Economic and Capital-Market Perspective

BY T.C. WILSON

Investment Evolution— Part Two. Is Your Company a Primate Investor?

*In Part One (*Physician Insurer*, Fourth Quarter 2011), T.C. Wilson discussed the basic elements of an "evolved" portfolio for a medical professional liability company. Minimizing tax payments, preserving capital, growing surplus, maximizing after-tax income, and/or achieving the highest after-tax book yield are still critical objectives. But, Wilson says, how your company attains these goals should have changed a while ago. With new pressure on income, companies need to consider a wider range of potential investments.*

Black swan events and the evolution chart

By definition, "black swan" events are high-impact, hard-to-predict, and rare occurrences that lie beyond the realm of normal expectations. Since there have been several such events over the last ten years, it might be worth considering a new metaphor as we continue to evolve. Regardless, insurers are facing new challenges, and it is time to step up and recognize that the world we live in today is a far cry from the one we knew yesterday.

Because income is a critical component of an insurer's business model, we will start with a 15-year table that tracks the yield spreads of U.S. corporate and U.S. high-yield bonds prior to, during, and following a major, unforeseen event.

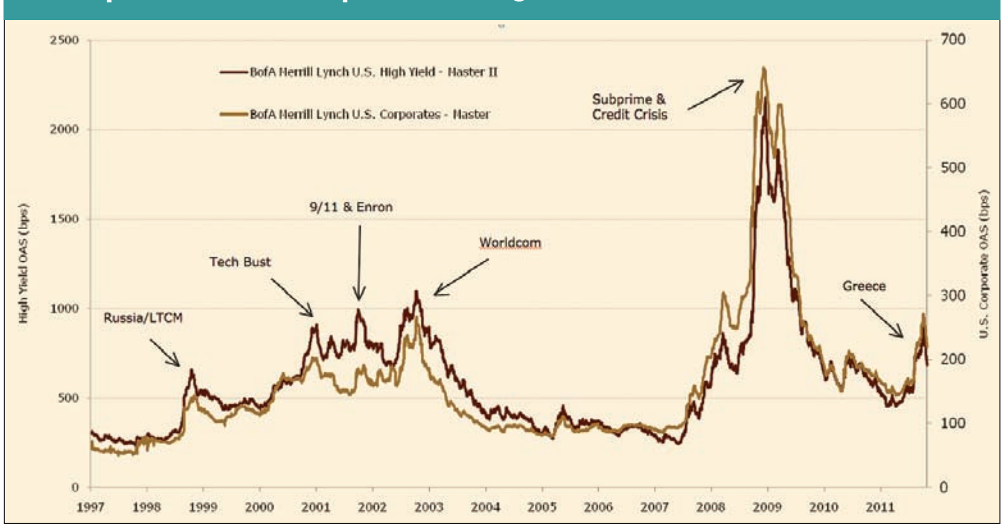
As you can see, after each major crisis (i.e., black swan event), there is a resulting contraction in yield spreads, indicating an opportunity for income-focused investors. Despite the downward trend in 10-year Treasury yields, the attractiveness of spread product (i.e., all non-government-related debt) should not be overlooked. Even as black swan events seem to occur with some regularity, the fixed-income markets have proved resilient, and credit spreads have recovered from crises.

It would seem that these supposedly "unexpected" events are here to stay, and as fiduciaries, you will need to take a hard look at the structure of your investments to ensure that the company's portfolio is insulated. Contrary to what many insurance executives and boards believe, expansion of assets (not contraction through simplification) has a better chance of protecting, and indeed improving, your portfolio in this most unpredictable and volatile period.

Evolution chart revisited

In the Fourth Quarter 2011 issue of *Physician Insurer*, we discussed the history of investments, and where we are today

Yield Spreads for U.S. Corporate and High-Yield Bonds



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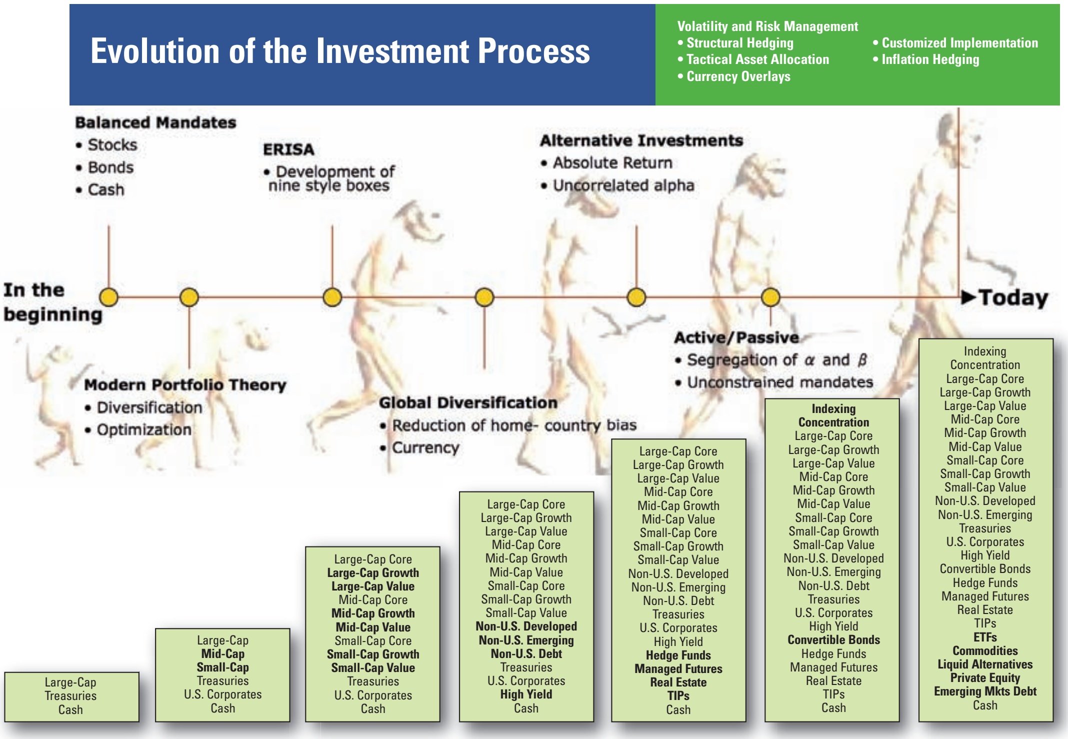

Source: Lazard and The Optimal Service Group

with new opportunities, themes, and strategies. Unfortunately, many insurance companies are still stuck in the early stages of the evolution spectrum. Investments should no longer take a back seat to underwriting in considering the overall profitability of the business. It is understandable that the process of evolution is growing at a rate that can best be described as dizzying, but to stay competitive in your market, you should consider going on the offensive.

With market volatility rising at an alarming rate, and the thirst for yield greater than ever, it would be imprudent for you, as fiduciaries for your companies' assets and shareholders, to ignore today's investment opportunities. Informed companies have embraced many of the strategies on the right side of the evolution spectrum, to complement their traditional investment-grade, fixed-income portfolios.

Where is the yield?

It's no secret that your investments have been getting squeezed as yields decline.

10-year Treasury Yields

Source: Bloomberg, Wells Fargo Advisors. Past performance is not an indication of future results.

Insurance companies that still believe that high-quality, government-issued debt is the safest investment now face a very challenging investment and economic future. Bond yields, historically, have had long secular moves, punctuated by sharp cyclical corrections. After falling to record low levels, 10-year U.S. Treasury yields remain range-bound, as investors worry about employment and a still-lagging national economy.

Tactically (near-term), we do not see a significant move in long-term rates, but strategically, we are concerned about the price (in terms of higher yields) of current policies. The risk in moving out on the yield curve will not likely be rewarded.

Things are not much better on the short end of the curve for insurers. In the past, investors could earn a relatively attractive return on short-term, fixed-income investments. With the Fed's commitment to holding the Federal Funds Rate at "exceptionally low levels through mid-2013," return opportunities have dropped dramatically. The best thing about short-term fixed income vehicles is that they serve as a defensive investment and may counteract an unexpected increase in yields/decline in bond prices resulting from a stronger than expected economic recovery or unanticipated inflation.

If there are limited opportunities on the long end of the curve and short-term maturities are yielding basically nothing, what is a company to do?

Expanding your assets

In fact, there are plenty of prudent opportunities to add yield over what Treasuries are paying these days. And not only yield, but total return as well can be achieved through exposure to asset classes not commonly used, but available, within your industry. Table 1 outlines a few of the asset classes that offer compelling yields, have attractive valuations, or can serve to complement a traditional, Neanderthal-type investment portfolio.

We strongly encourage you to look into each of these strategies and determine which are the best fit for your investment portfolio.

Table 1 Yields for Some Alternative Investments

Asset Class	Yield Range	Correlation to Intermediate Treasury
High yield bonds	7-8%	-0.17
Bank loans	4-5%	-0.30
Dividend-paying stocks	3-4%	-0.20
Emerging markets debt	5-6%	0.23
Master limited partnerships	6-7%	0.50
REITs	4-7%	-0.08
Long duration IG corporates	6-7%	0.74
Non-agency RMBS	4-8%	-0.21
Commodities	6-7%	-0.08
Hedge funds—diversified	0%	-0.27

Disclaimer: This table is provided for illustrative purposes only and is not indicative of any specific investments; individual investments may vary. Information has been gathered from sources that are believed to be reliable but its accuracy is not guaranteed. Past performance is no guarantee of future results.

Conclusion

After a favorable period of combined ratios in 2009 and 2010, greater competition and negative premium growth are putting new pressure on an insurer's investments to generate return. On the liability side, the volatility of losses has increased, so liquidity, duration extension, and surplus generation have become more critical objectives. As persistent low-interest rates continue to put a strain on investment income, the ongoing search for yield and total return will have to extend beyond outdated approaches. To accomplish this, find out more about each of the strategies on the right side of the evolution chart. If you do, living with the black swan will become a considerably more tolerable relationship. PIAA

For related information, see http://www.wellsfargoadvisors.com.

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