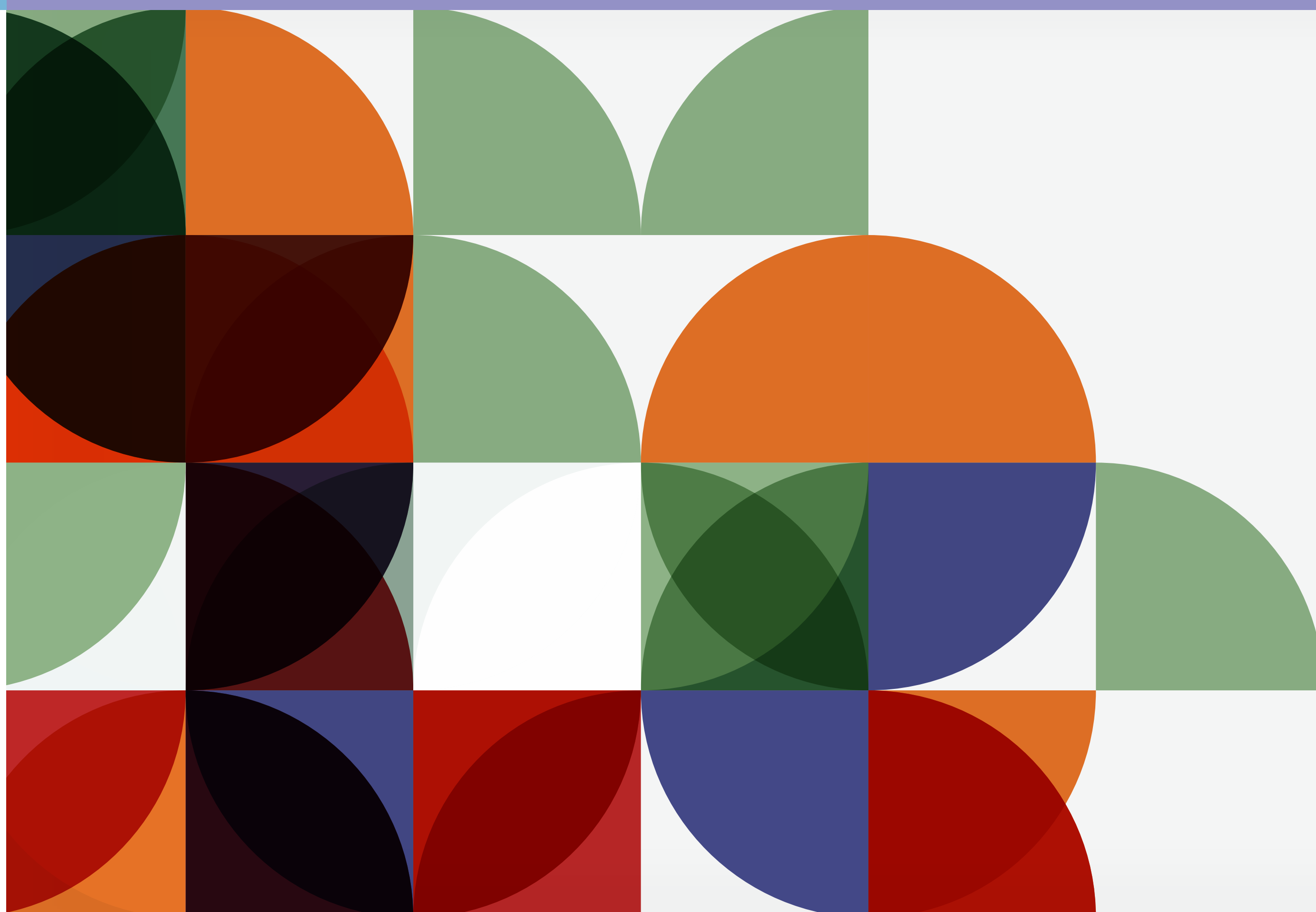
Q2 2019

Exchange-Traded Funds in General Accounts

A Look at How Life, P&C and Other Insurers are Using ETFs



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CONTENTS

3 Executive Summary

4 Introduction

7 Insurance Company ETF Investing: Life vs. P&C

8 Future Projections: More Users, Bigger Allocations

10 A "Systematic" Tailwind for Bond ETFs

12 Factor-Based Boom Builds ETF Demand

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INSURANCE COMPANIES ARE OPENING THEIR GENERAL ACCOUNTS TO A WIDER RANGE OF INVESTMENT STRATEGIES AND VEHICLES, AND THAT DIVERSIFICATION PUSH IS FUELING AN INCREASE IN THE USE OF ETFs

APPROXIMATELY 70% OF U.S. INSURANCE COMPANIES NOW INVEST IN ETFs IN THEIR GENERAL ACCOUNTS

Executive Summary

Exchange-traded funds are becoming standard investment tools for insurance companies, but for the moment, life insurers and property and casualty (P&C) companies are employing ETFs in different ways and for different purposes. Approximately 70% of U.S. insurance companies now invest in ETFs in their general accounts. Multiline and P&C companies are the biggest users, with 90% and 80% of study participants investing respectively, compared with 47% of life companies.

Life insurance companies are adopting ETFs first and foremost as a means to address short-term liquidity and cash management in fixed-income portfolios. Meanwhile, P&C companies are using ETFs mainly to obtain longer-term strategic investment exposures in equity portfolios. These varied applications show that ETFs are proliferating in insurance company general accounts due in large part to their versatility as investment vehicles.

This growth should continue in 2019 and beyond. About 40% of current insurance company ETF investors expect to increase ETF allocations in the next three years, with not a single study participant reporting plans to cut allocations over that period. Three-quarters of ETF non-users in the study say they expect their organizations to consider using ETFs at some point in the future. Those decisions will be influenced by insurance companies' building demand for new approaches like factor-based strategies, which institutional investors access mainly through ETFs.

Regulations and accounting rules are the biggest impediments to insurance company ETF investment and will play a big role in determining the pace of growth in the future. Already, a decision by the NAIC to allow insurers to use a "systematic value" accounting methodology has created new demand for fixed-income ETFs. As state and federal regulators become more familiar with the ETF structure and track record, Greenwich Associates expects an increasingly friendly regulatory environment to attract new insurance companies to ETFs and to open the door for larger allocations among current investors.

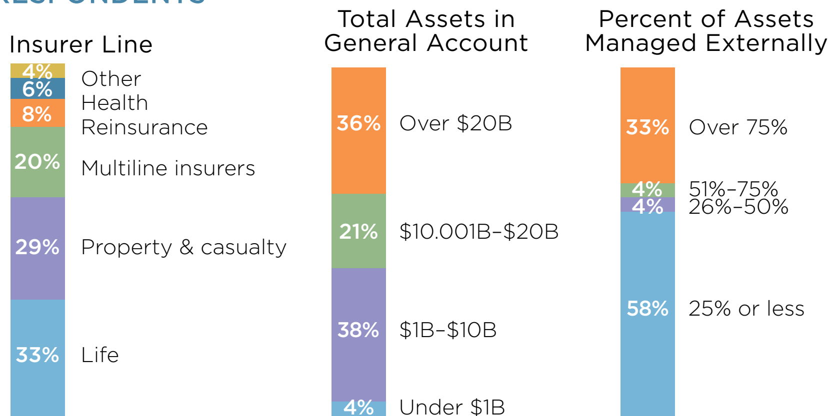
METHODOLOGY

Between January and March 2019, Greenwich Associates interviewed 51 professionals from across a variety of insurer lines and sizes for a study on ETF investment in the insurance industry, sponsored by Invesco. Thirty-three percent of study participants represented life insurance companies, 29% represented P&C insurers, 20% of were from multiline insurers, and the sample included representation from reinsurance, health insurance and other insurer lines.

Most companies in the study are large insurers, with 57% having more than $10 billion in general account assets, including 36% with more than $20 billion. More than three-quarters of the life companies have more than $10 billion in general account assets.

Most study participants manage a majority of their assets in-house. However, a sizable minority of one-third allocate more than three-quarters of general account assets to external investment managers.

RESPONDENTS



Introduction

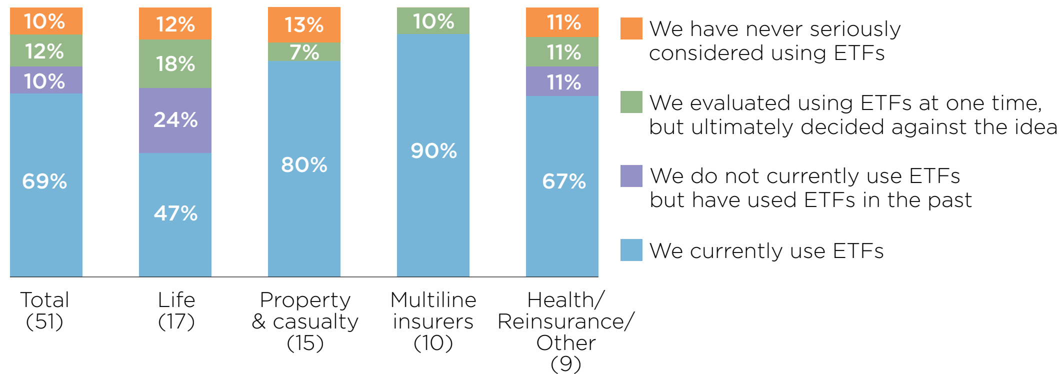
Insurance companies are opening their general accounts to a wider range of investment strategies and vehicles, and that diversification push is fueling an increase in the use of exchange-traded funds.

The proliferation of ETFs in insurance company general accounts reflects the fact that ETFs are highly flexible vehicles that can be used in many ways and for many purposes within an institutional investment portfolio. Life insurance companies are adopting ETFs first and foremost as a means to address short-term liquidity and cash management in fixed-income portfolios. Meanwhile, P&C companies are using ETFs mainly to obtain longer-term strategic investment exposures in equity portfolios.

Like all investors, insurance companies are trying to navigate a marketplace that is getting increasingly complex and challenging. In addition to the decade-long quest to generate sufficient yields in a

historically low interest-rate environment, insurers in 2018 were forced to contend with surging market volatility, sell-offs in global equity markets and a host of geopolitical risks ranging from trade wars to Brexit. In such conditions, it makes sense to expand the tool box of investment options, and both life companies and P&C insurers are finding ETFs to be effective in gaining exposures and adjusting portfolios, and as a vehicle for implementing new strategies like factor investing.

ETF USAGE IN INSURANCE COMPANY GENERAL ACCOUNTS



Note: May not total 100% due to rounding. Numbers in parentheses represent number of respondents.
Source: Greenwich Associates–Invesco 2019 U.S. Insurance ETF Study

Insurers are gravitating to ETFs for three main reasons. First, and by a wide margin, study participants cite "better cash or liquidity[1] management" as the No. 1 benefit. Second, insurance companies say they value ETFs' ability to efficiently "gain or maintain specific exposures." Third, insurers say they invest in ETFs to take advantage of "lower costs," including management fees and transaction costs[2].

Life companies are particularly attracted to cash and liquidity management benefits, while P&C companies focus more on ETFs' ability to easily deliver desired exposures and lower costs. In what could be another sign that insurance companies are taking on a more adventurous mindset with regard to general account assets, 40% of insurers in the study say they use ETFs to "take advantage of market dislocations."

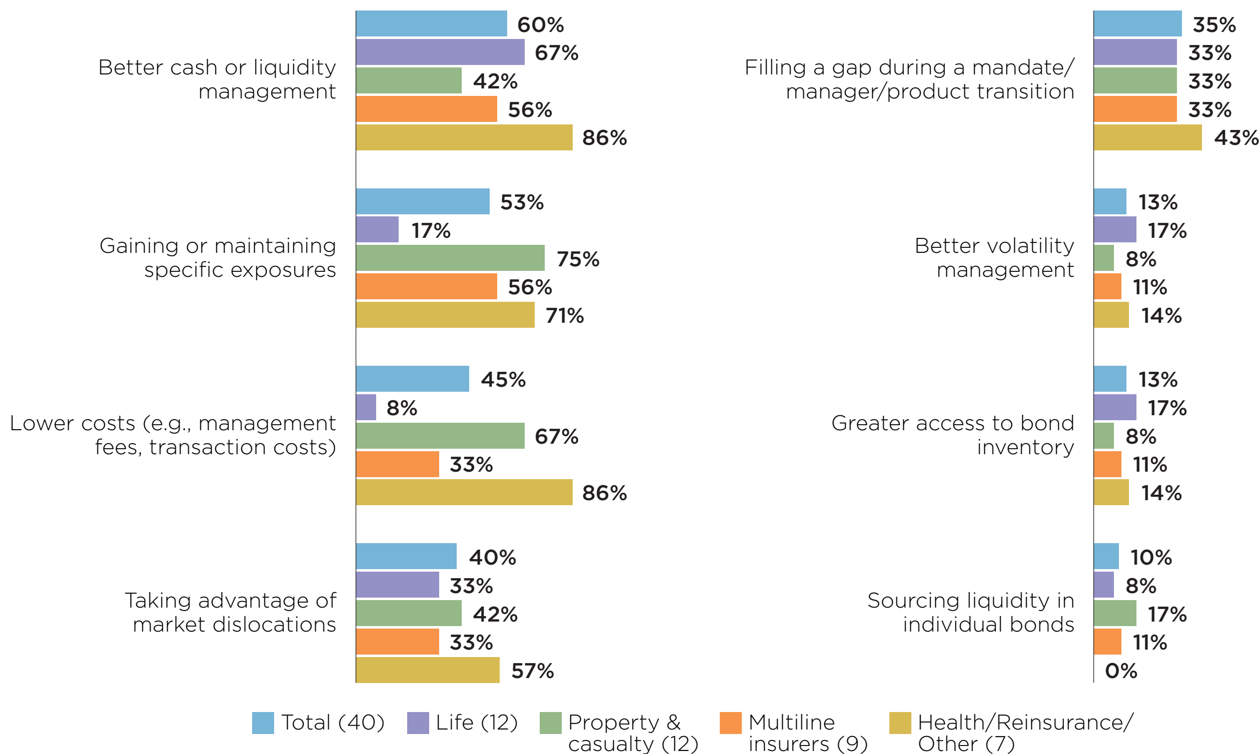
Insurers looking to use ETFs to diversify portfolios and otherwise implement their investment strategies received important assistance from the National Association of Insurance Commissioners (NAIC) with its 2017 ruling allowing U.S. insurance companies to use "systematic value" to account for fixed-income ETFs. Using systematic value rather than fair value can reduce the volatility of ETF valuations related to changes in interest rates and other factors. Some insurance companies moved quickly to take advantage of this shift, and demand for fixed-income ETFs has been building ever since.

Life companies are particularly attracted to cash and liquidity management benefits, while P&C companies focus more on ETFs' ability to easily deliver desired exposures and lower costs.

[1] Shares are not individually redeemable and owners of the Shares may acquire those Shares from the Fund and tender those Shares for redemption to the Fund in Creation Unit aggregations only, typically consisting of 10,000, 50,000, 75,000, 80,000, 100,000, 150,000 or 200,000 Shares.

[2] Since ordinary brokerage commissions apply for each buy and sell transaction, frequent trading activity may increase the cost of ETFs.

WHY DO YOU USE ETFs?



Note: Numbers in parentheses represent number of respondents.
Source: Greenwich Associates–Invesco 2019 U.S. Insurance ETF Study

As a result of these trends, approximately 70% of U.S. insurance companies now invest in ETFs in their general accounts. Multiline and P&C companies are the biggest users, with 90% and 80% of study participants investing respectively, compared with 47% of life companies.

HOW HAS YOUR USE OF ETFs CHANGED OVER THE PAST THREE YEARS?

"We have significantly increased our usage of fixed-income ETFs over the last three years for the purpose of improving the management of our cash and liquidity in our general account."

~ ***Life company***

"About three years ago we had zero exposure to ETFs. Currently, within our public equity bucket, we are 30 percent invested in ETFs. Our investing in ETFs basically had to do with lower cost and liquidity, but also with the performance of ETFs versus going active in the public equity space."

~ ***Health/Reinsurance company***

"The insurance industry changed accounting rules for bond related ETFs, so we changed to match."

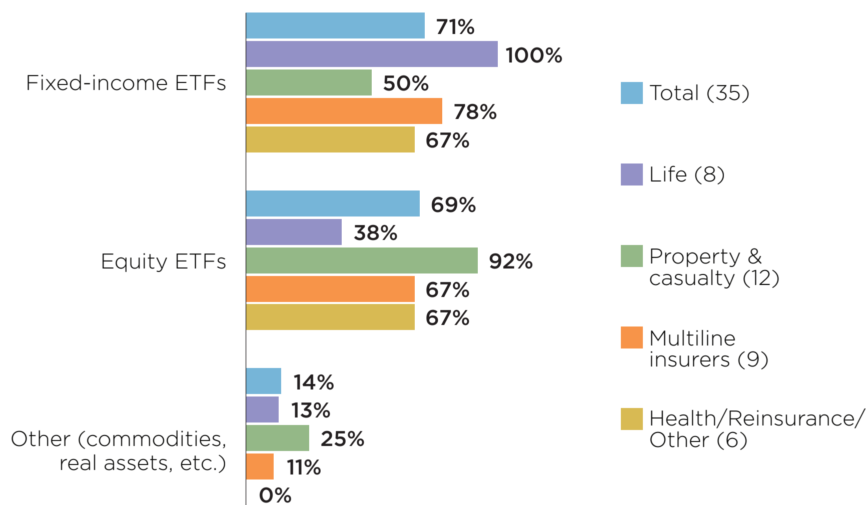
~ ***P&C company***

Insurance Company ETF Investing: Life vs. P&C

Life insurance companies are using ETFs primarily in fixed-income portfolios, most often as a tool to enhance liquidity and manage cash. Reflecting this function, most life insurance ETF holdings are short-term investments. Among life companies in the study, 83% report average ETF holding periods of six months or less.

P&C companies' primary use of ETFs to date has been to obtain desired investment exposures in equity portfolios. Three-quarters of P&C ETF investors report average ETF holding periods of a year or longer, including 50% at longer than two years. Those results show that P&C companies are adopting ETFs mainly as a vehicle for long-term, strategic equity investment exposures.

USE OF ETFs IN GENERAL ACCOUNT ASSET CLASSES



Note: Numbers in parentheses represent number of respondents.
Source: Greenwich Associates-Invesco 2019 U.S. Insurance ETF Study

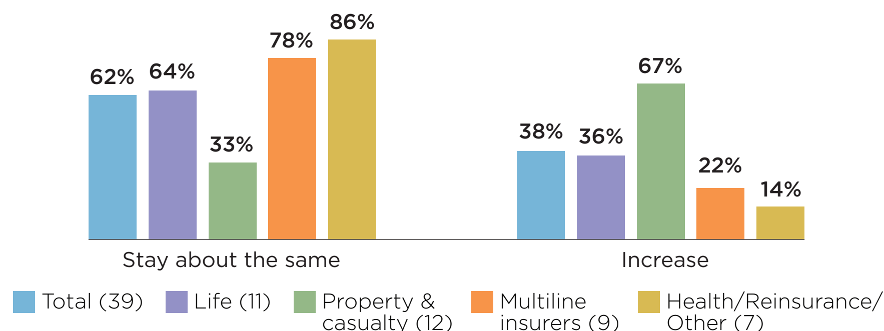
Industrywide, insurers employ ETFs at about an equal rate in equity and fixed-income portfolios; roughly 70% of ETF investors in the study use the funds in each asset class. However, usage rates vary dramatically between life and P&C companies. With portfolios weighted so heavily to fixed income, it's hardly a surprise that every one of the life insurance ETF investors in the study uses bond ETFs. By comparison, about half of P&C ETF investors use the funds in fixed-income ETFs. Meanwhile 92% of P&C ETF investors use the funds in equity portfolios, versus 38% of life companies.

At 25%, P&C investors are nearly twice as likely as their life counterparts to employ ETFs in other asset classes such as commodities. Mirroring those trends, the largest insurance companies in the study—a group dominated by life companies—are more likely to invest in bond ETFs, while smaller insurers make greater use of equity ETFs.

Future Projections: More Users, Bigger Allocations

About 40% of current insurance company ETF investors expect to increase allocations to the funds in the next three years. Not a single study participant reported plans to cut allocations over that period. P&C investors are the most bullish, with two-thirds planning ETF allocation increases, compared with 36% of current life insurance investors.

EXPECTED CHANGE IN ETF ASSETS



Total (39) Life (11) Property & casualty (12) Multiline insurers (9) Health/Reinsurance/ Other (7)

Note: Numbers in parentheses represent number of respondents.
Source: Greenwich Associates–Invesco 2019 U.S. Insurance ETF Study

ETF growth in the channel will also be fueled by new investors adopting funds. About 30% of the insurance companies in the study do not currently invest in ETFs, including 53% of the life insurers and 1 in 5 P&C companies. A majority of these non-users attribute their lack of interest to the simple fact that they trade their own portfolios of individual securities. However, nearly an equal percentage say they are prevented from investing by regulations, NAIC ratings requirements and/or accounting issues like GAAP rules and complex transaction reporting.

As one insurance company professional explains, "Our investment policy would permit investments into ETFs on the fixed-income side, but it's the accounting and regulatory issues and headaches that would make it prohibitive at this point." Another puts it more plainly, saying, "We would use ETFs if the regulations changed."

Regulatory and accounting issues are also the main factors limiting current users from investing in ETFs more broadly. Almost 60% of study participants cite regulation/accounting as limiting factors in their ETF allocations, and additional insurers cite other impediments related to state-level statutes, rules and requirements. Specifically, institutions say their ETF allocations are limited by requirements for investment-grade NAIC ratings and portfolio concentration limits.

Greenwich Associates expects an increasingly friendly regulatory environment for ETFs to attract some of these non-users to the funds and to open the door for bigger allocations among current investors.

WHAT CAN REGULATORS DO TO FACILITATE ETF INVESTMENT IN GENERAL ACCOUNTS?

"Provide distinct, clear guidance that permits us to use ETFs in the way we want. In other words, if we buy a fixed-income ETF it gets treated like a bond, not like equity."
~ ***Life company***

"We expect the regulatory environment over the next five years to be more in alignment with each underlying asset class and specifically in the treatment of fixed-income ETFs." ~ ***Life company***

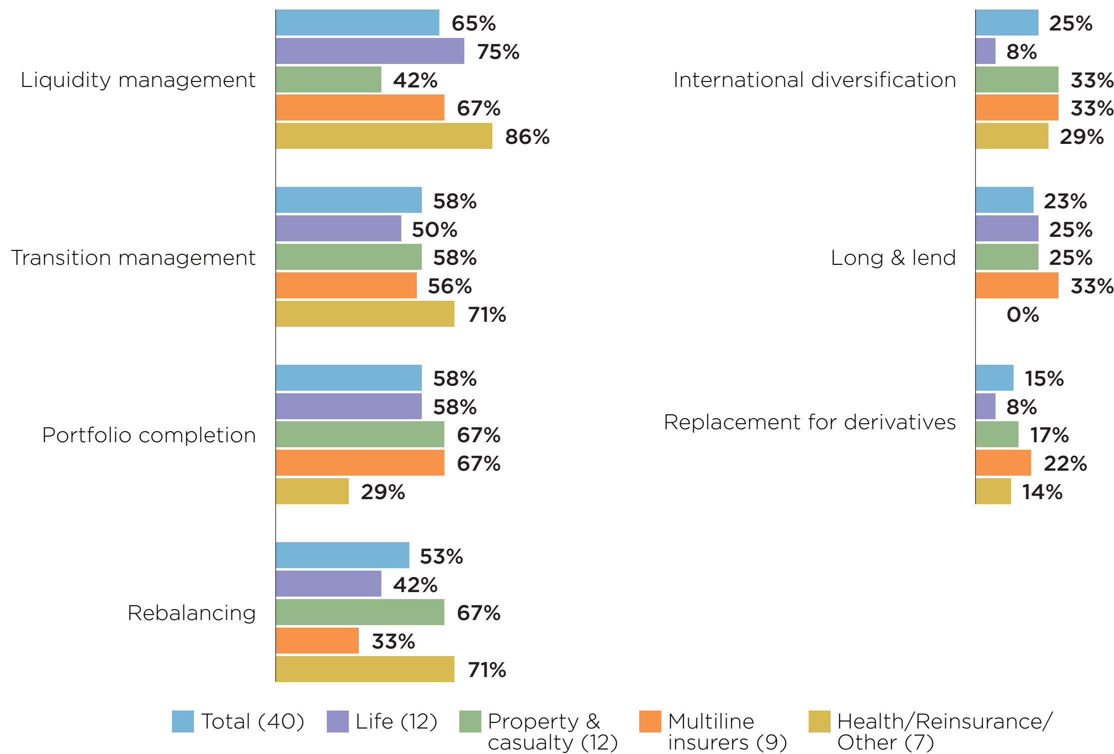
"I would expect and hope that there would be liberalization and expansion of NAIC ratings of ETFs."
~ ***P&C company***

The clearest example of this movement to date is the ETF-friendly systematic value ruling from the NAIC. We expect regulators and accounting rule-makers to continue moving in a more permissive direction, as ETFs build a track record of safe and effective use not only among insurance companies, but also among other institutional investors such as large asset managers and pension funds. As one study participant explains, “As regulators become more familiar with this asset class, the more inclined they will be to support their capabilities and use.”

This successful track record will likely entice some insurance company holdouts to revisit their decisions and give existing investors the confidence to expand ETF allocations. Currently, about half of insurers say they are at least somewhat concerned about the effect of ETF holdings on income statement volatility. Close to 30% express concerns about the effect of ETFs on high portfolio turnover.

However, changes in accounting treatment and the positive experiences of many insurance companies’ peers seem to be altering these perspectives. Three-quarters of ETF non-users in the study say they expect their organizations to reconsider that decision at some point in the future. A quarter of those insurers think that change could come in 2019, and three-quarters expect to reassess ETF use within the next two years.

WHAT ETF FEATURES WILL DRIVE FUTURE INVESTMENTS?



Note: Numbers in parentheses represent number of respondents.
Source: Greenwich Associates–Invesco 2019 U.S. Insurance ETF Study

Like growth to date, future insurance company ETF inflows will be driven by the flexible nature of the ETF structure. Insurance companies in the study report plans to use ETFs in a diverse range of portfolio functions across asset classes. Two-thirds of study participants and three-quarters of the life companies say their organizations plan to make more use of ETFs for liquidity management, and almost 60% of insurers overall say they will be using ETFs in manager transitions and for portfolio completion. Two-thirds of P&C companies and 42% of life insurers say they see potential benefits in using more ETFs for portfolio rebalancing.

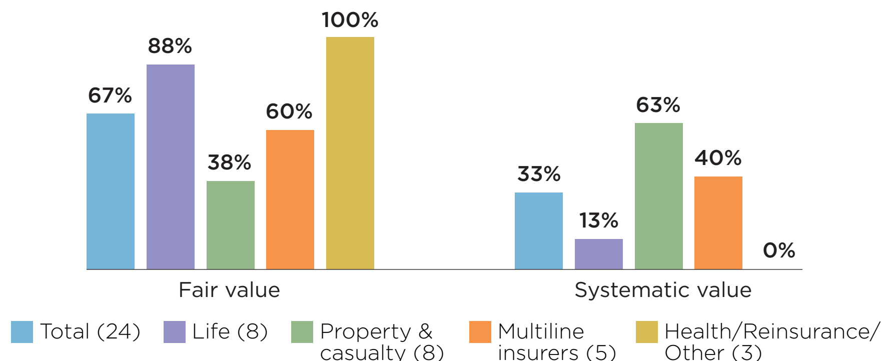
A "Systematic" Tailwind for Bond ETFs

In April 2017, the NAIC announced that it would allow insurers to apply the bond-like methodology of "systematic value" to fixed-income ETFs for accounting purposes. Relative to fair value treatment, systematic value has the potential to reduce volatility on financial statements. This change, which took effect in 2018, helps insurers meet internal risk and capital requirements, and generally makes bond ETFs more usable and attractive to insurance companies.

Relative to fair value treatment, systematic value has the potential to reduce volatility on financial statements.

However, there is an important caveat to the rule: Insurance companies holding qualifying ETFs must make a one-time selection to record the fund at fair value or systematic value. About 1 in 5 study participants and a quarter of the P&C companies say they are completely unaware of that important provision, and roughly 40% of insurers overall report they are not fully informed about the rule. From these findings, it's clear that more education on this topic is needed, and that an opportunity exists for ETF providers to help inform insurers about the details of these accounting rules.

FAIR VALUE VS. SYSTEMATIC VALUE



Note: Numbers in parentheses represent number of respondents.
Source: Greenwich Associates–Invesco 2019 U.S. Insurance ETF Study

To date, one-third of insurance companies have adopted systematic value for bond ETFs. However, that adoption rate is skewed heavily in favor of P&C companies, 63% of which are using systematic value. By comparison, only 13% of life insurance companies in the study have taken advantage of the new treatment, while 40% of multiline insurers are using systematic value.

These results might seem surprising on the surface, since life insurance companies are the bigger users of bond ETFs overall. The difference can be explained by looking at how life and P&C companies are actually employing ETFs in their portfolios. As noted earlier in this report, P&C companies are using ETFs mainly as a vehicle for obtaining long-term investment exposures, with three-quarters of P&C insurers holding ETFs for an average of a year or longer, and half reporting average holding periods of more than two years. Although ETF use among P&C companies is heavily weighted to equities, half of existing P&C investors have added ETFs to fixed-income portfolios, and it is these insurers who are driving the adoption of systematic value.

Life companies, on the other hand, most often use bond ETFs for short-term liquidity and cash management. With more than 80% of life companies in the study reporting average ETF holding periods of less than one year, these companies would realize far fewer benefits from the new accounting treatment and, therefore, have been understandably slower to make the change.

However, it should be noted that in its global research among institutional investors around the world, Greenwich Associates has documented a clear and consistent trend: Investors that start using ETFs for short-term and "tactical" applications usually start employing the funds for longer-term, strategic functions and exposures over time. We expect this trend to play out in life company general accounts, and for the NAIC ruling and the potential long-term benefits of systematic valuation to accelerate this process.

PICKING THE RIGHT ETF

How do insurance companies find the right ETFs for investment? To merit consideration among life insurers, an ETF must meet two fundamental standards: It must have sufficient liquidity, and it must have an acceptable rating from the NAIC. Nearly 85% of the life companies in the study name the NAIC rating as a primary criterion in selecting an ETF. For life companies, NAIC rating is even more important than the question of how well or how poorly a given ETF matches their exposure needs—the top-ranked criterion for P&C companies and, presumably, many other institutional investors. After these basic criteria, insurers of all types compare expense ratios and costs, as well as secondary factors like the benchmark employed and the firm behind the ETF, before making a final selection.

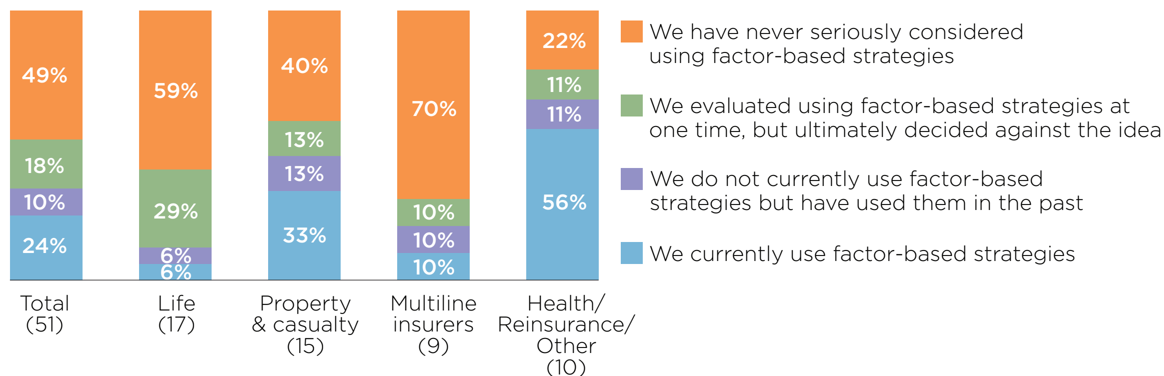
Nearly half of insurance company ETF investors say their process for evaluating ETFs differs across asset classes. In general, these differences mirror variations in the standard investment and research techniques in equities and fixed income, with investors emphasizing factors like specific company, industry and market cap exposures in equities, and duration and index replication in fixed income.

Factor-Based Boom Builds ETF Demand

Factor-based investment strategies have become a mainstay in the portfolios of asset managers, pension funds and other institutional investors. While these strategies have been slower to catch on among insurance companies, they are beginning to gain traction in general account portfolios—especially among P&C insurers. Approximately one-quarter of insurance companies in the study use factor-based strategies. That overall share covers a big divide between life companies, of which only 6% are investing in factor-based approaches, and multiline insurers, 10% of which have adopted these strategies.

The fact that P&C companies are leading the charge in this area makes sense, given their much bigger allocation of general account assets to equities and the fact that factor-based strategies are much more prevalent in equities than in fixed income. However, it does seem surprising that about half of study participants overall say they have never even seriously considered investing in these strategies, including 40% of P&C companies, 60% of life companies and 70% of multiline insurers.

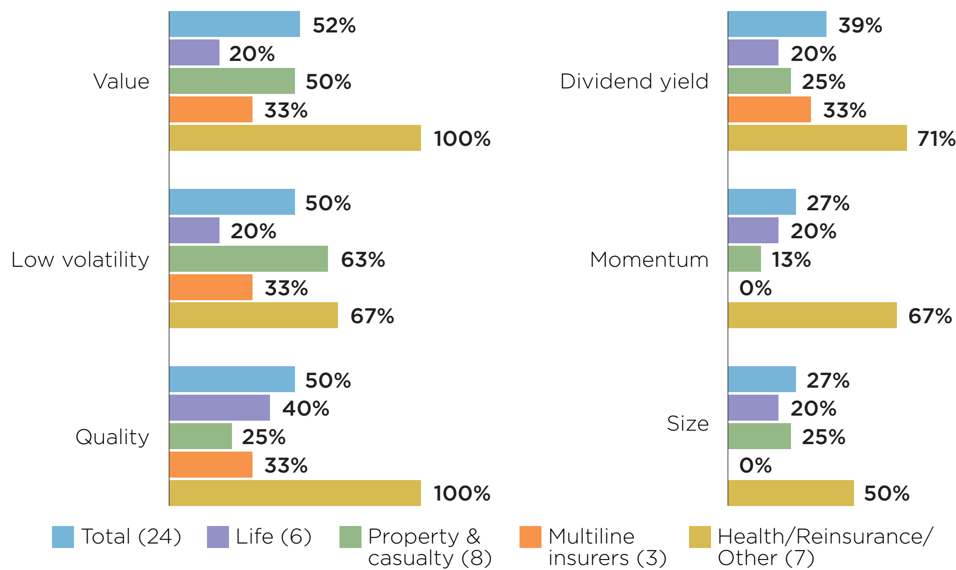
FACTOR-BASED STRATEGY USAGE



Note: May not total 100% due to rounding. Numbers in parentheses represent number of respondents.
Source: Greenwich Associates-Invesco 2019 U.S. Insurance ETF Study

Although a minority of about one-fifth of study participants say they haven't invested in these strategies because they simply don't believe in the investment theory/process behind factor-based approaches, most insurance companies are open to the concept but feel they lack the knowledge or historic performance data required to properly assess factor-based funds. One study participant attributes his organization's hesitancy to invest in factor-based strategies to a "lack of experience, education and familiarity." Another insurance company professional says she needs to see a longer track record of "proven, ongoing performance in a free-market environment" before committing assets to factor-based strategies, adding that "back-testing is 20/20."

INSURANCE COMPANY INTEREST IN SPECIFIC FACTORS

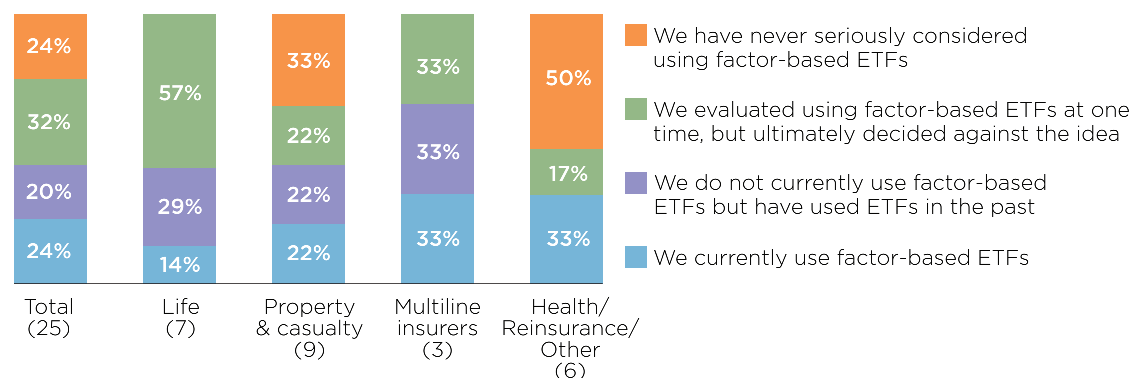


Note: Numbers in parentheses represent number of respondents.
Source: Greenwich Associates–Invesco 2019 U.S. Insurance ETF Study

Based on the trajectory of these strategies in the portfolios of other types of institutional investors, Greenwich Associates expects allocations to factor-based strategies to increase steadily in insurance company general accounts. This growth will likely be spearheaded by P&C companies and facilitated by providers that proactively educate insurers about the robust academic research backing these strategies, and the ample empirical evidence of their long-term effectiveness. In fact, this process is already underway: Among study participants that consider themselves well-informed about factor-based strategies, 45% say they are at least somewhat likely to start using or expand their use of these approaches.

That growth will, in turn, provide a significant boost to insurance company demand for ETFs, which have emerged as institutions' vehicle of choice for factor-based exposures..

USE OF FACTOR-BASED ETFs



Note: May not total 100% due to rounding. Numbers in parentheses represent number of respondents.
Source: Greenwich Associates–Invesco 2019 U.S. Insurance ETF Study

As insurance companies gradually embrace these strategies, demand patterns for factor-based ETFs will likely reflect the traditionally conservative investment strategies employed in general accounts. Insurers in the study say would be most attracted to value, high-quality and low-volatility strategies. Despite those preferences, study participants see the possibility of increased returns as an important potential benefit, ranking it alongside reduced costs and just ahead of reduced risk and outperformance relative to other strategies as reasons for investigating these strategies.

Demand for factor-based ETFs could be getting an additional lift from the NAIC ruling. Eighty percent of companies that have adopted systematic value for fixed-income ETFs say they are at least somewhat likely to start using or expand their use of factor-based ETF strategies—almost double the share of the overall research sample.

80% of companies that have adopted systematic value for fixed-income ETFs say they are at least somewhat likely to start using or expand their use of factor-based ETF strategies.

Conclusion

When searching for the right investment tools for the right jobs, growing numbers of insurance companies are gravitating to exchange-traded funds—regardless of whether that job is in equity or fixed income, or related to long-term investment exposures or short-term portfolio adjustments. In fact, to this point life insurance companies and P&C companies have come down at nearly opposite ends of that spectrum, with life insurers employing ETFs mainly for liquidity and cash management in fixed income, and usually holding the funds for less than a year, and P&C companies using ETFs to obtain strategic exposures in equity portfolios and often holding the funds for more than two years.

It is this versatility, along with the gradual emergence of a more permissive regulatory environment, that will continue fueling the expansion of ETF allocations in insurance company general accounts.

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About Risk

There are risks involved with investing in ETFs, including possible loss of money. Index-based ETFs are not actively managed. Actively managed ETFs do not necessarily seek to replicate the performance of a specified index. Both index-based and actively managed ETFs are subject to risks similar to stocks, including those related to short selling and margin maintenance. Ordinary brokerage commissions apply. The Fund's return may not match the return of the Index. Fixed-income investments are subject to credit risk of the issuer and the effects of changing interest rates. Factor investing is an investment strategy in which securities are chosen based on certain characteristics and attributes. There is no assurance that such ETFs will provide low volatility. Shares are not FDIC insured, may lose value and have no bank guarantee.

Before investing, investors should carefully read the prospectus/summary prospectus and carefully consider the investment objectives, risks, charges and expenses. For this and more complete information about the Fund call 800 983 0903 or visit invesco.com for the prospectus/summary prospectus.

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