ConnText Podcast

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TRANSCRIPT

Insurers' Investment Risk Attitudes with Matt Reilly, Head of Insurance Solutions

Conning ConnText is a quarterly podcast that features our firm's view of capital markets, trends and investment strategies for the insurance industry, hosted by Rich Sega, Conning's Global Chief Investment Strategist.

[OPENING MUSIC]

SEGMENT 1 – OPENING

[Rich Sega (RS)]

Hi, I'm Rich Sega. Welcome to the Conning ConnText podcast for the first quarter of 2024.

Today I'm joined by Matt Reilly, Managing Director and head of Conning's Insurance Solutions group. We'll be discussing some views the insurance industry has about the year ahead.

This is the time of year for looking ahead, setting plans and expectations, scanning horizons for signs of impending developments - the time for forecasts. And there are a lot of them at our fingertips. For those of us who do forecasting, or more accurately, projecting possible future outcomes based on what we think we know, it's a lesson in humility.

Much of what market forecasters were thinking last year at this time, about 2023, about a U.S. recession, about equity markets and interest rate levels, about inflation, and about politics, was wrong. And this year, a lot of what we thought we were seeing last year, looks the same.

SEGMENT 2 – ECONOMIC/CAPITAL MARKETS OVERVIEW

[RS] (Time stamp – 1:10)

The things we worried about last year, things like inflation, recession, geopolitical strife, are still with us, unresolved. If anything, some have gotten worse. Add to that the high tensions and soaring rhetoric of an election year, not just for the USA but for nearly half the globe. Getting the outlook right won't be any easier than it was last January.

The good news is that forecasts, predictions, outlooks, don't have to be spot-on-point estimates to be useful. Our projections need only help to describe and understand interrelationships and potential risks to investment strategies. That's why we do them; so here goes.

Inflation. While the last few months have shown progress toward lower overall price pressure, some components such as shelter and services inflation remain elevated. Others like vehicle and apparel prices have been somewhat of an offset. That has been enough to fuel the rally in interest rates beginning back in November. At this point, we see the bond market as overbought and vulnerable should the next several months of inflation data buck the current trend. While we don't see a need for more rate increases, we think the markets have gotten way ahead of the Fed by pricing in policy rate cuts down 150 basis points lower in 2024. The recent rate rally runs the risk of re-igniting demand before the Fed's inflation battle is won. Core inflation looks to be bottoming near 3% in the near term, toward but not at the FOMC target.

(2:40)

Economic activity is showing signs of deceleration from the impressive 5.2% annualized GDP growth in Q3. We continue to believe that the full impact of higher rates has not been felt and the possibility exists for a mild recession in 2024. We remain out of consensus on this point as markets have bought into the idea that the Fed is engineering a soft landing, thereby pushing rates lower, spreads tighter, and propelling equity markets to near record levels. We think sustainable growth of around 2 ½% can barely support current valuations, and combined with 3% inflation, will put upward pressure on interest rates.

Geopolitical challenges abound: Russia's ongoing assault in Ukraine, rising tensions between China and the West, the brutal Hamas attack on Israel now threatening the broader Middle East as supply is disrupted by current battles underway in the Red Sea. Further, elections to be held around the world are poised to continue the post-COVID trends of deglobalization, diminished free trade, populism, and protectionism. These are all anti-growth, inflationary forces.

SEGMENT 3 – INSURERS AND INVESTMENT RISK: SURVEY FINDINGS

[RS] (3:52)

Considering the pace of change and the heightened uncertainty across many high-stakes outcomes in today's markets, insurers must constantly monitor and adjust their portfolio management and outsourcing strategies to align their assets with liabilities while seeking market opportunity.

Now let's welcome to the podcast Matt Reilly, Managing Director, and head of Conning's Insurance Solutions group. Hi Matt! His team has recently completed an industry survey aimed at understanding exactly that.

Now Matt, please describe for our listeners the scope and depth of your survey. To whom did you reach out, and what were your specific objectives?

[Matt Reilly (MR)]

Rich, thanks for having me today.

This was our third year surveying insurance companies regarding their sentiment on the market and their views on a wide range of topics regarding their investment programs. We worked with a third party who surveyed and collected responses from 300 insurance industry professionals in investment and finance roles during the fourth quarter of 2023.

Our summary highlight include:

- Insurers again expect to increase their risk tolerance in 2024
- And generally insurers are optimistic about the investment climate as they look forward.

[RS] (4:57)

Nice. Overall, did the results align with your expectations going in, or were there any surprises?

[MR]

I think, similar to years past, there will be some findings that some people find surprising as they review these results. From our perspective, given the fact that we have ongoing dialogue with insurers, there wasn't a whole lot that surprised us.

I think that one of the surprises that many had last year and will carry over to this year is the expectation of increased risk tolerance and strong levels of optimism. If you were to have performed this survey, say, during the regional banking crisis earlier this year, I am sure the results would have been markedly different.

And along those lines, we would also expect to see maybe some bifurcation in terms of how different carriers are feeling about the world. And we did see that life insurers felt slightly more optimistic and more likely to increase risk compared to their P&C counterparts, who have been under more pressure with negative pressures in their operations as well as higher inflation and lower reinsurance capacity.

[RS] (5:57)

Yeah, as you point out, I was struck myself by the apparent high degree of optimism and increased risk tolerance among the respondents, given the myriad threats around the world. Seems like the doves are back in control.

Which are the markets and asset classes that risk-adjusted allocation models prefer these days, and that have current valuations supporting good risk-reward tradeoffs?

[MR]

This was an interesting area that we were looking forward to seeing the results, particularly in this year's survey.

Given the overall higher level of interest rates and associated prospective returns and yields for core fixed-income sectors, insurers saw a compelling case for increasing allocations to these sectors, and that's not something that we've seen a lot over the past few years. It was an area that actually close to two-thirds of insurers expected to increase in 2024.

A few repeat findings from last year are increased interest in private and real asset classes. This includes private placements, private credit and private equity on the private side. On the real asset side, insurers showed interest in increasing to both debt and equity strategies in the real estate and infrastructure spectrums. These sectors traditionally have an illiquidity premium associated with them that allows insurers to capture a yield premium while still being able to structure customized solutions for their (asset/liability management) ALM needs.

Rounding out interesting areas that companies were thinking about and that seemed to be supported by the markets these days, are CLOs and esoteric asset-backed securities. They've been a smaller but growing area of insurers' portfolio over the past few years and many still expect to see these allocations increase over the next few years.

[RS] (7:39)

Interesting you point out about private assets. Insurers' experiences with private assets, both debt and equity, have had a good run in the past several years. The survey seems to indicate, at one point, that we may be at a tipping point with private exposures expected to drop some over the next couple of years. At the same time, in another part of the survey, when asked about changes in asset allocations, folks are saying they will increase investments in privates, and they outnumber, by 2 or even 3 to 1, the decreasers. How do you interpret these data?

[MR]

Thanks Rich. I think that's an interesting point. There does seem to be some natural conflicting findings in this area.

In our conversations with carriers we do tend to see that many carriers are still thinking about the private parts of the market as areas to invest in and our findings do generally continue to support that.

What we did see that I found interesting is that [of] insurers who outsource some or all of their portfolio, over 50% of them expect to have 15% of their portfolios invested in private assets two years from now. And that's up from about 40% today.

We also asked about insurers' concerns allocating to private assets and our results indicate that there are some headwinds there, coming both regulatory and operating pressures. And we think that, given the general overall environment in both of these regards, both regulatory in 2023, around investment programs, as well as operating pressures in particular that P&C carriers face, I think the increased uncertainty on these two vectors can definitely lead to some consternation about private asset allocations moving forward.

[RS] (9:17)

Thanks for clearing that up. What would you say is the most significant finding in terms of a company's financial performance?

[MR]

I think generally one of the things that we've seen as a trend coming out of the lower interest rate environment is that insurers are still looking to make their portfolios work harder for them and trying to use that to drive more of their overall performance.

We've seen, and I think in some of the results you do see, a bifurcation of insurers and carriers who are spending more time, energy and resources on their investment teams and on getting the right partners in place and I think that's had meaningful performance differences. Over the next few years I think you will continue to see more insurers look for the right capabilities and partners to help them progress their programs. So I think really just investment into the future of their investment capabilities.

[RS] (10:07)

So what are we hearing in terms of those capabilities that insurers are valuing these days to enhance their programs?

[MR]

I think, as one would expect, insurers are continuing to be thoughtful and measured in this regard. There is always a cost aspect and consideration to these decisions: Where should one invest in their business? In addition, insurers are looking to access unique strategies that continue to be tailored for their unique needs as well as differentiated analytical capabilities.

In particular, we found that insurers are cognizant to ensure that the changes to their investment strategy are going to continue to support their overall business. It's been an area that we've had lots of conversations with carriers in 2023 and I think that wholistic view of investment strategy is one that's continuing to set us up for a busy 2024.

[RS] (11:02)

You know it's great that the industry is looking to take on risk and open up their opportunities, but what are they worried about? What are some of the concerns that you are hearing?

[MR]

We already spoke briefly about regulatory and rating agency considerations with regard to private assets. I would say one of the areas that insurers are always cognizant of is how their BCAR, BSCR or their RBC might evolve with prospective changes to investment strategy as well as some of the regulatory changes that are ongoing right now.

One of the things we've been spending more time on and helping insurers with is how to develop tools and embedding these into their considerations when they are thinking about their strategic asset allocation and working with them in a consultative manner so that they can become comfortable and understand prospective changes to their investment strategy and how they affect these important analytics.

Another question we often here is: How do we make our investment program more competitive?

One of the ways that we help insurers, and we see a lot of insurers looking to address this, is through accessing industry leading asset allocation tools and having that consultative approach to understand how to drive success in that regard.

Another tool that we that find insurers find very valuable - it helps them to answer the question *"What are others doing? If we move forward with this change how does that compare to others?"* – is peer analysis. So, being able to look at others in the industry - what they're doing, what our competitors are doing – that tends to be a very informative discussion that resonates across the organization, from the staff level to the management level and the board of directors.

So, very useful tool that has driven a lot of our conversations in this regard.

[RS]

Well thanks, Matt. There's a lot going on and we appreciate you thumbing your way through it.

[MR]

Thanks for having me on Rich.

SEGMENT 4 – CLOSE

[RS] (12:56)

Inflation is slowly moving towards the Fed's 2% target and growth is decelerating. Geopolitical challenges on multiple fronts have the potential to pressure inflation higher, and, despite slowing, the economy is still growing at a healthy clip.

With so much uncertainty, any forecast carries significant risk and a wide band of variability. Prudent investment strategies are informed by outlooks and projections but are grounded in solid fundamental research and time-tested asset-liability management models.

Thanks for listening in on our discussion. We invite you to join our podcasts throughout 2024 for what promises to be an exciting and challenging year.

We hope this information is helpful and we always welcome your feedback and questions. You can get messages to us through your relationship manager, your portfolio manager, or send them directly to us at ConnText@Conning.com (that's ConnText w/ 2 Ns).

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