

The Insurance *perspective*

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Industry Insight

A key objective of any successful investment program is based upon generating an appropriate return while assuming the least amount of risk appropriate for the portfolio. However, achieving this for an insurance company requires specific attributes that are very unique in comparison to any other investment portfolio. For an insurer, reducing volatility to surplus while maximizing net investment income is the fundamental approach for a successful long-term investment program. The majority of non-insurance investors are accustomed to comparing the total return of a portfolio to a total return benchmark. For these portfolios, volatility is typically measured by the standard deviation. An alpha is additionally utilized in order to compare the achieved return for any given standard deviation to the market. This article is designed to provide insight into how additional attributes must be considered before applying these attributes to an insurer.



Theron R. Holladay Sr., CFA
President and CEO

Return Measure: It is the basic design of an insurer that sets it apart from other investment portfolios. The assets need to be invested and structured to provide cash flows appropriate to cover the future claims of policy holders. The capital and surplus of an insurer represents the excess assets above what is necessary to provide for the liabilities. Regulation, regulators and rating agencies are focused on the stability of capital and the potential future risk to capital for insurers. This is because they never want to see surplus levels fall to the extent that the ability to provide for future claims is impaired. The stability of capital is the basis of many of the statutory regulations of the NAIC including Risk Based Capital (RBC), cost accounting and reserves, such as IMR/AVR. Amortized cost accounting is the foundation of statutory accounting and aimed at encouraging insurers to “buy and hold.” The desire is to encourage insurers to focus on how cash flow, book yield and surplus relate to the products that are sold by the company. This unique aspect places a high emphasis on the net investment income of the insurer. While total return includes the market value of an account at any given time, book yield is directly correlated to net investment income and provides for the ability to maintain surplus, pay growth rates on products, maintain RBC levels and provide for operations. Unfortunately decisions made only to enhance total return can result in reduced surplus, lower net investment income and higher IMR/AVR levels due to the nature and purpose of an insurer and the application of accounting regulations. Net investment income, cash flow and book yield must be a part of any return measure emphasized by an insurer.

Volatility Measure: Standard deviation is an important measure of volatility. When discussing performance, standard deviation is typically calculated from a total return calculation. The problem with being focused on the standard deviation of total return is that it provides little insight into the real risk of an insurance company. The two most important methods to reduce portfolio risk for an

insurance company are: diversification by holding a small percentage of surplus or unassigned funds in any one investment and a focused strategy of having assets that are appropriate for the products that the company provides to the public. If the assets of an insurance company produce cash flows that provide for the future claims, the policy holders are protected and risk is minimized. This is why an insurer does not report the market value of investment grade bonds. The market value of a bond will fluctuate with changes in interest rates. When assets are structured to provide for future cash needs, the company is secure as long as there is no credit event, regardless of what happens to interest rates between now and the date of the cash need or claim. This aspect of an insurer adds additional significance to the reported book yield of the portfolio. A low standard deviation of book yield is what separates an insurer over time. There are many ways to reduce the standard deviation of total returns on a bond portfolio. Unfortunately these methods are not often correlated to providing cash flow around the liabilities of the company. Insurance companies sometimes make well intended decisions to reduce volatility only to experience unintended declines in surplus, RBC or net investment income. For these reasons, volatility measures must consider surplus and the book value of assets.

Alpha: Alpha is one of five technical risk ratios used in modern portfolio theory (MPT) and is intended to help determine the risk-reward profile of a portfolio. Simply stated, alpha represents the value that a portfolio manager adds to, or subtracts from a portfolio's performance. Alpha is an important investment tool; however, before applying it to an insurance portfolio a deeper understanding is critical. The alpha calculation plots the abnormal rate of return of a portfolio in excess of what would be predicted by an equilibrium model, like the capital asset pricing model (CAPM). CAPM is a graph that draws a line between a "risk-free" investment and that of the "market." The points of each are simply plotted by considering the standard deviation and the total return of each security. Typically the 90 day T-Bill is used as the risk free rate and the S&P 500 Index is used to represent the market. The return of the portfolio is then plotted and if it is above the line it has a positive alpha. Unfortunately, these measures have no basis for the assets of an insurance company. Of prime consideration is the fact that the risk-free rate must be appropriate. For most types of investors this may be the 90 day T-Bill as it reduces volatility and is backed by the Government. However, the risk free investment for an insurer is unique and very specific. The risk free portfolio for an insurer would be a series of US Treasury Strips "laddered" in a way where the maturities directly align with the future liability cash flows. This is also unique for each insurer as products and history differs for each company. The benchmark index used to replicate the market should be one with a duration, maturity distribution and cash flow structure that approximates that of the liabilities of the company. Additionally, the benchmark would need to be comprised of investments that are allowed by the insurance department of the state of domicile and appropriate for the insurance products sold by the insurer. If both of these are calculated, then the alpha of the portfolio will be a true reflection of the value added by the portfolio's design. However, if the standard risk free rate is used, the results will not align to the unique characteristics of the company.

The purpose of this article is to point out some unique characteristics of an insurer that impact the return, volatility and benchmark measures used to gauge performance. As with any portfolio, it is important that all valuation tools are in line with the actual needs and objectives of the account. An insurance company is unique in comparison to all other portfolios. A focus on net investment income, surplus volatility, statutory accounting, IMR/AVR (if applicable), RBC and the liabilities can be accomplished while producing a good total return. However, the reverse is not necessarily true. A primary focus on total return can have very negative consequences for an insurer, especially if the benchmark and volatility measures are not tied to the value of the insurer. It is for this reason that volatility of surplus is such a key factor for regulators and rating agencies.

Economic Commentary



Chad B. Hoes,
Chief Investment Officer

We have reached the midpoint of the year and one thing remains constant thus far in 2018: volatility. From domestic stocks to yields on bonds to US trade tariffs, there have been some knee-jerk reactions and emotional responses in the market this year. Some of the major market moving items are discussed below.

US Bond Market – We have continued to hammer home the flattening of the yield curve and while 2018 has altered how the curve is flattening, the shifts in the curve remain pointed in this direction. Yields from the 1-month Treasury to the long-bond have continued to shift upward, with the largest magnitude of change occurring in the short- to mid-part of the curve. Specifically, the three-month Treasury increased 22 basis points in the second quarter while the ten-year shifted up 10 basis points and the long-bond remained flat. We continue to focus on the ten to fifteen year part of the curve as this provides the best value for plain vanilla core corporate bonds.

FOMC – The Federal Reserve met twice in the second quarter for scheduled rate decision meetings. The second meeting of the quarter and fourth for the year resulted in another quarter point hike of the short-term borrowing rate. At the June meeting, the Fed adjusted their 2018 forecast to include a total of four rate hikes in 2018, one more than previously insinuated. Chairman Powell stated “the decision you see today is another sign that the economy is in great shape” after unemployment fell and inflation exceeded their two percent target. The market has exhibited some anxiety about the Fed tightening monetary policy too aggressively. The move to more frequent press conferences and Powell’s “plain-English” style of delivery, as he coins it, is the Fed’s response. An updated dot plot (a projection by FOMC members of where the Federal Funds rate will be in the future) shows a median rate of 3.125% for 2019. In contrast to this perspective, the implied probability based upon futures trading is for a rate of approximately 2.5% as of mid-2019. This means the Fed is more optimistic for higher rates than what is currently being priced by the market. With the Fed’s new forecast of four hikes this year, we will keep a close eye on the market’s reaction as actual rate hikes transpire.

US Stock Market – Thus far in 2018, one in three trading days in the domestic equity market have experienced market movements of 1% or more. For perspective, the historical average for a full calendar year is a little over one in five trading days. Stated another way, if the volatility for the first half of 2018 continues for the remainder of the year the markets will have experienced more than three times normal volatility. While the S&P 500 has managed to turn positive for the year (2.65% YTD including dividends), the Dow Jones Industrial Average remains slightly negative (-0.73% YTD including dividends). The NASDAQ Index has recovered well from its pullback earlier in the year, gaining 6.61% in the second quarter (up 9.38% YTD including dividends).

Summary – I’m excited for the second half of the year to see what the Fed does and how the market reacts as well as watching to see if the increased volatility will continue. I anticipate the next Fed hike will occur at the September meeting, spread differential between 2- and 10-year Treasury yields will continue to fall and domestic equities will end the year higher than current levels.

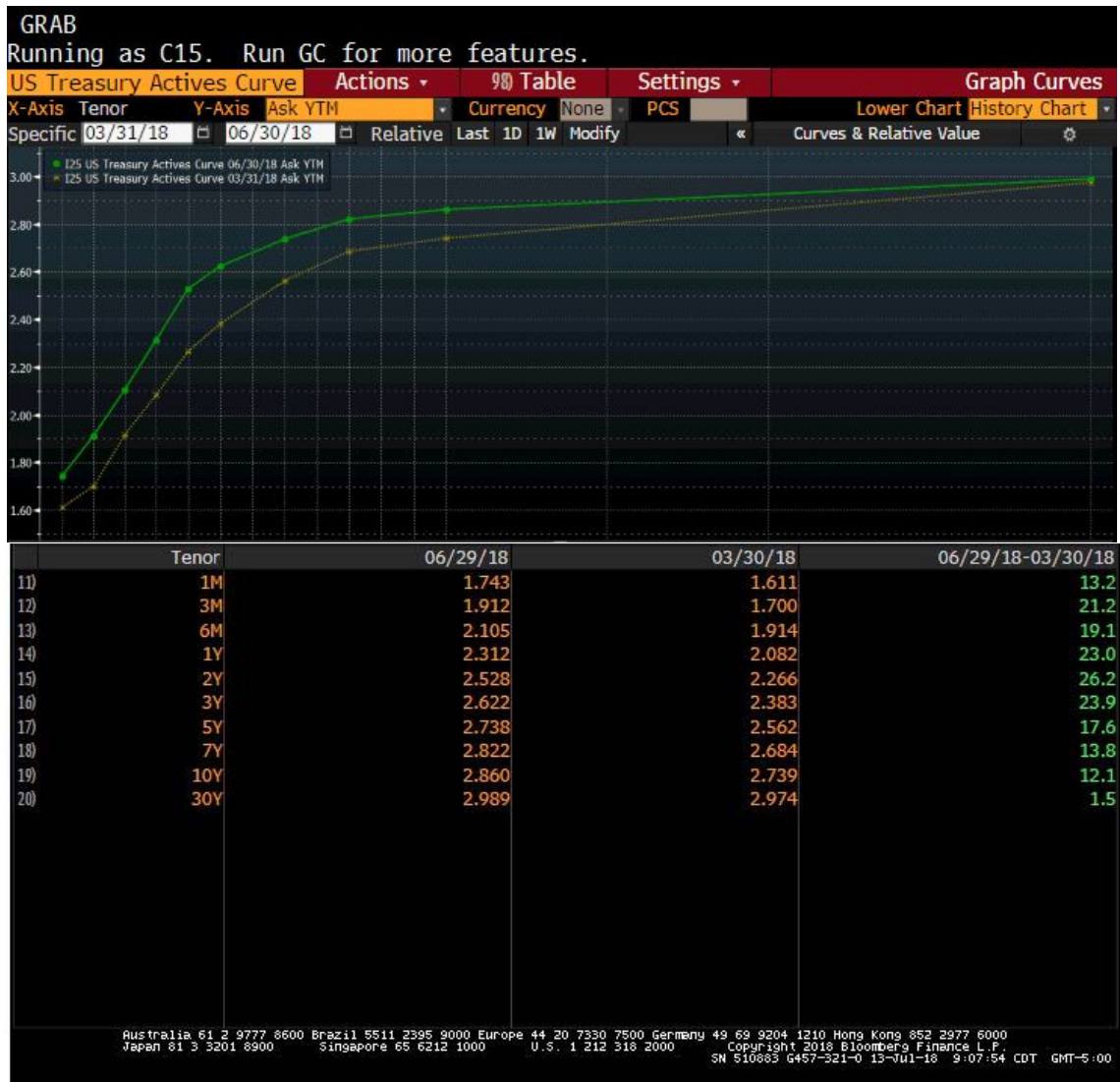
Interest Rate Spreads

As of: 6/29/2018

	Treasury	US Composite BVAL AA Curve		US Composite BVAL A Curve		US Composite BVAL BBB Curve		BFV USD Composite BB	
Term	Yield	Yield	Spread	Yield	Spread	Yield	Spread	Yield	Spread
1yr	2.33	2.586	0.256	2.761	0.431	3.014	0.684	4.0969	1.7669
2yr	2.52	2.862	0.342	3.038	0.518	3.319	0.799	4.5595	2.0395
3yr	2.63	3.028	0.398	3.224	0.594	3.545	0.915	4.9176	2.2876
5yr	2.73	3.281	0.551	3.453	0.723	3.879	1.149	5.4595	2.7295
7yr	2.81	3.499	0.689	3.669	0.859	4.192	1.382	5.9151	3.1051
10yr	2.85	3.738	0.888	3.914	1.064	4.499	1.649	6.3626	3.5126
20yr	2.91	4.056	1.146	4.323	1.413	4.913	2.003	7.0291	4.1191
30yr	2.98	4.14	1.16	4.277	1.297	4.842	1.862		

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US Treasury Yield Curve



S&P 500 Index



Dow Jones Industrial Average



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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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