Insurance – the third dimension

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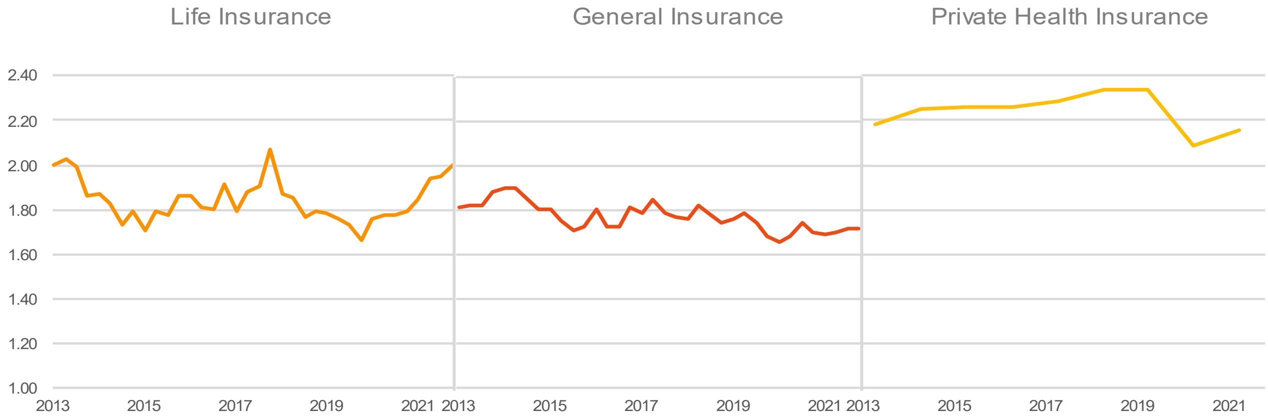
Investment strategies to manage evolving market conditions

Lower real yields from bonds over recent periods, a wider and increasingly sophisticated range of fixed income instruments, and underwriting challenges presented by climate change and population shifts, have all contributed to an increased focus and greater importance on investments results achieved by insurance companies. In this article, we examine suitable investment strategies for insurers to deal with evolving market conditions.

Monetary policy measures globally, initially following the post-GFC global recession and more recently in response to the COVID-19 pandemic, have led to lower real yields. Insurers are now entering a period of rising cash rates designed to deal with significantly higher inflation and the end of quantitative easing.

While underwriting profitability has suffered, solvency ratios for APRA-regulated insurers have remained resilient over time.

Chart 1: APRA-regulated solvency ratio



Source: APRA, Frontier.

Investment strategies generally vary for different types of insurers in line with the nature of their underlying liabilities, ranging from very short (private health insurers), relatively short (general insurers), and long (life insurers). Additionally, unregulated insurers, typically government insurers, tend to have longer-tail liabilities and typically positive cash flow profiles.

Given the short-term nature of liabilities, general insurers have continued to use fixed interest to ensure funds are available to meet liabilities as they fall due. At the same time, yield curve strategies, essentially mis-matched bond portfolios, and other forms of diversification not envisaged only a few years ago are being used to enhance returns. Diversifying assets include bank loans, some credit - predominantly investment grade and largely floating rate, and even private debt.

Similarly, private health insurers' portfolios have been dominated by fixed income and cash, though there has also been some recent diversification within portfolios.

Overall, we believe short duration insurers will benefit more from rising rates, with cash flows providing the opportunity to rebalance across the liability profile to higher yielding bonds. Although, identifying strategies to deal with the prospect of higher inflation continues to be important.

Pressure to generate higher investment returns is likely to come from higher claims inflation where the usual response of lifting premiums might undermine an insurer's competitiveness. General insurers however, can more readily reprice premiums compared to government insurers who operate in a more politically sensitive environment.

We have also seen general insurers moving into real assets in preference to other inflation hedges such as inflation-linked bonds. In a rising interest rate situation, drawdowns will result from the long duration nature of inflation-linked bonds. We have also observed people considering inflation-protected assets like commodities and infrastructure. Infrastructure is an attractive asset class for insurers; it has returned a bit short of equities over the long term, however capital asset charges are significantly less, and returns are likely to have some inflation protection from regular income.

The critical third dimension of any discussion on the investment of insurance assets is the requirement to choose an investment strategy that generates excess returns but also represents the efficient utilisation of capital. The degree of diversification in the minds of the insurer may well depend on their Prudential Capital Ratio target.

While shareholder funds facilitate diversification against the technical reserves (policyholder) portfolio, we have observed a trend to consider a 'whole of company approach' when investing. One example is investing in private 'insurtech' companies. The aim of these types of investments is not just to generate additional (private equity) returns, but to fund solutions which could reduce the claims handling expenses or improve operational efficiency.

At the Frontier annual conference earlier this year, delegate David Harley suggested life insurers should fund medical research in areas where pharmaceutical companies have little incentive for the use of off-patient medicines and combinations, to improve morbidity and mortality risks.

Despite enthusiasm for diversification, the requirement to balance return, risk and capital demands a thoughtful allocation of capital. During the March 2020 COVID-19 downturn, life insurers materially de-risked their equity portfolios from about 50 per cent to 20 per cent of portfolios to maintain their PCRs. Unfortunately, these equities exposures were typically not reinstated to take advantage of the subsequent rally and therefore essentially locked in low returns for the year.

Frontier's internally developed 3D risk surface tool helps show potential efficient strategic asset allocations for insurers, optimising for risk/return outcomes for a given level of capital.

The final word

A key question for insurers is what a traditional fixed income portfolio looks like when yields reach more normal levels, which will depend on where inflation settles. If inflation normalises at around 3 per cent and cash rates are 4-5 per cent, insurers' liability matching strategies will be easier to balance.

In the meantime, insurers will need to apply the more sophisticated strategies discussed in this article to maintain profitability.

Author

Cecily Williams, Principal Consultant

Cecily joined Frontier in 2022 as a Principal Consultant and provides consulting support to clients in the insurance and superannuation sectors. Prior to joining Frontier, Cecily spent close to 25 years with Mercer, including a period as Head of Retail Consulting. Over that time she was lead consultant for a number of Mercer's major clients across several segments. Prior to Mercer, Williams worked for ten years at NSW Treasury Corporation, and Share Analyst with MLC. Cecily holds a Bachelor of Economics from James Cook University.

To learn more, get in touch with Cecily on cwilliams@frontieradvisors.com.au

Frontier

Level 17/130 Lonsdale St, Melbourne VIC 3000

Tel +61 3 8648 4300

frontieradvisors.com.au

@frontier_adv