



## After the Fall: A Year-End Update

**Ray Helfer, CFA**

Director, Insurance Asset Management

In this wide-ranging interview, Rich Coffman, director of insurance business development, spoke to Ray Helfer, director of insurance asset management, about global equity markets, in ation hedging, rising interest rates, and year-end tax planning for insurance companies.

**Coffman: We've had quite a run up in the equity markets. For those who might not have gotten back into the market, is it an opportunity missed?**

**Helfer:** The run up in the equity market has been really positive and is a result of the reliquification of the market, particularly the financial sector, as well as a number of the industrial areas that were overly impacted on the negative side. The advice we're giving insurance companies is to think globally with respect to equity exposure, because we expect the pressure on the US dollar will continue as a long-term trend. We think those countries that make real assets, the commodities exporters, are going to continue to be drivers of the global rebound. Insurance companies that can afford to continue to make allocations to equities, from a risk-based capital standpoint, should consider international strategies, both in the growth and value space, as well as in the emerging markets. Those are

the areas where we think we'll see the highest growth and where it's going to be sustained in the coming decade.

Insurance companies that did not get back into the equity market were driven largely by balance-sheet considerations. They do need to consider whether they can afford the downside volatility of equities while they're looking at the upside opportunities, but we expect that P/E multiples will continue to expand as the global economy continues to rebound.

**Coffman: The inflation/deflation question seems to be on people's minds with all the government stimulus programs that have been put into place. What advice would you offer?**

**Helfer:** The biggest challenge insurance companies have with respect to inflation is that many have over 90% of their investments in fixed income, which tends not to perform well in

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## Normal, or Not?

The tone of economic data and financial asset prices improved markedly over the third quarter of 2009. Indeed, markets are increasingly pricing a more normal scenario for economic progression. However, my bias is to tilt toward risk assets as economic data continues to be supportive, but beware of signs that the current benign

"reflation" regime may be ending. I would broadly define my base case as reflationary, meaning an environment in which aggressive policy is leading to improving economic growth.

### What Has Changed?

With many assets and indicators back at pre-Lehman levels, including emerging market equities, the Chicago Board Options Exchange Volatility Index (the VIX), the US dollar, and emerging market external debt, the economic environment clearly has

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an inflationary, or rising interest rate, environment. What a number of companies have begun to realize through a lot of projection work we've done with them, is that in most cases what matters in a rising interest rate environment is how quickly rates rise. For most insurance companies, the cash flow from portfolios is so high that reinvesting in a higher-yield environment actually cushions the blow of market depreciation that inflationary concerns may cause in a fixed income portfolio.

Our expectation is that inflation is not really going to start to increase in the US for another year to a year and a half, and even then, we expect it will be much more modest than current expectations. So we are working with our clients to slowly reduce the overall duration of their portfolios from an asset liability management standpoint, while continuing to be fully invested in the various spread sectors of the market. We are not in favor of raising large cash positions because of the negative carry that puts on the trade and because a lot of shorter-duration securities that clients have on their balance sheets will be maturing and giving them the opportunity to reinvest in a higher-rate environment.

Again, we think the market will be surprised at the slow pace at which inflation comes back and at which the Fed begins to raise interest rates. But now is the time for insurance companies to think about the inflation implications of the major fiscal expansion that has been going on, both in the US and elsewhere.

**Coffman:** You mentioned the possibility of interest rates going up, and as we know, insurance companies are always searching for yield. So, with that forecast, are there certain investments you feel better about in terms of delivering income?

**Helfer:** The challenge over the first quarter of 2009 was to have the wherewithal to hold tight on the yield-oriented spread asset classes that insurance companies were invested in, given that the pricing of those securities was extremely poor, liquidity was low, and there was a lot of concern about default risk. We worked very closely with clients to fully understand the need to maintain those allocations and to determine which securities were well underwritten and likely to recover as market liquidity began to come back and the economy began to recover. In the second and third quarters of 2009, spreads came in quite dramatically. As we look forward, we think insurance companies should continue to invest in the spread asset classes, particularly in the shorter end of the yield curve, which is extremely steep.

We think that there continue to be opportunities in the agency area and the higher-quality asset-backed base. They are not the types of opportunities we saw in the first quarter, but they are certainly still opportunities to enhance income.

## A State of Flux: Taking a Selective Approach to the Muni Market

*For insurers that have an appetite for tax-exempt income, evolving conditions in the municipal bond market have provided plenty of food for thought. Director of Insurance Asset Management Ray Helfer offered his perspective.*

Over the past year, there have been two major challenges. The first was the decline of the monoline insurance companies during the financial crisis resulting in a lack of liquidity and spread-widening. I would note, however, that we believe there are still some very successful monoline insurers, and we expect that business to grow back and maintain an ability to define the base-case curve with respect to munis.

The second challenge, which will continue for the next several years in our opinion, is the erosion of the balance-sheet fundamentals of state and local governments. Despite the federal spending bill, which we believe will have a significantly greater impact next year than this year, there are hard decisions that have to be made at the local and state levels in terms of balancing budgets on an ongoing basis. So we expect that there will continue to be a lot of concern around individual credits. We're less concerned about general obligation securities in larger cities and more concerned about special purpose projects, such as stadiums, where we think taxpayers may pull back on their support.

The last few months have been an extremely attractive opportunity to add well-researched municipal bonds to insurance company portfolios that need to increase tax-exempt income. On the other hand, we have been increasingly selective about the types of securities we purchase. We expect there will be appreciation and a narrowing of the municipal curve relative to the taxable curve in the coming quarters. Part of that improvement will be driven by state and local governments repairing their balance sheets, but also by the re-emergence of the monoline insurers, which will provide some stability to the relative-value considerations that all investors use to ground their decision-making. ■

When you look longer out on the curve, most of the increase in market value due to spread compression is behind us. We still expect spreads to grind tighter, driven by a lot of demand on the long end of the curve. Pension plans have learned over the course of the financial crisis that they have been underweight fixed income. Given the long duration of their liabilities, we're seeing significantly increased flows within the liability-driven investment space, which is creating huge demand for the long end of the spread product area. So our recommendation to our insurance clients who are invested in that area of the market is to maintain those investments because of supply/demand dynamics. Earlier we had recommended maintaining those investments because of the overall valuation characteristics.



*"...now is the time for insurance companies to think about the inflation implications of the major fiscal expansion that has been going on, both in the US and elsewhere."*

— Ray Helfer, CFA

We suggest that clients remain fully invested in the spread areas of the market on the short end, with the expectation that these assets are no longer in rapid market appreciation mode but are in income-generation mode. Opportunities remain positive but more muted than they've been in the recent past.

**Coffman:** *As we look ahead to the end of the year, do you have any specific ideas about what insurers should focus on in their portfolios?*

**Helfer:** First, do your planning now because we expect that as the broker/dealers begin to tie down their balance sheets for year-end, we're going to see liquidity, which has really come back to the market, begin to ebb and flow. Begin to implement

your plan sooner than you would have in years past. Second, over the last year, insurance companies have been very focused on surplus management and balance-sheet management, and not as focused on tax management as perhaps they could have been. The numbers this year will tend to be much larger in terms of trying to balance unrealized and realized gains and losses, as well as taking into consideration certain types of writedowns or gains from the sale of affiliates.

Also, there are a number of insurance companies that have taken losses from an underwriting standpoint, or for other reasons, and they see less need for tax-exempt income for the next two to five years. But we would recommend that those companies consider holding off on dramatically reducing their municipal bond holdings because of the value we see in the municipal market. We think there will be time to make those asset allocation adjustments more opportunistically in 2010.

In thinking about year-end planning, we'd also emphasize liquidity. Insurance companies have done a fantastic job of reliquifying their balance sheets. As the economy emerges from the recession, we are challenging our clients to look at how much liquidity they have and think about whether they have too much. A year ago, that would have been heresy, but with money market securities currently trading at less than 25 basis points, liquidity is more expensive than it has ever been. So if an insurance company, from an asset liability management testing standpoint, has excess liquidity, we recommend that they look to put those funds to work in the market. The year-end planning process should include this idea of forecasting liquidity, certainly over the coming year, if not the coming two years. Companies should make their decisions and be a bit more aggressive in holding primary liquidity relatively low, focusing secondary liquidity in very liquid investments that are earning significantly higher income given the steepness of the yield curve in the current environment. ■

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**Normal, or Not?** (continued from page 1)

improved substantially. In addition, earnings growth expectations are above the (high) 2004 – 2006 levels, the distribution of global forward price-to-earnings (P/E) ratios shows a fairly typical split of high- and low-value countries, with most equity markets trading between 10x and 15x next year's earnings, and many investment-grade corporate bonds have traded back to yields that imply low risk premia. Credit markets are functioning again, as corporate bond issuance has been very strong for the last two quarters. This all suggests that investors are pricing a higher degree of normalcy back into financial assets.

**What Is Abnormal That Needs to Change?**

While it is seductive to think of the current environment in a typical cyclical framework, it is important to remind ourselves of what is unique to this cycle. First, credit demand remains weak, and credit supply is not functioning normally. This is evidenced by recent data from the Federal Reserve's Flow of Funds report, which shows how the crisis fully unwound private sector debt growth that expanded massively in the 1990s. In essence, the rise in government liabilities was the credible policy response that offset the private sector deleveraging. That said, such a situation can only persist for so long, as pressure for the overall level of debt to come down remains.

Second, labor markets in the developed world need to improve. Employment is a lagging indicator of economic growth, so it is important that we don't get too concerned about this. After all, as growth continues to improve, corporations will realize that they reduced employment to a level consistent with an unsustainably low level of demand. Despite this, the unemployment rate in most developed countries remains historically high, and corporations still hold more bargaining power than labor, which should restrain wage growth and retard the run rate of consumption in the next cycle.

Third, the price action of gold may be signaling some inflationary concerns. As the deleveraging forces eased and drove less capital repatriation back to the US, the strength in the dollar from late 2008 reversed. This weakening trend, influenced by the highly aggressive Fed policy, drove gold prices higher. As deflation continues, gold and equities should both increase in value. Their relative performance, however, may signal something about the degree to which markets think deflation is sustainable. Emerging market equities are keeping

pace with gold, but developed markets may have recently broken down. If this trend continues, it will signal that while deflationary policies may produce positive economic growth, such growth is being held above its natural rate artificially.

**What Is Priced?**

As the crisis and its economic effects accelerated downward late last year, corporate earnings estimates were slashed. Now that the global economy is clearly on firmer footing, it stands to reason that earnings estimates should be revised higher. This is exactly what has occurred. Twelve-month forward earnings estimates for US companies peaked at more than US\$100 per share in late 2007, and troughed at just over US\$63 per share in April 2009. This is a much deeper-than-average trough, by about 10 percentage points. Earnings expectations have rebounded to nearly US\$71 per share as of early October, and could easily move higher. This general pattern is not surprising. What is interesting is the timing and magnitude of how sharply earnings expectations are likely to rise back to a longer-term trend.

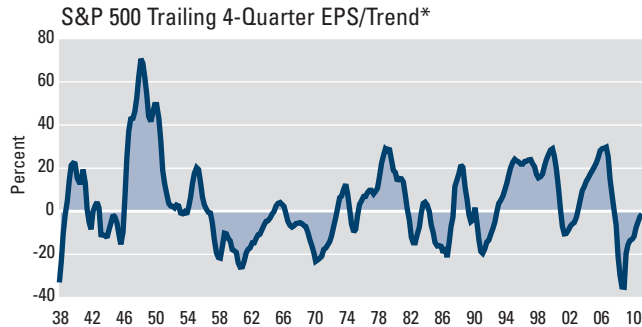
Essentially, bottom-up analysts are expecting earnings to fully revert back to the long-term trend by year-end 2011. This would represent nearly 20% earnings growth for 2010 and 2011, versus a trend growth rate of about 6.5%. While there is some variability, when earnings trough they tend to revert back to trend in eight quarters before overshooting and then reverting back down. The percentage increase in expected earnings is greater than normal, but that is because the drop was much greater than normal this time. This is an excellent example of the importance of the "normal cycle" debate: to the extent that we are in a normal cycle, these estimates are reasonable (**Figure 1**). If we are not, then these expectations are likely to be disappointed.

If we are normalizing, then equities easily have much more upside. Using the S&P 500 Index as a guide, if earnings follow the historical playbook and revert to the US\$91 trend by year-end 2011, and if we end 2011 with a 15x trailing P/E multiple, then the S&P 500 Index would trade at 1375, or more than 30% above current levels. This is heartening, as we are merely assuming historical norms; we don't have to make a "valuation doesn't matter" argument as we are just assuming reversion to long-run averages.

While 15x earnings is a long-term average, that average is associated with benign macroeconomic backdrops for corporate earnings, inflation, and growth. When the back-

Figure 1

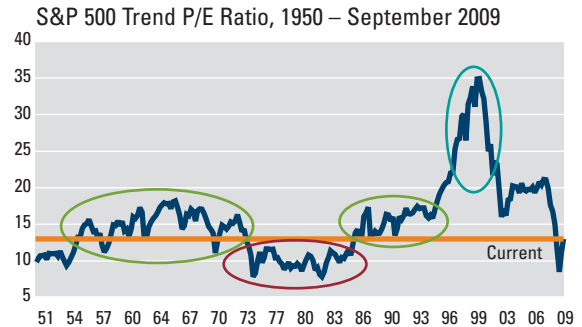
## Equity Markets Need a “Normal” Cycle



\*Using expanding window  
Source: Thomson Datastream

Figure 2

## How Long Does the Deleveraging Regime Last?



Source: Thomson Datastream

drop is less favorable, as it was in the 1970s, the valuation range tends to be lower. In that instance, the trend P/E varied between 8x and 12x. If investor expectations are disappointed, today's 13x trend P/E will look expensive. We don't know if the 1970s range will be the right one, but we do know that 15x is likely too high (Figure 2). As the consensus view continues to shift toward normalcy, and that view becomes increasingly priced into financial assets, the vulnerability to a change increases.

## What to Watch?

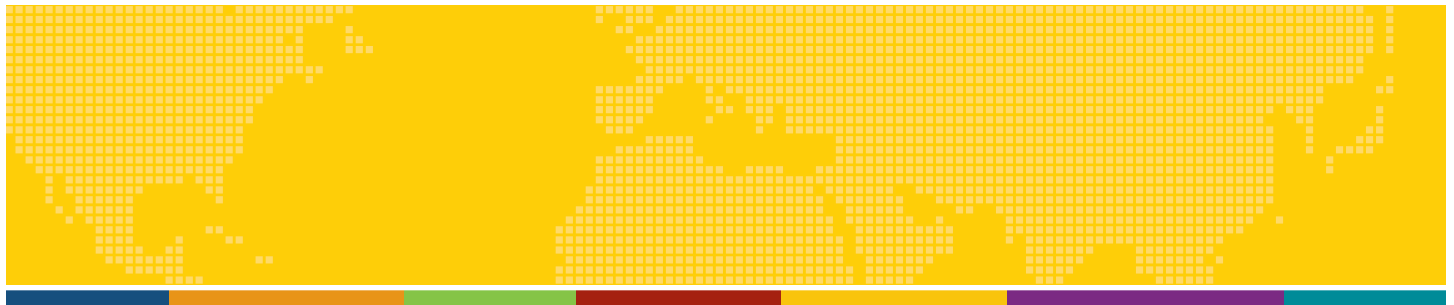
As sentiment is moving in a positive direction, I am on the lookout for signs that the increasingly expected normalization may go off course. Broadly speaking, I'm looking for correlation breakdowns. Correlations have been exceptionally high of late, which signals the fact that financial markets are being driven largely by common factors. Correlations are bound to fall, but the way in which that happens will help us figure out what sort of environment we may be transitioning into. In addition to gold versus equities, other correlations that bear watching include equities versus credit, and the pricing of sovereign versus inflation risk. If we are transitioning into a more normal environment, credit should be relatively unattractive versus equities, even if it remains attractive from a spread perspective. Now that spreads have fallen, the impact

of higher interest rates that would be associated with stronger growth would impact credit far more than equities. As such, high-yield bonds may be the better opportunity as the spread duration component remains a larger driver.

In terms of inflation risk versus sovereign risk, markets are currently pricing the former more aggressively. Credit default swap (CDS) spreads on US Treasury bonds are down to 20 basis points as of early October, down from 100 at their peak, reflecting lower levels of concern about the implications of the government bearing responsibility for troubled bank assets. Gold prices, meanwhile, continue to reach new highs. If markets start to get more concerned about the sustainability of government debt, protecting against generalized sovereign risk could be a more attractive form of insurance.

Our primary structural themes of emerging markets, natural resources, and precious metals remain largely intact given the current reflationary environment and the likelihood that it persists. Where I differ from the consensus is my view that the environment will be highly rotational going forward, and that a transition to a typical economic cycle is unlikely to follow the usual historical playbook. Looking forward, I am watching for data that will help identify the next regime. If the behavior of precious metals is any indication, then currency and inflation concerns may be with us sooner than we think. ■

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