DEPARTMENT

Economic and Capital-Market Perspective

By T.C. Wilson

Investment Evolution—Part One. Is Your Company a Primate Investor?

Turning back the clock: first quarter 2009

Do you remember sitting around your office with your colleagues, or even facing your investment committee and board of directors, discussing the disaster that had just struck your portfolio in 2008? "Liquidity," "depression," "subprime," "credit crunch," and "breaking the buck," were just a few of the words that had struck fear into investors, and you had every right to be worried. Your "conservative" investment approach had turned into one of the biggest misnomers in history, because you couldn't trade investment-grade bonds efficiently, and the ill-perceived safety of S&P 500 Index investments was thrown out the window after the index lost 37.0% for the full year of 2008. Except for low-yielding U.S. Treasuries, basically, nothing worked. The common theme then was that the investment model was broken, and asset allocation was a thing of the past.

In March 2009, we published an article for *Institutional Funds Investor*, "Your Investment Strategy: Don't Lose Faith, Seize Opportunities." The purpose of the article was to show that the insurance companies that survived the 2008 capital markets fallout were in a position to (potentially) reap extraordinary benefits, by holding fast to their investment models, despite all the hype from the naysayers of asset allocation modeling. We were firm believers that these opportunities needed to be acted on by re-balancing equity allocations to target or higher, making tactical shifts within fixed-income portfolios to take advantage of historically wide spreads, and further globalizing overall investments. Nearly every one of our clients vetted these options and made what many professionals called, at the time, the "leap of faith" back into the capital markets by putting public opinion aside.

Little did we know that from the time our article was published, the capital markets would explode. For the two-year period from March 31, 2009, through March 31, 2011, U.S. large-cap stocks rose a cumulative 73.2%, U.S. small-cap stocks increased by 104.8%, and U.S. mid-cap stocks climbed 108.4%. Non-U.S. equity markets also participated, with developed markets increasing 72.1%, and developing, or emerging, markets recording a remarkable 115.7% cumulative return. And it wasn't just equities. For the same period, U.S. investment grade bonds increased 13.2% but, more impressive were the cumulative returns of non-U.S. emerging-markets debt (+41.5%) and U.S. high-yield instruments (+79.58). Your surplus should be feeling pretty good right now—that is, if you made the so-called "leap."

Stuck in the primate stage of investing?

The illustration that follows depicts what is, we believe, the evolution of the investment process and the development of new investment opportunities.

Many of you will look at the illustration and start to wonder why your company favors the left side of the spectrum. Yes, minimizing tax payments, preserving capital, growing surplus, maximizing after-tax income, and/or achieving the highest after-tax book yield are still critical objectives. But, how your company attains these goals should have changed a while ago, by considering what has become available on the right side of the spectrum. These asset classes are readily available, and their accounting and regulatory requirements are easier than they were just five years ago.

Investment managers have become more aware that insurers are thirsting for new investment ideas to meet their

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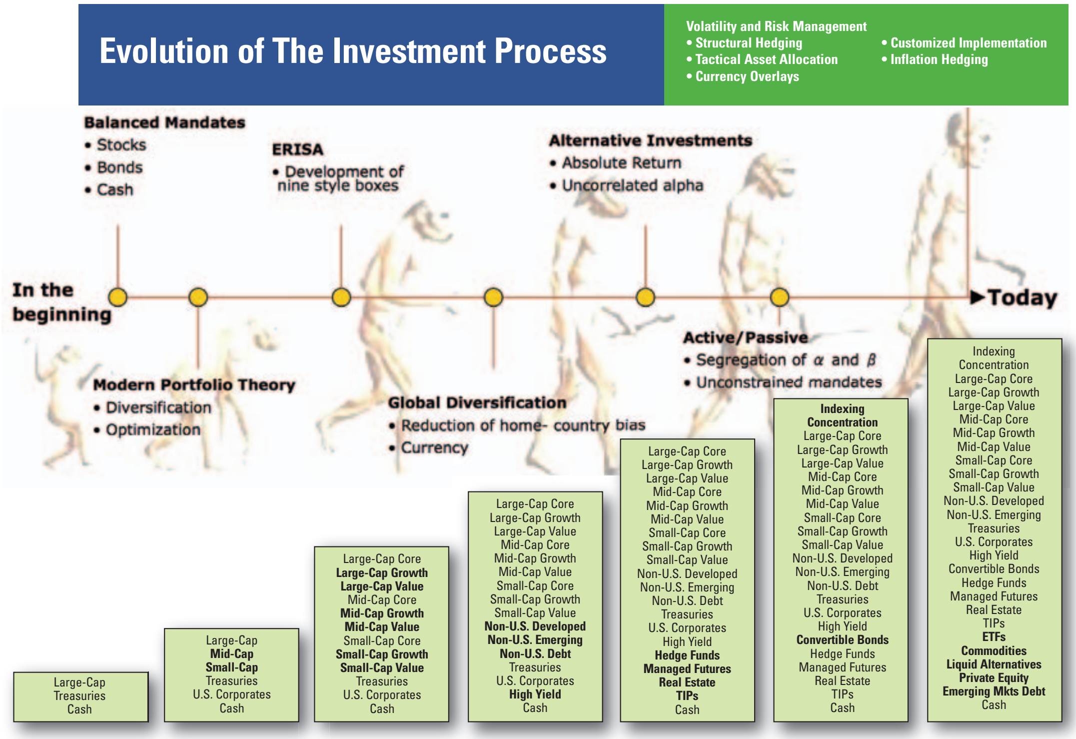

Source: Lazard and The Optimal Service Group

investment objectives, and they have committed time and resources to expanding their offerings. The key is to identify managers who specialize in certain areas and pairing them with others that specialize in others.

If you have not yet explored these available investments, then one of the biggest challenges your company will face is education. From a fiduciary perspective, it is imperative that company management, investment committees, and boards fully understand the pros and cons of any new investment in relation to your current portfolio. Moving across the investment spectrum is probably long overdue for many insurers, and further procrastination could leave these companies, in time, envious of their primary competitors and peers.

Going global

With U.S. fixed income at or near the end of a 30-year bull market, rates are set to rise, and insurers are struggling to book adequate yield, and they are looking elsewhere for help with cash flow expectations.

Some of the more investment-savvy insurers have identified opportunities outside of their traditional investment-grade fixed-income portfolios, by looking beyond the typical constraints outlined in the investment policy. This has led to initial and/or higher investments in emerging-markets debt in local currency, high-yield, sovereign debt, non-agency mortgage-backed bonds, and commercial mortgage-backed securities (CMBS), to name a few.

These types of investments are expected to increase the yield of a portfolio, broaden diversification by increasing exposure to a wider set of risk factors, and capture alpha (the excess return over a benchmark) by utilizing specialty sectors in a tactical manner. There is a lot to consider in going global, but it's a lot like refusing to move across the investment spectrum, as detailed above: staying domestic will put you behind.

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Final word

Let's not forget that in 2008, many insurance companies had solid underwriting results that helped offset the losses incurred from investments. It is important to understand the contribution that both underwriting and investment results make to the bottom line. Rarely do we see both components running on all cylinders, and when risk is being assumed on one side (underwriting or investments), it is usually wise to avoid taking on as much risk on the other side.

It is concerning to see insurance companies that are still stuck in the early stages ("primate") of investment evolution and, due to lack of understanding, are unwilling to make prudent changes to keep up with the ever-changing world of investments. In our opinion, those companies are at risk of losing enterprise value to others in the industry and setting themselves up for even more challenging times ahead. Is your company still in the primate stage? Statistics show that many insurers are, and that it is time to start considering what your successful competitors are doing. PIAA

In Part Two of "Investment Evolution," we will explore in more detail the expanding asset classes and provide additional guidance in helping you build a new investment strategy through global investments.

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