STRATEGIC ASSET ALLIANCE

THE INSURANCE INVESTMENT SPECIALIST

Risk Assets Primer for Insurance Companies

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By design, insurance company portfolios are never fully diversified.

Most insurers allocate their portfolios heavily towards investment-grade fixed income to account for policy holder obligations, reserves and sufficient risk capital.

With interest rates at or near all-time lows, investing in "Risk Assets" can be a viable option for insurers looking for ways to increase yields to support the underlying business.

What are "Risk Assets?"

Risk assets are any investment outside of investment-grade fixed income.

These assets provide greater potential yields, but with greater risk of loss and/or return volatility. Risk assets may also potentially help insurers maximize portfolio diversification.

What "Risk Assets" are Insurers Utilizing?

High-Yield Bonds:
High-Yield bonds are below investment-grade and carry a higher risk of default; however, these bonds pay a higher yield than investment-grade bonds.

Below Investment-Grade Ratings:
S&P: Below "BBB"
Moody's: Below "Baa"
NAIC: Bonds Rated 3 to 6

Common Stock (or Equities):
Common stocks are securities that represent ownership in a corporation, with the value of the stock being tied to corporate growth/stock market. Common stocks typically offer greater returns than bonds, but carry higher risk of loss, as well as increased return volatility.

Preferred Stock:
Similar to common stock, however the value of a preferred stock is tied to interest rates and not the state of the stock market. Unlike common stock, preferred shareholders have no voice in the future of the company.

Certain Long-Term Schedule Ba Investments*:
Schedule Ba investments constitute several "other" investments types, but includes risk assets utilized by insurers and risk pools. These assets are more yield-oriented, but come with greater risk of loss, volatility & liquidity risk.

Schedule Ba Risk Assets:
Collaterlized Loans
Bank Loans
Developed and Emerging Markets
Bank Loans
Real Estate
Sovereign/Global Bonds

**Many Schedule Ba investments are categorized as "alternative investments," such as hedge funds and private equity. SAA is, for the most part, not a proponent of alternatives such as hedge funds and private equity for insurers due to their high level of fees, potential lack of liquidity/ transparency, impact to capital ratios, and agency problems.*

How Are Other Insurance Companies Utilizing Risk Assets?

For commercial insurers, the decision about the size of the Risk Asset Allocation, as well as its composition, are growing more complex and difficult.

How can an insurer determine how large that bucket should be?
What asset classes are being utilized or newly considered for the 'Risky Bucket'?

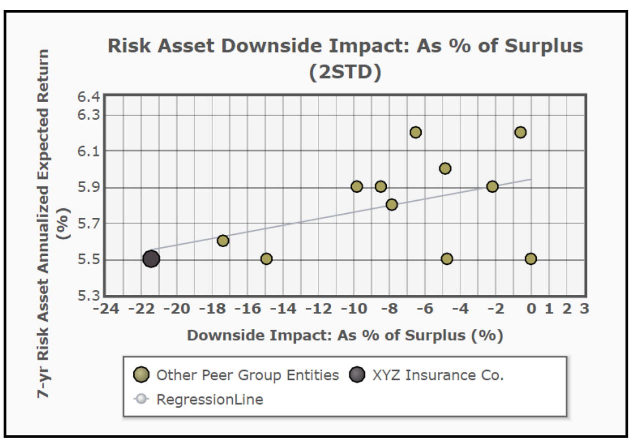
The answer to these questions varies greatly across the commercial insurance space. Thus, peer group analysis is important for your insurer to review how your risk asset allocation compares to peers of a similar size and line of business *(i.e. risk assets/surplus, expected return vs risk, etc.)*.

In comparing your insurer's risk asset allocation to peers, you can begin identifying how peers structure their investment portfolios:

Are they using strategies, tactics or ideas your insurer should consider?
What's the worst-case impact of your portfolio's risk appetite and how does it compare to peers?

You can request a complimentary peer group for your insurer here >>

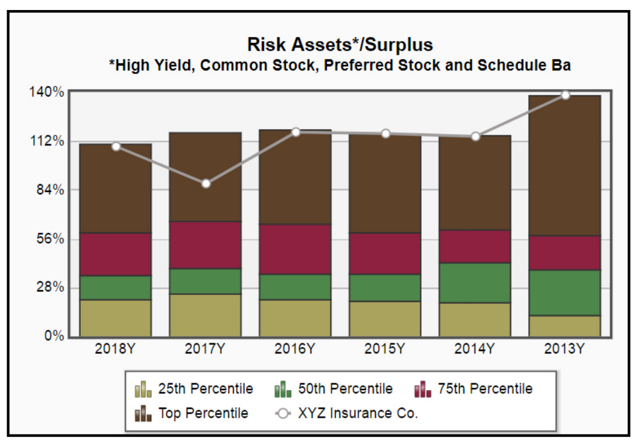
Sample Peer Group Exhibits:



This chart reflects the expected annualized return of your insurer's risk asset portfolio and the potential downside impact to surplus from market movements in risk assets*. Surplus growth and declines are primarily driven by the return and volatility characteristics in risk assets.

This broadly reflects your insurer's risk asset appetite, implied by your asset allocation. Are you comfortable with the potential shock to your surplus given a 2-standard deviation (95th percentile) volatility event? If your surplus looks mostly unaffected by a 2 STD risk asset event, should you consider adding risk asset exposure in order to gain additional return?

**Before Any Applicable Taxes*



This chart broadly indicates your insurer's allocation to "risk assets" relative to your peers.

Since returns are not guaranteed, an increase in your risk asset bucket over time should be yielding you an appropriate increase in return.

If your company is in a lower quartile, it is important to consider if any added benefits could be gained from your portfolio adjusted for risk.

Key Factors to Consider

Relation to Surplus
Simply looking at overall risk allocation can be a bit misleading. What we're really interested in is, "how much of your surplus is exposed to investment risk?" A more reliable metric is **"Risk Assets as a Percentage of Surplus"** *(aka Net Position)*.

A strong surplus position may allow your company to take on additional risk. In turn, increasing the amount of risk assets relative to surplus should correspond with an increase in expected return. However, leveraging too much risk relative to your surplus that is not properly compensated can be detrimental to your investment portfolio.

Why Risk Assets to Surplus?

Your surplus has many demands: underwriting, reserving, risk management, state regulations, etc.

Investments are just one component as it relates to how your surplus can be utilized in your organization's best interest.

Understanding Regulations
Regulations tend to act as constraints on potential allocations to certain asset classes or as limiting factors on those allocations. For example, many insurers can be limited to certain investments outside of investment-grade fixed income.

Thus, a review of the applicable regulatory framework is an integral part of any asset allocation (and investment policy) development. The best asset allocation framework is useless if it cannot be implemented due to regulatory restrictions.

Board/Committee Risk Tolerance
The risk tolerance of the Board, staff and Investment Committee is important to the development of a suitable investment program. Risk tolerance cannot be determined via a canned survey completed by the committee.

Various scenarios based upon different investment structures can gauge the impact of these scenarios on key investment and company metrics. This can determine how much risk the Committee and Management are willing to take on the investment side given objectives and constraints on the business side *(i.e. surplus levels, profitability, ratings, regulatory concerns, etc.)*.

SAA finds scenario-based impact analyses more helpful in enabling the Board and Management to identify and adopt an appropriate risk posture and asset allocation framework.

Example: if we showed a 20% allocation to equities and the stock market dropped by 40%, could the company sustain the resulting negative impact to surplus?

Could the company sustain the result of its auditors requiring a write down of assets and the resulting OTTI charge to earnings?

Does the company need to generate significant income from its investments to supplement potential operating earnings?

Key Factors: Line of Business

P&C
Commercial P&C insurers tend to have liability durations of less than 7 years, so the primary allocation of their investment portfolios is within the “core bond” space.

The fixed income allocation is supplemented by return-enhancing “risk assets” that will enable the company to grow surplus over time.

Life
Most life insurers need to maximize the spread they receive on investments in relation to the crediting rate they offer to their customers.

Asset/liability management thus becomes a key factor in the development of a life insurer’s investment program.

Health
Health insurers tend to have very short liability profiles and structure their portfolios based on cash flow modeling vs. liability matching.

Health insurers typically consider longer durations and accounting for the additional liquidity that companies may need to meet unexpected claims.

Getting Started / Rethinking Current Allocation

Given insurance companies take on risk as part of their core business, it is critical to balance the risk within the investment portfolio to that within the overall business.

In general, if an organization takes on more operating risk *(more business leverage – i.e. higher premiums/surplus or a focus on growth vs. profitability)*, it may be necessary to reduce the risk on the investment side; especially within the risk asset category. Conversely, a strong surplus position may allow for additional risk.

The higher an organization's allocation to more volatile risk assets, the more volatile its surplus level will be. If your company is looking to modify its risk asset allocation, it is important to model various asset allocation combinations; examining the volatility of surplus and worst-case drawdown profile of various assets and their impact on surplus.

A general rule-of-thumb is to begin modeling at 25% risk assets-to-surplus, to introduce what type of volatility would be introduced to your surplus. From there, your insurer or risk pool can conduct further testing and discussion, in order to determine what your investment committee is most comfortable with and what risk assets may be the most appropriate fit.

About Strategic Asset Alliance

SAA is an independent investment consulting firm that works exclusively with insurance companies and pooling organizations. Founded in 1994 by our President Alton Cogert, our experience and focus enables us to help our clients improve their investment process and enhance the value added by their portfolios which are critical components of their business.

We provide insurers with independent investment consulting services to aid their board members and senior executives in meeting fiduciary responsibilities, along with strengthening their investment program.

Our consultants are former senior investment executives at insurers and bring broad, deep expertise across the various lines of business. We have also worked with Pooling organizations for more than 15 years. We combine a knowledge of investments with an understanding of the insurance and pooling businesses.

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