Origins Capital

Insurance Asset Management

Generating value with dynamic risk positioning, overlays and strategic diversification: a counter-cyclical approach

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Balancing the procyclical and countercyclical elements

Difficult market conditions are making the going tougher for insurance companies, which have had to grapple with asset-liability management challenges, increasing restrictive accounting norms, and onerous regulatory requirements over the past decade.

To their credit, these companies are adapting to the dynamic environment, shifting portfolio compositions, and focusing on high-yielding alternatives. However, there is scope to expand the current portfolio in a way that pro-cyclical and countercyclical components are balanced.

In our previous article, we highlighted the factors that will shape future asset allocation strategies for insurance asset managers, including for risk management, a focal shift towards private assets, and changing regulatory and reporting standards.

In this article, we deep-dive into the techniques that would provide countercyclical elements to profit from market dislocations or price volatility. Such a robust investment framework that powers growth and strengthens portfolio resilience must take a three-pronged approach.

Dynamic asset allocation

Helps create value for shareholders and policyholders alike

Using dynamic asset allocation (DAA) in a manner that allows insurers to optimise investment portfolio performance is the key to align with evolving market conditions.

A KKR Inc survey from 2021 highlights how Chief Investment Officers (CIOs) have made substantive, structural shifts in their asset allocations. "They are embracing complexity and the thoughtful use of illiquidity, as public market assets roll off and excess cash builds up," the survey report notes.

Dynamic risk management
Active risk management is not about only viewing the portfolio through the lens of diversification but also through the prism of correlation. Factoring volatility regimes and managing exposures with a view on hedging enables upside opportunities (e.g., a private market portfolio that offers a longer-term hedge against structural shifts in the market).

There are three key aspects here:

- **Combining assets with lower correlations:** A diversified portfolio (comprising bonds, equity, real assets, private investments, and collateralised loan obligations) that has lower correlation with each other can yield robust overall returns, particularly in a highly volatile environment. As an example, the risk-return features of leveraged loans can improve the performance of a diversified portfolio since they tend to have a low correlation with bond indices.

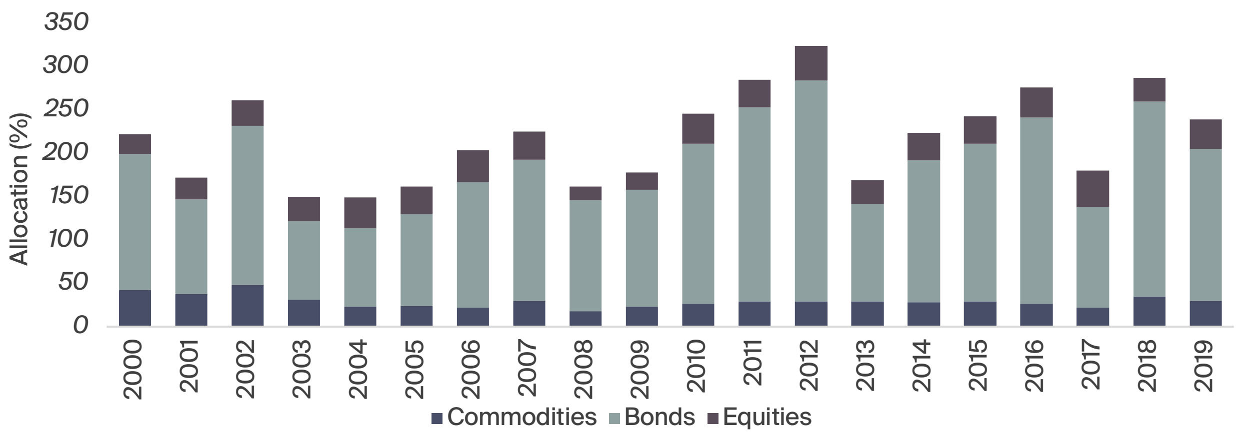
- **Strategic diversification:** The closest example is investors lately opting for **liquidity risk** (lower volatility) over credit risk. While that may be viewed as suppression of volatility in some cases, these portfolios are well diversified to offer consistent returns over time. The transactional nature of illiquid private investments implies skills and know-how considerations.

- **Factoring volatility regimes and ESG/sustainability trends:** This adaptive approach would reflect in a portfolio's effectiveness. For instance, passive exposure to bonds and equity may be concentrated in a 'main' market portfolio that benefits during market upswings and helps control costs. At the same time, active exposures may act as an adjustable hedge against risk. An alternative approach could involve managing **tactically** traded assets in tandem with short-term dynamic hedges. **ESG and sustainability considerations** need to be factored in when considering volatility regime shifts, as these ultimately impact long-term risk and profitability of specific economic sectors.

Rethinking risk parity

This is a compelling strategy for insurance companies aiming to optimise their risk-adjusted returns and being comfortable deviating from traditional portfolio allocations. For example, higher allocations to bonds and lower allocations to equities may ensure outperformance when equities are turbulent; but it may lead to underperformance when rates rise. Hence, adopting an allocation methodology that combines counter-cyclical components automatically would be beneficial.
In this case, equal risk contribution in a hypothetical portfolio is one such example. The graph below illustrates **how risk dynamics impact the allocation** (illustrative portfolio with three assets with allowed leverage). The objective is portfolio rebalancing and arriving at an asset class mix where each asset class will account for one-third of the portfolio risk[1].

Historical asset class weights of the equal-risk-contribution portfolio



Data from 31 Dec 1999 to 31 Dec 2019 Source: S&P Dow Jones Indices

[1] Target volatility will be set as the volatility of the equal-weight portfolio from the previous year.

Rebalancing and sector rotation

Rebalancing and sector rotation would ensure the portfolio remains aligned with the intended risk profile. Rule-based rebalancing can serve as a natural mechanism where taking profits from asset classes that have outperformed can be re-invested in cheaper asset classes. At the same time, these strategies should be employed in the context of market conditions and embedded in a **tactical asset allocation process**.

Overlay strategies

Help offset market volatility and make profit from potential market dislocations

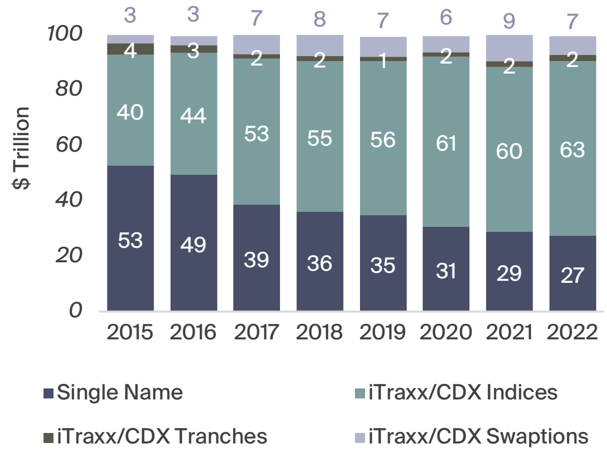
Overlay strategies have demonstrated their potential in significantly boosting investment performance. In 2022, CDX and iTraxx volumes reached an all-time high of nearly $36 trillion. This was an impressive 43% y-o-y increase *(DTCC, data as of Dec 2022)*, showing renewed interest by market participants. CDS product market share charts offer a sense of investor preference in terms of different products and risk exposure.

To use derivatives or not

Many insurance asset managers shy away from using derivative instruments or overlay strategies since it is possible to lose more than the investment principal. Moreover, actively managing and implementing these strategies requires skills and know-how. However, building such skills can be very beneficial to the investment process allowing to efficiently and safely implementing counter-cyclical strategies: These instruments not only ensure lower losses during a market downturn (when used to hedge), but also allow investors the opportunity to build positions at fire-sale prices when others are forced to sell. Below are a few of the most common strategies used:

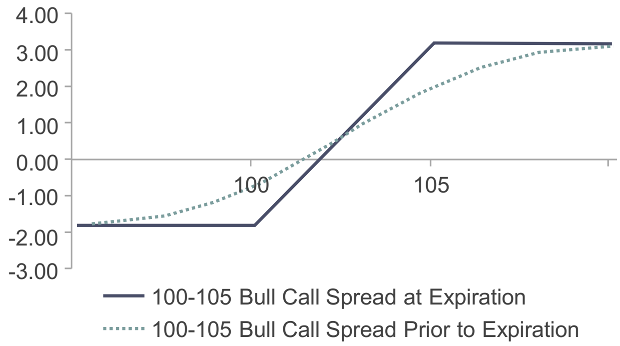
- **Vertical option strategies:** These can be effectively employed for both equity risk mitigation and risk taking, while adhering to regulatory guidelines and permitted categories such as hedging, efficient portfolio management, and trade preparation. Investors wanting to capture an asset appreciation while limiting the downside associated with an incorrect position can employ a bull vertical spread.
- **Credit default swap (CDS) strategies:** During extreme market downturns such as the Covid-19 crisis, anticipating

CDS product market share by notional outstanding



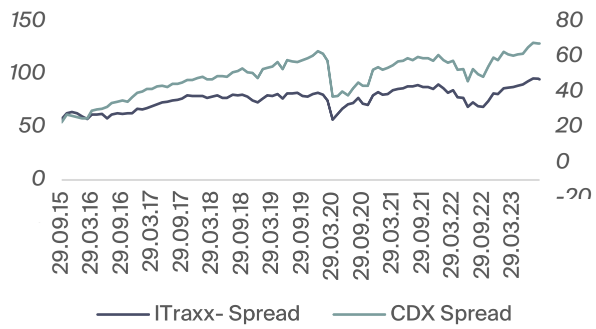
Source: DTCC, As of Dec. 30, 2022

Bull Spread Vertical

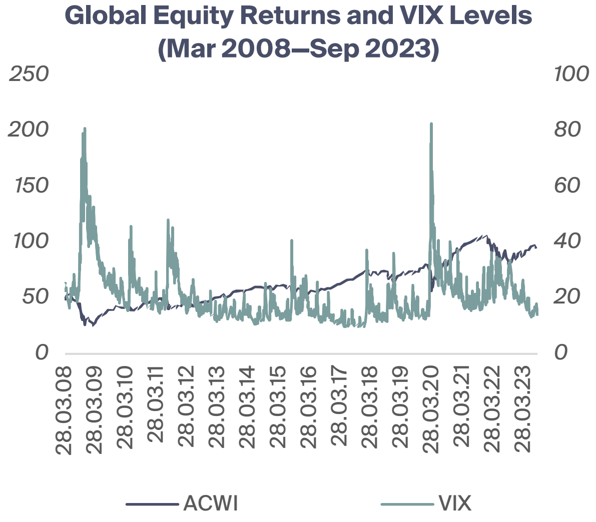


Source: Fidelity

Spread level for the CDX and iTraxx (HY – IG)



Source: Bloomberg, Date as of Sep 9, 2023 dislocations in the credit market can be challenging. Timely risk exposure adjustments are complex in cash portfolios, and selloffs can lead to significant losses. To protect investments, insurance asset managers can consider a basket of single-name CDS, and centrally cleared corporate CDS indices such as CDX and iTraxx. Moreover, diversifying across different CDS indices such as USD HY Index and iTraxx Crossover helps tailor the strategy to the specific exposures and risk profiles of clients.



Source: Google Finance, As of Sep 6, 2023

- **Other option strategies:** For risk mitigation, investment managers can opt for protective puts or collar options. By employing protective puts, insurance asset managers can limit potential losses on their equity positions, thereby reducing overall portfolio risk. A collar strategy is an effective way to create a risk-controlled range for an equity position, protecting against significant market downturns. **From a risk-taking perspective**, a long call (i.e., buying call options) enables investment managers to benefit from potential upside moves in the market without owning the actual shares. Alternatively, a bull call spread (see chart on page 4) is suitable when the asset manager expects moderate upside in an equity or an index. It provides a limited-risk-limited-reward scenario, making it a popular choice for taking directional positions with defined risk.

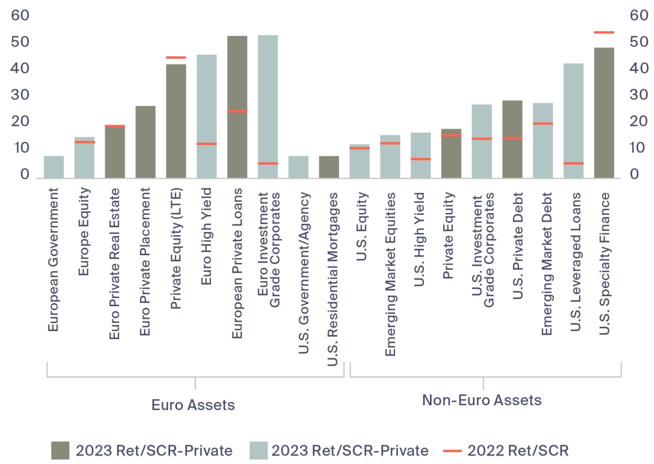
- **Tail risk hedging:** These hedging strategies must be used selectively, based on the portfolio size and down-market scenarios. Achieving a complete tail risk hedge may be counter-intuitive in larger portfolios. Conversely, smaller portfolios could face challenges since these strategies require expertise and can involve significant costs. Tail risk hedging can also help insurance companies in asset liability management, besides strategic and tactical asset allocation. The trade-off depends on the strategy chosen that balances the hedge quality and the costs the asset manager is willing to take. For example, historically buying VIX options were the most expensive hedges, also difficult to time – yet have performed the best during crises. However, betting on the Swiss franc vs the euro is a much cheaper hedge, albeit less effective.

Risk budgeting

Improves performance while keeping risk control and investment process discipline

Insurance asset managers need to budget risk in a manner that improves performance and maximises growth. We believe that using both solvency capital efficiency and expected shortfall (ES) or conditional VaR (CVaR) instead of VaR can enhance risk management. The primary goal is to achieve capital efficiency while concurrently safeguarding the value of financial assets by keeping an “economic” (mark-to-market) perspective.

Solvency Capital Efficiency 2023 vs 2022



Source: Neuberger Berman, as of December 31, 2022,

- **Capital efficiency:** Since insurance companies are subject to solvency regimes (e.g., Solvency II and SST regulatory framework), risk budgeting is critical from a capital allocation viewpoint. **Assets that generate little to no accounting volatility** and **present the highest yields against market solvency capital requirements** are likely the most capital-efficient investments. The chart on the right presents a brief overview of how fixed income, mainly private debt, has become more attractive compared with last year. It examines the year-over-year change in terms of solvency capital efficiency, by dividing the market solvency capital requirement of each asset class by the return estimates of 2022 (red lines) and return estimates of 2023 (blue and grey bars). Other asset classes that could be additive from an allocation point of view were high-yield bonds, emerging markets debt, European private loans and private placements, and private equity.

- **Shift from VaR to ES as a measure of risk:** VaR as a quantitative risk metric has limitations, particularly during periods of significant financial market stress. The limitation is notably reflected in capturing **‘tail risk’** in the loss distribution. Therefore, implementing a CVaR or ES measure, both for an internal models-based approach and determining risk weights for the revised standardised approach, is recommended. ES provides a more comprehensive assessment of tail risks by considering **both the size and likelihood of losses** beyond a certain threshold, while CVaR quantifies **the average loss over a specified time** of unlikely scenarios beyond the confidence level.

An asset manager using VaR may be able to calculate the probability of losses up to a certain threshold (e.g., 95% VaR of an investment portfolio is $2mn). But this would not provide insights into the severity of losses beyond the 95% threshold. On the other hand, CVaR or ES can helps estimate the magnitude of those losses. At this point, the asset manager needs to align investment decisions with the company's risk budget. With VaR, it may appear to be within the budget since losses have not exceeded $2mn in 95% of cases historically. However, through ES or CVaR, the asset manager may realise that by exceeding the $2mn threshold, the average additional loss would be $2.5mn. The shift to these methodologies will significantly benefit risk budgeting and facilitate prudent investment choices.

Stronger and sustainable value generation depends on dynamic risk strategies and disciplined risk management.

Institutional investors —insurers, pension funds or family offices — must follow a conscious approach to asset allocation and portfolio construction. They should determine their broad market preferences as the first step, combining macro and style factors. Key considerations would include:

- **An active portfolio management approach in turbulent times:** This would help reap higher benefits than a passive strategy. A multi-asset portfolio with a stronger tilt towards dynamic, active strategies should help deliver value more consistently. Preferably, allocations that combine traditional asset classes with private investments (such as infrastructure, private credit, or real estate) may boost portfolio performance, while hedging some risk through diversifications.
- **Tapping into overlay strategies not only as potential hedge but also as a counter-cyclical risk-taking tool:** Judicious usage of overlay strategies can enhance portfolio performance, provide risk control, and offer greater flexibility, lowering transaction costs when implementing tactical asset allocation strategies.
- **Considering correlation in line with regime shift, including ESG/sustainability “secular” transition:** Creating a portfolio with low-correlating assets is not enough – one needs to factor in a volatility regime that would influence correlations.

The above must be considered in addition to a host of other factors, such as regulatory constraints, investment time horizons, cash flow needs, ability to access markets or product types, governance capacity and fee levels, while constructing the portfolio. Regular portfolio performance assessment and reshuffling of exposures are also required to achieve the desired mix of returns.

How can all this be achieved? It all comes down to building and maintaining an **investment and risk management process that keeps as primary objective the economic value creation** for shareholders, policyholders/beneficiaries, and stakeholders alike.

If an institutional investor has limited resources, seeking assistance from third-party investment managers or expert consultants can help achieve a robust investment process and build consistent returns.