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Guest Column

Gone are the sleepy days of insurance asset management

Outsourcing on behalf of insurance companies has experienced steady growth for several years and is likely to continue, writes Prime Advisors' Brett Lousararian, CFA at Prime Advisors.

Historically, insurance companies' investment portfolios have contained limited allocations outside of public investment-grade bonds. Following the financial crisis, two key dynamics have led insurance companies to evolve from this "plain vanilla" approach – a trend that continues today. First, the low-yield environment has put pressure on investment portfolios to keep up with the demands of the insurance liabilities that they support. Second, the strong capital position of many insurers has frequently led to a higher degree of risk tolerance.

In this new era, many insurance company investment teams have the flexibility to view certain segments of their portfolio within a more traditional asset allocation framework, rather than being exclusively beholden to asset/liability management and cash flow matching. As a byproduct of this evolution, outsourcing on behalf of insurance companies has experienced steady growth for several years and is likely to continue on that trend. Between 2006 and 2015, global outsourced insurance assets grew by 14.3% CAGR, according to **Patpatia & Associates**' *2015 Insurance Asset Management Analytic*. In 2016, insurance company assets managed by external money managers reached a total of $987bn in North America, and $1.805tn globally according to **Insurance Asset Outsourcing Exchange and Insurance AUM**.

One of the biggest challenges that insurance companies face is a need to balance the competing dynamics of achieving their yield requirements while operating within a stringent regulatory and risk-based capital environment. For these reasons, there will always be a need for large allocations to investment-grade public bonds – an asset class that is typically managed by internal investment teams or third-party asset managers with a great deal of insurance expertise. Moreover, the recent low yield environment has presented an additional challenge for insurance companies in achieving their return requirements – and firms have increasingly been turning to investment-grade private asset classes.

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Private asset classes, including commercial mortgage loans (CMLs), private placement bonds, infrastructure debt securities and CLOs, all offer opportunities to generate incremental yield relative to comparably rated corporate bonds. Reasons for the increased yield include their private nature and em-

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bedded illiquidity premium. These asset classes also have other important portfolio benefits, including added diversification and limiting downside risk through the individually negotiated financial covenants that are often included in deal structures.

The largest life insurance companies have long been investors in many of these private asset classes through internal teams; however, mid and small-sized insurance companies of all types have typically experienced challenges when considering allocations. As it becomes increasingly difficult to find yield, many P&C and Health companies have started increasing allocations to private asset classes. Using these, typically longer duration asset classes, within a holistic portfolio construct will enable companies with shorter duration liabilities to barbell their portfolio to manage duration and cash flow needs, while increasing yield, all without sacrificing credit quality.

In addition to taking advantage of private, investment grade asset classes, the relatively strong capital position across the insurance industry is allowing companies the flexibility to generate yield through alternative asset classes, many of which are not traditionally considered capital friendly. Some of the most active areas today include below investment-grade assets, such as bank loans and high-yield bonds, along with a wide variety of Schedule BA assets in fund structures, including real estate, private equity and private debt strategies.

Given the limited supply and highly customized nature of these assets, they require large and deeply experienced teams to successfully originate and manage – expertise most insurance companies don't have in-house, and would find very costly to build. Given these dynamics, the most cost-effective and realistic option for the majority of insurance companies seeking to gain access to these opportunities is to partner with established market participants, rather than incur the expense and risk of attempting to build out the capabilities internally.

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Insurance companies will likely never be able to make investment decisions in a pure investment construct like other institutional asset owners might be able to, but the evolution that is taking place can't be understated. Regardless of how investment markets evolve, including a continuation of the recent rise in interest rates, it is likely that insurance company investing continues along the current trajectory, which only further increases the demand for third-party asset managers that have a high degree of expertise and understanding of the complex set of factors that impact insurance company investment decisions.

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