Selecting and Monitoring Investment Manager(s)

USA RISK GROUP CONFERENCE 2012

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Session Objectives

- Learn how to properly and efficiently select a "Best Fit" Insurance Asset Manager for your captive.
- Determine the elements of investment plan design that need to be completed prior to the manager search process.
- How to construct an appropriate "consideration set" of managers.
- Measuring results.

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Are you ready to pick an investment manager?

1. Do you have assets that need to support liabilities/claims payments?

Investment Plan Design Elements

2. Do you have an Investment Policy Statement (IPS)?
3. Do you have a Strategic Asset Allocation?
4. Do you have Investment Guidelines?
5. Have you designed Performance Benchmarks?
6. Do you have an Actuarial Report and Tax/Accounting Guidance?

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Investment Manager Selection

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Pitfalls to avoid at the start

When a Captive is deciding on which investment managers to evaluate, these are usually worth skipping:

- their brother-in-law, the broker
- the guy who handles the board members' personal account
- the insurer's pension/401k investment manager
- the most conveniently located manager
- the "one stop shop for all your financial needs" manager
- the firm that provides the fanciest reports and seems to have "decent" performance
- And do not necessarily include the firm(s) mentioned when the question "who do you know who does this business" is asked

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Insurance Asset Management

…requires a unique skill set and investment process

Institutional Investment Managers

- Investment process is designed for a "Total Return" objective
- There are usually no tax considerations when trading securities
- Risk budget is allocated uniformly across the portfolio
- Long-term bond portfolios are seldom constructed around liabilities (LDI)
- Regulatory and accounting considerations are minimal on a comparative basis

Insurance Asset Managers

- Investment process is primarily designed for an "Income Maximization" objective
- Most contemplated transactions are evaluated on an after tax basis
- Risk budget is apportioned across the liquidity, reserve, and surplus portfolios
- Reserve portfolios are structured to match anticipated claims payout patterns and the overall liability duration (ALM)
- Regulatory and accounting considerations may sometimes override investment considerations in security selection

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The Manager Selection Process

Four Steps to a "Best Fit" Manager

1. Evaluate the universe of investment managers
2. Screen to determine the "Consideration Set"
   - Qualitative and Quantitative analysis
3. Scrutinize finalists
4. Check references and industry reputation

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Qualitative and quantitative decision criteria

What's important to Captives ?

Service

- Receiving an appropriate level of high quality service for their account
- Ensuring that their account is a "good fit" in the manager's current book of business
- Ensuring that reporting meets the requirement of the captive and their captive management firm

Performance

- Protecting principal while earning a competitive risk-adjusted return
- Enjoying the ride!

Fees

- Paying an institutional fee rate
- Paying a competitive fee based upon the unique servicing requirements of their account

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Manager selection criterion
....the professional method

- **Philosophy**
  - “Total Return” or “Yield Maximization”
  - Active, passive or blended management
- **Process**
  - Top down or bottom up
  - Alpha attribution: duration, yield curve, sector, security selection
  - Style analysis
  - Tax efficiency
- **Performance**
  - MPT Statistical assessment (Risk-adjusted return analysis)
  - After-tax performance
  - Adherence to guidelines
  - Universe comparison
- **Personnel**
  - Insurance asset management experience
  - Insurance regulatory, tax and accounting expertise
  - Insurance Accounting and reporting capabilities
- **Client-specific criteria**
  - Execution of policy objective & adherence to guidelines and regulations
  - Fees/Value for service
  - Portfolio tax liability management
  - Client service and other administrative responsibilities
  - Accounting & Reporting efficacy
  - Overall relationship efficiency

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Evaluate the universe of investment managers

- **Data Sources**: eVestment Alliance, PSN, Wilshire, Morningstar, etc.
- **Recommendations from advisors**
- **Determine Insurance Expertise**
  - **Separate the Insurance Asset Managers from the Investment Managers eliminating:**
    - Institution managers primarily focused on pension, 401k, endowment and foundation or public funds markets
    - Wealth management or retail focused firms
- **The definitive differentiators**
  - Systems that optimize asset allocations subject to the insurer's liability structure
  - Demonstrated expertise in Asset Liability Management (ALM)

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Selecting the "Consideration Set"

How should you determine which Insurance Asset Managers to consider ?

Qualitative Criterion

- Insurance market focus
- Market segment
- Company size…target client size
- AUM Composition/Asset type

Quantitative Criterion

- Performance (total return composite or risk-adjusted after-tax)
- Fees

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Evaluating the "Consideration Set"

How to pick from the finalists

- Marketing materials and/or demonstrated interest
- Request for Proposal (RFP)
- Presentations
  - In-person
  - Webex/phone etc.

Do you know the right questions to ask?
Can you differentiate between managers and their styles?
Can you properly assess performance?

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Investment Manager Assessment

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Sample Bond Managers Performance

Period	1 YR.	3 YR.	5 YR.	Duration
BENCHMARK*	**5.8**	**5.65**	**5.87**	**3.97**
MANAGERS				
A	5.84	6.96	5.88	4.03
B	6.47	6.26	5.98	N/A
C	5.24	9.74	7.45	3.86
D	5.39	5.97	6.32	3.91
E	5.47	5.72	6.26	3.88
F	5.54	6.27	6.32	3.34
G	6.53	6.86	6.97	4.2
H	5.43	5.64	4.39	N/A
I	4.2	5.38	4.98	3.19

*BARCLAY'S CAPITAL INTERMEDIATE GOV/CREDIT
Data Through 12/30/11

Quantitative manager selection criterion
....the professional method

Performance vs. benchmark (rolling YTD, one, three, five year periods)

Modern Portfolio Theory (MPT) statistical evaluation

- **Alpha** –measures managers risk adjusted performance
- **Beta**– measures manager’s systemic risk
- **R-squared** – comparison measurement of managers returns to market index
- **Standard deviation** –measures manager’s return dispersion or variance
- **Tracking error** –measures how closely manager tracks index returns
- **Sharpe ratio** –measures manager’s excess return over risk – free rate of return
- **Sortino ratio** – Sharpe ratio refinement which differentiates harmful volatility from volatility in general by replacing standard deviation with downside deviation in the denominator
- **Up-market capture ratio** –measures manager’s performance in up markets relative to index
- **Down-market capture ratio** –opposite of up-market capture ratio
- **Batting average** –measures manager’s ability to meet or beat market consistently
- And many additional statistics measuring risk adjusted performance

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Measuring a Manager's Performance
....the professional method

Return analysis

- Performance vs. Benchmark
- Risk-adjusted performance
- Tax efficiency
- Net of fees
- Universe comparison

Compliance analysis

- Domicile regulations
- Investment policy
- Investment guidelines

Overall Program Efficacy

- Meets or does not meet expectations (returns, risk, communications, etc)
- Overall comfort level
- Plan revisions?

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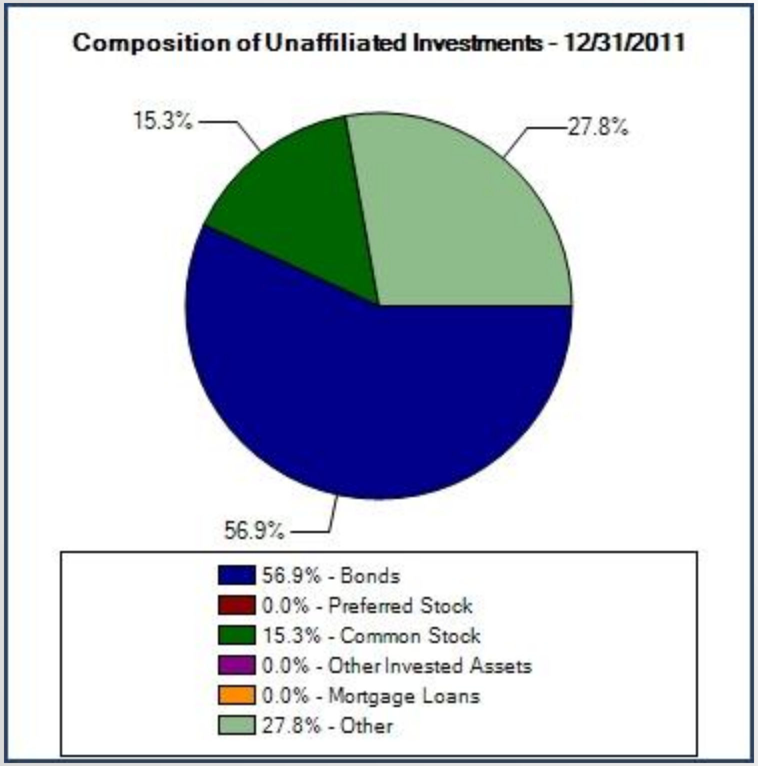
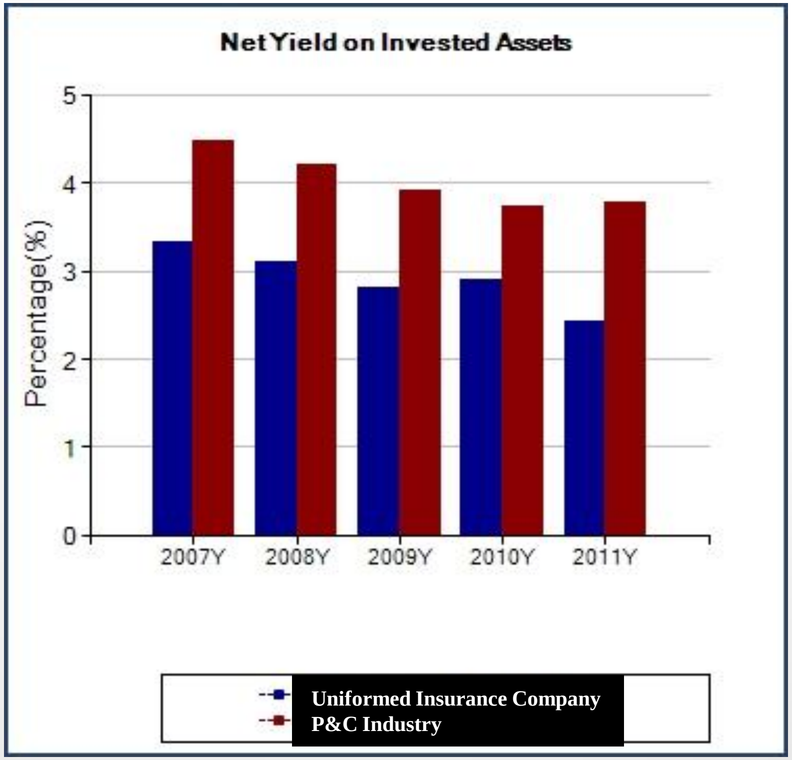
Case Study: Uninformed Insurance Company, a RRG

Total Portfolio Summary





Source: SNL data 12/30/11

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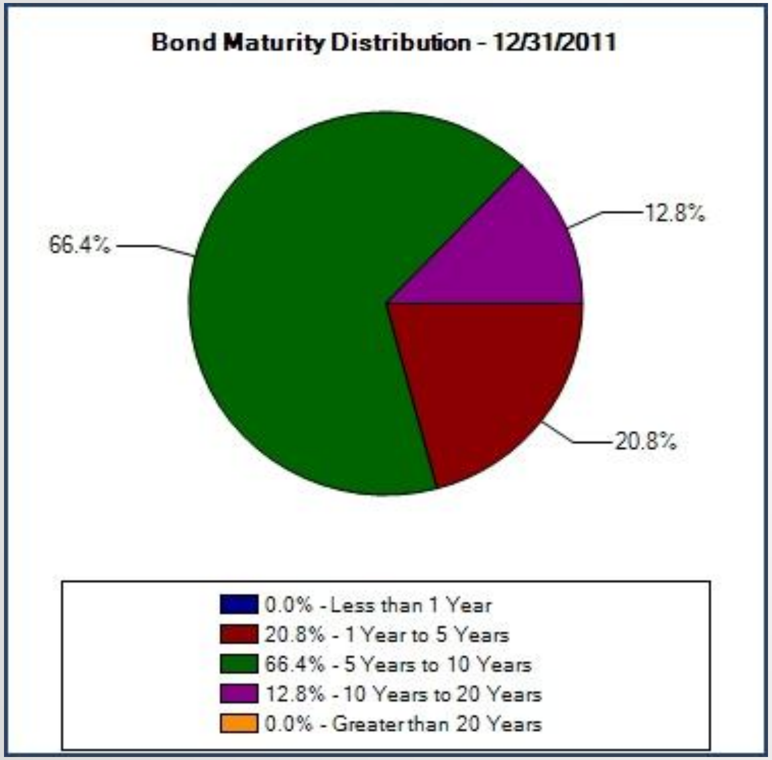
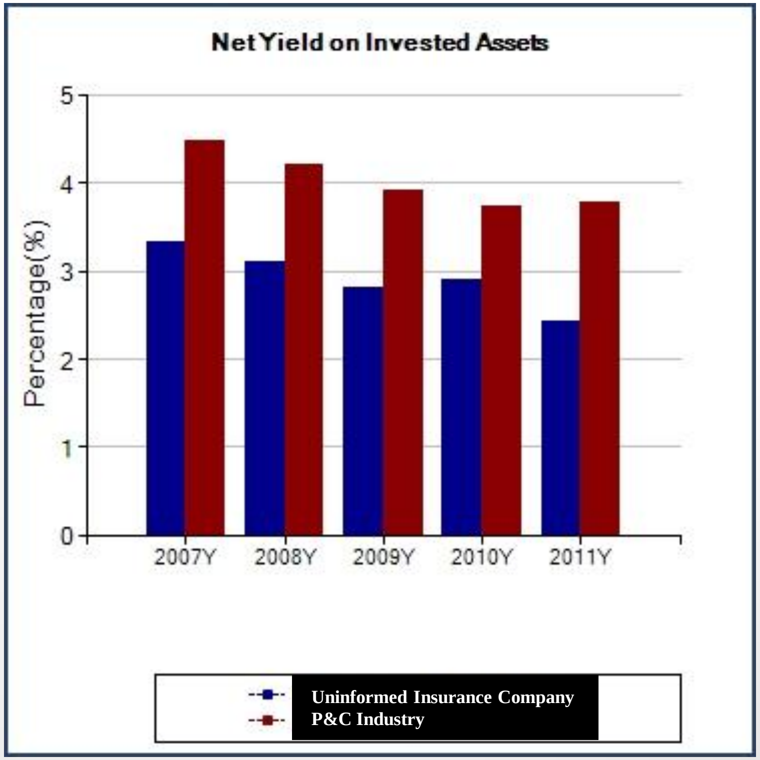
Case Study: Uninformed Insurance Company, a RRG

Bond Portfolio Detail





Source: SNL data 12/30/11

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Summary: Opportunity Cost
Why a finely tuned investment program is important to your captive

Case Study: UIC, RRG – $9,110,000 Portfolio, SC Domiciled Med Mal Writer

- Inefficient asset allocation Cost: $60,764 (2011)
  - Reducing cash position to 5% and investing in bonds @5.8% = $60,764 lost return for last year
- Underperforming P&C “Average Return” cost = $99,299 (2011) & $134,828 (2010).
- “Superior advisor/manager” benefit= $235,949 (2011) $225,928 (2010)
  - Assumes manager beats industry average of 3.66 and 3.93, respectively by 150BPs

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Keys for Success in Your Captive's Investment Program

CapVisor believes that the key to an optimized and successful insurance investment program is based upon the:

- Correlation of your investment strategy with your business objectives and risk tolerance
- Utilization of a component approach to align assets with underwriting/liability structure along three primary components:
  - Short-term liquidity
  - Loss reserve
  - Surplus
- Anticipation of changes in your circumstances and securities market trends in order to maximize return and protect portfolio liquidity
- Enforce a disciplined management style on selected manager and measure their ability to precisely executing strategies within investment guidelines and within regulatory, tax and accounting environment
- Frequent and effective communication of status, progress and results

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Session Conclusions

- Learn how to properly and efficiently select a “Best Fit” Insurance Asset Manager for your captive.
  - Right-Sized manager, target clients, investment sophistication, insurance expertise, philosophy/style, risk adjusted, competitive returns and fees, etc.
- Determine the elements of investment plan design that need to be completed prior to the manager search process.
  - Lack of a plan most often leads to selection of the wrong manager , not to mention a poor investment result
- How to construct an appropriate “consideration set” of managers.
  - Select from “Best Fit” consideration set an “Insurance Asset Manager”
- Measuring results.
  - Risk-adjusted, after tax returns are what’s important, not absolute returns (Performance vs benchmark)

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