SURVIVE OR THRIVE IN A NEW GLOBAL ORDER?

TOP 10 INVESTMENT IDEAS FOR INSURERS IN 2019

2018 was indeed an eventful year for investment markets as central banks and governments took or agreed to take the initial steps to reverse the monetary stimulus provided following the global financial crisis. This so-called quantitative tightening will continue to have a major bearing on investment markets in the coming years.

For much of 2018, we saw dispersion across markets, with the US experiencing volatile equity returns alongside increases in interest rates and bond yields. At the same time, European equity markets fell, and bond yields were subdued. And for emerging markets, 2018 was challenging, as ongoing trade disputes, dollar strength and fiscal concerns regarding their economies led to periodic bouts of volatility and overall negative returns.

In Australia, decent economic growth was sustained amid a continued rebalancing away from resource-driven sectors, with a weaker Australian dollar and accommodative monetary policy providing support amid concerning household debt levels. The equity market followed a similar path as its global counterparts, producing negative returns, whereas bond yields saw pronounced declines, particularly in the last quarter of 2018. Across the Tasman, the New Zealand equity market trended lower, and bond yields fell over the course of 2018.

In 2017, the theme of our Top 10 Ideas was managing assets in the context of increased geopolitical risks. These risks were omnipresent throughout 2018 as the increasing prominence of populist politics across Europe and the Americas, combined with Brexit and a US-Sino trade war, heightened tension.

Increased volatility and geopolitical risks remain at the forefront of our thinking for 2019 as the idea that the pace of globalisation may slow, pause or even go into reverse looks more credible. Even though ongoing political turbulence is likely to weigh on investment markets, with careful planning, this scenario may present a more-opportunistic environment for well-chosen strategies.

Globally, insurers will continue to focus on an environment in which the withdrawal (or at least reversal) of monetary stimulus means asset valuations are less-supported and geopolitical risks and protectionism have the potential to further disrupt markets. Against this backdrop, the need to generate higher returns remains as critical as ever given the business pressures the insurance industry faces.

To help navigate this challenging landscape, we have identified 10 investment ideas we believe insurers should consider as they develop their investment strategies into 2019 and beyond.

1. ENHANCE THE MARKET RISK FRAMEWORK

In the 10 years since the collapse of Lehman Brothers and the onset of the global financial crisis, insurers have been at the forefront of developing sophisticated frameworks for calibrating, monitoring and managing investment risk. An increasingly competitive commercial environment has combined with what at times seems like a sea of regulation to drive a strategic imperative to improve transparency, oversight and efficiency of insurers' investments.

Many insurers have made significant progress in improving the robustness of their market risk frameworks since the last crisis. However, the next crisis will likely be different. To ensure they are better prepared, there are specific actions insurers can take:

- **Market risk appetite:** Ensuring the market risk appetite is fully embedded and consistently applied across the investment value chain is fundamental. In particular, it is important that investment guidelines, constraints and parameters — in isolation and in aggregate — are compatible with the overall corporate risk appetite and aligned to market conditions.
- **Focus on asset-liability management:** Continuing uncertainty around the direction of bond and currency markets will increase the focus on matching liabilities with the right asset mix; any unintended mismatch can generate unwanted balance sheet and earnings volatility.
- **Asset diversification:** Although correlations can and do increase during a crisis, properly constructed portfolios will benefit from spreading assets and exposures across different risk and return drivers.
- **Investment governance:** This has become central to insurers' investment strategies — partly to ensure the overall approach is robust and, increasingly, to ensure that timely actions can be implemented.

2. ASSESS GLOBAL VERSUS REGIONAL ASSET ALLOCATION

The total value of goods and services traded across international borders has grown dramatically in recent times, with a corresponding trend towards positioning investment portfolios to benefit from globalisation.

However, political fragmentation, alongside increased protectionism and isolationist policies, may pose significant risks to continued globalisation as ongoing trade tensions between the US and China increase market volatility. This has (at least temporarily) reduced net capital flows from developed to emerging markets.

Should global trade plateau or reverse direction, a potential impact may well be greater divergence in returns across regions and countries, which could undermine the case for global rather than regionally biased portfolios and lead to heightened currency risks.

Insurers should assess whether their geographical allocation of assets remains appropriate given the heightened geopolitical risks and the impact these could have on currency exposures.

3. INCREASE FOCUS ON CREDIT EXPOSURE

As a default strategy for the balance sheet, corporate bonds and other credit assets have served insurers well over the longer term, with strong returns driven by low default levels, declining spreads and the continuation of a low-interest-rate environment. However, in a world of abundant credit, there is potential for declining lending standards to drive credit quality lower. Arguably, there has already been an impact:

- Investment-grade corporate bond leverage has increased significantly.
- A large and growing proportion of outstanding stock is rated BBB.
- More than three out of four leveraged loans are now “covenant-lite,” providing lower levels of protection — this has more than tripled since the global financial crisis.

Insurers will of course continue to allocate to credit assets, but manager and security selection are more important than ever.
Given the ability to rotate between credit sectors, actively managed mandates are well-placed to benefit from and manage through changes in the credit environment.

4. MANAGE LIQUIDITY REQUIREMENTS

Insurers have been increasing allocations to less-liquid assets in recent times — at one end of the spectrum, typically through moving from highly liquid sovereigns to corporate bonds, and at the other, by stepping in to fill the void left by those banks that focused on repairing their balance sheets following the global financial crisis.

We have seen central banks become the principal suppliers of liquidity, but it is now their stated intention to materially deleverage in the coming years. The degree to which liquidity and access to capital will decline has yet to be seen, but a heightened risk of a liquidity crunch within asset categories cannot be overlooked.

Insurers should robustly stress-test all aspects of their liquidity needs, both on the asset side (such as collateral for derivatives and illiquid asset types) and the liability side (such as claims and expenses) as well as for wider business needs (such as dividends, loan repayments and new business acquisition). This should be done under both business-as-usual and stressed scenarios.

5. IMPLEMENT PRIVATE MARKETS EXPOSURE EFFICIENTLY

The economic benefit of less-liquid private market assets, such as private debt, infrastructure equity and real estate debt, can enhance yield, deliver diversification and generate regulatory capital efficiency. Designing and executing an appropriate strategy to access and exploit the most-attractive assets and investment managers at the right price is key to maximising value. However, many insurers experience difficulty in implementing these strategies. An effective approach should focus on:

- Diversification of exposures across managers, vintages and strategies (for example, a private debt fund may hold only five to 10 underlying investments compared to at least 100 holdings for most liquid fixed income funds)
- Dispersion between manager returns — with a heterogeneous opportunity set and concentrated funds
- Regulatory capital efficiency (for LAGIC-regulated insurers, aggregation [diversification] benefits can be achieved via exposure to multiple APRA asset risk modules with the potential to reduce the total asset risk charge and hence APRA's minimum capital requirement)
- Access to best-in-class managers, funds and strategies — something that is often not feasible for new or small-scale investors
- Clarity and understanding of the fee structure of these funds operating in this sector — a critical factor
- Managing the increased operational and governance burden that inevitably comes with this asset class

Even though larger insurers can generally absorb the increased operational and governance overhead associated with this asset class, a growing number are increasingly accessing private markets through a fund-of-funds approach.

6. MANAGE INTEREST RATE UNCERTAINTY

As interest rates and government bond yields in the developed world remained at historically low levels, 2018 saw a more-hawkish Federal Reserve Board implement a number of US interest-rate rises, at odds with stubbornly low or, in some cases, negative rates in the eurozone, the UK and Australia, with the RBA interest rate remaining unchanged over the course of 2018.

The global interest-rate outlook requires insurers to focus on interest-rate sensitivity across both assets and liabilities. Ensuring the associated exposure is well-understood and within risk appetite requires a view of the exposure across the whole balance sheet rather than just the matching assets; for example, a faster-than-anticipated and/or significant increase in rates could impact the wider risk-asset universe as well as the matching asset portfolio.

Insurers should not overlook the opportunity to take advantage of this environment through expressing explicit interest rate views — for example, long or short duration (particularly within surplus funds) — or by replacing fixed with floating rate assets where there is less interest rate sensitivity. Both strategies should be considered in conjunction with appropriately skilled active managers (for example, within an absolute return fixed income fund).

7. INTEGRATE AND EMBED SUSTAINABILITY

Insurers increasingly see the value of integrating a more-sustainable approach with their investment strategies, while regulators such as APRA in Australia or the FMA and RBNZ in New Zealand have been increasingly demanding that insurers focus on environmental, social and governance (ESG) factors. APRA and RBNZ have previously indicated insurers should consider the management of climate risk within risk-management frameworks and business decisions.

At the same time, recognising their role in society and as long-term holders of capital, insurers have been independently adopting a more-responsible, sustainable approach, and we expect this to continue. In addition to managing reputational risk, for many insurers, this is also a wider asset-liability consideration.

Insurers are taking practical steps to integrate sustainability:

- **Governance:** determining investment beliefs in the context of a sustainable investment approach and setting policies and procedures
- **Strategy:** evaluating the benefits of introducing sustainable asset classes through modelling and stress-testing
- **Benchmarking:** adopting dedicated ESG benchmarks and considering the ESG credentials of underlying managers as part of the selection process

8. MANAGE INFLATION RISK

Although inflation in most developed economies has been moderate in recent decades, a continuation of this benign environment is by no means a given. The risks associated with higher price inflation can be quite investor-specific, but all institutional investors should be concerned about maintaining the "purchasing power" of their portfolios over time.

Insurers will also have additional considerations:

- Potential for **inflationary mismatch** between existing assets and liabilities (particularly for life insurers and accident-compensation schemes, where liabilities are typically longer-term and inflation linkage may be more explicit)
- The need for capital to generate a **return** to underpin longer-term claims increases (which often carry at least some inflation)

Making predictions about the probable level of future inflation is fraught with uncertainty, but the risks are likely skewed to the upside from a cyclical perspective. It is natural for insurers to review their exposure to higher inflation across both sides of the balance sheet as well as the implications for the future purchasing power of their customers' savings or retirement funds.

Mitigation can include inflation hedging through the use of inflation-linked bonds and derivatives to explicitly match inflation exposures or by investing in "inflation-sensitive" assets that are expected to provide a positive real return over the medium to long term, such as real estate and infrastructure.

9. REASSESS ACTIVE-VERSUS-PASSIVE APPROACH

The approach to implementing an agreed investment strategy is often considered in terms of "active-versus-passive" management. In practice, there are a number of drivers that influence the efficiency of the approach:

- Although investment management fees (for both active and passive) have been falling over recent years, fee levels continue to be the focal point of the debate. The commoditisation of passive management should not be confused with the fact that a large degree of skill, resource and infrastructure is required to deliver index-like performance.
- The growth of systematic, factor or "smart beta" strategies delivered through single or multi-factor funds has led to a much wider range of approaches. The blurring of the lines between active and passive should be considered in the context of how robust the underlying factors may actually turn out to be.
- As more assets are invested in index-tracking strategies, the potential for systemic risk should not be overlooked. To date, only pockets of concern have emerged, but there is a need for caution as the trend to indexation continues.

There is, of course, no single best implementation approach for insurance companies. The approach adopted should be considered in light of a number of factors, including (but not restricted to) investment beliefs, risk and return targets, costs, capital budget and stakeholder considerations.

10. ALTERNATIVE RISK PREMIA

We may well be moving out of an environment in which accommodative monetary policy has provided "easy beta" and equity and credit markets have generated strong returns with (until recently) limited volatility. As we transition towards a potentially higher-risk environment, it is important to consider sources of return that are less correlated to mainstream assets. Alternative risk premia (ARP) strategies can meet these criteria, representing a more-systematic approach to accessing consistent returns through exploiting market inefficiencies.

ARP strategies fill the gap between traditional multi-asset strategies and hedge funds, providing many of the diversification benefits of hedge funds but with lower costs and higher transparency.

SUMMARY

The shift in global order brings with it political and economic uncertainty, potentially giving rise to greater investment risk and market volatility. However, with this comes the opportunity to design and execute well-resourced and thoughtful investment strategies. Given the challenges of the business environment, insurers continue to seek out actionable investment ideas to generate the level of return necessary to sustain their businesses.

Mercer is the world's largest insurance investment adviser,[1] and whether you are considering your approach to managing market risk or reassessing your overarching asset allocation, our team of insurance investment experts is ideally placed to help you navigate the new global order.

We have helped many insurance clients design and implement strategies to deal with inflation risk, manage their credit exposures, assess regulatory capital implications, and optimise their passive and active approaches to markets, including introducing a sustainable approach. For insurers seeking alternative sources of income, Mercer's Alternatives business is well placed to provide access to private markets strategies underpinned by a range of best-in-class managers.

[1] Insurance Asset Outsourcing Exchange 2018

CONTACT

For further information or an informal conversation, please contact any of the following:

Denis Walsh
Principal, Australia
T: +61 3 9623 4201
E: denis.walsh@mercer.com

Felix Sun
Principal, Australia
T: +61 2 8864 6957
E: felix.sun@mercer.com

Alice Tjahja
Associate, Australia
T: +61 2 8864 6459
E: alice.tjahja@mercer.com

Colin Tipping
Partner, Europe
T: +44 20 7178 2699
E: colin.tipping@mercer.com

Andrew Epsom
Principal, Europe
T: +44 20 7178 2011
E: andrew.epsom@mercer.com

Michael Butler
Principal, Europe
T: +353 1 603 9759
E: michael.butler@mercer.com

Important Notices

References to Mercer shall be construed to include Mercer LLC and/or its associated companies.

This contains confidential and proprietary information of Mercer and is intended for the exclusive use of the parties to whom it was provided by Mercer. Its content may not be modified, sold or otherwise provided, in whole or in part, to any other person or entity, without Mercer's prior written permission.

The findings, ratings and/or opinions expressed herein are the intellectual property of Mercer and are subject to change without notice. They are not intended to convey any guarantees as to the future performance of the investment products, asset classes or capital markets discussed. Past performance does not guarantee future results. Mercer's ratings do not constitute individualised investment advice.

Information contained herein has been obtained from a range of third-party sources. Although the information is believed to be reliable, Mercer has not sought to verify it independently. As such, Mercer makes no representations or warranties as to the accuracy of the information presented and takes no responsibility or liability (including for indirect, consequential or incidental damages), for any error, omission or inaccuracy in the data supplied by any third party.

This does not contain regulated investment advice in respect of actions you should take. No investment decision should be made based on this information without obtaining prior specific, professional advice relating to your own circumstances.

This does not constitute an offer or a solicitation of an offer to buy or sell securities, commodities and/or any other financial instruments or products or constitute a solicitation on behalf of any of the investment managers, their affiliates, products or strategies that Mercer may evaluate or recommend.

For the most recent approved ratings of an investment strategy and a fuller explanation of their meanings, contact your Mercer representative. For Mercer's conflict of interest disclosures, contact your Mercer representative or see www.mercer.com/conflicts of interest.

Investing involves risk. The value of your investment will fluctuate over time, and you may gain or lose money.

Not all services mentioned are available in all jurisdictions. Please contact your Mercer representative for more information.

Investment management and advisory services for US clients are provided by Mercer Investment Management, Inc. (MIM), and Mercer Investment Consulting LLC (MIC). MIM and MIC are federally registered investment advisers under the Investment Advisers Act of 1940, as amended. Registration as an investment adviser does not imply a certain level of skill or training. The oral and written communications of an adviser provide you with information about which you determine to hire or retain an adviser. MIM's and MIC's Forms ADV Parts 2A and 2B can be obtained by written request directed to: Compliance Department, Mercer Investments, 701 Market Street, Suite 1100, St. Louis, Missouri 63101.

Certain regulated services in Europe are provided by Mercer Global Investments Europe Limited, Mercer (Ireland) Limited and Mercer Limited. Mercer Global Investments Europe Limited and Mercer (Ireland) Limited are regulated by the Central Bank of Ireland. Mercer Limited is authorized and regulated by the Financial Conduct Authority. Registered in England and Wales No. 984275. Registered Office: 1 Tower Place West, Tower Place, London EC3R 5BU

6009600h-GB AU