

# Are Your Reserves at Risk?

## Strategic Challenges in P&C Insurance Portfolio Management

For Property & Casualty (P&C) insurers, the investment portfolio plays a pivotal role in supporting policyholder obligations and preserving surplus. Yet, amid elevated inflation, evolving market dynamics, and tighter regulatory expectations, traditional reserve portfolio strategies—particularly those centered on investment-grade (IG) bonds—are facing increasing strain.

*Insurers must ask: Is our current asset allocation aligned with the realities of today's risk and return landscape?*

## Asset Allocation Trends by Insurer Size: Structural Constraints Drive Divergence

Smaller insurers (under \$250 million in assets) continue to maintain high allocations to cash (approximately 17%) and IG bonds (~69%), with limited exposure to equities (typically 10–11%). This liquidity preference reflects both operational caution and a lack of internal investment resources. At the sub-\$10 million level, portfolios often hold only cash or investment-grade bonds—resulting in under-diversification and exposure to interest rate and reinvestment risk.

These firms frequently miss out on low- or inversely correlated asset classes that can improve risk-adjusted returns and dampen volatility. Basic diversification—such as introducing U.S. large-cap equities—can enhance performance, but more sophisticated approaches include integrating high yield (HY), small/mid-cap equities, and non-U.S. exposures.

Mid-sized insurers (\$100 million to \$1 billion in assets) typically have broader diversification across equity capitalizations and credit tiers, but often lack access to “other assets” like private equity, direct lending, or hedge funds (NAIC Schedule BA). This creates a structural challenge—they are too large to rely solely on public fixed income, yet too small to efficiently access more complex, less liquid alternatives. The result: a suboptimal return profile relative to their risk-bearing capacity.

## The Reserve Portfolio Challenge: Inflation and Benchmark Risk

Reserve portfolios, designed to fund actuarially projected claims, are commonly benchmarked to the Bloomberg U.S. Aggregate Bond Index (AGG). Yet the AGG, while familiar, may no longer be an appropriate fit. Persistently high claims inflation and real negative yields have diminished its efficacy especially when asset liability management (ALM), specifically cash flow and duration-matching has not been done.

This misalignment puts reserve adequacy at risk—especially for firms with inflexible, duration-constrained portfolios. Without meaningful return enhancement, the portfolio may not grow sufficiently to match future liabilities, potentially eroding surplus.

### **Recent Shifts in Portfolio Composition (2020–2024)**

Recent data highlights measured but meaningful changes in P&C asset allocations:

- IG Bonds remain the core allocation, declining slightly from 60.8% to 60.4%.
- Equities fell from 13.9% to 13.1%, despite strong market performance—suggesting profit-taking or rising risk aversion.
- Cash and short-term instruments increased from 5.5% to 6.3%, likely reflecting opportunistic yield capture during the Fed’s rate hikes.

We also observe rising exposure to:

- Agency and private-label RMBS
- Asset-backed securities (ABS)
- Private credit and other Schedule BA assets

These shifts point to a desire for enhanced yield and structural diversification without materially increasing public equity risk.

### **Rethinking Risk: The Case for Credit and Alternative Diversification**

High yield bonds are often dismissed by insurers due to reputational concerns (“junk” label), yet this overlooks their role within a modern portfolio framework. From a volatility-adjusted perspective, HY bonds frequently deliver return profiles comparable to equities—but with significantly lower drawdown risk.

According to J.P. Morgan’s 2025 Long-Term Capital Market Assumptions:

- HY bonds offer expected returns approaching those of equities but at roughly half the volatility
- Direct lending/private credit adds meaningful alpha due to low correlation with public markets

For insurers operating under RBC and surplus preservation constraints, these characteristics support a more resilient return engine—particularly when added in modest, measured allocations.

## **The Power of Strategic Diversification**

P&C insurers remain concentrated in IG bonds and U.S. large-cap equities—an approach that increasingly exposes them to correlated market risks. Expanding into asset classes with lower or negative correlations (e.g., HY credit, structured products, and select private assets) can materially enhance risk-adjusted returns while supporting ALM and regulatory goals.

Even a 2–5% reallocation from core fixed income into diversifying sectors can reduce portfolio volatility and inflation sensitivity—critical for long-tail insurers with future-dated liabilities.

## **Conclusion: Meeting the Moment with Strategic Adaptation**

The investment landscape has shifted—and insurers, particularly those in the small to mid-sized cohort, must adapt or risk falling behind. Traditional strategies anchored to investment-grade bonds and liquidity buffers may no longer suffice to meet future claim obligations or protect surplus under stress scenarios.

Now is the time to reevaluate reserve portfolio construction using a broader, risk-adjusted lens. That means looking beyond labels, understanding the true risk-return profiles of credit and alternatives, and embracing disciplined diversification—even at modest levels.

By evolving asset allocation frameworks in line with modern capital market realities, insurers can enhance surplus resilience, regulatory compliance, and long-term financial stability. Failing to do so may not just mean lower returns—it may ultimately threaten reserve integrity.

---

**June 2025**

**Carl E Terzer**

**Chief Investment Strategist**

**CapVisor Associates, LLC**

