KERRY O'BRIEN & RICHARD TALMADGE

Episode 204: Esoteric ABS and the Evolution of Insurance Asset Management

GUEST Q & A

Stewart: Welcome to another edition of the InsuranceAUM.com podcast. My name's Stewart Foley. I'll be your host. Welcome back. It's so nice to have you. Thanks for joining us. Today we have sort of a dual podcast. We're going to be talking about the evolution of insurance asset management, and we're going to be talking about esoteric ABS in particular as an asset class. And we're joined by Kerry O'Brien, head of Insurance Portfolio Management at Insight Investment, and Richard Talmage, CFA, portfolio manager at Insight Investments. Kerry and Rich, thanks for joining us. Thanks for being on.

Kerry: Hi, Stewart.

Richard: Thank you.

Kerry: Thanks for having us.

Stewart: So, as often is the case, we want to get into the... We're going to set this stage a little differently. We're going to talk with you, Kerry, I mean, we have some mutual friends, and we're going to talk about kind of how insurance asset management has evolved because you run that group and you were brought in to build that group. I think a lot of people don't know how big Insight is and a lot of that history. Then I want to go over to Rich and talk about that asset class in particular. So just so our audience knows, you're going to be hearing from Kerry first and Rich second, and so we'll start this one like we start them all. Kerry, where did you grow up and what was your first job? Not the fancy one. And what makes insurance asset management so cool, and you and I know a lot of people who are fun and cool in this business, so that ought to be an easy one for you.

Kerry: We sure do, Stewart. So I grew up on Long Island and was born in Brooklyn, grew up on Long Island. My first job was actually two jobs. I had a newspaper route, and I also clammed the Great South Bay with my brother Joseph. So the two of us wake up, clam, depending upon the tide, and then deliver newspapers in the afternoon. So I actually, one time had a dream that I was clamming for newspapers, which was very stressful and I think, set me up to be able to deal with volatile markets.

Stewart: That's awesome.

Kerry: Yeah.

Stewart: And what do you think makes this business so cool? I mean, it's hard, right? The insurance asset management is hard. It's super hard. There's so many externalities. I've often said it's the smartest money in the world, but what makes it fun for you? I mean, you still love this game. I mean, tell me about that evolution.

Kerry: Yeah, I do still love this game. It used to be called sleepy insurance money, and it's anything but sleepy insurance money. It's evolved, as we've discussed, and it's more complex, it's more diversified. It's more astute investors dealing with insurance asset management. So it's come a long way and it's exciting to be part of this business and work with insurance companies.

Stewart: Yeah, it's like a four by four Rubik's cube, and except for, it seems like people keep taking stickers off the cubes and putting them on different places too, while we're at it because the rules keep changing. But can you talk a little bit about Insight? And you're owned by Bank of New York Mellon, you're $800 billion of AUM, which, I frankly didn't realize the scale of your operation until today, but talk a little bit about why you went to Insight and a little bit about your background, because we have some mutual friends.

Kerry: Yeah. Well, starting with Insight, it is owned by Bank of New York Mellon, a global SIFI, $1.7 trillion in AUM. We're $800 billion of that and growing. Roots in LDI, it's a UK-based company with North American operations. So the LDI fit with insurance asset management, I think, is a good one and a natural one. And I joined because I was outsourced twice. We all know the trend in insurance asset management has been to outsource. I was with a number of big insurance companies, which decided to outsource their investment portfolio. I've been inside insurance companies for over 25 years, managing portfolios, working with CIOs and investment teams to construct portfolios to support liability.

So the last time I was outsourced to one of the big players in external management, I decided to move to the other side to become part of a team on external management. And when I thought about where I wanted to land, I wanted an entity with an established insurance business. And I'm here to build it at Insight, but it is an established insurance asset manager. It's been managing insurance assets for over 30 years. So we actually have clients that have been with the firm for over 30 years, so they know insurance and the team has the expertise to manage insurance assets. So really happy to be a part of it. We have over $30 billion, 80 clients in the insurance space globally, 50 in North America. So it's real. Insight has flown under the radar and we're looking to grow and build our AUM in the insurance space.

Stewart: Speaking of insurance chops, you have plenty. You've been at AIG, you've been at Swiss Re, you were also an analyst at Munich Re. I mean, over the last, I don't know, I'm not trying to date you. I feel like I've been at this forever. What do you think are the biggest changes? I mean, I've said that insurance has changed more in the last three years than it has in the last 30, and I think that's evidenced by the much more interesting asset allocations of most insurers today. What do you see has changed in your tenure in this business?

Kerry: Well, the insurance business has changed because the number of risks that you need to model have just erupted from cyber, climate, you name it. So there's so many risks to incorporate into your insurance model and often, models don't work properly. So portfolios have to be evolved because they need to support the liabilities, the mix of liabilities. So what I've seen happen, starting at Munich Re, going to Swiss Re, then AIG, analyst portfolio manager, trader, leading teams of investment professionals, it's the level of diversity complexity, introducing CDS and hedging catastrophe bonds. I mean, this whole evolution of insurance product and then your portfolio and the assets that you allocate to across the investment opportunities set.

So there's so many different opportunities and investments to consider, and the insurance industry has embraced it. They've evolved with it, and they look to price this risk and position this risk within their portfolios and understand the correlation of each of these asset classes as they build out their portfolio, starting with the strategic asset allocation and working closely with CIOs to look at historical performance and return expectations, and then using capital asset pricing models to then decide, what is the right mix of assets to support this liability stream?

Stewart: It's funny, we have a mutual friend in Bill Poutsiaka, and Bill used to say that the thing that impressed him the most when he was the CIO at AIG P&C, was a good question from a manager, right? Because I think it's imperative that a manager understands the insurance operation that is creating liabilities that the investment portfolio seeks to defeat. And so when you're having these conversations, are they changed at all by the risks that you mentioned on the liability side? How do you see that wrapping back into the investment side? That was a heck of a long question and I'm sorry.

Kerry: It was, but I can try to unpack it. And Bill is a dear friend and mentor to me, learned a lot from him. We actually started at AIG at close to the same time. So he challenged me, I learned from him and yeah, fantastic insurance expert. So getting back to your question, we have a number of clients that really partner with us and ask us to help with solutions and providing analysis, modeling of their liability. So they open up their entire balance sheet, assets and liabilities, and the mix of insurance underwriting that they do, the pricing, the loss expectation, which, as we all have learned, given the number of climate events and catastrophic events, that modeling often results in just mismodeling and two, three times what you expected on the claim side and the loss side is appearing. So profitability, layer on top inflation.

So there's a lot of challenges facing insurance companies, and our client base is looking to us more and more to help them model out both the assets and liabilities, and we're equipped to do that. One of the reasons I joined, we have an actuarial team that works with the investment team and the client holistically, to come up with solutions and outcomes that we can hope to sort of match what the outcome desired is, with their investment portfolio, if that makes sense.

Stewart: Yeah, I mean it really does. It helps a lot. And I mean, when you're having those conversations with your clients, the one thing that I know from experience is, that in order to do the work you're describing, you have got to have a massive investment in technology and investment technology to do that kind of modeling. Can you talk a little bit about that aspect of your business?

Kerry: Yeah, technology is very important Stewart. Insight employs a team of actuaries who have actually developed in-house models that are utilized and customized for specific client needs. So they are able to simulate asset and liability behavior, conduct stress testing, and they also run scenarios. So it's pretty cool stuff.

Stewart: Cool. Okay. So as we turn our attention, Kerry, to today, what do you see as emerging issues or current issues when you talk with clients, both clients and prospective clients in your day-to-day job there?

Kerry: Yeah, I would say, one thing that we're hearing from clients is that given the move in rates, a lot of these insurance portfolios are underwater. There's a lot of losses embedded in the portfolio, and there's interest in recycling risk and trading and taking advantage of yield enhancement trades, but it's difficult, given the embedded losses. There's also, we're hearing that there's interest in investing in commercial real estate, away from office. So looking to broadly diversify their portfolios away from credit. And one area that we're hearing a lot of interest in is esoteric ABS. Everything is being securitized these days and we have a team at Insight that is very knowledgeable and has a long history of being involved in structuring deals in this asset class, knows the underlying assets that are being securitized and how to structure deals and really kick the tires on these esoteric assets that are being securitized.

So I would say, most of them are, I wouldn't say looking to increase risk, they're looking actually to reallocate out of equities or take that down a little bit and going into fixed income, core fixed income, given the return of yield and where the equity markets are trading right now.

Stewart: That's terrific, Kerry, thank you. And Rich, I think that's our queue. Let's talk about esoteric ABS, but first, I want to start with, as we always do, where did you grow up? What was your first not-fancy job, and what do you think makes insurance asset management cool?

Richard: Well, okay, so I've listened to a few of these podcasts, so I'm prepared, Stewart.

Stewart: I love it.

Richard: But I grew up in Hamden, Connecticut. My first not official job, if you want to call it that, was working for a plant nursery. So it was one of the larger growers of mountain laurels in the state of Connecticut, which of course, is the state plant. But I worked in the fields and basically, digging them up and pruning them and keeping them in good condition and bringing them to the farm stand, essentially, so-

Stewart: It's what we call it's honest work in Missouri, where I'm from. Rich, that's an honest day's work, right there.

Richard: Indeed. And what do I enjoy about insurance asset management? Well, and this is to my specific niche. I love my area because I get to learn so many new areas. It forces me to dig in and understand all sorts of new asset classes that in some cases, you hadn't really spent a lot of time thinking about historically. So just being on the frontier and identifying areas where in this vast and diverse economy that is the US, and not only the US, but the world. There's so many ways to generate an income and being on the frontier, it certainly allows me to identify some of those and evaluate whether they add sufficiently to a broader diverse portfolio.

Stewart: So this is the way the story has been told to me. There has been a lot of significant growth in esoteric ABS opportunities, both public and private, which has created opportunities for insurance companies who see an opportunity for stepped-up yield without sacrificing credit quality, which, as a former fixed income nerd, sounds like a good trade. What can you tell me about it? Is that right or wrong? And how would you gauge that opportunity today?

Richard: I would first go back and say that there's always been some long-dated string of these opportunities out there. And you go to the way back machine and you're in the late '90s, you're certainly still looking at things like aircraft and shipping containers and timeshare. And that really kind of exploded, I'd say, within the last 5 to 10 years, reflecting I think, the direction of the broader economy. So when we think about things like commercial real estate and autos, they've had a longstanding position in the securitization market and certainly, a longstanding position in the broader economy. But as we get into this new age of streaming media for example, there's been a vast amount of value unlocked that we're now, it's only starting to kind of tap into and recognize that things like music royalties and television distribution deals, as an example, are worth quite a bit, and in many ways, better reflective of where the economy is today than it was 20 years ago.

So I think one aspect of the esoteric space, I think there's automatically this thought that esoteric means strange and bizarre assets. And while it may be new to the securitized markets, the thing that we underscore is, these are assets that you were probably always underwriting as part of corporate balance sheets for some longstanding period of time. It's just, the only new aspect is really, the wrapper around them, the branding, so to speak, and coming in a securitized vehicle. Then all of the technology in that securitized vehicle that offers tremendous advantages to the investor class.

So I do agree with all that you said, in the sense that it is a yield pickup. I think one of the reasons for that too, is that there is this newness to it where a lot of investors that may be slower to adopt it, maybe part of it is just the complexity of it and having to get up to speed and understand it that those first handful of deals are coming at better yields and better spreads then you might find for that age-old product that you've underwritten and looked at a thousand times over. And then I think the other aspect too is, that it's taken a good bit of time for the rating agencies to get up to speed with it. So part of it is, this broader education of not only the investor community, but other players in the market, rating agency participants as well as lawyers and being able to go through the docs and make sure that the structures are sufficient, et cetera.

Stewart: So what role has a bank disintermediation played on this asset class? I mean, can you talk about, I guess, really at the heart of the question is, the sustainability of the asset class.

Richard: I think it's been huge. These would typically be asset classes that maybe they'd want to be pretty close to the vest on information. They probably didn't want to broadly shout from the rooftops, let's say, some of the aspects of their business. Many of these players are private entities unto themselves, so their natural funder, historically, has been banks. As we've seen the bank market pull back, it's created a very natural place for some of these esoteric asset classes to tap the capital markets, and specifically, insurance capital has stepped in to really fill that void. One thing that I think is worth pointing out, and it's a distinction that we haven't really dug into yet, is the private versus public. So esoteric, you can think of it as a Venn diagram. Broadly, you have esoteric asset classes, and then on the flip side you have private capital.

What we find is that the correlation of the two is pretty significant when you look at esoterics because of this desire for low levels of disclosure among the issuers. So doing an esoteric deal with a handful of investors is often quite valued by the issuer as it is by the investors. It also often means that the investors are able to, given the heavy lift that it takes to do the underwrite, it often means that you're almost assured of a seat at the table by the time it's done. Unlike the public markets where you may do all your underwriting and get your allocation that is 10% from what you thought you might get.

Stewart: One of the things that Kerry mentioned is the longevity of your team and that you've been in this asset class for a long time, and my experience tells me that that means you have relationships that may impact in a positive way on deal flow. So can you talk about deal flow and the importance of those relationships and how that plays into the kinds of assets that you're seeing?

Richard: Sure, yeah. I think I first started covering some of the esoteric sectors pre-GFC. So, looking at whole business deals, for example, in 2005, and I've just watched it blossom since. It is quite a clubby community, just as the insurance market is clubby in its own right-

Stewart: Certainly is.

Richard: ... The esoteric market, you repeatedly see the same types of bankers at the table, the same handful of lawyers looking at certain deal types. And I think the sourcing, critically, comes from those long relationships. And there's a very natural aspect that the first phone calls that might go out from an issuer standpoint are to the investors that played in previous deals. And so I think there's a very natural advantage to being in this space for a significant amount of time. What we have seen is that there have been some new entrants to the space, and not just from an investor standpoint, but also from a banker standpoint. And where we find value is, in having that longevity, trying to identify very quickly where some of those new names are and do what we can to try to get ahead of the curve and foster the relationships.

I think, generically, there's kind of two types of deals that we'll see in that private space, particularly, the syndicated and then the directly originated types. While I'd love to say that the directly originated types are the vast majority of what we do, the reality is, that those are slow-going. That gestation period can be quite long. In some instances, it could be 12 or 18 months between a first conversation with a potential issuer and getting the docs finalized to the point where you're ready to fund, as opposed to a syndicated opportunity where you may be able to step in and within weeks, if not well, maybe weeks to a few months, step in and have a product that you can put your investor in and feel comfortable about. But yeah, those relationships are key.

Stewart: And so talk to me a little bit about underwriting these credits. That process requires considerable institutional resources. I mean, it's kind of like I'm asking maybe if you could educate me a little bit for going forward here. Talk to me about underwriting this asset class. There's a variety of things in here, but generally, we're talking about esoteric ABS.

Richard: Well, I'd love selfishly, to be able to say, "Hey, me and my team could hang out a shingle and be able to do it just fine." The relationships may carry over, but the most important part of what we do from an underwriting standpoint, I think, relies quite heavily on let's say, all of the different areas of a scaled asset manager. So when we think about knowledge that we have from a corporate credit standpoint and the 30 analysts that we have in that area, when I talk about things that we do that are tangent to infrastructure and project finance, we talk about our resources there as well as even on the muni side where a lot of these asset classes may historically have resided in that space. And it may only seem new to us in our world, but we want to be assured that given, let's say, the prior issuers of this space, we don't feel like we're getting taken advantage of or arbitraged in some way, which is often the fear in our space.

And I think, when you go back historically and you look at some of the asset classes in the broader securitized space, that's where a lot of the pain has come. So we're very cognizant of that, and I think we bring to it sufficient humility that we say, "Well, we don't necessarily know everything about these asset classes day one, we'll leverage as much as we can, the resources that we have in our institution to try to get to a better outcome."

Stewart: I'm glad you brought up munis, a little known fact, Rich. I was the treasurer of the City of Columbia, Missouri, so back way back when the earth was still cooling, and I was early in my career. How does Insight view esoteric ABS from the standpoint of an insurance portfolio? Do you think that that is a passing opportunity that exists today and will go away? Or do you see it more as a core allocation to an insurer's portfolio that is kind of all-weather?

Richard: I think we see it as a core, and I'm sure Kerry can chime in as well on this, but I think the idea is that while we think of a collection of opportunities now as being locked in time, and that what we see as esoteric today, is going to be esoteric in 10 or 15 years, and that's just not the case. So I think it's just another way of saying being readily able to allocate to asset classes that take advantage of the securitized technology, but as I had mentioned earlier, better reflect kind of the direction of the economy or the great ones say where the puck is going, which is kind of where we want to try to be focused as much as anything.

Stewart: Absolutely. And I really appreciate the education on esoteric ABS, Rich, and I'm going to go back to Kerry and to wrap, if that's okay. We're going to carry on the way out the door. What are a couple of key takeaways that you'd like our audience to come away this podcast with? And I have a couple of fun ones for you, if you're willing.

Kerry: Right. Sure. So key takeaways are that Insight has an established insurance platform that has the expertise any insurer, multi-line insurer, or specific line of business could use, as far as asset management capabilities. Rich mentioned our credit capabilities. We're very research-driven. We have a sophisticated trading platform that uses technology, FinTech, as well as long-standing relationships with the streets. So we have that relationship that exists with the streets, so we see deals get good allocations, et cetera.

One other thing that I want to mention, since you brought up the Earth still cooling and Missouri, is that, another attribute that Insight had when I was contemplating where to go next, was that it has a really built out ESG framework, given the roots in UK and Europe far ahead of the US In ESG, we have very strong capabilities. And as you know, the US is sort of evolving with ESG and depending upon the state of domicile, some of our clients are using us to report, but also to achieve targets that they've established internally on climate and energy consumption within their investment portfolio. We are highly capable of doing whatever an insurer needs in their ESG journey.

Stewart: That's fantastic. Okay, so here's the fun ones. Ready?

Kerry: Yes.

Stewart: We have two questions and I'll just stick with you, Kerry, because it'll be easy. So what's a great piece of advice that you've gotten that you'd like to pass along and/or who would you most like to have lunch with, alive or dead?

Kerry: I didn't think about this beforehand, Stewart, so…

Stewart: That's okay. Listen, Rich and I can cue the Jeopardy music. This is what I used to do in class. I would go, (singing). So you've got time. So what do you think, what's a good piece of advice that you would give? And let me put it to you in a different way. What would you tell a 21-year-old Kerry O'Brien as she got her diploma from LeMoyne College? What would you tell yourself? What do you wish you would've known that day?

Kerry: That's a great question, Stewart. I would say, there's a number of things I would tell a 21-year-old Kerry O'Brien, be braver, speak out more, take more risk, and given my skills of pricing risk, I think the outcome would've been quite positive.

Stewart: I think that's fantastic. Now, do you have a lunch person that you... Is there anybody that you'd like to have lunch with? Like, no kidding. What about Poutsiaka?

Kerry: Warren Buffet.

Stewart: Oh, Buffet. Okay. All right.

Kerry: Warren Buffet, I'm sure his name has come up at a number of your podcasts, but I find him incredibly interesting and his long history of seeing investment cycles and talking to CEOs and global leaders, I think that access would be an amazing lunch. Actually, I owe Bill Poutsiaka a phone call. He was heading off to, I think, Asia, Japan, last we spoke, and I never followed up with him, but I will definitely.

Stewart: You've got to keep an eye on him. He's everywhere. He's everywhere. So we're thrilled to have you both on. Thanks so much. We've been joined today by Richard Talmage, CFA, portfolio manager at Insight Investments, and Kerry O'Brien, head of Insurance Portfolio Management at Insight Investments. Kerry, Rich, thanks for being on.

Kerry: Thanks, Stewart. Great to be here.

Stewart: Thanks for listening. If you have ideas for podcasts, please shoot me a note at stewart@insuranceaum.com. Please rate us, like us and review us on Apple Podcast, Spotify, or wherever you listen to your favorite shows. My name's Stewart Foley, and this is the InsuranceAUM.com podcast.