



# Financial *talk*

| 4<sup>th</sup> Quarter | 2010



PARKWAY ADVISORS, L.P.

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# Manager's Review

## Investment Strategies for Insurers

When compared to other investment portfolios, performance objectives and risk considerations are very different for an insurance company. Performance for insurance companies is centered on enhancements to net investment income and positive impacts to capital and surplus. The ability to impact these performance objectives is determined by the risk constraints of the company, which can differ dramatically from one insurer to another. As discussed in the last quarterly review, the two most important factors for controlling risk are diversification and the relationship of the investments with the products that the insurer sells. The products offered by insurance companies are unique and therefore the investment portfolios should also be different. The type of products offered by the insurer is the main factor that determines the appropriate portfolio maturity and cash flows. The purchase of a ten year bond could be a high risk for one insurer while significantly reducing the risk of another. This feature is centered on the basic obligation that there are sufficient cash flows to provide for the policyholders or members. This is the nature of many state and NAIC regulations including book value accounting and reserves such as IMR/AVR. This concept was discussed in more detail in the last review on interest rates.

Diversification is just as important; however, it is often applied inappropriately to insurance portfolios. This is one reason that we recommend that it is specifically addressed within the investment plan. Most people understand the importance of not having all of your eggs in one basket and diversification is discussed by most investment managers and investment programs. What is sometimes overlooked is that diversification parameters are very

different for insurance companies when compared to other types of investors. Insurance companies that consider only typical portfolio theory can be unintentionally hurt by investment decisions.

Diversification for an insurance company should consider the size of any investment as it relates to the capital and surplus of the firm and the amount of any AVR reserve (for life insurance companies). Targets should be set that would allow for several defaults before capital is reduced. Unfortunately, the recent economic crisis informed many insurers that their exposure to certain issues were too high. For example, two companies with \$100,000,000 in assets may require two very different maximum exposure limits to any single security. An investment of \$1,000,000 in a single A rated bond may be appropriate for one company with a capital and surplus of \$60,000,000, but could represent great risk to a company with a capital and surplus of only \$5,000,000. We typically recommend that investment grade holdings be limited to a range of 5 – 20% of capital and surplus or unassigned funds. This range allows for government securities at the 20% level and other investment grade issues at the lower levels. This allows for multiple issues to occur before significant deterioration is experienced in unassigned funds. It is also recommended that each issue be



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limited in size to the point that the company's standard AVR reserve can absorb several issues or surprises before any impact to capital occurs.

It is still important to consider diversification across all categories in assessing the risk of any investment portfolio. This includes diversification by asset type, geographic location, industry, collateral type, coupon, maturity and placement into the market. Additional research is often necessary so that overlap is limited among imbedded aspects of similar securities. For example, underlying geographical exposure of any MBS securities must be considered in order to avoid having too high a percentage of overall book value and capital exposed to a single location. The key is that every insurance portfolio needs to be unique and structured around the products offered and the specific reserves and capital of each company.

*-THERON R. HOLLADAY SR., CFA,  
PRESIDENT AND CEO*

**“...consider diversification  
across all categories...”**

# Analyst Commentary



**Chad B. Hoes,**  
**Portfolio Manager**

## Economic & Market Analysis 4<sup>th</sup> Quarter 2010 and Outlook

With 2010 in the history books, many wonder what our economy has in store for the New Year. Perhaps the markets will continue to rebound from the Great Recession or possibly linger to instigate dismal movement. Let's take a look at the economic data to identify where we've been and ascertain where we're going.

Consumer Confidence was released in October at 50.2 above the prior 48.5 and expected 49.9. The unemployment rate for October was announced in line with the prior and estimated 9.6%. Producer Price Index (PPI) was released at 0.4% for the month and 4.3% year-over-year, both of which were slightly lower than expected. Consumer Price Index (CPI), on the other hand, came in close to expectations at 0.2% for the month and 1.2% year-over-year.

An expected FOMC rate decision was released in early November to maintain the range of zero to 0.25%. The Fed acknowledged the "elevated" unemployment rate and admitted the "measures of underlying inflation are somewhat low." The Federal Reserve will continue purchasing Treasuries

through the middle of 2011, increasing stimulus and attempting to reduce unemployment and avert deflation.

November Consumer Confidence rose again to 54.1 above the estimated 53.0 and well over the prior 50.2.

The Unemployment Rate for November matched its highest point during 2010 of 9.8%, increasing from the prior 9.6% and higher than the 9.6% estimate. PPI rose 0.8% and 3.5% for the month and year-over-year, respectively, both of which were close to their corresponding estimates. CPI also rose slightly 0.1% for the month and 1.1% year-over-year, in line with the respective estimates. Leading indicators were higher at 1.1%, in line with estimates, suggesting the economy will continue to slowly strengthen.

December released another expected FOMC rate decision to hold the rate at zero to 0.25%, where it has lingered since December 2008. While "the economic recovery is continuing, though at a rate that has been insufficient to bring down unemployment," the Fed anticipates no change in the low rate for an "extended period." Consumer

Confidence was released at 52.5, below the prior 54.1 and estimated 56.3. The equity indices gained significant ground over the quarter. The S&P 500 Index increased 10.73% to finish the quarter at 1,257.64. The Dow Jones Industrial Average ended the quarter at 11,577.51, an increase of 8.02%. The NASDAQ Composite rose 12.33% to 2,652.87 over the fourth quarter.

The yield curve steepened over the fourth quarter. The 3-month treasury fell 3 basis points to finish at 0.12%. The ten-year treasury closed at 3.29%, 78 basis points above where it began. The long end of the curve recovered from the lowest level of the year to conclude at the approximate calendar-year average. It ended at 4.33%, 65 basis points higher than the previous quarter.

While the economy is exhibiting some signs of recovery, the low interest rate environment persists and unemployment remains high. With much pressure to keep rates low from the government, I anticipate a moderate increase in interest rates in 2011.

*-Chad B. Hoes  
Portfolio Manager*

“..pressure to  
keep rates low..”

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