AAM, playing the long game

Servicing insurance assets is not always a glamorous business. While many new entrants have come in to dazzle with their alternatives card, AAM has profited from its steady approach and, John Schaefer, chief executive, says the insurance-focused asset manager will continue to maintain a client-first dictum. Sarfraz Thind reports

Asset Allocation and Management (AAM) celebrates its 40th anniversary this year. The asset manager's name may slip under the radar when discussing the biggest and glitziest insurance managers in the world but don't let that fool you. AAM was built for handling insurer assets and has done so very successfully.

It currently ranks fourth on the list of largest unaffiliated asset managers by insurance assets in the US, according to the National Association of Insurance Commissioners (NAIC).

It is a record that chief executive, John Schaefer, is proud to keep. "That is our focus, managing insurance assets."

Schaefer, who joined the company 20 years ago from Zurich Scudder Investments (ZSI) where he was responsible for a group managing $82bn of insurance assets, is a throwback to an old school way of doing things. He modestly describes himself as a "one-trick pony" having worked uniquely in the fixed income asset management space for institutional accounts and insurers for the majority of his career.

In reality, the one trick has also seen him expand the AAM business from $8bn when he started in 2002, to $29bn now. Most of this (90%) involves managing core fixed income investments for insurer asset-liability management with average size clients in the $250m and under range, a few smaller and a few bigger accounts up to $4bn, all spread out across the US.

Meanwhile the list of clients has grown from well under a hundred to 120 today.

John Schaefer

THE OUTSOURCE GAME

The outsourced business in the US has been growing steadily the last few years and AAM has been there, grinding away to get a seat at the top table.

Despite having overseen a good relative growth in insurance, however, AAM remains small fry in the grand army of asset management behemoths in the US (its AuM is merely a speck in the eye of, say, a $9trn manager like Blackrock). But that is all part-and-parcel of this game. Winning new insurance assets is no easy task with the clustered competition from asset managers and a general reluctance by the larger insurers to outsource.

"The market share of any asset manager in the insurance space in the US is fairly small," Schaefer says. "When you particularly think that the largest insurance companies tend not to outsource,

> "I come from a firm where it was drilled into my head that our clients' interests come first and that is the way we built up. It's not about margin for AAM it's what is in the best interest of our clients."

or if they do outsource it would be very specialty type assignments, I would say our penetration in terms of the market value of insurance by assets under management is way in the low single digits – as is pretty much everybody else's."

Of course, the low-rate environment has attracted a number of new entrants into the insurance-focused business the last few years, but Schaefer says most of these have come in to salve the demand for alternatives and other specialty niches—not core. With the lucrative fees and higher margins in alternatives, the attractions are clear, though not everyone will be successful.

"Over the last thirty-plus years, you've had all sorts of entities trying to get into the space because they see there's a lot of assets to be managed," Schaefer says.

"Some of these come from the pension space which in a low interest rate environment is not growing at all. So growth for us as managers, away from insurance in the institutional space has been challenged."

Few of these newer entrants are really interested in AAM's market of the small, mid-sized insurer's vanilla fixed income asset management, Schaefer says. And, as a result, the ones in the top ten have remained there for a long period of time—"it's kind of a constant number".

Still, the demand for alternatives to core fixed income is clearly unavoidable, and AAM has been expanding its own expertise set too.

As an extension of core fixed income, it now provides services in areas like high yield bonds, commercial mortgage loans, direct lending, and other private placements done through partnerships with external specialists Securian Asset Management and Muzinich.

It also has a significant niche in convertible bonds, offered in partnership with a firm called Zazove Associates which it has been with for over 30 years now.

Finally, it invests in equities, though switched to a greater reliance on ETFs to do this because of the apparent cost value of passive versus active strategies.

Schaefer admits there is higher margin to be had in alternatives. But the lure of higher fees will not sway the company from its major motivation.

"I come from a firm that no longer exists [Scudder, Stevens & Clark] where it was drilled into my head that our clients' interests come first and that is the way we built up. So it's not about margin for AAM it's what is in the best interest of our clients. When you build a business with 120 plus clients you have to run the business well to make a fair profit margin. And that's what we've done."

Moreover, the company typically shares the fee arrangement with its alternatives sub managers which means it does not necessarily make up margin on that side.

A CHANGING BUSINESS

The US insurance business has undoubtedly seen rapid changes in the last few years. The slow decline of interest rates since 2008 means that risk tolerances have generally increased in the industry which has, in turn, led to a proliferation of life companies selling blocks of business or whole firms to aggressive alternative-oriented asset managers.

It is a way of exchanging your insurance business for increasing risk to earn a greater return, Schaefer says.

But AAM's own roster of clients – particularly the property and casualty (P&C) and health underwriters which make up 98 of the 120 insurers on its books (82 P&C, 16 health and 22 life) – have not changed their views on investing as much.

This cohort still see their prime businesses as underwriting. Fortunately for them, P&C companies in the US "are still running their businesses with a positive margin from underwriting", Schaefer says. And while the advent of the Affordable Care Act and other trends led to a lot of money being lost across the health insurance field that has reversed considerably now.

"I come from a firm where it was drilled into my head that our clients' interests come first and that is the way we built up. It's not about margin for AAM it's what is in the best interest of our clients."

"They're not in the business of generating a bunch of float to be aggressively managed," he says. "They built a business around underwriting and that's where the value add is coming from the insurance entity. It is a nice fit for an insurance asset manager that really wants to understand them and build an asset strategy around their objectives and bring a conservative framework to really allow the focus be on underwriting."

As for the broader market? It is mainly long-term rate stressed life insurance companies that have had to redefine their risk perspectives. So what are the consequences of the increased assumption of risk?

Many believe that given the vast amounts of central bank liquidity injected into the markets to salve various crises the past ten years, a reckoning could be in the offing. Schaefer, himself feels markets have not been fully tested yet.

"The risks are that you enter into a period where investment risk materialises and companies really don't have the strength or wherewithal to survive through the down cycle," he says. "We had some of this in the early days of COVID, but the Federal Reserve flooded the markets with liquidity which stabilised it. So we really have not lived through a meaningful down market. We will see how well positioned these companies are to survive credit weakness. Time will tell. If investment risk doesn't materialise, it'll be a homerun for those companies. If it does, we'll see."

They say that cockroaches and rats will survive the next Armageddon. And – not to put it quite in that category – AAM is certainly aiming for longevity through thick and thin.

This article first appeared on www.insuranceassetrisk.com on 28 February 2022.