The Insurance perspective

2019- Volume 13

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Economic Commentary


Trevor R. Rupe, Portfolio Manager

The third quarter gave us more of the same story we've heard throughout most of the past year. We saw equities ride the roller coaster: a big drop to start followed by some ups and downs with all the thrills. We continued to hear about issues and setbacks regarding the US/China trade war after the number of negotiations has entered into the double digits. We continue to see yields fall as economic data and recession concerns grow. All this bad news just in the intro? Let's dive into the specifics.

US Bond Market – Lets start on the worst news of the quarter. It finally happened. The historic recession indicator. The two-year treasury yield exceeded that of the 10-year Treasury for about a week at the end of August. This happens when the market is so pessimistic of the future economy, it is willing to lock in a lower yield on longer duration debt because of the concern rates are going to move even lower. During the quarter, rates did move lower with the 30-year leading the decline at a 42-basis point fall. More notably, this quarter also set the record for the lowest rate on the 30-year Treasury in history, a solid 1.95%.

FOMC – The Fed met twice in the quarter, with both meetings leading to 25 basis point cuts in the Fed Funds Rate. After initially anticipating 2-3 hikes during 2019, Powell acknowledged potential weakness in U.S. economic data along with weak global growth, thus cutting rates was a preemptive effort to keep the economy out of a recession. The market is currently pricing in an additional cut at the next meeting, which would bring the Fed Funds rate down to 1.5-1.75% after starting the year at 2.25-2.5%. In a world where over one-third of the sovereign debt trades at negative yields, including 5 of the most economically advanced G7 countries, the U.S. still offers the highest yields on sovereign debt outside of the 50-year Italian Treasury. Interestingly enough, Treasury Secretary Steven Mnuchin mentioned the U.S. was also exploring the idea of a 50-year ultra-long Treasury, which could make an appearance as early as next year as the U.S. looks for ways to finance its growing debt load.

US Stock Market – The S&P 500 began the quarter with a strong 6% sell off at the end of July before entering a volatile cycle in August marking close to six independent 3% moves, channeling between a price range of 2,850 and 2,940. After all the ups and downs, equities finished the quarter just above where it began, returning 1.65% for the quarter. Despite a seemingly strong equity performance thus far this year with the S&P's 20.55% return, the one year return only stands at 4.25% due to the December selloff/tantrum the equity market threw when presented with the prospect of another year of rising interest rates from the Fed. Defensive stocks, primarily those in the utility and consumer staples sectors, had the highest return during the quarter as investors moved to more stable, dividend producing securities.

Summary – This has been a tough year thus far for yields on the fixed income front. While this generally bodes well for unrealized gain positions on bonds, it makes further investment painful, especially considering putting money to work at these levels leads to overall book yield declines. There has been a fair amount of volatility in the equity markets, which has provided opportunities for those diligent enough to add to their equity allocation on pullbacks. I do anticipate flat to further declines in yields throughout the remainder of the year given lingering uncertainties with the trade war and global growth. The highlight and saving grace continue to be the U.S. consumer. Lower rates should help fuel the spending fire, which can further support equity prices heading into the holiday season. However, in a world with elevated levels of concern and the "recession" word being thrown around, new unforeseen developments pose greater threats to emotionally driven selloffs. As such, it wouldn't be shocking if we saw another large pullback in equities before wrapping up the year.

Why Invest?


Anthony Martin,
Investment Associate

What is the purpose of investments for an insurance company? The purpose and strategy concerning the investment of surplus will vary from company to company, but in this piece, the focus will be on the investment of policyholder dollars. The purpose of these specific investments should formulate the strategy of the insurance company in terms of the pricing and development of its products. The answer should also help determine how the portfolio is structured. Investments in the insurance space have been used to increase the profits of the company, and with proper product pricing they could achieve lower premiums in order to gain new business due to the better yield achieved through investments. The use of investments creates a more attractive model for the insurer to grow profits and a more attractive product for the policyholder. So given its previous uses, what should be the main focus and purpose of the investments for an insurer?

If the investment purpose leans to the side of only providing funds for the expected liabilities, the portfolio would be constructed by a mix of zero-coupon Treasury STRIPS that perfectly align cash flows with liabilities. Increased pressure would be on the actuary, and if a liability came earlier than expected, Treasury STRIPS would have to be redeemed before maturity causing lower than expected returns on investment. Though this is present in normal portfolios, the interest cash flows rolling off longer maturity securities allow a flow of funds which creates additional liquidity to cover unexpected liabilities without having to sell a security before maturity. While purchasing Treasury STRIPS would connect the dots and earn a small return on invested premium, it would have to be compensated by a more aggressive pricing model and lead to higher costs for the policyholders. The higher costs could reduce demand for insurance products and negatively affect the industry. Although it is important to match the assets and liabilities, it cannot be the sole purpose for investments in the insurance industry.

If the goal on investments leans towards increasing total return, the portfolio may consist of securities with larger standard deviations of return. Higher allocations to equity would be undertaken, more lower rated securities would be purchased, and alternative investments would be pursued. This type of portfolio would show higher expected returns, but the unreliability and increased risk of defaulted securities would substantially lower the real return on investments. Defaulted payments would diminish the trust of policyholders and insurers would not be able to sustain their businesses. This is why regulations provide parameters by which insurers can invest. The introduction of IMR and AVR for life companies has been used to deter insurance investments from total return mindsets and shift them to a long-term, buy and hold strategy. Insurance investments should be structured in ways to preserve the integrity of the insurance industry by protecting policyholders rather than chase after total return with policyholder dollars. Given these restrictions on total return for investments, should the investment portfolio aim for the highest possible yield?

At first glance, investing within the boundaries set by the NAIC and state laws while aiming for highest yield makes sense. Under this strategy, the insurer is able to achieve the highest investment income and offer attractively priced products to customers. If the investment approach simultaneously matched assets with liabilities along with investing for the highest possible yield, do they then reach the purpose of investing for insurance companies? Unfortunately, it is not this simple. Aiming for the highest possible yield opens up questions of diversification and how much exposure is allowed in a single name, industry, or country. Additionally, the two goals of matching and obtaining the highest yield do not always go hand in hand with one another. In most cases investing where there is highest yield may pose more risks. Common risks include extension or contraction risk for a structured product or callable security, liquidity risk, early sink payments, downgrade risk, and even default risk. Trying to time the market also becomes more prevalent when the goal is to obtain the highest yield, creating cash drag in the portfolio and missing opportunities due to speculation. Choosing whether to go longer or shorter on the investment horizon for the purpose of higher yield can open the portfolio up to reinvestment & market price risks depending on when the liability actually occurs. Additionally, the timing of cash flows may not be considered when only looking for highest yield. Payment dates could play a crucial role for P&C insurers who may have increased risks in certain seasons and liabilities that are more difficult to predict. This type of strategy also leaves out the analysis of how investment decisions impact RBC, the AVR impacts of choosing certain investments over others (when applicable), and the risks to surplus. In the low yield environment that the economy is currently in, it is tempting to shift the purpose of insurance investments to generating the highest yield. However, when the highest yield becomes the focus of investing, it can open the portfolio to more intricate risks that have the potential to do more harm than good even if they are allowed by regulations and investment policy.

So, what is the overall purpose of investments in insurance? At Parkway we believe that the goal of investments that are backed by policyholder funds is to create portfolios diversified with respect to surplus that match the invested assets to the liabilities of the insurance products sold. We do this in order to generate optimal risk adjusted returns to increase profit for the insurer and provide for policyholders. We believe that tailoring our investment strategy to each client's unique characteristics is the ultimate objective of the portfolio. In doing so we find it crucial to understand the products being sold, work with actuaries to determine the timing of liabilities, be knowledgeable of the historical financial statements, the nature of the reserves with respect to surplus, the ins and outs of IMR/AVR and RBC and work with management in determining risk tolerance and reaching objectives. The goal of investments is not just to make a profit or match assets to liabilities but to synergize the insurance industry, connecting the policyholder to the insurer, fostering the long-term relationship from purchase to payout.

Interest Rate Spreads

As of: 9/30/2019

Term	Treasury Yield	US Composite BVAL AA Curve Yield	US Composite BVAL AA Curve Spread	US Composite BVAL A Curve Yield	US Composite BVAL A Curve Spread	US Composite BVAL BBB Curve Yield	US Composite BVAL BBB Curve Spread	US Composite BVAL BB Curve Yield	US Composite BVAL BB Curve Spread
1yr	1.75	1.928	0.178	2.039	0.289	2.299	0.549	3.106	1.356
2yr	1.63	1.84	0.21	2.002	0.372	2.307	0.677	3.291	1.661
3yr	1.56	1.844	0.284	2.025	0.465	2.355	0.795	3.449	1.889
5yr	1.55	1.978	0.428	2.181	0.631	2.575	1.025	3.912	2.362
7yr	1.62	2.156	0.536	2.378	0.758	2.833	1.213	4.384	2.764
10yr	1.68	2.389	0.709	2.637	0.957	3.145	1.465	4.867	3.187
20yr	1.94	2.98	1.04	3.298	1.358	3.96	2.02	5.908	3.968
30yr	2.12	3.107	0.987	3.294	1.174	3.845	1.725	5.936	3.816

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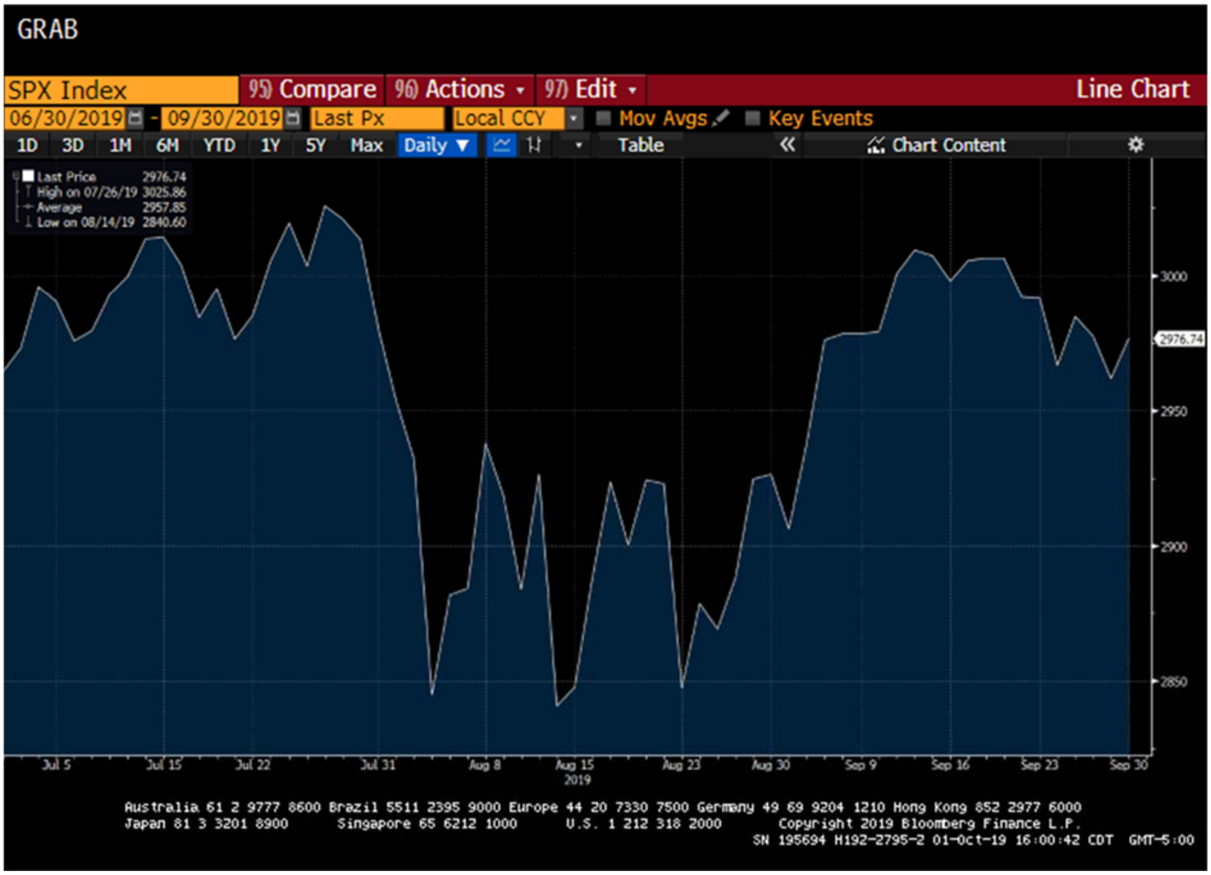
US Treasury Yield Curve

	Tenor	09/30/19	06/28/19	09/30/19-06/28/19
11)	1M	1.858	2.126	-26.8
12)	2M	1.848	2.142	-29.4
13)	3M	1.807	2.087	-28.0
14)	6M	1.813	2.090	-27.7
15)	1Y	1.745	1.925	-18.1
16)	2Y	1.622	1.755	-13.3
17)	3Y	1.560	1.706	-14.7
18)	5Y	1.544	1.766	-22.2
19)	7Y	1.613	1.875	-26.2
20)	10Y	1.665	2.005	-34.1
21)	30Y	2.111	2.529	-41.9

*Graphs obtained from Bloomberg Professional Service

S&P 500 Index


GRAB
SPX Index
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96) Actions
97) Edit
Line Chart
06/30/2019 - 09/30/2019
Last Px
Local CCY
Mov Avgs
Key Events
1D 3D 1M 6M YTD 1Y 5Y Max Daily
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Average 2957.85
Low on 08/14/19 2840.60
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2976.74
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2850
Jul 5
Jul 15
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Aug 30
Sep 9
Sep 16
Sep 23
Sep 30
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Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000 Copyright 2019 Bloomberg Finance L.P.
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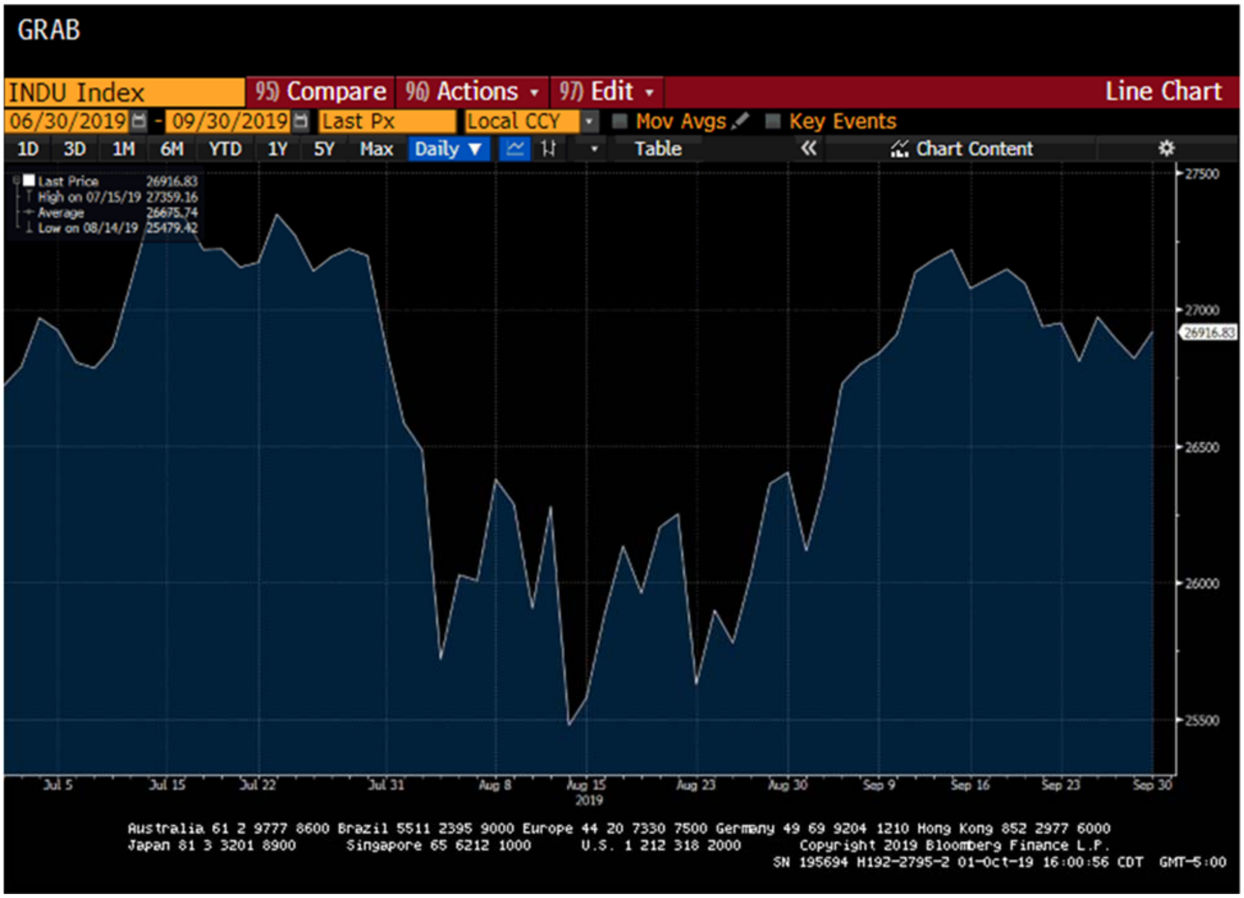
Dow Jones Industrial Average



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About this Publication

The Insurance Perspective is a quarterly publication prepared by the staff of Parkway Advisors, L.P. Each issue focuses on the U.S. economy and specific insurance industry issues and/or concepts. Our clients and prospective clients enjoy Parkway's dedication and unique focus on the insurance industry.

For More Information

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