

Exchanges at Goldman Sachs

What's on the minds of the world's largest investors?

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Allison Nathan: Against a volatile market and uncertain economic environment, what's on the minds of some of the world's largest investors?

Matt Armas: Insurers are looking at the backdrop with two lenses. They're increasingly worried about the potential for a recession or for the erosion of credit quality as the economy slows. But they're also very excited that interest rates are higher, that yields and returns available on, in particular, fixed income investments are higher. And they're really looking forward to taking advantage of those higher returns, those higher yields, to build those into their portfolios.

Allison Nathan: I'm Allison Nathan, and this is Exchanges at Goldman Sachs.

From rising interest rates to recession fears, insurance companies are taking a more cautious approach with their multi billion dollar investment portfolios. Today, Goldman Sachs's Mike Siegel, global head of the insurance asset management and liquidity solutions businesses, and Matt Armas, global head of insurance asset management, join me to discuss what's on the minds of this influential investor base. Mike, Matt, thanks for joining us.

Mike Siegel: Thank you.

Matt Armas: Glad to be here.

Allison Nathan: So just to set the stage, insurers represent one of the largest investors in the world. And so their investment decisions can have an outsized impact on markets and investment flows. So for our listeners, first, Mike, can you just broadly define for us what insurers as an investor base are and the impact they can have on the global economy?

Mike Siegel: Sure, Allison. First, insurance companies write protection. They write it against people's lives, their health, their property, autos, this building. In writing that insurance, they take in premium. And what do they do with the premium? They have to invest it. They have to invest it somewhere. And the industry in aggregate is about \$30 trillion. It's one of the three largest investing industries. So you've got the banks, the insurers, and the pension plans.

So with that large pool of capital, the question is: What are they doing with it? And it has a significant impact on where they're putting that capital to work.

Allison Nathan: So every year, your team publishes a very in-depth report looking at that question. How are insurers putting capital to work? Talk to us a little bit about who responded this year and how the survey was conducted.

Mike Siegel: This is the 12th year for us doing the survey. We had the largest response rate ever with 343 companies responding. Those companies manage over \$13

trillion in balance sheet assets, so a very broad and very sizable response.

It is a global survey. We had responses from Europe, from Asia, from the Middle East, from the Americas. Responses from life companies, property casualty companies, healthcare companies, and reinsurers. So a very broad participation in the survey.

Allison Nathan: And so it's an interesting moment in time. We are facing tremendous economic uncertainty. We have talked at length on this podcast about higher rates, volatile markets, and of course most recently the stresses in the banking sector. How are insurers thinking about the investment landscape against such a challenging backdrop? Matt, let's turn to you.

Matt Armas: Sure. I think insurers are looking at the backdrop with two lenses. One is our clients are telling us they're increasingly worried about the potential for a recession or for the erosion of credit quality as the economy slows. But they're also very excited that interest rates are higher, that yields and returns available on in particular fixed income investments are higher. And they're really

looking forward to taking advantage of those higher returns, those higher yields, to build those into their portfolios.

Allison Nathan: Right. So there is a silver lining to this backdrop, especially for this client base.

Matt Armas: Yes. And different than, say, pension funds or different than banks, insurance companies generally benefit with higher rates. And why do they benefit with higher rates is insurers generally do two big things. One is insurers protect things, as Mike mentioned. They write motor insurance or they write homeowners' insurance. And when you're protecting things, you want to make sure you have a big pool of assets available that are very high quality, that you can sell if you need to if there's a claim. And when there's higher interest rates available, the higher returns for those high-quality assets, insurance companies generally do better.

The second is they provide savings protection. They sell products to consumers that guarantee certain returns like annuities. And when interest rates are higher, they can offer higher returns to their end investors.

Allison Nathan: And so are you seeing insurers shifting their allocations? How are they responding to take advantage of these higher yields?

Matt Armas: What they're telling us is they intend to do two things. So insurers intend to buy these higher yields. So to buy longer dated fixed income securities, longer dated things like treasuries and government and agency and municipal bonds with longer maturities so they last longer and they want to buy those into their portfolios. And the second thing they want to do is they want to buy higher quality assets.

I mentioned before they're worried about the potential for recession or worried about credit quality deteriorating with a slowdown. So the way they protect themselves is they buy higher quality corporate credit or other types of credit in order to earn those returns in assets that are generally viewed as better credit risks.

Allison Nathan: So this survey was conducted before this recent turmoil in the banking sector. So would that change any of the results that you observed?

Matt Armas: So our survey did close in the last week of February, but one of the things that I would notice is that, when we look through the results -- and we certainly asked ourselves this question -- what you saw was clients preparing for things like higher rates, concerns around the potential for a recession and concerns around the deterioration in credit quality. So I would say, while it might be slightly different, I think insurers generally were preparing for an environment not dissimilar from what we're seeing today.

Allison Nathan: And Mike, let's talk about this a little bit more because, in the wake of these banking stresses, we've seen a big problem being this maturity mismatch where banks were holding a longer duration asset so they then had to sell in order to meet a gap between deposit outflows. Do insurance companies typically hold their longer duration assets to maturity? Is there anything like a mismatch in the industry?

Mike Siegel: Great question. And the answer is absolutely not. What these insurers typically do is they match the maturity of their assets to the maturity of their

liabilities so that they don't have to forcibly sell assets before they're ready. Matt mentioned keeping very high-quality liquid assets. So for property casualty companies that may end up having to fund a hurricane or an earthquake, they always have a pool of readily available short dated high-quality assets to sell to meet claims payments.

For life insurance companies, they are typically investing over the expected life of individuals, so they'll put their investments out further. But the companies are not subject to a run. They're not subject to their policyholders mailing in their auto policies or their homeowners' policies such that they need to meet a liquidity outflow.

And by the way, if somebody did mail in their policy, they're not getting any money back, so there's no point in doing that. So they take asset liability management very seriously. They do a lot of risk analytics. They hold capital against both their liabilities and their assets, but they're not subject to the same kind of issues that you see in the banking sector.

Allison Nathan: So insurers generally benefit from the

higher interest rates and yields. They are not subject to the same kind of stresses that we are seeing in the banking sector right now. What are insurers worried about right now?

Matt Armas: Insurers are worried about a few things. They're worried about inflation. And again, depending on the type of insurer. So if you insure cars and you have to replace the cost of that car, as the cost of cars go up, the cost of that insurance policy may exceed what you had written or reserved for last year. So inflation can impact your payouts in that way.

Inflation can also deteriorate the value of policies to your end customers in which they don't want to buy policies at today's interest rates. So inflation does present a problem for both our saving insurance companies and our protection insurance companies.

The second thing inflation does is it prompts a response from the Federal Reserve and other central banks. So when central banks go to defend against inflation by raising short-term interest rates, that puts pressure on the economy overall. And whether it's through increasing the

chances of a recession or by eroding activity in the economy which will eventually erode credit quality, that will come through the portfolio in the form of stress in some assets that you might own.

So insurance companies are concerned about the current environment, primarily, they tell us, around the inflation, the response to the inflation in monetary policy, and they're also concerned about eroding credit quality.

Allison Nathan: And do we see any differences regionally across the globe between US, EMEA, Asia insurance companies?

Matt Armas: On the worries, I would say there's more concern in the US around the inflation cycle and the monetary response. So the response by the central bank. And that makes sense because the US was the first country really to go through and start this inflationary monetary policy tightening cycle.

I would say in Europe, the concern seems to be more focused on geopolitical tension, which makes sense given that the energy disruption associated with the war in

Ukraine is really a European-central event. So I would say there are some regional differences, but I would say the concern that remains the highest across the world is the inflation and the potential responses from central banks to fight inflation.

Allison Nathan: So Mike, what are insurers doing to protect against these concerns, navigate around them, tactically, strategically?

Mike Siegel: So there's always an issue out there, whether it's inflationary recession, declining rates, which are an issue, rising rates. So in the current environment, as Matt said, they're taking advantage of the higher rates are good for the companies, as Matt said. It generates higher earnings. It improves their solvency. It's good for their policyholders. It's good for their shareholders. They're also going up in credit quality because they anticipate a potential recession, if not a likely recession. Given what's going on in the banking sector right now, they anticipate that recession might be deeper. So how do they forestall that? They go up in credit quality.

They're also taking advantage of the illiquidity in the

markets because the one advantage they have over the banks, over the pension funds, over the hedge funds, is they've got very patient liabilities. So they're able to put their capital to work. So they're taking advantage of illiquid markets. They're taking advantage of private markets.

Matt Armas: And private markets are another way to help with the credit quality question because, in private markets, when you're closer to the borrowers, when you are lending directly to the individual company, you generally have more ability to work with the company when the company runs into an issue. So whether it's having to amend a term in a contract or work with the borrower on a particular issue, having that direct access can really improve the outcomes once a company runs into trouble.

Allison Nathan: It's interesting you say that, Matt, just because there's a lot of questions being asked about shadow banking, the private markets, and whether that will be the next shoe to drop. But you're saying, even if it is, there's more ability to manage that outcome for insurers.

Matt Armas: Right. And having direct access and direct control over a situation allows the borrower and the lender generally to work together towards outcomes, which would be better than if it was left to a process in public markets. And as a result, moving up in quality is not just moving up in quality in terms of rating, which companies are, but it's also moving to have better control over situations to try to improve those outcomes.

Mike Siegel: And these companies are not new to the private markets. Many of them have been lenders into investment-grade private placements for decades into the middle markets for the last 20 years, so they've got well built out staffs that do underwriting and asset management. So they're not novices here.

Allison Nathan: And Mike, you mentioned liquidity, a big focus today, given what's going on, again, in the banking sector. What I'm hearing from you say is it's just not a big problem for insurers because they are in quite liquid assets to the extent that they need to be. But how are insurers thinking about the liquidity issues today?

Mike Siegel: So insurers are always taking a look at

their liquidity, what their liquidity needs are, the liquidity of the assets, and they schedule it out appropriately, very similar to when they do the asset liability management or matching the asset profile to the liability profile. In general, the industry has high-grade assets. And for the property casualty companies and the reinsurers, they tend to have shorter dated high-quality assets such that they can liquidate those if there's a catastrophe.

But in general, the illiquidity of the markets is an advantage to these insurers. They're the ones that can take advantage of these market dislocations because they have very patient liabilities. These liabilities are not subject to a run. So when they see the market seize up or when they see spreads widen in the various private markets, it's absolutely to their advantage.

And by the way, I think what we're seeing in the banking sector -- if I can offer an opinion there -- over time, these banks globally are going to become less levered; i.e., they're going to have to hold more capital. And as a result, I think they're going to be not as good lenders down the road or maybe not in the size. So somebody in the marketplace has got to take their place, and the insurance industry is

perfectly positioned to do that.

There is a concern in the marketplace that there will be less credit available. However, our industry has ample liquidity, is a willing lender, an experienced lender into the private markets, and they've already proven themselves over many decades, including from the last financial crisis, and I anticipate them to take advantage of the opportunities they're going to be presented currently and down the road.

Allison Nathan: In helping credit creation?

Mike Siegel: In helping credit creation, correct.

Allison Nathan: We've been primarily talking about insurers from an institutional investor perspective, but we all deal with insurance companies as policyholders as well, whether it's through our auto, homeowners, life insurance policies. What's the trickle-down impact of insurers' investment management practices to the individual consumer?

Matt Armas: Sure. And let's separate the different

types of policyholders. So for protection products, for people who have home or motor insurance, I would say the policy cost is generally going to reflect the inflation of the underlying assets. So if you're insuring cars and car values are going up, then they're paying those rates going up like the cars are going up. Where higher return rates available to those insurance companies, that helps offset a little bit of that pressure over time.

For life and savings institutions, which is the bulk of the investment in this industry, higher returns allow for better returns to policyholders. So whether you own a whole life policy where you're getting a variable dividend through time, those dividend rates will eventually start coming up. Whether you have a long-term savings product inside of a pension plan or an annuity, you're looking at potential better fixed income returns available to policyholders as these rates come up.

And also, as rates do come back towards more normal ranges, it allows the companies to innovate again, to write new style of products to solve this next generation's needs using more yield and return available in the market.

Allison Nathan: So the higher interest rates and yields that the companies are receiving do trickle down to the individual policyholders?

Matt Armas: It will get obviously to the end policyholder because, at the core of it, insurance companies serve clients, and their clients are policyholders. So their jobs -- and as they talk to us about their primary objective -- is to make sure that they can deliver the best returns and savings profiles to their clients. So as we work with our insurance clients, we're working very heavily on how do we bring new product that delivers better returns and better profiles to the end policyholder?

Mike Siegel: It's a very competitive industry, and if a company can go into the market and get these higher yields, they can turn around and translate that back into product pricing and their agents sell more products. And that then forces the next company to do the same. So, yes, these higher yields do translate down to the policyholder.

Allison Nathan: One topic that we've often explored on this podcast is ESG, and how are insurers viewing ESG at this moment?

Matt Armas: I would say there's an absolute focus on ESG, particularly in Europe and Asia. We've seen quite a strong response from our client base, particularly around are they using ESG in decision making? And we continue to see increased interest, year on year, in the survey out of Europe and Asia that ESG is not just one of many but increasingly a primary objective in their product development.

The second thing we see is how ESG is being used or the reasons that ESG is being used is also changing. A few years ago, this was largely constituent driven, so it was coming from boards of directors and other external forces. Now, increasingly, it's for anticipated changes in regulatory environments or for changes in portfolio risk mitigation. So we're seeing what ESG represents to these clients is changing alongside continued focus on it.

And one area in particular we're seeing quite a bit of interest is in things like net-zero decarbonization. So our clients tell us, again, particularly in Europe and Asia, that over 50% of our clients have made commitments to reduce the carbon footprints of their portfolios in what are called

net-zero commitments. And those clients are looking for solutions to help that ESG journey.

Allison Nathan: So as we look ahead, what are insurers expecting about the environment and what that means for them?

Mike Siegel: There's always something to be concerned about. And we have talked about inflation. We have talked about higher rates. We have talked about a concern about potential recession. Having said all of that, the insurers actually think this is a better investing environment than they've seen over the last several years. The insurers are more committed to putting capital to work than they have in the past. Granted, probably upping credit quality, although longer duration to grab the higher yields. They still think the equity market is going to be okay, and they're really putting capital to work in various forms of private markets.

So again, a lot of concerns, but they think it's a better investing environment than they've seen for the last several years.

Allison Nathan: Concerns but also opportunities.

Mike Siegel: Correct.

Allison Nathan: Mike, Matt, so great to have you back this year. Thanks very much for joining us.

Mike Siegel: Thank you.

Matt Armas: Thank you very much.

Allison Nathan: Thanks for joining us for another episode of Exchanges at Goldman Sachs recorded on Monday, March 27th, 2023. If you enjoyed this show, we hope you follow on your platform of choice and tune in next week for another episode. Make sure to share and leave a comment on Apple Podcast, Spotify, Stitcher, Google, or wherever you listen to your podcasts.

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