The Interview

Guest Q&A With

John J. Gauthier, CFA

Managing Insurance Assets: Lessons Learned By A Former CIO

IAUM: *Why are insurance assets managed differently than other types of assets?*

GAUTHIER: Insurance companies have numerous goals, objectives and constraints that may meaningfully differ from other types of managed assets. These can vary widely even within and across the industry. These goals can depend on, among other things, the company's ownership structure (stock or mutual, private or public), tax jurisdiction, regulatory jurisdiction, rating agency oversight, and products being supported by those assets. And all those unique attributes are IN ADDITION TO the unique risk tolerance, investment philosophy and investment capabilities/ acumen of the company's management team and board of directors.

Most companies care, to some extent, about one of two measures: growth in book value (per share) or annual earnings. While there's likely coincidence in the long run between those two goals above, and a total return strategy of most tax-deferred assets, in the short run they can have very divergent paths.

IAUM: *How might those differences play out in real life? What are some examples?*

GAUTHIER: They are all over the map, from the mundane to the complex. One could be as easy to needing to raise some cash for claims payments at a time you are bullish on the markets. Another could be to manage the company's tax position by selling securities at gains/losses to offset losses or gains from other parts of the portfolio. Another could be tactically increasing or decreasing your investment risk assets to offset changes in the risk position of your liabilities. A company may also decide from a long-term capital management standpoint to decrease exposure to equities in order to return capital to shareholders. All of these could have an impact on the asset management strategy, but might have nothing to do with the outlook for returns.

IAUM: *Those all seem like everyday decisions an insurance company would have to make. Why wouldn't those just be done in the normal course of business?*

GAUTHIER: They would be. But they might be muddied in a couple of ways. First, there needs to be alignment between what the board and senior management has outlined are the goals of the overall business, and the investment strategy. As has been well chronicled, the problem is that a lot of folks in the asset management profession want to be measured by the pre-tax total return versus a benchmark. That can work perfectly if the stars are aligned and the constraints around the benchmark are similar to the constraints around the insurance company portfolio: usually they are not. So a board and senior management team need to be real thoughtful about how to incentive the investment team vis-a-vis the overall goals of the firm.

Second, a lot of insurance company assets have been outsourced to the asset management industry over the last few decades. This has made total sense as the resources available through the asset management industry are available at a much cheaper cost than most insurers could replicate themselves. However, the insurer needs to be totally conscious of the different goals and objectives of the asset manager versus the goals and objectives of the insurers.

IAUM: *But there are lots of excellent asset managers offering customized solutions to the insurance industry.*

GAUTHIER: That is true. And the level of sophistication of asset managers managing insurance assets has grown dramatically over the years. Their capabilities can be a real complement to an insurer's internal capabilities. But you still have the issue of a divergent goals. Every asset manager wants to provide both great returns and great service to their clients, and let's face it, they want to grow assets. When they compete against on another, there are numerous qualitative ways insurers can judge them (the people they meet in the process, their presentation, on-site diligence, client references) but all asset managers like to be able to put their best foot forward QUANTITATIVELY.

IAUM: *Ah, you mean the old composite performance? Versus benchmark?*

GAUTHIER: Right! While every asset manager will accommodate and work with an insurer to meet the insurer's goals, some of that accommodation might actually negatively impact the asset manager. Let's go back to a couple of examples I outlined above. Say an insurer has a large unexpected mid-month claim (or any large cash outflow). The insurer notices that one of it's asset managers has a large cash balance so notifies the manager and withdraws the cash to pay the claim. Everything good right?

IAUM: *The manager has the cash and the company needed the cash so the portfolio supported the insurance operations. Sounds like it worked like it's supposed to.*

GAUTHIER: Maybe. But what if the manager was holding that cash for duration management purposes in order to decrease the portfolio duration (to below benchmark). Let's suppose that the withdrawal caused the duration positioning to go from short of benchmark to long. And let's suppose that rates when up meaningfully after the withdrawal. Now the manager has a negative performance month at a time when they were actually positioned correctly.

IAUM: *But that can always be explained at the next committee or board meeting.*

GAUTHIER: It can, and it can be footnoted on all future reports. But having sat on both sides of the table at those meetings for the last 30 years, I think it's clear that many things can happen: Depending on the relationship between the asset manager and the insurance CIO, the asset manager may denote the "non-discretionary" aspect of the performance. But now you have a negative performance period, and a year from now no one will remember the "non-discretionary" reason why the asset manager underperformed, but that they did actually underperform. And if the asset manager finds itself having the wrong portfolio positioning for a period or two, the investment committee could end up questioning the continued utilization of that asset manager given "performance reasons".

More broadly, the asset manager might have a negative performance portfolio in their composite portfolio (which might hurt their future fundraising, and ultimately ability to re-invest in the business).

So while the asset manager provided a service to the insurer (having cash available when necessary) it actually could tarnish the asset manager, both at the client, and more broadly, even if only a little.

IAUM: *Are there more optimal ways of meeting both the insurers and the asset manager's goals?*

GAUTHIER: Yes, and we'll explore those in our next session.

About Our Guest

John J. Gauthier, CFA served as Executive Vice President and Chief Investment Officer of Allied World Assurance Company, Ltd. from 2010 until his retirement in 2017. From 2008 to 2010 he served as Senior Vice President and Chief Investment Officer. Additionally from 2012 - 2017 he served as President of Allied World Financial Services, a subsidiary of Allied World. During his tenure as Chief Investment Officer, Mr. Gauthier was responsible for all aspects of Allied's $9 billion investment portfolio, including strategic and tactical shifts, risk management, and external manager oversight. Additionally, as President of Allied World Financial Services, Mr. Gauthier oversaw the purchase of minority interests in, and development of strategic relationships with, six strategic partners.

In addition to his investment-related responsibilities, Mr. Gauthier was a key participant in Allied's 10-person Senior Leadership Team responsible for strategic and operational decisions of the company and held several senior management committee assignments, including Risk Management, Capital Management and Treasury, Public Disclosures, Loss Reserves and Investor Relations. Mr. Gauthier was a frequent spokesperson for the company participating in earnings calls, shareholder meetings, and rating agency presentations.

Prior to his role at Allied World, Mr. Gauthier was a Managing Director at Goldman Sachs Asset Management, where he was responsible for the development of the insurance fixed income asset management business. Prior to his time at Goldman Sachs, Mr. Gauthier was a Managing Director at Conning Asset Management, where he oversaw the property-casualty asset management practice.

Mr. Gauthier has spent almost 30 years at the intersection of the insurance and asset management businesses. He has been a frequent speaker at industry conferences and has represented companies in front of regulators, rating agencies, stock analysts, and shareholders. He has also authored several articles in various insurance and risk management publications.

In addition to his successful professional career, Mr. Gauthier sits on the board of Middlesex Hospital and the Shuttle Meadow Country Club. He received a Bachelor of Science from Quinnipiac University and an MBA from the Wharton School at the University of Pennsylvania. He is a Chartered Financial Analyst. He and his wife, Anne, have two grown children and currently split their time between homes in Middletown, CT and Charlotte, NC.