How European insurers learned to love passive investing

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Traditionally, insurers have been active investors, usually matching their liability streams with corresponding assets and playing around the margin with security selection and/or asset allocation to attain additional investment income.

Besides taking into account their liability structure, insurance companies typically also have to consider complex regulatory and accounting constraints in their investment decisions. In order to comply with these constraints, insurers require a high degree of customisation in their investments, especially in the fixed income space. In this light, passive investment products – which are often only associated with one-size-fits-all ETFs or index funds – may not be the first choice for insurance companies to make strategic investments.

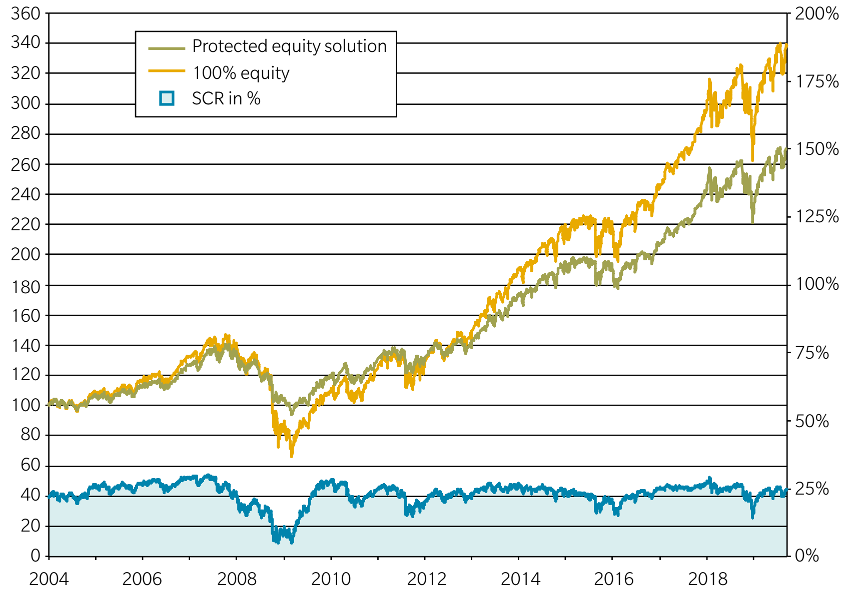
DWS believes the broader insurance industry may miss an opportunity by neglecting the considerable value an additional form of passive investing can bring – customised passive mandates which can offer a broad range of different investment outcomes while also taking into account individual investment constraints.

Indeed, some of the largest insurance and reinsurance companies in the world have begun to utilise passive mandates to “passivise” parts of their asset allocation, mainly in equities but increasingly also in fixed income.

What is a passive mandate?

A passive mandate in its most basic definition is nothing else than a separate account that follows a certain benchmark as closely as possible. This is usually done by a portfolio manager based on a set of rules and tasked with replicating a given benchmark within this set of rules. The legal structure can vary, such as being implemented in a separately managed account, wrapped in a fund structure, or through an investment advisory agreement, leaving the final decision on every transaction to the investor’s in-house investment team.

Fig 1: Passive S&P 500 strategy with a 80% protective put overlay



Performance backtest before costs, 01/01/2004 – 18/09/2019, reinvestment of net dividends, Maturity of options: 24 months, rolled after 12 months, equity risk SCR without symmetric adjustment.

Source: DWS International GmbH. Past performance, actual or simulated, is not an indicator of future results. Forecasts are not a reliable indicator of future returns. Forecasts are based on assumptions, estimates, views and hypothetical models or analyses, which might prove inaccurate or incorrect.

A range of customisation opportunities

An insurance company is by nature more constrained than almost any other institutional investor. Accounting, regulation, solvency capital and income generation, amongst others, are all very specific considerations for the insurance investor when implementing an investment strategy. This requirement for customisation is one reason why passive mandates are increasingly en vogue. Insurers are becoming more aware of a passive mandate's ability to be designed based on very specific rules and guidelines. Among the customisation abilities that an insurer can choose to implement:

- Exclusion criteria, e.g. an equity or corporate bond benchmark ex insurance companies in order to avoid investment into a competitor;
- Tracking combined benchmarks such as a MSCI World benchmark with individual regional weights, e.g. 50% MSCI Europe + 40% MSCI North America + 10% MSCI Pacific;
- Custom duration and rating buckets for fixed income benchmarks;
- Individual smart beta weighting schemes such as quality weighting for government bonds benchmarks or yield-focused strategies in the corporate bonds space;
- ESG considerations; and
- Capital efficiency, such as option-based protected equity strategies where passive strategies are the natural underlying as they can ensure the highest hedge effectiveness.

Case study: Passive protected equity strategies providing capital efficiency under Solvency II[1]

Under Solvency II, equity exposures are subject to a basic capital charge of 39% to 49%, depending on the country of listing of the individual stocks. Insurers can reduce the capital charge by applying certain risk mitigation techniques such as protective put option overlays. For example, a protected US equity strategy can be constructed by passively tracking the S&P 500 and buying put options on the S&P 500 for protection. The protection level is defined by the strike level of the options. For example, a strike level of 80% will limit the maximum drawdown of the passive portfolio to approx. -20%. In this way, also the Solvency II capital charge can be reduced to approx. 20% given that the option overlay fulfils certain conditions. For example, one main requirement for a full regulatory recognition is that the put options must be effective for at least 12 months. Some insurance companies also wish to construct a collar strategy by additionally selling call options on the same index to (partially) finance the purchased put options, but at the opportunity cost of limited upside. Protection overlays typically use listed index options. Hence, a passive equity portfolio tracking the underlying index is the natural investment strategy to ensure the highest hedge effectiveness.

ESG integration one major driver for customised solution

The rising significance of ESG is possibly one of the key catalysts behind insurers embracing passive investing. Tracking ESG indices is a faster way to render a part of the portfolio "ESG compliant" when compared with reconfiguring an existing equity or fixed income strategy.

ESG integration can range from the implementation of a simple exclusion list to the development of very customised best-in-class ESG benchmarks in cooperation with third-party index providers. In addition, smart ESG technology can allow for highly bespoke ESG programmes, wherein each investor decides what level of importance the different sub-components of the "E," the "S" and the "G" should have. In the absence of a common taxonomy around ESG, some investors may have a particular emphasis on one or several components of Environment, Social or Governance, such as e.g. carbon exposure or the death penalty.

There are two approaches where ESG can potentially be integrated into passive portfolios.

Approach 1: Replication of ESG index

With this approach, a portfolio manager tracks an ESG index such as the MSCI World ESG Leaders or the Bloomberg Barclays Euro Corporate Bonds SRI. Individual ESG exclusions can be implemented by constructing a custom ESG index in cooperation with established index providers such as S&P, MSCI or Bloomberg Barclays. However, the customisation possibilities can be limited to a certain degree.

Approach 2: Passive portfolio with custom ESG implementation

With this approach, the "ESG tilt" is directly implemented to the passive portfolio while tracking a non-ESG benchmark. The portfolio manager would typically apply an optimisation process to the ESG-adjusted portfolio by which he brings all relevant risk and return factors of the portfolio – such as country or sector weights – in line with the benchmark in order to minimise the portfolio's tracking error to the non-ESG benchmark or operate within a given tracking error budget. This approach allows for highly customised ESG screens using data of one or multiple ESG data providers. A regular exclusion list defined by the insurance company itself can also be easily implemented in this way.

Case study: Passive equity portfolios with structurally improved ESG metrics[1]

A European institutional investor with a passive equity portfolios that they want managed with structurally improved ESG metrics versus their benchmarks and a particular focus on the Social pillar. One portfolio is benchmarked against the MSCI World ex-Japan with custom regional weights while the other strategy tracks the MSCI Emerging Markets Index.

Both portfolios are managed with structurally improved MSCI ESG metrics versus their benchmarks, such as an improvement in the average MSCI IVA Score (0-10 scale) by +1.5 or a reduction in the average MSCI Carbon Intensity (in T CO_2e / USD Sales) of -20%. All ESG enhancements are implemented with the lowest possible ex-ante tracking error using a portfolio optimisation which aligns the sector and country weights of the ESG-adjusted portfolio with those of the two benchmarks.

Conclusion

Given the many advantages passive strategies offer, DWS strongly believes that passive investments should be well-examined for their usefulness by each insurance investor. Large and sophisticated insurance groups globally have already begun to do so, in spite of excellent in-house capabilities. Just as the rise of ETFs for tactical allocations appears to be strong, we also believe the share of passive mandates in insurance companies' strategic asset allocations will increase significantly over the years to come.

[1]*For illustrative purposes only.*