How do you balance the search for yield while still being mindful of investment risk?
Prolonged low rates and tight spreads have forced insurers to counter the margin compression from declining portfolio book yields. That means looking beyond core and core-plus fixed-income holdings to specialty asset classes such as private corporate credit, private equity, commercial mortgage loans, collateralized loan obligations, emerging markets debt, and alternatives. However, these strategies must be guided by current allocations, and decisions around duration should reflect the insurer's liability profile.

Given the current yield environment, what are your views on corporate credit?
It's still attractive, but public investment-grade credit is not terribly appealing because of the tight spread environment.

Given that insurers were early adopters of private credit, what are the benefits of this asset class today?
Private credit transactions continue to offer extra spread compared with public credit offerings with a similar rating. Lenders also have more control over deal terms, such as including covenants that protect against adverse circumstances which can lead to better outcomes.

Do you see insurers’ mandates expanding to global markets?
Prudent selection of international securities in public and private credit markets can provide a desirable level of diversification. But this is a challenging strategy for small to midsize insurers, particularly with regard to emerging markets. Among the key questions: What countries are most promising? Do you invest in dollars or local currency? Should you buy corporates or sovereigns, or a blend?

How do you think about structured credit as a source of carry?
Commercial mortgage-backed securities and residential mortgage-backed securities can be attractive sources of capital-efficient investment spreads. The declining supply of new issues in some sectors is pushing investors toward pools of legacy assets. Skillful credit selection can unearth opportunities in structured credit that offer a meaningful yield advantage to NAIC 1 corporate credit.

What about commercial mortgages?
The relative capital efficiency of commercial mortgages is expected to continue to improve with expected changes to RBC C1 factors for corporate credit and offer an attractive opportunity for insurers who are willing to take on the incremental illiquidity risk. That requires understanding the risks associated with real estate over a long investment cycle.

Are there opportunities in private equities?
We are seeing insurers invest in assets that are already delivering a cash flow, and have the potential to improve performance, rather than new issues. Secondary private equity can be attractive when approached in a risk-controlled manner.

Turning to other alternatives, what is your view on allocations to this asset class?
Alternatives remain a source of potentially higher returns, which must be balanced against higher risks and capital. We believe allocations to alternatives should fit specific portfolio needs and focus on managing downside risk. We also see some insurers turning to collateralized loan obligations at the investment-grade and below-investment-grade levels. Insurers have typically allocated to senior tranches, and now we see them contemplating allocations to mezzanine, junior mezzanine, and equity as a part of their high-yield and/or alternatives allocations.

As a portfolio manager, how do you incorporate these themes into your strategies?
Insurers should position their portfolios to have the flexibility to adapt to changing market conditions and capitalize on a range of opportunities. This includes investment-grade and below-investment-grade credit within both public and private markets, core and transitional commercial mortgage loans, the evolving securitized sectors, as well as alternatives including private equity. Voya Investment Management takes a holistic approach to deal flow that positions us to analyze and capture a broad range of spread premium to risk-free assets that may not be available to managers with a more limited scope.

For more information about Voya Investment Management’s Insurance Solutions Group, please contact John Simone at 212-309-8413 or visit www.voyainvestments.com/institutional
A decade ago, a typical investment portfolio held by a U.S. insurance company primarily consisted of bonds and more bonds—a relatively predictable stream of income to cover liabilities without undue risk.

Since then, insurers have diversified their portfolios, increasingly turning to experienced firms to manage their allocations to equities, mortgages, private credit, real estate, and specialized asset classes.

“Insurers face the dual challenge of low rates and tight spreads,” says Michael Pagano, head of insurance portfolio management at Voya Investment Management. “Their legacy books of fixed-income securities deliver higher earned yields than those now available in the market. When those securities mature or are called away, or when they have new premium income, insurers should consider fresh approaches to reinvesting those funds in the market.”

Overall, U.S. insurers reported more than $5.8 trillion of cash and invested assets, on a book/adjusted carrying value (BACV) basis, for 2015, according to the latest figures from the National Association of Insurance Commissioners (NAIC).

However, approximately 67 percent of insurers’ assets consisted of bonds, indicating that many companies have taken a go-slow approach to broadening their investment mandates. But there is plenty of activity on the margins of insurers’ portfolios, creating new opportunities for third-party management firms.

“We are seeing many insurance companies increase allocations to equities,” says Don McDonald, president and CEO, Prime Advisors Inc., an affiliate of Sun Life Investment Management. “One reason is the overall rise in equity market values; but others are moving small amounts of their assets to this sector. They are willing to pay a higher capital charge for carrying equities in order to gain exposure to potentially higher returns.”

GROWTH IN OUTSOURCING

*More insurance assets are being outsourced and more investment managers are competing for those
U.S. INSURER CASH AND INVESTED ASSETS 2011-2015 ($BIL)*

<table>
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<tr>
<th>Year</th>
<th>Total</th>
<th>Preferred Stock</th>
<th>Real Estate</th>
<th>Derivatives</th>
<th>Contract Loans</th>
<th>Loans and Other</th>
<th>Term Inv.</th>
<th>Cash &amp; Short-Term Investments</th>
<th>Mortgages</th>
<th>Common Stock</th>
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*Includes affiliated and unaffiliated investments. Source: National Association of Insurance Commissioners

assets,” says David Holmes, principal, Insurance Asset Outsourcing Exchange, who surveyed 52 investment managers for a May study, “Increasing Competition in a Growing Market.” He found that insurance general account (GA) assets managed by third-party (non-affiliated) investment managers totaled $1.9 trillion globally as of December 31, 2016.

In North America, third-party managers posted a gain of 10.2 percent in assets under management (AUM) in 2016, according to the report. That was a strong turnaround from the 1.2 percent decline in 2015, which was caused largely by mergers and acquisitions and associated insourcing.

“Outsourcing continues to be a major theme among insurers, and we expect this trend will continue,” says Pagano. “Rather than building an in-house team in private credit, for example, insurers can engage a management firm that already has those resources in place on behalf of its own balance sheet or [that of] a third party.”

AN EVOLUTION OF STRATEGIES

Life, health, and property and casualty insurers are seeking tactical opportunities for additional yield from their fixed-income assets — an objective that may be supported by a third-party adviser. “Interest rates remain stubbornly low, and the intermediate and long end of the yield curve has remained low,” McDonald says.

He adds that it’s important for insurers to take a focused approach to duration risk. “That means modeling a custom portfolio with laddered maturities and cash flows that align with the liabilities of an insurance company,” he says. “That includes having cash available for a situation involving catastrophic claims.”

Along with seeking incremental gains on their core holdings, insurers have been expanding their mandates to new types of credit, equity, and alternative assets.

“Initially, the insurance industry looked at allocations to specialized fixed-income mandates like high-yield bonds, emerging-market debt, and structured products,” says Holmes. “But higher demand has compressed the spreads on high-yield bonds, which are not particularly attractive now on a risk-adjusted basis. More recently, insurers are investing in private equity and private debt, which are less liquid but can generate cash flows and a premium over public debt.”

To serve insurers’ growing interest in equities, McDonald’s firm recently created two separate account solutions. “As insurers looking at the equity sector can consider several strategies, we have developed both a passive strategy based on the S&P index and an active strategy focusing on large-cap stocks that pay high dividends,” he says. “Both approaches can reduce volatility and be tailored to an insurer’s specific investment needs.”

Pagano points out that the NAIC is revamping its risk-based capital requirements. “We are seeing increased allocations to structured credit, which is tied to the U.S. consumer,” he says. “With the pending changes in corporate credit charges, this strategy can be more capital-efficient, as well as offer opportunities for higher yields.

“In the private credit arena, we continue to see attractive global issuance from borrowers in developed and emerging nations,” adds Pagano. “In some cases, a lender that can purchase credit in the issuer’s local currency, rather than in U.S. dollars, can gain greater access to attractive deal flow. Depending upon the nature of the buyer’s liabilities, those returns may need to be converted into dollars on the balance sheet.”

Insurers seeking to capture risk premiums are also shifting funds into alternative asset classes, and tapping the specialized expertise of third-party managers. Holmes notes that newly outsourced allocations to alternatives grew from 12.5 percent in 2009 to 21 percent last year.

“Large and midsize insurance companies are also allocating higher amounts to the real estate sector,” says McDonald. “There are also opportunities in dollar-denominated commercial mortgages, and private placements in international markets.”

NEW RISK MANAGEMENT TOOLS

Along with broadening their exposure to alternative asset classes, insurers are deploying sophisticated risk management tools and models. “They are expanding their thinking to include geopolitical and enterprise risks, rather than continuing with a narrow definition of investment risk,” says Holmes. “That modeling may also call for broader exposures to nontraditional investments.”

Foley lauds insurers for moving beyond traditional portfolio diversification models in addressing today’s risks. “Diversification needs a stable asset correlation matrix in order to work,” he says. “But under severe market duress, those correlations collapse and traditional assets may move down together.”

Foley adds that insurers should strive to address the risk factors that can influence multiple asset classes, which he says is “a simpler and more intuitive approach to risk modeling.”

SPONSOR CONTENT
We talked to Don McDonald, chief executive officer of Prime Advisors, Inc., a Sun Life Investment Management company, about the changing asset management needs of insurance companies — and the solutions that can help ensure success.

How do the investment needs of insurance companies differ today from ten or 15 years ago?
Ten years ago, the yield on 10-year U.S. treasuries was 5.25%. Today, it’s about 2.38%. Lower yields have had a significant impact on the earning power of insurance companies. Not surprisingly, the write-downs of other-than-temporary impairment assets caused by the global financial crisis are still top of mind. So insurers are looking to enhance yields, but without the risk of write-downs from certain asset classes.

How are you responding to these needs?
We focus on maximizing after-tax returns and delivering above-benchmark total returns. But we know that customization is critical, so we’ve always developed separate account solutions for each client. This means we manage hundreds of portfolios, each with separate investment guidelines, benchmarks, and risk tolerances.

Second, in addition to our fixed income capabilities, we are extending our offering into other growth and yield-oriented asset classes. We have introduced a separate-account high-dividend, low-volatility equity solution, along with a separate-account strategy closely correlated to the S&P 500. We’re able to provide a one-stop shop for both the fixed-income and equity portions of a portfolio. In addition, through our Sun Life Investment Management sister company, Bentall Kennedy, we provide access to the higher yield potential of U.S. commercial real estate, through their real estate-focused investment advisory platform.

Much of the opportunity for our clients comes from the more efficient management of surplus. We’re additionally able to trade liquidity for higher returns through investment in real estate and other private asset classes.

Short-term rates are rising. Does that change some of the strategies you employ for clients?
Yes, absolutely. The two-year U.S. treasury rate was 0.55% a year ago, and it’s now 1.41%. Even cash, with yields close to zero a year ago, is now returning 50 to 75 bps. And, in the short maturity area of the yield curve, we anticipate interest rates rising another 25 to 50 bps over the next six months.

So while the yield curve is sloping up, the short end is up dramatically and it’s very important for us to minimize cash balances and focus on more active management of this short-term money. Even as rates rise, we’re able to gain better yields without a significant pricing impact due to the shorter maturities of these assets.

How do you measure success for your clients?
Every client has a different definition of success, whether it’s stated in their mission statement or their investment guidelines. For us, it’s really about delivering on these different expectations. A huge part of our success is that we’ve exceeded benchmark performance for eight years in a row. What differentiates Prime is our strategy to maximize after-tax total returns, with no surprises. We do what we say we’re going to do, and we do it in a timely manner. As a result, we have an exceptionally loyal client base — their success truly is our success.

For more information about Prime Advisors, Inc. and its offerings, please visit www.primeadvisors.com.


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