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The case for a completion portfolio

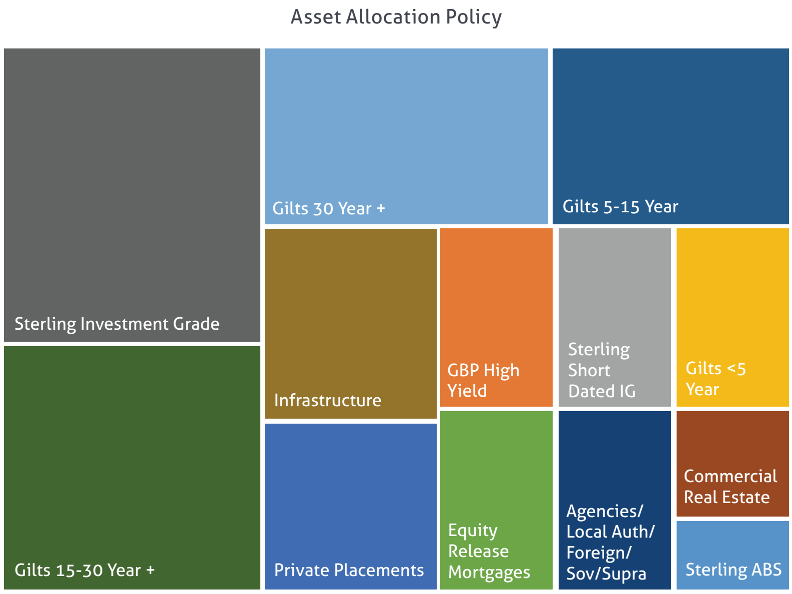
Insurers typically seek to maximise their return on capital, subject to prudential limits. To achieve this, they will invest the proceeds of their insurance activities in a diversified portfolio of assets and seek to create an efficient balance sheet. An efficient balance sheet is one that achieves the trade-off between the expected investment return and the capital the insurer is required to hold in aggregate. Although it is possible to allocate to specific assets with the desired characteristics, in practice insurers allocate to a number of broad investible asset categories.

The reason for this type of allocation is the practical need to put the allocation into recognisable and relatively broad sector allocations – "boxes":

1. Boards and investment committees can readily understand the asset allocation when presented in this way.
2. The boxes allow the insurer to assess whether the asset allocation policy is being consistently applied across different types of business.
3. Asset managers typically specialise by asset class and are organised around standard, rather than bespoke, benchmarks.
4. Boxes allow the insurer to compare their current managers to others with similar expertise.

In a diagrammatic form, the final allocation decision might look like figure 1, with different size boxes representing the size of the asset allocation.

Figure 1: Asset allocation



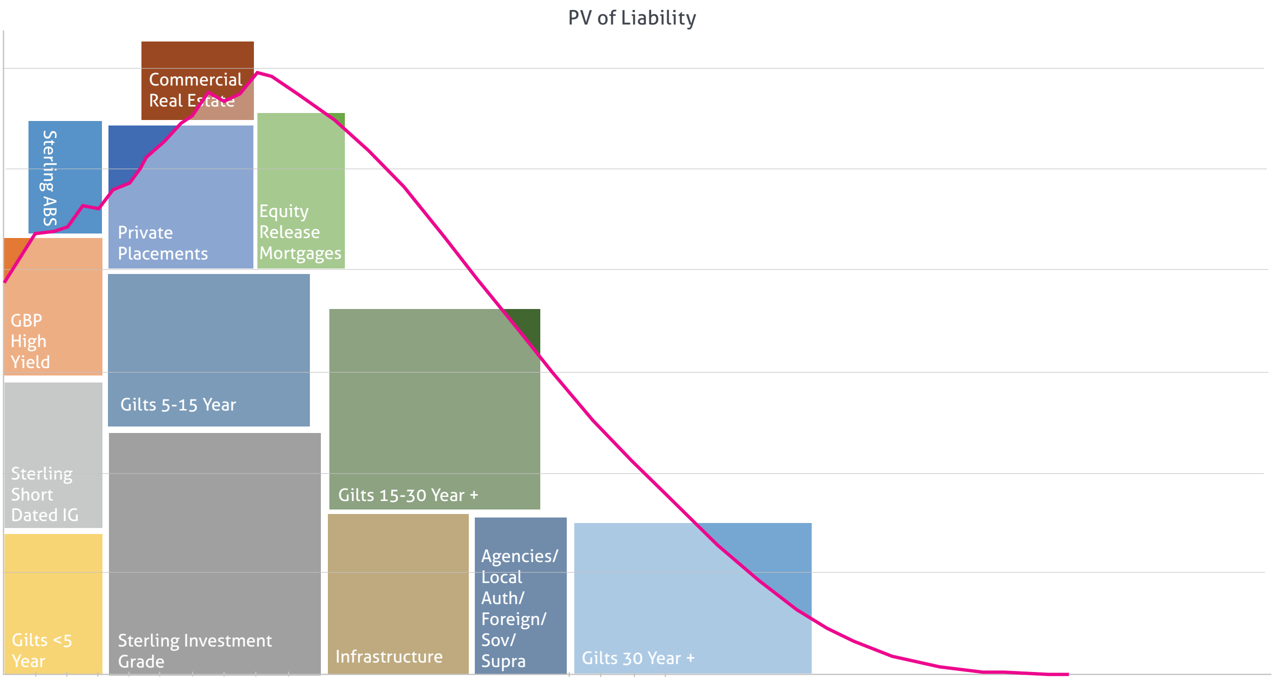
The policy shown in figure 1 may be a fair approximation to the insurer's ideal asset allocation, but it is likely to be far from perfect. In figure 2, the boxes have been stacked inside an envelope that represents the maturity profile of the insurer's liabilities: the boxes do not fit it well. By using asset allocation boxes the insurer's balance sheet is mismatched and hence less efficient.

The visual analogy is, of course, not perfect, but it does neatly expose the trade-off faced by an insurer deciding how to allocate assets against its liabilities.

As figure 2 suggests, the mismatch between assets and liabilities can be large. In addition, the appointed asset managers will take active risks relative to their benchmark and will act independently, possibly exacerbating the problem. The problem is not that asset managers do their own thing – it is presumably one of the reasons they were appointed – it is that the use of boxes creates unwanted asset exposures and leaves unmanaged liability exposures. Consequently, the insurer has to hold capital in reserve that might be deployed elsewhere: in other words, its balance sheet is inefficient.

The alternative to the box solution would be a bespoke optimisation to the liability profile, but this would have its own constraints and issues, not least of which would be the loss of the advantages of boxes that we have set out above.

Figure 2: Matching assets to liabilities



Accepting that the boxed solution has genuine practical advantages, how could it be improved? Note that some of the boxes above are filled with similar high quality collateral – namely gilts and bonds issued by highly rated agencies, supranationals and foreign sovereigns. We believe that these assets can be made to work harder. They are the safest assets available, liquid in times of stress and eligible for discounting with the central bank, which means that they are easy to repo and reverse repo.

We believe that the balance sheet can be made more efficient by using a portfolio to close the gap between the asset allocation boxes and the liability envelope:

1. Choose an 'ideal' boxed asset allocation – one which precisely reflects the insurer's return expectations and risk appetite.
2. Map the mismatch between this ideal allocation and the liabilities.
3. Define a bespoke long and short benchmark of gilts designed to eliminate the above mismatch.
4. Appoint a manager to manage the insurer's liquid collateral portfolio to achieve a return objective against this benchmark.

We are calling this a completion portfolio and think that the case for one is compelling for insurers.

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