Bond ETFs for Small Insurers: Impact and Value

For More Information:

Alton Cogert, CFA
President & CEO
Strategic Asset Alliance
acogert@saai.com

Ilene Kelman, CFA
Regional Director - IGA
Vanguard Group
ilene_kelman@vanguard.com

Generally, insurance companies of all sizes are using Bond ETFs within their investment portfolio more and more each year. In addition to diversification and reduced transaction costs, growth in usage can be attributed to the systematic value accounting methodology designated for Bond ETFs by the NAIC.

However, even with this NAIC designation, Bond ETF usage by smaller-sized insurers is growing at a slower rate than larger companies.

Strategic Asset Alliance and Vanguard recently discussed why smaller-sized insurers may not be considering Bond ETFs, what systematic value accounting would mean for their portfolios, and if there are areas in the Bond ETF space where they might find value.

Key Highlights:

1. Lack of familiarity is the main reason small insurance companies do not utilize Bond ETFs.
2. Systematic Value Accounting can remove the volatility of mark-to-market accounting.
3. SV Accounting is virtually the same as what accounting teams do today for individual bonds.
4. Insurers should effectively coordinate with their investment accounting and ETF providers to ensure they are prepared for SV Accounting.
5. Fixed income ETFs provide many of the same capabilities as derivatives, but with simplified accounting.
6. Diversification can be costly for small insurers, but a bond ETF can effectively solve diversification and liquidity issues.
7. ETFs can be used as a placeholder to maintain exposure while an insurer finds “right” bond to hold to maturity.
8. Small insurers can view bond ETFs as a simple way to access exposure and receive favorable RBC treatment.

© 2018, STRATEGIC ASSET ALLIANCE, INC. Document not to be reproduced without the explicit consent of SAA.

Bond ETFs for Small Insurers: Impact and Value

For More Information:

Alton Cogert, CFA
President & CEO
Strategic Asset Alliance
acogert@saai.com

Ilene Kelman, CFA
Regional Director - IGA
Vanguard Group
ilene_kelman@vanguard.com

Why might smaller-sized insurers not be utilizing Bond ETFs as part of their portfolio?

Strategic Asset Alliance: Possibly, this is due to lack of complete familiarity with some of the new NAIC rules on Systematic Accounting and the ability to categorize some ETFs similarly to SVO rated bonds. But, more importantly, it is likely due to what I would call the 'new investment adoption' process. Over the years, we've seen time and again where larger, better resourced insurers, looking for that 'edge' over competitors will take advantage of new and different investments that still fit within their conservative investment philosophy.

We saw it back in the 1980s with CMOs and in the 1990s with CMBS and Equity ETFs. Once the investment is more common with larger companies, many smaller companies then start asking how those investments might fit within their own portfolios. Of course, with fewer resources than their large brethren, it is vital that small companies look outside for independent advice and direction, as all investments have their positives and pitfalls.

Vanguard: Along those same lines, I've recently heard that some insurance accounting departments haven't had a chance to learn about systematic value accounting, which is a key reason for their lack of adoption. That said, insurance accounting systems that are widely used are set up for systematic value accounting, so they can receive the necessary cash flows to easily calculate the ETF's ongoing book value. Also, any insurers that don't use a third-party accounting system can access these files from multiple sources, including our website. Change takes time, but companies gain a full "tool set" by using fixed income ETFs, and systematic value accounting makes these tools fit a lot better from a statutory reporting perspective.

For smaller companies, what impact does systematic value accounting for Bond ETFs have on their portfolio?

SAA: Systematic Value Accounting is designed to provide bond-like accounting results on an insurer's statutory financials. It is an optional accounting treatment, so some insurers will see its benefits while others will take a wait and see approach, if they can indeed afford to wait while their competitors

© 2018, STRATEGIC ASSET ALLIANCE, INC. Document not to be reproduced without the explicit consent of SAA.

For More Information:

Alton Cogert, CFA
President & CEO
Strategic Asset Alliance
acogert@saai.com

Ilene Kelman, CFA
Regional Director - IGA
Vanguard Group
ilene_kelman@vanguard.com

take advantage of this method. Since we have not seen large market interest rate swings since this method became available, it will be interesting to see exactly how the accounting plays out in different rate scenarios versus the more volatile mark to market approach.

Vanguard: I often talk to smaller insurance companies that have a mutual structure and only utilize statutory accounting. For them, systematic value removes the volatility of mark-to-market accounting and provides similar accounting to the rest of the portfolio. As the accounting team becomes comfortable with the methodology, it can make implementation and ongoing administration easier for portfolio managers that want to use ETFs for both strategic and tactical purposes, such as exposure to sectors that are costly or difficult to source or for liquidity.

Are there instances where SV Accounting is a hindrance to smaller insurers?

SAA: All insurers should check with their investment accounting providers to make certain they are prepared for Systematic Value Accounting. It will take some coordination with information from the ETF provider, so make certain the ETF provider can indeed supply the required information.

Vanguard: I think any change may feel like a hindrance at the outset. To alleviate any process difficulties, we built an online tool to publish our daily cash flows to be accessed by any insurance accounting system. On our end, we wanted to make it simple for our clients, but at the insurance company level, they still have to get comfortable with the accounting process. As I mentioned before, the accounting is virtually the same as what the accounting teams do today for individual bonds, and for any clarification, we have easy to follow educational materials available.

Given all the ways that fixed income ETFs can benefit insurance companies, the payoff is definitely worth the minimal education time commitment. For example, most small insurance companies don't use derivatives, primarily because the accounting is so demanding. Fixed income ETFs provide many of the same capabilities as derivatives, but systematic value accounting is a lot simpler and far less demanding. My view is that the "hindrance" is the limited learning curve, but the long-term benefits outweigh any short-term

© 2018, STRATEGIC ASSET ALLIANCE, INC. Document not to be reproduced without the explicit consent of SAA.

For More Information:

Alton Cogert, CFA
President & CEO
Strategic Asset Alliance
acogert@saai.com

Ilene Kelman, CFA
Regional Director - IGA
Vanguard Group
ilene_kelman@vanguard.com

challenge.

If a small insurer were to consider Fixed Income ETFs, where else might they find value outside of the bond treatment?

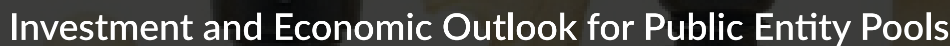
SAA: Both large and small insurers have a diversification problem, but for different reasons. Large insurers usually need to invest in such a large amount of a single issue, it could result in too large an amount versus the size of that issue. For small insurers, diversification can be quite costly, as the investment in any one issue could be so small that implicit transaction costs may easily eat up a good bit of the investment's yield. And, by implicit transaction costs, I would include a larger difference between the bid and offer prices, as well as the difficulty in finding a bond in just the right amount for diversification to be effective. Both these costs also impact the liquidity of the bond portfolio, whereas with a bond ETF these diversification and liquidity issues can be effectively solved.

Vanguard: That's a great point about the diversification. We often see our short, intermediate, and long-term corporate ETFs used to provide additional diversified corporate exposure, or our long duration corporate, government, and blended (government/credit) ETFs used to diversify and extend duration. Also, we frequently see ETFs used as a placeholder, to maintain exposure while a team is looking for the "right" bond to hold to maturity. It has become more difficult to source bonds in the past few years, because banks are holding a lot less inventory. This can make certain sectors costly or difficult to source, especially where an insurer might not have a team of dedicated analysts, like mortgage-backed securities, tax-exempt bonds, long-term corporate bonds, or even emerging market debt. There isn't always a bond readily available in the right quality and maturity that a company feels confident about owning for the next 10–30 years.

Insurance companies can also find value beyond the accounting treatment with a "liquidity sleeve." It's a small percentage of total assets, but it can be easily traded and allows an insurer to maintain full market exposure at all times. Insurance companies use this strategy to manage their tax exposures and for easy access to liquidity, while minimizing cash drag.

Finally, we often see our NAIC-rated Emerging Markets Government Bond

© 2018, STRATEGIC ASSET ALLIANCE, INC. Document not to be reproduced without the explicit consent of SAA.



For More Information:

Alton Cogert, CFA
President & CEO
Strategic Asset Alliance
acogert@saai.com

Ilene Kelman, CFA
Regional Director - IGA
Vanguard Group
ilene_kelman@vanguard.com

ETF and Total International Bond ETF used strategically in surplus portfolios to add income, diversification, and asset class exposure, while receiving favorable capital treatment. For a smaller insurance company, a diversified, separate account may be a lot more expensive than buying an ETF. As an additional benefit, ETFs tend to be much more liquid than individual bonds, primarily due to the large secondary market, so they are a great option when it feels like we're well into a credit cycle. While there may be a feeling that the credit cycle is turning, it's very hard to predict exactly when it will happen. In the meantime, nobody wants to leave too much on the table.

Source: Strategic Asset Alliance, Vanguard Institutional Investor Group
The information contained herein has been obtained from sources believed to be reliable, but the accuracy of information cannot be guaranteed.

For more information on Vanguard funds or ETFs, visit institutional.vanguard.com or call 800-523-1036 to obtain a prospectus or, if available, a summary prospectus. Investment objectives, risks, charges, expenses, and other important information are contained in the prospectus; read and consider it carefully before investing.

Vanguard ETF Shares are not redeemable with the issuing Fund other than in very large aggregations worth millions of dollars. Instead, investors must buy and sell Vanguard ETF Shares in the secondary market and hold those shares in a brokerage account. In doing so, the investor may incur brokerage commissions and may pay more than net asset value when buying and receive less than net asset value when selling.

Bond funds are subject to interest rate risk, which is the chance bond prices overall will decline because of rising interest rates, and credit risk, which is the chance a bond issuer will fail to pay interest and principal in a timely manner or that negative perceptions of the issuer's ability to make such payments will cause the price of that bond to decline.

Diversification does not ensure a profit or protect against a loss.

Stocks of companies based in emerging markets are subject to national and regional political and economic risks and to the risk of currency fluctuations. These risks are especially high in emerging markets.

All investing is subject to risk, including possible loss of principal.

Investments in stocks or bonds issued by non-U.S. companies are subject to risks including country/regional risk and currency risk.

© 2018, STRATEGIC ASSET ALLIANCE, INC. Document not to be reproduced without the explicit consent of SAA.