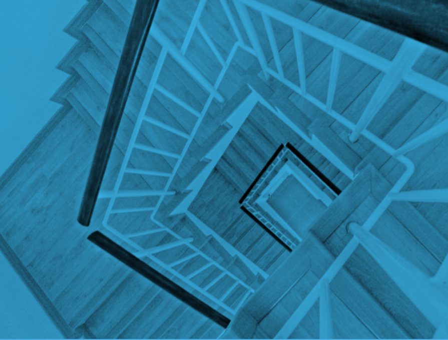

NEAM VANTAGE POINT

Perspectives

OCTOBER 2023

OUR VIEW ON INSURANCE CAPITAL MANAGEMENT TOPICS

IN THIS ISSUE ►

Rates, Risks & Enterprise Based Asset Allocation™ - Part One of Two

As interest rates shift, Property & Casualty insurers adjust their portfolios to keep investment strategies aligned with enterprise targets and preferences. We explore how restrictive (versus accommodative) monetary policy can impact enterprise risk and return expectations and investment choices.

EXECUTIVE SUMMARY

Enterprise based asset allocation (EBAA™) considers the joint implications of an insurer's exposure to capital market and insurance market expectations to formulate investment strategies. This holistic approach to evaluate risk and return, and their interdependencies across the organization, enriches planning, capital allocation and general decision-making within the firm. Increases or decreases in insurance rates and coverage terms influence the underwriting process. Similarly, investment choices consider current and projected interest rates and credit spreads. For Property & Casualty (P&C) insurers, this is particularly impactful given their significant allocation[1] to fixed income assets. Over a two-part series, we evaluate how different interest rate environments and shifting federal monetary policy can impact the EBAA™ findings for these insurers, including the associated implications of strategic repositioning of a portfolio given those findings.

BACKGROUND

Rising inflation, notwithstanding other macroeconomic concerns, served as a key catalyst to the rising interest rate environment that prevails today versus two years ago. From March 2022 to July 2023, U.S. monetary policy shifted dramatically from a highly accommodative focus to a significantly restrictive focus, with Federal funds rates increasing 11 times from virtually 0% to the current 5.25 to 5.50% target range over the period. Other interest rates were impacted as well with the 10-year treasury rate rising from historic lows south of 1% in 2020 to levels north of 4.5% in 2023. Obviously, these types of dramatic interest rate changes can have a major influence on capital markets generally, and with return opportunities and their associated risks across bond sectors and equity sectors specifically. For perspective, Exhibit 1 shows how the S&P500 returns compared to 10-year U.S. Treasury rates over 15 years from 2008 to 2022. These metrics exhibited a -0.54 correlation over this period, suggesting a reasonable inverse relationship between the two in most years, including 2021 and 2022.

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NEAM New England Asset Management

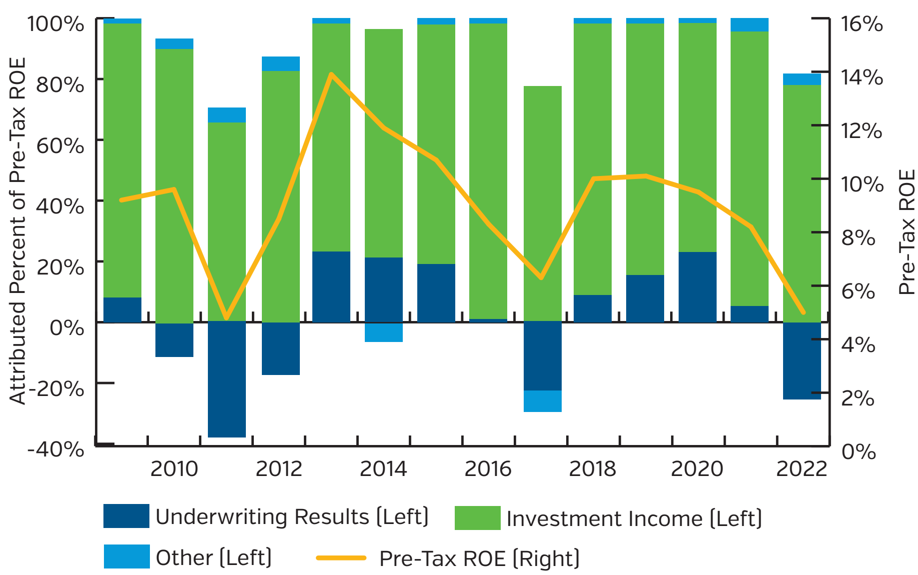
Exhibit 1. Trends Comparing the S&P 500 Annual Returns vs. the Average 10-Year U.S. Treasury Bond Rate from 2008 to 2022

Source: www.macrotrends.net, fred.stlouisfed.org, NEAM

A traditional strategic asset allocation usually seeks to optimize the portfolio weightings across investable assets to generate the highest measure of return per given measure of risk, given capital market expectations. This traditional approach ignores liabilities and does not reflect how assets and liabilities interact and jointly contribute to enterprise risk and return. Exhibit 2 illustrates how both investments and underwriting contribute to returns to capital for a P&C insurer and how this has trended over time. NEAM advocates a holistic approach to investment strategy development and refinement. This includes alignment of investment choices with operational objectives and enterprise risk and return preferences.[2] Accommodative and restrictive capital market and insurance market conditions are important components for that evaluative process, all of which can be assessed within a holistic asset allocation process, such as EBAA.™

Exhibit 2. DuPont Framework for Decomposition of an Insurer's Pre-Tax Return on Equity

Return on Equity = (Premium Leverage X U/W Margin) + (Investment Leverage X Investment Returns)



Source: S&P CAP IQ, NEAM

COMPARING EBAA™ OUTCOMES: SECTOR, DURATION AND CREDIT QUALITY

Case studies from actual EBAA™ assessments conducted by NEAM are used to evaluate the impact of accommodative and restrictive monetary policy on findings and preferences. We consider 10 U.S. P&C insurers and assess their EBAA™ results in 2021 (the accommodative period) and in 2023 (the restrictive period). The 10 companies vary in size and product focus and provide a reasonable, albeit small, representative sample of the broader universe of P&C insurance companies. Exhibit 3 below provides some demographics for the 10 firms alongside median operating statistics for those firms.

Exhibit 3. Selected Demographics & Operating Statistics of 10 Companies Used for the EBAA™ Case Study

Company	Product Line Focus	2023 Invested Asset Size Range ($mm)
1	Commercial	>1000
2	Commercial	500-1000
3	Commercial	500-1000
4	Personal	500-1000
5	Commercial	100-500
6	Personal	100-500
7	Multiline	100-500
8	Commercial	100-500
9	Commercial	<100
10	Commercial	<100

Baseline Medians (of the 10)	2023	2021	Difference
ROE	6.7%	6.4%	0.3%
ROA	3.2%	2.7%	0.6%
Book Yields	3.5%	2.7%	0.8%
Market Yields	5.2%	1.4%	3.9%
Embedded Gain/Loss % of Assets	-6.0%	4.8%	-10.8%
Core FI Allocation	83%	84%	-1.0%
Duration	4.2	4.3	-0.09
Average Credit Quality	AA-	AA-	N/C
Investment Leverage	1.7x	1.8x	-0.1x
T-VaR of Capital (99.5%)	26%	30%	-4.3%

Source: NEAM

For each company, and in each period, we apply reasonable constraints and allowances for sector, interest rate sensitivity, credit quality and the opportunity set.[3] Returns to equity (or surplus) and risk to equity reflect expectations with investment and underwriting performance over a 12-month period. The macro-level objective for each company was to enhance returns, particularly investment income returns, while keeping their enterprise risk levels at or near their prevailing levels.

Note that this is an anecdotal exercise. Under an EBAA™ framework each company will have unique and dynamic enterprise risk and return preferences, including the metrics used to measure risk and return. To the extent possible we attempt to level-set parameters and use consistent constraints across the 10 sample companies to maintain strong comparability. Although this was not fully possible in each case, we feel the directional outcomes are still relevant.

The findings indicate that EBAA™ perspectives and priorities evolved between the accommodative period to the restrictive period. In 2021, the focus was on preserving projected book yields, while in in 2023, there was less focus on future book yields. Instead, the focus was preserving near-term net income and equity capital (surplus) forecasts for the period, particularly given challenging underwriting results expected in 2023.

EBAA™ results suggested different sector changes between the two periods as well. Exhibit 4 summarizes the key differences in EBAA™ outcomes in 2023 and 2021. In 2021, the primary means to defend book yields was with sectors outside of high-quality core fixed income securities. Market yields for core fixed income were at or below embedded book yields for these companies that year. Most EBAA™ results suggested adding high dividend yielding equities and <BBB rated bonds. These were extremely compelling options to preserve investment income at the time. In 2023, with market yields over 180 basis points higher than embedded book yields, the dependence on risk assets to enhance income returns becomes less obvious. Indeed, most EBAA™ results in 2023 for the case studies suggest a combination of adding to core fixed income, meaningful rotations across core fixed income and reducing risk asset exposure.

Exhibit 4. EBAA™ Outcomes within Accommodative and Restrictive Monetary Policy Periods. Each Outcome Considers the "Similar Enterprise Risk" Scenario Relative to the Prevailing Base Allocation. (X) Indicates the Number out of the 10 Companies in the Case Study that Had the Outcome Listed

Portfolio Consideration	2023	2021
Sector Rotation	• Rotate the investment grade fixed income (core FI) allocation; more weight to structured securities. (4) • Add more to core FI, reduce risk assets / non-core. (3) • Add more to non-core / risk assets. (3)	• Add more to non-Core / risk assets. (9) • Little change in sector target ranges. (1)
Duration	• Little change in duration targets. (9) • Shorten duration. (1)	• Some degree of duration extension. (8) • Little change in duration targets. (2)
Credit Quality	• No change in average credit quality. (10) • Add more to non-traditional 'BBB'. (1)	• No change in average credit quality. (6) • Average credit quality target lowered by a notch. (4)

Source: NEAM

EBAA™ outcomes in 2023 were more the result of sector changes and less from changes in average duration or credit quality. In 2021, the market exhibited a traditional yield curve with slightly higher rates at longer maturities. For some companies, EBAA™ suggested modest duration extension or modest allocations to lower quality assets to reach for those higher yields. In 2023, the yield curve is inverted with interest rates at 10+ year maturities lower than short-term rates. EBAA™ outcomes in the first half of 2023 generally have not indicated any dramatic shift in duration as a result. Moreover, with the strong market yield environment across the yield curve, compelling reasons to go down in credit quality to enhance yield was not obvious with 2023 EBAA™ outcomes in the case study.

BEYOND SECTOR, DURATION AND CREDIT QUALITY

EBAA™ not only considers optimal scenarios or portfolios with the objective of maximizing returns for a given level of risk. The subjective viability of these scenarios is also considered. For most companies, the financial impact from an accounting perspective (e.g., net income from realizing embedded portfolio gains or losses and related taxes) must be factored in along with any economic and strategic views. The next part of this two-part series will evaluate how these additional factors influenced some of the investment strategies and differences outlined above.

KEY TAKEAWAYS

EBAA™ supports strategic investment decision-making in a holistic fashion, jointly considering performance expectations of investments, insurance underwriting and their interaction. When insurance markets fluctuate between "hard" and "soft," pricing and coverage terms go from restrictive to accommodative. Similarly, as the Federal Reserve raises and lowers interest rates, short-term interest rate targets these actions form restrictive and accommodative capital market conditions respectively. EBAA™ can help navigate through these varying market conditions.

Using EBAA™ case studies, we highlight how investment strategies and preferences changed in reaction to the restrictive positioning around interest rates in 2023 from the accommodative positioning of interest rates in 2021. Some of our findings include:

- In 2021, there was a significant reliance on risk assets, such as equities and below investment grade fixed income, to preserve book yields and overall investment returns.
- In 2023, high quality investment grade fixed income offers market yields that, in some instances, were 180+ basis points higher than embedded portfolio book yields, providing compelling return enhancement without relying on the volatility of equities to do so.
- In 2021, duration and credit quality changes were sometimes factors of strategic allocation decisions, but in 2023 changing duration and average credit quality to achieve higher yield was less likely.

NEAM encourages insurers to utilize a broad range of analytics that provide a rich perspective of potential opportunities to enhance risk-adjusted performance over time. EBAA™ is one vehicle for this. Either way, a holistic approach that jointly considers investments and insurance can be an effective way to assess investment strategy over a longer period as capital markets and insurance markets evolve. We encourage you to read part two of this two-part series for further discussion.

The EBAA™ analysis presented herein illustrates hypothetical estimates of return, risk, asset allocation and other metrics for what NEAM believes to be a representative sample of insurance companies. NEAM applies assumptions to generate these metrics, such as projections for capital market returns, insurance product performance, investment and underwriting risks and how those risks interact. The analysis aims to generalize the specific constraints, risk tolerances and objectives of each insurance company portrayed and uses a primary objective for all companies of maximizing returns and keeping enterprise risk static. NEAM makes no representation or warranty as to the reasonableness of the tool, reinvestment universe, constraints or assumptions applied. The metrics presented herein do not consider the effect of changing risk profiles, operating cash flows or future investment decisions, do not represent actual trades and may not reflect the effect of material economic and market factors, including the potential inability to execute the proposed portfolio repositioning. The reinvestment set includes investment types offered by NEAM, and other investment types not considered may have superior characteristics. Clients will experience different results from the information shown, including the potential for loss, and results may vary with each use of the tool and over time.

ENDNOTES

[1] See *Perspectives* "2022 P&C Industry Investment Highlights: Reversing the Declining Trend?" July 2023, for further discussion on recent U.S. P&C insurer investment allocation trends.

[2] See *Perspectives* "Layering Enterprise Risk Preferences & Rewards," January 2023, for further discussion on this concept.

[3] Note that this is an anecdotal exercise. Under an EBAA™ framework, each company will have unique and dynamic enterprise risk and return preferences, including the metrics used to measure risk and return. To the extent possible, we attempt to level-set parameters and use consistent constraints across the 10 sample companies to maintain strong comparability. Although this was not fully possible in each case, particularly as return time series data and related volatility across assets are highly dynamic, we feel the directional outcomes are still relevant for what is illustrated in this article.