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OUTSOURCING INSURANCE ASSET MANAGEMENT

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SECTION 1

OUTSOURCING INSURANCE INVESTMENTS

1.1 ROUNDTABLE

What factors should insurers consider when looking to outsource a part of their portfolio management to an asset manager or third-party?

1.2 WHITEPAPER

Outsourcing Investments: Considering the issues from an asset management perspective

1.1 ROUNDTABLE DEBATE

What factors should insurers consider when looking to outsource a part of their portfolio management to an asset manager or third-party?

Moderator

David Grana,
Head of North American Media, Clear Path Analysis

Panelists

Rip Reeves,
Chief Investment Officer, AEGIS

Aaron Diefenthaler,
Chief Investment Officer, RLI Corporation

John Patin,
Chief Investment Officer, Allied World

Joshua Neuman,
Chief Investment Officer, Ironshore

POINTS OF DISCUSSION

- *What are some of the motivating factors that an insurer would have for outsourcing a portion of their portfolio to a third party?*
- *How important is size and breadth of resources in selecting an investment manager?*
- *To what extent are modeling resources a consideration in selecting an asset manager?*
- *Other than fees, how do you distinguish among investment managers?*
- *How do you measure the success of the relationship with your current investment manager(s)?*

David Grana: What are some of the motivating factors that an insurer would have for outsourcing a portion of their portfolio to a third party?

Aaron Diefenthaler: On the insurance side, all of our departments run pretty lean. Any time you need access to expertise outside of your ability to bring those skills in house, you have to look to outsource. Often, if you do have a core bond mandate in-house, you are most likely looking at specialty asset classes. More often than not, that comes with a third-party relationship.

Joshua Neuman: Everyone you have on this roundtable outsources - perhaps all of their portfolio. And we certainly do as well. The first decision is whether you are large enough to do anything internally. At a $5 billion asset level, we are too small to do anything internally. Purely based on cost, we could never replicate the skills, expertise and experience that others have outside with our asset base. It takes many billions of further dollars before that would be reasonable to do in-house.

Usually, insurers are insourcing the core part of their portfolio. Much of this is commoditized. And they will generally have very large allocations. They tend to outsource more of the niche parts of the portfolio. This is where you rely on deep expertise - whether it be an asset class like high yield, real estate or private equity.

John Patin: I agree.

Rip Reeve: Me too.

David: How important is size and breadth of resources in selecting an investment manager?

John Patin: It depends on the mandate. If you are talking about a core fixed income portfolio, it can probably be outsourced to smaller teams or managers. Given the expected return of investment grade (IG) fixed income asset class, I believe smaller teams could manage the mandate, but if the mandate involves more than just the investment function, it may need more breadth. Ultimately, it depends upon the complexity of the strategy that you are going after. If the strategy has unique aspects, or more expected alpha, the more breadth and depth becomes a factor in selecting the manager.

Rip: It really does depend on the mandate. If you are looking at a mandate that is core fixed income, whereby you are investing in several high grade asset classes, a large scale insurance business may be beneficial. We generally use our core fixed income managers for their research, modeling capabilities, tax and regulatory assistance – in addition to portfolio management. Therefore, the breadth, depth and scale of the asset manager's capabilities – all the additional resources they bring to the table – are imperative.

In contrast, if you are hiring a niche player for a smaller allocation or a highly specialized mandate, you will likely research managers who have a very focused strategy and skillset. Perhaps their breadth and depth in the global market – and additional resources – may not be so important, given you're hiring them for a smaller niche mandate, as opposed to a larger, broad strategy.

Ultimately it depends on the mandate. When you look across the various asset classes and mandates in your investment strategy, you want to establish a stable of investment partners across the range from smaller niche players to those managers with a large global footprint. Ideally, you want to have manager diversification in your team.

Josh: Most of us lean on our core managers for many issues. That means we need breadth and depth. In other words, we are looking for research capabilities, their view on the economy, the ability to run different scenarios on interest rates, etc. We also need them to be able to cover many industries and types of fixed income, such as asset-backed, mortgaged-backed, corporates, governments, etc.

We also rely on a certain amount of services as well. When it comes to the niche managers, if we are looking for them to do high-yield bonds, that is all we care that they know about. We expect them to have tremendous resources and experience within high-yield bonds and don't care if they can't do much else.

Aaron: Size can sometimes be a detriment, particularly when you get into certain asset classes where you need to be somewhat nimble. You want to be able to pick and choose where you are placing that next marginal dollar with the best risk return profile.

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There are very large managers who get to a certain size and they have to buy everything that comes across their desk in order to feed all of the underlying constituents that they have. In those cases, size can be a headwind.

David: Are modeling resources one of the considerations that you are making when selecting a manager?

Aaron: We are using some of our core bond managers to help us with modeling capabilities. This is not something that we would be able to build in-house, due to costs. It is definitely something we look to outside managers to help us with.

John: We have 100% of our assets externally managed, so in the sense of modeling, it can apply to overall portfolio asset allocation and asset liability management, or to specific investment strategies (i.e. modeled returns from private investments, like equity in a credit loan obligation). As Aaron mentioned, within core managers, there may be a bit more dependence on providing multiple services. Modeling is perhaps one of the services, so it could carry importance in selecting a manager. Again, it is 100% dependent on the mandate.

When it comes to our niche managers, we may be able to run some analytics on what might happen to returns or income on a specific portfolio, given certain scenarios. They would be able to help us with that, but we are not looking to those boutique managers to model our overall portfolio.

David: Other than fees, how do you distinguish among investment managers?

Aaron: Operational support is really critical for those managers with the bulk of your assets. They need to be prepared to support us operationally with issues like modeling, investment accounting, regulatory changes, etc.

Rip: I agree with Aaron, especially if we are looking to hire a core manager. In that case, the laundry list of services we expect from them is long - and necessary - to compete for this type of business.

Whereas, if we are looking to fund a small or niche allocation, many of these additional services are not so important in the search process. You're focused on looking for the best team that can manage a specific mandate.

> "If we are looking for a niche high-yield mandate or some kind of niche asset-backed securities mandate or real estate, these managers will be managing for pension funds, foundations and other institutions"

Rip: Similarly, we have internal capabilities on asset allocation modeling. We typically invite one or two of our larger managers to provide their independent modeling opinion – as a compliment to our internally generated work.

David: With boutique managers would you look at what independent modeling you have been given by some of your core managers? Can you trust that opinion to be able to use it with your boutique managers?

Josh: All of us have to look at the overall risk in our portfolio, the sensitivity to interest rates and what impact certain events might have on our portfolios. All of us do this internally or with a system that we rent from someone like BlackRock, or that we get from our larger managers.

Part of the reason we ask our larger core fixed income managers is because they are managing the more commoditized portion of the portfolio. Their value proposition is, to a great extent, based on hand-holding and service, because the alpha isn't really there in the first place.

John: I think the industry places emphasis on investment managers by performance and track record. Services are great, but if the performance was severely below its peers or benchmark, I doubt they would be considered. I think too much attention is placed on fees. I am not afraid of paying higher fees if I feel that the alpha component is going to consistently be there. In the end, I wouldn't want to go to the cheapest doctor.

Allied World is also different in the sense that we have invested equity in general partner stakes of investment managers. From this perspective, we are looking for knowledge base and expertise that we are going to be able to leverage.

Additionally, we are also looking for growth of assets, since that provides economic upside to our equity investment. For those firms, there is a completely different set of qualities we are looking for.

Aaron: I couldn't agree more. Consistency and performance away from fees are paramount to allocation decisions.

Josh: There is a spectrum. The core managers are more commoditized. We are looking for them to have deep knowledge on managing money for insurance companies. If you look at who our core managers are, they have dedicated insurance groups. There are a lot of regulatory and accounting nuances around insurance, as well as issues around fees.

Once you move on the spectrum towards the more niche areas, you find that the managers have to be less focused on insurance and they don't need to have as many in-house resources and knowledge of managing money for insurers specifically.

If we are looking for a niche high-yield mandate or some kind of niche asset-backed securities mandate or real estate, these managers will be managing for pension funds, foundations and other institutions. They don't need to be focused solely on insurance companies. We won't be leaning on them for as much specialty knowledge. Here, we are just looking for the best horse, the best performance for every unit of fees and alpha.

David: How do you measure the success of the relationship with your current investment manager(s)?

Aaron: It can be summed up in a no-surprises result, including, but not limited to, pure total return performance. The manager should be able to step into my shoes and understand the challenges that I face. If they can anticipate some of these challenges and get in front of an issue by informing us in a proactive manner without any prompting from my team, that is a really successful relationship.

John: I completely agree. It comes down to what your objective was when you started the relationship. Performance over the years is a part of it, as well as the response and nature of the service that they are providing. With some of the general partner relationships we have, the success is going to be on the dividends they provide, as well as the unique insights and investment opportunities they can bring to the relationship. At the end, there is also the knowledge that they may have been creating for you and how you can use the knowledge to create efficiencies in the future.

Rip: I agree with Aaron's and John's comments.

Josh: Performance is paramount, but there is the also the question of how they are reaching that performance over time. You want to see consistency in their strategy, that they are following the strategy that they presented initially. That is how we measure success.

We also do appreciate a lot of communication and responsiveness. With everything being equal, even with a given level of performance, we do like a good amount of communication, reporting and responsiveness. And this leads to a successful, long-term relationship, which we have with many of our managers.

David: Thank you all for sharing your thoughts on this topic.

1.4 WHITEPAPER

Outsourcing Investments: Considering the issues from an asset management perspective

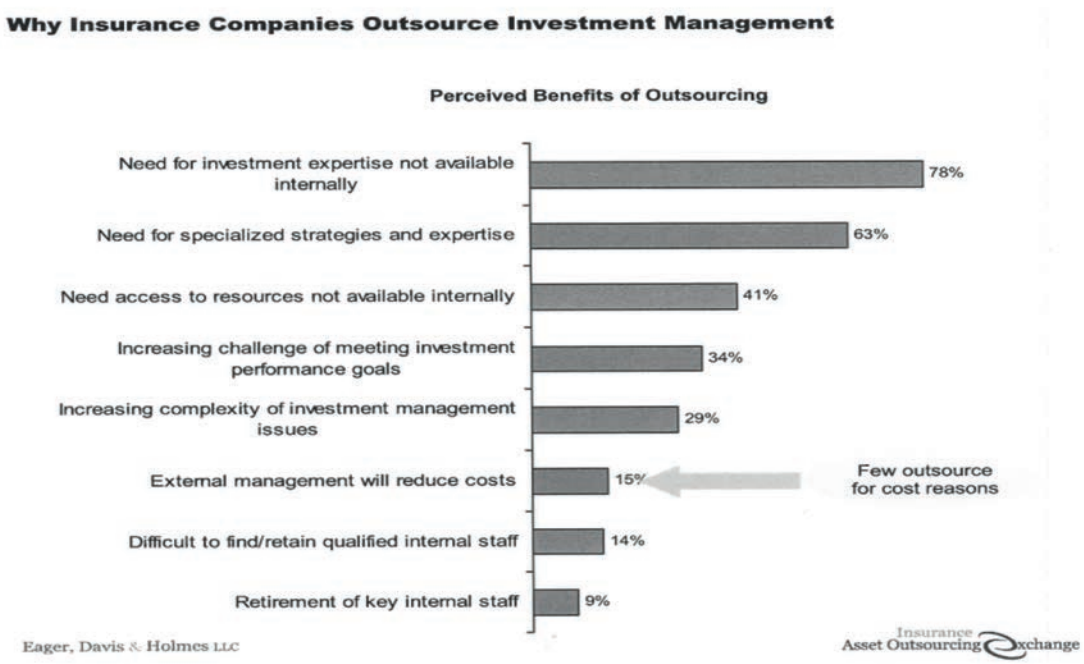
Peter A. Wirtala,
Insurance Strategist,
AAM Insurance
Investment
Management

As part of AAM's Insurance Asset Management for Insurers 2017 Report, seventeen U.S.-based insurers with a minimum of $1 billion in assets under management were surveyed on three commonly cited issues. Here is what they disclosed and what AAM's response was:

ISSUE #1: Carriers believe that small and mid-sized asset managers lack the internal resources to take on a large mandate.

Counter-intuitive as it may sound, there is an optimal range for the size of an insurance asset manager, and it is entirely possible to be too big. A firm that's too small will lack internal resources and scale, but a firm that's too large will lack flexibility and nimbleness to trade opportunistically and access markets with limited liquidity (a description that fits a growing swath of the bond market ever since the financial crisis).

For most companies, the decision to outsource any aspect of their business depends on numerous factors, many of which boil down to a desire to focus internal resources on core competencies while off-loading ancillary functions to third parties. Insurance asset management is no different; a carrier might have extensive knowledge of the markets in which they write insurance, but lack significant expertise in the investment markets.



Other issues driving the outsourcing decision include:

- *Realization of economies of scale inherent in the investment function*
- *Added flexibility in staffing and expense control for an insurer*
- *Expertise in the intersection of investment strategy with AM Best ratings, RBC ratios, taxes, state regulations, and other related concerns*
- *Access to technology and data services that may not be cost-effective to purchase internally*
- *Upgraded reporting capabilities*
- *Improved service*
- *Enhanced performance and access to experienced, investment professional specialists*
- *Ability to network with other insurance company clients providing access to best practices*
- *Access to the benefits of an outsourced Chief Investment Officer (OCIO)*

Insurers might reasonably view investments as a "non-core" function so outsourcing it allows the carrier's finance team to focus on core competencies like underwriting, reserving, new product design, and so on.

Partnering with an insurance investment manager gives an insurer access to a wide scope of resources and services, including broad investment expertise, asset allocation across various asset classes, dynamic financial analysis, extended research capabilities, sophisticated modeling capabilities, and upgraded service and reporting. Additionally, by outsourcing the investment management function, carriers incentivize their manager to deliver strong returns, responsive service, and constant improvement in their overall offering, in order to maintain the business and seek to grow assets over time.

We maintain that managers like AAM are optimally sized to execute tactical purchase and sale programs, while still having the scale necessary to offer strong fundamental research, best execution on trades, a high degree of client service, and access to cutting-edge technological systems and resources. A properly sized asset manager can take advantage of opportunities that smaller managers aren't offered and that larger managers often disregard due to the scale of the significant assets that they need to employ in the markets. The result for these boutique managers is highly customized portfolios that truly represent the best ideas of the firm's investment professionals.

AAM contends that when insurers contemplate the prospect of outsourcing to an asset manager, splitting the mandate and engaging boutique/niche firms for part of the assignment is an excellent way to complement the services provided by larger firms. Splitting mandates between a large company and a boutique firm exponentially expands access to investment opportunities, best ideas, additional thought leadership, more research capabilities and offers a perspective that otherwise might not be available to the insurer.

In terms of managing portfolios, larger firms need to maintain a broad, multi-discipline investment view in order to satisfy the needs of their diverse client base requiring managers to compete internally for resources. As a result, large manager's focus may be diluted as compared to a firm the size of AAM that concentrates exclusively on investing for insurance companies. However, if the insurer splits the mandate between AAM and a larger firm, that dilution of focus can be significantly dissipated.

ISSUE #2: Carriers who manage their investment portfolios internally face a drought of qualified investment talent.

A critical aspect to any successful business is the ability to attract, develop and maintain high caliber talent. Historically, insurers have been challenged in their ability to attract good investment professionals away from the investment management industry because asset management firms offer the prospect of more diversity in terms of experience, favorable compensation, equity participation and provide opportunities for promotion and career progression within the investment profession.

And today it is becoming even more challenging because the demographics of the workforce are dramatically shifting. Within the next 10 years, Millennials will comprise the majority of the labor pool and this group is motivated by variables that are different from the past. They seek environments that offer empowerment, flexibility and purpose and they are defined by a desire to have rapid career progression.

According to leading global executive search and talent advisory firm Sheffield Haworth: "Millennials are talented, dynamic workers and their influence on – and contribution to – the asset management industry will only intensify. Attracting, retaining and developing millennial talent are key to every firm's success – not just as a function of hiring, but also to keep abreast of important competitive changes, thinking and nuances impacting the future of asset management."

Boutique firms like AAM are ideally situated to attract talent by being able to offer dynamic, engaging environments with high-quality tools and opportunities for creative, entrepreneurial work. Niche firms offer employees a degree of autonomy and provide clients with easy and direct access to key employees.

Additionally, one of the strongest ways an investment manager can properly incentivize employees and avoid agency problems is by encouraging significant employee ownership, something that a boutique firm is ideally scaled to do. This encourages employees to build a long-term career with the firm and with it a record of successful, mutually beneficial client relationships.

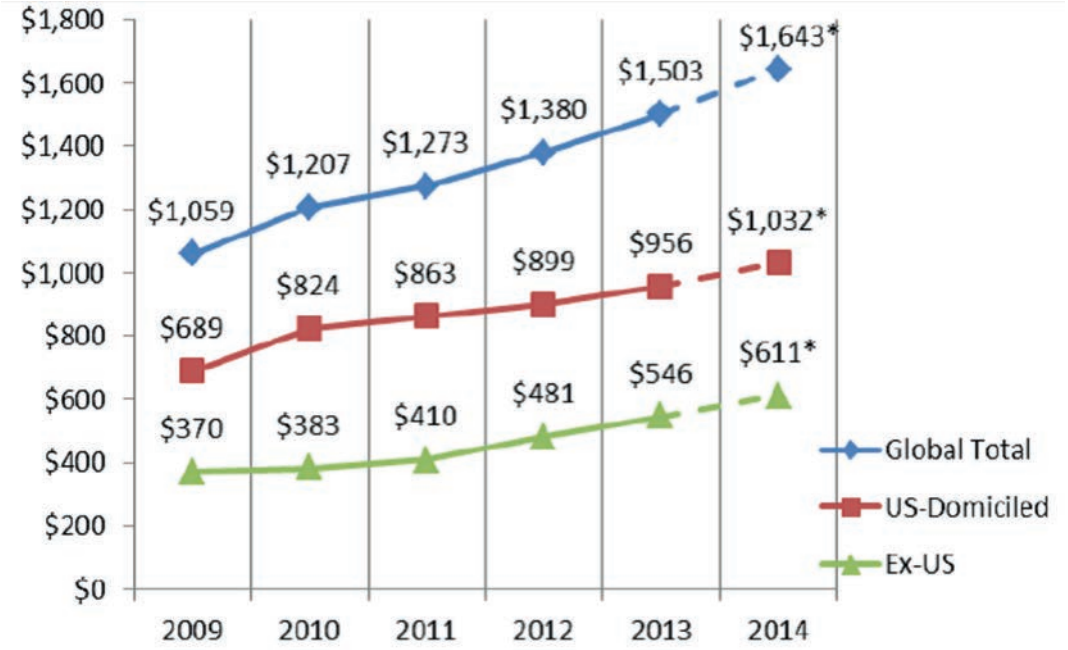
Professional advancement in the investment management industry is often not a matter of formal promotions and title changes, but of growth in the volume and size of assets being managed. A firm that rewards strong performance with increased responsibility and autonomy will be well positioned to attract and retain top talent even in today's competitive marketplace.

ISSUE #3: The participating insurers understand that stability and long-term focus are key to successful investment strategy, and are concerned that external investment managers may experience turnover in ownership, employees, or investment philosophy that cause disruptions in the portfolio.

This issue is a constant focus of successful asset managers. When evaluating an outsourced investment manager, attention should be paid not only to fees and performance but also to the stability of the company's talent pool, ownership structure, and ongoing operations, regardless of size. Boutique and niche asset managers can align employee interests directly with that of the client and can infuse organizational stability through meaningful ownership incentives.

Almost every Request for Proposal (RFP) issued by insurers seeking an investment manager requests information about the longevity and tenure of the investment professionals at the firm and the truth is that the client is directly impacted in terms of service by more than just the Portfolio Managers. There are many people in an organization that significantly contribute to the quality of service delivered. Companies with the ability to offer significant ownership stakes and other incentives can attract and retain high quality, young investment talent who are searching for a stable, long-term, and potentially lucrative career path.

Historical Growth of Outsourced General Account Assets



*Source: Outsourcing Monitor. * 2014 year-end estimate is projected from June 2014 manager-reported assets under management (AUM) from The Insurance Investment Outsourcing Report 2014, published jointly by the Insurance Asset Outsourcing Exchange, Insurance AUM and Insurer AM. 2009-2013 year-end estimates from IAM Annual Surveys and Insurance Investment Outsourcing Report, adjusted for non-participants in those surveys. In 2013, insurers outsourced about 16.5% of general account assets for investment management. That percentage is forecasted to increase to about 20%, or about $1.4 trillion, by 2019, according to the Outsourcing Monitor.*

Engaging a dedicated insurance asset manager could be an attractive option because it allows the carrier to overcome the complexity of the investment function and the challenges of developing and executing an investment strategy internally. Also it could boost earnings due to savings from significant economies of scale coupled with long-term outperformance. And while some insurers have a preference for very large, "name-brand" asset managers, there are significant benefits from partnering with a firm with the scale to trade nimbly and opportunistically for clients, while still possessing sophisticated resources and delivering a high degree of service. At AAM we believe we are ideally positioned to provide customized, client-driven investment solutions, exclusively for the insurance industry.

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