
Insurance Executive Review

Investment Opportunities For P&C and Life Insurance Companies

Seeking Attractive NAIC Rated Investments

ABSOLUTE RETURN STRATEGIES USING US TREASURY SECURITIES

An absolute return investment strategy that has historically generated consistent positive returns with the potential for an attractive NAIC rating freeing up reserves and providing leverage to insurer's operating results.

*The industry's current need is for higher investment returns without additional credit risk or volatility and improved portfolio diversification away from interest rates that can be structured within regulatory guidelines. US Treasury securities offer insurance companies the regulatory advantage of lower NAIC ratings, but have typically yielded and returned less than their higher credit exposure counterparts. Employing the skill at Dix Hills Partners may serve to extract higher returns from Treasury securities without leverage, simply through their proprietary tactical management of these securities. Virtually all of the investment and risk management needs of insurance companies mentioned above are imbedded in Dix Hills' investment strategy as demonstrated by their product structure and their past 5 year track record of managing assets. Accessing this investment strategy through a Structured Note vehicle, insurance companies may have the **potential to achieve higher returns**, report **lower credit exposure on Schedule D**, improve **overall portfolio diversification**, improve return on equity, and thus overall profitability **through the freeing up of reserves on assets with lower NAIC ratings**. Since their strategy is easily tailored to almost any investor's desired risk return profile, a product structure can be designed to fit almost any objective.*

Potential for Low NAIC Rating

As insurance companies look for investment alternatives for their general account, and other regulated portions of their balance sheet and investment portfolios, they need to be cognizant of the reserves required by the NAIC that is associated with those investments. The NAIC places reserve requirements on these securities, which requires the insurance company to set aside assets in risk-less securities to help protect the insurance company in case of problems with the rated securities. These NAIC ratings involve reserve ratios, starting at 0 (which applies to US Treasury Bills), which reflects a risk-less investment. As the risk of the investment increases, or liquidity of the investment declines, the reserve ratio goes higher.

Dix Hills' Benefit: One potential strategy benefit that is specific to insurance companies is that their duration-based strategy demonstrated the capability to generate substantial out-performance through portfolios of US Treasury securities. *As a result of holding only*

US Treasury securities in the portfolios, this should result in a low or 0 NAIC rating. Coupling a low NAIC rating security within an investment strategy that can deliver higher expected returns should be extremely attractive for insurers as it can free up company reserves that can be efficiently deployed to enhance the insurers overall balance sheet.

Portfolio Bias

Most insurance companies are required to invest mostly in fixed income as they have set liabilities (actual or actuarial), and seek to maximize these returns through assuming additional credit risk for higher yields and sometimes total returns while balancing reserve ratios versus equities and alternative investments. They use these assets to match liabilities in an overall portfolio sense, versus the estimated liability maturities. This exposure subjects the firms to certain risks centered around both the level and term structure of interest rates.

Dix Hills' Benefit: Their strategies are structured with an *absolute return approach that is capable of generating positive returns in most any market environment.* Additionally, *their investment strategy has been non-correlated with interest rates.* This correlation relationship has been stable over their 10 years of managing their flagship strategy. Their tactically driven Treasury Bond strategy has maintain a slight negative correlation with interest rates (as measured by the 10 Year Treasury Bond) and exhibits a strong negative correlation during period of market stress (sharp rise in yields). This diversification benefit is just another benefit their strategy has over both traditional fixed income investment strategies.

Portfolio Restrictions

Insurers are required to divide their assets into “buy and hold” versus “available for sale” and “trading” portfolios, where accounting treatment is different based on short or long-term objectives. The “buy and hold” securities bucket avoids mark-to-market treatment through book value accounting, which is very attractive accounting for the insurance company, however it does not allow for active selling or buying of securities. The “available for sale” portfolio does receive mark-to-market treatment and allows portfolio securities to have higher turnover, but this obviously generates losses more easily on market price moves and profits and losses fall right to the bottom line. Since insurers tend to actively manage their tax exposure, they are driven not to have much in the way of “uncontrolled” taxable events, preferring a more manageable “year end” tax management exercise.

Dix Hills' Benefit: As Dix Hills' Alternative Treasury Strategy (in a managed account) is actively traded, the strategy would typically generate taxable events and income statement effects. As insurance company investment gains and losses flow directly through to earnings, and ultimately generate tax liabilities, insurance companies would prefer all their assets in the buy-and hold bucket so as to manage earnings as tightly as possible. Additionally, since they use derivatives in a speculative manner, it would be frowned upon by the NAIC. Investing in this strategy through a private placement vehicle *would categorize the holding with mark-to-market constraints, and would require a significant reserve ratio. Through embedding Dix Hills' investment strategy within a structured note, with a final maturity; the investment can be properly placed within an insurer's "buy and hold" portfolio rather than being placed within the firm's "available for sale" portfolio.* The structured note could therefore be an attractive alternative for insurance companies and can be built by any high quality structured note provider with a standard or customized Dix Hills strategy using Treasury securities. If inside the structured note, the use of de-

Low NAIC rating
Treasury securities
Less reserves
Non-correlation
Absolute returns
Liquidity
“Buy & Hold” portfolio
Structured note
Low risk securities

derivative securities may also be used.

Low Yield Environment

As mentioned above, most insurance companies are required to invest mostly in fixed income as they have set liabilities (actual or actuarial). This exposure subjects the firms to certain risks centered on both the level and term structure of interest rates. The current level of interest rates (10 year Treasury: 4.15%) leaves a significant spread between the expected return and underlying actuarial returns. Additionally, after 20 years of decreasing yields (as measured by the 10 year Treasury yield) today's interest rate environment also entails a higher probability of rising yields which would severely impact an insurance company's underlying bond portfolios. Insurance companies are in dire need of higher return investments – especially those strategies that enable return generation during periods of volatile and increasing rate environments.

Dix Hills' Benefit: Their strategy is non-correlated with interest rates and affords the potential to generate positive returns in a rising interest rate environment. Historically, Dix Hills' Tactical Treasury strategy has exhibited a strong negative correlation during periods of bond market stress (sharp rise in yields) - a time when the insurer's underlying fixed income portfolios will perform poorly. This non-correlation with interest rates and the availability to generate positive returns during rising interest rate periods are just a couple of unique benefits of their US Treasury strategy.

Conclusion

The potential to provide low NAIC investment ratings, potentially higher risk-adjusted returns and the opportunity to generate returns in a rising interest rate environment are investment attributes that make Dix Hills' strategy attractive for insurance companies. Dix's investment strategy has the potential to provide solutions for the industry-specific demands insurers are facing today. These demands/limitations include the following:

- Insurers seek incrementally higher risk-adjusted returns which will drive overall insurer profitability
- Regulatory restrictions limit insurers ability to access higher returns
- Insurers favor investments that have low NAIC ratings (Lower NAIC rating minimize reserves held in lower return investments, which incrementally raise the overall portfolio return)
- US Treasury securities, the lowest NAIC rating securities, are not used extensively by insurance portfolio managers because of the lower coupon yields and the high pressure and demand for more income and thus profitability.
- Insurers favor investments that can be held in "buy-and-hold" investment portfolio (Mark-to market moves are not reflected on the firm's balance sheet).
- Insurers can benefit from inclusion of investment strategies which have uncorrelated returns to interest rates, which is the bulk of their portfolio exposure (thereby giving them the ability to smooth out volatility of their portfolio, and to potentially generate returns in periods of increasing interest rates)
- Low interest rate environment puts more pressure on insurers to seek investments and investment strategies that can provide higher returns.

Employing Dix Hills' value added investment skill can offer the opportunity to extract higher returns from Treasury securities without traditional leverage, simply through their proprietary tactical management of these securities. As a result, virtually all of the needs of insurance companies above are imbedded within Dix Hills' strategies as demonstrated by their product structure and their past 5 year track record of successfully managing ab-

Providing absolute return US Treasury based portfolio that is non correlated with long term interest rates and provides the potential for positive returns in a rising interest rate environment.

solute return assets.

About the Author



Charles L Ruoff CPCU

CR Market Strategies
crmarketstrategies.com

CR Market Strategies Inc. ("CRMS") was formed in January 2003 by Charles L. Ruoff, CPCU. Mr. Ruoff is President of CR Market Strategies Inc. an insurance marketing and risk management consulting organization based in Garden City, New York. Mr. Ruoff has been involved in insurance underwriting, international insurance brokerage and alternative risk management businesses having held executive management positions with Continental, AIG, Johnson and Higgins, Sedgwick James, and Acordia (Wells Fargo). He has been a speaker/panel member at numerous industry events during his over 40 years in the insurance industry including RIMS, CPCU and other conferences. His articles have appeared in many industry publications and is a member of the Advisory Board of St Johns School of Risk Management and Actuarial Science. CRMS serves as a consultant to Dix Hills Partners specifically concerning the development of investment solutions for the insurance industry.

Disclosures

Information and analysis contained herein has been obtained from Dix Hills Partners and CRMS believes these sources to be reliable, however, its accuracy and completeness cannot be guaranteed. This report is for informational purposes only and is not an offer to sell or the solicitation of an offer to purchase an interest in any of the funds managed by Dix Hills. This information should be considered and treated as confidential and no information contained herein either in whole or in part may be reproduced or redistributed without Dix Hill's express written consent. No offer or solicitation of any security may be made prior to the delivery of a definitive offering memorandum together with the subscription documents. The information contained herein is for informational purposes only, is current only as of the date hereof, and contains confidential and proprietary information. This document is confidential, is intended only for the person to whom it has been delivered and under no circumstance may a copy be shown, copied, transmitted, or otherwise given to any person other than the authorized recipient. This document does not take into account the particular investment objectives or financial circumstances of any specific person who may receive it. Before making any investment, you should thoroughly review the Fund's Confidential Private Placement Memorandum with your financial, legal and tax advisors to determine whether an investment in the Fund is suitable for you. An investment in the Fund is not suitable for all investors. CRMS makes no express or implied warranty, representation or guarantee as to the accuracy, validity, timeliness, completeness or suitability of any of the information obtained from third parties. An investment in this limited partnership involves a significant risk of loss.
