The Insurance perspective

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Industry Insight

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President and CEO

During recent presentations at insurance conferences, I received several questions related to investment performance measurement for insurance companies. As it has been a few years since I addressed this topic in the Perspective I wanted to summarize a few of my recent replies. Measuring investment performance is a critical component to understanding the financial health of an insurance company. However, the individual metric applied is often not in line with the overall goals and objectives of the insurer. The unique goals of the organization should be thoroughly outlined in both the ERM program and the business plans of the organization. Investment performance measurement tools should be developed to encourage and measure the achievement of these goals. A catalyst that is often behind a misalignment of performance measurements with the insurer's objectives is a tendency to simplify performance measurement to a single benchmark. When I observe this in actual practice either a single book yield target is listed or a total return benchmark is selected. The unique aspects of an insurance company often necessitates the use of multiple benchmarks customized to specific needs such as RBC enhancement, risk reduction in a specific area, net income/cash needs, surplus concerns, or the current insurance products.

It is also important to note that tools and benchmarks must also measure or be used in conjunction with risk measures. For an insurance company, the most effective methods to control risk are: 1. Diversification as it relates to single security exposure as a percent of surplus or the AVR reserve. 2. Proper alignment of the asset cash flows with the future expected cash flows of the liabilities.

Proper performance measurement must also consider the unique regulatory and accounting treatment of an insurer. Statutory accounting and NAIC regulation is designed to focus an insurer on a proper alignment of asset and liability cash flows. This is the basis of amortized cost treatment on the majority of investments, RBC and certain reserves such as IMR/AVR. Understanding these components, insurance companies are naturally focused on net investment income as measured by book yield; however, the use of book yield targets must be constrained by the ALM cash flow matching needs of the organization, product pricing, and the current market conditions. The preference given to any single measure will depend upon the specific needs and objectives of the organization. For instance, is an improved RBC level important from a regulatory view or has surplus as a percent of assets drifted historically due to a mismatch in the ALM strategy? When any single benchmark is used, unintended investment results can and will occur in other areas. This is because the investment strategy to enhance any one of these targets may actually reduce others. This is especially true if investments are managed with only total return considered.

When insurance assets are managed to optimize only total return there are several unintended consequences that often adversely impact the insurer. Decisions that a prudent investor would make in order to optimize total return may actually reduce surplus or the net investment income of an insurer. A key to understanding these potential issues is centered on the ultimate objective of the insurer. An insurance company is entrusted with funds that represent future payments to members or policy holders. As stated above, this simple concept is the basis for statutory accounting principles. A large component of total return is the unrealized position of a portfolio at any given time. However, insurance companies carry the majority of assets at amortized cost. The basis for cost accounting is that fixed income investments are to be held to maturity in a manner where the cash flows are sufficient to provide for the future expected claims of the insurer. This reduces the concern related to decreasing market prices and places the focus on net investment income. This focus is appropriate and actually reduces risk. Securities purchased should support the future cash flows of the representative product and provide sufficient book yield (spread) to support product growth rates and operations. This is true regardless of the direction of interest rates. Insurance investing should not focus on speculation or "bets" on interest rates, but work to ensure that surplus and net investment income are appropriate in any economic environment. Additionally, there are circumstances where a focus on total return would dictate the sale of a security in order to realize a gain and reinvest in another security with a better appreciation profile. If an insurer files an Interest Maintenance Reserve (IMR), then the gain on a disposal would not be realized initially, but amortized into income over the remaining life of the security that was sold. Companies might also try to generate positive return versus an index by shifting between asset classes, qualities, and/or concentrations. This reduces diversification and has significant impacts to risk based capital in addition to creating volatility in the AVR. This in turn can place downward pressure on surplus in addition to the trading impacts to IMR. More importantly, if the amount invested in any single security is large in relation to surplus, the risk to the insurer is enhanced. This would not be the case for other types of investors as diversification is considered based upon total assets.

This does not imply that total return is a completely useless tool, but for an insurer it should not be the primary focus. Most of you are aware that I often talk proudly of the tremendous total return history of Parkway; however, these are a by-product of a focused approach to managing toward the other objectives discussed above. There are some exceptions to not focusing on total return as the primary metric and the main example is with equity investments. With common stock total return should always be considered due the marked to market accounting treatment of this asset class and the impact to AVR. The overall allocation to common stock must still be constrained by the other items mentioned above and the performance of the total portfolio, including common stock, must be in line with the other performance objectives.

For insurance companies we recommend that the overall needs and objectives are outlined within a comprehensive investment plan and that several performance measures are outlined and given priority depending upon the unique needs. These can include: book yield in comparison to budget expectations, book yield comparison to competition and trends, surplus enhancements or the improvement in surplus as a percent of assets, enhancement to RBC, attainment of diversification goals, net income growth/performance relative to budget, ratio comparison to peers, enhancement to the BCAR score, and total return relative to any specific benchmark. Additionally, the top needs of the insurer can change over time. For example, surplus levels might be a focus due to regulatory changes, reduced levels versus industry needs, or potential acquisitions. A focus on surplus enhancement can produce investment decisions that differ from those used to enhance net investment income. While both might be important to your organization, one might take the primary focus for a certain time period. The tools used to measure this performance should be clearly communicated to the team that manages the assets. The key is that all parties are working together to achieve the overall objectives. This means that the asset managers, auditors, actuaries, and management must either work directly together or at least be on the same page with how each area affects the other. Working together is the best way to achieve positive overall returns.

Economic Commentary

Chad B. Hoes,
Chief Investment Officer

As we head into the final quarter of 2017, let's take a minute to recap an eventful third quarter. Multiple catastrophic hurricanes have wreaked havoc on many communities, domestic US equity markets have continued to reach new highs and the Fed is set to begin an unprecedented unwinding of Quantitative Easing. Below is further discussion on these topics as well as other key economic events of the third quarter.

US Bond Market – In the third quarter, all points of the Treasury yield curve shifted higher although the shorter end of the curve generally increased to a greater degree. The one-month Treasury increased 10 basis points over the quarter as did 2-year Treasury notes. 10-year and 30-year Treasuries shifted up only 3 basis points each. The last three weeks of September saw a significant run-up in the 10-year Treasury yield, increasing approximately 29 basis points. This was, in large part, due to the market's reaction to the Treasury auction as well as the market's outlook on monetary policy. The mid-part of the curve remains in a narrow trading range. In fact, the current trading range of 2-2.63% is the tightest spread range since 1965.

FOMC – The Federal Reserve has begun increasing short-term borrowing rates and continues along this trajectory (one more projection in 2017 and three increases in 2018). Additionally, the unwinding of QE began October 2017 as the Fed begins shrinking their $4.5 trillion stockpile of assets (see Trevor's write-up on the Fed unwinding). The Fed met twice in the third quarter and two FOMC meetings are scheduled for the fourth quarter of 2017. The July meeting was largely uneventful, with Yellen's Fed seeing the labor market as solid and economic activity as rising moderately. As widely expected, there was no change in the benchmark rate. While the September meeting yielded similar top-level results, Federal Reserve officials announced an October start to the unwinding of QE. This has been a much-anticipated event and the Fed has been sending extremely clear signals along the way in an attempt to avoid any disruptions or overreactions to the market. Despite "storm-related disruptions" (i.e. hurricanes) the Fed believes economic activity to be affected in the near term, but "past experience suggests that the storms are unlikely to materially alter the course of the national economy over the medium term."

US Stock Market –The equity market ended the quarter at an all-time high, with the S&P ending above 2,500 and the Dow above 22,500 points. This continues a solid upward trending momentum for domestic large cap equities. To illustrate the strength of this bull run, the last 5% correction, which typically happens on average three times per year, was in the summer of 2016. Moreover, this is the longest run without a five percent correction since the mid 1990's. The S&P 500 Index ended the third quarter up

4.48%. The Dow Jones Industrial Average concluded the quarter up 5.58% and the NASDAQ was up an impressive 6% for the quarter.

Summary – Heading into the fourth quarter, the markets are anticipating one more Fed hike to occur in the final month of the year as well as the Fed working out of its inflated balance sheet. While the equity market continues to reach all-time highs, we still believe multiples are high and the general market overpriced. I anticipate the fourth quarter to be relatively flat with the possibility of a slight correction at some point. Continue monitoring the 2 to 10 yield differential that points to the relatively flatter yield curve. With low inflation, easy monetary policy and the Fed raising short term rates I expect this yield spread to continue tightening.

Interest Rate Spreads

As of: 9/30/2017

Term	Treasury Yield	US Composite BVAL AA Curve		US Composite BVAL A Curve		US Composite BVAL BBB Curve		US Composite BVAL BB Curve	
		Yield	Spread	Yield	Spread	Yield	Spread	Yield	Spread
1yr	1.31	1.505	0.195	1.652	0.342	1.877	0.567	2.588	1.278
2yr	1.47	1.749	0.279	1.907	0.437	2.16	0.69	3.074	1.604
3yr	1.62	1.964	0.344	2.136	0.516	2.423	0.803	3.488	1.868
5yr	1.92	2.331	0.411	2.504	0.584	2.862	0.942	4.146	2.226
7yr	2.16	2.671	0.511	2.843	0.683	3.268	1.108	4.711	2.551
10yr	2.33	3.061	0.731	3.218	0.888	3.7	1.37	5.293	2.963
20yr	2.63	3.693	1.063	3.93	1.3	4.447	1.817	6.415	3.785
30yr	2.86	3.839	0.979	3.905	1.045	4.346	1.486	6.418	3.558

US Treasury Yield Curve

GRAB
Running as C15. Run GC for more features.

US Treasury Actives Curve | Actions | 98) Table | Settings | Graph Curves

X-Axis Tenor | Y-Axis Ask YTM | Currency None | PCS | Lower Chart History Chart

Specific 06/30/17 | 09/30/17 | Relative | Last | 1D | 1W | Modify | Curves & Relative Value

	Tenor	09/29/17	06/30/17	09/29/17-06/30/17
11)	1M	0.933	0.837	9.6
12)	3M	1.041	1.011	2.9
13)	6M	1.185	1.132	5.4
14)	1Y	1.289	1.228	6.2
15)	2Y	1.483	1.382	10.1
16)	3Y	1.622	1.546	7.6
17)	5Y	1.936	1.888	4.8
18)	7Y	2.169	2.140	2.8
19)	10Y	2.334	2.304	3.0
20)	30Y	2.860	2.835	2.5

S&P 500 Index

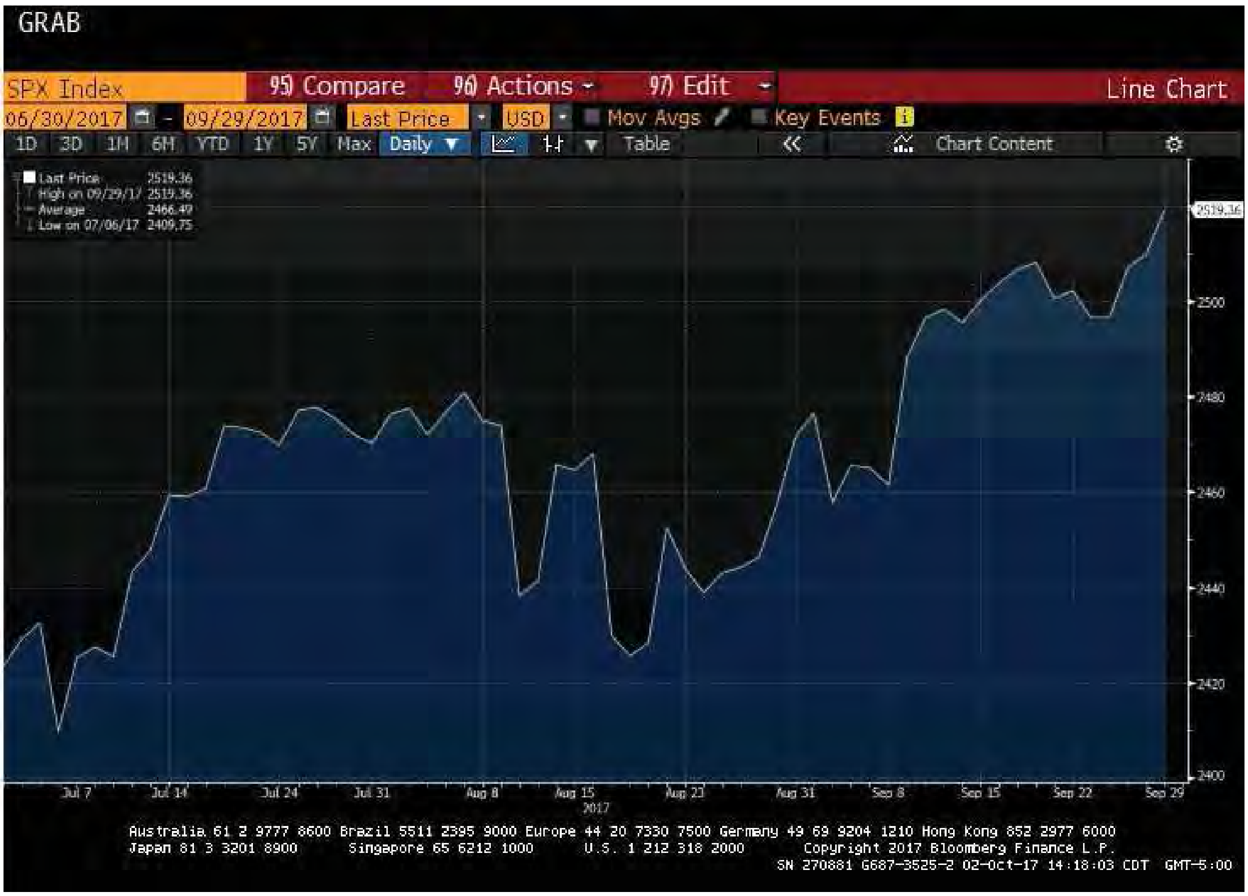
GRAB
SPX Index
95) Compare
96) Actions
97) Edit
Line Chart
06/30/2017 - 09/29/2017
Last Price
USD
Mov Avgs
Key Events
1D 3D 1M 6M YTD 1Y 5Y Max Daily
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Chart Content
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High on 09/29/17 2519.36
Average 2466.49
Low on 07/06/17 2409.75
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2460
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Aug 15
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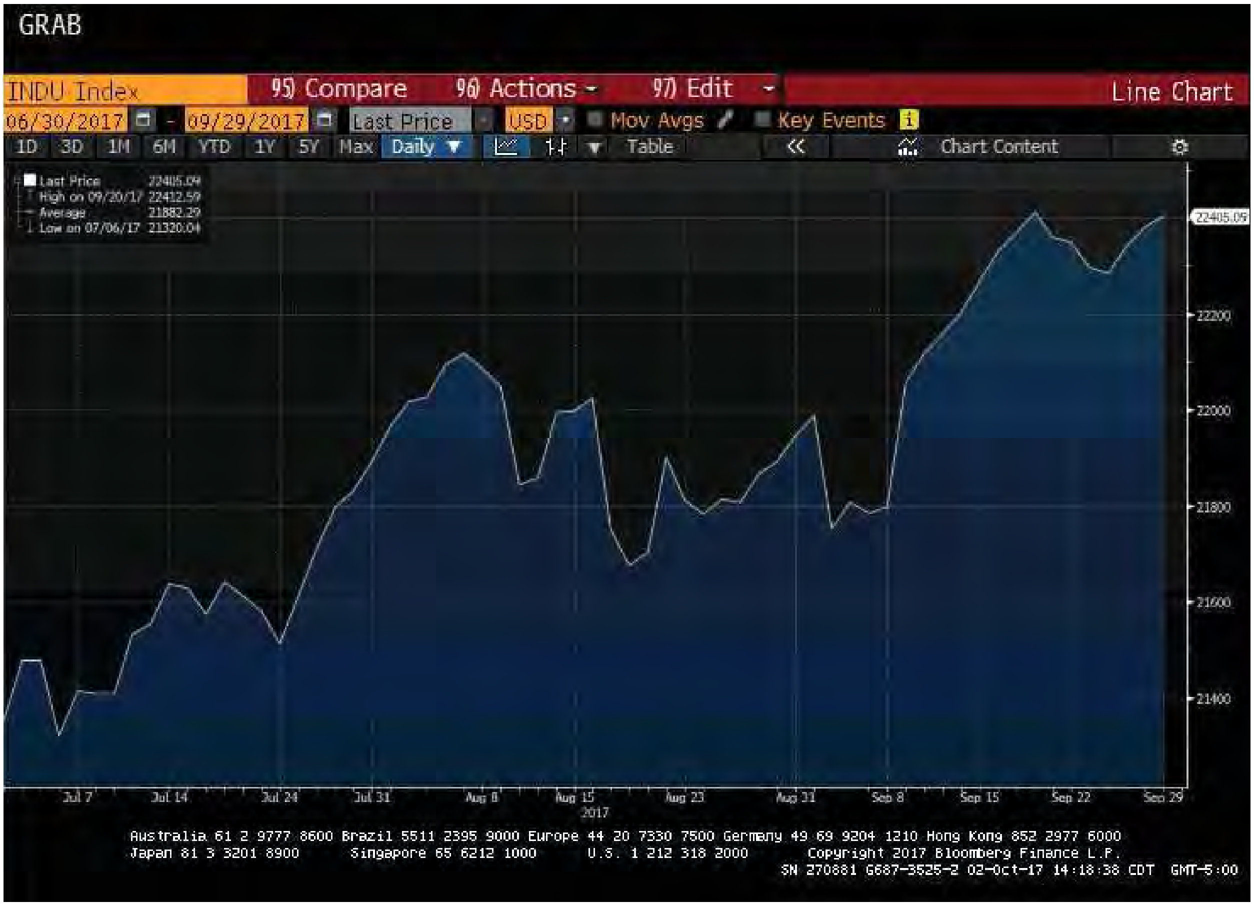
Dow Jones Industrial Average



Fed Unwinding

Trevor R. Rupe, Portfolio Manager

In response to the financial crisis, the Fed began injecting liquidity into the market through a program known as "Quantitative Easing" where they purchased securities in the open market. The asset purchases primarily entailed Treasury bonds and Mortgage-Backed Securities (MBS), which led to inflated prices and subsequently drove yields to historic lows. The idea behind this strategy was that low rates would spur growth through lending at banks. While this strategy arguably saved us from another "Great Depression" scenario, it did lead to an inflated balance sheet for the Fed. By the end of the 6th year, they had quadrupled their holding to an unprecedented 4.5 trillion dollars worth of securities.

After the Fed ended the bond buying program in October of 2014, they continued to reinvest any "roll-off" and maturities, so we have not seen any reduction in their balance sheet. Rates had generally been on a downward trajectory, up until the election of Trump who has been open and vocal about raising rates (among everything else). We have seen the Fed Funds Rate rise 3 times from .50% to 1.25% in 2017 and talks about reducing the balance sheet have been recent news. Selling securities from the inflated portfolio could create tremendous volatility with the surge of supply in the market, which would drive prices down and yields up. One of the Fed's goals is to avoid sending shockwaves through the market, but the market (especially fixed income markets) tend to be very emotional and react abruptly to anything viewed as potentially negative. This was observed in 2013 when the Fed simply announced it was going to taper back some of the asset purchases. This caused panic selling in the Treasury market causing rates to surge higher, a day known as the "Taper Tantrum."

In the last month's (September 2017) meeting, the Fed officially announced their plan for the unwinding of the balance sheet. Their initial plan is to simply let maturing securities, including any principal or interest, roll off without reinvestment. They will initially let 6 billion of treasuries roll off per month and slowly let the amount increase to 30 billion over the coming months. In regards to its MBS holdings, they will start at 4 billion and increase to 20 billion per month. Following this plan, the balance sheet is anticipated to drop below 3 trillion by 2020.

Ultimately, the Fed has been very transparent and methodical with their plans. With the Fed no longer buying securities, we anticipate that yields will continue their upward trajectory. However, in the event the market begins to think the Fed is getting ahead of itself and the economy cannot support higher rates, we could see a "flight to quality" where Treasury securities are purchased as a safe haven, thus driving yields back down. Essentially, the Fed feels the economic data numbers justify taking the economy off the "low rate crutches" they have provided, and hopefully they are right.

Disclosures

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The Insurance Perspective is a quarterly publication prepared by the staff of Parkway Advisors, L.P. Each issue focuses on the U.S. economy and specific insurance industry issues and/or concepts. Our clients and prospective clients enjoy Parkway's dedication and unique focus on the insurance industry.

For More Information

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