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INSURANCE ASSET MANAGEMENT, EUROPE 2019

Examining the economic and market hurdles facing asset allocators in their quest for outperformance

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**as at 30 Jun 2018*

Aberdeen Standard Investments

2.4 WHITEPAPER

Examining the growing role of private markets and the move towards multi-asset approaches – investment strategy, risk and operational considerations

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CRAIG TURNBULL

A survey we conducted with around 50 North American insurance groups across the US, Canada, and Bermuda, and across life insurers, general insurers, health companies, both large and smaller, showed some interesting results, in terms of their intentions around their fixed income asset allocation over the coming three years.

There was a range of alternative assets within the fixed income space that insurers are, on average, looking to increase their allocations to. This trend is particularly notable in the private space within infrastructure lending, commercial real estate lending and corporate lending, i.e. private placements within private markets.

This is a theme that many of us will recognise from the past three to five years in the UK with the move from public to private markets, particularly in the credit space. This is very much a global insurance phenomenon rather than simply UK or European.

We also see a similar trend, not quite as pronounced, towards private markets within equity-type assets. Across the private asset types such as infrastructure, real estate and private equity we see a strong intention to increase allocations among the group of North American insurance groups.

This seems to be part of a longer-term trend towards a more diversified set of equity-type assets that moves beyond vanilla, active public equity holdings and towards a wider range of growth assets.

All these trends can be considered in the context of the low interest rate environment and clearly Quantitative Easing has exacerbated the challenge of low interest rates over the past 10 years. But, long term interest rates within developed markets have been falling for the past 35 years or so, bringing challenges for long-term guarantees, solvency and profitably for short-term liability business.

Searching for yield

The incentive to find sources of yield and return in a capital-efficient and risk-adjusted way has perhaps never been greater and is one of the drivers behind the appetite for innovation we see in global insurance today.

The UK market is arguably more mature than some other parts of the world, particularly for Matching Adjustment (MA) business. There has been a great deal of focus on shifting out of public credit, particularly investment grade long dated credit, and into assets which are intended to be risk-equivalent. The idea here is not necessarily to move down the risk spectrum as there are easier ways of doing that than moving into private markets. The idea is to retain the credit quality in the assets that back UK annuity books but try to access the illiquidity that may be on offer from certain private asset classes.

Given there is an illiquidity premium on offer in certain private asset types, there is a strong economic rationale for these businesses to use that balance sheet and unique long term illiquid funding to access and monetise that illiquidity premium.

Over the last several years, several private asset classes have dominated activity within the UK market. Commercial mortgages, infrastructure lending, corporate private placements are all private asset classes where there is an established market in long-dated, investment grade quality private debt.

More recently, we have started to see an appetite for a more diverse range of private asset classes that can potentially also offer that type of profile. Ground rents has been a popular case though material investment in the asset class has so far been isolated to one or two insurers. Equity release mortgages have produced a great deal of interest in recent times though some notable voices have raised concerns with the way that insurers think about equity release mortgage valuation and credit risk assessment.

We will continue to see innovation and a widening set of investment horizons in terms of the sorts of private market borrowing sectors that these businesses will look to access.

Further challenges ahead

This rotation from public to private market has clearly not all been plain sailing. Several UK insurers have been frustrated by the pace at which they have been able to implement this rotation over the last three or four years. There are some challenges here that have been purely investment challenges. Clearly, we are dealing with illiquid private markets where, almost by definition, it won't be possible to be fully invested with large volumes of cash immediately.

Perhaps more subtly, MA books will have quite a demanding set of features, requirements and characteristics that they will require to be met in for the asset to be appropriate for these investment strategies. For example, investment grade quality, long duration with fixed cash flows that meet the various MA criteria; set of exposures that are well balanced geographically and by sector.

The role of the asset manager

This is where the asset manager can play an important role. Their understanding of the detailed risk assessment of these private assets, together with a deep understanding of insurers' regulatory modelling requirements, can ensure that the insurer is well equipped to develop a strong internal ratings process for these assets, thereby obtaining their appropriate capital treatment.

DR. BRUCE PORTEOUS

Investment guarantees are increasingly unaffordable. This is something that we have seen in the UK, Europe and Asia. It is becoming harder for insurers to offer guarantees and as they withdraw from offering such products there is a democratisation of financial risk as it transfers from the balance sheet of insurance companies onto the balance sheet of the individuals.

However, customers need help to balance these risks and still need to save for retirement over the long term. They will need help to understand their own appetite for risk and investment solutions that will help them to save over these longer periods of time in accordance with their own individual risk appetite.

Multi asset investing

Multi-asset investing ideas can be very useful in designing risk-based funds and these ideas also have balance sheet applications.

“Regulatory challenge is certainly quite natural given that these asset classes are ones that insurers have tended to be previously unfamiliar with”

This range of criteria may constrain the investment opportunity set and the pace at which these assets can be invested.

Perhaps more materially, challenges have arisen for insurers from their interaction with their regulator, particularly relating to the process of obtaining approval for use of internal models to assess capital requirements for these types of assets. This has largely been a question of pace. Regulatory challenge is certainly quite natural given that these asset classes are ones that insurers have tended to be previously unfamiliar with.

Our data shows that in 2005, emerging market equities was the best performing asset class, while in 2006 it was UK small cap. This shows it is very tricky to try and estimate from one year to the next which asset class is going to perform well.

Asset allocation is hard for investment professionals as well and this is where a rigorous investment process helps us control and manage risk with multiple asset classes.

We construct funds from a range of defensive funds as well as growth funds. Our defensive funds are essentially a mixture of cash and short-term bonds and our growth funds are largely equities with high yield bonds, emerging market local currency bonds, UK real estate and some absolute return type funds as well. These are the building blocks that we use to construct these funds. What is absolutely key to success is the investment process.

Building a portfolio

We start by selecting the appropriate asset classes, then do longer term strategic asset allocation. Typically, we use the types of models that would be very familiar to life insurance actuaries working on Solvency II to estimate the value of guarantees. This is where we project forward a multiplicity of asset classes allowing for the various correlations between them.

MA is growing fast

Our AuM is the fastest growing part of our business. The staff that we use to support it are also growing to support the overall growth. It is unusual for asset managers to see this type of growth in any one particular asset class.

In terms of the distribution of the business across the five types of risk, risk three, the middle risk profile, is the one that predominates, as we have a relatively risk adverse client base.

This is how we use diversification to manage and control risk. It relies very heavily on a tried and tested investment process. It may look easy, but it is quite hard to implement in practice and get it to do what it is supposed to do.

> "It may look easy, but it is quite hard to implement in practice and get it to do what it is supposed to do"

We then do shorter term tactical asset allocation which is underpinned by a very robust and rigorous process, involving our asset class experts and based on a documented approach where the consensus view is used to drive the Tactical Asset (TA) decision.

Using a funds of fund approach, we use our own funds and funds from third party asset managers to construct the portfolio. Then on an ongoing basis, we rebalance and check that these funds are doing what they are supposed to do.

The key point really is that in order to make this work, you need a well-defined and tightly governed investment process as these are the building blocks which drive the success of the approach.

For retail and balance sheet type investors, we have evidence to show that our investment process is doing what it is supposed to do in terms of risk and return. I have a similar chart demonstrating that over a five-year period the investment process is working.

Another risk measure is drawdown over a particular period. In our research, we have the maximum drawdown based on weekly data over the period from 2012-2018 and the maximum drawdown is the fall from peak to trough over that period. Within each category of the five risk profiles, the funds are doing exactly what they are supposed to do. The less risk that is taken, the smaller the drawdown. These funds also compare very favourably with the corresponding index drawdown statistics.

We see a multiplicity of uses for retail savers as traditional insurance business models break down and guarantees become extremely rare. This idea is a great guarantee replacement product for people who are saving over the long term.

We are speaking to a Taiwanese insurance company that realises that it can no longer provide the traditional with profits long term savings products in its market. It has looked at variable annuities, but they are considered too complicated, so they are looking for a relatively simple idea that will be a long-term savings substitute.

We are talking to several companies, particularly in Asia, about using these ideas to manage the assets backing some of the guaranteed business and also shareholder funds. It is a relatively simple idea but quite difficult to implement in practice in a credible way.

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