Louis Pelosi

Episode 250: Best practices: strategic asset allocation in an evolving regulatory environment

GUEST Q & A

Stewart: Welcome to another edition of the InsuranceAUM.com podcast. My name Stewart Foley. I'll be your host. Hey, welcome back. It's nice to see you and thanks for joining us again. We have got a great discussion for you today. It is called Best Practices in Strategic Asset Allocation in an Evolving Regulatory Environment. And we are joined today by Louis Pelosi, managing director of Client Solutions with SLC Management's Global Insurance Group. Louis, welcome. This is your first podcast, I believe. Welcome. We're thrilled to have you.

Louis: Thank you. Thank you for having me. Much appreciated.

Stewart: You're in the friendly confines of the insurance asset management community. No doubt about that. So you were steeped in the tee in insurance asset management at Sun Life Capital Management. Talk to me a little bit about, first of all, where did you grow up? What was your hometown? What was your first job? Not the fancy one. Don't tell me that you start at the top of the heap. And then tell me a little bit about how you got to the seat you're in today. Give me a little bit of your career journey just to kick us off.

Louis: Absolutely. So I grew up in a town in Connecticut. Waterbury, Connecticut. It's not got the best reputation anymore, but when I grew up, I enjoyed my childhood. The first job I had was actually working at a grocery store. Nothing fancy. Got it when I was 15, which now I think is probably illegal at this point.

Stewart: It was probably illegal back then too, Louis. What the heck?

Louis: Yeah, that could be.

Stewart: But Waterbury. I used to live in West Hartford. So Waterbury is near and dear to me. It's not that far down the street. It's not that far down the interstate. Connecticut is just not that big. So what was your high school mascot?

Louis: The Hearts actually. It's Sacred Heart, the Hearts. Terrible, terrible. The school doesn't exist anymore, but maybe because of the mascot name. You never know.

Stewart: Go Hearts. Go Hearts.

Louis: There you go. There you go. A lot of Italian immigrants in the town and my grandparents were two of them, and just great Italian food. So if you ever need good Italian food, that's the spot to go in Connecticut. That and New Haven. Great pizza.

Stewart: It really seems like that's true. All right. So how did you go from Waterbury to managing director Client Solutions of Insurance Asset management at SLC Management. And so got to be an interesting journey.

Louis: That's a mouthful.

Stewart: It is a mouthful.

Louis: I went to school at University of Connecticut for accounting and natural science. Quickly found after a few positions, internships and full-time positions in the insurance world that while I am an actuary, it is very boring, as one may guess. So I opted to move into more of an asset-focused role, as you mentioned at Prime Advisors and I haven't looked back since. So I've been in this position for about 15 years now, focused on again, asset allocation, regulatory capital, and other ancillary modeling for insurers. So it's been a long time, but I do very much enjoy this role.

Stewart: Yeah. It's funny because I worked at another firm in Connecticut, an insurance-centric boutique, and one of the things that was always amazing to me about Prime is that you had actuaries as PMs and it's like you have a really thorough understanding of the liability side of the balance sheet, which makes total sense as to why you're talking about best practices in SAA today.

So let's get into that. And so a good friend of mine named Jonathan Kalman coined the term 'externalities'. And I think that what's lost on a lot of folks who are trying to get into the insurance asset management space is that the externalities that insurers deal with are far, far greater than those of other institutional investor types, which is why pure performance does not win the day for the most part in the insurance asset management arena.

So can you talk a little bit about what are the key considerations to be aware of when you're going to do strategic asset allocation for an insurance company? And the last part of that question, as you well know, completely influences the answer.

Louis: Yeah. I mean, that's pretty much spot on your comments. The external factors being the overriding decision, whereas when you're an individual, you're mostly looking at what is the best performing asset with no consideration outside of that. When we're sitting down to look at strategic asset allocation, the first thing we want to understand is your liability profile. So are you a property casualty insurer who's exposed to a lot of catastrophe risk, therefore maybe needs additional liquidity? Are you a life insurer domiciled in the US while we're underwriting interest rate sensitive annuities, longer duration life policies?

You really need to understand exactly the business they're in. And every insurer is unique, so you're going to need to understand the nuances of them. And then there's also just a human element to each individual team at the insurance company. So whether the board or management, they're going to have different goals.

Some people are very focused on total return, return to shareholders or policyholders. Others are much more focused on a stable level of income, immunizing against volatility. There's not a right and wrong answer. If you think back to our finance one-on-one classes, you have your efficient frontier and as you go up and to the right, you get riskier and more return. Every one of those portfolios is theoretically efficient. It's just where along that curve do you align?

So when you're sitting down with an insurer, you've got to understand the liabilities. You've got to identify the capital, regulatory bodies that they're beholden to. And then you have to really get to know the individuals themselves and determine what are the best practices? Are we maximizing yield return? Are we minimizing volatility? Are we really trying to drive a solution? It's a jigsaw puzzle. Without all that, you'd be doing the jigsaw puzzle without the edge pieces to guide you.

Stewart: I mean, I think that's a really good analogy. And you're right. I mean I manage money for insurance companies too, and I have yet to meet an insurance CIO that didn't say we have a conservative investment philosophy. But what that means across the spectrum, and I do think that there can be an efficient point for a given insurer, but there's no two that are identical. They're like snowflakes. From a distance, they all look the same. Up close, all different. And even companies that have that look, I don't know, you tell me, that look the same in a peer analysis can have a very different asset allocation depending upon a myriad of things, including capital position, tax position, lines of business, personality of the board, risk profile.

I mean, how many times have you heard, have you been in an investment committee meeting? And if there's an idea that failed miserably 15 years ago, trust me when I tell you... You're laughing because people can't see you laughing, but it's true. People go, "Oh yeah. I remember when we did that with, whatever it was. That was a disaster. We're never doing that again." And so one of those deals exists in all these different companies too. And so I do think that you've done a beautiful job of talking about the varying goals of the portfolio.

You've got to understand the risk of the liability book and the characteristics of the liability book. And you talked about duration, convexity and whatnot. Talk about the differences between. And I ring the bell. I've always said this is the home of the world's smartest money and it's not because insurance companies have a better crystal ball than our colleagues in pensions and endowments, and individuals, but they do have a great deal, more things to be concerned about or constraints. Right?

So can you talk a little bit about the difference between an asset allocation for an insurance company versus that of a pension fund endowment or an individual?

Louis: Yeah. I mean, I would echo that we do work with endowments, pensions, foundations, just as you alluded to, and they have very similar liability-driven or LDI constraints, either cashflow matching, key rate duration or duration matching. Very similar concepts. And we've seen a lot of money managers or consultants or what have you come into the space and say, "Well, let's pick up and plop in, what we do for pensions." And the same lens that we do for... We could just do it for insurers, that to insurers.

And while that is true to some extent, there are other considerations such as capital, tax and then ancillary things as you alluded to before, whether it's board risk tolerance. You have different structures of insurers. Mutuals very focused on preserving policyholder surplus, stock companies where your return on equity or return to your shareholders is paramount. As you alluded to earlier, peer analysis. One of the most telling things is going into a board meeting or an executive management meeting and the shares may be trading at a discount to two or three peers.

Well, why is that happening? We need to know now because this is our wealth as well. So when you're looking at each insurance company, one of the first steps, one the first questions that we sit down because, again, the partnership is as important as the numbers that go into the model themselves. But the partnership is really... So let me ask you this, CFO, CIO, what is the capital system you're really built around? Are you focused on risk-based capital? Are you focused on your S&P rating, on your AM Best rating? And really what's your target rating there? Because that's going to determine where and where we can't allocate. We need to understand the tax structure.

Are you domiciled in the US? Are you in Bermuda and focused on avoiding effectively connected income or ECI? Because that's going to determine not only what assets we use, but the structure we're going to use them in. Which is even more important nowadays than when I started 15 years ago where you have all these different securitized vehicles, structured vehicles, rated notes that can be used to either alleviate capital concerns or tax concerns.

Stewart: You make a great point. I mean, I think that the structuring has become a much bigger deal almost it seems as it's not maybe as important as the asset class itself, but if you have two options for a particular exposure and one of them has a way of holding it in a significantly lower capital charge, that's going to be hard to beat or it's certainly going to be a consideration. Would you agree with me on that?

Louis: A hundred percent. If you don't have the right structure, it's a non-starter. That's definitely.

Stewart: So it's not exactly a headline that there's been a growing use of alternatives in the insurance industry. You mentioned structure and it's included more structured and less liquid, some private assets. How do you think about those alternative or less, more private asset classes? How do you think of that in the SAA process? And this is a super difficult question to ask and how do you think about liquidity when you mentioned various types of insurers, how does liquidity play into the SAA process?

Louis: That's a really tough but good question. So it's two parts, and I'll tackle the first one here, how does it reflect in the strategic asset allocation process? Well, if we think back to prior to the Tax Cuts and Jobs Act of 2016, property casualty insurers, the question wasn't whether or not to use tax exemptions. It was how much. How much can we use to benefit ourselves until we hit that alternative minimum tax threshold? That's the case now for private structured, excuse me, and less liquid assets. It's not whether or not many insurers should use them, it's how much because they just model both from a theoretical as well as a practical standpoint so well.

These assets have additional yield, very similar risk profiles, and many of them, either because they're thinly traded or very infrequently traded, have artificially low volatility. Now, what I'd say with that is you have to be careful because just because they have lower on paper volatility doesn't mean you need to load up on them and assume, "well, it looks like it had a 3% volatility the past 10 years." So going forward it's as safe as can be.

No, that's definitely not the case. It's just a factor of pricing transparency. So to your second question, when it comes to liquidity and optimal use of these in an insurance company portfolio, we're generally looking back to my earlier comment on the liability side. So if you were to sit down and we were to have the discussion, how do we model the appropriate usage of these assets?

Well, first we look at your liabilities. I'll pick property casualty in this case because they're cat exposed and have been less likely to use these private assets. Probably because of that, they have catastrophe risk, short-term liquidity risk. You really need to understand that. So when your portfolio management team sits down with you understanding the level of catastrophe risk, the timing of your reinsurance payments and how liquid do you need to be.

And then you kind work backwards from there, right? So you one minus that. So if you know that you need roughly 40, 45% of your portfolio to be generally liquid, well, that needs to be in assets that are very transparently priced, easily traded, can be done T plus one, T plus two. The remainder, well then we can start playing with your levers to liquidity, both making sure that you use those levers of liquidity, but also you're getting compensated fairly for it.

That's not new in the life space because they have such long duration liabilities. They've known about this, this trade for liquidity. It's nothing new there, but it's definitely growing and I don't really see that trend stopping as you mentioned, since it's in the headlines every single day now.

Stewart: I do think that there's a cost to being over liquid. There's a cost. If your portfolio is all super liquid and you don't need that liquidity, you are giving up yield, right? I mean, there is a price for being liquid. And so I think that... You talked about it, but it's really knowing the business and knowing the cat exposure and knowing the volatility and do they have alternative sources of liquidity? Do they have a federal home loan bank membership, for example? Or what's their sources and durability of a liquidity facility in case the tide goes out unexpectedly?

So it's interesting. I love talking about insurance asset management. I don't get a chance. Usually, we're talking about a particular asset class and it's fun to get to talk to you about the SAA component. So regulators have been focused on asset allocation recent years. There's some new regulations targeting assets heavily used in private equity owned insurance portfolio. So what should insurers be expecting moving forward on the regulatory front, kind of the title of the podcast.

I mean, we talked about the externalities, but the externalities for insurers are not a constant. They are evolving over time. So what's going on that side and what can we be expecting as we go forward here?

Louis: Yeah, Stewart. I mean, as you mentioned earlier, with insurers capital positioning and having a partner asset manager, a consultant that is aware of these changes is really one of the most important parts of managing those assets correctly because of topics that you just brought up, right? In the time I've been doing this and attending these Society of Actuaries at NAIC meetings, you may see one or maybe two work streams going on at any given time. In the past 24 months, there's three going on right now. We're seeing passages of new working groups every three to six months.

And really it's not just the US, it's Bermuda, it's passing new laws on their BSCR capital system. The same thing in Europe with solvency. What I would say is moving forward as an insurer, one, obviously staying on top of these changing regulatory environments because they have some material impacts on capital and how you should allocate.

But two, making sure that future investments are on the up and up we'll say conforming to these regulations. Because while certainly there's different interpretations and things are still being hammered out, for instance, CLO equity or really any residual equity tranche now. There's an interim charge that's going to be 45%. That's so much higher than the prior regime. That's something to be aware of because you don't want to wake up on 1/1/2025 and suddenly have significantly less capital be working with all because you weren't aware where things would be positioned on your balance sheet. So again, staying on top of the regulations and really making sure that whatever you are investing in to our early conversation is structured correctly.

Stewart: It's a great point. When you think about this in its totality, which the topic of the podcast is evolving is best practices in SAA in an evolving regulatory environment, what's your best advice or what are some of your key takeaways that you would offer to the insurance investment community to summarize the material we've covered?

Louis: Absolutely. In addition to staying on top of the regulations, because again, as far as I know as worded now, nothing is being grandfathered in really. So if you own it on your balance sheet, be aware to be you will be responsible for it. And that it's a necessary evil at this point. But the use of alternatives is here. If you want to price your product competitively, you are competing against large, sophisticated private equity insurers at this point that utilize these assets alternatives, less liquid or private assets.

So to be competitive, you also need to at least be examining if this would improve your portfolios returns and yields. That being said, many of these assets are being examined for things such as the NAIC's definition of a bond. So understanding of the underlying collateral and these very, very nuanced instruments going to meet those criteria. When I'm sitting down, again, the background of the actuary here kicking in is modeling cash flows.

It's easy for a portfolio manager to put in a handful of very complex structured securities. But modeling those cash flows and how they match up against liabilities in different interest rate environments, those can be very difficult, very, very difficult. And many of them are new structures that haven't seen a period outside of maybe COVID where extraordinarily easy money made it not as large of a hit potentially to price.

So we're going to be dealing with in the coming years these new creative structures and we're tapping actuarial teams to do cash flow modeling that can be quite in depth. So as you look at these products, it's really beneficial to insurers to understand what they're investing in, how the regulations apply to them, and really do they still meet our liability needs.

Stewart: That is a very good education. You've been an outstanding professor for the day on strategic asset allocation. I've got a couple of fun ones for you out the door, if you'll indulge me a little bit. I want to take you back. So you have a Bachelor of arts in actuarial science from Yukon. I want to take you back to when you graduated, and I'd love to know what you would tell people who are new to this business, coming out of school. Essentially, what would you tell a 21-year-old Louis Pelosi today about the insurance asset management business and where the opportunities lie?

Louis: This is a good way to phrase, would you tell your younger self to do anything different? I actually love my role. I wouldn't do anything different. I would tell 21-year-old me do exactly what you think you're doing right now because I hit the nail on the head. My advice to any actuary or anyone interested in the actuarial profession that if they're at all interested in the finance and investment space, it is, as you alluded to earlier, it's a niche market, right? There's not a lot of actuarial and investment professionals that are interested in the space.

So if you can get into it or want to get into it at all, give it a try because it is one of, in my opinion, one of the most fun actuarial goals, and it's really, again, a very thinly populated area. We could use more.

Stewart: Yeah. I mean I think it's really interesting because there's a lot of aspects of the investment market that's very quantitative as well, and the ability to understand both sides of the balance sheet would seem to me as someone who wishes they understood the liability side of the balance sheet a little bit better. Seems like it would be a competitive advantage. All right, last phone went out the door for you, and I'm looking forward to hearing your answer to this one. So you can have a lunch table of four, you and three guests. Up to three guests. Doesn't have to be three, but up to three. Alive or dead, who's going to lunch with you?

Louis: That's a good one. Alive or dead? I'm definitely picking Abraham Lincoln first. I love his biography and he's one of probably the best president we've ever had. You have to pick a significantly or significant historical figure. I mean, I know this is a cop out answer, but you have to pick someone like Jesus, right? You have to. We're going to dinner, the last supper? You got to pick that one. And then I got to throw in a fun one. Let's see here.

Stewart: Are you a sports guy at all?

Louis: Oh, for sure. But I'm thinking more along the lines of if I've got Abraham Lincoln who's a standup, just quality guy, Jesus, who is one of the most important figures in history, I'm going to pick someone wild and fun to throw it for a loop. I'm probably going to go…

Stewart: Is this your alternative asset allocation component?

Louis: Yes. This is my alts book.

Stewart: This is my alt book.

Louis: And I picked my fixed income in cash.

Stewart: I love it.

Louis: I got to pick my alts book, and I was going to say John Lennon, but I want to pick a cooler rocker than John Lennon. But no, I think I'll go with John Lennon for now.

Stewart: Oh, that's a great lunch. Jesus, Abe Lincoln, and John Lennon.

Louis: That's my alternatives bucket there.

Stewart: That's right. And Louis Pelosi, it's been great to have you on. Thanks for joining us and thanks for the education on SAA today. I really appreciate your expertise.

Louis: Thanks for having me.

Stewart: My pleasure. We've been joined today by Louis Pelosi, managing director Client Solutions Insurance Asset Management at SLC Management. Thanks for listening. If you have ideas for podcasts, and believe it or not, we got an email the other day asking us to do a podcast on a particular topic. So thrilled to have it. Stewart@insuranceaum.com. Please rate us, like us and review us on Apple Podcasts, Spotify, Google Play, or wherever you listen to your favorite shows. And tell your friends please. I look forward to seeing you next time on the InsuranceAUM.com podcast.