MERCER

welcome to brighter

2020 vision

insurers

Keeping it simple in a complicated world

Key investment ideas for insurers for 2020 and beyond

The theme of last year's outlook was "Braving the Elements — Surfing the Late Cycle." This theme informed our conversations with clients at our Global Investment Forums, which were held in major cities across the globe.

Following a volatile end to 2018, we anticipated a return to a more "normal" market environment, with the potential for higher interest rates, rising inflation and a recovery in financial market prices, albeit with periodic bouts of volatility. We re-focused clients on ensuring proper alignment of long-term strategic asset allocation targets, implementing robust risk-management and operational efficiency measures, and embedding sustainability into their investment process.

Although the majority of asset classes have posted strong returns for the year, a continued march lower in global interest rates forced insurers to stretch further for yield. The incremental movement out of the risk spectrum over the last several years left insurers concerned about the degree of hidden or unintended risk in their portfolios.

Looking forward to 2020, we must again consider the implications for insurance companies of a prolonged "lower for longer" environment and stretched valuations. Furthermore, insurers have to contend with non-investment related pressures, such as underwriting, M&A and increased technology disruption. On the regulatory front, our insurance clients continue to express concern that "regulatory intrusion" is proving challenging to investment activities, citing in particular the lack of regulatory harmony across Europe (and for some, globally) as a key issue.

With these challenges in mind, we continue to believe clients must ensure proper alignment between governance, operational and implementation aspects of investment strategy. Potential solutions to these challenges include:

- Properly balancing the competing objectives of generating income and surplus growth versus growing financial market risk
- Harvesting illiquidity premiums within select asset classes
- Using scale to assist in the operational and implementation responsibilities of portfolio management

By failing to prepare, you are preparing to fail

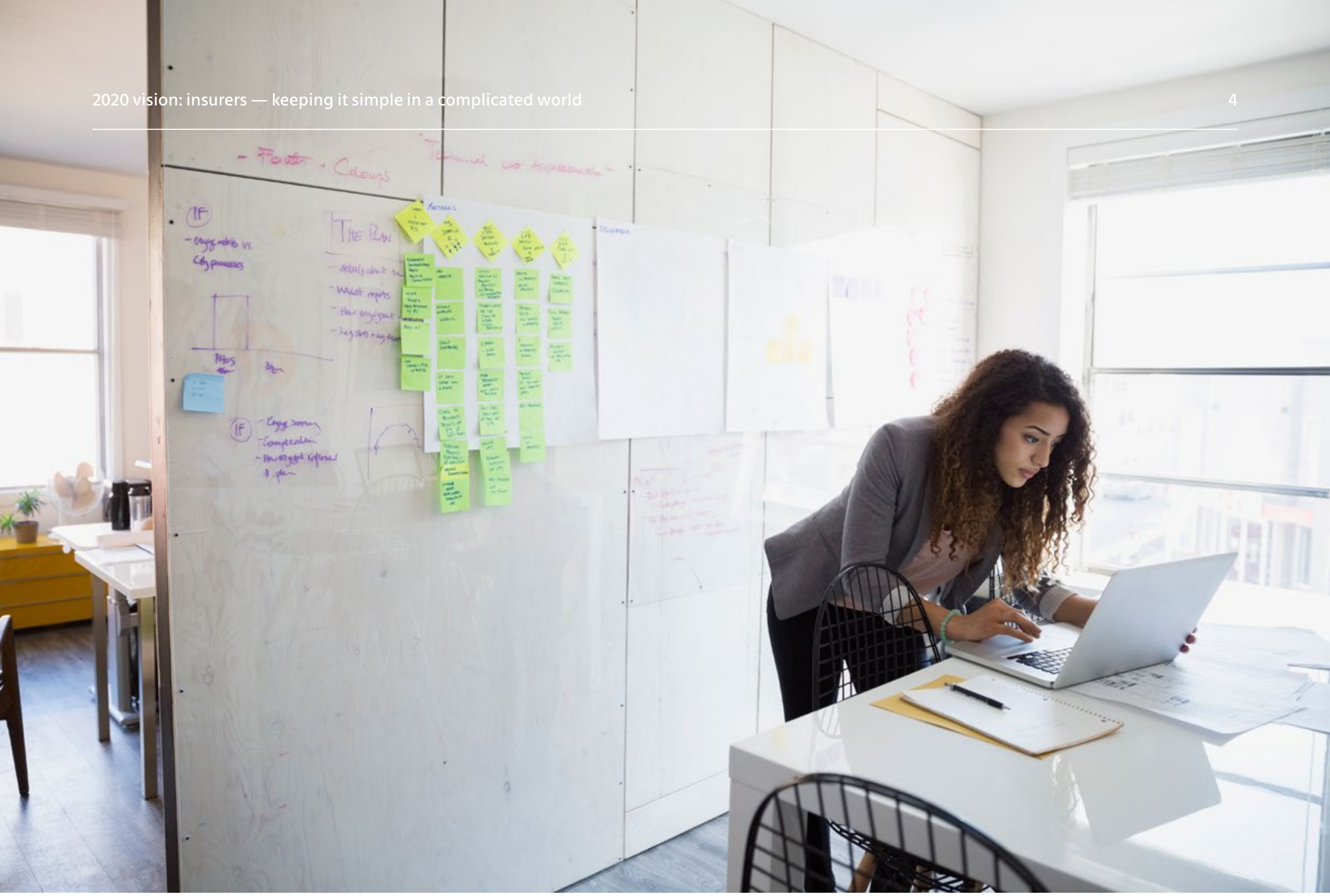
After a decade of strong financial market returns and growing concern regarding the maturity of the current economic cycle, we believe investors should be constructing portfolios that can weather a wide range of outcomes. Beyond investment strategy, however, this process should also include education and other steps to prepare investment committee members and other stakeholders.

Think "doomsday preppers," but not quite as dramatic. Having educated stakeholders with a well-defined process can help organizations respond more effectively in stressful periods. Here are a few examples of steps clients can take:

Review portfolio construction frameworks: Clients should ensure governing bodies, such as investment committee members, fully understand the difference between long-term strategic and short-term tactical investment policy positioning. The former is intended to align with the organization's long-term operating objective and regulatory constraints, whereas the latter provides flexibility to explore "tactical" deviations from those targets. Significant deviations should not be common, but are more likely to be utilized in periods of stress when asset prices have dislocated.

Flexibility to respond: Creating sufficient flexibility in investment policy statements can also help organizations respond to market opportunities. One example might be allowing high yield as a permissible asset class, but not yet granting core fixed income managers the ability to use it. A robust policy and discussion around rebalancing strategies is another important exercise.

Opportunity cost of lower risk: As investors hear more about the "end of the cycle," and headlines are filled with negative stories, it can be easy to drift lower in portfolio risk. This is often characterized by allowing equity exposure to fall below policy targets. Clients should remember that this lower risk exposure carries an opportunity cost. As with most things in life, timing is everything. A well-defined process aligned with overall organizational objectives and risk tolerance can help avoid mission drift in what could be an elongated economic cycle.



Review manager guidelines and benchmarks: Although such a review represents basic standard operating procedure for investment teams, our experience has shown that during periods of market stress, failure can often occur in the most obvious of places. Clients should conduct a thorough review of benchmark and guidelines to ensure appropriate alignment with underling strategies and objectives.

Ultimately, we are not advising clients to substantially reduce risk in their portfolios. Likewise, we are not advising clients to substantially increase risk. For now, sticking close to policy targets and understanding where underlying asset class or sector risks may be evolving is key to balancing portfolios in the current environment. The goal is to ensure the organization understands existing risks in portfolios, align those risks with its operating and liquidity objectives, prepare for how to respond in periods of market stress, and ensure the investment portfolio is supporting, not inhibiting, your overall strategic objectives.

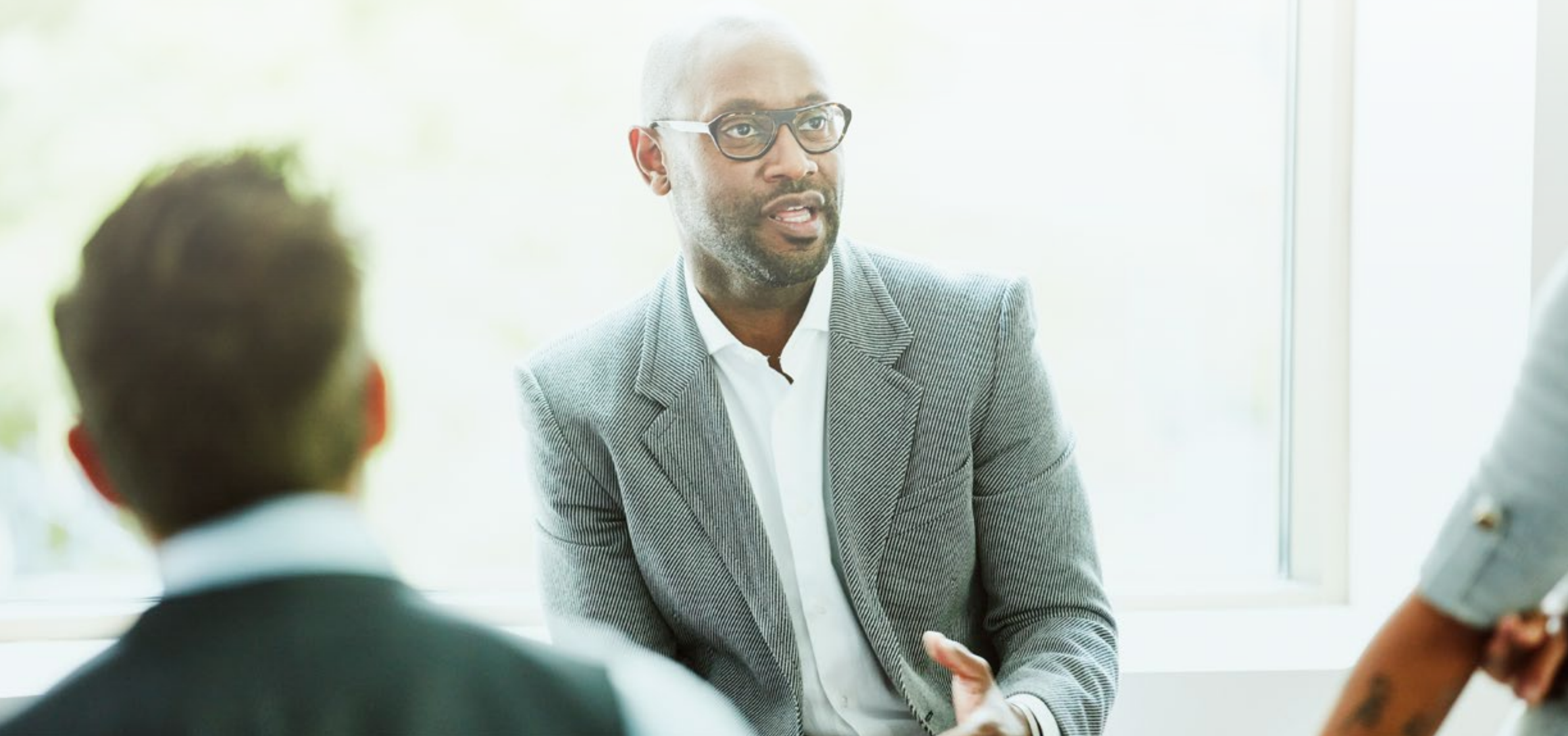
Diversify corporate credit risk

Most insurance companies have significant exposure to corporate credit risk in their portfolios. Although we continue to believe corporate fundamentals remain healthy on average, there are certainly pockets of mispricing that present challenges going forward.

To combat this risk, we recommend clients consider diversifying this risk through noncorporate sectors in both public and private markets. Within public markets, continuing to increase securitized asset exposure can help diversify underlying economic drivers (for example, corporate versus consumer) and dampen volatility.

Investment-grade private assets, such as corporate private placements or commercial mortgage loans, are also examples of asset classes that, though not trading at significant spread discounts, typically come with better deal terms and diversification.

Within below investment-grade, the theme is similar: Most insurance companies have purchased high-yield corporates or bank loans as a way to increase portfolio yield. Some of our clients were also active in securitized credit strategies that benefited greatly from the recovery in nonagency mortgage prices. Today, however, that opportunity set has dwindled. We believe clients should focus on more diversified "income" strategies that may result in a lower absolute yield but should protect more on the downside. These multi-sector funds can invest in both investment-grade and below investment-grade debt, but across a wider subset of sectors.



Be selective in private debt

Private debt, specifically corporate middle-market lending, has been a popular asset class with insurance companies.

Private debt's illiquidity provides clients with an opportunity to outperform public fixed income and diversify overall portfolio risk. At the same time, the market has changed significantly over the past decade and new risks are emerging. One of the most pressing concerns is identifying highly rated managers who have managed exposures across a full market cycle. As we look toward 2020, we believe clients should consider the following when evaluating the asset class:

- Be aware of EBITDA adjustments
- Understand actual borrower leverage (excluding EBIDTA adjustments)
- Evaluate manager's fund-level subscription lines and asset-backed leverage facilities
- Ensure managers have sufficient workout and restructuring capabilities
- Focus on managers that have invested through cycles

Insurers will remain challenged in 2020 to deploy capital prudently and identify managers and opportunities that will perform well through the cycle. We urge clients to adopt a forward-looking view anchored in a robust planning process.[1]

[1] Mercer. 2020 Vision: Private Markets, available January 2020.

Alternatives — opportunities remain

Beyond the popularity and emerging risks within private debt, we continue to believe alternatives more broadly can offer a solution to the low-yielding environment facing insurers.[2]

The ongoing convergence of public and private markets, however, should in theory put a dent in historical illiquidity premiums. This premium is only theoretical and known with certainty only after a private capital fund's life is over, which may be a decade or longer. We believe clients shouldn't take the consistency of this illiquidity premium for granted and be cognizant that some of the credit deterioration experienced in the public markets is also true in private markets.

That being said, we continue to see opportunities in alternative asset classes for clients who have sufficient capital and liquidity to invest in the space. Insurers have been at the forefront of private markets investing, including a long history of internally sourcing assets. As certain alternative asset classes continue to attract significant capital flows, there are signs insurers are finding it increasingly difficult to directly originate deals and get access to capacity constrained funds. Implementation and operations have become a major hurdle for the success of a private markets program. It is for these reasons we continue to see interest from clients in leveraging technology along with technical, legal and operational resources while retaining key decisions in-house. For some clients, this demand extends to complete customization and operational support for their alternatives program.

From an asset class perspective, we continue to see expanded interest outside of private debt, including real estate, asset-backed lending, infrastructure and more opportunistic strategies with managers that have unique sourcing, underwriting or asset management capabilities and a return profile less tied to general economic growth.

[2] Mercer. Public and Private Markets in Transformation, November 2019, available at https://www.mercer.ie/our-thinking/wealth/public-and-private-markets-in-transformation.html.

Update on capital-efficient strategies

Last year we introduced the emerging use of capital-efficient strategies for insurance companies.

Given the changing landscape, it's not surprising that asset managers are more focused on the insurance market. This has resulted in the continued development of capital-efficient structures, as well as the emergence of asset-management-owned, insurance-focused private equity strategies as a driver of product innovation. For better or for worse, these strategies fall within a gray area in the current regulatory framework. As a result, the National Association of Insurance Commissioners (NAIC) have been actively working to address and clarify its approach to the various structures. The primary points of concern so far have centered on "bespoke securities," such as collateralized fund obligations and principal-protected notes, although a variety of other structures may receive similar scrutiny. Our approach, as we communicated in last year's letter, was that any investment in a capital-efficient fund structure should at a minimum follow this rubric:

1. First and foremost, if you don't like the asset class in general, you shouldn't invest in it just because it is structured in an innovative way.

2. Clients should evaluate their true sensitivity to capital costs and whether the additional uncertainty and complexity is worth it for their specific organization.

3. Structures that are debt-orientated and that better reflect the credit quality of the underlying assets will align better with the spirit of current regulatory guidelines. Underlying assets that are traditionally on Schedule BA, such as private equity, are less likely to receive support for Schedule D Part 1 treatment, regardless of the structure.

Separately, the fund-rating framework at the Securities Valuation Office is going through changes, allowing for a broader range of fund types to receive NAIC ratings, a benefit previously only available to life insurers. This may open a broader subset of investment options for smaller insurance companies that could not previously access a separate account and/or better execution without the subsequent capital penalty.

We expect regulatory activity to increase over the coming years as the industry grapples with innovations in fund structures and the increased need for insurers to access asset classes beyond core fixed income in more efficient ways. This represents the potential for meaningful change within the industry, and we believe clients should be actively engaged in the conversation with NAIC. Our team devotes significant time to monitoring these developments and will be assisting clients in the coming years to navigate this changing landscape.

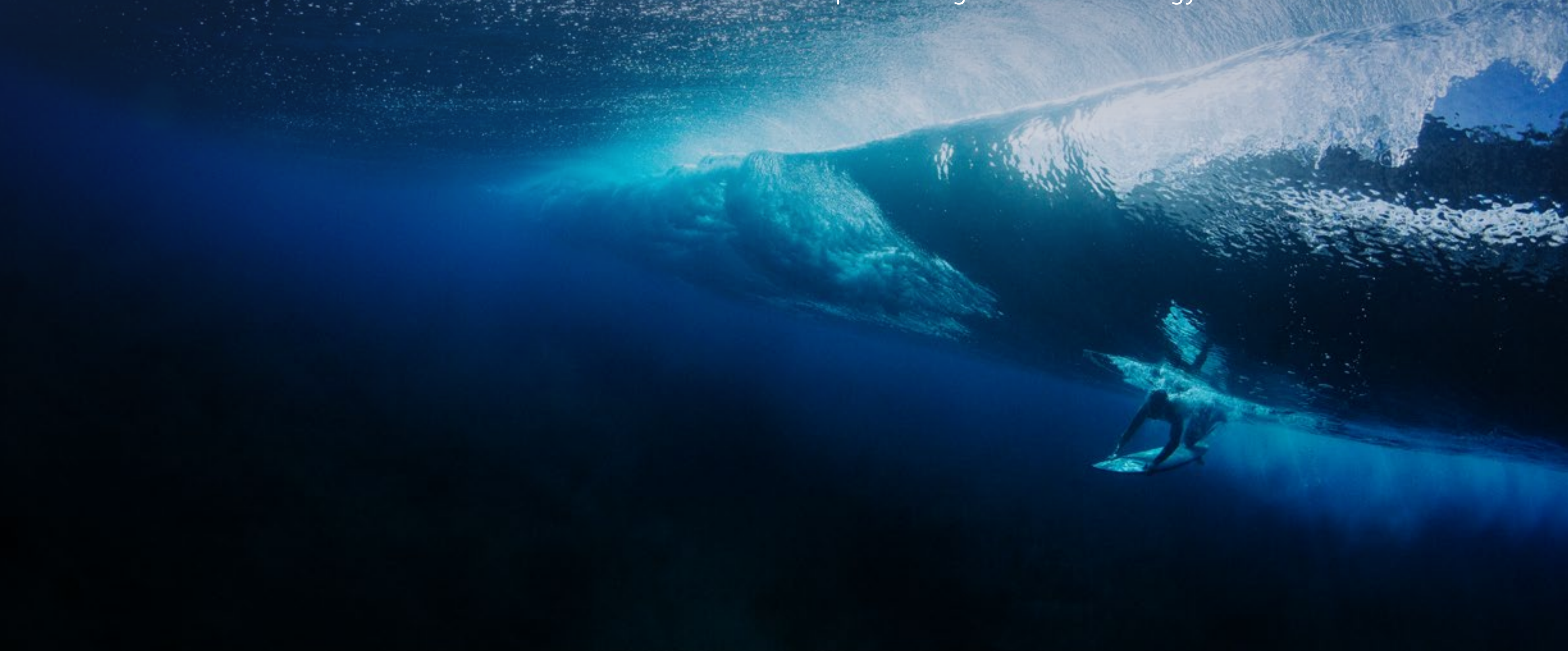
Position for climate change

Against a backdrop of increasing pressure from regulators, investors, rating agencies, environmental organizations and customers, one of the few certainties for 2020 is that many investment strategy conversations will revolve around the theme of responsible investment.

In the US, these conversations have been taking place at an increasing rate, although US insurers have been less active in significant implementation changes compared to other regions of the world (for example, Europe). In many regions, insurance companies face a current risk of "conform or be regulated."

Nonetheless, climate change in particular has potential ramifications across many aspects of the economy and insurance company balance sheets. This includes both underwriting and pricing decisions, as well as investment portfolio risks. As a result, we expect conversations on this topic to continue to increase.

Regardless of how the debate on incentives (for holding "green" assets) or penalties (for not divesting "brown" assets) unfolds, the practicalities of aligning capital-risk models to the time horizons associated with climate-change-related modeling are significant. Although it's difficult to accurately predict the impact on the investment portfolio of 2°, 3° and 4° warming scenarios, what is achievable is to gain an insight into how investors can align their portfolios to a more responsible mandate, taking into account environmental, social and governance and sustainability factors. Climate modeling of investment portfolios is a key input that should form an increasingly important role in designing and implementing investment strategy.



Conclusion

Insurance companies face many challenges as they enter 2020, with lower interest rates and portfolio income chief among them. This environment has resulted in incentives to add more portfolio risk.

Although there remain opportunities to capture risk premia, the challenges are mounting. Ensuring strong governance processes and educating stakeholders are important ways to prepare for the ominous "end of the cycle." But clients shouldn't be entirely defensive and should look for opportunities to add value through implementation, operations and customized strategies that better align portfolios with the asymmetry of return outcomes.

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Contact us

Steve Case, CFA
T: +1 212 345 027
E: steve.case@mercer.com

John Mohr, CFA, CAIA
T: +1 617 784 1223
E: john.mohr@mercer.com

Greg Halagan, CFA, CAIA
T: +1 612 642 8838
E: gregory.halagan@mercer.com

Chris Tschida, CFA
T: +1 612 642 8727
E: christopher.tschida@mercer.com

[3] Insurance Asset Outsourcing Exchange. Insurance-Focused Investment Consultant Compendium, 2019.

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