



INVESTOR INSIGHTS SERIES

Rock and a hard place

Low rates inflate liabilities, but regulation prevents insurers from pursuing alternatives

A decade of ultra-low interest rates has inflated institutional liabilities and widened the duration mismatch for insurers across the globe. Desperate for alpha, investment teams are turning to private equity, private debt, and other alternative investments to fill the void left by meager bond returns.

But as CIOs look to meet long-term obligations by investing in illiquid assets, many are finding that the same regulations designed to ensure solvency in the wake of the global financial crisis are limiting their ability to generate returns and, in turn, their ability to actually meet their growing liabilities.

Our recent survey of 200 CIOs and investment team members at life, property and casualty, and reinsurance companies in Asia, Europe, and North America shows that three-quarters of respondents find today's environment makes it increasingly difficult to balance generating alpha with the cost of capital while protecting assets against drawdown.

The survey results reveal three key trends driving investment strategy for insurance CIO teams:

- A decade on from the financial crisis, low rates still create significant difficulties for investment teams as they look to make up ground in a perpetual low yield environment.
- Insurers are willing to take on liquidity risk in pursuit of higher yields, but projected allocation shifts illustrate the negative impact of regulatory limitations.
- While many of the regulatory unknowns that vexed insurers have been revealed, CIOs are still looking for strategies that enable them to live under tighter, more complicated regulatory schemes.

- Three-quarters of insurers rank interest rates as a key portfolio risk
- 89% of insurers globally say regulations deter them from investing in higher risk assets
- Two-thirds of insurers outsource at least some of their portfolio, mainly to gain access to expertise

CIOs have built experienced teams with a diverse range of expert capabilities, but today's environment presents a higher level of risk and greater complexity. As a result, two-thirds of insurers say they are outsourcing critical portfolio sleeves so they can access more innovative and specialized capabilities.

While the challenge of generating more alpha can appear insurmountable, insurers are increasingly discovering that expertise exists to tackle the challenges in new and tailored ways that focus on outcomes rather than asset classes, and on liabilities rather than returns. Insurers with a flexible mindset are taking advantage of this external expertise, rethinking the shape of their portfolios and harnessing strategies that respond to their particular needs and constraints.

Low rates present an existential challenge to many insurers

Interest rates have been so low for so long it's easy to forget it was ever different. But CIOs never forget. They can't afford to.

Low rate policies from central banks impact the work of insurers as much today as when they were introduced a decade ago. And of all the portfolio concerns insurers must consider, it's clear that interest rates weigh most heavily on their minds, as nearly three-quarters (73%) of insurers rank them as a key portfolio risk concern.

Rate concerns run strongest in the US, France, and Germany, where the vast majority of insurers select this as their highest priority. While rates are not the top concern in Asia Pacific, where the financial crisis of 2008–2009 was less pronounced, rate repression is still a risk concern for two-thirds of insurers. Meanwhile, in the UK and Ireland, rates appear to have taken a back seat to Brexit as geopolitical factors rank highest.

Despite its prominent place in their collective consciousness, today's interest rate environment isn't the only risk worrying investment teams. Six out of ten insurers cite fears of an economic slowdown among their top portfolio concerns. This includes nine out of ten insurers in the US, seven out of ten in Germany, and three-quarters of those in Asia.

Adding to the mix are concerns over political issues such as Brexit and the US/China trade war and the risk they pose to portfolios. As a result, geopolitics rank third among insurers' fears, with the pressure felt most directly in the US, where 65% see this as a risk, and the UK and Ireland, where more than half (53%) say they feel the same.

Pressure increases on investment strategy

Insurers are managing some of these challenges better than others. Some 84% say the low rate environment creates significant challenges for them, including 41% who say low rates are "very challenging." This is not surprising given the sensitivity of their business models to rates – particularly the provision of annuities and other products that offer clients income guarantees.

In addition, 81% say they find this environment makes it challenging to meet long-term return assumptions, including 26% who say it's very challenging. Adding to the problems are the three-quarters of insurers who say asset-liability matching is challenging. All of these come to the top of the list ahead of traditional concerns for insurers including managing liabilities (57%) and managing longevity risk (53%). In an industry that depends on predicting and responding to the long term, this all adds up to a pronounced existential risk.

As a result, sourcing investments and constructing portfolios has become a vexing issue compared to just a few decades ago when portfolios were relatively simple to manage. This is why three-quarters of insurers today say they struggle to generate income and alpha, while also ensuring capital protection.

ABOUT THE SURVEY

Natixis Investment Managers, Global Survey of Insurers conducted by CoreData Research in August 2019. Survey included 200 investment professionals in insurance companies through Asia Pacific, France, Germany, Nordics, US and UK/Ireland.

Life Insurance

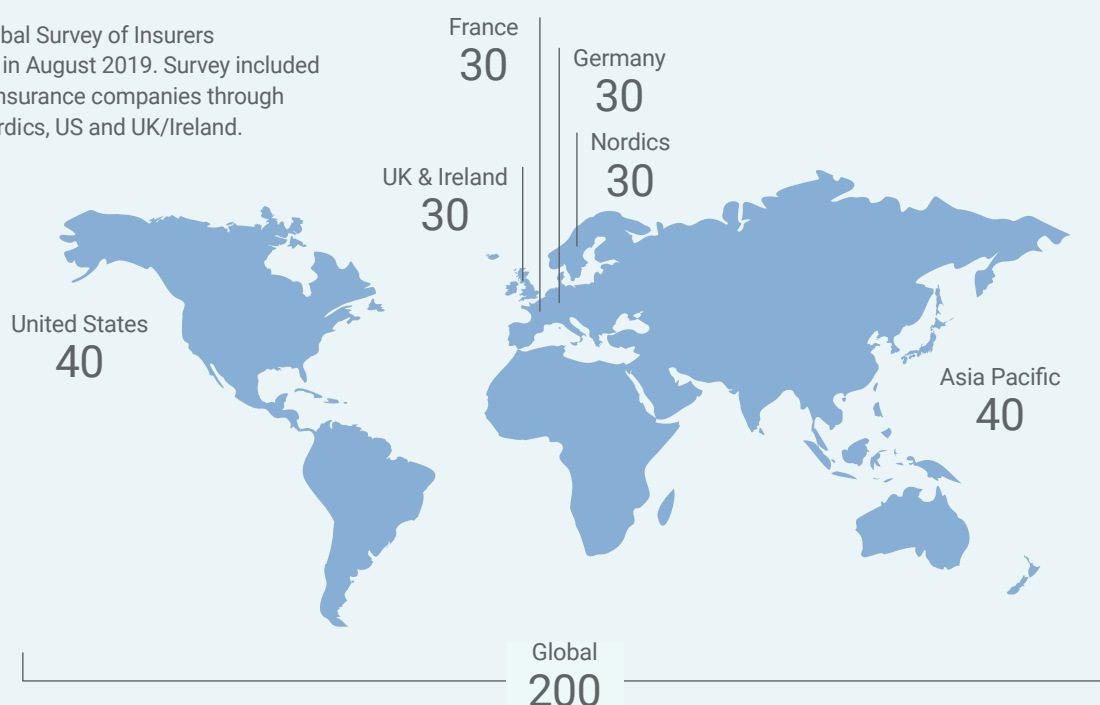
97

Property and Casualty

70

Reinsurance

33



Low interest rates crank up drive for alpha

Low rates have a number of tangible impacts on insurers' portfolios. Most visible are lower returns as bond yields, in tandem with rates, remain stubbornly subdued.

The upshot is that low rates and low yields create asset-liability mismatches. For many, this leads them to look to alternative investments for a wide range of portfolio functions where traditional assets are coming up short. Three-quarters of insurers express concern over the mismatch, explaining why many insurers are scrambling to meet investment guarantees and obligations to policyholders.

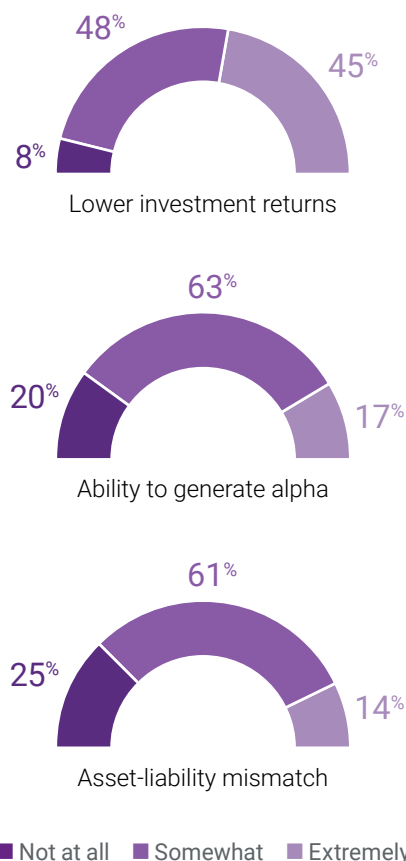
With returns from bonds insufficient to match liabilities, alpha is needed to fill the gap. This is especially challenging as two-thirds believe traditional assets are too highly correlated to provide distinctive sources of return. As a result, three-quarters (75%) say it's essential to invest in alternatives in order to diversify portfolio risk.

Along with serving as a bond replacement, alternative investments help teams address a wide array of portfolio objectives: Most frequently, insurers deploy alternatives to diversify portfolios and lower correlations (62%). More than half (53%) also say they are using alternative assets to replace fixed income assets in their portfolios. And almost the same number (51%) also look to alternatives to help provide alpha. Another four in ten deploy these strategies for risk and volatility mitigation.

Among all these applications, alpha may be the most pressing for insurers, as 65% say it is an increasing priority for their organization thanks to the low rate environment. But alpha generation is not an easy task as 80% say they are challenged to deliver on this front, with one in five reporting they are very challenged.

Raising the stakes are the numerous market and regulatory factors that must be balanced in pursuit of this critical goal. Three-quarters say they find it increasingly difficult to balance the need to generate alpha, protect assets, and monitor the cost of capital. It is this final tradeoff that may be inhibiting insurers' efforts to implement the strategies they see as instrumental to meeting these critical investment objectives.

Rate environment presents significant concerns



Top portfolio risk concerns for 2020

	Global	Asia Pacific	France	Germany	Nordics	United States	UK & Ireland
Interest rates	73%	65%	87%	83%	67%	88%	47%
Economic slowdown	61%	75%	43%	70%	33%	88%	43%
Geopolitical factors	48%	45%	33%	43%	43%	65%	53%
Market volatility	46%	35%	47%	43%	63%	50%	37%
Regulations	34%	53%	47%	33%	33%	15%	23%

Allocations reflect market challenges and regulatory limitations

Investment teams have a wide range of strategies at their disposal to address the challenges of today's low rate environment. Most frequently, they say they've turned to private assets (57%) and other alternative investments (55%), which have the potential to enhance alpha and generate non-correlated returns.

Beyond investing in alternatives, teams have taken a number of steps to adjust allocations to traditional assets such as diversifying by sector or geography (46%). Given the important role that fixed income plays in the portfolios of insurers, teams are adjusting bond allocations by shifting from investment grade to high yield (38%), increasing credit exposure (36%), and shortening duration (28%) of their holdings.

Overall, insurers appear to be satisfied with their portfolio moves as they anticipate only slight shifts in allocations from 2019 to 2020. The one place they appear ready to move, however, is increasing allocations to real estate and alternative investments by about 1.5%.

Views on the portfolio functions these strategies perform in today's market might suggest that current allocations and upcoming shifts would be significantly larger. But at a time when insurers need alpha to meet return assumptions and long-term liabilities, they are finding that regulatory requirements limit their ability to act. This is one of many regulatory challenges to which insurers have had to adjust while navigating a decade of ultra-low rates.

Regulation: protection or prevention?

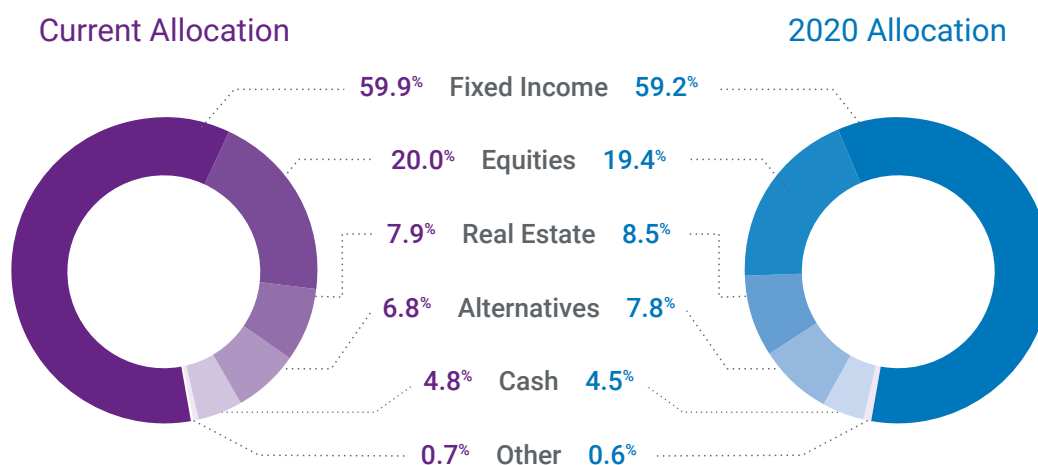
Nearly all (93%) insurers say they are well prepared for the changing regulatory environment. This is consistent with our 2015 survey,¹ when only 16% of European and US insurers admitted they were not ready for regulatory change. However, being prepared from an administrative and compliance standpoint does not necessarily mean they are well positioned for investment success.

Worldwide the vast majority of insurers report that regulatory capital requirements are orienting their portfolios towards low-yielding fixed income assets. A majority (60%) also say that increased capital and valuation requirements are negatively affecting the level of diversification of insurance portfolios.

Two-thirds of insurers say they find it a real challenge to generate alpha while also meeting regulatory requirements. Those in the US express most frustration, with three-quarters finding it hard to address the challenge of producing alpha within the confines of financial regulation. French (70%) and German (67%) insurers are not far behind in their frustrations.

Nearly all insurers (89%) say regulations are de facto stopping them from investing in higher-risk assets. In both Germany and France, some 97% of insurance companies complain that regulation deters them from investing in the alpha-producing assets they need to meet liabilities. This represents significantly more pain than in our 2015 survey, when approximately three in five insurers said regulation and capital requirements were frustrating attempts to invest in new and alternative asset classes.

Portfolio allocations holding steady



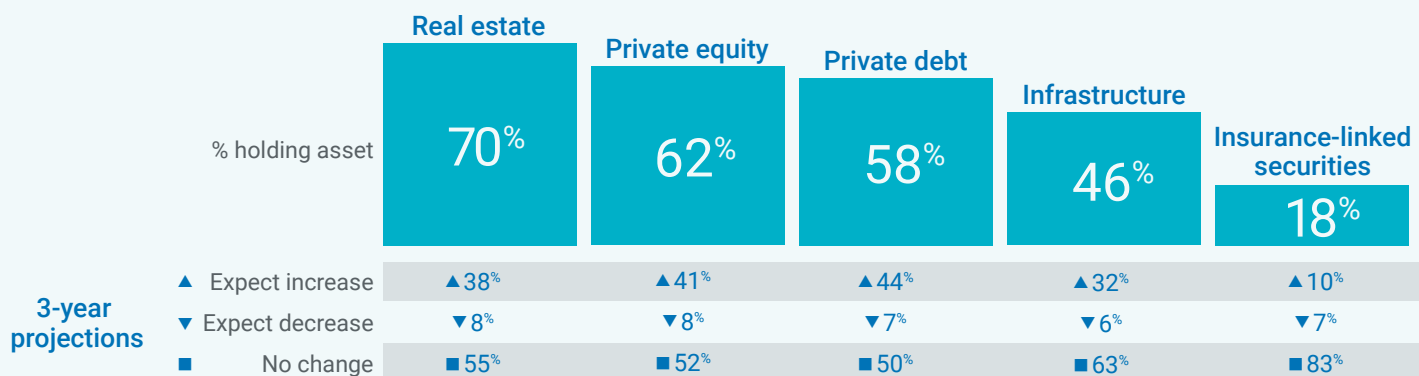
¹ Natixis Investment Managers 2015 Global Survey of Insurers, conducted by CoreData Research in July 2015. Survey included 200 decision makers in insurance companies through the US, UK, Ireland, France, Germany and the Nordics.

PRIVATE ASSET PREFERENCES

Private investments are a key part of the picture for most insurers, with 98% of life insurers included in our 2019 survey and 89% of property and casualty insurers and reinsurers reporting owning these investments.

Real estate, a holding traditionally associated with insurance portfolios, ranks at the top of the list with 70% reporting allocations. But significant numbers also include allocations to private equity (62%), private debt (58%), and infrastructure (46%). Only a smaller number report holdings in insurance-linked securities (18%) and other private assets (4%).

Convictions on private assets run high: More than nine out of ten insurers say they are looking to maintain or up allocations in 2020.



Allocation changes may not add to 100 due to rounding.

So how does regulation impact insurers?

Regulation is making an impact across the spectrum of insurance company activity. The biggest issues from an operational standpoint are implementation costs and technical challenges. From the perspective of CIO teams, the difficulties look different and center on increased capital requirements and implementing changes in risk management to comply with solvency assessments.

Regulation is not the only challenge

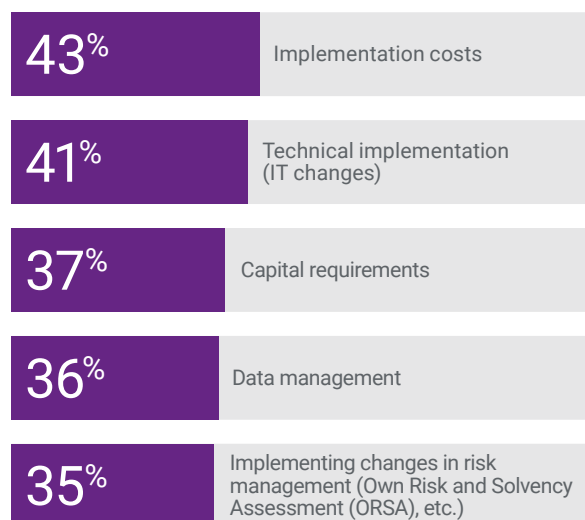
While regulation is the major reason for the slow adoption of private assets, there are other hurdles to pursuing alpha. The most often cited is complexity – the difficulty in understanding alternative strategies and implementing them successfully into a portfolio.

Nearly one-third of insurers say they lack the necessary expertise in-house to create a meaningful alternative allocation. Then there are internal restrictions imposed by insurer boards, which may prevent the CIO from adopting investment strategies which are designated risky or untested.

The roadblocks to implementation vary widely from region to region. In Germany, Asia Pacific, and France, complexity is the biggest hurdle. In the Nordics, fees are seen as the biggest obstacle. Insurers in the UK/Ireland find that internal investment restrictions are the main challenge.

Regulatory compliance presents a range of challenges

Percent responding yes, multiple answers allowed



The challenges to greater adoption are therefore two-pronged: on the one hand, the heavy hand of regulation; on the other, internal restrictions, ranging from self-imposed rules to a lack of in-house expertise in alternatives investing. What is needed, then, are alternative solutions that can exist within the constraints of the various regulatory regimes across the globe and which can be implemented with or without in-house expertise.

New thinking, external expertise

Survey results reveal that, despite some regional variations, insurers worldwide have largely the same needs with respect to the use of alternatives:

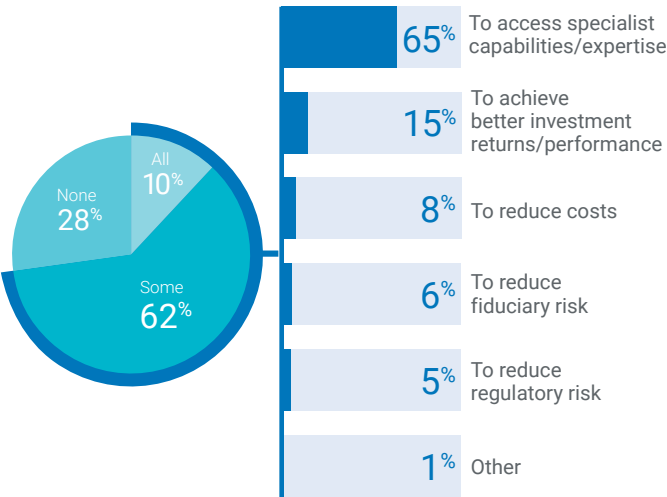
- New sources of alpha that are decorrelated from traditional assets
- Access to new sources of alpha, while keeping on the right side of regulators
- The extra alpha must not increase overall portfolio risk
- The production and deployment of alpha must be fully understood

But few insurers are able to satisfy all these needs internally, which points to increased relationships with external fund managers who have accretive skillsets, strategies and resources to deploy them. In fact, more than half the insurance investors surveyed said regulation has increased their need for external specialized investment managers.

This process has been under way for some time. Globally, more than seven in ten insurance investors already outsource some of their portfolio management – and one in ten insurers delegate their entire portfolio to outside firms.

Insurers outsourcing to gain access to expertise

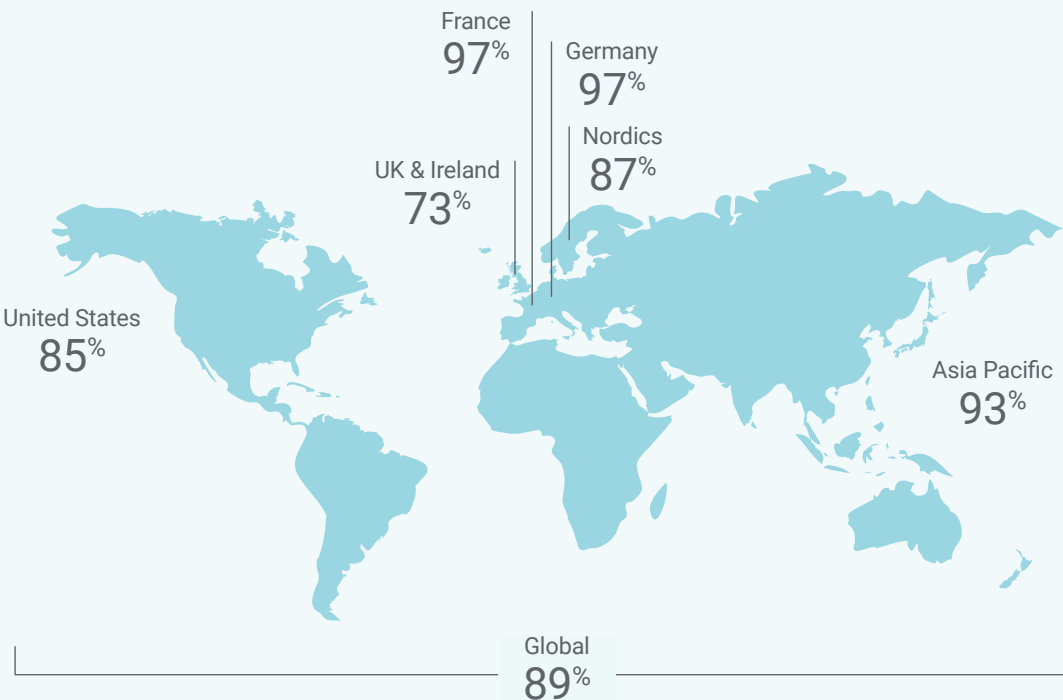
Almost three-quarters of insurers outsource at least some of their portfolio



On average, insurance investors outsource just under half of their portfolio to third-party investment firms. High yield corporate debt, investment grade corporate debt, private equity and emerging market equities are the primary asset classes where insurance investors are looking for outside help.

Regulation roadblocks

Insurers report that regulations are a significant deterrent to investing in higher risk assets



CLIMATE RISK ON THE HORIZON

Climate change stands out among risks for CIO teams. Half of those surveyed say climate change is a challenge to their organization. Two-thirds go so far as to call it a core business issue or are starting to consider it a core business issue. Among property and casualty carriers and reinsurers that number reaches 71%.

Almost half (46%) say climate has resulted in changes to their investment policy. But there is little consensus in how ESG (Environmental, Social and Governance) is implemented: Exclusionary screens (17%), integration into existing process (16%) and best-in-class selection (12%) are most frequently cited.

While 31% say they do not yet incorporate ESG in their investment process, that number is likely to rise in time as companies look to grapple with concerns over climate-related losses (39%), increased liabilities (25%) and health impacts (24%).

Outsourcing preferences differ by region: In France and the Nordics, insurers are most likely to delegate emerging market equities to a third-party manager. In Germany private equity and private debt are the largest asset classes outsourced. And insurers in Asia Pacific, the US and the UK/Ireland are most likely to outsource investment grade corporate debt strategies.

The main motivation for delegating to external managers is to access specialist capabilities. In the past these specialist capabilities included emerging markets portfolios and high yield strategies. In the future, they may increasingly include strategies that are smarter in using risk budgets, are regulation-aware and are also conscious of internal constraints on strategies and fees.

What attributes do investors most prize in external managers? Naturally, a manager's performance track record tops the list, but it is matched by expertise. Help with regulatory changes is cited by four in ten insurers as an important service offered by third-party investment firms.

Flexible strategies, flexible mindsets

The obstacles to insurers generating additional alpha can appear insurmountable. Harnessing extra alpha without taking extra risk and without exceeding regulatory capital guidelines can seem an impossible trick to pull off.

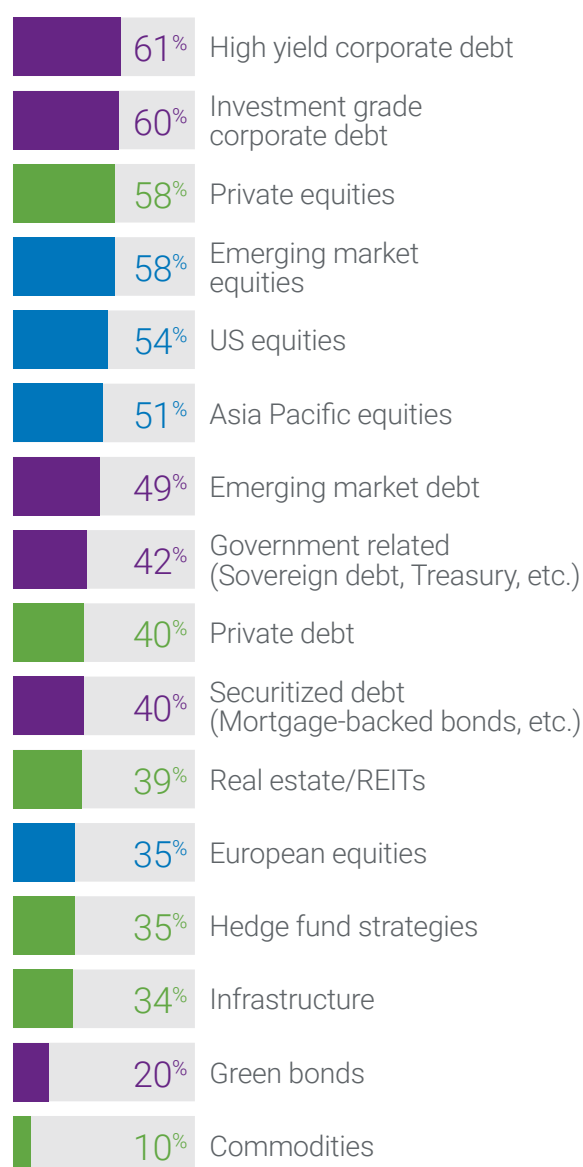
It may well be impossible through the prism of traditional investments. And, as a legacy of the past, many insurers are resourced to approach investment through traditional assets.

However, expertise does not have to originate within the company investment team. Independent investment firms have created strategies precisely to address insurers' need for alpha. Expertise exists to tackle the challenge in new and tailored ways that focus on outcomes rather than asset classes, on liabilities rather than returns.

Insurers with a flexible mindset are taking advantage of this external expertise, rethinking the shape of their portfolios and harnessing strategies that respond to their particular needs and constraints.

To some CIOs, this kind of approach may seem experimental and somewhat gung-ho. Others are embracing assets and strategies that have the potential to solve the growing scale of the issues they face.

Asset classes outsourced



■ Fixed Income ■ Equities ■ Alternatives

Surveys cited: Natixis Investment Managers Global Survey of Insurers conducted by CoreData Research, July and August 2019. Survey included 200 investment professionals from insurance companies throughout Asia Pacific, France, Germany, Nordics, US and UK/Ireland.

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All investing involves risk, including the risk of loss. Investment risk exists with equity, fixed income, and alternative investments. There is no assurance that any investment will meet its performance objectives or that losses will be avoided.

Alpha is a measure of the difference between a portfolio's actual returns and its expected performance, given its level of systematic market risk. A positive alpha indicates outperformance and negative alpha indicates underperformance relative to the portfolio's level of systematic risk.

Alternative investments involve unique risks that may be different from those associated with traditional investments, including illiquidity and the potential for amplified losses or gains. Investors should fully understand the risks associated with any investment prior to investing.

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