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Sent: Tuesday, December 19, 2006 10:46 AM  
To: Sharon Atkins  
Subject: Three Major Pitfalls of Insurer Investing: #3 - Conflicts of Interest

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\*\*Three Major Pitfalls of Insurance Investing:  
\*\*\*#3 - Conflicts of Interest  
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Also in this issue:  
\*\*SAA named top consultant in market share  
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If you have read this newsletter over the years, you know that there are indeed many more than three major pitfalls facing investing for insurance companies.

However, in this issue, we will focus on the third of the three major pitfalls that are so general in nature and pervasive that most insurers probably have not completely addressed them. Virtually all of us are subject to these problems in various forms and in various areas.

From our earlier newsletters, you will remember the other two major pitfalls are Corporate Governance and the Active Management Problem. If you would like copies of those newsletters, please go to <http://saai.com/publications/newsletters.php>.

#3 - Conflicts of Interest

The dictionary defines 'Conflict of Interest' as a "clash between requirements or implications."

In practice, this clash between requirements or implications can be seen in numerous relationships within the investment process. Some of these conflicts are readily apparent, so much so that the law has deemed disclosure a requirement. However, many of these conflicts are not as easy to see and, thus, can be more pernicious than those that are disclosed.

We will not outline obvious conflicts, but will attempt to outline a few conflicts we see in the investment process that you may not be considering.

Back when credit problems were the issue of the day (and they will be again as the economy slows), we saw numerous instances of investment managers more focused on their performance than on the best interests of their clients. We have many stories of managers who refused to sell newly below investment grade credits (and, thus, newly outside of investment guidelines) because they realized that taking a 'hit' to principal could not be readily offset by gains in principal (unlike in the equity markets, investment grade fixed income limits our 'gains' to simply recouping face value). So, these managers talked on and on about the fact that these credits would eventually be upgraded and not to be concerned. Of course, it did not help that some of these problem credits were named Enron or Worldcom. However, the basic conflict remains: The manager wants to perform well in order to maintain your business, but this drive for performance could actually be against the risk parameters set down by the Board.

A less than obvious conflict of interest is found at insurers who rely primarily on their investment manager(s) for strategic asset allocation analyses, including DFA and ALM. Most prevalently, there are the fixed income managers who perform analyses that recommend a decrease in equity allocation. Although, this may indeed be the correct conclusion, there is no way to initially separate the fixed income manager's bias to obtaining more assets from his analytical conclusion. Only by seeking out unbiased advice on the issue can the insurer be certain that the conclusion is worthwhile. Alas, within the universe of insurers with insurance specialization, it is their analytical capabilities that are used as a competitive weapon versus their peers. However, it is just those capabilities that have the built in conflict of interest.

Another conflict of interest is found where managers and consultants say that their fee will be reduced (or eliminated) with the use of 'soft dollars'. This has immediate appeal to insurers who want to make their income statement 'geography' look better, as the cost of services is imbedded in the cost of securities (an asset) and not shown as an expense. Without discussing the potential for a dubious calculation methodology for such 'soft dollars', the conflict here is primarily one that provides an incentive to trade over the best interests of the insurer. More trades mean more soft dollars, and it is suddenly easier to justify a premium fee. Also, this trading may run afoul of the latest Other Than Temporary Impairment interpretations and result in negative unintended consequences.

Related to this, though not directly, are the built in conflicts of those who manage and market hedge funds as well as broker/dealer firms who laughably don the mantle of 'unbiased' consultants or managers.

Finally, we do not want to leave the issue of conflicts of interest, without pointing at our own industry of investment consultants. We have stories of consultants who appear to be focused on pushing as many changes as possible in custodians and managers, despite the best interests of the insurer. Of course, with all this added complexity, the client grows more and more dependent upon the consultant to sort things out. Could these changes be made in a simpler format? Could the old 80/20 rule be adhered to with more cost effective results? Upon review, we have seen the answers to both these questions to be a resounding 'yes', while the insurer's best interests take precedence.

Thus, if your consultant starts recommending changes, your question should include 'What is the cost/benefit from this change?' and 'Is there a simpler and cheaper way to achieve the same results?'

In addition, since the largest consultants were recently revealed by the SEC to have their own admitted conflicts of interest with the managers they recommend, your other questions should probe such relationships in detail.

These are just a few of the conflicts of interest we note in the investment process of insurers. There are many more and it is up to all of us to be aware of them, understand them and manage them properly.

As always, your comments and questions are much appreciated.

And, on behalf of everyone at SAA, I sincerely hope that you and your family have a Happy Holiday Season!

Thank you.

Best Regards,

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\*\*SAA named top consultant in market share

We typically do not like to 'toot our own horn', but I thought you would be interested in this. Thank you to all of our clients and friends, who truly deserve the credit.

According to the recently released results of the 2006 Survey of Insurance Companies' Investment Management Practices, Strategic Asset Alliance leads in insurance investment consultant market share, both for manager search / evaluation and for other services provided to insurance companies.

The Survey was conducted by Eager, Davis & Homes, of Louisville, KY.

"We congratulate Strategic Asset Alliance on this achievement," commented David Holmes, Partner Eager, Davis & Holmes. "Over 150 insurance companies representing over \$1 trillion in assets, participated in our survey."

The partners of Eager, Davis & Holmes are trusted advisors to institutional investment managers. Periodically, since 1991, they survey insurance company investment practices. For more information on how to obtain a copy of the completed survey results, contact David Holmes at [dholmes@eagerdavisholmes.com](mailto:dholmes@eagerdavisholmes.com).

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