The Frontier Line

Asset allocation for liability aware investors

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Frontier Advisors
Forefront Thinking

About Frontier

Frontier Advisors has been at the forefront of institutional investment advice in Australia for over 25 years and provides advice on over $600 billion of assets across the superannuation, charity, public sector, insurance and university sectors.

Our purpose is to empower our clients to advance prosperity for their beneficiaries through knowledge sharing, customisation, technology solutions and an alignment and focus unconstrained by product or manager conflict.

Joanna Yang

Associate

Joanna Yang joined Frontier as an Associate in 2021 and is a member of the Liability-Driven Investment Team.

Prior to joining Frontier, she worked at EY for two years in the Government and Public Sector Actuarial and Transformation team and one year in the Banking & Capital Markets team providing analysis and advice to various clients across the health, human services and banking sectors.

Joanna holds a Bachelor of Science (Mathematics and Statistics) and Masters of Actuarial Science from the University of Melbourne. She is currently completing her qualification to become a Fellow of the Institute of Actuaries Australia.

Introduction

This paper explores asset allocation themes among Australian state and territory-based government, liability aware investors. These insurers are not regulated by APRA and typically manage long-tail liabilities. Most are compulsory third-party (CTP) and workers' compensation schemes. Our analysis is based on publicly available data at 30 June 2022.

Government, insurance schemes not regulated by APRA are typically characterised by:

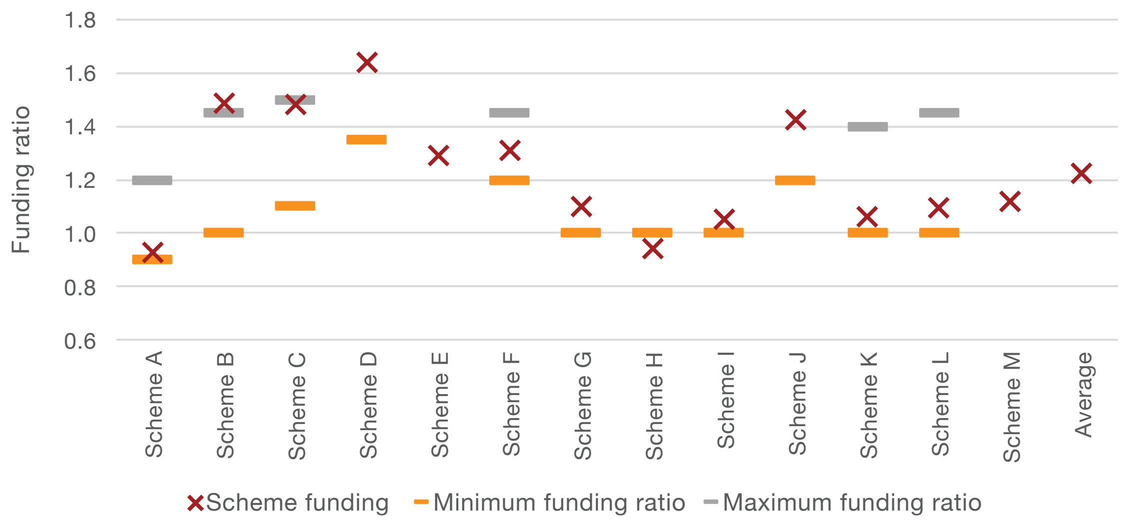
- A longer-term investment horizon, in part because of the long duration of their liabilities and their sensitivity to changes in inflation and superimposed inflation.
- Additional flexibility in investible asset classes that may be prohibitive under APRA's Life and General Insurance Capital Standards (LAGIC), such as equities, real assets and alternatives.
- A higher willingness to invest in markets overseas and a higher propensity to invest in illiquid asset classes due to their zero-tax status and positive cash flow profile.

While there is a broad spectrum of government insurers, they ultimately have the same underlying objective – to maintain a sufficient level of solvency or funding to meet their obligations as they fall due while maximising real returns over the long term. In this paper, schemes and investors are used interchangeably.

Current strong positioning

Most Australian government insurers are in a strong financial position with funding ratios within target bands. The majority of schemes, illustrated in Chart 1 have long duration liabilities and a reliable and steady premium income which enables them to target a lower funding ratio than many of their private counterparts. In addition, these schemes are backed by an implicit state or territory government guarantee, which provides them with a backstop in the event of funding challenges. The willingness to activate this source of funding varies materially as evidenced by the range of the scheme funding targets. Conversely, if schemes are very well funded, governments can extract funds in the form of a dividend.

Chart 1: Funding ratios FY22



Source: 2022 annual reports. Note: there are some schemes with no minimum or maximum funding targets.

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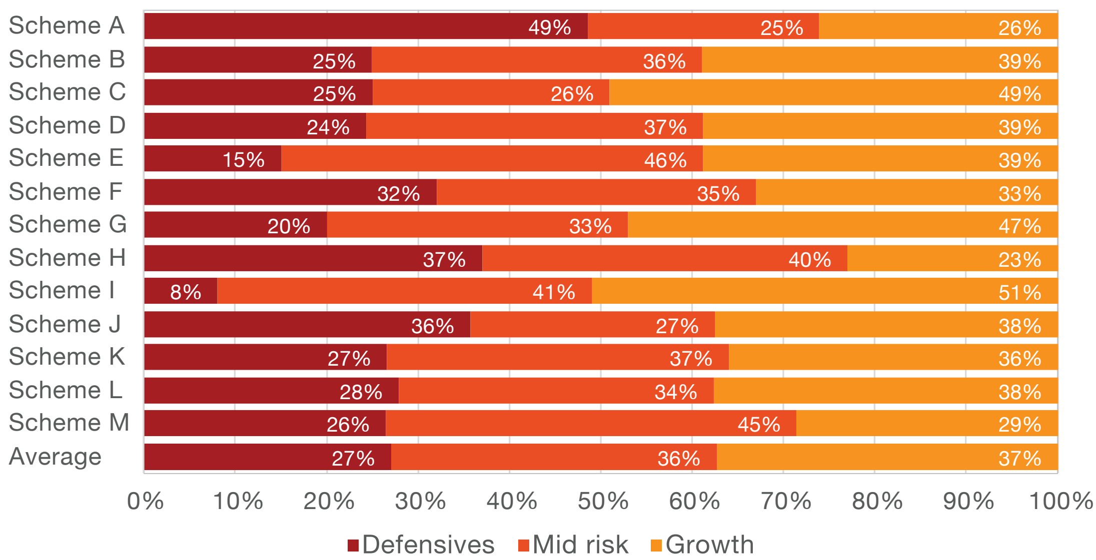
Asset allocations

In recent years, there has been a progressive shift towards more growth and mid-risk investments over defensive fixed interest assets. This has resulted in a move away from the traditional asset-liability matching approach, in which investment portfolios attempt to match liability cash flows or duration with high-quality nominal and inflation linked bonds. However, as seen in Chart 2, not being APRA regulated allows these schemes the flexibility to invest in higher risk asset classes more readily as they are not subject to asset risk charge restrictions, which eliminates the need to maximise regulatory capital efficiency. The stability of premium income; long duration nature of the liability profiles; long-term time horizons; and generally strong funding positions, allows these schemes to withstand shorter term investment result volatility more easily.

These schemes typically target a return objective of between CPI + 2% to CPI + 5%. The increased allocation to riskier assets has been beneficial for investment returns in a period where low interest rates prevailed. While the allocation of defensive asset classes varies significantly, the average allocation to fixed interest and cash across the schemes is just over 25%.

Chart 2: Asset allocation growth/defensive split FY22



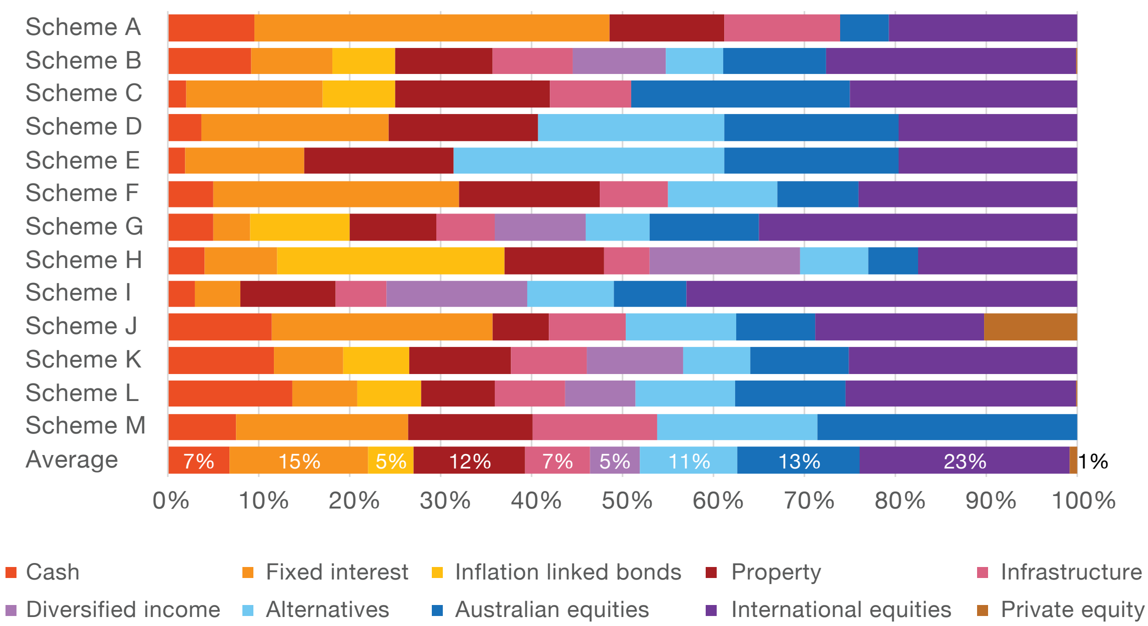
Source: 2022 annual reports.

Chart 3 shows a more granular breakdown of portfolios by asset class.

Interestingly, all schemes have a significant portion, almost 25% on average, invested in international equities despite managing domestic only liabilities. This is because there is no tax benefit of a home country bias to Australian equities (unlike for superannuation funds or tax-exempt investors) and no restrictions on holding domestic assets. Therefore, government insurers are free to allocate to their preferred equity markets on a risk-adjusted basis.

Additionally, there is continued growth in what we consider mid-risk asset classes such as unlisted property, unlisted infrastructure and private credit. In their favour, government schemes generally have a higher tolerance for illiquid assets and can take advantage of their cash flow duration profile. There is growing confidence these investments can provide a hedge to domestic inflation while offering a positive real return over time. In the case of private credit, schemes are attracted to the floating rate nature of the underlying securities. To invest in mid-risk assets, some schemes have had to improve their corporate knowledge, particularly of infrastructure which is beginning to supersede historical allocations to property. With few exceptions, investments in mid-risk assets are being funded by inflation linked bonds, nominal government bonds and some equities.

Chart 3: Detailed asset allocation FY2022



Source: 2022 annual reports.

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The final word

As we move toward a more normalised interest rate environment where risk-free rates are higher, it remains uncertain whether schemes will move back to a more traditional asset liability matched approach, or whether they will experience the benefits that additional diversification from mid-risk and growth asset classes can bring to their portfolio.

While rising interest rates and higher bond yields make traditional fixed interest assets more attractive, the previous scarcity of institutional quality alternative investment ideas pushed schemes into traditional asset classes. Going forward, we expect further diversification, with the opportunity in new asset classes likely to continue to tempt investors in the future.

Want to learn more?

Frontier Advisors has experience working with a range of government insurers across a number of states and territories helping create diversified portfolios, fit for both the current and future investment environment. Please reach out to our dedicated LDI & Government Team if you would like more information on how we can help you customise your portfolio.

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