Institute and Faculty of Actuaries

Balancing investment risk and return in a low yield environment

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Lane Clark & Peacock LLP

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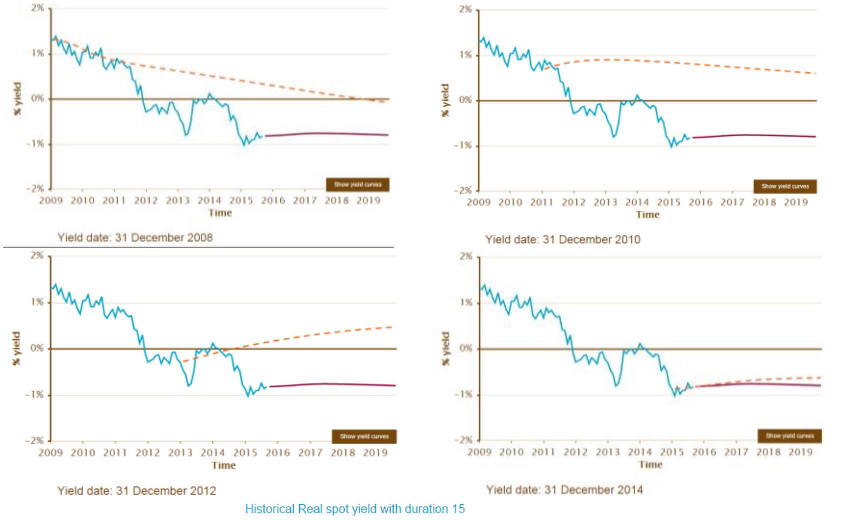
Real rates continually defy expectations

But they can't fall forever



Historical Real spot yield with duration 15
Projected Real spot yield based on market data at 31 August 2015

Source: LCP RITA

How investment actuaries help insurers

Set a sensible investment strategy

Implementation

Ongoing monitoring

The GI actuary's investment thesaurus

"Credit"

Growth assets

Absolute return

LDI

The GI actuary's investment thesaurus

"Credit"	Growth assets	Absolute return	LDI - Liability driven investment strategy
• Lending to corporates • Bonds – investment grade to high yield • Loans • Direct lending	• Higher risk - used for 'spare' assets with a view to targeting a high yield • Examples such as : equity, property, private equity, hedge funds.	• Any type of investment aiming to beat a cash benchmark. • Hedge funds • Diversified growth funds • Absolute return bond funds	• Any investment strategy based on liability cash flows

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Agenda

How insurers' investment strategies have developed under the low yield environment

Positioning your bond portfolio for the future

- investing sensibly into a rising interest rate environment

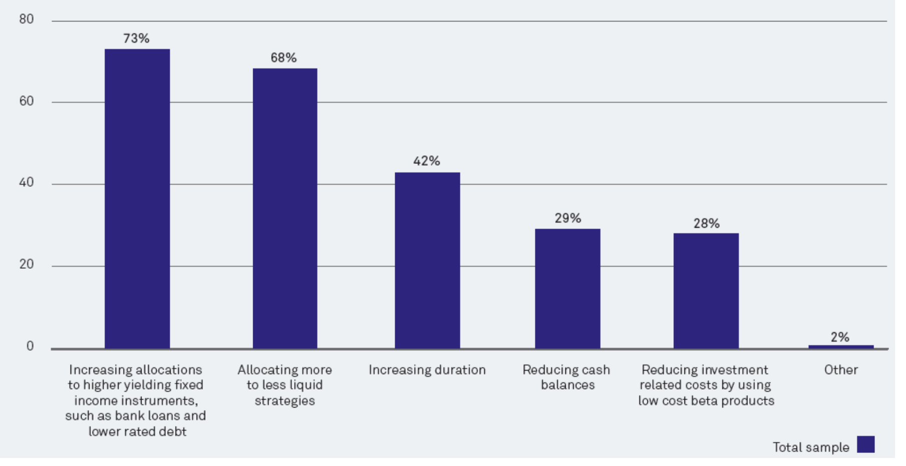
Diversifying the growth assets

Managing PPO risks effectively

Next steps

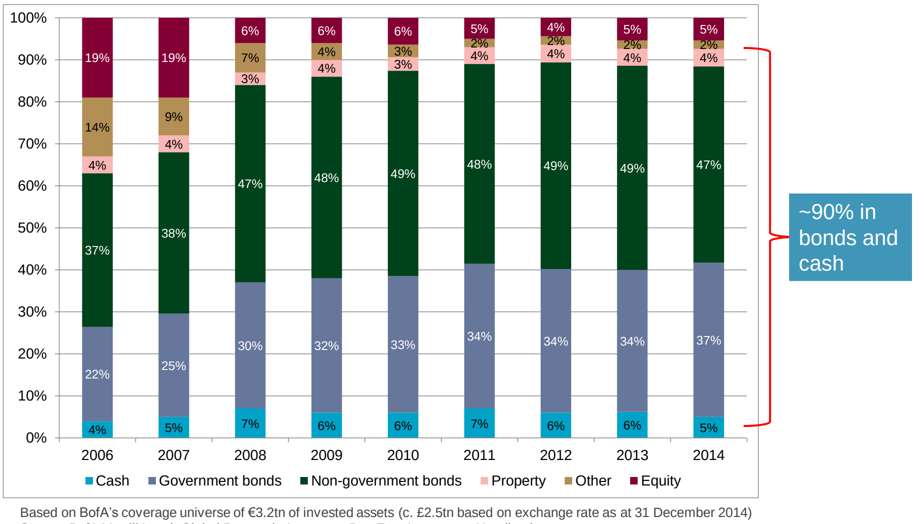
Responding to the low yield environment

How insurers are adapting investment strategies to the low interest rate environment



Source: The Economist Intelligence Unit, May 2013, BlackRock

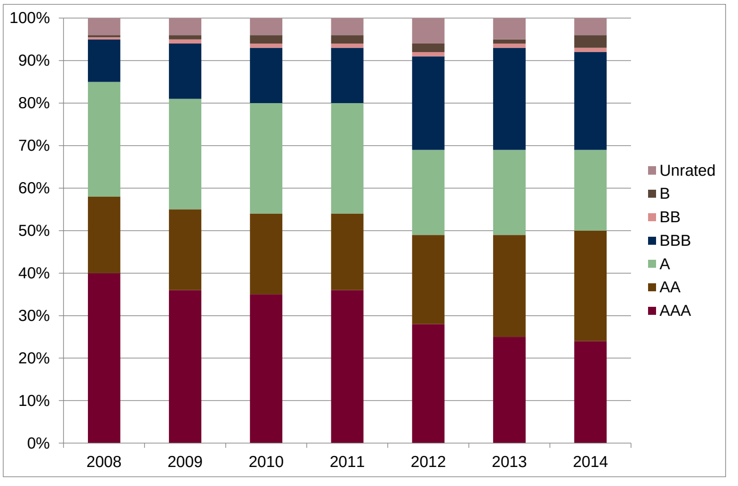
On the face of it, insurers' investment strategies remain defensively positioned



Based on BofA's coverage universe of €3.2tn of invested assets (c. £2.5tn based on exchange rate as at 31 December 2014)
Source: BofA Merrill Lynch Global Research, Insurance Pan Euro Investment Handbook

But average credit quality has been worsening

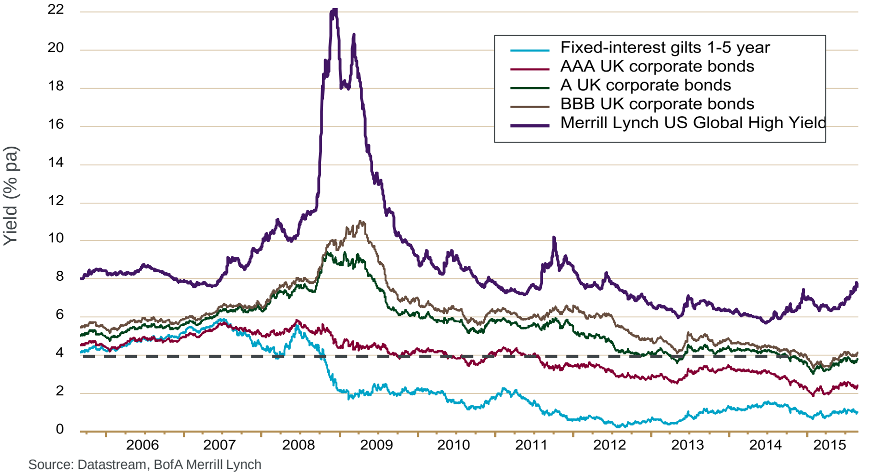
Breakdown of corporate bond credit ratings



Based on BofA's coverage universe of €3.2tn of invested assets (c. £2.5tn based on exchange rate as at 31 December 2014)
Source: Datastream, BofA Merrill Lynch Global Research, Insurance Pan Euro Investment Handbook

Understanding the drivers of the shift to lower-rated bonds

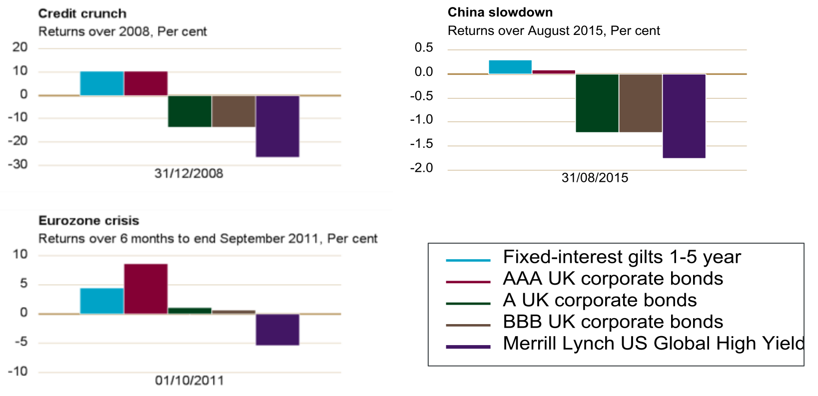
Taking on more risk just to maintain investment returns



Source: Datastream, BofA Merrill Lynch

Playing a dangerous game?

Leaving yourself most vulnerable at the worst time



If there is a market correction, lower quality bonds may well be hit hardest

Source: Datastream

What can insurers do instead?

Maintain corporate bond exposure, but in a more resilient way

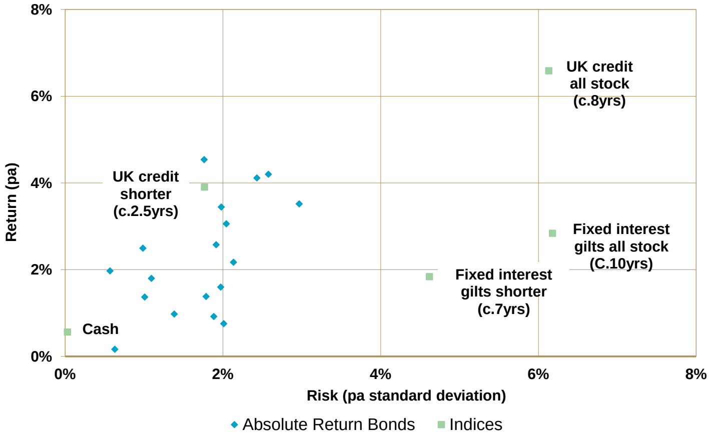
- "**Absolute return bonds**" are products specifically designed to be resilient in down markets (ie when yields are rising)
  - targeting a return of cash +2 to 4% pa with low volatility
  - not "relative to" a bond benchmark index
- Typically invest in bond markets on a global basis
  - no single approach – different investment managers use different philosophies

Advantages	Disadvantages
Smoother returns and more diversification	Approach may be unfamiliar
Specifically designed to be resilient, so may be attractive in a rising interest rate environment	Choice of manager will be important
Flexibility to capture opportunities quickly and avoid over-heated areas of the market	
Enable you to bank profits made recently	
Capital implications	

Absolute return bond track record

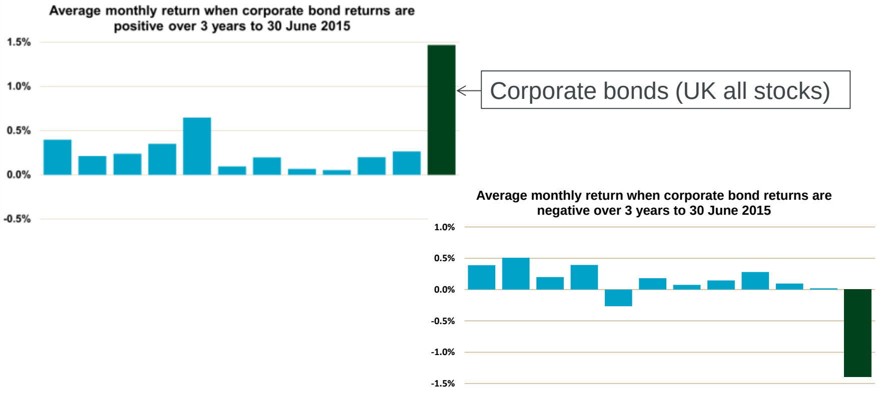
Achieving smooth “all-weather” returns

Risk vs Return on Absolute Return Bond Funds
Over 3 years to 30 June 2015



Capturing upside and limiting losses

Achieving smooth “all-weather” returns

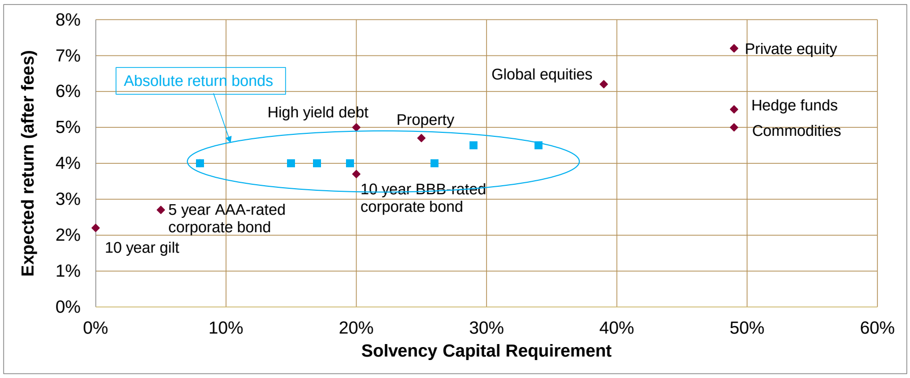


The managers look to limit downside in negative months and capture upside in positive months

Source: Investment managers, Bloomberg, LCP. Blue bars represent a range of absolute return bond managers researched by LCP

Making efficient use of your risk capital

Solvency II may be a catalyst for making absolute return products more attractive



The "look-through" principle underlying Solvency II may allow you to take credit for the diversification and careful risk management that absolute return bond approaches offer

The chart above is for illustrative purposes only, to show the extent to which a manager's approach may affect the SCR on a "look-through" basis. We have used LCP's best estimate assumptions of the expected returns over the 10 year period from 30 June 2015

What could you do instead?

New opportunities to get extra yield

Supply

Demand

Outcome

The opportunity is multi-faceted

Descriptions and indicative target returns from researched managers

Direct lending funds

8 – 10% (UK and / or Europe)

Commercial real estate ("CRE")

7 – 9% (UK and / or Europe)

Multi-asset funds

Blended approach, perhaps global
4 – 6%

Infrastructure debt

4 – 6%

Regulatory capital

8 – 12% (Europe)

"Opportunistic credit"

12 – 15% (Global)

An alternative approach to credit

Look for opportunities to increase yields

Advantages	Disadvantages
Diversification away from traditional credit with much higher return potential	New asset class so limited track records
Lending is secured, so higher recoveries in event of default	Illiquid, so need to hold for life of the fund
Wide range of approaches means that tailored approach possible	Fees

Capital requirements?

Diversifying the growth assets

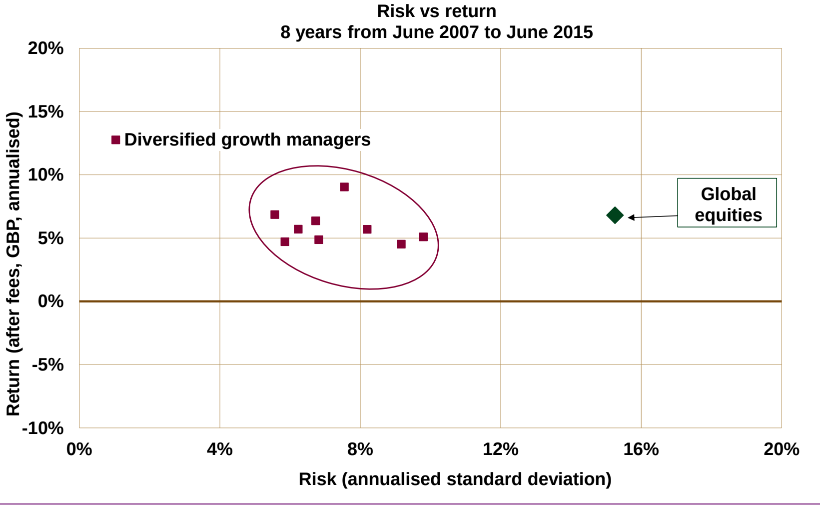
Often a significant driver of market risk capital

- "**Diversified growth**" products typically target a return of cash +4-6% pa with particular focus on downside protection
  - not "relative to" an index
  - "equity-like" returns with lower volatility
- Typically invest dynamically across a wide range of asset classes

Advantages	Disadvantages
Smoother returns and more diversification	Approach may be unfamiliar
Specifically designed to be resilient	Choice of manager will be important
Improves your governance, capturing opportunities quickly and avoiding over-heated areas of the market	
Enable you to bank equity profits made recently	
Reasonable terms and good track records	
Capital implications	

Diversified growth track record

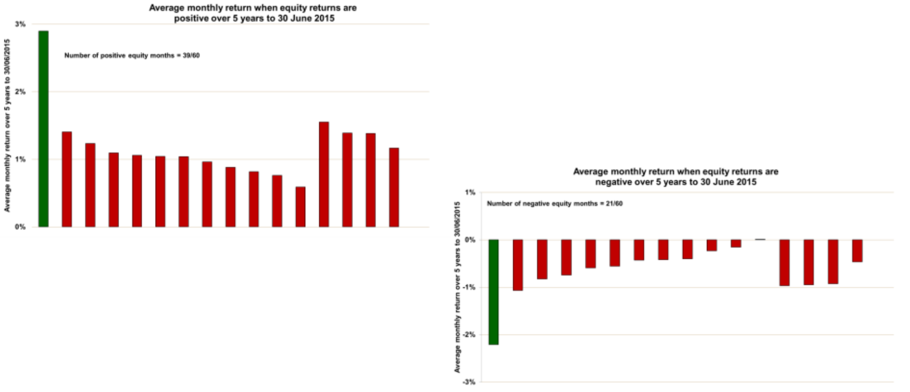
Achieving equity-like returns with significantly less volatility



 The red squares above represent the diversified growth products researched by LCP.

Capturing upside and limiting losses

Achieving smooth "all-weather" returns

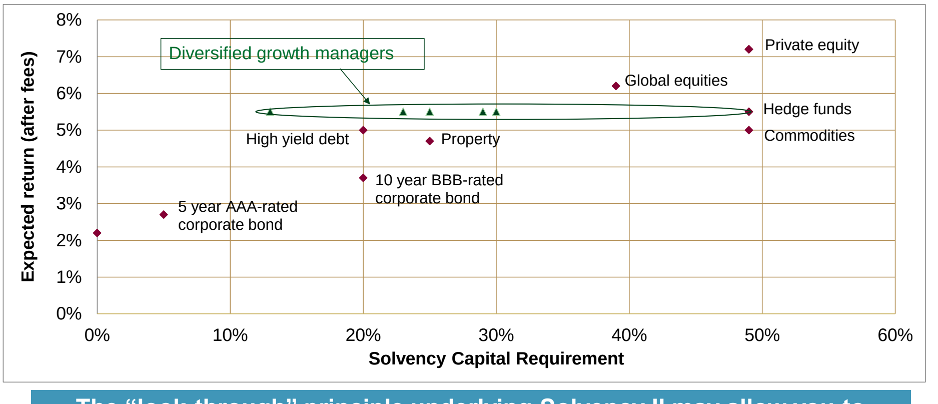


The managers look to limit downside in negative months and capture upside in positive months

Source: Investment managers, Bloomberg, LCP. Green bar represents the FTSE All World Equity Index, red and blue bars represent diversified growth managers.

Making efficient use of your risk capital

Solvency II may be a catalyst for making absolute return products more attractive

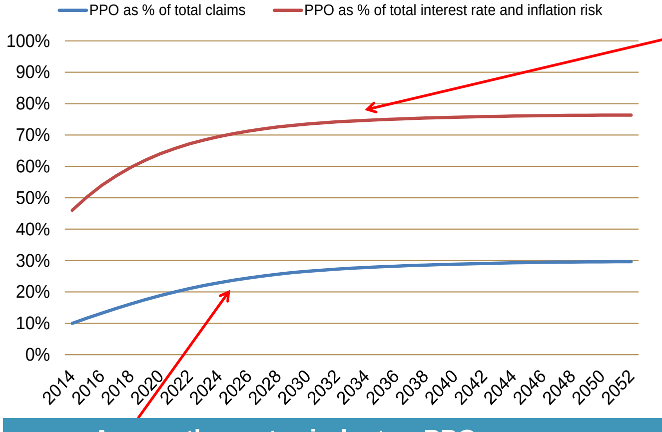


The "look-through" principle underlying Solvency II may allow you to take credit for the diversification and careful risk management that diversified growth approaches offer

Managing PPO risks effectively

PPO reserves and risks are expected to grow rapidly

As the number of cases being settled increases



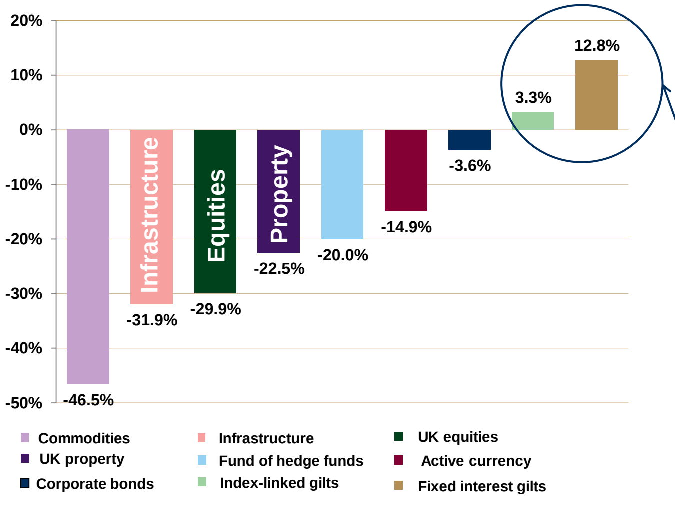
Because PPOs have such a long term, they could quickly dominate market risk

Across the motor industry, PPO reserves may end up representing around 30% of total reserves

Source: Institute and Faculty of Actuaries – October 2013 – showing PPO reserves (settled PPOs only) as a proportion of UK motor market reserves. LCP analysis to estimate interest rate and inflation risk.

Matching assets should go up when your liabilities go up

Asset class returns during 2008



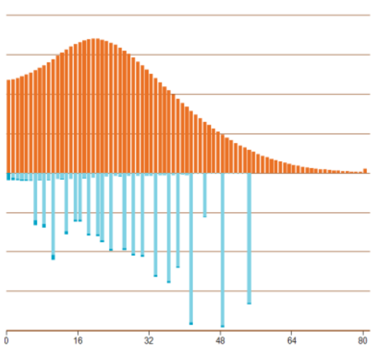
Gilts are priced in a similar way as PPOs. Therefore, in a distressed environment such as 2008 where falling bond yields pushed up the value of PPO reserves, only gilts offered protection

 Source: Bloomberg

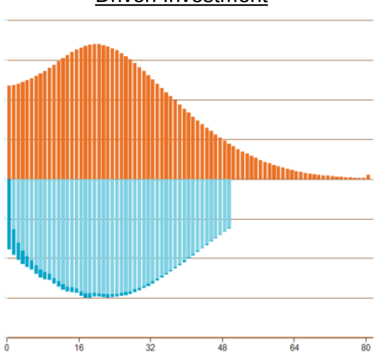
Achieving precise cashflow matching

Using liability driven investment (LDI) approaches

Matching achieved through holding index-linked gilts



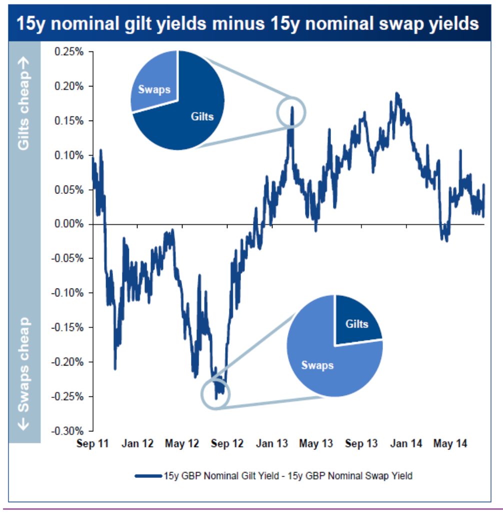
Matching achieved through holding the same amount in Liability Driven Investment



Liability Driven Investment strategies are widely used to manage interest rate and inflation risk, by matching the cashflows in a precise way

What is Dynamic LDI?

Selecting the best value instrument to manage risk

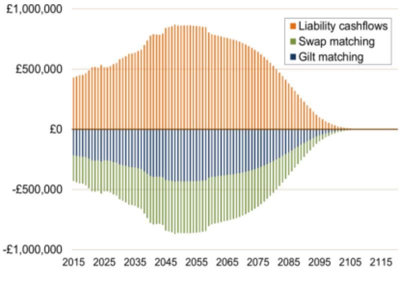


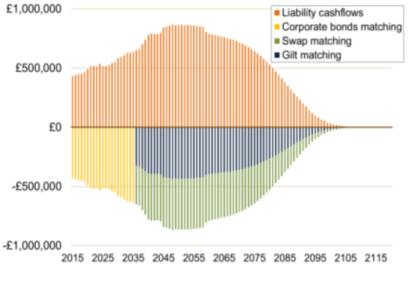
- Gilts and swaps do not always yield the same
- Given free choice we would invest in highest yielding instrument
- "Dynamic LDI" managers adjust the allocation between gilts and swaps over time
- This process can add value over the long term

 Source: BMO GAM

Potential investment strategies to back PPOs

"Pure" Dynamic LDI vs introducing a corporate bond element





	Option 1 Using pure Dynamic LDI	Option 2 Using 50% Dynamic LDI and 50% corporate bonds
Expected excess return (pa)	~0.5%	~1.0%
Impact of corporate bonds falling in value by 10%	0%	-5%

 Note: Figures for illustrative purposes

Call to action

Balancing investment risk and return

Position your bond portfolio for the future

- Simply worsening the credit quality to maintain yield can be a dangerous approach
- ***Absolute return bonds*** may help you achieve smoother and more resilient returns
- ***Credit opportunities*** may enable you to take risk where it is properly rewarded

Diversify the growth assets

- ***Diversified growth*** products offer a low-governance way to achieve equity-like returns with much lower volatility

Managing PPO risks effectively

- PPO risks are already large and growing
- A ***Dynamic LDI*** approach can manage these risks very effectively, in a cost-efficient way

The "look-through" principle underlying Solvency II may allow you to take more credit for products that offer diversification and careful risk management

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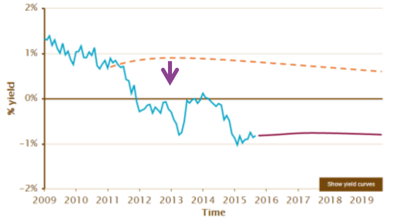
Professional support
Enterprise and risk
Learned society
Opportunity
International profile
Journals
Suppo

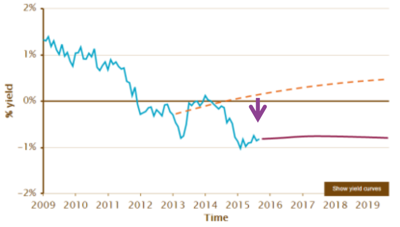
Real rates continually defy expectations

But they can't fall forever

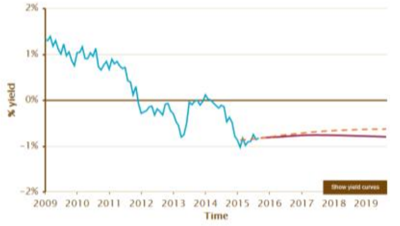
Yield date: 31 December 2008



Yield date: 31 December 2010



Yield date: 31 December 2012



Yield date: 31 December 2014

Historical Real spot yield with duration 15

Projected Real spot yield based on market data at 31 August 2015

Source: LCP RITA