HEALTH WEALTH CAREER

MERCER INSURANCE INVESTMENT TEAM

INVESTING IN A NEW WORLD

TOP 10 INVESTMENT IDEAS FOR INSURERS IN 2017

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PREPARING FOR A CHANGE IN DIRECTION

In our "Top 10 Investment Ideas for Insurers in 2016," we warned of a possible sea change in the economic environment during 2016, with the potential for material unforeseen risks emerging at some point. While we could in no way have predicted with any conviction the dramatic change in the geopolitical environment that occurred over 2016, there is little doubt that a sea change has occurred. For financial markets, this has led to periodic bouts of volatility following events such as the United Kingdom's vote to leave the European Union and the election of Donald Trump as the next President of the United States. However, against this backdrop of political uncertainty, global financial markets have in general held up well, buoyed by expectations of positive economic growth. Recent equity market rallies further add to **signs that investor sentiment is moving toward a decidedly more "bullish" mood.**

Nonetheless, **significant downside risks persist** as many questions remain unanswered, not least is the sustainability of the global economic recovery in the face of increasing geopolitical fragmentation, the gradual build-up of inflationary pressures, and the continuing uncertainty around the efficacy of central bank and governmental policy actions.

In addition to the market risks, the final International Financial Reporting Standard for Insurance Contracts (IFRS4) is due for release in 2017, with implementation slated for 2020, which will raise considerations for asset-liability matching

To help insurers face these challenges, the global Mercer Insurance Investment Team (MIIT) has identified **10 investment ideas that we believe are pivotal to the successful management of an insurer's assets through this period of uncertainty**. We highlight the nature of the likely benefit for each idea – split between governance, financial and operational. While not all of these ideas will be appropriate for every insurer, they are intended to provoke debate around an appropriate course of action. We would be happy to discuss these ideas with you in more detail.

FINANCIAL

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OPERATIONAL

"Plug the gaps, avoid the traps"

1. Optimise the Investment Operating Model. An insurer's investment operating model is the framework covering all aspects of the investments, from governance to strategic asset allocation to implementation. We are seeing increasing focus from insurers looking to review and optimise their operating models. A framework that was previously acceptable, when investment returns were more easily achievable and asset strategies were more straightforward, may now need enhancing on the back of increased complexity in investment approaches and in light of additional scrutiny from boards and regulators.

A review can include areas such as the robustness of the overall investment governance structure, the processes for selecting and filtering the asset class universe, and the operational management of the assets.

FINANCIAL

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"Consider the impact on asset liability matching"

2. Emergence of IFRS4. The final International Financial Reporting Standard for Insurance Contracts (IFRS4) is due for release in 2017, with implementation slated for 2020. Together with insurers' capital requirements, the liability basis is typically a key consideration for insurers' investment strategy. In particular, asset liability matching reduces reported investment risks and allows for smoother emergence of profits. Insurers should ensure the implications for investment strategy receive high visibility in their IFRS4 implementation projects.

FINANCIAL

GOVERNANCE

"Stay invested but also protected"

3. Protect the Downside. The uncertain macroeconomic and political environment continues to give the potential for sudden significant volatility in financial markets across areas such as equities, currencies and bond yields. Recent global developments, including the fragmentation of previously settled political norms around trade and debt, further increase this risk.

For bond yields and currencies, this will encompass the management of risks across assets and liabilities, and the overall asset-liability management approach should be reviewed to confirm that it appropriately manages these risks.

Faced with the potential for increased risk in growth assets, insurers need to be prepared to either adopt a long-term perspective and ride out shorter-term volatility (to the extent its risk appetite permits this), dynamically react to the environment (more on this in idea No. 3), or consider building explicit downside protection into their investment strategy (for example, protecting against falls in equity markets).

FINANCIAL

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"Recognise emerging opportunities"

4. Capture Emerging Risks and Opportunities. The US Federal Reserve Bank appears poised to raise interest rates, with a rate-rising environment being further encouraged by Donald Trump's stated views on fiscal policy expansion. In addition, there is the potential for protectionist policies under a Trump-led administration. Both of these may further exacerbate the heightened volatility in emerging market assets and currencies that we have experienced over recent years.

This environment presents both risks and opportunities for investments in emerging markets, which in the longer term have the potential to enhance returns, but at the cost of shorter-term volatility. We encourage insurers to review the overall strategic balance between developed and emerging markets in their portfolios and ascertain whether current conditions mean a more dynamic position is appropriate.

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FINANCIAL

GOVERNANCE

"Better the prospect by widening the context"

5. Investigate Alternative Return Generators. The global policy focusing on monetary stimulus has created an abundance of capital seeking higher investment returns. This has led to a reduction in the yields available on the assets traditionally used by insurers, and even though we expect yields in some markets to gradually start ticking up (e.g. the US), they are likely to remain at low levels for some time. To improve the quality of returns achievable from growth portfolios, we recommend seeking a greater contribution from nontraditional sources of return, including illiquidity and manager outperformance (also known as "alpha"), through widening the investable asset class universe. This could include:

- Private market allocations, e.g. direct lending to corporates.
- Absolute return-focused mandates, e.g. absolute return fixed income.
- Liquid alternative strategies, e.g. alternative credit.

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"Be able to pay on a bad day"

6. Understand and Utilise Liquidity. Insurers typically focus on ensuring adequate asset liquidity to support the insurance and operational needs of the business. However, holding excess liquidity can present a significant opportunity cost in the form of lower returns. In addition, it should be noted that an insurer's liquidity requirements and the liquidity of its asset portfolio will change over time. Insurers should regularly review their liquidity risk and requirements to not only ensure that business needs are met, but also that investment opportunities are not missed. For example, as regulatory reform has led to a reduction in banks' willingness and ability to lend to corporates, there may be an opportunity for insurers with excess liquidity to step in as alternative providers of direct lending to generate additional returns.

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"Position for the longer term by building a sustainable base today"

7. Integrate Environmental, Social and Governance (ESG) Considerations. The ongoing global initiative to introduce voluntary climate-related financial disclosures at a company level will potentially have a far-reaching impact on insurers. We suggest insurers proactively consider the impact this initiative may have on reporting and disclosure from an investment perspective. This may include requirements for a broader understanding of the carbon footprint of equity portfolios and the impact of varying climate scenarios on portfolio returns.

Climate change is only one of many material ESG issues that can have a meaningful impact on risk and return outcomes, and thoughtful consideration should be given as to how best to integrate these wide-ranging issues.

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"Increase proficiency through efficiency"

8. Adopt Smarter Implementation. While investment strategy is generally the key determinant of realised returns, efficient implementation can provide a meaningful further uplift to efficiency. This can include areas such as:

- Ensuring asset management fees are competitive, leveraging the scale of assets across the balance sheet.
- Achieving market exposures in a cost-effective manner by using active management where there is a demonstrable benefit, but otherwise implementing using low-cost passive vehicles (e.g. through the use of pooled funds or Exchange-Traded Funds).
- Considering the outsourcing of mandates for nontraditional assets that previously would have been accessible only to larger investors.

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"Adopt a broader perspective of risk"

9. Consider Alternative Risk Quantification Measures. Value-at-risk measures continue as the market standard for risk measurement among financial practitioners, and this is also typically one of the main measures that insurers focus on when setting their investment strategy. While such measures are a key tool for measuring risk, there are several limitations in their use. These include a reliance on underlying model assumptions and the danger of "black box" optimisation that is blind to risks that are not easily modeled (e.g. specific geopolitical risks that have grown in importance). We recommend that traditional risk measures be complemented with alternative measures, both when setting the overall market risk appetite and when determining the underlying strategic asset allocation. For example, more extensive use of scenario testing enables an insurer to:

- Better understand the sensitivity of the portfolio to its underlying risk and return drivers.
- Be able to incorporate potential future structural changes (e.g., technological and demographic factors) on a forward-looking basis.
- Make better guided risk management decisions in a fast-changing environment.

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"Watch, wait and be prepared"

10. Align Management Information with Need for Dynamism.
The quality and quantity of management information provided to insurance boards and committees have improved in recent years, driven by factors such as increased regulation and stakeholder demand. However, in our experience, this is still a work in progress for many insurers, with the focus being on improving the clarity and brevity of the range of management information that is produced and presented to stakeholders.

In addition to ensuring the appropriate quality of management information, we encourage insurers to move one step further in setting and monitoring specific triggers for action (e.g. around asset-liability mismatches) in case experience diverges materially from expectations. Given the uncertain economic environment, we would expect such a framework to be able to quickly pay back the efforts required to design and implement the process.

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IMPORTANT NOTICES

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