

The
Insurance
perspective

2017 - Volume 7



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Industry Insight

Recently, I have been part of several conversations regarding the most optimal questions to ask of any advisor seeking to manage the assets of an insurance company. While it is always important to consider questions specific to the needs of your organization, there are several questions that are vital questions to ask. The following provides commentary on several of the most important questions that any insurance advisory firm should be able to answer.

Does your firm have a platform and focus on the insurance industry?

Investing money for insurance companies is completely unique compared to any other type of advisor service. This is due to the unique nature of statutory accounting, insurance reserves, and very unique regulation. All of these items are built around the concept that the majority of the assets are specifically designed to provide cash flow to support future liabilities. The majority of assets are carried at amortized cost and often gain/losses are not able to be recognized as they become part of future reserves within IMR.

Therefore, performance objectives are centered on book yield, net investment income, surplus, and/or RBC enhancements. The accounting, investment, and actuarial systems necessary to best position assets to provide for liabilities require an extensive investment themselves. Because of these and many other attributes, it is important to make sure that any advisory firm seeking to serve your organization is dedicated to the industry.

Does the advisor have any shared values with our organization? I believe that this is important in all aspects of life and that one should not separate who they are in their personal life from their business life. Relationships and business is most successful when we work with others that share our values and goals in life. Clearly, this can differ for each insurance company. For example, Parkway Advisors designed its business model to align with Biblical values. Therefore, we gravitate to serving others that share this value system. Clearly, this helps us be in line with the long term objectives of our clients in which we share this commonality.

What insurance specific services are offered by the advisor? As mentioned above, the needs of an insurer are unique. Any advisor focused on the insurance industry will have specific services for insurers. It is good to understand if these services fit the needs required by your organization. Services offered by insurance advisory firms should include: Asset/Liability management, assistance with AM Best ratings, investment statutory reporting, preparation of IMR/AVR, assistance with the design of an ERM program, peer analysis, actuarial assistance with asset cash flow projections, strategic planning, budget and business plan assistance and design.



Theron R. Holladay Sr., CFA
President and CEO

How can the advisor assist our company with expense reduction? A focus on the insurance industry provides niche advisory firms the ability to assist an organization with expense reductions. Through NAIC and state insurance code knowledge, astute advisors can remove or even entirely eliminate, custody fees in most states. Additionally, investment statutory accounting fees can be reduced or eliminated. With the ability to combine insurance services under a single fee structure, insurance advisors can also reduce or remove other expenses such as ERM design fees, certain aspects of compliance reporting, and other areas. It is important to research this in determining the best manager to select.

Does the advisor work consultatively with our other service providers? All parties that serve your organization should be working together to achieve your objectives. It is impossible for an advisor to be effective without understanding and working with the accounting team, actuaries, rating agencies and auditors. Of prime importance is understanding the assumptions and projections of the liabilities with the actuary. This will determine the appropriate asset mix, maturity, and needed yield of the investments.

Are the employees of the advisor extensively trained in statutory accounting and insurance regulation? Any investment decision made by an advisor should be performed with an understanding of how it will impact surplus, RBC and net income. This knowledge is only there with specific and comprehensive training in statutory accounting, insurance reserves and state and NAIC regulation. An advisor without this knowledge can significantly reduce income for the insurer even if they have a great total return performance record.

Does the advisor have actuarial, statutory accounting, and insurance investment software internally? The best way to understand the impact of investment decisions is the ability to perform “what-if” statutory financials ahead of any transactions. This will demonstrate how gains/losses are processed through IMR and the financials. The top insurance advisory firms internally prepare NAIC compliant investment schedules and can adjust them daily with hypotheticals.

Does the advisor and its principals have a clean record with the SEC and FINRA? This simply stands to reason. It is always important to perform background checks on anyone wishing to be a steward of the financial resources of others. For an advisory firm the regulatory body that oversees investment advisors is the SEC. Financial violations and past terminations can be found in FINRA’s data base under the broker check feature. An effective method is to ask any potential advisor if either their firm or the principals of the firm have past complaints or judgements against them or if they have ever been terminated from a financial organization. It is important to know the answers to these ahead of time and to inquire deeper if the record is not clean.

How can the advisor help our organization improve surplus, net income, book yield, RBC? The performance objectives of each insurer is unique; however, it is important to know how the advisor plans to help you achieve your objectives. Surplus is impacted by many investment items and can often be improved with reduction in assets with high asset concentration factors for AVR. As AVR decreases the surplus will increase. RBC can be enhanced with an understanding of insurance companies and through diversification as it relates to overall surplus. Book yield is often the primary performance measure for an insurer as it directly relates to the annual reported net investment income. The advisor should be asked how they plan to maximize book yield under the necessary risk restraints.

How does the advisor work to reduce insurance specific investment risk? While there are many risks involved in asset management, the two greatest methods for controlling insurance specific risk are:

1. Making sure that the asset cash flows are appropriate to support the products that are sold to policy holders (ALM strategy). This strategy can differ greatly from one insurer to another as each client is unique and different products are sold. An improper ALM strategy is the main reason many insurers currently have reduced book yields and a surplus to asset ratio that is declining.
2. Diversification is important for any investor, but is very unique for insurers. Diversification should consider the amount at risk in any single issuer as it relates to total surplus and should be a percentage of AVR for a life company. Proper diversification alone can improve RBC and significantly reduce risk. Improper insurance diversification is the main reason insurance companies lost money in the financial crisis.

Will the advisor assign our company an investment management team, accounting team, & regulatory specialist? Having multiple teams assigned helps ensure that someone familiar with the investments and accounting of the insurance company is always available.

I would recommending combining these questions with others that are specific for your needs anytime you are considering working directly with an outside advisory firm. Having the answers to these questions will help you select the advisor best suited for your specific needs.

Economic Commentary



Chad B. Hoes,
Chief Investment Officer

It's time for a new calendar as we kick off 2018. The new tax plan takes effect this year, Congress will be picking up the budget cap discussion after kicking the can in December and the Federal Reserve continues its rate-hiking strategy as the economy remains strong. This New Year promises to be one chalked full of news, events and exciting times. Let's recap the final quarter of 2017 before shifting our focus entirely to 2018.

US Bond Market – I'm sure you're all tired of this phrase, especially from me, but the flattening of the yield curve continues. The shorter end of the US Treasury yield curve shifted up in the fourth quarter, over twenty-five basis points at each tenor out to the 5-year. The long end of the curve, as represented by the 30-year Treasury, fell twelve basis points to end the year at 2.74%. After a tumultuous third quarter for the 10-year Treasury,

this point on the curve ended the year at 2.4%, which was over thirty-six basis points higher than its 2017 low in early September. The short-end of the Treasury yield curve has continued to rise harmoniously with the Federal Reserve's increases to their benchmark rate.

FOMC – Speaking of the Fed, the fourth quarter brought two scheduled rate decision meetings, both of which played out exactly as the market and economists anticipated. October was the Fed's full month of quantitative easing unwinding. So far Yellen and company's plan to let maturing securities (including principal and interest) roll off their inflated balance sheet without reinvestment is progressing as planned. Initial expectations were about \$6 billion of Treasuries per month rolling off by attrition, slowly increasing to \$20 billion per month which is scheduled to occur in January. The November rate decision meeting left rates unchanged for the fourth consecutive time. The second rate decision meeting of the quarter and final for the year occurred in mid-December at which the Fed raised rates to the current range of 1.25-1.5%. This marked the third rate increase in 2017 and the Fed has signaled three additional hikes in 2018. The forward curve based upon future implied probabilities is projecting a Fed Funds rate of about 2% by year-end 2018, which translates to an approximate fifty basis point increase from the current range. Yellen has begun setting the stage for the transition to her successor Jerome Powell with comments that indicate his involvement in the consensus and strategy to gradually hike rates. Yellen's final scheduled meeting as Chairperson will be January 30-31, which will conclude her service that comprised three decades of monetary policy involvement at the federal level.

US Stock Market – Domestic equities continued rallying to end the year about half a percent off all-time highs. With Congress passing a tax-overhaul plan and managing to avoid a government shutdown, traders and capital market investors favored the prospects for a continued increase in stock prices and valuations. Despite many calling for a market correction, we have yet to see even a five percent correction in quite some time. In fact, the current bull market is the longest stretch without a three percent correction in US history. The S&P concluded the quarter up 6.63% and 21.8% for the year. The Dow Jones Industrial Average wrapped up the year with a solid 10.9% fourth quarter performance and gained 28.07% for the calendar year. The NASDAQ lagged these other indices in the fourth quarter (up 6.57%) but finished 2017 up 29.7%.

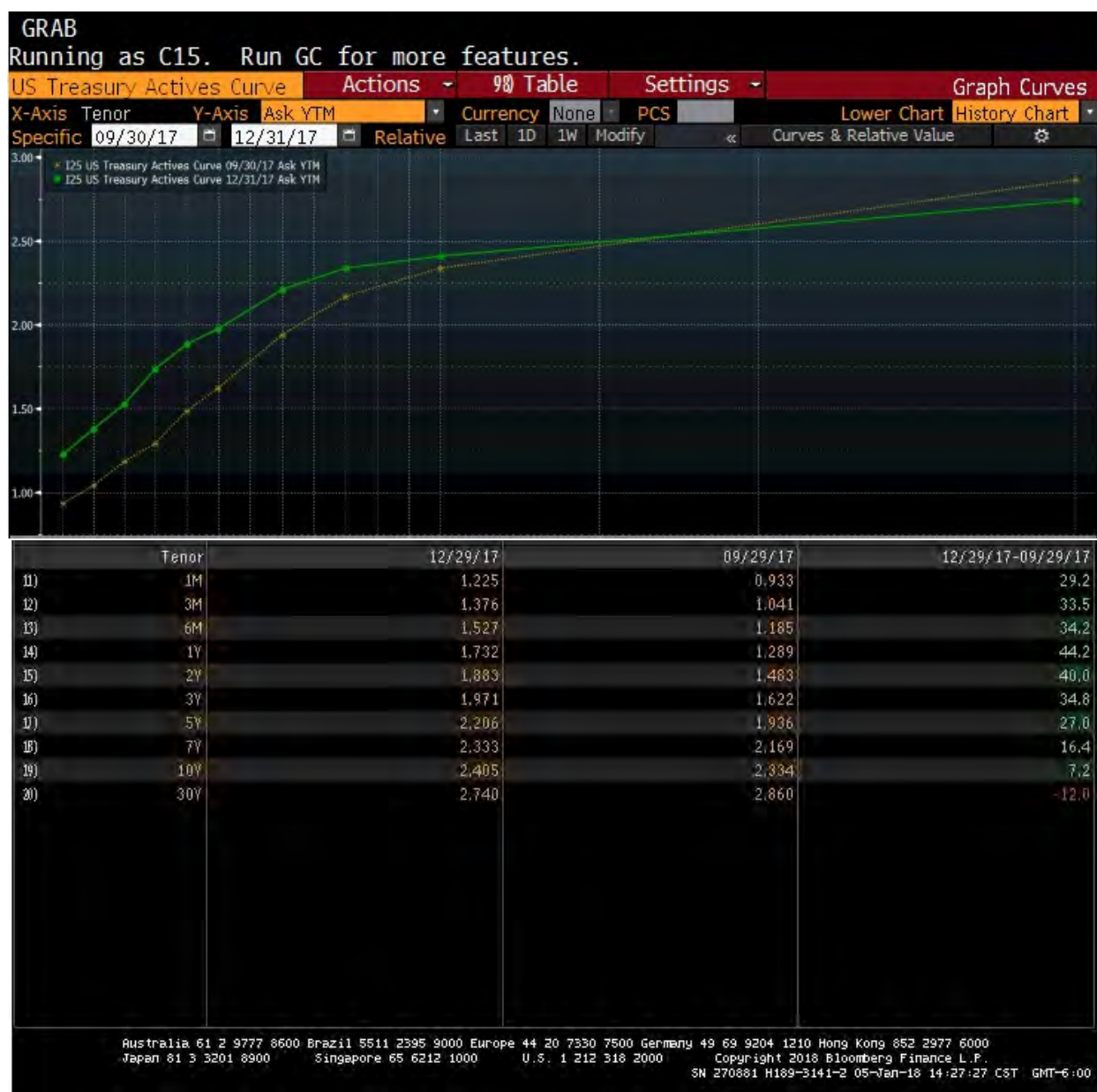
Summary – It was an eventful fourth quarter and 2018 is set up to be a lively year. I anticipate two to three rate hikes by the Fed, more highs reached in the equity market (despite a possible correction) and a continued flattening of the yield curve.

Interest Rate Spreads

As of: 12/29/2017

Term	Treasury	US Composite BVAL AA Curve		US Composite BVAL A Curve		US Composite BVAL BBB Curve		US Composite BVAL BB Curve	
	Yield	Yield	Spread	Yield	Spread	Yield	Spread	Yield	Spread
1yr	1.76	1.911	0.151	2.039	0.279	2.242	0.482	3.019	1.259
2yr	1.89	2.123	0.233	2.253	0.363	2.499	0.609	3.424	1.534
3yr	1.98	2.281	0.301	2.426	0.446	2.711	0.731	3.787	1.807
5yr	2.2	2.542	0.342	2.684	0.484	3.041	0.841	4.371	2.171
7yr	2.33	2.794	0.464	2.933	0.603	3.357	1.027	4.884	2.554
10yr	2.4	3.091	0.691	3.23	0.83	3.705	1.305	5.404	3.004
20yr	2.58	3.499	0.919	3.753	1.173	4.251	1.671	6.405	3.825
30yr	2.74	3.613	0.873	3.715	0.975	4.155	1.415	6.332	3.592

US Treasury Yield Curve



S&P 500 Index



Dow Jones Industrial Average



Stock Market Valuations



Trevor R. Rupe,
Portfolio Manager

Something you're bound to see a headline about when it comes to the stock market is that things are "overvalued" and trading at very high "multiples" or "valuations." You may also hear that because of this, we are due for some colossal crash. While it is true that we are currently writing history in regards to the longest bull-run without a 3% correction, valuations are not always a clear indicator that a crash is imminent. The most common way to measure where an equity lies on the "value" scale is to look at its P/E (price to earnings) ratio. The P/E ratio represents the company's stock price divided by the earnings the company generates on a per share basis. The higher the ratio, the more "expensive" the stock is. These ratios will vary greatly industry to

industry, and even stock to stock depending upon where they stand in their development (new companies may not generate earnings initially).

When looking to analyze longer term trends and adjust for the impacts of inflation, Robert Schiller created the CAPE, a cyclically adjusted price to earnings ratio. The CAPE ratio recently passed 30, which marks the third time in history it has reached this level. Unfortunately, after reaching these levels in the past, the market experienced some tumultuous volatility that sent stocks down sharply. In 1929, the CAPE ratio remained above 30 for about 2 months before crashing upwards of 80%. However, a more positive scenario occurred in 1997 where the ratio remained above 30 for several years, even reaching 44 at the end of 1999, before the "technology bubble" burst that cut stock prices in half. However, I wouldn't argue that two events in history provide us a large enough sample size to determine that once valuations reach a certain level, there is going to be a crash. In fact, bear markets can even happen at "low" valuations. There have been approximately 15 bear markets since WWII, and 7 of those occurred when the CAPE ratio was below the 18.6 average.

I also don't want you to take away that there is no possibility of a crash, as ultimately a higher valuation means stocks have more room to fall, which carries a higher level of risk. However, higher valuations are correlated to lower future potential returns. Historically when valuations are elevated, subsequent returns are less than those on average following times when valuations are low. Ultimately, it's hard to say how much of an impact valuations really have in the current market. Markets aren't as driven on fundamentals as they might have been in the past, and instead are influenced by future expectations (as seen in regards to tax cuts, improving global growth, etc) along with market trends and momentum. In addition, the market is much more efficient than it has been in the past with technology that has allowed far more people to invest, reduce trade costs and increase liquidity. With fixed income yields still near historic lows, many in retirement have left higher allocations to stocks. The new "normal" in the equity market could be that it trades at higher P/E ratios than historically. Another scenario is that

the market could even trade “sideways” for a bit without any substantial moves in either direction to allow earnings to catch up with current prices.

While valuations are currently at historically elevated levels only seen twice before, valuations have generally been more useful for setting investor expectations on potential future returns as opposed to predicting crashes. More importantly, as prices remain elevated and we are long “past due” for a correction, now still remains an opportune time to review your equity allocations, potentially take some gains and rebalance where necessary to mitigate risk within your equity portfolio.

Disclosures

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About this Publication

The Insurance Perspective is a quarterly publication prepared by the staff of Parkway Advisors, L.P. Each issue focuses on the U.S. economy and specific insurance industry issues and/or concepts. Our clients and prospective clients enjoy Parkway's dedication and unique focus on the insurance industry.

For More Information

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