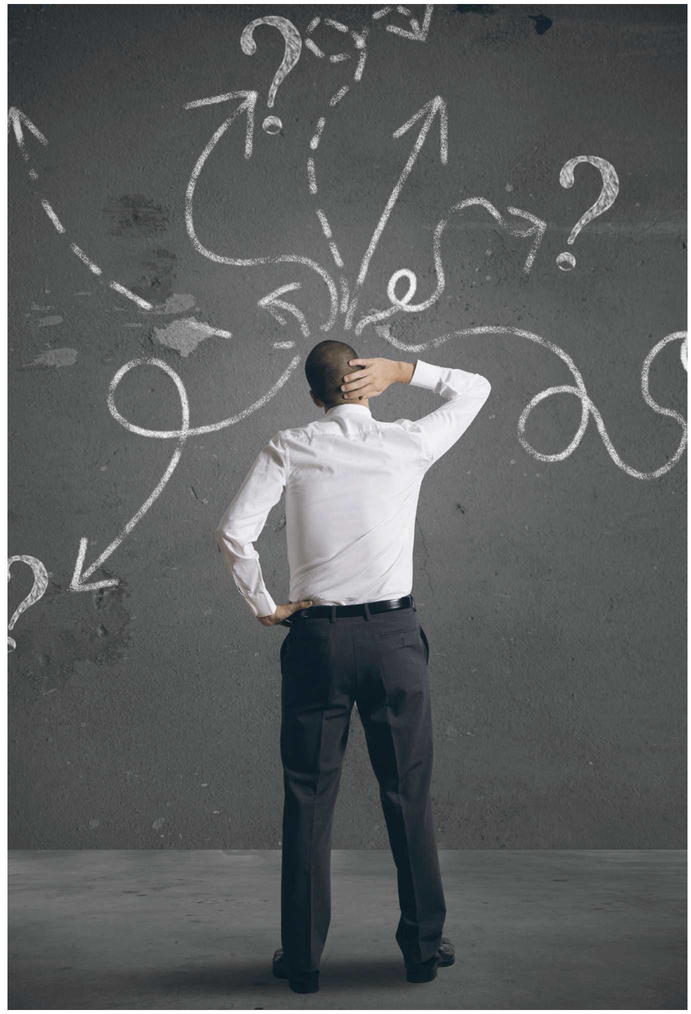
How Are Insurance Companies Dealing with the Low Yield Environment? No Silver Bullet but Plenty of Gold Dust!

By Will Rainey

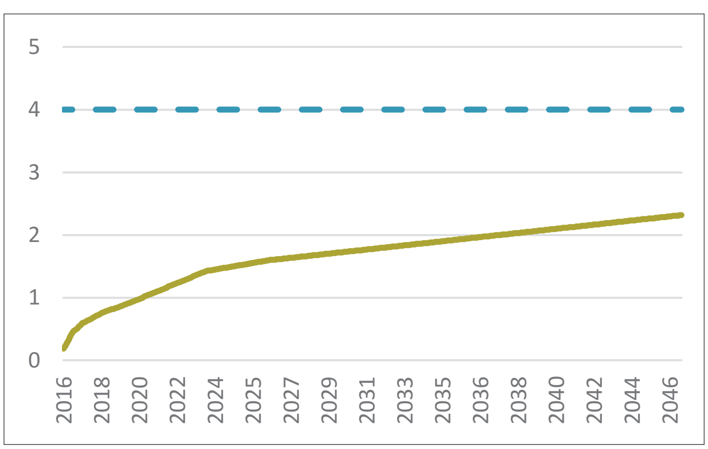


Many conferences and articles have discussed what insurance companies should do in the current low yield environment from an investment perspective. Unfortunately it seems there is no silver bullet which can overcome this challenge. As a result, insurance companies are taking a variety of actions to try and improve their outcomes. In this article we provide an overview of the different areas where insurances companies have been making changes.

BACKGROUND: THE LOW YIELD ENVIRONMENT

The low yield environment looks like it is here to stay. Figure 1 shows that the market expects U.S. cash rates to remain well below historical averages for over the next 20 years. Other developed markets have a similar or even bleaker outlook.

Figure 1: Market expectations of U.S. cash rates over 20 years, % pa



(as of September 30, 2016)

With yields expected to remain so low, it becomes more challenging for investors to generate returns from their assets. Not just returns from cash and bonds, where they are directly linked to the low yield, but also more challenging to generate returns from other asset classes. As the demand for asset classes with a higher expected return (and higher risk) has been increasing to compensate for the low return on the cash and bonds, the additional returns expected from these assets diminishes. This leads to many investors materially increasing the amount of risk they are taking and not expecting to get the corresponding reward compared to historical levels.

SO WHAT ARE INSURANCE COMPANIES DOING?

We are seeing insurance companies reviewing each step of their investment process and trying to see if they can add a bit of value or reduce costs at every stage. In Figure 2, we consider examples of how insurance companies are making changes at each stage of the investment process cycle in order to improve future outcomes.

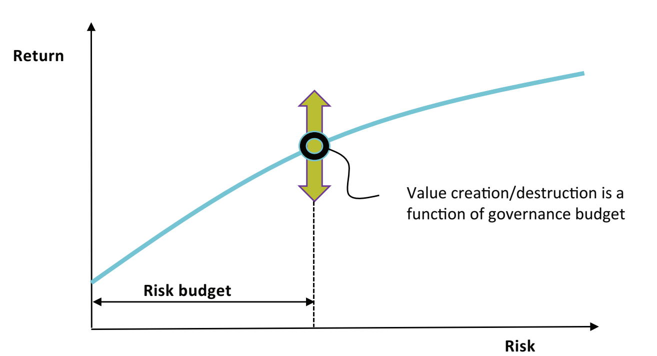
Figure 2: Example investment process cycle

1. MISSION AND GOVERNANCE

Adding value by splitting decision makers and implementers: With greater accountability comes greater focus. Insurance companies are segregating functions with clearly defined roles to improve the decision making processes and ensure there is greater accountability for the decisions. For example, specialist risk teams (implementers) who are responsible for ensuring the level and type of risk taken does not exceed those set by the senior management (decision makers).

Research by Clarke and Urwin[1] has shown that the best asset owners in the world are increasingly looking at ways to improve their decision making processes and maximise the efficiency of their governance budget to add value within the investment process. The amount of value that can be created, for a given risk budget, will depend on size of the governance budget and how the governance budget is allocated (Figure 3).

Figure 3: Schematic of Governance Budget and Risk Budget



2. RISK MANAGEMENT

Adding value by reducing asset and liabilities mismatches: Insurance companies are revisiting their investments to ensure their assets match the liabilities to reduce risk based capital charges. Whilst matching assets to the liabilities has been something insurance companies have been doing for a long time, over recent years there has been increased number of insurance companies carrying out reviews of their Strategy Asset Allocation (SAA) given changes in regulations (increased capital charges for mismatches between assets and liabilities), increased number of asset classes and instruments that can be used to match liabilities and better ALM software to help identify and manage mismatches.

3. PORTFOLIO CONSTRUCTION

Adding value by increased globalization of asset classes: Insurance companies are increasing the amount of global assets in their portfolios to improve risk-adjusted returns. Overseas (global) assets provide much greater diversification in terms of companies, sectors and industries compared to the domestic markets and as a result reduces the amount of investment risk within an asset class. The currency risk that comes with investing overseas needs to be managed to ensure that the diversification benefit is not overshadowed by higher capital charges.

Adding value through illiquid assets: Whilst spreads on illiquid assets, such as infrastructure debt, have reduced over recent years, insurance companies are still seeing the benefits of holding illiquid assets to meet their liabilities and increase yields relative to the current assets held. This is especially true with some regulatory bodies allowing for an illiquidity premium to be added to the discount rate in respect of some of these assets held (which reduces the capital requirements and reduces mark-to-market risk).

Adding value via diversification: By increasing the range of asset classes being used in their portfolio, insurance companies are benefiting from diversification. Whilst investing in some alternative asset classes may not reduce the initial risk based capital requirements (i.e., provide limited protection in short term extreme risk scenarios), the improvements to the risk-adjusted returns can add material value over the long term. For example, replacing part of the equity allocation with a portfolio of alternatives assets can generate a similar expected return but with a 30 percent pa reduction in the year-on-year volatility.

4. IMPLEMENTATION

Adding value by reducing fees: In a number of cases, insurance companies have not used their increasingly material size to negotiate favourable terms with their external investment managers. As a result, insurance companies that are using external investment managers are now re-negotiating the fees they are paying to ensure they are aligned with market norms and are appropriate given the size of the mandates. A full fee review of investment managers can help save a lot of money. For example, we have seen fees being reduced from 150bps to 70bps for a US$100 million credit mandate.

Adding value by altering the investment management structure: There have been many articles on the limited benefits of using investment managers which try to outperform the market (active management)—with more than half of them underperforming after allowing for costs and/or fees. As a result investors are moving to a passive implementation approach (i.e., investing in line with the market) to save money on fees and therefore adding value to the bottom line.

Alternatively, where a company has a strong belief in active management they are now moving to an approach which uses a pool of managers (five to eight best-in-class managers) which take larger positions away from a benchmark. This approach to active management has been shown to increase the chances of adding value after fees as the managers only hold their best ideas in their portfolio rather than a wide range of mediocre positions just to ensure their risk position is close to the benchmark.

5. MONITORING

Adding value by using dashboards: There is a saying that "what gets monitored, gets managed." Our experience is that this is not always the case, with many investors monitoring every aspect of their investments with no direct evidence that this monitoring has led to action or better outcomes. As a result we are seeing a change in the monitoring frameworks to use "dashboards." These dashboards not only track key factors but provide an indicator when they breach pre-agreed levels which call for action. Knowing in advance what actions will be taken, and under what scenarios, can add material value and improve operational efficiency, i.e., ensure that time is spent monitoring the areas which will add the most value.

CONCLUSION

Insurance companies, like most other investors, are re-assessing how they can improve their outcomes given the low yield environment. This means revisiting many areas of the investment process which have been unchanged for many years.

So whilst there might not be a silver bullet to deal with the low yield environment, making a series of improvements in different area means there is plenty of gold dust within the investment process to improve outcomes going forward. ■

Will Rainey, FIA, is the head of investment strategy, Asia at Willis Towers Watson in Hong Kong. He can be reached at *Will.rainey@willistowerswatson.com.*

ENDNOTE

1 Best-Practice Investment Management: Lessons for Asset Owners from the Oxford-Watson Wyatt Project on Governance.