



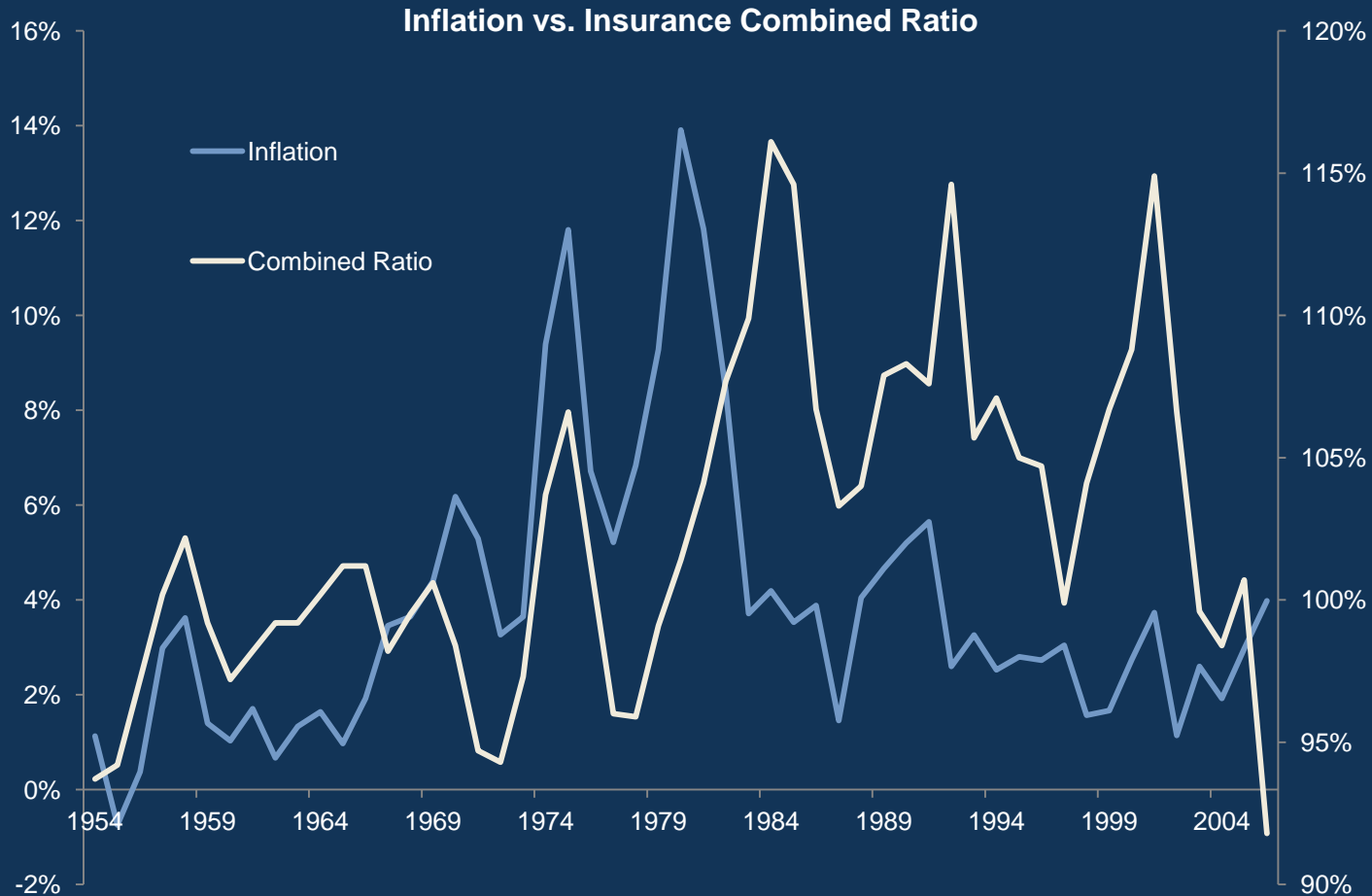
**Asset
Management**

PPOs: An increasing challenge for insurers

ALM perspective

Current Issues in General Insurance
GSAM Insurance Asset Management
May 2013

The impact of inflation on the insurance industry



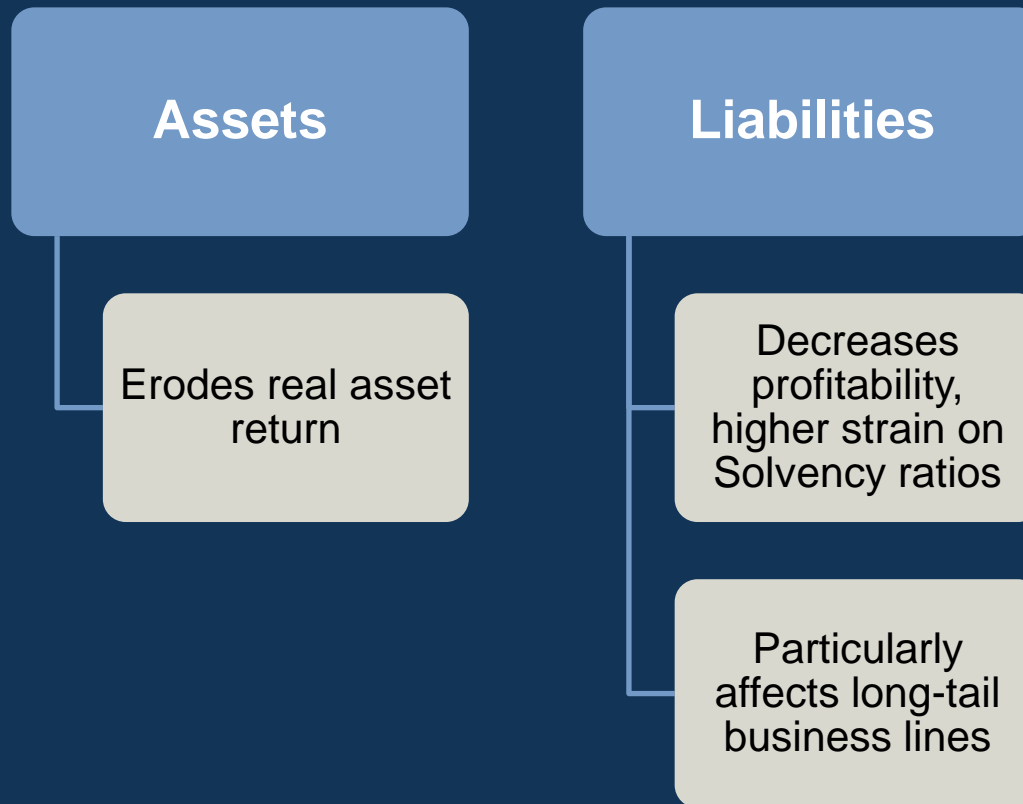
Source: AM Best

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The impact of inflation on the insurance industry



Inflation affects both the asset & liability side of the balance sheet



Periodic Payment Orders (PPOs)...

...from an ALM perspective



Indexation

- What indexation method is employed for PPO payments
 - ASHE survey
 - Earnings Index
 - Retail Price Index (RPI)

Impact of Inflation

- How does inflation impact PPOs?

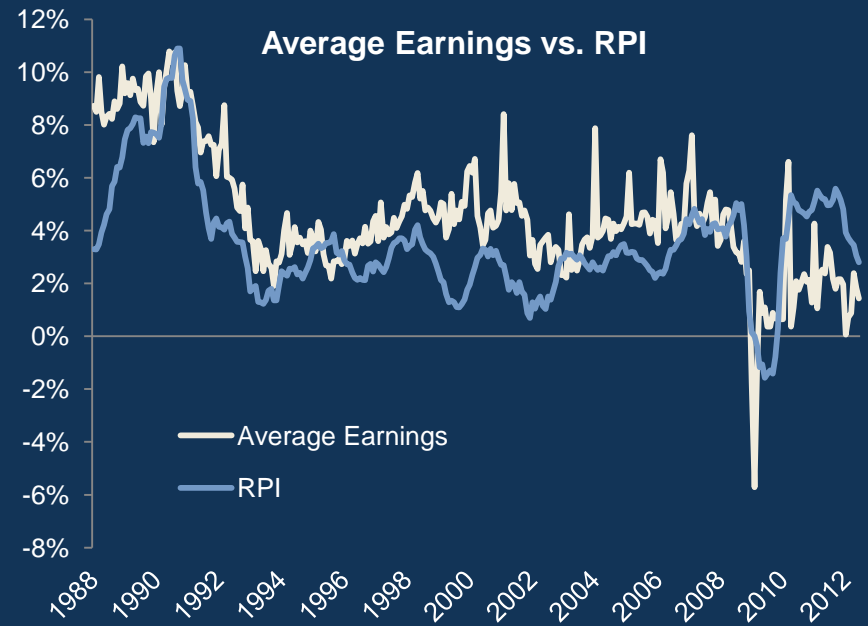
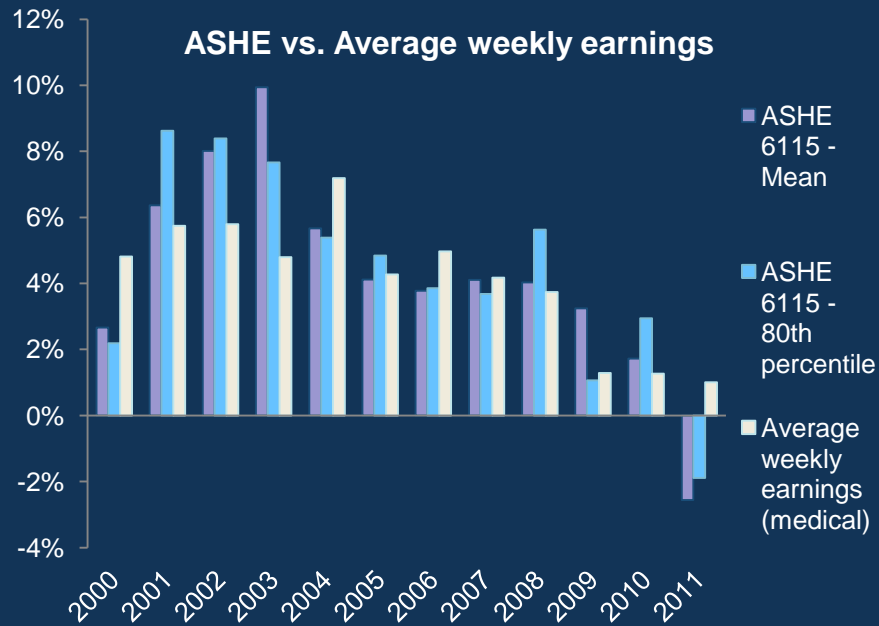
Investment Strategy

- How does that influence the optimal investment strategy?
 - Credit
 - Equity exposure

ASHE – Annual Survey of Hours and Earnings

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Indexation Method

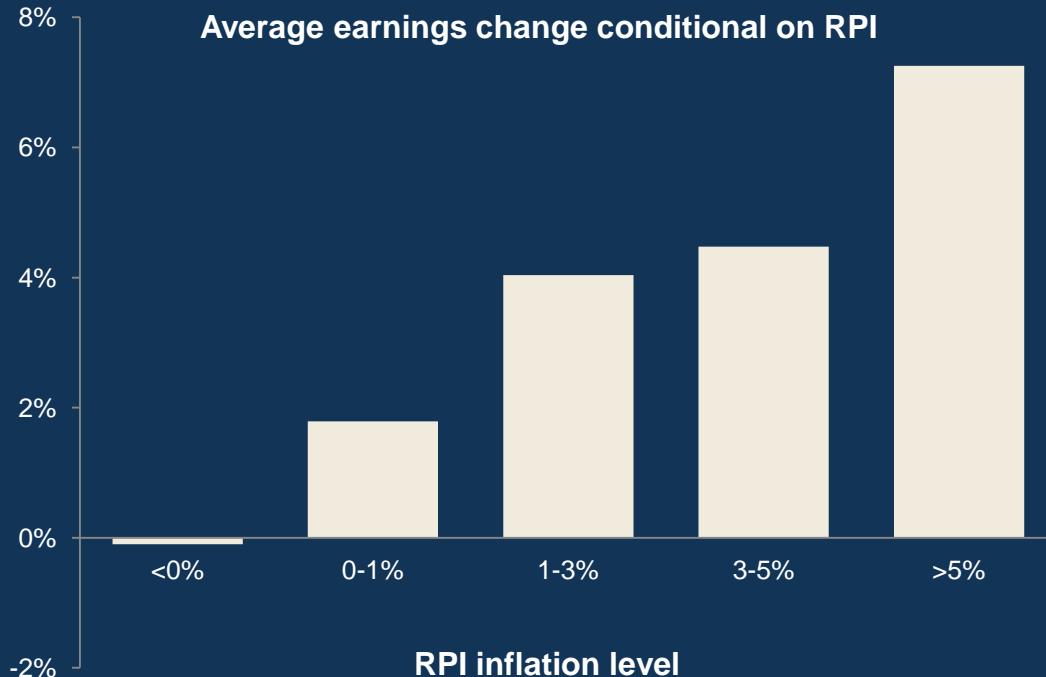


- Survey vs. Index
- Not “hedgeable”
- Short history, annual data points

- Rising inflation will impact PPO Claims
- Close link to RPI but basis risk emerges

Source: ONS,
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Measuring RPI inflation sensitivities

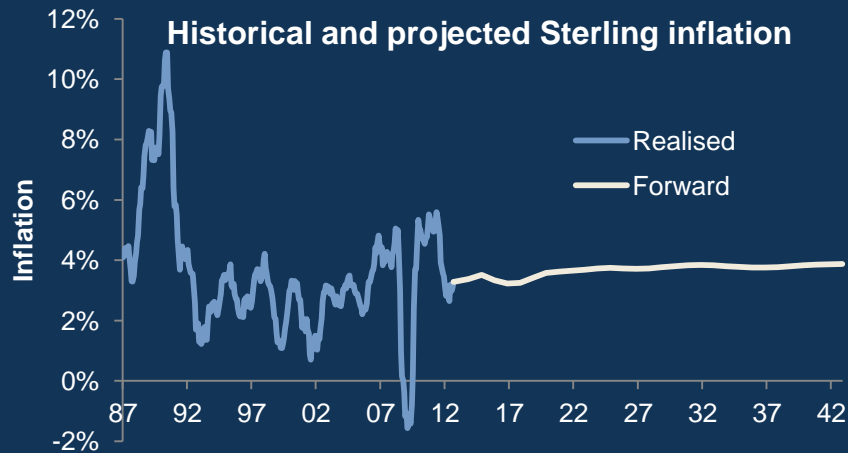



- Correlation is stronger in the tail of the distribution
- It is possible to adapt the investment strategy to make it more efficient

Source: ONS.

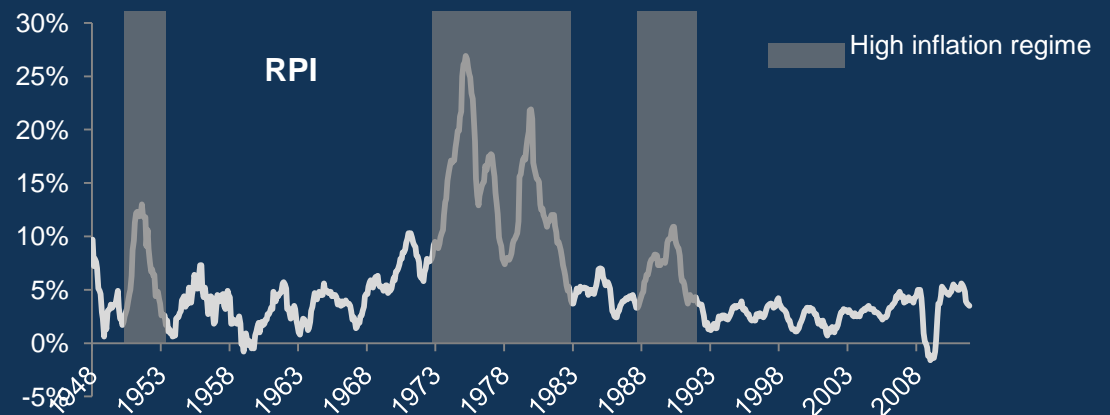
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Hedging



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- Hedging solutions available:
 - Inflation linked bonds
 - Inflation swaps
 - Limited price indexation (LPI) swaps

- Regime switching nature of inflation



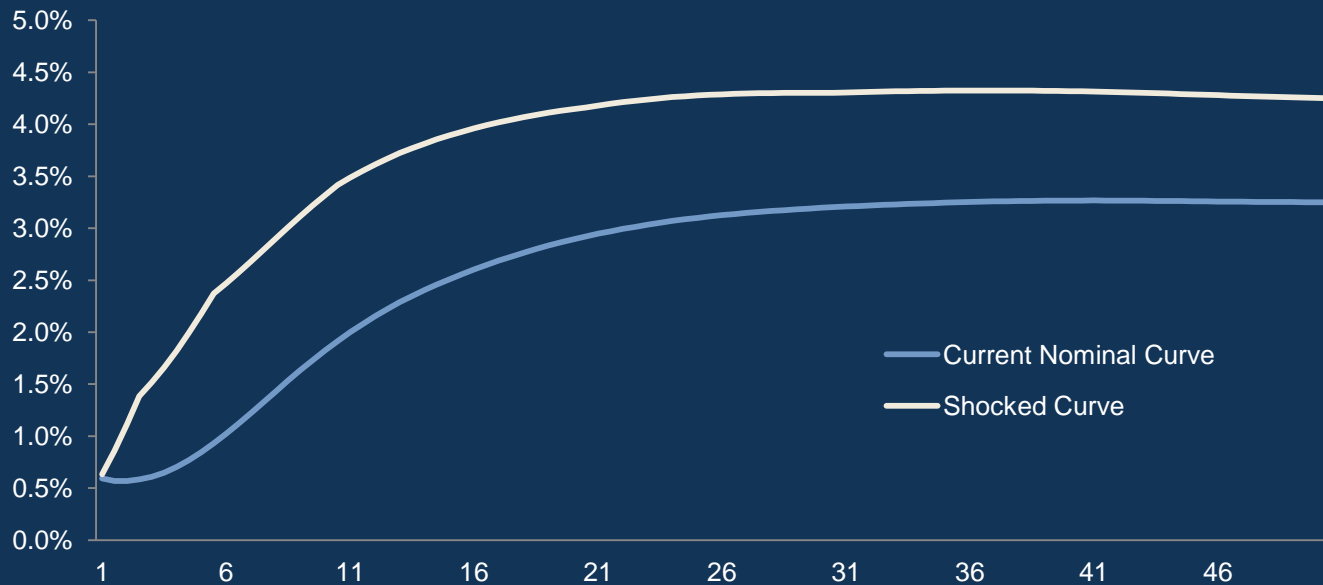
Source: GSAM, as of 21 March 2013

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Impact on economic variables



- Rising inflation would lead to an immediate rise in interest rates

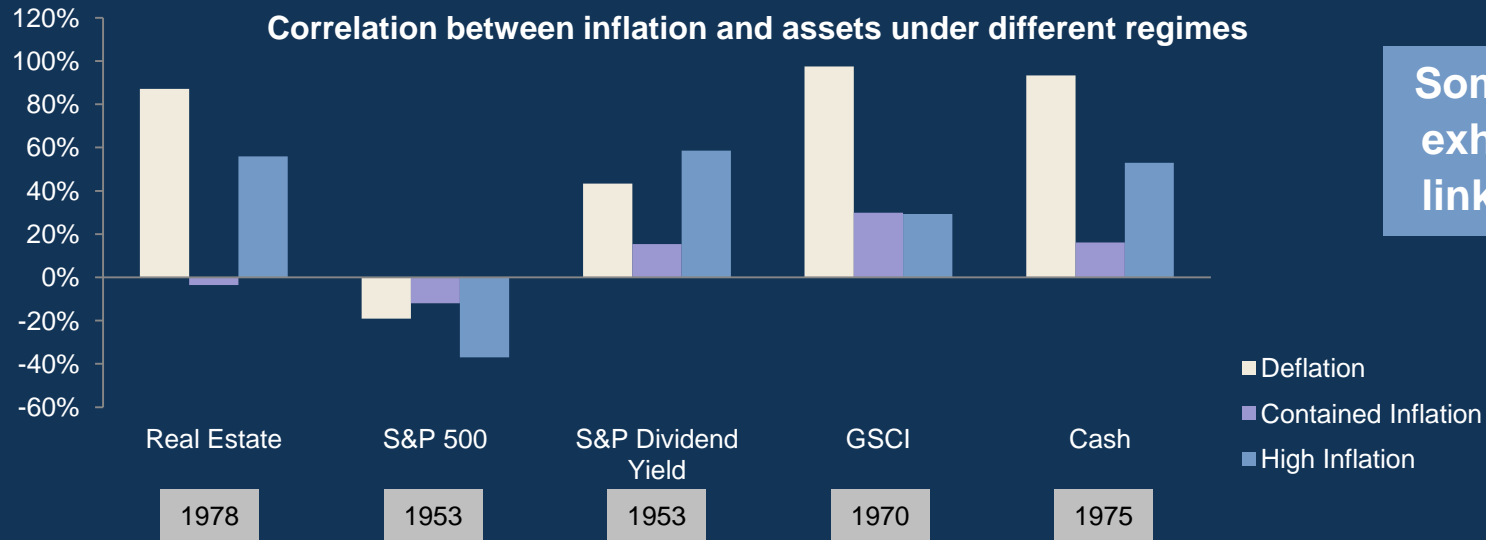


- Investments in FRNs (e.g. Bank loans, FRNs) would provide a medium term solution


Source: GSAM

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Adapting the long-term investment strategy



Some assets exhibit a natural link to inflation

- 
- Average earnings linked to both inflation and economic growth.
 - Investments in assets whose performance follows the state of the economy:
 - **Equities:** Tend to outperform in periods of high economic growth.
 - **Real assets**

Source: GSAM, Barclays. Deflation/Low inflation is defined as inflation below the 10th percentile of the distribution, High inflation is defined as above the 80th percentile of the distribution. Past correlations are not indicative of future correlations, which may vary.

There is no guarantee that these objectives will be met.

The portfolio risk management process includes an effort to monitor and manage risk, but does not imply low risk.

Key takeaways



Short term *Hedging*

- Use of inflation hedge overlays
- Dynamic approach - hedge ratio is adjusted to market conditions

Medium term *Floating rate investments*

- Rising inflation will impact rates
- Floating rate products would mitigate the risk of rising rates

Long term *Inflation resilient investments*

- Long-term cash flow matching specific asset classes may be considered:
 - Certain equity sectors, high dividend equities
 - Real assets

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