Portfolio management for institutional investors. Insurance companies.

Portfolio Management
for Financial Advisers

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- The key characteristic of insurance is the need to match the asset and liability interest rate risk, while earning a favorable income spread between the two

- The insurance industry includes a range of companies in the fields of life, health, property and casualty insurance

- The companies might be involved in business activity as:

  1) **Publicly owned** and **traded stock companies** that operate on a for profit basis

  2) **Mutual companies owned** by their policy holder and operated on a not for profit basis

Life vs. non-life insurance companies

LIFE AND NON-LIFE INSURANCE COMPANIES

- Asset liabilities management is the most critical issue for all insurance companies
- All insurance companies operate as a fiduciary like „quasi-trust fund". Thier primary objective must be to assure portfolio assets will be sufficient to meet future policy holder payouts

LIFE INSURANCE:

- Interest rate risk is critical as life insurance companies are exposed on both asset and liability side of balance sheet. Changing rates not only produce gains or losses on the investment portfolio and a change in present value of the liabilities, but also potential cash flow needs on the liability side (usually during rising rate environments)
- In general liability durations have become shorter

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Life Insurance

Risk Objectives

- Do not take risks that would imperil the future ability to meet policyholder payouts

- Life insurance companies are heavily regulated and must maintain reserves and capital sufficient to absorb investment loses while still meeting policy holder payouts

- The **surplus** (the excess of the present value of assets less present value liabilities) can be managed more aggressively.

Life Insurance

Risk Objectives

Risk considerations in life insurance companies focus on:

- **Asset Valuation**. Declines in market value could eliminate the surplus cushion, leaving the company with inadequate capital and severely restricting future business operations
- **Cash Flow Impairment**. Loss of income or even delays in collection could impinge on the flow of funds to pay policy benefits
- **Reinvestment Risk**. Predictability of cash flow is also important because the reinvestment rate earned on these cash flows has a significant impact on profits. A more predictable reinvestment rate is favorable
- **Credit Risk**. There is little room for defaults and even credit downgrades are detrimental because they reduce portfolio market value and the AVR surplus
- **Product Characteristics**. Newer types of policies like universal life are designed in ways that may allow higher risk objectives

Life Insurance

Return Objectives

- The **primary objective** is to **earn the minimum return** (net crediting rate) necessary to meet policyholder/regulatory requirements. If met, this should be sufficient to maintain the surplus
- Generating a **positive spread** (return in excess of net crediting rate) will increase the surplus and enhance the companies competitive position
- In recent years the trend has been toward segmenting the portfolio by line of insurance business or product and adopting tailored O&Cs by line of business.
- Total return measurement of returns is sometimes employed but realized return (income plus gain or loss on assets sold) is more typical and often required for regulatory measurements

Life Insurance

Constraints

- **Time horizon**: varies by line of business from short to long
- **Taxes**: are complex. In simplest terms the returns necessary to meet the crediting rate are tax-exempt and additional positive spread is taxed.
- **Liquidity Needs**: are generally low. They may vary by line of business and may need to consider disintermediation cash flow needs. Traditionally insurance companies have been important investors in private placement fixed income securities, but this has diminished in favor of securities with better secondary liquidity

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Non-Life Insurance Companies

Risk Objectives:

- Non - Life is far more **exposed to unpredictable policy payouts**. Inflation risk is present if policies require paying the replacement cost of the insured item. Both factors make risk tolerance lower
- **Investment income must be predictable** to cover operating cash shortfalls during some periods of the underwriting cycle
- **The underwriting cycle refers to the industry's habit** of underpricing policy premiums in order to sell more business during good times. Low premiums often lead to operating losses and a cash shortfall from the business later
- While overall risk tolerance is low, the surplus may be invested more aggressively

Non-Life Insurance Companies

Return Objectives:

The primary objective is to earn a positive spread and increase the surplus.

This must be balanced with the need for predictable investment income to buffer underlying business volatility.

Non-Life Insurance Companies

Constraints

- **Time horizon:** generally short but may include a „long tail" to fund potential distant payouts on policy disputes that end in litigation
- **Taxes**: Complex and must be considered
- **Liquidity:** General focus on shorter term fixed income securities to meet mostly short duration liabilities (except for the „long tail")
- **Legal/regulatory**: Complex but less restrictive than for Life insurance
- **Unique**: Varies by product and situation

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Summary

LIFE INSURANCE	NON-LIFE INSURANCE
Longer asset and liability durations	Short asset and liability duration
Substantial interest rate risk, but little inflation risk	Substantial inflation risk, but little interest rate risk
Aggregate payouts are more predictable	Subject to unpredictable payouts
Earn a spread for asset returns over and above required returns on liabilities	Earn a spread for asset returns over and above required returns on liabilities
Liabilities have short tail	Liabilities have a long tail
No underwriting cycle	Pronounced underwriting cycle

THANK YOU