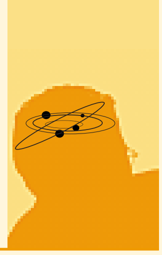

ASSET MANAGEMENT FOR LIFE INSURERS

LOOKING TO BROAD PROVIDERS WITH A FULL RANGE OF SKILLS

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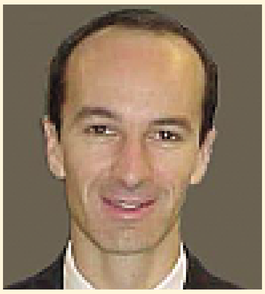

Fally: full-time job

Managing assets on behalf of a life insurance company, bank or company's pension scheme has never been more challenging than in today's complex and diverse financial markets.

Globalisation, new investment opportunities, increased regulatory scrutiny and changing technology have strained the resources of many institutional investors. Keeping up with investment and legislative issues can be a full-time job. And as clients become more sophisticated, maintaining the staff required to coordinate the fiduciary, investment management, oversight, actuary, recordkeeping, custodian and benefit payment functions can be both daunting and expensive. As a result, a growing number of institutional investors are beginning to outsource asset management and fiduciary work to specialists.

Who is a candidate for sub-advisory or fiduciary outsourcing? An insurance company or financial institution with limited resources internally, with a small corporate governance budget, or institutions without specialised investment expertise. Committee members often have various responsibilities of which investment, pension sponsorship or fund management is but one.

Multinational insurance companies with subsidiaries in several countries are seeking global providers to satisfy the largest exposures they have. A global actuary and common investment platforms for global managers to select from are increasingly in demand.

There are a number of advantages in turning to a large investment manager including global reach and specialised expertise as well as economies of scale that provide cost-efficient access to global trading capabilities and pooled investment solutions on a global basis.

Bundling assets in pooled solutions increases your operation's investment critical mass. By gathering all your service needs and hiring a single provider, you consolidate your purchasing power and enhance your client profile within a fiduciary manager who has multidimensional skills.

Hiring an outside manager allows you to stay current with the latest advances in technology and investment management as well as legal and compliance issues, all of which would be expensive and time-intensive to master in-house. The rationale behind outsourcing asset management is the same as for outsourcing other non-core activities: allowing professionals with specialised skill sets and greater resources to manage or advise on an area outside your core expertise.

Beyond these practical considerations, however, is the importance of ensuring that the firm entrusted with your assets is committed to best practices in fiduciary management. In today's increasingly complicated legal, regulatory and compliance environment, it is essential that you work with a skilled partner/provider who engenders your trust and takes fiduciary responsibilities as seriously as the do their own.

In the US, the Employee Retirement Income Security Act of 1974 (Erisa), a federal law that sets minimum standards for pension plans in private industry, requires fiduciaries to apply the following obligations: duty of loyalty; exclusive benefit of the plan; prudent expertise; diverisification, and operating pursuant to plan documents.

REGULATION

But these responsibilities also need to be applied to insurance companies and other sub-advisory clients. As the regulatory environment becomes more demanding, adopting best practices and appropriate procedures for investment and oversight of their investments must be a priority for insurance companies, banks and other financial institutions who seek external fund management expertise.

Oversight of the portfolios should include a comprehensive process for reviewing investment managers,

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> **Benoît Fally, State Street Global Advisors**

the appropriateness of particular asset allocations, and the structure and amount of fees. While a profusion of manager choices may seem attractive for a large provider, this abundance increases the burden of oversight for the investment committee or their fiduciary adviser/consultants.

With many life insurance companies seeking to close funding gaps caused by declining asset values during the recent equity bear market on the one hand and higher liabilities amid record low interest rates on the other, investment officers need sophisticated solutions only large institutional managers can provide. Firms have pioneered new approaches, including better methods for allocating assets and liabilities in a dynamic way as funding ratios and risk premia change, or proprietary pooled swap solutions provide European life insurance companies, banks and fund managers with a more robust way to hedge against inflation and interest rate risk.

Outsourcing of responsibilities is not the only area where firms look to utilise specialists. In an effort to make the most of their financial budgets, investors including financial services firms are also turning to institutional managers to fill gaps in their operations.

Some investors with internally managed assets are leveraging the global round-the-clock trading capabilities of large money managers to take advantage of regional trading desks and broker relationships to avoid expanding their own trading facilities. Similarly, investment research staffs are being asked to conduct complex projects for organisations that cannot undertake such projects given lack of internal expertise. In still other cases, firms are outsourcing the production of investment beta – and in some cases, alpha – while retaining control of some aspects of the investment process such as asset allocation.

SPECIALIST HELP

On the whole, investors of many types are recognising the advantages of employing specialists to assist their committee, firm or plan to accomplish non-core activities. Other investors are becoming comfortable outsourcing to experts and bundling their needs with a major provider of a range of financial services to meet their objectives most effectively.

Managing assets for a life company should be based on a very different model from the sales-driven, alpha-generation mutual fund business. Asset allocation is the key and liability measurement should be the starting point.

There have been many long-standing problems in the life industry, which have now been inherited by the asset managers who are winning sub-advisory mandates. Guarantees were given away for nothing, and asymmetric products have been part of the industry for some time, where the customer is not exposed to downside as well as upside.

RISK CONTROL

Asset managers now have the opportunity to address these problems within the industry through dynamic risk allocation products, many of which were developed originally for pension funds, but can now be applied in a different arena.

Alpha is not generally recognised by many investors in life insurance policies. That is why this industry plays to the strengths of managers offering beta solutions through passive investing.

Institutional investors have moved from balanced management to specialist management and back again. The non unit-linked life business has a parallel agenda, with the same constraints as the pension business, with the failed or defunct desire to extract alpha strategies. The real requirement should be to control risk, which can be effectively achieved through a dynamic asset allocation model.

Passive strategies should play an important role in sub-advisory business as they have very clear benefits in the equity area. While pure passive management might be much less relevant in the life insurance context, passive managers can construct a series of building blocks. Optimal indices of sub-components can be constructed for clients in area such as fixed income. In fact the biggest growth in our fixed income business is in liability matching, with insurance companies no longer focusing on returns, but liabilities.

For these purposes, it is easier to have an out-of-house manager, as there are no vested interests

Outsourcing case study

When State Street Global Advisors completed the transition for assets overseen by high street bank Abbey and its two life insurance subsidiaries Scottish Mutual and Scottish Provident, many people in the industry thought the deal was too large.

However, 150 portfolios, split between global equity and fixed income, were brought onto the SSgA system overnight before the portfolios were rebuilt.

SSgA had to account to clients for the performance of funds during a very complex period of transition.

SSgA also had to successfully manage any reputational risk, as this was a controversial deal, particiculalry due to the closure of Abbey's front-end asset management offices in Glasgow.

Nick Lacaille, European chief investment officer for State Street Global Advisors, recently presented a strong case for life insurers to outsource assets to external players with a passive competency at a conference hosted by PWM at the London Stock Exchange

involved. The life company needs to examine all opportunities in the swaps market, for instance, and needs an external provider with many different experiences. When life companies take full responsibility for these strategies, they will need external help.

SYSTEMATIC

There is a new breed of asset managers who believe in a systematic process to assess information on a whole range of stocks. They can provide enhanced and full active returns in addition to passive skills. They can look at both value and growth stocks simultaneously, without the emotions inspired by company visits.

These managers also have a vital role to play in transition management, where the investment banks are no longer the only players.

More growth in outsourcing is expected, but insurance companies and fund houses need to look to broad providers with a full range of skills. Asset managers cannot pretend to have the ability to conduct a full liability matching service for life companies. They must do this themselves, as this is the core part of their business.

But we can do the asset allocation. If you have a top-heavy equity team within an asset management division, and the sensible decision is to get out of equities, it can be a very difficult decision to make. But an external asset management provider can stand aside from these constraints.

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