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Viewpoint

August 2022

ASSET MANAGEMENT | WHITE PAPER

Risk Matters

An ongoing series examining current investment risks for insurers and how modeling can help develop holistic enterprise solutions.

Equity Investing for Insurers: Keeping Steady on the Till in Rough Seas

By Matt Reilly, Managing Director, Institutional Solutions

A smooth sea never made a skilled sailor. – Old English Proverb

Equity markets had been smooth sailing for investors over the past decade with the S&P 500 Index returning 16.9% a year through 2021. However, as investors are learning in the beginning of 2022, these returns are not without risk. With the unwinding of pandemic-driven fiscal and monetary policy accommodation, levels of inflation not seen in decades, and heightened volatility from geopolitical shocks, choppiness has returned to the seas of financial markets.

As long-term investors, insurance companies face a unique challenge. Growth assets, stocks in particular, have played a key role in meaningful surplus growth amid meager reinvestment rates in predominantly fixed income portfolios. While yields are improving, real returns from fixed income are expected to be poor. Insurers need to decide what to do with their portfolio of growth assets amid increasing uncertainty.

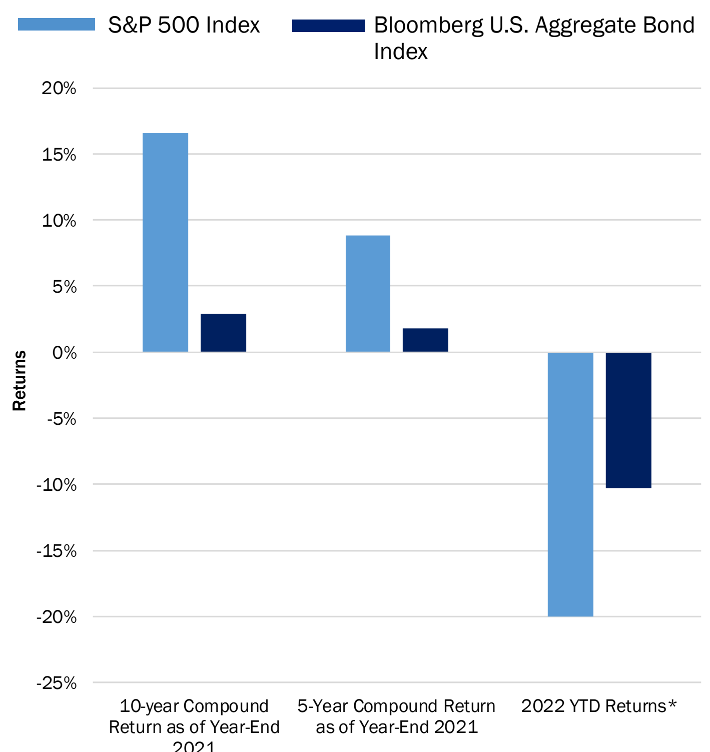
Conning has reviewed recent equity performance, examined divergent asset allocations pursued by insurers, and proposes some analytical frameworks to help insurers keep a steady approach to investment strategy. Despite current equity market conditions, we remain convinced that many insurers would benefit from exposure to stocks and other growth assets over the long term and a number should consider expanding their equity holdings.

A Rising Market Squall

During the past decade equity investors regularly witnessed double-digit gains in equities with few exceptions. However, in 2022 the S&P 500 was down 20% through June (see Figure 1). Making the situation worse, the usual ballast of fixed income was also down due to higher interest rates and wider spreads in credit markets: the Bloomberg U.S. Aggregate index returned -10.3% through June 2022 (see Figure 1).

Recent historical equity drawdowns were more harsh: the S&P 500 fell 38% in the early part of 2020 due to the pandemic and was down 54% in less than a year amid the 2007-2008 financial crisis.[2] With that in mind, insurers allocating to equities need to be mindful that the next bout of choppy market performance may be on the horizon.

Figure 1 Historical Stock, Bond Total Returns[1]



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*As of June 30, 2022.

For insurers, these precipitous declines are exacerbated as balance sheets are typically leveraged (more dollars of investments than surplus) and equities are marked to market on balance sheets. An insurer with a 2-to-1 ratio of investments to surplus and a 10% allocation to equities would have lost 2.6% of surplus with the drawdown through June 2022. While this risk to hard-earned surplus and the fast-rising market volatility are far from ideal, these risks need to be reconciled with the higher returns equities could potentially deliver over the long term.

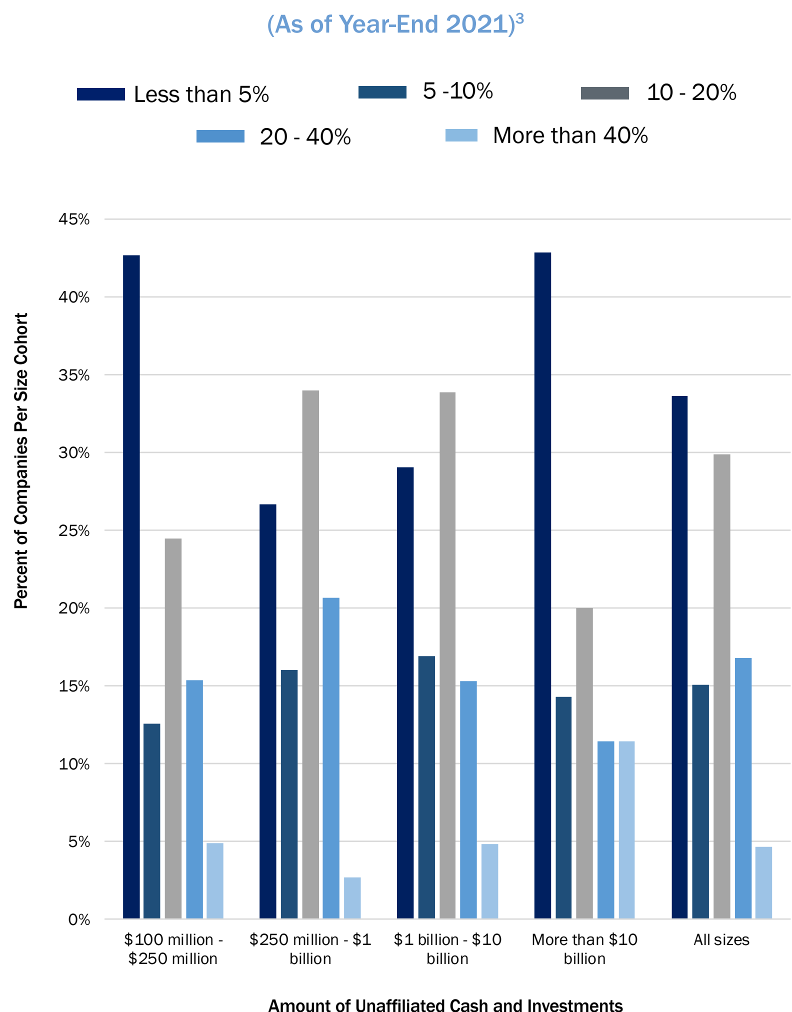
Asset Allocation: Industry Inconsistency

An insurer's investment strategy needs to be mindful of the underlying needs of the business, incorporate regulatory and rating agency considerations, and represent the organization's risk preference and ability to sustain through periods of volatility. However, while insurers may have similar businesses and stakeholders, their asset allocations vary meaningfully within and across size levels. A focus on equity allocations offers a good window to the issue.

In a review of 2021 year-end statutory filings by P&C companies, the median allocation to stocks was 11% but the underlying data reveals a far more diverse landscape (see Figure 2).

In both the largest and smallest companies, more than 40% have less than 5% equity exposure. Many small insurers might suggest that they are not large enough to include equities in their portfolios, but that may be more a comfort level than a fact given the equity holdings of peers. Larger companies with limited equity exposure may suggest they must manage to rating agency scrutiny, but again peers have the same concerns and many have greater equity exposures. The data overall suggests there is little consistency among companies in their asset allocation strategies yet, given that they have more in common than not, the ideal allocations would likely be more consistent. Firms underexposed to equities might benefit from a better understanding of how equities could aid a portfolio.

Figure 2 Equity Allocation As a Percent of Unaffiliated Investments in P&C Portfolios



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The majority of insurers with larger equity allocations have been long-term equity investors and have grown these allocations meaningfully over time. This equity exposure has helped them grow surplus and capital, thus slightly offsetting the corresponding additional regulatory and rating agency scrutiny. However, higher investment returns alone are not enough to justify increased equity allocations, especially given the rising underlying risk we have seen in 2022.

Benefits of Diversifying with Equities

As insurers assess the impact of recent market volatility on their portfolios and assess their tolerance for risk in what could be a sustained period of higher volatility, how do they properly assess the alternatives? Conning recommends that equity allocations need to be viewed in light of the potential diversification benefits, a company's capital position, and its tolerance for risk.

Insurers' portfolios are typically heavily invested in bonds, with a median bond allocation of 74% for P&C insurers.[2] However, most of the bond sectors are relatively highly correlated (see Figure 3). In environments in which bonds perform poorly, insurers should expect similarly poor performance across their bond positions. Generally, equities have little correlation with bonds and may offset bond performance offering meaningful portfolio diversification.

Figure 3 Conning Projected Long-term Investment Correlations

	Treasurys	Investment Grade Corporates	Tax-Exempt Municipals	MBS	ABS	CMBS	US Large Cap Equity	International Developed Market Equities
Treasurys	1.00							
Investment Grade Corporates	0.95	1.00						
Tax-Exempt Municipals	0.89	0.84	1.00					
MBS	0.85	0.81	0.80	1.00				
ABS	0.60	0.62	0.52	0.51	1.00			
CMBS	0.90	0.93	0.80	0.78	0.59	1.00		
US Large Cap Equity	- 0.04	0.06	- 0.03	- 0.02	0.03	0.03	1.00	
International Developed Market Equities	- 0.01	0.06	- 0.01	0.00	0.06	0.04	0.78	1.00

Prepared by Conning, Inc. Sources: ADVISE® Enterprise Risk Modeler and GEMS® Economic Scenario Generator. See Efficient Frontier disclosure included at the end of this Viewpoint.

Incorporating the diversification benefits of equities into an all-fixed-income portfolio (which generally has lower volatility) can help reduce risk while enhancing returns (see Figure 4). In addition, the standard deviation (or volatility) of the portfolio adds to risk-adjusted returns. Across value at risk (VaR) and tail value at risk (TVaR) calculations at the 95th and 99.6th percentiles,[4] measures are improved reducing the risk of tail-risk events in the portfolio. Diversification can often be a portfolio boost, similar to how sailing with the wind can aid a mariner's progress.

Figure 4 Conning Projected Annual Analytics of Model P&C Portfolios

	Model P&C Portfolio	Model P&C with 10% Equities	Difference
Average Return	2.37%	2.54%	0.16%
Portfolio Standard Deviation	3.32%	3.19%	- 0.13%
Sharpe Ratio	0.56	0.63	0.07
95th VaR (Downside) Return	- 3.14%	- 2.68%	0.46%
95th T-VaR Return	- 4.59%	- 4.27%	0.32%
99.6th VaR (Downside) Return	- 7.01%	- 6.66%	0.35%
99.6th T-VaR Return	- 8.48%	- 8.30%	0.18%

Prepared by Conning, Inc. Sources: ADVISE® Enterprise Risk Modeler and GEMS® Economic Scenario Generator. See Efficient Frontier disclosure included at the end of this Viewpoint. Learn more about SAA modeling here.

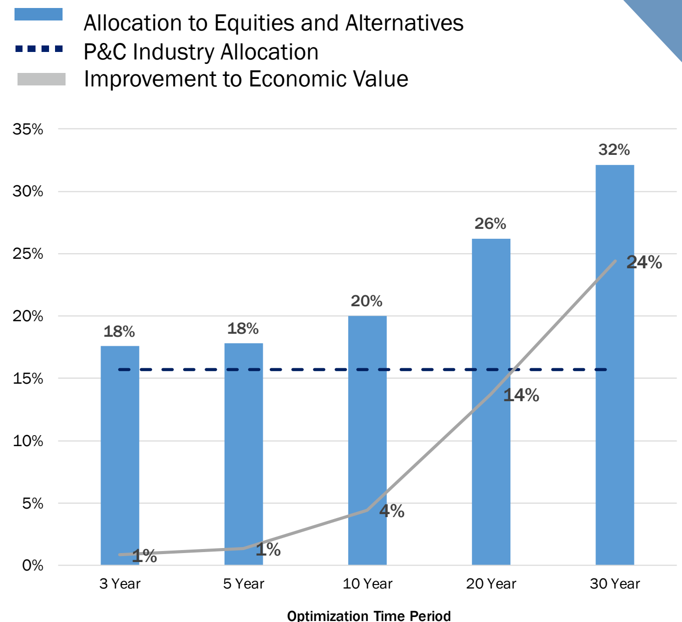
A Strategy to Stay on Course

While keeping the ship afloat in turbulent times is important, insurers must keep their eyes on the horizon to achieve long-term goals. Similar to how an individual's risk tolerance should vary based on shorter versus long-term objectives, insurers need to assess these trade-offs and costs. Assets that are backing near-term well-known claims payments should have a less aggressive stance than one for excess funds or surplus intended to support enterprise growth. Alternatively, a start-up insurer with growth-funding needs over the next 12-24 months should have a more conservative risk profile than a well-established insurer planning for the decades ahead.

Conning modeled the P&C insurance industry and its asset allocation and optimized across varying time periods. Figure 5 looks at how the capacity for equity and alternatives increases while maintaining a consistent level of risk. Initial simulations over three- and five-year periods yield little incremental terminal economic value[5] (gray line) from marginal increases in equity and alternative allocations. As we model out 10-, 20- and 30-year simulations however, the allocations to equity and alternatives increase and add meaningfully more value. In the 30-year optimization, P&C companies would increase their equity and alternative allocation from 15% to 32% of their invested assets. This resulted in 24% higher ending economic value while maintaining the same level of risk. Part of this can be explained by the meaningful risk higher inflation presents to P&C insurers, and the hedge that equities provide to offset that risk.

As insurers think about optimizing the long-term value of their enterprise for decades instead of years in the future, their capacity for higher -returning assets increases meaningfully. This results in significantly higher levels of surplus and economic value; as the time frame extends, so does the potential payoff and risk-reducing characteristics.

Figure 5 Capacity for Equity and Alternatives as Time Period Increases



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Modeling: Charting a Custom Path

The heightened market volatility of 2022 may cause more insurers to revisit their level of comfort with investment risk. It may be premature to change target allocations, but it is never a bad time to develop a long-term strategy. Conning believes an insurer's investment strategy should align with the company's goals, risk preference and long-term operating objectives. In our view, insurers should conduct a comprehensive strategic asset allocation exercise that applies the proper timeframe and accounts for the future states of the market and the business while considering key constituents. This exercise should incorporate a detailed analysis of downside risk analytics that can help stakeholders become comfortable with historic market stresses and a broad range of more adverse outcomes.

Every insurer is different, but Conning believes opportunities exist for many through larger allocations to "riskier "assets, such as equities, to enhance portfolio returns, levels of surplus and company value. This strategy has been successfully deployed by select insurers operating within the common regulatory framework.

Our analysis illustrates the value that higher equity allocations can have for the industry in aggregate, but each company is unique with regards to its underwriting risk, risk tolerance, rating and regulatory considerations and state regulations. It is critical to consider how any changes to long-term investment strategy are supportive of the many needs of each insurer. Conning's modeling and investment capabilities can help insurers navigate the litany of considerations as they consider an investment strategy that seizes potential opportunities in equities and risk assets.

Risks

Market, or systematic, risk is the risk that individual stock returns may be correlated with general market downturns regardless of the particular business conditions and outlook for the individual stocks. Inflation erodes the purchasing power of future cash flows from investments. In times of high inflation the value of securities may be reduced. Liquidity risk can occur when market conditions do not allow transactions to be made in a quick and orderly fashion in relation to indicative market prices.

RELATED CONTENT

Inflation for P&C Insurers: Managing Risks to Both Sides of the Balance Sheet
Matt Reilly and Yazeed Abu-Sa'a from the Institutional Solutions team offer insights to help P&C insurers prepare to manage the impact of inflation. This is the first in the "Risk Matters" series. Learn more here.

Matt Reilly, **CFA,** is a Managing Director in Conning's Institutional Solutions group and leads the team responsible for the creation of investment strategies and solutions for insurance companies. He joined Conning in 2015 and was a portfolio manager before assuming his current role in 2018. Prior to joining Conning, he was with New England Asset Management. Mr. Reilly earned a degree in economics from Colby College.

ABOUT CONNING

Conning (www.conning.com) is a leading investment management firm with a long history of serving the insurance industry. Conning supports institutional investors, including insurers and pension plans, with investment solutions, risk modeling software, and industry research. Founded in 1912, Conning has investment centers in Asia, Europe and North America.

Footnotes:

[1]Analysis covers P&C insurers that have over $100 million in unaffiliated investments and whose data was available from S&P Global Market Intelligence as of 12/31/2021. For the purpose of the industry holdings analysis we focus on the P&C industry as opposed to its life and health counterparts; this is due to the much larger allocation to equities, 27% in the P&C industry at year end 2021 compared to 1% and 10% in the life and health industries, respectively. We would note the frameworks and philosophy can be applied to health and life insurers as well, although to a lesser extent.

[2] Copyright 2022 S&P Global Market Intelligence

[3]Included in the graph are P&C entities whose data was available at the end of May 2021 through S&P Global Market Intelligence and had net cash and invested assets in excess of $100mm.

[4] These percentiles represent a 1-in-20-year and 1-in-250-year occurrence in our distributions.

[5]Economic value is a calculation conducted at the end of the simulation period, in this case 3, 5, 10, 20 and 30 years. It is the market value of assets at the end of the period minus the discounted value of the liabilities at the end of the period, plus the future value of operations. This methodology we believe appropriately measures a P&C insurer's value and should resemble surplus except for some accounting and reporting differences.

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