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Goldman Sachs Asset Management

Capital management

Looking beyond share buybacks

Jared Klyman of GSAM Insurance Asset Management explains why European Insurers may want to consider a multi-asset class investment strategy to deploy and grow the capital base

MARKET CONDITIONS and changing regulatory regimes have pressured the capital levels and earnings of European financial institutions. In today's low-yield environment, companies are also looking for strategies that are accretive to return on equity (ROE), such as share buybacks, acquisitions or reinsurance.

Against this challenging backdrop, GSAM Insurance Asset Management has found that a multi-asset class investment strategy may provide an alternative use of capital. In this article, we present a case study of an illustrative European multi-line insurer managing capital according to Solvency II requirements. It demonstrates that an investment strategy may offer greater enhancement of ROE in both the short term and long term, while offering the potential for strong return on capital.

The primary source of capital efficiency for the investment strategy is a concept we call the investment-to-capital 'leverage' effect. Due to diversification of market risk with other risks on the balance sheet within the Solvency II framework, an insurer is able to put more assets to work through investments than can be returned via share buybacks.[1]

Evaluating capital strategies

We consider three capital strategies for Theoretical Insurance Company (TIC), an illustrative multi-line European insurer with a balance sheet that is representative of findings from the Quantitative Impact Study 5.[2] Figure 1 contains summary information about TIC, which is assumed to have a Solvency II ratio of 165%, against a target of 150%. The case study assumes that TIC has capital available to return to shareholders through share buybacks (or dividends).

1. TIC balance sheet

	Assets	Liabilities	
		850	Insurance reserves
		150	Shareholder equity
Total Assets	1,000	1,000	Total liabilities

Market capitalisation	=	150
Capital to deploy	=	9
Earnings	=	19

Certain values in the table are rounded

Source: GSAM. For illustrative purposes only

Capital-deployment strategies

Below is a summary of the capital-deployment strategy options explored in our case study (see figure 2).

Option 1. Retain available capital

This strategy involves retaining the capital on the balance sheet and corresponds to maintaining a solvency ratio of 165%.

Option 2. Share buyback

Shares of TIC are repurchased from the market, where the size of the buyback programme reduces the solvency ratio from 165% to 150%. The share buyback size corresponds to about 0.9% of TIC's assets, or about 6% of the market capitalisation (or, equivalently, about 6% of shareholders' equity).

Option 3. Multi-asset class investment

This strategy is a 6: 1: 1 investment in high-yield bonds, hedge funds and private equity, respectively, sized to maintain the solvency ratio at 150%. We assume in this example that we allocate to these asset classes from cash. The investment-to-capital 'leverage' effect for this strategy is 5.7, meaning the investment size (4.9%) is 5.7 times as large as the capital required to back it under Solvency II (0.9%). In this example, the after-tax return on shareholders' committed capital would be 16.8%, which exceeds most insurers' hurdle rates.[3]

2. Summary of capital-deployment strategies (% of TIC assets)

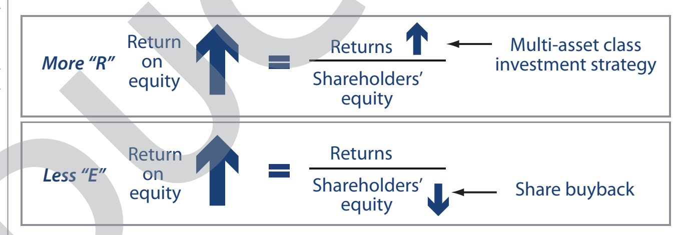
Strategy	Share buyback	Multi-asset class investment
Share buyback	0.9%	0%
High yield	0%	3.7%
Hedge funds	0%	0.6%
Final private equity value	0%	0.6%
Annual private equity commitment	0%	0.2%
Investment reallocation	0%	4.9%
Investment-to-capital 'leverage' effect	n/a	5.7

Source: GSAM. For illustrative purposes only

[1] *Returning versus investing 'excess' capital: Looking beyond share buybacks*, by Jared Klyman, August, 2012. *http://www.goldmansachs.com/gsam/worldwide/insurance/thought-leadership/insurance-insights/index.html*

[2] Solvency II capital requirements may differ between the QIS5 specification and the Level 2 draft specification; however, we anticipate capital charges to be broadly similar for private equity, hedge funds, and short- to intermediate-maturity high-yield bonds.

3. Methods to increase ROE



'Returns' in the ROE ratio above refers to earnings (i.e., net income)

Source: GSAM. For illustrative purposes only

Summary of results – weighing short-term and long-term impacts

Share buybacks provide an immediate boost to ROE through a reduction in the size of shareholder equity (see figure 3).

Investments in cash assets such as high yield, hedge funds or public equity can provide returns within the first year, and may outperform a share buyback on an ROE basis over a one-year period. Private equity offers a greater long-term potential to improve earnings (hence ROE), based on our assumptions. However, the early years of the private equity programme may have negative returns as fees are paid while the private equity investment builds size on the balance sheet (J-curve).

The multi-asset class investment strategy in this example is designed to capture the short-term impact of the share buyback and the long-term upside from private equity. The strategy is expected to outperform share buybacks after just one year, and continues to build greater shareholder value as the J-curve effect mitigates over the ensuing five years (see figure 4). The size of the multi-asset class investment strategy is largely responsible for the impact to earnings; that is, it is about 5.7 times as large as a share buyback programme for the same impact to the solvency ratio.

> An investment strategy may provide a greater boost to ROE in both the short term and long term, with the potential to offer stronger return on shareholders' committed capital

Breakeven analysis – testing the investment return assumptions

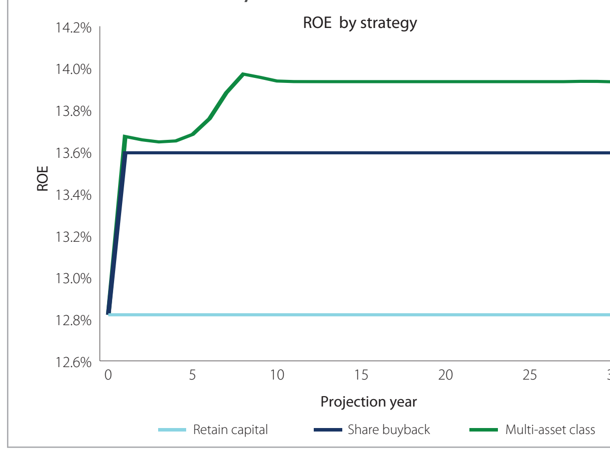
Share buybacks inherently add risk to the balance sheet, as they directly reduce surplus. An investment strategy adds risk because of the increased volatility of existing surplus. In order to evaluate this risk, we stress test the asset class expected return assumptions. We determine how large a reduction to the returns results in the multi-asset class investment strategy breaking even with the share buyback strategy as measured by ROE in the long term. The model's expected return assumptions are as follows: high yield 4.6%; private equity 11.3%; and hedge funds 5.9%.[4] The breakeven analysis shocks down the expected return assumption by 28% (for example, the stressed high-yield return is 3.3%), which reduces the long-term ROE of the multi-asset class investment strategy to match that of the share buyback strategy. Furthermore, we find that the stressed return assumptions lower the return on shareholders' committed capital from 16.8% (best estimate) to 12.3%, which still exceeds typical insurer hurdle rates.

This analysis provides the insurer with a context around which to decide on the validity of the investment strategy. If the stressed levels of returns are deemed conservative, then the multi-asset class investment may be a more attractive use of capital than a share buyback. It is also worth noting that the majority of these investments are assets that, while not entirely liquid, can be sold if necessary, while a buyback strategy is largely irreversible. In an environment where solvency ratios are highly volatile, the extra flexibility provided by the surplus reinvestment strategy may be attractive. Further analysis may be made on the downside risk associated with both the buyback and the investment strategy in stressed markets.

[3] We define return on shareholders' committed capital as the IRR of the investment strategy, with an initial cost of 9 and future after-tax net cash flows from investment returns.

[4] The cash yield assumption is 0.2%. Surplus-backing cash is assumed to be sold to fund the investment strategy. All return assumptions are net of investment fees. The high-yield assumption is also net of expected losses due to defaults.

4. The multi-asset class strategy has a larger ROE impact than the share buyback



Source: GSAM. For illustrative purposes only

Conclusion

There are many possible uses of capital, and returning capital to shareholders in the long term remains an important goal. We find that investments in capital-intensive, return-generating asset classes may be currently underutilised. An investment strategy may provide a greater boost to ROE in both the short term and long term, with the potential to offer stronger return on shareholders' committed capital.

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