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The Next Revolution for Investing in Capital Markets: Taking Away Beta-Risk with Life Settlement Portfolios

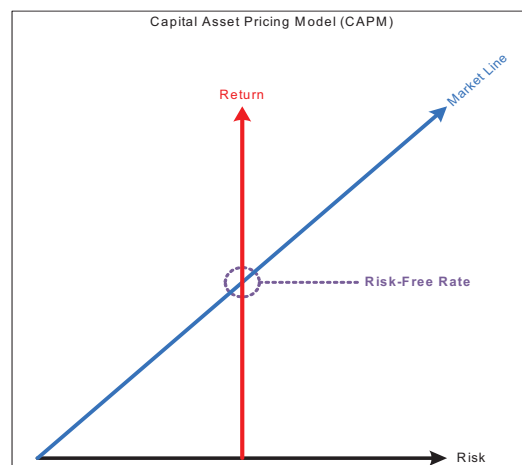
by Tom Climo ©2008

Investing in capital markets has experienced four revolutions.

The first was the Keynesian Revolution. In Chapter 12 of *The General Theory of Employment, Interest, and Money* (1936), Keynes likened capital market trading to selecting a beauty pageant winner. The winner is not the contestant *you* find the most attractive, nor the contestant a larger group of people (the press) tells you will win; rather, it is that contestant chosen by a panel of judges. To select in advance the winner requires the ability to formulate criteria which the judges, acting first alone and then in unison, deploy in choosing their winner. So it is with investments in capital markets.

The second was the Numbers Revolution. With empirical research out of the University of Chicago, this revolution tied together a 1918 scientific researcher's attempt to predict a drunk's next step in an open field (which he reluctantly concluded was impossible owing to the "random walk" of the drunk) with loads of 1964 evidence and data demonstrating an identical pattern of behavior from the movement or performance of stock market prices. This Revolution demonstrated that capital markets behaved as if they were statistically perfect. This was called the Efficient Market Hypothesis (EMH).

The third was the Pricing Revolution circa 1970 which followed on and supported EMH with a way of understanding risk and return that would provide predictive confirmation about the behavior of prices in a capital market. The evidence derived from correlating the risk of an investment with its anticipated return produced a straight-line linear graph or model that was at once fascinating in its simplicity as well as exciting for its explanatory power. Using a left-to-right 45-degree line, The Capital Asset Pricing Model (CAPM) begins at its low point at the risk-free rate of return (on a United States Treasury Note, for example), and, as it ascends, tracks ever higher levels of return for riskier activities, whether from stock market and options trading, or racetrack and other forms of gambling.



The fourth was the Portfolio Revolution, which removed standard deviation from a combination of investments – called a portfolio – and assembled it in such a manner that the standard deviation or “alpha” risk of the return on investment was zero. Diversification of a portfolio is often portrayed by having a vendor add sunglasses to his existing raincoat business, to cover his options, so to speak. But the result is mathematically more certain than the portrayal. In fact, the mathematics is so certain that alpha-risk can be shown to be disassembled through diversification after the random combination of any 23 or more stocks. This leaves only market or “beta” risk that cannot be eliminated.

Now, through the courtesy of Mr. Warren Buffet, we have arrived at our fifth and – potentially – final frontier for revolutionizing capital markets – the elimination of Beta-risk.

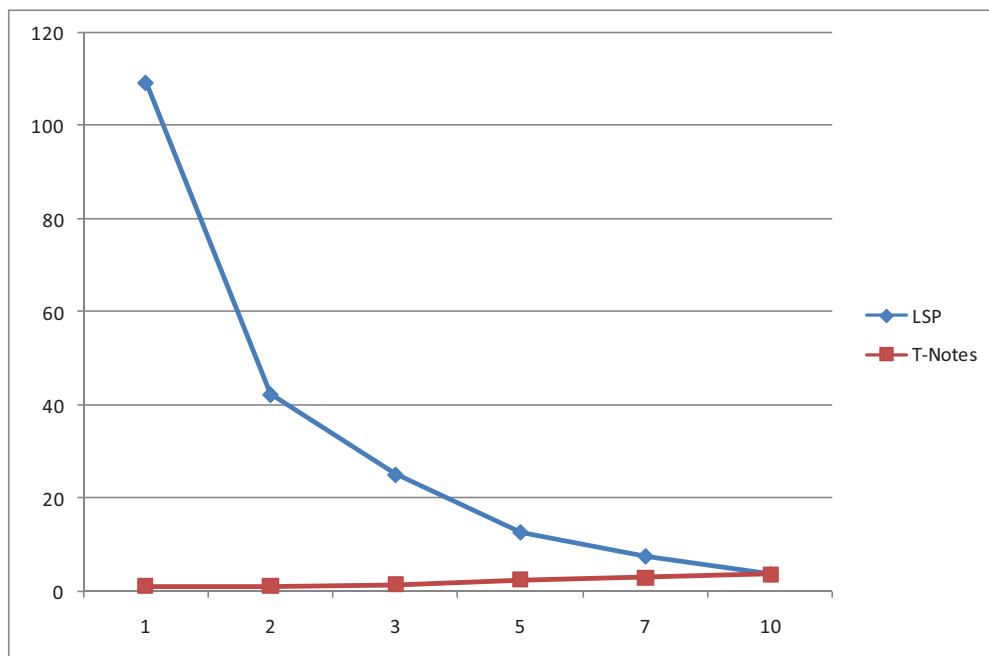
Buffett began with the irrefutable proposition that everyone dies, and followed it with the equally irrefutable proposition that, statistically, those with serious illnesses die sooner. In cases where a pre-illness life insurance policy exists and the death of the intended beneficiary of this policy and/or the high cost of health care in treating the serious illness requires immediate cash to the holder, those with death benefits (that arrive later) can trade them (at a discount) for immediate cash payments.

This “Life Settlement Capital Market” is impervious to up and down business cycles, bear and bull stock markets, or other circumstances that create Beta-risk. Unlike the beauty pageant, there are no rival contestants, each subject to the whims of a panel of judges. There is a lone contestant wearing a banner naming not her State but the amount of money (“death benefit”) we can expect to receive.

Eliminating Beta-risk on a properly discounted life settlement policy can finally enable an investor to return to Keynes and choose the beauty pageant winner. The rate of return with zero alpha *and* zero Beta-risk is superior to any and all other capital market investments which carry Beta-risk. The current downturn in capital markets provides ample evidence of the truth of this proposition. While those without life settlement portfolios watch portfolio values fall, the death benefit of a life settlement portfolio remains constant.

However, despite this obvious attraction and superiority of a life settlement portfolio, don’t go thinking that investment opportunities with positive Beta will now disappear. This owes itself to the availability restriction inherent in acquiring a life settlement portfolio. For example, a well-known Life Settlement Company that has been in existence for seventeen years has acquired only 5,856 policies with death benefits of \$1.1 billion. That’s acquiring less than a policy a day, and no more than \$65 million of face value per year. Unlike the Stock Market, the Life Settlement Capital Market has a formidable barrier to entry I call “savvy,” or the ability to find participants willing to trade at discount cash now for death benefits. There must exist an early free-of-illness decision to purchase a large life insurance policy that is quite frankly absent for most people living in the United States, and elsewhere for that matter.

A life settlement investment significantly enhances the impounded value of an investment portfolio by assuring a stated volume return (the death benefit). Rates of return are not affected by shifts in the fate of markets, only by the wait in time from the date of investment to the date of payment as beneficiary. The shorter the wait, the higher the return. If the insured passes within the first three years, the return to the life settlement beneficiary ranges from 25% to over 100%. Similarly, the longer the wait, the less the return. However, even a six-year wait for the passing of a seriously-ill insured will earn 10%. When mapped against the existing risk-free or Treasury note rate, life settlement portfolios outperform every instance of Treasury returns until the tenth year.



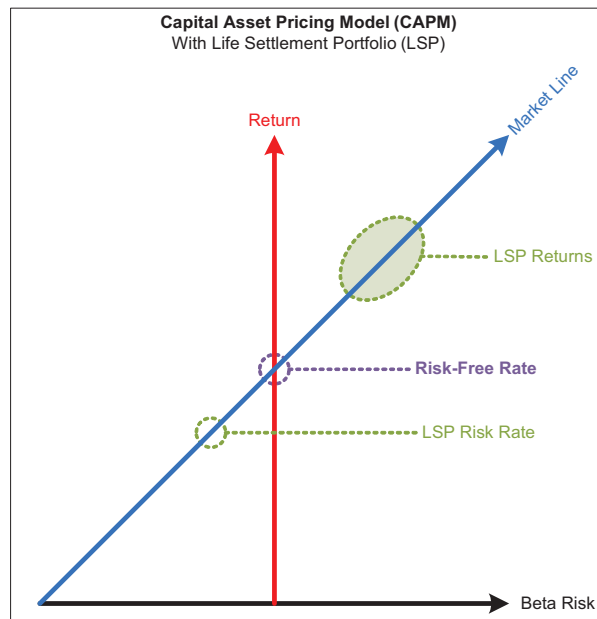
The graph above tells us that returns from a Life Settlement Portfolio (LSP) fall to the right of the risk-free or Treasury note rates on the CAPM provided the death benefit is paid before the tenth year. As life settlement returns are all without Beta-risk, it is superior to any and all conventional returns carrying Beta-risk. Eliminating Beta-risk has shifted the CAPM to react and adjust to time, not risk. This is a revolution of overwhelming importance, and if used will significantly and forever improve any level of investing and for all portfolios.

Can Beta or market risk be introduced into life settlement portfolios? Yes, if and only if life insurance companies default on paying death benefits. This is a most unlikely event, and is mitigated by two observations, one anecdotal, the other empirical.

During my days as a Faculty Resident in the London office of Arthur Andersen & Co, a *pro bono* auditing exercise was conducted by the public accounting firm to gauge the financial strength of the United States of America. Andersen used as its comparable the Prudential Life Insurance Company of North America. The conclusion convincingly favored Prudential as having the greater net worth. Therefore, returning to the Capital

Asset Pricing Model, this would put a death benefit payment (from Prudential) to the left or less risky than the payment on a Treasury note (from the United States of America).

In addition, the life insurance industry has conducted considerable research into its responsibility and success at meeting the obligation to pay a death benefit when connected with a proof of death and absent circumstances such as fraud or pre-existing conditions that could invalidate a death claim. In the entire history of life insurance policies, the incidence of defaulted death benefit payments fails to register even a scan or blip in a chart or screen correlating death benefit claims with death benefit payments where a proof of death is provided. The prospect of a life insurance company failing to pay a death benefit is less likely than the United States of America defaulting on a Treasury note payment. This association of zero Beta-risk with positive extra-risk-free return is at the basis of the revolution brought to capital asset pricing by life settlement portfolios.



In conclusion, when a portfolio can be assembled that outperforms at every frontier of return any and all other portfolios, because it does not carry either alpha or more importantly Beta or market risk, then economic decision-making instruct the prudent investor to assemble this portfolio either in whole or as part of an existing portfolio. The premiere item for optimum portfolio selection has now become the life settlement product.

To learn how to get your hands on this product, contact the author at:

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