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Execution is the key to a SAA success

Jaijit Kumar, Head of Asia Insurance Solutions, at Invesco talks about how to design and implement successful strategic asset allocations (SAA).

Jaijit Kumar

***Insurance Asset Risk:* How do you assess constructing the portfolio from the ground up for new asset classes?**

Jaijit Kumar: SAA design usually starts with an assessment of long-term capital market assumptions for various asset classes.

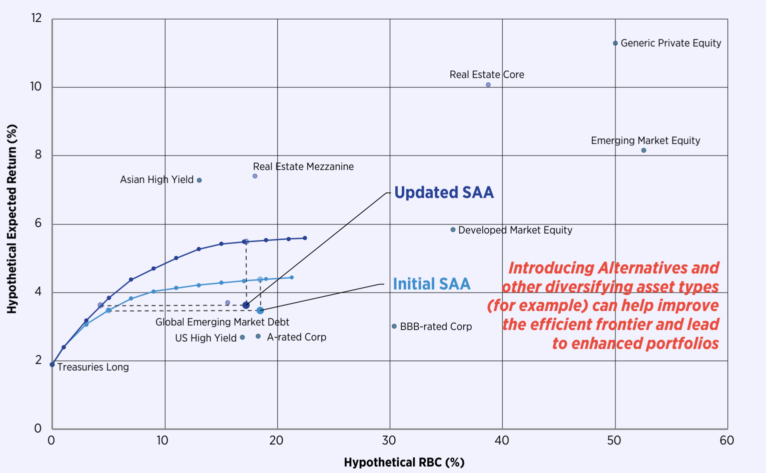
These assumptions are dynamic as they get updated regularly based on latest market developments. Any investment process should use the market assumptions' inputs and their updates to assess the efficiency of any allocation, and consider new asset classes, in order to most effectively meet target yields or returns.

One of the initial parameters to consider may be the expected return/yield, but it is always interesting to also look at how expected returns stack up against potential capital charges.

Looking at a single dimension alone could potentially lead to inefficiencies in the portfolio. Certain asset classes have middle-of-the-road spreads compared to others. But, if we were to consider these from a return on capital perspective, for a longer-term horizon, these asset classes could appear relatively efficient. Conversely, other asset classes, while having a relatively high current spread, may not look as efficient once the capital charge is factored in.

Designing an appropriate SAA is an iterative process – selectively adding/reducing various asset classes until one gets to an asset allocation that is in-line with expectations and constraints – and leads to an improved SAA (from an asset perspective) as graphically represented below.

Illustrative Efficient Frontier



Source: Invesco. For illustrative purposes only. There is no guarantee the hypothetical results can be achieved

IAR: What are the challenges for insurers in this process?

JK: Once asset types are narrowed down to some extent and deemed to add value to a portfolio, selection of managers, setting up of mandates and guidelines, and other operational aspects come to the forefront.

Ensuring the strategies selected are a good representation of what has been modelled is also very relevant. It is important to ensure a deep and thorough understanding of new asset class and what is required from an implementation and monitoring perspective.

There will be sources of additional yield/return offered by different asset types and it remains vital to assess whether or not these assets are within the appetite of the insurer. This means analysing the specific sub-asset types within a broader asset class – for example, understanding the differences in the risk-reward profile and capital implications of investing in core vs value-add vs opportunistic real estate strategies. These are all examples of real estate exposure, but have different objectives and profiles. It is also important to ensure that managers have the expertise, capabilities, and resources to appropriately manage any such asset classes.

This is an on-going process – and the portfolio has to evolve as market conditions change and asset class profiles change over time. Hence, continuous review should be an integral part of any SAA process and framework.

IAR: What are the key considerations when conducting a review of the SAA?

JK: SAA reviews could lead to potentially enhancing portfolio profiles by selectively adding asset classes that have favourable risk-reward characteristics. This may mean the reduction in exposures to public/listed assets and a corresponding increase in private/unlisted assets to generate additional premium.

As part of any such analysis, the sources of additional premium need to be assessed carefully and one needs to ensure that other risk parameters (such as liquidity) remain well managed and in accordance with an insurer's risk appetite. Ensuring portfolios remain resilient under market conditions, identifying areas of particular sensitivity, and constantly assessing efficient ways to manage and mitigate such risks should be a key part of any SAA process.