



LIFE INSURANCE INVESTMENTS AND BOND YIELDS

ABOUT THE AUTHOR



Gustaf Hagerud is the Managing Director of Ress Capital. He has worked in the financial industry for almost 40 years. Gustaf spent most of his time on global asset allocation and strategic portfolio construction. He served as the deputy CEO of the public pension fund AP3 for seven years, responsible for all investments, including global equities, global bonds, hedge funds, private equity, real estate, forestry, infrastructure, and insurance-linked securities. Before that, he spent ten years working with global asset allocation at the pension funds Alecta and AP1. He began his career in the banking sector, as a trader at Nordea and Swedbank. Gustaf holds a PhD in Finance from Stockholm School of Economics. His research focuses on volatility forecasting, and he has co-authored a textbook on the Swedish financial markets.

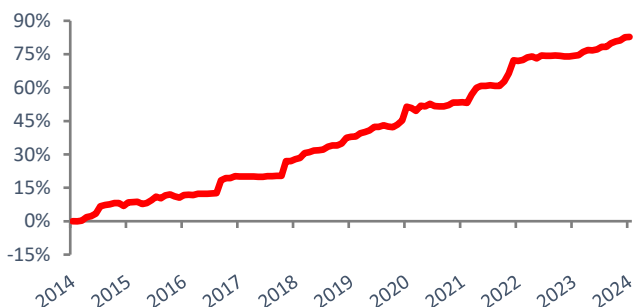
EXECUTIVE SUMMARY

- Life Insurance investments have historically shown low correlation to bonds as well as other asset classes. Investors want to understand the interest rate sensitivity of our niche asset class.
- In this Market Insight, data is presented that supports the conclusion that bond yield movements have a limited effect on the prices paid for life insurance policies in the secondary market.
- It is mainly demographics and investors' need to diversify portfolios that drive the pricing of assets and expected returns of investing in the secondary market for life insurance policies.
- We expect this trend to continue and see no major changes to the market in the coming years.

INTRODUCTION

Ress Capital has been active as a fund manager in the secondary market for US life insurance policies for over a decade. In our view, the strongest arguments for being invested in the asset class are: i) the return is fundamentally uncorrelated to returns of other asset classes, ii) the high risk-adjusted return, and iii) the downside protection in the form of small and few periods with a negative return. In *Graph 1*, these three characteristics can be clearly observed.

Graph 1. 10 Years Performance of Ress Life Investments



Source: Ress Capital

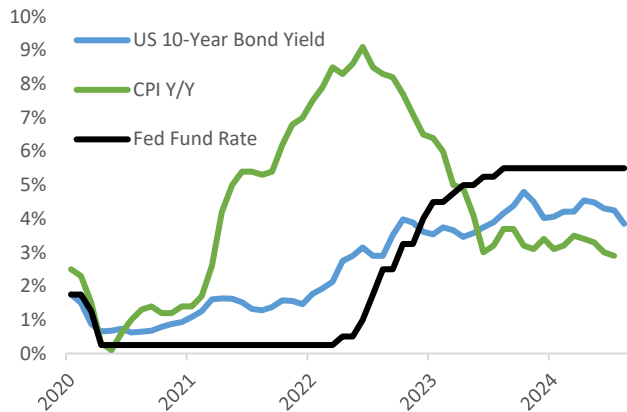
In the period 2022-2024, when interest rates and bond yields have been at their highest levels since the Great Financial Crisis, we have received several questions from clients regarding the interest rate sensitivity of our asset class. In this Market Insight, I will give evidence that the correlation between the return of conventional fixed income investments and our asset class is very low. Furthermore, arguments will be given as to why the secondary market for US life insurance policies is not affected by changes in fixed income markets. In connection with this, a short presentation of the secondary market for US life insurance policies will be included. The paper concludes with an outlook for the asset class in the coming years.

FIXED INCOME MARKETS 2011-2024

The fund, Ress Life Investments, was launched in April 2011. During the first 10 years of investing, in 2011-2021, the inflation rate in the US was relatively stable, and monetary policy was supportive of growth. However, in 2021 global inflation started to move higher, mainly depending on supply-side disruptions caused by Covid-19. With Russia's invasion of Ukraine in February 2022, CPI in the US moved sharply higher and peaked at 9.1% in June 2022.

Facing inflation well above its target, the Federal Reserve tightened monetary policy by increasing the policy rate by 500 basis points from March 2022 to July 2023. The increase in interest rates led to higher bond yields globally. In the US, the 10Y government bond yield went from 1.9% in February 2022 to 4.8% in October 2023. *Graph 2* shows i) headline CPI, ii) the Fed Fund Rate, and iii) the US 10Y government bond yield during this dramatic period.

Graph 2. Inflation, Fed Fund Rate, and 10Y Bond Yield



Source: Federal Reserve Economic Data

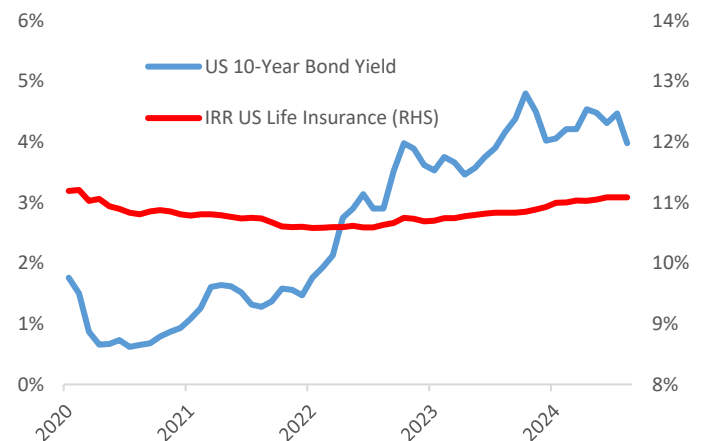
EVIDENCE FROM THE SECONDARY MARKET FOR LIFE INSURANCE POLICIES

Even though the sharp increase in government bond yields affected many asset markets markedly, no major price movements were noted in the secondary market for US life insurance policies. To illustrate this observation, we have analysed the *implied internal rate of return* (IRR) for prices paid in US dollars for US life insurance policies transacted on the secondary market. These implied IRRs are the equivalent of the market yield for ordinary bonds, in that they indicate the expected return for holding an asset for the duration of the investment.

At Ress Capital, we have recorded IRRs, i.e. expected returns, for US life insurance since 2012. *Graph 3* shows the series of expected returns in Ress Capital's database for US life insurance policies transacted on the secondary market in the years 2020 to 2024. In the same graph, the yield for the US 10Y government benchmark bond is shown. Data for both series are monthly. As can be seen in the graph, the volatility for the US government bond yield is higher than the volatility for the implied IRR for US life insurance policies. The correlation coefficient between the two data series is -0.1, but given the uncertainty in the estimation, it is prudent to assume that the correlation is zero.

Before I give explanations for the observation that the secondary market for US life insurance policies is mainly unaffected by events in the listed bond and money markets, an introduction to the market is presented in the following section.

Graph 3. US Life Insurance Policies and 10Y Bond Yield



Source: Ress Capital and Federal Reserve Economic Data

INTRODUCTION TO THE SECONDARY MARKET FOR US LIFE INSURANCE POLICIES

The secondary market for US life insurance policies, also known as the *Life settlement market*, offers individual policyholders the opportunity to sell their life insurance policy. Individuals selling their policies are usually retirees who no longer have the need for life insurance coverage. The most common reason for selling is that the policyholder's children are now adults and thus can provide for themselves. Life insurance was important in an earlier stage in life when financial protection for the individual's spouse and children was essential. The insured selling a policy has often paid premiums for many years and the policy has an economic value, which the individual can realise by selling the policy to a financial investor, like for example Ress Life Investments.

The overwhelming majority of US life insurance policies never pay out, since most policyholders let their policies lapse, by ceasing premium payments at some point in time. In some cases, the policyholder has the opportunity to surrender the policy to the insurance company for a nominal cash amount. However, financial investors in the secondary market usually pay substantially higher prices compared to the surrender value offered by life insurance companies. Therefore, the secondary market disrupts the monopolistic pricing power that life insurance companies have over their buy-back offers to the insured.

Without a secondary market, the policy owner would be worse off since their only alternative to lapsing the policy would be to accept the relatively low surrender value. This aspect is important from an ethical perspective since the secondary market benefits the consumer.

The secondary market for US life insurance policies is very small compared to the primary market, but it is growing as more policyholders discover the market's benefits. For a more comprehensive description of the market, the reader

can consult Ress Capital's white paper *Investing in US Life Insurance Policies*.

There are a large number of variants of life insurance contracts in the US market. Policies most often transacted on the secondary market are so called *universal life policies* that last for the insured's entire life. At maturity, the beneficiaries receive the *insurance amount* specified for the policy. For this insurance coverage, the policy owner pays monthly premiums, which are either fixed or increase over time.

All the terms are in absolute US dollars, and there is no indexation of premium payments or insurance amounts concerning inflation. Thus, periods of low or high inflation during the contract period, will not affect how much the client will have to pay in premiums or how large the payout will be at maturity.

ARGUMENTS FOR THE LOW CORRELATION

The observation that prices for life insurance policies traded in the secondary market are very stable over time depends fundamentally on the fact that neither the supply of policies to the market nor the demand for policies is closely connected to liquid financial markets. In the following two sections arguments will be given as to why changes in the fixed income market will not significantly affect the demand for policies or the supply of policies, respectively.

Before those arguments are presented, I will make some comments on the credit risk of investing in life insurance policies. For life insurance policies issued by insurance companies with an investment grade rating, the credit risk is very low. This is a consequence of the fact that the market is regulated to protect the consumers and to make sure that the life insurance companies have enough reserves to fulfil their commitments. The regulation entails that an individual holding a life insurance policy can have a very high conviction that the insurance amount will actually be paid to the beneficiaries at maturity, which could be in 30 to 40 years.

Given the low credit risk of life insurance policies, the value of the contracts will not be affected by events in the listed or unlisted credit markets. Most importantly, in periods when the business cycle is weak and the risk of default for lenders generally increases, the value of a life insurance contract will remain stable, while credits will most likely lose value. For this reason, the analysis presented in this Market Insight focuses on the correlation between US government bonds, rather than investment-grade bonds.

THE SUPPLY SIDE OF THE MARKET

Central to the analysis of which factors govern the supply of insurance policies in the secondary market, is that consumers' willingness to sell their policies appears to be independent of the state of the US economy. The supply is rather dependent on the attractiveness to be compensated for an unwanted insurance contract.

As noted above, Ress Capital has not been able to detect any correlation between the yield for government bonds and the IRR of transacted insurance policies in the period 2012-2024. Accordingly, one must find other arguments, other than financial, as to why prices in the secondary market for US life insurance policies are disconnected from publicly traded fixed income markets.

In my view, the underlying explanation is that the supply side is primarily driven by factors dependent on the seller's life situation, rather than on the price of policies. A common rationale for individual clients to sell their life insurance coverage is that they either do not need the coverage or that the premium they pay can be used for other purposes, or a combination of both. The seller has most likely reached a stage in their life when the financial situation is such that the spouse or children can manage without a large lump sum payment in the event of the policyholder's passing. This is confirmed by the fact that the sellers of policies are most often in their seventies.

It is important to note that out of 10 issued policies that are owned by the original policy holder, 9 never pay out, primarily because policyholders stop paying premiums. Thus, there is evidence that clients cancel the life insurance coverage because they do not need the insurance or because they do not find the premium cost worth the benefit that insurance provides.

Given the empirical evidence of correlation and Ress Capital's database on the sellers' characteristics, the conclusion is that the insureds' age decides the supply of policies to the secondary market. Changes in demographics is therefore a major explanation for the number of policies that come to the market any given year. Since changes in demographics are long-term, this will explain why the price of policies, and therefore the IRR, move very slowly, as can be seen in Graph 3. Furthermore, this will explain why the yield of government bonds appears to have a relatively small effect on the market price of policies.

One can also note that since the sellers of policies are usually in their seventies, they are less likely to have large mortgages. Therefore, they are less likely to have a personal situation that is affected by changes in government bond yields. This is particularly true for the average seller of a policy where the insurance amount is usually above 500,000 US dollars.

In the last section of the Market Insight, price data from the US housing markets is compared to the government bond yield. This is done to illustrate that there are other consumer markets, where publicly traded fixed income markets have a relatively low impact on prices.

THE DEMAND SIDE OF THE MARKET

In the previous section, I argued that the relative return of fixed income assets does not in any significant way affect the consumers' willingness to sell their policies. On the demand side, when financial investors evaluate the policies, the situation is of course different. However, as can be noted

In Graph 3 the IRR for life insurance policies transacted has only risen marginally since the Federal Reserve initiated its monetary policy tightening. Between March 2022 and July 2024, the IRR has increased by 50 basis points, compared to an increase of 230 basis points for a 10Y US government bond.

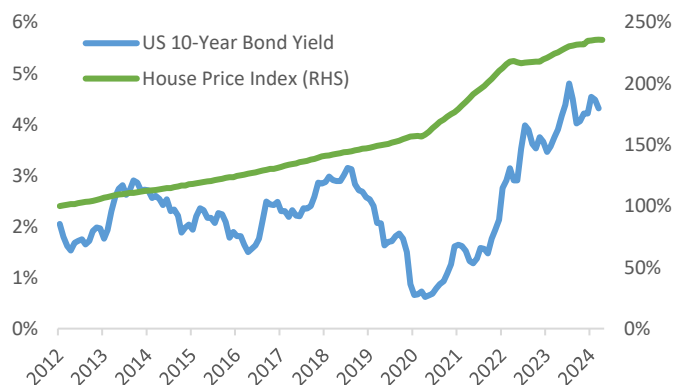
In my interpretation, the demand for policies by investors is primarily driven by an objective to find a return stream that is unaffected by the macroeconomic environment. Investors are sophisticated and spend much time and resources in creating a total investment portfolio with a high risk-adjusted return over time. They have allocated into the asset class because the underlying risk that the investors are compensated for is *longevity*, which is the risk that the assumed life expectancy is incorrectly estimated. The longevity risk has no fundamental connection to most other risks present in financial markets and is underrepresented in most investors' portfolios.

It is also important to consider the observation that allocations to the secondary market for US life insurance policies are most often long-term. Most investments in the asset class are in closed-end funds, with a term of 8 to 10 years. Thus, changes in bond yields will not have a short-term effect on the prices of policies bought by investors. Furthermore, an open-ended fund of life insurance policies will after a few years be cash flow positive, when policy payouts will be larger than premium payments. This will lead to a situation where cash can be reinvested in policies and contribute to an increase in investment demand in the market.

A PARALLEL TO THE HOUSING MARKET

To illustrate that it is not unique that asset markets where individual consumers are important agents can have a low correlation to bond yields, I have looked at the US housing market. The housing market should be a market where interest rates and bond yield matter a lot to prices. Furthermore, it is a market that depends on longer-term demographic trends. *Graph 4* shows, the US 10Y government bond yield and house prices according to U.S. Federal Housing Finance Agency. Data is monthly from 2012 to 2024.

Graph 4. US House Prices and 10Y Bond Yield



Source: Federal Reserve Economic Data

For the 12-year period studied, the correlation coefficient between the changes in the bond yield and the change in house prices is 0.1. Given the uncertainty in the estimate, the correlation can be assumed to be zero. We can therefore draw a similar conclusion, as was done for the secondary market for life insurance policies, that in the medium term, residential house prices have a low correlation to the fixed income markets.

The fact that the correlation between house prices and bond yields is very low can appear to be counterintuitive, given that many new home buyers take out a mortgage to finance the purchase.

The conclusion will have to be that there are certainly other factors that determine the price of houses. Given the fact that house prices have risen by over 200% since 2012, a possible explanation would be that there has been a lack of supply of houses, and demographic changes have led to more families looking for housing.

CONCLUSION

Ress Capital has for several years argued that the secondary market for life insurance policies has a weak connection to the US fixed income market. In this Market Insight, I have presented evidence that the correlation in the last 12 years has been very low between the IRR for life insurance policies and US bond yields. In the same way, as for the US housing market, other factors have dominated. The interpretation from the secondary market for life insurance markets is that demographics is a major explanation of the supply of policies and therefore also the prices paid for policies by financial investors. The demand for policies is mainly driven by long-term allocations of up to 10 years. This creates a situation where also the demand side has a limited connection to liquid fixed income markets.

Given this interpretation, Ress Capital expects no major changes in the gross returns that investors can get from an allocation to the asset class. Thus, even if we in the coming two years, experience lower bond yields, the secondary market for US life insurance policies will most likely give investors a gross return of approximately 11%, and a net unleveraged performance in the range of 7% to 8%.

ABOUT RESS CAPITAL

Ress Capital is an alternative investment fund manager (AIFM) regulated by Finansinspektionen, the Swedish Financial Services Authority. The company employs eleven people at its office in Stockholm. Ress Capital has since 2011 purchased life insurance policies on behalf of the fund Ress Life Investments, which is listed at NASDAQ Copenhagen.

The management team has extensive experience and complementary backgrounds in financial markets, life insurance, and international experience from having worked at major banks and hedge funds.

Proprietary portfolio management systems and pricing models have been developed internally which gives us a competitive advantage when selecting policies. Ress Capital also collaborates with external medical underwriters, specializing in senior mortality in order to provide more accurate assessments.

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