HOW TO BUILD AN EFFICIENT PRIVATE MARKETS PORTFOLIO FOR INSURERS, PART ONE

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In this first installment of a three-part series on insurance general account portfolios, we focus on building and maintaining a private markets allocation. Stay tuned for NEPC's take on constructing liquid credit allocations and optimizing public equity allocations for taxable insurance portfolios.

Insurers are increasingly turning to private markets to enhance portfolio outcomes.

While insurance companies historically relied on investment-grade fixed income as their primary investment asset class, they are finding they can boost income and improve total returns, while only modestly increasing capital charges through investments in private markets. However, not all private market strategies are created equal. It is vital for insurers to not only understand the different private market categories and scrutinize investment managers, but also size allocations appropriately and put a plan in place to measure the success of these investments.

Allocating to private markets requires a multi-year time horizon and the ability to withstand illiquidity.

At NEPC, we believe private markets play an important role in increasing portfolio income and total returns. At the same time, there are several considerations that need to be addressed prior to making an investment. Importantly, allocating to private markets requires a multi-year time horizon and the ability to withstand illiquidity.

SETTING STRATEGIC ASSET ALLOCATION

To start, we suggest a minimum target allocation of 3% to 5% so that the allocation can have a material impact at the total portfolio level. While allocation sizes will vary across organizations, sizing will ultimately depend on the insurer's surplus position, liquidity needs and business lines. Allocation sizes will also partly rely on the underlying private markets strategy; for instance, an insurer whose private markets portfolio is focused on middle-market direct-lending strategies might be able to tolerate an allocation closer to 10%, while those investing in higher risk or less liquid strategies, such as opportunistic credit or private equity, might prefer a target allocation of 5% or less.

In addition, insurers with less surplus and/or shorter-dated liabilities might lean towards a smaller allocation while those with a higher surplus and longer tail liabilities might be more open to a higher allocation. Insurers also need to consider the risk-based capital charges from private markets and the capacity of their staff or consultants to manage and monitor individual strategies. We recommend performing detailed studies on both asset allocation and enterprise risk management to determine an appropriate target allocation.

INVESTMENT STRATEGY SELECTION

Once a strategic target allocation is determined, it is time to select an appropriate strategy within the different types of investments that comprise the private markets universe: private debt[1], private equity and real assets. When deciding on an investment approach, insurers must balance their desire for higher total returns and portfolio income with the higher capital charges that come with many private market strategies. As a result, insurance companies have largely concentrated their private market exposure in private debt. Private debt's appeal lies in its high level of current income, lower capital charges, and relatively better liquidity profile.

To be sure, the private debt space is vast and varied. It is not a one-size-fits-all asset class. It offers a broad range of strategies that can be customized based on specific investment objectives, risk constraints and return targets. Amid this array, insurers typically start with middle market direct-lending strategies for their reliable income, lower risk of default, and bond-like capital charges.

For insurers looking to diversify away from direct lending while still taking a conservative approach, we recommend asset-based lending strategies. Although still a nascent asset class, these approaches offer a similar risk profile, modest diversification, incrementally higher returns, and similar capital charges as compared to direct-lending strategies.

Beyond private debt, we find that certain real assets strategies can be attractive. For example, we believe infrastructure debt strategies complement private debt approaches, while still offering income and a healthy level of downside protection. Private equity strategies are less utilized in insurance investment portfolios because they are generally among the least liquid and riskiest categories within private markets. That said, there are some strategies within private equity, such as secondaries, which might offer a lower risk profile and/or higher levels of income compared to traditional buyout or venture strategies.

UNDERSTANDING VEHICLE CHOICES

Private market strategies are often structured as closed-end or lock-up vehicles that tie up investor capital for five to 10 (or more) years. While that is still typical, there are an increasing number of open-end or evergreen vehicles available, particularly within private debt and real assets. Open-end vehicles typically draw down capital in a short period and then reinvest proceeds until a redemption request is submitted by the investor. However, investors should not view open-end vehicles as a source of liquidity as it may take several years until all capital is returned following a redemption request. The value in choosing an open-end vehicle is the ability to have constant exposure in the portfolio. With closed-end funds, there is an ongoing need to commit new capital to maintain a desired target allocation.

We have found that insurers prefer a mix of structures in their portfolios. Open-end funds can provide a consistent portfolio exposure while closed-end funds that return capital allow the insurer to decide if they want to re-up with an existing general partner or move on to a new firm and/or strategy.

[1] Private placement bonds are an asset class typically held by insurers. As the name suggests, these bonds are less liquid and not publicly traded. That said, we view private placement bonds as part of the investment grade fixed income opportunity set given the credit quality of these companies is often BBB or better. When we refer to "private debt" we are referring to below investment grade exposure that is highly illiquid often in a draw-down vehicle.

USE OF RATED NOTE STRUCTURES

Within each of the aforementioned vehicles, there are other factors to consider. Increasingly, many private market strategies are offering so-called rated note feeders. These structures allow an insurance company to access a private market strategy with a reduced capital charge[2]. Historically, for many insurers, private market strategies were held on Schedule BA and received higher capital charges. Rated note feeders allow insurers to access the same private market strategies while receiving bond-like capital charges.

For example, rather than committing $10 million to a strategy and the entire amount being held on Schedule BA, insurers can commit the same amount but hold approximately $8 million on Schedule D and the remaining $2 million on Schedule BA. Taking this approach results in a lower capital charge for the insurer. The split between Schedule BA and D will vary across rated note feeders and the Schedule D charges are typically a mix of investment-grade and below-investment grade debt.

At NEPC, we characterize rated note feeders as a nice-to-have option for most insurers, as opposed to a need-to-have one. We suggest insurers first evaluate private market strategies based on their investment merits. The availability of a rated note structure can serve as another factor to consider or act as the tiebreaker in the case of two strategies that have similar merits.

ILLUSTRATIVE RATED NOTE STRUCTURE

FIRST DEBT TRANCHE
A – BBB Rating
Typically 40%-60%

SECOND DEBT TRANCHE
B – BBB Rating
Typically 20%-30%

EQUITY TRANCHE
Not Rated
Typically 10%-20%

MEASURING PORTFOLIO SUCCESS

Prior to starting a private markets program, we recommend establishing long-term return targets. We also suggest setting objectives for individual strategies at the time of commitment. The table below provides a broad outline of our expectations for different private market asset classes.

We believe it is important to put in place quantitative metrics to measure success in a private market portfolio prior to making an investment. To that end, we often focus on investment multiples and rates of return.

Within the multiples category, Total Value to Paid-In (TVPI) and Distributed to Paid-In (DPI) are our preferred metrics. They are useful for assessing the amount of value created and distributed, but neither measure the time value of money. For this reason, we also report Internal Rates of Return (IRR) and Time-Weighted Returns (TWR).

ILLUSTRATIVE STRATEGY RETURN TARGETS

Strategy	IRR Return Target	TVPI Return Target
Direct Lending	8% - 12%	1.2x-1.4x
Opportunistic Credit	13% - 15%	1.5x-1.8x
Distressed Debt	15% - 18%	1.7x-2.0x
Real Assets	12% - 18%	1.4x-1.8x
Private Equity	20% - 25%	2.0x-3.0x

Since fund managers control the timing of cash flows, the CFA Institute recommends using IRR over TWR. However, it also recognizes the need for TWR as part of total program returns for all investments.

[2] To be clear, the vast majority of rated note structures are found within the private debt space, though we have seen them in both the real asset and private equity space as well.

To learn more about private market investments, or to conduct asset allocation and enterprise risk management studies to determine an appropriate target allocation for your portfolio, please contact your NEPC consultant.

IMPORTANT DISCLOSURES

Past performance is no guarantee of future results.

All investments carry some level of risk. Diversification and other asset allocation techniques do not ensure profit or protect against losses.

This memo should not be considered customized investment advice. Please contact NEPC for advice specific to your investment program.

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