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The case for active portfolio management

Although regulatory and accounting incentives may encourage some insurance companies to pursue a passive investment strategy, Eugene Dimitriou, senior vice president at PIMCO, says there are increasingly compelling reasons for insurers to actively manage their portfolios

INSURANCE COMPANIES often question the degree of active management they should consider for their investment portfolios. Some industry experts argue that – as insurance liabilities are typically not liquid – it is appropriate to invest in illiquid assets and harvest the incremental spreads in excess of those available on more liquid bonds (illiquidity premiums). The argument, however, extends beyond the initial purchase: why not forgo bid/offer spreads altogether by avoiding active trading entirely? While illiquidity premiums are difficult to quantify, it might appear to be a 'free lunch' that insurers may be able to 'lock in' from day one.

Regulatory and/or accounting treatments, at times, reinforce the argument for not trading. The UK's matching adjustment and Italy's *immobilizzato* regulations, for example, afford insurers a more benign capital regime for liabilities that are backed by assets managed with low, or no, turnover.

While such arguments appear quite compelling, there are substantial counter-arguments to consider, especially for fixed income.

- Locking in current spread levels by investing passively may preclude subsequent alpha generation from good credit selection or from new market opportunities. A good example would be Verizon's circa \$50 billion debt issuance prompted by the company's purchase of Vodafone's US stake in Verizon Wireless. Investors who had the requisite liquidity were able to access this opportunity and gain 7% within a month. In short, insurers, pension funds and others with relatively long-term investment horizons have the opportunity to become liquidity providers for markets.

- Bond markets are considered inefficient by many in the industry; as such, passive strategies should generally underperform actively managed portfolios for a wide range of reasons, as my colleague Jim Moore argued in his October 2014 Viewpoint, *Sorry, Mr. Bogle, but I respectfully disagree. Strongly.*[1] Insurers have, in the past, expected actively managed bond portfolios to yield up to 100 basis points (bp) of annual incremental return over and above a benchmark or other passive strategy over time. Even highly constrained 'buy and maintain' mandates with limited opportunities for active management carried expectations of around 25bp of incremental yield. As banks withdraw capital from trading activities and central banks reduce their unconventional support mechanisms (as seen in the US and the UK), capital markets may become increasingly exposed to violent shifts due to technical, rather than fundamental, reasons. Insurers with an active investment mind-set are likely to profit from such inefficiencies.

- Active management also tends to afford a wider range of investment opportunities. Consider, for example, the performance of more liquid credit default swaps (CDS) relative to cash bonds (less liquid) through the global credit crisis. Spreads on CDS traded up to 100bp tighter than those of comparable bonds in 2009. By 2011 and 2012, the situation had reversed, allowing those insurers that actively managed their assets to exploit this technical differential.

Insurers that pursue passive hold-to-maturity strategies may enjoy benign regulatory and accounting treatments, which may protect them against the punishment of mark-to-market (MTM) pricing on their technical accounts. However, markets are increasingly able to 'look through' such crutches to identify true MTM values, and thus position themselves accordingly. Solvency II will afford much greater disclosures than ever before and will provide a new window into the financials of insurance companies. This could prove to be quite uncomfortable during difficult times. Even if regulators and accountants tolerate a benign non-MTM regime in times of crisis, crucially, equity investors will not. Those insurers with assets that are not fully marked-to-market may become 'forced' sellers of such assets due to investor pressure, even if regulators and accountants tacitly appear supportive.

Conclusion

Insurers ought to be cautious not to surrender asset liquidity in their portfolios thoughtlessly by embracing a passive approach. In an era when many insurance companies (especially life insurers) consider infrastructure debt, commercial real estate debt and similar strategies to be attractive for capital reasons, there are equally compelling arguments to maintaining a sizeable allocation to actively managed liquid assets.

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[1] www.pimco.com/EN/Insights/Pages/Sorry-Mr-Bogle-But-I-Respectfully-Disagree-Strongly.aspx