MILES Capital

MILES Capital

OBAA®

OBJECTIVES-BASED ASSET ALLOCATION®

TRULY EFFECTIVE ASSET ALLOCATION FOR INSURANCE COMPANIES

DOES YOUR PORTFOLIO SUPPORT YOUR BUSINESS OBJECTIVES?

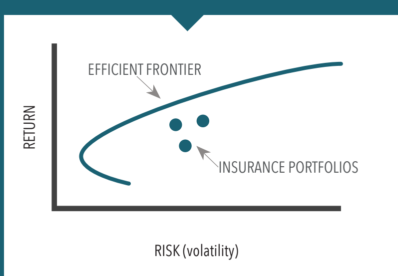
INTRODUCTION

The importance of asset allocation in driving portfolio performance has been well researched and documented over the years. Done correctly, an insurer's asset allocation investment strategy should position its portfolio to deliver the investment outcomes that support, enhance, and help achieve the firm's business objectives. Done incorrectly, the investment portfolio may significantly detract from business results, potentially leaving the insurance company with asset management gaps or at a competitive disadvantage.

Traditional asset allocation is centered on Modern Portfolio Theory, developed in the 1950s. Modern Portfolio Theory considers the return and risk (volatility of returns) of numerous asset classes and creates an efficient frontier, combinations of the asset classes that provide the maximum return for any given level of risk, also referred to as mean/variance optimization (MVO). There are additional methodologies today, such as core satellite and risk factor. These methods are often used by pensions and other types of investors, but are they appropriate for insurance companies? And do they drive business performance?

FIGURE 1

MODERN PORTFOLIO THEORY CONSIDERS THE RETURN AND RISK (VOLATILITY OF RETURNS) OF NUMEROUS ASSET CLASSES



MVO: MEAN/VARIANCE OPTIMIZATION:
A combination of the asset classes that provide the maximum return for any given level of risk.

Each of these methods focus on historical asset class specific characteristics, such as the long-term return and risk characteristics, and assumes investors can hold a portfolio that falls on the efficient frontier. These characteristics do have applications to a sub-set of insurance company assets, such as equities. Optimization around total return and volatility is an important concept for these assets.

However, insurers have concerns that extend well beyond total return due to their business initiatives and constraints. As demonstrated in the efficient frontier image to the left (figure 1), insurer portfolios almost never fall on the efficient frontier due to industry considerations. These include regulatory and rating agency guidelines, product and business development, surplus growth, alternative measures of risk, net investment income generation, and others.

As a result, using traditional methods of asset allocation for insurance company investment portfolios may be incomplete and can lead to ineffective asset allocation decisions.

Experience tells us that many insurers do not have a true asset allocation strategy that aligns the portfolio with their needs and objectives. Traditional methods of portfolio allocation and management often fail to deliver the results that drive profitability and competitive positioning.

Over our more than three decades in working with insurers, we have developed a different methodology: Objectives-Based Asset Allocation® (OBAA®). OBAA® is based instead on meeting the critical needs of all insurers and helping them to achieve their business objectives. And it moves asset class optimization to the correct place in the process – after these objectives are considered. **We have designed and deliver a solution that directly aligns with your business.**

the foundation: DESIGNED FOR INSURERS

Objectives-Based Asset Allocation® is a comprehensive asset allocation strategy that is designed to 1) clarify the purpose of asset class exposures in meeting the core needs of insurers, 2) identify and prioritize the business objectives, 3) create a purposeful allocation targeted to support business objectives, and 4) provide direction for portfolio impact well into the future.

OBAA® is an asset allocation methodology uniquely designed for insurers by insurance asset management professionals. It is specifically designed to address the below tenets that we believe an effective insurance investment portfolio should possess:

1. RECOGNIZES INSURANCE ASSET MANAGEMENT IS DIFFERENT

OBAA® directly incorporates components that matter to an insurance company, such as capital, company size, ratings and regulation, credit risk and a variety of other considerations.

2. RECOGNIZES THE ROLE OF THE PORTFOLIO

OBAA® seeks to structure the investment portfolio to optimize the business objectives of the insurer, not just standard deviation or total return.

3. HELPS ADDRESS CORE NEEDS OF ALL INSURERS

All insurers have four fundamental investment needs (figure 2): Yield Generation, Growth of Surplus, Inflation Protection, and Risk Mitigation. Understanding the purpose of each asset class (i.e. which need it best serves) is the foundation for an effective asset allocation strategy.

4. INCLUDES ALL APPROPRIATE ASSET CLASSES

OBAA® considers over 30 unique asset classes and strategies, ensuring breadth of inclusion. This helps ensure exposure to a breadth of asset classes and that insurer portfolio strategy evolves as the insurance company evolves and/or the investment environment changes.

5. RECOGNIZES THE STRATEGIC NATURE OF ASSET ALLOCATION

OBAA® provides each insurance company client with a forward-looking, multi-year analysis that directly addresses its key objectives. It is, in effect, a five-year strategic plan for the insurer's portfolio.

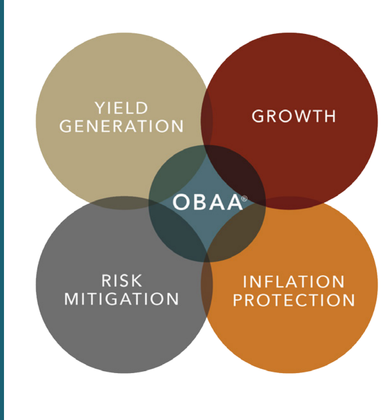
6. DYNAMICALLY INCORPORATES MARKET AND INSURER CHANGES

OBAA® evaluates success based on how the portfolio results serve the objectives of the insurance company. It continuously and dynamically incorporates market and company data in order to help ensure proactive and strategic decision making.

7. PROVIDES EFFECTIVE COMPARABILITY

OBAA® produces a library of analytics illustrating the effectiveness of the asset allocation strategy specifically relating to the insurance company (figure 3). These can be used for direct compare and contrast analysis of the current asset allocation with a Strategic Asset Allocation to identify strengths and weaknesses, as well as potential solutions.

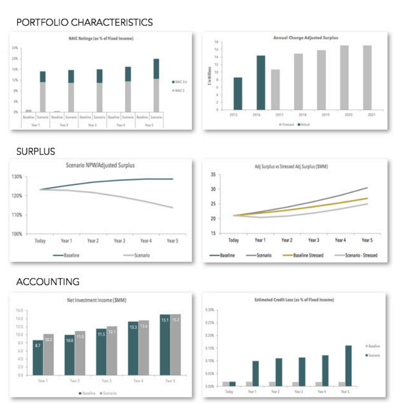
FIGURE 2



ALL INSURERS HAVE FOUR FUNDAMENTAL INVESTMENT NEEDS

30 *unique asset classes &* **STRATEGIES**

FIGURE 3



OBAA® PROVIDES A FULL LIBRARY OF ANALYTICS

Objectives Based Asset Allocation® is a forward-looking methodology that takes into consideration the impact an asset allocation will have on key metrics, both today and over the next several years. This helps to identify gaps or unintended consequences of an asset allocation that might not otherwise be visible, with the goal of enhancing strategic decision-making.

OBAA®, BY DESIGN, HELPS ENSURE THAT THE INVESTMENT PORTFOLIO IS STRATEGICALLY ALIGNED WITH THE BUSINESS OBJECTIVES OF THE INSURER.

UNDERSTANDING WHAT IS IMPORTANT

Any successful asset allocation methodology or investment portfolio for an insurer must first start with gaining an understanding of the company. This includes:

1. COMPANY PROFILE: Incorporating considerations such as size, type, liquidity, capital, business lines, financial strength ratings, and a review of appropriate industry peers and competitive landscape.

2. COMPANY OBJECTIVES: What is important to that company? For example: What is the company trying to achieve in the current and coming years? What critical constraints exist?

Objectives and constraints are different for each company and can include such things as yield targets, surplus management, ratings, capital requirements, liquidity and many others. As you would expect, it rapidly becomes clear that effective asset allocation for an insurance company is much more complex than the simple return and risk model from Modern Portfolio Theory. There are multiple, and many times competing, objectives as well as multiple constraints. This requires a model that allows for the simultaneous adjustment of multiple variables.

Our OBAA® model is based on a multivariate analysis which allows for optimization along several competing objectives. OBAA® goes beyond traditional asset allocation in order to connect your portfolio with your business. Our approach proactively assigns purpose to the insurance asset portfolio.

PROCESS DESCRIPTION DETAIL

Four key components make up our OBAA® process: Inputs, IMPACT Portfolio Analysis℠ (IMPACT), Outputs, and Continuous Review. There are four necessary inputs for OBAA®, two of which are market oriented and macro-based, and two are client-specific.

1. **The broad asset class universe** of 30 asset categories is included and aligned with each need. For example, corporate bonds most closely align with the need for Yield Generation, while private equity supports Growth of Surplus.

2. Our **capital market forecasts** support the forward-looking nature of our model and also provide for comparability between potential portfolio scenarios. Forecasts include interest rates, spreads, default rates, and equity market appreciation.

3. The **insurer business profile** includes the characteristics noted above in "Understanding What Is Important" and provides insight regarding the positioning of each client to identify what portfolio changes could be appropriate in the future.

4. Our **insurer interview results** in input for our model regarding capital efficiency and long-term business changes as well as documentation of the identified and prioritized client objectives and constraints.

These items provide a foundation for developing an asset allocation strategy that is designed to deliver investment outcomes that support, enhance, and help achieve the firm's business objectives. They also serve as the inputs for the analytical model, IMPACT.

IMPACT is the second key component in our OBAA process and it is a proprietary, multivariate, time series analytical model that produces a variety of asset allocation solutions that are specifically designed to enhance the documented set of prioritized business objectives. This model is different from the traditional MVO model by balancing the core needs and the prioritized objectives of each insurer with the company-specific constraints that have been identified. IMPACT then generates three types of forward-looking reports and results for analysis by our Asset Allocation Committee.

These Output reports make up the third phase and include:

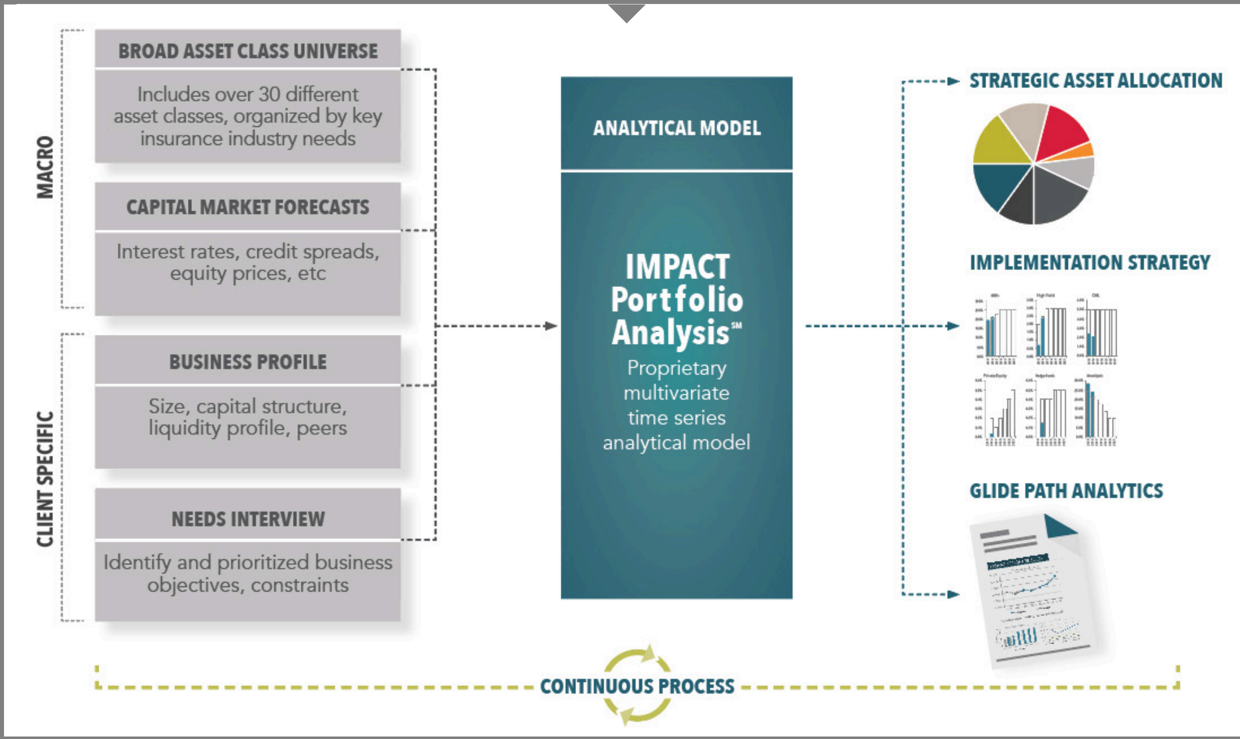
1. A **Strategic Asset Allocation** recommendation that identifies the mix of assets best suited to meet company goals,

2. An **Implementation Strategy** that provides a multi-year approach to implementing portfolio changes to minimize tax and trading considerations, and

3. Glide Path Analytics that illustrate strategic projections for key company metrics relative to both the insurer's objectives and the existing investment strategy.

We conduct annual reviews with each client to update company and market information, and revise, as appropriate, the asset allocation recommendations. This final component, or continual process review, of our OBAA® process helps to ensure the asset allocation strategy remains suitable and comprehensive, and incorporates any changes in the investment environment, the company's objectives, constraints, and business profile.

The result is an insurance-based asset allocation strategy that helps ensure the investment portfolio is strategically designed to help support the insurer's key business objectives.



DETERMINING SUCCESS

When asset managers typically review performance it is often in the context of total return relative to a benchmark. That is not surprising given the popularity of Modern Portfolio Theory which is centered on total return. As we have discussed, for insurance companies, total return is only part of the story. To determine whether or not the asset manager has truly been successful, performance should be considered in a broader context.

Insurers must assess the degree to which the asset portfolio helped the company achieve its objectives. Performance of an asset class versus a benchmark has relevance, but it is secondary to performance versus company objectives.

We highlight this in the below scenarios. As an executive, assume you had to choose between the following scenarios:

SCENARIO 1: The company achieves all of its objectives for the year, including achieving its yield and net investment income (NII) targets, surplus growth, BCAR improvement, or some combination thereof. However, some asset classes underperformed their generic public market benchmarks.

SCENARIO 2: The company does not achieve any of its critical objectives: potentially missing its yield and NII targets, growth remains stagnant, and the BCAR decreases. But, most asset classes outperform their generic public market benchmarks on a total return basis.

The obvious choice for most insurers is Scenario 1, which drives home the need to have the right asset allocation. However, it does not mean that we ignore relative performance vs. benchmarks for the various asset classes. Whether it is a total return benchmark, a yield target or some other benchmark, relative performance is still an appropriate means for assessing the capabilities of the asset manager within the individual asset classes. But total performance relative to achieving objectives is a better way to assess the ability of the asset manager to deliver an appropriate asset allocation.

CONCLUSION

Asset allocation is the most critical component to achieving desired investment portfolio performance. We believe that an effective asset allocation methodology must contain the following characteristics:

- A focus on the insurance company and what it is trying to achieve;
- An ability to consider the company profile and address the impact to key insurance metrics;
- Forward looking analysis to help identify gaps and avoid unintended consequences; and
- An ability to measure performance of the allocation vs. relevant company objectives.

Done correctly, asset allocation should deliver a portfolio with true direction. OBAA® aligns a tailored list of asset classes, unique to each insurer based on industry, size, peers, and objectives, with the desired business outcomes. It illustrates gaps in the current strategy and projects dynamic, forward-looking solutions to help meet each company's critical objectives and support competitive positioning.

THE POTENTIAL BENEFITS OBAA® PROVIDES INSURANCE COMPANIES ARE:

- Clarity: Understand what you own and why, identify gaps and how each asset class fits
- Purpose: Create a portfolio strategy truly aligned with business outcomes
- Direction: A multi-year solution designed to help deliver results that matter to you

WITH OBAA®, YOUR PORTFOLIO IS DESIGNED TO DO MORE.