

A game of strategy

The investment environment is likely to remain challenging for the next year. This makes insurers' tactics for their asset management even more important.

Investment management for insurers is proving to be an increasingly important topic, as stretched balance sheets force firms to ensure that they have alternative methods of income.

Much has been said about the catastrophe losses this year, but one less-discussed impact has been a growing focus on asset management.

Insurers have widely reported combined ratios heading substantially north of 100%, following the Japan earthquake, Queensland floods, tornados in the US mid-west and multiple quakes in New Zealand, but it is clear that the picture for those seeking to cope through active asset management is almost as challenging.

Reactions spoke to asset managers from the largest firms in the US and Europe. Low yield within the investment markets has been a recurring theme and the wider economic downturn looks set to create further hurdles.

"This is a unique situation. Given that interest rates have never been this low, we're breaking the records in terms of bond yields and treasury yields," says Mark Oldcorn, insurance business head for Europe at Goldman Sachs Asset Management (GSAM).

"It's an acute situation when you overlay the uncertainty on global growth and uncertainty on whether we're entering a recession with the associated credit deterioration that may occur, and that's not even addressing the sovereign issues that people are struggling with," he says.

Indeed, Oldcorn describes the ranges of pressures as almost without precedent. "I haven't seen it in my lifetime," he says. "I suggest that it's potentially worse than for most people's lifetime."

The situation is further exacerbated by the lack of firming in rates throughout the insurance market, with only property-catastrophe rates starting to firm and forecast to rise in January.

"It's a difficult market for many insurers," says Woody Bradford, president at Conning. "You've got a set of insurance companies that have been slowly leaking excess reserves over a number of years, so there's not a lot of cushion and not a lot of margin for error."

What's more, for those insurers seeking to compensate for poor underwriting returns with effective asset management, Bradford sees increasing volatility in almost every asset class. "It's a tough time in the capital markets," he says. "Increasing uncertainty is becoming the norm both in the economy and in capital markets."

Bill Rotatori, president of GR-NEAM agrees, and notes that in the



US market five-year US treasury yields were resting at around 2% at the year end.

"That's a big change and that affects reinvestment yield, that affects ongoing levels of investment income and at a time when there's other challenges in insurer's business, it is the last thing they need to help at this point," he says.

"Just for insurers, in general, to generate an adequate return on capital is likely to be a challenging environment with investment yields where they are," says Rotatori, who argues that 2011 is unlikely to see asset returns compensating for losses from underwriting.

Three challenges

For Bradford at Conning, the challenges have resulted in a broader economy that he describes as "stochastic" following the economic crises that began in 2008, explaining that although many people view these events as random, in a purer sense it means something else.

"We use it in a statistical sense to describe the fact that there are an infinite number of scenarios that can happen and that insurers need to prepare for a range of outcomes, not just two or three," he says.

In particular, Bradford highlights three challenges for firms in their asset management strategies: regulation, risk and yield. "How those pieces tie together is where we're having a lot of the most interesting conversations," he says.

What unites the three concepts, Bradford says, is risk-adjusted returns on capital, which is at the heart of the pressures faced by firms now.

"As we think about our insurance company clients, ultimately, what they're trying to optimise for is their return on capital and trying to manage that in a risk adjusted way," he says. "That's an important part of how we try to help them tie it together."

Oldcorn at GSAM says: "The good news is that the insurance industry is not as damaged as it was post-2001 and 2002 in the last time

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of capital markets dislocation, mainly because they don't have the same wholesale funding and liquidity issues that the banking sector does.

“They've also done a better job of measuring and managing risk into this downturn than they did in the last one.”

Oldcorn argues that in previous periods of depressed yields the insurance industry has been “in the eye of the storm”, resulting in distress, rescue rights issues, and recapitalisation. However, there is not the same level of anguish in the industry at the moment.

“in general, the industry is well capitalised and because obviously if you take more risk you have to have more capital... the insurance industry is relatively well placed to make those decisions and that is absolutely at the core of what they're doing, what they're looking at, what they're debating internally and what they're talking to people like us about.”

It is perhaps, surprising, therefore, that so many of the asset managers Reactions spoke to do not consider the recent decision of Standard & Poor's (S&P) to downgrade the US's debt rating as another weight for insurers to bear.

Many consider the ratings action to have had little impact on strategies for insurers, and some say that is had little impact on the market itself.

“I think it's more symbolic than anything,” says See Yen Quek, head of fixed income investments at Delaware Investments. “If you look at the levels of treasuries hanging at 2%, it means that the market is not concerned at the default risk of US treasuries and it just shows you that the demand is still there.

“It's more symbolic and it does impact some compliance and policies that are being looked at this point, but it hasn't driven to a lot of selling.”

Indeed, Bradford at Conning suggests that the first question that has been asked of asset managers in this regard is relating to portfolios that are required to maintain a certain level of triple-A securities.

Matt Malloy, managing director in the global insurance solutions group at JP Morgan Asset Management, agrees that, at least to a certain extent, the downgrade was “shrugged off” by the markets, even for those individual firms who were also downgraded as a result of the decision

“It absolutely introduced a level of volatility and there was a number of triple-A-rated mutual life insurance companies that were automatically downgraded because, you can't have a financial company or a corporate with a higher rating than the sovereign ratings,” he says.

“Companies like New York Life, Knights of Columbus, and Northwestern Mutual all lost their triple-A ratings with S&P, but that doesn't seem at least in the near term to have significant implications for their business models.”

Nonetheless, he maintains that this does not mean that the decision has not been taken seriously. Merely, he suggests, that there are bigger issues attracting attention within the markets at the moment.

“Certainly from a rates perspective, we got downgraded and rates continued to go down, which is sort of counterintuitive if you think about it,” he says. “I think it's been taken seriously and it's

introduced a level of volatility into the system that is causing discomfort and caution, but I don't think that in and of itself, that action has impeded what insurance companies do or need to do in terms of their portfolios.”

Malloy adds: “The bigger issue that people are focused on is this ongoing pressure and the sovereigns in Europe and what the implications may be of a sovereign default in the European markets and how that may ripple through the financial system.”

The European perspective

In Europe, Philip Michaelsen, JP Morgan Asset Management's head of strategic insurance sales for the EMEA region, and Dirk Popielas, head of the firm's European insurance solutions group, agree that the wider issues with sovereign debt have distracted from a serious issue on the other side of the Atlantic.

“I don't think there's been much of a reaction, quite frankly, from insurers that we've seen. There wasn't really widespread concern about that from the conversation we've had,” says Michaelsen.

Both cite the rates on US paper, which has seen yields continue to lessen with spreads compressing and rates further lowering in spite of what the ratings agency deemed a higher risk.

“The market perception is still like it was before the downgrade,” says Popielas. “US paper, government paper, is still seen and anticipated and felt like very safe paper and a safe haven investment.”

Michaelsen adds: “Fine is probably not the right word, but for the European insurance companies there are obviously pretty imminent issues to resolve on their own doorstep.”

Indeed, Rotatori suggests that the continuing decline in yields in spite of the downgrade reflects investors still feeling confident about acquiring US securities.

“It shows that it is still, for lack of better alternatives, a safe haven,” he says. “That's still the market that people feel the most comfortable with for high quality and for liquidity.”

Indeed, according to Bradford, while the first question that many clients are keen to ask remains “should I be posturing to protect myself?” there are also firms actively searching for opportunities in response.

“An increasing number of clients are very interested in buying opportunities and are looking for opportunities to take advantage of dislocations,” he says. “I think it's a handful, but it would be wrong for me to tell you that there is one theme that we are hearing in terms of market sentiment.”

Emerging excitement

It is clear that all of the asset managers are reporting insurers showing an increased interest in alternative asset classes that may provide much sought after yield, with emerging market debts and private equities among those most commonly suggested.

That is not to suggest, however, that emerging markets represent the only area mentioned by asset managers, with many keen to stress the full universe of investment options.

Alternatives including real estate, commercial loans and infrastructure are also agreed to provide positive options for insurers looking for a boost to their balance sheets.

It is simply that emerging markets are the areas that generate the most excitement from both asset managers and their clients.

“Emerging market debt is one of the areas of biggest focus for us,” confirms Malloy. “Emerging market private equity has been an interesting place for us as well, both in Brazil and China in particular and to a lesser extent, India.”

“We've been very active, and continue to be active in China and we've raised a fund and have a very large private equity business in Brazil...and those are areas where the returns targets are more

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Woody Bradford, president at Conning

compelling even on a risk adjusted basis, relative to the domestic market. So that would be another area where if an insurance company has the dry powder from a capital budgeting perspective, they’re looking to put money to work in those markets.”

Oldcorn at GSAM agrees that there is value to be found in this territory.

“If you look at the balance sheets of most of these emerging markets they’re much sounder in terms of debt ratios, in terms of reserves that they’ve built up and in terms of growth, which are the three things that are driving the activity in the periphery,” he says.

“It’s a much better position so the performance has been a lot better too in that asset class.”

Indeed, asset managers report that every insurer with which they speak asks about alternative investments, and the vast majority are keen to hear about emerging market options.

However, some express scepticism at the description of these options as a “new” asset class.

“If you’ve been in the investment world long enough you will know that there are no real new classes, there are only recycled classes,” says Quek at Delaware. “All these new classes, all it means is that the sellers have figured a way to sell an old product with a new story,” he notes.

Although investors are currently being driven away from the safety of US sovereign bonds by the lack of yield, Quek argues that there are options in North America that provide lessened risk over the “low-hanging fruit” of Asia.

“A good middle ground is in corporate bonds,” he says. “Given the low default rates and the strong balance sheets at some corporations in the US and given the fact that some of the problems that led to financial institutions being cleaned out have been mostly recognised, we don’t expect to see a default and that’s a good place to earn extra return.”

“You’re not going to get a return like you did in the past, but it could be a better return than you would expect in the domestic US market,” says Quek.

Randy Brown, global head at Deutsche Insurance Asset Management, shares the belief that some asset classes may be being overlooked in the search for yield in emerging markets, in particular highlighting infrastructure options.

“There is a need for capital to be provided to rebuild infrastructure globally and someone needs to provide that capital,” he says. “Banks are doing less of it and, therefore, insurance companies and others need to step in to do that.”

“There’s a natural need for that capital source, so we think that infrastructure is an attractive long-term asset class,” says Brown.

Brown also argues that in favour of real estate, citing the quality of borrowers and loans being underwritten as both being increasingly high.

“Everyone’s shouting emerging markets, but if you look at emerging markets, I think yields have really come a long way...I think these other asset classes are currently more attractive,” says Brown.

A challenging outlook

Nonetheless, the outlook for the investment climate remains volatile, according to almost all of the asset managers to which

Reactions spoke.

Many also cited continued low rates of yield, and noted that investors should position themselves for the situation not to improve in the short to medium term.

The question, therefore, becomes one of asking not if rates will rise, but when.

“Our expectation is that rates will stay relatively low for the foreseeable future because there is a global economic slowdown and it will take a long time to work our way out of the excesses that have worked up over many years, whether that is US housing, or government over issuance of debt and those types of things,” says Brown.

“These issues will take quite a while to sort themselves out so we think that rates will stay relatively low and on the whole that means that buying high quality relatively shorter duration spread assets makes sense. You just buy them and hold them and let them mature, and then on some of these alternative asset classes we do think there’s a lot of opportunity,” he says.

Bradford at Conning agrees: “I don’t think you will see increases in yield for a couple of years now, but when it changes it might happen quickly, so we are counselling our clients to position for that scenario, among others,” he says.

“Right now, many clients are trying to position for a period of fairly low rates for a fairly decent period of time, but preparing for a spike when it comes.”

Such an environment is leading asset managers like Malloy, Michaelsen and Popielas at JP Morgan to advise their client towards hyper vigilance on diversification, both in markets and classes.

“There are a lot of ways that we’re working with clients. There are more liquid, more risk-based, capital-friendly ways of gaining exposure to the emerging markets. So, for example, emerging market debt is something that insurance companies have increasingly turned their eyes to,” says Malloy.

Warning of the challenges of forecasting the future, Michaelsen nonetheless agrees that diversification in the today’s climate remains hugely important.

“I don’t think that there’s an asset manager out there with a crystal ball,” he says. “The name of the game remains diversification, getting diversified sources of return, making sure that you’re not overly concentrated in one asset class or sector and trying to access some of these asset classes that weren’t available before.”

Most important, though, argues Popielas, is that the insurers who are looking to invest do not do so passively if they are looking to maximise returns, by for example buying an index.

“I would strongly encourage insurance companies or regulated entities not to invest passively into specific classes,” he says. “You need an active manager to avoid the potential fallout and defaults that will definitely happen in all regions and all the themes and all the factors that are relevant for the portfolio.”

Oldcorn at GSAM is confident that, in many cases, such a change in attitude is already underway, with those in the C-suite keen to ensure that asset management is being approached as progressively as possible.

“I think people are working through the issues, they’re modelling their liabilities, they’re looking at the universe of available assets and they’re trying to identify the efficient frontier between risk and return in the most capital efficient way,” he says. “That’s at the forefront of what CFOs, treasurers, internal capital departments, actuarial departments are doing and many of them are resourced in a big way to work through those issues.”

“That’s absolutely the name of the day within the industry.”

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