The Insurance *perspective*

2020- Volume 18

PARKWAYADVISORS

6550 Directors Parkway Abilene, TX 79606 800.692.5123

www.parkwayadvisors.com/

Follow us on in

Economic Commentary

Chad B. Hoes,
Chief Investment Officer

Twenty-twenty is now behind us. Some are rejoicing, some are still struggling, but all are hopeful for a better new year. The US economy remains mixed in its recovery. While GDP has rebounded and the technical recession has ended, unemployment in the US remains high. As discussed last quarter, the "k-shaped" recovery is resulting in low-income earners and small businesses rebounding much slower than the rest of the economy.

FOMC - The Fed remains committed to its "whatever it takes" approach in an attempt to fuel an economic recovery as quickly as possible from the COVID-19 induced recession. At its most recent meeting in December, the Fed indicated the pace and quantity of its asset purchasing would continue. The Fed has purchased $120 billion per month in Treasuries and mortgages since the middle of June. The total quantitative easing (QE) for 2020, which began in March, is $3.064 trillion. This amount almost rivals the three previous rounds of QE combined. The Fed's balance sheet alone now totals $7.5 trillion, which is approximately 34% of US GDP.

The Fed Funds rate is expected to remain near zero for the foreseeable future. The longer-term median Fed Funds rate expected by the Fed is 2.5% and an unemployment rate of 4.1%. Assuming a recovering economy and the need to step closer to this longer-term median rate, the next logical step for the Fed would be to cease QE purchases. The timing needs to be after risks have subsided in the domestic economy, employment has stabilized, and inflation is appropriate. Signaling an end to QE too soon could result in another taper tantrum as occurred in 2013, which resulted in a rate spike and dramatic declines in the equity market.

US Bond Market - The Treasury yield curve steepened during the fourth quarter, with the short-end falling a few basis points and the mid- and long-ends rising, ending the year at one of the steepest levels in the past four years. A steepening yield curve signals the market's anticipation of a recovery and is typically followed by expansionary monetary policy. The yield on the one-month US Treasury cut in half in the fourth quarter, falling 3.5 basis points (bps) to 0.03%. The ten-year US Treasury increased the most on the curve during the quarter at 23 bps, ending the year at 0.913%. This part of the curve has trended upward since it's low in early August of 0.508%. While you might look at the 10-year yield and be happy it is close to 1% (although who gets happy about a 1% 10-year Treasury?!), yields are still incredibly low. For perspective, the 1-month and 6-month Treasuries are down 140 and 150 bps, respectively, over the previous year-end. The 10-year Treasury is 100 bps lower than the previous year-end. Moreover, US corporate bond spreads ended 2020 at the tightest level of the year. While mid- to longer-term Treasury yields may slowly increase, we anticipate corporate spreads will remain tight and overall yields will remain in the depressed range. Moreover, we expect fixed income investors will continue to seek increased levels of risk in order to achieve higher returns.

<u>US Stock Market</u> - Domestic stocks continued rallying through the fourth quarter, ending at all-time highs. The S&P 500 Index returned 12.14% and the Dow Jones Industrial Average returned 10.73% for the quarter. The NASDAQ, comprised primarily of technology companies, returned 15.67% for the fourth quarter, soaring over 45% for the year. While smaller companies have lagged in their recovery, the fourth quarter did level the playing field. The Russell 2000 Index, a small market capitalization index, finished the year just off all-time highs, returning 31.35% for the fourth quarter, which is approximately double its mid-March 52-week low. Although the domestic stock market is at the highest valuations in history, there is significant positive momentum; however, we would not be surprised by a pullback in the near term.

<u>Summary</u> - January brings not only a fresh new year but the inauguration of the 46th President of the United States and a change of power in congress. Domestic equity remains near all-time highs yet the economy is not fully recovered from the COVID-induced recession. This means the perceived recovery is merely artificial and if not managed well from a monetary and fiscal policy standpoint, market turbulence will ensue. We expect yields to remain low, unemployment to slowly improve, and stocks to slump from all-time highs.

Industry Insight

Should an insurance company invest in common stock? If so, what allocation is appropriate and what approach should be developed? This is a question that I am often asked and has been recently requested as a topic for the Perspective. Similar to many investment issues for insurers, the appropriate answer varies dramatically from one organization to the next. It also varies depending upon the type of insurer and the specifics of any possible reinsurance program. Two organizations of the same asset size, in a similar location and selling similar insurance products may need a completely separate equity strategy. I will cover some of the main topics that must be considered in order to answer the questions above. Many aspects of this discussion are specific to life and health organizations; however, the general premise applies to all insurance carriers. As I progress through a series of questions to consider, I will be using a hypothetical insurer as an example. For purposes of simplicity, I will assume that this organization has assets of $100,000,000 and surplus of $8,000,000. This should make it simple to consider any application in percentage terms and compare it to your organization.

Equity exposure increases surplus volatility - The majority of the assets of an insurer are carried on the books at amortized cost. This basis of statutory accounting was created in order to focus an insurer on cash flow in order to protect members/policy holders. The fundamental key is the production of asset cash flows that support the outgoing cash flows of the liabilities. Unlike fixed income, common stock is carried on the books of an insurer at market value. This is due to the fact that equity cash flows are not contractual. This means that the overall book value of assets will increase or decrease with changes in the value of your equity holdings. This aspect of statutory accounting, by regulatory design creates, surplus volatility.

Consider surplus as a percent of total assets - As common stock increases surplus volatility, it is important to consider the risk you can take as it relates to surplus. If your organization cannot assume additional surplus volatility due to the ALM needs, RBC or surplus concerns, it is not an appropriate time for you to invest in common stock regardless of how tempting the markets might appear. When surplus as a percent of total assets is below 4%, several financial concerns can start to occur. In these situations, it is appropriate to consider if equities should be avoided or limited.

Consider the impact in a worst-case scenario - As an organization serving your policyholders, it is important that investment decisions focus on the long-term financial health and stability of the organization. This is why it is important to consider a probable worst-case scenario of any single asset or asset class. Basically, you do not want a single scenario to exist that would call into question the going-concern of the organization. A good question to ask is, “what is the minimum level of common stock exposure that would end the going concern of the organization if the equity markets realize a substantial decline in value?” The surplus level of our example company is $8 million (8MM) and we will assume that the authorized control level of RBC is $1,000,000. This means that the total surplus of the organization must be above this number. Currently there is a $7MM cushion above this RBC level. However, most states require surplus levels around three times the authorized control level. Otherwise, many additional restrictions apply. In this scenario, a 50% decline in equity markets would place the example company below state required levels with an equity allocation of $10MM or greater. **This establishes that, for our example, an allocation to common stock needs to be below $10MM.**

Consider surplus - The range above is only to define the absolute borders of any allocation. We can assume that the actual maximum appropriate allocation should be nowhere close to 100% of surplus as it would be imprudent to have an allocation near a level so potentially dangerous. As common stock generally appreciates over time, an allocation to equity can enhance unassigned funds long-term. Insurance regulation is built around ensuring that cash flow is available to provide for liabilities. This is why bonds are carried at amortized cost under statutory guidelines. Basically, any equity allocation is somewhat of a bet in the short run and is best served as a portion of surplus. One could also assume that in a recession, problems would also occur in other areas of the portfolio; therefore, a 20% additional markdown would provide assurance to the typical insurer with high diversification and a good ALM program in a typical recession, regardless of the severity. **This helps additionally define the optimal level of exposure between 0 and $6.4MM.**

Likely corrections and the impact to the gain from operations - While a severe recession, like the financial crisis of 2008 or the current pandemic, might occur relatively infrequently, 5 and 10% corrections happen regularly. In addition, a 20% correction should be anticipated to have a high probability of occurrence every 5 – 7 years. This is why considering how these scenarios would impact the organization is helpful in determining how much risk your organization might be willing to accept. Assume the net gain from operations in our example is $1,000,000. Risk adverse insurers with a positive gain from operations often desire to keep net gain positive. A possible option is to limit equity exposure to the level that a 20% decline in equities would continue to allow a positive gain from operations to be realized. Depending upon your own risk tolerance and any potential impact to the total financials, you can adjust these targets to the specifics of your organization. **In our example, this type of strategy would limit the maximum exposure to common stock at $5,000,000.**

Consider other assets carried on the books at market value - Common stock exposure cannot be considered in a vacuum. Any assets carried at market value need to be considered within the limits you establish for any equity exposure. If your organization has $2,000,000 in other assets that are marked-to-market and these assets are highly correlated to common stock, it would be prudent to further limit the maximum equity allocation by this amount.

Consider how equity exposure is viewed by regulators and rating agencies - It is also important to consider how regulators and rating agencies view exposure. AM Best bases its rating in part on their BCAR score and other aspects on subjectivity. The score and outlook can be negatively impacted when exposure to any assets that are marked-to-market exceeds 50% of surplus. Most state regulators are also concerned when these assets exceed 50% of surplus as it creates volatility. When an insurer sells a high amount of annuity products this often becomes a deeper concern. For these reasons, many insurers decide to set the max allocation at 50% of surplus. **In our example this would establish an appropriate range of 0 to $4,000,000 in securities that are marked-to-market.**

Impact to AVR and RBC – The Asset Valuation Reserve (AVR) is a credit quality reserve for life companies that pulls funds from surplus in order to buffer the organization in the event of problems. As the NAIC views common stock as one of the highest risks, this asset class carries a high reserve between 10% and 20%. Understand that an initial investment in common stock of $5,000,000 could increase AVR by as much as $1,000,000, resulting in an equal decline of surplus on day one of investing. The increased risk of an equity portfolio also requires a very high C1 factor held against the portfolio for the purpose of calculating Risk Based Capital (RBC). For many organizations, RBC is a top concern; therefore, it is important to consider this.

Actual Allocation Decisions - It is important to establish an initial range based upon the parameters discussed above. However, any actual allocation within this range must be tailored considering the unique risk tolerances and circumstances of each organization. In our simple example, we established that an absolute range between 0 at the low end and $4,000,000 as a maximum allowed exposure. Once a range is defined for your organization, I would recommend that initial allocation or target is set below any maximum limit in order to allow for appreciation. One strategy might be to set limits within the 50% of surplus target and based upon the total net income in the previous year. **A 30% surplus allocation would set a range between 0 and $2.4MM in our example and an initial target allocation might be established at $0–1.9MM depending upon the specific risk tolerance of the example company.**

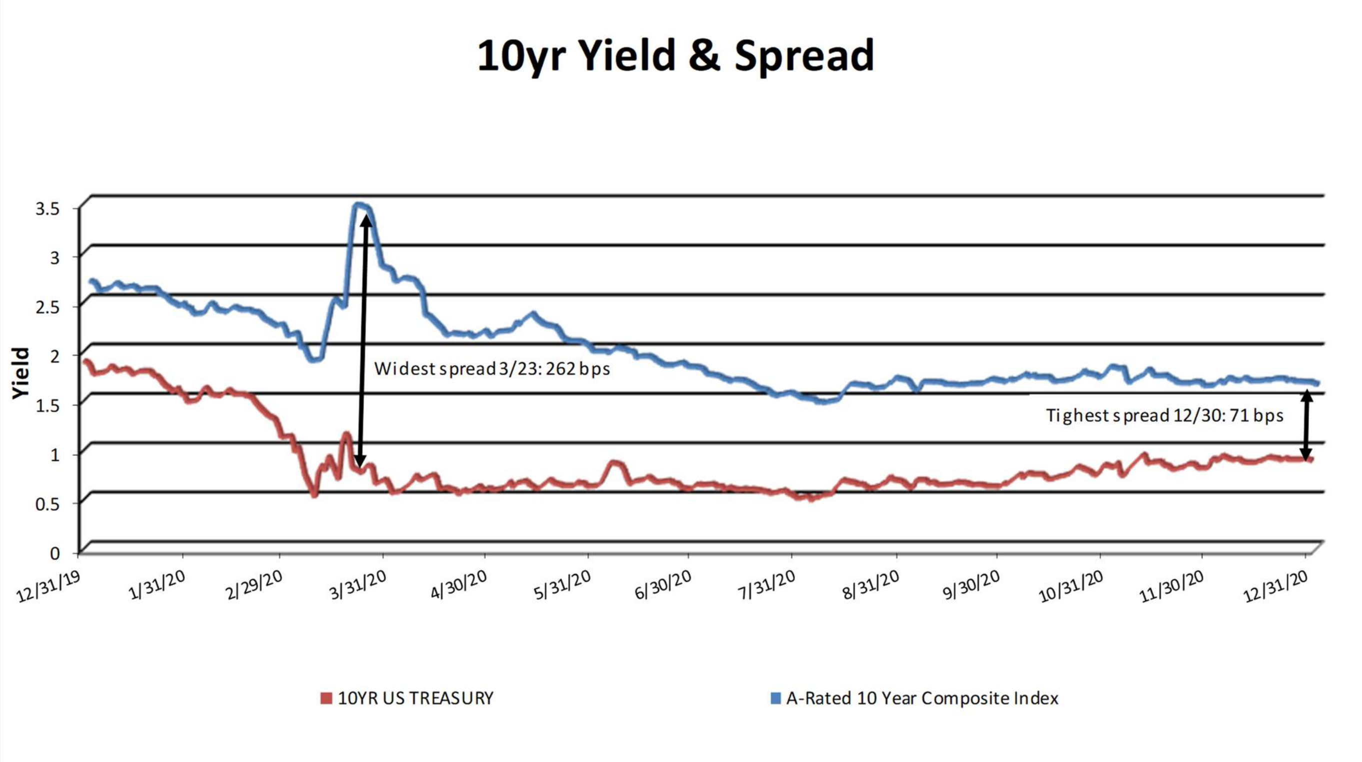
While the above information provides a template for appropriate allocations to equities, it is also imperative to begin an equity program slowly and methodically, regardless of the initial allocation. While it is easy to get allured by the seemingly ever- increasing market, even in spite of a pandemic, an insurance company should not jump in head-first. As insurance companies have constant cash flow, there is an innate ability to average into the market during various cycles without having to hold cash.

Interest Rate Spreads

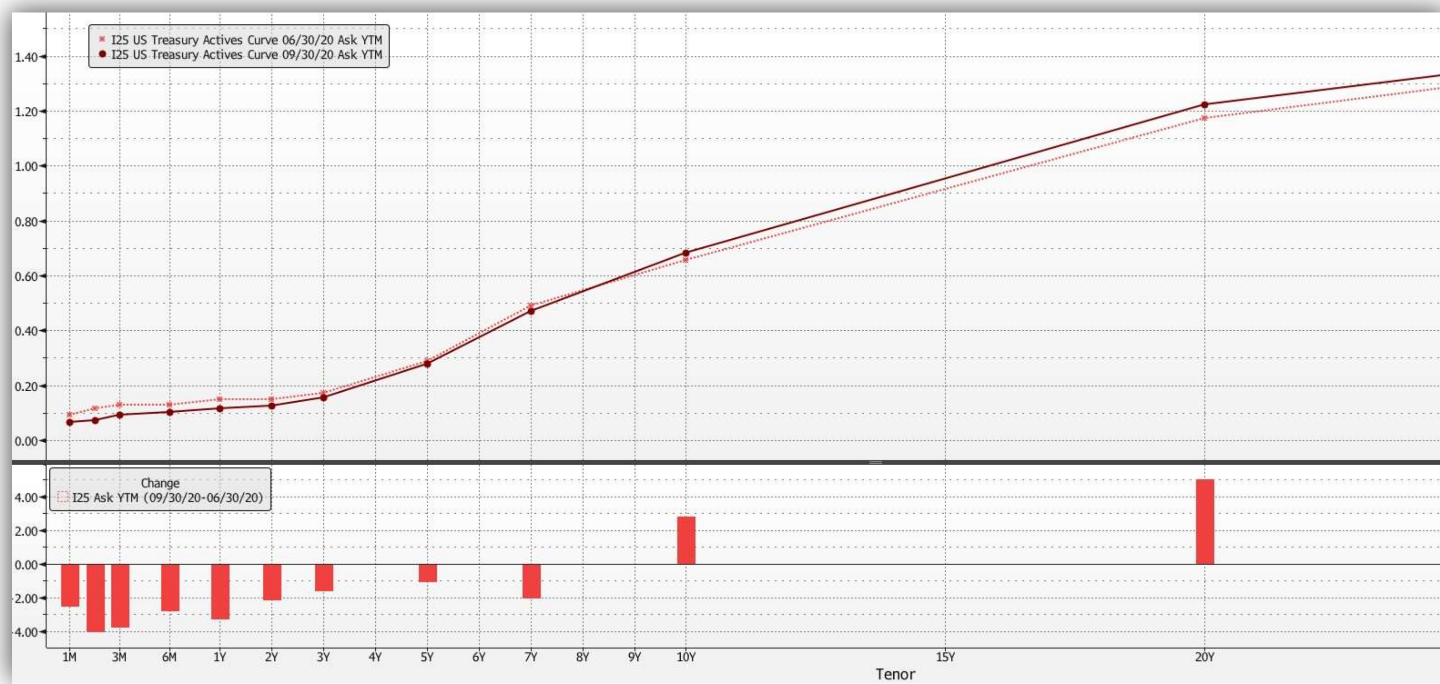
As of: 12/31/2020

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	0.1	0.201	0.101	0.249	0.149	0.476	0.376	1.334	1.234
2yr	0.13	0.247	0.117	0.32	0.19	0.559	0.429	1.83	1.7
3yr	0.17	0.333	0.163	0.437	0.267	0.686	0.516	2.265	2.095
5yr	0.36	0.643	0.283	0.775	0.415	1.043	0.683	2.966	2.606
7yr	0.65	0.998	0.348	1.163	0.513	1.488	0.838	3.534	2.884
10yr	0.93	1.44	0.51	1.623	0.693	1.997	1.067	4.071	3.141
20yr	1.45	2.235	0.785	2.506	1.056	3.047	1.597	5.286	3.836
30yr	1.65	2.496	0.846	2.602	0.952	2.925	1.275	5.107	3.457

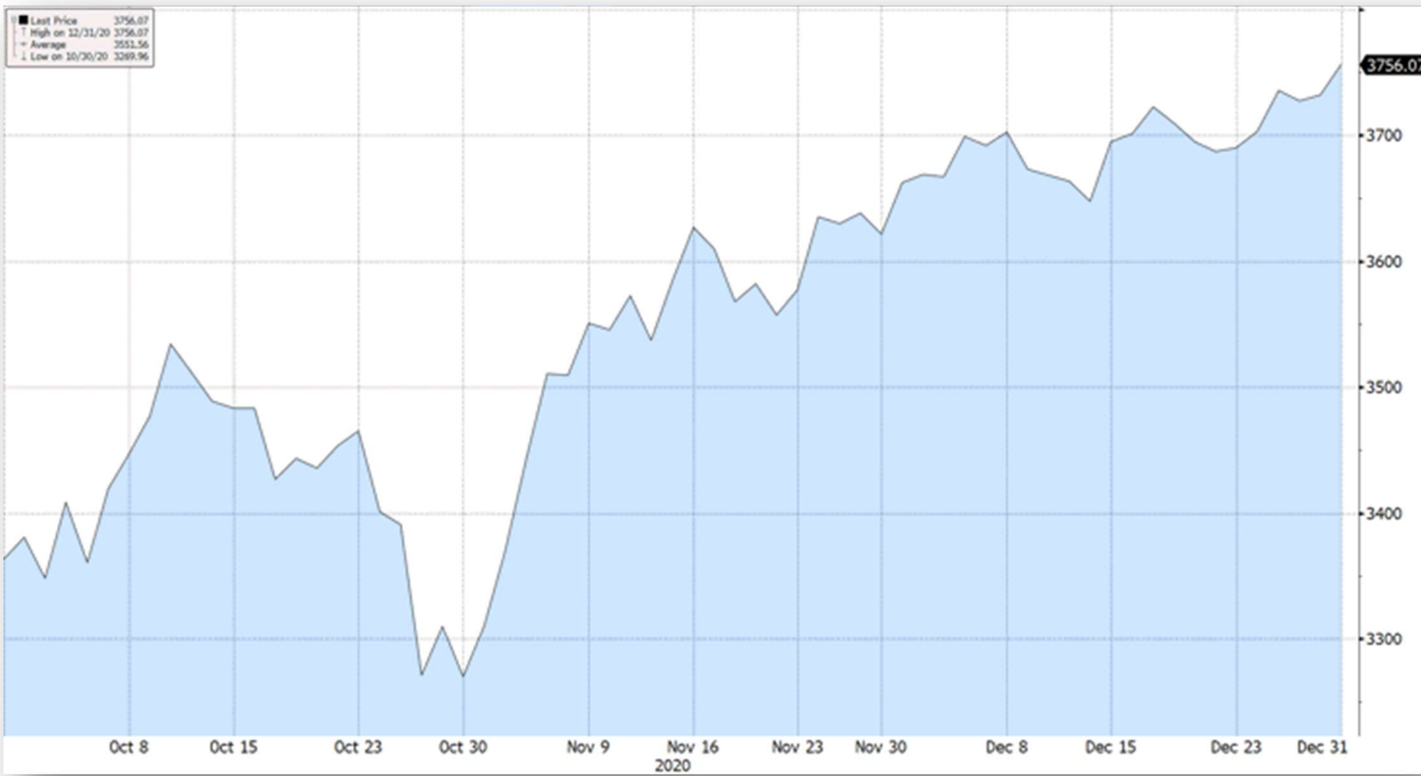
Disclosures: This material is for your use only and is based upon information which we consider reliable, but we do not represent that it is accurate or complete and should not be relied upon as such. Information was obtained from Blooomberg and represents the respective Bloomberg US Composite BVAL and Bloomberg Fair Value Composite Curves. Spreads are calculated off the Treasury yield for each term.


10yr Yield & Spread
Yield
3.5
3
2.5
2
1.5
1
0.5
0
Widest spread 3/23: 262 bps
Tighest spread 12/30: 71 bps
12/31/19
1/31/20
2/29/20
3/31/20
4/30/20
5/31/20
6/30/20
7/31/20
8/31/20
9/30/20
10/31/20
11/30/20
12/31/20
10YR US TREASURY
A-Rated 10 Year Composite Index

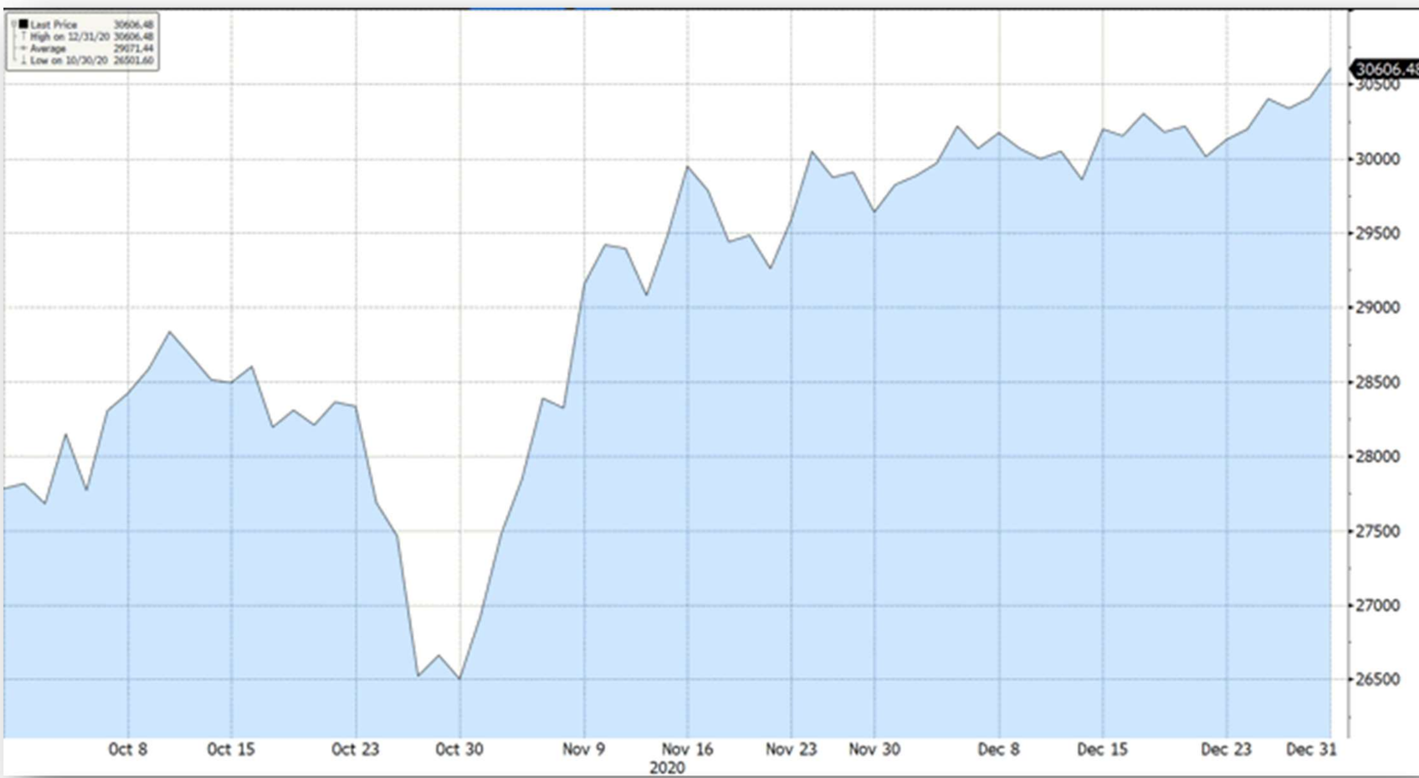
US Treasury Yield Curve



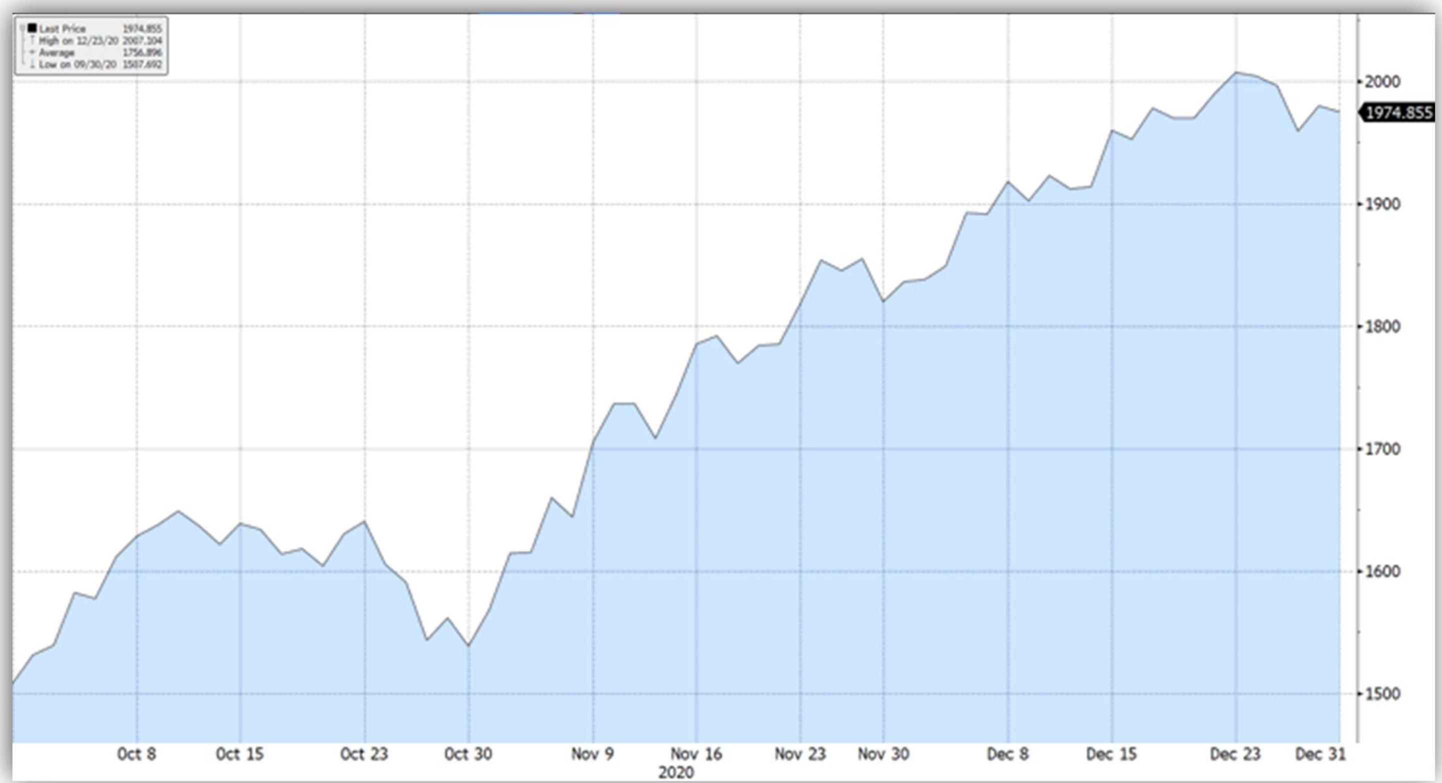
S&P 500 Index


Last Price 3756.07
High on 12/31/20 3756.07
Average 3551.56
Low on 10/30/20 3269.96
3756.07
3700
3600
3500
3400
3300
Oct 8
Oct 15
Oct 23
Oct 30
Nov 9
Nov 16
2020
Nov 23
Nov 30
Dec 8
Dec 15
Dec 23
Dec 31

Dow Jones Industrial Average



Russell 2000 Index



Disclosures

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

We welcome your inquiry and can be reached by mail at Parkway Advisors, L.P., P.O. Box 5225, Abilene, Texas 79608 or by phone at (800) 692-5123 or by fax at (325) 795-8521. A copy of our Form ADV, Part II is available upon request.

For more information, please email info@parkwayadvisors.com or visit www.parkwayadvisors.com