What do clients with Reinsurance Companies need to know about Rising Interest Rates?

10 years ago, investment strategies for reinsurance companies were pretty easy. Although the restrictions of what you can and cannot invest in have not changed much, the investment climate certainly has. In December of 2005, the 10 year treasury was 4.39%, as I write this article today, the 10 year treasury bond is hovering around 2.22%. As a result, overall yields are almost half of what they were! In today's environment, between the costs of annual administration, trustee fees, investment advisor fees, taxes and licensing; a passive investment portfolio yielding around 2% may not provide your clients with the level of investment profit it has in the past; and now we have a new risk in the market – Rising Interest Rates.

Although rising interest rates may provide an opportunity for increasing income, the value of many fixed income investments may decline as rates begin to rise. Reinsurance Companies need to work with an experienced advisor to analyze the fixed income investments in their portfolio, re-evaluate the role they play in their overall investment policy and consider strategies to mitigate risks.

Our team has 4 questions we attempt to assist our clients in answering about their existing portfolios. This article will provide insight into these 4 questions along with information on how to create a plan of action.

1. What do I own and why?
2. What will happen to my portfolio?
3. What other risk exposure do I have?
4. What action should I take?

With over 15 years of experience in managing investments specifically for reinsurance companies, our team is uniquely positioned to assist reinsurance company owners in addressing these questions, and creating the right plan.

What do I own and why?

With a reinsurance company, a client typically holds a trust account and a surplus account. The trust account is generally governed by the administrator of the insurance product and holds the unearned premium reserve required to cover claims on outstanding obligations of the reinsurance company. The trust typically lists how the account can be invested, or references another document or statute with that information. Surplus accounts hold earned funds and can be invested at the discretion of the reinsurance company, typically without any restriction.

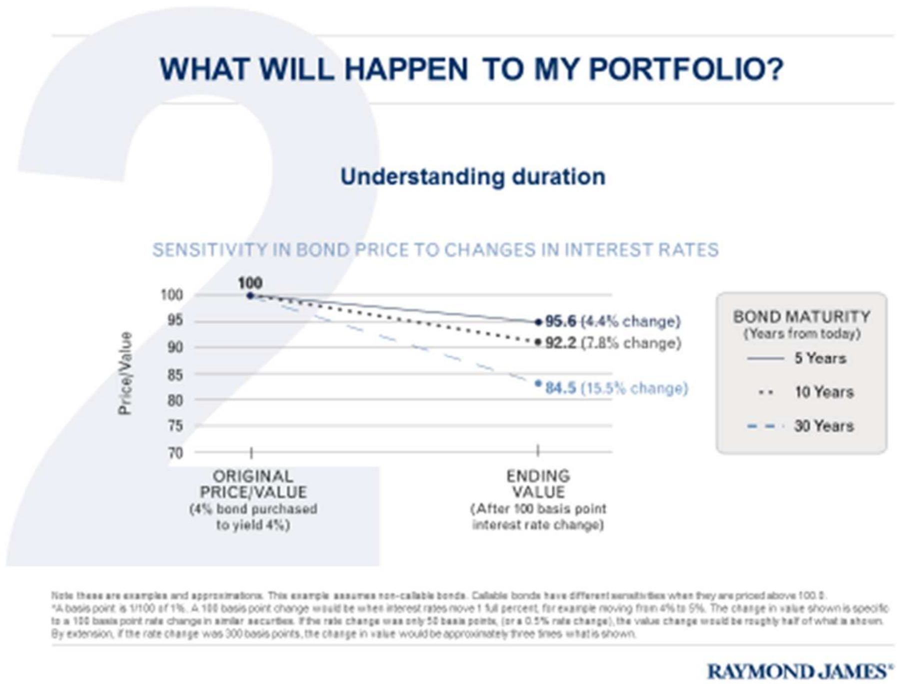
When reviewing what you own, it's important to identify if you own individual bonds, bond funds, ETF's, closed-end funds etc., each has different characteristics, risks and rewards. In reviewing why you hold them, you may have selected the positions for the income they provide, to preserve capital or to diversify the portfolio. In some cases, you may have selected investments simply based on the suggestion of your investment advisor, or what was allowed by the trust agreement. Nevertheless, it's critical to know what you own.

What will happen to my portfolio?

This is where duration becomes important. In simple terms, modified duration gives an idea of how the price of a bond (or portfolio of bonds) will be affected should interest rates change. A higher duration implies greater price sensitivity to a change in interest rates. The duration of a bond is primarily affected by its current coupon rate, yield and remaining time to maturity. If all else remains equal, a bond's duration will increase as:

- Time left to maturity increases
- Coupon rate decreases
- Yield decreases

This chart illustrates how a bond's value is reduced when interest rates rise. Conversely, the value would increase when rates fall. This example assumes a 4% coupon bond with a 4% yield at inception (priced at par: 100.0). If the market rate for bonds went up 5% (a 100 basis point change), the value of the bond would decline by the amount shown.



If economic conditions continue to improve, interest rates are likely to rise. Although traditionally serving as a conservative part of a portfolio, bonds do pose risks in a rising interest rate environment. For example, when interest rates rise, bond prices typically decline.   Another issue to consider is that the higher the duration of a bond, the greater its price sensitivity to changes in interest rates. If you own individual bonds to receive steady, consistent income, you may not be as concerned about changes in the value of your bonds since they will continue paying out income regardless. However, if you are instead using bonds to achieve an attractive total return, you may want to reposition assets to help you better achieve this goal, since your bond values may drop as interest rates rise.

What other risk exposure do I have?

There are tradeoffs to understand with every decision you make in your portfolio. For example, shorter maturity bonds will typically have a lower yield. Higher-yielding bonds of similar maturities will generally present a higher credit risk. How certain risks impact you differs depending on your objectives and the types of investments you own.

There are numerous other risks investors should be aware of when reviewing their fixed income portfolios including:

Purchasing power risk - Over time inflation may lower the value of returned principal. This means an investor will be able to purchase less with the proceeds received at maturity. Higher inflation usually result in higher interest rates.

Reinvestment risk - Those who lock in their returns by investing in long-term bonds might not be able to reinvest at higher rates when rates go up. However, those who buy short-term securities or callable securities may face the risk of having to reinvest at lower rates when interest rates drop.

Foreign bonds - Additional risks include, without limitation, liquidity, currency fluctuations, differing accounting standards, political and economic instability, and differing tax laws. Investors may benefit from professional management.

High-yield bonds - Not suitable for all investors. The risk of default may increase due to changes in the issuer's credit quality. Price changes may occur due to changes in interest rates and the liquidity of the bond. When appropriate, these bonds should only comprise a modest portion of a portfolio. As with foreign bonds, investors may benefit from professional management.

What action should I take?

The steps to take in reviewing your portfolios start with the amount of risk you are taking in your accounts. Everyone has unique and individual circumstances and this will impact what you own and why. If your reinsurance company has a steady earnings curve, you may wish to match your fixed income and investment maturities to your earnings. Others may have the desire to purchase a new dealership at a point in the future, or to retire other debt. Your specific needs should impact the design and management of your portfolio.

Our team has the ability to run an analysis on any individual bonds and portfolios to assess the credit quality, exposure by credit rating and diversification. We can use this analysis to quantify the potential impact of a rising interest rate environment on the value and expected total return of your portfolio's holdings.

The three action steps we recommend for all our clients are:

Step One:	Reaffirm why you own what you do, and your risk tolerance.
Step Two:	Assess possible outcomes and what if scenarios
Step Three:	Implement strategies to manage risks

The best investment portfolios start with a plan. The plan should outline not only the allowable investments, but the objectives for the portfolio, the acceptable risks and the desired outcomes.

Cornerstone Financial Consulting (cfcinvesting.com) is dedicated to supporting the particular needs for reinsurance companies. If you are not sure where you stand in any of these review steps, please feel free to reach out to us.

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