



Does your investment portfolio make the grade?

Ten questions every Insurance Company should ask about its investment process. By Stephen Sonlin, Managing Director, Head of Conning Research & Consulting

Events of the past year have kept insurance investment departments busy evaluating what to buy, what to sell and what to hold, while balancing these decisions against the overall business objectives and investment guidelines of the organization.

Now that the dust is beginning to settle, companies are taking stock of the damages and evaluating how their investment process fared through these adverse market conditions. While it is a safe bet that most investment results were less than stellar, it may be less clear whether these results were simply a function of the poor economic and capital market environment or were exacerbated by a suboptimal investment process.

Return performance is one measure of an investment portfolio's effectiveness, but it, alone, is not sufficient to reach any conclusions about the overall effectiveness of your investment process. A well designed investment process requires the identification of an optimal investment strategy, the creation of a well structured set of guidelines for building the investment portfolio and a security selection process that will allow you to squeeze out additional returns while avoiding negative surprises. Inefficiencies in any one of these three areas can lead to suboptimal investment performance.

If you are looking to optimize your investment process, the

first step will be to determine where your process would benefit from some fine tuning. To assist you in getting started, we put together a checklist of ten questions that every insurance company should ask about its investment process. The answers will allow you to determine if, and where, weaknesses may exist. Once identified, you can start to make the necessary corrections so you are better prepared for the next, inevitable, market downturn.

Question 1: Does our investment portfolio maximize the benefits of diversification?

While 2008 may have demonstrated that diversification is not the sole answer to risk control, it still reigns supreme in identifying strategies that get the maximum expected reward for a given level of risk. Risk accumulation, the opposite of diversification, remains one of the biggest culprits of portfolio inefficiency. In a world of momentum and bubbles, where out-performance is often valued more than risk control, diversification can be relegated to the back seat. Because diversification controls risk, it puts limits on potential upside gains as well as downside losses. It thus becomes tempting to avoid diversification during good times when everything seems to be moving up and losses are the ►

exception. The potentially devastating results of such a strategy is that years of gains can be wiped out, in simply a matter of days, when the market reverses. A strategic asset allocation study that includes an efficient frontier (risk/reward) analysis can assure that you are avoiding dangerous risk accumulations and that you are getting the maximum expected reward for the level of risk you are taking within your investment portfolio.

Question 2: Are we appropriately considering our liabilities, capital structure and financial objectives when setting our investment strategy?

The most misunderstood aspect of strategic insurance investment management is the role that the liabilities, capital structure and financial objectives play in the process. While it is generally clear that good investment results translate directly into improved financial results, it is less obvious how risk, as measured by the variability of the investment results, translates into financial risk. The risks assumed by your investment portfolio can be reduced significantly if your investment strategy is designed in a manner that considers the investment portfolio's relationship to your company's underlying liabilities, surplus and financial situation. The key to understanding the financial risks of different investment strategies is in recognizing the relationship between an insurance company's assets and liabilities. Factors such as interest rates, inflation and the strength of the economy link liabilities and assets together allowing some natural risk offsets. Assets can thus be invested in more efficient ways to enhance a company's financial risk/reward trade-offs.

Question 3: Are we confident that the risk profile of our investment strategy is consistent with our desired risk tolerance?

This assumes that you have an established risk tolerance. A more appropriate question might be: Do we know what our desired risk tolerance is, or even what it should be? Don't be surprised if the answer to this question is "no". There are a host of financial and regulatory reporting requirements that insurance companies need to monitor, reflecting some of the many risks that need to be kept in check. Specifying a company's tolerance for risk requires a concise list of risk measures, an appreciation of the amount of risk being taken under each identified risk measure and knowledge of how much the company is being rewarded for taking on additional risk relative to each measure. In this way, investors can quantify what is basically a subjective measure: How do we feel about risk? Without a solid understanding of your company's risk tolerance, it becomes difficult to know with certainty whether your investment strategy is optimal.

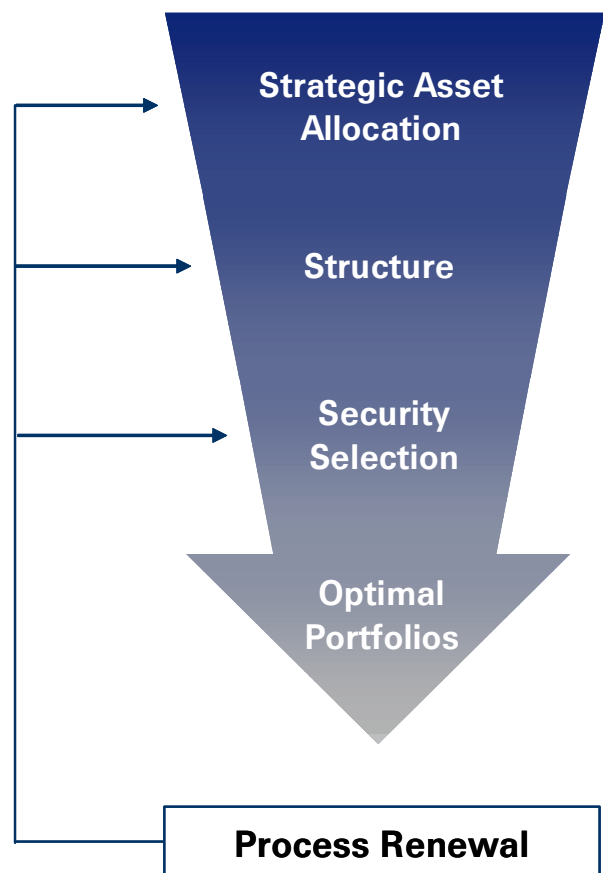
Question 4: Are our investment benchmarks consistent with our investment strategy?

Benchmarks play a critical role within the investment process incorporating information about the company's investment objectives, its neutral, or desired, investment strategy and its risk tolerance. Benchmarks allow company management to assess how the performance of their investment portfolio compares to that of the general market. However, because the benchmark also communicates important information about the objectives and risk tolerance of the organization, it is imperative that the selected benchmark is consistent with the desired investment strategy. Thus, benchmark selection is every bit as important as the performance of the investment portfolio relative to the benchmark.

Question 5: Do our investment policies and guidelines ensure efficient structuring and risk control within our investment portfolio?

While a benchmark is an important component of a well constructed investment policy statement, investment policy guide-

lines are also critical. Investment policy guidelines go beyond the benchmark and incorporate much more detail about the structure of securities that will make up the company's investment holdings. Issuer limits, quality standards and security restrictions should be specified in a manner that reflects your risk tolerance but allows sufficient room for the portfolio manager to add value. Tight restrictions relative to the benchmark will result in investment performance that is very close to the benchmark performance, while looser restrictions allow for the possibility of greater out-performance but also carry with them the possibility of significant underperformance. Well designed investment strategies can be undermined by lax investment guidelines that can accumulate much more risk than what the benchmark strategy would imply.



Question 6: Is our investment portfolio in compliance with our investment guidelines?

There is no sense spending a great deal of time and effort on developing appropriate strategy, benchmarks and guidelines if there is no process in place to assure that these instructions are being followed. Compliance procedures, while not the most exciting part of the investment process, are critical to assure that the implementation of the investment process is being carried out consistently with the desires of the organization. Effective compliance procedures can avoid issues of irrational exuberance in a strong market and prevent desperation moves that attempt to recover from a series of bad calls.

Question 7: Do we have systems in place that allow us to monitor deviations we are making against the benchmark?

A good investment monitoring system will allow you to see exactly how the structure of your actual investment holdings compare to that of your investment benchmark. Short-term deviations from the benchmark can occur due to company

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◀ imposed gain/loss restrictions or operational cash flow needs. More often, though, these deviations are a reflection of the tactical positions that the portfolio manager is making relative to the benchmark. Large deviations can result in significant basis risk between the actual portfolio performance and that of the benchmark. Deviations from the benchmark should be monitored and explained so that you clearly understand the reasons behind the deviations.

Question 8: Have downgrades in our portfolio been less frequent and less severe than the overall market?

Excess returns through active portfolio management can be generated by over or under weighting sectors or through superior issue selection. Superior issue selection occurs, for example, by identifying individual securities that are strong from a fundamental, technical and relative value perspective. Ultimately, investment performance is enhanced by using these skills to select securities that have attractive return potential relative to their risk. Issue selection capability can be tracked by monitoring the frequency and severity of rating downgrades within your investment portfolio and comparing the ratings migration statistics to that of the index. Poor issue selection also can create management challenges in cases of fair market value and other than temporary impairment valuation questions along with accounting questions such as held to maturity treatment. These developments add weight to the importance of security selection.

Question 9: Has our risk-adjusted investment performance beaten the benchmark?

Performance measurement is not just a matter of comparing actual portfolio returns against a selected benchmark. It is also important to assure that performance is not the result of increasing portfolio risk. The key question becomes: was the portfolio out-performance the result of skill or was it the result of taking additional risk within the portfolio structure? If excess returns are generated simply by taking on additional risk, even though the portfolio return may exceed the benchmark return in absolute terms, the excess returns may or may not be sufficient to overcome the additional risk that is introduced into the portfolio.

Question 10: Do we have an attribution system in place that allows us to understand the drivers of our investment performance?

Whereas an investment monitoring system will allow you to see, ex-ante, how the structure of your current investment holdings compare to that of your investment benchmark, a return attribution system will provide you with information, ex-post, about why portfolio returns differed from benchmark returns. An attribution system goes beyond simple total return performance comparisons and provides you with the reasons behind the return performance. A better understanding of how your investment manager is generating return performance will allow you to assess whether the investment tactics being employed are sustainable and consistent with your investment objectives.

Does Your Investment Portfolio Make the Grade?

As the above questions demonstrate, a strong investment process is composed of many inter-connected investment operations. In working with insurance companies to improve their investment processes, we have uncovered many different ways that investment results go bad. Some companies experience good performance relative to their investment benchmarks but run into trouble because their benchmark is not aligned properly with their liabilities, risk tolerance or financial objectives. Others have appropriate strategies in place but institute ineffective

benchmarks and guidelines that allow the portfolio to deviate substantially from the intended objectives and risk tolerance. Still others have both good strategy and effective benchmarks and guidelines but suffer from poor security selection.

Whatever the cause of poor performance, the end result is still painful, especially in times of severe market dislocations such as has been recently experienced in the global economy. Shoring up your investment process not only makes good business sense, but it is a critical part of a sound enterprise risk management process. Instituting an optimal investment process will not necessarily prevent you from suffering investment losses in the future, but it can go a long way in helping to minimize the pain. ●

Quick Investment Quiz:

1. Does our investment portfolio maximize the benefits of diversification?	<input type="checkbox"/> Yes	<input type="checkbox"/> No
2. Are we appropriately considering our liabilities, capital structure and financial objectives when setting our investment strategy?	<input type="checkbox"/> Yes	<input type="checkbox"/> No
3. Are we confident that the risk profile of our investment strategy is consistent with our desired risk tolerance?	<input type="checkbox"/> Yes	<input type="checkbox"/> No
4. Are our investment benchmarks consistent with our investment strategy?	<input type="checkbox"/> Yes	<input type="checkbox"/> No
5. Do our investment policies and guidelines ensure efficient structuring and risk control within our investment portfolio?	<input type="checkbox"/> Yes	<input type="checkbox"/> No
6. Is our investment portfolio in compliance with our investment guidelines?	<input type="checkbox"/> Yes	<input type="checkbox"/> No
7. Do we have systems in place that allow us to monitor deviations we are making against the benchmark?	<input type="checkbox"/> Yes	<input type="checkbox"/> No
8. Have downgrades in our portfolio been less frequent and less severe than the overall market?	<input type="checkbox"/> Yes	<input type="checkbox"/> No
9. Has our risk-adjusted investment performance beaten the benchmark?	<input type="checkbox"/> Yes	<input type="checkbox"/> No
10. Do we have an attribution system that allows us to understand the drivers of our investment performance?	<input type="checkbox"/> Yes	<input type="checkbox"/> No

Drop one grade level for every “No” answer recorded. A perfect score means that you earned an A+ and can sleep well at night knowing you are prudently managing your investment results while being mindful of financial ramifications and risk control. One to three “No” responses means you are probably getting by but have room to improve. More than three “No” responses indicates you may have significant opportunities to improve investment performance. If you do not know the answers to some of these questions, then you would benefit from an investment review that can provide you with further insights into your investment process.

Stephen Sonlin is a Managing Director at Conning and Head of Conning's Research and Consulting business. Steve has spearheaded the development of Conning's strategic asset allocation and enterprise risk management consulting services and has more than 20 years of experience serving the insurance industry. As a knowledge leader in the insurance industry, Conning serves clients with a unique combination of asset management, strategic consulting and insurance research. Among the top three global insurance asset managers (Insurance Asset Manager, 2008), Conning has \$77 billion in assets under management, as of March 31, 2009. Headquartered in Hartford, CT, with offices in New York, London and Dublin, Conning & Company is a member of the Swiss Re group of companies. More information is available at www.conning.com.