

What is a TEP?

A Traded Endowment Policy (TEP) is a mid-term with-profit endowment no longer required by the original policyholder who has sold it on the open market at a price greater than the surrender value.

Whilst some endowment policies were simply regular premium savings plans, the vast majority of endowment policies were taken-out by the original policyholders as a means of repaying a mortgage. However, a large number of policies are either surrendered early to the issuing life company or they are sold through the Traded Endowment market.

It is estimated that only around 30% of endowments are held to maturity by the original policyholders and about 30% are cancelled or surrendered in the very early years. The remaining 40% are either surrendered or sold in the mid to late term of the policy. Not all policies can be sold. There is, for example, currently no market for unit-linked or unitised policies.

The Traded Endowment market exists because the surrender values quoted by many life offices do not fully reflect the true value of the policy as a continuing contract and many investors are willing to buy policies for more than the surrender value because they recognise such policies represent a low to medium risk investment opportunity. Examples are pension funds and investors looking for a guaranteed return at a future date in time.

The mechanics of the process.

Endowment policies are normally taken out for a specified term, usually between 10 and 25 years, but occasionally longer. They are taken out for an agreed amount, the 'basic sum assured', which is the guaranteed figure the life office will pay out at maturity or on the earlier death of the life assured. The policyholder pays a regular premium to the life office, which is invested to provide the plan benefits. Life office with-profit funds are invested in a wide range of asset classes such as fixed interest securities, property and equities (both UK and overseas) and the investment managers are able to make long-term investments. However, the returns are not guaranteed.

In addition to the basic sum assured, with-profit policies receive a share of the profits earned from the investments in the with-profit fund. There are two ways that life offices distribute these profits.

- An 'annual or reversionary' bonus normally added to the basic sum assured each year, which once added cannot be reduced or taken away.
- A 'terminal' bonus that is added at the end of the policy term, or on the earlier death of the life assured.

With-profit policies benefit from a technique known as 'smoothing' which basically means that in years of good investment performance not all of the investment growth achieved in the with-profit fund is paid out as bonuses. Some is held back in reserve so that bonuses do not necessarily have to be reduced in years of poor investment performance. However smoothing can only go so far and in prolonged bear market phases such as 2000-2003 many insurance companies with-profit funds reserves have been depleted to the extent that most have reduced bonuses. As investment conditions improve and the reserves replenish, increases in bonus rates should return.

Bonus rates depend on the investment performance of the life offices, the strength of the life offices, which has a bearing on asset allocation of the with-profit fund, and the way they choose to allocate profits.

When an investor buys a traded endowment policy he is buying an existing investment which comes with a number of benefits:-

- The vast majority of the charges inherent in the policy are incurred in the first few years and these have effectively been paid by the original owner.
- The policy will also have several years reversionary bonuses already attached to it (once added these cannot be reduced or taken away).
- The policy will also participate from future reversionary bonuses (increasing the guaranteed value) and normally a final terminal bonus.
- The policy can be used as security against a loan.

Trading and ownership responsibilities

There are a number of companies who specialise in traded endowment policies and have developed sophisticated valuation systems enabling investors to purchase TEPs at rates that provide the potential to achieve attractive returns from low risk and sometimes no-risk investments. Trading is very simple and can be completed in a very short period of time.

When an investor buys a policy it is legally assigned to the new owner who takes on the responsibility for future premiums.

The life assurance element of the policy remains on the original life assured. When the policy reaches maturity (or if the original life assured dies) all the benefits are paid to the new owner.

Details correct as at 08-05-06.

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