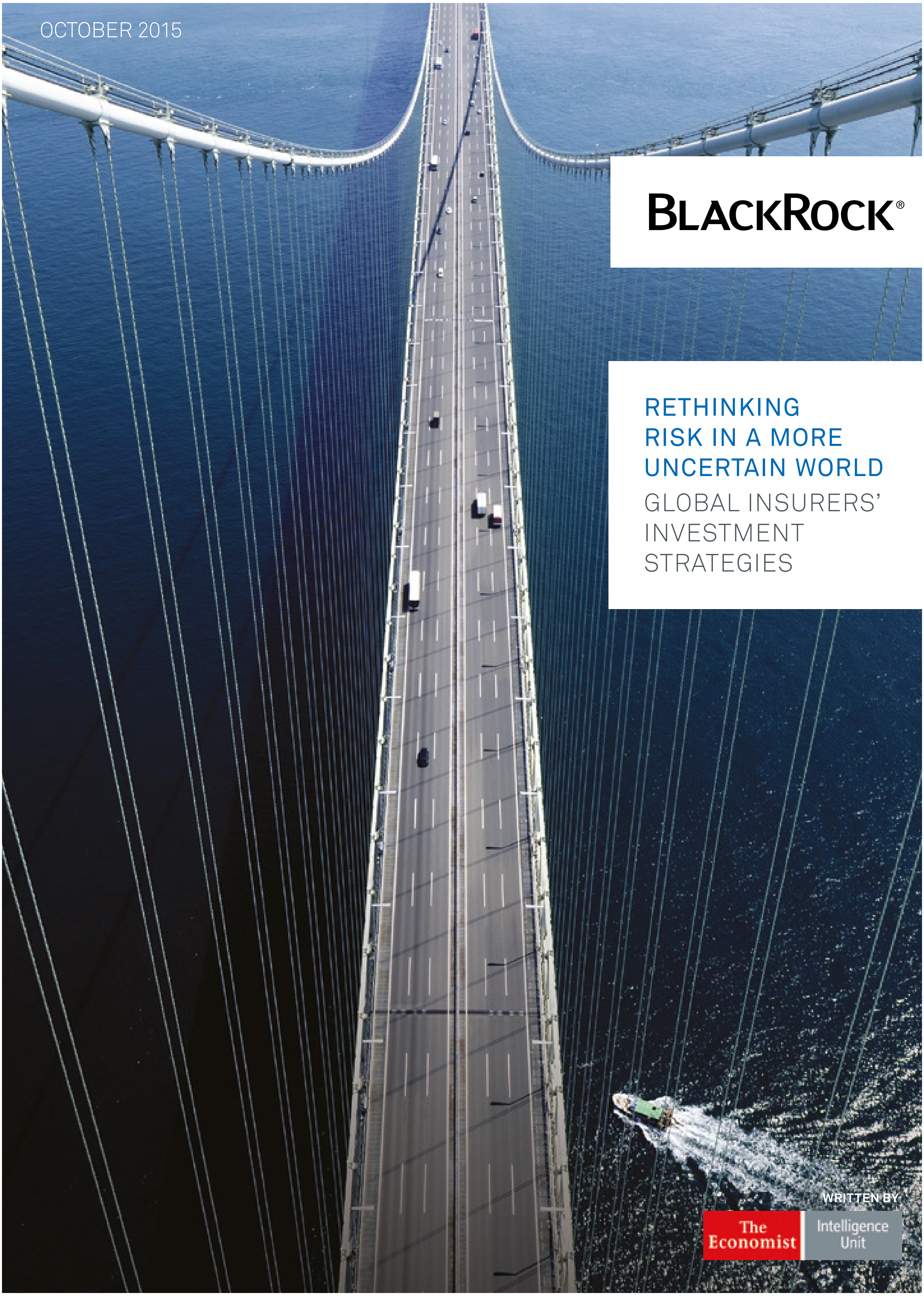
OCTOBER 2015



BLACKROCK®

RETHINKING RISK IN A MORE UNCERTAIN WORLD

GLOBAL INSURERS' INVESTMENT STRATEGIES

WRITTEN BY
The Economist Intelligence Unit

Foreword

In the first quarter of 2015 capital markets were shaken by a number of seismic events. These included the start of European quantitative easing (QE), accommodative policy from the Bank of China, the Swiss National Bank's change in stance on the currency peg versus the euro and intense focus on the US Fed's next move in the interest rate cycle. All these events have shaped the thinking behind this year's EIU survey. As a team we are keen to understand more clearly the impact that QE and monetary policy more broadly are having on capital markets and investment yields and ultimately, what the consequences are for insurers.

In previous surveys, we have focused on regulation and the low yield environment. The results have certainly supported the shift in investment and risk management behaviour that we have witnessed as a business over the past years. As we reflect on this year's results, the rising prices of risk assets as a result of the introduction of QE have, for insurers, been offset by the continued drain on yields from traditional fixed income sectors that the 'low for longer' policies have engendered. As a result of the strong demand for quality assets from European and Japanese central banks, there is a dearth of income-yielding assets available to investors, the largest of which of course are insurers – and insurers have a voracious appetite for income.

The results this year confirm the importance of long-term investors' ability to take advantage of the illiquidity premium in certain asset classes, as finding liquidity in traditional fixed income markets has become more challenging. Insurers' cash holdings are increasing, and they are looking to deploy when yields reach more attractive levels. In the meantime the lack of liquidity is encouraging the use of derivatives and exchange traded funds. This certainly points to an increased onus on insurance boards to comprehend the balance sheet and liquidity dynamics that these opportunities and challenges present. As always, we encourage our insurance clients to ensure they fully understand the sources of risk that are driving returns, to make sure they remain suitably diversified and are able to respond to the changing investment and regulatory environment.

David A. Lomas, ACII,
Managing Director, Global Head,
Financial Institutions Group

RETHINKING RISK IN A MORE UNCERTAIN WORLD

Global insurers' investment strategies

CONTENTS

Commissioned by

BlackRock

About this report

Rethinking risk in a more uncertain world: Global insurers' investment strategies is a report written by The Economist Intelligence Unit (EIU), commissioned by BlackRock. It looks at investor sentiment and the outlook for investment strategy at insurance companies worldwide, particularly in relation to their fixed-income portfolios and asset allocation more broadly.

In June-July 2015, the EIU surveyed 248 senior executives in the insurance and reinsurance sectors with estimated assets under management of US$6.5trn:

- 18% of companies had assets of US$75bn+,
- 30% had assets between US$10bn and US$75bn, and
- 52% had assets between US$500m and US$10bn.

By business line, the breakdown was:

- 33% in life insurance,
- 26% in multiline,
- 20% in property and casualty,
- 13% in health, and
- 8% were from reinsurance.

Geographically, the respondents' profile was:

- 48% of respondents came from EMEA,
- 25% from North America,
- 18% from Asia-Pacific, and
- 9% from Latin America.

The EIU also conducted eight in-depth interviews with senior executives from the insurance sector. The insights from these interviews appear throughout the report. The EIU would like to thank the following individuals and their organisations (listed alphabetically) for sharing their views and experience:

- **ACR Capital Holdings:** John Tan, group chief executive
- **Allstate Insurance Company:** Judy Greffin, executive vice-president and chief investment officer
- **Guardian Financial Services:** Paul Dixon, chief investment officer
- **Insurance Europe:** Olav Jones, deputy director-general
- **International Cooperative and Mutual Insurance Federation (ICMIF):** Shaun Tarbuck, chief executive
- **Pool Reinsurance:** Ian Coulman, chief investment officer
- **XL Group:** Mike McGavick, chief executive officer (and chair of the Geneva Association)
- **Zurich Insurance Company:** Julian Temes, head of strategy implementation

Arthur Piper was the author of the report and Martin Koehring was the editor.

October 2015

Executive summary

Divergent monetary policy is creating a unique set of challenges for global insurers. While they have seen the positive effects of quantitative easing (QE) on asset prices and economic growth in the short term, they also fear the market imbalances and unsustainable investment environment it may create. Combine this with continued low interest rates in some regions and concerns of an interest rate hike in others, as well as a lack of liquidity in the fixed income market, and insurers face a quandary.

"QE's impact on asset prices is leading insurers to seek more risk"

These complex concerns are driving changes in insurance investment strategies, according to our fourth annual survey of global insurance companies, conducted in July 2015. QE's impact on asset prices is leading insurers to seek more risk, although fears of an asset price correction and a lack of quality opportunities in some asset classes suggest that insurers are taking a balanced approach to deploying cash—keeping their powder dry for when the opportunities arise. At the same time, more than two-thirds of insurers are planning to make greater use of derivatives and exchange-traded funds; one reason for this is the lack of liquidity in investment grade fixed income.

This report presents the highlights and analysis of the survey findings, together with additional insights from industry leaders and independent commentators. The key findings of the research suggest:

Insurers see positive short-term effects of QE and looser monetary policy. Almost half of insurers surveyed have made significant changes to investment strategy in light of QE and monetary policy, with asset prices and economic growth expected to be positively impacted in the short term. A similar number are making or are planning to make changes in the coming 12-24 months—a trend most pronounced among North American insurers.

Divergent monetary policy and the potential negative long-term effects of QE worry insurers. Just under half of the insurers surveyed cite the low interest rate environment as a major market risk, especially in North America and EMEA, although the risk of sharp rate rises also troubles many, especially in Asia-Pacific. A majority of insurers worry that QE and monetary policy create imbalances in markets that negatively impact the economy as well as an unsustainable environment for the insurance industry. Mike McGavick, chief executive officer of XL Group and chair of the Geneva Association, speaks for many insurers when he says that "a continued distortion of the market is what we worry about long term". Against this backdrop, it is not surprising that our survey suggests most insurers want to see the pace and size of QE reduced and monetary policy tightened.

Insurers are planning to raise their risk exposure in search of higher yield. More than half of insurers are looking to increase risk exposure over the next 12-24 months, compared to just one-third in last year's survey. "Like many (re)insurers, our goal in increasing risk appetite on the investment side is to increase yield," explains John Tan, group chief executive of ACR Capital Holdings.

Insurers are changing the composition of their risk assets. Equities will be given a smaller allocation as insurers reposition their risk exposures to generate income. More than four in ten insurers are planning to reduce their exposure to equities—especially in North America, where more than half intend to do so. This may be driven by concerns around quantitative easing: the possibility of asset price corrections is seen as a major risk by one-third of insurers. Our survey suggests insurers are turning to a broader range of risk assets, particularly income-generating alternative credit investments; four in ten insurers are increasing their allocations to commercial real estate debt and direct lending to SMEs. Ian Coulman, chief investment officer at Pool Reinsurance, explains that his company began diversifying risk exposure three years ago by reducing equities and adopting "a multi-asset credit strategy", focusing on a "well-diversified risk portfolio".

Insurers are struggling to find a good home for their increased cash holdings. Almost half of respondents expect to increase cash holdings over the next 12-24 months specifically because of QE and monetary policy, and more than one-third plan to increase cash holdings more generally. Importantly, this includes nearly half of those looking to increase their risk exposure. Shaun Tarbuck, chief executive of the International Cooperative and Mutual Insurance Federation, says: "Finding homes for the money that are not going to penalise insurers from a regulatory viewpoint but give them a decent amount of return is an issue." Mr McGavick confirms this view: "We're holding cash as we want the flexibility to be opportunistic."

Challenged liquidity is making it difficult to access the fixed income markets. Approximately half of respondents wish to increase their holdings of quality fixed income assets, with investment grade corporate bonds and government bonds the most popular choice. However, they are struggling to find what they need—over two-thirds of insurers say lack of liquidity is making it difficult to access fixed income investments and roughly three quarters believe that liquidity is challenged relative to pre-financial crisis levels. According to one insurer: "Spreads on high-quality, investment grade fixed income are illogically tight, so the supply is picked over, and what is available is less attractive." Against this backdrop, lack of liquidity is encouraging the use of derivatives (seven in ten insurers agree); four in ten insurers are planning to increase their use of derivatives over the next 12-24 months.

> *"...lack of liquidity is making it difficult to access fixed income investments"*

1

Uncharted territory

XL GROUP'S MIKE MCGAVICK HIGHLIGHTS THAT

> *"a continued distortion of the market is what we worry about long term"*

—A VIEW SHARED BY MANY INSURERS.

Loose global monetary policy in the form of low interest rates has prevailed since the financial crisis, but unconventional monetary policy in the form of quantitative easing (QE) has changed sharply over the past year. As expected, the US ended its US$3trn programme in October 2014,[1] the same month in which Japan unexpectedly boosted its existing policy by raising the annual amount of cash pumped into the economy to ¥80trn (US$712bn), up from the previous target of ¥60trn-70trn adopted in April 2013.[2] In addition, the European Central Bank (ECB) launched its long-awaited €1trn (US$1.1trn) QE programme in March 2015 to get the economies of the eurozone moving again.[3]

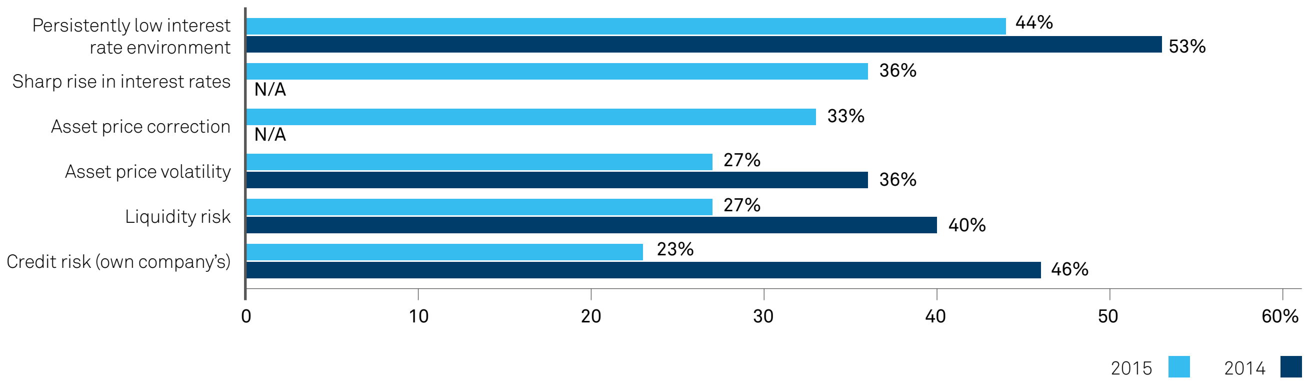
More than four in five insurers (81%) in the survey say QE is justified because they believe it will have a positive effect on economic growth over the next three years. Insurers also believe QE will continue to have a positive impact on asset prices. Despite these short-term positive effects, an even higher proportion of insurers (84%) would like to see the scale and/or size of QE reduced, with just over half concerned that it creates an unsustainable longer-term environment for the insurance sector.

"We're in uncharted territory," says Judy Greffin, executive vice-president and chief investment officer at Allstate Insurance Company. "All asset prices—not just fixed income—have been influenced by QE. As they take the punchbowl away, all markets are going to struggle to figure out what that means."

Paul Dixon, chief investment officer at Guardian Financial Services, agrees that QE has affected asset prices in general and has pushed up equity and bond prices as well. "It makes it harder to evaluate risk clearly," he explains, "because one can't really say how much the price of an S&P 500 stock, say, is overvalued because there's just more money in the system. The situation has led to a slight underpricing of risk in the fixed income sphere for insurers, particularly as you go out on the liquidity and risk spectrum." He adds that boards are asking

CHART 1: WHICH OF THE FOLLOWING DO YOU CONSIDER TO BE THE MOST SERIOUS MARKET RISKS TO YOUR FIRM'S INVESTMENT STRATEGY / PORTFOLIO OVER THE NEXT 12-24 MONTHS?

Select up to two.



Source: Economist Intelligence Unit survey, June-July 2015

1 "What is quantitative easing?", *The Economist*, March 9th 2015
2 "A bigger bazooka", *The Economist*, October 31st 2014
3 "Getting the machines revving," *The Economist*, March 9th 2015

more questions about both asset-class selection and asset-manager selection because of the longer-term potential impacts of QE.

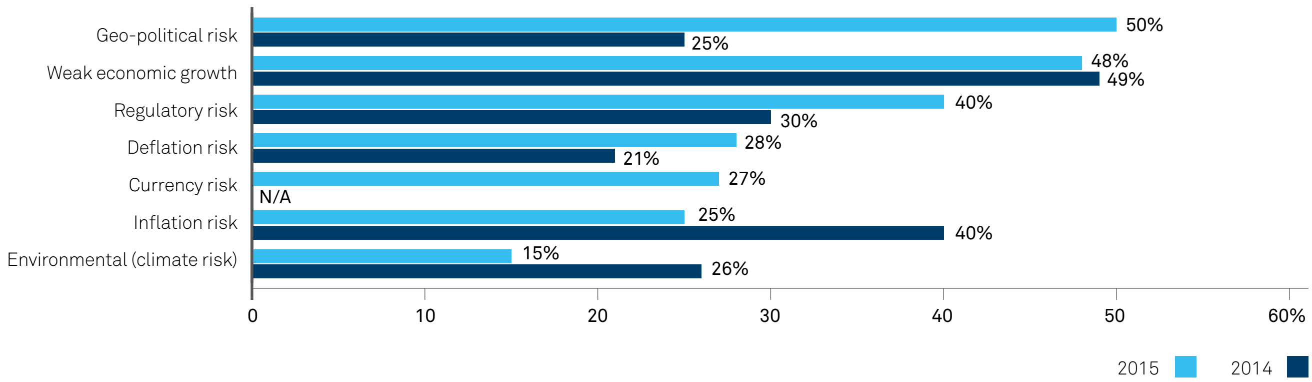
XL Group's Mr McGavick highlights that "a continued distortion of the market is what we worry about long term"—a view shared by many insurers.

Almost half of survey respondents have made significant changes to their investment strategy in light of QE, while just under half (43%) are making or planning to make changes over the next 12-24 months—a trend most pronounced among North American insurers (see Allstate case study overleaf). On the one hand, this has involved a change in risk appetite. With QE pushing rates down while supporting high valuations for risky assets, more than half of insurers are looking to increase risk exposure over the next 12-24 months, and almost four in ten expect to maintain risk exposure. The adoption of greater risk is a response to the continuing environment of low interest rates and low yields. By contrast, in last year's survey, only one-third said they were looking to increase risk exposure and about half intended to maintain risk levels.

On the other hand, balancing the short-term advantages of QE with the longer-term worries over other market risks is pulling insurers in opposite directions. Persistent low interest rates are the most serious concern for 44% (see chart 1) over the next two years, but 36% worry about a sharp rise in rates—especially in Asia-Pacific (51%) (see chart 10 in the appendix). These tensions are playing out against a background of increased concerns over geo-political risk and regulatory upheaval (see chart 2).

CHART 2: WHICH OF THE FOLLOWING DO YOU CONSIDER TO BE THE MOST SERIOUS MACRO RISKS TO YOUR FIRM'S INVESTMENT STRATEGY / PORTFOLIO OVER THE NEXT 12-24 MONTHS?

Select up to three.



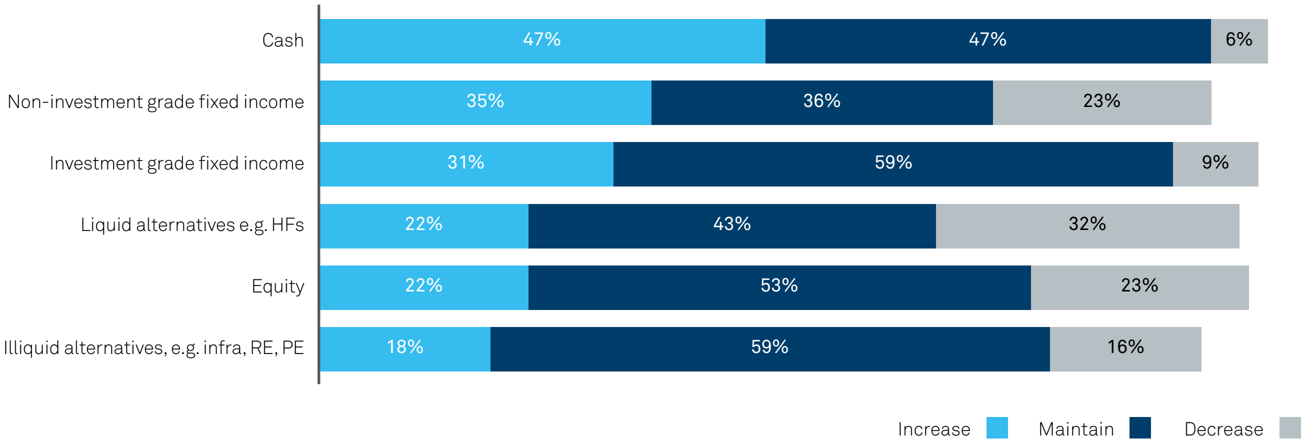
Source: Economist Intelligence Unit survey, June-July 2015

Olav Jones, deputy director general of the industry body Insurance Europe, comments that in Europe in 2014, people were still hoping that interest rates would increase. However, factors such as the ECB's QE programme have meant that more insurers have begun to diversify some of their asset allocation to higher yield assets as part of their duty to deliver good returns and meet their guarantees to policyholders.

"People have said, 'we can't wait any longer, we need to do it,'" he observes. He believes the trend has taken a while to grow because of the cautious nature of those in the industry, but is now under way. There is also competitive pressure, he says, because the supply of such assets is limited. Our survey suggests regional pressures are also at play (see appendix). Chief investment officers know that it is one thing to plan to increase risk exposure; it is another to achieve it.

In part, this is what is driving insurers to increase their cash holdings in the coming 12-24 months. Almost half anticipate pursuing this strategy, with the same proportion saying they want to maintain cash holdings (see chart 3). Insurers want the ability to invest when the chance arises. "We're holding cash as we want the flexibility to be opportunistic," explains McGavick.

CHART 3: IN RESPONSE TO QUANTITATIVE EASING AND MONETARY POLICY, HOW ARE YOU LIKELY TO ALTER YOUR ASSET ALLOCATIONS IN THE COMING 12-24 MONTHS?



Source: Economist Intelligence Unit survey, June-July 2015

ALLSTATE SHORTENS DURATION RISK AND DIVERSIFIES ITS PORTFOLIO

Over the past few years, Allstate Insurance Company has diversified its portfolio to deal with the impact of QE, the continuation of a low yield environment and low returns. Allstate has shortened the duration of the fixed income assets in its property and casualty business to two to three years, rebalanced the overall mix of assets in its portfolio, and re-allocated the risk to more attractive returning assets.

"We have also looked at the landscape outside of traditional fixed income classes to find assets that we believe will deliver good risk-adjusted returns over the next several years," says Judy Greffin, executive vice-president and chief investment officer at Allstate.

Allstate has switched more of its allocation into fixed income below investment grade as an alternative to equities. "We like the risk-adjusted returns associated with below investment grade credit," she adds.

Municipal bonds also play a role in the portfolio too: traditionally they have had a good risk-return profile in terms of credit risk and the company enjoys tax relief on its investments.

At the same time, the company has increased its focus on what she calls performance-based assets, which include private equity and real estate investing, while it has reduced its holding in hedge funds.

"We have excess liquidity in the portfolio so, even if it gets choppy over the next two to three years, we can afford to own these investments. Over the long run, they're going to be good investments," she predicts.

BlackRock view

INTEREST RATE DYNAMICS

The current landscape can be characterised by several key themes. In terms of fundamentals, actual and expected US growth remains broadly positive, but storm clouds linger in non-US markets. The Federal Reserve proved to be extremely cautious by holding policy steady in September, while most other major central banks remain well entrenched in easing initiatives. Capital markets continue to face trends of constrained liquidity and higher volatility, with idiosyncratic credit risk rising across sectors.

Our outlook for the US economy is for continued steady, positive growth, predominantly influenced by a positive environment for the consumer. The combination of low interest rates and energy prices, and strengthening labour and housing markets should continue to be supportive of spending. We anticipate that commodity prices will remain soft, but that core inflation will trend toward the Fed's targets over time.

In Europe, there remain concerns over fiscal issues and an uneven and sluggish recovery despite ongoing stimulus. Nonetheless, we expect that ECB policy will remain a supportive factor for markets, given its affirmation that it would be ready to expand or extend QE if needed. In Asia, China's efforts to transition to a consumption-based economy and Japan's challenges to reflate will continue to create regional and global headwinds.

While we had hoped the Federal Reserve would take the opportunity to begin normalising monetary policy and reduce broad-based uncertainty in the market, global concerns took over. We view recent Fed inaction as raising multiple questions around central bank credibility and more broadly, around the efficacy of the current monetary policy tool set. The Bank of England has also recently become more wary in terms of the timing of any lift-off in the UK, due to external market dynamics, and despite a continuing moderate uptrend in UK GDP.

With central banks globally displaying heightened sensitivity to volatility and arguably to asset prices, we remain cautious on risk and are focusing on strong structures and credits. We believe the investment community has shied away from the blind pursuit of yield at any cost, and that balance sheet protection will become more of a focus for insurance companies in the coming year. Our expectation for heightened illiquidity and the market's strong negative reaction to idiosyncratic credit stories will continue to influence our positioning.

Our expectation is that interest rates will be higher a year from now and that the Federal Reserve will be in the early stages of a shallow-sloped tightening cycle, potentially followed by the Bank of England with a few months' lag. Influencing the pace of a rate rise will be our expectation that global investment flows will continue to favour US fixed income assets.

Jeff Jacobs,
Managing Director, Global Head of the Financial Institutions Group - Portfolio Management

2

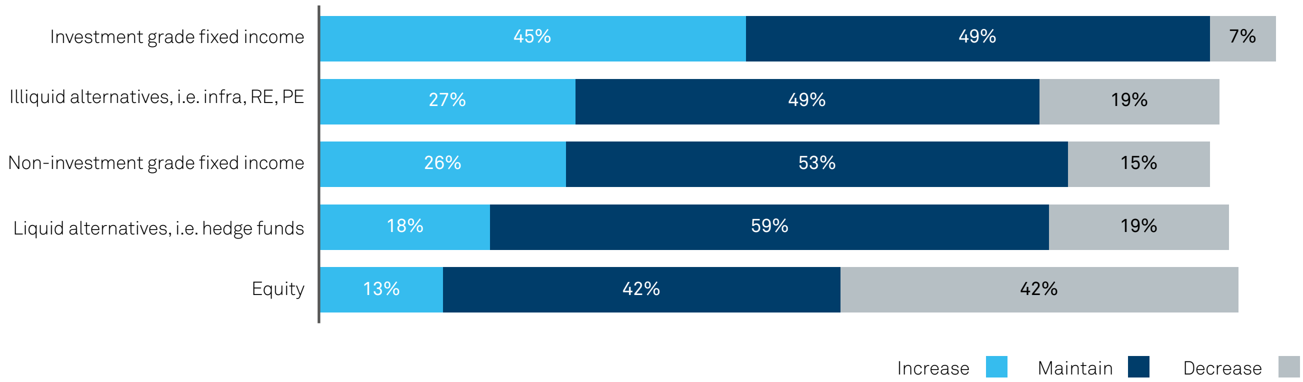
Seeking elusive quality in fixed income

A 2014 study by the Bank of England found that QE in the UK and the US had led to a rebalancing of insurers' portfolio allocations into more risky assets—most markedly into corporate bonds.[4] However, stricter capital requirements under Solvency II-style regulations are pushing investors towards "safer" assets with lower capital charges and away from equities and non-investment grade debt; Solvency II introduces a new regulatory regime for assessing solvency capital needs in the insurance industry in the EU and is set to come into effect on January 1st 2016.

The results of the BoE study are reflected in our survey. Approximately one-third of respondents (35%) (see chart 3) intend to increase holdings of non-investment grade fixed income products over the coming 12-24 months specifically in response to QE and monetary policy. And around a quarter (26%) plan to increase holdings in this asset class more generally over the next two years (see chart 4).

In contrast, 45% of respondents are increasing their holdings of investment grade fixed assets, with this "safer" asset class no doubt more popular at least partly due to the capital charges of Solvency II.

CHART 4: FOR EACH OF THE FOLLOWING ASSET CLASSES, PLEASE INDICATE HOW, IF AT ALL, YOU WILL BE CHANGING YOUR INVESTMENTS OVER THE NEXT 12-24 MONTHS.



Source: Economist Intelligence Unit survey, June-July 2015

"I think the biggest change to asset allocations over the next year or so, particularly from a European perspective, will be based on regulatory oversight," Shaun Tarbuck, chief executive of the International Cooperative and Mutual Insurance Federation (ICMIF) says. "Whether it is international, regional or national, regulation is pushing insurers into totally secure investments." He observes that this development has pushed demand for fixed income products through the roof and is driving insurers to hold more cash. "Bond holdings are increasing because it is the only place you can put your money that the regulatory authorities deem to be safe," he explains.

4 Joyce, M, Z Liu and I Tonks, "Working paper no 510: Institutional investor portfolio allocation, quantitative easing and the global financial crisis", Bank of England, 2014.

BlackRock View

CREDIT AND THE SEARCH FOR YIELD

Central bank bond buying in Europe is crowding out investors even more than it has in the US, which puts more pressure on the global supply of quality, yielding assets. The search for yield is also pushing investors down the credit spectrum, which is a tailwind for European high-yield issuance. In the first quarter of 2015, we saw €30 billion of new issue activity, up more than 70% from a year earlier. This is a market that has grown nearly four-fold since 2009, so the opportunity set is dramatically larger. The issuance is similar to what we saw in the US, with much being done to extend maturities or to refinance existing debt at better rates. However, there is one important difference: in Europe, much of the debt that's being refinanced is bank debt, so we're seeing that credit move off bank balance sheets and into a growing bond market.

We think the global trend of banks keeping less credit on their balance sheets, and more credit becoming available to investors, is still in its middle stages. Overall, we think we're moving into a world where investors have access to a much bigger supply and broader spectrum of credit investments. In the US, the policy-driven movement of leveraged lending away from banks is most advanced, which is why we see the increase not just in bond and loan markets but in private equity firms, alternative credit managers and business development companies (BDCs) providing this kind of credit. There's significant potential for this type of lending to be extended beyond the companies engaged in LBOs and M&A that have traditionally used it. European regulators are pushing their banks to de-leverage as well. However, when you look at the transition from bank lending to public market financing, the process in Europe is about a decade behind what we see in the US market. In the US, 15% to 20% of corporate credit is provided by banks, with the rest distributed and owned by investors. In Europe, those proportions are reversed.

Looking ahead, we expect the rate rise to be gradual and the final rate destination to be relatively low. The last time this happened, in 2004 to 2006, high yield and loans were two of the best performers in fixed income markets, just as they were in previous tightening cycles in 1994 and 1999. When rates are increasing, that's generally a time when economic activity and corporate earnings are improving—while both companies and the investor base tend to take on more risk. Investors will need to exercise additional caution in their positioning and focus more on credit selection in the coming years. We like some of the strategies that target idiosyncratic risk or pure illiquid credit. We see a lot of opportunities where you can isolate events with great upside downside risk without the market bets. At the same time, with some of the off-the-run illiquid opportunities, one can structure better protections and pricing and earn a good premium to the liquid markets.

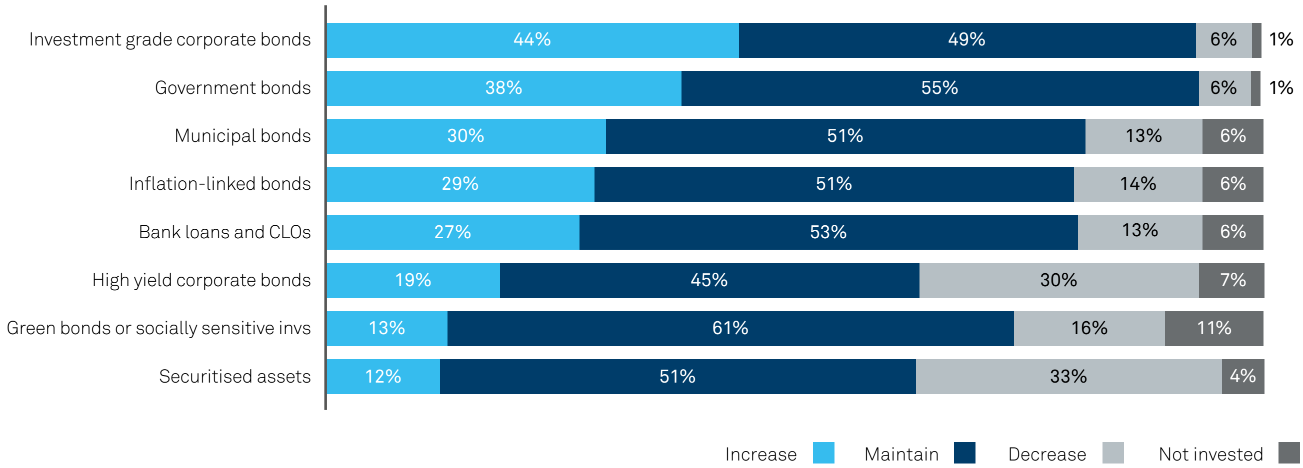
James E. Keenan,
CFA, Managing Director, Global Head of Fundamental Credit, Head of Americas Fundamental Credit

2

More than one-third of respondents to the survey expect to increase their cash holdings. Of those looking to increase their risk exposure, this rises to 45%. With underwriting becoming more profitable, more have cash available. Some will use this to fund mergers and acquisitions. Others are struggling to put the cash to work within their portfolios. Returns on fixed income are harder to find, so holding on to cash until the right opportunities arise has become a reality. "Chief executive officers are beginning to feel that whatever happens on the investment side is just icing on the cake," Mr Tarbuck points out.

Among fixed income assets, insurers are planning to increase holdings in corporate bonds (44%) and government bonds (38%), despite historically low, or even negative, yields (see chart 5).

CHART 5: FOR EACH TYPE OF FIXED INCOME ASSET, PLEASE INDICATE HOW, IF AT ALL, YOU WILL BE CHANGING YOUR ALLOCATIONS OVER THE NEXT 12-24 MONTHS.



Source: Economist Intelligence Unit survey, June-July 2015

"The presence of negative yields on fixed income assets here in Switzerland and in many parts of the European fixed income curve has become something we cannot ignore nor fail to address head on," says Julian Temes, head of strategy implementation in Zurich's investment team.

"This is not normal. But I think we are going to see monetary policy remain quite loose for the coming years and we'll obviously continue to have a distortion in asset prices to the extent there is a dependence on central-bank liquidity provisioning. A zero interest rate or negative interest rates creates a very strange anchor for any portfolio, and benchmarks and portfolio manager actions must reflect this."

Zurich has responded, among other ways, by explicitly avoiding investing in negative rates, while continuing to focus on meeting its liability matching goals, and moving into more illiquid asset classes (see Zurich case study opposite).

ZURICH'S STRATEGY REVIEW EXAMINES PERFORMANCE FEES

Zurich is currently undertaking a strategy review to re-examine the alpha and beta potential across asset classes to identify which of those classes would generally benefit from more active management, and which might be better on the passive route. Tied to this is the question of performance fees paid to managers on assets such as corporate loans—an area insurers have become more interested in recently.

"If we can demonstrate to ourselves that the asset manager is genuinely generating alpha, that the sector can provide alpha, and that it's not going to be taken away (by the impact of fees or other such considerations)—that the excess performance has some degree of permanence and is not easily commoditised away—then we will surely entertain paying performance fees," says Julian Temes, head of strategy implementation in Zurich's investment team. Another part of this strategic review is looking at whether Zurich should outsource or insource newer investment asset classes. The review is assessing long-term views on market considerations—such as supply, demand, depth of the sector, expected spread, and expertise required to adequately monitor credit risk evolution—and the effort taken in its analysis of whether to build an internal team from scratch or to fully, or partially, outsource the management of these asset classes.

Zurich's newer investments are largely focused on private debt, including term funding, collateralised loan obligations (CLOs), real estate loans, infrastructure and corporate loans. "We have a lot of initiatives in the illiquid space—some of them in place for quite some years, others quite new and in true formation stage—and we need to understand and trade off the relative value and underlying risks amongst those," Mr Temes explains. Corporate loans are the most recent addition to the portfolio. Zurich has been investing in syndicated loans in the US and is looking to invest in more loans to small- and medium-sized enterprises (SMEs) in Europe. Mr Temes points out that since banks have traditionally dominated the corporate loans space, it has been complicated to find the right asset manager with the experience of putting together good third-party mandates, while avoiding potential conflicts of interest at various points of the value chain. Zurich started with bank-syndicated loans. "They are a bit easier to manage in terms of outsourcing, and their depth of market allows for more analysis and a modicum of liquidity," he explains. They have enabled Zurich to build up expertise and understanding for the next step—direct investing.

"Yields in Asia have remained relatively stable, but we don't expect such a high yield from our investment side as we used to," says John Tan, group chief executive at ACR Capital Holdings. "We are happy to achieve 5%. Last year, we were lucky to get 6%." Mr Tan says the business has been extremely cautious in investing in more risky assets, which make up only 10% of his allocation.

Almost three quarters of insurers in our survey think fixed income market liquidity is challenged relative to pre-financial crisis levels. And more than two-thirds say lack of liquidity is making it difficult to access fixed income investments. Mr Tan suggests that part of the liquidity problem with corporate bonds is related to the fact that because people are expecting US rates to rise by the end of 2015, buyers want to wait to secure a better yield. That could be one factor contributing to why more insurers are holding increased quantities of cash, as well as seeking shorter duration fixed income products. They want to be ready for the longer term when QE programmes end or rates rise.

BlackRock view

FIXED INCOME LIQUIDITY

The report cited: "over two-thirds of insurers say lack of liquidity is making it difficult to access fixed income investment and roughly three quarters believe that liquidity is challenged relative to pre-financial crisis levels." There is no question that bond markets are evolving. From our perspective, the conditions leading into the financial crisis were neither healthy nor sustainable and several dynamics we observe today reflect intended consequences of regulatory reform. Market participants need to recognise that times have changed and we all need to adapt.

BlackRock has been adapting by making changes to our trading capabilities, portfolio construction, and risk management. For example, we have adjusted our trading behaviour to not only be a "price taker" but also a "price maker." A "price maker" is a market participant that expresses a price at which he or she is willing to buy (or sell) a particular security. Today, this behaviour is more predominant in equity markets and has not traditionally been a role played by buy-side fixed income traders. However, by supplementing our fixed income trading capabilities with new skillsets and analytical tools, we have adapted to become a "price maker" to help our clients obtain more liquidity at a better price.

To supplement liquidity provided directly by broker-dealers, we have developed our technology to support more electronic tools and access additional pools of liquidity with a focus on four key objectives:

(i) connecting to multiple electronic venues;

(ii) aggregating multiple sources of liquidity;

(iii) streamlining trade workflow; and

(iv) developing analytical tools to assess the security-level cost to transact in various market conditions.

We formed a strategic alliance with MarketAxess, a leader in electronic credit trading that provides Aladdin clients access to a large and diverse set of market participants. We have a similar alliance with Tradeweb Markets LLC in the interest rate space. These alliances provide BlackRock and Aladdin users with additional sources of liquidity.

Portfolio managers continually assess and evolve their portfolio construction processes to account for changes in the bond markets. Changes that portfolio managers have made include: longer holding periods, holding more liquid securities, maintaining higher liquidity buffers and adjusting these buffers to current market conditions, reducing portfolio turnover and velocity, adopting liquid derivatives, and incorporating liquid ETFs into their portfolios.

While today's market liquidity environment is certainly challenging for insurers, there's much that can be done to navigate the changes that have taken place. It's time to adapt and focus on solutions.

Richard Prager,
Managing Director, Head of Trading & Liquidity Strategies Group

Diversifying the alternatives

“Worldwide, there is a significant interest in diversifying assets with yield,” Olav Jones from Insurance Europe observes. “There is interest in infrastructure, alternative investment into SMEs, and insurers are looking to invest more directly into debt. However, the regulatory treatment of these assets needs to be improved to remove unnecessary barriers to investment.”

Meanwhile, equities have been even more penalised by regulators as an asset class through increased capital charges, he adds. Equity allocations will be reduced as insurers reposition risk exposures to generate income. More than four in ten insurers in our survey expect to reduce their exposure to equities, especially in North America where more than half say they plan to do so (see Allstate case study at the end of section 1).

Ian Coulman, chief investment officer at Pool Reinsurance, points out that his company began diversifying risk exposure three years ago. This was achieved by reducing equity allocation, which made up about 60% of risk allocation despite comprising only 10% of the actual asset allocation.

“We adopted a multi-asset credit strategy which invests in high-yield emerging markets and senior loans, or bank loans.” He explains that he is looking to add a larger allocation to these types of risk assets, but in a much more diversified way than before. “It’s a priority to ensure there’s not a huge amount of cross-correlation of private assets,” he continues. “You need a well-diversified risk portfolio that is going to be relatively uncorrelated.”

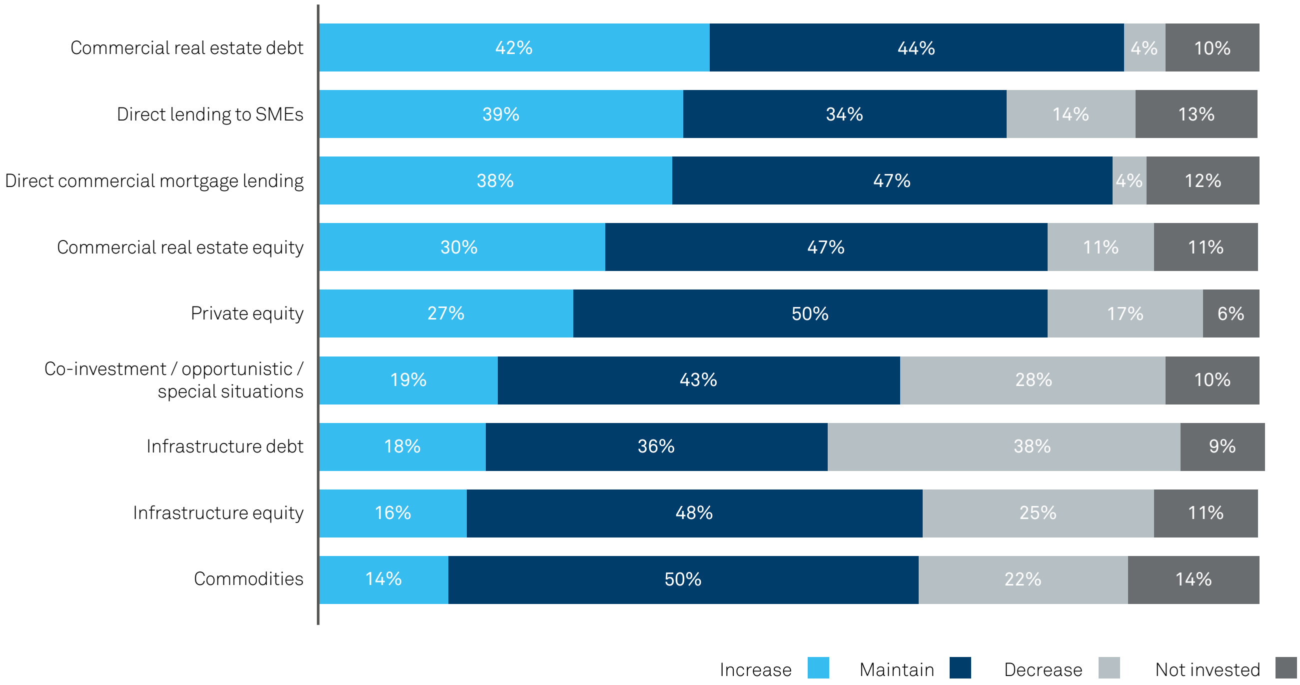
Not that investing in alternative asset classes is always possible. Rule-setters are actively working with the industry to lift some of the barriers to investment. For example, Generali has sought access to the lending market through joint ventures, a move made possible for the company since the Italian government removed constraints preventing insurers from investing directly in debt.[5]

Demand exists. Insurers responding to our survey want to increase their exposure to less liquid assets, particularly in commercial real estate debt (42%), direct lending to SMEs (39%), commercial mortgage lending (38%) and infrastructure debt (18%). Overall, more than 80% plan to increase holdings in at least one of these alternative credit asset classes (see chart 6 overleaf).

5 Foglia, G and M Emma, “New direct lending opportunities in Italy”, *International Tax Review*, August 29th 2014

3

CHART 6: FOR EACH TYPE OF PRIVATE MARKET ASSET PLEASE INDICATE HOW, IF AT ALL, YOU WILL BE CHANGING YOUR INVESTMENTS OVER THE NEXT 12-24 MONTHS.



Source: Economist Intelligence Unit survey, June-July 2015

One surprise finding in our 2015 survey is that, compared with the 2014 edition, infrastructure investment seems to appear less compelling. Almost four in ten respondents say they wish to reduce their planned allocations to infrastructure debt. That does not mean that infrastructure is no longer attractive, rather that it is highly competitive, in short supply and sometimes has lower than expected yields. As a result, many insurers who had planned increases to their portfolio are revising their goals for this asset class and are seeking to diversify elsewhere.

Guardian Financial Services, for example, set an objective of investing about 9% of its portfolio backing annuities into several new asset classes in 2014, including infrastructure debt. They have almost completed one allocation and are half way through another.

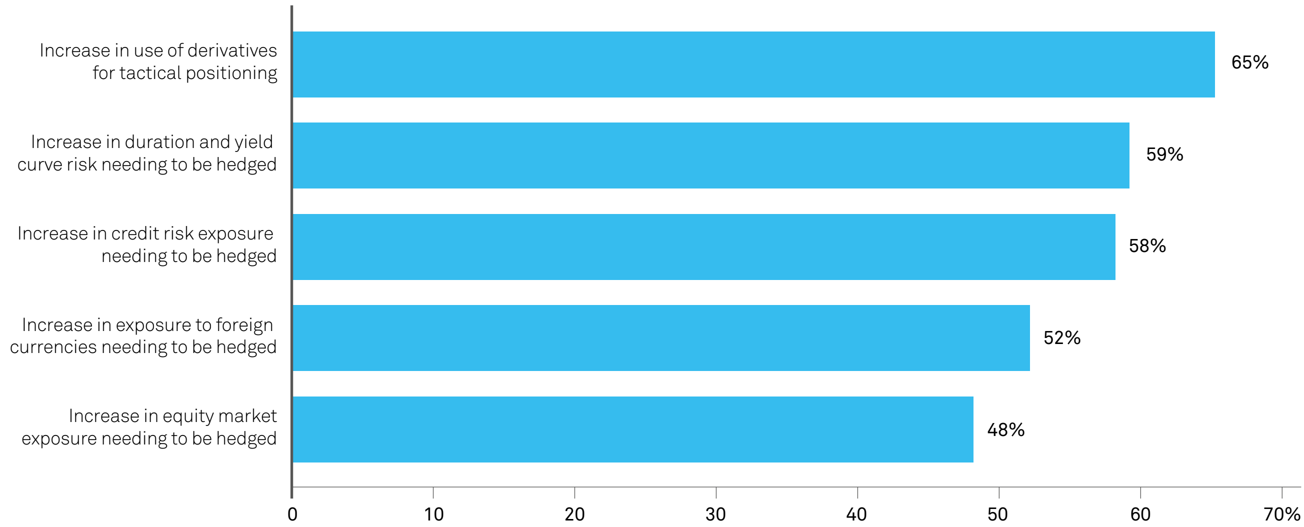
"Now we've paused," Mr Dixon says. "We're not seeing a lot of investments that meet our criteria right now. For example, if I'm asked to lend £50m-£100m (US$76m-US$152m) to another hotel now, when I'd budgeted to lend to industrial projects during the next six months, I'll wait." He points out that rather than fulfil the mandate and take on a bit more concentration risk, the company prefers to forgo some income and yield to be sure it is getting the right structure and the right underlying assets in which to invest.

Mr Tarbuck highlights that effective regulation around infrastructure is not fully in place in Europe yet—a situation, he believes, that is causing insurers to lose money because they are not able to diversify their portfolios into a wider range of investment products. In Europe, Jonathan Hill, European Commissioner for Financial Stability, Financial Services and Capital Markets Union, has announced a review aimed at making infrastructure investment more attractive for the insurance industry.[6] The identification and calibration of infrastructure investment risk categories under Solvency II remains an issue of contention; the European Commission has asked the regulator, the European Insurance and Occupational Pensions Authority (EIOPA), for advice on the issue.[7]

While interest in these less liquid alternative investments is likely to remain strong, the lack of liquidity in bond markets is encouraging an increase in the use of derivatives and exchange-traded funds for more than two-thirds of our survey respondents. Four in ten insurers, especially larger insurers, are looking to increase their use of derivatives over the next 12-24 months. The most popular reason is 'tactical positioning'. Together with higher levels of cash holdings, this is providing insurers with greater flexibility to invest when the opportunity arises. When exactly that will be remains a moot point.

CHART 7: WHY ARE YOU PLANNING TO INCREASE YOUR USE OF DERIVATIVES OVER THE NEXT 12-24 MONTHS?

Please select all that apply.



Source: Economist Intelligence Unit survey, June-July 2015

6 Hill, J, "Next steps to build a capital markets union", speech in Brussels, June 8th 2015. Available at http://europa.eu/rapid/press-release_SPEECH-15-5137_en.htm

7 *Consultation Paper No. CP-15-004 on the Call for Advice from the European Commission on the identification and calibration of infrastructure investment risk categories*, EIOPA, September 29th 2015.

BlackRock view

ENHANCING FLEXIBILITY WITH ETFs

Fixed income exchange traded funds (ETFs) are changing the way investors access the bond market. Bond ETFs promote market stability, add liquidity, and improve price discovery.

As divergent monetary policies, market imbalances, and a liquidity-constrained environment drive changes in insurance investment strategies, insurers are making more use of ETFs, particularly for efficient and low-cost equity beta exposure. The number of ETF adopters in the US has more than tripled in the last three years, driven in part by the surge in fixed income ETF usage. In fact, approximately 30% of general accounts have now reported using an ETF.

In periods of stress, when bond prices become volatile and bonds are hard to trade, fixed income ETFs have been a positive force for stability, adding liquidity and price transparency in the bond markets. If a financial shock disrupts prices, investors may find it difficult to trade individual bonds and instead turn to fixed income ETFs.

For example, bond ETFs provided liquidity during the 2008 financial crisis, the 2010 European sovereign crisis, the 2011 US Treasury downgrade, and the 2013 'taper tantrum'. In each dislocation, bond ETF trading surged, in contrast to illiquidity in the underlying bond markets.

Bond ETFs create a new liquidity layer by allowing buyers and sellers to trade directly with each other on exchange in a transparent manner without having to source the individual bonds. In the first three quarters of 2015, for every US$5.5 traded in iShares iBoxx $ High Yield Corporate Bond ETF (HYG), only US$1 traded in the underlying bond market via a creation or redemption.

Accessing liquidity has been one driver of fixed income ETF adoption but insurers have found a variety of other uses for fixed income ETFs as well, including:

Tactical applications: Leveraging the liquidity and tight bid/offer spreads of some fixed income ETFs to help manage cash and/or tactical market exposures. Some insurance companies have generated additional income through ETF securities lending.

Strategic applications: Using fixed income ETFs for longer holding periods in smaller entities where they desire greater diversification than can be achieved through buying individual bonds. With defined maturity ETFs, it's possible to target a specific duration or manage against a particular liability.

Liquidity applications: Fixed income ETFs trade on exchange. The incremental liquidity of the exchange diversifies an investor's liquidity away from the OTC market. Insurance companies can use fixed income ETFs as a vehicle to acquire or dispose of cash securities.

There are many applications for fixed income ETFs which leverage their scale, diversification, transparency, and liquidity relative to the traditional OTC markets. The significant growth of fixed income in recent years make them a viable alternative for fixed income exposures and risk management for insurance companies.

Mark Wiedman,
Senior Managing Director, Global Head of iShares

Conclusion

While most insurers welcome the short-term effects of QE and looser monetary policy, they are equally concerned about the longer-term imbalances created as a result. Many are taking advantage of the effects of QE on asset prices and, in light of the weak returns from investment grade fixed income assets, have decided to increase their risk exposures. They are on the lookout for additional yield from more complex investments, while remaining determined to keep an eye on the potential extra risk they are taking on.

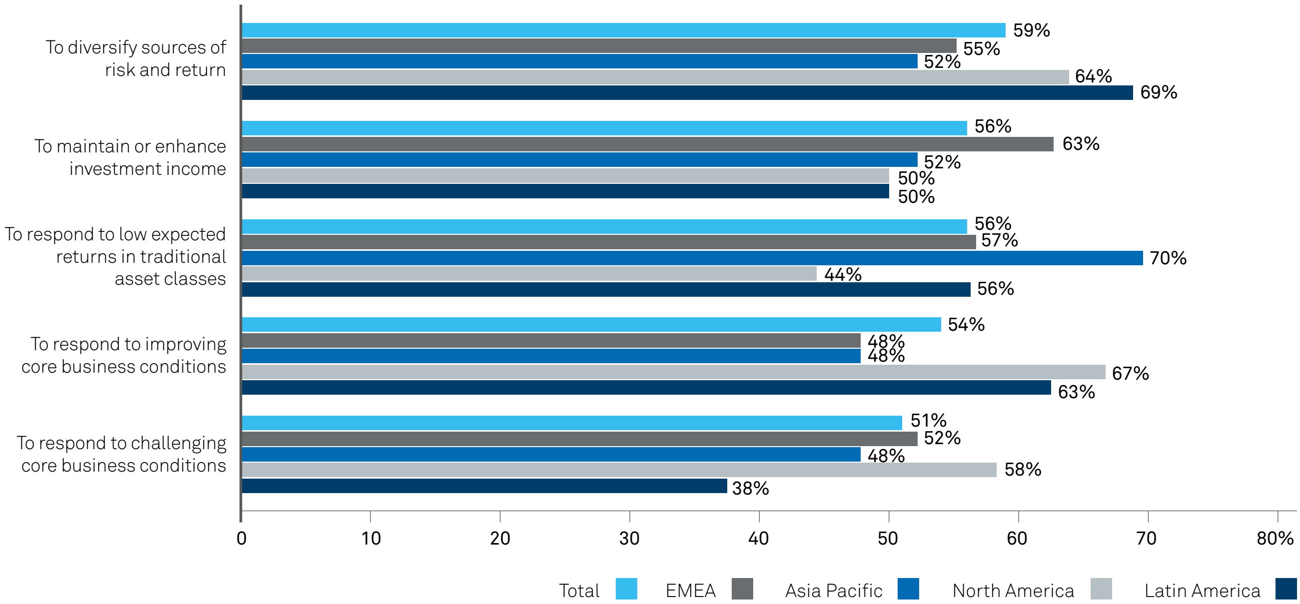
Some insurers are finding ways to protect their capital by holding shorter duration fixed income products and some, such as Allstate, have found that adding lower grade corporate and municipal bonds to their portfolios has struck the right balance in terms of risk and return. Most are planning to diversify. Cash holdings have increased partly due to higher underwriting profits and partly because there is a lack of investment opportunities in some asset classes. Some insurers are choosing to keep their powder dry.

There is a similar picture in the alternatives segment, where insurers plan to diversify their portfolios by adding higher-risk, higher-yield assets. But, again, opportunities in some asset classes, such as infrastructure, have not kept pace with demand. This has increased competition and lowered yields on certain offerings.

Chief investment officers plan further diversification within private assets because they want to avoid over-exposure to the same type of risk across different asset classes. Given the relative novelty and complexity around private assets, such as direct lending to SMEs, even the largest insurers are paying increasingly close attention to the risks involved. Insurers should pause for thought. If investors begin chasing these new assets in sufficient numbers, in two or three years' time they could face the same challenges and shortages that those wishing to invest in infrastructure face today. To achieve a more diverse portfolio, insurers may need to stay further ahead of the crowd, continually rethinking asset allocation and risk exposures.

Appendix

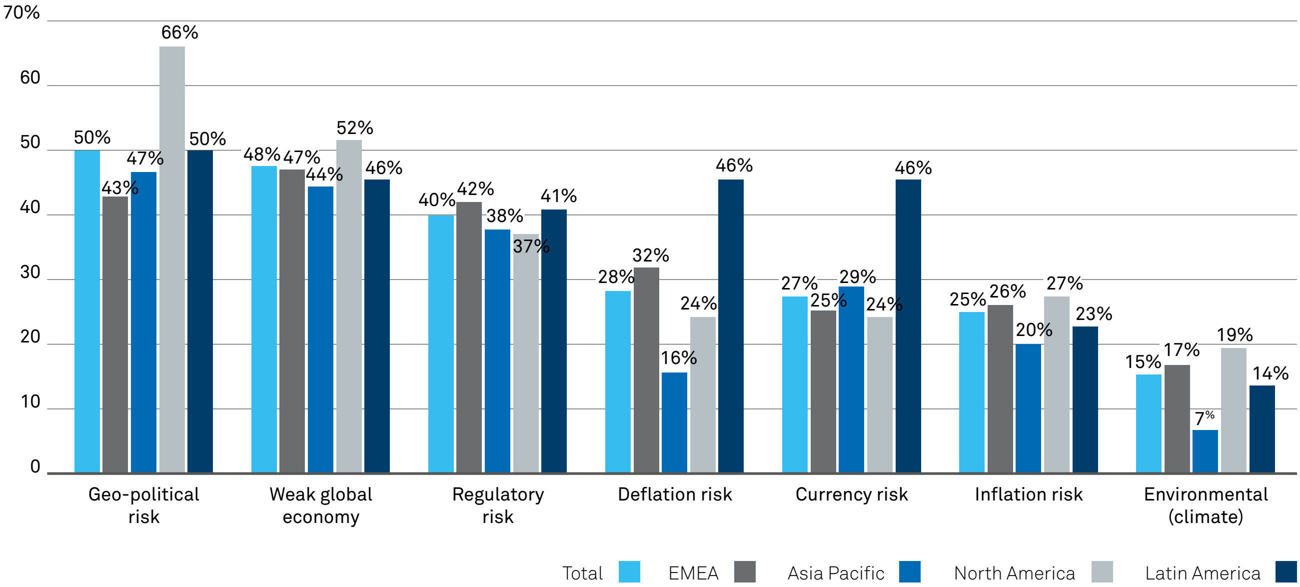
CHART 8: WHY WILL YOUR FIRM INCREASE ITS INVESTMENT RISK EXPOSURE OVER THE NEXT 12-24 MONTHS?



Source: Economist Intelligence Unit survey, June-July 2015

CHART 9: WHICH OF THE FOLLOWING DO YOU CONSIDER TO BE THE MOST SERIOUS MACRO RISKS TO YOUR FIRM'S INVESTMENT STRATEGY / PORTFOLIO OVER THE NEXT 12-24 MONTHS?

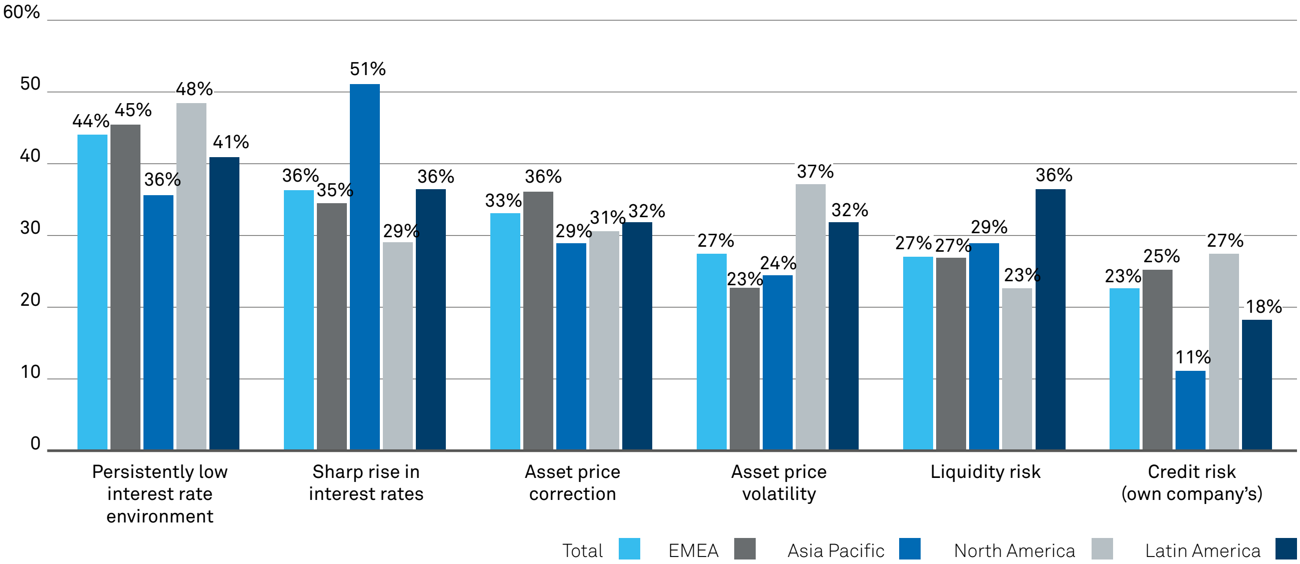
Select up to three.



Source: Economist Intelligence Unit survey, June-July 2015

CHART 10: WHICH OF THE FOLLOWING DO YOU CONSIDER TO BE THE MOST SERIOUS MARKET RISKS TO YOUR FIRM'S INVESTMENT STRATEGY / PORTFOLIO OVER THE NEXT 12-24 MONTHS?

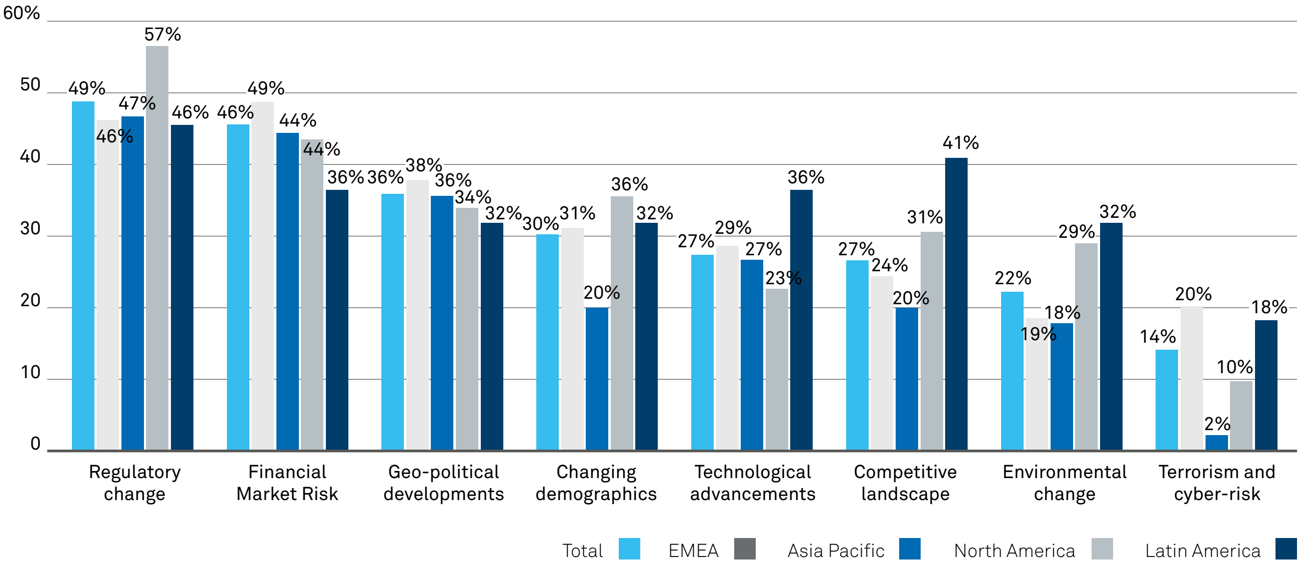
Select up to two.



Source: Economist Intelligence Unit survey, June-July 2015

CHART 11: WHAT DO YOU BELIEVE ARE THE MOST CRITICAL DRIVERS OF CHANGE IN THE INSURANCE INDUSTRY IN THE NEXT 12-24 MONTHS?

Select up to three.



Source: Economist Intelligence Unit survey, June-July 2015

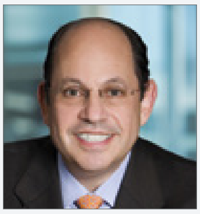
BlackRock commentators

David A. Lomas, ACII, Managing Director, Global Head, Financial Institutions Group, Institutional Client Business

Mr Lomas is the global lead for the financial institutions business, which focuses on managing balance sheet and sub-advisory assets, and providing risk management services. In this capacity, he is responsible for BlackRock's strategy, service offering, client strategy and client proposition. Mr Lomas is a member of BlackRock's Global Operating Committee and BlackRock's Institutional Client Business Executive Committee.

Mark Wiedman, Senior Managing Director, Global Head of iShares

Mr Wiedman has global responsibility for the iShares business, and is a member of BlackRock's Global Executive Committee and Global Operating Committee. He joined BlackRock in 2004 to help start the advisory business, which evolved into the Financial Markets Advisory Group within BlackRock Solutions. This group advises financial institutions and governments on managing their capital markets exposures and businesses. Prior to moving to iShares in 2011, Mr Wiedman was the Head of Corporate Strategy for BlackRock.

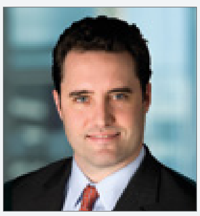


Richard Prager, Managing Director, Head of Trading & Liquidity Strategies Group

Mr Prager is responsible for overseeing the firm's trading functions and the Cash and Securities Lending business. He serves as Chairman of the Americas Executive Committee and is a member of the Global Operating Committee. Prior to his current role, Mr Prager was a member of BlackRock's Financial Markets Advisory Group (FMA) within BlackRock Solutions, where he advised clients in managing their capital markets exposure and businesses.

Jeff Jacobs, Managing Director, Global Head of the Financial Institutions Group - Portfolio Management

Mr Jacobs, is a portfolio manager and has been a member of the Financial Institutions Group at BlackRock since its inception, holding a variety of positions, including Co-Head of FIG Portfolios, and Senior Portfolio Manager.



James E. Keenan, CFA, Managing Director, Global Head of Fundamental Credit, Head of Americas Fundamental Credit

Mr Keenan leads the strategy for Global Fundamental Credit and is responsible for providing oversight of the investment process and performance, the partnerships with BlackRock's distribution channels, and the team's infrastructure. Mr Keenan is a member of BlackRock's Global Operating Committee and the BlackRock Alternative Investment Executive Committee.

Notes

Notes

Notes

WHY BLACKROCK

BlackRock helps people around the world, as well as the world's largest institutions and governments, pursue their investing goals. We offer:

- A comprehensive set of innovative solutions, including mutual funds, separately managed accounts, alternatives and iShares® ETFs
- Global market and investment insights
- Sophisticated risk and portfolio analytics

We work only for our clients, who have entrusted us with managing $4.5 trillion*, earning BlackRock the distinction of being trusted to manage more money than any other investment firm in the world.

About BlackRock's Financial Institutions Group

We work in close partnership with insurers, offering investment management, strategic advice, liability assessment and, in partnership with our colleagues in BlackRock Solutions, investment accounting and risk management services. Through our deep commitment to this partnership, we seek to help our clients succeed in an investment environment characterised by increasingly complex financial, accounting and regulatory developments.

- Team of 107 client service professionals located in New York, San Francisco, Princeton, London, Munich, Copenhagen, Amsterdam and Milan
- Manage $358 billion in unaffiliated general account and sub-advisory assets for approximately 160 clients in 36 countries
- Provide risk management and investment accounting services to 61insurers through BlackRock Solutions

Data as of 30 June 2015. Source: BlackRock

Want to know more?

+44 (0)20 7743 3300 BlackRockInternational.com FinancialInstitutions@blackrock.co.uk

* Source: BlackRock. Based on $4.5 trillion in AUM as of 9/30/15.

004495b-IMPEG-0300-OCT 16

BLACKROCK®