Alternative Investments in Insurance

Diversification and risk enhancement in an evolving general account investment management environment

An excerpt from Patpatia & Associates' *2015 Insurance Asset Management – A Bridge to Corporate Profitability*

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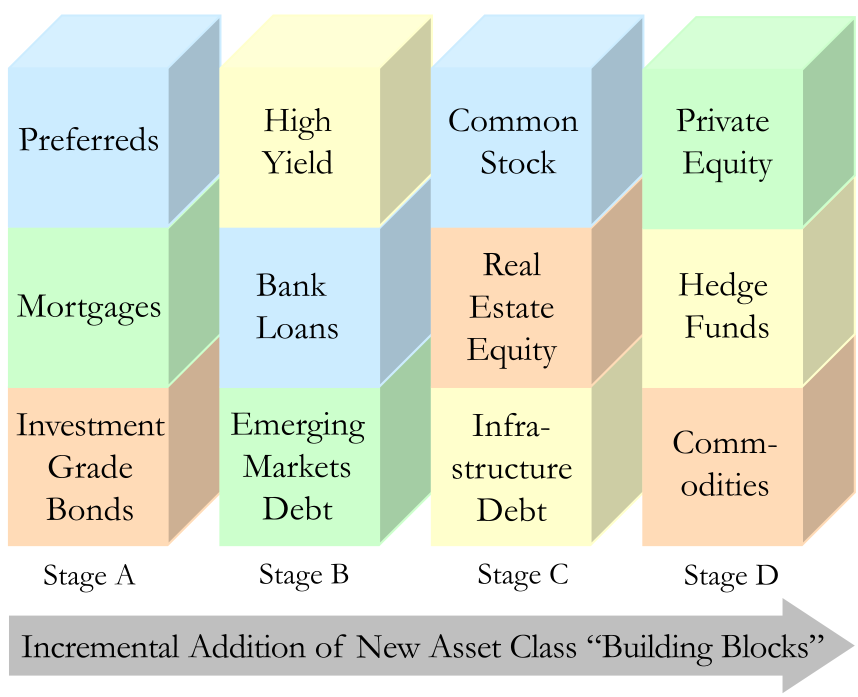
Evolving Investment Strategies to Meet the Challenges of the Low-Yield Economic Environment

As traditional fixed income strategies have generated declining returns in the low yield environment, insurance companies have been spurred to search for new investment opportunities, including alternative asset classes. For many firms, these investments constitute a fundamental change to their insurance general account investment practices, to be harnessed not only to enhance returns, but also to better manage risk through portfolio diversification.

This diversification is happening in an evolutionary, not revolutionary, fashion. For all, fixed income remains the primary driver of yield. However, many insurers who had previously focused efforts exclusively on selecting investment grade, domestic fixed income (i.e. core bond strategies) are now beginning to experiment with both higher-yielding investments and equity-type investments.

In the face of current economic challenges, insurers have found they need to fundamentally change their approaches to portfolio construction. Leaders are now deploying multi-asset portfolio optimization to harness the benefits of diversification to achieve superior risk-adjusted yields, without taking on outsized loss potential. Of course, this also necessitates that firms improve their market risk monitoring solutions.

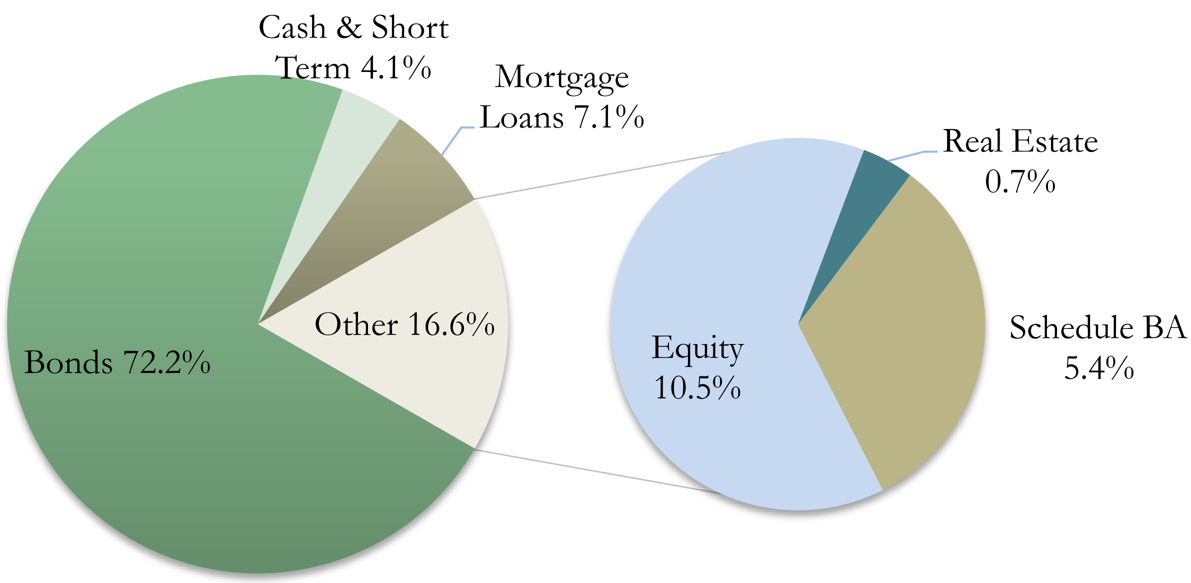
A Multi-Component Investment Evolution



Diversified Investment Strategies

Of course, insurers' general account portfolios remain driven largely by income-oriented assets. These bond, commercial mortgage, and short term holdings are well suited to addressing the cash flow needs and stable values necessary to back insurance liabilities. Regulatory treatment, insurance ratings agency methodologies, and statutory & GAAP accounting prinicipals have all been aligned to favor these core portfolio components, locking them into their primary role in most insurers' portfolios.

U.S. Insurance Industry General Account Asset Allocation, 2013



However, the insurance industry's long-term trend toward higher-returning, capital appreciation-oriented asset classes is unmistakable, especially when one views the evolution of the industry's portfolio distribution over the past five years. Although allocations to bonds have remained relatively stable since 2008 (approximately 72% of the portfolio), insurers have redeployed some of their cash & short-term bond positions that had built up following the financial crisis, decreasing as a proportion of the overall portfolio from 6.5% in 2008 to 4.1% in 2013. At the same time, allocations to equities and Schedule BA assets increased from 9.2% and 3.8%, respectively, in 2008 to 10.5% and 5.3% in 2013.

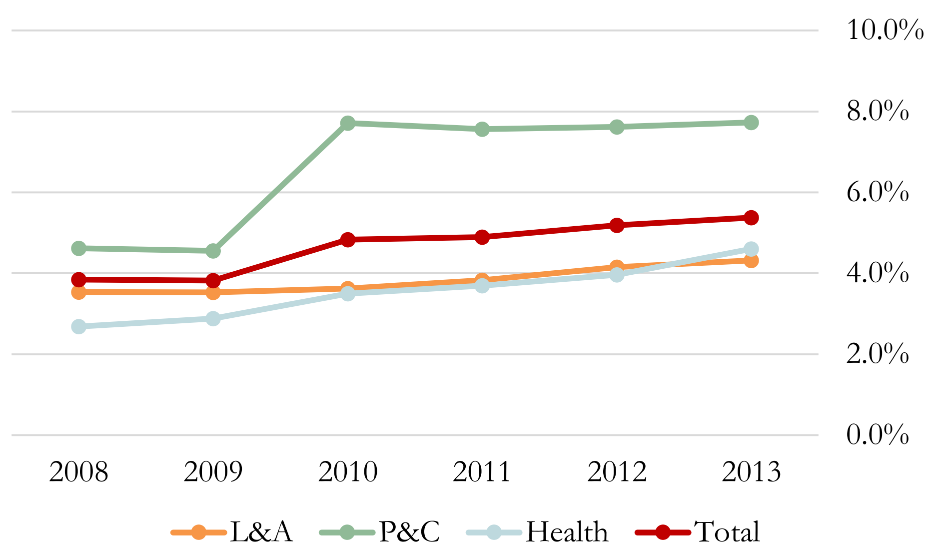
Source: NAIC

Increasing Investments in Alternative Asset Classes

As they attempt to maximize returns in a low-yield environment, many insurers have particularly increased their allocations to a variety of alternative asset classes, including hedge funds and private equity, as well as other specialty investments, such as infrastructure, mineral rights, aircraft leases, and debt & real estate limited partnerships. In statutory filings, these non-traditional investments are classified in the U.S. as Schedule BA assets.

This gradual evolution in strategy has been reflected in insurers' portfolios. In fact, in 2013, Schedule BA assets accounted for 5.4% of insurers' total invested assets, up from 3.8% in 2008.

Allocation to Schedule BA Assets by Business Line, 2008-2013



This increase is reflected across the entire industry, as all business lines have grown their allocations to a material extent. P&C insurers implemented the largest increase in allocations to Schedule BA alternatives, from 4.6% of total invested assets in 2008 to 7.7% in 2013, capitalizing upon the relative flexibility of their constrained total return investment programs. Health insurers similarly increased their Schedule BA allocations from 2.7% in 2008 to 4.6% in 2013. L&A carriers made the most modest, though still significant, proportional increases to their Schedule BA alternative assets, from 3.5% in 2008 to 4.3% in 2013, due to the constraints of the book income investment approach and significant regulatory risk-based capital implications.

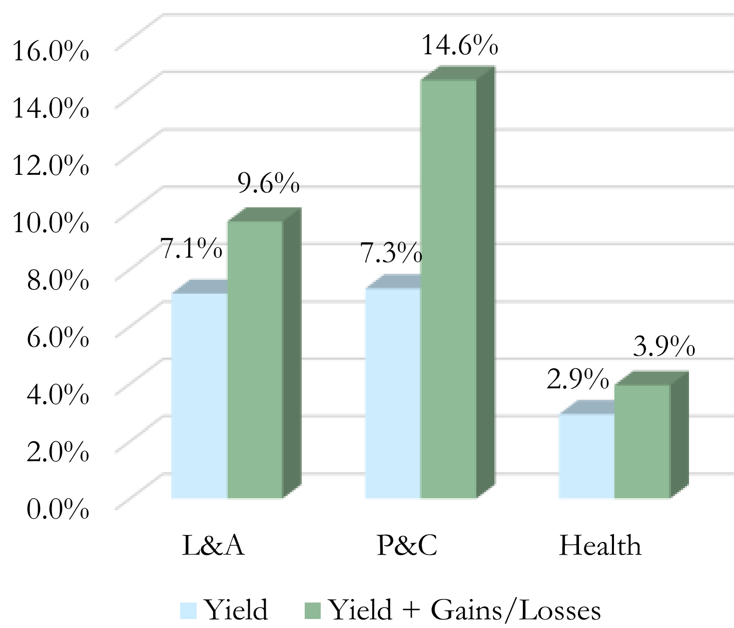
Source: NAIC

Achieving Enhanced Financial Returns

Insurers are investing in Schedule BA alternative assets for a variety of reasons. Many are harnessing alternatives particularly to realize the diversification benefits of assets with returns that are less correlated to their core fixed income portfolios. A number also seek to tap enhanced return potentials through both yield generating (e.g. infrastructure, mezzanine finance, equity real estate funds) and capital appreciation (e.g. hedge funds, leveraged buyouts, distressed debt, venture capital, commodities) vehicles.

Unsurprisingly, yield on Schedule BA assets was typically higher than that on fixed income assets – around 7% for both L&A and P&C insurers. L&A insurers that focused more directly on yield-oriented strategies achieved a modest uplift from capital gains, producing a total return of 9.6%. P&C insurers, which made extensive use of appreciation-focused assets, benefited more significantly from capital gains, reaching 14.6% total returns. However, this was not universally the case. Health insurers' Schedule BA investments yielded only 2.9%, failing to significantly outperform fixed income investments, with total returns that only reached 3.9%.

Insurers' Returns on Alternative Investments
Schedule BA Yield & Realized Gains/Losses
by Business Line



Source: NAIC

Unique Tactics of Insurance Business Lines

Life & Annuity Insurers

Because of their preference for income over capital appreciation, L&A insurers have been slower than those in other business lines to make large proportional allocations to more volatile assets, such as equities and Schedule BA. Unlike other insurers, their use of equities has decreased since 2008; however, Schedule BA allocations have grown by nearly one percentage point. These have been limited not only to limit price volatility, but also to avoid onerous risk-based capital requirements, which are more severe than those imposed on property & casualty and health firms.

Historically when life insurers have invested in alternatives, they have concentrated on less liquid private asset partnerships. These are more compatible with their traditional book income strategies, investing in products that bring significant income potential (e.g. from mezzanine financing interest or infrastructure use fees/ real estate rents) or limited pricing volatility (e.g. illiquid private equity fund interests held at commitment values in initial years).

However, innovative life insurers are beginning to draw upon less correlated alternatives to mitigate overall portfolio risk. Firms have learned from the credit crisis that investing in fixed income does not automatically protect from value impairments. Therefore, many life insurers are now keeping greater attention on portfolio total returns, while still investing to maximize book yield. In that light, they are starting to grow modest exposures to less correlated hedge fund and commodity investments to reduce aggregate portfolio volatility and increase risk-adjusted total returns.

Property & Casualty Insurers

Due to the distinct nature of their liabilities, P&C insurers have greater latitude in selecting investment strategies than do their L&A peers. Unlike L&A insurers, most P&C companies' liabilities are typically short-term and claims payments tend to be covered by current premiums. As a result, their general account reserve portfolios are generally significantly smaller relative to their premium flows when compared to those of life insurers, who need to save up for large, predicable future payments.

Source: NAIC

Unique Tactics of Insurance Business Lines (continued)

Property & Casualty Insurers (continued)

P&C insurers' more modest investment portfolios are relied upon primarily to cover these unanticipated cash flow needs resulting from high claim events. This requires P&C insurers' investment portfolios to maintain significant levels of liquidity, allowing asset sales to raise any necessary cash in these loss scenarios. P&C firms have reallocated funds from bond & cash postions into appreciation-oriented assets, such as private equity and hedge funds.. This has resulted in P&C insurers having the largest allocation to Schedule BA assets of any business line (7.7%, vs. 4.3% for L&A and 4.6% for health).

Health Insurers

In many ways, modern managed care health insurance businesses represent an outlier in the marketplace, with business fundamentals and investment patterns that differ significantly from those of peer companies in the L&A and P&C business lines. Health insurers' business models more closely parallel operating companies, financing healthcare networks for ongoing preventative as well as critical care, than they resemble the traditional indemnity insurance models of life and P&C firms. This limits the need for large, long-term investment portfolios.

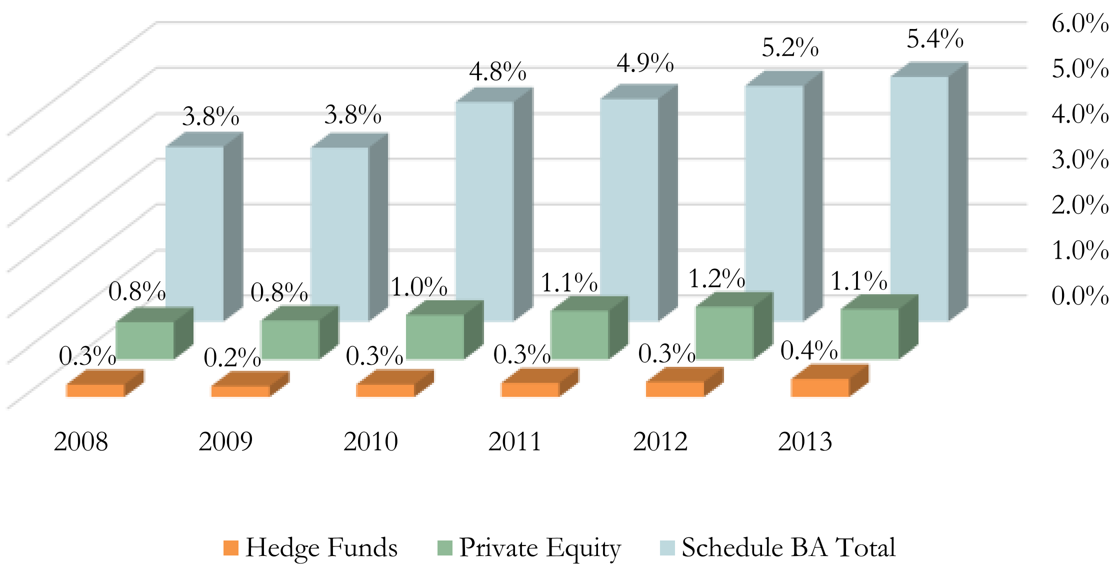
However, health insurers do maintain focused long-term investment portfolios to both protect against unanticipated claims incidence and boost corporate returns. Leading health insurers have been seeking to mitigate the effects of the low-yield environment by adjusting their portfolios in favor of higher returning assets, and have approximately doubled their allocation to Schedule BA assets (2.7% to 4.6%) since 2008.

Source: NAIC

Alternative Asset Class Spotlight: Private Equity & Hedge Funds

Insurers have particularly focused on private equity and hedge funds. In 2013, U.S. insurers' total investments in private equity and hedge funds, including those made without a traditional asset manager as an intermediary, reached 1.5% of insurers' total invested assets – a 5.9% CAGR from 2008. Private equity accounted for 73% of these investments, while hedge funds made up the remaining 27%. The remainder of Schedule BA assets were comprised of focused credit strategies, infrastructure & private real estate fund investments, and other commingled investment solutions.

U.S. Insurers Hedge Fund, Private Equity, & Total Schedule BA % Allocations



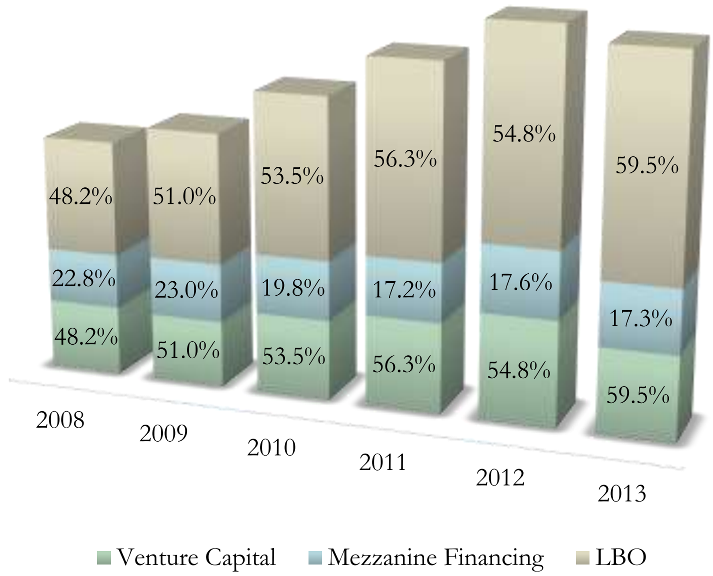
Private equity has long been a component of many insurers' portfolios. Insurers, particularly life carriers with long duration liabilities, have been attracted to private equity's multi-year investment cycle and illiquidity premium. Many are also attracted to its lack of mark-to-market pricing, avoiding the earnings volatility generated by public equity investments.

However, private equity's illiquid nature and vintage year dependency of returns are portfolio construction challenges for many insurers, particularly in property & casualty lines, where liquidity is prized. Even in the life segment, certain income oriented strategies, such as mezzanine finance, have been preferred, and many insurers are reallocating their alternatives portfolios toward greater hedge fund exposure upon maximizing their illiquid equity risk budgets.

Source: NAIC

Asset Class Spotlight: Private Equity & Hedge Funds (continued)

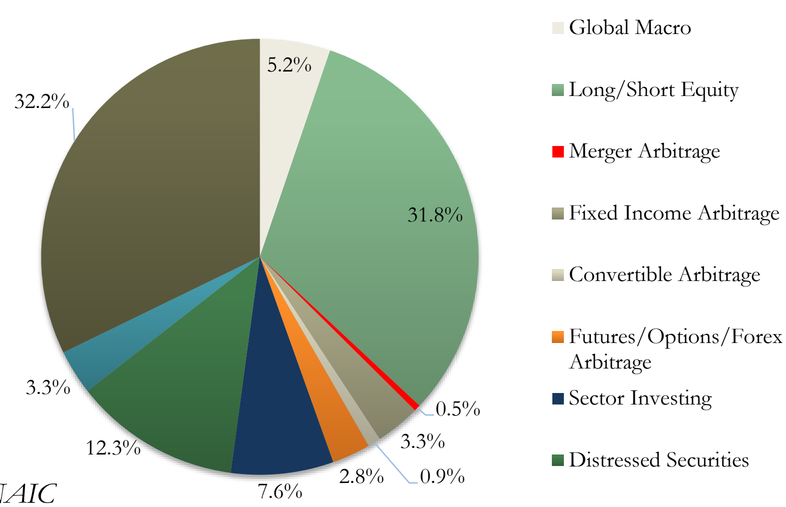
Private Equity Exposure by Strategy, 2008-2013



Total Private Equity Growth: 8.9% CAGR

Although subject to mark-to-market driven earnings volatility, hedge funds present a very attractive value proposition for many insurers, leading to strong recent growth. Particularly attractive is hedge funds' ability to harness a diverse array of investment & trading strategies that may be combined to address nearly any risk-return spectrum. Furthermore, experienced portfolio strategists may assemble multiple investments into customized, liability-driven portfolios in a way that other alternatives cannot. Furthermore, certain delivery vehicles, such as hedge fund managed accounts, provide lookthrough transparency to underlying securities holdings, allowing for improved monitoring and, in certain circumstances, superior capital treatment.

Hedge Fund Investments by Strategy



Total Hedge Fund Growth: 11.2% CAGR

Source: NAIC

Challenges to Executing an Effective Alternatives Strategy

Insurers are struggling with a number of issues as they strive to incorporate alternatives into their portfolios in a cost-effective and risk-managed fashion:

1. Educating Investment Team and Management

Lack of detailed knowledge & awareness of alternatives inhibiting investments

2. Constrained Portfolio Management Resources

Internal personnel lack time to properly research and oversee alternatives

3. Ability to Access and Select Top Performing Managers

Difficulties locating, attracting, and conducting due diligence on managers

4. Integration in General Account Asset Allocations

Issues determining the role of alts in surplus and liability portfolios

5. Ensuring the Security of Investments & Validity of Information

Critical to managing risk and avoiding unanticipated investment failures

6. Achieving Attractive Returns After Expenses & Capital Charges

Must generate sufficient net returns to merit use of alts relative to other investments

7. Demonstrating Value Versus Other Asset Classes

Must provide financial & diversification benefits to justify additional risk & effort

8. Stringent Risk Reporting Needs

Alts funds frequently have insufficient transparency & reporting for stat filings

9. Limited Communications with Alternatives Advisors

Managers are often not "high touch" enough to support insurer needs

10. Concerns About High Fees

Standard fee structures can be challenging to justify use of alternatives

11. Minimal Insurance Knowledge in the Alternatives Space

Many managers view insurers as identical to all other institutional investors

12. Alternatives Industry is Product, and Not Solutions, Focused

Insurers require a consultative approach, not insertion of a one-off investment fund

Each presents a unque impact on both outsourced and internally managed alternative investment programs.

Insurance Company Implementation Tactics

To address these challenges and grow their exposure to alternative asset classes, insurers are taking advantage of diverse hedge fund & private equity access points.

Historically, firms have relied primarily on of the shelf fund of funds vehicles. However, along with the double layer of fees, these portfolios are rarely optimized for insurance companies objectives. Only recently have fund of funds providers begun to develop insurance-specific portfolios tailored to liquidity & volatility targets, and insurers broader investment strategies (e.g. fixed income replacement).

Insurers are also beginning to retain these firms to assemble fully custom portfilios optimized for their unique needs. By retaining managers of managers that have an actionable understanding of insurance investments and regulatory constraints, insurers may investment disciplined alternatives portfolios constructed to maximize diversification benefits within insurance company general accounts, in order to best capitalize on RBC or economic capital model covariance factors to reduce net capital charges under U.S. statutory or Solvency II regimes.

Increasingly, insurers are turning to managed accounts providers, particularly for hedge funds & managed futures solutions. These managed account platforms provide the reduced fees, security, transparency, and liquidity of segregated investments, alongside the superior manager access and disciplined due diligence provided by multi-manager providers.

Larger insurers are also increasingly building out their own alternative investment teams to support direct placements into partnerships. In certain segements, particularly income oriented private asset opportunities including equity real estate, infrastructure, and mezzanine finance, insurers are also coordinating co-investment programs alongside managers and creating their own domestic and international deal sourcing capacity.

This remains a struggle for many organizations however, as only the largest insurers yet have sufficient allocations to justify large teams comparable to leading funds of funds advisors. This is leading several to employ multi-manager fund advisors on a consulting basis, to capitalize on their access to top managers and deep investment & operational due diligence resources.

Representative Hedge Fund Investing Approaches

Top 10 Multi-National Life & Annuity Insurer

- The current hedge fund allocation is about $1.5 B (0.9% of the general account), with a 3-4 year target to take the hedge fund portfolio to over $3 B – *believes it is currently under invested in hedge funds*
- While the firm does not use any consultants, it maintains many fund of funds relationships
- Is strategically moving away from investing in commingled fund of funds and towards separate accounts, with plans to use these accounts to tactically shift in and of strategies, capitalizing on trending themes
- On a direct investment basis, has about 2 dozen different funds
- Is focusing on diversifying into strategies such as macro, systematic, and CTAs – *has been staying away from mega multi-strategy funds as believes that off-the-shelf funds underperform*
- Has developed some specialty equity exposures capture the upside of demographic consumer trends around minorities and women
- Primarily conducts its own due diligence, but does draw support from fund of funds relationships

Top 10 Multi-National Life & Health Insurer

- While currently holding minimal alternative investments, over the last 6-9 months has been looking at broadly expanding the alternatives portfolio – *expects buildup to happen over the next 3-5 years*
  - Is considering a hedge fund allocation, as well as private equity, real assets, and other alternatives
- Has been filling gaps in expertise by bringing on high profile new talent, from both asset managers and other insurers with more experience managing alternatives
- Decisioning around which alternative assets to bring on weighs return with volatility, focusing on a strong contribution to overall net investment income
- Is favoring hedge funds over private equity and real estate, believing these illiquid asset classes do not have returns that are as stable as often believed (e.g. idiosyncratic vintage year risk)
- For hedge funds, would want a unit trust structure to provide advantages from a regulatory point of view

Representative Hedge Fund Investing Approaches

Top 10 Life, Annuity, and P&C Insurer

- Is a mature hedge fund investor, having consistently held investments since 2004 – *even developed a new fund of funds relationship during the 2008 financial crisis*
- Has a 3 person hedge fund team primarily focused on the general account, but also managing hedge funds for the firm's DB pension plan and separate account assets
- Maintains a moderate risk-return profile in the hedge fund portfolio, leveraging it as a diversifier for the private equity portfolio
- While primarily focused on direct investments, has one hedge fund of fund relationship tailored to focus on emerging managers

P&A

Top 20 P&C and Life Insurer

- Has a small, mature program, with allocations weighted towards the P&C side of the business – *P&C is managed on a total return basis, reducing ALM risk*
- Uses external managers for capabilities that are difficult to replicate using existing, in-house resources
- Prefers specialist strategies, such as activism, and is not interested in simple "stock picking," such as equity long/short strategies or broad index-based investing

L&A Insurer Subsidiary of a Foreign National Conglomerate

- Was significantly invested in fund of funds relationships 10-12 years ago, but new parent closed the program down after acquisition
- Over the last 2 years, the internal investment team has been pressuring the parent company's management to rebuild the hedge fund program – *the investment team is actively documenting the continuing presence of alpha in hedge funds to overcome concerns at the parent company*
- If given permission to rebuild the program, the investment team definitely plans to use a partner, either a fund of funds or an operational due diligence consultant

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