Examining the trends in insurance asset management: data, investment strategy and advances in administration

Moderator:

Noel Hillmann, Managing Director, Clear Path Analysis

Panellists:

David Sullivan, Senior Vice President, Northern Trust

Craig Armstrong, Managing Director, Portfolio Management, Cutwater Asset Management

Anthony Grandolfo, Chief Investment Officer, Validus (Insurance) Group

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Noel Hillmann: Thank-you to the panel for joining me for this debate.

With dual developments in both market regulation and technology infrastructure, are we seeing a universal shift towards investment and administration outsourcing being the accepted norm or is there a continued case for internal management?

David Sullivan: There absolutely has been an increase in both investment and administration outsourcing although it isn't an all or nothing proposition. Within our insurance client base we are seeing certain types of asset management functions being performed in house with an increased amount of support from outside providers, both in terms of asset management as well as operational support. Our clients are getting into new asset classes and we are supporting them where they are using external managers by assisting with their data needs. We also have insurance clients who manage their investments in house. As they rely on their in house investment management expertise to access new investment areas, we are supporting them by providing an increased amount of back and middle office operational support.

It does vary across the board certainly with the overarching trend of more outsourcing both in terms of management and operational support functions.

Noel: Are you seeing a split between insurers, where smaller firms outsource more than larger ones?

David: It isn't necessarily correlated to size as often times larger insurers will have larger portfolios which will allow them a greater degree of diversification by asset class. Larger insurers do have more infrastructure when compared to smaller ones. However, it depends on the degree of variation that our clients are seeking within their investment portfolio allocations, whether that is a reliance on in house expertise from a portfolio management or operational support perspective.

Noel: What are your thoughts on this Craig?

Craig: Cutwater was established twenty years ago as an affiliate manager of an insurance company but also with a dual mandate to establish a third party asset manager. As part of that mandate we are out speaking with insurance companies and in doing that I’ve seen that there is certainly still a case for continued internal management particularly at the larger insurers. In our current mandates we have seen that larger insurers are looking for complimentary strategies. Whilst they may be internally focusing on broader markets they may also be looking for an alpha manager to complement internal staff in a very sector specific way and perhaps bring to the table a skill set that they haven't developed in house.

As you move into the smaller insurance companies, this is where our infrastructure and front to back office capabilities as an asset manager, accounting provider and administrator come into play. We do have the infrastructure and have devoted the resources and technology to building that infrastructure which can certainly help out a smaller insurer. They may take advantage of these additional capabilities more than a larger insurer would.

Noel: Anthony, what is your view on this issue from your seat within an insurance company?

Anthony Grandolfo: It is certainly not a universal shift towards investment and administration outsourcing but clearly there is a trend in that direction for a lot of insurance companies. It is driven by the increased market complexity and the need for sophisticated risk management analytics and reporting that skew the cost benefit analysis more towards outsourcing for all but the very largest balance sheet companies.

I agree with the others that companies are diversifying into alternative asset classes and other areas that they may not have traditionally managed internally. They are looking for external asset managers who have expertise in those areas. The other trend to highlight is that this evolution is not just demand driven, as we have seen the asset management industry invest quite a lot in building out its insurance focused teams and strategies that endeavour to really understand the unique needs of insurance company investing. They have been able to offer a more appealing product and set of services to companies then they ever have before.

We are likely to see a trend towards a hybrid model where for companies who have been investing in core fixed income internally it won't make sense to pay an asset manager to do what they have been doing well for a number of years. They will certainly look to have a number of speciality managers as part of the team that would be a compliment to the total investment process.

Noel: In regards to outsourcing, what areas of outsourcing have you already taken advantage of?

Anthony: We currently outsource our entire investment management administration process. What has been a change for us is the establishment of the internal Chief Investment Officer role. The goal with this is really to be able to craft our investment strategy in a way that ties what we expect our managers to execute for us to the overall company goals in a holistic enterprise-wide, efficient, effort. While it's recognised that there is a lot of value to the scale and resources of third party managers, the need for internal investment management expertise and oversight has been recognised as being essential to driving our overall process in a way that makes it a best fit for Validus.

Craig: In cases where we have had successful relationships with insurance clients, we find that it is crucial to truly partner with the client in order to thoroughly understand their business. As a non affiliated asset manager looking in at insurance companies, you want to make sure that you are really sensitive to their needs. This is not just of the global investment goals of the firm, but down to the more detailed operational aspects of how their assets are managed and also what their liability profile looks like.

David: I would agree with Craig there. What we have seen within our insurance segments relates to understanding the specific needs of clients and really defining where they end and we begin. We take a holistic approach to the relationship and get to what the root causes are that drive our clients business. We have a 40-year track record helping insurers, asset managers and other institutional clients protect their assets and reduce operational costs and risks.

Noel: Anthony, we have seen at Clear Path Analysis that there has been a growth in the number of investment solution providers who are catering to insurers. Have you seen a growth in the differentiation of strategies offered over the past couple of years?

Anthony: It hasn't been differentiation so much as an overall increase in provider teams bringing people onto their teams who have direct experience on the insurance asset management side or who have grown up under that investment mindset. Insurance investing is unique, and even within the industry, different types of insurance companies require different investment approaches. Large insurance companies expect to interact with asset managers who speak the same language as themselves, understand capital charges, ALM, accounting issues, what rating agencies require and all other aspects of managing both sides of the balance sheet.

It hasn't been differentiation by manager so much as a collective beefing up of capabilities in this area.

Noel: Historically insurers relied on fixed income assets to make-up the core of their investment plans. But with such historically low yields can the next 10 years be as fixed income centric as the past decade?

Anthony: This industry will continue to be fixed income centric but there has already been a clear trend towards diversifying away from purely core fixed income.

The trend that we're seeing is being driven by the fact that we're at the end of a three decade long drop in inflation and corresponding bull market in bonds. It's only prudent to begin thinking that the future is unlikely to produce the same level of returns as we've seen in the past. We have seen a lot of insurance companies get into floating rate assets like bank loans and increased interest in private equity opportunities, hedge fund strategies, infrastructure, high dividend yielding investments, etc. This is ongoing and is likely to continue.

Every insurance company does have a different liability profile and tolerance for risk. At the end of the day these are changes at the margin as opposed to major asset allocation shifts. Core fixed income is essential to backing most liabilities. It is also not clear that the impact of rising rates won't negatively affect other asset classes. The quantitative easing program carried out by the Federal Reserve has lifted asset classes across the board. One might suspect that as that program unwinds we will see it negatively impact many non fixed income asset classes as well.

Noel: You mention the move towards private equity and hedge funds which are areas that attract quite high capital charges. How has the board within your own insurer reacted to the idea of moving into these riskier areas and has there been any push back in doing so?

Anthony: In everything we do we are looking at whether we are getting paid enough for the amount of capital that we need to deploy in any given endeavour. This is always taken in the context that we are an insurance company not an investment company so our primary motivation all of the time is preservation of capital and making sure that we support the underwriting business.

To the extent that we have some excess capital we will look at a whole host of alternatives for deploying it into. If there is a capital markets opportunity offering a higher return on that capital and it fits within our overall risk parameters for the company then it is something worth us considering.

Noel: Craig, Cutwater is historically a fixed income shop but what is your view on whether the next ten years are going to be as fixed income centric as the past decade. Do you feel there will be an evolution going on in the provider industry to cater to this change?

Craig: We certainly see traditional fixed income remaining a dominant investment for insurers as the assets are highly liquid, rated, capital efficient and well suited to match insurance liabilities.

We are at the end of a thirty year bull market and our lens tends to focus only on that thirty year time frame and not beyond that to the longer term. One of the things that our Chief Investment Officer, Cliff Corso, likes to look at is the very long term averages on ten year U.S treasuries. We have a graph that goes back to post Civil War days and what you see is that in the late 70's and early 80's period there was an anomaly in the ten year interest rate in the U.S where inflation got out of control and rates went very high. Looking past that period, ten year treasury notes range between 3% -4%. That is because the real rate of return component, which is usually fairly well correlated to the GDP is in fact in that 2%-3% range. Then the other component would be inflation.

As we consider the next ten years, where rates may go and what sort of risks are embedded in portfolios, we don't see a violent spike in rates, perhaps a modest rise. As we think about how to invest over the long term we remain aware of the rate risk, but we don't see it going back to those high teens. It may settle on a more long term average around the 3%-4% range.

Clients generally are looking to diversify away from their core strategies and are looking more at those alpha generating strategies. One example that we see from clients is more of a focus on structured products. We spend a lot of time looking at commercial mortgage and asset backed securities. In looking at those sectors we are thinking about adding alpha into the portfolio. If rates do go up what sort of risk should we be putting into the portfolio? By this I mean risks that won't be as correlated to fixed income assets – targeting more equity like returns within the investment grade sector. This would be assets such as commercial credit, asset backed or perhaps some highly rated high yield paper.

Anthony: Another important aspect to consider is that different insurance companies think about the trade off between income and total return differently. You may have a group of insurance companies that have the same view on rates and act somewhat differently as a result, so a total return manager is likely to stay relatively short duration for some period of time in a rising rate environment where as a yield orientated investor would be welcoming that result.

It also depends on the type of company that you are. For life companies that are fairly well matched between assets and liabilities, higher rates may be relatively neutral for them in terms of the overall balance sheet impact. It is not as much of a concern for those companies.

Noel: David, what are your views on this?

David: It is certainly a question of degree and is all relative within our insurance client base. However, there has been a shift in core fixed income views. We haven't nor would we ever expect to see allocations resembling those that we have seen in some of our other client segments, particularly foundations, endowments and sovereign wealth clients. What we have seen is changes at the margin. We have in some instances seen clients heading further afield with their risk allocations, in a way that they may not have considered before. These are areas like hedge funds, private equity and so forth. However, in all instances this is being done against the backdrop of the conservatively structured fixed income heavy portfolios they operate, driven by the liability profile and the regulatory framework.

Noel: There is an increasing trend for insurers and asset managers to look beyond domestic borders for suitable investment ideas. How are the respective panellists adapting in terms of data they're accessing?

David: The broadening of investment exposure on a geographic basis is certainly a trend. Regardless of the manner that these assets are being accessed, it adds a fairly significant layer of complexity to the data needs of our clients. More sophisticated analytics requirements are really the end result of investment data coming to us from more sources. Regardless of whether this data is being gathered internally or externally, the mandate for us is to integrate the data and return it to our clients in a more value added fashion, allowing them to make informed investment decisions.

Regardless of the interest rate environment over the longer term, the more demanding needs of insurers is a trend that we would expect to see continue given the increased regulatory burdens that our clients are facing around the world. It is not just about the investment environment but also the regulatory environment along with competitive pressures within the business which are raising the bar across the industry in this area.

Craig: Cutwater is very data intensive and we have both internally generated and purchased data. The key for us is to build a central repository to hold that data, scrub the data and ensure its accuracy. As a U.S dollar based investor we don't face the challenges that you would face if you were going into local markets or operating across the globe in various time zones, etc. I appreciate that but don't see those types of challenges presently, but that may change over time as insurers diversify into other asset classes.

The pure amount of data that we are pulling in and maintaining be it pricing data from multiple sources, ratings and/or descriptive data really means the data management operation is becoming quite a challenge. The way we have addressed this data need is by building the necessary infrastructure internally, both in terms of people devoted to our data maintenance, scrubbing and updating as well as the technology, both externally purchased and internally built.

The challenge for us in regards to data is not only about the collection of data but also the reporting of that data back to our clients. The manner in which they are set up to analyse and receive it at their end is also of crucial importance. It is a very targeted stream of data that goes back to our clients, not just pointing a fire-hose of data at them but integrating those data needs with their own in house functions.

Noel: Anthony what are you expecting from your managers as they invest for you beyond the US border?

Anthony: The demands placed on our managers are driven by the global footprint of our underwriting side of the business. As our global footprint grows we would continue to have an asset portfolio that reflects these needs. However, the more one is accessing investments from overseas markets, particularly in less developed regions, the need for good quality intelligence is key. This is where the expertise of a larger external asset manager provides more than we can efficiently do in house. There is an awful lot of data that needs to be collected, analysed and supplied in an easily digestible form for your client base. For us it is a key part of what we look for in an external manager, to ensure that they have a global footprint that could expand as our business expands.

Craig: We do a lot of work maintaining data in house. The handing off of this data to the client is a very important step. In this step each client has their own very specific data needs with internally evolved or external providers who have very specific requirements about how that data is given to them.

Noel: We'll finish there. Thank you all for sharing your insights on this topic.