

Article for New Model Adviser

Q and A Tax

Capital Settlement

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As Ben Dawson got out of his car in the car park of the Halfway Inn, he stepped into the middle of a deep puddle. “That would never have happened if the clocks hadn’t gone back – it would still be light enough to see!” thought Ben.

Ben was here for one of his regular meetings with Tim Harmer, an old friend and fellow IFA with his practice in the next town, where they discuss client experiences and business opportunities. Last time they met, Ben had been about to move house and Tim had told him about a scheme to save stamp duty on the purchase.

Tim was already at the bar and had bought Ben a pint. “Hi Ben, good to see you again. How are things?”

“I think it’s probably fair to say that we’ve both had easier years, don’t you?” replied Ben laughing.

“You’re certainly right there”, said Tim, “by the way, how did your house move go?”

“In the end, the survey threw up a few problems and whilst we were renegotiating the price, the economy and prospects took their nose dive. The vendor decided to pull out and wait to see what happens to the market – with hindsight, I think it’s a bit of a relief, so we’ve decided to wait until things settle down a bit before we start looking again. I guess the good news is that prices are still coming down.”

“I don’t blame you, but once things sort themselves out, people like you who are trading up should be in a good position,” said Tim.

“I hope so,” replied Ben, “anyway, enough about me! How are you finding the investment markets?”

“Well, I every time I think we’ve hit the bottom, something else seems to happen and markets drop again! I’m sure that buying opportunities are starting to appear, but you’d need to be a brave man to go back in at the moment. I have been selling quite a few structured and guaranteed products recently, but now interest rates are starting to

fall, and probably a fair bit to fall yet, I think these may become less and less attractive. What do you think, Ben?"

"I agree with you Tim. Those clients that have bought these at good rates over the last few months seem happy, but I've been looking around for other options recently, especially funds that aren't correlated to interest rates."

"Have you found anything?"

"Well, I have – I only came across it a couple of weeks ago and I'm still looking at it, but I do think this will offer some options for some of my wealthier clients. It's a new fund based on US life settlements, have you heard about it, Tim?"

"No, Ben, tell me more."

"Well, this particular fund seems to have addressed a lot of the problems associated with life settlements. Rather than holding the life policies directly, as the other funds on the market do, it invests through an index of life policies, based on a sample of 200 policies. By not holding the policies directly, the fund has avoided the need to make premium payments which would have acted as a drag on performance. It also removes the possibility that a policy may be declared void by the insurer when a claim is made, for example, as a result of non-disclosure of information at inception. This fund is underwritten by a well-known international investment bank, and this guarantees the return of the capital invested at the end of the 7-year term."

"This does sound interesting, Ben, what sort of returns are they quoting?" asks Tim.

"The average target return is between 8.5% and 9.0% a year, but it could well be higher, based on the claims experience of the policies forming the index – effectively, what happens is that the first claims on the policies underlying the index are used to meet the return of capital guarantee, and then once this has been done, each further claim drives returns to the investor. The target return has been based on the mortality assumptions, but if more claims are made, investors receive more upside. There is a cap on the upside of 100%, but in reality, what this means is that if the cap is hit before the maturity date, investors will be offered the chance to roll-over into a new tranche."

"The returns do sound attractive, especially with the capital guarantee, even assuming that a client has fully utilised their CGT annual exemption, they could still get a net return of 182% of the initial investment. What downsides can you see, Ben?"

"Well, the main one is that there is unlikely to be a secondary market for the fund, especially in the early days, so once in, the investor needs to hold it until maturity. However, I don't think this would be a problem as I wouldn't put all of a client's investment into a fund like this and therefore liquidity could be provided by the rest of the portfolio. Also, as this is aimed at the more sophisticated investor, there should be other assets that could be realised. The second thing is that, currently, it is only available as a growth fund, but I do know that they are looking at producing an

income version that could produce around 7% a year with full capital protection, but we'll need to wait to see the exact terms of the income version when it comes along.”

“That would definitely be interesting with interest rates on their way down at the moment. I guess we also need to be aware that these sorts of funds will have been tarnished by the viaticals fiasco a few years ago, won't we?” says Tim.

“Yes, I think you're right, but really, this fund is sufficiently different that this shouldn't be a problem. The policies underlying the index have values in excess of US\$ 1 million each, and some substantially more, so we are not in the “distressed sale” area that caused the problems for viatical settlements. It is also worth saying that the fund does not invest in viaticals, so the sort of ethical and moral problems associated with these won't affect the fund. We may still have problems with perception in some clients' minds. I have started discussing the concept with a couple of my clients, and this hasn't been a problem so far.”

“I am sure, Ben, that if these sorts of thing are covered off early on, it won't be a problem. I would be really interested in finding out more about this fund – I can already think of a few of my clients it would be appropriate for.”

“Of course, Tim, come over one day next week, and I'll take you through it all in detail. Now, how about another pint?”

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