Analyzing the outlook for insurance asset management in North America as insurers seek to cover their liabilities and generate returns in a low yield environment.
Summary: Insurance Specialization Matters

Long-term investment success in managing assets for insurance companies requires an understanding of the complex environment in which insurers operate, a recognition of the uniqueness of each company, and a breadth of investment capabilities which can offer attractive risk-adjusted returns over market cycles. Partnering with insurers to interactively develop bespoke investment solutions produces company-specific, optimized portfolios. Insurers often seek customized, capital-efficient portfolios that balance multiple, sometimes competing, objectives and constraints, including risk/return preferences, income needs, accounting and regulatory considerations.

Investment Success: Bespoke Investment Objectives Play A Key Role

For many insurers, total returns represent only one dimension of the effort to create value through the investment portfolio. Important constituents ranging from policyholders to regulators to external capital providers demand stability of income and careful risk control. Consequently, the relatively simple investment objectives written for total return mandates fall short. In their place, insurers and their asset managers need to substitute objectives and constraints that address a long list of considerations. Some of the most important include:

- Risk control
  - What is the working definition of “preservation of capital”? Specifically, how much risk is too much risk?
  - What are the risk metrics to be used in measuring exposures in assets, liabilities, and surplus?
  - How do the qualitative objectives of risk management translate into quantities of risk?
- Returns: economic perspectives and accounting perspectives
  - How to decide on the primacy of income or total return?
  - How to evaluate trade-offs between the two, and how to incorporate the perspectives of the various constituencies?
- Capital efficiency
  - How to judge prospective deployment of capital from both an economic and an accounting perspective?
  - How to make trade-offs between the two?
- Liquidity
  - How to measure liquidity?
  - How to judge the costs and benefits of alternative degrees of liquidity?
- Performance evaluation
  - How to judge the effectiveness of the investment effort, in the context of these many considerations?

Careful quantification of the risks, rewards, and other aspects of the portfolios are an essential step on the path to investment success for insurers. While the end result of policy decisions reflect sound judgment, informing these judgments with estimates of the quantities of risk and return is a crucial step in developing sound conclusions. The best investment processes are explicit about both the investment objectives and the measures and quantities that will assist in execution and evaluation.

Given the inherent operating leverage employed by insurance companies, intentional assumption of meaningful risk is generally concentrated in the liabilities rather than the assets. As a result, some investment managers employ scenario-based risk budgeting which can serve as a powerful tool for managing the expectations of insurers. It attempts to quantify the impact of multiple “what-if” possibilities, e.g., renewed European debt crisis; US growth exceeds expectations, etc. Managers use this model output to communicate with clients in order to manage expectations.

Bespoke vs Generalist: Hybrid Managers Dominate Rankings

For purposes of this publication, Clear Path Analysis uses the term “bespoke insurance asset manager” to refer to firms which have dedicated insurance teams which specialize in providing services to the insurance industry and which customize strategies to fit insurance company constraints. In fact, many of the largest, bespoke insurance asset managers are units of very large firms which are otherwise generalists.
The latest survey by Insurance Asset Manager indicates that insurance companies have outsourced the management of $1.15 trillion of general account assets. The top ten ranked managers share 82% of the total. Of these top ten, seven are divisions of much larger investment management firms.

Clients of these “hybrid managers” benefit from the breadth and scale of the larger firm delivered by the specialist team. Hybrids are fully capable of managing to a pure total return objective. In many ways, this is where they always begin. They manage portfolios to maximize return subject to a myriad of other objectives and constraints which can render the total return starting point nearly unidentifiable. Further, these firms gain from the perspective of clients across all industry / client segments, providing a complete picture of the marketplace and its evolving trends.

Some hybrid managers implement a hub and spoke model for portfolio management, meaning that a dedicated insurance team is positioned as a hub for insurance portfolio management, connected via spokes to each of the many spread sector expert teams throughout the firm. This model allows 100% dedication and expertise in serving insurance companies to be combined with 100% dedication and expertise in specific spread sectors, such as structured products, bank loans, or emerging markets. This dual expertise can contribute to investment success.

Overall, bespoke insurance asset managers speak the same language as the clients they serve which lays the foundation for smooth working relationships and a greater likelihood of being able to respond favorably to needs prevalent amongst insurance companies. This insurance-wise orientation is not limited to portfolio management decision making. Customized operational procedures can lead to insurance client satisfaction, including a more controlled environment. For example, bespoke insurance asset managers are more likely to build gain / loss budget tracking into trading and compliance systems. Additionally, many mandates from insurance companies require multiple separate accounts in order to reflect two realities of the insurance business: 1. the need for different accounts for each of the many insurance legal entities involved; and, 2. the requirement to have separate accounts for each underlying insurance product to which the assets relate (e.g., whole life, universal life, fixed annuity writings, etc.). The cost accounting systems of some insurance companies require this product by product breakout in order to track business line profitability.

Given the overall growth in insurance companies outsourcing the management of assets, generalist managers are showing increased interest in this market segment. Some of these generalists are smaller firms which specialize in one or a very limited number of assets classes or fixed income spread sectors.

“Clients of these “hybrid managers” benefit from the breadth and scale of the larger firm delivered by the specialist team.”

Industry Outsourcing Trends: Broad Market Mandates Are Alive And Well

According to the Insurance Asset Outsourcing Exchange, North American insurance companies provided third party investment managers with $25.0 billion in fixed income mandates during the first half of 2013. The top six recipients of these mandates accounted for 84%, or $21.0 billion. All but one of these managers has more than $300 billion in total AUM. Looking at these mandates from the perspective of strategy type, fully 65% were broad market (global, single continent, or single country). The second and third largest categories were MBS at 11% and corporate bonds at 10%, respectively.

Industry And Client-Specific Knowledge: Augments Investment Excellence

Understanding underlying insurance products assists in the management of risks. The tremendous complexity of the insurance industry provides significant opportunity for asset managers with knowledge to favorably differentiate themselves. Simply referring to the “insurance industry” belies the extensive differences between the various segments (life; property and casualty (P&C); reinsurance). Even within any one segment such as life, the needs and risks associated with fixed annuity writers is in sharp contrast to those who sell universal products. Having a bespoke insurance asset manager who incorporates the unique uncertainties of the specific liabilities can prove valuable. In this example, fixed annuities have near certain cash inflows and outflows (recognizing the uncommon early redemption, with penalty) as compared to universal products with cash inflows which are modeled based on expectations of consumer behavior and market performance. As a result, the assets of these two products can be managed very differently across many dimensions, including liquidity.

A second example of the value of industry-specific knowledge is related to the confidence level in reserve analysis. Actuarial assessments result in a range of estimates which are discussed by management. A specific number is then agreed upon and adopted for reserve purposes and for liquidity management purposes. Even within the P&C segment, the confidence and predictability associated with auto insurance reserves and, therefore, cash flow, is much higher than for directors and officers (D&O) insurance. The former is often referred to as
“The broader the asset management firm, the more able an insurance company is to leverage an established relationship.”

a high frequency, low severity line of business compared to D&O which is low frequency, high severity. Managers who intuitively understand the business risks underlying the portfolios they manage can look at portfolio investment guidelines in a deeper, more comprehensive way.

Client-specific knowledge also matters. Circumstances for any one company can change over an extended period of time or they can change suddenly. Imagine a property insurance company which experiences a significantly larger than expected loss due to a catastrophe. Needs for liquidity and capital efficiency could alter the company’s asset allocation. The same company, having just experienced a significant operating loss, might be more willing to realize capital gains in order to fund the purchase of higher yielding assets for the long term. Additionally, insurance companies do not operate in vacuums. Evolving capital markets can drive changes in client needs and preferences. For example, a general expectation for higher interest rates has increased some companies’ allocations to floating rate instruments.

At some points in time for certain insurance companies, a preference for total return management might exist, especially for a limited portion of its assets. As noted above, bespoke insurance asset managers attempt to maximize return subject to constraints. “Hybrid” asset management firms can make their pure total return strategies available in separate accounts or in commingled investment vehicles which are rated by the NAIC in order to consume less regulatory risk-based capital compared to unrated vehicles. Both the insurance company and the asset manager expend significant effort to develop a mutual understanding, as well as technology connections, reporting requirements, etc. As the markets or a client’s preferences evolve towards a more customized set of requirements, transitioning an existing manager to this new paradigm is easier and more efficient.

The broader the asset management firm, the more able an insurance company is to leverage an established relationship. Several large insurance companies described themselves as total return focused prior to the financial crisis, only to embrace multiple constraints post-crisis, such as downside risk targets and risk based capital utilization targets. In a highly commoditized product environment, one of the most durable competitive advantages is a client-centric approach to solution creation, leveraging both experience and expertise.

Insurance Investment Specialization: Portfolio Optimization Adapted To Client And Market Evolution

Long-term success as an insurance asset manager requires an underlying robust investment process. This is related to the earlier point regarding the operating leverage inherent in the insurance industry, which magnifies any unexpected or undesirable asset management performance. The first level of insurance specialization involves the ability to manage portfolios in compliance with multiple constraints, such as book yield and interest rate duration targets, minimum average credit quality, and maximum tenor of any individual holding. Even higher value offered by a bespoke insurance asset manager is portfolio optimization, which results in achieving an optimal balance between the client’s top goal (e.g., maximize book yield per unit of duration) and its multiple, sometimes competing constraints, including risk-adjusted after-tax expected returns, capital efficiency, liquidity requirements, realized gain/loss limits, etc. What serve as constraints for some clients might be the top goal for others, such as maximizing expected return per unit of regulatory capital. Finally, the greatest value is having the portfolio optimization adapt to evolution in both the client organization and the markets. The vast majority of the $25.0 billion in 2013 new business mandates referenced earlier were subject to significant constraints requiring optimization techniques.

Changes in client circumstances and capital markets necessitate the adaptability of these optimization models. A company might execute a secondary offering of common stock, thereby relieving capital consumption as a binding constraint. That one development could result in a significant portfolio repositioning out of A-rated bonds into BBB-rated bonds in search of higher yields. Extending this hypothetical, if rates have fallen significantly since the original A-rated bonds were purchased, a migration to BBB-rated bonds might not generate higher book yield and, therefore, might not result in an optimal portfolio for book yield sensitive accounts. Contrary to generalist managers who measure performance based primarily on total return metrics, hybrid managers are more likely to possess the tools required to adapt to these changing market and client needs.

The continuing advancement towards Solvency II (S2) adoption will potentially increase the importance of robust portfolio optimization. S2 requires that insurance companies pass a “use test” demonstrating that their internal models are used as part of their actual decision-making process. A quantifiable approach to portfolio optimization could serve as an important component of meeting the use test requirement.

Another facet of insurance investment specialization is the ability to rotate across spread sectors and to find value
across all of the credit sectors, including US investment grade corporates, high yield bonds, bank loans, emerging markets, RMBS, CMBS, and ABS. This breadth of spread sector expertise improves the ability of the asset management firm to communicate to clients when a specific sector falls in relative value. The appearance of conflict could arise when a firm that manages assets solely in a single spread sector, such as emerging markets, observes that the relative value of that spread sector has fallen. Any recommendation to the client to decrease its allocation to that sector would result in a direct reduction in firm AUM. Firms with expertise in multiple spread sectors can see such a recommendation to reduce an allocation as an opportunity to build credibility and a long term relationship with a given client, who has the ability to reallocate to another spread sector with the same manager. This is one of the many reasons to include firm-wide broad market overviews as part of regular portfolio reviews with clients. These regular updates help to answer the question, “What is the overall firm doing in its non-insurance core and core full discretion accounts?” Any asset allocation shifts at the firm level would be discussed resulting in an assessment of how that shift could or should be applied to the client’s portfolio.

Conclusion

Insurance specialization contributes to investment success. Understanding the industry and the client aids in the development of customized investment objectives. Those objectives are inputs into an adaptable portfolio optimization tool which assists in producing superior, client-specific investment results. Bespoke asset managers need to be flexible in their approach and offer the full range of coverage, from total return orientation to fully customized, but having all of the tools to support insurance companies whose needs evolve should prove helpful to insurers over the long-term.

“Bespoke asset managers need to be flexible in their approach and offer the full range of coverage . . . ”
Setting an asset allocation plan that matches an insurance company’s investments to their liabilities, risk preferences and business model

Noel Hillmann: Thank-you to everyone for joining me today for this debate.

I’d like to begin by asking, how has the panels’ asset allocation plans evolved over the last 12 months, based on both ORSA and other external influences?

Andres Vilms: In my case, the annuity business has been acquired by a new owner, so there’s a great opportunity to take advantage of new investment capabilities. More generally, in the US annuity and life insurance business the allocation really starts with the requirements for funding the liabilities. The key determinants from that perspective are the interest rate risk profile in terms of both duration and convexity, the liquidity needs, latitude for credit risk and so forth. That overall risk profile creates a form of benchmark for the assets specifically backing liabilities. That in turn frames how you look at new investment opportunities.

Michael Fosbury: First of all we’re not large enough to be impacted yet by ORSA so we haven’t made any changes based on ORSA. Other external influences though are obvious, interest rates being as low as they have been, instigating us to at least look at alternatives that we hadn’t considered in the past, such as mezzanine debt. We’ve looked at various other alternatives and haven’t done anything else yet. We’ve taken a dim view towards corporate debt, one of our three basic food groups. Saying that, leveraged buy-outs are back into play and corporations in general are just more shareholder friendly than they are bondholder friendly. We’ve taken that into consideration and shied away in a few instances and going to our other two food groups which include municipal and residential mortgage securities.

Thomas Frazier: I would say in the last 12 months there really hasn’t been any change from external regulatory influences that has had a direct bearing on decision making. Rather, the models that we use to support our asset allocation plans have become more robust and comprehensive over the last three years. There have been important changes there but in terms of influencing decisions, that comes through discussion and isn’t really model driven. We are constantly looking at the external capital market environment for the attractiveness of various asset classes. In that regard we’ve been increasing our allocation to equities because we felt they’ve been attractive.

Steven Kreider: We see insurers increasingly seeking to expand the matrix of opportunities they have to increase yield; some of them are doing it by investing in credit on a global basis in a new process. Specifically we have seen insurers extending the global reach of their credit mandates, extending from developed markets to emerging markets. They are also expanding the range of their credit instruments from loans and high yield to structured products. Perhaps most importantly they are evolving new approaches that share a key characteristic: they’re more seamless. Instead of carving out narrow, single sector mandates, for example US bank loans or sovereign debt, they are instead creating mandates that seek the best credit investments across a range of geographies and a range of credit instruments. The range of instruments includes structured products, non-agency mortgages, CLOs, CMBS, leveraged loans, little middle market loans as well investment grade and high yield bonds.

The range of geographies extends from the US across both developed and emerging markets. These broader, more flexible mandates are entirely sensible to us; they facilitate apple to apple comparisons of investment opportunities and they recognize that asset allocation and sector allocation are somewhat artificial. A single
issuer may borrow in several different markets in several different vehicles. The best value depends on conditions at the issuer and at the markets. Having the ability to move easily across artificial boundaries created by indexes creates better opportunities to enhance value.

**Noel:** Steven mentioned the development from domestic to international investing, exploring the wider investment opportunities but maybe on a slight parallel to what has been invested into in domestic markets. Do you see a rationale for the internationalisation of investments?

**Andres:** It’s important to distinguish the core portfolio backing the life insurance liabilities and its alignment with those liabilities. To the extent that those liabilities are US market driven and US dollar denominated, the focus on opportunistic credit would not be so much in the international space. That said, if there are opportunities and risk tolerance for taking additional foreign exposure, surplus would be the area that you would have some latitude. Certainly the bulk of the portfolio would be more focused on US dollar opportunities.

**Noel:** There was some thoughts expressed there, Tom, about the potential to move towards structured products, CMBS opportunities. You just mentioned however, that there haven’t been significant changes in your asset allocation strategy. Is there reason behind that and are there certain triggers that you’re waiting for before you make any switch?

**Tom:** I did mention we’ve increased our equity allocation over the 12 months. In terms of fixed income, we have been significantly overweight in structured products and credit and have held very few treasuries in the past five years. That hasn’t been a change because we’ve been in those opportunities since the fall out of the financial crisis.

**Noel:** In terms of risk budgeting, what are some of the leading ways to employ risk budgeting in the asset allocation exercise?

**Michael:** In terms of how we deploy our capital as efficiently as we can, primarily we use Best’s Capital Adequacy Ratio ("BCAR") or Risk-Based Capital ("RBC") ratios to define how much more capital intensive assets we want to purchase. Typically the most capital intensive products right now are commercial loans. We don’t really care how capital intensive they are, we like them the best and that’s where we’re going to invest. Typically RBC or BCAR ratios are what we use for budgeting.

**Andres:** There should be both a top down and a bottom up component. The bottom up component is more naturally tied in to the construction of the investment portfolio. In terms of looking across your different risk categories and managing the risks, for interest rate risk obviously you look at duration matching and key rate durations. In the credit area, the RBC factors that Mike referred to, play a significant role in setting quality targets. That gets supplemented by concentration limits for issuers and sectors. For liquidity management purposes you want to look at your contingent liquidity and factor in how stress liquidity will impact different tiers of your asset portfolio and your liability in force. So those are important bottom up elements. From the top down perspective, it’s necessary to define the overall enterprise risk appetite in terms of the financial metrics that are important for financial management. This is in order to manage the exposure to different types of market moves and their impacts on income sensitivity or capital sensitivity. Connecting that to ORSA, which we talked about on the other question, in its initial form is not particularly prescriptive but what it does is encourage is a well thought out view of risk and return. That should include the connection of risk appetite and risk budgeting to asset allocation.

**Steven:** Like astute poker players, insurers need to look at risk in ways that reflect unique characteristics of their insurance books and their business strategies. They need to translate sensible investment objectives, such as preservation of capital, into actionable guidance for their investment portfolios. Risk budgeting is one tool that can be useful in this sector. What’s key is customising the process for the idiosyncrasies of the insurer. To extend the poker metaphor; the first thing you do when you go to the Friday night poker game is to take money out of your right pocket and put it in your left pocket. That way if it all goes bad, you still have the bus fare home. Likewise, every insurer needs to know how much risk is too much risk in the investment portfolio and this means being very explicit in how to measure the risk and how to decide on how much is too much.

**Tom:** It’s an extension on what we’ve seen recently in terms of the enterprise risk management processes, an extension of mean variance optimisation modelling that we’ve always applied to the investment portfolio as a way to gauge what our left tail risk is along with using value at risk models. But since we’re not just an investment company, we have to apply those models on an enterprise level looking at underwriting and reserve risk, catastrophe risk, the leverage in product mixes which amplifies risks, and looking at any possible correlations there might be to determine what the overall value at risk is on an enterprise level. Again, these are directional guide posts that we use, not “The” answer that we just blindly follow. So when we’re applying those models we’re constantly challenging the assumption. I would say that you get as much value out of the process in the dialogue that you follow as you do out of the results that you end up with.
Noel: I'd like to come back on a point you made earlier, Steven, about how much risk is too much risk. When we think about employing risk budgeting in the asset allocation exercise, what is your thought process around how insurers can match up new asset classes that are becoming available with the risk budgeting exercise? Is this a good area to be pushing and isthis an area that is good to be venturing into? What are the different approaches you see to risk budgeting?

Steven: The main thread that runs through the best approaches connects fundamental analysis of the individual issuers and securities to an understanding of what that means for the performance of the securities in different environments. There's an old saying in football from Woody Hayes at Ohio State that when you pass the ball, three things can happen and two of them are bad: interception or completion. Likewise in investing when you build a portfolio three things can happen and two of them are bad. The two bad outcomes are a big slump in growth or a large rise in inflation. The main idea that should run through any effort to incorporate new assets into a portfolio is to have an understanding of how those assets are going to perform in situations where growth disappoints or inflation surges upwards.

Noel: When moving between assets and particularly moving into new assets that you haven’t previously had an exposure to, including that in the risk budgeting and not necessarily knowing the performance at the outset, how do you approach that as regards to the risk budgeting? What is the variation and error margin you put in place to say it could have this effect, it could be as minor as this?

Andres: The starting point before getting deeply into the quantitative analysis in this area is to consider the qualitative aspects from an enterprise risk management perspective. First you have to evaluate your core competency and skill set and what your opportunity is for superior performance in a particular asset class. Following that are the fundamentals that Steven talked about. And then you’ve got to look at the risk profile and the cash flow properties of the asset to understand whether it fits in, in terms of backing your liabilities or whether it has to be more of a tactical or a surplus optimisation type play. Without thoroughly understanding the asset and having a good view of the risk profile of the expected return and cash flows, you can’t make a strong case for its inclusion in the portfolio.

Noel: How do current valuations influence your asset allocation decisions Michael?

Michael: We basically use valuations in risk-return trade-off considerations. There are some securities whose valuations suggest we just don’t want to invest in with rates as low as they have been and just not being rewarded for what we perceive the risk to be. Whereas in other points in time there could be the exact same fundamentals, but in a higher interest rate environment we’re just more comfortable taking that risk on. Then we have some specific things like, we try not to get into high premium bonds that we feel have any sort of credit issues. We happen to feel that corporates have been tight for some time; we’ve looked for alternative areas so it’s just part of our general game plan considering where current valuations are relative to where we prefer to see them and how we want to invest in them.

Noel: How do current valuations influence the asset allocation decisions of the insurers you tend to work with?

Steven: Valuations drive returns. Wide spreads and low prices create the possibility for big returns in the future. Valuations in many markets today are attractive, especially in relation to fundamentals. The conventional approach to asset allocation relies heavily on historical returns and correlations and while we would agree it is important to have a clear understanding of history, the most effective asset allocation regimes are driven by valuations. Importantly in fixed income, valuation refers not just to yield but also to spread; after all the level of yields is typically hedged in the liability book. Spreads are only part of the consideration for value and credit. Generally, it’s the capitalisation of the changes in spreads that has the largest impact on results. Looking around the markets today shows a wide variety of opportunity in this way and insurers who use valuations to drive their asset allocations will benefit proportionately.

Noel: How do current valuations influence your asset allocations Tom?

Tom: We have allocation ranges so it affects it on the margin. Therefore, as a property and casualty insurance company, we’re always going to have predominant allocations to income generating assets. Again we have a range, so as fixed income and sectors within it become more or less attractive, we will tilt the allocation to those favourable sectors. As spreads get wider, we’re underweighting treasuries and allocating more to spread products. Relative to history is what I’m talking about. When they’re historically tight we’ll increase our allocation to treasuries and so on but you will have minimum and maximum amounts to these allocations, particularly in the broad asset classes like equities and bonds where we’re going to be ramping up our allocation to equities when fixed income opportunities aren’t as attractive. We do have rebalancing guidelines, but those are guidelines, not automatic rebalancing adjustments. We are always taking into account relative valuations.

Andres: To evaluate the opportunities in the context of current valuations, it’s necessary to distinguish between
Setting an asset allocation plan that matches an insurance company’s investments to their liabilities, risk preferences and business model

strategic and tactical considerations and their materiality. Going back to the core driver of asset allocation alignment with liabilities, a big question is whether what you’re seeing are shorter-term market price fluctuations. If the original investment thesis and the appropriate construction of the portfolio to fund the liabilities still holds up and you still expect good long-term performance, then you won’t be as interested in creating material turnover in the portfolio. At the same time, you do want to look for tactical opportunities on the margin in the way that Tom described it. Also, you need to be alert to structural changes or regime changes. If there are significant developments in the capital markets that are changing risk-return relationships going forward in ways that alter key assumptions underlying the construction of the portfolio, then it’s necessary to revisit the asset allocation at least from an investment risk-return perspective. In general the scope of review will be influenced by materiality and also the need to look at that fundamental alignment with the liabilities.

Noel: How does your sensitivity to the timing of potential underperformance impact your asset allocation decisions Michael?

Michael: Getting back to the liabilities, our liabilities are not interest sensitive so we’re actually not too concerned about interest rates going up or down so much as we might be if we had ‘hot money’ liabilities. Our sensitivities are with potential underperformance; we recognize that we’ll lose the market valuation if rates go up but we view the opportunity to get higher earnings much more fondly so we’re not too concerned about potential underperformance.

Andres: In the annuity and life insurance world, and especially with longer duration liabilities that are market sensitive, you are constructing the portfolio to be a good fit with the liabilities. If done properly, that can produce an overall asset liability portfolio that isn’t unduly sensitive to the timing of potential underperformance. In particular, fluctuations in total return should not materially impact the ability of the assets to fund the liabilities and provide you with an expectation of profit. However, accounting and capital rules can reduce the effectiveness of investment strategy in some circumstances, which is why it’s critical to monitor income and capital sensitivities relative to the risk appetite. Also, from a broad strategic perspective you’ve got to be on the lookout and understand inflection points in your business strategy and mix or your external environment such as regulation.

Tom: It is something we have to pay attention to in the short run even though we are long term investors. If for example we had an excellent year and certain asset classes have done extremely well, we might have to be sensitive to losing such gains particularly if on the underwriting side of the operation we’re not having as good of a year. We’re sensitive to looking at the insurance operations and making sure that we don’t want to have a bad investment and a bad underwriting result in the same year. We will lock in gains where it’s appropriate because we are trying to achieve a certain level of return on equity each and every year. If we feel it’s appropriate to hedge to that result because of uncertainty, we might do that in the short run. But in general, we are long term investors and we prefer not to try to hedge a short term result. However, sometimes it can be necessary.

Steven: Conventional approaches to asset allocation frequently overlook the negative consequences that result from bad performance in bad markets. A tell-tale sign of this shortcoming often appears in discussions of performance that either ignore risk adjustment or make the risk adjustment without reference to the timing of excess returns. In general, economies under stress and markets under stress often present important strategic opportunities for insurers. Insurers who coordinate asset allocation with their long range strategic business plans position themselves to create a lot of value. Accordingly, the best asset allocation approaches will take inspiration from the insurers’ business strategy and adopt risk budgeting and performance attribution measurements that incorporate timing effects.

Andres: As a final point, I would just add that one of the practices that ORSA encourages is to look at a multi-year projection of solvency and financial results. That’s a valuable practice for promoting that connection. It creates an improved understanding of what the business strategy implies over multiple years, and what the major dependencies and inflection points are.

Noel: We’ll conclude here. Thank-you to everyone for their time and input.

“fluctuations in total return should not materially impact the ability of the assets to fund the liabilities . . .”
What is the future for insurance investment management in a low yield environment as insurers look to invest outside traditional bonds?

Wyn Jenkins: Before we plough into the questions it would be nice to get to know a bit about your backgrounds.

Tom Rogers: I’ve been in my current role for a little over a year and prior to that I was in Robert’s role, for about five years. Prior to that I was in the risk and investment management side at Centre within the Zurich Group of Companies and prior to that another insurance company.

Robert Torretti: As Tom indicated he was in my role previously. I took on this role in October 2012 as head of the Americas. Prior to that I was the regional investment manager for Latin America which reported up to Tom then as well. I’ve been with the Zurich Group for about three and a half years, having joined in February 2010. Prior to that I did a number of different roles at AIG primarily in their international life insurance businesses both in investment management and insurance operating companies.

Wyn: How has Zurich Insurance Group’s investment strategy evolved over the past few years and how has your attitude to risk evolved? The interesting thing about that is maybe whether it’s changed pre and post economic downturn.

Tom: The short answer to whether it has really changed pre and post the financial crisis is no. We have always begun with our insurance liabilities, developing our investment strategies so that approach remains constant through time. I don’t want to say we are very conservative but we are very risk aware in our analysis and in our development of that investment strategy. The overall asset allocation on a strategic basis has evolved slightly over time but not materially over that five year period.

In 2003-2004 Zurich did go through its own little financial crisis when the markets were not in general crisis. In that time period we really developed the framework, that thought process, that approach, of let’s focus on the risk management vis-à-vis our liabilities in order to make sure that we have the right asset allocation approach, that again has remained constant, we’ve been constantly trying to improve our approach and to do a better job of analysing and measuring the risk and managing that as well but materially nothing has changed in the intervening five years.

Wyn: Given the conservative investment style of your insurance group, has the low interest rate environment posed a unique opportunity to take a less reserved investment stance, a few more risks and maybe a bit more diversity in your investment portfolio?

Robert: As Tom said, there is a risk-aware or disciplined approach to investment management at Zurich. We have a focused approach and a long-term view. A low interest rate environment may appear to present some opportunities but in a low interest rate environment you have to be conscious of the fact that it’s dangerous to chase yield that can lead you to taking risks that you don’t necessarily understand. We are very focused on understanding the risks that we take, keeping our eye on that ball, producing stability in the company and a sustainable performance. This is because if you are chasing higher yields you have a potential downside which is risk and so should view it as a long term investor. Zurich and insurance companies in general are all long term investors overall; avoiding making bad bets rather than necessarily seeking great deals. As part of that we’ve helped stabilise markets during the financial crisis but also paid a price in the form of low interest rates. Like savers in general, we have lower returns on our assets than we used to have and so the lower interest rates also produce a higher value and an increase in the value of future liabilities. Really where I think insurance companies have focused is more on disciplined underwriting in their insurance businesses and delivering strong underwriting results becomes more important than necessarily chasing yield.

Wyn: It does sound like you’ve not been reactionary at all to the low interest rate environment; you’ve stuck to your guns, accepted a lower return and tried to do things in other parts of the business like the underwriting, is that fair?
What is the future for insurance investment management in a low yield environment as insurers look to invest outside traditional bonds?

Robert: That’s fair and I believe Tom would agree but I’ll let him speak for himself.

Tom: I would agree with that. As Robert said, we certainly try to understand the investment alternatives before we make any big commitments into those and so certainly we look at the private placements market, we look at the bank loans, we look at infrastructure, we look at a lot of things. We even do some of them but it’s critical to us to understand what risks we’re entering into and it’s not just investment risk, but the operational risk, the legal risks, really touching on all of the basics before we execute any particular strategy. That slows us down a bit. There clearly is pressure from shareholders and from other stakeholders to raise investment yields and investment income but we remain disciplined and focused on that framework of making sure that the analysis is complete and that the risks are well understood before we move into those points.

Touching a bit more on the next question, our mission as we see it in investment management at Zurich, is to maximize the risk adjusted returns of our investments relative to liabilities. It’s in that spirit that we do all of our analysis and really try to make sure that we cover all the bases in doing that.

Wyn: Considering insurers need to meet the Solvency Modernisation Initiative and their own risk and solvency assessment regulations, how high is the highest investment risk spectrum? How far can you push the boundaries in the context of increasing regulations and oversights from regulators on what you’re doing?

Tom: The answer is that you could push it as high as the regulators will let you but from our internal point of view we’ve always managed to our own risk tolerance. That risk tolerance may or may not be higher than other insurance companies in similar businesses. There’s a broad spectrum; Zurich isn’t at either extreme in that spectrum but the way I would put it is that we try to calibrate our risk taking on an economic basis to a Double A rating. That philosophy is really what guides our risk management processes. It’s really looking at economic capital, using our internal models as the driving force as one of the constraints. When it comes to the Solvency Modernisation Initiative or the Own Risk Solvency Assessment regulations around the world, those are also constraints that can affect our asset allocation and affect our investment process. Those are very much more in the constraint category than if you will the objective, which is to maximise the risk adjusted return of investments relative to the liabilities. That objective really integrates into the internal capital models. The overall approach is: maximise return net of liabilities, subject to internal economic capital and external regulatory capital constraints. The regulatory solvency rules form constraints within that internal economic framework.

Wyn: It sounds like at Zurich you have very robust internal systems which are almost your priority. Would it be fair to say that in a lot of insurance companies, if you think about the pressures, you’ve got shareholders on one side and regulators on the other? Is that a fair way of looking at the pressures on each side?

Tom: There are many stakeholders but yes there are two potentially competing pressures within the industry. I don’t really see that as something new.

Wyn: What role are alternative fixed income instruments having in your investment thinking such as bank loans, emerging market debt and even new areas such as renewable energy and trade finance?

Robert: Tom did say in answer to one of the earlier questions that we certainly look at different forms of investments and that we hold some of the investments that you cite. We already hold alternative investments including hedge funds which may invest in fixed income. Other alternatives that we also hold, private equity and real estate, wouldn’t necessarily be fixed income instruments. We regularly review opportunities to invest in new asset classes and look at the strategic asset allocation opportunities. There are potentially some opportunities in new areas, including infrastructure investments but we review those within the context of the structured approach. We don’t see infrastructure debt or other fixed income opportunities differently in that process.

In the emerging markets space I would say that it’s an area that the firm has been focused on in building its core business. In the Americas region we have had our expansions in Latin America through a joint venture and long term distribution agreement with Banco Santander, and organic growth. We have also carried out some acquisitions in other emerging markets. We look at and invest in these markets quite significantly through local businesses.

Wyn: Given some of the main objectives of insurers are very...
different to other institutional asset owner groups, do you believe that an external asset manager must have a dedicated approach to managing insurance assets or do generalist asset managers bring a certain value add to their investment approach? To what extent do you use external managers?

**Tom:** We’re a very large user of external asset managers, I don’t have the number in front of me at the moment but I believe it’s about two thirds of our assets are managed externally. The question of should an external asset manager have a dedicated approach to managing insurance assets or do generalist managers add value: there’s room for both. Certainly for the largest part of our portfolio, we would like our asset managers to have a good understanding of the insurance industry, the business, the regulatory environment, even the accounting environment. All of those factors are parts of the constraints that we operate within in the mission to achieve the highest risk adjusted return on investments relative to liabilities.

We do differentiate on different sources of return so some of the portfolio is really focused on only trying to get the return that we can with minimum risk. Some of that is then saying, where can I take some market risks? Credit or equity markets would be examples there, and take some market data and derive some excess return out of the market data. Then there’s a third component which is the skill based return that we look for from our managers as well. The manager who has very few constraints and doesn’t have to worry about the insurance world of regulation and accounting and things like that and how their decisions might impact the capital situation of a statutory reporting company, they can produce more alpha because they are less constrained. We do have a home for some of that investment in our balance sheet. Also, the largest part of the portfolio is fixed income. A lot of those constraints do apply. They can have a major impact on the company. We do want our managers to understand that environment we are operating in and that they are contributing to in their investment activities.

**Wyn:** You said roughly two thirds is given to external asset managers at the moment. Has that changed at all over the last five years?

**Tom:** Not significantly no. We sold in 2001 our investment management arm to Deutsche Bank and started on the outsourcing path at that point in a very big way. It served us well through the financial crisis; we do have processes in place where we talk with the managers on a very regular basis in a formal manner as well. Where we find that they are not delivering what they promised, if that occurs, then we’ll go through what we would call ‘a correction process’ and try to find out what happened and why and implement any changes to correct the situation. In the worst case it could mean firing the asset manager and replacing them with somebody else. Typically we have good dialogue with our asset managers. Where we find issues like that they implement changes to address those issues and we move on.

**Wyn:** Do you find within external asset managers that there is plentiful expertise in terms of the way they understand the insurance industry?

**Tom:** I would say yes.

**Wyn:** As your investment universe expands, do you envisage a point where you will be outsourcing more of your investment activities than you currently do?

**Robert:** As Tom discussed, we do outsource a substantial part of our investment management in particular security selection and trade execution. We haven’t changed significantly over the past years but we try to look at these outsourcing decisions using a disciplined approach about whether to outsource and to whom to outsource particular mandates. In my particular region of the Americas, the US and Canadian businesses are outsourced almost entirely for public securities. Yet in Latin America, it’s almost entirely internally asset managed. Some countries around the globe have hybrid solutions where some asset classes are insured and some are outsourced. I don’t believe there’s a one size fits all solution but I can certainly envisage portfolios that might be outsourced in the future. It’s also possible that we might insource something that was previously outsourced.

**Tom:** The decision to insource versus outsource is really a cost benefit analysis in terms of what it is that you get from either the teams that you have and the cost that they incur versus what you could get as an alternative outside. We hold ourselves to a very high standard and we hold our external asset managers to a very high standard.

**Wyn:** Thank-you Robert and Tom for sharing your views, it is most appreciated.

“I don’t believe there’s a one size fits all solution but I can certainly envisage portfolios that might be outsourced in the future.”
In the intensely focused search for yield, insurance companies have a myriad of objectives and constraints that they try to balance, including risk/return optimization, regulatory risk-based capital (RBC) efficiency, and managing volatility associated with a potential rise in interest rates. Suitable spread sectors increasingly employed by insurance companies to potentially achieve one or more of these objectives are described more fully below: structured products; bank loans; emerging markets debt.

Structured Products, specifically Non-Agency RMBS and CMBS

NAIC modeled structured product securities can offer low duration loss adjusted yields of 6-8%, with NAIC 1 level RBC treatment. This one spread sector can help insurance companies achieve all three objectives mentioned above simultaneously. The investible universe of NAIC modeled CMBS is currently greater than $510 billion in outstanding par while the NAIC modeled non-agency RMBS universe is greater than $420 billion.

Unlike most debt securities, the NAIC designations assigned to non-agency RMBS and CMBS are dependent upon the owner’s book price compared to modeled ratings-level threshold prices. As a result, three different insurance companies could own the same security and record it at three different ratings. At the NAIC summer meeting, the securities valuation task force decided to continue using the current model and methodology to compute for 2013 non-agency RMBS and CMBS capital charges. Unlike typical NAIC 1 securities that have limited price upside, deep discount NAIC 1 non-agency RMBS and CMBS still have potential for equity-like performance in a recovering economy without compromising downside protection or extreme interest rate sensitivity.

Exhibit 1 depicts some milestones and assumptions associated with the NAIC methodology. Robust modeling tools at the insurance company or its asset manager can help identify those securities that are most likely to benefit from price appreciation resulting from the upcoming model release.

Bank Loans

Bank loans are floating-rate instruments, a feature deemed attractive by some investors because it protects the value of the loan from a rise in interest rates. Additionally, loans are senior in the capital structure and secured by specific collateral, which will provide some downside protection in the event of default. As a result, loans tend to be less volatile than high-yield bonds. Some insurers focus their investments in bank loans in the BB rated segment based on the belief that it offers a more efficient usage of RBC relative to the segments rated B and below.

One misconception is that loans do not offer much yield given that LIBOR is extremely low, and many investors think LIBOR will stay low for quite a while. While rates could remain low for an extended period of time, our experience indicates that almost every new issue and close to 70% of the entire loan market today has a LIBOR floor in the range of 0.75% to 1.0%. The result is that the market today can provide a high level of current income and a relatively attractive yield in a low-interest rate environment.

Another misconception is that some investors still view the loan market as a private and clubby market with limited liquidity. In fact, the market has developed significantly over the past decade, and today over 10 major dealers provide daily trade execution, offering liquidity very similar to that of the high-yield bond market. According to S&P/LCD, the market for loans is roughly $625 billion versus $1.1 trillion for the high-yield bond market.

As a result of these characteristics and the evolution of the marketplace, some insurers are changing their view of bank loans from being a tactical investment to being an integral part of their strategic asset allocation. A supporting reason for this development is that bank loans have a low correlation to most of the other asset classes in which insurers invest. In fact, in the case of Treasuries, correlation is actually negative. For diversification reasons as well as the opportunity to earn high current income with protection from rising interest
Insurance companies’ search for yield: suitable investment ideas

Exhibit 1

**The NAIC Advantage in Non-Agency RMBS and CMBS**

**November 2009**
NAIC adopts the American Council of Life Insurers proposal to modify capital requirements for non-agency RMBS/CMBS and replace the previous practice of applying Acceptable Ratings Organization ratings with an approach based on loss adjusted intrinsic value.

**Year-End 2010**
NAIC Valuation of Securities Task Force instructs the SVO to revise Base Case peak to trough HPA assumptions to -34% from -38% the prior year. SVO revises scenario weightings to assign higher probabilities to economic tail scenarios.

**Year-End 2012**
Year-end valuations reflect a more conservative bias in scenario weights and a new rating model. While it is difficult to disentangle the impact of the change in scenario weights and the implications of the new model, the more conservative bias is largely mitigated by strong appreciation in US housing over the previous year. The relationships among economic risk sensitivity, housing market beta, and NAIC classifications remain dislocated, with higher risk option ARM and subprime sectors experiencing increases in NAIC 1 break-even pricing on an equally weighted basis.

### Weighted Average

<table>
<thead>
<tr>
<th>Year-End</th>
<th>Year-End 2009</th>
<th>Year-End 2010</th>
<th>Year-End 2011</th>
<th>Year-End 2012</th>
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<tr>
<td></td>
<td>Weight (%)</td>
<td>Peak-to-Trough HPA (%)</td>
<td>Weight (%)</td>
<td>Peak-to-Trough HPA (%)</td>
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<tr>
<td>Most Aggressive</td>
<td>3.0 -33.0</td>
<td>5.0 -31.0</td>
<td>5.0 -33.0</td>
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<td>Aggressive</td>
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<td>20.0 -31.0</td>
<td>20.0 -33.0</td>
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<tr>
<td>Base Case</td>
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<td>50.0 -34.0</td>
<td>50.0 -35.0</td>
<td>50.0 -34.0</td>
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<td>Conservative</td>
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<td>20.0 -38.0</td>
<td>25.0 -37.0</td>
<td>25.0 -37.0</td>
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<tr>
<td>Most Conservative</td>
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<td>5.0 -59.0</td>
<td>15.0 -60.0</td>
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<td>Weighted Average</td>
<td>-38.5</td>
<td>-35.3</td>
<td>-36.3</td>
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### Year-End 2012 Changes in RMBS Ratings (%)

<table>
<thead>
<tr>
<th>Up</th>
<th>Unchanged</th>
<th>Down</th>
</tr>
</thead>
<tbody>
<tr>
<td>31</td>
<td>22</td>
<td>47</td>
</tr>
</tbody>
</table>

Source: Barclays, NAIC, Western Asset

**Distribution of RMBS NAIC Ratings as of Jan 2013**
rates, an increasing number of insurers express interest in this spread sector.

**Emerging Markets (EM) USD-Denominated Debt**

On a ratings-equivalent basis, and, therefore, a regulatory RBC-equivalent basis, EM debt generally offers higher yields than the debt of US domiciled companies. With EM BBB rated corporate debt paying, on average, 90bp more than its US comparable, some insurance companies are assessing the credit and other risks associated with EM debt relative to domestic credit, and they are deciding to reallocate from US obligors to similarly rated EM issuers. This is especially true in the BBB rating level, where the insurer usually has a large existing US allocation which is generating yields which are hard to tolerate over the medium to long term given the characteristics of their liabilities and the related need for income.

The attractive fundamentals of many EM countries—including strong growth, demographics, productivity catch-up and healthy balance sheets—are well known and, we believe, should continue to support EM assets over the longer term. However, the sharp sell-off in EM bonds and currencies since May highlights that this is not a one-way trend and that these markets are not immune to global economic and market forces.

In our view, concerns over the normalization of US Federal Reserve (Fed) monetary policy caught the EM sector at a vulnerable time. Declining growth rates throughout the sector (and in particular fears over a Chinese hard landing) served to further unnerv investors who were already concerned with valuations in the context of higher US rates. While some of the structural vulnerabilities amongst certain EM countries are nothing new, selling pressure exacerbated by recent outflows from the asset class has brought these back into sharp focus. Insurers considering an EM allocation are interested in whether current pricing in EM bonds and currencies correctly reflects underlying fundamentals and whether they offer attractive opportunities to generate returns.

**Fundamental Backdrop**

Underpinning our assessment of valuations is our central view that while the eventual “tapering” of asset purchases by the Fed will remove an important element of support for developed market (DM) bond yields, the broad backdrop of moderate (but improving) growth, continued policy accommodation by the major central banks, benign developed world inflation and some evidence that Chinese growth is stabilizing should be broadly supportive for risk markets. This includes EM at these current “cheaper” levels. In addition, EM-specific factors such as flexible exchange rate regimes, large foreign exchange reserves, generally low levels of external debt (particularly short-term external debt), lower levels of inflation and monetary policy flexibility bring comfort to EM investors that 2013 is not a replay of the balance of payments crises seen in the 1990s.

**External Debt (USD-denominated Sovereign and Corporate Debt)**

Although the future normalization of US monetary policy brings new challenges to EM policymakers, particularly with respect to the impact of capital flows on bond yields and currency levels, we believe sovereigns are generally well positioned to weather the storm and have plenty of policy levers to ease the transition. Very few EM countries are default candidates, and although there may be some ratings pressure amongst more vulnerable countries, we do not see downgrades to speculative grade; in fact, we still forecast ratings upgrades over the coming year, e.g., in the Philippines.

EM external debt, with $1.2 trillion outstanding, is valued as a spread over US Treasuries, just like other spread sectors. There is a US rates component and a spread/credit risk component to the all-in yield. In our view—particularly as we are not forecasting negative ratings actions—the back-up in external debt spreads relative to comparables makes valuations attractive at current levels. Given the yield enhancement offered by EM debt, this view on relative valuation supports the trend of insurance companies increasing their EM allocations.

Exhibit 2 illustrates the widening in investment-grade-rated EM sovereign bonds relative to similarly-rated US corporate bonds. Although EM spreads on an absolute basis are far from the highs seen during past crises, we have not seen current relative spread levels since 2004. This seems to imply good value given our view that the market is correctly discounting a low probability of severe sovereign strain.

**Exhibit 2 EMBIG IG Spread Less US Credit Spread**

Source: JP Morgan, Barclays, Western Asset. As of 31 August 2013.

We also believe that recent market volatility has created attractive opportunities within EM corporate bonds. When rating EM corporate credit issuers, ratings agencies rightly take into consideration country risk. However, typically a “strong” corporate issuer will receive a lower rating than a comparable developed market bond due to the domicile of issuance. In
addition, despite many EM companies being “under-rated” for the standalone strength of their balance sheets (Exhibit 3), EM corporate bonds trade wide to developed market comparables on a ratings basis (Exhibit 4). Insurance company investors will seek to pick through credits using top-down and bottom-up expertise to discern those credits which may benefit from the recent local currency weakness and those which may be more vulnerable.

In summary, each of these spread sectors can help insurance companies increase yield while achieving one or more objectives such as achieving risk / return optimization, regulatory risk-based capital (RBC) efficiency, and managing volatility associated with a potential rise in interest rates. The significant variation across the respective performance histories in Exhibit 5 underscores the benefits of diversification and could serve as an argument for making allocations to all three sectors, for those insurance companies where it fits within their other constraints.

**Exhibit 3**

<table>
<thead>
<tr>
<th></th>
<th>EM Corporates</th>
<th>US Corporates</th>
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<tbody>
<tr>
<td>A</td>
<td></td>
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</tr>
<tr>
<td>BBB</td>
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<tr>
<td>BB</td>
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<tr>
<td>B</td>
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**Exhibit 4**

<table>
<thead>
<tr>
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<th>EM Corporates</th>
<th>US Corporates</th>
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<tbody>
<tr>
<td>A</td>
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<tr>
<td>BBB</td>
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**Exhibit 5 Index Returns**

<table>
<thead>
<tr>
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<th>1yr</th>
<th>3yr</th>
<th>5yr</th>
<th>10yr</th>
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<tbody>
<tr>
<td>Total Return (%)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Barclays US</td>
<td>-8</td>
<td>-6</td>
<td>-4</td>
<td>-2</td>
</tr>
<tr>
<td>Asset Backed</td>
<td>-6</td>
<td>-5</td>
<td>-4</td>
<td>-2</td>
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<tr>
<td>Securities Index</td>
<td></td>
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</tr>
<tr>
<td>JP Morgan</td>
<td>-1.6</td>
<td>-2.5</td>
<td>-1.1</td>
<td>-2.5</td>
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<tr>
<td>CEMBI</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>S&amp;P/LSTA</td>
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<tr>
<td>Performing Loan Index</td>
<td>2.6</td>
<td>1.9</td>
<td>4.9</td>
<td>5.5</td>
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<tr>
<td>JP Morgan</td>
<td>5.0</td>
<td>5.0</td>
<td>7.8</td>
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<tr>
<td>EMBI Global</td>
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<tr>
<td>B of A Merrill</td>
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<tr>
<td>Lynch US</td>
<td>10.7</td>
<td>10.7</td>
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<tr>
<td>Home Equity Loan</td>
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<td>5.0</td>
<td>7.6</td>
<td>4.8</td>
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<tr>
<td>Loan Index</td>
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<td>8.6</td>
<td>7.6</td>
<td>7.6</td>
</tr>
<tr>
<td>Barclays US</td>
<td>8.8</td>
<td>8.8</td>
<td>7.6</td>
<td>7.6</td>
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<tr>
<td>Aggregate Index</td>
<td></td>
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</tr>
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</table>

*Source: Bank of America, Merrill Lynch Global Research. As of 30 June 2013.*

*Source: Bank of America, Merrill Lynch Global Research. As of 30 June 2013.*

*As of Aug 31, 2013*
Bespoke Solutions
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Optimization Across Constraints
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Risk-Based Capital Efficiency
Customized Benchmarking
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212.601.6218
insurancebusiness@westernasset.com