SEA CHANGE BRINGS OPPORTUNITY

TOP 10 INVESTMENT IDEAS FOR INSURERS IN 2016
WILL REALITY BITE FOR INSURERS IN 2016?

2015 was a mixed bag for insurers, with most asset classes providing low/mediocre economic returns, though with some exceptions — both on the upside (Europe and Japanese equities) and on the downside (emerging markets). But mostly, it was a year of anticipation — waiting for US interest rate rises and preparing for the advent of a new regulatory regime that will have far-reaching consequences beyond its European base. With 2016 now upon us, the anticipation has become reality, and there will be a rigorous examination of the investment and risk management practices that insurers have previously developed. Furthermore, new unforeseen risks will no doubt rear their heads at some point.

To help insurers prepare for this sea change, the Mercer Insurance Investment Team (MIIT) in Europe presents 10 ideas for successfully managing investments in 2016 and beyond. Although not all of these ideas will be appropriate for every insurer, they are intended to provoke debate around an appropriate course of action. Strategies that may have worked well in the past decade are unlikely to be optimal moving forward, given the new economic, regulatory, and stewardship realities facing the sector.

We have grouped these ideas depending on where they mainly fall (see left) in the investment process, and we highlight the nature of the likely benefit — split between governance, financial, and operational.

**1. Incorporate ESG beliefs and factors.** Thoughtful consideration of material environmental, social, and governance (ESG) factors and active ownership can have a meaningful impact on risk and return outcomes. Insurers have many options for incorporating ESG factors into investment decisions. For example, insurer corporate bond exposures in the energy and utility sectors may top 10% of total invested assets on average. It seems natural for an insurance company that may be affected by the change in the frequency and intensity of natural catastrophes caused by climate change to consider the impact these may have on its investment portfolio.

For a typical insurer, we estimate that these 10 ideas in aggregate could represent up to 100 bps of unexploited risk-adjusted value. These ideas will each be expanded in a series of papers over the coming 10 months.
2. **Review governance and costs.** Robust investment governance has the potential to both minimise nasty surprises and improve the upside outcomes through better and more timely decision-making. It remains central to meeting the expectations of all stakeholders (regulators, shareholders, policyholders, and directors). A review of the overall investment operating model will help achieve improved efficiencies and effectiveness in terms of:

- An efficient decision-making structure.
- The right quantity and quality of resources — an optimal blend of internal and external resources (for example, between asset managers and in the use of external consultants).
- An objective cost-benefit assessment of the operating expenses (internal and external).

3. **Robustly manage market risks.** In reaction to the low-yield environment, many insurers have been increasing the amount of market risk they are taking and investing in new and more complex asset classes. However, it will be important to confirm that the existing risk management framework remains fit for purpose (if this was not reviewed at the same time). In many cases, we expect some form of upgrade will be necessary.

4. **Optimise pension fund risk under Solvency II.** Insurers have generally been focusing on ensuring that their core business is adequately positioned to meet Solvency II requirements. As a consequence, their pension funds have often attracted less attention. For many insurers, the pension fund assets and liabilities are significant contributors to the net assets and capital requirement. This has been confirmed by the recent regulatory detail around the treatment of pension funds.

We believe many insurers can release value by reviewing:

- The capital efficiency of the pension scheme assets.
- The ability to meet the Solvency II reporting requirements.
- Potential liability management exercises that could completely remove an element of liabilities.
5. Increase diversity of returns. Although many insurers have been venturing outside of the traditional equity/fixed income fare and into alternative asset classes to improve yield and efficiency, in many cases there is scope to take this further — both within fixed income and more widely. For example, life insurers are now being recognised as essential suppliers of capital to long-term real estate and infrastructure projects. And for many other insurers, deeper insight is allowing them to discern between different types of alternative fixed income assets (for example, within emerging market debt) and avail themselves of a premium that, at first sight, appears unachievable.

6. Target the right degree of liquidity. There is clearly a risk of investments not being liquid enough to support the insurance and operational needs of the business, particularly under more stressed conditions. An additional, less obvious risk is the investments being too liquid. Not exploiting excess liquidity can present a significant opportunity cost in the form of lower returns, which in a doubly soft environment (low underwriting rates and low interest rates) can cause business-level viability concerns. Although insurers have varying opinions and needs regarding investing in more illiquid assets, any move to a more illiquid strategy needs to be accompanied by a robust liquidity risk measurement and management framework.

7. Hedge against extreme outcomes. Although governments and central banks have (just about!) managed to protect against some of the more extreme scenarios that were feasible in the aftermath of the 2008 global financial crisis, the possibility remains of a more extreme event occurring again. The pricing of many hedging instruments (for example, equity options) varies over time, and an attractive entry point can be selected for implementation of a hedging strategy when conditions are more benign.
8. Prepare for further interest rate rises. The US Federal Reserve has at long last started the gradual journey of interest rate rises from recent historically low levels. In anticipation of this, government bond yields had already slowly been starting to creep up. However, the longer-term path of future interest rate rises remains highly uncertain, with associated volatility for fixed income pricing. Unless an insurer has a strong belief around its ability to predict the path of interest rates being priced into fixed income markets AND its expectations are below the rates being priced into markets, some form of mitigation should be considered (such as shortening interest rate duration on surplus assets).

“Ride the bumps, but avoid the humps”

9. Review your implementation approach. Efficiency imperatives are causing more institutional investors, including insurers, to reassess the approach they take to implementing their investments. In particular, the use of fiduciary managers to complement internal expertise is becoming more popular. Such an approach can bring a number of advantages:

• Access to asset types that would not normally be available to smaller mandates.

• Improved governance and manager review process, ensuring that the best-in-class managers are used.

• Lower fees, as fiduciary managers may be able to access significant economies-of-scale reductions.

“Blend expertise, retain more value”

10. Robust management information. Increased regulation and stakeholder demand have improved the quality of management information for investments; however, further improvements can often be made. Key to this is to monitor the right things (forward-looking risk and historical performance), present this clearly and concisely (for example, in a risk dashboard), and ensure specific triggers for action are identified in case experience diverges materially from expectations.

“Read the signals, ignore the noise”
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