Is the Investment Model Still Broken?

2018 also marked the 10-year anniversary of The Optimal Service Group’s whitepaper: Don’t Lose Faith, Seize Opportunities, a piece describing the importance of asset allocation within surplus portfolios. In 2018 and the years leading up to it, we have seen similarities between those periods and the year 2008 and its surrounding years. The same statements many made coming out of 2008, such as “asset allocation doesn’t work;” “let’s completely revamp our investment approach;” and “we should just invest in U.S. Treasuries,” were the same phrases we addressed coming out of 2018.

Increased market volatility has again reared its head, to a point where the fundamentals of modern portfolio theory have been questioned. But we submit to you that the case for asset allocation and diversification among a multitude of asset classes has never been more prevalent. In 2018 we saw surplus values negatively impacted for many investors by approximately 10 to 15% losses in long-only global equity positions. We even saw core bond allocations produce muted to negative total returns, an event one would not expect in a market environment where risk-on assets took a significant hit.

So this is the question at the forefront of many investors’ minds today: What company wouldn’t be discouraged with investments after a year like 2018? The immediate answer is that many companies

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that remained disciplined after 2008 reaped the benefits of holding a portfolio with allocations to multiple asset classes. Total return performance of global long-only equity saw annualized returns of more than 9% for the 10-year period after January of 2009.¹ Our answer now turns into a reciprocating question: So what about 10 years from now? Research shows that history may not always repeat itself, but it does rhyme.

Balancing underwriting and investments
In 2018, many insurance companies had solid underwriting results that were able to aid in offsetting the losses suffered in investment portfolios. Ironically, the story was inverse of that seen in 2017, as investment portfolios saw historical highs and underwriting results were subpar at best. To optimize enterprise-level performance, it is pertinent that the attention given to investment portfolios aligns with that given to the underwriting operations. It is not often that we see both components running on the same cylinders, and when risk is being taken on one side, it is usually wise to avoid taking on as much risk on the other side. We believe this balance is critical to both the near- and long-term success of an insurance company’s enterprise-level operation. Investment results will likely revert back to making a positive contribution again, and it is essential that an appropriate investment strategy (i.e., asset allocation) is in place to take advantage when they do. It may be time to consider tactical (or shorter term) shifts within your company’s investment portfolios, while not abandoning your entire investment strategy. Be selective about where you want to take risks and which types of investments are most suitable for your respective needs.

Setting the stage for asset allocation
Insurance companies have to consider many operational and business factors before developing an appropriate asset allocation strategy. In contrast to foundations, endowments, or pension plans where spending needs, distributions, and longer-term liabilities are at the forefront of asset allocation development, insurance company portfolio investments have shorter investment time horizons and are driven by additional risk-based factors. The first step in any investment process begins with establishing clear and concise objectives including, but not limited to, capital preservation, minimizing tax drag, enterprise cost cutting, recognizing and adhering to regulatory changes, growing surplus, and/or maximizing after-tax income. Once these objectives have been set, an assessment of enterprise-level risk should be conducted. Some companies like to review peer comparisons to see how other companies are prioritizing their risks. Finally, dynamic financial analysis (DFA), is essentially a method used to provide deeper insight into enterprise risks and potential rewards than analyzing key ratios and scenario testing. DFA models allow for a high degree of detail including, but not limited to, analysis of reinsurance programs, modelling of catastrophic events, and/or dependencies of random events. Once these three stages are complete, the development of asset allocation can begin.

The importance of asset allocation
As a refresher, let’s define asset allocation: it is a method for determining the most appropriate mix of investments (i.e., diversification) that is likely to produce the best expected return for a given level of risk. Diversification among multiple asset classes is likely to generate more consistent returns. As a result, what many successful investors understood in the late 1990s, and what many acknowledge today, is that reducing downside risk through diversification can help produce strong results (with lower volatility) over time as markets cycle through the emotions of fear and greed.

Insurance companies are the ideal entities to understand the benefits of diversification within asset allocation; most notable of these is the potential to mitigate unanticipated risk. After all, insurance companies are in the business of risk management. The pooling process employed by insurance companies diversifies the risk from any one insured loss. The same applies to the pooling of different asset classes. Any one asset class may produce volatile returns. Combining different asset classes makes possible the potential for more consistent returns.

Ten years ago, when we were conducting our analysis of the insurance space, we found that many insurance companies did not pay much attention to diversification because they did not believe the concept would benefit their investment portfolios. Today, even in a rising interest rate, increased merger and acquisition, and potentially lower for longer global equity return environment, we still see many insurance companies maintaining an asset allocation consisting of just three asset classes or less. Doing nothing to diversify your investments, in our opinion, could stall your company’s growth and positioning in an industry that has evolved through intensified competition and consolidation, and that will continue to change.

Current capital market assumptions and opportunities
As a bull market charges ahead, some investors forget about the times
when the bull was not raging. Recent memory could suggest that the equity market should continue to increase. Consequently, such investors continue to purchase assets at high prices; then suddenly, the market drops, as we saw in 2018. Unprepared investors may then wonder how they missed the peak. Investors experience a similar situation in down-trending markets—assuming that the market will continue to decline, when it may be reaching a bottom. Instead of considering a long-term view in which the market fluctuates, investors can behave as though current trends will not change. Before getting into specific types of opportunities, we believe it is critical to have thoughtful capital market assumptions (CMAs), since these are a key input of the DFA model and the ultimate asset allocation.

Over the past 10 years, we have seen a relatively consistent upward trend within risk-on capital markets, until the end of 2018. The decade-long bull market was tested amid rising interest rates, geopolitical tensions, and concerns that the global economic expansion may be running out of steam. Going forward, over the long term, we see higher volatility in the capital markets and lower-than-historical total returns in the fixed income markets as well as the equity markets. Because we believe that interest rates will be gradually rising, bond prices will likely be negatively impacted; however, higher yields will likely offset some price declines. We also expect to see improvements in the growth of international developed markets, with emerging-market growth leveling off. With those themes as a backdrop, we believe greater importance will be placed on alternative investments (i.e., private equity and debt) in order to help reduce traditional asset-class risk.

Opportunities vary among the many types of corporate investors. Insurance companies that are income-focused are starting to see slightly higher yields on government-backed paper, especially on the shorter end of the curve. However, those focused on total return have seen heightened fluctuations in absolute performance and have begun to explore opportunities such as short-duration, high-yield strategies. With the U.S. 10 year Treasury duration currently more than 8.5 years, a yield outlook between 3.00 and 3.30 and a rising-interest-rate environment, we currently see opportunities for both income and total return in mandates that are investing toward the shorter end of the yield curve and mandates that implement alternative investments, particularly private debt and equity hedge strategies. We believe such an approach is prudent in order to take advantage of the current opportunities, but strongly recommend detailed research, and due diligence, on the investment managers and their capabilities before proceeding. A knowledgeable and experienced debt and alternative research team is very much a necessity.

Summary
Let’s face it, for investment executives and consultants who believe in an investment model that utilizes effective asset allocation, diversification means always having to say you’re sorry. However, given the unpredictable nature of capital markets and insurance companies’ high priority of reducing enterprise level risk, the investment model still remains unbroken. We believe as we head into a future with heightened volatility, lower returns and rising interest rates, asset allocation is more important now than it was 10 years ago.

Reference
1. Morningstar Direct, MSCI All Country World Index.

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