Alternative Paths: Alt Assets May Offer Insurers Greater Yields, Returns and Risk Management

By Richard L. Sega, FSA, MAAA, Global Chief Investment Strategist

For more than a decade, insurance companies have sought greater yields than the near-zero interest rates offered by traditional fixed-income strategies. Many have found opportunities in alternative strategies, or “alts.” Is this a road other insurers should consider?

There are many forms of alts spread across the investment landscape. Some fit the perception of alts as being further out on the risk curve, but several alts can help reduce portfolio risk. To decide if alts are an appropriate investment, it’s important for insurers to know their investment goals and what portfolio issue must be addressed. How much risk is the insurer comfortable with? And if an insurer ventures into new investment territory, does its staff have the asset management skills, knowledge of the regulatory framework, accounting skills and more to include alts in the portfolio successfully?

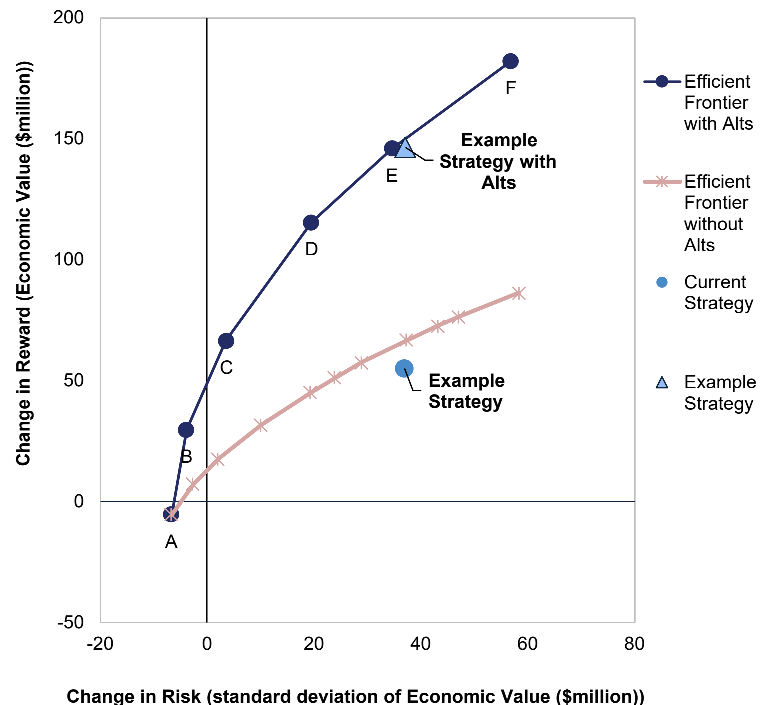
Conning believes alts may offer insurers a greater menu of investment choices to help further diversify a portfolio, generate greater yield and return, and improve downside protection. In Figure 1, an efficient frontier analysis shows the potential difference in the risk/return for a portfolio with alts vs a portfolio without alts, illustrating the opportunity to enhance economic value by considering the risk-adjusted return benefits of incorporating alts into portfolios.

We also think that, as with any investment selection, an alt must align with an insurer’s investment strategy. However, if insurers can learn how to assess the array of suitable investment options, the education and experience gleaned in the process could pay greater dividends down the road.

A Rich and Varied Asset Class

When thinking of alts we commonly think of *asset types*, like below-investment-grade fixed income (both developed and emerging markets), hedge funds, private equity, real estate, commodities, currencies, and derivatives. Even further out on the risk spectrum are distressed assets, fine art, non-fungible tokens (NFTs), and cryptocurrencies. There are also alternative strategies, such as absolute return, multi-strategy, factor-based, and quantitative methods.

Figure 1 Efficient Frontier Analysis – Portfolio with Alts vs. Without Alts [1]



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Conning modeled a sample insurance company’s financial statements in ADVISE® Enterprise Risk Modeler using ©2021 S&P Global Market Intelligence (see below). Future underwriting results were modeled using assumptions developed by Conning. Reward is the change in average projected economic value earned by various modeled investment strategies over the multi-year horizon for 1,000 scenarios. Risk is the change in standard deviation of economic value. Economic value is the market value of assets less the present values of liabilities plus the present value of operations beyond the horizon.

While we tend to group them in portfolio asset allocations, alts comprise a rich and varied set of investment opportunities and challenges. They derive their value and performance characteristics from just about every corner of the global economy.

For Insurers, Additional Considerations

Varied as they are, alts have several common features that offer both advantages and drawbacks.

The main attraction is the ability of alts to expand the investible universe and potentially improve a portfolio's risk-reward potential.

At the same time, a few features often concern investors. These traits are not universal, and not all alts exhibit them all the time, but generally:

- Alts have limited liquidity
- Alt strategies often lack transparency
- They charge fees significantly higher than those for core assets.

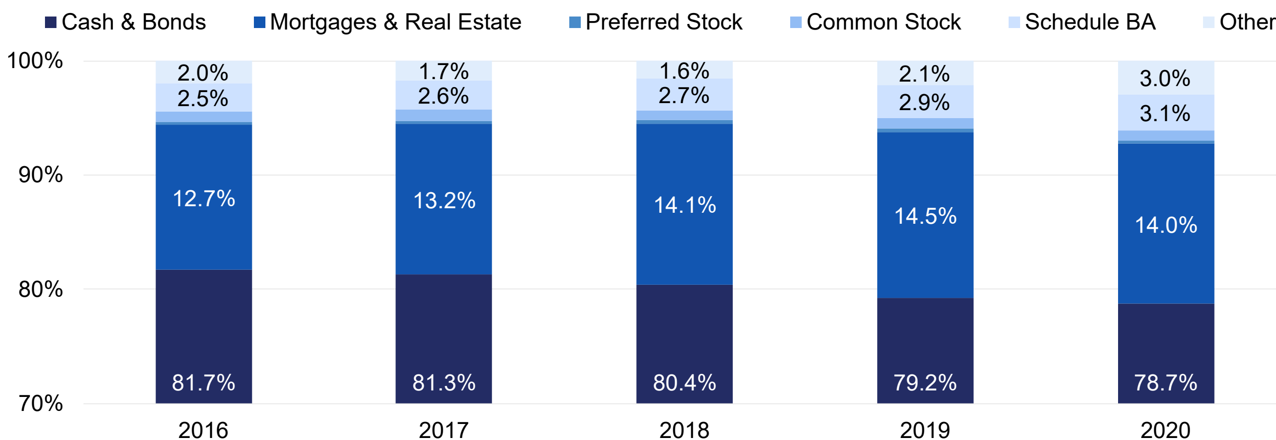
Insurers often have additional considerations with respect to alts:

- Alts typically are subject to regulatory limits and required disclosures
- Alts attract high capital charges.
- Accounting and tax calculations may be unfamiliar
- Board approval may be required and investment guidelines may need to be amended
- Alts need specific risk-management techniques, data, and systems for monitoring and reporting positions and activity
- Alts tend to trade in specialist markets, so outsourcing to appropriately skilled asset managers is often prudent.

The tug-of-war between the desire for better income and returns versus the operational friction of educational, regulatory, informational, and procedural challenges has held the insurance industry back from diving headlong into the asset class. While alt allocations among U.S. insurers are still currently in the low single digits, they show signs of increasing as a percentage of insurance portfolios. Holdings in long-term bonds decreased over three percentage points from 2016-2020 (see Figure 2).

For example, long-term bonds and cash holdings for life insurers still represent the highest allocation of their portfolio assets compared to other broad asset classes (together over 78% of investable assets). However, allocations to bonds and cash have been decreasing, primarily driven by a decrease in holdings of long-term bonds. From 2016 to 2020, the life industry overall has shown a decrease in bond holdings and an increase in mortgages.

Figure 2 Life Industry Allocation by Asset Class (as % of Investable Assets)



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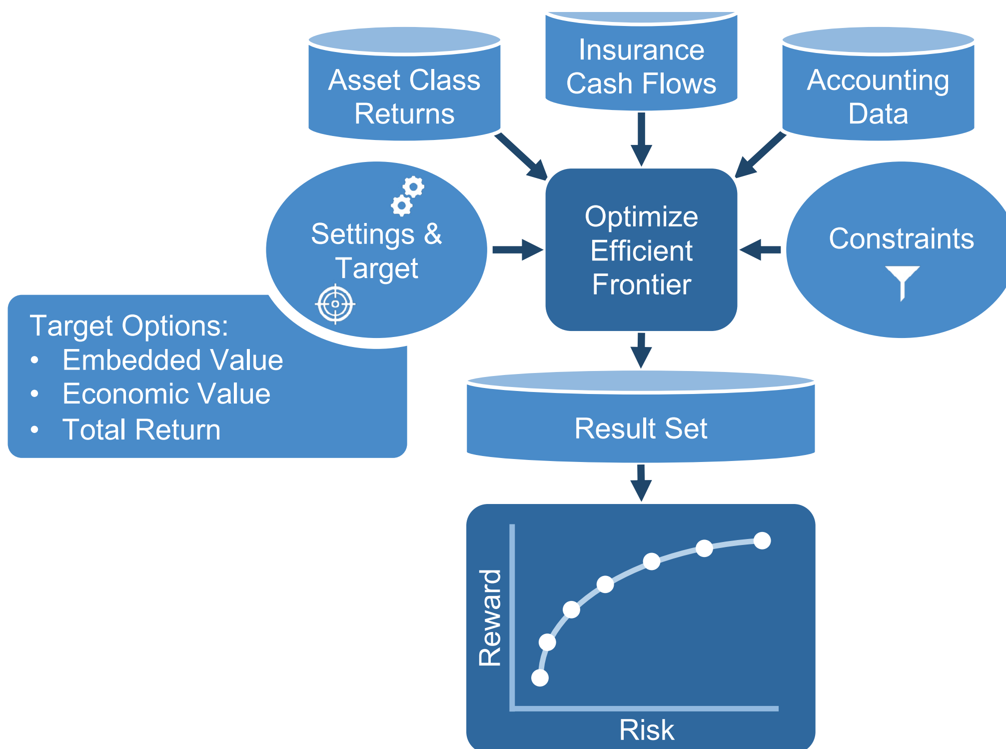
In 2021, however, it is primarily the largest insurers making this shift. Insurers with less than $1 billion in assets are more dependent on bonds in their asset portfolios.[2] Even with an increase to mortgage holdings, bonds remain the predominant asset class for the life industry.

The Learning Curve May Pay Dividends

In 2021, many alt assets have been outperforming more traditional insurance portfolio fixed-income assets, such as cash and treasuries. Selecting appropriate alternative assets requires careful assessment of an insurer's goals, portfolio structure, risk tolerance, and ability to effectively manage the assets, as well as an understanding of how the assets have performed historically during various market conditions. A strategic asset allocation analysis can be a valuable step in helping insurers set the strategic targets of their portfolios (see Figure 3) and can also offer guidance in terms of what types of assets to add - and what to avoid.

Figure 3 Basic Strategic Asset Allocation Analysis Framework



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For smaller and mid-size insurers who don't have the capabilities or desire to manage an alt asset, external managers can help with this assessment. However, due diligence in this step is crucial, as performance disparity is far greater among alt managers than in traditional asset classes. Insurers will want to know if a manager's current return is a measure of alpha (manager outperformance) or beta (volatility) and ensure they are not paying alpha fees for beta performance. The portfolio exposures may be small, but a poor experience with an external manager could hamper the longer-term opportunities for portfolio growth if it makes an insurer hesitant to widen its investment universe.

For many insurers, the alts consideration is an attempt to improve yields. That begs the question of what may happen when and if interest rates return to "normal," i.e., higher: Will the trend into alts subside if insurers' goals can be met by more traditional means?

There might be some pullback if it becomes easier to cover margins again with high grade fixed income. However, after insurers educate their board members, establish accounting, reporting, and risk management procedures, and benefit from diversification, it's likely they will continue to invest in alternative assets. The potential benefits of an expanded investible universe may be too good to walk away from in the future.

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