Investment and Economic Outlook for Public Entity Pools

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Transcript of material presented through the Association of Governmental Risk Pools

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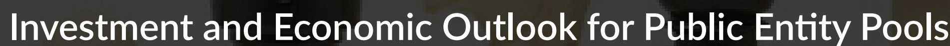

Investment and Economic Outlook for Public Entity Pools

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This is a transcript of the December 2018 webinar provided by AGRiP to its membership, featuring Strategic Asset Alliance resources and expertise. AGRiP produces and delivers at least four webinars annually to help members remain current on key operational areas, explore hot topics, and evaluate trends.

Dan Smereck, Managing Director, SAA, presented, "Investment and Economic Outlook for Public Entity Pools" to review key investment issues and challenges addressed by small and large pools alike; including a blind peer analysis of pooling clients across multiple portfolios.

Copies of the recording and presentation materials can be found here.

Here are highlights from the webinar:

How Did Last Year Compare to Prior Years?

What you'll see is a sea of green (gains) for 2016 and 2017, but this year you see a split between gains and losses. With rates rising across the market place and the Fed's policy, you see a contrast between how the markets have performed for the last couple of years.

This is the first time in a couple of years we have seen fixed income returns in the negative, which is due to rising rates.

Did Risk-Taking Payoff Last Year?

Most of the Pools we have the pleasure of working with can invest in assets outside of Treasuries & Agencies. (Although, some Pools we work with are fully restricted). If you didn't take risk outside of investing in high-quality bonds, were you compensated for the last 12 months (ending in November)?

Most asset classes had negative returns or were only up slightly, except for U.S. Equity Markets which was up almost 6%. International stocks were the biggest loser during that period at around -7.5%.

Sharpe Ratio is a metric that asks, "were we compensated for taking risk by investing in any of these asset classes, as compared to only owning 30-Day Treasury Bills?" In the past year, outside of equities, the answer was a resounding, "No."

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How Did We Fare in the Past Three Years?

Going back three years, things look a lot different. Overall, if you invested outside of treasuries, then you've had a pretty good three-year run by investing outside of investment grade bonds (assuming your Pool had the flexibility to do so).

Did Risk-Taking Payoff the Last Three Years?

The answer was a resounding, "Yes." U.S. Equities were up almost 12% the last three years. Looking at the Sharpe Ratio, effectively everybody got paid for taking risk. What we saw in some organizations, whether they were commercial insurers or risk pools, they considered taking on more risk, because they could earn more.

> **"What we always keep an eye on for our commercial and Pooling clients alike:**
>
> **Managing for Yield.**

Core Fixed Income Outlook

Core fixed income is the lion's share of how Pools are investing to support reserves and liabilities, regardless of whether your Pool is restricted to Governments & Agencies or can fully invest in other asset classes.

Looking at the U.S. Bond Market as compared to the Global Bond Market (which includes the U.S.) in 2013, the difference was 0.37%. Going to the end of November 2018, that difference is now 1.35%. Translated another way, foreign investors could invest in the U.S. (assuming they hedged their currency exposure effectively) and potentially earn 1.35% more by investing in the U.S. Over time that has put downward pressure on longer-term rates.

Looking at the 2yr-10yr spread, the difference in 2013 was 264.8 basis points. In 2018, that has collapsed to a mere 20 basis points. So, you're not getting paid for going out longer and taking on treasury risk. The Fed is very much in-tune to this with the policy that's currently in place.

The Yin & Yang of Fixed Income Investing: Price Change vs. Yield

What we always keep an eye on for our commercial and Pooling clients alike: managing for yield.

Why is that? If you look over the past three decades and ask, "how much of

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my total return did I earn, because of yield?" – the answer is that almost all of it is yield.

From 1990-99, 96.75% of return from investing in bonds was due to the yield embedded in your portfolio. The small contribution from price change was mostly due to the fact that yields were generally falling. From 2000-09 same story (90.64% return due to yield), but now the relationship has changed and price change is now negatively contributing to return for bonds. As of the end of November 2018, all of your return has been due to yield.

Different Managers, Same Levers for Yield
Whether you manage your Pool's portfolio internally or have outsourced it, it doesn't matter what these managers say - there are only so many levers to pull when dealing with yield in your portfolio. These are the top-eight levers you can pull to manage your yield and risk exposure in your fixed income portfolio:

1. Duration
2. Convexity: *How sensitive is duration to changes in interest rates?*
3. Yield Curve: *Where you invest along the curve - are you short or long?*
4. Sectors: *Where are we invested?*
5. Security Selection
6. Quality:
7. Liquidity: *If I need to sell something and I'm carrying it on my books at "100," can I sell it close to "100?"*
8. Structure: *Be mindful how cashflows get allocated to the investors.*

> **"It doesn't matter what these managers say:**
>
> **There are only so many levers to pull when dealing with yield in your portfolio.**

Why Consider Risk Assets (if you can)?
A board member looking at the range of volatility in a one-year period for equities (going back the last 67 years) might say, "wow! if I invest in equities there's a chance I might lose 39% in the worst possible year?"

Yes, that did happen, however if you hold these products for five-year periods then that -39% event disappears (from -39% to -3%). If you look even further, which is typical of risk pools, you see negligible downside risk in the 10- and 20-year rolling periods. That's a disconnect that can occur when

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we talk about asset allocation with our clients. We have clients that are, and rightfully so, concerned about the one- or two-year exposure. They ask, "can we endure the one-year, worst case scenario when thinking about the long-term benefits." In all scenarios, both outlooks need to be considered when potentially investing in risk assets.

How Are Other Pools Investing?

We've talked about fixed income and risk assets, now let's see how they are put into action across SAA's Pooling clients. This blind Pool Peer Analysis (as of 9/30/18) represents 18 pooling clients across 25 portfolios and totals $3B in assets. The mix is 81/19, so we spend most of our time in core fixed income, but have about $500M in risk assets.

Peer Comparison: Fixed Income Portfolios

Duration:

One of the key fixed income metrics we look at, in a summary-type fashion, is duration. As a rule-of-thumb: you take duration and if the Fed raises rates 100 basis points, and your duration is four, then you would to lose 4 percentage points of value. Most of our Pooling clients are in the 4-4.5 duration range, with book yields(%) ranging from 2.7-2.8. There are some outliers due to line of business, but most portfolios are intermediate in duration. The key is, regardless of where your Pool is, there is upward pressure on those yields as rates continue to get higher.

Allocation:

The typical Pool portfolios we see with more diversification into asset classes outside of treasuries and agencies (when it's available to them) tend to have better risk-adjusted profiles over time – both on a total return-basis and (more importantly) the quality of their yield.

When looking at it by credit exposure, even though across our Pooling clients there is a disparity between allocations to corporates, ABS, CMBS, etc., the quality is still very high. We are taking on credit risk, but not as much as the allocation overview might indicate. A lot of those instruments are very high-quality rated.

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Something to keep in mind: you must always be very careful when taking credit risk these days and have a manager that's doing the actual work in understanding the actual underlying risk, as opposed to relying on the rating agencies.

Peer Comparison: Risk Asset Portfolios

When we first talk to Pools, often they look at risk assets from the perspective of, "how much of our total portfolio is invested in risk assets?" We have some Pooling clients that have a significant portion in risk assets, with a median being 18.7% in risk assets and 15.6% of the portfolio in risk assets averaged across the Pools in this analysis. It's important to note that those median and average numbers are somewhat skewed as three of the pooing organizations within the peer group do not invest in riskier assets; either due to restrictions or by choice.

"What's the type of investment you consider when getting into riskier assets?

Surplus

Often times risk allocation can be a bit misleading, because what we're really interested in is, "how much of your surplus is exposed to investment risk?" Thus, the metric we tend to place more faith in when looking at how Pools are allocated is "Percentage of Surplus" (aka Net Position).

Why do we look at it this way?

Your surplus has many demands: from your underwriting, reserving, risk management, and what the legislature is presumptively going to push down on you (depending on the state you're in). With all those different pressures on your surplus and its potential uses in your member's best interest, investments are just one component of that.

Some clients have found, for their Pool and type of book they have, that investing more outside of core fixed income has worked out well for them from a total-return and diversification point-of-view.

That finding is represented when viewing these Pool portfolios through this metric, with even a few clients having north of 50% of their surplus invested in risk assets; with the median at 26.8% and average at 25.4%. We raise this, because Pools often ask SAA, "what's the type of investment you consider when getting into riskier assets?"

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Generally, we like to start at 25% of surplus to start the discussion, so we can show what type of volatility would be introduced to your surplus.

> **“Manager Fees: Anybody north of 25 basis points –**
>
> **You need to get on the phone.**

Allocation
How are these Pools allocating risk assets? Across the board they are allocated very differently, but there's one common theme: most Pools understand and are comfortable with outside of bonds are U.S. Equities. U.S. Equities are the lion's share, but after that it's International Equities, then High-Yield Bonds. We're certainly aware of alternatives, but typically in practice they are not implemented for Pools or commercial carriers.

With Pools it's about finding how comfortable they are with their equity exposure or are there other lower-volatility risk assets (i.e. high-yield bonds, bank loans, etc.) that may fit into the risk asset allocation.

How Are Other Pooling Portfolios Performing?

Peer Comparison: Fixed Income Performance

How were these Pool's fixed income portfolio performing in the last year? As of 9/30/18, it's been rough. Why? Rates have been rising, so we've seen unrealized gains go away; at worst they have turned into unrealized losses. It's been rough for the markets also, but you're still earning income during this period, because you're collecting that coupon.

There is one Pool in the positive and how is that? They're a health trust and they own a lot of floating rate securities that are very short. As rates have risen, they've benefited from it.

Peer Comparison: Fixed Income Management Fees

Anybody north of 25 basis points – you need to get on the phone. Generally speaking, we continue to be pleasantly surprised at how fixed income management fees have continued to come down. A highlight for Pools, both small and large, there isn't much slope in the 12-15 basis point fee range.

Even if you're a smaller Pool, a lot of these fee savings are available to you. This analysis represents 12 managers across the U.S. of various sizes, but the

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fees are all very comparable.

Peer Comparison: Risk Asset Performance

Pools that had a higher exposure to U.S. Equities had a higher return relative to one another in the past year (as of 9/30/18). Looking at the three-year period and it's the same trend. Looking at it from the total portfolio, in the past year Pools that invested in risk assets outperformed simply investing in bonds. Over the three-year period it's even starker.

In general, if you have the capacity, you will have a better turn profile over time by diversifying into some of these assets, but the past year has show to be a very good time to be in those riskier asset classes.

Looking Ahead

Risk Management

Risks we are currently unaware of or underestimate – a prime example of this is the presumptive coverage issues that are flowing through the legislatures across the U.S. What does this mean? It ultimately means the members are going to pay more, but in the interim for Pools that price this or for their reinsurance partners – what do Pools need to do to manage this?

World Debt

Rate increases propose a challenge, because it makes the federal debt cost more than it has in quite some time. Worth keeping an eye on, because leverage works negatively and positively. Global debt will have to be dealt with in one way or another and amplifies the potential of where yields could go.

Global Demographics

The developed world is getting older, which means the "rich" world is getting older. What does that mean for the different sectors? How are the demographics working for or against us? For example, China with their one-child policy may get old before they get rich. What I mean by that is, they may be the largest economy in the world, but on a per capita basis, they aren't anywhere near the U.S.

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