Risk Pool Investment Outlook: 2021

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Dan Smereck, Managing Director, SAA, presented, “Risk Pool Investment Outlook: 2021” to explain how pools of different types are dealing with the uncertain investment environment and how today’s economy indicates where markets might be headed.

Dan reviewed a blind peer analysis of pooling client portfolios to help explain how investments are being impacted by current events. Attendees also gained initial insight into the practice of environmental, social and governance investing (i.e., ESG investing) and other practices worth monitoring.

This webinar was provided by AGRiP to help members remain current on key operational areas, explore hot topics, and evaluate trends.

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Below are highlights from the webinar:

How Were Markets Impacted in 2020?

Fixed Income:

There are four distinct bond markets that represent where pools, and frankly the insurance industry, generally invest the bulk of their investment portfolios:

- *Aggregate Bond*

  This bond market represents all of the investment-grade fixed income options risk pools can invest in. Investment-grade meaning any bond that’s rated between BBB to AAA.

- *Intermediate Government/Credit*

  This bond market represents U.S. Treasuries, government-related and investment grade U.S. corporate securities that have a maturity between under 10 years.

- *High-Yield Bond*

  High-Yield bonds are below investment-grade and carry a higher risk of default; however, these bonds pay a higher yield than investment-grade bonds

- *U.S. Treasury*

  Treasury bonds are fixed income securities issued by the U.S. Department of Treasury.

In March and April, as whispers of a pandemic began and then manifested, you can see the treasury market starting to reflect investors' appetite to stay away from risk. Thus, their market values went up and yields went down.

At the same time, the aggregate and intermediate markets took a dip and then sharply reversed themselves. The high-yield market showed the greatest 'shock' and dropped nearly 20% in March/April. However, it has come back up since.

For risk pools and their fixed income portfolio, the important takeaway is: even though there's been rough spots, especially if you're invested in high-yield, it's all come back on the heels of potential euphoria and optimism as it relates to the pandemic.

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Equities:

Overall, the equity markets dipped at the start of the pandemic, but have rebounded greatly with some equity markets being ahead of where they were pre-pandemic.

U.S. Treasury and Credit Yields:

The biggest thing affecting the risk pooling business is that yields are low and it starts with the treasury market.

At the start of the year, many were seeing 1.5% on money held in money market funds or sweep accounts, but fast-forward a few months and that has gone back to 0%.

These declining yields in are going to greatly affect all other fixed income instruments as they are priced off of the treasury curve.

In SAA's view, currently high-yield has a much better risk/return profile in the 'middle' part of the maturity range (i.e. 5-7 years) than investment-grade bonds do.

For risk pools, the important takeaway is: as it relates to yields relative to treasuries, you can still make money, but you have to consider the type of risk that you are willing to take on as an organization, assuming the policy and regulations allow your pool to invest outside of treasuries.

COVID-19 Update

Federal COVID Response:

Depending on the program, there's still trillions of dollars available to be utilized in response to COVID-19. For optimists, there is some hope that Congress can provide some sort of support and relief before they break for the holidays/year.

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Unemployment & Unemployment Insurance:

One major issue we focus on in light of the pandemic is employment. Over the last couple of weeks, a number of articles highlight the increase in people leaving the workforce, whether voluntarily or involuntarily.

We think that trend is going to continue especially in sectors most affected by COVID, such as hospitality or small businesses.

In regards to those utilizing unemployment insurance to help make ends meet, the 2008-09 period had 7.5 million people on some type of insured unemployment program.

In 2020, during the pandemic that number is up to **28 million people**. To put things in perspective, that would represent the entire state population of Texas.

Impact on Federal Debt & Stimulus:

The U.S. currently sits at 130% of Federal Debt-to-GDP. That amount of debt is projected to continue to skyrocket for the long-term future.

However, the cost to finance Federal Debt appears to be declining through 2023 and is projected to have a stable outlook after that, based on the policy the Federal Reserve has continued to broadcast.

Looking ahead to the next 3 to 4 years, both political parties should have the flexibility to afford whatever stimulus is needed to help families, businesses, etc. re-emerge from the COVID-19 lockdowns and its related economic issues.

Risk Pool Investment Peer Analysis

21 Risk Pooling Clients / 40 Portfolios / $5.6B in Assets / As of 9/30/20

Fixed Income Portfolio Book Yield & Duration:

Two very important metrics for a risk pool's fixed income portfolio are Book Yield and Duration. Duration measures the sensitivity of a bond's price relative to interest rate changes. Book Yield indicates the raw earnings power of the portfolio, which is especially important to a risk pool's financial statements and pools that mark-to-market.

Looking at the peer group of pools, the noticeable trend is the higher the duration in your portfolio, the higher your yields tend to be.

Fixed Income Portfolio Sectors:

Across the peer group is a lot of variability as to how the fixed income portfolios are comprised. A lot of these portfolio structures are dependent upon the restrictions in the respective states of each pool and/or the risk tolerance of each pool's investment committee.

Generally, the risk pools that have more exposure and latitude to invest materially in Corporate Bonds & Taxable Municipal Bonds and/or Asset-Backed/Com-

mercial Mortgage-Backed Securities tend to have higher yields and higher earned income relative to pools that are constrained to just Governments & Agencies (or even worse in our opinion – not investing in other asset classes even it is allowed).

<u>**Fixed Income Performance – 1 Year:**</u>

Looking at the fixed income performance for each risk pool (going back 12 months as of 9/30/20), generally longer maturity (duration) portfolios saw much greater total return.

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Clients in the duration range of 3-5 years were up almost 6% on a trailing-year basis. However, it’s important to consider that most of these portfolios have book yields in the 2-3 percent range – displaying how much interest rates have dropped.

For risk pools in that similar range, once we get past November, return on these bonds will naturally decline. The ‘shock’ in interest rates and policy change is most pronounced over the 1-year horizon. If we go back further to 3-years, portfolios in that same range are seeing a total return of about 4.5% instead of 6%.

Yield in the fixed income portfolio represents 95% of what your total returns are going to be. So, if you have a portfolio with a book yield of 2.5 percent, however the 1-year performance is showing a return of 6%, that means at some point returns will come back down to more closely reflect that 2.5%.

<u>**Fixed Income Management Fees:**</u>

Across our risk pool client base, the average and median fees both equal to 11 basis points per year *(or 0.11%)*.

Most of the clients paying below 11 basis points are fairly constrained. Thus, their manager does not manage many assets outside of treasuries & agencies.

The risk pools paying higher than the 11 basis point average are not constrained. Thus, their manager is utilizing the full spectrum of the investment grade markets.

Depending on the size of your risk pool, the one takeaway from this peer comparison is the size of the portfolio does not garner a pricing trend in either direction (increase or decrease).

View Risk Pool Peer Database >>

Risk Asset Allocation – as a % of Surplus/Net Position:

Risk assets are any investment outside of investment-grade fixed income, such as equities or high-yield bonds.

Simply looking at overall risk allocation can be a bit misleading. A more reliable metric is "Risk Assets as a Percentage of Surplus" (aka Net Position), because risk pools use surplus for so many things (i.e. reserves, risk management programs, etc.).

The average range for our risk pooling clients is 20-23% of risk assets as a percentage of surplus.

For risk pools looking to dive into risk assets, we typically target 25% of surplus as a starting point to determine how risk assets can be blended into the portfolio strategy. This should determine how much risk assets will help enhance returns over the long-term and potentially increase investment income during times of low-yield.

Risk Asset Allocation:

When looking at the makeup of the risk asset portfolio, our risk pooling clients are primarily invested in U.S. Equities.

While the risk asset portfolio is mostly U.S. equities, most of the pools have diversified in some capacity to international equities, high-yield bonds, and/or

bank loans. This is not only for diversifying the portfolio, but to also potentially enhance the income element of their risk asset allocation.

Risk Asset Performance:

Over the last year, U.S. Equities were the risk asset class to be in from a performance perspective. Risk pools that only allocated their risk asset portfolio to U.S. equities were well above everyone else.

Pools with more diversified risk asset portfolios had to endure more volatility over the last year, but were still earning income during that time period.

We take more substance in risk asset performance over a longer-term (3-5 year horizon) and look for risk assets to outperform fixed income by 300-500 basis points. When expanding performance for these risk asset portfolios over 3 years, you'll see that performance is much closer to that goal, even outside of just U.S. Equities.

The Quest for Yield

Potential "Switches":

Risk pools have five switches they can look at and tinker with as it relates to finding more yield within the fixed income portfolio:

- Duration
- Credit Quality
- Liquidity
- Structure
- Leverage

Potential Avenues for Diversification:

- High-Quality Corporate Bonds

In our view, diversification is the only free lunch in investing and investment-grade corporates may be a viable option for even constrained risk pools.

In a sample asset allocation for a risk pooling client with a $50 million portfolio, allocating 25% of the portfolio to investment-grade corporate bonds was estimated to add material investment gains over a 10-year period, while also reducing overall portfolio volatility.

- High-Yield Bonds

  Looking at the 10-year return of U.S. Treasuries, U.S. Investment Grade Corporate Bonds, and U.S. High-Yield Bonds, the return volatility of high-yield bonds are not too dissimilar from corporate bond returns.

- Floating-Rate Bank Loans

  Floating Rate Bank Loans, a risk asset class, have almost no duration exposure, yet have a similar yield when compared to high-yield bonds.

Making Sense of the E.S.G. Landscape

Defining the E, S, & G:

E.S.G. investing is becoming more and more prominent as managers and other organizations try to evaluate how “sustainability” factors into their investment decision-making process.

- Environmental

  The easiest for risk pools to define internally and typically highlights the policies towards investing (or divesting) in carbon emissions, energy efficiency, water scarcity, waste management and pollution mitigation.

- Social

  Depending on the values and perspectives of the underlying pools, it can be

harder to define. Common evaluation criteria for investment/divestment include: diversity & workplace policies, labor standards, product safety, customer privacy and community impact.

- Governance

  Much like the “Social” criteria, defining the ‘G’ is very much dependent upon the organization. Common evaluation criteria for investment/divestment include: Board structure & composition, executive compensation, political/lobbying contributions, and any ethical or strategic violations.

ESG Market Size:

In 2016 the global market size for assets considered “ESG” was $22 trillion. In 2018 that number reached $30 trillion.

Early estimates anticipate that the global market size for assets considered “ESG” will be north of **$40 trillion for 2020**, and will most likely be closer to **$50 trillion in global ESG assets**. For reference, the U.S. Equity market is roughly $30 trillion in total.

View SAA’s Risk Pooling Case Studies >>

Source: Strategic Asset Alliance
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