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Session 25PD
Investment Manager Searches for Insurance Companies

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Summary: More life insurance companies are hiring outside managers for their investment portfolios. Small companies are hiring managers to handle their core portfolios, while large companies tend to hire specialized managers to complement their in-house management. Panelists discuss the process of selecting outside investment managers—from hiring consultants to doing the search internally. The panel also addresses developing requests for proposals, formulating a list of potential managers or consultants for the request for proposals, and evaluating the proposals and comparing performance.

Mr. Victor Modugno: I am currently employed by Transamerica Asset Management where, among other things, I'm involved in looking for specialized managers to supplement our in-house managers. We have a distinguished panel. We're going to be looking at investment manager searches, both from a small company point of view, where investment managers are used for core bond management, as well as from a large company point of view, where outside managers are generally used only for specialized management, if they're used at all. The first two speakers are going to be talking primarily about the core bond management for the smaller companies. Our first speaker is Michael J. Christ, vice president and director of

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research of Asset Consulting Group. Michael is a chartered financial analyst (CFA) with nine years of experience with Asset Consulting Group. His responsibilities include asset allocation optimization, insurance modeling, tax optimization, and risk analysis. Mike has performed extensive research into global markets and has brought experience in modeling, designing and implementing traditional and nontraditional portfolios. He received degrees in engineering management and applied mathematics from Southern Methodist University and is a member of the St. Louis Society of Financial Analysts and the Association of Investment Management and Research. Asset Consulting Group works with insurers in manager searches, and Michael will be talking about the process of developing requests for a proposal or RFPs.

Our next speaker is Frederick W. Jackson. Rick is an FSA, CFA, and vice president of Scudder at Kemper Investments. As an insurance strategist, he participates in establishment of portfolio strategy, asset allocation, and insurance client analysis. He coordinates asset/liability management for clients with interest-sensitive life and annuity products. Rick joined Scudder in 1993. Prior to that, he had been product manager at Allamerica, and prior to that, he was at Paul Revere and National Life of Vermont.

Scudder was listed, in a recent issue of *Insurance, Finance, and Investment,* as the largest independent investment manager for insurance companies. Rick will talk about core bond management for small companies. He might be a respondent to an RFP that Mike's group would develop.

Our final speaker is Ronald S. Oldenkamp, president of Genesis Marketing Group. Ron has over 27 years of experience marketing investment management services and developing new investment products for the insurance industry. Prior to founding Genesis in 1993, Ron had over 15 years of experience in working with major insurance companies, including Metropolitan Life. During his tenure at Met-Life, he was a sales leader for 10 consecutive years. Ron has also been involved in marketing Standard & Poor's (S&P) index guaranteed separate accounts for several insurance carriers. Ron represents niche managers, typically small shops that do not have internal marketing people, on a contingency fee basis. Ron has introduced these managers to insurers seeking specialized investment managers, in addition to representing them in the stable value, pension, and endowment markets. Ron will talk about niche managers that are used by large insurance companies to supplement their internal core management. In this case, there is usually no RFP process. Ron would approach these insurers directly, perhaps in conjunction with an indexed separate account.

Mr. Michael J. Christ: Since we have such a focused group, I'll try to keep my comments brief, and then maybe we could close our formal remarks to get some feedback in terms of some personal issues that you might have with regard to some of these topics. I'm going talk about the manager search process. Before I do that, I felt it would be important to mention what we feel is essential, in terms of getting your arms around other issues that relate and have a major impact on the manager search process. First, you must clearly understand your investment objectives and your tolerance for risk, and your overall investment philosophy as an organization. How do you approach the asset allocation or asset/liability management process? What kind of skills do you have from an internal capability, not only in terms of investment management skills? There might not be any. You might outsource all of it in terms of the ability to monitor, to calculate performance, and in terms of performance diagnostics, attributions, sensitivity analysis, and other types of tools. It's important to get a clear understanding as to how your particular organization might be structured because that would have a major impact on how you conduct a search, and on the types of firms that you would look for in a search. So I'll briefly talk about some of those issues, and then get into the actual search process.

First, what is the goal or objective for investments? What's the role of the investment portfolio? Is it there just to support the liabilities and to meet your corporate objectives? Do you have a book yield posture, or is it more total return? How do you view, or how does upper management view the investment function? How does upper management view the investment portfolio? What are the incentives there? Do you use it as a source of competitive advantage, or as an insulator against poor operations, etc.? What's fairly important with regard to how you implement the portfolio, which will relate to the search process, is how you're handling the asset/liability work. Think of a continuum from completely matching the liabilities to more of a going concern or a total return approach. How are you positioned on this continuum with regard to your assets and your liabilities? What is the strategy that you have in place to manage your portfolio *vis-à-vis* the liabilities? Do you use dynamic financial models? Do you do a kind of cash-flow testing and term structure testing? What are the issues there as it relates to an investment portfolio? That has an impact as to the type of firm you may hire when you do a search. If you do this work internally, there might not be a need to hire or to limit the list of candidates for a particular type of assignment. However, if you need this type of service, there are only a limited number of firms that can provide really high-end asset/liability assistance, as well as superior investment management services. So it does have an impact on the type of firm that you might look for. We're not even talking about the assignment yet, or what kind of assignment it is, but the issues come into play.

In terms of assessing the internal capability, you might already manage money internally. You might outsource all of the investment management capabilities and all of the portfolio management capabilities. When you look at your internal function: how is the department structured, how many people do you have, what are their titles, how do they report, how do they report to upper management, what kind of skills do they have, what are their requirements, what kind of technology systems are there, and how do you interface with the accounting people? A whole host of issues come into play with regard to internal capabilities. If you manage your money internally, what are you doing to keep up to date or to be aware of the recent trends and activities in the marketplace? What kind of budget do you have to be able to purchase systems, to be able to hire people, to make that internal function as solid as you can make it? All those things come into play.

To talk about external management, you need to have a handle on what you have internally, but when you talk about external management, you get into the search process and what type of firm you want to hire. To be able to answer that question, you first ask: What's the purpose of outsourcing the investment function? Is it for the whole portfolio, a portion of the portfolio, a specialty mandate, tax advantages, and so on? That clearly will drive the type of manager that you will hire. For example, internally, we break down money management firms that have a particular expertise with insurance companies by tiers, and there are certain firms out there that have internal capabilities that are non-investment related, but impact the investment management function. For example, some firms have in-house actuaries; some people have experts that deal with accounting and regulatory issues. Some managers have whole departments dedicated to just the insurance asset management function. Some firms can offer auxiliary services, such as reporting-filing blanks for you. Using their systems, they can offer it at a competitive fee. Those firms we earmark as Tier One or Tier A types of firms.

Then you move down to Tier B, they might have an internal insurance asset manager specialist, they call it product specialist or strategist, that can help in terms of developing the assignment, developing comments for the asset/liability decision, and can help with policy issues, guidelines, etc. Then there are firms in the lower tiers that don't necessarily have a particular strategic initiative to develop in-house consultative capabilities to insurance companies, but are superior investment firms. You might be looking for a firm that has great in-house capabilities with regard to assets and liabilities, or you might have an in-house accounting person that you can talk to. You might have all those internally. So the mandate might be, let's go out and hire the best investment manager, and we'll develop the policies, and we'll get into the issues with regard to how it's structured.

I think an important point to mention is that, whether you're considering Tier A, Tier B, or Tier C firms, any one of those tiers may or may not be appropriate given a particular assignment. It's always important, when you start talking to investment management firms, to really understand how and where they add value. For example, let's talk fixed income. You might be looking at a fixed-income firm that historically, when you look at composites, might have a very strong core bond program. Let's say we're interested in core bonds. Not only does it have to be investment grade, but we won't allow triple B's. We're going to highly constrain the mortgages; we're not going to allow any below investment grade, and we're not going to allow any non-dollar.

An investment management firm may add values in those areas where you're precluding them from investing. It's very important to be able to understand the skill set of the manager, and to be able to understand where that manager adds value because that manager may not perform well in a highly constrained environment. It's important to be able to understand that as part of defining the assignment. A lot of times what happens is that the guidelines are customized to a particular manager. More often than not, the appropriate way to go about it is from the top down, that is, you're implementing an asset and liability strategy. You already have the portfolio guidelines in place, from a broad perspective, and now you're trying to find specific managers to fit particular areas of the portfolio. Then you need to find managers that add value in a particular way, still within the guidelines. It's very important to keep that in mind.

In terms of the actual search process, there's a whole host of ways you can break down these issues: identifying the needs, preferences, and constraints. That is, what does the policy statement look like, what are the guidelines, and what are the committed investments? Are there any loss constraints? Identify and manage your list. Identifying the list is not an easy thing to do. There are databases out there. We purchased several databases. They're easy to get your arms around. They're as cheap as $3,000, and some of them are as expensive as $440,000. All of them have searching capabilities, and so you could run a core bond search, and get a small list of 700–800 firms. What do you do with that information? You have this big list. Searching databases might be a starting point. But to take it to the next level, it really requires a lot more hands-on work. It requires, in most cases, some knowledge of the business. This is a little self-serving coming from a consultant, so take it all with a grain of salt: it's helpful, at least, to have a good working knowledge of the managers that are out there, that have experience managing insurance portfolios. For the most part, a lot of them are fairly well known. If you're talking about a pretty standard assignment that includes core bonds or multi-strategy bonds, it's pretty straightforward. There are a number of firms out there that you probably are aware of. It's easier to get the list, so to speak.

The next stage is the typical request for a proposal process, here you would send out a detailed questionnaire asking for a whole host of both qualitative and quantitative information with regard to the investment management firm. You talk about the firm, its structure, and its ownership. You talk about the assets that they manage in this particular discipline, the assets that they manage for insurance companies, and the assets they manage for insurance companies in this particular discipline. Then you get into the actual investment philosophy and process to understand how the firm is structured from that standpoint. How do they utilize their analysts, how do they do credit research, and how stable is the investment management team and function? How are those people compensated, and what incentives do they have in place to keep the key people at the firm? A whole host of those qualitative issues need to be flushed out through this request for a proposal. On the quantitative side, it's fairly easy to break down the numbers. By looking at performance, you'd use modern portfolio theory statistics. You might look at alphas and betas, and some of that information is good. The problem here is that most of the time, the mandate will have some sort of constraints, so you have to be careful in terms of the composites that you're looking at, that the managers may provide to you. Then you determine whether that fits within the assignment that you have. It could be quite different.

Once you do your analysis, create a short list. We always recommend on-site interviews. It's amazing what you'll learn going into an investment management firm, kicking the tires, talking to the people, looking at their trading desks. Look at how the portfolio managers communicate with their trading desks, or whether they trade themselves. How do they capture data, and how do they capture research? How is the firm is structured internally? How do they communicate? What are the issues? It's hard to determine that when you read through an RFP, so we highly recommend, when you've narrowed the list down to a few, doing an on-site visit. You can bring them in, and have them meet your investment committee or go through whatever process works in terms of the actual hiring. But from a due diligence standpoint, it certainly makes sense to really have your handle around some of these managers. That comment was really for more broad mandates. Ron will get into what the issues are for those types of mandates.

Here's another way of looking at it, starting from the objectives of the scope for the assignment, to applying some sort of analytical tools to help you sort through the data, to the final selection. In terms of criteria for evaluation, experience is one. These aren't necessarily listed in order of importance, but there is a reason why performance is listed last. If a firm doesn't have the resources, the flexibility, the systems, the modeling and reporting, and depending on how important each of these areas are to you, it will determine the type of firm you may want to hire.

Performance clearly is important, but performance in and of itself may not be sufficient enough to meet your needs. So it's very important to look at a whole host of issues pertaining to performance that may come into play as you look for a money management firm. Qualitative and quantitative aspects are pretty straightforward, but very important.

Finally, there are a number of tools out there, from a performance standpoint, that you could utilize. We've developed some tools internally, where we can rank managers by using a number of different characteristics. We might look at how they do in up markets versus down markets, which is how much risk they take, what their standard deviation or semi-deviation is, and what the risk is on the downside. How often do they perform, what kind of tracking error do they have? How statistically significant are the performance results, how do they look on a one-to-three-year rolling period, relative to the benchmark. So there's a whole host of quantitative, statistical types of measures that can be applied to performance to get a better handle on how a manager has actually done, whether it's relative to a custom benchmark or a published benchmark, or relative to a peer group. So you can apply these types of technologies to an individual manager, or even to a group of managers. These are just some examples of some quantitative applications on the performance side. So that's kind of a brief overview of the search process. At this time, I'll turn it over to Rick, who's going to talk about the core bond assignment.

Mr. Frederick W. Jackson: I'll be talking about some of the same topics you've talked about from the core bond manager point of view or from the insurance asset manager point of view. Investment management should make a positive contribution to earnings per share. I would think you'd go outside because you found a way to add value to your bottom line. If you can't do it in-house, or if you find that a particular manager can provide coverage on an asset class that you don't currently have, and you figure it will be worth the fee that you're going to pay, then that would be a reason to choose an outside manager. You're also going to be leveraging economies to realize the most efficient operating and financial structure that works for your firm. You would also have a need to manage risk for both capital markets and your risks relative to liabilities.

Mike focused on the asset/liability management issue, which is very important to us. One of the things we're saying is that there's an increasing trend for the companies to focus on what they're doing best. It is somewhat of a virtual company-type approach, where you outsource those functions that aren't directly central to your business. In some cases, the investment management process is often in that category.

Selecting a consultant. About five or ten years ago, there was a smaller universe of consultants that we had to deal with. Recently in the last three to five years, there has been an increase in the number of consultants. I would say initially there were few qualified consultants. Asset Consulting Group is one of them. There are an increasing number of qualified consultants as they get more involved in the searches. They do play a very important role in many searches, and there's a lot of advisory experience that they've built up over the last three to seven years, such that there is a real service provided. But look at them as you would your managers: check on their references, and see who they've done work for. See if they've worked with life insurance companies before, or what's the extent of their own client base. In determining the consultant's role, are you dealing with a manager search only, or are you going to see some analytics provided as well?

Mike was giving some indication that his group does provide some services beyond the search, and that addresses the last point. In some cases, you're really dealing with a spot assignment where the consultant is brought on just to identify the appropriate manager. Are they going to be part of an integral team structure going forward? I think that's important to identify. Some companies that are larger and have a better sense of what the investment process is all about are more likely to make a spot assignment. In some cases, the consultant continues to help the company, not only with the initial evaluation but also with the ongoing evaluation of the managers that have been hired.

Mandatory inputs from the consultant. The policy statement really helps get at what the investment guidelines are going to be or already are. Typically, we'll see duration and convexity targets in the RFP, or you'll get questions on what you think would be an appropriate duration and convexity target for the particular client. There would be sector allocation constraints. If they aren't in the actual request for proposal, they would certainly become part of the investment guideline process. I'll spend a little bit of time on return objectives and benchmark creation. Mike had a continuum of total return versus cash matching. We've seen another continuum with our client base between total return and yield. There's very much a focus that life insurance companies are definitely yield-oriented. We've also seen that with that yield orientation, a great deal of measurement is being done on a total return basis. So what might seem to be a conflict in a total return approach versus a yield approach can kind of work together. I think it's important to recognize that most companies dealing with a spread product or with pricing spreads, as life insurers or annuity writers, do have to focus on yield. The problem with then evaluating and creating benchmarks based on yield, is there wouldn't be the proper incentives to investment management, to pay close attention to risk, if you're just going to get out there and get the highest yielding instruments. So it's making the investment manager focus on yield, but at the same time, it makes sure that they're delivering a

total return performance that ultimately makes it to the bottom line. It does reflect the fact that there are risks inherent in some of these securities that do have optionality in them.

So the benchmark creation becomes very important. There's a lot of work being done right now on the benchmarks that reflect either asset/liability management work, or, in some cases, optimization modeling, that leads to a recognition of the liabilities. I've heard the term used, don't give the asset manager a lay up benchmark to beat, a Lehman Aggregate or a Lehman Government/Corporate that has an inappropriate allocation to government securities. If you're really going to be investing in a spread product, then perhaps some combination, using a property/casualty Lehman product that will reflect the fact that you're going to be looking for more corporates to support your spread goals as a life insurer company. That would lead to a better benchmark creation. That gets into how much your manager will help you with that process, or whether it's going to be the consultant that's going to be helping with the process.

One of the points that Mike made that I think was very valuable is that you should know your own process very well. Know what your strengths are in terms of how well you understand the investment process, and if you have the in-house capability to evaluate managers yourself, and be aware of that. If you don't, then don't necessarily think in terms of a spot assignment with a consultant being limited to just finding that manager, since you may need help later. Another item is that you should be very aware of regulatory issues, risk-based capital, and the rating agencies. This is very important to many companies, as *is Financial Accounting Standard (FAS) 133*. There are a lot of regulatory issues, so it helps to have an insurance asset management outfit that helps you understand these issues. Tax strategy applies more to property/casualty companies, although it does have its implication for life companies.

Then there is the manager search process. I think it's important to identify whether you are dealing with a core or specialty mandate. We'll talk more about the core mandate because our firm has around 115–120 relationships. The majority of them are core management relationships. We are in multiple manager situations, but more of our relationships are core mandates. There should be the insurance understanding as I've mentioned. Our group has insurance strategists that are particularly involved in the process of working with the insurance company to make sure that we understand their liability structures and how the asset allocation, and the investment guidelines will reflect that unique flavor of their business. Fee tolerance is one of the things going on. We've seen a shakeout of some firms that don't use the economies of scale. Some fee levels are in place that provide adequate returns to some of the investment managers. We've seen several firms

merge. I think TCW went in with Conning. There are a few other firms that have had challenges, profit-wise. So it's important to realize that there is a certain fee level that's out there that's going to guarantee that the manager does at least make some kind of profit.

There are ancillary services involved in this search process, I think Mike referred to this as well, but the core service is the investment management process. You do have things like asset/liability management support. You do have, in some cases, regulatory accounting support. You do have some help with Schedule D. There are quite a few other ancillary services, and depending on your firm, if you do have weaknesses in those areas, there are some managers who will provide those services. Reporting requirements are part of the same issue. We are a high-service firm, focused on giving clients what they're really looking for. In some cases, there are situations where you may not want high levels of service. What you're looking for in service expectations should be clear up front.

Managing the managers. The mandate should be clearly defined. Reporting and communication needs should be well defined. There should be an ability to monitor the results. I think that was what Mike was referring to in his work there. From the insurance manager point of view, on the liability side, I think it's important to know the investment management firm structure. Is it part of an insurance company, and if so, how is it related to that insurance company, or is it an investment boutique that is really dealing with a total-return-type focus? What are the other affiliations? What are you really dealing with? Mike mentioned that there should be experience with insurance-specific mandates. It would be nice to have insurance strategy development capabilities, so that you are tied in to the liability structure of the client company. There needs to be tolerance for telling the manager what to do. In some cases, that's where a consultant can be helpful. Sometimes the senior management of a smaller company may not know how to manage the manager. I think that that's something you need to know about your own firm. The manager should be a qualified manager from the rating agency's perspective. I know our firm deals quite a bit with A.M. Best and actually incorporates discussions with the analysts into the rating agency process and determines what's important to A.M. Best in terms of developing that rating. In most cases, the whole A.M. Best rating process is very important to the firm.

In terms of getting to economies of scale and scope of the manager, you need to know that there are assets under management that ensure that the revenue base is there for the firm to stay in business. There should be diversity in the client base. That helps the client in terms of getting different types of services. To the extent that the manager you're looking for has a diverse client base, then they've probably seen things before in one form or another that can bring a different perspective, or can

bring a perspective of experience to a mandate. So that's helpful to see. I mentioned servicing philosophy earlier. Typically, with our group, we have the primary contact being a relationship manager, who typically is a portfolio manager in some situations. We may also have an insurance strategist involved, depending on how interested the client company is in asset/liability management issues and insurance strategy issues. But typically, the primary contact is a relationship manager who is a portfolio manager, or had significant portfolio management oversight responsibility. Again, the range of services that should be available in a good core management situation includes actuarial modeling, tax, and dynamic financial analysis.

On the asset side, it's important to know the philosophy of the asset manager, just the same way you need to know your own philosophy. You need to know what kind of approach the asset managers or the investment managers bring to their own business, particularly with respect to discipline. If you had a situation where you had multiple portfolio managers with an insurance asset manager, then you would like to look for a process that ensures continuity and consistency across the board. You do not want to deal with a portfolio manager in different situations that would bring an inconsistent approach. There should be an investment strategy group that establishes policy that meets regularly to review economic conditions and comes up with certain positions as to what kind of bets the firm will take to look for relative value in the market. Which asset classes are cheap? Which asset classes are expensive? That should be reflected in a discipline that goes across the firm. You should look for that. You look for a strength of research.

One of the main areas where an asset management firm can provide value is identifying, in advance of rating agency upgrades or downgrades, which companies are in line for upgrades or especially deteriorating credits. You can get hurt quite a bit on the way down more than you can on the way up. We have multiple research analysts in our group, and their goal is to precede the rating agencies in downgrades, so that we can pass that information along and take action on deteriorating credits before they actually are acted upon by S&P or Moody's. You should look to have trading authority in the hands of the investment manager because these decisions have to be made in a short time frame before this information filters through to the market. You don't want to tie the hands of your investment manager and review every single trade. It's very important, if you're going to get good execution, that you give the authority to that trusted manager to act in due time upon the recommendations that its research people provide to it.

Performance experience is very important. There should be a history of consistent performance over time to match or beat the appropriate indexes. You're looking for that kind of experience over a period of time, so that it just hasn't been a fortunate

period of lucky performance. There are some more aggressive or more conservative approaches. I'll just lightly touch upon that. On the asset side, the investment manager should also be very attuned to the insurance company's attitudes on gain and loss taking. We've seen an awful lot of attention from our clients of where they are at year-end. You have to be prepared to support their needs to take gains or losses, to help them with some management of their balance sheet. Your core manager should be familiar with all meaningful asset classes. I'm making the assumption that if the core manager isn't helping you with the asset allocation process, and they will be at least involved with a consultant who's involved with determining where relative value exists. One of the toughest situations is where you have multiple managers and you have no one changing the allocation when relative value shifts in the market. So if someone has $100 million of assets in mortgage-backed securities and $100 million in corporate bonds, and the mortgage-backed securities all of a sudden become very expensive, then the allocation perhaps should not stay at 50/50. There should be someone reviewing the overall asset allocation to determine when there are changes.

That relates to the next point of presenting alternative investment ideas. You would want your core bond manager to be able to shift from relative value plays to recognize the cheaper values that are out there and get the company into those better-returning situations. Again, there should be quantitative solutions backing the recommendations from a manager. You would look to have systems in place that demonstrate that there is some stress testing going on, especially with respect to some of these assets with optionality. Duration versus a sector security-specific value-added approach is one place that you can look to see if a manager is taking positions on shifts in interest rates. If someone is anticipating that Greenspan is going to be raising interest rates, they might look to shorten a mismatch and limit the impact of a rise in interest rates on values from a total return perspective. That kind of approach is taken by some firms, as opposed to being more duration-neutral, and focusing on a sector security-specific approach.

I have one last point on the asset side. There needs to be an ability to manage within a constrained environment. Many companies are very severely strained by capital, and by rating agency ratios. The flip side of that point is that you also need to recognize some unusual situations, such as when clients have unconstrained environments. I know of one particular client that we have that has very limited or almost no tax involvement. They have a very strong surplus position. They don't have year-end reporting requirements, so there's a recommendation that they're more heavily into equities than other firms might be that have more severe constraints. So part of the constrained continuum is recognizing where the company has the ability to take additional risk and where it is relatively

unconstrained. Then it's the responsibility of the investment manager to have them out there taking more risk, if there is more return associated with that.
What are specialty mandates? The possibilities include mortgage-backed securities, asset-backed securities munis, collateralized bond obligations (CBOs), collateralized loan obligations (CLOs), privates, equity, private equity, converts, derivatives, emerging stuff, structured products, and euros. I have seen a situation in one particular state where there is legislation that does allow a life company to take advantage of munis. That was kind of surprising to me. Collateralized bond obligations, collateralized loan obligations, privates, and equities are different types of specialty mandates. You want to see what each specialty manager's track record is. Again, as you do with the core manager, you want to know what the number of insurance mandates are, what the strength of the organization is, how long they've been doing this, and the number of people.

You're looking for cutting-edge technology and economies of scale. You're also looking for trade execution. If you do have an investment department of your own, and they have some views on certain asset classes, it does help to get other perspectives on their views.

Finally, what are the pitfalls? I guess there's a lack of control, if there are multiple managers involved. There is a concern about some confidentiality issues. It really comes down to the perception of management there. You may run into situations where the manager knows the assets, but lacks insurance company knowledge. So that is the core bond manager's view of this investment manager search process.

Mr. Ronald S. Oldenkamp: I'm going to share with you some ideas regarding specialty asset managers. We've had a number of discussions with insurance carriers over the past few years that have shown an increase in the interest in specialty managers because of the compression of spreads that we see in the marketplace with traditional asset management. I think one of the reasons for that is that it's difficult to expect internal management to be good in all asset classes, and all strategies. Another challenge we're seeing today is that interest rates are at historical lows. It's pretty challenging to get additional spreads when traditional asset classes are not providing normal spreads that we'd expect over Treasury bills. Our interest has focused exclusively on the smaller managers who can provide a different strategy that can add value. We tend to look for managers that everyone would want to see who demonstrated some type of consistency in outperforming a specific benchmark, and who have good risk controls, so that you can sleep well at night and avoid unpleasant surprises. Of course, what that should lead to is low volatility, so you can manage, within your own portfolios, return expectations. Specifically, we look for money managers to work with who have a great deal of experience and knowledge in a particular area, and are highly skilled and

specialized. We tend to look at the money management universe as a universe where the traditional asset classes have a lot of people who are very skilled in what they do, and they tend to squeeze spreads out of traditional markets. We think it's easier if you do something different, or look at different niches in the market place, to achieve more consistent and higher spreads. We've also found that these types of asset classes tend to be uncorrelated with core portfolios of insurance companies.

We're going to share with you five examples of managers that we have worked with who provide quite a variety of strategies, including index arbitrage, convertible arbitrage, a dividend recapture strategy for taxable short-term money, a mortgage-backed specialist, and a new one called a market momentum index offered by Bank of America. W.G. Trading has been one of our most successful managers in providing that coveted spread over three-month Treasury bills. They had an objective of a 300–500-basis-point return over Treasury bills, which is a fairly aggressive goal. They also have a goal of maintaining the corpus or the principal amount of the assets invested and of providing consistent, positive returns. The principals of the firm actually invented the first real-time trading systems in 1979 for Wall Street, so they have over 20 years experience in this asset category. To the best of our knowledge, they probably are the most experienced of anyone in the industry working with indexed arbitrage. So let's see how they've done.

They have consistently outperformed their benchmark, and in fact, they've even outperformed the Lehman aggregate bond index for the past five years.

A risk/return analysis would show that you're paid very handsomely for the risk that you incur in return. The sharp ratios are very strong, at 2.4. So there is a very strong risk/return relationship and a very consistent track record. Another unusual strategy is a dividend cash capture strategy for corporate cash. It is intended to be held more than 90 days. This is a type of strategy that offers a tax-advantaged return; almost 90% of the dividend income is tax-free. They provide 90-day liquidity and superior short-term results. This is a fully hedged strategy that focuses on investment-grade utility preferreds. Let's see how they've done. Again, there are very consistent returns and a significant spread over 90-day T-bills. There is a very positive risk/return relationship, extremely strong sharp ratios, and an alpha of 8.86.

The next manager is Noddings Investments. They also have a large amount of experience in this business. The principals of the firm have over 30 years of experience. They were one of the pioneers in convertible hedging. They're one of the oldest firms in the business today offering convertible arbitrage. Their only focus is convertibles. Their objective is to beat the London Interbank OfferedRate (LIBOR) by 100–200 basis points. Again, stability of principal is a key factor. They're using mathematical models to identify attractively priced convertible bonds,

and they are hedging them by short sale of common stock. Their performance record has had a fairly good trend line and good consistency. They still have a better sharp ratio than the Lehman Aggregate and a strong alpha. These are all important factors in looking for a specialty money manager.

Sporl and Company is another firm where the principals have 25 years of experience. They specialize in premium pass-through mortgages. They have developed some good risk controls within their portfolios by keeping the duration short and monitoring prepayment risk. What's interesting about their strategy is that they do particularly well in rising interest rate markets, which in today's environment is very appealing. Their objective is to beat 90-day Treasury bills by 200 basis points. They pretty much have been able to do that over a 10-year period. They're adding value relative to the benchmarks in a Triple-A government portfolio.

Bank of America is one of our newest additions. As you know, Bank of America is a highly rated institution with skills in many different areas. They have developed a market momentum index that is based on a basket of long-and-short positions in bonds and currencies and real estate. They provide high liquidity in the portfolio, and they can offer this in a structured note product to provide principal protection. We've combined them with Sporl, who was the last manager we discussed, in a mix of 85% Sporl and 15% market momentum. It provided a very attractive spread pattern. With the Bank of America index, you can actually combine it with a variety of different money managers to provide uncorrelated returns within a particular product. This has a lot of possibilities for the insurance industry. Of course, we have a very good risk/return ratio with attractive alpha to the portfolio and a very strong sharp ratio of 1.5%.

In our experience working with insurance companies, we've found a number of advantages in using a specialty manager, including not only capturing expertise that's not normally available from an internal management standpoint, but as an additive to an existing portfolio. Now that can be focused on making a particular product more effective, or offering new types of products to your particular marketplaces. We have been highly successful on a specialty S&P index product for the institutional markets, where we provide a guaranteed return over the index, some type of spread over the index, such as 25 basis points. This particular product, with the carriers we've worked with, has been one of the most profitable products in their line-up of group insurance products. But it's not just limited to group insurance products. It can be used for individual products. You may want to go out and put together a fund of funds. This is a new area and insurance companies have that unique ability of offering products that can be structured to meet specific needs of the marketplace. You may even want to go as far as offering

something that would be attractive to other insurance companies. But the bottom line to all of this is that this is a way to attract more assets, add more profitability to your company, and provide those uncorrelated returns that can be so important, and diversification of risk within your portfolios.

How do you get started? One way of course is to call in a consultant who can provide you with assistance. Exploring these different asset classes is very interesting, and there are a lot of smart people who know how to add value to portfolios. I think you'll find that one of the drawbacks to specialty managers is that they will have limited capacity on how much they can take. They can't run billions of dollars. That's why there are niche markets. You can aggregate these managers to add value to larger portfolios. I suggest you talk to others in the industry who are using outside managers so you can find out about their experiences. I find there's a pretty good information flow among the carriers willing to talk to one another and share their experiences. Evaluate for yourself your risk and rewards, and whether that fits and whether this is a comfortable type of situation for you. Finally, when all else fails, give us a call; we'd be glad to talk to you.

Mr. Alan C. Leland, Jr.: Ron, I'd like to ask a question about the Bank of America market momentum strategy.

Mr. Oldenkamp: Market momentum index, yes.

Mr. Leland: Could you explain that in a little more detail? What is that all about?

Mr. Oldenkamp: I'll try. It's fairly new to us; it's an index developed by Bank of America. You could almost call it a Commodity Trading Pool Advisor. It uses a variety of futures and a commodities index. There's a prescribed index that they have developed that looks at the momentum of different types of asset classes within an index. It will shift the emphasis on different asset classes as time goes by. And they've found that it is very strongly uncorrelated to the other financial markets, and it can add a significant value to more traditional types of strategies in the marketplace. They have a nondisclosure that you have to sign to get into the actual guts of the index, and they'll be happy to share that with you.

Mr. Leland: Would it be fair to say that when you plotted out the results, you've done that in combination with 85% of the Sporl?

Mr. Oldenkamp: Yes.

Mr. Leland: Such that the Bank of America results, in and of themselves, outperform the benchmark by quite a bit, but with a lot of volatility.

Mr. Oldenkamp: Exactly, there is a lot more volatility.

Mr. Leland: Sporl dampens the volatility—

Mr. Oldenkamp: It pushes it way down. We were showing low volatility strategies. We can plug different mixes in that, and as you increase the mix, the return jumps dramatically, with more volatility. But it's still a positive slope, as far as risk and return are concerned.

Mr. Modugno: I have a question regarding these returns you're talking about, which are basically bull market type returns. What about the argument that those are bull market strategies? How would they perform in a bear market because all those returns were in a bull market?

Mr. Oldenkamp: The question is on bull market strategies. If you look at W.G. Trading, they are a true arbitrage strategy. In other words, they're long and short and have exactly the same correlated assets for a spread. It doesn't matter what happens to the markets. It's indexed arbitrage, and once they put that trade on, it doesn't matter where the markets go. They know that in 90 days or so they'll get the spread that they locked in. I think there's some truth to having some market impact with the convertible arbitrage, if markets are going south. I think they perform worse than you would like them to. As I mentioned for Sporl's strategy, if interest rates rise, they actually do better. They're buying premium pass-throughs, and if you're familiar with premium pass-through mortgages, you buy them at a premium, and there's a prepayment speed on those. When rates rise, the prepayment speeds actually decline. When that happens, you actually get a higher return on those premium pass-throughs. So it somewhat depends on the strategy. Some have no correlation whatsoever, and some are hurt by it and some are helped by it.

Mr. Modugno: What about the B of A? Is that a bull market strategy?

Mr. Oldenkamp: I have not studied that enough to comment on whether that's a bull or bear market strategy. I would say that because we're looking at commodities, it's totally uncorrelated, so I'm not sure I can make a comment on that. My suspicion is that it's done well in most markets. I have a question. In your experience in searches for money managers, what percentage of your searches are really dependent or critical on there being a lot of experience in the ancillary services, the accounting, and the reporting for insurance companies versus just pure money management?

Mr. Christ: I'd say roughly 30% of the searches that we do require some sort of additional capability beyond just purely managing a portfolio. So the majority are assignments where it's not necessary to have a whole in-house skill set, but we'll assist in some of those other areas, whether it be record keeping or asset/liability management.

Mr. Jackson: I'm curious as to how many of your clients actually go ahead and visit portfolio managers.

Mr. Christ: Usually, if there's an internal staff involved that helps with the search process, more often than not, they do go visit. If it's a committee, they usually don't. So whoever takes ownership of the search process at the insurance company is who will, in some cases, dictate whether or not they do enough hands-on due diligence themselves or completely outsource it to a consulting firm. They say, "We trust your judgement; just bring us two or three managers here."

Mr. Jackson: We wish more would go out and visit.

Mr. Modugno: Do you have a lot of people visiting you?

Mr. Jackson: Typically, we get hired first, and then they come visit, which seems kind of crazy. You really don't know what you're getting.

Mr. Modugno: Scudder is a good name maybe that's why they visit after hiring you.

Mr. Jackson: They should be skeptical and want to see for themselves. I think it's a great idea to visit. You really should see what you're getting. But it doesn't happen as often as you might think it should.

Mr. Modugno: How many people visited Sporl?

Mr. Oldenkamp: Not too many. With the W.G. Trading, we have a fair amount of desire to see the operation because it's so unusual. There's probably someone else who offers an arbitrage strategy like that, but we're not aware of that source. W.G. Trading is one of a kind. The good news is it's one of a kind, and the bad news is, it's one of a kind. They want to see how these computers operate and how their trading strategies operate in real life.