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Viewpoint

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Combating Higher Volatility with a Managed Dividend Equity Strategy

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Volatility appears to have returned to equity markets, adding the problem of additional risk to many insurance portfolios. Conning's High Dividend Equity (HDE) strategy may be a solution.

After a long period of lower-than-average readings, the Chicago Board of Exchange's Volatility Index (or VIX, a widely accepted measure of market volatility) spiked to levels in early February that it had not reached in years. Perhaps more importantly, the VIX seems to be settling at an average level more in line with the level seen over the past 25 years. While rising volatility may represent a return to normalcy, it can also exert downward pressure on equity prices.

However, there may be some relief from this renewed volatility for insurance companies that invest in equities: insurers using passively managed index strategies may benefit from a managed strategy focused on a narrow universe of equities that pay high dividends.

Conning believes many insurers benefit from some level of equity exposure, but we are also sensitive to an insurer's need for income and downside protection. We believe these needs can be addressed through our HDE strategy, which invests in a select group of equities that have consistently paid higher dividends than the broader universe of stocks and have provided solid capital growth.*

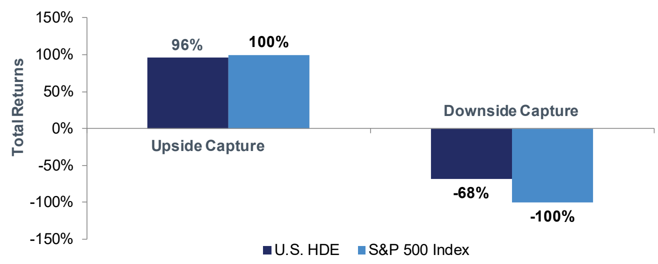
Conning's HDE strategy leverages our deep expertise in credit research, which provides us with a distinct perspective on company fundamentals. The firm's disciplined screening process of the HDE investment universe identifies high quality companies that have paid a consistent dividend and also have the potential to grow their dividend. These companies are generally higher quality, lower leverage firms with strong leadership teams that have managed their businesses successfully through multiple credit cycles.

While their price performance may trail the broader universe of stocks in up markets, these companies historically have experienced less downside risk than the broader market.

Lower Volatility, Competitive Performance*

A key goal for insurance equity investors is to capture market gains while limiting exposure to losses, a goal Conning's HDE strategy has historically met. Since inception on Jan. 1, 2011, the strategy has captured 96% of the gains of the S&P 500 Index while experiencing only 68% of its losses (see Figure 1).

Figure 1 U.S. HDE Upside/Downside Capture Ratio*



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Conning's HDE strategy is a focused portfolio of between 40 and 60 equally weighted names. In general, an unmanaged equity index such as the S&P 500 Index must own capitalization-weighted positions of a broad cross-section of companies in its market, regardless of their fundamentals. As a result, while a passive index may experience the upside of successful companies, it keenly experiences the downside of struggling companies as well. By equally weighting our quality companies, Conning's HDE strategy seeks to avoid the risk of a single large company severely compromising performance.

Credit Expertise is Differentiator

Conning's credit expertise, built upon decades of experience, differentiates our equity investment process from

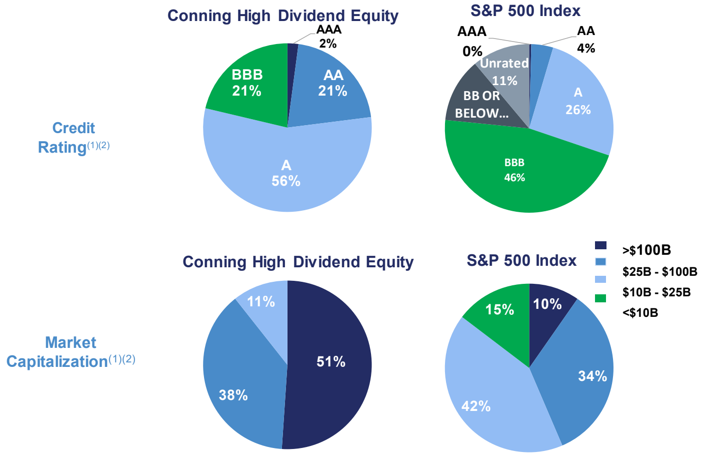
*Past performance is not a guarantee of future results.

most. HDE companies must pass thresholds for free-cash-flow generation and historical dividend-payout consistency. We also analyze them from a balance-sheet perspective with an eye on debt, as a company's leverage can have a direct impact on its ability to pay dividends and manage long-term dividend growth.

In addition, companies that fit Conning's HDE investment requirements are often managed by strong, highly experienced teams, and the added flexibility of lower leverage allows them to add shareholder value in many ways, such as dividend increases, share buybacks, accretive M&A activity, or prudent re-investment in their businesses.

Insurers allocating to a strategy such as HDE with its significant percentage of large, highly rated firms may also help raise the quality of their overall portfolios (see Figure 2). The broader equity universe will typically not offer such a strong concentration of high-quality companies.

Figure 2 Conning HDE vs. S&P 500 Index



Prepared by Conning, Inc. Source: ©2017 FactSet Research Systems, Inc. - used with limited permission. 1. Based on equal-weighting; 2. Based on S&P Ratings.

Diversification, Tax Advantages and Income

Insurance portfolios largely allocated to fixed income may gain diversification through an allocation to HDE, not just in terms of asset class but also in terms of company exposure, as some of these financially strong companies are not frequent bond issuers.

Insurers may also benefit from an HDE allocation if they are eligible for tax savings by owning the dividend-paying stocks of other companies via the dividends-received deduction (DRD). With inflation possibly lurking, an equity allocation may also be a useful inflation hedge as well.

Conning notes that dividend-paying strategies like HDE are not meant to be a bond-income replacement for an insurer's portfolio. Rather, we believe HDE may be a better fit for an insurer than a broader equity strategy, and insurer portfolios may benefit from equity exposure for its diversification, inflation hedging and growth potential. We believe a high dividend equity strategy makes the most sense among equities given its historically lower volatility, relatively higher income and tax-savings potential.

Optimism for Growth

U.S. economic forecasts are generally calling for continued growth. A growing economy tends to drive higher equity prices and allow companies to grow dividends. While interest rates have risen recently (and more short-term increases are expected to be part of U.S. monetary policy) rising rate environments are not necessarily bad for stock prices. In fact, equity markets tend to do well in a rising rate environment, as long as the rise in rates is not linked to a spike in inflation.

We believe the HDE strategy can help insurers meet their goals by providing:

» lower volatility than a passive equity strategy
» downside protection versus the broader equity market
» a tax-saving opportunity through the DRD
» diversification to a fixed-income heavy portfolio*
» potential capital appreciation in a rising rate environment.

Conning (www.conning.com) is a leading investment management firm with a long history of serving the insurance industry. Conning supports institutional investors, including pension plans, with investment solutions and asset management offerings, award-winning risk modeling software, and industry research. Founded in 1912, Conning has investment centers in Asia, Europe and North America.