COMMON Investment Mistakes

Made by Captive Owners

When organizing a captive, new captive owners put a lot of effort into the insurance side of their company – picking the right captive manager and domicile, making sure the underwriting and claims processes are in place. Yet often they treat the captive's investments as an afterthought, putting it to the wayside until it can no longer be overlooked.

According to Carl Terzer, principal of CapVisor Associates, LLC, "Captives should be paying a lot more attention to their investment program and bring more discipline and analytic support to the decision-making process than they are." Industry analysts estimate that 50% or more of a captive's profitability comes from their investment program, yet Terzer has found that captive board meetings are primarily about underwriting and liability issues, leaving investments only a small portion of the allotted time.

Written by Karrie Hyatt

Terzer founded CapVisor Associates in 2008 as investment advisory firm that focuses on the insurance marketplace, providing custom solutions for insurance asset management. He also teaches courses about captive investments for International Center for Captive Insurance Education (ICCIE).

With more than 30 years' experience in insurance asset management, Terzer has seen the growth of the captive industry over the course of his career and with that experience he has seen a lot of mistakes that captives make regarding their investments. Here are five that he has found to be most common.

Investment Policy is an Afterthought

When captives are formed, they will get all the major service providers in place – their captive manager, attorney, claims manager, accountants. How they intend to manage their investments is rarely a part of the early decision making process. Often new captives will leave investment decisions until it becomes an urgent need and then pick an investment manager without knowing how they really want to approach investments.

Terzer believes that it needs to be an upfront consideration for any captive, but has found that it seldom happens that way. "Most captive boards are made up of officers of the parent company which could be a construction company or group of doctors or whatever. Their profession is something other than running an insurance company and it certainly isn't investment management, so they're really handicapped. That generates an over reliance on the investment manager they pick."

Creating a company investment policy, or Investment Policy Statement (IPS), early on can help captives make the most of their investment funds. It will also help the investment manager meet the needs and interests of the captive owners. Terzer recommends that companies think about how much of a downturn they would be willing to sustain during a given year and how much liquidity they want to have. Captive owners should make sure they understand the difference between wealth management and insurance asset manager, as well as their investment horizon. They also need to consider how involved they want to be – whether they are going to be monitoring their investments quarterly or if they are more interested in where they will end up in three to five years.

Terzer added, "They really ought to be having a much more thoughtful process to developing their investment strategy. It should really be articulated in their policy statement and they should have that in place before they pick their manager. Otherwise, their manager will bring their biases to the table and could unduly influence the captive to do it their way instead of the way the captive would be more comfortable."

"To create an investment policy," he continued, "A captive can hire a consultant or they can put somebody on their board who's got investment savvy and has some insurance understanding. Hopefully, that person can lead them to better decisions."

Selecting the Wrong Investment Manager

Choosing an investment manager should be like picking out a new car, according to Terzer. As it stands, most captive owners will stop by a few tables at captive conferences to talk to investment manager candidates. Or they will get a couple of recommendations from an advisor, such as their captive manager, accountant, or regulator.

Terzer likens this method to choosing a new car based on what your neighbors think. "It's like going to three or four neighbors and saying what three kinds of cars should I look at. It's absurd. You'd never do that with your own money or decisions, especially if you were aware of a better way. Those car buying decisions you make are worth 30 or 40 thousand dollars, but why use an even less scientific or analytic approach, no data points, for a decision regarding 5, 10 or 50 million dollars of a captive's money?"

Part of this misstep is that many captive owners don't understand that there is big difference between investment management and insurance asset management. Terzer said this a specialty that many wealth managers may not understand. "Insurance asset management is pretty much an area of expertise unto its own. Just because you can manage assets doesn't mean you can manage insurance assets, it's a real specialty within the scope of investment management."

"The primary difference between an investment manager and an insurance asset manager, with regard to taxes," added Terzer, "Is finding an asset manager who can dynamically balance the captive's portfolio between taxable and tax-exempt investments. It's a firm who understands the underwriting and the liabilities side of the captive and manages that portfolio in a manner correlated to what's happening with the liabilities side of the financial sheet."

This is why a well thought out investment policy can be key to selecting the best investment manager. Like selecting the data points that are most important in a new car, a new captive should look at what they want to accomplish with their investments

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and select a manager who can help meet those goals.

"It's important for captives to make the selection of their investment manager much more carefully," continued Terzer. "I realize [new captives] are not all going to use a consultant. I realize that they're not all going to do the due diligence we feel they should do. However, using a few of these risk-adjusted statistics provided by [a consultant] can be a tremendous help in assessing a manager's 'skill' level – something that cannot be gleaned looking at historical nominal returns. Instead of asking about nominal returns for the last five years, captives should ask for the manager's Alpha and Information Ratio, then they can compare managers on a risk-adjusted or 'skill' basis. A bit of education goes a long way to helping them identify a good manager from an average or not-so-good manager."

Investing Too Late

Sometimes the biggest mistake a captive can make is waiting too long to start its investment program. Captives will start with their initial capital, start writing policies and collecting premium and putting into their bank account, letting it accrue. Terzer said, "The mistake captives make is often allowing that money to accumulate to too high an amount which has a tremendous opportunity cost. This cost is the difference between the 25-50 bias points a bank may pay on cash balances – a negative 'real' rate of return, after inflation – and what a bond portfolio could generate which could be between 1.5 and three percent [per year]."

He suggests that when a captive's bank account accrues to between one and two million, the captive should start to consider their investment program and line up an investment manager. It generally doesn't take long for a captive to accumulate that much. Even small captives and those in the 831(b) market will often start with a million in capital before writing their first year's premium.

> *"[New captives] will be quite limited with a new captive as to what they can do because they don't have claims experience and they have to remain liquid and represent quality,"* added Terzer. *"Obviously if they have no claims experience they have to remain fairly liquid, so it needs to be a judgement call."*

If captives wait until they have four or five million in the bank, they have waited too long and investing becomes an afterthought. According to Terzer, "The opportunity cost for that is pretty high. In the example, above using 2% bond portfolio return vs .25 basis point on a five million bank balance, the opportunity cost is $87,500 per annum. That pays a lot of bills."

Investing Too Early

Another common mistake is investing before they have enough capital in the bank. Captives will begin operations, have money accumulating and will want to immediately start investing it without much consideration as to how they should invest it. Terzer describes it like this, "The investment manager is very kind and helpful, gives them boilerplate type investment policy statement and guidelines and even helps pick the benchmark they will be measured against. The [manager's] biases are often apparent in that the documentation reflects the way that they want to manage the money and the risk tolerance that they think is good for the captive, usually with little input from the captive."

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"That's jumping the gun the other direction because now you really have someone else's plan," said Terzer. "You've got the manager's plan, so there are all kinds of biases built into that."

Not Managing from an ERM Approach

What all the previous mistakes amount to is a lack of comprehensive approach to managing the liabilities and investments for a captive. Terzer recommends that captives should look at their business from an enterprise risk management (ERM) viewpoint – a company-wide approach to managing risks. ERM, in the case of a captive, is about looking at both liability and investments and approaching them in a balanced way.

"They should not, as most do," he said, "Look at the liability side and then the investment side in silos and make decisions separately. That's what most companies do and it's wrong. You have to look at the symbiotic relationship between asset and liabilities – the investment program has to correlate to the underlying liability structure of the insurance company."

Terzer jokes that "If you've seen one captive, you've seen one captive," and has found that captives that approach their investments with as much interest as the insurance side can create a much more solid company. ■

Karrie Hyatt is a freelance writer who has been involved in the captive industry for more than 10 years. More information abour her work can be found at www.kerriehyatt.com.

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