Insurance Asset Management Market Dynamics 2014:

Market Summary

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PATPATIA & ASSOCIATES, INC.

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The Evolving Insurance Market Dynamic

Following a period of dramatic recovery that lasted from 2010 to 2012, the North American insurance industry has settled into steady growth fueled by rising demand and demographic change. Accelerating elder services costs, a consequence of increased longevity, continue to drive growth in the Life & Annuity (L&A) sector. The Property & Casualty (P&C) sector – benefiting in part from relatively forgiving weather patterns – saw net income grow by an estimated 60% in 2013, while also achieving its first underwriting profit in four years. In the Health sector, meanwhile, the implementation of the Affordable Care Act (ACA) in 2014 has added approximately 3 million new customers to the U.S. health insurance marketplace. The result is an insurance industry with over $7 trillion in invested assets and $1.9 trillion in premiums, representing 1.4% year-on-year growth.

> **Challenges Facing the Insurance Industry**
>
> - ✓ Rise of the millennial consumer
> - ✓ Aging of the sales force
> - ✓ Modernizing distribution channels
> - ✓ Advent of new technology
> - ✓ Competition from "disruptive" providers
> - ✓ Low interest rate environment
> - ✓ Interest rate uncertainty

Yet insurers are also faced with a number of urgent challenges. Insurers must reimagine distribution channels in order to attract younger customers. Traditional, agent-driven distribution channels have failed to make significant inroads with Gen Y and Millennial consumers. Today, the median age of a life insurance agent is 51; to connect with customers, insurers must cultivate agents that are younger and more diverse. In addition, new hybrid distribution channels, integrating in-person agents with digital technologies, must be made available to serve customers who prefer to research, and even purchase, financial products online. Insurers can learn from "disruptors" in other segments of financial sector – for instance, from the various wealth management start-ups which have successfully utilized gamification, personalized online risk analyses, and easy-to-read digital dashboards – to deploy new technologies that can help attract internet-savvy customers.

At the same time, insurers must seek out new sources of investment returns. Net yield on invested assets for Life & Health companies has declined from 5.1% in 2009 to just 4.8% in the third quarter of 2013. For P&C insurers, meanwhile, net investment yield has declined even further, from 4.2% in 2009 to 3.5% in 2013. As fixed income strategies consistently fail to generate sufficient investment income, insurance companies have begun to search for new investment opportunities

An Evolving Investment Approach

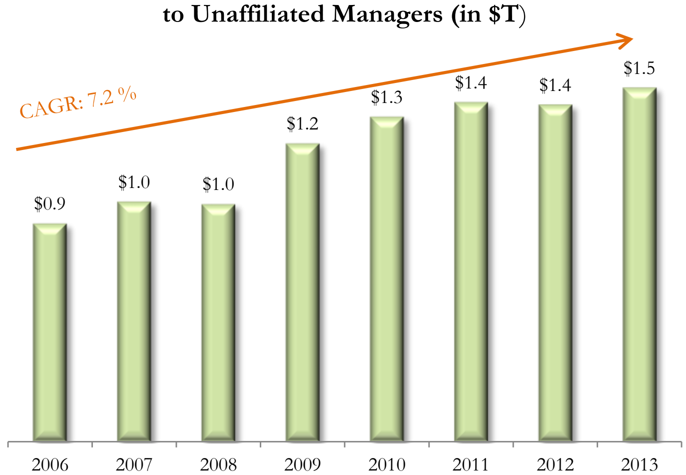
In response to the challenges of the prolonged low interest rate environment, as well as the more stringent oversight and reporting requirements put in place by post-2008 regulatory reforms, insurers have begun to take a more diverse approach to the investment process, choosing increasingly sophisticated investment strategies and enhancing their investment organizations.

In part, this can be seen in insurers' demand for alternative asset classes. Insurers' allocations to private equity and hedge fund investments have increased significantly in recent years. Long-term infrastructure investments, which have the potential to complement insurers' ALM portfolios, are gaining in popularity, as well.

In their search for yield, insurers are also exploring non-traditional fixed income strategies. This trend is evident in the changing composition of core-plus mandates. Once limited to a relatively narrow selection of investments, today's core-plus mandates routinely include bank loans, high yield bonds, collateralized loan obligations (CLOs), and emerging markets debt (EMD). While for some, these asset classes may represent "parking strategies" – a means of generating return while waiting for developed-market interest rates to rise – for many these investments constitute a fundamental change to insurance company investment practices.

Some insurers have also strategically altered their operational business model in order to prioritize investment activities. Many companies are investing in enhanced in-house investment units and upgrading risk analytics. Some firms are even appointing separate insurance Chief Investment Officers (CIOs) for the first time, either separating the function from treasury units or affiliated asset management subsidiaries. This is bringing increased control, creativity, and responsiveness to the investment function.

Insurance General Account Assets Outsourced to Unaffiliated Managers (in $T)

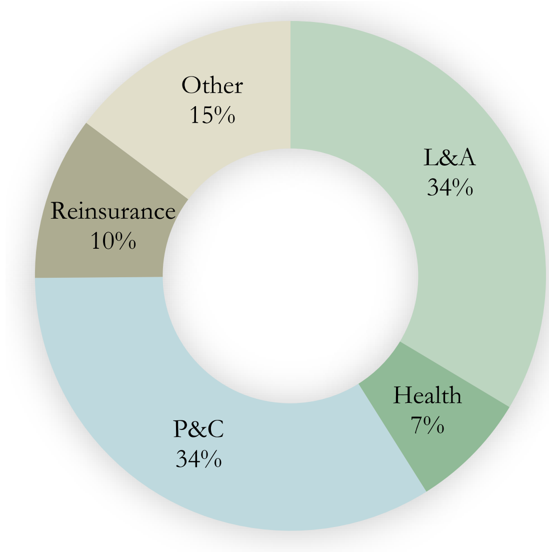


Furthermore, outsourcing continues to increase as firms seek to enhance their returns. This allows insurers to deepen their investment risk budgets without overextending their resources or extending their expertise. $1.5 trillion of insurance assets are now managed by professional asset managers, a CAGR of 7.2% since 2006.

Implications for Insurers

The propensity to outsource is no longer a hallmark of any particular business line. Although P&C insurers have historically accounted for a larger share of outsourced general account assets, L&A insurers now are equally keen to outsource. At year-end 2013, L&A and P&C insurers accounted for equal shares of the outsourced insurance asset management market.

Insurer Outsourced Assets by Business Line



Neither is outsourcing the exclusive domain of either large or small insurers. Patpatia & Associates' historical data show a "middle market" that is steadily growing, with insurance companies in the $5-$25 billion range constituting the largest share of outsourced general account assets for the first time in 2013. The time of only boutique insurers under $1 billion in assets employing third parties has gone, and even the largest firms are seeking to add external management to add niche investment strategies, where they lack experience, personnel, deal flow, or compelling performance.

In selecting a manager, insurers of all size segments and business lines must look beyond investment performance. In addition to regulatory reporting capabilities – more important than ever given regulatory changes in both the United States and Europe – insurers must carefully evaluate a manager's ability to provide services such as ALM analysis, tax modeling, and portfolio risk reporting. Luckily for insurers, a greater number of survey participants offer these services than ever before.

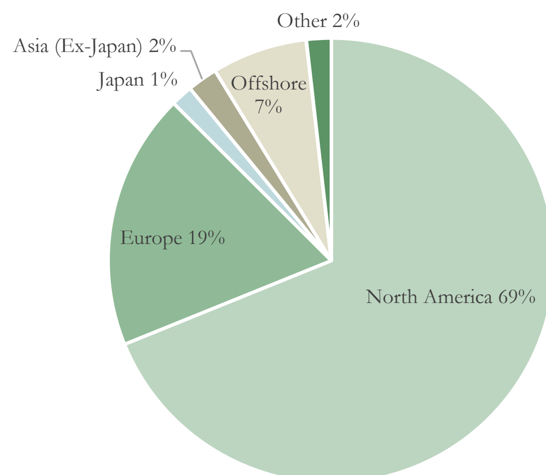
Implications for Asset Managers

Insurance general account outsourcing continues to present attractive opportunities for asset managers, and currently accounts for 6% of leading managers' assets. Large insurance mandates frequently exceed $1 billion in core strategies and $250 million in specialty asset classes, leading to sticky relationships averaging 10-13 years.

Implications for Asset Managers (continued)

Asset managers must be able to provide insurers with the increasingly sophisticated investment solutions they desire. While core fixed income managers have historically predominated, opportunities are arising for managers of all types. Focused firms with differentiated asset class specialties (e.g. munis, global, convertibles) are benefiting from the growth of insurers' demand for *Single Asset* mandates, which constituted 35% of outsourced mandates in 2013, up from only 15.5% in 2011. Alternatives managers are also increasingly capitalizing on the demand for non-traditional strategies, including private equity, hedge funds, and real estate & infrastructure.

Insurance General Account AUM by Client Location

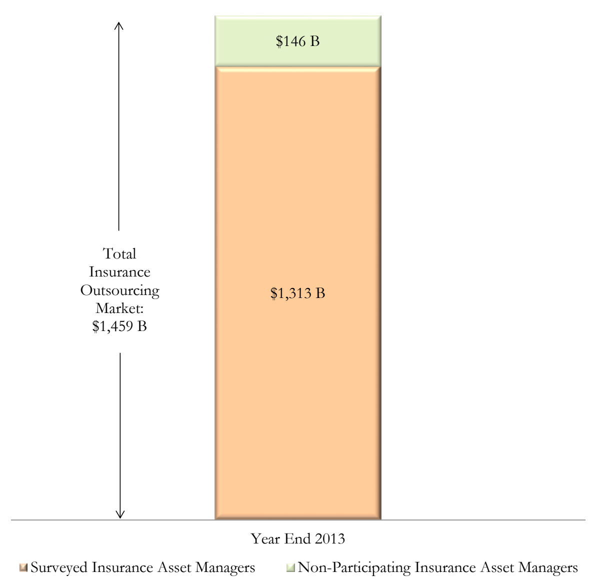


Insurance asset management has become a global business. Insurance clients outside of North America accounted for approximately 30% of managers' insurance general account AUM in 2013. As the insurance markets of South and East Asia rapidly expand and outsourcing becomes increasingly established, these markets will also become critical to managers' global asset gatherings strategies.

Over 70 asset managers currently focus on managing insurance assets. Those participating in Patpatia & Associates' 2014 survey cover approximately 90% of the market and represent a range of investment strategies, from fixed income-only to specialty and alternative asset managers.

As the market grows more competitive, managers must approach the insurance market as a discrete business. Successful firms will adhere to a customer-centric business approach, investing in knowledgeable insurance experts, specialized technology and analytics, and targeted branding to establish themselves as trusted partners and to differentiate themselves in the growing marketplace.

Total Outsourced Insurance General Account Assets



For further analysis of the insurance asset management marketplace, please see Patpatia & Associates' 2014 Insurance Asset Manager Survey, to be published by Thomson Reuters Insurance Finance & Investment in October 2014.