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Perspectives on the Investment Industry

INSURANCE ASSET MANAGEMENT

To Enter the Market or Not? Pros and Cons

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Executive Summary

Insurance companies historically have captured the attention of only a handful of managers willing to educate and build a staff to manage the assets of this distinctly different—and somewhat challenging—market segment.

Today, insurance companies are increasingly attracting investment managers with the lure of a large pool of investable assets and potential profitability, among other draws. While undeniably attractive, insurance asset management is not without its challenges, such as fee sensitivity, and the demand for specialized knowledge and resources.

Insurance asset management, like all businesses, has definite pros and cons. Investment firms that carefully consider these characteristics, however, and then commit to the requirements needed to succeed are positioned to enjoy long-term success in a corner of the marketplace not yet saturated with managers.

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INSURANCE ASSET MANAGEMENT

Why the Buzz?

Insurance companies historically have generated little attention from the asset management community. Until recently, that is. Today, there is much buzz about the attractiveness of this often overlooked corner of the marketplace.

Why the sudden interest in insurance companies as clients? We can point to a few key reasons.

First, over the past several decades, small and medium-sized insurance companies have increasingly, albeit slowly, outsourced asset management because of pressure on their bottom line combined with a need for investment experts to help navigate the dynamic investment markets.

Second, the recent financial crisis has intensified bottom line pressures and investment risks, and ultimately, underscored insurance companies'—of all sizes—need for outside expertise. This crisis actually marked the first time that large insurers, to any significant degree, sought investment experts to help manage their assets.

Third, opportunities with other institutional investors, such as pension plans and endowments, were declining. Defined benefit plans were closing or seeking passive investments, while endowments were re-examining their investment strategy in light of liquidity pressures brought on by the crisis. The outcome: a rapid acceleration in asset managers' interest to develop capabilities—knowledge and resources—to manage insurance assets.

Managing insurance company assets is different from managing traditional segments of the institutional marketplace,

such as pension funds and endowments. For instance, investment objectives and constraints, and buying behavior are distinctly different. To successfully manage assets in this space requires commitments of both time and resources.

INSURANCE COMPANIES AS CLIENTS

Pros and Cons

All businesses carry pros and cons, and insurance asset management is no exception. Let's first take a macro-level look at important considerations for managers interested in exploring this segment of the market.

Pros

- ▶ Available Investable Assets
- ▶ Autonomy
- ▶ Specialization can Create Foothold in Marketplace
- ▶ Opportunities for Alternative Investments

Cons

- ▶ Limited Profitability
- ▶ Restricted Performance Opportunities
- ▶ Specialization, Time and Resources Required
- ▶ Inefficient

Now, let's delve into the intricacies of managing insurance company assets, starting with the pros.

Pros

Available Investable Assets

- ▶ **Large Pool of Assets.** The insurance industry generates a large pool of investable assets driven primarily by the fact that insurance companies charge premiums to insure certain risks, accumulate the inflows, invest them and then pay out a portion in claims over time. While the timing of the liability stream related to the claims varies greatly

by line of insurance business, there is always a lag time—sometimes quite lengthy—between the collection of the premiums and payout of the claims. This generates investable assets in multiples of the actual equity of the insurance company.

Estimates of total assets held by insurance companies exceed \$6 trillion in the U.S. alone, notably more when including non-U.S. companies. A large percentage of these assets, however, are held by very large insurers, most of which will always be managed by in-house staff. An estimate of investable assets available for outsourcing in the U.S. is currently approaching \$1 trillion.

- ▶ **Sizable Mandates Awarded.** Insurance companies do not shy away from concentrating assets with a few managers, or even just one. This allows them to both manage fees more aggressively, and build close relationships with managers they respect and trust. In turn, managers that provide quality services and capabilities can grow assets rapidly. The bulk of insurance assets are invested in fixed income; however, large insurers have been known to allocate sizeable assets to alternatives.
- ▶ **Growing Outsourcing Trend.** The outsourcing trend is well documented by a number of industry studies—a movement that has accelerated with the financial crisis. Insurance companies, many with financial pressures, are increasingly focusing on their core capabilities and outsourcing other functions, namely the management of a portion of their assets. While outsourcing historically has been most popular among small to medium-sized companies, large companies are now instrumental in fueling the trend.

Autonomy

- ▶ **Limited use of consultants.** Only a handful of consultants have gained traction in the insurance marketplace, particularly compared to the pension fund arena. The reason is that insurance investing requires knowledge of a variety of issues specific to the industry; therefore, opportunities for manager selection are somewhat limited. While a relatively small number of dedicated consultants have penetrated the marketplace to-date, the number appears to be on the rise. Currently, however, the lack of consultant presence allows managers in this space to generate business by dealing directly with insurers.

Specialization can Create Foothold in Marketplace

- ▶ **Specific knowledge required creates barriers to entry.** The investment requirements of insurance companies differ greatly from other institutions in that they are buffeted not only by economic and financial concerns, but other issues including actuarial, accounting, and regulatory matters. Managers committed to insurance asset management must both clearly understand and appropriately respond to these needs. Only those firms that build the resources necessary to meet these requirements will be successful, and realistically, only a limited number actually do so. Therefore, this segment is far less crowded and competitive than the rest of the marketplace.
- ▶ **Service-oriented relationships engender long-term clients less susceptible to performance issues.** Insurance companies operate under various objectives and restrictions, making unconstrained investment performance relatively difficult

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to achieve. A premium is placed on high quality service, with satisfied insurance companies typically retaining investment managers over the long-term, even without strong investment performance.

Opportunities for Alternative Investments

- ▶ **Opportunities to manage alternative investments with less fee pressure and industry knowledge required than with core fixed income.** As mentioned earlier, large insurers often allocate significant assets to alternative investments. Since these capabilities are viewed as specialties, insurers generally seek to allocate them to managers with specific expertise rather than their core managers. The goal for these investments is to generate impressive investment returns; therefore, managers typically are not required to have the same in-depth industry knowledge as the core managers, and the fees are not as challenging.

Cons

Limited Profitability

- ▶ **Fee sensitivity, especially in core fixed income.** As mentioned previously, the majority of insurance company assets are invested in core fixed income. Given the constraints associated with these assets, it can be difficult to generate returns in excess of stated benchmarks. Therefore, insurers often are not willing to pay the fees required to manage these assets for higher-than-benchmark returns. Simply put, they often view management of the assets as a support function rather than an investment management capability.
- ▶ **Service-intensive relationships limit profitability.** While providing personalized service to insurers can result in long-standing relationships, it can also be both time-consuming and costly.

Unless the manager participates in a limited way by managing only specialized products, significant resources often have to be dedicated to insurance investing to be successful.

Restricted Performance Opportunities

- ▶ **Constraints on investing, related to insurance operational issues, limit performance opportunities.** Insurance operational issues restrict managers from touting these capabilities, and if they manage the assets, they may not be able to use the performance record in marketing-related efforts.

Specialization, Time and Resources Required

- ▶ **Knowledge of insurance investment issues required.** In addition to the functional investment requirements, managers must bring deep knowledge of insurance investment issues to the table. Product specialists, and client relations and sales personnel, should have a solid understanding of insurance asset management to perform their respective roles.
- ▶ **Presence in insurance marketplace for a period of time often necessary to build momentum.** Patience and time are required to build mutually beneficial relationships and a sound reputation in the insurance segment— typically one to two years. Managers, however, frequently underestimate the necessary commitment and wind up exiting the business when progress is slower than expected.

This revolving door of managers has led insurance companies to spend a great deal of time getting to know managers before making a hiring decision. Only when an insurance company feels confident in a manager's long-term commitment will they make a hiring decision.

► **Resources, beyond traditional investment management resources, often required.** Again, because of the specific nature of insurance asset management, dedicated and knowledgeable resources are required. Investment, sales, servicing, and marketing personnel, as well as the operations team, should have some degree of industry-specific knowledge. Firms with large investments in this area should consider establishing a separate division, which integrates all functions dedicated solely to managing and servicing insurance clients.

Inefficient

► **Customization makes efficiencies difficult to achieve.** Each insurance company has unique economic drivers, and accounting, and regulatory guidelines; therefore, insurance portfolios need to be customized, especially for core assets. Understandably, these factors make it difficult to build economies of scale in the investment function.

Conclusion

As you can see, the insurance industry presents a compelling opportunity for asset managers although it is not without its challenges. So, managers interested in making a foray into insurance asset management should proceed with both understanding and caution.

Investment firms that want to consider the insurance marketplace should first make sure that its products and services align with its core competencies and overall capabilities. Next, firms should conduct thorough due diligence, thinking through their strategy, and developing a focused—and realistic—business plan. Finally, a point that cannot be over-emphasized, managers must make sure that their staff is properly educated on the nuances of this industry.

Insurance asset management is interesting and exciting—and brimming with financial opportunities—for those managers that weigh the pros and cons, understand the challenges, and make informed decisions before moving forward. ■

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