STRATEGIC ASSET ALLIANCE
THE INSURANCE INVESTMENT SPECIALIST

Investment Seminar for Gov't Risk Pools: Sample Case Study
"A Tale of Two Pools: Risk Asset Allocation"

Introduction

The Board members from two governmental pools continue to grumble about low, single-digit fixed income returns. Yet, they also remain concerned about the implications should rates rise sharply and unexpectedly as the Fed's tapering program ends, Europe slowly recovers, and geopolitical tensions ease.

Although more volatile, the Board members generally agreed that risk assets had a significantly better long term risk/reward profile.

With fiscal year results compiled, both Boards discussed the how different asset allocations may provide better long-term financial results in support of the Pools' primary goals – availability of coverage and stability of pricing.

Background

Pool #1 provides multi-line, P&C insurance in the interior Northeast. While the book of business fluctuates somewhat, it has been fairly consistent across workers' compensation (50%) and commercial property/auto (50%). $500,000 retention is in place across all business lines, and the reinsurance program remains stable.

Even with this fiscal year's slightly negative results, the actuarial report indicates adequate loss reserves across all business lines with fairly stable claims frequency, severity, and payout patterns.

The core fixed income portfolio is of high quality (AA- average credit rating) with a duration of 3.45 years. Risk assets consist passive index funds across U.S. large cap (60%), U.S. mid cap (30%), and U.S. small cap (10%).

Pool #2 provides multi-line, P&C insurance in the coastal Southeast. While the book of business fluctuates somewhat, it has been fairly consistent across workers' compensation (30%) and commercial property/auto (70%). $750,000 retention is in place across all business lines, and the reinsurance program remains stable although pricing for weather-CAT risk has increased over the past three renewals.

With strong financial results for the fiscal year, the actuarial report indicates conservative loss reserves across all business lines with stable claims frequency, severity, and payout patterns.

The core fixed income portfolio is of high quality (AA- average credit rating) with a duration of 5.3 years. Risk assets consist passive index funds across U.S. large cap (40%), developed international equity (30%), high yield fixed income (30%).

Strategic Asset Allocation Considerations

1. For both pools, the investment policy is flexible and allows risk assets up to 25% of invested assets or 50% of surplus, whichever is less.

2. Although rising rates would affect the core fixed income portfolios from a mark-to-market perspective, both pools projected neutral to positive operating cash flows over the next 2-3 year period which would prevent the liquidation of core fixed income holdings to fund operations and the potential to realize losses by doing so in a rising rate environment.

3. Currently, alternative asset classes are not permissible for either pool; however, Board members are open-minded depending on transparency and fee levels.

4. General expectations are for risk asset classes to earn an additional 3%-4% above annualized core fixed income returns for the next 5-10 years; however, the annualized volatility of risk asset classes range from approximately 3x to 8x that of core fixed income.

Staff Recommendations

Pool #1

Staff recommended the risk asset allocation be increased to 15% of the total portfolio (almost 40% of surplus) from $5M to $12.5M over the next twelve months using the current risk asset allocation targets. Alternatives were briefly discussed and excluded from consideration. No changes to the fixed income portfolio were recommended.

Board Action – Not Approved.

Pool #2

Staff recommended the risk asset allocation be increased to 20% of the total portfolio (almost 60% of surplus) from $25M to $51M over the next twelve months using a revised risk asset allocation of U.S. large cap dividend-focused (80%), U.S. Bank Loans (10%), and U.S. REIT (10%). Alternatives were briefly discussed and excluded from consideration. No changes to the fixed income portfolio were recommended.

Board Action - Approved

Discussion & Action Items

1. Even with the limited financial information presented do you believe both Pool#1 and Pool #2 have an argument to increase the risk asset allocation? Why? Why not?

2. Are you concerned with the pools' assumptions regarding core fixed income?

3. While both Boards excluded "alternatives," do you think this may be a missed opportunity given the long-term Sharpe ratios and correlations to core fixed income?

4. Why do you think the Boards acted the way they did? Does that align with your recommendation?