Pureprofile

INSURERS ARE TAKING ON MORE INVESTMENT MANAGEMENT RISK AND ARE INVESTING MORE IN TOOLS TO MANAGE IT

A report for Ortec Finance

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Introduction

Managing risk is the key challenge for investment management professionals working for insurers and the past few years have thrown up a wide range of challenges in this area from rising inflation and interest rates to ongoing issues around currency and liquidity. In addition to all of that there is climate risk looming over all investments.

That is the background behind the global research Pureprofile conducted for Ortec Finance with investment management professionals at life insurance companies, Lloyds of London insurer and reinsurers as well as fund managers who support insurers.

We conducted research with insurance investment management professionals based in the UK, the USA, France, Germany, Hong Kong, Italy, Netherlands, Singapore and South Korea to get as wide a perspective as possible. Collectively the organisations the professionals surveyed work for manage around $5 trillion to give an idea of the scale of the firms contacted.

Ortec Finance's motivation for commissioning the research is that they provide insurers with a range of services to help them deal with challenges like complex liabilities, low yields, increasing investment performance analysis demands, or to assess and manage climate change related risks and opportunities.

Specific services Ortec Finance provides to insurers are around asset liability management, asset allocation, risk management, economic and climate change scenario testing and performance measurement and attribution. For further information visit https://www.ortecfinance.com/en/industries/insurance-companies

The research looked at a range of issues including how attitudes to risk amongst insurance investment management professionals have changed in the past year and how they might change in 2024 as well as what impact that is having on asset allocations.

We asked about views on alternative asset classes and how risk is being managed as well as looking at how insurers have coped with inflation and what new issues are concerning them such as ESG and greenwashing.

The results provide a valuable insight into the views of insurers.

HOW RISK ATTITUDES ARE CHANGING

The research shows that insurers expect to take on more risk in 2024 when it comes to their investment portfolios.

Over the past 12 months, 51% of those surveyed believe the risk profile of the funds they help to manage has increased, compared to 41% who think it has fallen. However, over the next 12 months, 59% believe the risk profile will increase further – 14% anticipate a dramatic rise – and just 39% believe it will fall.

This growing risk appetite is reflected in how survey respondents see the funds they help manage changing their asset allocation over the next 24 months. US equities and Emerging Market equities are growing in popularity. Around 81% expect to increase their allocation to US equities while 72% believe their allocation to Emerging Market equities will rise.

The study asked insurers to select the three main risks they believe the sector faces in terms of their investment portfolios. Nearly three out of four (72%) selected inflation while 57% who cited a stock market correction and nearly half (49%) selected climate change. Around 39% chose geopolitical instability as one of their three main risks, but just 7% included a recession in their top three.

It also delved into more specific risks facing insurers when managing their investment portfolios over the next 12 months and found 74% interviewed expect an increase in credit risk while 72% believe there will be a rise in currency risk. That dropped slightly to 68% who believe equity risk will increase this year.

Around two out of three (65%) think there could be an increase in the interest rate risk facing insurers, and 63% there could be an increase in liquidity risk.

ALTERNATIVE ASSET CLASSES ARE PROVING MORE ATTRACTIVE

Insurers and insurance asset managers are set to increase their allocation to alternative asset classes over the next three years. Nearly nine out of 10 (89%) of those surveyed expect a rise in allocations to alternative assets with 13% expecting a dramatic increase.

What is driving the switch? Around three out of four (73%) said it is due to greater transparency and reporting around investing in alternatives while 62% pointed to the wider investment choice in the alternative assets sector.

Around 59% highlighted the diversification benefits of investing in alternative assets while 20% are attracted by the good yields on offer.

Direct real estate investment is regarded as the most attractive alternative asset class in terms of increased allocations over the next two years with, 73% expect an increase in the sector followed by 69% and 66% respectively expecting allocations to private equity and hedge funds to rise. The table below shows how their views on allocations break down across different asset classes.

Alternative asset class	**Percentage of insurance investment professionals interviewed who expect their funds to increase exposure over the next two years**	**Percentage of insurance investment professionals interviewed who expect their funds to decrease exposure over the next two years**	**Allocation with stay the same/don't know**
REITS	58%	3%	39%
Direct real estate investment	73%	6%	21%
Infrastructure	60%	3%	37%
Private equity	69%	2%	29%
Hedge funds	66%	10%	24%

One consequence of the increased focus on alternatives is that the level of direct investing from insurers and insurance asset managers – investing directly into underlying assets rather than fund investing - is set to rise.

Over the next five years, 16% of respondents to the survey expect a dramatic increase in this from insurers and insurance asset managers, and a further 79% anticipate a slight rise.

HOW TO MANAGE RISK

Insurers are boosting spending on scenario modelling, optimisation and testing in the face of rising investment complexity and challenges for the industry, the study found.

Nearly nine out of 10 (87%) questioned are increasing spending at their own firm while 86% expect increased spending across the sector as a whole over the next three years with 14% forecasting a dramatic increase.

The key point driving spending on scenario modelling, optimisation and testing is that 84% believe the level of investment complexity and challenges the industry faces will increase over the next two years.

A key part of that is the growing use of alternative asset classes by insurers. Almost all (97%) questioned say the relatively new risks and issues such as liquidity and correlation posed by alternative asset investments means insurers and insurance asset managers need to invest more in scenario and stress testing.

The increased focus on more esoteric, illiquid and unlisted asset classes as the search for yield intensifies is regarded as the biggest factor driving increased spending on scenario and stress testing. The growing focus on transparency and reporting is seen as the biggest factor in the study.

Technological advances and regulatory pressures are adding to the need for bigger budgets along with climate risk and scenario testing as well as the general rise in risks faced by insurers.

Just one in seven (14%) rate the accessibility, user friendliness and overall usefulness of current stress testing, optimisation and scenario modelling software as excellent while 69% believe it is good.

Currently three out of four (75%) insurers and insurance asset managers conduct up to 50% of scenario modelling, optimisation and stress-testing in-house. Around half (46%) questioned say insurance asset management consultants conduct up to 50% while 46% say specialist companies carry out up to 50% of the work.

INFLATION HAS NOT GONE AWAY

Insurers still see inflation as the biggest risk they face, even though they have taken steps to address the issue and inflation is falling worldwide.

Overall, 40% of survey respondents believe the portfolios they help to manage are 'very well' hedged against inflation, and 55% say they are 'quite well' hedged.

The study found 79% of the insurance investment professionals interviewed say the funds they help to manage have increased their allocation to inflation linked bonds over the past 12 months. More than half (54%) say they have increased their allocation to money market accounts and 47% have invested more in Indirect (listed) Real Estate.

Nearly two out of five (38%) and one in five (21%) say the funds they help to manage have increased their allocation to gold and infrastructure respectively, to help hedge against inflation.

In terms of what action survey respondents expect the funds they help manage will take over the next 12 months to hedge inflation, 75% expect them to increase their allocation to inflation linked bonds while 53% expect an increase in allocations to money market accounts, and 51% anticipate more investment into gold. The table below sets out allocations have changed in the past 12 months and will change over the next 12 months.

Asset class	**Percentage of insurance investment professionals interviewed who say the funds they support have increased their allocation to this asset class over the past 12 months to help hedge against inflation**	**Percentage of insurance investment professionals interviewed who expect the funds they support to increase their allocation to this asset class over the next 12 months to help hedge against inflation**
Inflation linked bonds	79%	75%
Money market funds	54%	53%
Indirect (listed) Real Estate	47%	45%
Direct Real Estate	44%	40%
Gold	38%	51%
Infrastructure	21%	22%
Other commodities	15%	14%

GREENWASHING IS A MAJOR CONCERN

Insurers are becoming increasingly concerned about greenwashing as ESG requirements become tougher.

Nearly half (45%) are very concerned about the current level of greenwashing when it comes to investing with 53% quite concerned, the study found.

Institutions questioned are planning to increase allocations to green bonds and specialist climate focused funds in the portfolios they manage over the next two years with 62% boosting allocations to green bonds and 75% to specialist climate focused funds.

But they are concerned that the range of investments insurers can access will shrink over the next two years due to increasingly stringent ESG requirements. Around 80% expect a rise in the range of investments becoming unavailable for investment because of ESG requirements with 9% predicting a dramatic increase.

Just one in five (18%) believe the industry as a whole has very good ESG strategies and programmes in place currently. That rises to 21% when companies were asked about the strategies and programmes their organisation has in place.

The table below shows how respondents rate the ESG strategies and programmes of insurer and insurance asset managers in general and of their own organisation.

How do you rate ESG strategies and programmes?	**For insurers and insurance asset managers**	**For your company**
Very good	18%	21%
Quite good	41%	27%
Average	7%	18%
Quite ineffective	22%	23%
Very ineffective	12%	11%

Conclusion

Our research shows insurers are prepared to take on more risk when it comes to their investment portfolios, and they are acutely aware of the challenges they are facing.

As they look to expand on the range of asset classes they invest in and diversify their portfolios, they need to invest more in scenario and stress testing and have a strong oversight of their investment funds and how they would be affected by varying changing risk factors.

The benefits of investing in alternatives are many, from diversification of portfolios to returns linked to inflation. There is also greater transparency around reporting, and more investment opportunities in these sectors so it is not surprising to see insurers increasing their allocations to these markets.

However, as their investment portfolios change so to do the risks they face, and it is imperative that insurers have a good understanding of these and robust strategies for managing them.

Scenario modelling and stress testing is vital to the success of insurers and their investment programmes and that is reflected in the increasing budgets. While firms are generally happy with the software available there is room for improvement and a growing demand for specialist support.

Increased use of alternative asset classes is a key factor in the increased spending, but insurers are grappling with a wide range of issues including the need for greater transparency and regulatory pressure as well as climate risks.

Although inflation is falling, insurance investment professionals still see it as a major threat to their portfolios. Most have been proactive in taking steps to ensure they are adequately hedged against it, and these are evolving in terms of planned asset allocation for 2024.

However, with rising prices and pressure on economic growth, the threat of stagflation is real, and this is clearly a concern for insurers.

There is strong demand among insurers and insurance asset managers for specialist climate focused funds and green bonds. But that is running up against increasing concern about the current level of greenwashing and a belief that the range of investment opportunities available to insurers will narrow over the next two years as ESG requirements become tougher.

Insurers increasingly need support on identifying investment opportunities which deliver for their institution and meet ESG requirements which means a tougher focus on greenwashing.

In these volatile and challenging times, insurers need to be aware of the many risks facing their investment portfolios and be in a position to monitor these and have strategies in place for managing them.

About the research

- Ortec Finance commissioned independent research company Pureprofile to interview 100 investment management professionals at life insurance companies, Lloyds of London insurer and reinsurers and at fund managers who support insurers in November 2023. Survey respondents are located in the UK, the USA, France, Germany, Hong Kong, Italy, Netherlands, Singapore and South Korea. Collectively the organisations they work for manage around $5 trillion.

About Ortec Finance

Ortec Finance is the leading provider of technology and solutions for risk and return management. It is Ortec Finance's purpose to enable people to manage the complexity of investment decisions.

This is accomplished via the delivery of leading technologies and solutions for investment decision-making to financial and real estate institutions around the world. Ortec Finance's strength lies in an effective combination of advanced models, innovative technology, and in- depth market knowledge. This combination of skills and expertise supports investment professionals in achieving a better risk-return ratio and thus better results.

Headquartered in Rotterdam, The Netherlands, Ortec Finance has offices in Amsterdam, London, Toronto, Zurich, Melbourne, Singapore and New York. www.ortecfinance.com