Captive 101: Asset Allocation

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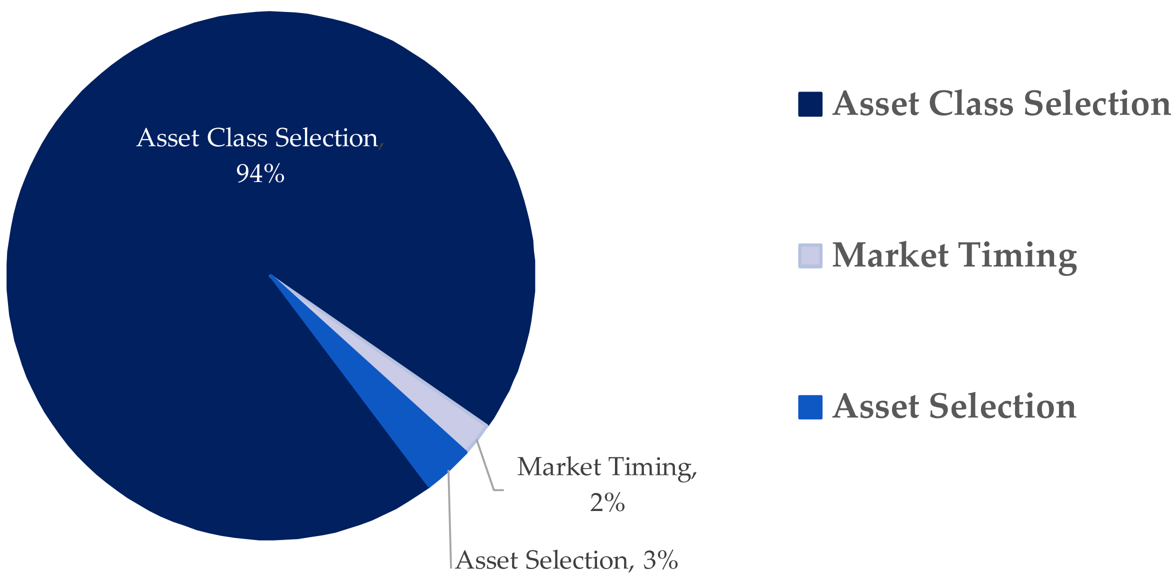
Asset Allocation

- The most important decision you will make for your captive's investment program!



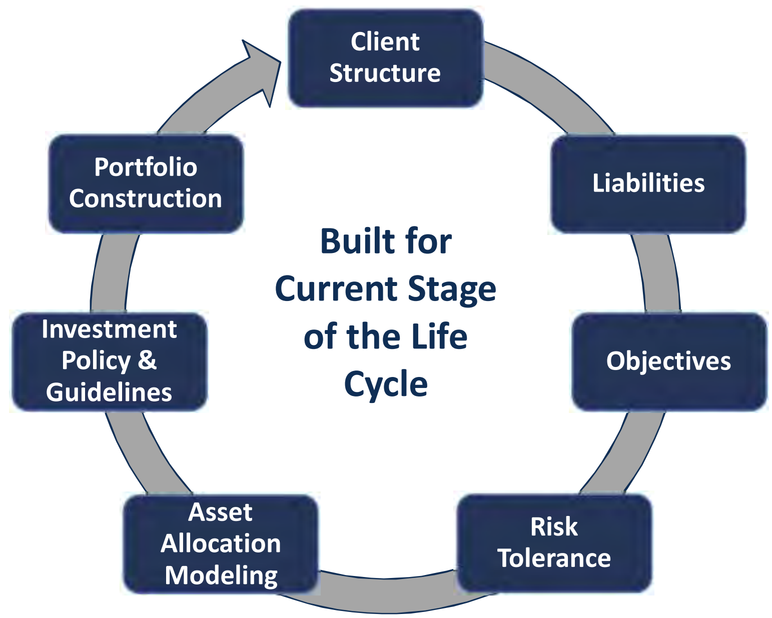
Sources: Ibbotson and Kaplan entitled "Does Asset Allocation Policy Explain 40%, 90% or 100% of Performance?" (2000).

Overview: Asset Allocation

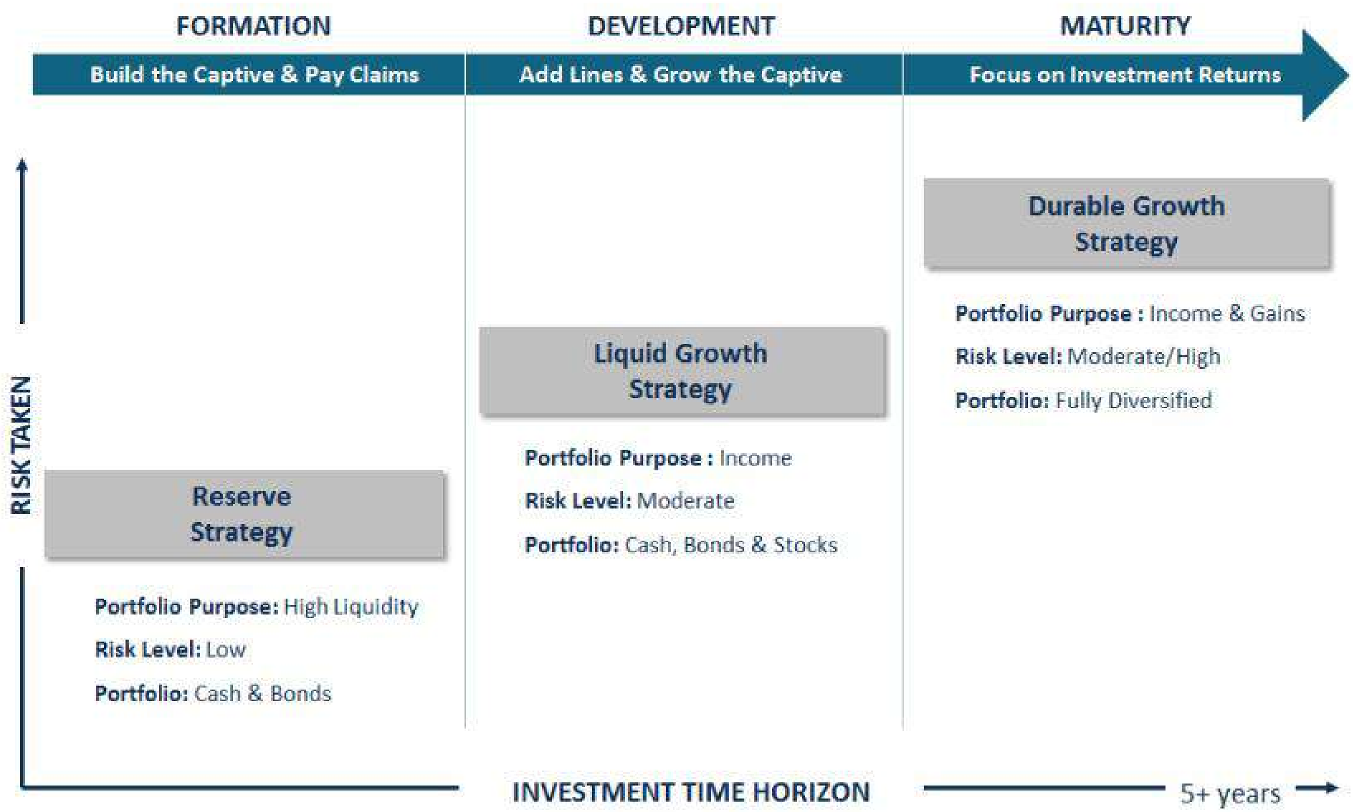
Recommendations Should Incorporate Both…

- Client Variables
    - Å Capital (i.e., current, target, surplus)
    - Å Risk tolerance & liquidity needs
    - Å Stage of the captive life cycle
    - Å Ownership structure
    - Å Claims history
    - Å Domicile
- Portfolio Variables
    - Å Asset class outlook
    - Å Duration positioning
    - Å Portfolio diversification
    - Å Review of strategy cost effectiveness
    - Å Forecasting of market trends and interest rates

High Level Asset Allocation Policy



Life Cycle and Captive Business Model



How Does Asset Allocation work?

Consultant or Investment manager will:

- assess clients objectives, risk profile, regulatory environment and lifecycle stage
- propose asset allocation "mixes" that are aligned with client situation
- test new asset allocations vs current allocation under various economic conditions
- test allocations' results for key metrics (e.g. Expected Return, Risk (Volatility) and Sharpe Ratio)
- identify Risk/Return trade-offs of proposed mixes
- stress Test portfolio mixes
- determine feasibility and timing for implementation of optimal strategic asset allocation

Strategic vs. Tactical Allocation

Strategic Asset Allocation

- Intermediate to long-term horizon
- Typically 5-15 Years measured in "business cycles"
- Utilizes projected underwriting results
- Incorporates customized risk and return measures
- Governed by broad tax, statutory, and company-specific guidelines
- Defines range of allocations

Tactical Asset Allocation

- Short to intermediate-term horizon
  - Typically 3-18 months measured in Weeks, months & quarters
- Utilizes actual underwriting results
- Incorporates current capital market pricing and relative valuations
- Governed by "temporary" modifications to investment guidelines
- Defines specific allocation

Strategic vs. Tactical Allocation

Strategic Asset Classes	Tactical Asset Classes
• Cash • US Bonds • US Equities • International Bonds • International Equities • High Yield Bond • Preferreds • Convertibles • REITs, MLPs, Commodities • Hedge Funds	• Corporate Bonds • Government Bonds • Asset Backed Securities • Agencies • Mortgage-Backed Securities • TIPS • US Large Cap Stocks • US Mid Cap Stocks • US Small Cap Stocks

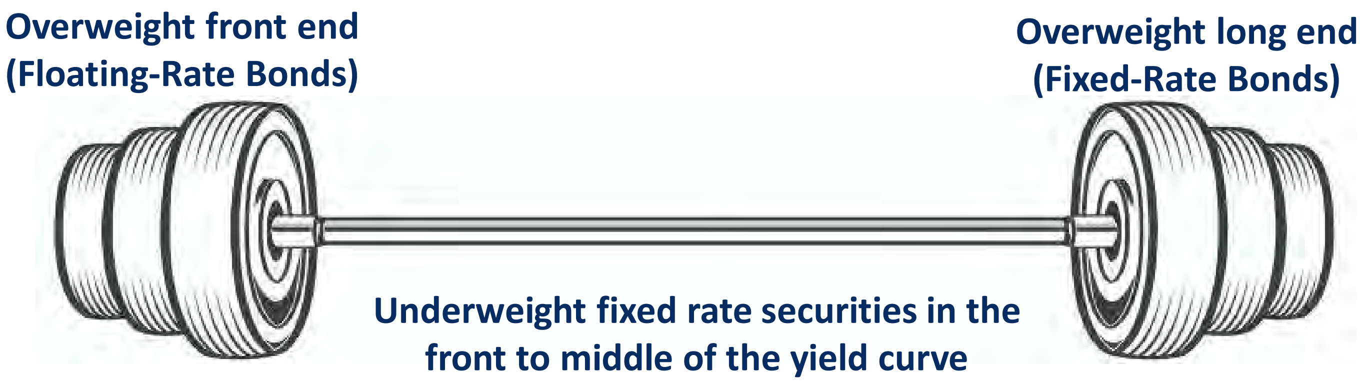
How to Manage Risks

- Risks that should be regularly discussed with your investment manager:
  - Interest Rates & Yield Curve
  - Issuer/Credit Risk
  - Market Liquidity
  - Portfolio Liquidity
  - Style (Growth vs. Value)
  - Global Economy

- Steps you can take to offset the negative impact of rising rates:
  - Reduce Interest rate risk with shorter durations
  - Use a “Barbell” Yield Curve Strategy
  - Use Fixed Rate & Floating Rate Bonds

Defensive Barbell Positioning

- Guard against Fed rate hikes: 2 to 3 year maturities most susceptible
- Left side of barbell: Floating-Rate Bonds (rising rates = higher income)
- Right side of barbell: Longer maturity (i.e., 5+ years) Fixed-Rate Bonds
- Goal: Maintain same yield as Index with only ¾ of the interest rate/duration risk

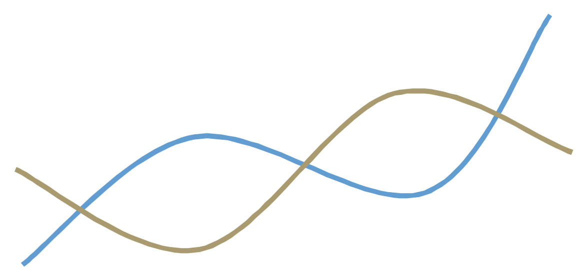


Risk Reduction is a Function of Diversification

- Diversification is a function of combining imperfectly correlated asset classes

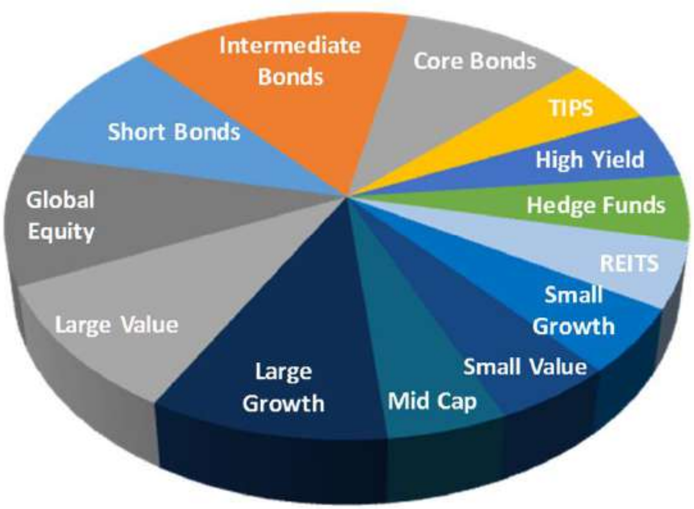
High Correlation

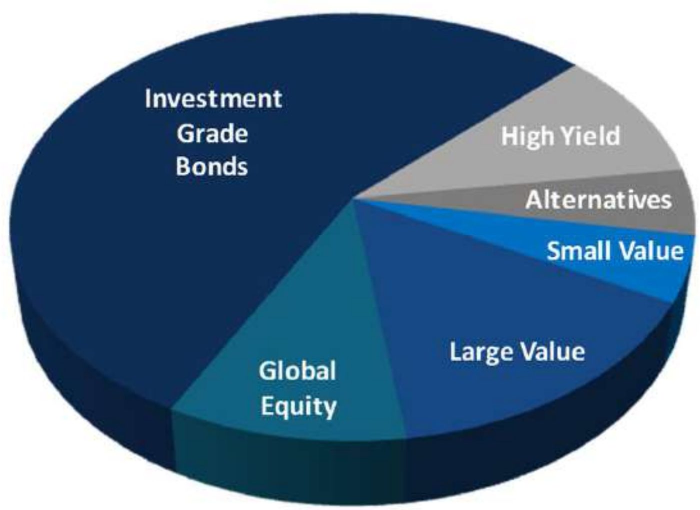
Low Correlation



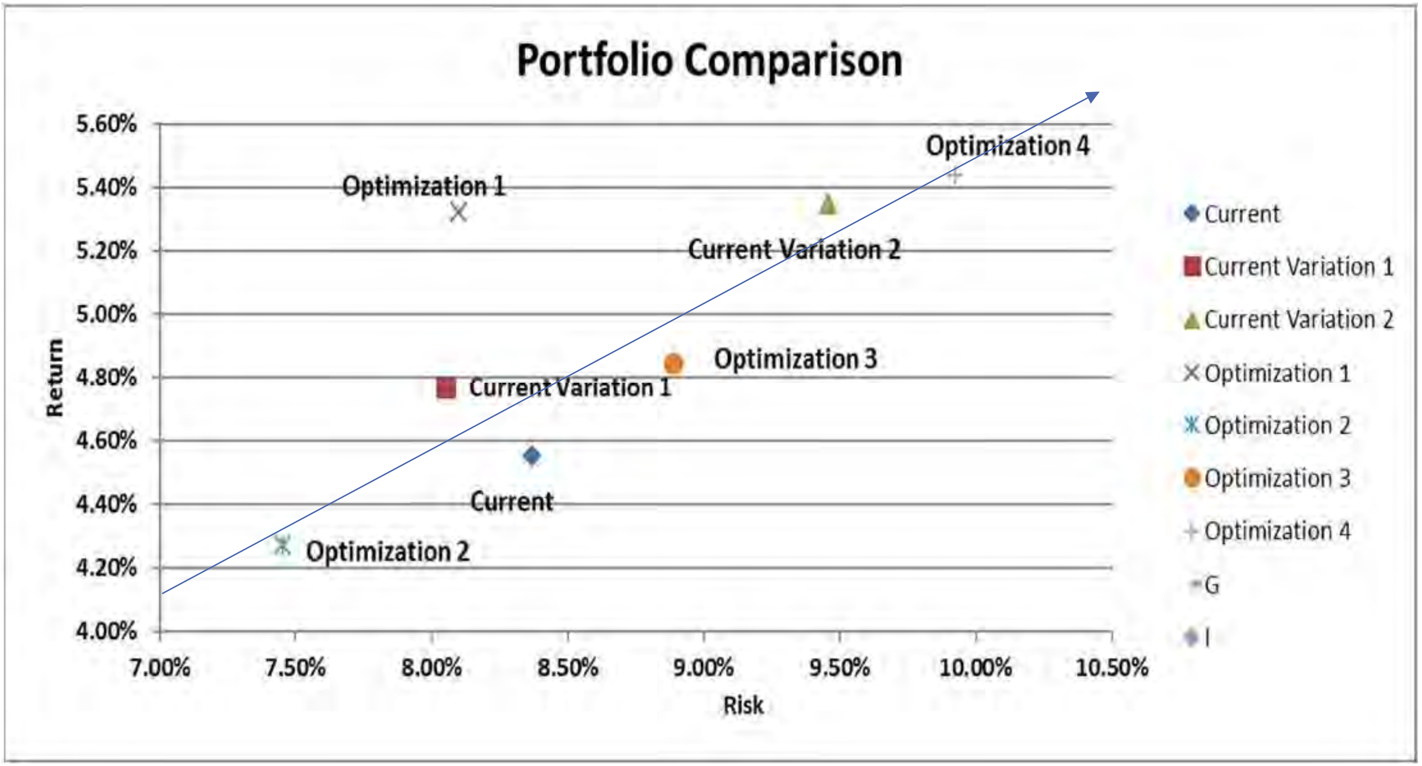
Diversification in Moderation

- Important to have exposure to different asset classes
- But, investing in too many asset classes isn't always optimal
- Over-diversification can be costly and inefficient





Risk/Reward Analysis



Market Risk Analysis

	Tail Risk Comparison				
		Standard Deviation			
Portfolio	**+2**	**+1**	**Mean**	**-1**	**-2**
Current	18.31%	7.78%	4.55%	1.33%	-9.21%
Current Variation 1	18.01%	7.87%	4.77%	1.67%	-8.47%
Current Variation 2	20.91%	8.99%	5.35%	1.71%	-10.21%
Optimization 1	18.64%	8.44%	5.32%	2.20%	-8.00%
Optimization 2	16.53%	7.14%	4.27%	1.40%	-7.99%
Optimization 3	19.46%	8.27%	4.85%	1.42%	-9.77%
Optimization 4	21.76%	9.26%	5.44%	1.61%	-10.89%

Heat Map

Additional Factors

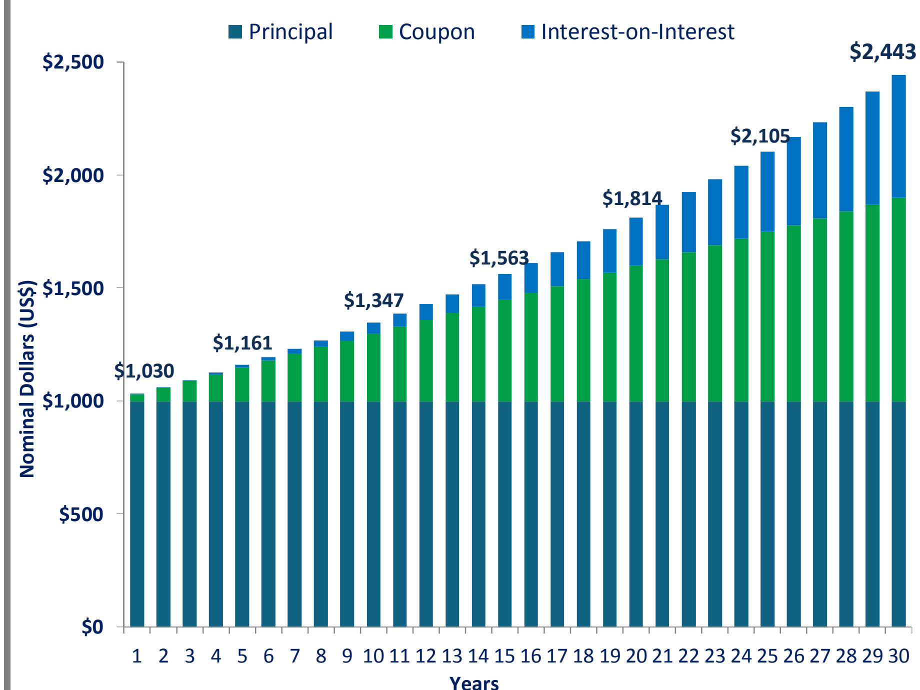
- Other variables that can impact an investment portfolio
  - Types of Investment Managers
  - Active vs. Passive
  - Fees: Cost & Transparency
  - LOCs vs. 114 Trusts
  - Regulatory Environment

What happens without an investment plan?

Breaking down $1,000 invested at 3% over 30 years

- $1,000 in cash for 30 years means you start and end with $1,000 (teal bars):
- However, investing $1,000 at 3% for 30 years could earn…

$1,000 Principal
$900 in Coupon payments
$543 in Interest-on-Interest
$2,443 Total

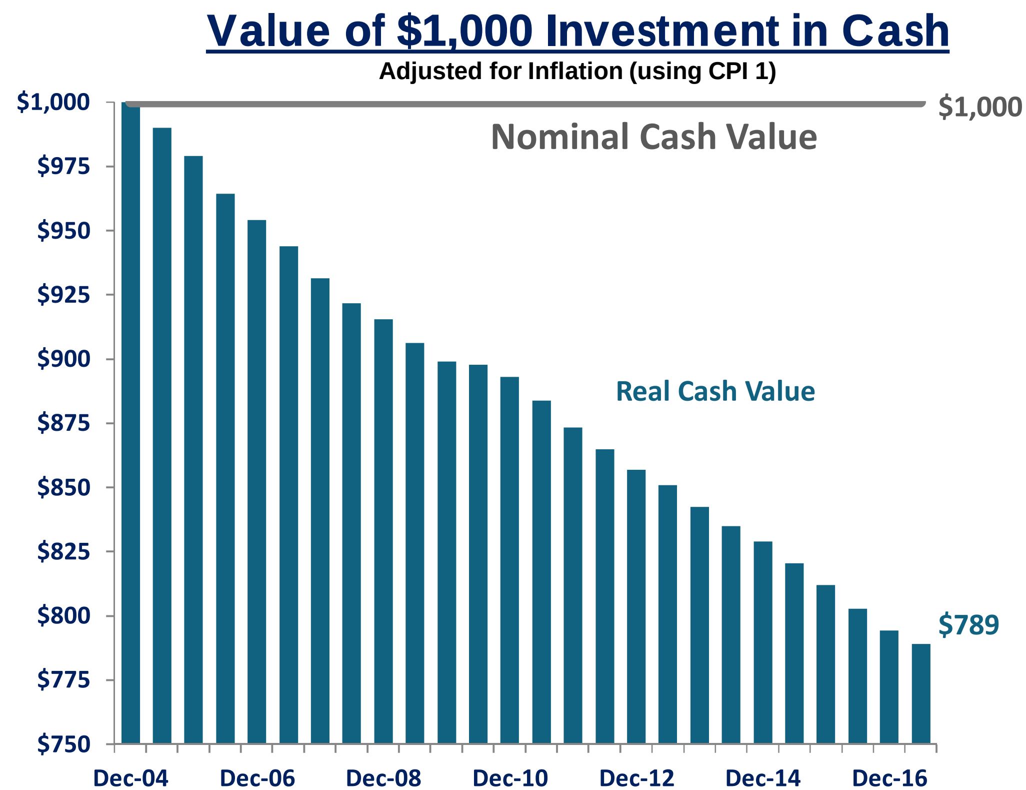


[1] Example assumes $1,000 is invested at a fixed rate of 3% over 30 years.

Source: Performa Limited (US), LLC

The Cost of Cash

- Holding cash maintains nominal value (grey line), but sitting in cash means losing real value (teal bars)
- Over time, inflation erodes purchasing power
- Ex: Holding $1,000 in cash since 2005 would result in a value of $789 in June 2017, adjusted for inflation



[1] US Consumer Price Index (CPI) Urban Consumers Less Food and Energy (Seasonally Adjusted)

Source: Bloomberg; Performa Limited (US), LLC

In Summary…Plan Ahead!

Prepare…	An investment plan at the time of captive approval
Develop…	A strategy that is tailored to your captive
Recognize…	Captives are unique; they differ from mainline insurers, individuals, parent assets, etc
Ensure…	You investment manager understands captives

Sample Questions to ask your investment manager

- How do you define and manage risk?
- How are you positioned for rising interest rates?
- What percentage of the portfolio is liquid?
- Please provide the rationale for the benchmark(s) you have selected.
- What factors have impacted my portfolio's performance?
- What is your short term/long term outlook for markets?
- What should be the triggers for making investment policy changes?

Final Thoughts

- Question & Answers