



STRATEGIC ASSET ALLIANCE  
THE INSURANCE INVESTMENT SPECIALIST



## Risk Assets Primer for Government Risk Pools

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## Risk Assets Primer for Government Risk Pools

**By design, risk pooling portfolios are never fully diversified.**

**Most risk pools allocate their portfolios heavily towards investment-grade fixed income to account for policy holder obligations, reserves and sufficient risk capital.**

With interest rates at or near all-time lows, investing in “Risk Assets” can be a viable option for risk pools looking for ways to increase yields to support the underlying business.

### What are “Risk Assets?”

Risk assets are any investment outside of investment-grade fixed income.

These assets provide greater potential yields, but with greater risk of loss and/or return volatility. Risk assets may also potentially help risk pools maximize portfolio diversification.

### What “Risk Assets” are Risk Pools Utilizing?

#### High-Yield Bonds:

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.

#### Common Stock (or Equities):

Common stocks are securities that represent ownership in a corporation, with the value of the stock being tied to corporate growth/stock market. Common stocks typically offer greater returns than bonds, but carry higher risk of loss, as well as increased return volatility.

#### Preferred Stock:

Similar to common stock, however the value of a preferred stock is tied to interest rates and not the state of the stock market. Unlike common stock, preferred shareholders have no voice in the future of the company.

#### Certain Long-Term Schedule Ba Investments\*:

Schedule Ba investments constitute several “other” investments types, but includes risk assets utilized by insurers and risk pools. These assets are more yield-oriented, but come with greater risk of loss, volatility & liquidity risk.

#### Below Investment-Grade Ratings:

S&P: Below “BBB”

Moody’s: Below “Baa”

NAIC: Bonds Rated 3 to 6

#### Schedule Ba Risk Assets:

Collateralized Loans

Bank Loans

Developed and Emerging Markets

Bank Loans

Real Estate

Sovereign/Global Bonds

*\*Many Schedule Ba investments are categorized as “alternative investments,” such as hedge funds and private equity. SAA is, for the most part, not a proponent of alternatives such as hedge funds and private equity for risk pools due to their high level of fees, potential lack of liquidity/ transparency, impact to capital ratios, and agency problems.*





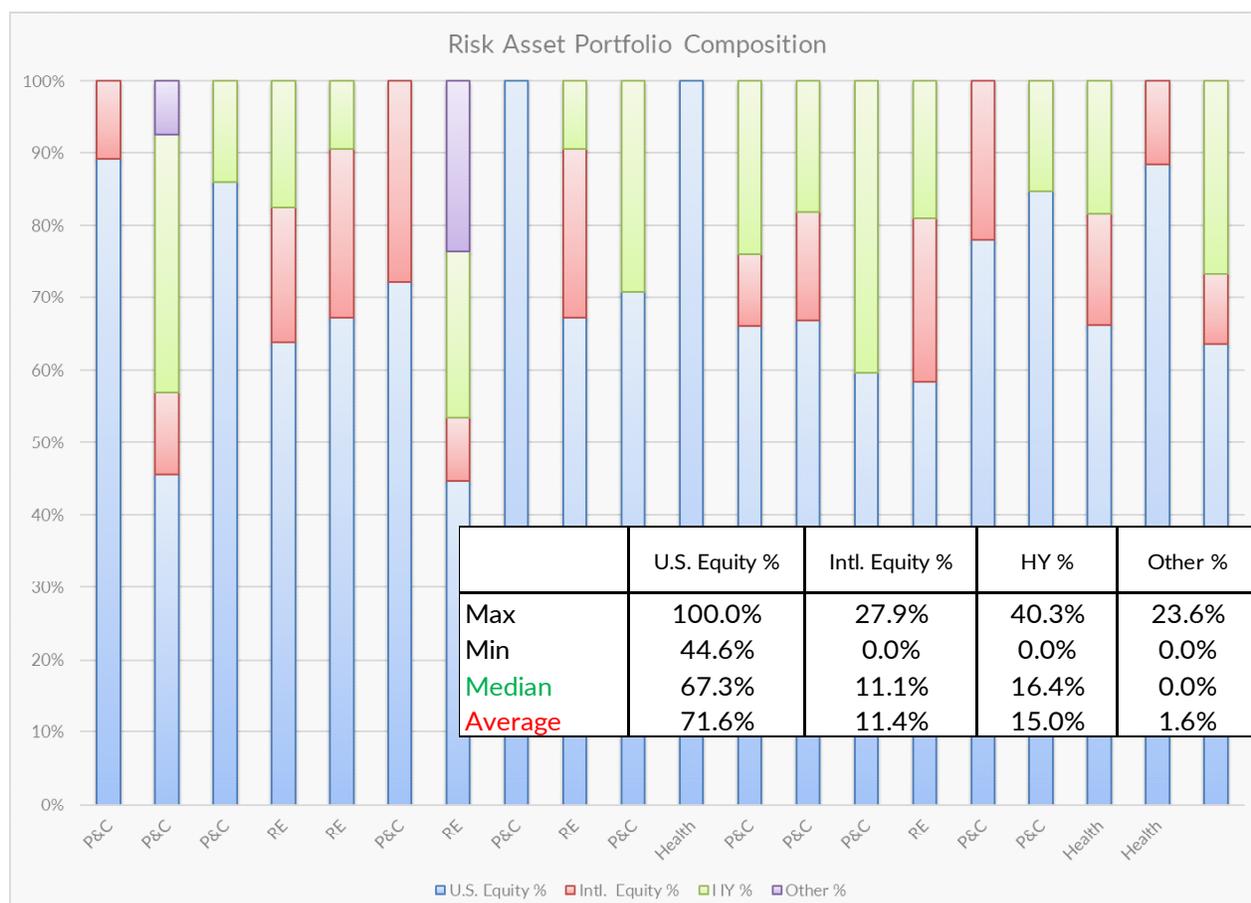
# Risk Assets Primer for Government Risk Pools

## How Are Other Risk Pools Utilizing Risk Assets?

Across SAA’s proprietary risk pool peer group\*, risk pools are allocated very differently, but there’s one common theme: **most Pools understand and are comfortable with U.S. Equities (Common Stock).**

U.S. Equities are the lion’s share, followed by International Equities and High-Yield Bonds.

Some SAA Pooling clients have a significant portion in risk assets, with a median being 15.4% in risk assets and 14.9% of the portfolio in risk assets averaged across the Pooling entities.



\*As of 6.30.19 - Peer Group includes 18 SAA Risk Pooling Clients with 23 portfolios and ~\$3.6B in assets. Median and average allocations include two pools that do not invest in riskier assets; either due to restrictions or by choice.





# Risk Assets Primer for Government Risk Pools

## Other Key Factors

### Relation to Surplus

Simply looking at overall risk allocation can be a bit misleading. What we're really interested in is, "how much of your surplus is exposed to investment risk?" A more reliable metric is **"Risk Assets as a Percentage of Surplus"** (aka *Net Position*).

A strong surplus position may allow your company to take on additional risk. In turn, increasing the amount of risk assets relative to surplus should correspond with an increase in expected return. However, leveraging too much risk relative to your surplus that is not properly compensated can be detrimental to your investment portfolio.

### Understanding Regulations

Regulations tend to act as constraints on potential allocations to certain asset classes or as limiting factors on those allocations. Government Risk Pools are often restricted to only investing in Treasuries & Agencies. For risk pools where regulations only permit them to invest in Treasuries & Agencies or investment-grade bonds, exposure to risk assets can be achieved through the entity's captive insurance portfolio.

Thus, a review of the applicable regulatory framework is an integral part of any asset allocation (and investment policy) development. The best asset allocation framework is useless if it cannot be implemented due to regulatory restrictions.

### Board/Committee Risk Tolerance

The risk tolerance of the Board, staff and Investment Committee is important to the development of a suitable investment program. Risk tolerance cannot be determined via a canned survey completed by the committee.

Various scenarios based upon different investment structures can gauge the impact of these scenarios on key investment and company metrics. This can determine how much risk the Committee and Management are willing to take on the investment side given objectives and constraints on the business side (i.e. *surplus levels, profitability, ratings, regulatory concerns, etc.*).

SAA finds scenario-based impact analyses more helpful in enabling the Board and Management to identify and adopt an appropriate risk posture and asset allocation framework.

### Why Risk Assets to Surplus?

Your surplus has many demands: underwriting, reserving, risk management, state regulations, etc.

Investments are just one component as it relates to how your surplus can be utilized in your organization's best interest.

**Example:** if we showed a 20% allocation to equities and the stock market dropped by 40%, could the company sustain the resulting negative impact to surplus?

*Could the company sustain the result of its auditors requiring a write down of assets and the resulting OTTI charge to earnings?*

*Does the company need to generate significant income from its investments to supplement potential operating earnings?*





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## Getting Started / Rethinking Current Allocation

**Given government risk pools take on risk as part of their core business, it is critical to balance the risk within the investment portfolio to that within the overall business.**

In general, if an organization takes on more operating risk (*more business leverage – i.e. higher premiums/surplus or a focus on growth vs. profitability*), it may be necessary to reduce the risk on the investment side; especially within the risk asset category. Conversely, a strong surplus position may allow for additional risk.

The higher an organization's allocation to more volatile risk assets, the more volatile its surplus level will be. If your company is looking to modify its risk asset allocation, it is important to model various asset allocation combinations; examining the volatility of surplus and worst-case drawdown profile of various assets and their impact on surplus.

A general rule-of-thumb is to begin modeling at 25% risk assets-to-surplus, to introduce what type of volatility would be introduced to your surplus. From there, your risk pool can conduct further testing and discussion, in order to determine what your investment committee is most comfortable with and what risk assets may be the most appropriate fit.

## About Strategic Asset Alliance

**SAA is an independent investment consulting firm that works exclusively with risk pools and insurance companies.** Founded in 1994 by our President Alton Cogert, our experience and focus enables us to help our clients improve their investment process and enhance the value added by their portfolios which are critical components of their business.

**We provide insurers and pools with independent investment consulting services** to aid their board members and senior executives in meeting fiduciary responsibilities, along with strengthening their investment program.

**Our consultants are former senior investment executives at insurers** and bring broad, deep expertise across the various lines of business. We have also worked with Pooling organizations for more than 15 years. We combine a knowledge of investments with an understanding of the insurance and pooling businesses.

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