LE estimates should continue to improve

This presentation can be found under the title "Role of Life Settlements in a Fixed Income Portfolio" at www.miles-capital.com/insights/news.html.

David W. Miles
Chief Executive Officer
dmiles@miles-capital.com
(515) 224-2718