Viewpoint

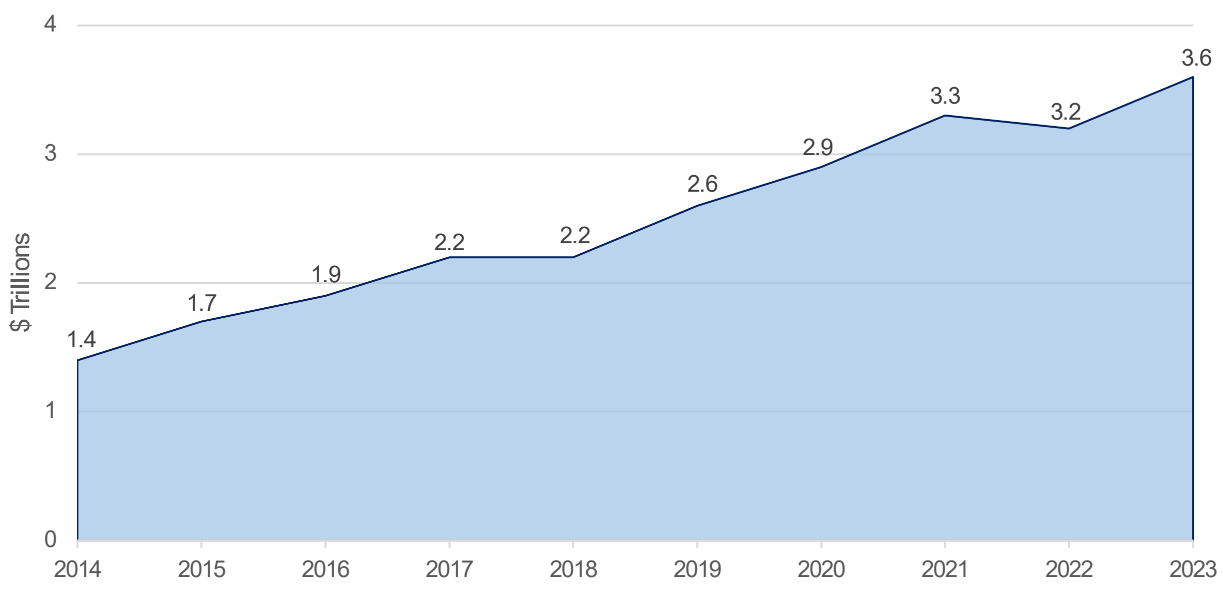
July 2024

Unlocking Performance: The Rise of Third-Party Managers in Insurer Portfolios

By Matt Reilly, Head of Insurance Solutions, and Lauren Forando, Senior Analyst

As the evolution in capital markets, regulations and stakeholder requirements increase the complexity of insurance company general account management, insurers have also been making their investment programs more sophisticated. These are some of the reasons insurers have continued to grow their relationships with asset managers (see Figure 1).

Figure 1 - U.S. Insurers Third-Party General Account AUM, 2014-23



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Conning's annual survey of insurance executives and our ongoing dialogue with insurers suggest the outsourcing trend will continue to grow. However, insurers' demands are changing: they want asset managers to go beyond simply looking for competitive return streams. They want managers to provide customized strategies and unique capital-efficient structures and become true business partners. Insurers are measuring outsourcing success by how it helps them manage efficient investment programs with diversified investment strategies that provide competitive returns, allowing them to free up resources to develop other valuable business capabilities.

Outsourcing Decision Drivers

Per the National Association of Insurance Commissioners (NAIC), insurers with smaller investment portfolios are the majority of firms outsourcing, likely due to their lack of scale for an internal investment operation. NAIC data also indicates that life insurers outsource less than property & casualty or health insurers.[1] (Life companies' higher level of integration between asset and liability performance likely leads to a desire to have more oversight and control over the investment program.)

Figure 2 - Which attributes does your firm consider in order to determine outsourcing its investment assets?

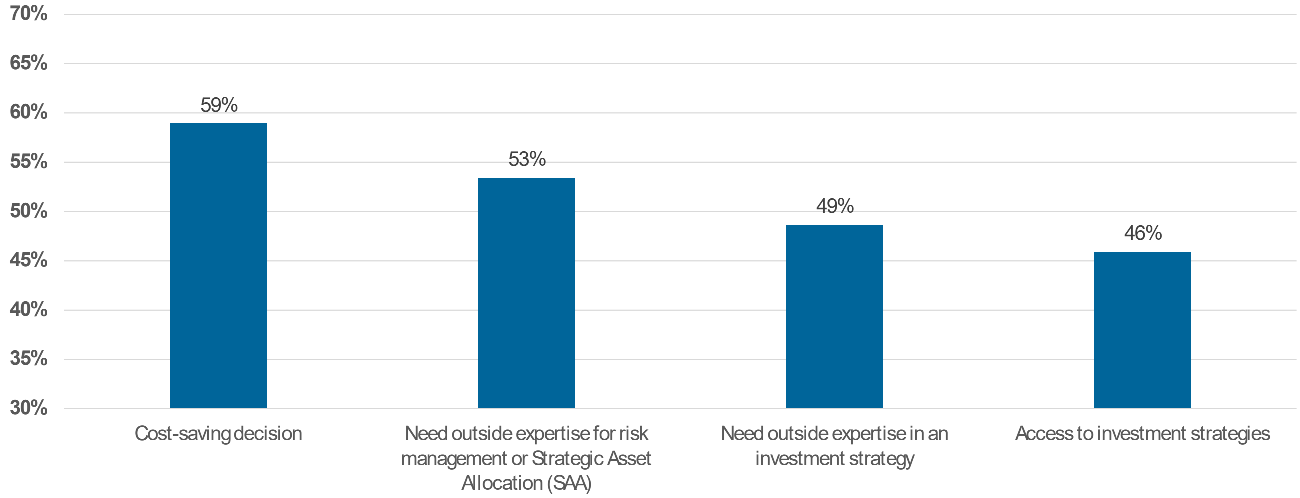

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Figure 2 shares insights from our annual survey regarding insurance carriers that outsource all or some of their investment portfolio. When asked what drives their investment outsourcing decision, the most commonly cited response was the ability to lower costs. Outsourcing may reduce a need for internal investment support, allowing insurers to redirect those expenses to other capabilities such as distribution, underwriting, and claims.

The second-most common rationale cited for outsourcing was accessing risk management and asset allocation capabilities. Insurers can partner with managers to provide modeling capabilities, stress testing and help them understand how to construct resilient investment portfolios. External managers can bring a range of knowledge, skills and capabilities to help strengthen insurance companies, and respondents said they want to work with managers who possess a variety of capabilities.

Outsourcing can often be cheaper than developing in-house solutions and may allow companies access to additional resources and investment opportunities. As insurers continue to diversify their investment portfolios, sourcing unique investment strategies with managers who have expertise is critical. Insurers can and do build teams to manage certain strategies, but the required scale and cost may be excessive for medium and smaller insurers.

Expanding Investment Universe

During the recent decade-plus era of relatively low interest rates, insurance companies faced a difficult choice: increase investments in riskier assets or accept lower yields from traditional portfolio staples. Figure 3 demonstrates that insurers opted for the former during the past five years, investing more in alternative assets that primarily reside on Schedule BA.

Figure 3 - Increasing allocations to alternative assets

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Some companies may be able to manage a high-quality fixed income portfolio with internal resources, and these portfolios might be concentrated in one or two high-quality sectors. However, insurers diversifying into other markets will require greater specialization and resources. For instance, structured securities require specific skills and tools to properly assess collateral performance and cash-flow sensitivity.

Again, the costs of supporting this expanded skill set may be too much for smaller firms; engaging with an external manager may be more efficient.

Valuable Input for Investment Strategies

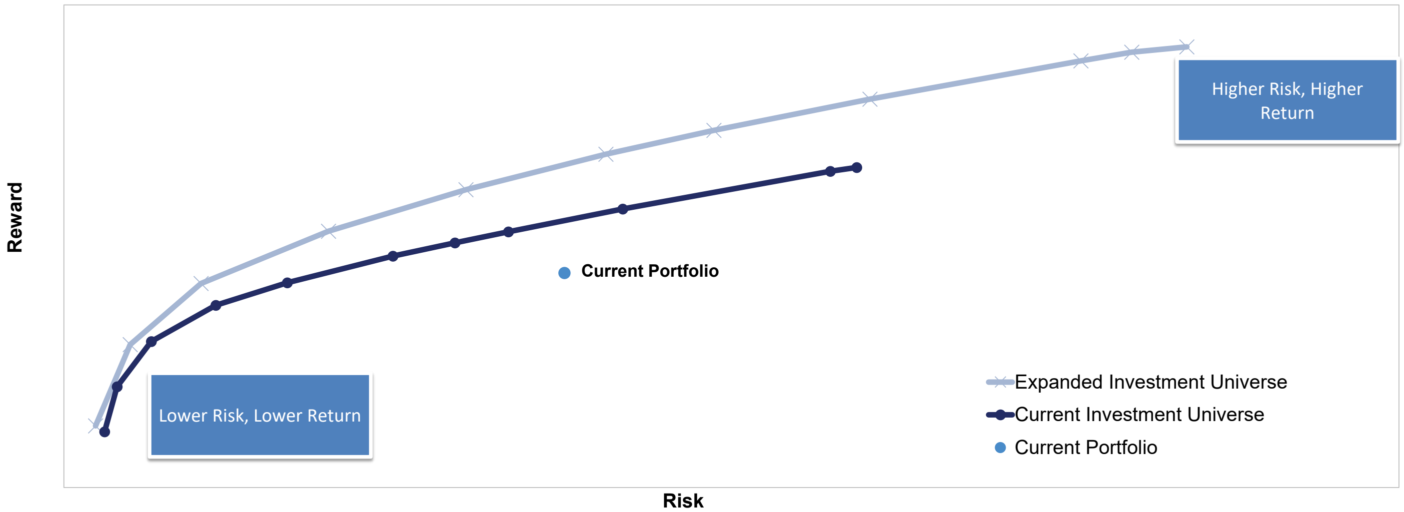
A case study can help illustrate these concepts. We selected a property & casualty insurer with a portfolio value of $550 million and modeled investment strategy options that demonstrate value-add opportunities available via outsourcing.

The insurer's portfolio initially was only invested in the types of high-quality securities often found in internally managed portfolios, such as Treasurys, municipal and corporate bonds and public equity. Figure 4 displays the current portfolio and two efficient frontiers.

The lower efficient frontier ("Current Investment Universe") only allows for the high-quality, traditional fixed income sectors currently in the portfolio. The second, higher efficient frontier - the "Expanded Investment Universe" efficient frontier - is higher and to the left of the "Current" curve. That means that the "Expanded" frontier potentially offers equivalent returns at a lower risk to the portfolio, and higher returns for the same level of portfolio risk.

The "Expanded" universe also allows for modest allocations to sectors that most smaller firms may not have capabilities to manage. In this case, the universe includes higher levels of structured securities, including esoteric asset-backed securities. In addition, it includes allocations to sectors not currently in the insurer's portfolio, including collateralized loan obligations, private placements and commercial real estate debt and equity. To execute on the "Expanded" strategy, the insurer would need to either invest in an internal team or hire an external asset management firm, or even multiple firms, to manage this array of assets.

Figure 4 - Efficient Frontier Comparison – Core Fixed Income vs Allowance of Alternative Assets



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By allowing for an expanded array of investment types and sectors, insurers may improve their chances of achieving investment program goals. Higher levels of income, better downside protection and enhanced capital efficiency could all be achieved with more diversified portfolios.

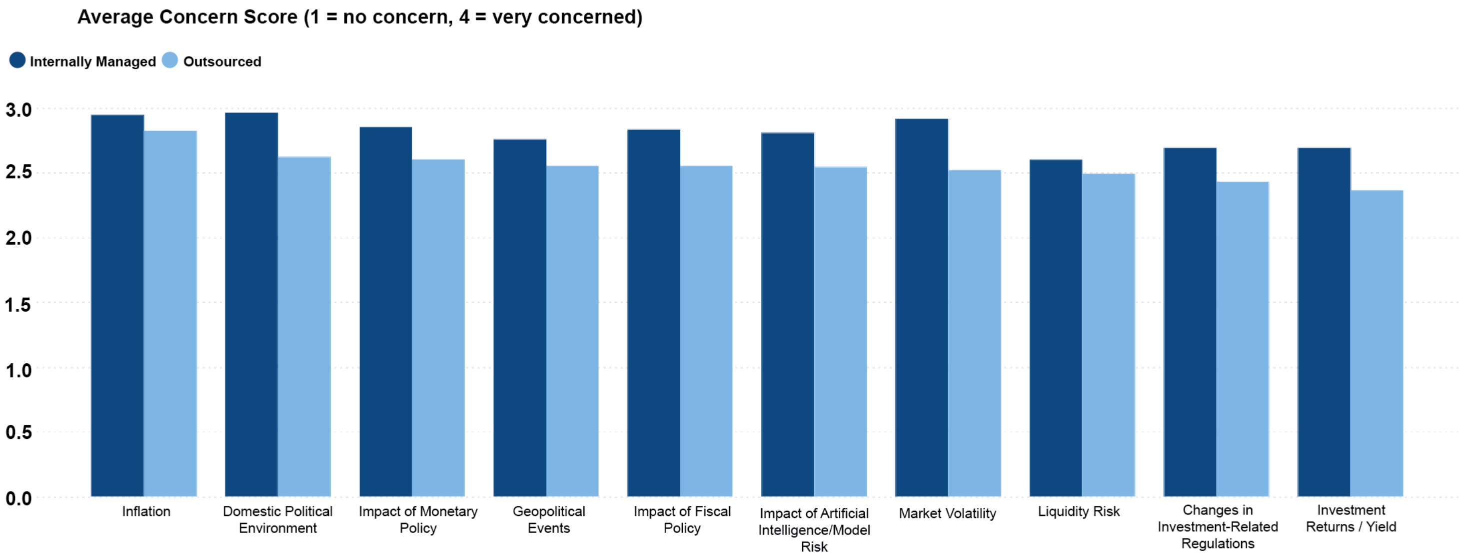
Outsourcing may help insurers access professionals with the skills and knowledge to execute specialized market strategies in a more cost-effective way.

Conclusion

Insurers are seeking more than competitive returns when outsourcing portfolio management – they are looking to save costs and expand access to more diverse investment options and develop relationships with managers who can add value to their business.

In addition, Conning's survey also showed that respondents who outsource some or all of their assets had lower concerns about investment risks (such as inflation, geopolitical, etc.) than insurers who manage all their assets in house (see Figure 5). This suggests that an intangible peace of mind comes from partnering with the right asset manager. Insurers seeking these benefits should look for an asset manager who understands the specific needs of insurers, has extensive experience in modeling portfolios as well as specialty asset classes, and also has a high level of client service to address day-to-day questions and develop new ideas to optimize performance.

Figure 5 - Lower Risk Assessment by Insurers who Outsource Assets



"outsourced" includes all respondents who indicated they outscurce either all or some of their general account assets to a third-party asset manager.

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Footnotes

[1] © 1990-2024 National Association of Insurance Commissioners, Capital Markets Special Report, "U.S. Insurers' Outsourcing to Unaffiliated Investment Managers Holds Steady at Year-End 2023," Jennifer Johnson and Jean-Baptiste Carelus, https://content.naic.org/sites/default/files/capital-markets-special-report-im-outsourcing-ye2023final.pdf - This data is reliant on statutory regulations

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