



INSURANCE INSIGHTS | MACRO STRATEGY

Strategic Asset Allocation: Balancing Art and Science

Discussion

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Guy Haselmann, Head of Thought Leadership at MetLife Investment Management (MIM), recently sat down with Ruth Farrugia, Global Head of Insurance Asset Management at MIM, to discuss strategic asset management for Insurance Companies.

Guy: Could you explain what Strategic Asset Allocation (SAA) is?

Ruth: In its most basic terms, Strategic Asset Allocation is the method by which insurance investors can find a diversified portfolio that suits their investment goals over different time frames. Insurers will use an SAA framework to find the best portfolio that is expected to achieve their target returns, while also considering individual balance sheet restrictions and factors. SAA work is often used to guide annual business plans, pricing for existing and new business—and use the exercise to better understand asset allocation effects over the medium- to long-term horizon.

Guy: It sounds like there are many factors that go into finding the optimal portfolio?

Ruth: When we work with insurance companies, it becomes obvious that their investment strategies are not only focused on the average expected returns of their portfolios; they care about aspects such as earnings, liquidity, return on regulatory and economic capital and measuring risk. An advanced SAA process will consider several factors when producing an optimal portfolio and needs to factor in intrinsic and extrinsic variability, changing business goals and market conditions.

Guy: Will portfolios differ significantly across your various insurance clients?

Ruth: Absolutely, and this is because insurance portfolio needs and requirements differ greatly across different balance sheets. Each underlying business will determine liability profiles and margins, and each insurer will have its own unique set of restrictions and factors. We always recommend a disciplined Asset-Liability Matching philosophy. Since our investors are liability driven, this approach is consistent with their ultimate mandates, and there should also be consistency and alignment with their business obligations. The added focus might cover long-term pension-risk-transfer cash flow, which tends to be stable or involve guaranteed products that tend to be more interest-rate sensitive, compared with P&C portfolios that try to find a balance between total rate of return, income and liquidity.

For us, the true objective of SAA is met when art and science coalesce.

Guy: Is Strategic Asset Allocation more art or science?

Ruth: This question often arises. For us, the true objective of SAA is met when art and science coalesce. Our work generally involves detailed optimization work, and the analysis helps us better understand impacts of an investment strategy over different time frames. We believe that an SAA exercise done well provides directional insights and perspective, yet the investment strategies need to be flexible to capture variability and opportunities along the way.

Guy: Tell me more about your Strategic Asset Allocation approach and what goes into it.

Ruth: We have a comprehensive approach to our SAA work that combines top-down and bottom-up inputs. For us, it starts with the macroeconomic view and an assessment of market technicals, rates outlook and asset origination pipelines. We have active discussions with our portfolio management teams across all our sectors, both public and private. We want to capture market views and understand prevailing and emerging themes in their respective sectors and industries. We want to leverage the breadth and experience of our public and private platforms. The asset allocation process is ultimately the product of MIM views on markets and what we think we can achieve in terms of returns coupled with individual portfolio demands.

Guy: My sense is that the top-down aspects is the “art,” while the bottom-up quantitative analysis is the “science.” What does your quantitative analysis look like?

Ruth: We do quantitative analysis and optimization work for both existing and new money. To explain a bit more about optimization and how we think about asset allocation, we do not rely on just one measure like TROR (Total Rate of Return) or Sharpe Ratios but rather on a variety of risk metrics over a defined period. We look at asset allocation in different stages, taking a medium-to long-term perspective. We have our own internal models to help us understand how risk/return changes over different time periods that can range between one to five years. We start by looking at all asset sectors across the curve in our investment arena and look at returns versus respective capital regimes, but we also consider all other financial metrics. We would look at returns on the asset classes on book or market yields; it can be TROR and income factoring in return on statutory as well as economic capital. The objective function will be to strive to optimize or maximize return subject to capital charges. It should be noted that our investors’ focus tends to be risk-adjusted returns.

Guy: Does your optimization results allow for a host of constraints or provide comparative results?

Ruth: We are able to put in various constraints, such as liquidity, production limits in certain assets and duration, and also factor in credit views. The optimization model can actually create an efficient frontier that tells us where our portfolio should be

compared to where we are. It is an input into our overall portfolio strategy, and it is just as important as our market outlook. In practice, this output helps ensure that our investment activity is beneficial for our operating earnings. We built models with flexibility to be customized for various capital regimes and constraints. Separately we want to understand how the resulting portfolio risk changes over different time periods, so we overlay risk metrics, and we do impact analysis to project potential impacts.

Guy: On the one hand, you are seeking a long-term optimization target, but earlier you said you want to maintain flexibility. How does that work?

Ruth: There is certainly a trade-off. Our approach is to seek long-term strategic targets, while simultaneously maintaining enough flexibility to change with the market and be pro-active to take advantage of market opportunities. The last few years have certainly presented some great opportunities to coupon up. In practice, the foundation of the optimization output provides us efficiency ratios for each asset class that allows us to quickly know the impact of asset allocation changes on capital. In practice, having an optimization target while simultaneously maintaining flexibility is doable and are not mutually exclusive choices. Our basic philosophy goes beyond basic market measures and incorporates a holistic investment asset allocation process with the goal of profitable asset liability management, while meeting our required return objective that will be additive to the bottom line.

Guy: It sounds like SAA work can be quite time consuming, particularly given so many potential inputs and constraints.

Ruth: On the practical side, SAA work varies a lot among insurance clients. A complete SAA exercise can take a lot of time and resources as you suggested. So, having the right technology and analytical tools matters, and this can affect how often it is done. Insurance clients usually have a formal governance and risk appetite framework that guides their investment strategy, so SAA outputs can also be used to create new investment strategies or change how portfolios are positioned. The bottom line is that it is good practice to have a formal process for asset allocation strategies that aligns the business goals and asset opportunities as they change. It ensures balance sheet alignment across all stakeholders.

Guy: Economic and geopolitical conditions have changed dramatically during the past two years. Have you noticed material changes to your SAA outputs?

Ruth: Absolutely. The changes have been dramatic, and they have certainly affected how we adjust our portfolio mix. Insurance balance sheets have faced many challenges, such as tight monetary policy, recession fears and intensifying geopolitical tensions. Earlier last year we also saw a mini-banking crisis that shook investors' confidence. These events made us focus more on portfolio positioning and review our SAA. Many insurers have changed their asset allocation to adapt to the new market conditions and started looking for higher yields. Although moderating, inflation and recession risks are still there, but so are opportunities. Balancing risk/reward in these uncertain environments is harder. We need to balance being strategic and tactical, especially with moving interest-rate changes and the cost of switching. When we design investment strategies, we want to keep the flexibility but also consider the risk appetite framework and balance sheet goals.



Guy: Was the dramatic rise in official interest rates in 2023 a catalyst for outsized asset allocation shifts?

Ruth: Higher yields across public and private markets have led to both strategic and tactical changes in portfolios. When we manage portfolios, we use a more dynamic SAA process that starts with an unconstrained view of markets, see our paper [Relative Value & Tactical Asset Allocation Q1 2024](#), but we also update all client assumptions as needed.

Guy: Does your work consider an assessment of the ratio of upside potential versus downside risk?

Ruth: Whenever we talk about changing asset allocation, we pay a good deal of attention to downside risk. Given the higher-yield environment, we have seen a clear preference lately for higher-quality assets in

investment strategies. Insurers want to be ready to take advantage of market disruptions. In turbulent times, being able to tactically shift to capture opportunities is important—as the famous saying goes, “Never let a good crisis go to waste.” This should probably be part of the SAA thinking, no matter the time horizons, and may be the most difficult part of the exercise, especially when you know that macro forecasts will not go as planned. Therefore, it is important to know your portfolio risks and deal with areas of weakness. Strategic portfolio positioning is a continuous task, implementing a good SAA is a very fine line. It is all about capturing relative value and harvesting return, while never losing sight of your ultimate targets!

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