The Insurance *perspective*

2022- Volume 24

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Economic Commentary

This quarter was marked by continuing price pressure due to the Russian/Ukrainian crisis and renewed Chinese COVID-19 lockdowns weighing down global economic activity. The FOMC is committed to returning inflation to the 2% mark as we reach a 40-year high. The S&P has fallen 21% since the beginning of 2022, which marks the worst 6 months in the last 50 years.

Federal Reserve

Inflation data shows that CPI rose 8.6% year-over-year in May, the highest inflation since January of 1982. To fight rising inflation, the Federal Reserve hiked interest rates by 75 basis points, the largest interest rate hike since 1994. The current federal funds rate is currently in the 1.5% to 1.75% range. According to Fed official's median estimate, they expect a rate of 3.25% to 3.5% by year end. This signals an additional tightening of 175 basis points. While there seems to be certainty in increasing interest rates, the markets are predicting a 65% chance of another 75 basis point hike in the July FOMC meeting, in addition to many other smaller increases throughout the year. Large interest rate increases, such as this, do present a risk of producing a recession rather than a 'soft landing.' The Fed is also continuing to reduce its holdings of Treasury securities, agency debt, and agency mortgage-backed securities in their effort to reduce the size of their balance sheet.

Domestic Fixed Income Market

Throughout the quarter, yields on US treasuries saw an increase. For investors that hold to maturity, such as insurers, the rising interest rates are causing a realization of higher yields on new purchases and increasing cashflows to support their products.

As the Fed continues to fight decades high inflation, the board is instituting the most hawkish monetary policy that the economy has seen in recent memory. The Fed directly controls the FED Funds Rate which impacts the short end of the curve, which is where the most movement has occurred. While we have seen the longer end of the curve increase, this has been predominantly due to the natural sell-off of longer duration assets in an inflationary environment. If inflation persists, and the Fed continues their hawkish stance, we very well could see the committee push the economy into recession, like what Paul Volcker instigated. Although this is unpalatable progression of events, it is a better scenario than run-away inflation that persists for years.

Domestic Equity Market

As commodity prices remain high with supply chain issues ongoing amid a weakening consumer, companies have reported lower than expected earnings and guidance. Subsequently, the S&P 500 and NASDAQ Q2 returns were -16.5% and -22.5% respectively, while their six-month returns are -21% and -30.3%. This quarter was the NASDAQ's worst since the 2008 financial crisis and the S&P 500's worst 6 months since 1970. The market is fearful of a recession especially as the Feds most recent GDP forecast, anticipating a quarter of negative growth, which meets the technical qualifications to be defined as a recession. This would be the second quarter in a row with a decrease to GDP growth as Q1 of this year saw -1.6% growth.

Summary

As the Fed hikes interest rates and continues to reduce its balance sheet, with a commitment to its 2% inflation target, there remains uncertainty around the possibility of a recession. As a response to this fear, investors are continuing to remain "risk off". We will continue to watch the Fed, the market's expectations of this aggressive hiking cycle, the actions the Fed takes to reduce their balance sheet, and the condition of the market amid fear of recession.

Industry Insight

Recently, I have been part of several conversations regarding the most optimal questions to ask of any advisor seeking to manage the assets of an insurance company. While it is always important to consider questions specific to the needs of your organization, there are several questions that are vital questions to ask. The following provides commentary on several of the most important questions that any insurance advisory firm should be able to answer.

Does your firm have a platform and focus on the insurance industry?

Investing money for insurance companies is completely unique compared to any other type of advisor service. This is due to the unique nature of statutory accounting, insurance reserves, and very unique regulation. All of these items are built around the concept that the majority of the assets are specifically designed to provide cash flow to support future liabilities. The majority of assets are carried at amortized cost and often gain/losses are not able to be recognized as they become part of future reserves within IMR. Therefore, performance objectives are centered on book yield, net investment income, surplus, and/or RBC enhancements. The accounting, investment, and actuarial systems necessary to best position assets to provide for liabilities require an extensive investment themselves. Because of these and many other attributes, it is important to make sure that any advisory firm seeking to serve your organization is experienced in managing assets within the industry.

What is your company's Total Return performance?

What makes for a good total return can have severe negative impacts to net investment income and surplus, due to the unique nature of insurance statutory accounting, regulation, and reserves. Any performance targets that an advisor should set for your company should be based upon your specific needs and objectives. It is also best to consider the statutory financial impact of any transaction upon a client and to make sure that every client is measured towards unique performance criteria. While total return performance can be actively monitored, it should almost never be the primary return objective for an insurer.

Does the advisor have any shared values with our organization?

I believe that this is important in all aspects of life and that one should not separate who they are in their personal life from their business life. Relationships and business are most successful when we work with others that share our values and goals in life. Clearly, this can differ for each insurance company. For example, Parkway Advisors designed its business model to align with Biblical values. Therefore, we gravitate to serving others that share this value system. Clearly, this helps us to be in line with the long-term objectives of our clients with whom we share this commonality. Investment screening is one way in which an advisor can help your company better express its values, through its holdings.

What insurance specific services are offered by the advisor?

As mentioned above, the needs of an insurer are unique. Any advisor focused on the insurance industry will have specific services for insurers. It is good to understand if these services fit the needs required by your organization. Services offered by insurance advisory firms should include Asset/Liability management, assistance with AM Best ratings, investment statutory reporting, preparation of IMR/AVR, assistance with the design of an ERM program, peer analysis, actuarial assistance with asset cash flow projections, "what-if" analysis, strategic planning, budget and business plan assistance and design.

(Industry Insight cont'd)

How can the advisor assist our company with expense reduction?

A focus on the insurance industry provides niche advisory firms the ability to assist an organization with expense reductions. Through NAIC and state insurance code knowledge, astute advisors can remove or even entirely eliminate, custody fees in most states. Additionally, investment statutory accounting fees can be reduced or eliminated. With the ability to combine insurance services under a single fee structure, insurance advisors can also reduce or remove other expenses such as ERM design fees, certain aspects of compliance reporting, and other areas. It is important to research this in determining the best manager to select.

Does the advisor work consultatively with our other service providers?

All parties that serve your organization should be working together to achieve your objectives. It is impossible for an advisor to be effective without understanding and working with the accounting team, actuaries, rating agencies and auditors. Of prime importance is understanding the assumptions and projections of the liabilities with the actuary. This will determine the appropriate asset mix, maturity, and needed yield of the investments.

Are the employees of the advisor extensively trained in statutory accounting and insurance regulation?

Any investment decision made by an advisor should be performed with an understanding of how it will impact surplus, RBC and net income. This knowledge is only there with specific and comprehensive training in statutory accounting, insurance reserves, and both state and NAIC regulation. An advisor without this knowledge can significantly reduce income for the insurer even if they have a great total return performance record. It is important for any advisor to continue their education in ever changing state and NAIC regulation; through the NAIC working groups and talking to each state's department of insurance.

Does the advisor have actuarial, statutory accounting, and insurance investment software internally?

The best way to understand the impact of investment decisions is the ability to perform "what-if" statutory financials ahead of any transactions. This will demonstrate how gains/losses are processed through IMR and the financials. The top insurance advisory firms internally prepare NAIC compliant investment schedules and can adjust them daily with hypotheticals.

Does the advisor and its principals have a clean record with the SEC and FINRA?

This simply stands to reason. It is always important to perform background checks on anyone wishing to be a steward of the financial resources of others. For an advisory firm, the regulatory body that oversees investment advisors is the SEC. Financial violations and past terminations can be found in FINRA's data base under the broker check feature. An effective method is to ask any potential advisor if either their firm or the principals of the firm have past complaints or judgements against them or if they have ever been terminated from a financial organization. It is important to know the answers to these ahead of time and to inquire deeper if the record is not clean.

How can the advisor help our organization improve surplus, net income, book yield, and RBC?

The performance objectives of each insurer is unique; however, it is important to know how the advisors plans to help you achieve your objectives. Surplus is impacted by many investment items and can often be improved with reduction in assets with high asset concentration factors for AVR. As AVR decreases the surplus will increase. RBC can be enhanced with an understanding of insurance companies and through diversification as it relates to overall surplus. Book yield is often the primary performance measure for an insurer as it directly relates to the annual reported net investment income. The advisor should be asked how they plan to maximize book yield under the necessary risk restraints.

How does the advisor work to reduce insurance specific investment risk?

While there are many risks involved in asset management, the two greatest methods for controlling insurance specific risk are:

1. Making sure that the asset cash flows are appropriate to support the products that are sold to policy holders (ALM strategy). This strategy can differ greatly from one insurer to another as each client is unique and different products are sold. An improper ALM strategy is the main reason many insurers currently have reduced book yields and a surplus to asset ratio that is declining.
2. Diversification is important for any investor but is very unique for insurers. Diversification should consider the amount at risk in any single issuer as it relates to total surplus and should be a percentage of AVR for a life company. Proper diversification alone can improve RBC and significantly reduce risk. Improper insurance diversification is the main reason insurance companies lost money in the financial crisis.

Will the advisor assign our company an investment management team, accounting team, & regulatory specialist?

Having multiple teams assigned helps ensure that someone familiar with the investments and accounting of the insurance company is always available.

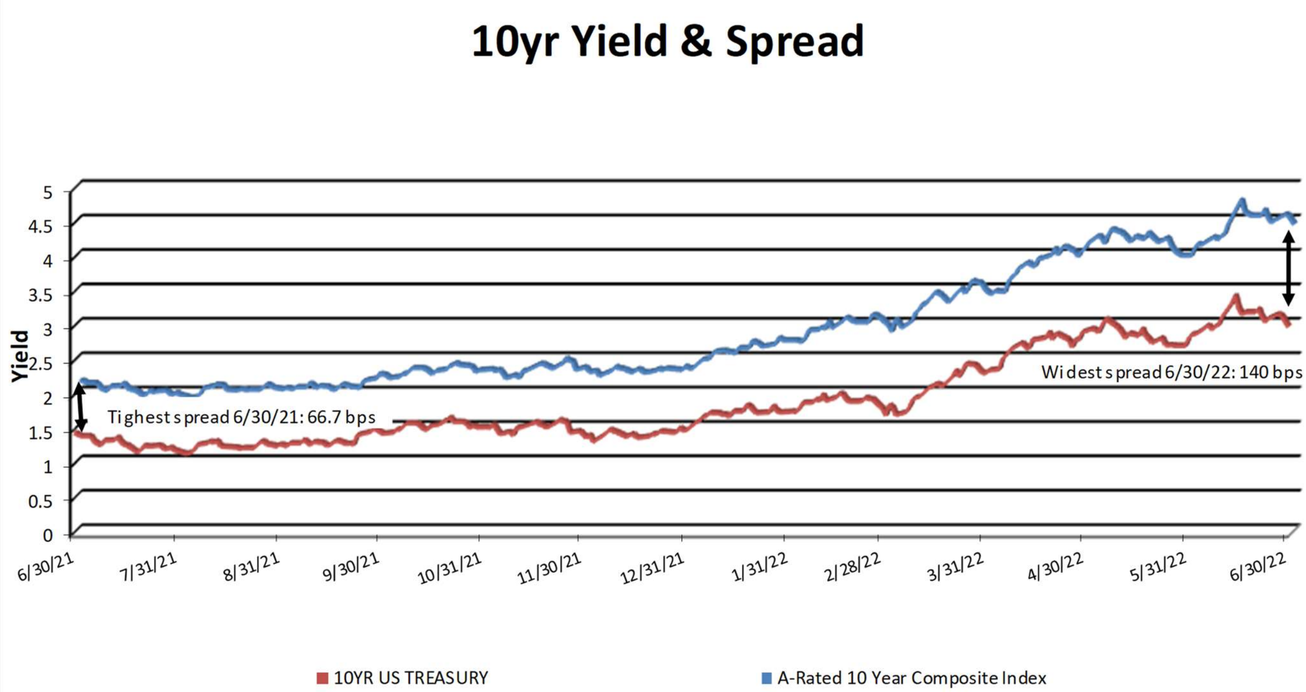
I would recommend combining these questions with others that are specific for your needs anytime you are considering working directly with an outside advisory firm. Having the answers to these questions will help you select the advisor best suited for your specific needs.

Interest Rate Spreads

As of: 6/30/2022

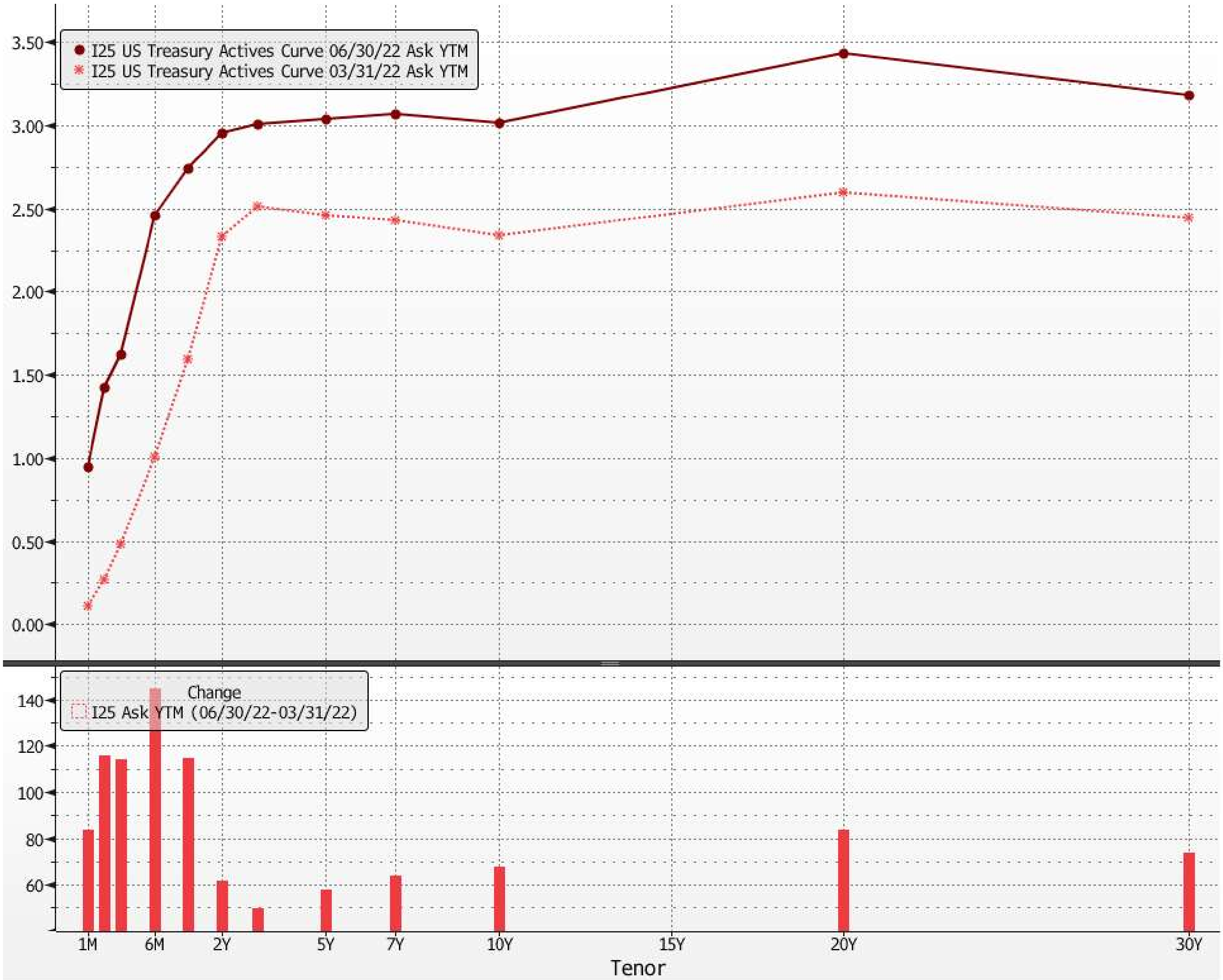
Term	Treasury Yield	US Composite BVAL AA Curve Yield	US Composite BVAL AA Curve Spread	US Composite BVAL A Curve Yield	US Composite BVAL A Curve Spread	US Composite BVAL BBB Curve Yield	US Composite BVAL BBB Curve Spread	US Composite BVAL BB Curve Yield	US Composite BVAL BB Curve Spread
1yr	2.8	2.8901	0.0901	3.0365	0.2365	3.6013	0.8013	5.4862	2.6862
2yr	2.92	3.3057	0.3857	3.5335	0.6135	4.1088	1.1888	6.1255	3.2055
3yr	2.99	3.4299	0.4399	3.7232	0.7332	4.3289	1.3389	6.5662	3.5762
5yr	3.01	3.6684	0.6584	3.9921	0.9821	4.6355	1.6255	7.0141	4.0041
7yr	3.04	3.843	0.803	4.1953	1.1553	4.8997	1.8597	7.2497	4.2097
10yr	2.98	4.0726	1.0926	4.4172	1.4372	5.1397	2.1597	7.4487	4.4687
20yr	3.38	4.5326	1.1526	4.8527	1.4727	5.4465	2.0665	7.7612	4.3812
30yr	3.14	4.5018	1.3618	4.6644	1.5244	5.1698	2.0298	7.5335	4.3935

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.

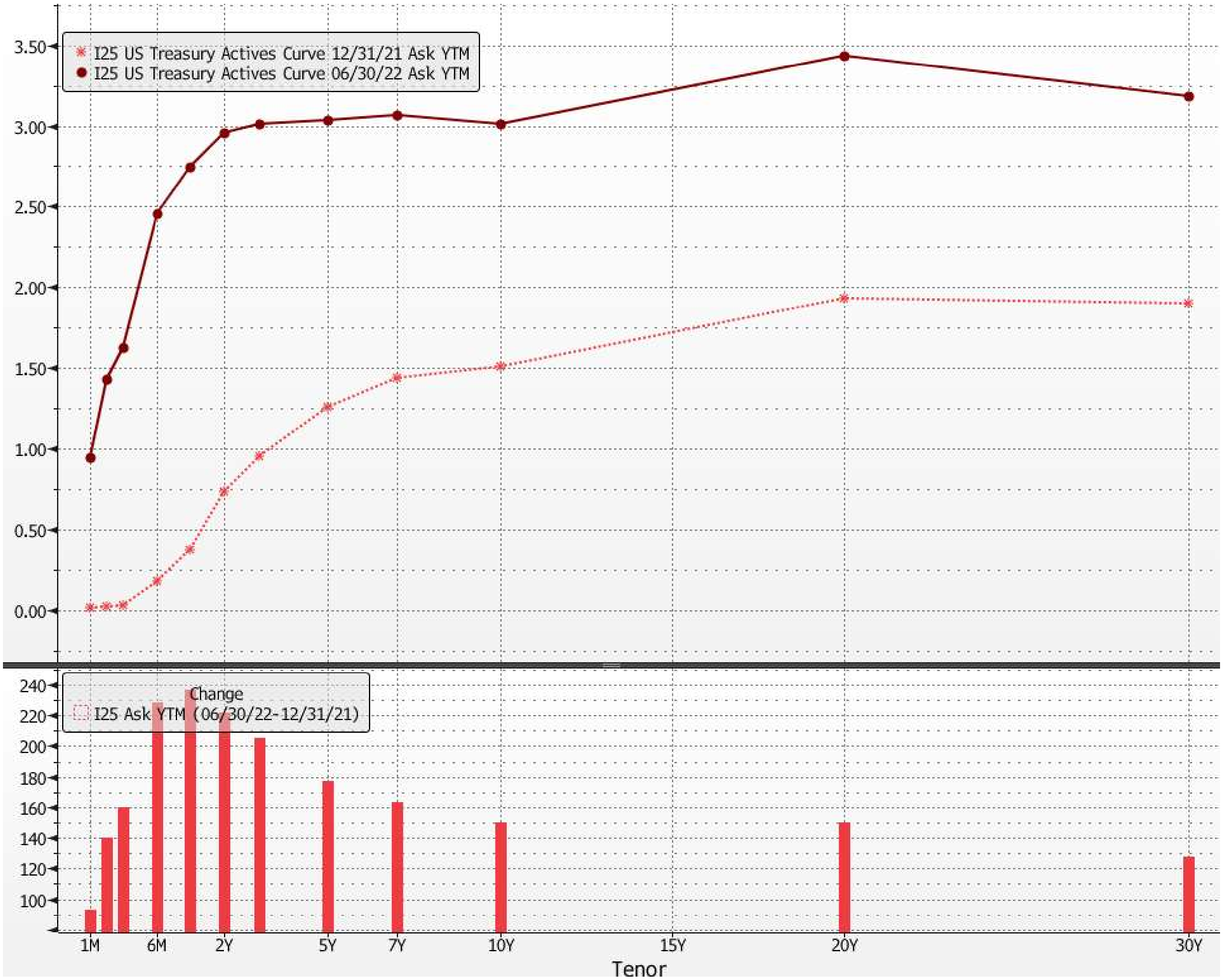


10yr Yield & Spread
Yield
5
4.5
4
3.5
3
2.5
2
1.5
1
0.5
0
Tighest spread 6/30/21: 66.7 bps
Widest spread 6/30/22: 140 bps
6/30/21
7/31/21
8/31/21
9/30/21
10/31/21
11/30/21
12/31/21
1/31/22
2/28/22
3/31/22
4/30/22
5/31/22
6/30/22
10YR US TREASURY
A-Rated 10 Year Composite Index

US Treasury Yield Curve 2nd Quarter



US Treasury Yield Curve YTD



S&P 500 Index

Last Price 3785.38
High on 04/04/22 4582.64
Average 4112.41
Low on 06/16/22 3666.77
4600
4400
4200
4000
3785.38
3600
Apr 14
Apr 29
May 16
2022
May 31
Jun 15
Jun 30

Dow Jones Industrial Average

Russell 2000 Index

Disclosures

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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

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.

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