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Multi-asset, absolute return funds for Insurers

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Disclaimer and thanks

- These are personal views, not the view of Aviva or any of its businesses
- This is not investment advice
- I'm grateful for comments and advice from my colleagues and friends at the following firms:
 - Aviva
 - Aviva Investors
 - Blue Mountain
 - EY
 - L&G
 - Taconic
- However, any errors and omissions are mine alone



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Scope

Do absolute return funds have a place in insurance portfolios?

- Definition and features
- Components and construction
- Implementation, insurers' capital and practicalities



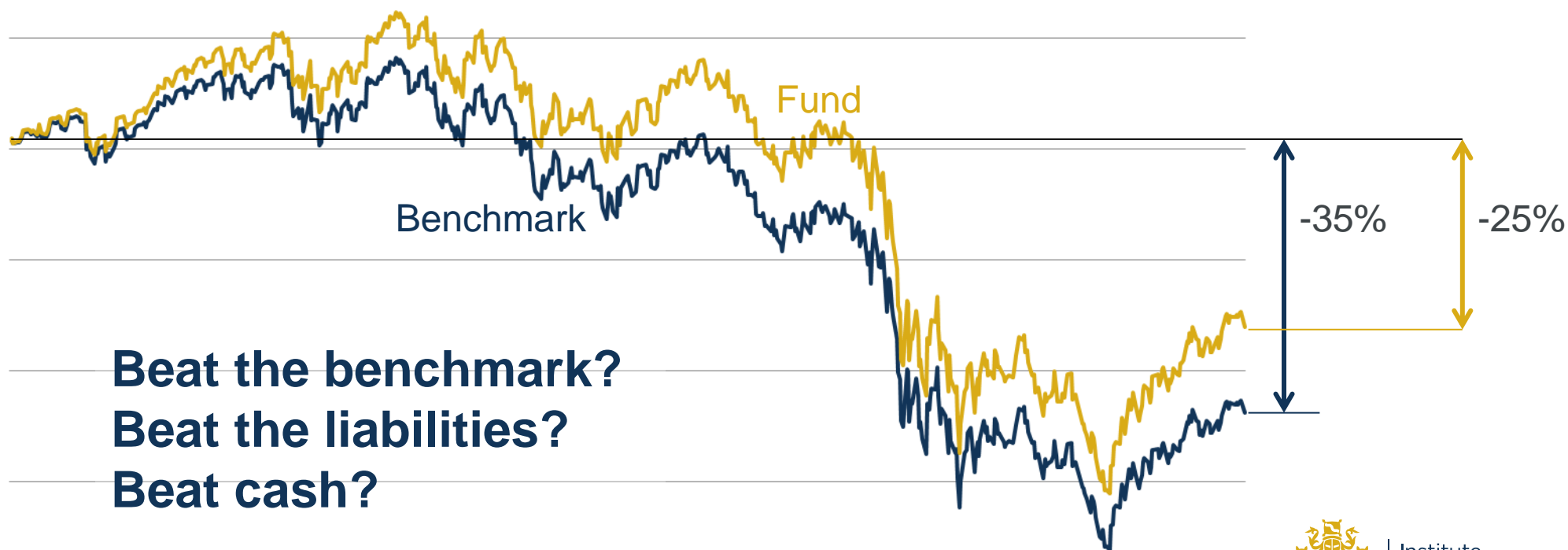
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A hand holds a magnifying glass over a landscape. The lens of the magnifying glass shows a detailed view of a river valley with hills and trees. The text "Definition and features" is centered within the lens.

Definition and features

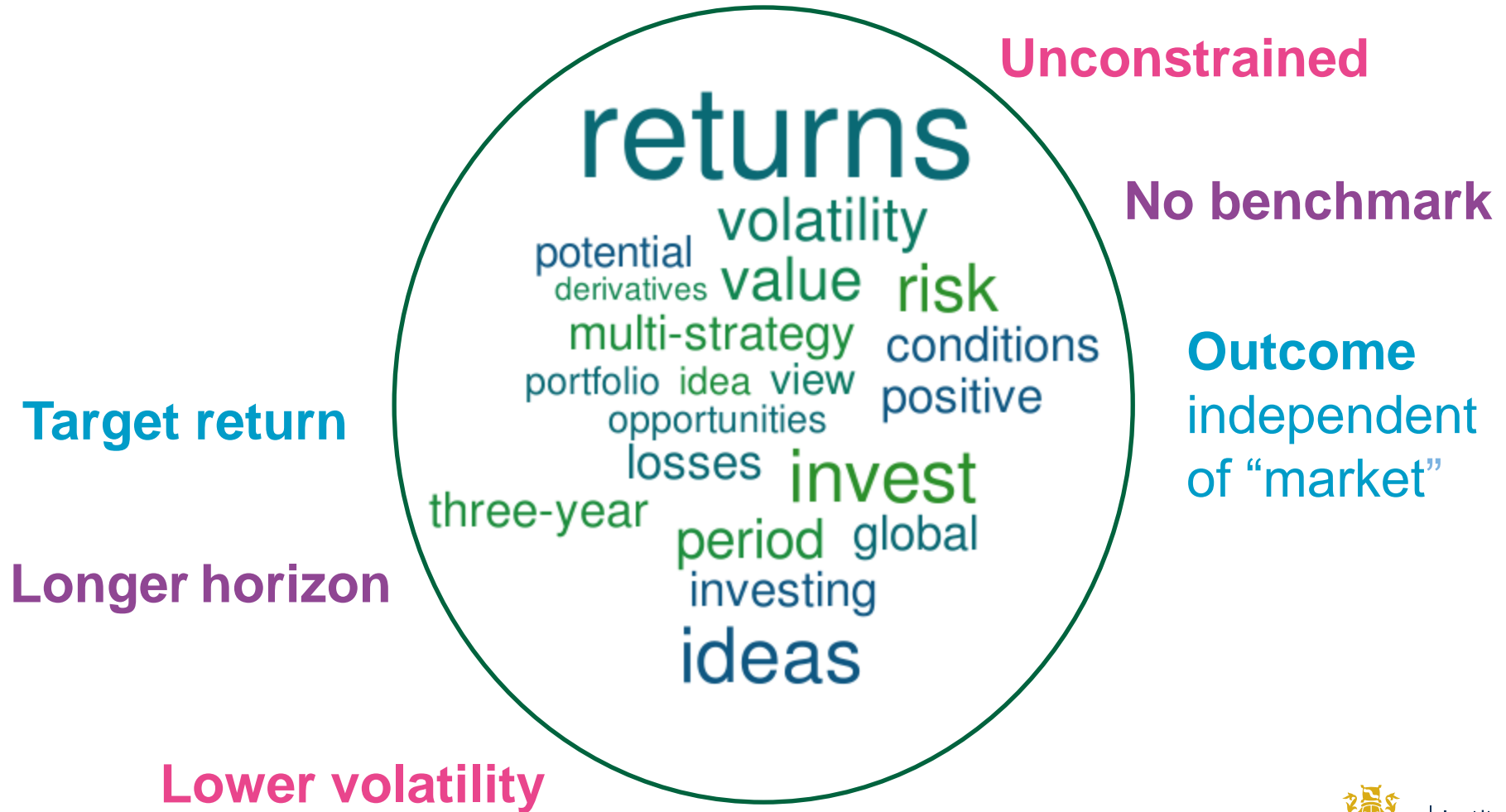
Absolute return | “You can’t eat relative returns”

“Superstar fund manager beats benchmark by 10% this year”



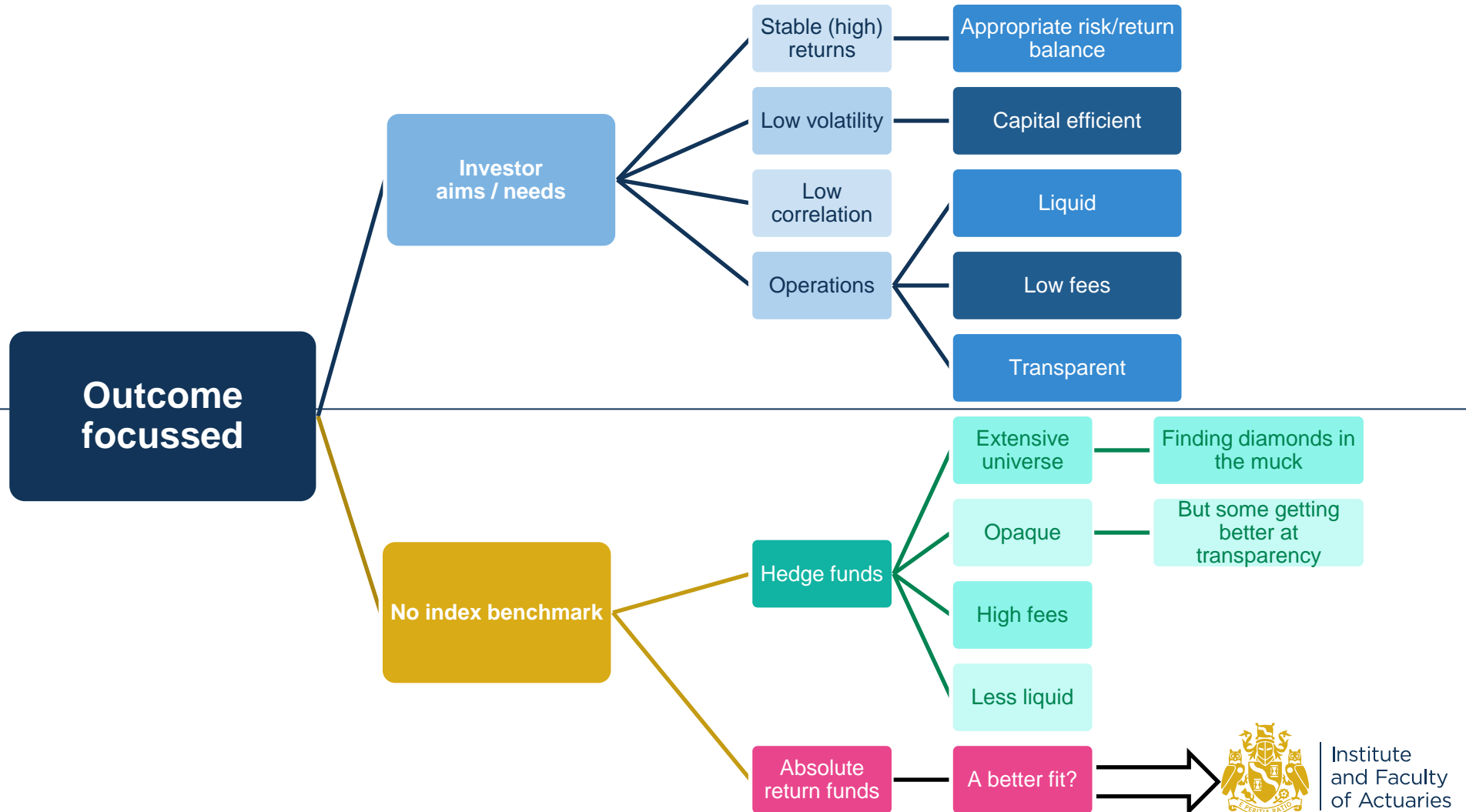
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Absolute return | Outcome focused

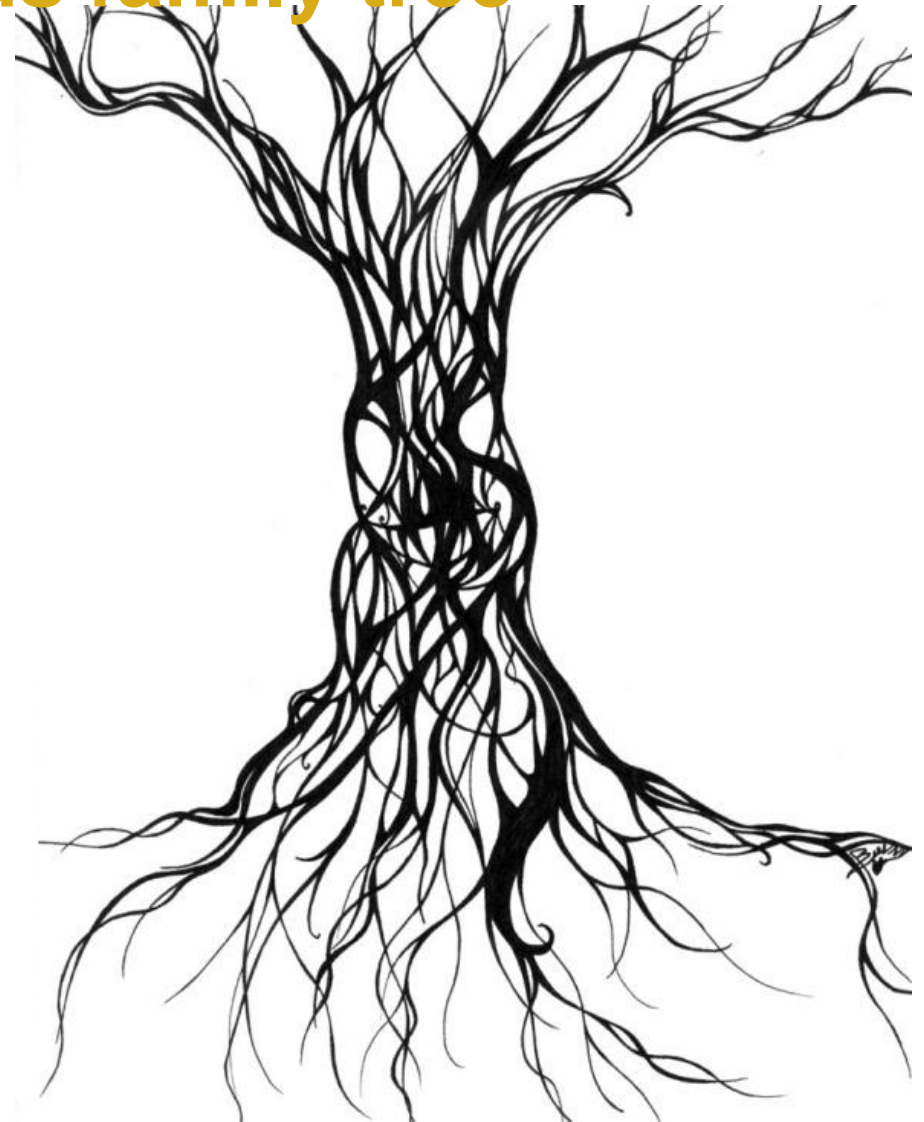
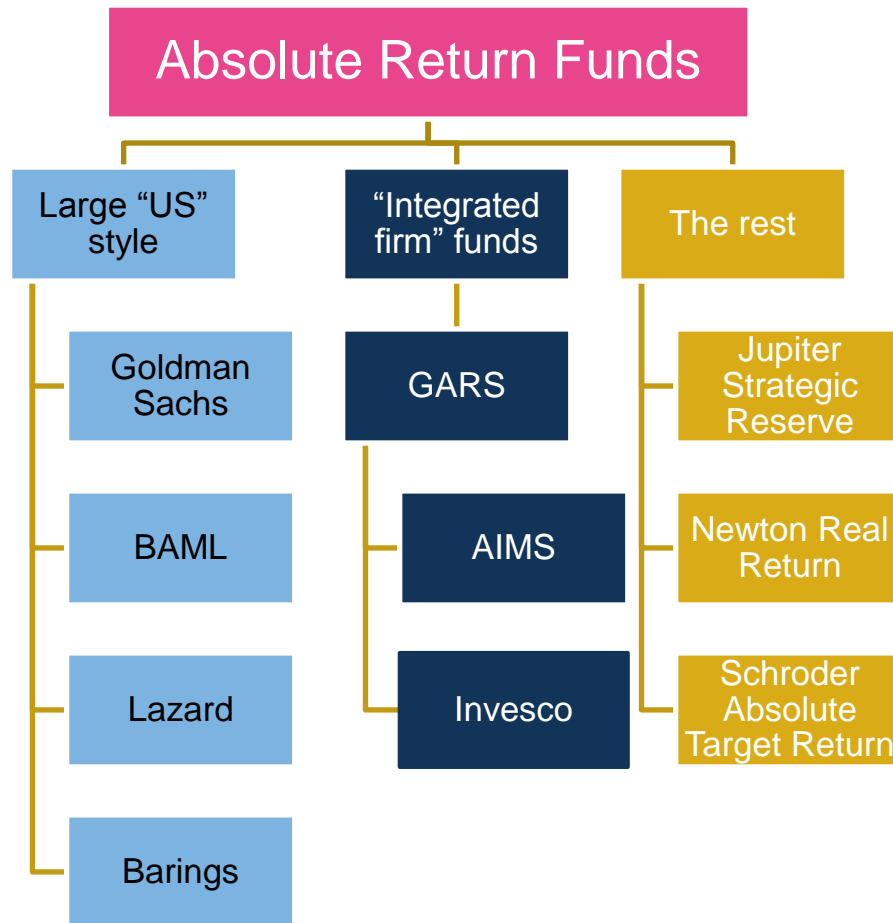


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Absolute return | “You can’t eat relative returns”



The absolute return funds family tree

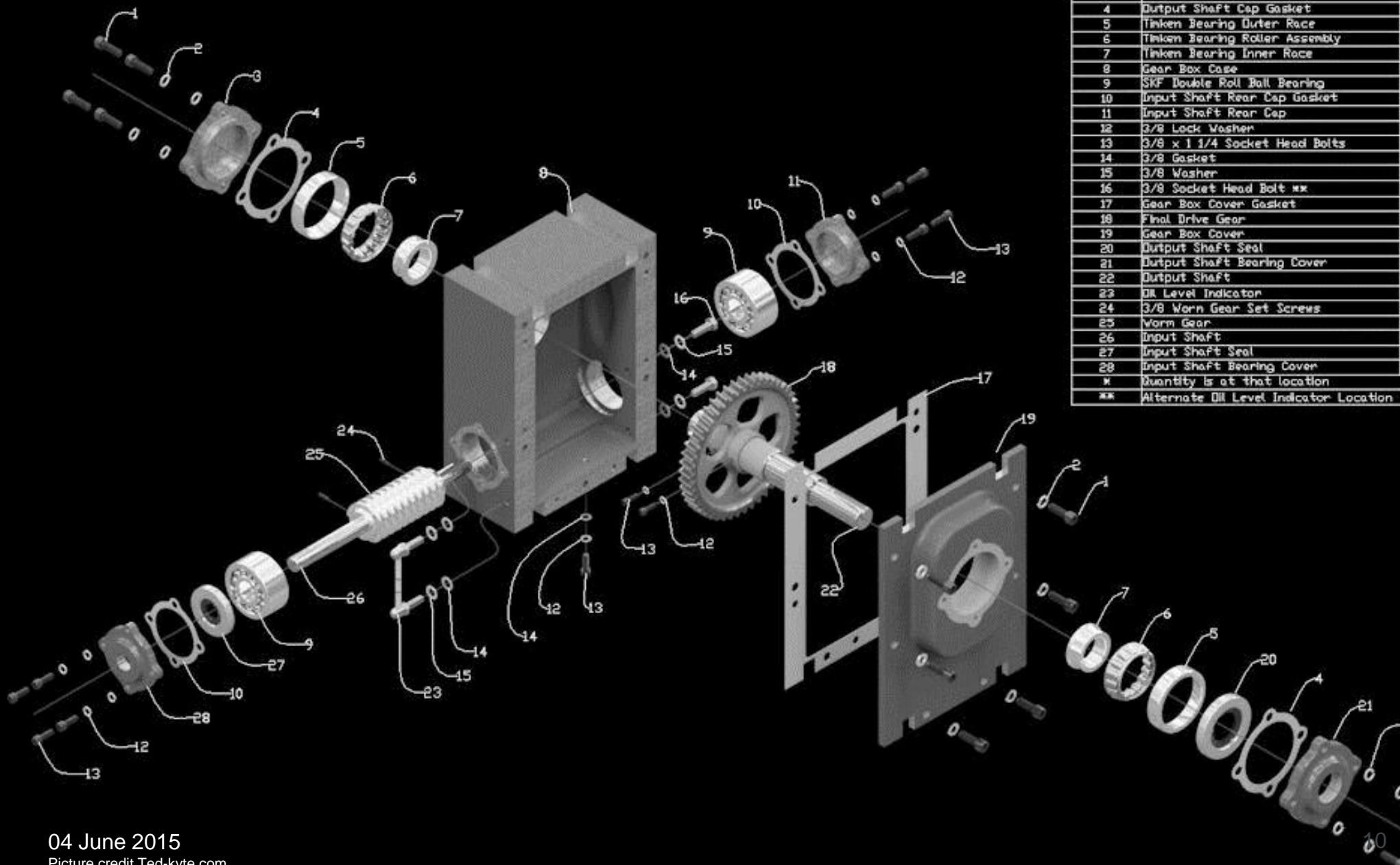


Components | Fund features

- Target return
 - Positive returns over 3 years rolling
 - Cash + c.5% | over 5 years rolling
- Aspirational trailing volatility and correlation
 - Typically 50% of MSCI World equity index volatility
 - “low” correlation
- Daily liquidity
- Flat fees (c. 80bps-150bps)
 - No performance element



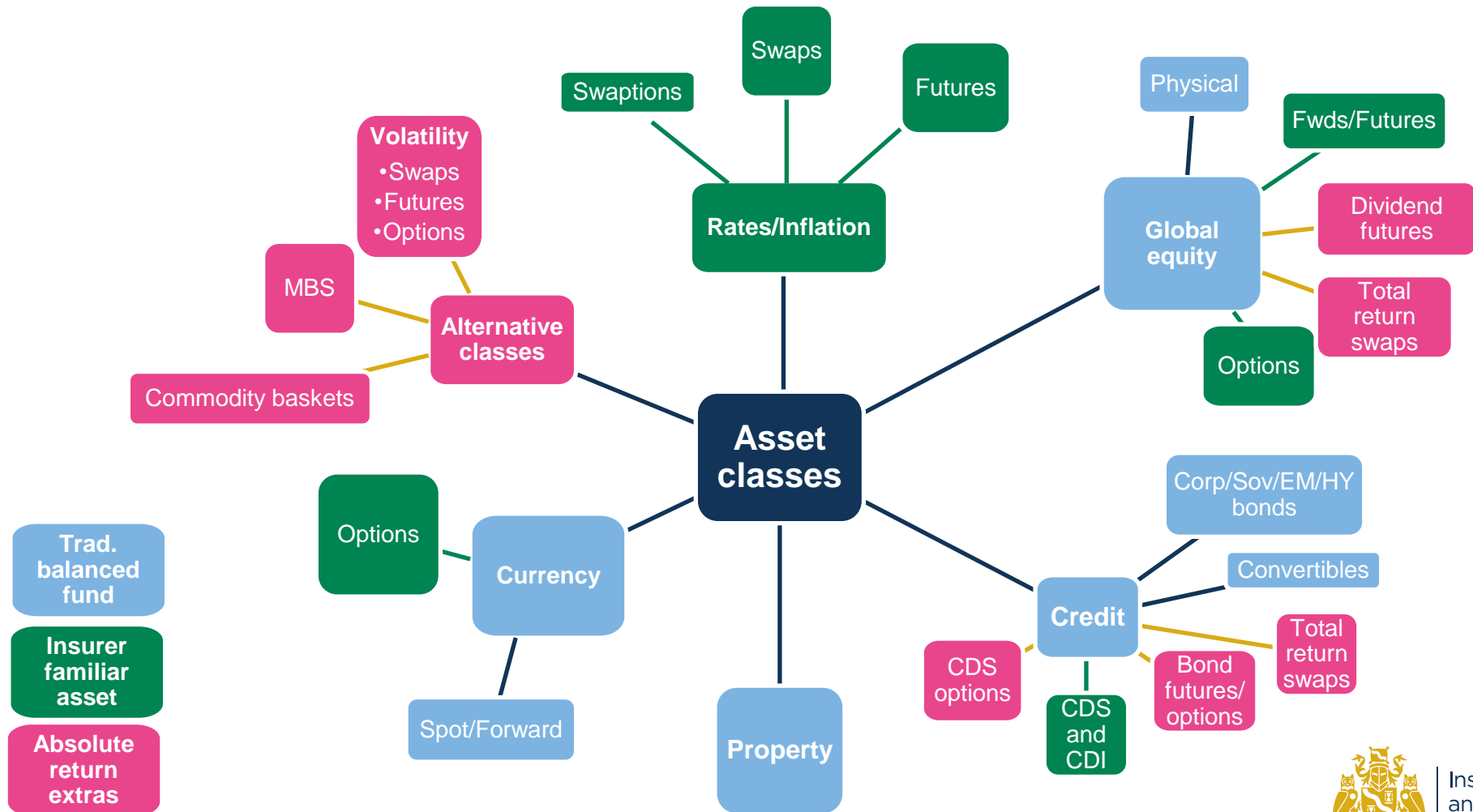
Components and construction



04 June 2015

Picture credit Ted-kyte.com

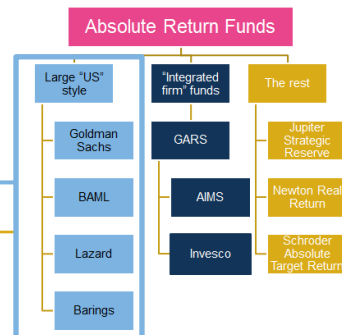
Components | Liquid Asset classes



Construction | “US style” and the others

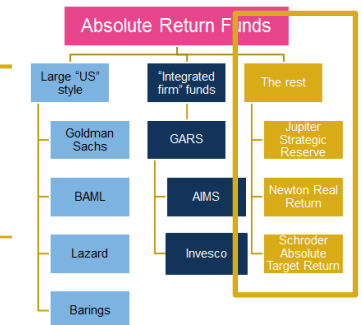
US style

- Huge asset managers
- Multi-asset team
 - SAA to allocate risk budget
- Budget allocated to specialist teams
 - eg US equity, UK credit etc
 - Teams allocate to “best-ideas”
- Potential overlap in trades
- Leverages huge infrastructure, but joined-up risk management a challenge



Smaller managers – SAA led

- Multi-asset team run in isolation from other specialists
- Develop own views or express “house view”
 - “fundamental value driven”
 - Macro-economic views
- Portfolio constructed via SAA within team
- Risk management within fund and at company level



Construction cycle | Integrated-firm funds

Monitor risk exposures
Reporting of positions

Monitoring

Ideas

“Best ideas” sourced from
around the business.
No constraints.
Overlaid with “house view”

Multi-asset team
build diversified
portfolio with well
defined structure

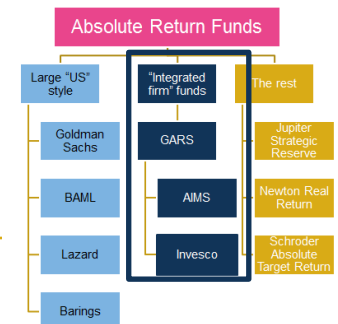
Portfolio built and hedged
Risk management central

**Filtered by
multi-strat
team**

Fit with rules?
Already considered?
Impractical?

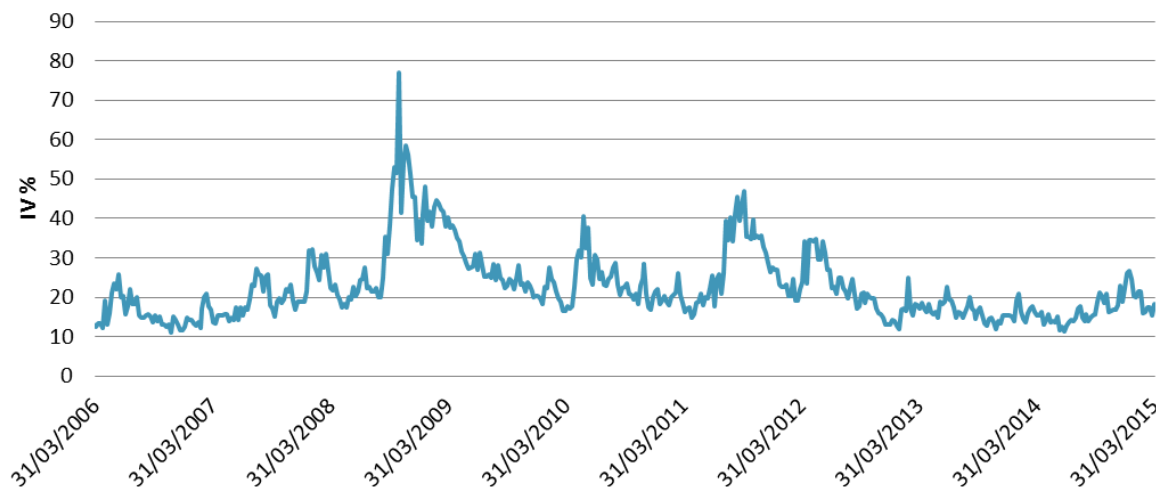
Approval

Committee of senior investors and risk managers



Integrated-firm funds | Example trades (1)

- Market/directional
 - Long European equity – via call options
 - Positive house view on European recovery/QE fuelled bubble
 - Volatility at all time lows, so options look cheap
 - Option cheapness would partially offset a (small) fall in the equity index



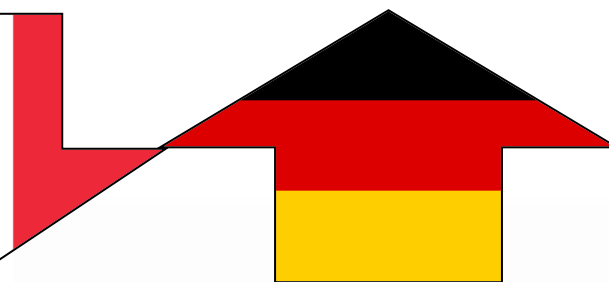
EuroStoxx 50
Option Implied
30 day Volatility



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Integrated-firm funds | Example trades (2)

- Relative value
 - Long German v short French equity
 - France doing badly (fiscal deficit, uncompetitive labour cost, political issues)
 - Germany doing well and holding its own globally + benefiting from increased consumption in emerging markets



Audi
Vorsprung durch Technik



Integrated-firm funds | Example trades (3i)

- Tail hedge/Risk reducing
 - Long US large cap vs Small cap (S&P500 vs Russell 2000)
 - Positive cost of carrying the position (difference in dividend yields)
 - In “risk-off” small cap (should) fall further

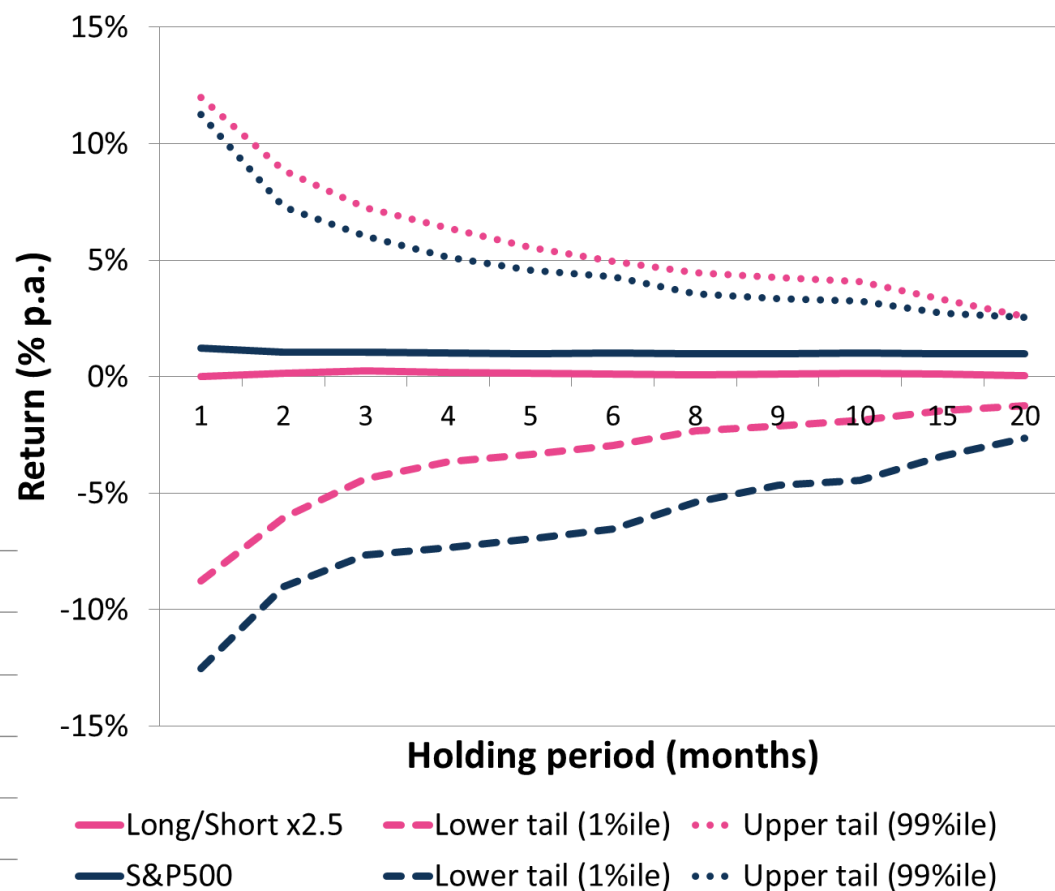


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Integrated-firm funds | Example trades (3ii)

- Time series hide too much
- Horizon plot
 - Compares different holding period returns

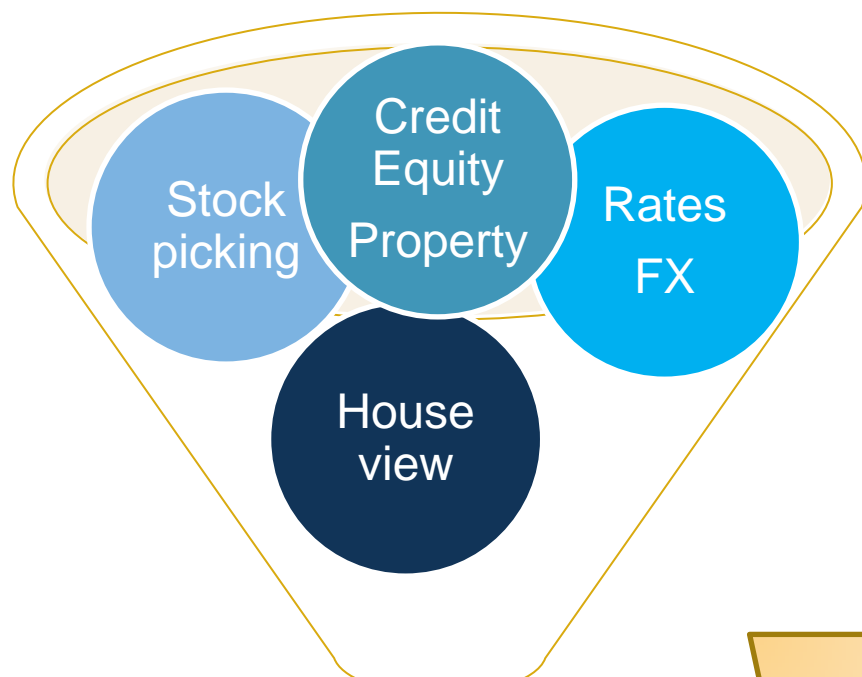
Conditional returns



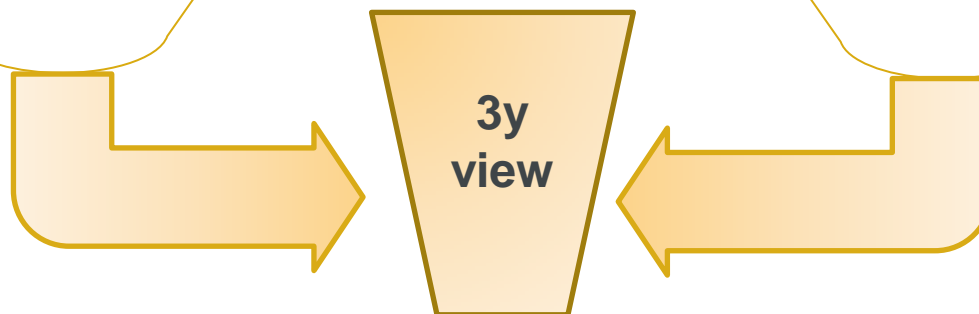
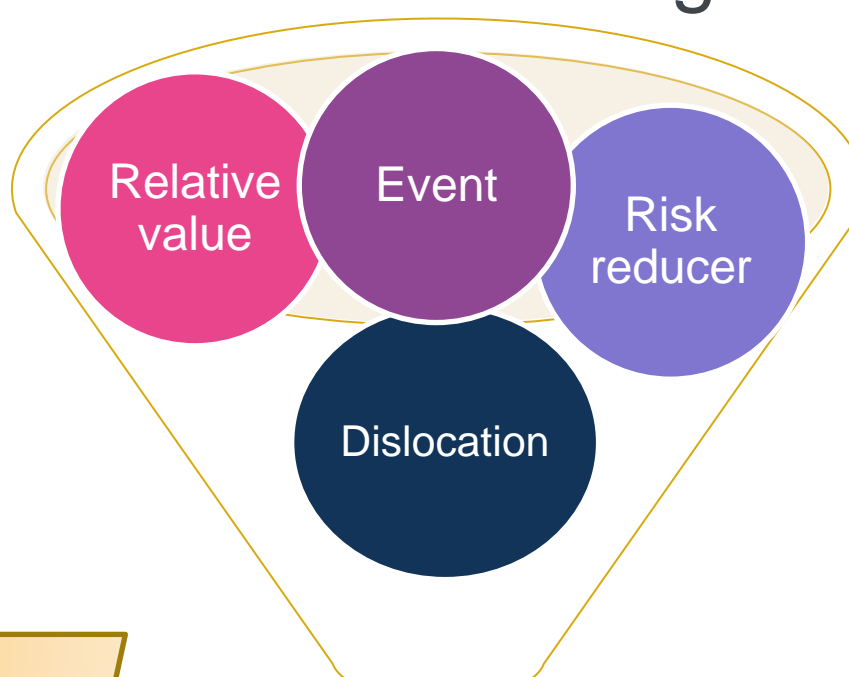
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Portfolio structure | Buckets

Directional/market



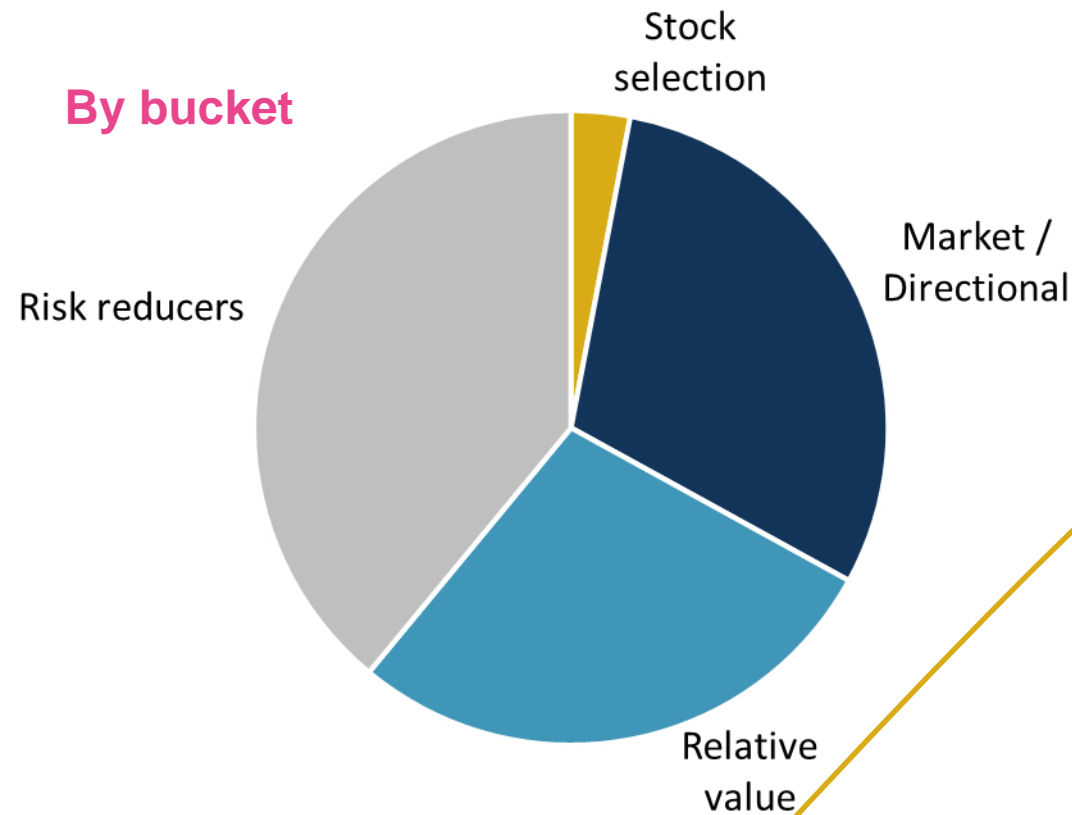
Neutral/tail hedge



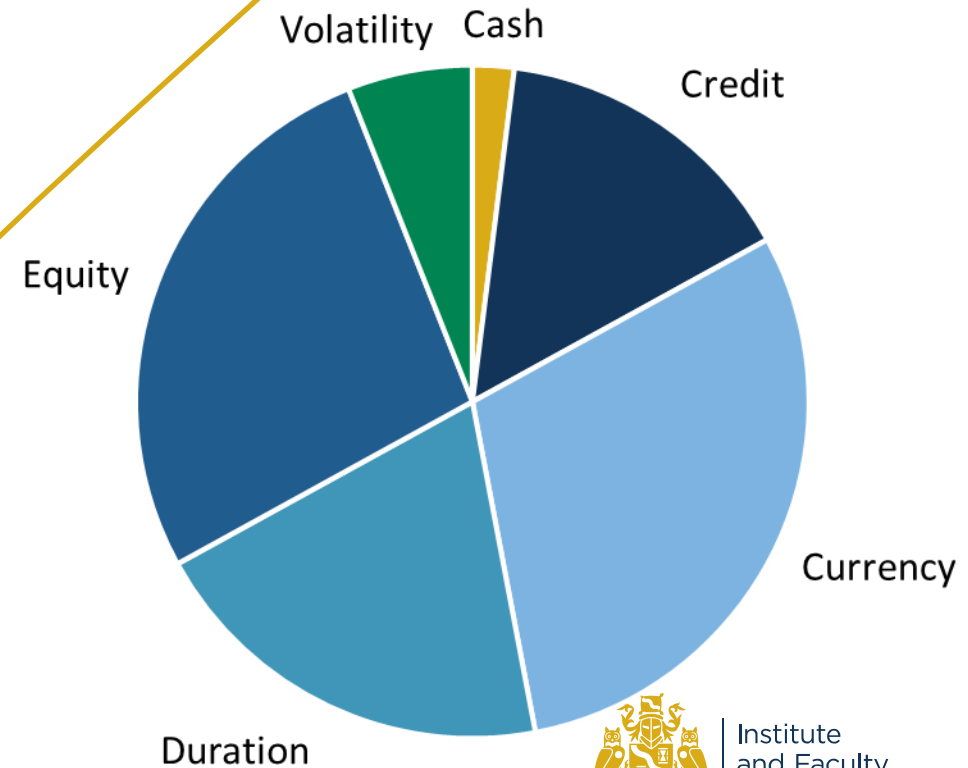
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Portfolio structure | Top down risk contribution

By bucket



By asset class

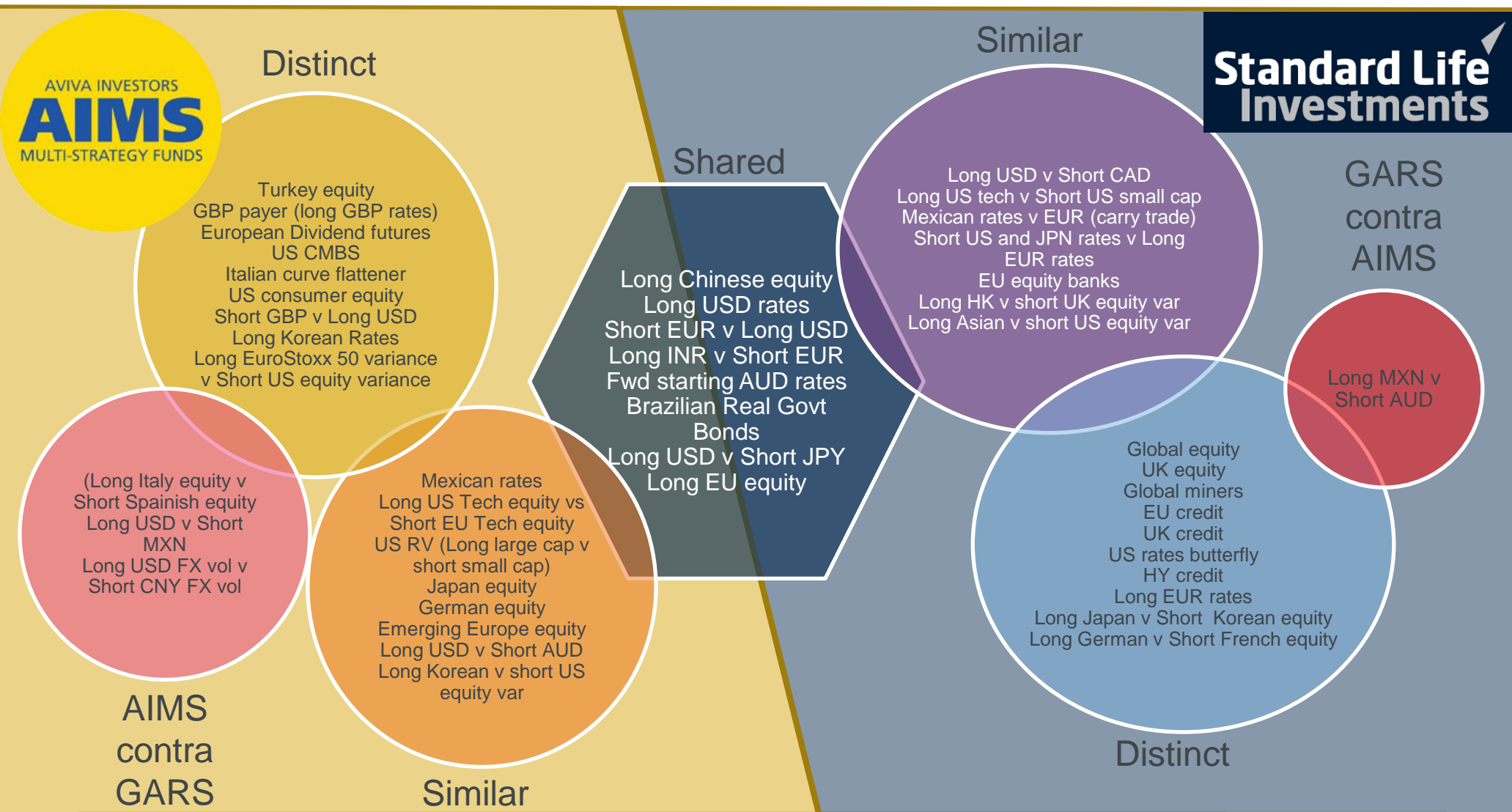


Composition | Balanced and risk focused

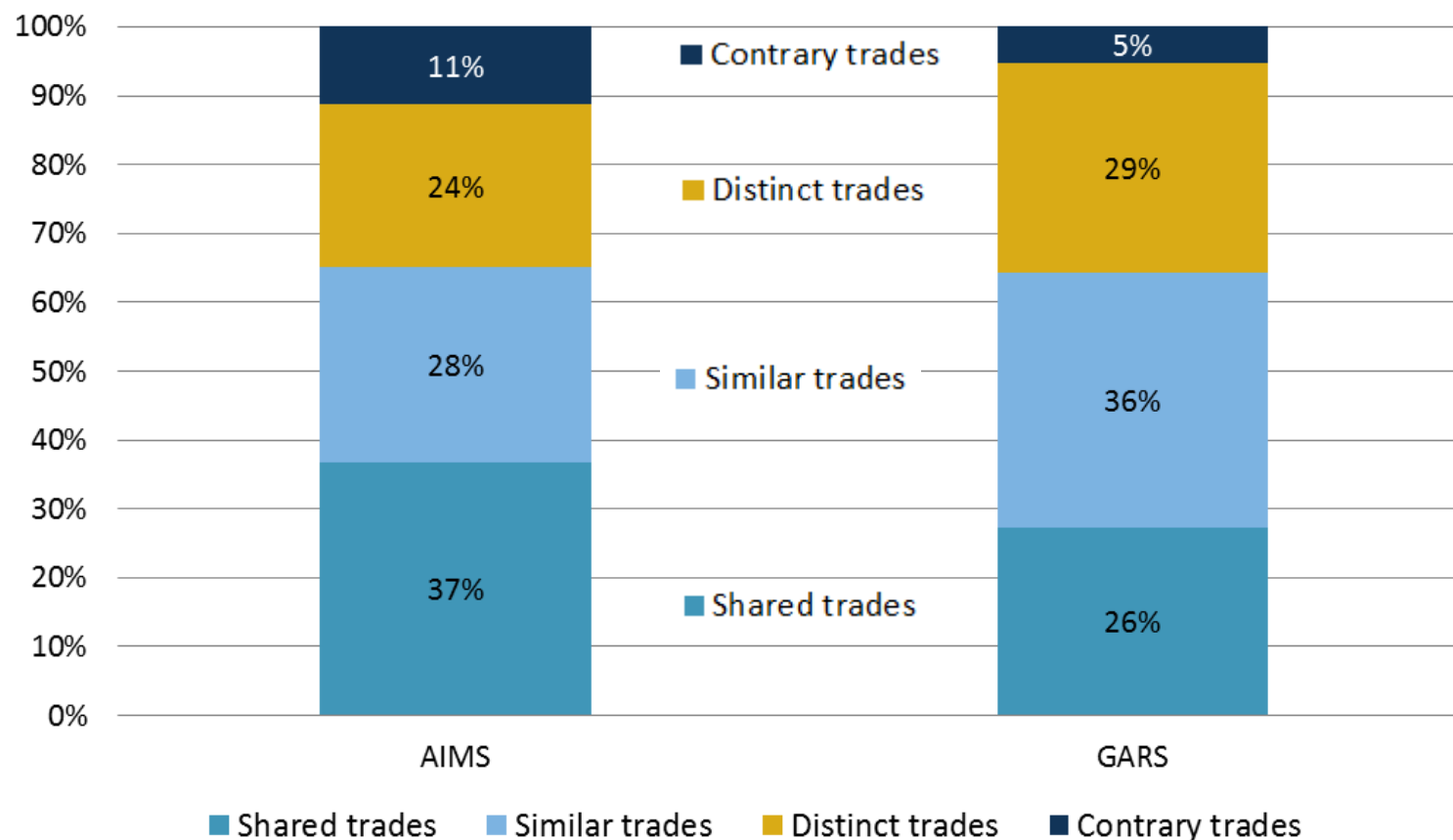
- Target return
 - Achieved via unconstrained mandate
- Balanced allocation
 - Risk categories
 - Asset classes
 - Trade types
 - Implicit/explicit risk mitigation
- Risk management
 - Drives allocation rather than being a by-product



AIMS and GARS | Overlapping positions?

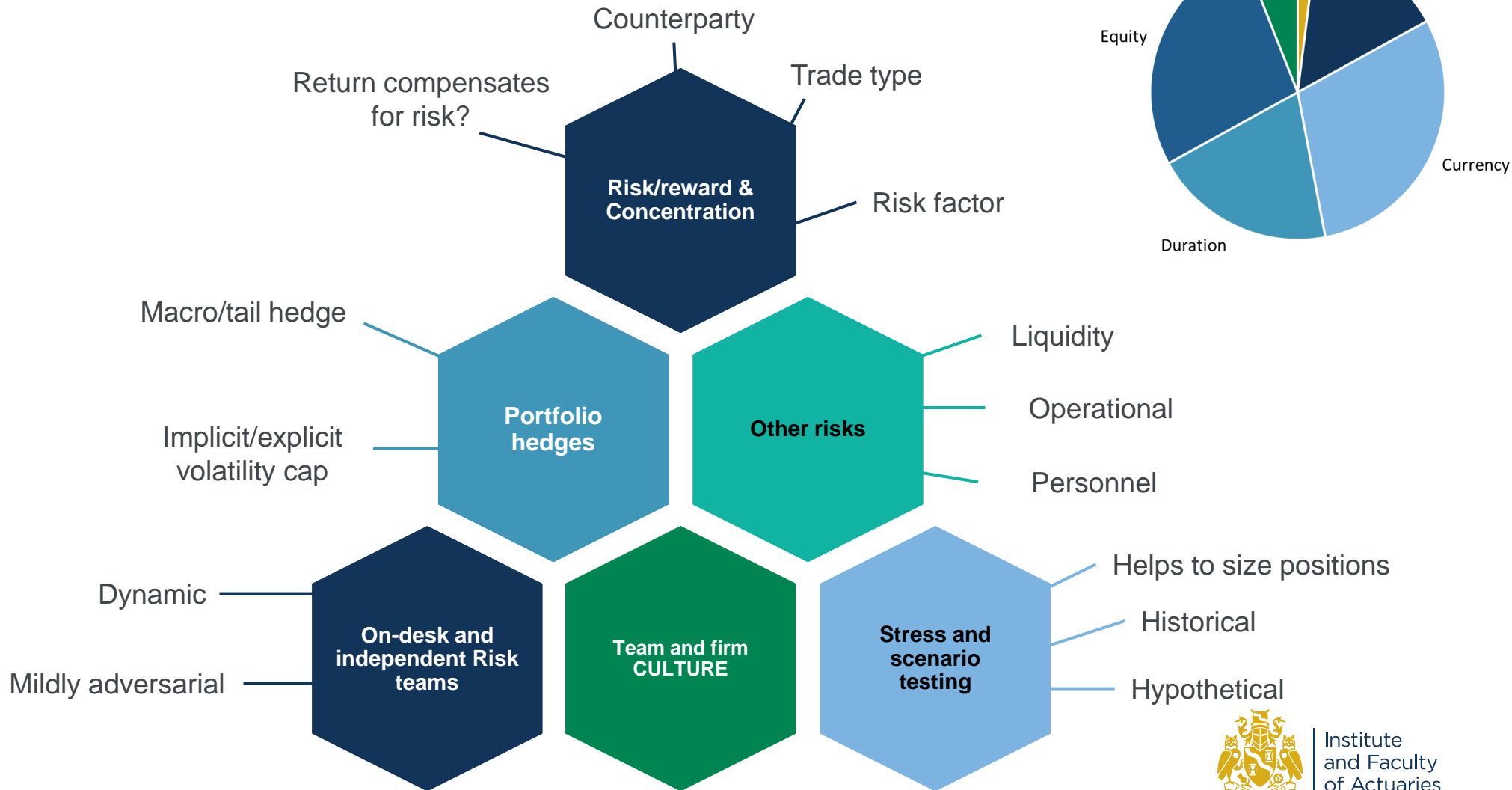


Overlapping positions | Risk weighted splits



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Risk management | Insurer-like?



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Insurance considerations
**“Theory is splendid but until put
into practice it is valueless”**
JC Penney

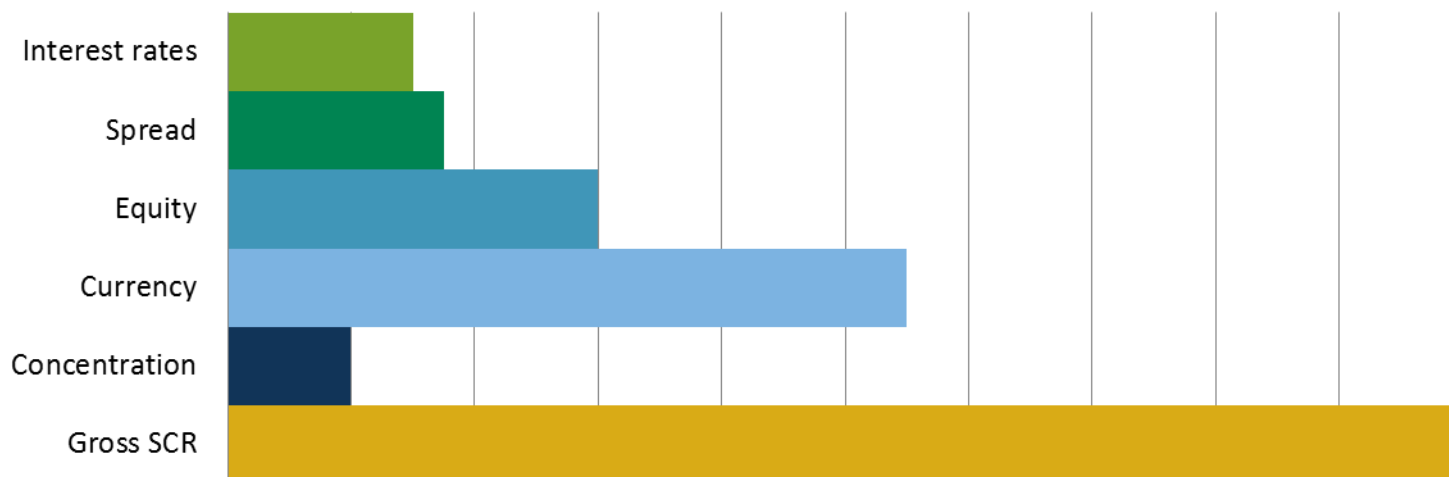
Practicalities and Implementation

- Capital and portfolio optimisation
 - Modelling
 - Risk appetite (quantitative)
 - Reporting transparency
- Influencing (the hard part)
 - Attitudes
 - Education
 - Risk appetite (qualitative)
 - Return on capital / fees

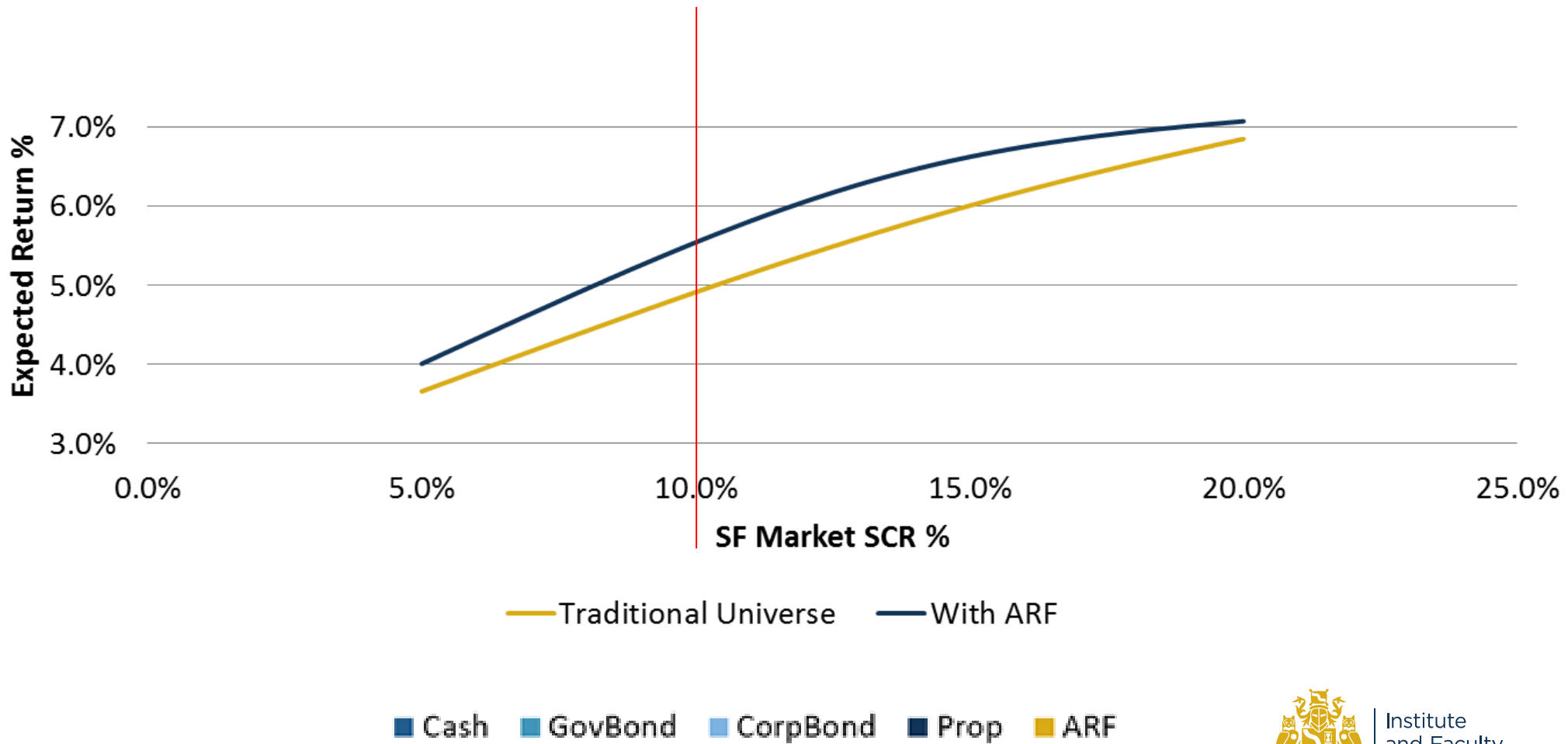


Capital | SII

- Must look-through into components of fund
 - Unless immaterial allocation => Type II equity c.55% shock
 - Choice is then standard formula or (partial) internal model
 - Not all risks will be reflected (volatility, for example) in standard formula
 - Justify taking credit for risk mitigation vs dynamic hedging?

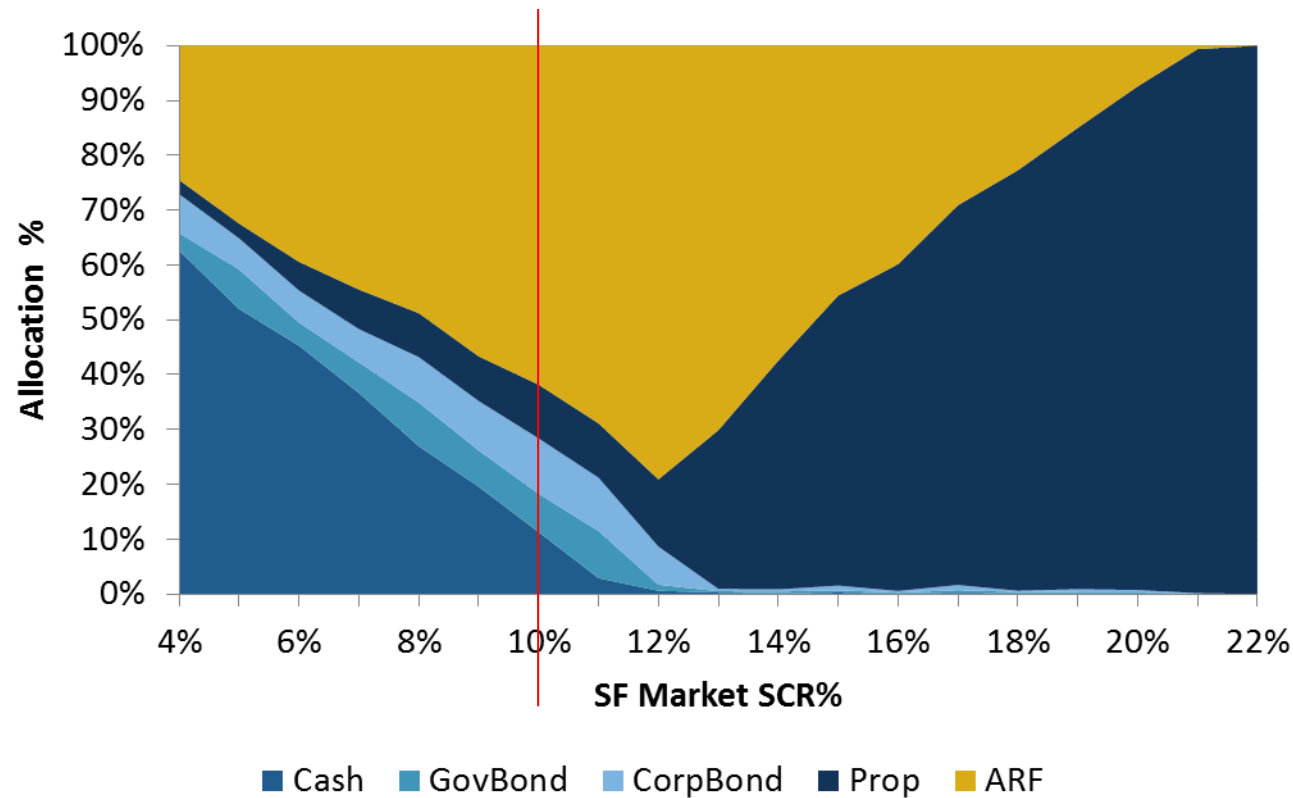


Capital | SII standard formula

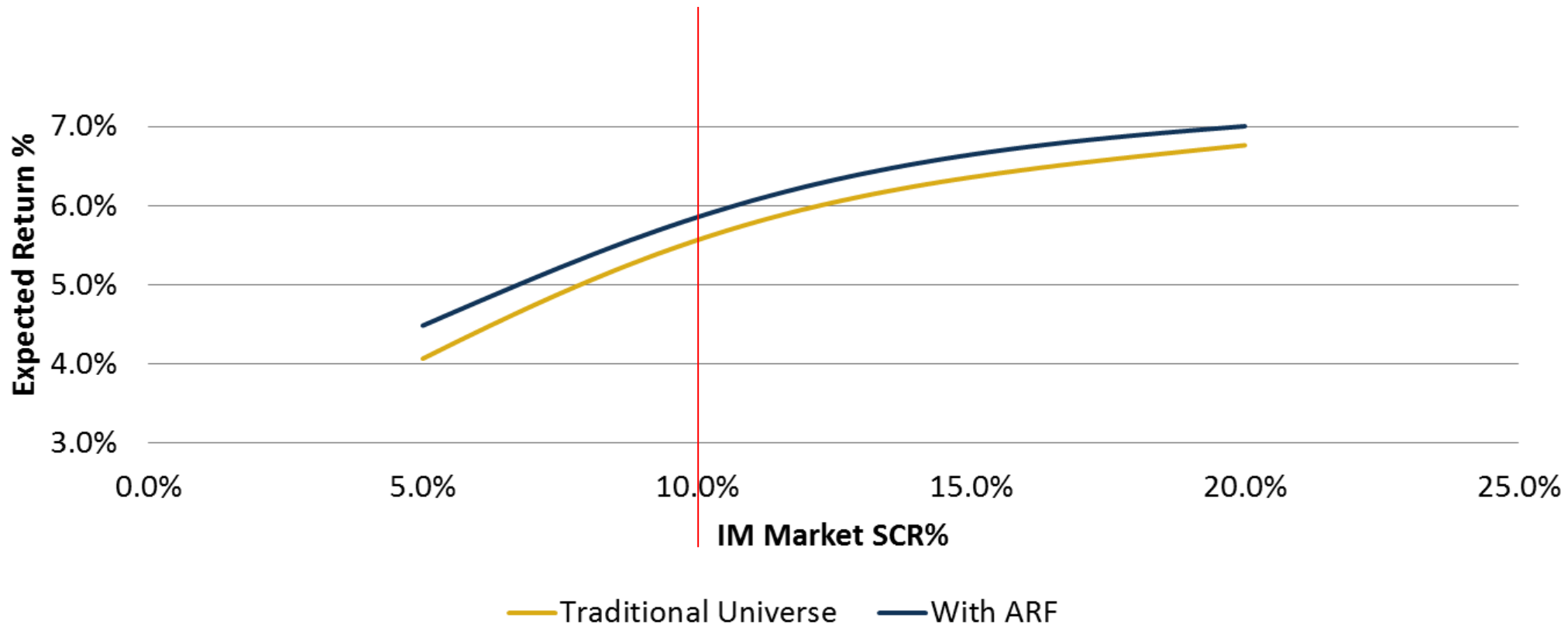


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Efficient frontier | S2 SF Allocations

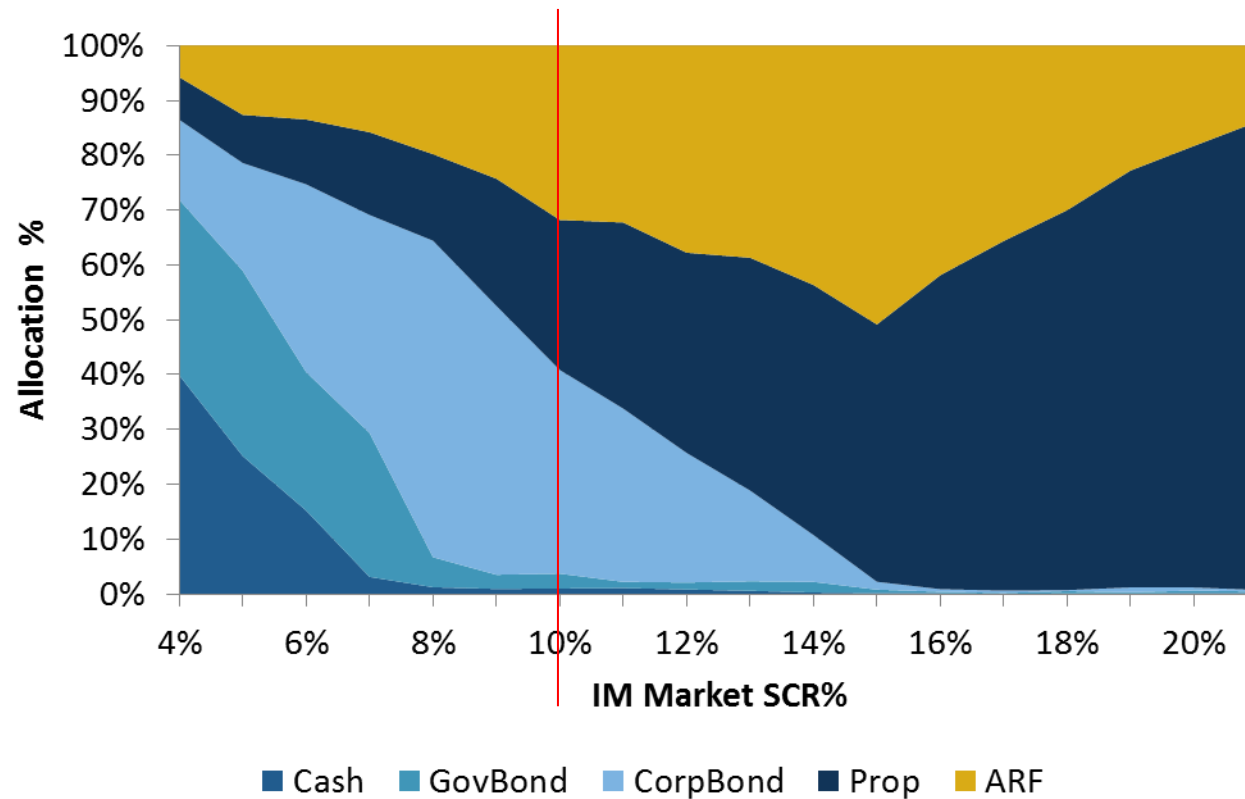


Capital | SII Internal Model



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Efficient frontier | S2 IM Allocations



Capital | SII internal model considerations

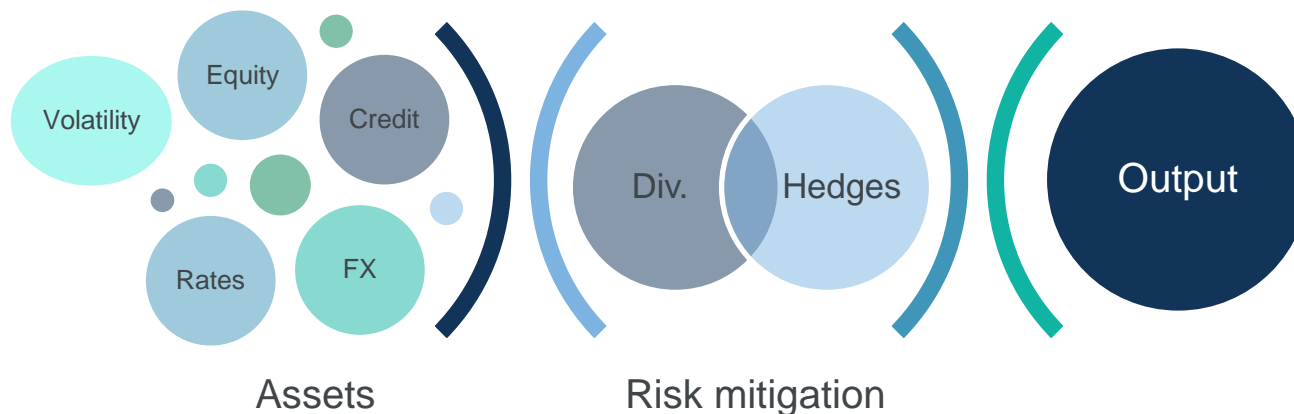
- Look through
 - Data and time lags
 - Dynamic portfolios
- Possible modelling methods
 - Parsimonious
- Potential issues
 - Modelling of diverse/exotic risk factors
 - Data (lag and quality)
 - Refreshing the calibration



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SII IM Modelling approach | Point in time

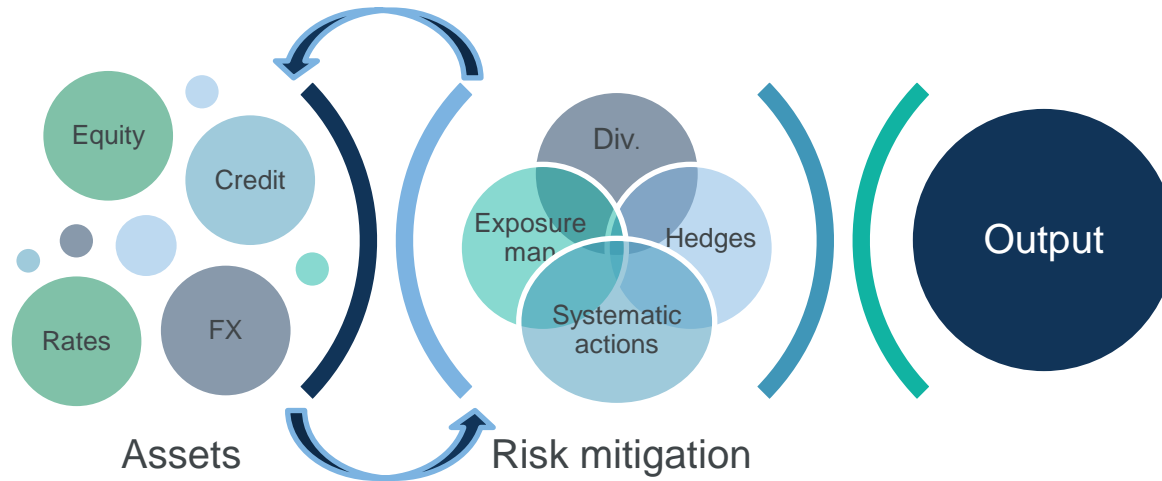
- Fixed portfolio
- Run single-step 1y VaR allowing for diversification



- Output stresses by risk driver or single “Absolute return” line
- No allowance for “trading actions” etc

SII IM Modelling approach | Enhancements

- Capture systematic trading rules? Dynamic hedging?
 - Justifiable risk mitigation?
- Run 1y VaR allowing with 1 month steps, testing for mitigations



- Considerable effort
- Likelihood of convincing PRA?



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Attitudes | Too complex???

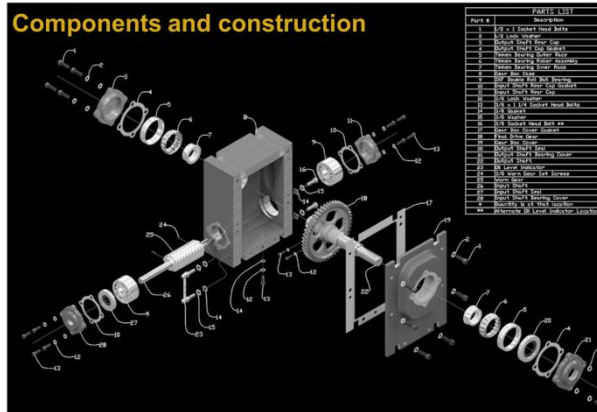
- Hitting a Cash+X target with low volatility seems like voodoo
- But is it any more complex than things we are more used to?
 - Reinsurance and hedging
 - Solvency II (!!)
 - Financial reporting
- Helps when it's "close to home"
- A lot comes down to communications, the funds would help themselves out greatly by avoiding jargon. It even confuses the professionals...
 - "US butterfly" (Wildlife? Equity? Rates? FX)
 - "Germany v France" (football?)



Scope

Do absolute return funds have a place in insurance portfolios?

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Answering the question

Do absolute return funds have a place in insurance portfolios?

- Yes, it may have a place, but...
 - Depends on the insurance business
 - Attitudes may have to change (a lot in some cases)
 - Decision makers need time to learn enough to make informed decision
 - Expect significant internal challenge
 - Need to find a good manager > thorough due-diligence
 - Past performance is rarely a good metric
 - Institutional fit | processes | risk management
 - Practical hurdles
 - Reporting / look-through
 - Modelling for SCR





Questions



Comments

The views expressed in this presentation are those of the presenter.



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