A publication of WorldTrade Executive, Inc.

# Insurance

FINANCE & INVESTMENT

*The strategic resource for insurance investment professionals*

August 31, 2006 • Vol. XI, No. 14

## IN THIS ISSUE

**1** ASSET MANAGER SPOTLIGHT: GE Asset Management. It has been close to a year since GE Asset Management embarked on its strategy to grow its external management operations. IFI speaks with Kathy Karlic, executive vice president and chief investment officer—Fixed Income and Jack Boyce, senior vice president-Institutional Investments.

**4** RISK MANAGEMENT TALKING POINT. **The Erosion of Insurability.** After seven costly hurricanes, insurance companies are questioning how much risk they can take in vulnerable coastal areas. IFI looks at these and other related issues. *By Evan Mills, Ph.D.*

**10** INVESTMENT MANAGEMENT TALKING POINT. **Credit Selection as Key Alpha Generator.** With interest rates low and credit spreads tight, fixed income investors are searching for alternative alpha generating strategies. *By Greg Hartch, GE Asset Management.*

**14** RISK MANAGEMENT: HURRICANE SEASON. **KBW: Insurers Might Permanently Depart Coastal P&C Markets If Another Katrina Hits.**

**15** Who's Where

ASSET MANAGER SPOTLIGHT

## GE Asset Management

# GEAM Acquires $1.5 Billion in Insurance Company Assets

It has been close to a year since GE Capital completely divested itself of its insurance operations – a process that began a year ago May when the company spun off its consumer insurance unit, Genworth Financial, in an initial public offering that raised $2.83 billion and ended this June when it sold its Insurance Solutions business to Swiss Re.

At the same time, its asset management division, GE Asset Management – which continued to manage the bulk of Genworth's assets – began to explore opportunities in third party asset management.

As of June 30, GE Asset Management had $94 billion in insurance assets under management, most of which originated with GE-related portfolios. The company, though, is also gaining traction among unrelated insurers. Year to date it has added $1.5 billion in unaffiliated insurance AUM – most of which was attributed to life insurance company mandates and all of which was within the fixed income asset class. "We are getting more momentum, more traction in the insurance market," says Kathy Karlic, executive vice president and chief investment officer - Fixed Income.

IFI spoke with Karlic and Jack Boyce, senior vice president - Institutional Investments to get an update on its growing third party operations.

> ***After assets and liabilities are matched, the question becomes for insurance companies how to earn better return on a surplus.***

*continued on page 3....*

# Insurance
FINANCE & INVESTMENT

*The strategic resource for insurance investment professionals*



Insurance Finance & Investment is a twice-monthly general circulation publication. No statement in this issue is to be construed as a recommendation to buy or sell securities or provide investment advice.

2250 Main St., Ste. 100
P.O. Box 761, Concord, MA 01742 USA

Tel: (978) 287-0301 Fax: (978) 287-0302
Email: info@wtexec.com, Web: www.wtexec.com

One-year subscription: $1,849. Please add $50 for non-U.S. postage



## Company Index

Allstate .......... 5, 6
American Superior Insurance Co. .......... 7
The Andover Cos. .......... 6
Assurant, Inc. .......... 16

Baker, Donelson, Bearman, Caldwell & Berkowitz, PC .......... 15

Cantor Fitzgerald .......... 16
Ceres .......... 4

Eagle Investment Systems .......... 15

GE Asset Management .......... 1, 10
GE Capital .......... 1
Genworth Financial .......... 1

Florida Citizens Property Insurance .......... 7
Friedman, Billings, Ramsey & Co., Inc. .......... 16

Hingham Mutual Group .......... 6

Keefe, Bruyette and Wood .......... 14

Lexington Insurance .......... 6

Mellon Financial Corporation .......... 15
Mississippi Winderstom Underwriters Association .......... 8

Patpatia & Associates .......... 15
Poe Financial Group .......... 7
Prudential Annuities .......... 16

State Farm .......... 5

Wachovia Securities .......... 16

GE, continued from page 1...

**Q: As you discuss the investment environment with insurance companies, what are you finding to be their current requests or requirements from an external manager?**
Karlic: One of the trends we are seeing is that more insurance companies are rethinking the investment management of their surplus. After assets and liabilities are matched, the question becomes for insurance companies how to earn a better return on their surplus.

**Q: I realize each client is different, but what is one possible investment strategy that you might recommend?**
Karlic: Well, equities as you know have outperformed the bond market over the last ten year period, so we are looking at adding equity management into the surplus. There are regulatory issues involved, so it necessitates a careful balance of risk and return. You have to weigh whether there will be any cash needs that need to be met from the surplus account, for instance, such as dividends. Also, if the insurance company has consolidated operations, those calculations have to be spread across the entire organization. You also have to think about the benchmark, risk management techniques, can you measure the returns and what are the investments that meet those risk-return profiles.

**Q: What else are insurance companies inquiring about?**
Boyce: Credit risk management. Since credit defaults are athistorical lows currently, now is the time to prepare for a likely shift. There will be great demand for a strong credit team and an independent view of each portfolio holding. [see Credit Selection as Key Alpha Generator, pg 10].

**Q: Can you give me an example of a credit risk that could remain under the radar until it is too late?**

*A lot of private companies are taking public firms private, across many different sectors. You have to think through what this might mean for the portfolio, especially if you are receiving less information than what you used to when the company was public.*

Karlic: One is the merger and acquisition activity happening in a lot of sectors right now. A lot of public firms are being taken private, across many different sectors. You have to think through what this might mean for the portfolio, especially if you are receiving less information than what you used to when the company was public.

**Q: What is the value-add that GE Asset Management is able to offer an insurance company?**
Boyce: Most firms are looking for expertise in asset management beyond merely managing a bond portfolio. They are looking for a relationship in which they can ask these sorts of questions [regarding M&As and credit risks].

Every insurance company faces a unique set of liabilities. The best way we can help is to leverage our experience to understand the company and its goals. Our approach is to listen and respond to a host of unique needs including credit, tax, capital gains, portfolio quality, etc., and build a portfolio to reflect these objectives. ■

# Ron Pressman New Head of GE Asset Management

Last month, Ronald R. Pressman, a 26-year veteran of GE, was named president and CEO of GE Asset Management (GEAM). He succeeded John Myers, who retired after nearly 37 years at General Electric, including 20 at GEAM. Pressman was president and CEO of GE Insurance, and chairman, president and CEO of GE Insurance Solutions. He was also president and CEO of GE Capital Real Estate. Prior to that, he was CEO of GE Power Systems Europe and led several business units for GE Power Systems in the United States.

# Erosion of Insurability

by Evan Mills, Ph.D., Ceres

If available and affordable, insurance is grist for economic development and the financial cohesion of society, as well as security and peace of mind in a world where the knowledge of hazards lags their evolution. Unanticipated changes in the nature, scale, or location of hazards are among the most important threats to the insurance system, and thus to the health of the global economy.

Insurers have an obligation to their customers and shareholders to maintain solvency. In this context,they have reacted to a legacy of non-actuarial rates, rising losses, and a decreasing predictability of losses in a business-as-usual manner—i.e., by elevating prices and restricting the scope of coverage. This is a rational short-term business response, but one which has led to a crisis of insurance availability and affordability in the United States. The Insurance Information Institute issued a study in 2006 identifying climate change as a manageable concern for U.S. insurers, but does not delve into questions of availability and affordability.[1]

*"This (insurance crisis) could bring our economy to a screeching halt."*

–Alex Sanchez,
Chief Executive Officer,
Florida Bankers Association

After seven costly hurricanes in two years, insurers are questioning how much risk they can take in vulnerable coastal areas. The shortage of available coverage is particularly acute in the reinsurance sector. In 2005, U.S. reinsurers incurred $1.29 in claims and operating expenses for every $1.00 in premium revenue.[2] In response, higher reinsurance prices—reported to have increased by up to 200 percent in some areas of the country[3]—have pushed up the cost of primary insurance coverage and contributed to decisions by primary insurers to cut back on coverage in risky areas.

As outlined in Box A later in this section, the most visible responses are price increases or the non-renewal of homeowners' policies. However, terms are also being tightened. For example, many insurers in hurricane-prone states are selling homeowners insurance policies with percentage deductibles for storm damage, instead of the traditional dollar deductibles used for claims such as fire and theft. Percentage deductibles vary from one percent of a home's insured value to nearly 15 percent, depending on many factors that differ by state and insurer.[4] These responses place a greater financial burden on the consumer, and have the potential to slow reconstruction after a major loss event.

Among the impacts of reduced insurability is a stronger reliance on governments as insurers of last resort. As insurers refuse to take on new policyholders, decide not to renew existing policies or raise rates, mandated state-run insurance "pools" are created in an attempt to fill the coverage void, and to redistribute the losses across a larger number of insurers (including those experiencing no direct losses from the event) (see Box B).

Historically, U.S. flood and crop/hail insurance risks were deemed largely uninsurable by the private market, which resulted in major government-sponsored insurance programs. Losses from another weather-related risk—mold and mildew—have also recently swelled to levels such that exclusions are approved in more than 30 states.[5] With an outlook predicting more intense weather catastrophes, one can only expect the availability and affordability problem to become more acute.

As insurers of last resort, governments have had a poor track record in attempting to operate actuarially sound insurance programs. With more claims in 2005 than in its entire 37-year history,[6] the U.S. flood insurance program was bankrupted 10-times-over by Hurricane Katrina, and the crop insurance program often pays out more in claims than it receives in revenues. These programs also typically offer limited coverage, with a maximum of only $250,000 for the flood program and no coverage for temporary living expenses or business interruptions. These concerns are serious enough that the Government Accountability Office is investigating these questions. Society cannot take for granted that government will assume the exposures that insurers jettison.

Government-run insurance pools are not a cure-all for price increases, as reinsurance prices are increasing for these pools too. The Mississippi Windstorm Underwriters Association's reinsurance costs increased by 488 percent in 2006.[7] Meanwhile, individual reinsurers are offering "thinner" layers of coverage to their primary insurer customers, e.g. in $5-million increments versus $25- to $50-million increments in the past.[8]

It might be assumed that the problem is limited to the household sector and stems simply from insurance regulation, i.e., that insurers are not allowed to charge actuarial prices to households, for political reasons, while they are far freer to do so for commercial customers. Yet, news reports state that even some unregulated "surplus lines" homeowner insurers are staying away,[9] even though they are free to charge any price.

A crisis of availability and affordability has also emerged for commercial customers. Allstate dropped 16,000 commercial customers in Florida in 2005,[10] and some commercial businesses in the Gulf are being forced to "go bare", i.e. are unable to find insurance at any price. Commercial insurers are seeing wind deductibles of 5 percent in some cases, which can correspond to $25 to $50 million per loss.[11] Florida

## A: WITHDRAWAL OF HOMEOWNER'S INSURANCE

Homeowners coverage in at-risk coastal areas along the Gulf Coast, Florida and parts of the East Coast has been hit especially hard, with bigger impacts still to come. Events of the past year show that insurers cannot take for granted that regulators will allow them to raise prices[19] or withdraw[20] from at-risk markets. Among the trouble spots:

In Florida, as of March 2006, 225,971 homeowners' property policies were cancelled and 224,868 non-renewals were issued, while 489,418 new policies were written within the past year (by both private insurers and Citizens, the state-operated insurance company).[21] Allstate plans not to renew 120,000 policies in Florida by the end of November 2006, instead offering new policies to another insurer.[22] This decision comes on the heels of Allstate's decision to cancel 95,000 policies in Florida in 2005.[23] State Farm (the state's largest property insurer) won't renew 39,000 windstorm policies in 2006 and plans to cancel all condominium building policies, which total 1,500 statewide. Additionally, State Farm is asking the Florida Insurance Commission to approve a 74-percent rate increase.[24] Owners of 1,500 square-foot homes are seeing their premiums double to $10,000 or more for windstorm insurance, facing a total home insurance cost of more than $13,000 on average.[25] For the same-sized home, some Florida customers face a deductible upwards of $18,000.[26]

Along the Gulf Coast, Allstate is aggressively cutting its exposure after Hurricane Katrina led the insurer to post a third-quarter loss of $1.55 billion in 2005, an amount its chief executive called "simply unacceptable."[27] Allstate, which expects to handle 300,000 Katrina and Rita claims, said it would seek to raise premiums, boost policy deductibles, and reduce the insured temporary living expenses available to dislocated policyholders in areas prone to disasters.[28] In 2006, Louisiana Farm Bureau Mutual Insurance announced it would drop wind and hail storm coverage from more than 7,000 customers in South Louisiana.[29] In Mississippi, Allstate and State Farm, two of the state's largest insurance firms, have not yet requested a rate increase, but they have restricted the areas they cover.[30] Allstate plans to drop 140,000 customers in 18 coastal parishes across Louisiana, although this has been challenged by lawmakers.[31]

In New York, Allstate, the largest provider of homeowners insurance in the state, is no longer

*continued on page 6...*

## Continued from page 5...

State Chief Financial Officer Tom Gallagher declared that commercial insurance "is where the crisis is now."[12] Florida's insurer of last resort (Citizens) will only provide commercial coverage up to $1 million per customer.

The RSUI Group is the major player for general commercial insurance in Florida and Louisiana, and experienced a $133 million underwriting loss in 2005. Noting the shortfall of reinsurance coverage, it has stopped writing new wind insurance for properties between North Carolina to just south of Houston, Texas. Policyholders able to get $400 million or even $1 billion in commercial property limits prior to Hurricane Katrina may now encounter sub-limits for wind peril totaling perhaps $100 million.[13] Moreover, reinsurance pricing is essentially unregulated and yet it, too, has been beset with problems of availability and affordability.

The impacts on non-household customers are also exemplified by the recent imposition of relatively negligible $50 million aggregate windstorm claim limits for energy insurance (e.g., offshore oil platforms) where none existed previously, and this is coupled with up to 500 percent increases in premiums for facilities in the Gulf of Mexico.[14] This response is reflective of losses between 2004 and 2005 that were ten-times the premiums collected, and that reinsurers have pulled back the coverage offered to primary insurers. The mutual insurer (OIL) covering 100 oil producers, is expected to pay only about half of the claims incurred by its members and has lowered maximum payouts, increased

## Withdrawal of Homeowner's Insurance Continued from p.5

offering new policies on Long Island, New York City, or Westchester County in order to "better manage its exposure" to anticipated coastal storms.[32] As of June 2006, Allstate, with a 25-percent market share in metropolitan New York, also decided it won't renew approximately 30,000 policies because of hurricane risk, even though nearly 70 years have passed since a hurricane last struck the U.S. areas.[83] In 2005 Allstate cancelled 28,000 policies in New York.[34]

In Massachusetts, Hingham Mutual Group, one of the leading homeowners insurers' on Cape Cod and surrounding islands, does not plan to renew about 6,500 homeowners' policies in 2006. The company decided to retreat from the Cape and other coastal areas after brokers reported that reinsurance costs would be rising 20 to 30 percent in 2006. The Andover Cos., the state's largest home insurer, decided in May 2004 that it would not renew all 14,000 of its policies on Cape Cod and the islands. NGM will be dropping 2,300 homeowners on Cape Cod.[35]

In Rhode Island, some insurance companies plan to discontinue homeowner coverage in coastal neighborhoods altogether.[36] Others are cutting back on the number of coastal houses they will cover or refusing to offer new policies to houses within a few miles of the ocean.[37] The Rhode Island superintendent of insurance regulation has been allowing companies to cancel policies in some neighborhoods so the companies don't feel compelled to leave the state altogether.[38]

In South Carolina, local insurance agents have banded together to form a new organization because they are worried about the dwindling number of companies writing homeowners policies along the coast.[39] Lexington Insurance is only writing policies for homes valued at more than $500, 000 and is not renewing many policies.[40] The Insurance Group in Myrtle Beach has turned away many homeowners who have homes valued at $250,000 or less.[41] As already noted, theinsurance giant Allstate has stopped writing policies for new businesses up and down the East Coast, including South Carolina.[42]

deductibles, and tightened the terms (e.g. for business interruption) going forward. OIL has lowered its upper limit on aggregate payable claims from $1 billion to $0.5 billion.

*Insurers are being pinched by higher reinsurance prices (or poorer terms), upward revisions in projections from catastrophe losses, and expectations from rating agencies to establish more capital in anticipation of rising future losses.*

Insurers are being pinched by higher reinsurance prices (or poorer terms), upward revisions in projections from catastrophe losses, and expectations from rating agencies to establish more capital in anticipation of rising future losses. One of the leading catastrophe modeling firms, RMS Consulting, has roughly estimated that the projected upward trend in losses corresponds to a potential gaping hole of up to $120 billion in the capital required by the U.S. insurance industry to be able to pay losses.

As a result, it is not surprising that the natural reaction of insurers has been to cut their exposure to the riskiest areas and to alter

## B: GROWING FINANCIAL EXPOSURE FOR STATE INSURANCE POOLS

As more private insurers scale back coverage in high-risk areas, special insurance plans known as residual, shared or involuntary markets are coming under increasing pressure to act as insurers of last resort. These markets, currently operating in 32 states, are set up by state regulators working with the insurance industry. FAIR (Fair Access to Insurance Requirement) Plans, the largest of the property insurance pools, have grown both in the number and value of insurance policies written. Yet, these pools are not immune to the very problems they are designed to address.

Residual markets are rarely self-sufficient. Where the rates charged to high-risk policyholders are too low to support the program's operation, insurers are generally assessed according to their share of the voluntary property market to make up the difference. These additional costs are typically passed on to policyholders in the plan in the form of higher rates, and in some states to policyholders in the conventional insurance markets as well. It is worrisome that some plans have had to turn to outside sources, e.g. a $1.5-billion bond measure in Florida.[43] These insurance pools are under especially strong pressure in Florida, the Gulf Coast and the Northeast. In the past two years, state-operated insurance pools in Florida, Louisiana and Mississippi have added more than one million new homeowners' policies, creating additional financial exposure as deficits have already ballooned to billions of dollars. Florida's insurance pool, for example, already has a combined $2.2 billion budget deficit over the past two years and in 2006 it needed a $715 million bailout from the Florida legislature.[44, 45] In Mississippi, the insurance pool is using $100 million of federal block grant money to pay off its losses.[46]

Florida, which has been hit with seven major hurricanes in the past two years, faces the biggest insurance pool crisis. American Superior Insurance Company, with 60,000 policyholders, was the first to become insolvent.[47] Poe Financial Group, Florida's fourth largest personal insurer, collapsed in April 2006, leaving 316,000 policyholders in need of coverage.[48] Many of customers left stranded by Poe Financial will likely be absorbed by Florida Citizens Property Insurance Corp., the

*continued on page 8...*

Continued from page 7...

the pricing and terms of c overage. The effectiveness of this response in the long-term, however, is likely to be limited. The Tyndall Center for Climate Change Research has estimated that insurance premiums would have to increase many fold in order to keep up with risinglosses.[15]

While some industry observers state that insurers can always adapt to rising losses, one must keep in mind that adaptation can be slow. In the case of Hurricane Katrina, the American Association of Managing General Agents stated that it could take as long as two years before insurers return to the market (assuming no further catastrophes in the region).[16] A related nuance is the often cited aggregate capacity of insurers to pay losses, which currently exceeds $400 billion. This number however is misleading for two important reasons. First, segments of this surplus are limited to insurance categories loosely if at all related to climate change (e.g. medical malpractice). Second,individual insurers can only tap their own individual resources; the industry-wide resources are not pooled. According to the Wharton School, more than 80 percent of the top insurers have less than 0.5 billion in net worth and 200 have a net worth of less than $0.05 billion and are thus quite vulnerable to large disasters.[17]

Insurers may protect themselves by withdrawing from markets, tightening terms or increasing prices, but this can have a chilling effect on construction and real estate markets, as well as business investment broadly. In fact, unavailability of insurance is already impeding the reconstruction of New Orleans.[18]

## Growing Financial Exposure of State Insurance Pools
Continued from p.5

State's insurance plan of last resort. The Citizens Plan already has 881,808 policyholders, and is adding about 40,000 new customers each month.[49] Citizens expects to have added 470,000 policyholders by the end of summer 2006.[50] If this prediction is correct, Citizens will end up with 1.5 million policies, up 850,000 from April.[51] According to Mike Dooley, President of the Florida Association of Realtors, "Citizens is no longer the insurer of last resort. Citizens is becoming the insurer of only resort."[52] Even after the state legislature bailed out Citizens with $715 million from a state surplus, homeowners are picking up the rest of the tab through assessments to their policies, which are in some cases are twice as expensive as last year.[53] In late 2005, the head of Citizens warned of triple-digit premium increases in coastal locations.[54]

In Mississippi, the state's Windstorm Underwriters Association, which insures people who live in coastal counties, reports that its reinsurance costs went up 488 percent in 2006.[55] The increase came after the state's Wind Pool suffered a $745 million loss from Katrina, four times more than its $175 million in assets.[56] All insurers writing policies in Mississippi are assessed losses from the Wind Pool, and thus insurance companies paid $545 million to the Mississippi Windstorm Underwriters Association for losses from Katrina.[57] Even after the fund used $100 million of federal block grant money to pay for losses, homeowners are still going to face a 100 percent increase in their premiums.[58] Since Hurricane Katrina, the number of Wind Pool policyholders jumped from 1,000 to more than 17,000.[59]

In Louisiana, approximately $250 million will have to be paid by policyholders to pay offlosses the State's Citizens Plan due to Hurricanes Katrina and Rita.[60] As customers are forced to the residual market, they must pay 10 percent more, and, in turn, insurers remaining in the market must increase their contributions to the pool to pay claims. Louisiana's pool is expected to swell to 200,000 insureds in 2006.[61]

Because insurance is key to a healthy economy, insurers face unusual levels of scrutiny and public pressure. As a result, continued efforts to restrict coverage could be slowed or thwarted by a backlash from consumers, investors, and regulators. This, along with other factors (e.g. the broad geographic and business scope of climate change impacts), means that insurers are not likely to be able to simply “wall off” the problem. ■

— Excerpted with permission from The Ceres' publication, *"From Risk to Opportunity: How Insurers Can Proactively and Profitably Manage Climate Change."*

ENDNOTES:

1 Valverde, L.J. Jr. and M.W. Andrews. 2006. “Global Climate Change and Extreme Weather: An Exploration of Scientific Uncertainty and the Economics of Insurance.” Insurance Information Institute.
2 Tuckey, S. 2006. “Hurricanes Boost Reinsurers’ Combined Ratio by 23 Points.” National Underwriter Property & Casualty, p. 6, March 27.
3 Financial Times. 2006. 8 February.
4 Insurance Information Institute. 2006. Hot Topics & Issue Updates. “Hurricane and Windstorm Deductibles.” July.http://www.iii.org/media/hottopics/insurance/hurricanwindstorm/
5 Hartwig, R.P., Wilkinson, C. 2003. “Mold and Insurance.” Insurance Issue Series Vol. 1 No. 4. Insurance Information Institute, New York, NY. (August 2003).
6 Cavanaugh, B.B. 2006. “High Water Mark.” Best’s Review, pp. 49-54, July.
7 Insurance Information Institute. 2006. Hot Topics & Issue Updates. “Reinsurance.” July. http://www.iii.org/media/hottopics/insurance/reinsurance/
8 Sclafane, S. 2006. “Cat Re Capacity Shrinks for Key Regions.” National Underwriter, July 17, pp. 12–17.
9 Ruquet, M.E. 2006. “Watch out for Speed Bumps… As Softening Market Gains Momentum.” NationalUnderwriter, May 22, page 12.
10 Lynch, D. 2006. op. cit.
11 Sclafane. 2006. op. cit.
12 Horvath, S. 2006. “Some Businesses Operate Without Insurance.” Palm Beach Post, July 9.
13 Ceniceros, R. 2006. “Catastrophe Cover Capacity Shrinking.” Business Insurance, May 15, p. 1.
14 Pilla, D. 2006. “More Storms on the Horizon.” Best’s Review, pp 81–85, May.
15 Sclafane, S. 2006. “Gaping Captial Hole Troubles Cat Modeler.” National Underwriter Property & Casualty, p. 8, June 12.
16 Ruquet, M. 2006. “MGAs See No Quick Fix on Cat Coverage.” National Underwriter Property & Casualty, p. 7, May 15.
17 Wharton Risk Center. 2005. “TRIA and Beyond.” Philadelphia, PA.
18 Calder, C. and T. Griggs. 2006. “Insurance An Obstacle in N.O.” The Advocate (July 15).
19 Bushouse, K. 2006. “Legislature Seeks Freeze on Rate Hikes for Home Insurance.” South Florida Sun-Sentinel, July 13.
20 Mowbray, R. 2006. “Law Bans Dropping Coverage: Battle with Allstate May Go to Court.” New Orleans Times Picayune.
2173 Annualized numbers for all property policies as of 31 March 2006, provided by Jonathan Kees, Dir. Communications at the Florida Office of Insurance Regulation during 28 June 2006 phone conversation.
22 Allstate Floridian. 2006. Press Release: “Allstate Floridian Welcomes New Insurer to Florida Market.” 12 May 2006.
23 Adams, M. 2006. “A Storm of Trouble.” USA Today, June 8.
24 Waddell, L. 2006. op. cit.
25 Waddell, L. 2006. op. cit.
26 Adams, M. June 2006. op. cit.
27 Kuykendall, L. 2005. “Allstate Cuts Gulf Coast Exposure After Hurricane Insurer Reports Loss of $1.55 Billion: ‘Virtually No New’ Policies.” The Wall Street Journal, October 21.
28 Kuykendall, L. 2005. op. cit.
29 Gagnet, K. 2006. “Homeowners Struggle to Find, Afford Post-Storm Insurance.” The Advertiser, July 6.
30 Hipp, L. 2006. “Dale OKs Hikes for Twelve Insurance Companies.” Miss. State Repr quoted in Clarion Ledger, June 23.
31 Mowbray, R. 2006. op. cit.
32 Bernstein, J. 2006. “Allstate: No New LI Home Policies.” Newsday, January 12.
33 Adams, M. June 2006. op. cit.
34 Adams, M. 2006. “Strapped Insurers Flee Coastal Areas. USA Today, April 26.
35 InsuranceJournal.com. June 4.
37 Lord, P. 2006. “Homeowners Near Coast Get Surprise on Insurance.” The Providence Journal, June 11.
38 Lord, P. 2006. op. cit.
39 Lord, P. 2006. op. cit.
40 Burns, J. 2006. “Insurers Team Up to Fight Policy Downturn.” The Sun News, May 23.
41 Burns, J. 2006. op. cit.
42 Burns, J. 2006. op. cit.
43 Hull, P. 2006. “Money Alone Can’t Buy Insurance.” The Post and Courier, June 4.
44 Insurance Journal. 2006. Fla. Property Owners to Pay 1% Insurance Charge for Hurricanes.” June 2.
45 The Economist 2006. “The Price of Sunshine.” June 10.
46 Waddell, L. 2006. op. cit.
47 6/30/06 – Louisiana Hurricane Season No Insurance for Industry
48 Cornejo, R. 2006. “Large Florida Homeowners Insurer Goes into Receivership Following Hurricanes.” Best’s Review, p. 6, June.
49 The Economist 2006. op. cit.
50 Total number of policies as of 31 March 2006, provided by Jonathan Kees, Dir. Communications at the Florida Office of Insurance Regulation during 28 June 2006 phone conversation; Hsu, S. 2006. “Insurers Retreat From Coasts: Katrina Losses May Force More Costs on Taxpayers.” Washington Post, April 30.
51 Waddell, L. 2006. op. cit.
52 The Economist 2006. op. cit.
53 Rawls, L. “State Realtors Head Calls for Affordable Catastrophe Insurance.” Palm Beach Post. 2006, June 22.
54 Waddell, L. 2006. op. cit.
106 Sclafane, S. 2005. “Florida Homeowners Rates Could Triple, Citizens Warns.” National Underwriter Property & Casualty, p. 21, 5 December.
55 Insurance Information Institute. 2006. Hot Topics & Issue Updates. “Reinsurance.” July. http://www.iii.org/media/hottopics/insurance/reinsurance/
56 Juneau, D. 2006. “Louisiana Hurricane Season No Insurance for Industry.” Bayou Buzz, June 29.
57 Hipp, L. 2006. op. cit.
58 6/30/06 – Louisiana Hurricane Season No Insurance for Industry
59 Hipp, L. 2006. op. cit.
60 Juneau, D. 2006. op. cit.
61 Hsu, S. 2006. op. cit.

# Credit Selection as Key Alpha Generator

by Greg Hartch
GE Asset Management

With interest rates low and credit spreads historically tight, it is not surprising to see fixed income investors searching for alternative alpha generating strategies using macro-quantitative or currency overlays. While some of these strategies may offer value, investors should not lose sight of a more basic alpha generation strategy: fundamental credit selection. In the current environment, where default rates on corporate and asset-backed bonds are at historic lows, the importance of credit selection may take a backseat to other strategies, but over the investment cycle credit selection is of high importance. Certainly, credit selection was the primary tool for generating excess returns four years ago in the aftermath of the Internet/telecom bubble. Today, with signals suggesting that the current benign credit environment may be replaced by a more turbulent period in the years ahead, investment firms would be wise to refocus on the importance of internal research staffs and quality fundamental research.

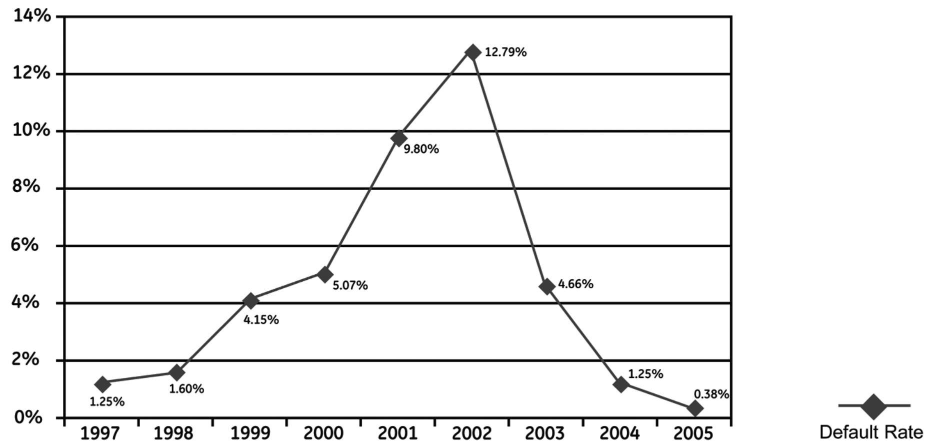
**The Next Inflection Point – The Return of the Credit Cycle.** Since the peak of defaults in 2002, the credit markets have improved rapidly resulting in a significant tightening of credit spreads. For example, default rates on high-yield corporate bonds have declined from a high of 12.8% in 2002 to 0.4% in the first half of 2005, while the average high-yield credit spread has narrowed from 856 bps to 404 bps (see Exhibit 1). Similarly, with respect to investment grade corporate bonds, the Moody's downgrade/upgrade ratio has gone from 5.30% in 2002 to 1.24% year-to-date 20052. The average credit spread on the corporate portion of the Lehman Aggregate has declined from 265 bps in October 2002 to a low of 75 bps in March 2005, and currently stands at 88 bps3. During such a dramatic shift in credit fundamentals and spreads, investors that were long credit outperformed. Similarly, as the differential in spreads between higher-rated and lower-rated securities has declined, the ability of generating alpha from superior fundamental credit selection—while still possible—has narrowed.

The downgrading of both General Motors and Ford by the major rating agencies to non-investment grade earlier this year and the dramatic widening of spreads in both credits may have served as a wake-up call to investors that fundamental credit selection matters. In fact, although current credit statistics remain robust and there are few projections for dramatic increases in default rates over the near term, the seeds of the next down credit cycle are being sown. This fact is perhaps most apparent in the volume of higher risk security issuance and the amount of private equity that has been raised which will fuel leveraged buyouts. Encouraged by a receptive high-yield market and low interest rates, the amount of CCC issuance has soared both in nominal and percentage terms. In 2004, lower rated issuance (CCC, NR, and split B/CCC rated) constituted 20.6% of high-yield issuance, which surpassed the previous high of 20.5% set in 19984 (see Exhibit 2).

Add to this a record amount of private equity being

**Exhibit 1**

**Default Rate of HY Bonds 1997-2005[1]**




Default rate is at historic lows and is likely to increase over the next few years.

[1]Source: Altman High Yield Bond Default and Return Report, First Half 2005 Update, Citigroup United States Corporate Bond Research, by John Fenn and Gabriella Petrucci, July 26, 2005, Exhibits 7 and 9.
Information noted above was obtained from third-party sources deemed reliable; however, GEAM has not undertaken any independent verification and no representation is given as to the accuracy of such information.

raised and conditions ripe for a return of leveraged buyouts and you have the recipe for greater turmoil even among higher-rated issuers. Finally, in the face of stagnant equity markets, managements seem by and large to have tired of repairing balance sheets and now are focused on returning capital to equity in the form of stock buybacks and increased dividends. Some Wall Street analysts have noted that recent CCC issuance consists primarily of refinancings whose performance will likely be superior to that of CCC bonds of earlier vintages. Perhaps they are correct, but even if the next down cycle is half of what we went through in 2001-2002, we are likely to see a fairly significant increase in default rates and greater differentials in the spreads of securities. In such an environment, credit selection will likely return as a primary tool for alpha generation.

**Quality Fundamental Research – What Does it Look Like?** Three elements are critical for superior fundamental credit research: (i) an experienced team of investment professionals, (ii) independence from consensus Wall Street research, and (iii) a well-established process that ensures both regular surveillance and a full sharing of information.

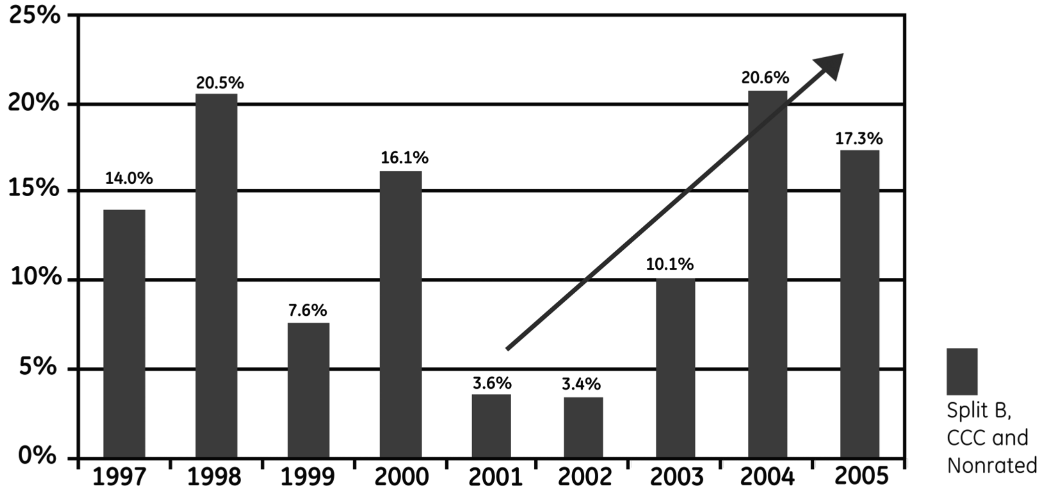
***People:*** Let's begin with the importance of people. There is nothing more important than investing in a team of research professionals with a range of prior experiences and memories long enough to know several credit shocks. Ideally, the team will have analysts who have worked at rating agencies, Wall Street firms and asset management firms, as well as analysts with strong finance backgrounds. This breadth of backgrounds provides a much fuller context to have a robust discussion of credit developments and allows analysts to have greater conviction in diverging from the market consensus.

***Even if the next down cycle is half of what we went through in 2001-2002, we are likely to see a fairly significant increase in default rates and greater differentials in the spreads of securities***

***Independence:*** In the most recent credit down cycle in 2001-2002, investors who followed the market consensus

**Exhibit 2**

## Issuance of Riskier Securities (% of HY Deals) 1997-2005[4]




[4]Source: JP Morgan Research.
Information noted above was obtained from third-party sources deemed reliable; however, GEAM has not undertaken any independent verification and no representation is given as to the accuracy of such information.

Continued from page 11...

generally suffered higher losses than their counterparts with strong independent research teams because most Wall Street analysts and the rating agencies failed to predict the scope of the defaults. The best way to ensure independence is to insist that analysts conduct primary research in the form of reading 10-Qs and 10-Ks rather than simply reading Wall Street summaries; that they seek out one-on-one meetings with management rather than simply listening to quarterly calls; that they speak directly with rating agency analysts rather than listening to conversations that others had with the agencies; and that they reconstruct balance sheets and examine covenants rather than solely relying on the work of others. In addition, firms should attempt to leverage any unique internal channels to gain new insights, whether such insights are gained through cross-asset class discussions within an asset management organization or discussions with affiliate businesses that have operating insights into a particular industry.

The importance of an independent, internal research staff is underscored by a separate trend emerging from the aftermath of the last credit cycle: namely the changes in Wall Street research. Struggling to superimpose principles designed to address the excesses in equity research that occurred during the Internet/telecom bubble, Wall Street firms are increasingly changing the structure of their fixed income and equity research teams. In fact, some Wall Street firms have combined their fixed income and equity research teams into single teams where some analysts are asked to cover credits for both equity and fixed income investors. While in theory this sounds like more comprehensive coverage of a single credit, in practice it tends to stretch individual analysts and diminishes the quality of their output. Other firms are deemphasizing written research and creating desk analyst positions attached to the trading desks. Another trend is that Wall Street research teams are losing many senior analysts to hedge funds and other buy-side asset managers. While numerous excellent sell-side analysts remain that are very helpful in formulating investment decisions, these trends serve to underscore the importance of internal research teams and are likely to place at a disadvantage smaller asset managers lacking resources to hire internal credit staffs.

***Process:*** Emphasizing independent research may sound great, but if you do not have a well-organized investment process, the research may not translate into actual alpha for investors. First, information must be shared fully between research teams and portfolio managers. For example, at GE Asset Management, we begin each day with a morning meeting on our trading floor attended by all fixed income investment professionals, and have established a centralized database to hold credit opinions and disseminate intra-day significant events. We also have regularly scheduled relative value discussions with portfolio managers, monthly credit optimization meetings, and reviews of special mention and watch lists. It may sound elementary, but if you do not put information in the hands of the right people it will not translate into action. Second, it is imperative to leverage technology to ensure that your research team is focused on the most important credits. The sheer number of credits available in today's fixed income markets may overwhelm even the largest research teams. An area that may offer particular alpha for strong fundamental research is structured products (MBS, ABS and CMBS). The challenge for investors in structured products is that without monthly surveillance of thousands of separate transactions on a monthly basis, it is impossible to proactively sell deteriorating credits. In addition, the rating agencies—which were criticized in the corporate sector for being too slow to act—are probably even slower in adjusting ratings in structured products. Technology offers potential solutions to these challenges. By using quantitative tools that complement fundamental analysis, it is possible to tackle the challenge of where to focus and gain the greatest alpha.

*"It is imperative to leverage technology to ensure that your research team is focused on the most important credits. The sheer number of credits available in today's fixed income markets may overwhelm even the largest research teams."*

**Conclusion.** There is an old adage that investors should "keep their eye upon the doughnut and not upon the hole." In the current environment, it certainly is possible to find alpha in various exotic derivative and quantitative strategies, but in addition, investors would be wise to stay focused on fundamentals and rely on a strong internal research team capable of remaining independent from the market consensus. Prepared investors will weather the next credit cycle much better than those fixated on finding that elusive portable alpha strategy that promises high returns for low risk. ■

This article was originally published last Fall.



# KBW: Another 'Katrina' Could Result in Permanent Departure from Coastal P&C Markets

One year after Hurricane Katrina devastated the Gulf Coast and flooded 80% of the city of New Orleans – resulting in a cumulative insured lose of $60 billion – a new report by Keefe, Bruyette and Woods suggests that some insurance companies are still under-estimating the damage that could result from a major Category 5 hurricane.

To be sure, forecasts of hurricane activity for 2006 have been revised to reflect a milder season. Should such a scenario materialize -- with little or no losses -- reinsurers will have a significant level of cash at their disposal, says Cliff Gallant, managing director and senior Property and Casualty Analyst at KBW.

"In this case we could expect reinsurers to issue special dividends and to buy back stocks." Asset and investment management strategies, despite the excess cash, he says, are unlikely to change as there are few opportunities for growth among these firms and they are more inclined to reward shareholders in the case of a windfall.

Other factors that are likely to result in large one-time dividends and share repurchases are rating agency pressures and increases in expected hurricane frequency by modeling agencies. These might limit the ability of companies to use excess capital for additional growth, Gallant says. "Furthermore, the Class of 2001 in Bermuda will have "come of age," reaching its fifth-year anniversary date. This means that capital charges applied by major rating agencies will drop materially because the business models would now be considered 'mature,'" a report by KBW on the subject says.

*"At the very least we would be in serious turmoil; we would see pricing go up in all lines of business."*

However, should the worst case event develop either this year or next – a category five hurricane that causes $100 billion in insured losses – Gallant believes there would be a wholesale exodus from the P&C coastal markets. "At the very least we would be in serious turmoil; we would see pricing go up in all lines of business." If the losses are exceptionally severe, investors might decide it is impossible to underwrite coastal risk, he adds. The United States has been devastated by hurricanes, as well as other natural disasters, in the past and insurers have not abandoned markets, Gallant acknowledges. But there is an additional wild card at play that could tip the markets: "right now there is a debate underway whether the weather is changing. Some people say yes, some say no. But I think if we were to have a third bad year it would have a psychological impact on investors and capital would be hesitant to return."

In the meanwhile, insurance companies are grossly underestimating their exposure to another category five storm, Gallant continues. "We are skeptical of the Probable Maximum Losses (PMLs) of many insurance companies." Also, he adds, companies' definitions of PMLs tend to vary. In the report, "All or Nothing: The Impact of Weather Extremes,"he notes that a Category 5 storm event would be much bigger than Katrina, yet the PML loss estimate for several companies is lower than their actual Katrina loss. "While we know reunderwriting has occurred, we believe that skepticism is warranted considering some of the gross miscalculations that companies made in 2005."

# One Year Later, Volume of Insurance Losses Remain Unclear

A recent ruling by the Louisiana Supreme Court could deepen insured losses in the state of Louisiana from hurricanes Katrina and Rita.

The Supreme Court of Louisiana recently upheld a law as constitutional giving policyholders an additional year to make claims or file lawsuits against insurance companies for an claims resulting from Hurricane Katrina or Rita.

"This is a significant piece of legislation," says Dickie Patterson, a Baton Rouge, La.-based partner with Baker, Donelson, Bearman, Caldwell & Berkowitz, PC and former Deputy Commissioner of Insurance for the State of Louisiana from 2003 to 2005. At the same time, he adds, the Louisiana legislature and business community have been very cognizant of the need to protect the insurance markets. If even only a few companies were to leave, it would have a domino affect on the local industry, he says. "The government is moving very cautiously in its dealings with insurance companies," he says.

The state's program as a carrier of last resort would be dramatically affected if several insurers were to leave the state, Patterson says. It is funded by active insurers in the Louisiana market. ■

WHO'S WHERE?

## New Appointments

**Assurant, Inc.** has named **John Egan**, vice president, investor relations. Currently, he serves as vice president, administration, Assurant Asset Management where he is responsible for tracking and evaluating insurance portfolio performance through financial analysis of sector, quality, duration and security levels. He also serves as the company's liaison with custodian banks, brokers and external audit managers. In his new role, Egan will work with **Melissa Kivett,** Assurant's senior vice president of investor relations, in managing Assurant's communications with shareholders and the financial community.

***

**Mellon Financial Corporation** has formed a new management team for its Eagle Investment Systems subsidiary that includes **Lou Maiuri,** a senior executive in the investment technology industry, rejoining the organization from Fidelity as its new chief executive officer. In addition, **David Palten,** current chief executive officer and one of the company's founders, will become chairman when Maiuri rejoins in October. Also, **John Lehner** has been promoted to president of Eagle.

Maiuri originally joined Eagle in 1996 as a partner. He was responsible for the development of the Eagle PACE product, including overseeing the build-out of its performance measurement and attribution capabilities. Lehner will now be responsible for international operations, product management and its services teams.

# Asset Manager Survey to be Released

**Patpatia & Associates** and **Insurance Finance & Investment** are in the process of compiling its first joint survey of insurance asset mangers. The survey will differ from previous years' editions in that it will solicit more in-depth information about the capabilities, experience and investment strategies of the asset managers going beyond such standard information as assets under management and asset class specialization.

**To participate, please contact Jessica Burke at 510.559.7140 or jburke@patpatia.com. To participate, please contact us no later than September 22, 2006.**

Continued from page 15...

***

**Will Cannon, Eric Dobbie, Derrill Pratt** and **Anne Turner**—all former members of Wachovia Capital Markets' team—have joined **Friedman, Billings, Ramsey & Co., Inc.**'s Institutional Brokerage. Now Senior Vice President, Sales Trading at FBR, Cannon served as director of Equity Sales Trading at Wachovia. Turner, previously vice president, Equity Capital Markets-Corporate and Executive Trading, will be vice president, Sales Trading at FBR. Dobbie joins FBR's Equity Trading department as senior vice president. Most recently, he was director & senior listed position trader for Wachovia Capital Markets. A senior vice president, Equity Trading at FBR, Pratt was director of NASDAQ Trading.

***

**Bruce Ferris** has been named vice president of Strategic Account Management for **Prudential Annuities.** Prior to joining Prudential, he spent 11 years with Hartford Life Insurance Company.

***

**Kristina Clark** will join **Wachovia Securities'** Debt Capital Markets (DCM) group as a managing director. Clark, who currently serves as managing director and senior analyst in the Fixed Income Research Group, will assume a senior coverage role focusing on specialty finance companies and banks. Clark has been at Wachovia for almost three years. Prior to joining Wachovia she was a senior research analyst at Banc of America Securities.

***

**Cantor Fitzgerald & Co.** has added eight new hires to its Debt Capital Markets Group -- **Lynn Lounsbery, Howard Furman, Larry Strang, Mark Mottolese, William Grigsby, David Newton, Mike Bennis** and **Therese Zuch.** Lounsbery joins the Cantor Fitzgerald in Albany as part of the corporate bond trading desk. She previously worked at First Albany where she was responsible for trading cross-over and project finance credits in the industrial and utility sectors. Furman, Bennis, Newton and Strang join the Cantor Fitzgerald in its Boston office as part of the sales team. They were part of First Albany's sales office in Wellesley, MA. Mottolese and Grigsby join the firm's Naples office. Mottolese joins the sales team with a background in research and sales in credit products and Grigsby as a Credit Desk Analyst specializing in cross-over and project financing security analysis. Both came from First Albany. Zuch joins the New York office as part of the Credit Sales team. She previously worked at Raymond James, CIBC and Smith Barney. ■