

# Asset risk: Play it again Sam

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Effective asset-liability management is gaining momentum for pension funds and life insurers. BRAVE Partners considers the next steps in this process and suggests that property-casualty and general insurers could learn a few lessons and improve results by following suit.

MAY 23, 2010

## ALM vs LDI

Asset-liability management (ALM) has come of age for life insurers and pension funds. At BRAVE Partners we keep an eye on the conference circuit. Conference organisers do a great job and the partners have attended and spoken at many excellent events. However, the titles and the programs for these conferences is driven by researchers calling round and asking what people are thinking about. As a result the conference agenda is the financial markets equivalent to the output of a New Labour focus group. The firm was faintly amused to see the learning outcome advertised on the incisivetraining Inflation Risk course: "Comparing ALM and liability-driven investment". There will no doubt be differences, but these will be subtle compared with the overall concept of matching assets to liabilities.

## A long way

Effective ALM has come a long way in the last five years. The investment banks can take a lot of credit for driving the agenda here. Naturally, they have not done this as a purely altruistic, charitable donation to society – they have done this to sell products and make money. The difference here is that the products really are useful and risk reducing, unlike some of the more esoteric structures, particularly around the credit markets, of three plus years ago.

## Risk hedging

Financial News produced a March 2010 report giving a summary of the risk and ALM management activities of six UK pension schemes. Most, if not all, had reduced the scheme's exposure to inflation. A good proportion were also looking at hedging longevity risk through the developing longevity swap market.

"Asset liability management (ALM) is now at the core of the strategy for larger pension funds and life insurers. This is highlighted by the fact that conference agendas have shifted from discussing the benefits of ALM in general, to discussing the subtle differences between particular brands of ALM process. Promoting solid, sophisticated ALM to life insurers and pension funds is one activity that the investment banks can be proud of over the past five years."

Christopher Cloke-Browne  
Managing Partner  
BRAVE Partners LLP

### Inflation risk

Certainly BRAVE Partners does believe that there is a significant inflation risk. The firm has commented frequently on this lurking issue for UK pension schemes in articles such as [“Is now the time to have an inflated expectation of your pension fund?”](#) The firm takes comfort in this reported hedging activity.

### True alternative assets

To BRAVE Partners the next logical step in the process is for liability driven investors to seek out assets that have the appropriate characteristics to match their liabilities.

### Music to my ears

Music publishing rights is one such asset that has recently come to the attention of BRAVE Partners. The problems at EMI and the sense that piracy and new media is killing the music business means that any asset with the work “music” immediately puts the promoter on the back foot. Music publishing differs from CD sales and is still in rude health. It is the EMI music publishing business that seems, so far, to have kept it above the waves that are threatening to swamp it.

“Life insurers are hampered in their quest for efficient ALM by the asset rules imposed by regulation. An ideal investment in the wrong format produces an unacceptably high capital charge. ALM for insurers is therefore doubly difficult as the investor needs to serve two masters: the liabilities and the regulatory capital.”

Christopher Cloke-Browne  
Managing Partner  
BRAVE Partners LLP

Music publishing is the copyright on the songs themselves, initially owned by the writers. This asset can develop stable long term cashflows. Royalty payments are due from almost any use of the song from CD sales to mobile ‘phone ringtones, video games (Guitar Hero is a significantly growing source) and even music in cuddly toys. The revenues thus seem to be driven by growing population and affluence and have grown at above inflation over the last 30 years.

Long term, inflation beating revenues driven by growing population and affluence would seem to be an ideal asset for a pension scheme. Moreover, there is a link, albeit tenuous, to longevity. The copyright lasts for 70 years after the composer’s death. If the rights are purchased from a live composer, the value of those rights will increase if the composer lives longer than expected. This is by no means a perfect hedge – not should it be the driving factor in deciding to invest. However, across a large pool of composers, it should offer some protection against a large shift in mortality rates.

Music publishing would seem like one appropriate asset, there are many others. Part of the issue that life insurers face is fitting the form of the investment into their regulatory capital rules. Regulation assigns different capital charges to different types of investment. The form of the investment is crucial for these businesses.

## Lessons for P&C and general insurance

The ALM mantra has not swept through P&C and general insurance. Certainly in some P&C businesses, such as property catastrophe, all that really matters for the investments is stability and liquidity. Here the liabilities are large, risky and uncertain in their timing. Access to a known amount of cash is critical as the claims come in.

## Casualty lines

However, casualty lines of business are much longer tailed and consequently have a longer investment horizon and more risk exposures. Keeping to the topic of inflation, casualty business has a strong inflation component. Liability claims can take decades to settle. Premiums are calculated on the expected value of the final claim. A swift bout of inflation between collecting the premium and paying a claim can create significantly larger payouts than anticipated. It therefore makes sense to match this risk through investments. Similarly, there are areas where an insurer is exposed to oil and other commodity prices. Again, investments can mitigate these risks.

## BRAVE Partners services

The BRAVE partners have extensive experience in developing and implementing ALM strategies for insurance businesses. The firm maintains a careful eye on investment opportunities and analyses how these might fit an overall insurance company investment strategy.

## Interaction

If you enjoyed this commentary and would like to receive a weekly update by E-Mail, then please contact BRAVE Partners on [commentary@bravepartners.com](mailto:commentary@bravepartners.com)

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- Efficient and effective ALM is about as close to a free lunch as possible within liability risk management.
- In contrast to the market's reputation, for years most insurers seemed to turn down this opportunity.
- Life insurance and pensions are now rapidly gaining sophistication, the next goal is to bring the concept to casualty insurance.
- BRAVE Partners can advise on the asset financing opportunities to meet a variety of ALM needs.

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