SIZE DOESN'T MATTER ANY MORE

David Kilborn of Performa gives advice on how to find the right investment solution for captives

Written by
David Kilborn

David Kilborn, CFA, is Performa Limited (US), LLC's president and chief investment officer, responsible for the firm's overall global investment policy. Prior to joining Performa, he served as chief investment officer of Dwight Asset Management Company where he was responsible for over $75bn in fixed income client assets. He has more than 20 years of investment management experience.

Investing captive insurance assets began in the offshore, high-net-worth market. Large multinational banks ruled the landscape, armed with wealth advisers and bundled financial solutions from letters of credit facilities to investment services and beyond.

The captive industry has changed significantly and captive owners today want unbundled solutions to access the best providers in each area. Unfortunately, the evolution of investment management for small to middle market and start-up captives and RRGs has not kept pace. Why?

For one, the 2008 credit crisis still harbours bad memories and the clean-up has eroded returns. Cash offers nothing and bonds have little left. Many new and smaller captives continue to wait for higher yields or are hesitant to stick their toes into other assets. The loss of a number of letter of credit providers has hurt as well.

The investment management marketplace provides a second reason. The old, offshore captive investing method mirrored asset allocation models for wealthy individuals. Today, there is no doubt that captive insurers are institutional customers and not retail. The problem is that many captives fail minimum portfolio size requirements at large investment management firms. As a result, cost effective management for the unique needs of captives is lacking. Effectively blocked, captives end up with the default choice of the original banks and financial advisers that still cater to them.

The right service providers are those that possess a deep understanding of a captive's business goals, life cycle and industry. Applying that standard to investment managers leads to active collaboration. This ensures a baseline of success for the captive's balance sheet and an institutional-grade portfolio tailored to specific goals and multi-pronged requirements.

Diversification and asset allocation remain the biggest determination of a captive portfolio's long-term success. Hiding premiums in cash is not risk-free. Inflation costs dearly in the absence of returns. Preserving capital is primary but treasury bonds offer "return-free-risk" if not managed properly. Generating consistent, positive returns and reliable income streams remains important. Rising interest rate fears and aversion to riskier assets will subside if your captive's portfolio is a) managed on an active basis; b) well diversified within each market segment and by prudent exposure to different markets that move independently; and c) structured to harness liquidity when it is needed most.

Captives must anchor their portfolio with bonds, but obtaining an actively managed, diversified bond portfolio is difficult with limited options available. Whether investing through a broker's "wrap programme" or having an adviser or trust department build a portfolio of individual securities, both have pitfalls. No one wants an expensive, generically built portfolio that has no regard for the objectives of the captive and sacrifices liquidity and diversification. Captives should demand institutional quality portfolios that meet their needs with fees lower than those charged to retail investors.

The bond market rewards large, institutional investors (pension funds, etc.). As bonds trade by appointment, transparency is limited and big investors reap higher liquidity and volume transaction discounts. This bias against individual and smaller investors reduces returns and portfolio flexibility. Having to sell small positions into a volatile market when faced with a liquidity event creates permanent impairments on a captive's balance sheet.

The creation of the bond index ETFs (exchange-traded funds) with NAIC 1 ratings (a prerequisite in many states for obtaining the best capital treatment by regulators) is intriguing. However, these ETFs still have drawbacks. They are passively managed, index products built for a wide audience. Even the low fee funds (and many are not) guarantee returns below the index with no captive insurer's objectives or capital preservation in mind.

From Performa's perspective, we feel smaller captive insurers need a better way to invest in an institutional, actively managed setting with a philosophy and investing process that understands the needs of the industry. Captives deserve an equal footing with larger, institutional bond investors to garner the same efficiencies and economies of scale that were previously elusive. The answer is an actively managed, NAIC 1 rated vehicle where regulators will allow a look through to the underlying bonds. That day has come, so get ready to unleash the power of your captive's balance sheet.