

Zero Coupon Bond Opportunity

A zero coupon bond is available periodically which yields 12% annually and has a maturity of up to four years. The collateral for the bond is a life settlement guaranteed by one of the largest insurance companies in the United States.

Background - Over the last decade, life settlements have become an investment alternative for banks, hedge funds, pension funds and insurance companies. The investment has no correlation to the economy, oil, interest rates or the stock market. The primary collateral for this investment is a death benefit which is guaranteed by a large insurance company.

A market has evolved in which a person can sell their ownership in an insurance policy on their life. Intermediaries locate persons who no longer need their insurance or no longer want to pay for the policy and buy the policy from the owner at a price which normally is much higher than the surrender value. As policies are bought, they are pooled with other person's policies until the pool is large enough to sell to institutional investors. Since the policies are bought at a discount to the face amount of the policy, when the face amount is paid; a gain is realized by the investor. When a large pool is assembled, actuarially it can be determined with a great deal of accuracy what the duration and yield will be on the portfolio. Warren Buffett's company, General Re has been active in these types of investments and his company loaned \$400,000,000 to another company for the purpose of acquiring portfolios of life settlements. Thus, portfolios of life settlements have found a place of prominence in the investment arena. The National Association of Life Settlements has been formed to oversee and formulate policies for the business of life settlements.

Current Structure of the Zero Coupon Bond

In the past, life settlements as an investment; was unavailable to the average investor. In recent years that has begun to change. At first, some intermediaries which bought life settlements, would offer out fractional interests in a particular life settlement to investors. Let's say for an example, the intermediary purchased a policy for the cost of \$200,000 with a face amount of \$1,000,000. They then could get 10 investors to put up \$20,000 per investor and the investor would then have a 10% ownership in a million dollar death benefit, which would be collected at some point in the future. Thus, the \$20,000 investment was collateralized by \$100,000 in future payment. So, the only downside was the length of time to elapse from the time of purchase until the \$100,000 was collected upon death of the insured. This structure has now been enhanced by the use of a re-insurance company which guarantees a term certain on such an investment. Now the investment is not only safe, but the investor knows on the front end the longest period the money will be outstanding. The term certain is normally in the four year range

- A creative broker dealer has now streamlined this whole process with the issue of zero coupon bonds with a term certain. The structure is as follows:
- A death benefit guaranteed by a large, A+ rated, insurance company is purchased
- The policy is placed in trust at a large bank for the benefit of the bondholders
- Monies are escrowed with the trust bank to pay the premiums on the policy for the next four years
- A re-insurance company is contracted and paid to guarantee that if the policy does not pay in four years, they will purchase the policy from the trust and the trust pays the bondholders
- The bondholders receive their principal and interest at the time of death of the insured or at the end of four years
- So, the investment has a life ranging from one day up to four years

In summary, investors now have the opportunity to purchase a bond which has both a principal and interest guarantee and yields at the rate of 12% per annum. A four year bond will pay the investor 48%. However, it should be understood that the investor will earn the 48% no matter when the bond pays due to death or the re-insurance payment. Thus, if the policy pays earlier than four years, the yield is much higher than 12%. If the bond paid after two years, the yield is 24% and if it paid after year one, the yield would be 48%. So, the bond could offer much higher yields than conventional investments, without the risks associated with the price of oil, interest rates, the economy, or the volatility of the stock market.

Using Leverage as a Yield Enhancement

We have already seen that the zero coupon bonds offer an attractive yield with a principal and interest guarantee. This asset, much like real estate, can be leveraged to create a much higher return without significant risks. Let's say an investor has \$60,000 a year they could invest that could purchase zero coupon bonds annually and earn the 12%. Or they could use the \$60,000 annually to pay interest on a \$1,000,000 of borrowed money. The million dollars could be used to purchase the zero coupon bonds and the bonds could serve as collateral for the loan. Now the investor is paying \$60,000 a year for loan costs, but he is earning \$120,000 a year in future bond interest. If the bond goes to the term certain of four years, the investor would have paid \$240,000 in interest, but would collect \$480,000 after the repayment of the loan. So, on a cash on cash basis, a 100% gain has been realized or a 25% cash on cash annual gain. Pretty good economics on a relative safe strategy.

Now consider this; if the bond paid in one year, the investor would have paid \$60,000 in interest, but would have received the same \$480,000 in interest, which would make the cash on cash return of 800%. So using the leveraged approach to the purchase of zero coupon bonds would guarantee the investor of making between 100% and 800% on his investment.

Conclusion

The whole idea of a good investment is a balance between risk and reward. Generally, an investor cannot achieve a good return without taking on a good bit of risk. In the United States, we can only reduce risk down to a certain level and that happens to be a Treasury bond, an FDIC insured bank deposit and a guarantee from a major insurance company. Beyond this point, if these risks are unacceptable to us, we must resort to hiding our money in a can, which has its own set of risks. It would appear, that the zero coupon bond offers an investor a great return with minimal risks associated with the investment. For 200 years in our country, life insurance companies have continued to pay the life settlement of their customers and there is no reason to believe that trend will not continue to be the case moving forward. Thus, the zero coupon bond, collateralized buy a life settlement, offers a unique investment opportunity!