PRESENTER: Hello and welcome to asset.tv with me Mark Colegate. European insurers have got a lot on their plate from Solvency II through to a world of low to negative yields, but what does it mean for their asset management arms and the solutions that are available? To discuss that, I'm joined here by a quartet of experts from Legal & General Investment Management. Let's meet them. On the panel, we have Graham Wardle, Senior Portfolio Manager within the LDI Funds team; Martin Dietz, Senior Portfolio Manager, Multi-Asset Strategies; Uday Patnaik, Head of Emerging Market Debt; and Medhi Guissi, Co-Head of Solution Strategy. Well, Medhi, just to kick things off, could you give us a bit more detail on the insurance business as LGIM? MEDHI GUISSI: So we manage as of today US$140 billion on behalf of the insurance companies. Around 50% of these assets come from our parent company, Legal & General, across Balkan, which is protection and general insurance books. We also manage third party insurance assets in the UK, but also in international markets. Solutions is at the heart of what we do at LGIM. With the investment departments, we have a centralised quantitative analytics function, which houses investments and also insurance experts, who work very closely with our portfolio managers on the active side, like Woody, Martin and Graham, in order to design and implement bespoke investment and risk management solutions which are meeting specific insurance outcomes, like accounting, regulatory capital, business and economic risk, and ESG. And what I would like to say is that, as of today, we offer a wide range of solutions for insurance companies. Starting from booking management to cashflow matching credit, equity protection, up to the more holistic solutions of the world, like managing an entire investment portfolio in line with insurers' specific balance sheet requirements. PRESENTER: And what are some of the main trends that you're seeing in the European insurance and investment market at the moment? MEDHI GUISSI: So, if I look at Europe, we're talking about an industry that's rich on the asset side, nearly €10 trillion last year. Most of these assets are backing traditional life policies which embed financial guarantees ahead of unit linked, ahead also of property and casualty and healthcare policies. To answer your question, I'm going to focus on the life insurance business, but I'm very happy to talk about other business lines if you would like to. The first point to keep in mind is that the answer would be obviously quite different from one country to the other, and from one insurance company specifically to the other, but it's important to keep in mind that an important number of life insurance companies have sold financial guarantees to their policyholders, and they did not necessarily hedge those guarantees accordingly in terms of duration and complexity. Hence, an important number of them have been really challenged by the negative interest rate environment, as well as the implementation of Solvency II, which introduced I would say a market-based valuation of balance sheets, coupled with risk-based capital requirement, and also increased transparency and reinforced corporate governance. So, in terms of team, we saw consistently yield investment being a major team in the industry, whereby an important number of insurance companies have rethought their LDI strategy by progressively introducing liquid and illiquid credit as core components. We've also seen an important number of insurance companies running active duration strategies, but also trying to cheapen as much as possible the cost of complexity hedging. And today in this environment where we have I would a combination of low rates, even lower yields, we see capital efficient growth being an increasingly important theme for insurance companies which are seeking to meet their long-term obligations, while controlling balance sheet volatility and regulatory capital charges. It's important to keep in mind that in this environment where basically the traditional life policies which are embedding financial guarantees are becoming expensive, with I would say negative interest rates, as well as Solvency II, if I focus on Europe as an example. The future of long-term savings and life insurance policies may actually sit under the unit-linked business, as well defined contribution pensions. I think this is a very important area of growth, where insurance companies have an important role to play. For instance, if I take post retirement income, this is today a global theme, so there is no doubt about it. And I personally believe that in this area there is still a lot of room for innovation, because we haven't reached yet the level of maturity that we would like to see. And I would also say that there is still a lack of supply in terms of the investment offering there that we're expecting in the market. So I see there an important number of insurance companies that would need to invest in terms of investment capabilities, as well as technology, in order to build integrated solutions that are offering to the end customers a combination of a diversified stream of income, as well as longevity protection. PRESENTER: Thank you for giving us that overview. Now, Uday, we mentioned yield and income there a few times. What sort of interest are you seeing from insurers in emerging market debt, your area of specialism? UDAY PATNAIK: Actually there's been a significant amount of interest in emerging market debt, and precisely for one of the main reasons that Medhi mentioned was this search for yield. But I should say emerging market debt, it's a fairly wide universe, and specifically what insurance companies are looking for is access to investment grade hard currency sovereign and corporate debt, so specifically investment grade hard currency. And we've been actually been doing an educational process with our clients, and explaining to them that through investing in emerging market hard currency IG debt that you get a superior risk return on capital and capital efficiency via this investment versus your traditional asset classes that you think of, which would be European IG and US IG. PRESENTER: And is now a good time to be investing in emerging market debt? UDAY PATNAIK: Actually both tactically as well as from a long-term horizon I would say yes. In emerging markets, over the last six months, we have had a meaningful retracement in spreads. So from a tactical standpoint this is a great place actually as an entry point. But from a longer-term perspective as well, this convergence trade between emerging markets and developed markets is still in place. And again Medhi and I in the solutions team, we recently wrote a white paper again explaining the benefits of investing today in emerging market debt. And what you see is investing in EM, you get excess returns net of FX hedging costs throughout the risk spectrum, and without having to actually take meaningful duration for that either. PRESENTER: Uday, fund managers always claim it's a good time to be investing in their markets. So can you tell us when is it not a good time to invest in emerging market debt? UDAY PATNAIK: Actually I was fairly negative on EM end of last year up until really about a month or so ago, and in fact I was here on asset.tv giving my prognosis, my concerns. But generally speaking the reason I'm more positive for example on hard versus local currency debt is I'm still rather positive on the US dollar versus EM currencies. So I think if you're taking the risk in EM local markets, your returns aren't going to be (a) as good as hard currency, especially for the volatility that you're taking. Now what I would say with hard currency is because we've had a meaningful retracement, including NIG, this is a great place to pick an initial investment. But I think for me it's the dollar. When you see a strengthening dollar, which we have seen for the first half of this year, it's difficult. I do expect the dollar will have one more leg up, which is why I would refrain from investing in local markets right now and would prefer hard. PRESENTER: Martin, multi-asset, we hear a lot of people talking about multi-asset investing now. Doesn't that tell us that it's an overcrowded and expensive trade? MARTIN DIETZ: I don't agree that multi-asset or all asset classes are expensive. I think what is more true is that returns going forward will be lower. So let me explain what I mean. Now obviously returns have been very strong. If we look at US equities they have been going up since early 2009, and that has only been partially supported by earnings being very good. I mean we see a strong leg up in earnings right now, which are the US tax cuts, but in general yes valuations have become a bit more rich. But the question is what is the neutral reference point for these valuations? So, if we just look at history, historic averages, yes current valuations are higher than they have been historically, but we actually favour more looking at asset classes versus each other. So if we look at equities versus bonds, we find that current equity valuations probably imply a similar equity risk premium than what we've seen historically. So we would assume the same amount of outperformance of equities over bonds that we've seen historically. And that's true for lots of asset classes. So the mystery, the issue is more on the bond side, where obviously yields are very low, spreads are very low on investment grade credit as well, and that causes some pain for some insurance companies. But the uncomfortable truth is this is all simply a result of being in a low growth, low inflation environment, where really yields are not going to go anywhere over the short and medium term, and in particular in the eurozone where we see inflation particularly low, and growth still only going up very gradually. So being in multi-asset obviously there's lots of asset classes we can pick, and so there is a segment I would say in the middle, mid-risk assets that I think are actually still quite attractive. They haven't gone up quite as much as the equities. They still promise quite a decent yield or return, and that includes emerging market debt, potentially high yield, infrastructure and REITS on the property, on the listed side as well. PRESENTER: Now Medhi mentioned a little earlier capital efficient growth strategies, where does multi-asset fit in with that? MARTIN DIETZ: People do multi-asset for lots of different reasons, and they're very different incarnations of multi-asset funds obviously. Now what is relevant for an insurance company, well Solvency II gives a very explicit benefit to diversifying your portfolio, to moving away from just a focus on investment grade credit or equities for the return seeking side. So you get a benefit for diversification, and that should we used. Now it can be quite hard I guess for an individual insurance company to stay on top of 10 or 15 different asset classes. So a straightforward way of just getting that diversification is outsourcing it to an asset manager like us, so us running a diversified portfolio for an insurance company. And we can do that in a very straightforward strategic way as a package solution. Number one almost on the other end of why people do multi-asset, there is a big scope I guess in multi-asset to generate top-down macro-based alpha for clients. We can invest across all of the different asset classes. We can put on relative value trades between the different asset classes. And again this is maybe something where people might do it themselves, same as they might run this diversified portfolio themselves, they might decide we want to do TAA all by ourselves. But that be quite hard. You need to stay on top of markets, you need to have the implementation capability, you need to be able to act quite quickly, you need to risk manage your positions, all of this. So it can be quite attractive to outsource that part of a portfolio. PRESENTER: And Graham, where does LDI fit when it comes to these capital efficient strategies? GRAHAM WARDLE: Yes, I mean the point is that long-only equities are very expensive for insurers to hold under the Solvency II framework. So effectively insurers need to have a very strong market view to justify the cost of capital for holding equities. Alternatively therefore you need to add some sort of hedging overlay to the equity portfolio to achieve the required return. So what we see now as a result is an increased focus on protected equity solutions, which has been identified by the low rate environment, the hunt for yield, and the strong growth that we've seen over the past few years. So our dynamic equity protection strategy can help smooth some of the adverse outcomes, protect against some of the worst downturns, and also add the capital efficiencies that insurers will need within their portfolios. PRESENTER: And what are some of the more, some of the underlying investments that you'd be putting the money into to achieve this? GRAHAM WARDLE: So the point is for index equities, you can't use a linear instrument like a futures or a TRS to hedge the exposure. Because as the hedge ratio goes up, effectively the cost of capital reduced return falls. So for an indexed portfolio you need to use non-linear instruments like options. For an active portfolio actually you can use futures to hedge some of the exposure, but you've got to be very mindful of the basis risk between the active portfolio and the futures, so managing that risk is key. PRESENTER: And what would you say makes LGIM unique in this space, what are your USPs when it comes to LDI? GRAHAM WARDLE: I mean, as Medhi said, we have a very client-focused, solutions-focused view. So we don't just have an off-the-shelf product that we push out to our clients. Every single solution has to be designed mindful of the client's current assets, what regulatory framework they operate in, and what capital efficiency they need to achieve. So that's really on the solutions side. We're obviously a global asset manager. We can access the full global investment universe, the full global set of instruments. And our global trading team has a very strong track record of outperforming passive benchmarks through a combination of algorithmic trading methods, being able to access bank AXAs. So we can get very big size done in the market, and also know where the liquidity is in different instruments. So all of that together in the round means that insurers can get a more cost effective, it's better from a governance perspective than implementing this sort of strategy directly with a bank, which is historically what insurers have done. PRESENTER: Well you mentioned passive investing there. Uday, when it comes to emerging market debt, does it ever make sense to go for a passive investment strategy? UDAY PATNAIK: Well I'm an active manager, so I have a bias. But in my opinion emerging market debt, in the asset class in general it really lends itself very well to active management, and I'll name you a few reasons. Number one is the information asymmetry in this asset class. Unlike other asset classes which are perhaps a bit more established, there are more analysts covering the asset classes. In emerging markets, there are a handful of people looking at quasi sovereign investment grade debt in Kazakhstan, looking at the financial banks etc. in Nigeria etc. So you have information asymmetry, and you can capture that with an active manager. The other thing with active management which is really important is that you have to understand emerging markets, it's a very dynamic asset class, right. There are over 60 countries that are in a JPMorgan index, approximately 550/600 corporates. So you always have credits moving from sub-investment grade to investment grade, and unfortunately from investment grade to sub-investment grade. And through active management, if you have the right investment process set up, you can sell credits which you believe are going to be effectively jumped well before they are, and preserve capital, which is obviously very important from a Solvency II perspective. MEDHI GUISSI: If I may add to his point, because we talked about the capital efficiency, which falls under pillar one of Solvency II. But we should not forget about pillar two, which is as equally important as pillar one. Under pillar two the regulator is asking insurance companies to manage the risk on a forward looking basis. And given the nature of the asset class we're talking about, we believe that managing it on an active I would say implementation fashion is providing you the alignment with pillar two, which is as I said as equally important as pillar one. PRESENTER: Multi-asset investing, you've talked a little bit about using it in capital efficiency strategies, where else can it fit in with the insurance industry? MARTIN DIETZ: I mean a good use for multi-asset is unit-linked portfolios, where usually you get some key constraints, and we are very well used to managing within these fee budgets. We think a multi-asset portfolio works really well in improving upon say standard equity implementation that we might still see, or the old fashioned balanced portfolios who are just government bonds or credit and equities. So diversification, multi-asset can really add something, and improve risk-adjusted returns for these portfolios. And then the second one is obviously on the DC side, where we see say target date funds or structures that people use over the long term. We see diversification, we see multi-asset towards the endpoint. There's a bit of de-risking, but obviously returns should still stay as high as they can. So we can use multi-asset there. And then I would say the last one for me is where obviously in the current environment we don't get a lot of people who buy annuities anymore. Annuities are priced off the bond markets of course, so people are not happy with the rates they're getting on the annuities. So using income drawdown, basically staying invested while you need the assets to generate cashflows, that's a good area for multi-asset. So we're used to looking at the risk management side of these portfolios, keeping returns up, but also looking at the cashflow side. So we know they're going to have to generate a certain degree of cashflows that people want to use. PRESENTER: What would you say to someone who says well the fund management industry is really good at accumulating, but where's the proof when it comes to decumulation multi-asset can deliver? MARTIN DIETZ: So I mean decumulation is a new concept, so there are different approaches out there. And I would say it's maybe not clear yet what the right way is to managing these portfolios. We probably think we've been out very early with some really good ideas. There's lots of thought leadership that we've pushed out as well. One of the main considerations is of course we know very well how to manage risk-adjusted returns, and then overlaying that additional consideration, which is the cashflow generation. We don't want to be forced to sell any assets just to generate cashflows at the wrong point in time, so you always need to be aware of where you are. We want to look in cashflows ideally for the short term, so we're never forced sellers in these portfolios. And so that's a couple of tricks that we try to use in this case. PRESENTER: Uday, from your point of view where else can insurance companies be using emerging market debt? UDAY PATNAIK: I think absolute return strategies are very interesting for various reasons. But I would say number one that they're de-correlated from some of your traditional asset classes that people invest in, which would be global equities, let's say high yield, IG debt. And you could effectively pick up return, excess return without having to for example increase your duration risk. So for your growth portfolios specifically as a diversifier it just makes a tremendous amount of sense in my opinion where you can pick up excess yield, boost your operational profits without having to take the duration risk. PRESENTER: Now you're talking about the opportunities and the solutions, but what are some of the risks? In the LDI space, what are you keeping an eye, what could go wrong? GRAHAM WARDLE: From its inception LDI is a risk management strategy, and it really is at the heart of how we design and construct portfolios. PRESENTER: So what investment banks had in 2008, so what, you know? GRAHAM WARDLE: Yes that's true. I mean I suppose the point is on this more dynamic protected equity strategy the details really do matter in terms of how the performance will look like. So in particular on this type of strategy insurers need to be focused on the pin risk of entry and exit. So effectively where you're getting in the market, where you're getting out of the market. Basis risk if it's an overlay between your hedge and what you're actually holding underneath it. And the primary risk is how is the structure being designed. It goes back to the point that we were saying that it isn't an off-the-shelf product, it needs to be designed with the specifics of the capital efficiency the particular insurer needs. And the point is that we can help mitigate all of these risks by designing the structure properly, and running forward and backward looking analysis to show how it would perform in different markets. PRESENTER: Well you mentioned it's really important to have this element of bespoking; could you just explore that a little bit more, how personalised does this need to be? GRAHAM WARDLE: So we take an example that we implemented recently for a client. They had a very bespoke allocation to world equities, so they had specific weightings. So effectively it's being able to decompose that portfolio into the specific country weightings, and then being able to access the instrument within that that provides the most liquid instrument to trade. So it may not immediately be obvious which future is the most liquid in which particular markets. So you need to be able to have a lot of experience in trading it to access the correct one. PRESENTER: Thank you. Martin, what are some of the potential risks and downsides of multi-asset? MARTIN DIETZ: The way we manage multi-asset, and it's all about risk management of course. So we don't have benchmarks, we don't have anywhere to hide. We own all of the risk, and we need to manage against these risks to give people good returns. Now what we would use as the backbone of all of our structures is just using diversification. So splitting the portfolio across different regions, across different currencies, different asset classes. So that diversification is really one of the proven concepts I would say where no matter what unexpected risks come along, it gives us a certain degree of protection in the first place. Now obviously particularly in actively managed portfolios we are also going to be assessing the risks that are out there, and then we're going to decide if we want to manage against these risks by hedging, by reducing exposure and so on and so forth. Right now what are we concerned about? Well I think over the last say one, two, three years, what we've seen is a rise in geopolitical political risks. We call this the new political paradigm. So we thought we knew about how the world works a couple of years ago, and how countries interact with each other, and all of that is now changing. So that creates lots of uncertainty. If this is about trade wars, or if this is about people changing alliances to a degree, all of that means very big risks for us as multi-asset investors. So what we would always be looking at is can we hedge against that specific risk? Now we would want to hedge when the hedges are cheap, and ideally they're not priced in. We would look at direct hedges, we would look at macro hedges, and we would see if we think we're still rewarded for taking the risks. In a multi-asset portfolio in particular we need to take some risks. We just need to make sure they're measured and controlled. PRESENTER: Well something like Trump and trade, what's your thinking around that, and how does that then affect your view of risk and what you do in portfolios? MARTIN DIETZ: So that's really right now at least at the core of this political paradigm. Now historically we've seen people working together more and more closely. We've seen some of the trade barriers come down, and that seems to be going a little bit in reverse. Now right now it is mainly the US versus the rest of the world. What we obviously need to monitor is this idea of being very selfish when it comes to trade and to tariffs, does this spread out further? We're not seeing this right now. And I guess if we look at the market response to some of these announcements, I think most market participants don't quite believe that this is the general direction of travel. But we need to be really vigilant and careful about what is going on in markets. PRESENTER: Uday, when it comes to emerging market debt, can you reduce the risk in investing in that asset class? By nature it's pretty volatile isn't it? UDAY PATNAIK: Yes, and it depends also what part of the spectrum you're on. So emerging market debt, I mean let's put a size on the universe. The investible universe of emerging market debt is just over US$11 trillion equivalent. But in that universe you have AA all the way down to CCC. So you can reduce the risk for example if you're in hard currency versus local currency, if you're an investment grade versus sub-investment grade, and if you're in shorter duration debt versus let's say long duration debt. But to the point being made risk management is critical in emerging markets, because in emergency markets yes we have the geopolitics as we know in EM, but you also have the commodity risks. We're priced in hard currency off US treasuries, so you have the rates risk. You have the global volatility risks, and of course then you have your own country risk. So if you're investing in Brazil or Mexico etc. PRESENTER: And just moving on. Medhi, we hear a lot more about ESG investing these days, how important is that to the insurance industry? MEDHI GUISSI: So there is no doubt that ESG is now I would say a major theme in the global asset management industry. The European insurance regulator is actively promoting basically ESG practices. The European Commission has recently set up a high level group of experts that will, on sustainable finance. And this group will basically be soon taking concrete measures on an ongoing basis. And coming back to the [unclear 0:27:30]. They've been actively promoting basically ESG by telling insurers that they should integrate it fully into their investment process, but also taking into account ESG outcomes when it comes basically to their own risk and solvency assessments. And at the moment there are some discussions on whether sustainable indicators should be taken into account when it comes to insurance stress testing. Personally I wouldn't be surprised if ESG becomes almost a hygienic factor when it comes to insurance asset management. And last year or the year before, I don't really remember, but a major player in the insurance space has taken the strategic decision to fully integrate ESG as part of its investment process, but also to actively engage across the entire investment portfolio. So these are strong signs that we are heading towards that particular direction. PRESENTER: So how do you go about actively engaging as an investment with corporates when it comes to ESG? MEDHI GUISSI: So we have a corporate governance team which actively engage with a wide range of companies globally speaking. This team is independent from the business, and directly reports to our chief executive officer. What we need to keep in mind is that the engagement could potentially be complemented by the climate impact pledge, whereby the corporate governance team follows actively around 90 companies. These are the largest companies in the critical sectors when it comes to the transition towards to low carbon economy. And the idea there is to potentially divest from the companies that do not meet our minimum ESG criteria, and fail to engage with us over time. PRESENTER: And can you have an active approach to ESG whilst running passive portfolios for clients? MEDHI GUISSI: So let me break it down between passive and active. So if I look at the way we approach ESG in the indexed space, there are three levels of potential implementation. So the first one is exclusions, it's basically about excluding some securities. For instance those which do not comply with UN global compact principles. The second layer of implementation is around integration, which leads to a relatively low tracking error. And the idea is to tilt an indexed portfolio in line with specific ESG scores. And the third level of implementation is what I would call impact investing, and the idea there is to focus on the ESG leading companies. And this approach tends to lead to a relatively high tracking error. It's important to keep in mind that when it comes to our approach in the indexed space, the three approaches I have mentioned to you earlier, it tends to be complemented with the active engagement of the corporate governance team as I told you earlier as well. As well as the climate impact pledge, provided this is required by our clients in the specific mandates. We have built over the years in the indexed space IP when it comes to a wide range of themes, like climate and diversity. And we're currently actively investing in our quantitative infrastructure in order to scale out ability to provide a level of flexibility that clients are seeking in this particular space. If I look at ESG from an active perspective, it's fair to say that it's embedded in the fundamental DNA of how our analysts and portfolio managers are assessing the risks and opportunities across the capital structure. So what I would like to say is that ESG should be seen here as an additional layer of scrutiny, which is helping you reinforce the fundamental I would say assessment of a particular sector or a particular company. So for instance the companies that have a very strong corporate governance are much less likely to lead to negative surprises for investors. And those which constantly ignore basically environmental issues and keep hurting the environment are much more likely to face political and regulatory pressure. So the way we look at it is that ESG is here to compliment the fundamental assessments of our analysts and portfolio managers, in order for us to build a high conviction portfolio which tends to be concentrated, which reflects at the same time our long-term themes and views that will be I would say shaping the future. And we believe that this approach can only improve financial performance in the medium long run, as well as enhancing risk-adjusted returns. PRESENTER: Well let's bring that through to you as the fund managers and risk managers. How much consideration do you pay to ESG when it comes to putting together an LDI solution? GRAHAM WARDLE: I think to go back to Medhi's point about what ESG truly is, it's a way to essentially add alpha to a portfolio. And as I said initially that an overlay strategy can really remove some of the beta from a portfolio, so effectively it can enhance the risk-adjusted returns. PRESENTER: Well then turning to the investment side of things Martin, how much time do you spend thinking about ESG when you're putting portfolios together? MARTIN DIETZ: So the way we do multi-asset really is as asset allocators. So I would use some of the existing building blocks we have, that may be index, that may be active building blocks, to put a multi-asset portfolio together. So it will always depend on the client requirements if that is more heavily focused on the specific ESG building blocks, or if I used our more standard funds which obviously the engagement part in it, so they're covered by our corporate governance team. So it will depend on what clients want in terms of the intensity of the ESG tilt. PRESENTER: Uday, how about you when it comes to emerging market debt? UDAY PATNAIK: Well actually quite interestingly we very recently won our first ESG mandate for an insurance company in Germany. And we're actually working, tomorrow we'll be funding our second mandate, not for an insurance company but again an EM ESG mandate. So this is becoming increasingly important. But what I would say in emerging markets it's almost embedded when you invest in EM, because when you invest in EM the first question is who owns the company? What's the relationship in the political spectrum? Who are their accountants? Have they been changing their accountants frequently, which is always a bad sign, etc. etc. So it's like I think what Medhi was saying that if you're investing properly a lot of these questions you should be asking yourself actually before you even put a dollar into the sovereign or the corporate. PRESENTER: We are out of time. We have to leave it there. Gentlemen, thank you all very much indeed. And thank you for watching. From all of us here at asset.tv, goodbye for now.