Tontine Takeoff? Old Concept Gets New Wings

September 30, 2024

"Tontines" are a very old form of investment, and there have been many variations. The basic idea is that the longest surviving investors in tontines will be credited with tontine assets attributable to investors who predecease them. This concept is potentially quite useful in designing products for converting accumulated investment assets into a reliable income stream that provides an attractive rate of return. Such "decumulation" products are, of course, currently in high demand as the boomer generation moves through its retirement phase. Annuities historically have been able to provide a reliable income stream for the life of an annuitant or other specified periods. Over the past several years, however, different types of non-annuity products have been developed that, by incorporating tontine-like features, aim to provide a higher rate of reliable income payments than possible under a conventional annuity. Set out below is a high-level overview of one such product, brought to market by Stone Ridge Asset Management, that makes use of both an open-end mutual fund and a closed-end fund. **The Open-End Mutual Fund Phase** The mutual fund is a series-type open-end investment company registered with the SEC. This mutual fund imposes eligibility requirements such that all of the investors in any given series (referred to as a "cohort") are the same gender and age. The age requirement ranges from 60 to 75 years, depending on the series, as of the series' time of inception.

The initial offering of each mutual fund series' shares will be at a per-share price that is designed to enable that series to have sufficient assets to pay its scheduled distributions (as described further below). All subsequent issuances or redemptions of the series' shares are priced at their net asset value. Thereafter, until the series' cohort reaches age 80:

- New members may join the cohort; and
  Any cohort member may purchase or redeem the fund series' shares at any time.

When a series cohort reaches age 80:

- Any remaining outstanding shares of that series attributable to cohort members who have died are terminated via a mandatory redemption at net asset value;

- The surviving cohort members are reminded of their right to redeem their shares at net asset value;

- If, after any redemptions occasioned by the above, the mutual fund's adviser determines that the series no longer has sufficient scale to reliably achieve its objectives, the adviser may decide it is appropriate to liquidate the series; and

- Otherwise, subject to approval by the fund's board and by a majority vote of the cohort members, the open-end fund series will be reorganized into a series of a closed-end fund, as described below. If such approval is not forthcoming, the board will consider what future course would be in the best interest of the series and its cohort.

The Closed-End Fund Phase The closed-end fund is an SEC-registered series-type investment company. Cohort members can acquire closed-end fund shares only via the above-mentioned reorganization — which is designed to be tax-free — when the cohort reaches age 80. Pursuant to the reorganization, persisting cohort members' mutual fund series shares will be converted into closed-end fund series shares having the same net asset value. Thereafter, these cohort members will have **no ability to purchase or redeem shares** of the closed-end fund. However, if a cohort member dies while owning closed-end fund shares, those shares are canceled and the investor's remaining interest in the closed-end fund is thus forfeited without compensation. **The fact that the forfeited value remains in the closed-end fund series, where it is available to support future distributions, helps to support a higher scheduled distribution rate for this product than otherwise would be possible. Fund Investments and Distributions** Both the mutual fund and the closed-end fund:

- Will invest primarily in U.S. government securities; and

- Plan to make scheduled monthly distributions to cohort members at a constant rate totaling $1 per share per year.

These distributions, which are expected to exceed the series' net investment income and capital gains, are not guaranteed by any party other than the relevant series. Thus, if a series runs out of funds to pay the scheduled distributions (which is a bigger risk during the closed-end fund phase), the related cohort's entire interest in the series will terminate without further payment to the cohort members. The distributions are scheduled to continue until the cohort reaches age 100, and the product is designed with the intent that all the closed-end series' assets will be exhausted at, but not before, approximately that time. Any assets remaining in the series at that time will be paid out in a single liquidating distribution to the then-surviving cohort members. **Annuity-Like Aspects** Products that incorporate tontine-like features can require significant actuarial input similar to that required for complex annuity products. For example, under the product described above, it is actuarially challenging to adjust the initial purchase price of the mutual fund series' shares such that, given the scheduled $1 per share annual distribution rate and numerous variables, it is highly likely that the corresponding closed-end fund series' assets will not be exhausted until approximately the time

when the cohort reaches age 100. Nevertheless, such products are different from traditional annuities, because there is no guarantee backing up the distribution payments, and the products have been regulated under federal securities law rather than state insurance law. **Future Flying Conditions** The current climate in the retirement market includes both persistent demand for attractive decumulation vehicles and intermittent investor aversion to purchasing annuities. These factors support the forecast of favorable prevailing winds for products that incorporate tontine-like features, given the relatively
attractive rates and predictability of distribution payments that such products, properly designed, can offer.

Authored By

Thomas C. Lauerman

Related Industries

Life, Annuity, and Retirement Solutions
Securities & Investment Companies