Article from

Risks & Rewards

February 2016
Issue 67

Correspondent's Report from the SOA 2015 Annual Meeting and Exhibit

By Warren Manners, Martin Bélanger, Jeff Passmore, Jon Mossman, Peter Sun

The 2015 SOA Annual Meeting was held at the Austin Convention Center in the heart of the Austin, Texas business district. The ACC is nestled between the shores of Lady Bird Lake and the historic 6th street district, offering visitors a diverse cultural flavor of what the capital of Texas has to offer. This year's annual meeting provided members with an eclectic menu of topics to choose from including product and regulatory updates, new in-force management strategies, application of behavioral economics to the insurance world, and a session on how actuaries can better project confidence and courage. There was even a *Shark Tank* themed session where real business ideas in search of investment dollars were pitched to sharks and audience members alike.

A great many sessions had to do with predictions: interest rates, reserve regulations, reinsurance trends, etc. One of the most provocative was the opening presentation by the keynote speaker, Salim Ismail. The predictions he highlighted were fantastic, extreme and mind blowing … and more than likely to come true. It brought to mind a quote from the legendary Yogi Berra, "It's tough to make predictions, especially about the future."

What follows is a brief report from Investment Council members on some of the more investment-focused sessions as well as a wine tasting network event co-sponsored by the Investment Section and the Entrepreneurial Actuary Section. [WM]

EQUITY INVESTING FOR LIFE INSURERS (SESSION 90)

As the title suggests, this session focused on the use of equity type investment vehicles in life insurer general account (GA) portfolios. Mary Pat Campbell from Conning Research and Consulting kicked things off by providing a historical perspective. She began with a theme that was likely the preface of half the presentations at the annual meeting: the persisting low interest rate environment has driven insurers to look outside of their traditional comfort zone in search of extra yield. An optimistic projection of rates still shows net book yields are not expected to get back to 2008 levels for another six years. A less optimistic (Japan) scenario could extend it much further and recent U.S. history looks eerily like the early days of the Japan deflationary period.

Conning research showed a clear trend in the growth of Schedule BA assets for life insurers, primarily in joint ventures and hedge funds. In 2013 Conning polled life insurance CEO's asking what their investment plans were for the near term. While a majority indicated a desire to increase GA allocations to preferred and common equity, the data shows they have tended to hold steady at around 1 percent of total GA assets. There have been some exceptions though, specifically for new Private Equity and Asset Management firms that have acquired fixed and equity indexed annuity blocks.

Peter Sun from Milliman took the podium next, offering a forward looking perspective that outlined the cost/benefit tradeoff of increasing exposure to equities. Peter began by highlighting the benefits of investing in equity, namely, higher returns over long periods, high liquidity, and a hedge against inflation. The latter is particularly important as retirement income protection products take off, which are more exposed to inflation than pure insurance.

Sun outlined three primary challenges to investing in equity: 1) uncertainty of returns, 2) lack of equity selection expertise in house, and 3) a high 30 percent RBC charge.

Regarding uncertainty of returns, gross fixed income yields over the past five years are down nearly 100 bps whereas the average equity return is greater than 10 percent. So even with a 30 percent RBC charge you can still achieve risk adjusted returns comparable to decent fixed income returns. Additionally, the GFC has demonstrated that fixed income values can be just as volatile as equity returns.

Regarding in-house expertise, the enhanced investment techniques VA writers have developed over the past two decades are now being considered for GA portfolios. Strategies like volatility control funds, risk control funds and CPPI can be customized to target a certain desirable level of volatility and a way to manage overall exposure.

Lastly, regarding the high RBC charge, two strategies were posited as ways to help mitigate this cost. One takes advantage of the short futures positions utilized by these aforementioned allocation strategies. These short positions can offset long cash positions, reducing the dollar RBC charge. The other approach is to use ICOLI—insurance company owned life insurance—as a wrapper around Risk Managed Funds. RBC uses a look-through principle that looks to the underlying investment to determine the appropriate risk charge, but this principle does not apply to ICOLI policies. The RBC charge is tied to the ICOLI policy rather than the underlying investments which could potentially lower the RBC percent charge substantially (full disclosure, Sun emphasized the importance of discussing this strategy with a tax expert). [WM]

DC PLANS—THE END OF CHOICE (SESSION 94)

Session 94 was one of the many sessions that focused on defined contribution pension plans, an area that was underserved by the SOA Annual Meeting in the past. This is a welcome development as DC plans have become a permanent fixture.

Three industry experts provided their point of view on the DC market. The first speaker, Marcia Dush of Buck Consultants, provided an overview of the evolution of the DC market, since the enactment of ERISA in 1974. DC plans went from being supplemental savings plans to being the primary retirement vehicle for many workers. Although a return to DB plans is unlikely, she highlighted the two main benefits they provided to members: 1) employees did not have to make choices, and 2) the plan delivered a predictable retirement income. Her suggestion was to make DC plans more like DB plans by introducing auto-features and focusing on retirement income and not accumulated assets.

The second speaker, Gene Paranczak of Vanguard, presented the plan sponsor view. He provided an overview of the trends in plan design for DC plans. These include streamlined lineups, automated features, professionally managed accounts, a focus on fees and better engaged and educated participants. He described the concept of tiering, which involves having different groups of funds, each targeted to a different group of members. Tier 1 funds are all-in-one investments, such as target-date funds and target passive members. Tier 2 funds are broadly diversified investment options, covering equity, fixed income and capital preservation. Tier 3 funds include specialty investment options and are intended for do-it-yourself investors.

The last speaker, Lori Block of Buck Consultants, presented the participant view. She made the point that most plan members are smart and well intentioned, but that sometimes reality gets in the way of doing the right thing. She argued that we should focus on financial wellbeing and not so much on retirement readiness. Financial wellbeing focuses on the total individual, not just on their financial assets. Her approach involves understanding who your audience is and that the messaging must be different depending on the generation you're addressing. Some of the tips she suggested to reach your audience include being entertaining in your delivery of education, targeting your messaging, providing accessible self-diagnostic tools, tracking members' progress and personalizing features.

> This year's meeting agenda included a *Shark Tank* themed session where real business ideas ... were pitched to sharks and audience members alike.

Overall, this was a very strong session that covered a lot of ground and was very applicable even to a non-U.S. DC plan sponsor. [MB]

NEW DEVELOPMENTS IN PENSION FUND INVESTMENTS (SESSION 180)

This presentation was a panel-style presentation representing four different perspectives on recent developments in pension investing.

There was an audience of about 30 investment actuaries with a variety of backgrounds. Some were pension actuaries working mainly on the liability side of the pension balance sheet. Others were investment consultants. Most worked with corporate pension plans in the U.S. However, there were a number of Canadian actuaries and some public pension actuaries as well.

The presenters were pleased with the audience participation—there was a lively question and answer session at the end. They were also pleased with the size of the audience given this session was in the final time slot of the final day of the Annual Meeting.

Simplify, Grow and Protect

Tamara Burden, FSA, CFA, is a principal and managing director of Milliman Financial Risk Management. She presented a retirement investment risk management approach that is an alternative to traditional asset allocation and diversification. This approach, titled the Managed Risk Strategy uses a futures overlay to capture a majority of the upside of equity performance and protect against the majority of the downside of equities.

Tamara advocated for the approach by first illustrating the historic failure of diversification through static asset allocation. She pointed out the increasing correlation of different asset classes, especially during times of trouble. She also pointed out the consistent relationship of equity underperformance during periods of high volatility.

Furthermore, she illustrated how periods of low volatility and high volatility tend to persist and showed that this suggested a dynamic approach to volatility management. Using market returns from 2000 through 2014 and simulated portfolios, she illustrated the outperformance of this approach to a static allocation of 60 percent stocks and 40 percent bonds. She concluded by illustrating how this approach can be even more powerful during the pay-out phase of retirement investing.

Pension Risk Transfer

Scott Gaul, FSA, MSAA, is SVP and head of Distribution, Pension Risk Transfer for Prudential. He presented on the pension risk transfer (buyout annuity) market in the U.S. He first discussed tools along the risk management spectrum for U.S. corporate pension plans—including taking advantage of funding relief, risk reduction strategies with plan design, liability driven investing asset strategies and risk transfer strategies. He then described three risk transfer alternatives, comparing the advantages of lump sums to buy-in annuities and buy-out annuities.

Scott spent some time clarifying the differences between buy-in annuities where the annuity is an asset of the plan, and a buy-out annuity where the annuity becomes an asset of the participant and the plan liability is settled. Scott showed how the new corporate pension mortality basis of RP 2014 and MP 2014 made buy-out annuities cheaper than the all-in, economic cost of managing a pension plan. He concluded by discussing in-kind asset transfers as part of a buy-out annuity purchase.

Recent Developments in Corporate Pension LDI

Jeff Passmore, FSA, CFA, is an LDI strategist with Barrow, Hanley Mewhinney and Strauss. He discussed two trends in corporate pension liability driven investing: building customized liability benchmarks and pension funded status and risk reporting. With each he provided some observations and things to watch out for.

In discussing custom liability benchmarks, he described a framework for analyzing the three hedgeable sources of pension volatility and provided some quantification of each of these sources relative to the total pension volatility. He suggested that volatility from credit spread changes can be much greater than is commonly believed and described how this can undermine some approaches to pension hedging. Jeff also discussed how the duration of pension liabilities can be different than the duration of the benefit cash flows and how this issue could be addressed from a practical standpoint.

Second, Jeff spent some time discussing pension asset-liability reporting and suggested some best practices. These included providing information in a tiered format with a summary for those readers only needing the high level information. This summary can be followed by detailed information for those readers requiring more detailed information. He concluded by describing pension risk measures that could be used in an asset-liability report to help plan sponsors monitor progress in de-risking the plan.

Liability Driven Investing for Small DB Plans

Alexander Pekker, ASA, CFA, Ph.D., is the director of Quantitative Strategies at Sage Advisory Services. Alex explained an economical approach that small companies can take to implementing LDI. He began by showing the size of the small plan market—81 percent of pension plans with at least $1million in assets have $25 million or less in assets. He suggested that these plans are underserved, despite being subject to the same regulatory requirements as larger plans.

He then illustrated many of the challenges that small plan sponsors face and discussed which of these can be addressed. In particular, he discussed how exchange traded funds (ETFs) can be used to create customized solutions in an economical way for small plan sponsors. He contrasted ETF-based solutions with mutual fund-based solutions, highlighting the shortfalls of mutual fund approaches and the benefits of ETF-based approaches.

Alex also pointed out the importance of appropriate LDI expertise in creating these solutions including investment actuarial expertise. He concluded by showing an example that illustrated the hedging success of an ETF-based solution for a small pension plan. This example used five years of historical market returns to illustrate the hedging capabilities of this approach. [JP]

The presentation is available on the SOA website at: *https://www.soa.org/files/pd/2015/annual-meeting/pd-2015-10-annual-session-180.pdf*

RISK MANAGED FUNDS: PRINCIPLES AND APPLICATIONS (SESSION 123)

Insurance companies have widely adopted Managed Risk Funds within their variable annuity offerings over the last several years. Currently, there are approximately 200 Managed Risk funds in the VA space with over $270 billion in assets; five years ago, only a handful of these funds were live in the market. This widespread adoption of Managed Risk Funds sprang from the financial crisis, as insurance companies looked to design more sustainable variable annuity offerings.

Managed Risk Funds have advantages and disadvantages for investors. Although Managed Risk Funds will potentially reduce returns during rising markets, they can also provide substantial benefits during severe, sustained market declines. This is particularly important for retirement-oriented investors, who face the sequence of returns dilemma.

Going forward, the insurance industry faces certain challenges regarding Managed Risk Funds. One major challenge concerns benchmarking, and how to evaluate the performance of these funds. Risk Controlled indices and peer group comparisons can be helpful benchmarking tools.

Zack Brown from Milliman and Samir Mathur from the Capital Group presented on the history and rationale for the development of Managed Risk Funds. This session gave a fairly comprehensive overview of the Managed Risk Fund landscape with

Zack focusing on VA writer's perspective and Samir focusing on the fund company's perspective. [PS]

JOINTLY SPONSORED WINE TASTING NETWORK EVENT

The Entrepreneurial Actuary Section and the Investment Section jointly sponsored a wine tasting at MAX's Wine Dive on Tuesday night. Co-hosting the tasting were Stephen Camilli, vice chair of the Entrepreneurial Actuary Section Council and Jon Mossman, vice chair of the Investment Section Council. The sommelier who led the session was very enthusiastic and very knowledgeable and encouraged the group to speak up about their thoughts on the wines we were tasting. Four wines were tasted in order from the lightest to the heaviest.

The first was a sparkling wine from the Loire Valley in France. Many tasters agreed it had a dusty undertone which apparently comes from the yeast that has died in the bottle after the second fermentation has taken place (space does not allow me to go into a detailed description of the method used to produce quality sparkling wines). The second wine was a Riesling from Mosel, Germany which people were surprised to note had a faint taste of gasoline which is a classic feature of a good Riesling. The third wine was a Cotes du Rhone red from France which was spicy and had a hint of leather on the nose. The last wine tasted was a Merlot from Tuscany, Italy and was excellent despite what the movie Sideways had to say about Merlot.

After the official tasting, attendees stuck around for a glass or two of their favorites, some delicious tapas and some networking with fellow wine-loving actuaries. [JM] ■

Warren Manners, FSA, MAAA, is senior vice president, Group Risk Management, with Swiss Re America Holding Corporation. He can be contacted at warren_manners@swissre.com.

Martin Bélanger, FSA, FCIA, is director, Investments, Western University. He can be contacted at mbelang7@uwo.ca.

Jeff Passmore, FSA, EA, is client portfolio manager, LDI Strategist, for Barrow Hanley. He can be contacted at jeffpassmore@hotmail.com.

Jon Mossman, FSA, is a consultant with Towers Watson. He can be contacted at Jonathan.Mossman@towerswatson.com.

Peter Sun, FSA, MAAA, is a consulting actuary with Milliman. He can be contacted at peter.sun@milliman.com.

Investment Section Council Call For Volunteers

The SOA Investment Section Council is seeking talented individuals living in geographic locations outside of the US/Canada to help shape the Investment Section newsletter, *Risks & Rewards*. R&R recently started a new section titled "International Focus" designed to provide international actuaries with a platform to share interesting investment related topics from their region.

The council is looking for volunteers to be Investment Council Regional Representatives from Latin America, Central Europe and Asia/Pacific—responsibilities include authoring articles, being a conduit for other regional actuaries looking to publish articles, and helping to connect events in your region with the worldwide investment actuarial community.

Ideal candidates will have strong English writing skills and be able to ensure accuracy of content in articles before submission. Interested candidates please send an email to warren_manners@swissre.com and nboezio@sympatico.ca explaining why they are interested in the job and why they believe they would be a good fit.