SMALL CHANGES, BIG IMPROVEMENTS

David Kilborn of Performa discusses how to maximize the long-term success of your captive by avoiding investment hurdles often faced by captive owners

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Setting up and operating a successful captive program is by no means an easy endeavor. Considerations are seemingly endless and the details can become paralyzing at times. However, those sponsors who persevere, come armed with a thoughtful business plan, and employ a partnership approach with qualified service providers, typically enjoy success that can markedly exceed even lofty expectations.

Too often we encounter captives whose sponsors have taken the time, resources, and effort to complete the setup process, but have not reached their full potential due to a lack of prudent premium, regulatory capital and surplus management directives. A captive insurance company should take a holistic approach to long-term investment planning, which requires collaborating with an asset manager that understands the nuances of a captive balance sheet.

For those within or just beyond the captive formation stage, as well as those trying to improve their overall captive financial performance, we highlight a few misconceptions and real hurdles to getting all of a captive's cylinders firing in unison.

Simple planning

To us, building a captive is analogous to buying a new house. Much time is rightfully spent on the big picture; overall design, exterior materials, school district, etc. These themes overlay well with captive design; determining the type of self-insurance solution, choosing between a single sponsor and a group captive and picking the best domicile. After the big decisions have been made, later decisions usually appear minor and less impactful.

It is certainly possible to acclimate to a new house with little furniture, details and bare, white walls. However, most prefer a vibrant, customized environment. Choosing details like curtains, fixtures, and paint colors are individual preferences. For captives, these decisions are akin to picking other service providers, choosing collateral vehicles and banks, mapping out risk tolerances and designing investment guidelines.

Collectively, small, detail-oriented decisions can add up and overwhelm. These choices and the planning behind them are the backbone that creates a unique experience. It turns a house into a home and a captive from a risk management tool to a powerful income generating asset for the sponsor.

Captives that do not develop a thoughtful investment plan prior to approval can find the asset side of the balance sheet with little character and a bunch of bare walls. The right long-term, tailored plan for managing a captive's assets can result in significant benefits that accrue from inception as opposed to incurring ongoing opportunity costs.

Opportunity cost and the time value of money

With no investment roadmap, captive owners end up with increasing cash balances from premiums, but little to show for it. Typically, we do not agree with conventional wisdom, but the premise that doing nothing is neither a plan nor an action is something we believe accurate in this case.

While interest rates are at rock bottom, holding cash over and above daily operational or known liquidity needs has two distinct costs: 1) no income generation and 2) value erosion from inflation, which is the harder to visualize, carbon dioxide of investment portfolios. To illustrate, we offer two examples using $1,000.

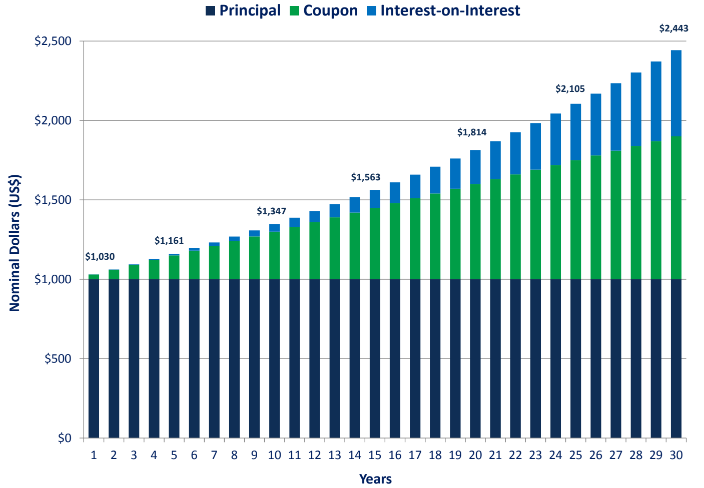
Chart 1 *(see page 10)* depicts $1,000 invested at 3% annually over 30 years. The green bar (coupon) represents the total accumulated interest at each year-end ($900 by year 30). The blue bars show the compounding effect of interest-on-interest, accumulating $543 more after 30 years. $1,000 in musty, old bills has become $2,443 30 years later. Chart 2 shows inflation's effect on $1,000. Using actual inflation data, 2005's $1,000 cash is only worth $806 in 2016's buying terms, which translates to a 20% loss over 11 years. The earlier you invest – for college, retirement, or captives – the more interest-on-interest you will earn over time.

Significant cash holdings discard the benefit of premium float - such a powerful tool that Warren Buffet and others use it as the cornerstone of managing insurance company balance sheets.

Avoiding the inflation trap, earning income and reaping the benefits of compounding is easily achieved by investing cash in a high quality, actively managed investment grade bond strategy. For those sponsors fearful of volatile investing environments, market timing is not necessary since a growing captive constantly averages its investment cost basis as premium dollars continually move onto the balance sheet and flow into the investment program. Eventually, today will be just

Chart 1

Breaking down $1,000 invested at 3% over 30 years

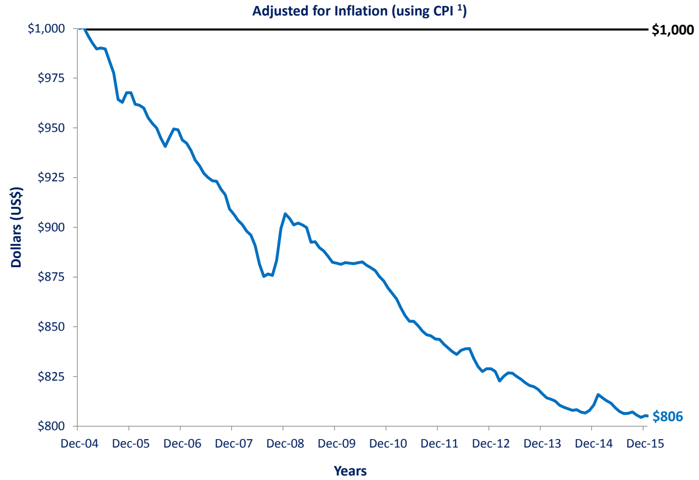


Source: Performa Limited U.S

Chart 2

Value of $1,000 Investment in Cash

Adjusted for Inflation (using CPI [1])



Source: Bloomberg, Performa Limited U.S

[1] Consumer Price Index

a speck in the rear view mirror and will have little bearing on average purchase prices.

Other hurdles

Producing a great business plan does not always guarantee balance sheet operational nirvana. Other hurdles sit in the way for those without a large portfolio. New/early stage captives can have trouble finding a fiduciary that will prudently manage their captives' assets. Many captives are not big enough to garner attention from large investment management firms. As a result, cost effective, institutional quality portfolio management available to pension funds, endowments, and foundations can be difficult to access and captives are left with few choices beyond a retail broker platform or their bank trust department.

The typical brokerage "financial advisor" is not required to be a fiduciary to their clients and typically focuses on other investor types, which does not foster a beneficial partnership. Using a broker or trust area can easily result in the captive owning a cookie cutter, retail style portfolio with expensive third-party mutual and exchange-traded funds or a passively managed, buy-and-hold strategy. Danger lurks.

Lack of fee transparency (multiple layers), inappropriate investment strategy (not customized), lower liquidity (small positions) and unnecessary over diversification are other pitfalls we have seen. Furthermore, a lack of direct relationships with anonymous, third-party portfolio managers can erode communication and confidence.

Generalist or specialist

Captives have their own unique profiles, justifying a tailored approach. Their investment objectives differ from mainline insurers, individuals and even their parent company's pools of assets (pension funds, corporate cash, 401k plans). It is critical for captive sponsors to find the right service provider to lead the formation process as is choosing the best investment management partner to manage the balance sheet assets.

With the requisite captive industry experience and a deep understanding of each captive's specific business, industry, and regulatory requirements, the right investment manager can guide captives through their entire lifecycle from early stage formation to development and maturity. Understanding the nuances of captive structures and managing the competing risk tolerances within sponsoring entities helps on a collaborative basis. It may not be surgery, but mistakes in any field can be costly.

Further education and assistance

With nearly 25 years of experience managing portfolios for captives, Performa is one of the leading investment manager specialists in the industry. Globally, Performa has over $3bn in captive client assets under management and advisement (as of 5/31/2016). Our clients range in age from newly formed to over 30 years of insurance history and in size of investable assets from <$1m to > $300m. Our clients manage an array of risks for companies and groups in diverse industries across offshore and US domiciles.

When looking for answers on best practices for managing captive balance sheets, Performa has the experience, knowledge and tools to help build custom solutions that meet the unique needs of each client. We are proud of our ability to provide institutional quality, internally managed fixed income and equity strategies to captives of all sizes at a cost that provides great value. Whether the right solution for your captive is utilizing Performa's actively managed, captive focused mutual funds or separately managed portfolios, we bring daily liquidity, broad diversification and economies of scale to bear for each of our captive relationships.

Many captives deserve better investment solutions than what is readily available. Instead of shouting at the windmills, consult with an investment manager that has been listening to captive insurers for over two decades. Use our collective experience to unleash the power of your captive's balance sheet.