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Perspectives

Tailored and Transparent: The Key to Absolute Return Funds Under Solvency II

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Introduction

In the search for attractive and diversified returns, European insurance companies have generally dismissed absolute return funds as potential investments due to lack of familiarity, the complexity of understanding risk and return drivers, implementation hurdles, and the potential for a skeptical regulator particularly in the context of Solvency II. According to a recent Preqin study[1] of more than 5,000 global institutional investors, insurers represent just 4% of all institutions invested in absolute return funds. Moreover, those that do invest in absolute return funds allocate only a small portion of their assets into such funds, an average of 3.3%. For Europe specifically, these figures are likely to be lower.

Navigating the absolute return universe can be tricky for new entrants who try to go it alone. After all, while there are only a handful of absolute return strategies, there are over two dozen different absolute return sub-strategies. Many of these sub-strategies have different alpha return drivers, utilize varying types of securities, and focus on a range of trading frequencies. In some cases, the systematic risk exposures are different from those that insurers have traditionally invested in. There is a fairly wide range of divergence of investing styles, both between strategies and also among managers within strategies.

Integrating an investment in absolute return strategies with the insurer's existing risk analysis system might at first glance not seem worth the trouble. However, adding absolute return funds to an insurer's portfolio does not necessarily mean that a new asset class is being added. In fact, many funds employ a strategy that uses plain vanilla instruments. For insurers, this means that little or no additional modeling is needed to integrate new funds into existing capital/risk models and reporting processes, at least if one has transparency to underlying positions. In fact, the integration issues can be minimal if the correct strategy is employed and the right partner chosen.

[1] 2016 Preqin Global Hedge Fund Report

A typical taxonomy of the absolute return (or hedge fund) universe breaks absolute return strategies into four main groups:[2]

Equity Hedge
- Objective: To capture value via long and short exposure mainly in equities and equity derivatives, deploying either a quantitative or fundamental investment strategy
- Includes: Equity Market Neutral, Fundamental Value/Growth, Quantitative Directional

Event-Driven
- Objective: To capture value from anticipated corporate actions such as mergers, restructurings, financial distress, debt exchanges, and security issuances
- Includes: Merger Arbitrage, Credit Arbitrage, Special Situations, Distressed Debt

Relative Value
- Objective: To capture value from price discrepancies between various related securities, usually corporate securities within the same capital structure or fixed income instruments (e.g., structured credit, government bonds). The investment thesis is usually predicated on a convergence of these pricing discrepancies
- Includes: Convertible Arbitrage, Fixed Income Arbitrage, Volatility Arbitrage, Asset-Backed Arbitrage

Macro
- Objective: To capture value from the movement of underlying economic variables and their impact on equity, fixed income, currency and commodity markets
- Includes: Discretionary Thematic Macro, Systematic Diversified Macro, Commodity Trading Advisor (CTA)

Understanding these strategies, and specifically an individual manager's execution of each, does take some initial research and education, but attractive risk-adjusted return and correlation characteristics make absolute return strategies a compelling option for allocation within an insurer's portfolio.

I. Attractive Risk-Adjusted Returns and Correlation

One can position to stay liquid and add a diversifying, attractive return stream by investing in absolute return funds.

In response to the current low yield investment environment, many insurers have increased yield potential by either going out the risk curve for traditional investments (e.g., adding equities or high-yield bonds) or by adding less liquid investments such as real estate, private debt, and infrastructure. However, one can position to stay liquid and add a diversifying, attractive return stream by investing in absolute return funds.

As illustrated in Exhibit 1, absolute return funds have performed well in comparison to traditional investments, returning a solid annualized 10.1% over the last 27 years with a volatility of 6.7%. This compares favorably to equities from a risk-adjusted return standpoint, which have returned 6.2% with a volatility of 15.1%. While higher quality bonds have done well on a risk-adjusted basis over this period as well, with annualized returns of 6.2% and volatility of 5.4%;[3] these returns were generated during a period in which interest rates declined significantly. Tailwinds like this are highly unlikely to occur in the future: with yields on 10 Year U.S. Treasuries and German Bunds at around 1.47% and -0.13%, and the spread on U.S. and EUR investment grade-rated credit at 146bps and 137bps, forward-looking return expectations are decisively lower.[4] Looking at other time periods shows similar results, as the exhibit illustrates, with hedge funds outperforming both equities and bonds on a risk-adjusted basis.

[2] Hedge Fund Research, www.HedgeFundResearch.com
[3] As measured by the Barclays Global Aggregate Bond Index as of March 31, 2016.
[4] As of June 30, 2016

Exhibit 1: Annualized Risk and Return of Hedge Funds versus Equities (in USD)
February 1990* – June 2016

	MSCI World Index		HFRI Fund Weighted Composite Index		Barclays Global Agg Index	
	Equity Return	Equity Risk (Volatility)	Hedge Fund Return	Hedge Fund Risk (Volatility)	Bond Return	Bond Risk (Volatility)
Feb 1990 - Jun 2016	6.2%	15.1%	10.1%	6.7%	6.2%	5.4%
Feb 1990 - Dec 2002	4.6%	15.1%	14.8%	7.2%	7.8%	5.0%
Jan 2003 - Jun 2016	7.7%	15.1%	5.8%	5.9%	4.7%	5.7%
Jan 2009 - Jun 2016	10.5%	15.6%	5.6%	5.4%	3.4%	5.3%

Source: Bloomberg, Hedge Fund Research, Inc. - www.hedgefundresearch.com.

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Past performance may not be indicative of future results, and any investment described in this document can lose value. Time period used is based on the latest inception date of one of the indices.

** Data for the Barclays Global Agg Index is available starting in February 1990.*

In addition, as Exhibit 2 shows, the correlation of hedge funds to bonds is low at <0.2. While the correlation of absolute return funds to equities is higher at 0.7-0.8, the headline numbers masks significantly lower correlations for various absolute return strategies.[5] Moreover, when the volatility ratio is incorporated, the beta is relatively low at ~0.35.[6]

Exhibit 2: Correlation Matrix and Beta of Equities, Bonds, and Hedge Funds (in USD)
January 1994* – June 2016[7]

	S&P 500 Total Return Index	MSCI World Index	HFRI Fund Weighted Composite Index	Barclays Global Agg Index	Barclays US Agg Index	Beta of HFRI Fund Weighted Composite Index to:
S&P 500 Total Return Index	1.00					0.35
MSCI World Index	0.95	1.00				0.36
HFRI Fund Weighted Composite Index	0.76	0.80	1.00			NA
Barclays Global Agg Index	0.16	0.25	0.15	1.00		0.18
Barclays US Agg Index	0.03	0.01	0.02	0.69	1.00	0.04

Source: Bloomberg, Hedge Fund Research, Inc. - www.hedgefundresearch.com.

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[5] There are many strategies, such as equity market neutral, credit arbitrage, and discretionary macro, which have a correlation to equities that is significantly lower than 0.6-0.8.
[6] The beta is calculated by multiplying the correlation of two investments by the volatility ratio.
[7] The time period for the correlation matrix was chosen because data for the Barclays US Agg Index was available from January 1994 onwards.
* Data for the Barclays US Agg Index is available starting in January 1994.

II. Liquidity

Absolute return funds offer a wide range of investment strategies, as indicated earlier, with significant differences in invested securities, investment horizon and investment approach. They also have varying liquidity profiles. Some strategies focus on investing in the listed liquid securities of a particular benchmark index or stock universe and seek to generate alpha by having a relatively concentrated long book in underpriced securities while shorting overpriced instruments. In terms of liquidity and complexity, the investment exposure is fairly similar to that which many insurers with mixed book portfolios already have, except it introduces a "short" element.

A smaller subset of strategies is significantly more illiquid and complex. For example, distressed debt is a strategy in which managers will invest in equity or debt instruments of companies in bankruptcy and may actively engage in the bankruptcy or restructuring process; in this case, underlying securities are often illiquid and profit realization could take several years. Activism is another example of an absolute return strategy with a longer term time horizon. Although the underlying instruments traded may not be illiquid by definition given that they often are publically traded equities, activist funds often have lock-ups and gates to ensure that the investment manager has time to carry out its intended activist strategy. After all, activism often involves getting on boards, changing management, rejiggering the balance sheet, and improving operations. All of this takes time.

That said, compared to other alternative investments such as real estate, private equity, and infrastructure, where an investor may only get the investment back after 5-10 years, absolute return funds generally offer far better liquidity. More than 95% of absolute return funds offer quarterly liquidity or better, while 60% of funds offer monthly or even daily liquidity.[8] The very small percentage of funds that offer semi-annual liquidity or less tends to focus on investments in private equity or private debt.

III. The Regulatory Challenge

Despite the attractive risk-adjusted return and correlation characteristics, the regulatory requirements of Solvency II[9] make investing in non-traditional investments such as absolute return funds challenging for European insurers. Solvency II prescribes an onerous capital treatment for "funds" without look-through (Pillar I) and requires insurers to fully understand and report on what is on the balance sheet (Pillar II and III).

Moreover, the ability of hedge funds to rotate between sectors, asset classes, and securities raises some questions from insurers about the stability of risk (and hence capital charges).

However, these issues can be properly addressed and should not be reasons to eliminate absolute return funds from consideration. Transparency and customizable separate accounts can help solve the Pillar I and Pillar III issues. Understanding of the funds and subsequent Pillar II issues can be achieved with the right asset manager showing the way.

The key is to work with an experienced absolute return allocator who can construct an optimal portfolio with considerations for capital relief, diversification benefits, and targeted level of alpha drivers/complexity. All this should be done in a manner tailored to the insurer's exiting risks and processes.

[8] 2016 Preqin Global Hedge Fund Report

[9] The Solvency II directive is an EU regulatory framework for insurance companies that is focused on managing all the risks insurance companies face throughout their organization. The directive is divided into three pillars:
- Pillar I prescribes capital requirements and addresses an insurer's measurement of assets, liabilities and capital.
- Pillar II prescribes governance and supervision requirements.
- Pillar III focuses on disclosure and transparency requirements.

IV. The Benefits of Transparency

Transparency to the underlying positions can reduce capital charges of the Solvency II "standard formula." While funds without look-through would receive a prescribed 39% or 49% stand-alone capital charge, funds with look-through can have charges as low as 10-20%.

A diversified absolute return fund portfolio will have significant exposure to non-Type 2 equity securities[10] and a significant short book. Hence the portfolio will benefit from reduced net exposure (where short positions offset long positions), and diversification of instruments, which will produce a lower capital charge for the absolute return fund portfolio. Moreover, the diversification of adding an absolute return fund investment to an overall insurer portfolio can provide additional capital benefits. The benefits of transparency are obvious when comparing Exhibit 3 and 4. Transparency of the absolute return fund portfolio reduces the SCR by 7% (from 19.7% to 12.7%) in the case of a 20% reallocation away from credit, and by 5.2% (from 14.2% to 9%) in the case of a 20% reallocation away from equities into absolute return funds.

The diversification of adding an absolute return fund investment to an overall insurer portfolio can provide additional capital benefits.

Exhibit 3:
Solvency Capital Charge: No Look-Through for Absolute Return Funds[11]

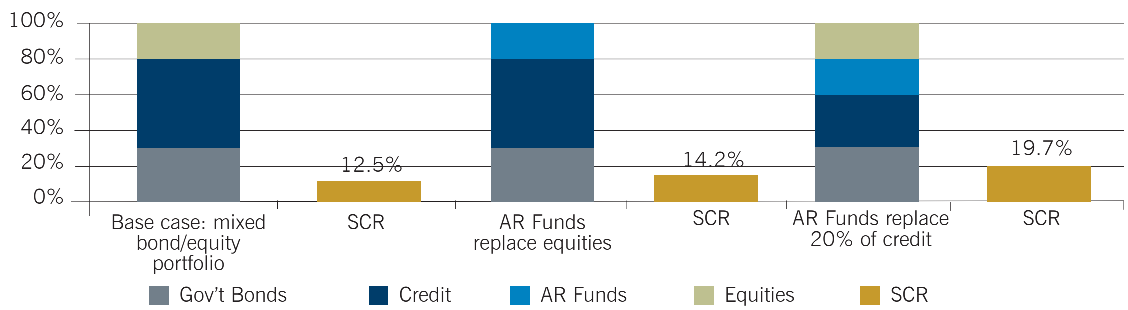
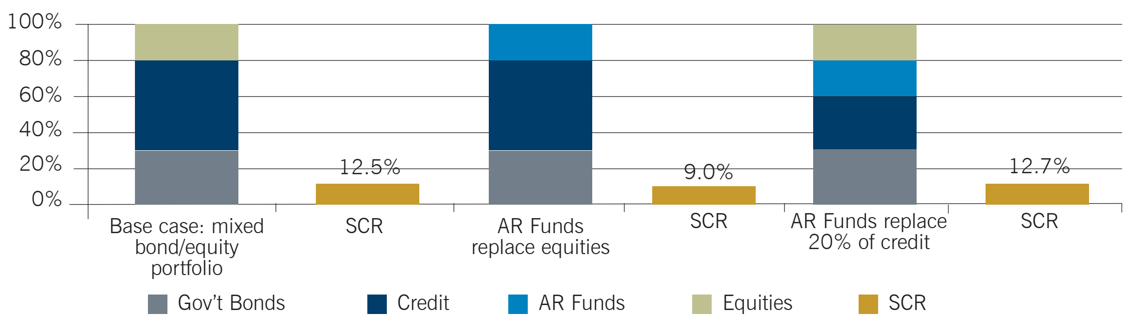


Exhibit 4:
Solvency Capital Charge: With Look-Through for Absolute Return Funds[11]



SCR = Solvency Capital Requirement
Source: PAAMCO calculations

[10] Type 2 equity securities are equities listed in emerging markets, non-listed equity, hedge funds and any other investments not included elsewhere in the market risk module.

[11] Hypothetical SCR figures were created using the Standard Formula as specified by *European Insurer's and Occupational Pension's Authority's (EIOPA) Delegated Regulations 2015/35* and related technical documents published on 30.04.2014. Credit portfolios are assumed to have duration of 15 years and be 25% of each of credit ratings AAA, AA, A, and BBB (investment grade fixed income securities). Equity portfolios are either specified to be Type 1 Equities with 39% SCR or Type 2 Equities with 49% charge or a portfolio of half and half with an SCR of 44%. All symmetric adjustments are considered to be 0% for these calculations. All correlation matrices between Investment Market Risks are those specified by the Standard Formula. Total SCR is the sum of individual SCRs, while diversified SCR is the result of using correlations to combine individual SCRs. Hedge fund SCRs are calculated as either: 1) with no look-through (transparency) attracting a 49% equity charge or 2) on a look-through basis in which the net exposure is considered and all short positions are considered "hedges." The net exposures used for this example are 26% net exposure to credit and equity and -3% net exposure to fixed income; these exposures were based on PAAMCO's portfolio positions in the Pacific Atlantic Master Fund L.P. at December 31, 2015. PAAMCO does not represent that these SCR calculations meet all requirements of Solvency II, and does not represent that all interpretations of SCR calculations are represented, and no statement should be interpreted as making such a representation.

Although the absolute return fund industry may still have a legacy of being considered opaque and non-transparent, this is far from true today. The industry has come a long way to meet investors' needs regarding transparency since the Global Financial Crisis of 2008. Increased disclosure requirements, the ever increasing demand from institutional investors wanting transparency, the growth of managed account platforms and availability of third-party risk aggregators have combined to make absolute return managers generally more comfortable providing transparency. In fact, a recent survey of absolute return managers indicated they viewed transparency as a key driver of change in 2016.[12]

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Is transparency a panacea? Although it certainly helps, it is important to have the ability to invest via customizable, separate accounts. After all, insurers differ substantially in their appetite for asset risk, liability profile, need for capital efficiency, comfort with complexity, and ability to model different types of securities. As such, there is no one-size-fits-all methodology. Portfolio construction should be tailored to each insurer's needs.

V. Customized Separate Accounts

When constructing absolute return fund portfolios for insurers, there are a few key things to keep in mind:

- **Other assets of the insurer:** The first thing is to understand the risks currently taken by the insurer's portfolio and to understand the capital implications. Insurance companies are unlikely to want a new investment to double up on any existing risks. Indeed, an insurer would typically prefer that a new fund offsets other risks in the portfolio (e.g., interest rate or credit risks). New funds would need to fit into any existing asset/liability management processes or allocations.
- **Vanilla assets:** The portfolio should be tailored to exclude instruments the insurer is not set up to model. Generally this may eliminate strategies such as distressed debt that may have a high degree of private or hard to model securities (e.g., post-reorganization equity, litigation/liquidation claims) and macro strategies, such as volatility arbitrage, that may have a high degree of exotic derivatives.
- **Stability of risk factors:** To mitigate unexpected volatility in capital charges, the portfolio should be constructed in a way that mitigates excessive fluctuation in risk factors.

[12] 2016 Preqin Global Hedge Fund Report

There is a widely held misconception that hedge fund risk profiles vary wildly day-to-day, when the truth is that for many absolute return funds the risk exposures are rigorously controlled and fairly stable. Portfolio construction for an insurer can formalize any desired constraints. This should be done via manager selection and imposing guidelines on managers related to leverage, exposure, and other risk factors.

- **Low exposure to traditional risk factors:** As the majority of insurers' balance sheets tend to be invested in traditional asset classes such as fixed income and equities, they already have sufficient exposure to traditional risk factors such as interest rates, credit spreads, and equity markets. Insurers are therefore likely to want to be as neutral to these risk factors as possible while having a high degree of expected alpha which arises from strategies diversifying away from traditional risk factors. This could eliminate strategies such as directional long short equity, directional credit, and event strategies such as activist, which typically have a higher degree of systematic risk to traditional credit and equity markets. Instead, the market-neutral versions of these strategies tend to be more favored by insurers.

VI. The Right Partner

Constructing portfolios of absolute return funds that have desired characteristics requires expertise in analyzing and choosing hedge fund managers and tailoring mandates. Some managers may only have a short return history. Strategy classifications can only go so far in delineating managers' styles. In addition to strategy and manager selection, successful implementation also requires expertise in setting up separate accounts, negotiating terms such as desired transparency and investment guidelines, operational due diligence, monitoring of business and investment risks, and integrating the investments into the insurer's risk framework. It takes work, but it is worth the diversification benefits. And doing the construction with an expert that has done it many times before is often the solution for new entrants to the industry. The net returns are likely to be higher as the absolute return fund expert typically negotiates fees down. Further, the insurer's internal resources can be conserved.

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VII. Conclusion

Many insurance companies are currently missing out on the opportunity to invest in absolute return strategies and obtain attractive, liquid, diversifying yields. To overcome historical bias against the industry, it would be best to do research to understand what absolute return investments offer and to appreciate how the absolute return fund industry has matured.

Absolute return funds do offer attractive return characteristics, but they also require a bit of work to get there. Transparency and customized separate accounts are key. Fortunately, there are plenty of managers to assist the insurance industry in gaining the exposure that is appropriate for them.

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