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North American Insurance Survey

Tackling the twin forces: interest rates and technology



A study of investment strategy through one-on-one
interviews with senior investment professionals - October 2018

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Introduction

The North American insurance industry is facing challenges on two fronts: a sustained period of low interest rates and rapid technological change.

Insurance companies are adapting their investment strategies to meet these challenges. Will the successful businesses be those that evolve their existing models? Will they be those that embrace the revolutions under way: in private markets, in risk management and in technology-driven changes across all facets of the insurance industry?

Aberdeen Standard Investments recently commissioned one of the most comprehensive surveys of the North American insurance industry. This independent survey involved interviews with **45 senior investment professionals**. Collectively, respondents accounted for **30% of all insurance assets** managed within North America and **\$3.6 trillion of investments**.

The survey identified several inflection points for the industry. Together, these represent a call to action for the insurance industry – and the asset managers that serve them.



Key findings

Survey Statistics



77% agree, 14% disagree
expect to struggle to meet target investment returns



80% agree, 11% disagree
business outperformance requires raising investment risk



56%
intend to increase alternative credit



79%
cited specific asset class expertise as driver of external manager selection



86% agree, 8% disagree
external asset managers are meeting investment needs



76% agree, 12% disagree
the trend to increase alternatives will drive more use of external managers



46%
cited risk management as key area for improvement



86% agree, 10% disagree
insurance industry is on the verge of a seismic tech-driven shift



One
Just one respondent sees technological change having a major impact on investment strategy



37% agree, 42% disagree
investment strategy is increasingly driven by regulatory change



32% agree, 53% disagree
insurers are seeking to increase international assets



One
Just one respondent cited ESG expertise as a key factor during external manager selection



Survey quotes

"I have been arguing with the board, we cannot increase investment returns without increasing our risk tolerances"

Canadian P&C insurer

"It takes time to build up real estate loans; we don't expect to reach our target allocation until 2020"

Mid-sized US P&C insurer

"It has been slow getting private placements, lots of demand"

Bermuda insurer

"It is taking longer than expected to reach our target allocation [for private equity]"

Mid-sized US P&C insurer

"It quickly becomes obvious when a potential asset manager hasn't done even the simplest of research and read through our annual report"

Canada Large P&C insurer

"We are increasingly relying on our external asset managers to run risk scenarios"

Mid-sized US Health insurer

"Our modelling capabilities will never be on a par with those of a global asset manager"

Mid-sized US P&C insurer

"Insurance is a very old industry and the principles have not really changed. The shift to computers and the internet was profound, but did not have a significant impact on our investment strategy"

Large Canada P&C insurer

"Tech will change all distribution, which will squeeze out marginal players, which will in turn change balance sheet objectives"

Small US Life insurer

"Many US corporations really are global, so we get global diversification without needing to invest in non-US financial markets"

Mid-sized US P&C insurer



Four themes, one story

North American insurers have successfully managed their business through a difficult period. Falling bond yields and changing regulations have unquestionably presented challenges to the industry. As a consequence, however, several interesting questions need to be asked:

What will be the impact of lower expected returns?

Future investment returns are likely to fall short of insurers' internal targets. Uncomfortably, this return outlook is happening as insurers are becoming more reliant on these returns to provide a source of competitive advantage.

Will insurers seek to enhance returns by shifting allocations away from public and towards private market assets? If so, the challenge will be accessing these private markets and meeting target weightings.

Will insurers respond by outsourcing more of their investment needs to external asset managers?

Certainly external managers can provide necessary expertise. However, insurers will likely seek a genuine partnership rather than the simple provision of an investment service. This involves demonstrating a genuine understanding of insurers' needs. Further, external managers will be expected to collaborate on setting investment strategy and supporting risk management activities.

What impact will technology have? Big data and artificial intelligence are impacting operational activities within the insurance industry. However, so far, there is little evidence it is bringing any significant change to insurers' investment strategies.

Executive summary

The research identified four themes that we believe will shape the industry and influence the way that investments are managed.

Themes

Setting the scene

The North American insurance industry is in good health, with premiums expected to grow across all insurance industries. Insurers have, in general, successfully managed their businesses – and balance sheet risks – through a period of falling bond yields and changing regulations. Low yields have driven a shift in investment portfolios from public to private market assets in search of higher returns. Changes to solvency and accounting regulations are driving changes in investment strategy for insurers in Bermuda and Canada, but less clearly so in the US.

Theme 1:

Investment returns: when the tide goes out...

77% of insurers surveyed expect to struggle to meet target investment returns

In contrast to the healthy backdrop set out above, insurers expect future investment returns to fall short of their internal targets. A decline in expected returns is happening just as insurers are becoming more reliant on these returns as a source of differentiation in a highly competitive environment. Insurers are responding to this expected shortfall in returns by actively seeking to further increase allocations to alternative assets to plug the gap. By contrast, there is limited appetite to add to overseas exposures. A downturn in the credit cycle is seen as the key risk to investment returns.

Theme 2:

Optimising alternative allocations

56% intend to increase alternative credit

As insurers seek to maximise investment returns, they continue to reduce exposure to traditional fixed income assets and increase exposure to alternative assets. Corporate loans, real estate loans and private equity were the most cited asset classes within

alternatives for additional investment. However, our interviews revealed that insurers are struggling to reach target allocations. Accessing these assets is challenging due to the added complexities involved. There are inevitable time lags between committing capital and gaining exposure. And demand exceeds supply for the specific assets that meet the needs of insurers.

Theme 3:

The value of outsourcing: beyond alpha

76% expect the trend to increase alternative assets to drive greater use of external managers

The ongoing shift from public to private markets will necessarily drive an increase in outsourcing to external managers. Many insurers have strong in-house investment capabilities and primarily look to external managers for specific asset class expertise. However, the delivery of investment returns from harder-to-access asset classes is, while necessary, not sufficient to meet insurers' needs. Investment experts within insurance companies need to collaborate with external asset managers to manage the additional complexities and risks of these investments. In addition, they value a dialogue with their peers at external managers on investment strategy. External managers are mostly seen to be delivering on essentials, but sometimes need to do more to understand the specific needs of their insurance clients.

Theme 4:

The technology tipping point?

86% agree that the insurance industry is on the verge of a seismic tech-driven shift

Only one respondent sees technological change having a major impact on investment strategy and management approach

The industry is in the process of being reshaped by the advances in technology. These changes are expected to largely affect the operational facets and distribution routes of the industry, with limited concerns about increasing competition – in part because competition is already intense. But despite this period of rapid change, insurers do not expect to have to adapt their investment approach.

Methodology & coverage

Aberdeen Standard Investments commissioned an independent global strategy consultancy to carry out the fieldwork and analysis that forms the basis of this report.

Methodology

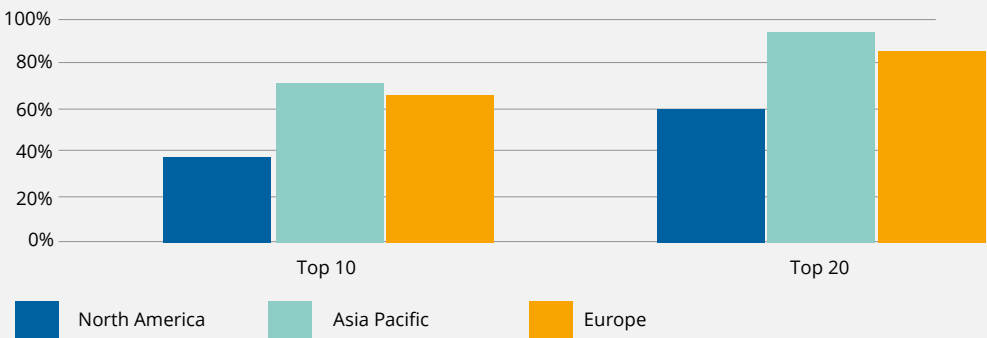
We conducted 45 in-depth face-to-face interviews with senior investment professionals during the summer of 2018. The majority of the interviewees were either Chief Investment Officers or, for firms where this role does not exist, the senior executive, actuary or risk officer responsible for investment strategy.

Coverage

The research was conducted in the three mature markets in North America: Bermuda, Canada and the United States.

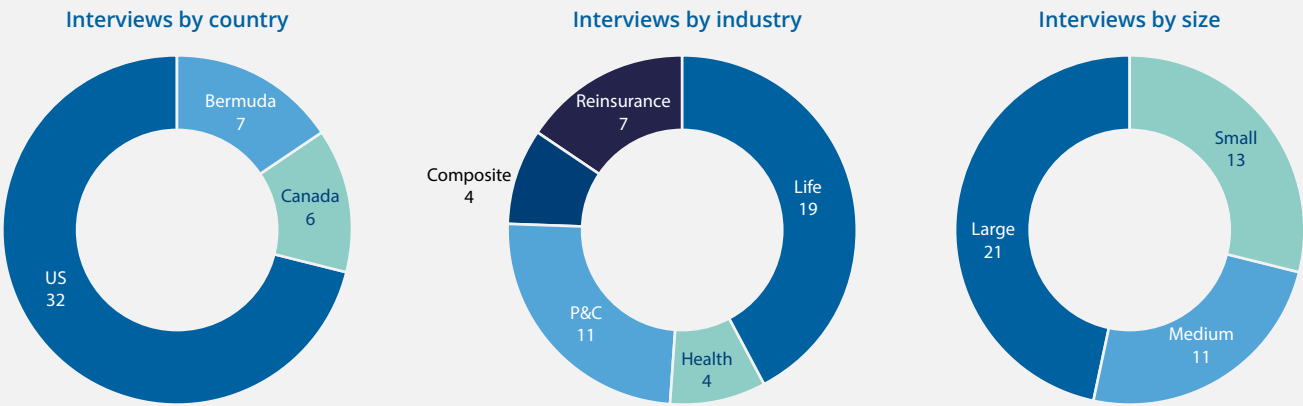
The research population was selected to ensure representative market coverage on four dimensions: geography; sub-industry; company size; and domestic and international firms. The survey focused on investment management of assets on the balance sheets of the insurance companies. The North American insurance market is more fragmented than both the Asia Pacific and European markets. Respondents interviewed represented around \$3.6 trillion of assets under management, an estimated 30% of total insurance assets within the region.

Market share of largest companies by total assets

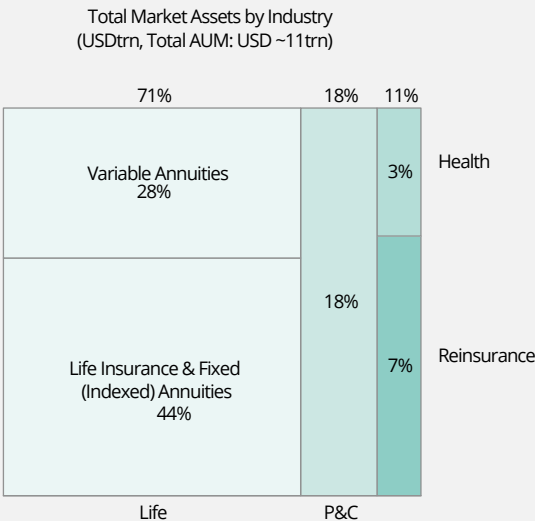
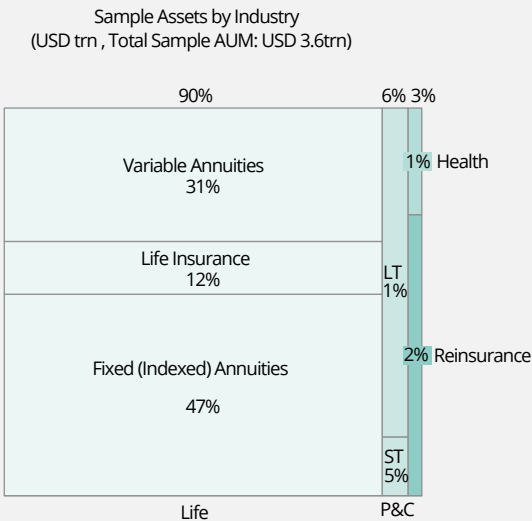


Source: US Department of Treasury Annual Report on Insurance Industry, Bermuda Monetary Authority Annual Reports, Canada Office of the Superintendent of Financial Institutions statistics, Company Annual Reports

Coverage (number of firms)



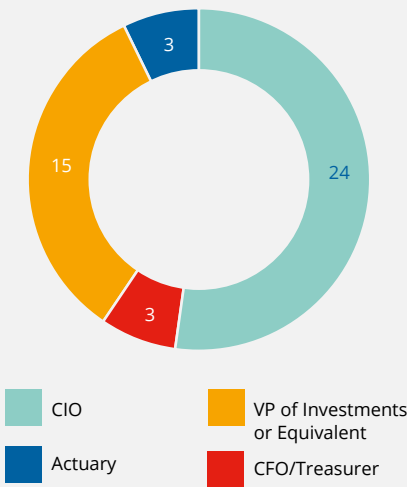
Coverage (by assets)



Q Please indicate your asset, revenue and new business split by product

Source: ASI North American Insurance Survey 2018, US Department of Treasury Annual Report on Insurance Industry, Bermuda Monetary Authority Annual Reports, Canada Office of the Superintendent of Financial Institutions statistics, Company Annual Reports

Interviewed by role



Source: ASI North American Insurance Survey 2018

“Respondents interviewed represented around \$3.6 trillion of assets under management, an estimated 30% of total insurance assets within the region.”

Setting the scene

The North American insurance industry is in good health, with premiums expected to grow across all insurance industries. Insurers have, in general, successfully managed their businesses – and balance sheet risks – through a period of falling bond yields and changing regulations. A sustained period of low yields has driven a shift in investment portfolios from public to private market assets in search of higher returns. Changes to solvency and accounting regulations are driving changes in investment strategy for insurers in Bermuda and Canada, but the effect is less clear in the US.

The backdrop for this survey is a prolonged economic expansion, a healthier insurance industry than in some Asian and European markets, and low government bond yields around the world. Low yields have led insurers to tilt their investment allocations from public to private markets in search of higher returns. These ‘findings’ confirm what we already know, but provide the necessary baseline for us to explore future trends in the four themes that follow.

Growth industry

Collectively, the insurers surveyed expect to see premium growth across all insurance industries and products (see figure 1). However, uncertainties do exist, centred on the ageing population – particularly for health insurers – and shifting patterns of buying behaviour among their customer base. Competitors provide a threat, but as one US P&C insurer observed: “**insurance is already highly competitive and we don’t expect this to change any time soon**”.

Balance sheets well managed

North American insurers have, in general, successfully managed their businesses – and balance sheet risks – through a period of falling bond yields and changing regulations. In contrast to a number of the European and Asian insurers we interviewed in our earlier surveys (2015 and 2017 respectively), falling bond yields and regulatory changes have not created an existential threat to insurers operating in North America. Historic returns have been adequate to meet guarantees. This reflects the fact that guaranteed returns were never as high as in some European countries, while US long-bond yields never reached the lows seen in Germany and Japan.

Significant existing exposures to alternative assets

In line with global trends, the low bond yield environment has led investors to shift from investment-grade bonds into alternative fixed income assets in search of higher returns. Investment portfolios today have meaningful exposures to a variety of alternative fixed income assets (see figure 2). Insurers in North America have significantly higher exposures to these assets than their peers in Europe and Asia according to our previous surveys. In part this is due to the broader and deeper markets in these assets, but it is also probably due in part to the time lag between surveys. We explore future trends in theme two.

There is some variation across industries. Health and P&C insurers have lower-than-average allocations to alternative fixed income markets, but higher exposure to (combined public and private) equities (see figure 3). The equity exposure of life insurers in the US has historically been penalised (through capital requirements) much more than Health and P&C insurers, with state regulators requiring life insurers to be much more conservative with their asset exposure.

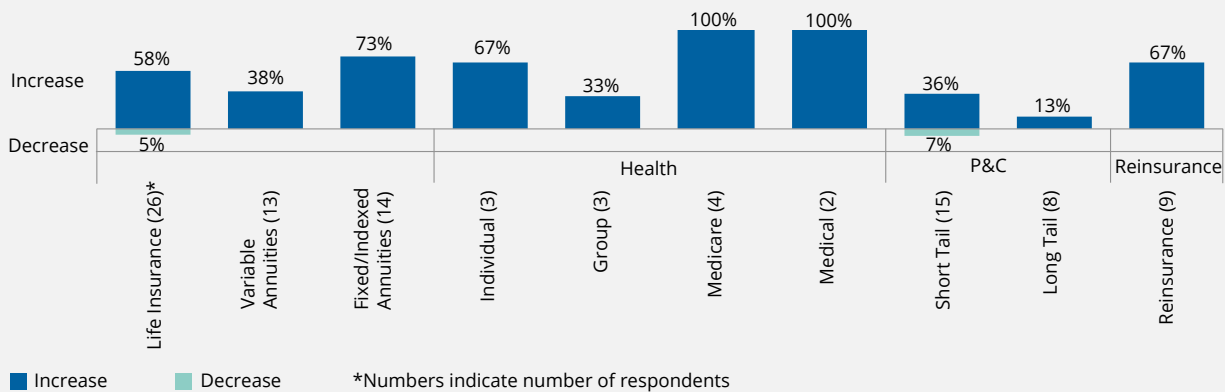
Regulatory changes ongoing in Bermuda and Canada

Solvency and accounting regimes are seen as representing a significant challenge to insurers in Bermuda and Canada, but less so in the US (see figure 4). Bermuda and Canada are seeing major changes in solvency regulations, which have implications for asset allocation strategy. This is similar to the story in European and Asian markets.

A large US Life Insurer who expected limited impact on investment strategy from regulatory change told us that regulation is “**Very slow moving... Nothing immediate on the horizon... We will adjust as they come**”.

Figure 1

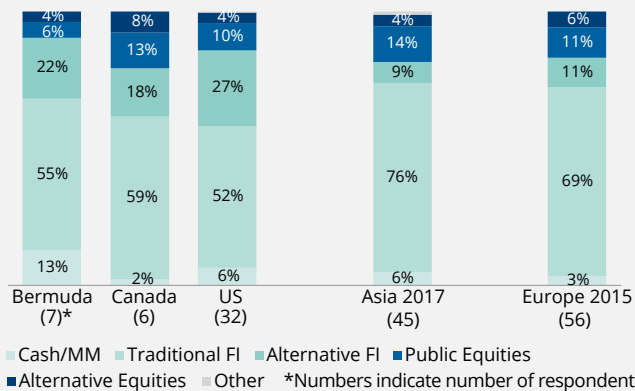
Expectations for net insurance premium growth over next three years (by product)



Q Excluding growth driven by investment returns, to what extent do you expect the flow of insurance premiums (i.e. net flow) to change over the next 3 years?
Source: ASI North American Insurance Survey 2018

Figure 2

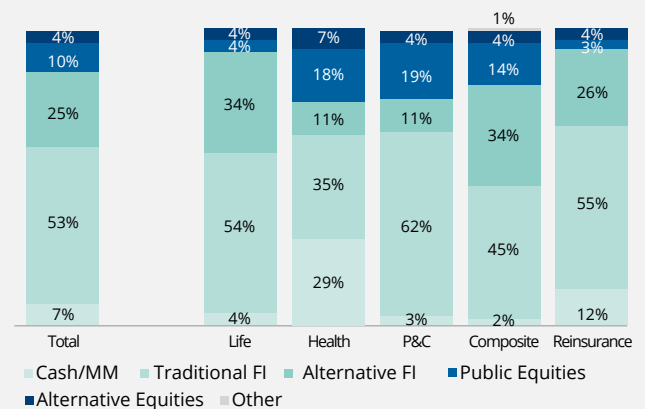
Current asset allocation (by country/region)



Source: ASI North American Insurance Survey 2018

Figure 3

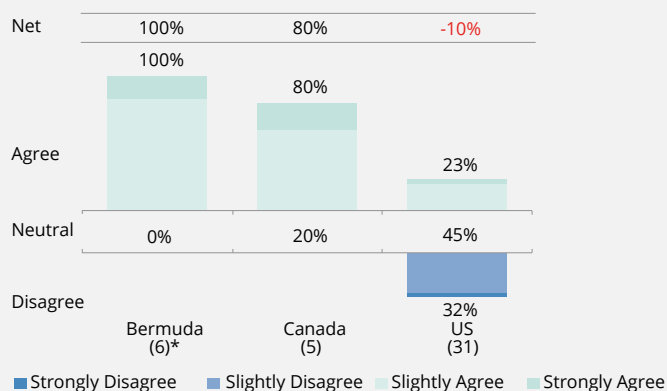
Current asset allocation (by industry)



Source: ASI North American Insurance Survey 2018

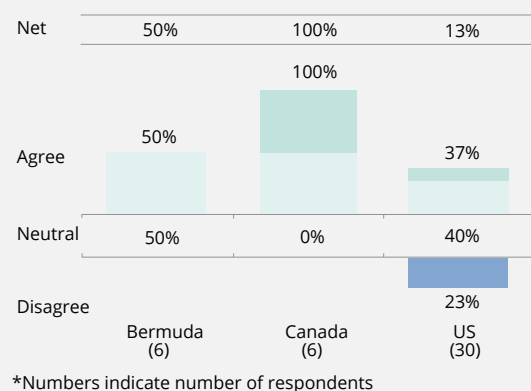
Figure 4

A. Solvency-related regulation will pose a significant challenge to providers



Q. To what extent do you agree with the following statements with regards to the next 3 years
Source: ASI North American Insurance Survey 2018

B. Accounting-based regulation will pose a significant challenge to providers



Theme 1:

Investment returns: when the tide goes out...

In contrast to the relatively healthy backdrop set out in setting the scene, insurers expect future investment returns to fall short of their internal targets. A decline in expected returns is happening just as insurers are becoming more reliant on these returns as a source of competitive advantage. Insurers are responding to this expected shortfall in returns by actively seeking to further increase allocations to alternative assets to plug the gap. By contrast, there is limited appetite to add to overseas exposures. A downturn in the credit cycle is seen as the key risk to investment returns.

ASI view: Our own work on the history of asset allocation over two centuries leads us to conclude that private markets can provide a persistent return premium as long as investors fully understand the underlying risks: both increased illiquidity and increased complexity.

Mind the return gap?

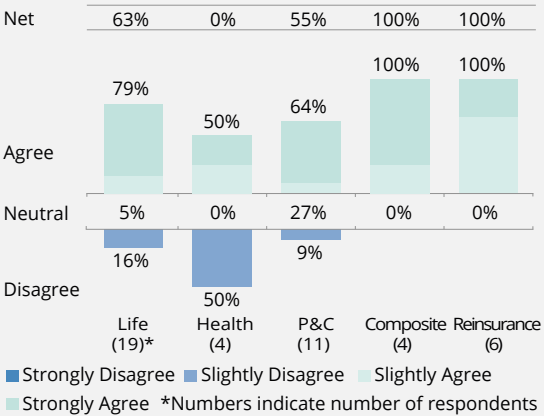
The majority of North American insurers believe that their current investment strategy needs to change. Based on their current asset allocations, insurers expect to see future investment returns fall short of their internal targets (see figure 5). Where there was disagreement with this statement, it was only because the “**expectation is already that returns are low**”, as one US health insurer told us. A prolonged low interest rate environment was cited as a key risk to investment portfolios by 37% of those surveyed (see figure 10 later in this section).

Investment returns as a source of competitive advantage

As Warren Buffet famously said: “you only find out who is swimming naked when the tide goes out.” This low return environment has arrived just as insurers are becoming more reliant on these returns as a source of competitive advantage. Insurers see limited scope for operational gains. The life industry is facing distributional challenges. The health industry is facing regulatory uncertainty. The P&C sector faces high claims inflation. And the reinsurance industry has attracted a lot of capital and is highly competitive. Overall, this is a highly competitive industry.

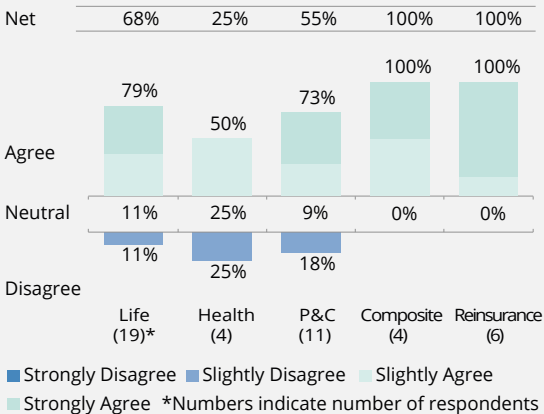
Higher investment returns is one route to better corporate results, but comes with trade-offs. “**I have been arguing with the board, we cannot increase investment returns without increasing our risk tolerance**” as one Canadian P&C insurer observed. This concern is shared by 80% of survey participants (see figure 6).

Figure 5
The market will struggle to meet target investment returns over the next three years



Source: ASI North American Insurance Survey 2018

Figure 6
Providers are concerned about their ability to generate business outperformance without significantly raising their investment risk



Source: ASI North American Insurance Survey 2018

In search of yield

When we asked insurers what was the primary driver for future asset allocation changes, higher returns topped the bill; with yield enhancement, accessing the illiquidity premium and risk adjusted returns all cited (see figure 7). Diversification was the other major driver.

Figure 7

Yield enhancement is primary driver for asset allocation change



Source: ASI North American Insurance Survey 2018

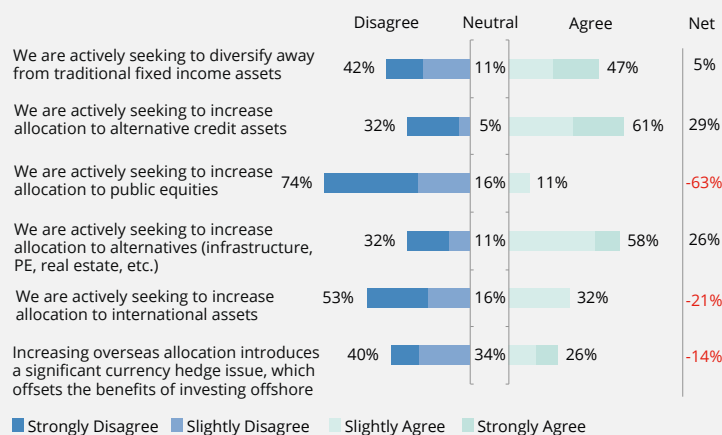
Asset allocation intentions: increasingly alternative

Insurers are responding to this shortfall in expected returns by actively seeking to further increase allocations to alternative assets (see figure 8). By contrast, insurers are neither looking to increase allocations to equities, nor international assets in search of higher returns.

The rotation out of traditional fixed income is expected to be weighed towards trimming municipal bonds and investment-grade corporate bonds. **"Municipals are no longer as attractive given recent tax reform"**, observed a small US P&C insurer. There are few intentions to cut exposure to treasury bonds. A medium US P&C Insurer pointed out.

Figure 8

Asset allocation intentions



Q To what extent do you agree with the following statements

Source: ASI North American Insurance Survey 2018, Sample = 38

Impact of municipal bond tax reform

US P&C insurers have historically had a significant allocation to tax-exempt municipal bonds due to their tax benefit (with an average allocation of 9% in the survey). Recent US tax reform decreased the corporate tax rate from 35% to 21%, reducing the tax benefit from tax-exempt municipal bonds and making them less attractive relative to taxable bonds on an after-tax basis. Consequently, P&C insurers are planning to re-optimize their asset allocations by shifting a portion of their tax-exempt municipal bonds to investment grade corporates.

On the other hand, US life insurers have historically had minimal allocations due to the smaller tax-benefit but the tax reform has simplified the proration to a flat 30% which may make tax-exempt municipal bonds more attractive for them.

Limited appetite for international assets

There is limited appetite to add to overseas assets (see figure 9). US insurers have little incentive to invest in non-US dollar assets when there are US dollar assets available in such volume and diversity, especially given there are various forms of cost inevitably incurred in the implementation of currency hedging programmes. A mid-sized US P&C insurer told us **“Many US corporations really are global, so we get global diversification without needing to invest in non-US financial markets”**.

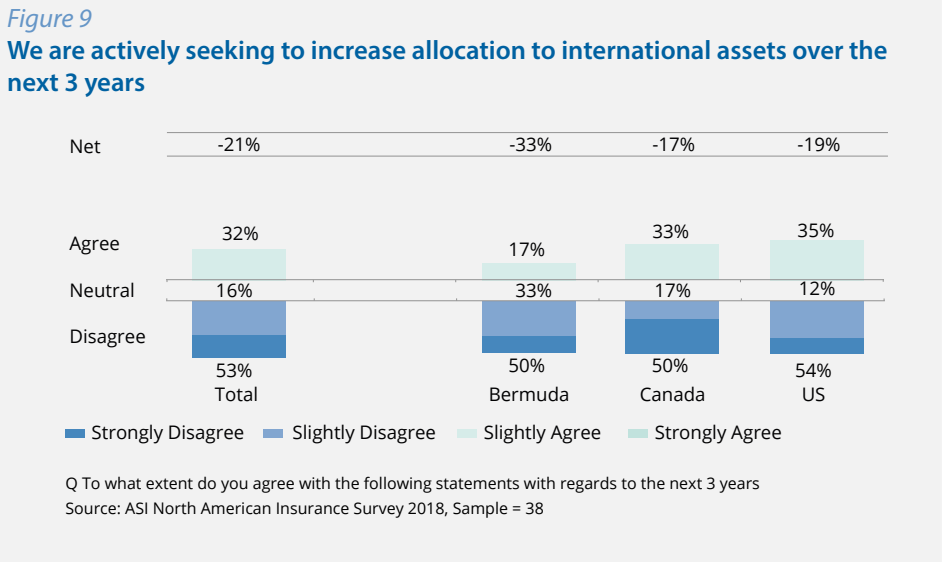
However, it also is true that US regulatory capital does not have a mark-to-market treatment of derivatives and this makes it harder to get regulatory capital credit for currency hedging, thereby making non-US dollar assets capital-inefficient for backing US dollar liabilities. Still, hedging was generally not cited as an issue. But this was either because the insurer was only considering US dollar denominated international assets, or they were not considering overseas assets at all. A mid-sized US life insurer said **“We would only invest in US dollar denominated international assets”**.

Interest rate and credit cycle concerns

The prolonged period of low interest rates was seen as the key risk to investment portfolios by 37% of insurers (see figure 10).

Rising interest rates were also cited as a concern. The majority of insurers citing this concern were fixed annuity providers. They worry that, if yields increase too quickly, it could trigger an increased surrender rate and make it hard to meet liquidity requirements. By contrast, when the weightings for the top three risks are combined, credit devaluations topped the list of concerns, with 61% of those surveyed citing it as a key risk to their investment portfolios over the next 3-5 years (see figure 10). Indeed, there are **“some early indications that we are nearing the end of a credit cycle”**, said one small US life insurer.

However, there is no clear consensus that we are at the end of the credit cycle. Some insurers are reacting to these concerns and others are not. **“We are deliberately increasing the average credit quality of our bond portfolio through replacement”**, according to one large US life insurer. But the survey did not reveal evidence of an industry-wide trend to reduce credit risk. That said, in general, insurers indicated a preference for illiquidity risk over credit risk at present.



A consistent global view on risks, except on protectionism

Most risks are common across all countries (see figure 11). However, insurers in Canada and Bermuda have a very different view of the impact of protectionism from the US counterparts. Canadian and Bermudan based insurers cited protectionism as a key risk. By contrast, US insurers, the potential beneficiaries of a more protectionist political regime, placed this issue well down the ranking of the threats to their businesses.

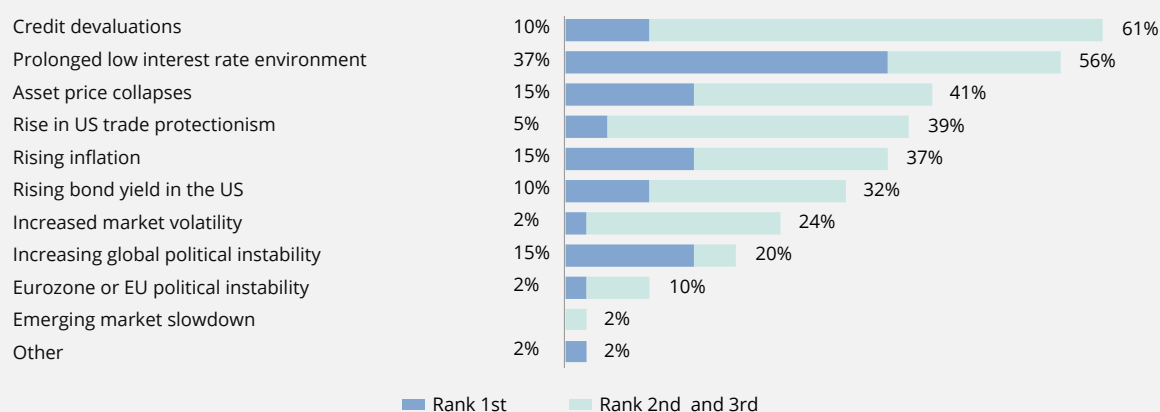
In general, global political and economic risks are low down the list of worries for the industry.

Our Conclusions

We have carried out a study of 200 years of asset allocation. It tells us that the continuation of the shift from public to private assets can be a successful strategy for years: private markets can provide a persistent premium return. But investors need to fully understand the underlying risks. We expand on this in our conclusion.

Figure 10

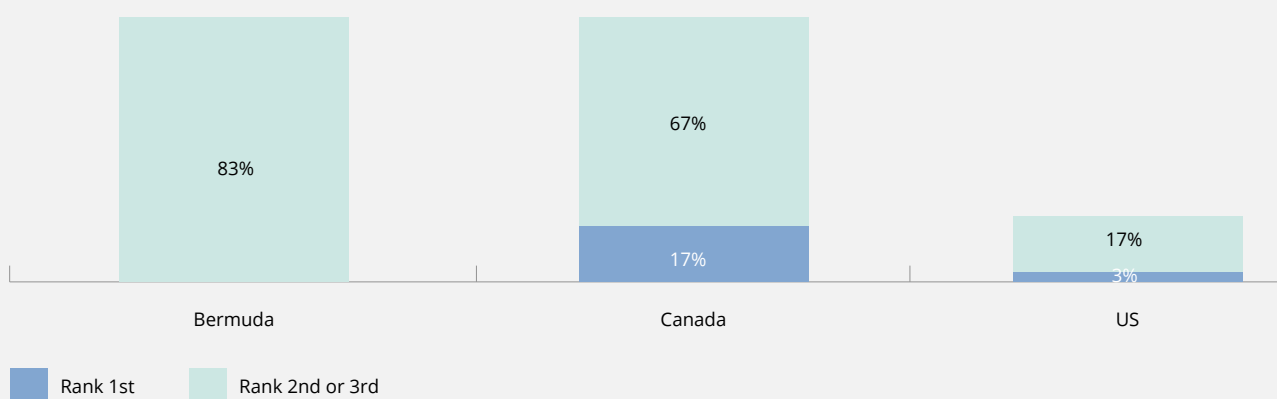
Key risks to insurer investment portfolios over the next 3-5 years



Source: ASI North America Insurer Asset Management Study 2018, Sample = 41

Figure 11

Trade protectionism as a risk to insurer investment portfolios over the next 3-5 years



Q Please rank the following future financial & political scenarios by the risk they pose to (re)insurer investment portfolios over the next 3-5 years
Source: ASI North American Insurance Survey 2018, Sample = 41

Theme 2:

Optimising alternative allocations

As insurers seek to maximise investment returns (theme 1), they continue to reduce exposure to traditional fixed income assets and increase exposure to alternative assets. Corporate loans, real estate loans and private equity were the most cited asset classes within alternatives for additional investment. However, our interviews revealed that insurers are struggling to reach target allocations. Accessing these assets is challenging due to the added complexities involved. There are inevitable time lags between committing capital and gaining exposure. And demand exceeds supply for the specific assets that meet the needs of insurers.

ASI view: *With access proving difficult, we see room for insurers to look for 'alternatives to alternatives' in search of higher returns or greater diversification. We explore potential candidates in our conclusion.*

The switch from public to private market assets is set to continue

The way the world is financed has fundamentally changed. As banks are forced to retreat from risky lending, institutional asset managers are filling the void. The switch from public to private markets is set to continue. Insurers are expected to reduce exposures to traditional fixed income assets and increase exposures to both alternative fixed income and alternative equity investments, in search of higher returns through the capturing of the illiquidity premium (see figure 12).

Within the alternative fixed income space, corporate loans were the most cited fixed income asset class for additions (see figure 13). They offer the closest private market parallel to existing holdings in corporate bonds. Real estate loans, which include longer duration loans, are also favoured. Infrastructure debt also offers long-duration bonds but was not attracting much attention.

"Sounds great on paper, but haven't seen any good opportunities" a small US life insurer observed.

Protection against rising rates led some insurers to seek floating-rate loans. **"Higher, floating-rate yield and capital efficiency make CLOs very attractive"** said one medium US Life Insurer.

The ongoing switch from public to private is true of equities too (see figure 14). Also notable was the lack of interest in hedge funds and commodities, both of which had enjoyed strong inflows between the bursting of the TMT bubble and the global financial crisis (2002 – 2007).

Access is a barrier to meeting target weights in alternatives

While quantitative analysis points to sharply rising allocations, the face-to-face interviews highlighted the difficulties of reaching desired weightings. As the series of quotes below reveal, there is insufficient supply to meet demand.

"It takes time to build up real estate loans, we don't expect to reach our target allocation until 2020"

Medium US P&C Insurer

"It has been slow getting private placements, lots of demand"

Bermuda Insurer

"It is taking us longer than expected to reach our target allocation [for private equity]"

Medium US P&C Insurer

Our discussions revealed the primary reason for this barrier was the limited supply of private credit meeting the needs of insurers; in particular, long-duration investment-grade credit.

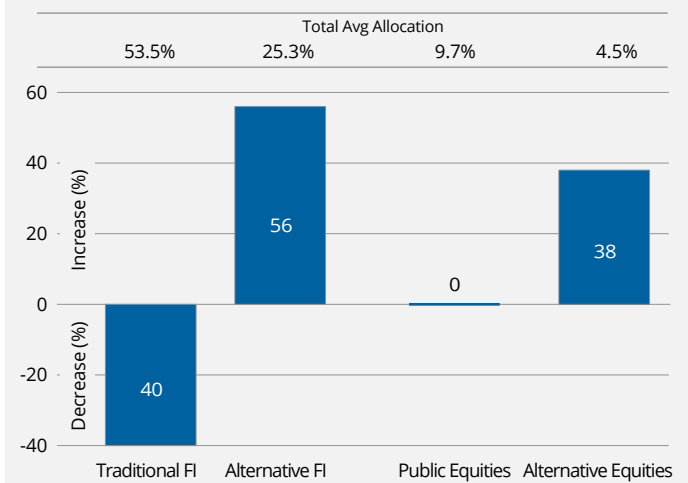
We would note that this is a global phenomenon, with insurers in Europe and Asia following a similar strategy. Our 2017 survey of insurers in Asia Pacific revealed an additional driver for alternative allocations. The limited supply of longer-duration assets in local markets made Asian insurers more willing to overcome the barriers of foreign currency hedging costs and regulatory capital issues in order to match longer-dated liabilities.

Our Conclusions

With insurers struggling to reach target weights in alternative assets, there is room to look for 'alternatives to alternatives'. The secondary market in private assets offers one route, albeit access here is challenging too. Other options include some liquid alternatives, which can offer both higher returns and/or diversification benefits.

"The way the world is financed has fundamentally changed."

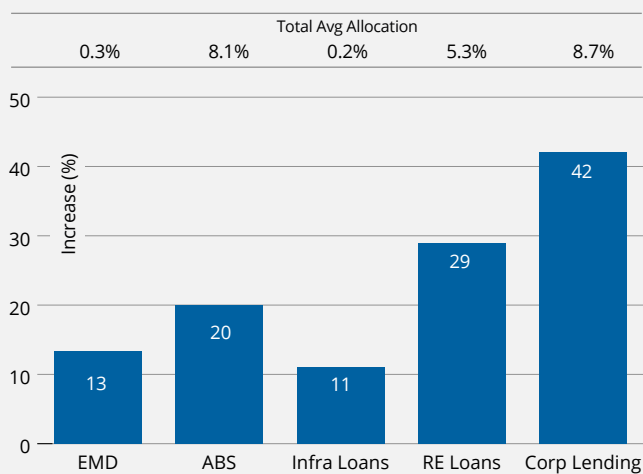
Figure 12
Net respondents changing asset allocation over the next 3 years



Q How are your assets split into the following asset classes approximately, and how will they change over the next 3 year (increase, decrease, remain)?

Source: ASI North American Insurance Survey 2018, Sample = 45

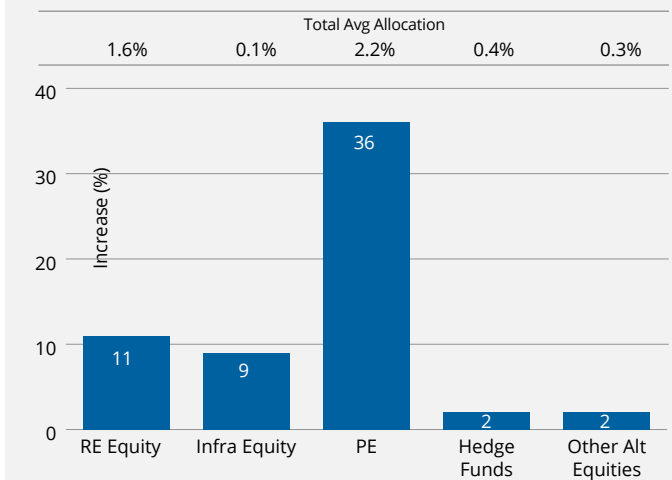
Figure 13
Net respondents changing alternative fixed income allocation over the next 3 years



Q How are your assets split into the following asset classes approximately, and how will they change over the next 3 year (increase, decrease, remain)?

Source: ASI North American Insurance Survey 2018, Sample = 45

Figure 14
Net respondents changing asset allocation over the next 3 years (excluding fixed income)



Q How are your assets split into the following asset classes approximately, and how will they change over the next 3 years (increase, decrease, remain)?

Source: ASI North America Insurer Asset Management Study 2018, Sample = 45

Theme 3:

The value of outsourcing: beyond alpha

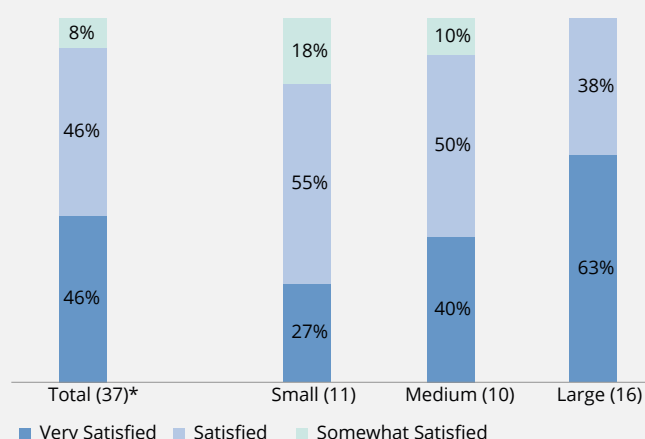
The ongoing shift from public to private markets (theme 2) will necessarily drive an increase in outsourcing to external managers. Many insurers have strong in-house investment capabilities and primarily look to external managers for specific asset class expertise. However, the delivery of investment returns from harder-to-access asset classes is, while necessary, not sufficient to meet insurers' needs. Investment experts within insurance companies need to collaborate with external asset managers to manage the additional complexities and risks of these investments. In addition, they value a dialogue with their peers at external managers on investment strategy. External managers are mostly seen to be delivering on essentials, but sometimes need to do more to understand the specific needs of their insurance clients.

ASI view: For asset managers to add value to the investments of insurers, they need to: deliver alpha; demonstrate knowledge of local regulations; and provide advice on asset allocation and risk management – all in the context of the specific needs of the client. Our survey pointed to one area where North American insurers potentially lag behind their European peers: integrating the analysis of ESG risks into their investment process.

Insurers in-house investment capabilities are strong

What are insurers looking for from their external managers? The starting point is that 92% of insurers surveyed were either satisfied or very satisfied with their existing investment capability, versus 8% who were somewhat satisfied (see figure 15). The exceptions were some of the small and medium sized firms. Outsourcing is largely focused on accessing specific asset classes and insurers are generally positive on the outcome. With insurers looking to increase exposures to alternative assets, outsourcing is set to increase.

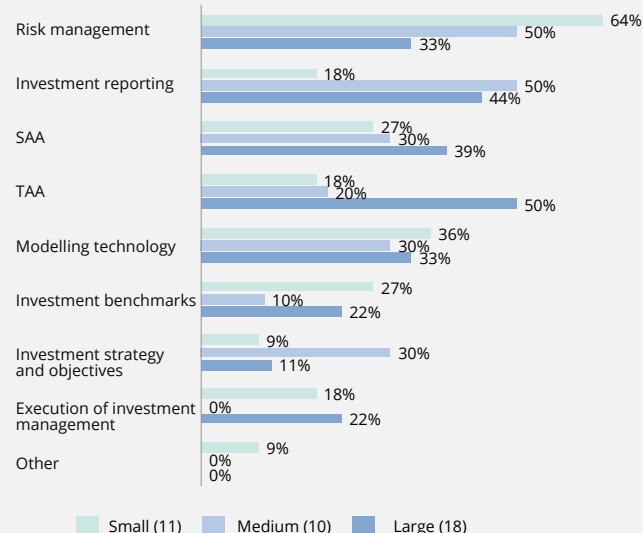
Figure 15
Satisfaction with existing internal capability



Q4.13. How satisfied are you with your existing internal investment capability?
Source: ASI North America Insurer Asset Management Study 2018

While insurers were generally satisfied with their internal expertise, this did leave areas for improvement. Risk management is a key area where further progress is required, particularly for small and medium-sized firms (see figure 16). Asset allocation – both tactical and strategic – was cited as an investment skill with scope for upgrading by larger insurers. Investment reporting was another area for improvement, reflecting the increasing complexity of the underlying investments.

Figure 16
Key investment capabilities to improve on



Q What are the key areas you need to improve on?

Source: ASI North America Insurer Asset Management Study 2018

External managers bring skills in specific asset classes and risk management expertise

With insurers confident in their own investment capabilities, it is not surprising to see that the key factor when selecting an external manager was expertise in the specific asset class (see chart 17).

Figure 17

Key factors during external manager selection



Q Please rank the importance of the following factors when selecting an external asset manager
Source: ASI North America Insurer Asset Management Study 2018, Sample = 38

Investment strategy expertise is valued, but not investment advice. The investment experts within insurance companies want a peer-to-peer discussion with their external managers on asset allocation issues. **“We can always be improving our TAA”** said one large US life insurer.

This asset allocation discussion included benchmarking. **“We are looking to introduce benchmarks, however the common ones aren’t appropriate”** a medium-sized Bermuda reinsurer correctly observed.

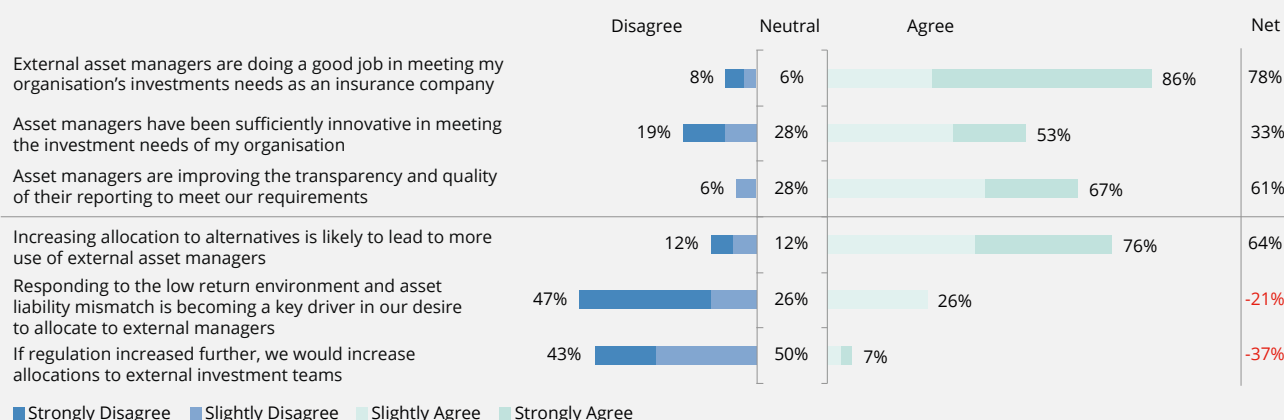
Risk management was highlighted as an area where external managers can add value. The growing exposure to private markets brings a more complex mix of risks into the equation. A US health insurer told us that **“We are increasingly relying on our external asset managers to run risk scenarios”**. And a medium-sized US P&C insurer said **“our modelling capabilities will never be on par with those of a global asset manager”**.

Insurance expertise is seen as a necessary skill, but insurers are not looking to their asset managers for advice on liability management. Price is always an issue and passive management has grown as a percentage of public equity assets in recent years. Insurers surveyed held 30% of their externally managed equities in passive strategies, with a further 8% in quantitative active strategies. By contrast, only 11% of externally managed traditional fixed income exposure was passively managed. However, insurers appreciate that you get what you pay for with more exotic alternative asset classes.

ESG ranked bottom of the list of 13 factors considered during external manager selection. A large US P&C insurer told us **“Unless there is a mandate from the Board, I don’t believe ESG should be a part of our investment strategy”**. Others see it as an issue for the future. A large US life insurer said **“We are looking at ESG from a holistic perspective and certainly want to be a leader in the future, but it is very challenging to set a consistent rule for investments”**.

Figure 18

Key investment capabilities to improve on



■ Strongly Disagree ■ Slightly Disagree ■ Slightly Agree ■ Strongly Agree

Q To what extent do you agree with the following statements
Source: ASI North American Insurance Survey 2018, Sample = 36

External managers delivering on the investment needs of insurers

86% of insurers surveyed agreed that their external asset managers are doing a good job in meeting their investment needs (see figure 18). 53% said that asset managers are sufficiently innovative in meeting these needs, both in investment approach and to meet the growing reporting requirements of modern insurance companies.

Insurers acknowledged that increasing exposure to alternative assets will also mean increasing working with external managers. The key barrier to winning mandates was demonstrating an understanding of client-specific needs (see figure 19). As one large Canadian P&C insurer observed, *“It quickly becomes obvious when a potential asset manager hasn’t done even the simplest of research and read through our annual report”*.

Our Conclusions

Insurers primarily look to these managers for specific asset class expertise. But those external managers that want to become trusted partners of insurance companies must do more. They must demonstrate a genuine understanding of the insurers’ needs, engage in a dialogue of equals on investment strategy and provide support on risk management.

Only one respondent cited ESG expertise as a key factor during external manager selection. We expect more prioritising of ESG factors in the future, reflecting the trend we are seeing in Europe and Asia. ESG analysis is increasingly both an important ingredient in identifying investment opportunities and understanding risks.

Figure 19

What are the main hurdles that external managers need to overcome?



Source: ASI North American Insurance Survey 2018



Theme 4:

The technology tipping point?

The industry is in the process of being reshaped by the advances in technology. These changes are expected to affect primarily the operational facets and distribution routes of the industry, with limited concerns about increasing competition – in part because competition is already intense. There is little consensus on the impact of changing regulation, with some insurers seeing this driving changes in their investment strategy and others believing the industry remains ahead of the curve.

ASI view: Given the scale of the disruption that big data and artificial intelligence applications are bringing across the insurance industry, we wonder whether it is right to expect that these changes will have minimal impact on investment strategy.

Technology is expected to reshape the industry...from the inside

There is a strong consensus that the industry is in the process of being reshaped by the advances in technology (86% agree, see figure 20). However, the changes are expected to affect primarily the operational facets and distribution routes of the industry.

Insurers see limited repercussions for investment strategy, at least for now. The survey revealed less concern about the impact on the level of competition, with 67% of respondents expecting the

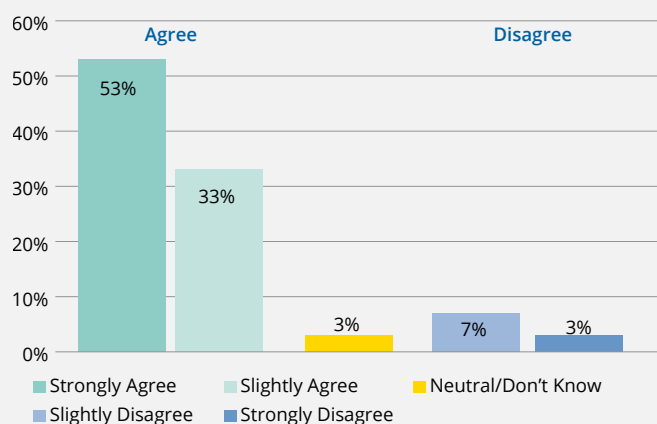
impact to be minor (see figure 21). In part, this reflects the reality that competition in most insurance industries is already intense. ‘Technological advances and disruption’ are low down the list of key factors that affect future market growth and mix (see figure 22). Most strikingly, only one of the insurers surveyed expect technological changes to have a major impact on investment management and management approach (see figure 23)

Our discussions revealed some of the expected drivers of change for these aspects of the business. We set out some of the common issues around these aspects in the table below.

| Table heading | |
|------------------------|--|
| Distribution routes | Shift away from traditional brokers/agents to direct, online, apps, robo-advice, comparison |
| Product mix | P&C: Usage based insurance, ride sharing, autonomous cars |
| | Life: Lifecycle proposition (modular products that cater to policyholder’s current life-stage), Wellness programmes, demographics, interaction with pension system |
| | Health: ACA impacts on Medicaid and Medicare, demographics |
| | All: Bundling within and across insurance lines |
| Underwriting practices | Big data, telematics, artificial intelligence, genetics, enabling faster and more accurate underwriting |
| Pricing | Improved data (including public unstructured data) and model sophistication supporting increased granularity and precision |
| Level of competition | Very competitive already, old industry, low perceived risk of real disruptors |
| Claims management | Speed and accuracy (decrease fraudulent claims) |
| Consumer loyalty | May decrease with shift to comparison and commoditisation of insurance, or increase with bundling, embedding |

Figure 20

To what extent do you agree that the insurance industry is on the verge of a seismic, tech-driven shift within the next ten years?

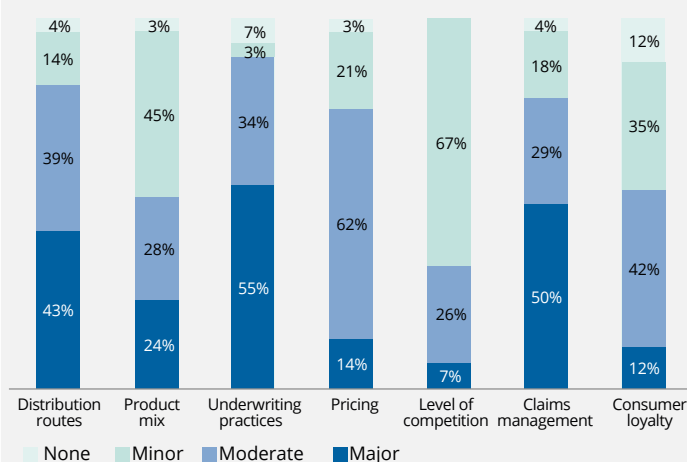


Q To what extent do you agree that the insurance industry is on the verge of a seismic, tech-driven shift within the next 10 years

Source: ASI North America Insurer Asset Management Study 2018, Sample = 30

Figure 21

To what degree do you expect the following aspects of your industry to be affected?

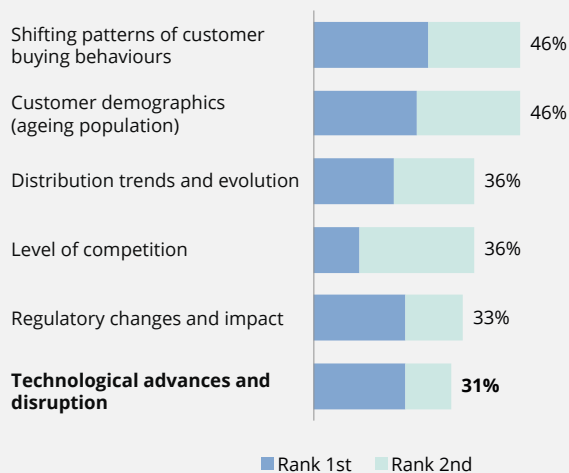


Q Which of the following aspects of your industry do you expect to be impacted and to what degree?

Source: ASI North America Insurer Asset Management Study 2018, Sample = 29

Figure 22

Key factors that affect future market growth and mix

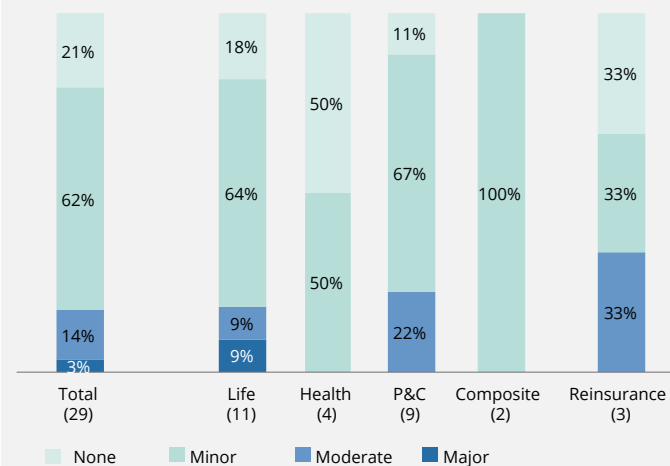


Q Please rank the following factors based on their impact on market growth and mix over the next 3 years

Source: ASI North America Insurer Asset Management Study 2018, Sample = 29

Figure 23

Technological Impact on Investment Strategy and Management Approach



Q To what extent will these changes cause you to rethink your investment strategy and overall investment management approach?

Source: ASI North America Insurer Asset Management Study 2018, Sample = 29

Our conversations with insurers provide more colour on where these operational issues could trigger an increase in the level of competition.

A mid-sized US Life Insurer told us they expect the **“largest potential disruption to occur in distribution, combination of changing customers and shift to digital... Expect large changes when somebody gets it right”**.

“Drones, artificial intelligence, telematics, usage based insurance, claim pay-out automation... Lots of known disruptions already happening or on the horizon”, said a Canadian P&C Insurer.

Others highlighted the need for increased investment as an immediate competitive issue. A Bermuda insurer **“will be forced to invest in tech by competition from start-ups innovating across distribution, underwriting and claims management”**.

Differences in key factors impacting future market growth by sector

Each insurance industry is facing distinct market changes that will influence future industry growth and product mix.

Life insurers cite influences across all key factors. Ageing demographics should translate into higher future demand and volume across all life products. However, there is significant potential disruption in the way life products are distributed as each new generation becomes more familiar with direct and digital offerings in comparison to the traditional intermediated path. It is expected that the successful implementation of direct routes – including the use of robo-advice – will also grow the market significantly as it targets the historically underserved mass-affluent customer segment.

While the industry has always been highly competitive, it is being disrupted by a new breed of private equity-backed life insurer entering the market, which places a stronger focus on investment capabilities to drive competitive advantage. Pure technological advances such as artificial intelligence are expected to have a limited impact on overall market growth and business mix. However, it will contribute to maintaining the high level of competition in the industry.

Finally, while large regulatory shocks are always possible, there are none on the foreseeable horizon, beyond the after-effects from tax reform and the appeal of the Department of Labor fiduciary rule.

Health insurers are particularly focused on two factors expected to affect market growth and business mix: customer demographics and regulation. The ageing population will shift the product mix towards Medicare in the US, while any further (and currently highly uncertain) changes to the Affordable Healthcare Act have the potential to directly impact Medicare and Medicaid, and indirectly private health insurance significantly.

P&C insurance customers are already shifting towards digital and direct channels, especially for individual products. Further rotation to direct channels will place pressure on pricing and future premium growth. So too will the rising dominance of comparison websites, similar to the experience of, for example, the UK auto-insurance industry.

Similarly, technological advances – including telematics, big data and analytics – are expected to improve underwriting practices and pricing with implications for future growth.

Finally, the proliferation of ride sharing and the potential for autonomous cars could move the product mix away from individual policies towards more fleet insurance.

The Reinsurance market will be affected by the continual evolution of international laws and regulations, such as the introduction of the BEAT provision (Base Erosion and Anti-Abuse Tax) in the US tax reform. Similar to the other insurance industries, reinsurance is intensely competitive due to an abundance of capital. Finally, the shift to the direct channel is also occurring in the reinsurance industry, with potential implications for future growth and mix.

Our Conclusions

Only one of the participants sees technological change as having a major impact on investment strategy and management approach. Given the rapid pace of change in so many facets of the industry, we wonder if the industry is being complacent about the impact on investment strategy.



Conclusions

Four themes, one story

North American insurers have successfully managed their businesses through a period of falling bond yields and changing regulations. However, future investment returns are expected to fall short of internal targets. This is happening just as insurers are becoming more reliant on these returns as a source of competitive advantage.

Investment strategy will seek higher returns through further shifts from public to private market assets. However, accessing these markets is proving challenging and portfolios will struggle to reach target weights.

This shift will necessarily increase outsourcing to external managers due to a lack of internal capabilities. Insurers primarily look to these managers for specific asset class expertise. But those external managers that want to become valued partners of insurance companies must do more. They must demonstrate a genuine understanding of the insurers' needs, decode the complexities of private markets, engage in a dialogue of equals on investment strategy and provide support on risk management.

Technology, in the form of big data and artificial intelligence, is bringing immediate and significant change across all operational facets of the insurance industry. But – for now – it is not seen as bringing about a significant change in investment strategy.

These are the findings of the survey. What are our views? We sound an amber warning on four areas. And we highlight two areas where there is scope for a global asset manager to add value.

Understanding the fundamental risks of private markets

How should insurers think about the strong consensus view driving the shift from public to private assets? After all, betting with the consensus is rarely the path to superior returns. Yet this shift reflects a fundamental change in the way that business is financed. Demand and supply are rising in tandem. We carried out a study of the history of asset allocation over 200 years – the history is British but the inferences are global – and two lessons stand out.

First, this shift can last for years. An influential actuarial paper made the case for embracing illiquid assets in 1862. By 1890, fully 80% of life office assets were invested in non-exchange traded assets.

But eventually investors became complacent and misjudged risk. Insurers suffered losses when falls in agricultural land prices led to defaults. Sometimes, what looks like an illiquidity premium turns out to be credit risk. It can be difficult to separate the two forms of risk. The lesson is that understanding the underlying fundamentals is key.

Assistance on asset allocation: expertise and structure

50% of large insurers cited tactical asset allocation as an area for improvement for their in-house investment capabilities, compared to just 18% of smaller insurers and 20% of mid-sized firms. This pattern is true of strategic asset allocation too, albeit the differences are less marked (27% for small firms, 30% medium, 39% large). This does raise the question of whether some smaller firms are unaware of their lack of expertise relative to their larger peers, who generally have more resources dedicated to these areas. But it also reflects the fact that other smaller firms do recognise this as an area of weakness, which they have already solved through outsourcing to external experts.

Getting asset allocation decisions right is not enough. Assets have to be held in the right structures, tailored to the individual needs of the insurance company. The right structure can enhance capital efficiency, reduce balance sheet volatility and prevent the swings on income statements created by mark-to-market pricing of risk.

The risks and uncertainties of rapid technological change

Insurers are alert to the known risks and opportunities of rapid technological change, but exposed to the many unknowns that accompany these changes.

Insurers are focused on the opportunities that technology brings, through operational improvements. But they may be playing down the threat of new competitors – as well as the threat from existing competitors that successfully embrace new approaches. The impact of technological change is primarily on the liabilities side: such as increased efficiency in managing claims and payments, and improved pricing of risks. But changes in liabilities could eventually lead to changes in the way that assets are managed too.

A McKinsey study (*Notes from the AI frontier: applications and value of deep learning*, McKinsey Global Institute) estimated a range of the impact of artificial intelligence across 19 sectors. The maximum impact on insurance sector was estimated at 7.1% of revenues, making it the third-most affected sector after travel and high tech.

Technology is already changing investment on many fronts:

- enabling the isolation of risk premiums in smart beta applications;
- high frequency trading;
- nowcasting of economic data; and
- machine learning applications in investment decision-making.

Yet the fundamental nature of insurance investment has changed little over the last two centuries. Investment strategy is largely buy-and-hold, matching the duration of assets and liabilities. The long-dated nature of the liabilities allows for a significant exposure to more illiquid assets. Advanced computing makes actuarial calculations significantly easier to carry out, but does not change the underlying maths.

Nor does artificial intelligence remove the need for human judgement. Effective risk management requires a codification of this judgement alongside quantitative modelling. Technology provides tools to manage more effectively the many complexities of investment, but does not provide complete solutions.

It is clear that the successful firms of the future will have embraced technological change. But managing exposures to more exotic asset classes requires expertise that is difficult for, say, a robo-insurer to replicate. The ability to combine technological expertise with investment expertise will be an increasingly important differentiator.

Complacency on ESG risks?

US insurance investors lead the global pack in terms of the shift from public to private markets, and from active to passive. But they appear to lag when it comes to prioritising the integration of ESG analysis into their process. Only one respondent cited ESG expertise as a key factor during external manager selection.

Yet in our opinion ESG analysis is not simply driven by the desire to do the right thing. There is well-documented academic evidence of a link between good management of ESG risk and good management of the financial risks that determine the creditworthiness of a company. Investors who do not incorporate ESG analysis in their process are putting themselves at an information disadvantage.

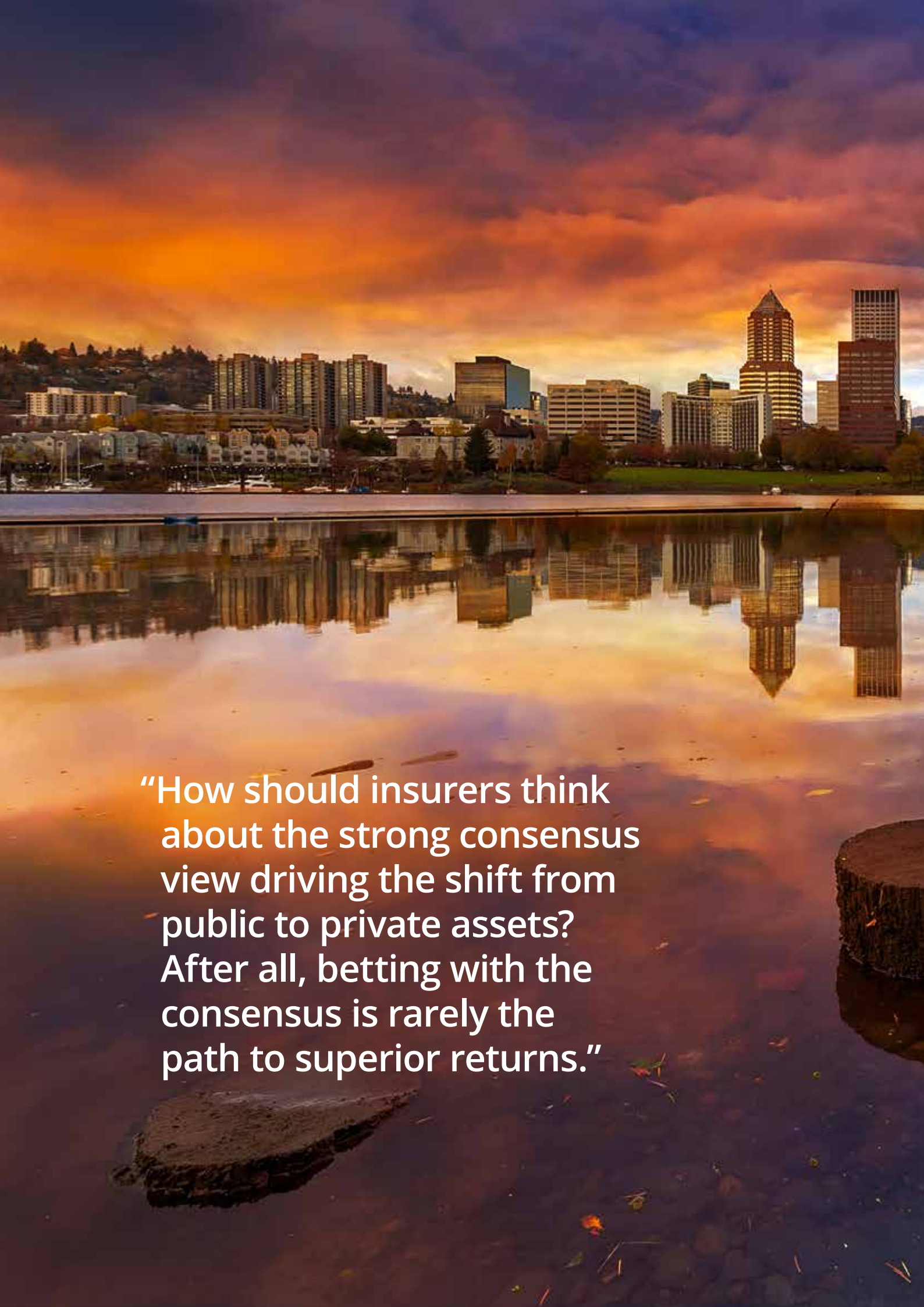
Alternatives to alternatives

Investors are struggling to reach target weightings in private markets. Secondary markets in private assets provide one possible avenue to accelerate additions to private markets, but liquidity in secondary markets is even lower than the primary market. Insurers can consider alternative strategies in public markets for sources of higher return and increased diversification. Outcome-oriented multi-asset strategies, US dollar-denominated emerging market debt and systematic alternative risk premium strategies are all examples that have the potential to offer appropriate risk-return characteristics for North American insurance investors.

A deeper understanding of risk

Insurers look to external asset managers for their expertise in risk management. The increasing shift into more complex private markets is likely to put a premium on those managers able to offer advice across a broad range of assets and strategies. These asset managers can triangulate: specific expertise in alternative asset classes; an understanding of the regulatory implications of investing in those asset classes; and the specific needs of the client.

Investors need to understand the real dimensions of risk. Backward looking measures of risk are not enough. Incorporating human judgement into forward-looking scenario analysis leads to better-informed decision making. But investors also need to understand the limits of risk models. A fundamental understanding of investments is also key. Best practice combines sophisticated modelling of these fundamentals with a realistic appreciation of the ability of those models to manage the unknowable.

A photograph of a city skyline, likely Seattle, reflected in a body of water at sunset. The sky is filled with dramatic, orange and purple clouds. The city features several prominent skyscrapers, including the Smith Tower. The water is calm, creating a clear reflection of the buildings and the sky. In the foreground, there are some dark, rocky outcrops in the water.

“How should insurers think about the strong consensus view driving the shift from public to private assets? After all, betting with the consensus is rarely the path to superior returns.”



Market Focus - US

Overview

- Largest insurance market in the world with USD \$1.4 trn in total direct premiums written in 2017, representing ~30% of total world direct premiums and 80% of North America insurance assets
- Very mature market, overall growth expected to be in line with inflation
- Highly fragmented, top-20 insurers only capture ~60% of direct premiums written (compared to >80% for most countries) and is dominated by domestic insurers
- Insurers are generally very well capitalised (average RBC ratio >400%)

Regulation & Legislation

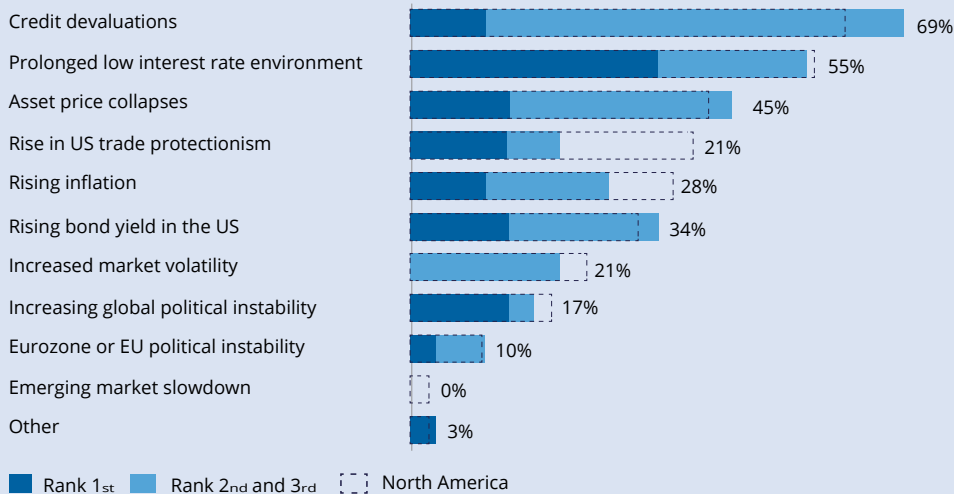
- State based regulation, but solvency regulation set at federal level by the National Association of Insurance Commissioners (NAIC)
- Risk-based capital (RBC) regime, currently undergoing modernisation initiative which includes increasing the granularity of RBC investment risk factors and a shift towards principle-based reserving for life insurers
- Follows Generally Accepted Accounting Principles (GAAP) accounting standards which is rules based rather than principle-based like International Financial Reporting Standards (IFRS); currently no plan to change to IFRS
- Tax Cuts and Jobs Act (TCJA) was signed into law in December 2017 which reduced US corporate tax to 21%, however the impact is subdued for life insurers given their material deferred tax assets, and partly offset by changes in the computation of insurance reserves for both life and P&C insurers
- The Affordable Care Act (ACA) has had a significant impact on US Health insurance industry, however the current government's efforts to repeal the ACA is creating significant uncertainty for health insurers
- Department of Labor's fiduciary rule was repealed in June 2018, yet it has already had an impact on products (shift to fee based rather than commission based) and customer attitudes

Key Risks

- Early indications that the US corporate credit cycle may be ending has resulted in credit devaluations being the clear lead risk to US insurers
- Despite recent interest rate increases, prolonged low interest rates remain a key risk to insurers, particularly for life insurers with their longer duration liabilities
- On the other hand, insurers are also worried about yields rising too quickly which could drive higher surrender/withdrawals from annuities leading to potential illiquidity challenges
- High valuations across asset classes driven by strong demand places asset price collapses as the third highest rated risk
- Given domestic focus, relatively less concern around US trade protectionism and international risks compared to the rest of the region

Key Risks

Key Risks to (Re)insurer's Investment Portfolios

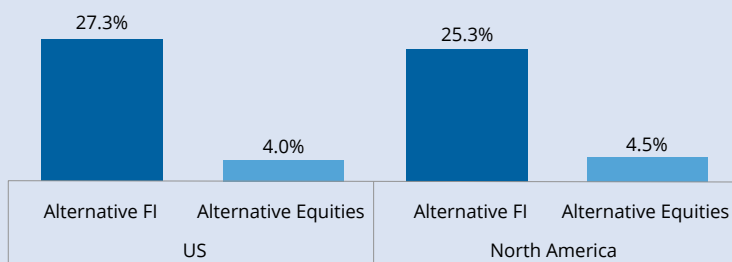


Q Please rank the following future financial & political scenarios by the risk they pose to (re)insurer investment portfolios over the next 3-5 years. Sample Size = 29

Allocation to Alternatives

- Limited differential to overall North America average allocations given relative size of US compared to Canada and Bermuda
- Higher allocation to alternative fixed income reflects maturity and insurer familiarity to private placements and asset backed securities

Current Allocation to Alternative Assets

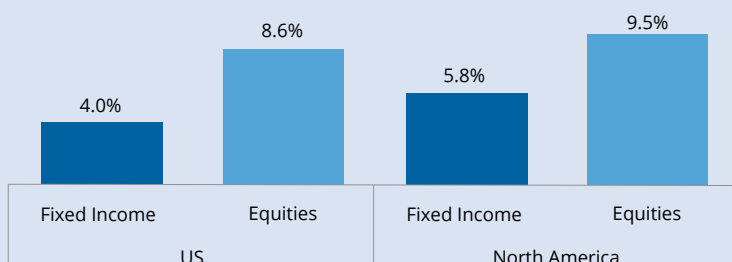


Q How are your assets split into the following asset classes approximately. Sample Size = 32

International Allocation

- Lower international allocations relative to North America average given the depth, breadth and maturity of domestic US assets limiting the incentive to look elsewhere

Current Allocation to International Assets

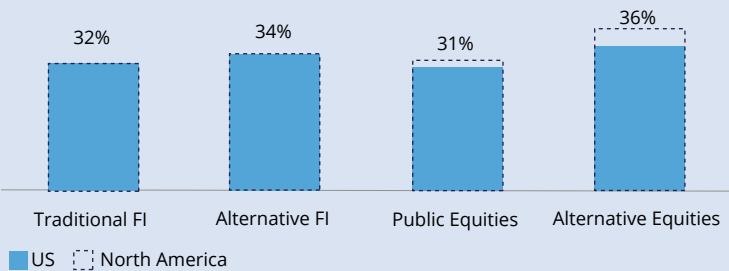


Q How are your assets split into the following asset classes approximately. Sample Size = 32

External Asset Managers

- Allocation to external asset managers is driven by asset class expertise but varies significantly by insurer size and operating model, averaging out at ~35% across all major asset groups
- Smaller insurers generally have higher allocation to external asset managers given limited internal capabilities
- Larger insurers have traditionally only outsourced more exotic alternative assets, but there is a growing segment of PE backed insurers that are the opposite, internalising alternatives and outsourcing traditional beta-focused assets resulting in a flat average across the asset groups

Proportion of Assets Managed by External Asset Managers



Q Please indicate the proportion that is held with external asset managers. Sample Size = 26



Market Focus - Canada

Overview

- Large insurance market with USD \$120 bn in total direct premiums written in 2017, placing it as the 9th largest country in the world , and contributing 15% to the total North America insurance assets
- Mature market, growth expected to be in line with inflation
- Highly concentrated with top three insurers capturing ~50% of total Canadian insurance assets

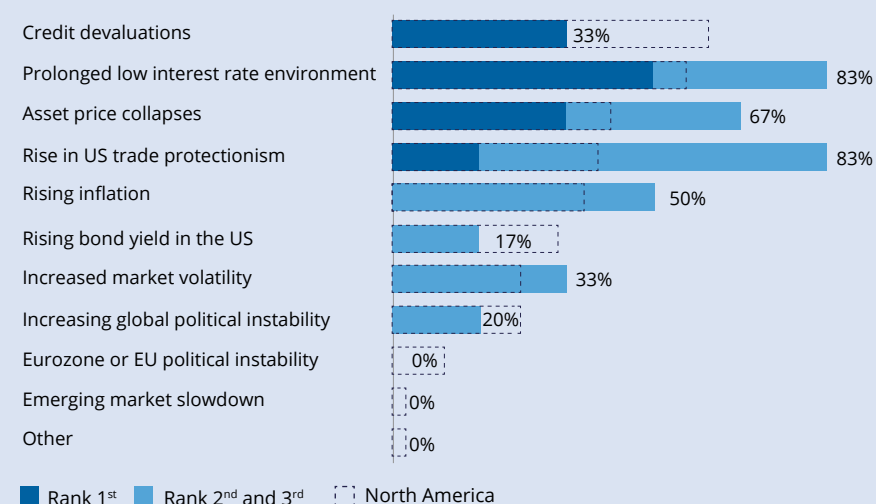
Regulation & Legislation

- Shared by provincial/territorial governments (market conduct) and federal (solvency)
- Separate solvency standards for life insurance (Life Insurance Capital Adequacy Test [LICAT]) and P&C insurance (Minimum Capital Test [MCT])
- LICAT only recently introduced on 1st Jan 2018, capital neutral for the industry but better reflects risks (more sensitive) and aligns with incoming IFRS 17 accounting standards
- Canada adopted IFRS in 2011, insurers are currently preparing for the introduction of IFRS 17 in 2021 which includes material changes to both calculations and financial statements

Key Risks

- Prolonged low interest rates rated as a significantly higher risk given limited forward guidance and neutral rhetoric from the Bank of Canada in comparison to the Federal Reserve
- US trade protectionism is also rated significantly higher due to the potential implication (such as tariffs) on the local economy and investments
- These are offset by credit devaluations, though it remains a material risk

Key Risks to (Re)insurer's Investment Portfolios

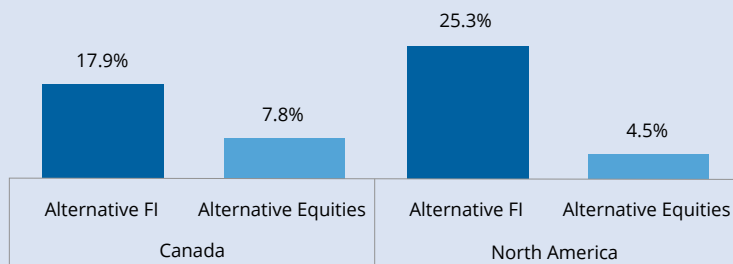


Q Please rank the following future financial & political scenarios by the risk they pose to (re)insurer investment portfolios over the next 3-5 years. Sample Size = 6

Allocation to Alternatives

- Lower allocation to alternative fixed income driven by lower supply relative to the US, specifically asset backed securities and private placements asset classes
- Offset partly by higher alternative equity asset allocations, the majority of which is commercial real estate equity

Current Allocation to Alternative Assets

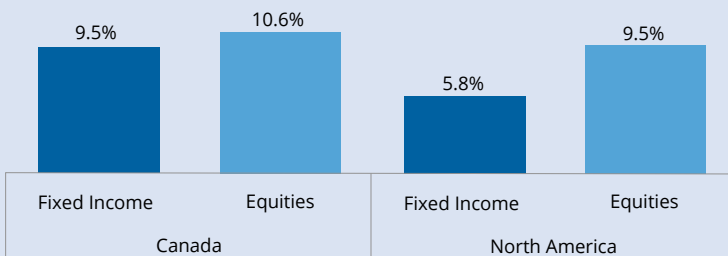


Q How are your assets split into the following asset classes approximately. Sample Size = 6

International Allocation

- Higher international allocation, majority of which is placed in the US
- Diversification benefit cited as the primary factor for allocating internationally

Current Allocation to International Assets

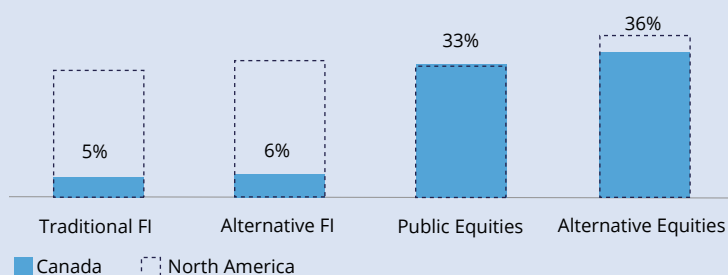


Q How are your assets split into the following asset classes approximately. Sample Size = 6

External Asset Managers

- External asset managers primarily used for their specific asset class expertise
- Dominance of traditional investment operations lead to limited use of external asset managers for fixed income asset classes

Proportion of Assets Managed by External Asset Managers



Q Please indicate the proportion that is held with external asset managers. Sample Size = 6

Market Focus - Bermuda

Overview

- British overseas territory that was originally a centre for captives but has since expanded to be one of the top reinsurance markets
- Insurance assets make up 7% of total North America insurance assets. This proportion is expected to grow given current momentum (20% increase in assets from 2016 to 2017)
- However, it is facing challenges from tax reform in the US (lower corporate tax and introduction of the new Base Erosion & Anti-Abuse Tax) reducing Bermuda tax advantage, and continuing uncertainties around Brexit

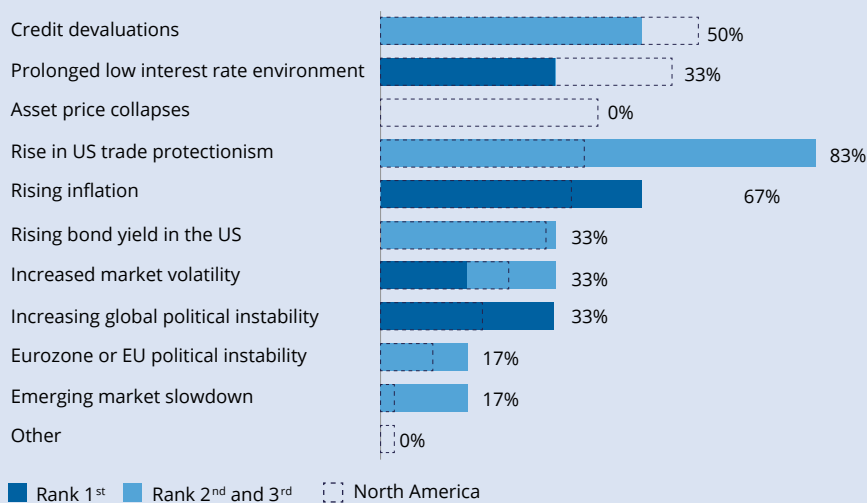
Regulation & Legislation

- Segmented solvency standards, Solvency II equivalency for commercial (re)insurance market and separate, less onerous regime for captives
- No specific national accounting standard, permits the use of either IFRS or GAAP

Key Risks

- Higher allocation to international assets to match international liabilities drives stronger focus on global risks, especially US trade protectionism given most (re)insurance underwritten in Bermuda is for the US
- Asset price collapses are generally viewed as a consequence of global macroeconomic risks or high inflation rather than a direct risk in itself

Key Risks to (Re)insurer's Investment Portfolios

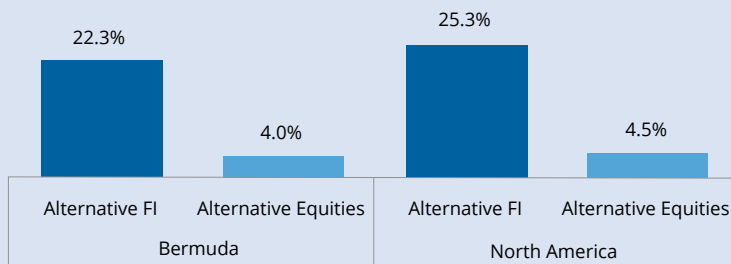


Q Please rank the following future financial & political scenarios by the risk they pose to (re)insurer investment portfolios over the next 3-5 years. Sample Size = 6

Allocation to Alternatives

- Allocation to alternatives is in line with North America average and is similarly driven by search for yield through idiosyncratic risk

Current Allocation to Alternative Assets

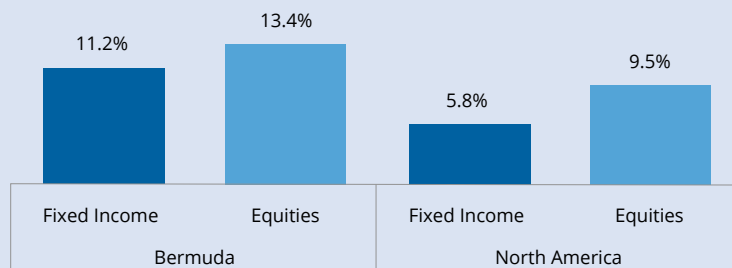


Q How are your assets split into the following asset classes approximately. Sample Size = 6

International Allocation

- Significantly higher allocation to international assets, driven by need to match international liabilities rather than for enhanced yield or diversification benefits

Current Allocation to International Assets

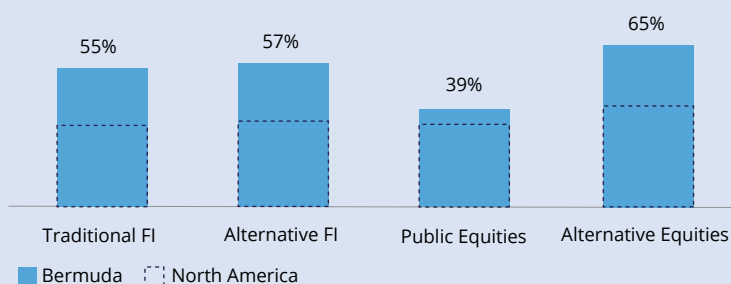


Q How are your assets split into the following asset classes approximately. Sample Size = 6

External Asset Managers

- Like the rest of North America, asset class expertise is the primary reason for use of external asset managers
- Stronger emphasis on underwriting and relatively smaller scale in comparison to North America average results in significantly higher allocation to external asset managers

Proportion of Assets Managed by External Asset Managers



Q Please indicate the proportion that is held with external asset managers

. Sample Size = 6



Aberdeen Standard Investments Insurance Specialists

We help insurers optimise their asset yield and capital efficiency and meet their reporting requirements.

Insurance solutions

Insurers have unique investment needs. On the one hand they need to generate sufficient returns on their assets to meet long-term commitments to policyholders. On the other, stringent regulation means that any investment risk needs to be balanced against solvency capital requirements and the potential for balance sheet volatility.

At Aberdeen Standard Investments, we have been helping insurers manage these challenges for almost 200 years. We provide access to a range of strategies and asset classes that can help enhance the risk-adjusted return on a portfolio.

Proven partner for insurers

We manage over \$415 billion of assets for insurers worldwide*. Our clients include some of the world's largest Life, Property & Casualty, and Reinsurers, as well as regional and local providers. All are supported by our dedicated insurance solutions team with extensive actuarial, reporting and risk management expertise.

Full breadth of investment capabilities

We provide investment approaches from pooled to customized portfolios or complete investment outsourcing. We utilize the complete investment universe to help diversify risk while enhancing potential return including investments in active, quant, multi-asset, private market and alternative investments.

* Source: Aberdeen Standard Investments, as at 31 December 2017.

Important information

Investors should be aware that past performance is not a guide to future results. The value of investments, and the income from them, can go down as well as up and investors may get back less than the amount invested.

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