Enhancing your investment strategy in today’s investment climate

Ben Grainger & Ryan Allison, EY
1. Backdrop to the current macro-economic environment
2. Key investment strategy considerations
3. Key questions to reflect upon when assessing the effectiveness of your strategic asset allocation
   ► How do you choose between investments?
   ► How do you know your asset allocation is providing you with the best return on risk?
4. Extended case study: enhancing your investment strategy
5. Conclusion
“A lack of clarity could put the brakes on any journey to success.”

Steve Maraboli, Behavioural Scientist
Backdrop to the macroeconomic environment
The search for yield continues amidst a challenging economic backdrop

The fall in the annual gilt yield emphasises the need for firms to search for yield

Source: Markit, iBoxx £ Gilts 1-3 index
The challenging environment extends to both corporate bond and equity investments

**Spreads are below long term averages**

Source: Markit

**A turbulent geopolitical environment threatens recent strong equity returns**

Source: https://uk.investing.com

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*FTSE 100 historical data*

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But other opportunities exist for non-life firms to combat the existing climate

Source: EY with template from IFoA non-traditional working party
Key investment strategy considerations
Key investment strategy considerations

Issues facing insurance companies:

- Margins are low, in part due to low investment returns
- Insurers are taking on more risk through their investment portfolios
- Balance sheets are increasingly complicated with a number of sometimes conflicting metrics

Asset optimisation has been largely limited to the “low hanging fruit” (e.g. moving to illiquid assets in annuity funds).
Key investment strategy considerations

- Investment risk appetite
- Environmental, social and governance (“ESG”)
- Solvency ratio
- IFRS profits
- Current returns
- Investment opportunities
- Duration matching
- Liquidity constraints

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How do you know your asset allocation is providing you with the best return on risk?
How do you know your asset allocation is providing you with the best return on risk?
Understanding the question and key considerations

1. Do you know the entire asset universe that you have available to you? Could there be any new asset classes or sectors for your firm to explore?

2. How frequently do you perform a fundamental review of the constraints imposed on your asset selection? Could some constraints be relaxed, removed or refined?

3. Have you considered optimisation techniques to make your assets work harder? Could you generate additional yield from your existing portfolio?
How do you choose between investments?
How do you choose between investments?
Understanding the question and key considerations

- Being able to effectively and efficiently determine when an asset is good value, appropriate relative to your existing investment portfolio and in line with your risk appetite is crucial
- Key considerations when choosing between investments might include the following:

1. Investment limits / restrictions
2. Fit with liabilities
3. Value for appetite
4. Assessment against wider and secondary constraints
5. Operational constraints

- Concentration limits
- Sector restrictions
- Risk appetite limits

- SII ratio
- % of portfolio in liquid asset
- IFRS profits
- Return volatility
- Economic capital

- Initial assessment
- Board approval
- Regulatory conversations
- Valuation capital models
An extended case study: enhancing your investment strategy
Extended investment strategy case study
High-level synopsis of a non-life firm

- We have assumed that the non-life firm has motor insurance liabilities, with duration of one year.
- The average asset allocation does not include allocation to CIS, derivatives, investment pools, inadmissible assets and “other”, for simplicity.
- We have assumed that investments in government bonds are entirely in gilts, for simplicity.

Average asset allocation for a non-life firm based on YE15 PRA returns

- Gilts
- Corporate bonds (A-rated)
- Cash (including cash equivalent)
- Equity (Type 1)
- Property

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## Extended investment strategy case study

### Possible options for consideration

<table>
<thead>
<tr>
<th>Option Description</th>
<th>Base</th>
<th>Option 1</th>
<th>Option 2</th>
<th>Option 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allocate assets as per “average asset allocation” (c.90% in cash, government bonds and corporate bonds)</td>
<td>✔</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Switch c.15% from bonds to short-dated qualifying infrastructure debt</td>
<td></td>
<td>✔</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Maintain c.75% of assets in cash, government bonds and corporate bonds</td>
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<td></td>
<td>✔</td>
<td>✔</td>
</tr>
<tr>
<td>Balance sheet volatility constraint and allow SCR to vary</td>
<td></td>
<td></td>
<td>✔</td>
<td></td>
</tr>
<tr>
<td>SCR constraint and allow balance sheet volatility to vary</td>
<td></td>
<td></td>
<td></td>
<td>✔</td>
</tr>
</tbody>
</table>

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Extended investment strategy case study

Output of option implementation

Enhancing investment strategy: possible options for consideration

<table>
<thead>
<tr>
<th></th>
<th>Base</th>
<th>Option 1</th>
<th>Option 2</th>
<th>Option 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Blended return</td>
<td>1.00%</td>
<td>2.00%</td>
<td>3.00%</td>
<td>4.00%</td>
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<tr>
<td>SCR</td>
<td>25.00%</td>
<td>26.00%</td>
<td>27.00%</td>
<td>28.00%</td>
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<tr>
<td>Balance sheet volatility</td>
<td>29.00%</td>
<td>30.00%</td>
<td>31.00%</td>
<td>32.00%</td>
</tr>
<tr>
<td>RoC</td>
<td>33.00%</td>
<td>32.00%</td>
<td>31.00%</td>
<td>30.00%</td>
</tr>
</tbody>
</table>
Conclusion
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- Insurers need to understand their entire asset universe and also how they make investment decisions.

- Insurers need an effective investment framework to clearly articulate risk measures / objectives / constraints, in order to make informed investment decisions.