Deutsche Asset
& Wealth Management

Asset allocation strategies for a (still) low interest-rate world

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Passion to Perform

For Institutional Investors Only

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Executive summary

Insurance companies have struggled to remain profitable in the low interest rate environment of the past several years. The narrowing spread between insurers' assets and liabilities have crimped earnings and spurred the companies to consider alternative investment strategies. However, regulators, concerned about solvency, have limited their ability to invest in equities and other assets aside from fixed income. Alternative asset classes such as hedge funds and certain private equity may have high capital requirements, but in the right structure or investment vehicle may be advantageous.

In the case of fixed income, extending duration or moving down the credit spectrum represent the more likely sources for yield enhancement. Extending duration is risky given the uncertainty over the Federal Reserve's "tapering" timetable and the recent credit market volatility. Moving down the credit spectrum, by contrast, has the potential to generate better returns with less relative increase in expected risk. This can be done with assets that are close analogues to core fixed income, such as commercial mortgage-backed securities (CMBS), bank loans, collateralized loan obligations (CLOs) and high-yield bonds.

Asset allocation strategies for a (still) low interest-rate world

Insurance companies have struggled to remain profitable in the declining interest rate environment of the past several years. Central banks' accommodative monetary policies since the 2008 financial crisis have pushed rates on government debt to near historic lows; in some instances, real interest rates in developed economies have turned negative.

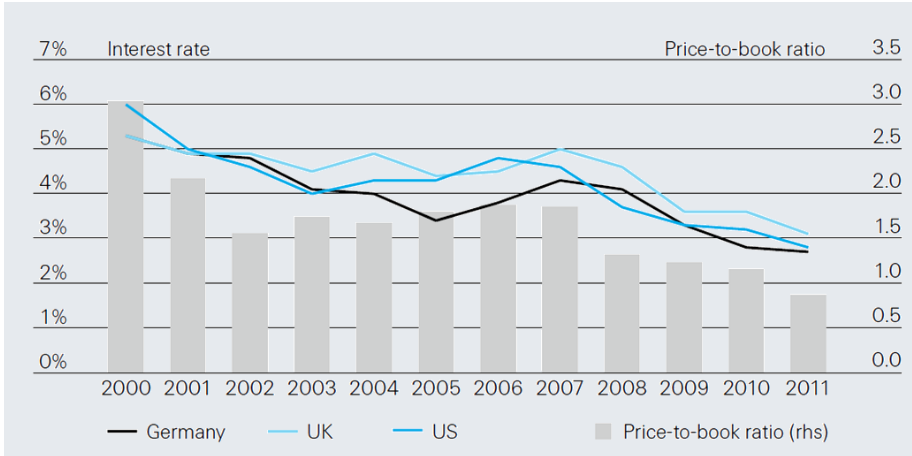
Insurers have changed their pricing on new policies to reflect this environment, but legacy products with prices based on higher interest rate assumptions will take time to expire. These costlier liabilities are difficult to fund profitably in the current low-rate environment, making asset-liability management a challenge.

In turn, this erodes the market value of insurance companies and makes it more expensive for them to raise capital. Investors recognize the earnings pressure that low interest rates cause and mark down the value of insurance assets as rates fall. As Figure One illustrates, the average price-to-book ratio of a sample of large European and American insurance companies fell by over two-thirds between 2000 and 2011, as interest rates fell by about 50 percent.

Insurers cannot look overseas to obtain the returns they need. The secular decline in government yields has been a global phenomenon, across all the major developed economies, and one that pre-dates the financial crisis. The U.S. 10-year Treasury yielded about 8 percent in early 1995; it has been on a downward trajectory ever since. Ten-year bonds from other high-quality sovereign issuers have declined in a similar fashion, as Figure Two illustrates.

Other types of bonds, apart from Treasuries and agencies, have seen a similar compression of spreads and yields. In the investment-grade credit market, this has been driven in part by low net issuance in recent years, which has reduced supply to the point where investors are bidding up prices (and thereby compressing yields) on the remaining bonds.

Figure One: Insurer price-to-book values and long-term interest rates

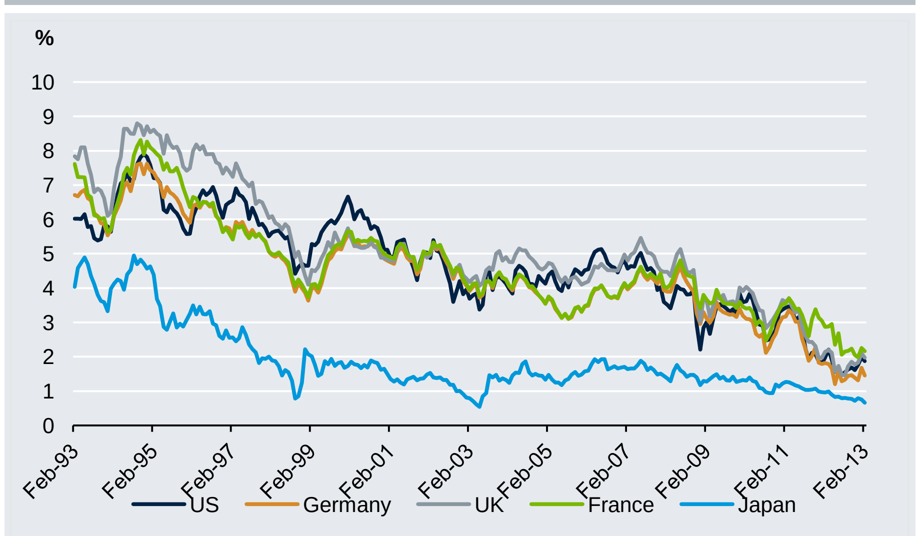


Source: Bloomberg, Swiss Re, Economic Research & Consulting. Data through year-end 2011.

Note: the company sample includes Generali, Prudential PLC, Great-West Life, Aflac, Lincoln, Protective Life, Torchmark, Legal & General, Swiss Life, Allianz, AXA, CNP, Helvetia, Hartford, Met Life, Sun Life.

Figure Two: Global government yields near historic lows

10-year government yields



Source: Bloomberg as of February 28, 2013.

For illustrative purposes only

Insurers are also limited in their ability to seek return in other asset classes. Regulators since the 2008 financial crisis have highly prioritized solvency from a run-off perspective in the new rules they have written. So while market conditions have caused insurance companies to look beyond bonds, regulators have made other alternatives less palatable. While insurance regulators are aware of the difficulties this is causing insurance companies, systemic risk and solvency concerns have taken precedence in their rulemakings.

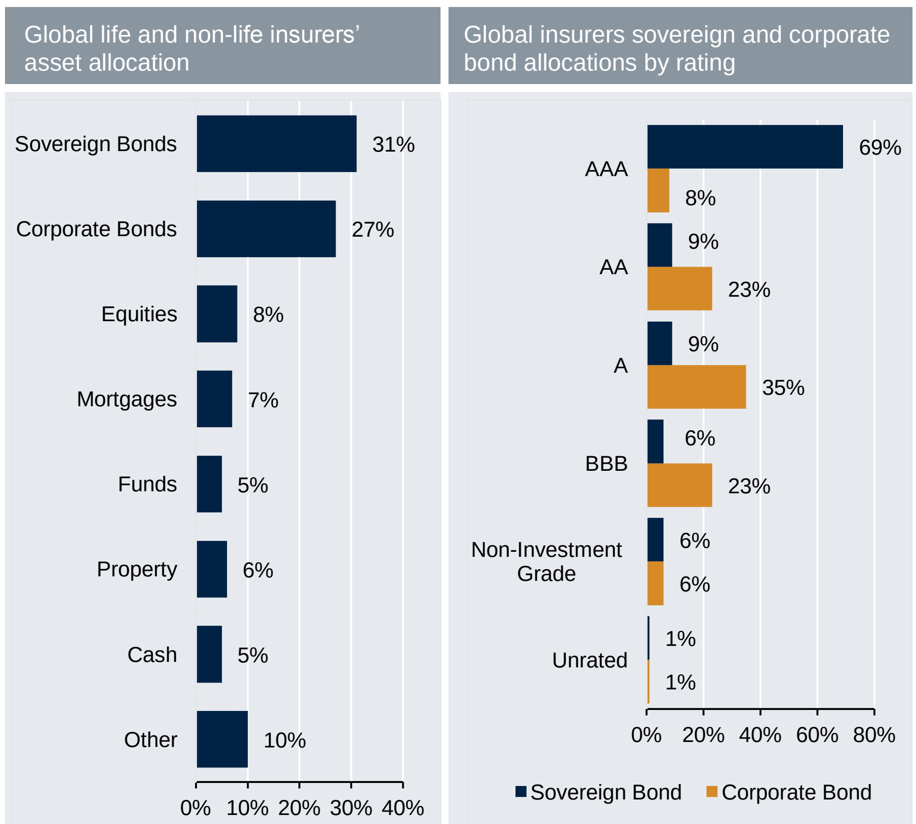
Portfolio responses

The traditional responses to a compression of yield in the fixed income market are a move down in credit quality or out in duration. Since the turmoil in the bond markets at the end of June, portfolio managers have been reducing their duration in fear that the low interest rate environment might be ending in the foreseeable future. Insurance portfolio managers are likewise looking to position themselves for future interest rate increases by keeping their durations short.

Going down in credit could be a more attractive move for many insurance companies, and such a reallocation is supported by the economic cycle. Corporate balance sheets are in good shape and credit fundamentals are supportive. Insurance company fixed income investments remain overwhelmingly conservative; three quarters of all corporate bonds in their portfolios are rated single-A or better. (See Figure Three.)

How are insurers invested globally?

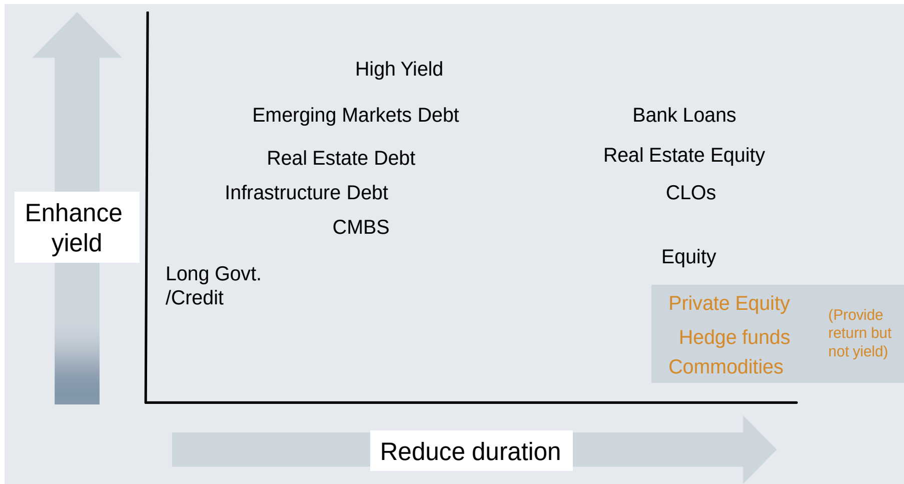
Figure Three: Insurers' asset allocations



Notes: As at December 2012.

Source: Insurance Collateral Survey, BNY Mellon/Insurance Risk/Ernst & Young, Insurers can travel down the credit spectrum via a number of different types of products that are close analogues to their core holdings, such as high-yield bonds, bank loans, CMBS and CLOs. Along with the possibility of gaining more yield, these structures can reduce duration, and they have their own specific benefits. (See Figure Four.)

Figure four: Duration risk versus yield enhancement



Source: Deutsche AWM relative estimates as of 05/15/2013.

This information is a forecast and due to a variety of uncertainties, and assumptions made in our analysis, actual events or results or the actual performance of the markets covered may differ from those presented. The information herein reflect our current views only, are subject to change, and are not intended to be promissory or relied upon by the reader. There can be no certainty that events will turn out as we have opined herein.

CMBS, for example, provides exposure to the revival of the commercial real estate market, and the highest tranches of the instruments can be appropriate for insurance companies. Bank loans are another example. They provide the opportunity for a higher yield but are also floating rate, so they have no duration risk.

CLOs are also floating rate. They gained a bad reputation during the financial crisis as repositories for toxic loans banks did not want to hold. However, the new crop of CLOs are less risky, being designed with a high degree of asset visibility so investors know what is in their portfolios. Critical to success in this bond category is using that transparency wisely in assessing opportunities.

Other close analogs to core include private real estate debt, emerging market debt and infrastructure. These provide yield enhancement and diversification while giving insurers exposure to potentially attractive sectors.

Even among these assets, yields have fallen recently. There has been a significant reallocation to these assets by insurers and other investors, which has compressed yields, making some of them less attractive from a risk-adjusted return perspective. However, depending on market levels, they remain worth investigating.

Another approach taken by some more sophisticated insurance companies is the use of derivatives to assemble a synthetic asset allocation that improves yields and reduces duration. This can be accomplished using total return swaps or a combination of futures and options, although it requires the insurance company to invest in strong internal risk management, and even so, regulators will set practical limits.

Alternatives to core

Assets that do not have fixed income's iron clad relationship with interest rates can be attractive in some circumstances. Regulators' tolerance for assets that bear no resemblance to traditional core components, such as equities, commodities, private equity and hedge funds, varies from state to state and country to country. From a solvency perspective, these assets typically attract a higher capital charge.

While the higher capital charges make these investments more expensive from a return on surplus point of view, depending on their structure and the returns they offer however, the math can work under certain circumstances. Apart from yield enhancement, these assets also have some ancillary advantages. For example, insurance companies can invest their surplus assets and excess capital in these assets to take advantage of diversification benefits resulting from their lower correlation to core fixed income holdings in their portfolios, and achieve some degree of offset to declines in bond market values if rates rise.

Insurance companies also have an advantage over other regulated institutions, such as banks, when investing in some of these asset classes. Unlike banks, where depositor money is more mobile, insurance policyholders cannot accelerate the timing of their claims, so when investing, they can take on more liquidity risk in return for improved terms. For example, an insurance company could invest in private equity which generally has low liquidity but expects higher returns.

As Figure Five shows, a significant number of insurance companies plan to hire alternative or asset managers with a particular investment expertise. One-in-five expect to outsource private debt management, double the amount that currently do so. Private equity fund-of-funds are growing in popularity also, with 14 percent of insurers reporting that they will likely issue new mandates for that asset class.

Figure Five: Likely new alternatives mandates

Percent of US Insurance Companies currently outsourcing and likely outsourcing new alternatives mandates

Alternative Investments and Real Estate		
Base: Current/likely users	Current use	Likely new mandates
Private debt	11%	20%
Private equity fund of funds	6%	14%
Private equity (single funds)	9%	12%
REITs	7%	11%
Mezzanine debt	4%	10%
Infrastructure	4%	10%
Hedge fund of funds	4%	9%
Hedge funds (single manager)	5%	6%
Commodities	1%	6%
High future outsourcing activity likely		

Source: Eager Davis & Holmes 2012 Survey of Insurance Companies, October 2012.

Conclusion

Despite a possible perception and focusing on asset allocation, there are five ways to increase yield in a fixed income portfolio: the use of duration; leverage; volatility; liquidity; and credit. Given the need to be conservatively invested, insurance companies will typically avoid volatility and leverage. They can use their tolerance for illiquidity to invest in asset classes that some other institutions must avoid, such as private debt and private equity.

Like most investors, insurers are reducing duration in anticipation of rising rates. To do this, while increasing returns, they can go down the credit spectrum using instruments that also shorten duration, like bank loans, or have other advantages, like CMBS.

These types of instruments often have more attractive return/duration trade-offs than straight investment grade bonds. They can be supplemented by alternative assets, carefully chosen and with the right investment structure so their return is still attractive when the capital charge is factored in. With current returns low, and rates possibly on the rise, these are options from which insurers can benefit.

About Deutsche Asset & Wealth Management

Deutsche Asset & Wealth Management is a leader in the global insurance investment business. With its one focus on working with insurance companies in the management of their assets, we deliver performance by leveraging our scale and global platform. To that end, Deutsche Asset & Wealth Management provides customized investment portfolios based on clients' specific risk and return objectives across active, passive and alternative asset classes, together with advisory solutions and world-class service specific to the unique needs of insurance companies. Deutsche Asset & Wealth Management is the recipient of multiple awards and with nearly $200 billion in assets under management is among the largest and best-recognized third-party managers of insurance portfolios in the world.*

Risk disclosures

High Yield: Investment in high-yield bonds face the risk that the creditworthiness of the issuer may decline, causing the value of its bonds to decline. In addition, an issuer may be unable or unwilling to make timely payments on the interest and principal on the bonds it has issued. Because the issuers of high yield bonds (rated below the fourth highest category) may be in uncertain financial health, the prices of their bonds are generally more vulnerable to bad economic news or even the expectation of bad news, than those of investment grade bonds. In some cases, bonds, particularly junk bonds, may decline in credit quality or go into default.

Credit and Interest Rate–Bonds: Bond investments are subject to interest-rate and credit risks. When interest rates rise, bond prices generally fall. Credit risk refers to the ability of an issuer to make timely payments of principal and interest.

Credit and Interest Rate–Loans: Loan investments are subject to interest-rate and credit risks. Floating rate loans tend to be rated below-investment grade and may be more vulnerable to economic or business changes than issuers with investment-grade credit. Adjustable rate loans are more sensitive to interest rate changes.

Equities Securities: The principal risk of investing focused on equity securities is that the value of such securities will rise and fall with the value of the underlying equities. Stock prices can be affected by a variety of business risks, including but not limited to poor management and reduced product demand, as well as movement in financial markets, which may affect the stock price regardless of company performance.

Foreign Investments: Investing in foreign securities, particularly those of emerging markets, presents certain risks, such as currency fluctuations, political and economic changes, and market risks.

*Assets under management as of June 30, 2013: $187 billion; Awards from *Reactions* Global , *Reactions* London Market, and *Intelligent Insurer*; First or second place among largest insurance asset managers by IAM Surveys (2008-2013)

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