BLACKROCK®

DRIVING RETURNS: GLOBAL INSURERS RECONSIDER FIXED INCOME AND PRIVATE ASSETS

WRITTEN BY
The Economist Intelligence Unit

FOREWORD

As we approach the final few months of the year, insurers continue to face multiple challenges. The 'low for longer' yield environment remains with us, which, combined with persistent slow economic growth, is driving insurers to reevaluate their portfolios in the search for income. Across the industry there is a widespread acknowledgement that we need to evolve to meet the challenges ahead, but accomplishing this is no simple matter and individual firms are at very different stages of execution.

As our report shows, increasing numbers of insurers are, for example, reconsidering the appropriateness of using current fixed income benchmarks to position their portfolios and expect to focus more on absolute returns in the future. Many are looking to private market assets such as real estate and infrastructure to achieve this, although internal barriers need to be overcome before the widespread allocation to investments such as these becomes the norm. Overall, however, we expect insurers to increase their allocation to illiquid assets over the next few years, and as they do so it will become more important than ever for them to find the right partners in order to identify the most suitable kind of opportunities and execute them effectively.

Growing numbers of insurers are outsourcing part of their investment management function to external providers. However, this can be a daunting step – the shift to utilising third party investment managers may require a significant change of culture within a firm, and is not something that can be rushed. Time may be needed to educate boards about how an external partner could help them to take advantage of opportunities they would be unable to pursue in-house. The importance of such education cannot be underestimated.

But whether firms choose to ultimately outsource some of their investment management decisions or work with external providers in other ways, partnership of one form or another will become increasingly important over the next few years as insurers seek to shape their portfolios to meet the challenges ahead. That is why it is the responsibility of managers like BlackRock to continue delivering a flexible partnership model underpinned by deep insurance expertise. It is indeed in this spirit that we present this report, which is intended to shine a light on the key issues facing the insurance industry so that, together with our partners, we can identify the most appropriate solutions. I hope that you find the report informative and useful as you plot a course through the testing period ahead.

Sincerely,

David Lomas, ACII
Global Head, Financial Institutions Group, BlackRock's Institutional Client Business
financialinstitutions@blackrock.com

Driving returns: global insurers reconsider fixed income and private assets

CONTENTS

About the research

In June and July 2014 The Economist Intelligence Unit, on behalf of BlackRock, surveyed senior executives from insurance and reinsurance companies around the world to understand how they were responding to the pressures their fixed income portfolios are under, and how they viewed private market asset classes such as real estate and infrastructure as an investment opportunity.

In total, we surveyed 243 respondents worldwide, who between them have over US$6.2trn assets under management (AuM). Insurers were grouped by AuM as follows: there were 47 with more than US$75bn in AuM (19%); 34 with US$25bn-75bn (14%); 33 with US$10bn-25bn (14%); 32 with US$5bn-10bn (13%); 74 with US$1bn-5bn (30%); and 23 with US$500m-999m. Life insurers accounted for 79 responses (33%); health for 33 (14%); property and casualty for 49 (20%); multiline for 55 (23%); and 27 were reinsurers (11%).

In addition, in-depth interviews were conducted with insurance industry leaders and independent experts. We would like to acknowledge our gratitude to the following interviewees for their time and insights (listed alphabetically):

- **David Babbel**, professor emeritus (insurance and risk management), The Wharton School, University of Pennsylvania
- **Roger Birt**, head of mandate management, Old Mutual South Africa
- **Peter Brooke**, head (balanced fund allocations), Old Mutual's South African Life division
- **Paul Dixon**, chief investment officer, Guardian Financial Services
- **Don Guo**, chief investment officer, Asia Capital Reinsurance Group
- **Jim Maher**, chief risk officer, Platinum Underwriters Reinsurance
- **Gil Mathis**, head of insurance investments, Voya Financial
- **Carlos Montalvo**, executive director, European Insurance and Occupational Pensions Authority
- **Cecilia Reyes**, chief investment officer, Zurich Insurance Group
- **Frank Swedlove**, chair, Global Federation of Insurance Associations
- **Carlos Wong-Fupuy**, senior director, A.M. Best

Executive summary

With the profitability of insurers under increasing pressure, boosting returns on investment is a top priority for the industry. Not only is risk appetite going up, but the range of investment risks insurers are taking on is also becoming more varied. This is evident in the willingness among senior insurance executives to allocate a much greater proportion of their portfolios than ever before to higher-yielding opportunities, in particular to private asset classes.

The proportion of insurers who intend to allocate more than 15% of their portfolio to private market assets is set to nearly double over the next three years. However, significant barriers remain: good investment opportunities in private asset classes such as infrastructure and real estate can be hard to find. Nonetheless, the significant and growing demand for such assets implies that insurers are no longer averse to venturing out of their comfort zones.

More broadly, a third of insurers intend to increase their risk exposure over the next three years, most commonly to replace or enhance investment income and diversify portfolios. This trend is global, with risk appetite rising among insurers of all types across the world. Within their fixed income portfolios, insurers are switching their focus towards managing duration risk and anticipate greater use of absolute return as a measure of performance. Managing book yield has been the top priority for almost half of insurers over the past three years, but with interest rate rises looming, managing duration will become the primary focus for many.

This report presents the highlights and analysis of the survey findings, together with additional insight from industry leaders and independent commentators.

The key findings from the research are as follows:

Insurers are worried most about the risks posed by uncertainty over economic growth, inflation and interest rates. Close to half the survey respondents (49%) see weak economic recovery as the single biggest macro risk to their fixed income portfolios. Two in five also cite inflation risk as a key concern. The proportion of US insurers worried about inflation is even higher (49%) now that the American economy is gaining momentum. Also, 54% of respondents cite persistent low rates as a key concern, and a similar proportion (50%) see rising interest rates as a risk to their investment-grade core fixed income portfolios. “We’re managing [inflation] risk by not taking on as much of it,” says Jim Maher, chief risk officer at the New York office of Platinum Underwriters Reinsurance.

Duration risk is set to replace book yield as the top concern in fixed income for insurers. Increasing or maintaining book yield is currently the main objective for insurers managing investment-grade core fixed income portfolios (46%), more so than managing duration risk (42%) or credit risk (33%). However, in the next three years book yield will remain a top priority for only 26% of respondents. In the same period, duration risk and liability matching will continue to be a top concern for many more insurers (43%).

Absolute return is becoming more important as a key measure of performance for fixed income portfolios. Almost half of survey respondents (45%) say that absolute return will be the primary measurement for assessing the performance of their fixed income portfolios over the next three years, compared with just 30% who assign the same importance to it currently. The growing popularity of absolute return is matched by an almost corresponding decline in the importance of relative return as a yardstick of success.

One in three insurers intends to increase risk exposure over the next three years. More than half the survey respondents (51%) intend to maintain their current risk profile over the next three years, but one in three plans to increase risk appetite. Of this group, over two-thirds (68%) see it as a way to replace or enhance investment income, while others see it as a way of achieving their diversification targets. "In this low interest rate environment, companies would like to increase their yields," says Carlos Wong-Fupuy, Senior Director at AM Best. "But investment managers don't think that's possible without change [in asset allocation]."

Private asset classes are becoming crucial to insurers' diversification strategy. In a market where income remains scarce, higher-yielding private asset classes are becoming increasingly attractive to insurers. Three years ago just 6% of insurers had over 15% of their portfolios in private asset classes. That figure has risen to 26% now, and in three years 46% of insurers will have over 15% of their portfolios invested in private assets. Fifty-six percent of those surveyed strongly agree that private asset investments represent a very attractive option, and 50% agree that they offer a diversified source of risk and return. Real estate (36%) and infrastructure (34%) are particularly popular among those planning to increase their exposure to this asset class.

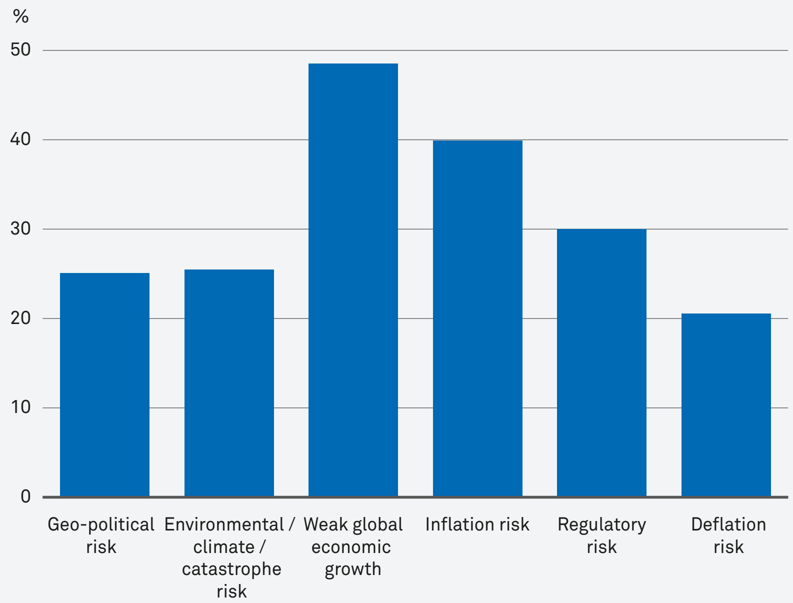
Barriers to investing in private assets remain high for insurers. Private assets may be growing more attractive to insurers, but they still face substantial challenges in increasing their allocation to this asset class. Lack of access to the right opportunities (40%), concerns regarding transparency (40%) and uncertainty over how regulators would treat such moves (33%) are the most serious ones. The challenge, according to Cecilia Reyes, Chief Investment Officer of Zurich Insurance Group, is in matching the funding structure of insurers with the relatively less liquid opportunities in this category.

SECTION 1

Evolving strategies to address persistent concerns

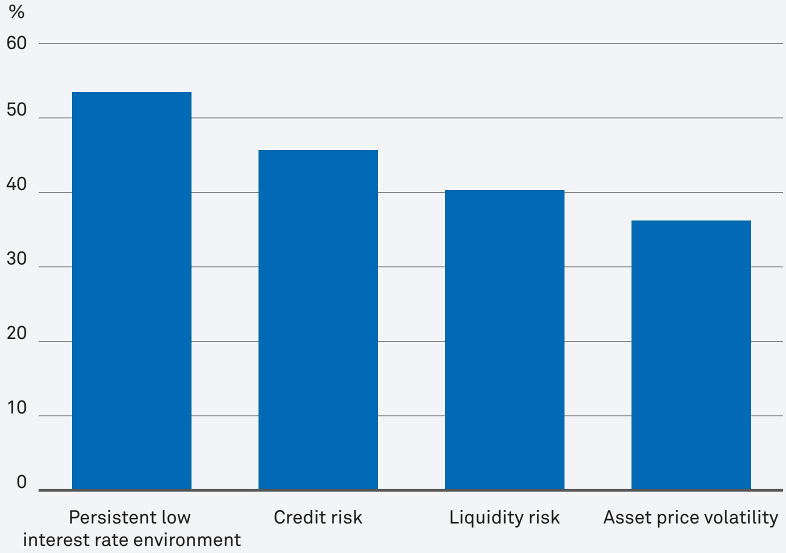
The shaky economic recovery around the globe is making insurers and reinsurers understandably nervous about the outlook for their investment portfolios. Almost half of those surveyed for this report see weak economic growth as the most serious macroeconomic risk to their fixed income portfolios and persistent low interest rates as the most worrisome market risk. [See charts 1 and 2].

CHART 1: WHICH OF THE FOLLOWING DO YOU CONSIDER TO BE THE MOST SERIOUS MACRO RISKS TO YOUR FIRM'S INVESTMENT STRATEGY / PORTFOLIO OVER THE NEXT THREE YEARS?



Base: Global (n=243)

CHART 2: WHICH OF THE FOLLOWING DO YOU CONSIDER TO BE THE MOST SERIOUS MARKET RISKS TO YOUR FIRM'S INVESTMENT STRATEGY / PORTFOLIO OVER THE NEXT THREE YEARS?



Base: Global (n=243)

In June 2014 the World Bank, in its *Global Economic Prospects*, predicted global economic growth of 2.8% for the year, rising to 3.4% in 2015 and 3.5% in 2016. These figures were lower than its previous estimates, suggesting that economic recovery may be under way but is not assured. Europe in particular is struggling to bounce back, with the European Central Bank (ECB) saying in September that euro zone GDP would still only reach 0.9% by the end of 2014 – a downgrade since its last statement at the beginning of the year. These forecasts underline the concerns insurers harbour about a prolonged period of low growth and low interest rates in the world's major economies.

Carlos Montalvo, executive director of the European Insurance and Occupational Pensions Authority, thinks the macroeconomic environment is especially challenging for European insurers. Interest rates on the continent have been scraping the floor for three to four years already, and that's unlikely to change any time soon. "Why we are concerned is that we look at the markets now and we look at what has happened in Japan, and that scenario is a big source of risk for Europe," he says. For insurers, the cost of not adapting to this situation in good time could be huge. "Insurers will ask: 'Are all the products I have been offering for the last 100 years suitable for this reality or not?'"

SECTION 1

Evolving strategies to address persistent concerns continued

In fact, some insurers may be getting quite close to a tipping point. "If interest rates stay low for much longer, insurers will not be able to support their distribution fees and administrative expenses," says David Babbel, professor emeritus of insurance and risk management at The Wharton School, University of Pennsylvania.

That, to some extent, explains why one in three insurers in our survey intends to increase risk exposure over the next three years. More than two-thirds (68%) of those in this camp are considering a higher risk profile primarily as a way to replace or enhance investment income, while others are motivated more by their quest for greater diversification.

Increasing or maintaining the book yield of their fixed income portfolios is currently the main objective for most insurers, and greater diversification is the favoured tool for achieving it. "On the fixed income side, we have a strategy of diversifying," says Don Guo, chief investment officer at Asia Capital Reinsurance Group. "We are not as focused as before exclusively on the highest-quality bonds. We also invest in other fixed income products, such as emerging-market credit. This is something that we are looking at to defend ourselves against interest rate risk."

Mr Guo says that with some investment-grade core fixed income products such as government bonds getting quite expensive, managers need more flexibility in the products they can buy. "If you don't give some latitude to the investment managers, then it is very difficult to generate alpha in your fixed income portfolio," he explains.

To deal with the persistent low-rate environment, many are looking to invest in higher-yielding opportunities outside investment-grade core fixed income such as private assets. Fifty-six percent of insurers strongly agree that private asset investments represent a very attractive option, and 50% say that they offer a diversified source of risk and return. For many, the most attractive vehicles for achieving diversification in this category are real estate (36%) and infrastructure (34%).

“Like most US insurers, we have expanded the number of asset classes within fixed income, but in our case it has been modest,” says Gil Mathis, head of insurance investments at Voya Financial, which has added municipal bonds and mid-market loans to its fixed income allocation. “We are trying to achieve better diversification, given the dramatic shrinking in the investment-grade fixed income supply relative to a couple of years ago.”

In many countries, new opportunities are opening up in infrastructure and real estate, with banks scaling back their exposure to these asset classes and many governments revising policy and regulation to make them more attractive to insurers.

However, some insurance executives feel that the message to the industry has been mixed so far. “The banking regime has changed, and politicians have strongly encouraged the insurance and pensions industry to invest heavily in infrastructure,” according to Paul Dixon, chief investment officer at Guardian Financial Services. “But that doesn’t appear to be completely joined up at the top, with insurance regulators seeming to tread very cautiously and hesitantly when it comes to satisfying themselves that insurers have access to the appropriate competencies to acquire and manage these investments. As a result, this is delaying our ability to invest.”

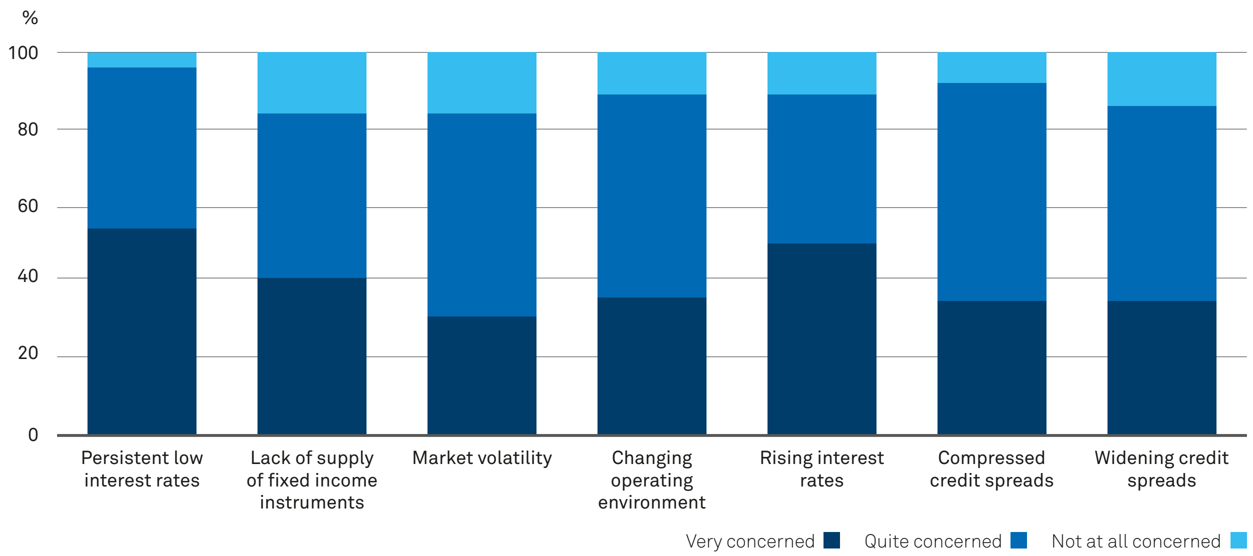
SECTION 2

Redefining approaches to fixed income

The uncertain outlook for interest rates worldwide is posing a range of risks for insurers. Jim Maher, chief risk officer at the New York office of Platinum Underwriters Reinsurance, says his institution is seeking to manage the risk of inflation by matching the duration of fixed income products on the liability side of the portfolio and by staying short on the assets that back the business's surplus. "We're managing that risk by not taking on as much of it," he says. "We tend to think interest rate risk is not well rewarded now with interest rates so low, and the risk that would show up if there were a 300 basis point or so rise in rates is a lot greater than you seem to be getting paid right now to take that risk."

The spectre of rising interest rates is also one of the reasons why insurers are diversifying within their investment-grade core fixed income portfolios, and outside of it too [See Chart 3]. "My concern is that interest rates will inevitably rise, and rise by a significant amount," says Professor Babbel of The Wharton School. For insurers with good asset and liability match procedures in place, fixed income assets should depreciate at the same rate that liabilities decline, according to him. But for life and annuity insurers, there could be trouble ahead. Professor Babbel warns that healthy policyholders cash out in these circumstances and take their money elsewhere, leaving the insurer with policyholders who are likely to be in poorer health, and hence have shorter lifespans. "This can wreak havoc on the insurers who retain this business," he says.

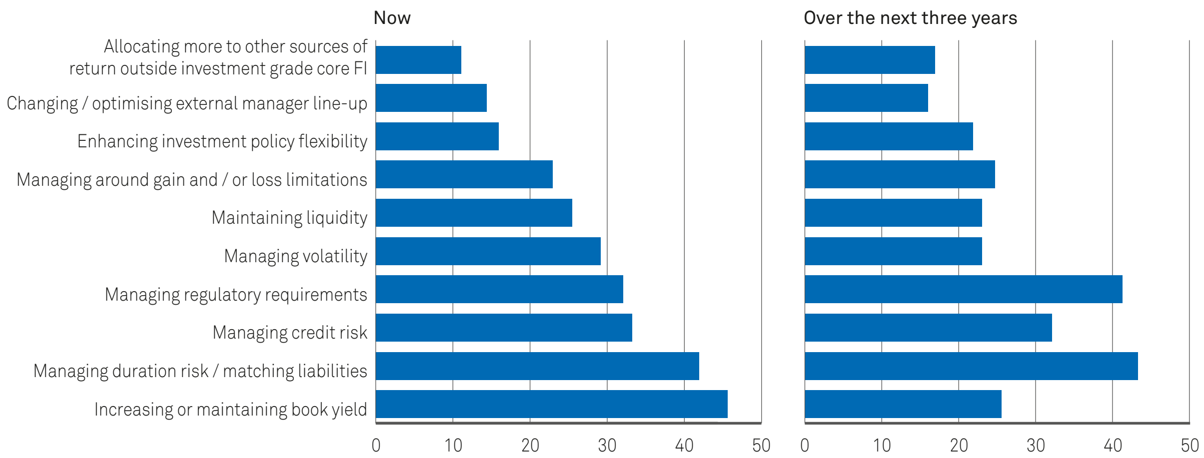
CHART 3: PLEASE INDICATE HOW CONCERNED YOU ARE, IF AT ALL, ABOUT EACH OF THE FOLLOWING CHALLENGES FACING YOUR INVESTMENT GRADE CORE FIXED INCOME PORTFOLIO.



Base: Global (n=243)

As things stand, it is the search for yield that is pushing insurers to look beyond investment grade in diversifying their fixed income portfolios. Increasing or maintaining book yield is currently the top priority in managing fixed income portfolios, and over the next 12 months more insurers will increase than decrease their allocations to high-yield corporate bonds and municipal bonds. But that is set to change over the next three years: our survey shows that increasing book yield drops down the list of priorities of insurers by 20 percentage points [See chart 4].

CHART 4: WHAT ARE YOUR TOP PRIORITIES IN MANAGING YOUR INVESTMENT GRADE CORE FIXED INCOME PORTFOLIO NOW AND OVER THE NEXT THREE YEARS?



Base: Global (n=243)

Managing regulatory requirements is going to become a bigger priority for insurers over the next three years [See Chart 4], the likely reason why a significant minority of insurers is looking to decrease risk profile – especially in the health and reinsurance sectors, where investment managers are still seeking to add to their investment-grade core fixed income portfolios. "In several European countries, with life business, you have local regulators asking companies to build additional provisions depending on the quality of their investments," says Carlos Wong-Fupuy, senior director at A.M. Best. Regionally, demand is high in Asia, where uncertainty about capital stipulations in the future may dampen risk appetites.

"I think the greatest concern is to what extent the impact of regulation, and to some extent changes to accounting rules, will lead to changes in how you do your business," says Frank Swedlove, chair of the Global Federation of Insurance Associations (GFIA). He worries that imminent changes in capital and solvency

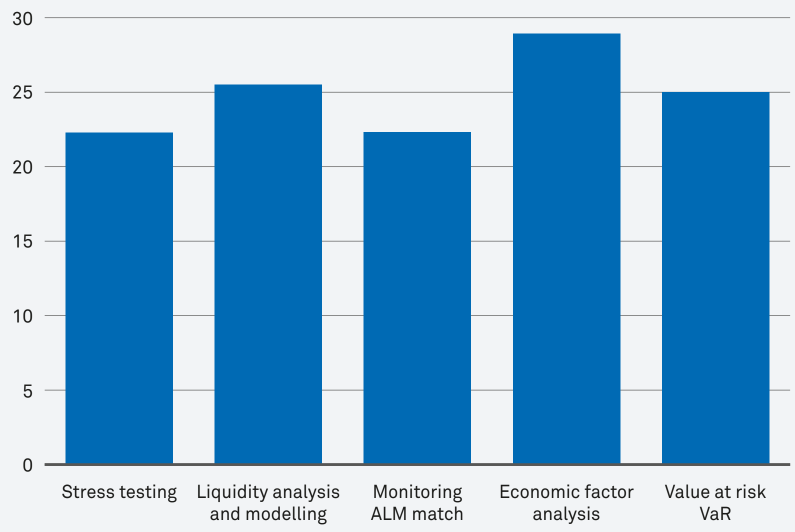
Redefining approaches to fixed income continued

regulation could penalise companies investing in long-term products and encourage short-termism. "Increasingly, the balance sheet of an insurance company is being forced through regulation to look like that of banks."

Quality indicators for investment-grade core fixed income have generally remained the same over the last couple of years, except for capital efficiency, which has greatly improved. In addition, there has been an across-the-board increase in the application of a wider variety of risk management techniques to insurers' portfolios, with a net increase of 11 percentage points in the reliance on tools such as economic factor analysis and value at risk (VaR), implying that risk management strategies are getting increasingly complex and sophisticated [See Chart 5].

CHART 5: COMPARED TO THREE YEARS AGO, HOW HAS YOUR USE OF THE FOLLOWING TOOLS CHANGED WHEN ASSESSING RISK IN YOUR PORTFOLIO?

% saying 'more use'



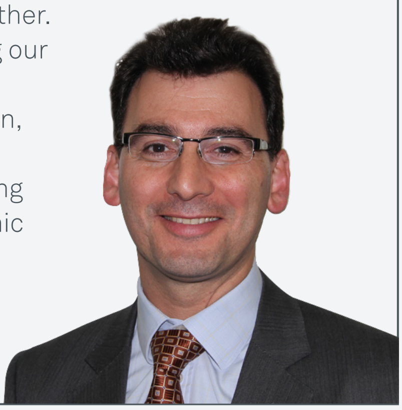
Base: Global (n=243)

Another facet of the changing approach to fixed income strategy is the growing popularity of absolute return among insurers as a benchmark for measuring the performance of investment portfolios. Over the next three years insurers will be most interested in tracking the performance of their overall portfolio by looking at the absolute return it provides (45%), while the current importance of book yield and relative return is set to decline [See Chart 6].

BlackRock view

A combination of persistent low yields, a reduction of liquidity within investment grade credit and new incentives to diversify asset risk is encouraging many insurers to seek new sources of yield in riskier sectors of fixed income and alternative asset classes. However, an asset class isn't diversifying simply by virtue of having a different name; it needs also to have different risk and return drivers. One of the issues highlighted by this trend is the availability of reliable data for these new investments to help with an understanding of the drivers of risk and return. In this environment, possibly the most important challenge for insurance companies, and the asset managers supporting them through the diversification process, is one which BlackRock has embraced. Portfolio managers work in conjunction with our Risk & Quantitative Analysis team to collect more and better data, identify risk proxies, and build models which improve our understanding of these asset classes.

Equally, some insurers have adopted tactical short duration positions against the liabilities with a view to making an excess return relative to liabilities once rates rise. The story of the last six years in Europe and the Americas, and for far longer in Japan, has been that it is difficult to call the timing of interest rate changes. Companies adopting this approach need to be aware of the economic risk if rates stay low for longer than they expect, or even fall further. We assist our insurance clients with their assessment of this risk by using our Aladdin risk platform to quantify the effects of various "stress scenarios", also incorporating the impact of the stress on the liability value. In addition, we are able to calculate the amount of regulatory capital required for running interest rate risk relative to the liabilities under Europe's impending Solvency II regime, thus assisting with an assessment of both the economic and regulatory view of risk.



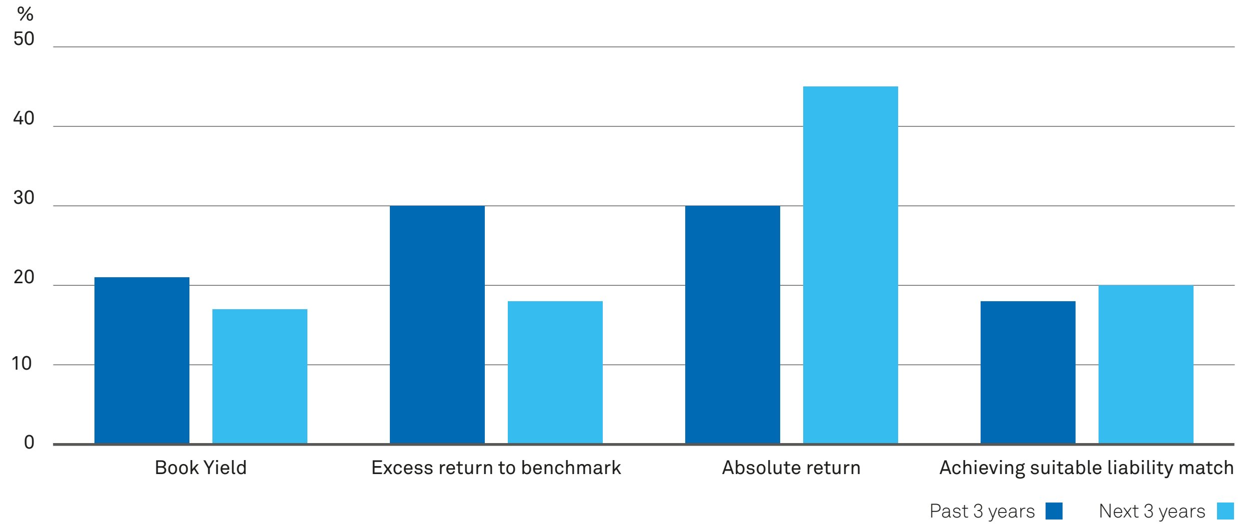
Mark Azzopardi
Head, Insurance Client Strategy

Some investors counsel caution, though. Cecilia Reyes, chief investment officer at Zurich Insurance Group, says that putting too much emphasis on absolute return could add unintended risks to an insurer's balance sheet. An insurer overly concerned with a spike in rates, for example, would shorten the duration of the assets relative to liabilities. "Ex ante, this is an uncompensated ALM [asset-liability management] risk that needs to be covered by capital. Ex post, if you get this wrong, i.e. interest rates continue to go down and remain down, then the insurer that paid a huge cost as capital is destroyed by the declining interest rates," she says. "Ex post, if you get this call on interest rates right, capital allocated to this risk was not deployed elsewhere, so there was an opportunity cost. This is an unintended – I would say misguided – risk from a balance sheet perspective."

SECTION 2

Redefining approaches to fixed income continued

CHART 6: WHAT WAS YOUR FIRM'S PRIMARY METHOD FOR ASSESSING THE PERFORMANCE ITS FIXED INCOME PORTFOLIO OVER THE LAST THREE YEARS? WHAT WILL IT BE OVER THE NEXT THREE YEARS?



Base: Global (n=243)

CASE STUDY: OLD MUTUAL – DIVERSIFYING IN A HIGH INTEREST RATE ENVIRONMENT

While insurers in Europe and the US grapple with near zero interest rates, their counterparts in emerging markets such as South Africa face quite the opposite challenge: how do you navigate your investments through a high interest rate environment? At the time of writing, the South African repo rate was 5.75%. But as one of the country's biggest insurers, Old Mutual has learned that the need to diversify is still important.

The current primary concern of Peter Brooke, who manages the balanced fund allocations within the firm's South African life business, is the value of equities, which he believes are now on the high side. Old Mutual and other South African insurers invest heavily in equities, Mr Brooke says, because historically they have provided better returns and protect against sharp spikes in local interest rates and the devaluation of the rand.

However, for the past ten years Old Mutual has sought better returns than it can achieve from investment-grade core fixed income by investing in long-term projects such as toll roads, prisons and power plants, both domestically and across Africa, where the need for better infrastructure is acute. Roger Birt, head of mandate management, says this has been possible because the organisation is not selling as many guaranteed income products as before, which has enabled it to invest in fewer liquid assets. However, because of liquidity concerns, infrastructure is likely to remain at less than 10% of Old Mutual's overall portfolio.

"The key benefit is that they certainly provide very good returns," Mr Birt says. They also smooth concerns about potential portfolio volatility, he adds.

BlackRock view

The current global landscape is characterised by economic division and diverging monetary policy paths. The Federal Reserve and the Bank of England will likely be the first developed central banks to remove accommodation, while the ECB and Asian central banks have begun to employ non-traditional policy tools to stave off sub-trend growth and deflation, a trend we expect to continue.

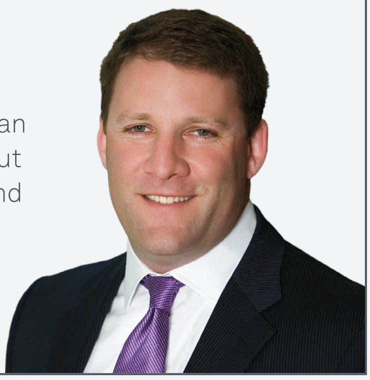
Our outlook for the US economy is for continued slow and steady fundamental growth and for inflation to normalise toward the Fed's targets. Most broad economic categories from labour to production to consumption have shown marked improvement from the weather related rut of the first quarter of 2014. Sectors that lagged, such as housing, have also begun to show a more material improvement. Modest wage pressures and rent escalation have contributed to an increase in most price indices, but broad scale inflationary pressures have yet to emerge.

Europe, meanwhile, continues to face several headwinds. Fragmentation, deflation, and broadly weaker-than-hoped -for economic growth have left European government bond yields at historic lows and expectations high that the ECB may extend its recent quantitative easing programme to include additional asset classes such as sovereign debt. Regardless of whether this comes to fruition, European interest rates should remain supressed over the coming year and support the relative attractiveness of the US rate environment.

We anticipate that an initial hike in the Fed Funds rate and the first step toward normalization of the zero-interest rate policy will take place during the early part of 2015. Consistent with our growth outlook, we expect US interest rates to drift higher, but not spike. Structural demand for income, decreasing supply trends and a lingering 'low for longer' interest rate backdrop, even after the start of any accommodation reversal, will factor into the rate trajectory for some time, limiting the degree to which longer-dated yields in particular will rise. We therefore favour US curve flatteners.

We also continue to favour risk assets in general. Easy global monetary policy and volatility, while rising, will continue to support valuations. The unwind of accommodation should contribute to an uptick in volatility, but we believe strong positive technicals, the relative attractiveness of absolute US yield levels and the aforementioned demand for yield will continue to favour investment grade spread sectors.

In positioning for this environment, insurers will also need to be more flexible within their fixed income allocation by broadening investment policies within accounting considerations, regulatory requirements and other meaningful balance sheet constraints. We expect to see more insurers widen their opportunity set, implement simple derivatives strategies, and update their guidelines to reflect the current environment and not the backdrop that existed as recently as a few years ago. Even small adaptations, such as increasing concentration limits or credit parameters, can increase manager flexibility to meet the clients' investment objectives without changing the overall risk profile in an environment of gradually rising rates and increased volatility.



Jeff Jacobs
Global Head, Financial Institutions Group, Fixed Income Alpha Strategies

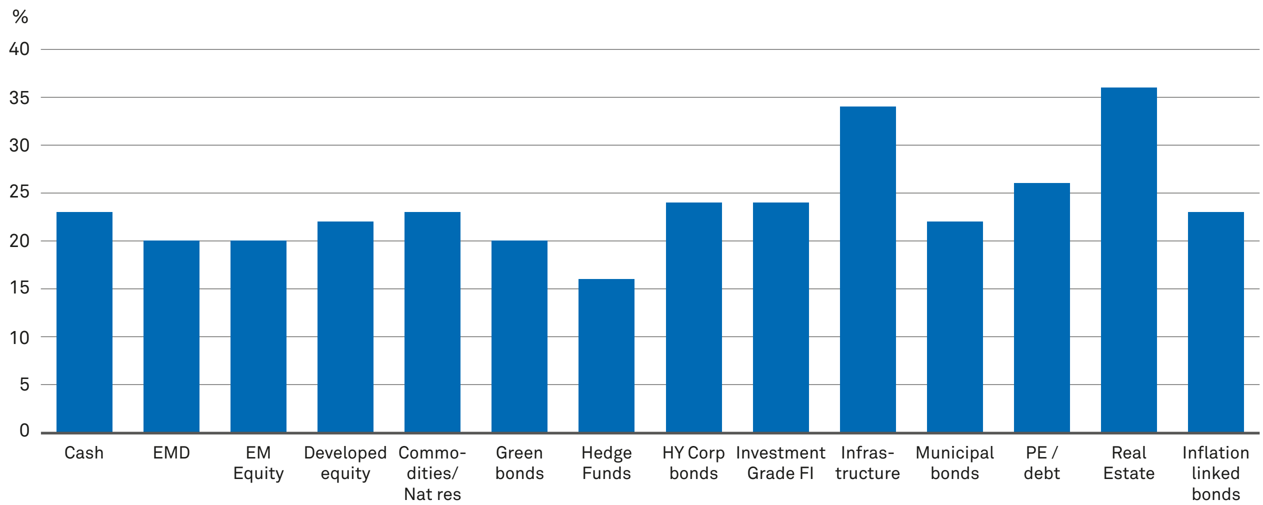
SECTION 3

The growing appeal of private asset classes

Insurers have maintained overweight positions in investment-grade core fixed income over the past three years, but the survey for this report confirms that the pendulum is now moving gradually in the other direction. The two leading asset classes to which investors plan to increase their allocation over the next year are real estate (36%) and infrastructure (34%) [See Chart 7].

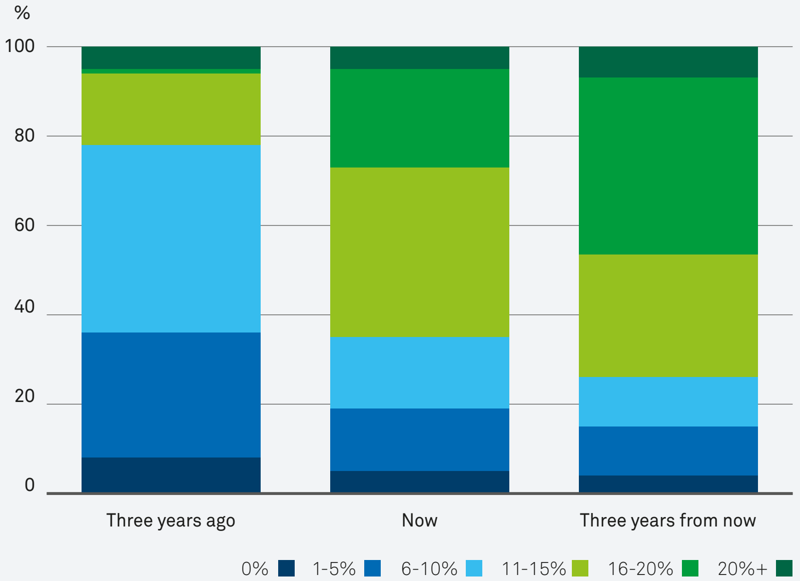
CHART 7: FOR EACH OF THE FOLLOWING ASSET CLASSES, PLEASE INDICATE HOW, IF AT ALL, YOU WILL BE CHANGING YOUR INVESTMENTS OVER THE NEXT 12 MONTHS?

% saying 'increase'



Three years ago nearly two in five respondents (42%) had between 6% and 10% of their investment portfolios invested in private market assets. Today, this has risen to between 11% and 15% allocated in this area, and within the next three years the same percentage anticipates it will be between 16% and 20%. Three years ago, just 6% of insurers had allocated more than 15% of their portfolios to private assets. Currently that figure stands at 26%, and in three years almost one in two (46%) insurers will have over 15% of their portfolios invested in private assets, which only underlines the significant increase in interest from insurers this category will see over the next few years [See Chart 8].

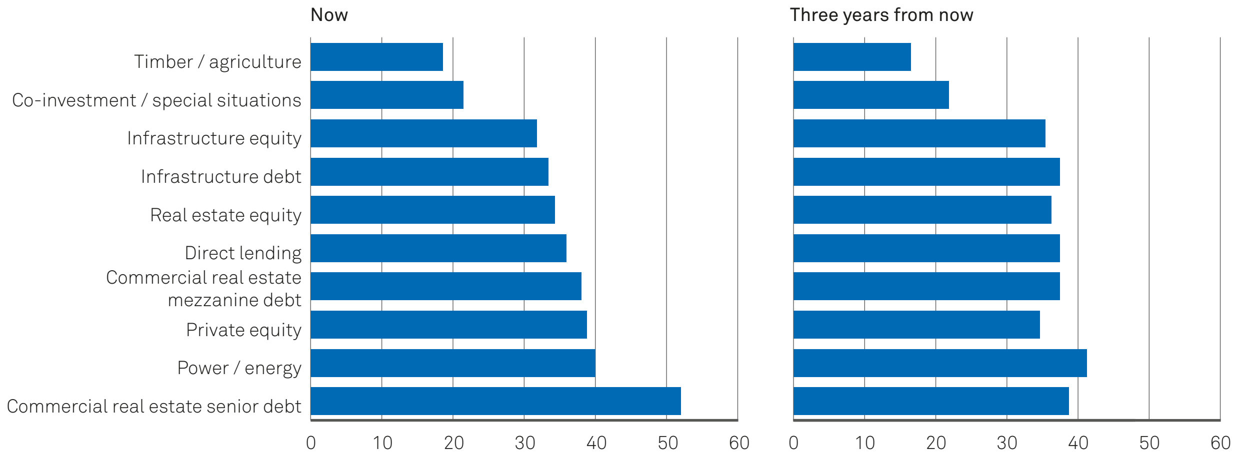
CHART 8: WHAT PERCENTAGE OF YOUR PORTFOLIO HAS BEEN OR WILL BE ALLOCATED TO PRIVATE MARKETS ASSETS? HOW MUCH DO YOU ANTICIPATE INVESTING IN THESE ASSETS THREE YEARS FROM NOW?



Base: Global (n=243)

The range of assets in this category in which insurers are currently investing and plan to explore in the foreseeable future is wide [see Chart 9]. Physical or fixed assets – power plants, real estate and transport projects, for example – are most attractive, particularly to European and US insurers.

CHART 9: HAS YOUR FIRM INVESTED IN, OR HAS PLANS TO INVEST, IN THE FOLLOWING TYPES OF PRIVATE MARKET ASSETS?



Base: Global (n=243)

SECTION 3

The growing appeal of private asset classes

continued

Fifty-six percent of insurers strongly agree that private asset investments are a very attractive investment opportunity, and 51% say that they offer a diversified source of risk and return. These reasons seem particularly compelling for life insurers, which generally have long-dated liabilities, and so the less liquid nature of these assets is not an issue.

BlackRock view

The growing interest in private infrastructure revealed in the report is consistent with conversations we are having with insurance clients globally about this fast-growing asset class. Institutional investors are increasingly attracted to infrastructure debt to provide the long-term cash flows necessary to help them meet their long-dated liabilities, while the premium associated with illiquid investing also offers returns above comparable liquid investments.

Global infrastructure spending is forecast to grow significantly over the next few decades, but deleveraging pressures on banks and restrictions on government spending have created a funding gap. Governments are therefore increasingly looking to the private sector to supplement public spending and public bond issuance.

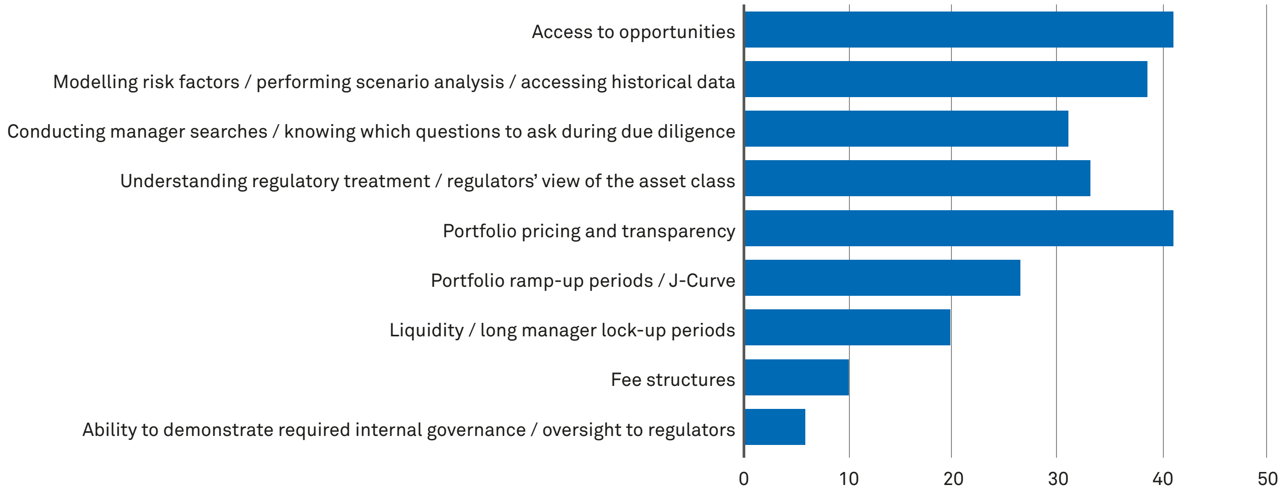
Investing in a senior secured position in the cashflows of essential infrastructure assets allows insurers to achieve more positive spreads without sacrificing investment quality. In addition, while the reduced liquidity of the private market was once a deterrent, the ability to lock-in long-term tenor at spreads above comparable public markets is increasingly helping insurers to more closely match their long-term liabilities. We have had many conversations with insurers who are re-evaluating the liquidity they require and determining that taking the illiquidity risk of private assets such as infrastructure debt is a trade-off that is attractive. The opportunities are similarly robust in infrastructure equity as a result of the same dynamics. This asset class offers a significant yield component and inflation protection to the portfolio, though can be expected to have greater earnings volatility than debt.

The growing demand from governments for private infrastructure investing has created a favourable regulatory environment for long-term capital deployment. In North America, there has been significant investment deal-flow in energy-related assets, driven by the shale gas revolution and the growth of state-level renewable energy programmes. Additionally, we anticipate a blossoming of US public private partnerships, with the potential for a significant pipeline building into 2015. In Europe, a broad range of infrastructure opportunities exist, from social infrastructure such as schools building programmes to transport and energy-related investments.

Jim Barry
Global Head, BlackRock Infrastructure Investment Group

Guardian Financial, which has recently invested in real estate debt, is a good example. The debt fills a gap in the company's investment spectrum and is a good diversifier away from traditional investment-grade fixed income bonds, according to Paul Dixon, the firm's chief investment officer. Such instruments are more readily available now the banks have retrenched, and it has a range of other benefits [see case study on page 24]. "When you look at the economic fundamentals of this asset class and of this sector within the asset class, you can drill down into specifically what we like within it," Mr Dixon says. "It appears very attractive relative to other fixed income-like opportunities."

CHART 10: WHICH OF THE FOLLOWING DO YOU EXPECT TO BE THE MOST SIGNIFICANT CHALLENGES OR RISKS WHEN INVESTING IN PRIVATE MARKET ASSETS OVER THE NEXT THREE YEARS?



Base: Global (n=243)

Given that such assets are often hedged against inflation risk and come with a premium because they ar e less liquid, the rationale for investing in them becomes quite compelling for many insurers. But the barriers to doing so are significant, too. Most typically, insurers complain of trouble with portfolio pricing and transparency (40%) and with access to the right opportunities (40%) [See Chart 10].

Mr Wong-Fupuy of A.M. Best says there is a real lack of understanding about private assets among insurers: "I don't think it's necessarily the investment managers' fault. In many cases, some of these products that we call private market assets are simply very opaque."

SECTION 3

The growing appeal of private asset classes

continued

That can be because of the complexity of the schemes on offer, or because of their novelty. "If you talk about listed shares or publicly traded bonds, you can get a value from the markets. But to make a value of HS2, Britain's high-speed rail project, for example, which is going to mature in, say, 40 years, the valuation is going to be based on a number of assumptions, about which nobody can be really certain." He says that in such cases, traditional risk factors that insurers may use, such as historical data, are unsuitable.

"Banks have stepped away from some of these activities, leaving an attractive opportunity for insurers," points out Ms Reyes of Zurich Insurance, adding that the underlying risks – credit spread risk and default risk – are similar to more liquid assets, such as publicly traded corporate bonds. The challenge, as she sees it, is to match the funding structure of the insurance company, which is very illiquid in nature, with opportunities from less liquid assets, and that can take a lot of extra work compared with investing in more traditional asset classes.

For Zurich, which has invested in these instruments in the past, the most attractive opportunities today for achieving good excess returns are those located in Europe. "You have to be able to decompose the total return for compensation for credit risk and compensation for the less liquid nature of this investment," she says. "And it's that risk assessment that is challenging. Nevertheless, you have to do it. Otherwise, you are taking on risks you don't understand."

Voya Financial has also been investing in the corporate private placements market, an area that according to Mr Mathis, the firm's head of insurance investments, is more mature in the US than in Europe. It is part of a strategy to diversify the company's holdings in a variety of private assets, which now includes investment in the corporate private placements market, direct lending to commercial real estate and private equity. In future, it is also likely to include real estate direct property ownership. "We haven't materially grown our exposure, but have been getting into different things to diversify – although I could see us increasing the overall size of this area in future," he says. An attractive aspect of the corporate private placement markets, Mr Mathis says, is that there is typically some spread compensation for the lower level of liquidity associated with such assets, yet recent history suggests the assets may turn out to be more liquid than envisaged if structured properly.

"One of the biggest problems some companies faced in the last recession was that some of the 'liquid' assets they had invested in, such as complex but publicly traded structured assets, turned out not to be liquid at all. Whereas in areas such as the private placement market, liquidity held up pretty well because the buyer base knew the assets and were comfortable with them," he says.

BlackRock view

Real estate has attracted strong investor interest as part of a wider migration to 'real assets' and income-producing alternatives in a world of low interest rates. The growing popularity of real estate has resulted in increased capital flows, which has meant more liquidity for all investors, but has also led to rising valuations and eye-catching sale prices on trophy properties. Some investors are beginning to adjust their objectives – and expand their choices on the wide menu of strategies that is one of the hallmarks of the asset class. Initially, flows were strongest for core real estate, but more investors are now turning their attention to opportunistic investments outside their home markets. We see them seeking opportunities ranging from properties in hard-hit European peripherals, where values are still around 30-50% below their peak, to plays in some Asian markets, where long-term growth bodes well for investments.

Yet this does not mean that core, income-producing investments in developed markets are out of favour. On the contrary: In the UK, we expect the core space to deliver above average returns both this year and next; in the US, moderate economic growth and near-record-low new construction creates good potential for property income growth. Other key strategies, such as high-yield debt and public REITS, also offer good opportunities for those desiring high income yields or public market liquidity.

The combination of regional disparity in the pace of the global real estate recovery and local economic forces has created a number of attractive opportunities around the world, each with its own unique characteristics. Some investors may be well served by domestic markets but, taken in aggregate, we believe today's global opportunity set gives investors the ability to position themselves across the risk spectrum to meet a variety of investment objectives. Creating value will mean thinking 'local' in terms of market cycle, structural change and financial conditions.

Simon Treacy
Global Chief Investment Officer and Head of US Equity, BlackRock Real Estate

But finding the right project can be tricky. "Whether it's infrastructure debt or real estate, you just don't call your broker and say 'I want to buy a few 100 million of such investment'," Ms Reyes says. "The sourcing of the investment opportunity is much more complex, and there is a lot more internal infrastructure you need to actually take advantage of these investment opportunities."

Zurich has partnered with specialist investment asset managers to help overcome such difficulties, but she says regulation remains a concern. "Insurance regulation is very much still biased to favouring liquid and simple traditional assets. So we have to create special structures to hold these investments so that they comply with admitted asset regulation in the various jurisdictions that we encompass, and that's the reality right now of insurance investment regulations."

Mr Swedlove of the GFIA thinks regulators should have a dialogue with the industry to understand the adjustments that need to be made in investment strategy in order to keep pace with changing market dynamics. "Diversifying is something that should be rewarded as opposed to penalised," he says. "As long as the appropriate due diligence takes place and the overall portfolio remains essentially sound, then regulators should look at that in a positive way."

SECTION 3

The growing appeal of private asset classes

continued

CASE STUDY – GUARDIAN FINANCIAL SERVICES: HITTING THE DIVERSIFICATION SWEET SPOT

In October 2013 Guardian Financial Services, a UK life assurer, decided to invest £350m (US$546m) in commercial real estate debt – the first time it had done so. The firm has traditionally used corporate bonds to match its £8bn book of annuity liabilities, but those assets have looked less attractive in recent years.

Paul Dixon, Guardian's chief investment officer, says that a limited supply of corporate bonds and tight credit spreads had made it more difficult to achieve targeted returns. "You end up with an overconcentration of risk if you are continually only buying debt issued by large multinationals."

The company used real estate debt to diversify out of traditional investment grade fixed income bonds. Mr Dixon says it has helped him enhance his overall risk/reward profile. What is more, the diversification play comes with high levels of security and has an attractive default rate, too.

But it is not without risk. "The simplest mistake would be to finance the wrong asset," he says, "or to pick the wrong sponsor - somebody who is not thorough and robust in their business modelling and their management of the business."

With an eight-person group to oversee more than a total of £15bn of assets, appointing an in-house team was not an option. So, Guardian decided to appoint a specialist manager to handle the real estate debt mandate. "Picking the right manager is by far the single best risk management tool," according to Mr Dixon. "Don't pick a bloke and three guys with screens who say they can do it, pick people with a track record."

He also says insurers should not rush into the first opportunity that comes their way, but set something like a three-year time scale to invest. Guardian is now looking at another £350m-scheme for infrastructure debt, which will edge the proportion of the portfolio invested against annuity liabilities into private asset classes towards 10%.

Conclusion

An uncertain economic outlook, weak investment income, and interest rate and inflation risk are forcing insurers to rethink their investment strategy, particularly in fixed income. Diversifying out of core fixed income and into opportunities in higher-yielding categories such as private assets is emerging as a key component of this strategy, although most insurers are likely to proceed on this path with caution.

How far insurers can go with this strategy remains to be seen. Scarcity of good diversification opportunities and the complexity of investing in private asset classes such as real estate and infrastructure projects can sometimes pose a significant challenge. Still, insurers must be willing to step out of their comfort zone if they have to meet their income and diversification objectives.

Investment managers will need to be more flexible with their fixed income strategy to take advantage of opportunities in higher-yielding asset classes. They will need to dig deeper to find the right balance between allocating to investment-grade core fixed income products and private asset classes. They will also have to assess whether diversification should be handled in-house or outsourced to specialists in different market niches.

All this will have to be done in step with efforts to stay on top of the constantly shifting regulatory landscape. Ways to measure performance may have to change, too. What may be right for one investor or portfolio may not be so for others. But as our survey for this report confirms, insurance executives around the world agree that when it comes to investment strategy, only one thing is certain for now: change is on its way.

BlackRock commentators

David Lomas, Global Head, Financial Institutions Group, Institutional Client Business
David A. Lomas, ACII, Managing Director, is Head of BlackRock's Global Financial Institutions Group within the Institutional Client Business. This global business is focused on managing balance sheet and subadvisory assets, and providing risk management services to financial institutions. Mr. Lomas is responsible for BlackRock's strategy, service offering, client strategy and client proposition. He sits on BlackRock's Global Operating Committee.

Mark Azzopardi, Head, Insurance Client Strategy
Mark Azzopardi, Managing Director, is a member of the Client Strategy team within BlackRock Solutions. BlackRock Solutions is responsible for developing, assembling and managing investment solutions involving multiple strategies and asset classes. Within Client Strategy, Mr. Azzopardi has a specific focus on Insurance Solutions.

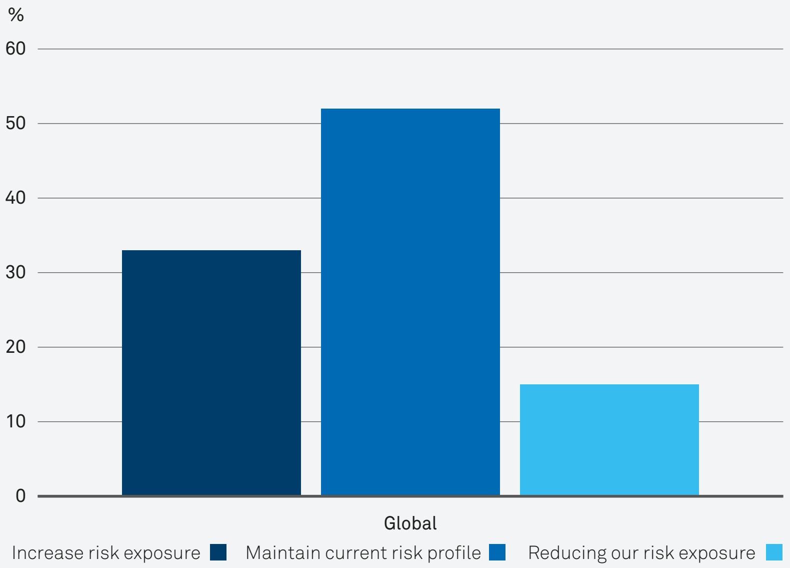
Jeff Jacobs, Global Head, Financial Institutions Group, Fixed Income Alpha Strategies
Jeff Jacobs, Managing Director and portfolio manager, is Global Head of the Financial Institutions Group within the Multi-Sector Institutional division of Americas Fixed Income Alpha Strategies. Mr. Jacobs has been a member of the Financial Institutions Group at BlackRock since its inception, holding a variety of positions, including Co-Head of FIG Portfolios, and Senior Portfolio Manager. or iShares prior to that and has been in the iShares business since 2003.

Jim Barry, Managing Director, Global Head, BlackRock Infrastructure Investment Group
Jim Barry, Managing Director, is Global Head of BlackRock Infrastructure Investment Group. Mr Barry leads BlackRock's direct infrastructure investing initiatives in infrastructure equity and debt. Prior to joining BlackRock in 2011, Mr Barry was CEO of NTR plc, a leading international developer, owner and operator of a portfolio of diverse infrastructure businesses.

Simon Treacy, Managing Director, Global Chief Investment Officer and Head of US Equity for BlackRock Real Estate
Simon Treacy, Managing Director, is Global Chief Investment Officer and Head of US Equity for BlackRock Real Estate and a member of the Real Estate Global Executive Committee. Mr. Treacy is responsible for the overall investment strategy and performance of real estate portfolios globally as well as overseeing all of Blackrock's advised real estate funds and investment vehicles.

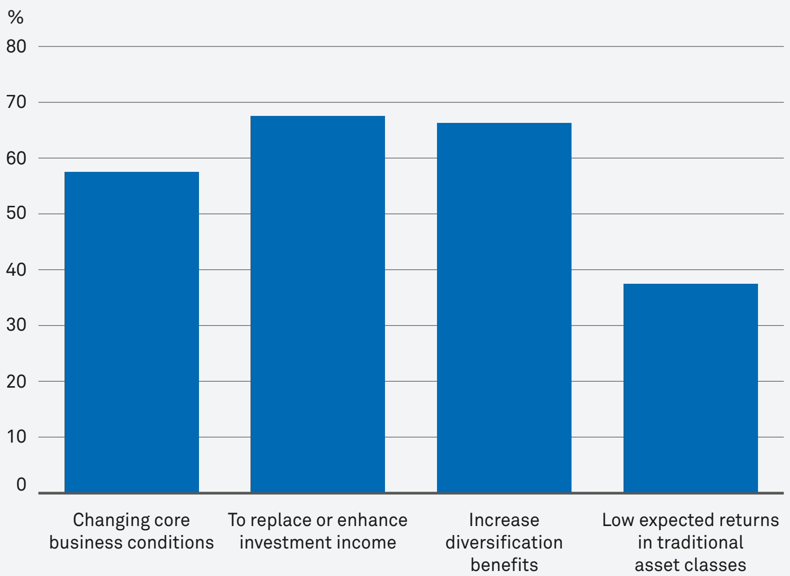
Appendix

OVER THE NEXT THREE YEARS, HOW DO YOU EXPECT YOUR FIRM'S ATTITUDE TO PORTFOLIO RISK TO CHANGE?



Base: Global (n=243)

WHY WILL YOUR FIRM INCREASE ITS INVESTMENT RISK EXPOSURE?

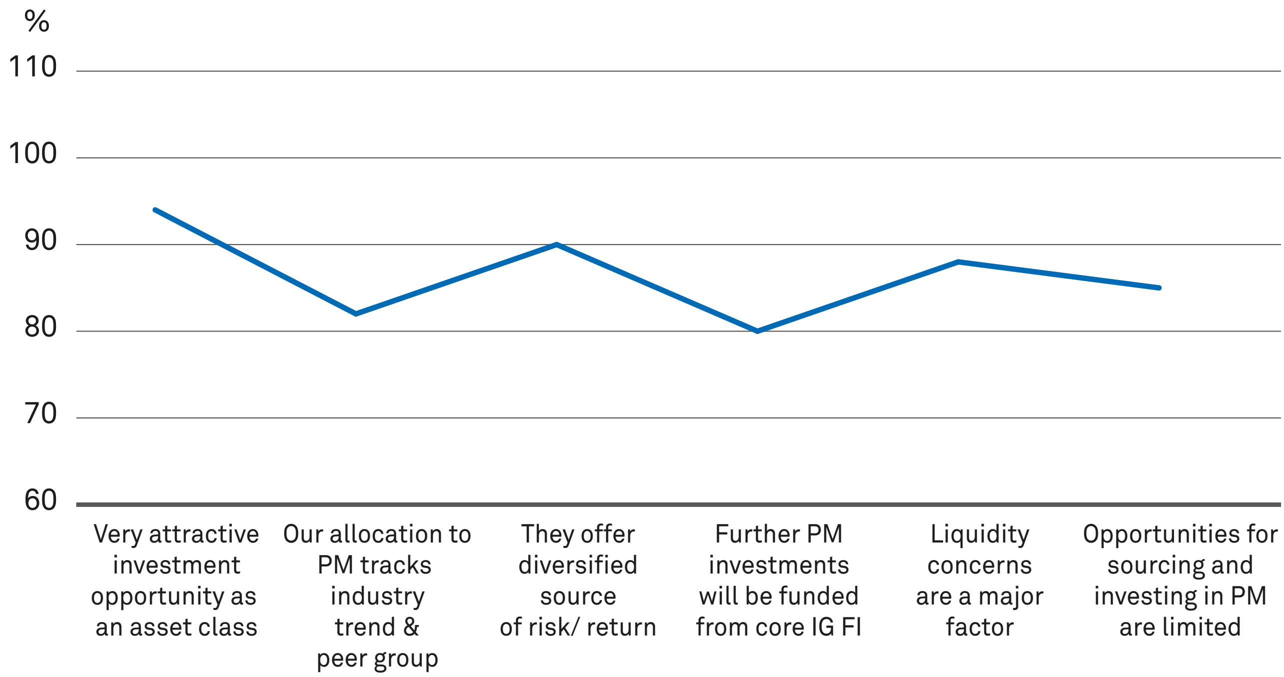


Base: Global (n=80)

Appendix continued

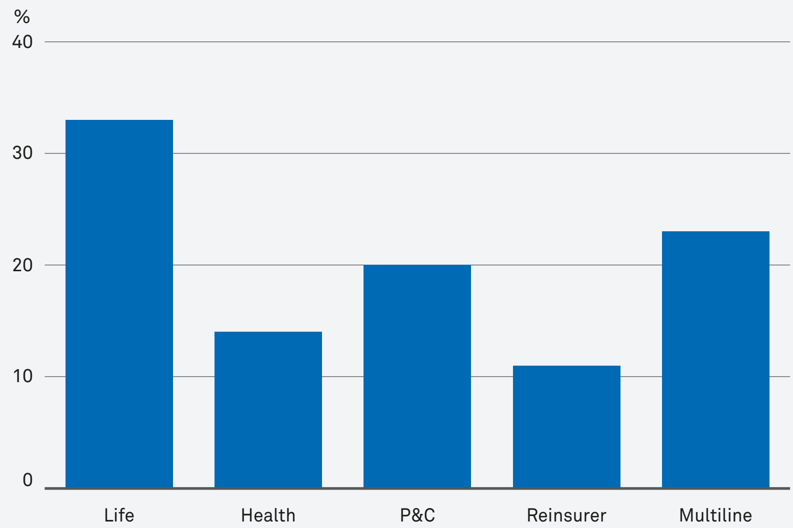
TO WHAT EXTENT DO YOU AGREE WITH THE FOLLOWING STATEMENTS ABOUT PRIVATE MARKET INVESTMENTS?

% agree and strongly agree



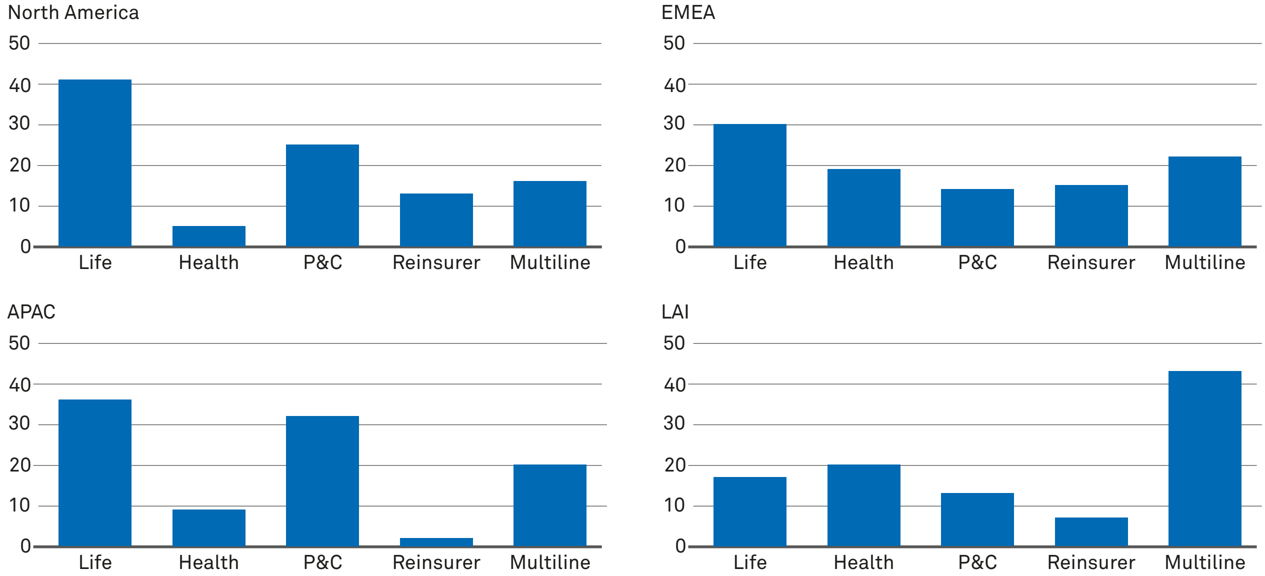
Base: Global (n=243)

HOW WOULD YOU BEST DESCRIBE YOUR COMPANY?



Base: Global (n=243)

HOW WOULD YOU BEST DESCRIBE YOUR COMPANY?



Base: North America (n=63) EMEA (n=106) APAC (n=44) LAI (n=30)

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1 AUM as of 30 June 2014. 2 Source: Pensions & Investments as of 31 December 2013. 3 Correct as at 30 June 2014

Want to know more?

+44 (0)20 7743 3300 blackrock.co.uk FinancialInstitutions@blackrock.co.uk

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