UNLOCKING CAPTIVE CAPITAL

Investment appetite varies hugely among captive owners, but few argue holding cash in the bank is a practical use of capital. As London & Capital launches the first indices for captive investments, we examine the issues at stake

If there is one area of captive operation that divides opinion, it is investments. When London & Capital approached *Captive Review* to launch an indices exclusively aimed at captives, we immediately got to work sounding out the industry as to where the ground lies.

A huge division quickly emerged between those observing the trends among European-based captive owners and those on the other side of the Atlantic.

While American-owned captives prefer to get inventive and actively seek out ways to make their available capital turn a profit for them, the typical European captive appears content to plonk its cash in the bank or focus on loaning reserves back to the parent company.

Of course not every captives' needs are comparable and investment strategies or the appetite for investing will vary on the kind of lines that are being written.

A vehicle writing short-term business that has a quick turnaround in premiums and claims, such as healthcare, is going to need fast and efficient access to capital for example. On the flip side, a captive writing workers' compensation will have a much longer term strategy and may be able to chase bigger returns.

Written by
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Chalk and cheese

While Figure 1 illustrates the long-term benefits of making use of varying asset classes compared to holding money in cash, Figure 2 is an indication of the kind of money management the typical captive in Guernsey undertakes.

It is not suggested captives should take a deep plunge into just one asset class and more often than not strategies like the ones outlined in Figure 3 made up of a combination of investments will be put forward by an investment manager.

"In Guernsey, clients that have a strategy other than loaning back to parent or parking it in cash are very far and few between," Stuart Brown, executive director at Aon Insurance Managers in Guernsey, tells *Captive Review*.

"If they do, it will be a managed portfolio generally by an asset manager or a bank and it will have government bonds in a few financial institutions and that's about it."

Brown adds local banks are regularly on their back to expand the investment possibilities emerging from captives, but often when these are tabled to the board it is viewed as an added risk on top of the insurance risk already being taken.

"You would have thought with the low interest rates, if anything was going to be a catalyst to spur them on to make other investments it would be the environment we are in now and the fact that they know they are getting absolutely nothing on their bank deposits," he says.

In the United States, such a captive attitude is met with a combination of scepticism and outright disbelief.

Both Stewart Feldman, CEO at Captsone Associated, and Michael Schroeder, president of Roundstone, say putting in place an investment strategy should be a big part when establishing any captive.

"In the States people are very focused on what you do with your assets," Schroeder tells *Captive Review*. "In the 20 years I've being doing this it is very rare, I think we maybe have one captive, that just lets its money sit there. Almost every one of them wants to make it work.

"One of the upsides of owning a captive is you get to do the investment on your funds whereas in traditional sixth-cost insurance you don't."

Although American-owned captives are more keen to exploit possibilities in the investment space – from patent rights in music loyalties and tax claims to money market and mutual funds – there remains a significant amount of parent loan backs.

"Lending it back to the parent is an investment activity, they are not loaning it at 0%." Feldman says. "Our more than 100 captives often have loans to affiliates and those are very profitable. All the years I've been involved none of those loans have gone bad and in fact if there is any entity that a captive should know the financial solvency of, you would think it would be one of its affiliates."

Drive for change?

So while the US appears to be streets ahead of Europe in regards to convincing its captives to invest, what is likely to convince owners that such activity is worth their time and effort as well as a safe bet in protecting their vital capital?

The indices produced by London & Capital (p20, 21) is designed to be used as a yardstick for captive owners to assess how their own investment portfolio is performing, rather than convincing otherwise reluctant boards to alter their strategy.

Brown believes it will be innovative new products and in particular alternatives to the traditional Letter of Credit (LOC) that fronting insurers demand from captives before providing their services.

He highlighted BNP Paribas' LOC product which acts as a hybrid and offers greater returns than cash, while Barclays is pushing its Security Trust Agreement (STA) which can behave as an LOC but is more flexible in increasing and decreasing the collateral held.

"If there is a product which can tie in collateral requirements, which is always a bug-bear, with having a certain amount in bonds then they generate interest and get the boards talking," Brown adds.

Euler Hermes offers a deductible guarantee product as an alternative to a LOC, and is targeting captive companies and their parents in Europe.

"This is something we identified about three years ago that corporates and their captives didn't really have many options," says David Weale, manager in the bonding department at Euler Hermes.

"They either block out some cash or they provide an LOC that has to be treated under their banking arrangements. What we are offering is very much akin to the LOC, but taking it out of the banking world and trying to remove the underlying security that the banks would insist upon."

HISTORICAL ASSET CLASS PERFORMANCE

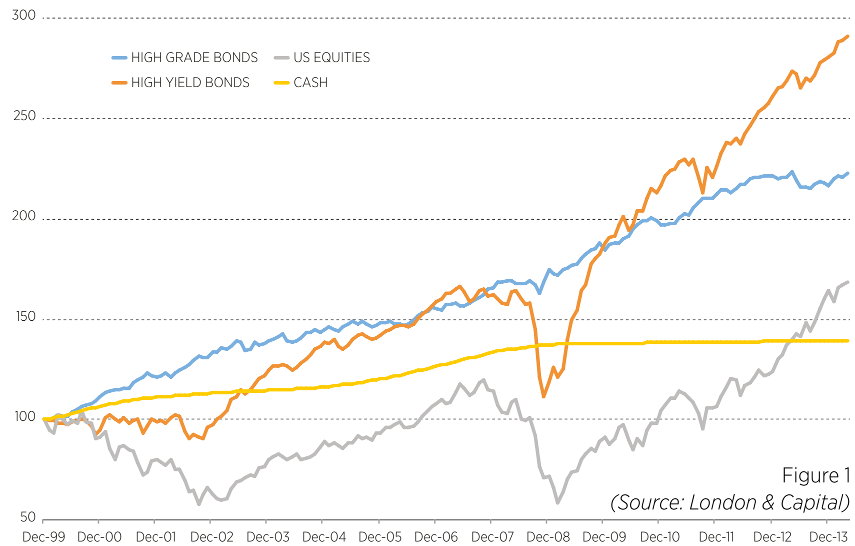

Figure 1
(Source: London & Capital)

"One of the upsides of owning a captive is you get to do the investment on your funds whereas in traditional sixth-cost insurance you don't"

MICHAEL SCHROEDER, ROUNDSTONE

HOW GUERNSEY INSURERS TYPICALLY INVEST

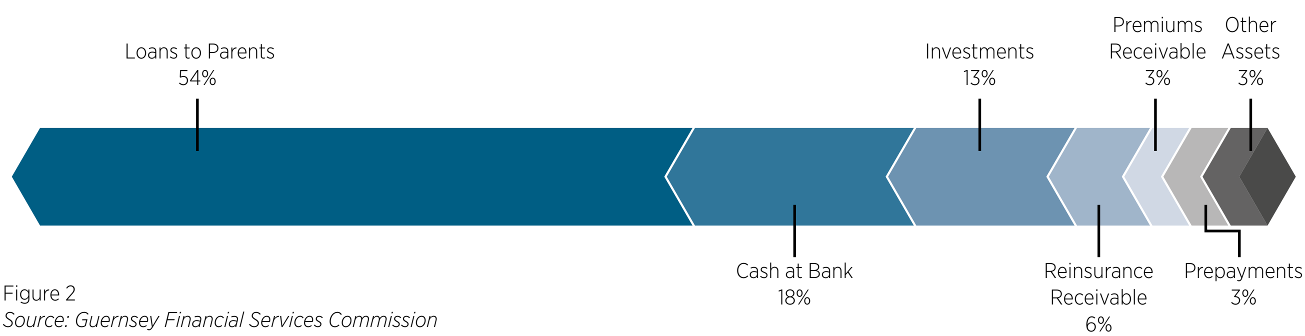

Figure 2
Source: Guernsey Financial Services Commission

Q&A: INDICES EXPLAINED

London & Capital has produced the first indices aimed exclusively at captive strategies, and Neil Michael, executive director at L&C, outlines what they tell us and how they can be used

Captive Review: How would you describe the three indices and their relative differences?

Neil Michael (NM): The three indices are structured to occupy three main points on the lower half of the risk spectrum. As we move from the London & Capital Index 1 to Index 3, the main difference is an increase in weight to the more risky asset classes such as high-yield bonds and equities, as well as an extension of the duration of the portfolio, to match the duration of captive liabilities.

One might think, therefore, that with some exposure to risk assets, the indices could be too risky for a captive. However, in practice, we have found that the indices were quite resilient to extreme market movements.

For example, in 2008 when the S&P500 index was down 37%, the longest duration and therefore most risky L&C Captive Index, Index 3, was only down 14.63%,and subsequently recovered strongly in 2009 while the L&C Captive Index 1 actually posted a positive return.

The other main difference is to do with the maturity of the high-grade bond exposure. Although Captive Index 1 has a much higher exposure to bonds, the maturity of this exposure is much shorter.

This has meant that in periods of rising interest risk, such as 2013, Index 1 was once again able to preserve capital, as the maturity profile of the bonds was much lower and therefore less sensitive to a rise in bond yields.

CR: How would you assess the historical performance of captives across various strategies given captives are on the whole risk averse?

NM: All three of the strategies achieved positive performance over the long term with the only general aberration taking place in 2008 due to the credit crisis – all three strategies increased value in 2009.

Specifically, Index 2 and 3, which have medium and longer term investment outlooks respectively, were negatively affected by the downturn in the short term (12 months or so) while Index 1, which has the shortest investment horizon and is therefore the most conservative of the three, was fairly well insulated.

A predominantly conservative strategy did provide a smoother ride through the downturn, although when performance was evaluated over the long-term, the relative outperformance of the strategies with medium and longer term outlooks was considerable.

> "All three of the strategies achieved positive performance over the long term with the only general aberration taking place in 2008"

The key question for captives in this context is whether they are able to take a longer-term view or whether the likelihood of capital calls on their portfolios constrains this.

CR: Most observers identify with the 2008 crisis, but what was the real effect of this on captive strategies and what other market events have affected performance over the last 10 years?

NM: As suggested, the biggest episode from the last 10 years was the post-Lehman crisis of 2008 and we're all painfully aware of its impact on financial markets, particularly risk assets.

If the portfolio was in cash, that provided a level of insulation. As we know, since then interest rates have lowered significantly which has meant cash biased portfolios have received very little return on their cash investments.

If you look at the different indices that we have constructed, the most conservative one (Index 1) preserved capital in 2008 so it did what it was supposed to do.

If you're a captive with a short-term bias and you need to pay claims at relatively short notice and capital preservation and liquidity is key, the money was there. You could access it at short notice with no loss of value.

If your captive has a longer-term outlook, and is therefore more tolerant of short-term volatility and your asset allocation was more like Index 3, then you would be subject to the vagaries of market sentiment because of your exposure to risk assets.

However, if you look at the performance of Index 3 during the worst of the crisis in 2008, instead of being down 37%, the index was only down by just over 14%.

Further, by forcing you to remain in the market instead of panicking and jumping out just when the worst was over, Index 3 enabled the investor to benefit from the significant recovery that followed.

Research into human behavioural biases suggests that investors tend to panic during periods of market stress and jump out of the markets only to miss out on market rebounds.

By the very nature of being in Index 3, you have a higher tolerance to volatility so you can withstand a short-term market disruption – 2008 was a great example of this.

The other interesting episode was mid-2013, when the US Federal Reserve (Fed) announced it was considering reducing the amount of extraordinary liquidity support it was providing to the markets. While equities are perceived as a "riskier" asset class, and the biggest potential source of volatility in the investment portfolio, it can work the other way as well.

In May 2013, when the Fed first started to suggest tapering quantitative easing, this caused considerable panic in the high-grade bond market, leading to a significant move out of bonds into equities, resulting in strong performance for Index 3.

The fear was that inflation would become a major feature as the outlook for the global economy improved. Inflation is generally the enemy of a fixed-income investor as it reduces the purchasing power of the coupon. So we had increasing volatility in the bond markets.

Despite this, Index 1 which has the highest exposure to high-grade bonds, coped well as the duration and maturity of the bond allocation is very short and therefore much less susceptible to the rise in bond yields that took place in 2013.

So once again, Index 1 preserved capital. Looking at Index 3 again, although the duration of the bond allocation was higher, the overall exposure to high-grade bonds is lower.

Although the high-grade bond market fell by about 2% in 2013, the equity market rose by 32%. So the different macro-economic episodes over time affected the components of indices in different ways, and as a result the overall returns of the indices have been more consistent than any one individual asset class.

CR: Do you think that the indices have thrown up a strategy that has proved resilient in all weathers?

NM: The strategy that stands out in terms of "all weathers" is Index 1. Although it hasn't produced high absolute returns, it still produced a return significantly better than cash (cash being the neutral or no-risk position that many captive insurance companies adopt).

It beat inflation because it has produced a return of 3.6% and the target level of inflation is normally around 2%. And it has preserved capital over time as well through all the different market cycles we have seen over the last 10 years. We can probably argue that Index 1 is the most resilient through all economic climates.

CR: Do you think that the indices suggests a benefit either way for a passive or active investment strategy?

NM: We think the indices can be followed in both ways. Effectively, they are a form of passive investment from an asset allocation point of view because the asset allocations are fixed through time.

What the indices avoid is the behavioural biases associated with human nature in terms of chasing returns, buying expensive assets and then panicking when markets turn.

That is one advantage of passive investment over active investment from an asset allocation point of view. However, it need not be all or nothing – within each asset class you can either be passive or active.

So if you think active management doesn't suit your captive, you can just replicate the performance of each asset class within the index in those static asset allocation proportions.

You can do that in a number of ways. First, using ETFs or no-load funds that are well known, very cheap, very large, very liquid or you can do it through individual bonds and stocks. Second, your investment portfolio can try and replicate one of the indices through buying a sample of bonds and equities within each asset class.

You can also take an active management approach, recognising that the portfolio will then be more subject to the vagaries of the market and that market timing skills have to be good. If your portfolio is in the hands of a good manager then it may be able to outperform.

Active management tends to be more expensive, subject to periods of underperformance and the transactions costs tend to be higher.

CR: Now the captive\ market has a set of indices that provide light on benchmark performance, do you think this will change the way captives view their investment strategies?

NM: These indices should help to de-mystify the financial markets for a lot of captive insurance companies that aren't necessarily investment experts. This will provide them with a point of reference which they can use to judge the performance of their current investment portfolio.

They can see what 'good looks like' and then see the performance of their own investment portfolio and ask whether it is performing in the appropriate way. We anticipate that this will enable captives to reassess their current investment portfolios accordingly. It will also provide concrete data to enable boards to determine which strategy or level of investment risk is appropriate and reasonable.

The choice will ultimately come down to the precise nature of their business – is it short-term, medium-term or long-term? What is their appetite for risk? How much short-term volatility can their available capital buffers withstand?

By referencing the London & Capital Captive Indices, captive owners and their professional advisers are receiving information on which to base their decisions, information they may not have been getting either consistently or at all in the past.

HOW HAVE THE PROFILED INVESTMENT STRATEGIES PERFORMED?

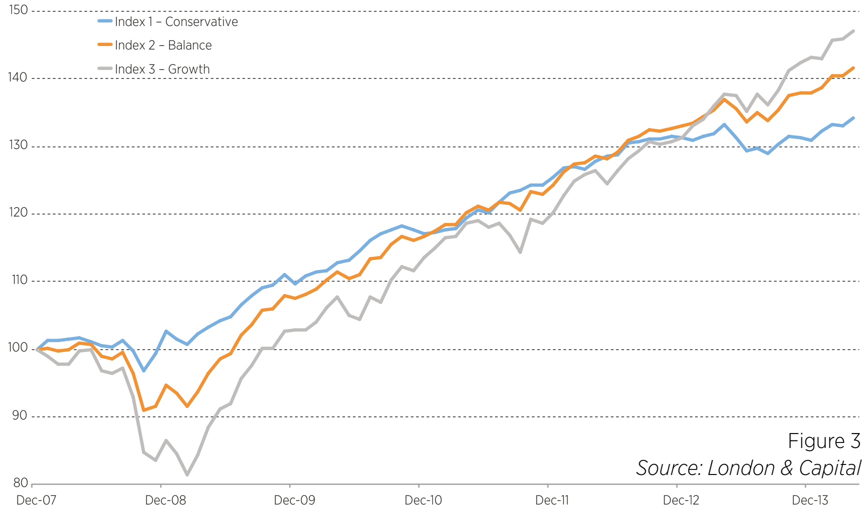

Figure 3
Source: London & Capital

ASSET ALLOCATIONS

	Index 1	Index 2	Index 3
HIGH-GRADE BONDS	90%	70%	50%
HIGH-YIELD BONDS	0%	10%	15%
US EQUITIES	5%	15%	30%
CASH	5%	5%	5%

Source: London & Capital