A strategic approach to asset allocation

Property-casualty insurance carriers, among others, are under growing pressure to find new ways of increasing their investment income, writes Lloyd H. Ayer, Insurance Strategist within Deutsche Asset Management's Client Solutions Group.

Insurers recognise that their investment portfolio exists primarily to support their underwriting business and so stable investment income is one of their primary concerns. Yet, lower investment yield over the years is putting a strain on insurers' profitability. As a result more insurers are starting to explore what used to be considered non-traditional asset classes, beyond core investment grade fixed income securities.

Higher yielding assets typically come with additional risks and it's important that these risks are measured individually and on a total strategic asset allocation level. In addition, we think it's necessary to consider the possibility of stable and stressed investment environments, as well as changing conditions, like low and falling interest rates to a rising rate environment for example.

Current market yield serves as a proxy for the level of investment income expected from an investment made today (YE2016). The three-year standard deviation is our chosen measure of expected risk for that investment and the most recent period represents a very stable investment horizon, with exceptionally low volatility.

This situation is most evident in the three-year standard deviation of 7% on US large-cap equities, which is less than half of the historical average over the last 20 years of 14% (S&P 500, as of Dec. 31, 2016). The risk adjusted yield comparison chart (see chart 1) illustrates attainable investment income compared to risk, given a stable environment consistent with the last three years.The risk adjusted yield measure – the basis points return obtained for every 100 basis points of volatility – allows a comparison of investment income across asset classes and puts volatility in perspective.

The first three markers on the graph (in blue) represent the core of the typical US insurance company asset allocation. They comprise familiar investment grade bonds, very liquid, and are intended to support the overall operations of the insurance company. These high quality sectors return 50-90 basis points of income per 100 basis points of volatility.

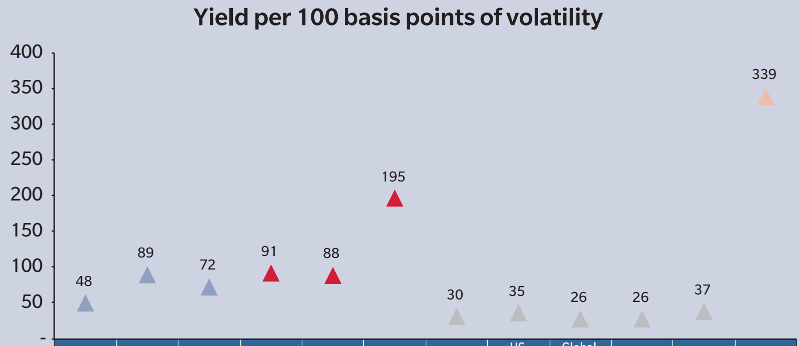
Municipal bonds are shown on a tax-adjusted basis consistent with their after-tax benefit to P&C insurers. The modelled tax benefit makes Municipal bonds the most-favorable investment grade sector with a risk-adjusted yield of 89 basis points (based on the conclusion shown in the chart). Without adjusting for the tax benefit, the risk-adjusted yield drops to 61 basis points.

Safer bond investments typically have the highest risk-adjusted yield, but in the current environment, they may not provide enough yield to support operations. For example, U.S. Treasury bonds maturing 1-3 years have a risk adjusted yield of 152 basis points. But the 1.2% absolute return is likely not sufficient to meet overall objectives. Hence insurers are rethinking their investment strategies.

Low and continually declining bond yields have led insurers to look beyond investment grade fixed income assets in search of yield. Many have allocated to alternative fixed income such as high yield bonds, bank loans, and emerging market debt (EMD). These assets provide a yield premium to investment grade bonds, but also come with more risk. On our risk-adjusted basis, the yield on High Yield and EMD is still comparable to the core investment grade sectors. So insurers aren't necessarily assuming an unreasonable amount of risk to increase yield.

Also by replacing interest rate risk with credit risk, some insurers are actually shifting the source of risk from the less preferred interest rate risk to the more preferred credit risk. Bank loans are exceptionally favorable by

Chart 1: Risk-adjusted yield comparison



	Treasury	Municipal*	IG corporate	High yield	EM debt	Bank loans	US large-cap equity	US dividend equity	Global infra equity	US listed REIT	US listed MLP	Private real estate
▲Risk-adj yield	48	89	72	91	88	195	30	35	26	26	37	339
Current yield	1.9%	3.8%	3.4%	5.9%	5.3%	4.1%	2.0%	3.0%	3.1%	3.5%	8.0%	4.4%
3yr std dev	3.9%	4.3%	4.7%	6.6%	6.0%	2.1%	6.8%	8.7%	11.6%	13.5%	21.7%	1.3%

- Current Yield: Index yield for fixed income as of 2016YE, Dividend yield for equities
- Risk-Adjusted Yield: Income yield available per 100 basis points of standard deviation (Yield / 3yr Standard Deviation)
- *Municipal Bonds tax adjusted by 1.45x, Yield prior to adjustment is 2.6%, or a risk-adjusted yield of 61 basis points
- Index List: BC US Treasury, BC Municipal Bond MM, BC Corporate Investment Grade, BC High Yield VLI, JPM EMBI Global Diversified USD, S&P/LSTA Leveraged BB Loan Index, S&P 500, DJ US Select Dividend, Dow Jones Brookfield Global Infrastructure Index (USD), S&P US REIT, Alerian MLP Index, NFI-ODCE Value Weighted Index

Past performance is not indicative of future results.
Data source: Deutsche Asset Management, Bloomberg, NCREIF, December 31, 2016

this measure. At 195 basis points of yield per 100 basis points of volatility, it is the second most-favored asset class considered.

The next five categories on the asset spectrum are public equities. Traditionally, public equities are used by P&C insurers to grow surplus. But in recent years insurers have sought out dividend strategies as dividend yields have gone above investment grade bond yields. However, equities are much less attractive from the risk-adjusted yield perspective, because volatilities are relatively high compared with investment grade fixed income securities (see chart 2).

That said, in a total portfolio context, considering diversification with the core bond portfolio and the potential for appreciation, equities do have a place in the P&C insurer asset portfolio. Typically, a portfolio consisting of 100% core bonds has higher long-term volatility than a portfolio of 90% core bonds and 10% public equities. So in this hypothetical scenario, a company can allocate 10% of the portfolio to dividend equities that yield more than bonds and increase investment income, the expected return, and may reduce overall portfolio risk.

The last marker on the chart highlights private real estate, which should also be thought of as a proxy for many private investment strategies implemented by insurers. The yield premium is demonstrated here by comparing the private Real Estate asset to the listed REIT asset, a yield difference of about 90 basis points.

Private markets also have favorable volatilities: the private real estate index is based on appraisals rather than capital market pricing. For institutions with quarterly reporting and long-term horizons, the private appraisal based index returns may best represent the investor experience.

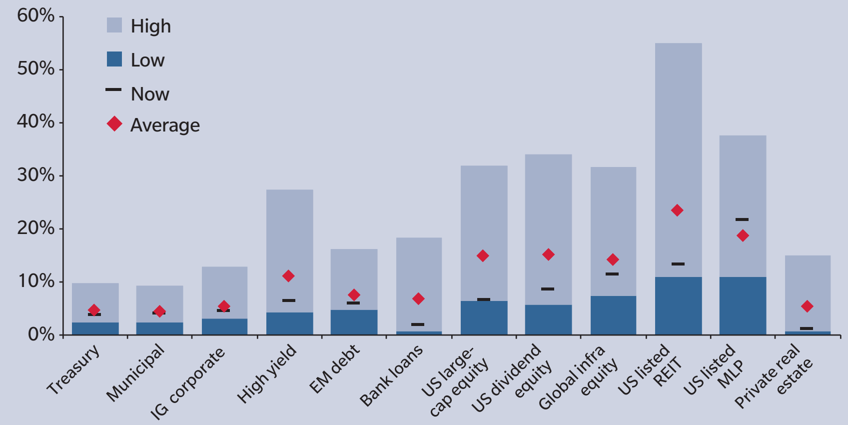
We believe that volatility will pick up in the future across all asset classes. But on a relative basis we would expect the relationships between sectors to remain. For example, when overall market volatility does increase, investment grade bonds would be expected to maintain higher risk-adjusted yields compared to equities, even though the absolute risk-adjusted yields may change significantly. An example that could potentially cause a shift in the relationships would be a reduction in corporate taxation by the Trump administration which would be a positive for public equity but it would erode the premium enjoyed by municipal bonds.

The total portfolio approach to asset management will likely continue to create opportunities for insurers despite changes in the investment environment. We believe it is often possible to improve the return on an insurance investment portfolio without assuming excessive risk. What's important is that all individual factors are taken into consideration and the strategy is executed in a careful, measured way.

Even with the data, however, construction of an insurance strategic asset allocation program goes beyond simply taking a "black box" approach based on questionnaires. Strategic asset allocation requires a deep understanding of an insurer's specific objectives, operating environment and constraints. That includes regulatory, accounting, and tax considerations, and the ability to synthesize and incorporate these additional inputs into the modelling. Knowledge of an asset class's features is not enough; it is just as important to understand the drivers of asset return potential in the context of the overall insurance program to provide appropriate options and solutions.

Chart 2: Historical volatility

3-year rolling standard deviation (last 10 years)



- Current Yield: Index yield for fixed income as of 2016YE, Dividend yield for equities
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