The Frontier Line

Stronger investment returns for insurers

Issue 220 | February 2024

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Frontier Advisors | Forefront Thinking

About us

Frontier Advisors has been at the forefront of institutional investment advice in Australia for over 25 years and provides advice on around $660 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.

AUTHOR

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Principal Consultant

Elie joined Frontier as a Principal Consultant in June 2018. Elie works in a specialist client consulting role, leading the liability driven investor and government client segment. He joined Frontier from Mercer where he spent 10 years as an investment consultant. Most recently he was the Head of Mercer's Consulting practice in Melbourne and a member of the Institutional Wealth Leadership Team. Prior to this Elie worked at Lanteri Partners Group Wealth Management and UBS Wealth Management and brings with him a total of 18 years of experience. Elie has a Masters of Applied Finance & Investment, a B.Comm (Economics) (Hons) and a BA (Psychology & Sociology) from Deakin University and is RG146 compliant.

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, Cecily worked for ten years at NSW Treasury Corporation, and Share Analyst with MLC. Cecily holds a Bachelor of Economics from James Cook University.

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Our observation of investment trends in 2023

Insurance companies enjoyed positive investment returns in 2023 as the benefit of higher bond yields flowed through to portfolios. This follows a long period of low returns and unrealised capital losses on longer duration bond holdings as yields rose from historic lows.

According to data published by APRA, the 2023 financial year experienced higher investment returns compared to the 2018 financial year. We compared these returns to recent Australian CPI prints to show how, despite improved returns over 2023, the high rate of inflation, followed by higher yields made it difficult for investment portfolios to keep pace. This is a very different experience for insurers compared to the last five years where inflation was historically low and bond yields offered a stable return above inflation.

While higher yields generate higher returns (from bond portfolios), the downside is that they are a response to higher inflation and a headwind to real returns. Looking ahead, despite an inverse yield curve, we have anecdotal evidence that insurers expect inflation to be transitory and have been cautiously lengthening duration to lock in higher yields in anticipation we have reached a peak in the rate cycle.

In 2023, we assisted many insurers to review or appoint new bond managers as they increased their fixed interest allocation, typically funded from cash or growth assets.

Within fixed interest, our clients added allocations in high quality domestic and international credit, around AA or better, to enhance yield (relative to government bonds) on what was widely considered to be on attractive risk adjusted terms.

Additionally, we observed continuing interest and investment in private debt markets by most insurers. As private debt investment strategies launch, insurers have looked to the asset class as it offers attractive yield, supported by strong structural protection and beneficial capital treatment as an attractive alternative to equities. The trend to investment in private debt does not appear to be abating.

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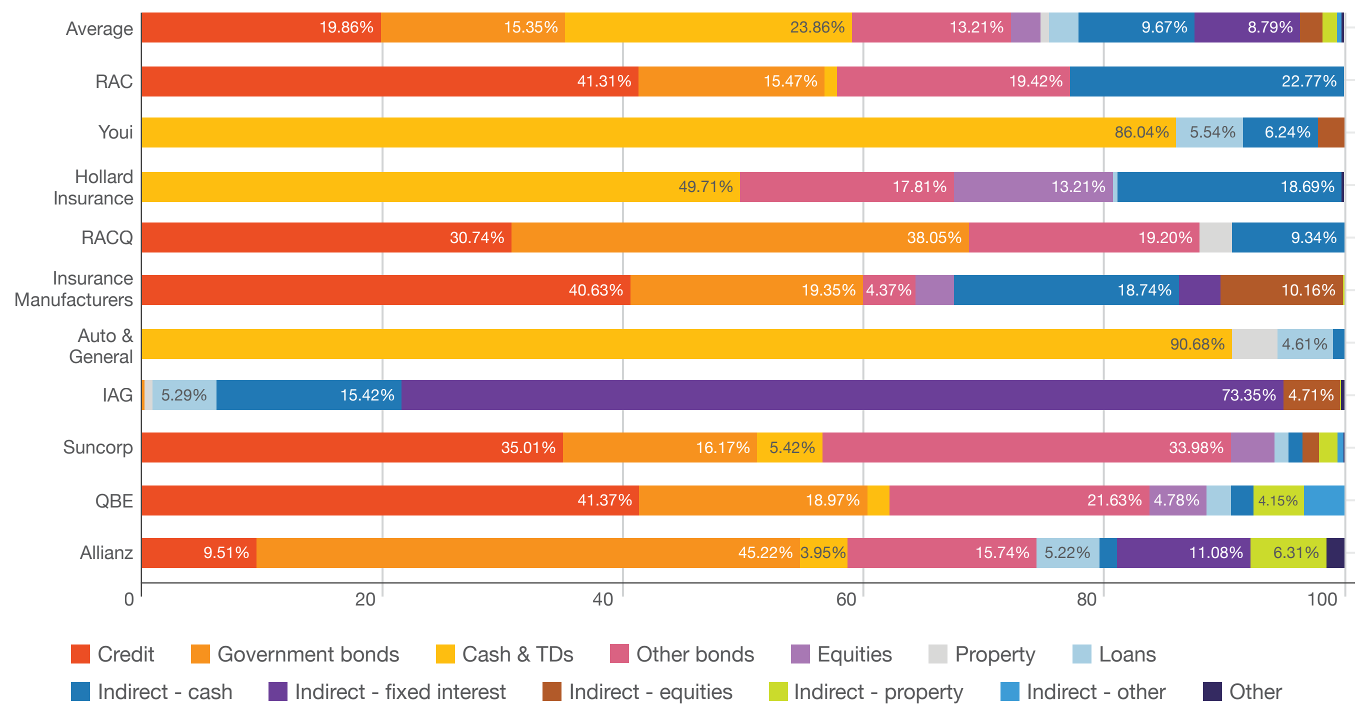
Seven of the ten general insurers have a meaningful investment in credit, while indirect fixed interest appears in four portfolios with one insurer, IAG, classifying almost all its fixed interest exposure as 'indirect'. This allocation can be compared to the aggregate of credit, government bonds and other bonds.

Chart 1: Investment portfolio split by direct and indirect asset classes (%) as at June 2023



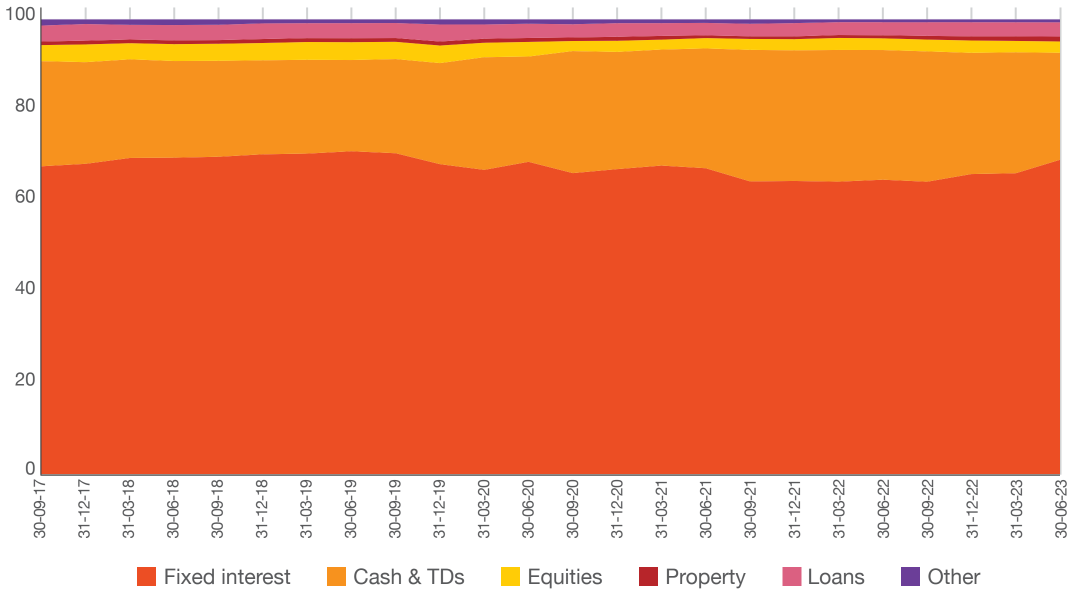
Source: APRA

Note: Values below 3.95% are intentionally omitted from the chart labels for better visual clarity.

From an asset allocation perspective, as bonds regain their appeal, insurers slightly reduced their allocation to equities. This strategy may prove fruitful in a scenario of higher for longer rates, or conversely, an economic downturn if monetary policy has tightened beyond that which produces a soft landing.

In the general insurance space, data reported by APRA shows a modest reduction in the allocation to equities over 2023, as expected.

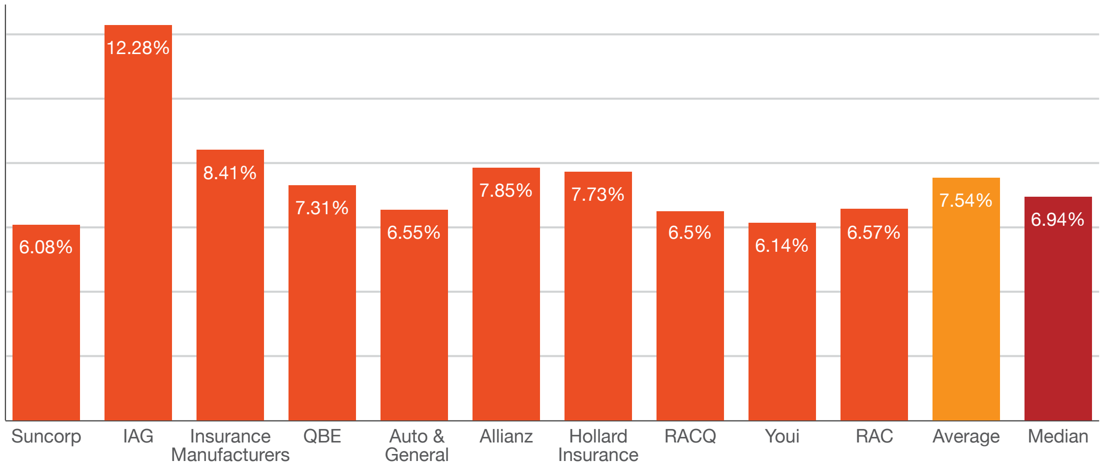
Chart 2: Average investment portfolio split over time by asset class (%)



Source: APRA

An increase in insurers' asset risk charges (likely credit risk) as a percentage of the investment portfolio reflects the move away from government bonds and cash into riskier, but higher returning fixed income assets.

Chart 3: Asset risk charge to investments ratio (%) as at June 2023



Source: APRA

Longer dated insurers' ongoing interest in unlisted infrastructure has continued, driven by healthy returns and an inflation linked cash yield, however accessing suitable opportunities at an appropriate price is important to long-term success. Many opportunities are emerging in the energy transition and decarbonisation space. Our clients are talking about the opportunities which might open up as Australia and other OECD countries transition to a low carbon economy.

While insurers have climate change top of mind, and a desire to implement ESG policies, we have seen only developing interest in investing in green bonds. The hesitation stems from a scarcity of underlying projects which generate a risk and return profile suitable for an insurance company. Companies may also want to ensure they can deliver on any green commitments to stakeholders.

The final word

A more normal interest rate environment is offering opportunities for insurers to reposition portfolios back toward lower risk asset classes and further segment fixed income portfolios into more meaningful buckets including private debt.

The recent shift in market conditions demonstrates how important it is that insurers review their risk appetite, investment strategy and test portfolio construction ideas on a regular basis.

Want to learn more?

Frontier Advisors has experience working with a range of 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 with your portfolio.

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Frontier Advisors is one of Australia's leading asset consultants. We offer a range of services and solutions to some of the nation's largest institutional investors including superannuation funds, charities, government / sovereign wealth funds and universities. Our services range from asset allocation and portfolio configuration advice, through to fund manager research and rating, investment auditing and assurance, quantitative modelling and analysis and general investment consulting advice. We have been providing investment advice to clients since 1994. Our advice is fully independent of product, manager, or broker conflicts which means our focus is firmly on tailoring optimal solutions and opportunities for our clients.