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AFM investment survey 2022. Increasing interest in investments?

Overview

The gradual economic and market recovery from the Covid pandemic was never going to be straightforward – the effects of a combination of significant central bank stimulus and government support through wider fiscal support mechanisms such as furlough schemes were always going to be difficult.

However, no one could have reasonably predicted the significant changes in geopolitical and economic conditions that we have seen over the past year, with material increases in actual and expected inflation levels and interest rates, and elevated market volatility. Given the interlinkage between interest rates, inflation and valuations of riskier assets such as equities, this environment has impacted returns on all investments. AFM (Association of Financial Mutuals) members have not been immune from this.

In addition to the market-related risks, many AFM members are also paying close attention to the wider regulatory environment. There is now even more uncertainty around the eventual direction of the insurance regulations given the UK government's recent announcement that it will be scrapping the Solvency II rules, although we expect that this will still look to adopt a Solvency II type framework. Wider stakeholder demand is also requiring many investors including insurers to upgrade their sustainability and climate risk approaches.

Given these three drivers, we believe now is a highly challenging time for AFM members to be setting, reviewing and implementing an investment policy. Recognising this, we feel that benchmarking around how AFM members in aggregate are considering their investment approaches provides valuable information to aid more informed and robust investment policies for members.

To facilitate this information sharing within the sector, we issued an AFM focused Investment Survey to members in September 2022. The survey focused on the following areas that are integral to the investment approach:

Area		Considerations
A	Investment objectives	• Relative importance of investment returns for business • How investment risk is measured • Plans for changing risk level • Impact of likely changes in insurance regulations • Influence of mutuality on objectives
B	Investment markets / economy	• Expected changes in equity markets, interest rates and price inflation • Key macroeconomic risks • Key risks for investment portfolios
C	Asset strategy	• Expected changes in asset allocation • Impact of capital requirements • Asset-Liability Matching approach
D	Governance	• Governance structure (Investment Committee, use of external support) • Any constraints from governance on investment approach
E	Implementation	• Balance between active and passive management • Asset manager structure and desired characteristics • Use of Tactical Asset Allocation
F	Sustainability and ESG	• Importance of ESG (Environmental, Social & Governance) factors • Implementation of ESG policy • Influence of mutuality on ESG policy

In total, there were 20 responses to the survey. The results were highly interesting and informative in many areas and are summarised in the following sections.

Survey results

A Investment objectives

For any business there will be some combination of strategic risks that are being taken with the expectation that the model can deliver value for stakeholders from these risks. For AFM members, this will normally be some combination of investment and insurance (life, non-life or health) related risks.

The vast majority of respondents to the survey (95%) viewed investment risk taking – via higher investment returns – to be either moderately or highly important for the overall business model. As such, we expect that there will be appropriate management focus on ensuring that the right level of investment risk is being taken, and that the returns from this are being maximised subject to constraints such as governance.

One respondent noted that ***"Whilst underwriting is a key focus, our investment returns fund our charitable giving, which is embedded into our business model"*** – linking higher investment returns to ESG (mainly social) criteria in addition to supporting wider objectives.

Survey participants on average were content with the current level of investment risk being taken, with over two thirds looking to retain this. Of the remainder, this was split equally between those looking to increase and decrease risk levels. Given the inherent economic and market uncertainty at the current time we expect that many AFM members may be nervous about fundamentally changing risk levels.

The majority of respondents have set targets around the investment risk level and the return objective. However, there was no clear consensus around how these are defined. For investment risk, just over half of respondents measured this by the Solvency II SCR (Solvency Capital Requirement) (noting that for

Chart 1 – How important are high or superior investment returns for your overall business model?

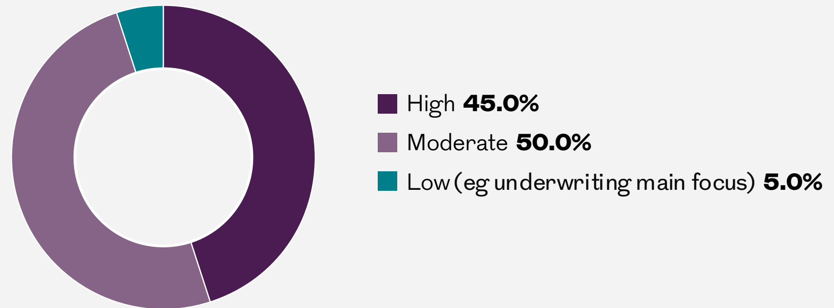


Chart 2 – Are you planning to increase, maintain, or decrease the overall risk in your investment portfolio in the next 12 months?

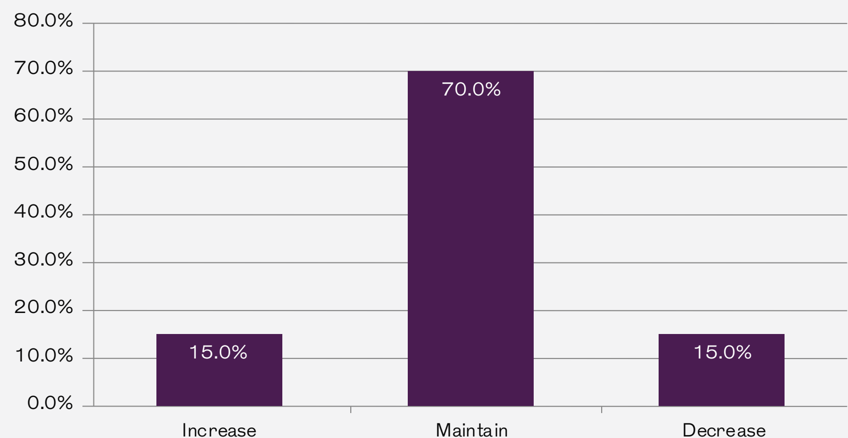
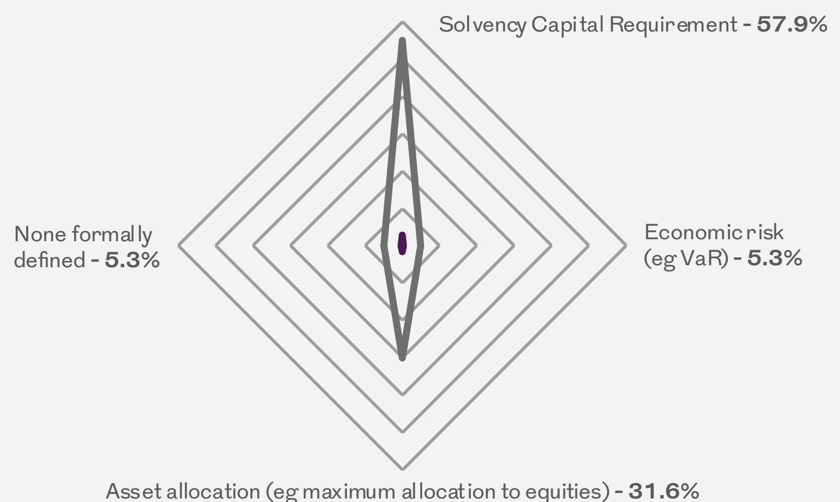


Chart 3 – What is the main metric for defining the amount of investment risk you take?



Source: RLAM for illustrative purposes only.

some AFM members this is not relevant due to their regulatory status) with most others measuring this through asset allocation ranges and limits. One respondent mentioned that they ***"use a risk scoring metric that defines a low/medium risk profile within the portfolio"***.

Similarly for the return target there was even less consensus with around a third measuring this as a nominal objective (eg X%) and another third as an outperformance target over a market benchmark. One respondent mentioned that they had differing objectives between sub-portfolios ***"It depends on the portfolios, but usually nominal. We also have a significant portfolio invested with an inflation plus target"***.

There is no one right approach for setting these measures, but what is important is that there is a robust approach to setting the metrics (including consistency with the overall business objectives – for instance if targeting a certain Solvency ratio or Asset-Liability matching approach), that these are monitored regularly, and with appropriate actions taken if experience diverges materially from expectations.

In addition to business specific criteria that will impact on the level of investment risk and objectives and metrics around this, there will be various external drivers influencing these. For the survey, we asked around the impact of two drivers – insurance regulations and AFM members' mutual status.

The majority of respondents felt that upcoming insurance regulatory changes would have no material impact on their investment approaches – likely either through the expected changes being focused more on the larger annuity writers, or some participants not being directly impacted by these changes due to their regulatory status. Of those who did believe there would be a material influence, most were expecting this to be positive (likely due to a reduction in the operational burden through easements or through an improved solvency position). One respondent noted that they were ***"hoping that there may be a slightly more relaxed approach to regulatory and legal constraints moving forward"***.

Most survey participants – just under two thirds – felt that their mutual status did impact on their investment approach.

There were various supporting comments provided including that the ***"Business model could only operate as a mutual"***, that being a mutual meant they were ***"very conscious of the need to preserve capital"*** and with another saying this facilitated the ability to ***"take a long-term view"***.

Chart 4 – How do you define the return target for your portfolio?

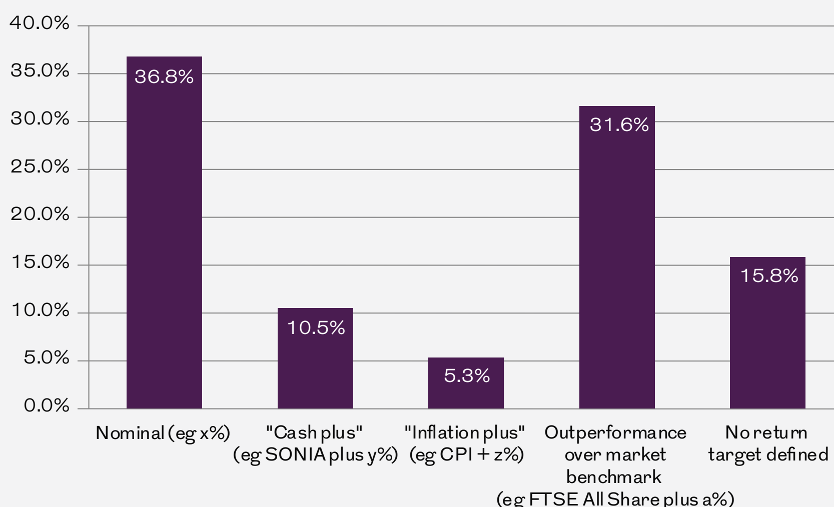


Chart 5 – How are you expecting changes in the regulatory environment (eg Solvency II) to impact on your investment approach?

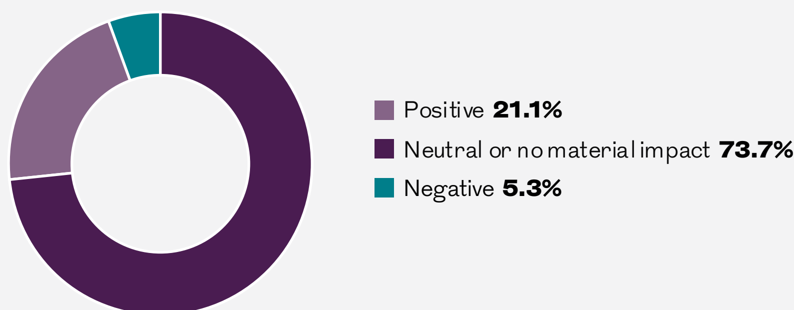
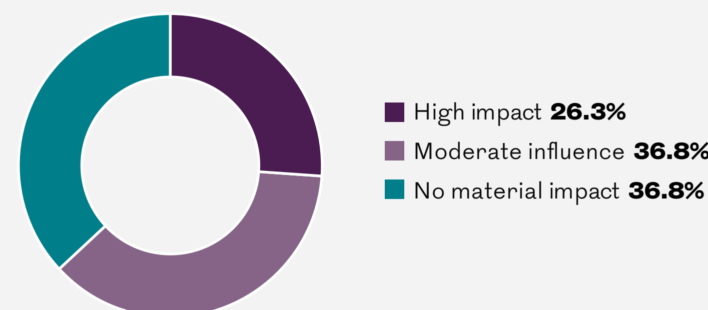


Chart 6 – How much impact does being a mutual make on your investment approach?



Source: RLAM for illustrative purposes only.

B Investment markets / economy

Economies and investment markets have been subject to significant change, volatility and uncertainty over the course of 2022 driven by the ongoing repercussions of the Covid crisis (and the management of monetary and fiscal stimulus used) and the ongoing conflict in Ukraine. These have resulted in significantly higher inflation levels emerging – at levels not seen for 40 years – and major interest rate hikes globally as governments and central banks react, as well as ongoing falls and volatility in risk assets.

When asked for views on future price inflation levels and interest rates, most respondents were expecting more of the same. Over two-thirds felt that UK inflation (CPI) levels in three years' time would be 3% pa or more – well above the Bank of England's 2% target. In addition, the vast majority of respondents were expecting further interest rate rises – with over 90% expecting a 3% rate or higher in a year's time, and over 40% expecting a rate of 4.5% or higher.

Survey participants were also generally bearish on (UK) equities, with three quarters expecting a fall in the level of the FTSE 100 from the start of September levels to the end of 2022.

Higher inflation was viewed as both the key macroeconomic risk and the main challenge for AFM members' investment portfolios over the next year. The second macro risk that caused most concern was of a global recession (one third of respondents) – with this risk being exacerbated by the increased interest rate environment being adopted to manage higher levels of inflation. Consistent with this interlinkage between risks, some supporting comments were provided including ***"It is very hard to differentiate the impact of one issue from another at the moment"*** and ***"hard to choose given they all apply!"***

Chart 7 – Where do you expect UK price inflation (CPI) to be in 3 years time?

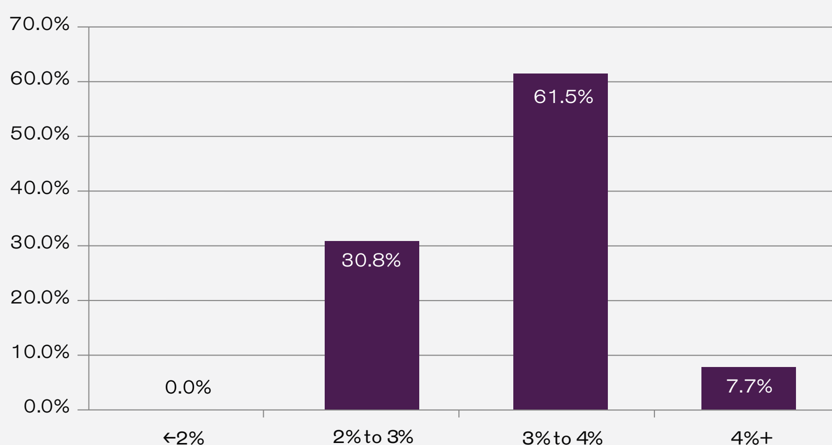


Chart 8 – Where do you expect UK base rates to be in 12 months time?

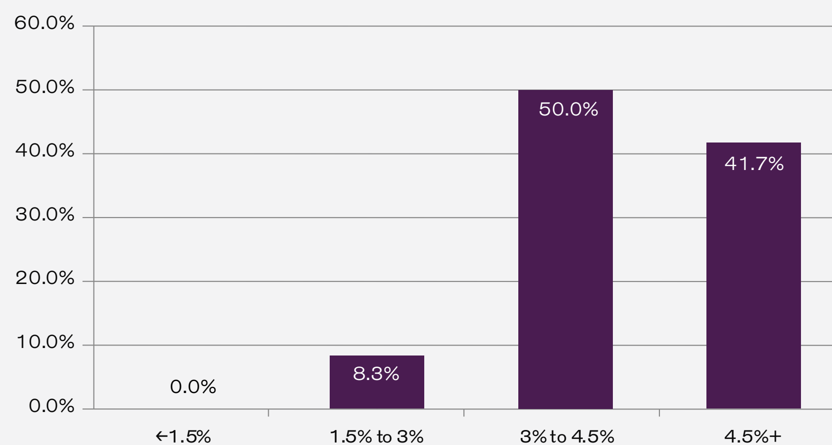
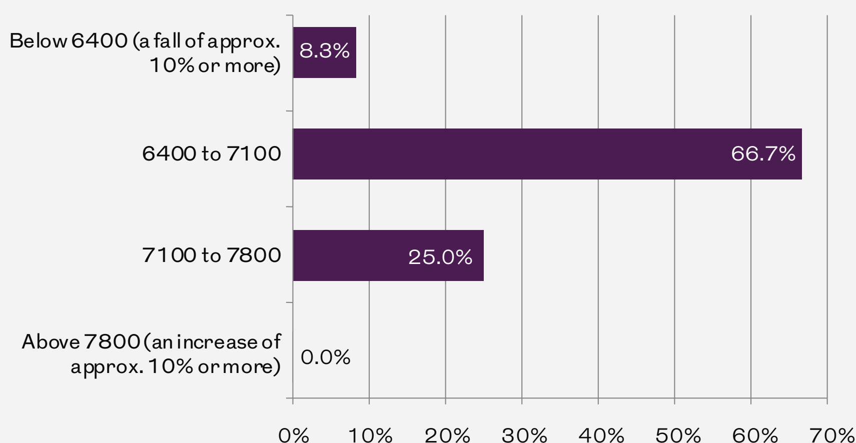


Chart 9 – Where do you expect the FTSE 100 will be at year end 2022 (7,148 as at 1 September 2022)?



Source: RLAM for illustrative purposes only.

There is general acknowledgement that inflation risk presented material challenges for AFM members (this will typically impact on other areas of businesses as well as investments such as underwriting and expenses). However, it will be interesting to see how members look to manage this risk. On the investment side there are various options available including inflation-linked bonds, certain infrastructure and property assets, and inflation derivatives. However, each of these presents certain challenges included around current pricing, governance requirements and increased operational burdens.

Chart 10 – What is the key macroeconomic or geopolitical risk that could impact on markets over the next 12 months?

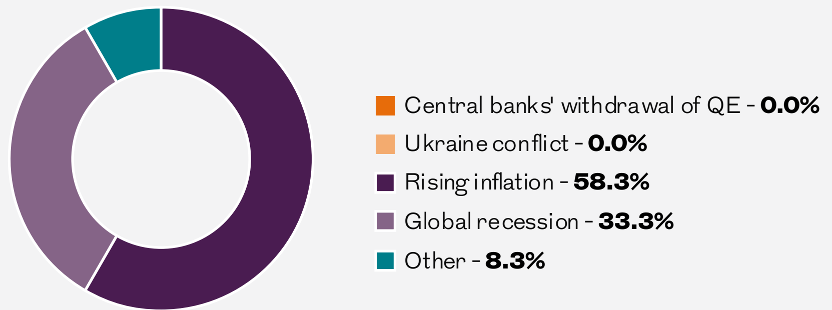
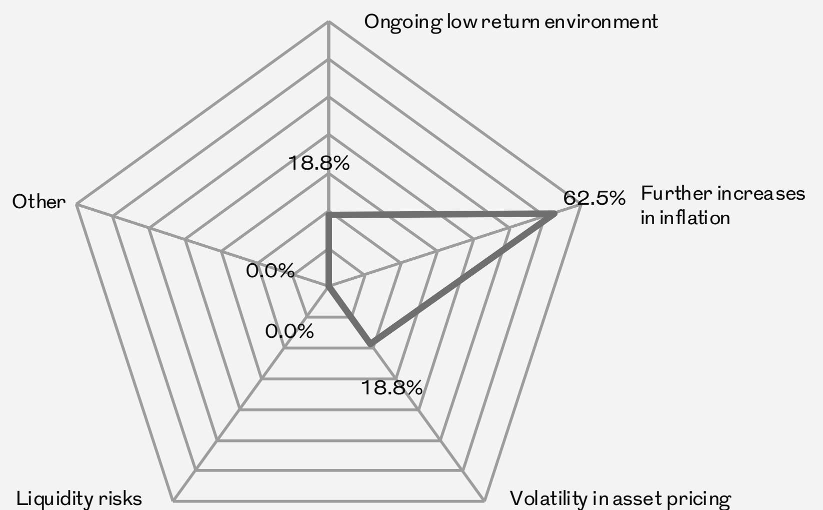
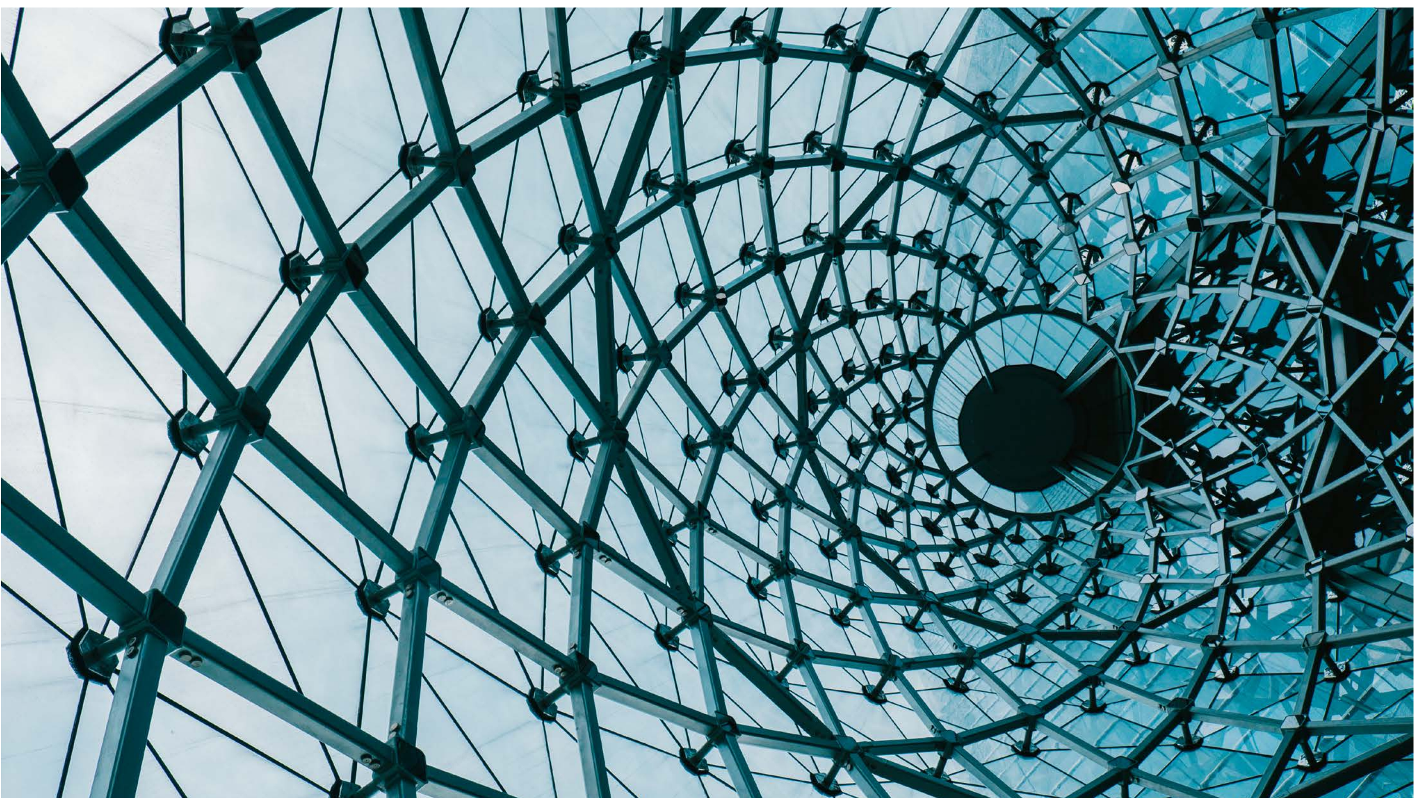


Chart 11 – What is the key challenge for your investments over the next 12 months?



Source: RLAM for illustrative purposes only.



C Asset strategy

Given the fundamental changes in market conditions over the course of 2022 – in particular with materially higher interest rate and inflation levels and expectations now having emerged – a key consideration for AFM members is the extent to which the current asset allocation remains fit for purpose.

Just over half of the survey participants indicated that they were planning to change their asset allocations over the next year. Of these, the majority were expecting to introduce new asset classes (rather than just changing the balance between existing assets) with a preference for using more liquid and listed assets, but with some respondents indicating expected investment into private markets and absolute return type investments.

Whilst these new asset classes have the potential to increase investment efficiency (expected return per unit of risk) they are likely to increase the operational and governance burden, and also potentially investment management costs. For many AFM members, there will also be the requirement to ensure that the investment approach remains aligned with the Prudent Person Principle. Given the size of investment portfolios for many AFM members there therefore needs to be an appropriate balance between the potential efficiency of the investments against any investment constraints that may exist.

For many AFM members, the investment approach is not just about maximising returns subject to an acceptable level of risk, but there also needs to be awareness of the impact of investments on the Solvency position (immediate impact through the SCR and longer term through ongoing volatility in the balance sheet position) and the potential need to structure at least part of the assets to match the liabilities.

Chart 12 – How are you intending to change your asset allocation over 2022 / 2023?

Chart 13 – Which asset class are you looking to increase your allocation to most over the next 12 months (including new allocations)?

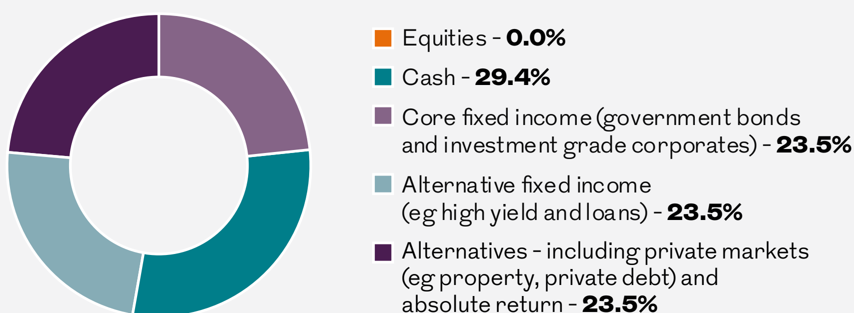
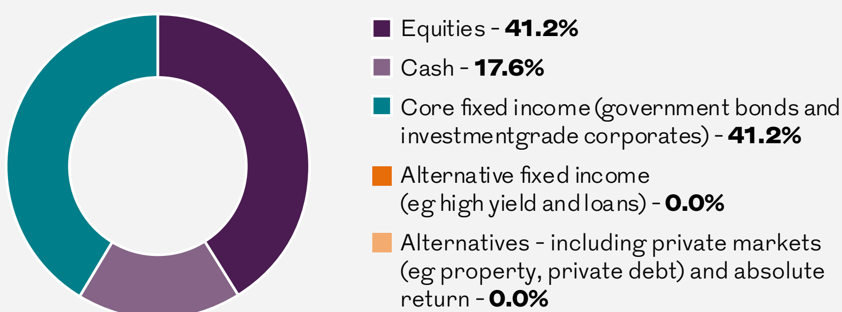


Chart 14 – Which asset class are you looking to decrease your allocation to most over the next 12 months (including removing entirely)?



Source: RLAM for illustrative purposes only.

Just under two-thirds of respondents felt that the SCR was either moderately or highly important for the investment approach (for some of the remaining one third we expect that the Solvency Capital Requirement will not apply). This introduces another dimension when setting the investments — the capital consumption and capital efficiency of different investments, which may differ from the economic risk and returns.

For the matching approach (specifically the liability exposure to changes in interest rate and inflation expectations), just over two-thirds viewed this as having either a moderate or high level of focus. Given the significant volatility seen recently in interest rates, bond yields and inflation levels, we expect that for many AFM members — particularly with longer duration liabilities — Asset-Liability Management is seen as being even more important currently.

Chart 15 — How important is the Solvency II Solvency Capital Requirement (SCR) for investment decisions?

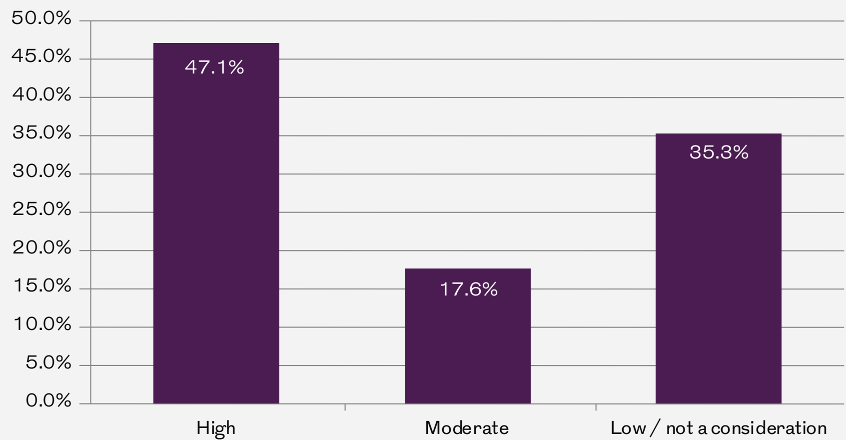
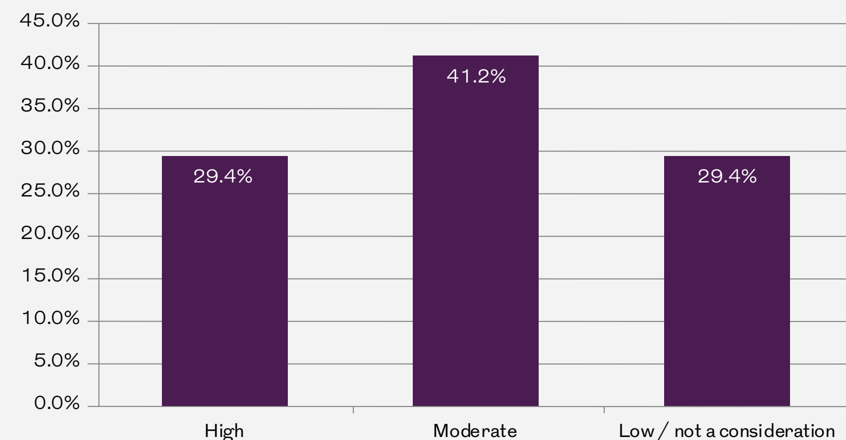


Chart 16 — How much focus is there on matching the assets to the profile of the liabilities (eg maturity, inflation, cashflow profile)?



Source: RLAM for illustrative purposes only.

D Governance

For any investor, there needs to be compatibility between the overall sophistication of the asset strategy and the available governance and operational oversight available. This can include the knowledge and experience of senior management and non-executive directors responsible for investment oversight as well as the ability to identify key risks in the investments and monitor and manage these over time. For regulated insurers, this requirement is formalised via the Prudent Person Principle.

Just over half of the survey participants stated that the available investment governance did place some restrictions on the investment strategy that could be adopted, although for the majority the impact of this was felt to be limited. For the other participants who said there were no restrictions, this could be because either there was no intention to invest in more complicated and less transparent assets, or due to there being a deliberately strong oversight framework in place for a more involved asset strategy.

Many investors including insurers have been increasingly looking at more complex asset classes such as private markets, absolute return and alternative listed credit. Such assets may offer an enhanced risk / return profile, but the policy needs to be consistent with the available or potential governance budget (as well as increased illiquidity, costs and monitoring) that needs to be balanced against this.

Over two-thirds of the respondents indicated that they did have a dedicated Investment Committee (or other dedicated body for oversight of investments). Of those that did have such a committee, the most common meeting frequency was either quarterly or three times a year, although these meetings were more frequent for around one fifth of respondents.

Chart 17 – Does your available investment governance (skills, knowledge, reporting etc) place constraints on your investment strategy and implementation?

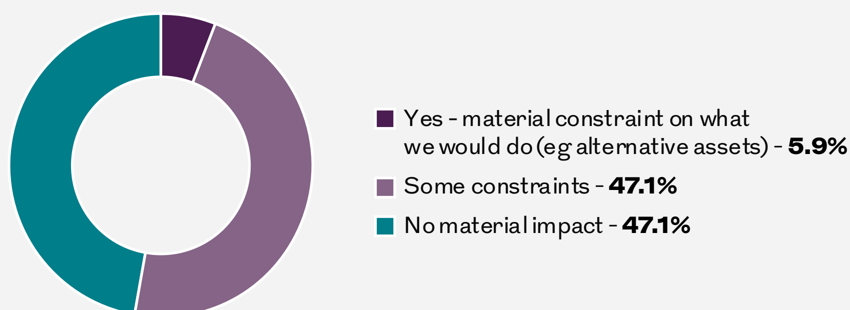
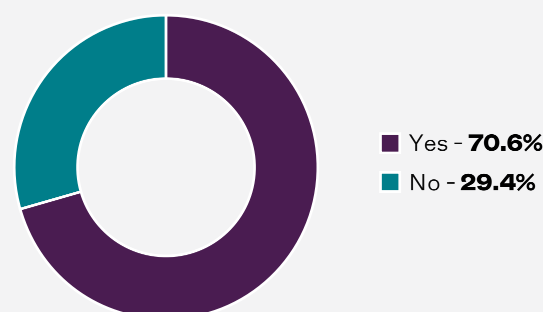


Chart 18 – Do you have a dedicated Investment Committee (or other dedicated body for oversight of investments)?



Source: RLAM for illustrative purposes only.

Chart 19 – How many meetings would this committee typically have over a 12 month period?

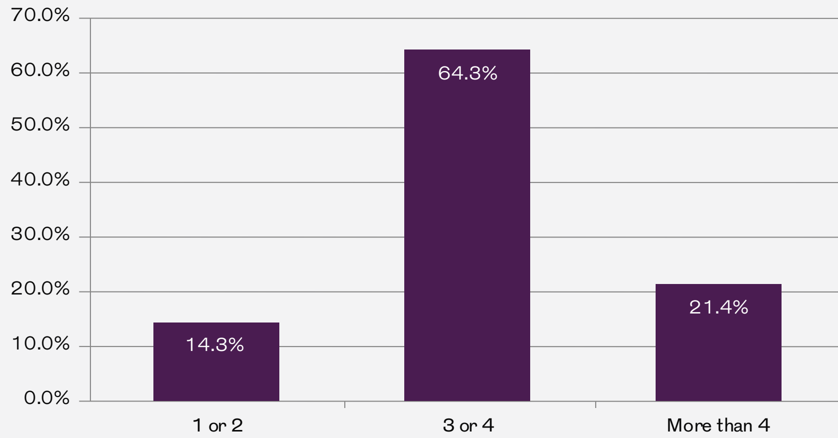
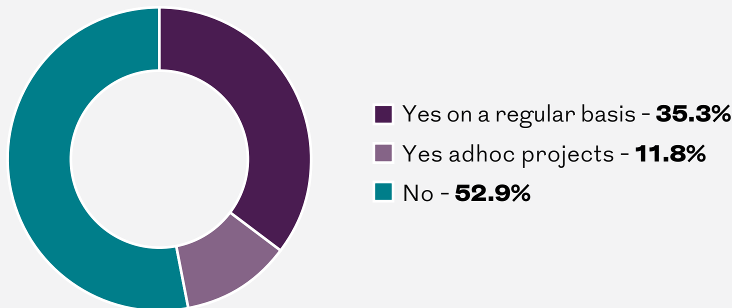
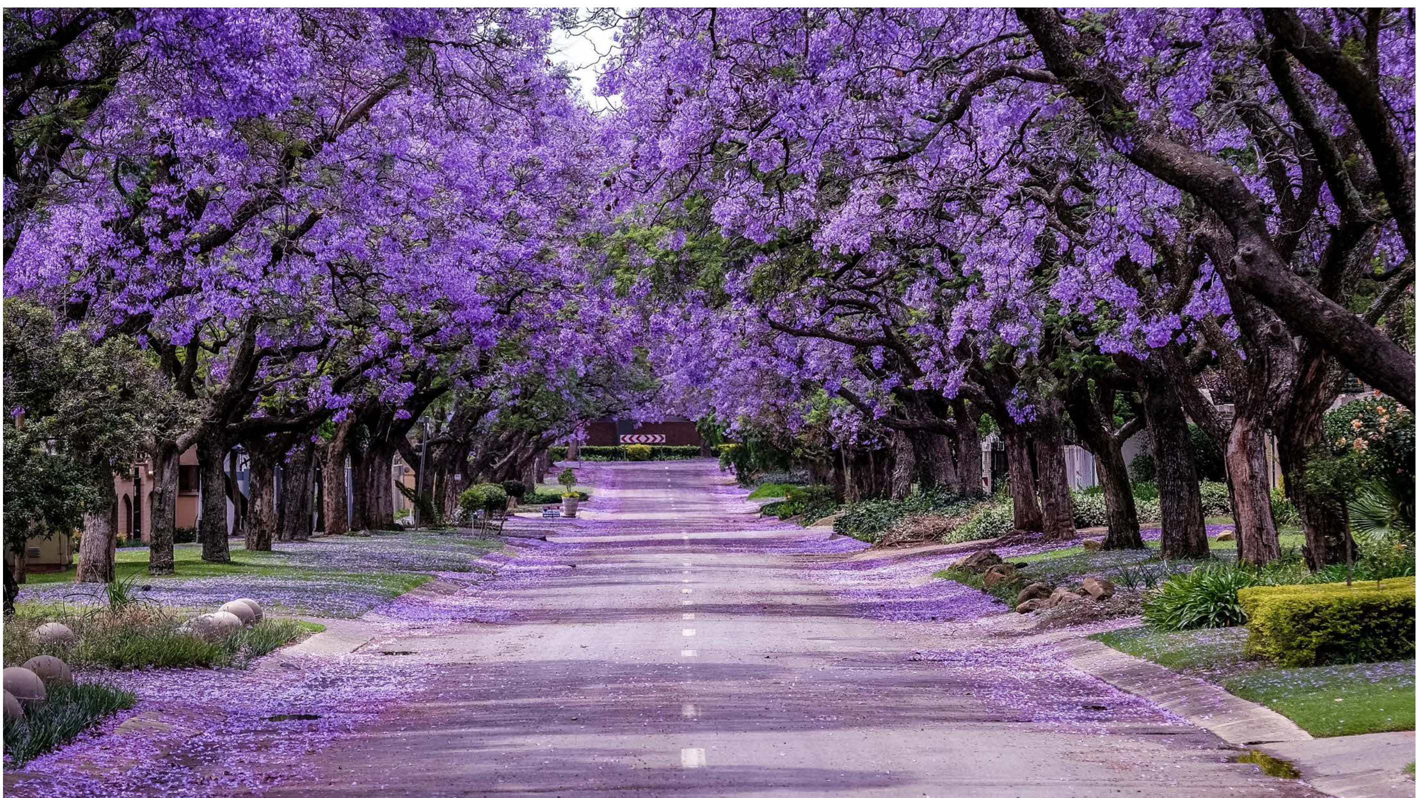


Chart 20 – Do you use investment consultants to support your investment decisions?



Source: RLAM for illustrative purposes only.

Just under half of the survey participants use investment consultants – either as part of a regular engagement or for ad hoc projects. Such consultants can provide additional support to enhance the governance budget, although this needs to be balanced against the additional costs.



E Implementation

The majority of the survey participants (over two-thirds) implemented their investments exclusively via funds rather than segregated accounts. Of the remainder, most used a blend of funds and separate accounts, with just over 10% of respondents saying investments were implemented only via segregated accounts. There are pros and cons to either approach – for example funds typically offer improved diversification and liquidity benefits (especially for smaller mandates) whilst separate accounts can offer more customisation.

The next areas considered were around active management – both in the context of the underlying asset managers looking to add value through taking security and sector positions relative to market benchmarks, and by managing the allocation between different asset classes to exploit market mispricing (Tactical Asset Allocation).

The survey results revealed a strong belief in the benefits of using active asset managers, with all responses stating that these represented at least part of the implementation approach, with just over three quarters using active managers for all assets. Whilst active managers would tend to charge higher fees than passive equivalents and require increased oversight, there appeared to be the belief that the net return potential was still superior to passive solutions.

The beliefs around the value of Tactical Asset Allocation appeared much less strong however with the majority preferring a longer term asset allocation approach. For those that did operate a very dynamic approach in this area (around one-third of respondents) we expect that the decisions and implementation would be largely outsourced to underlying asset managers.

Chart 21 – Do you implement your investment policy using funds or segregated accounts?

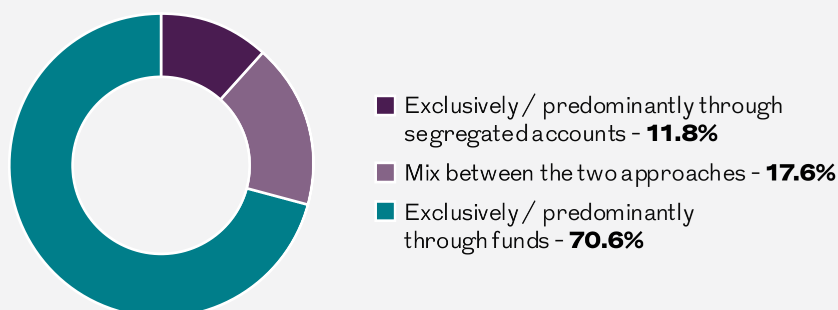


Chart 22 – What is your balance between passive (tracking an index) and active management?

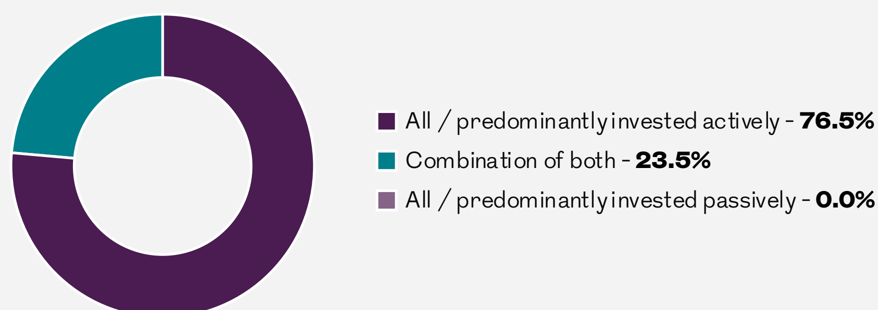
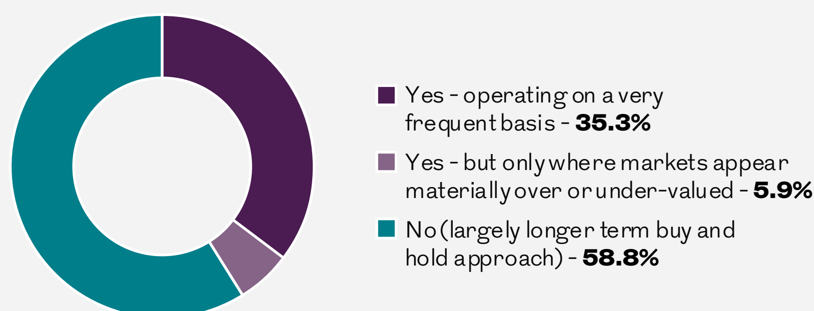


Chart 23 – Do you operate a Tactical Asset Allocation framework?



Source: RLAM for illustrative purposes only.

Most of the respondents (nearly two-thirds) used only one asset manager to implement their portfolio with a quarter using more than three managers. We expect that the use of one manager is justified either from the perspective of simplicity (eg single reporting provider), reducing costs and through the consideration of an asset manager as a strategic partner via an outsourced CIO type relationship. The use of more managers can be beneficial to improve active diversification and using managers only where they have specialist capabilities in an asset class.

The most important factor participants looked for from an investment manager were a strong track record (just under half) and asset class expertise (just over a third). Consistent with the use of active managers referred to above, lower costs were not generally raised as a key driver. Some respondents were looking for more specific insurance awareness from their managers, with one noting that ***"Matching capabilities / understanding of liabilities"*** was an important factor.

Chart 24 – How many different asset managers do you use to implement your investments?

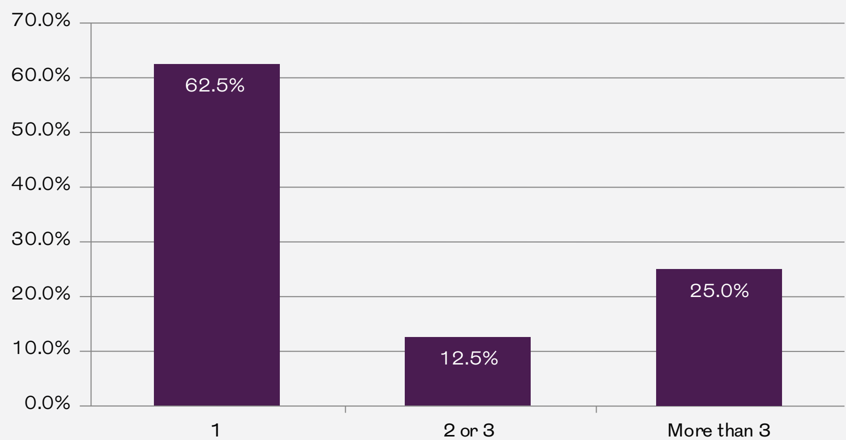
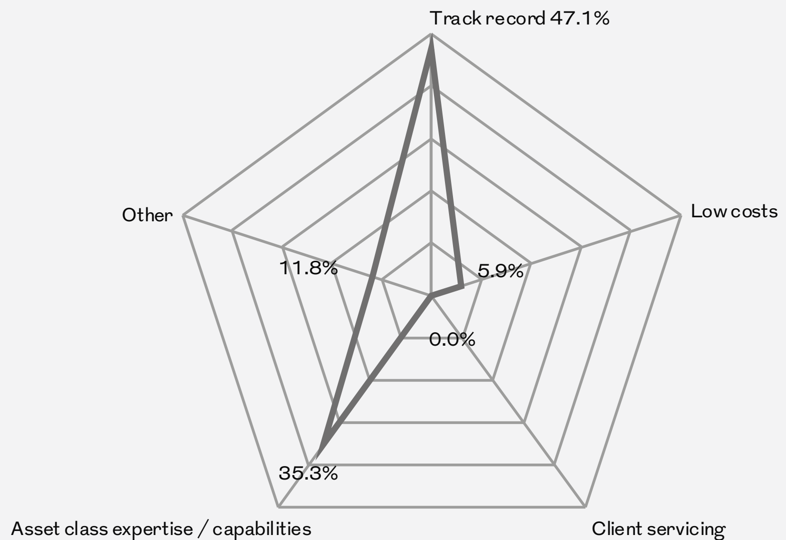


Chart 25 – What is your most important consideration for selecting a manager?



Source: RLAM for illustrative purposes only.

F Sustainability and ESG

Chart 26 – Where are you on your ESG investing journey?

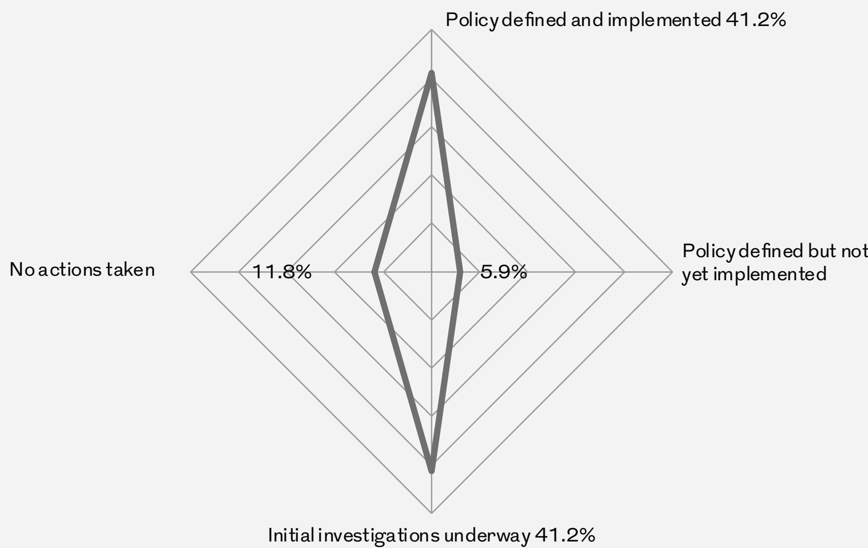
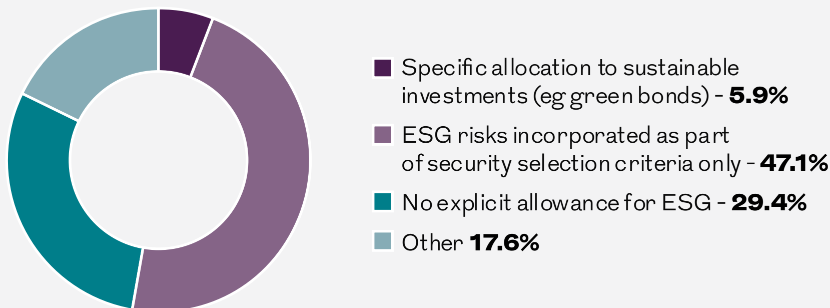
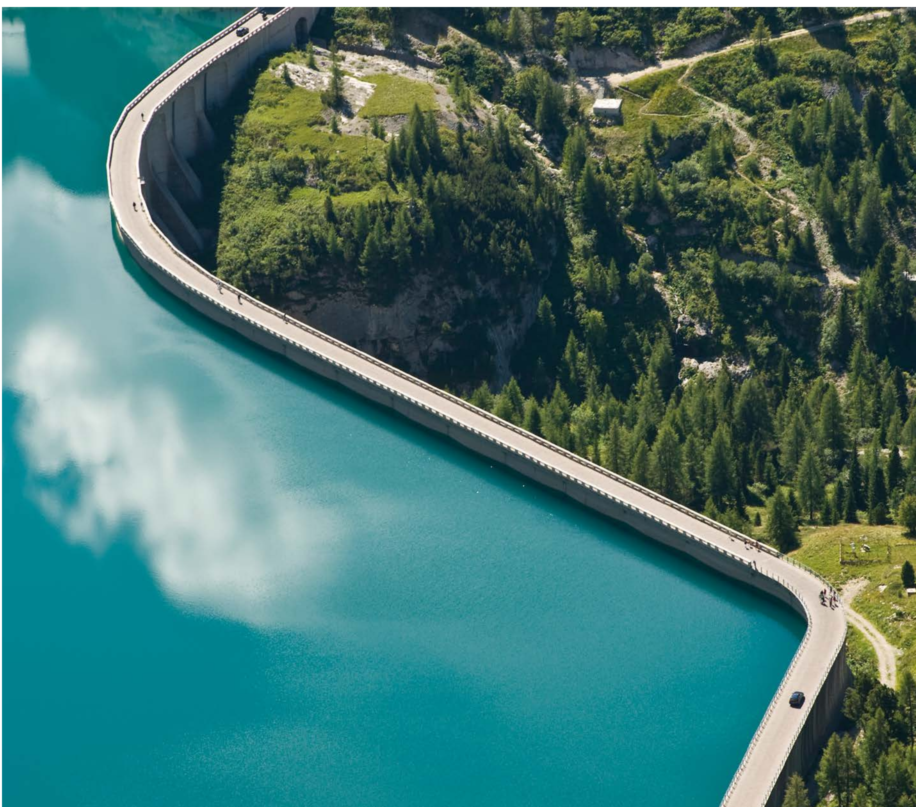


Chart 27 – How are you looking to implement ESG within your investments?



Source: RLAM for illustrative purposes only.



ESG and sustainable investing – particularly around climate risks – have received much prominence recently with materially increased demand and expectations from stakeholders including regulators that the associated risks should be identified, measured, monitored and managed.

The majority of survey participants (just under 90%) have at least started the journey in defining an ESG policy for their investments, although for over half of these the policy has not yet been implemented. Even where this has been implemented there was recognition that this was only the initial step with a comment stating that they were ***"satisfied we are meeting the regulators' expectations but more work to do"***.

Where ESG considerations were being allowed for in the investment portfolio, responses indicated that this tended to be more around incorporating ESG risks as part of asset managers' security selection framework rather than having more specific allocations to dedicated ESG assets such as green bonds.

The most prevalent ESG risk being integrated was climate risk (all responses where ESG was being allowed for) with corporate governance, diversity and inclusion and social impact also being recognised by most. Just under half of respondents stated that support for local communities was a feature of their investment approaches, likely supported by their mutual status.

As we would expect, there was an apparent strong reliance from members on their asset managers to integrate ESG risks in the investments. Various comments were provided such as they ***"Rely on our manager"***, that ESG capabilities were ***"very much a consideration in choosing our manager"*** and that they ***"conform with the ESG policy of our asset managers"***.

An important factor for investors when deciding on their ESG approach is the underlying beliefs of key stakeholders (eg Board, Executive Committee, members) around ESG and sustainability. Ideally these should be understood at the start of the process so the ESG policy can then be implemented consistently.

In terms of beliefs, we asked around two areas: First, any perceived trade-off between ESG and financial returns and second, whether being a mutual influenced the ESG approach.

On the first point, more than three-quarters of respondents felt that financial returns were more important than ESG criteria, with none stating that financial returns should be subordinate (which would be more consistent with impact investing). In our view, it is possible to integrate ESG criteria and preserve financial returns but the implementation of this is critical to avoid issues such as greenwashing and poor or misleading data.

On the compatibility between mutuality and ESG investing, most respondents (nearly two-thirds) stated that being a mutual meant that ESG investing was more important to some extent (either moderately or highly). The remaining third thought it made no material difference. A supporting comment stated that the link between ESG and mutuality ***"has the potential to be very strong, but we also need to be clear that we are not increasing risk to our members"***.

Chart 28 – Which aspects of ESG do you take account of in your investment portfolio?

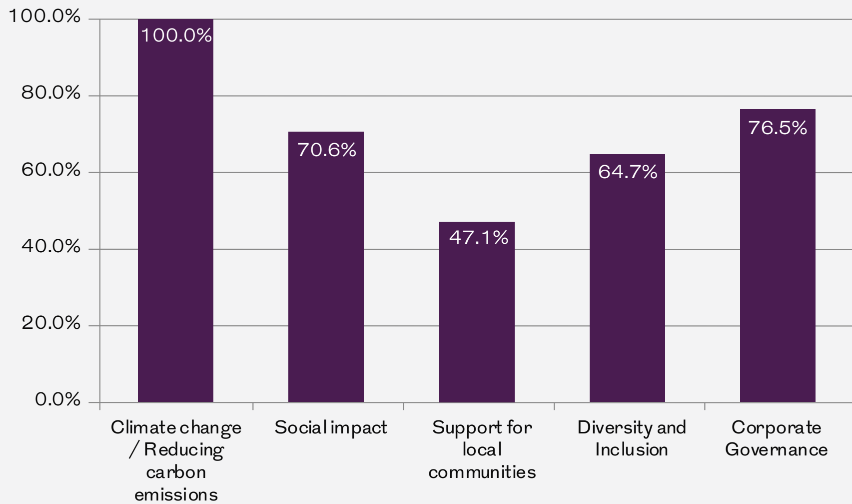
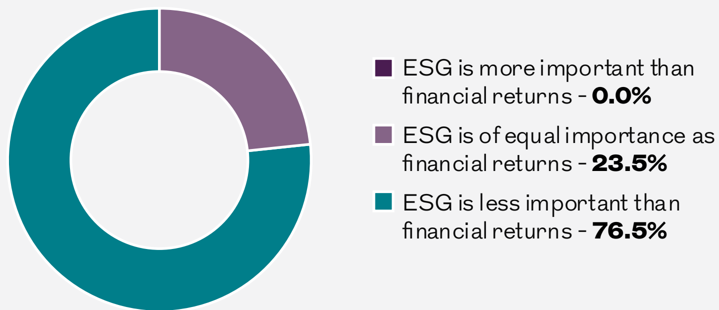
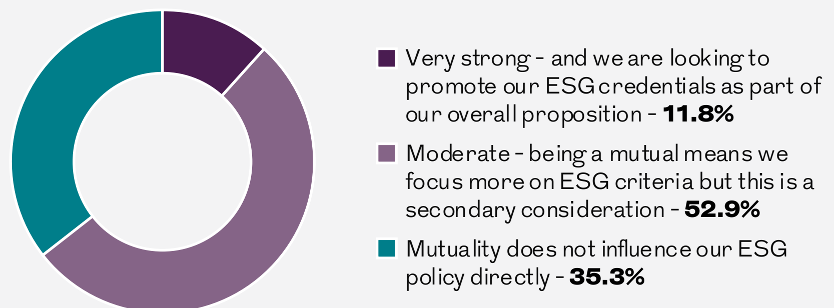


Chart 29 – Which statement best describes your view on any trade-off between ESG and financial returns?



- ESG is more important than financial returns - **0.0%**
- ESG is of equal importance as financial returns - **23.5%**
- ESG is less important than financial returns - **76.5%**

Chart 30 – How would you best describe your view on the compatibility between mutuality and ESG investing?



- Very strong - and we are looking to promote our ESG credentials as part of our overall proposition - **11.8%**
- Moderate - being a mutual means we focus more on ESG criteria but this is a secondary consideration - **52.9%**
- Mutuality does not influence our ESG policy directly - **35.3%**

Source: RLAM for illustrative purposes only.

Doing the right thing?

There is no one right approach that AFM members should be taking to react to the highly challenging business, economic, market and regulatory environment that has emerged over the past year – particularly with regard to inflation risks. However, what is important is that each member should have undertaken an appropriately robust approach to review the ongoing suitability of the investments, even if this results in no change. The vast majority of survey respondents felt that investment returns were highly or moderately important for their overall business objectives indicating the benefits of getting the investments 'right'.

According to our survey, over half of the respondents were looking to make some changes to their asset allocation over the next 12 months, be it introducing new asset classes or changing the balance between existing ones. As part of this, the majority of respondents will be further building out their ESG approaches, with most believing that being a mutual makes this even more important than for other investors.

It will be interesting to see how strategies do change in practice, and how these help AFM members navigate the uncertain and volatile environment we continue to face.

The value of investments and the income from them may go down as well as up and is not guaranteed. Investors may not get back the amount invested.

For Professional Clients only, not suitable for Retail Clients.

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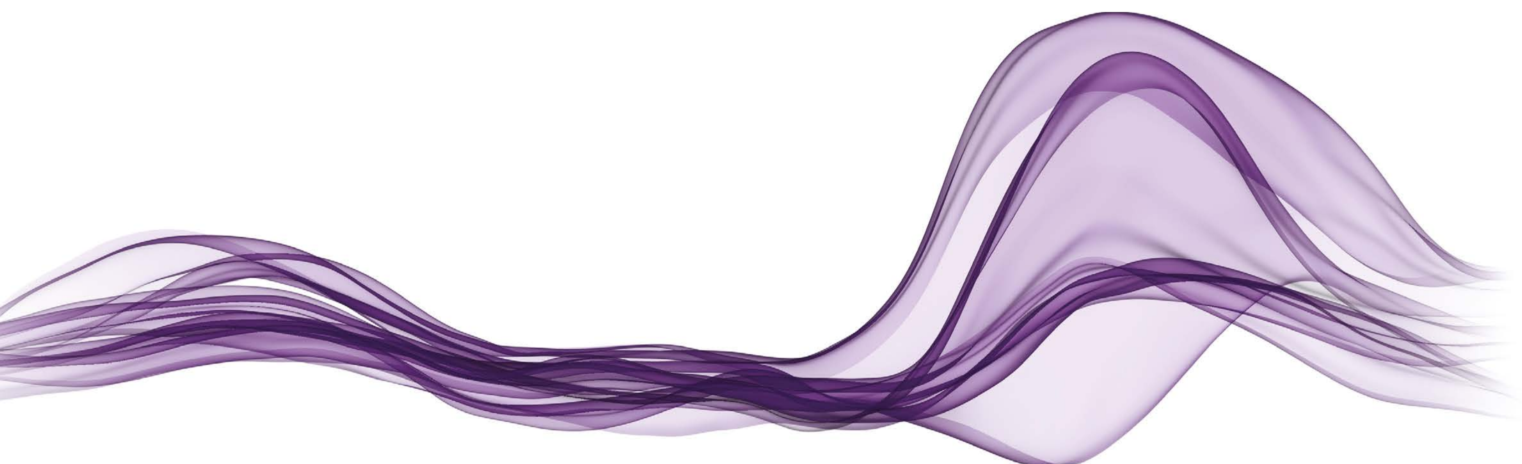

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