Coherent Pricing of Life Settlements Under Asymmetric Information

Preliminary Version

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Abstract

Although life settlements are advertised to deliver a profitable investment opportunity with a low correlation to market systematic risk, recent investigations reveal a discrepancy of expected and realized returns within the market. While thus far this discrepancy was attributed to the allegedly poor quality of the underlying life expectancy estimates, in this paper we present a different explanation on the seemingly high reported expected returns based on adverse selection. In particular, we provide a coherent pricing mechanism and pricing formulas in the presence of asymmetric information with respect to the underlying life expectancies. Therefore, our study sheds light on the nature of the "unique risks" within life settlements recently alluded to in the financial press.

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