Capital Markets Special Report

The **NAIC's Capital Markets Bureau** monitors developments in the capital markets globally and analyzes their potential impact on the investment portfolios of US insurance companies. A list of archived Capital Markets Bureau Special Reports is available via the **index**

Insurance Industry Year-End 2013 Exposure to Mutual Funds

Investing in funds provides investors with diversification across asset types as well as benefits from daily liquidity during periods of stable market function. These features, along with a record of relatively stable returns, have allowed fund investments to grow. The Investment Company Institute (ICI), an association of regulated funds, reported that mutual fund assets reached $32 trillion worldwide in Q2 2014. Equity funds made up a large portion of the worldwide total at $14.209 trillion. Bond funds held $7.626 trillion, followed by money market funds with $4.417 trillion. Balanced/mixed funds held close to $4.065 trillion and $1.684 trillion was held by funds classified as Other.

Throughout this report, the phrase "fund investments" is intended to capture all types of funds, with separate discussion included for specific fund types. Only open-end investments meeting criteria set by the U.S. Securities and Exchange Commission (SEC) are considered "mutual funds". Exchange traded funds (ETFs), although possibly formed as open-end investments, generally do not qualify as mutual funds under the federal Investment Company Act of 1940 (40-Act). However, a subset of open-end investment ETFs may qualify for an exemption to the 40-Act rules on direct sale and redemption. For these particular situations, these ETFs may be considered mutual funds. These ETFs mainly focus on index and bond investing and are a subset of the open-end funds referenced in this report.

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Types of Investment Funds

OEFs (mutual funds) and CEFs are two types of investment companies regulated by the SEC under the 40-Act. A 40-Act registered fund has strict rules on (among other activities) portfolio concentration, hedging and leverage. By following the 40-Act rules, the funds have the ability to advertise and are eligible for inclusion as investment options in retirement plans. In addition, investors are not limited to accredited investors, which are defined by the SEC under Rule 501 of Regulation as individuals or institutions with a high net worth or high income. The benefit to investors in 40-Act registered funds is that the potential for losses is intended to be mitigated by the aforementioned restriction on concentration, hedging and leverage.

An investment fund offers shares to investors and purchases a portfolio of assets with the proceeds. Historically, fund assets have mainly included stocks, bonds and fixed-income instruments. Through SEC exemptive orders (an exemption from one or more rules of the 40-Act), funds have evolved over the years to focus on particular sectors (real estate investment trust [REIT], technology, etc.), commodities (e.g., gold) and even investment strategies (market neutral, long, short, etc.). Funds that mainly invest in commodities or pursue particular strategies (long-short, contrarian, etc.) are considered "alternative asset" funds. Long-short strategy funds attempt to minimize market exposure with long positions (owning shares) and short positions in the market. Contrarian funds buy assets believed to be out-of-favor with prevailing market views in hopes of increasing value as market views change.

Several differences exist between OEFs (mutual funds) and CEFs. OEF shares are continuously offered or redeemed by the fund. The OEF share price (the price at which shares are purchased or sold by investors) is based on the fund net asset value (NAV) at the close of trading. CEFs offer a fixed number of exchange-traded shares in an initial public offering. The price at which CEF shares trade is determined by market forces and not just NAV of the underlying assets. The share price can be higher or lower than NAV. When the share price is higher than NAV, the shares are said to be at a premium to NAV. Conversely, when share price is lower than NAV, it is a discount. CEFs can leverage their investments by issuing securities that are senior in priority of payment to the shares held by investors (preferred stock or notes) or borrowing to purchase additional assets. Leverage increases the volatility of returns to fund investors. For example, common shareholders will miss dividends if income is too low and dividends are not paid to the preferred shareholders or if interest is not paid to note-holders.

Active versus Passive Investment

Investment funds can be actively or passively managed. Investment funds that attempt to mimic the composition and return of an index, such as the Standard & Poor's 500 (S&P 500) Index, are passively managed. These funds are known as index funds. The portfolio composition of an index fund changes if the composition of the index changes. The composition of actively managed funds changes at the discretion of the fund manager. Thus, portfolio turnover is typically lower in index versus active funds. Rather than mimic the return performance of the index, actively managed funds attempt to outperform the index by buying undervalued securities, which they hope will later appreciate in value.

In large-cap equity investing, it has been observed that index funds have a return advantage over actively managed funds across five-, 10- or 20-year periods. This is partly due to the lower cost of operations for index funds. A screen of large cap blend funds in the Morningstar database shows that the average expense for the category is about 1.10% with a year-to-date (YTD) return of about 11.6%, whereas the Dreyfus S&P 500 Index fund, also large cap blend, has an expense ratio of 0.50% with a YTD return of 14.20%. The return advantage of index funds over actively managed funds is smaller in small-cap equity investing.

Fund Expenses

Funds can be load or no-load. Load funds can be front-end (i.e., commission is paid at the time of investment) or back-end (i.e., commission is paid at redemption). Funds also levy marketing and distribution fees known as 12b-1 fees (named after the SEC rule authorizing the fee). Funds also pay a management fee for investment advisory services. These fees (among other lesser known fees) comprise the fund expense (also referred to as an expense ratio). A typical actively managed fund's expense is greater than 1% of total net assets (TNA) whereas an index fund expense is typically less than 1% of TNA. The higher the fund expense, the larger the drag on performance relative to index funds.

U.S. Insurance Industry Exposure

As of Dec. 31, 2013, insurers reported $83.8 billion as the book/adjusted carrying value (BACV) of fund investments (or 1.5% of the industry's total cash and invested assets). Of this amount, money market funds were the largest exposure at about $44.1 billion. The second largest exposure was to equity funds at about $27 billion, followed by debt funds at $8.7 billion. ETFs comprised $22.2 billion in BACV of fund investments, $1.74 of which were eligible for reporting as Schedule D-1 Bonds or as Schedule D-2-1 Preferred Stock which are defined in the *Purposes and Procedures Manual of the NAIC Investment Analysis Office (NAIC P&P Manual).*

Based on a review of existing bond ETFs reported by insurers in 2013, more than 90% were approved by the NAIC Securities Valuation Office (SVO) for inclusion in *Statement of Statutory Accounting Principles (SSAP) No. 26 – Bond, Excluding Loan-Backed and Structured Securities (SSAP No. 26)* reporting, and received an NAIC 1 or 2 designation. About 70.9% of these bond ETFs carried an NAIC 1 designation as shown in Table 2. Although the SVO also maintains a bond fund list for OEFs for *SSAP No. 26* reporting, there are currently no approved funds on that list, and there has been no bond mutual funds eligible for *SSAP No. 26* reporting since 2011.

Table 1: 2013 U.S. Insurance Industry Mutual Fund Exposure (BACV, Mil. $)

Fund Group Name	Life	P/C	Fraternal	Title	Health	Total	Pct of Total
Asset Allocation Fund	352.4	776.4	116.3	0.0	609.2	1,854.3	2.2%
Closed-end Funds	1,285.9	467.4	101.3	0.2	21.1	1,875.9	2.2%
Commodity Fund	161.6	159.1	1.8	0.0	10.2	332.7	0.4%
Debt Fund	2,337.2	3,439.2	70.4	104.8	2,732.1	8,683.7	10.4%
Equity Fund	4,893.1	15,713.6	338.1	221.9	5,840.7	27,007.5	32.2%
Money Market Fund	19,879.5	18,189.9	178.8	66.8	5,737.4	44,052.5	52.6%
Real Estate Fund	1.9	0.0	0.0	0.0	0.0	1.9	0.0%
Industry Total	**28,911.7**	**38,745.7**	**806.7**	**393.8**	**14,950.6**	**83,808.6**	**100.0%**
Pct of Industry Total	34.5%	46.2%	1.0%	0.5%	17.8%	100.0%	

Note: Fund Group Name is a classification from Bloomberg. The Fund Group Name includes all investment fund types.

Table 2: 2013 ETFs with NAIC Designations (BACV, Mil. $)

NAIC Designation	Life	Property	Health	Fraternal	Title	Total	Pct of Total
1	1,568.8	608.0	213.8	78.6	0.0	2,469.3	70.9%
2	465.9	101.9	117.0	23.5	0.0	708.2	20.3%
3	16.2	17.9	0.7	0.1	0.0	34.9	1.0%
4	119.5	122.1	29.4	0.2	0.0	271.2	7.8%
Segment Total	**2,170.4**	**849.9**	**360.9**	**102.4**	**0.0**	**3,483.6**	**100.0%**
Pct of Segment Total	62.3%	24.4%	10.4%	2.9%	0.0%	100.0%	

**Does not include money market mutual funds.*

In 2013, the insurance industry acquired $3.8 billion in fund securities, including the common and preferred shares, and notes. Dispositions were about $88.8 million for a net acquisition of $3.7 billion. Equity funds, at $1.7 billion, were the largest share of acquisitions. Money market funds were second largest at $1.2 billion. Mutual funds treated as common stock under statutory accounting principles reported an unrealized (mark to market) gain of about $43 million at year-end 2013.

As mentioned above, funds reported under the industry group names of money market, equity and debt funds comprise the largest three fund types, in size order, for U.S. insurers. Looking at individual funds comprising each type, as of year-end 2013, BlackRock Liquidity Funds TempFund Portfolio (TMPXX) was the most widely held money market fund among insurers as measured by BACV at $2.2 billion. According to Morningstar, a provider of independent investment research as well as a provider of data on various types of investment offerings, as of October 2014, TMPXX was a taxable money market fund with $56 billion of total net assets. Assets were allocated in cash (96.7%), bonds (1.1%) and other (2.2%). The fund has the highest quality ratings of AAAm from S&P and Aaa-mf from Moody's Investors Service.

The most widely held equity fund by U.S. insurers was the Vanguard Institutional Index Fund (VINIX) at $2.5 billion BACV. VINIX is categorized as a four-star large cap blend fund by Morningstar and had total net assets of $182.5 billion at year-end 2013. A large cap blend fund is one that invests in value and growth companies with market capitalization greater than $10 billion. U.S. stocks made up 99.4% of the fund's allocations, with the remainder split between non-U.S. stock (0.29%) and cash (0.33%). The PIMCO Total Return Fund (PTTRX) was the most widely held debt fund among U.S. insurers, with a reported $370 million BACV at year-end 2013. PTTRX is categorized as an intermediate-term bond fund, with a four-star ranking. The fund had $170.9 billion total net assets as of October 2014 down from a high of $293 billion in 2013. The outflows from PTTRX increased following the departure of Bill Gross from PIMCO in September 2014, the firm he founded. The fund experienced $27.5 billion in outflows in October 2014 according to Reuters. Mr. Gross has since been replaced by a team of three portfolio managers who previously worked with him managing this fund at PIMCO.

Table 3 below shows the U.S. insurance industry's exposure to the top 10 fund managers as measured by BACV as of year-end 2013. Vanguard at $9.3 billion BACV tops the equity list, while PIMCO at $1.3 billion BACV tops the debt list. Dreyfus ($6.1 billion) tops the money market list, followed by BlackRock ($4.9 billion) and Wells Fargo ($4.2 billion).

Table 3: Top-10 Fund Families by Fund Type (BACV, Mil. $) as of Year-End 2013

Top-10 Fund Family - Money Market Funds

Fund Family	BACV
Dreyfus	6,116
BlackRock	4,902
Wells Fargo	4,219
JPMorgan	3,769
Goldman Sachs	3,672
Northern Trust	3,392
Fidelity	2,452
State Street	2,340
Morgan Stanley	1,924
AIM	1,668
	34,454

Top-10 Fund Family - Equity Funds

Fund Family	BACV
Vanguard	9,342
DFA	767
Capital Group	722
American Funds	662
Artisan	408
Dodge & Cox	338
Fidelity	321
T Rowe Price	320
State Farm	290
Templeton	257
	13,427

Top-10 Fund Family - Debt Funds

Fund Family	BACV
PIMCO	1,248
Vanguard	1,076
Ashmore	537
Stone Harbor	528
BlackRock	193
Evergreen	173
JPMorgan	150
Wells Fargo	147
Eaton Vance	131
	4,183

Statutory Accounting and Reporting of Fund Investments

Under current statutory accounting guidelines, the accounting and reporting of fund investments varies based on the legal structure of the fund and the assessment of the fund by the SVO. Mutual funds, regardless of the type of mix of securities, and unless specifically exempted, are captured within *SSAP No. 30—Investments in Common Stock (excluding investments in common stock of subsidiary, controlled or affiliated entities)*. Certain money market mutual funds, Class 1 Bond funds, and ETFs, which qualify for bond treatment as designated by the *NAIC P&P Manual* are captured within SSAP No. 26. ETFs, which qualify for preferred stock treatment as designated by the *NAIC P&P Manual* are captured within *SSAP No. 32—Investments in Preferred Stock (including investments in preferred stock of subsidiary, controlled or affiliated entities)*.

The Statutory Accounting Principles (E) Working Group has a current "investment classification project" which is anticipated to include explicit discussion on the accounting for fund investments. Initial discussion topics within this project include the possibility of creating a new SSAP, and corresponding financial statement schedule, to capture all fund investments to allow for easier identification and assessment within the financial statements. With such a proposal, it is anticipated that coding in the schedule would allow for similar funds (bond, equity, index, etc.) to be grouped together. Additionally, consideration is anticipated to clarify the measurement method for fund investments, as funds captured within *SSAP No. 26* (e.g., SVO approved bond ETFs) are currently subject to an amortized cost methodology. As fund investments do not have a contractual amount of principle due, or a set maturity date, an amortized cost methodology is not feasible for these investments. Furthermore, as existing statutory accounting guidance is silent on certain types of funds (e.g., closed end funds, hedge funds, etc.) the investment classification project is also expected to include discussion of those types of funds.

New Money Market Mutual Fund Rules – Effective 2015

In July 2014, the SEC released new rules for money market mutual funds. The new rules define a retail fund (versus institutional funds) and when a fund can suspend redemptions, as well as give retail fund board of directors the option of calculating NAV using amortized cost or the penny-rounding method.

The final rules defined a retail money market fund as "a money market fund that has policies and procedures reasonably designed to limit all beneficial owners of the fund to natural persons." Money market funds seek stability and security with the historical goal of minimizing asset loss and thereby keeping NAV at $1. To "break the buck" damages investor belief in money market funds as risk free assets. Having the ability to suspend liquidity is equally damaging to the notion that money market funds should be treated as cash equivalents.

While the performance history of money market funds is relatively stable, the 2008 financial crisis showed that they are not necessarily risk-free. Under rule 2a-7 of the 40-Act, which defines a money market fund, funds must hold short-term, highly rated securities. This definition has allowed these funds to hold, for example, commercial paper (CP). Historically, proceeds from CP were used to purchase low-risk, short- to medium-term, highly liquid assets. In the early 2000s, proceeds were being used to purchase mortgage loans and other long-term assets for securitization into residential mortgage-backed securities (RMBS). When RMBS liquidity dried up by 2008, and defaults and losses ensued, a small number of funds that purchased CP backed by RMBS broke the buck. Additionally, a $1 NAV was not "real" because of penny-rounding; penny-rounding allows a fund with an NAV of $0.98 to round up to a resulting $1 NAV. Lastly, money market funds may impose liquidity fees of up to 2% of the value of shares redeemed, or temporarily suspend the right of redemption if the fund's board of directors determines that doing so is in the best interest of the fund.

Conclusion

Fund Investments, at only 1.5% of cash and invested assets, are a small part of insurer portfolios; however, they serve as a source of liquidity, as well as diversification. Money market funds were the largest allocation among the industry's mutual fund exposure. Current NAIC discussions are underway to improve the statutory accounting and reporting for fund investments. The updated July 2014 SEC rules defining a retail investor, method of calculating NAV and suspending redemptions are intended to give retail investors comfort and are not expected to affect insurers as institutional investors.

The industry's exposure is concentrated in a few fund families, namely: Dreyfus (14% of money market funds), PIMCO (16% of fixed-income funds) and Vanguard (38.8% of equity funds). These fund families are the largest) in those fund types with total assets under management measured in trillions of dollars.

The Capital Markets Bureau will continue monitoring the U.S. insurance industry's fund exposure along with the impact of regulatory changes and report on these investments as deemed appropriate.

February 6, 2015

Major Insurer Share Prices

			Change %			Prior		
		Close	**Week**	**QTD**	**YTD**	**Week**	**Quarter**	**Year**
Life	Aflac	$61.28	7.4	0.3	0.3	$57.08	$61.09	$61.09
	Ameriprise	134.79	7.9	1.9	1.9	124.94	132.25	132.25
	Genworth	7.76	11.2	(8.7)	(8.7)	6.98	8.50	8.50
	Lincoln	55.80	11.6	(3.2)	(3.2)	49.98	57.67	57.67
	MetLife	49.60	6.7	(8.3)	(8.3)	46.50	54.09	54.09
	Principal	49.65	5.8	(4.4)	(4.4)	46.93	51.94	51.94
	Protective	69.95	0.0	0.4	0.4	69.95	69.65	69.65
	Prudential	77.80	2.5	(14.0)	(14.0)	75.88	90.46	90.46
	UNUM	33.56	8.0	(3.8)	(3.8)	31.06	34.88	34.88
PC	ACE	$112.88	4.6	(1.7)	(1.7)	$107.96	$114.88	$114.88
	Axis Capital	50.74	(0.3)	(0.7)	(0.7)	50.90	51.09	51.09
	Allstate	70.93	1.6	1.0	1.0	69.79	70.25	70.25
	Arch Capital	60.01	3.5	1.5	1.5	57.97	59.10	59.10
	Cincinnati	51.94	2.8	0.2	0.2	50.51	51.83	51.83
	Chubb	100.82	3.0	(2.6)	(2.6)	97.90	103.47	103.47
	Everest Re	182.62	6.6	7.2	7.2	171.38	170.30	170.30
	Progressive	26.38	1.7	(2.3)	(2.3)	25.95	26.99	26.99
	Travelers	107.20	4.3	1.3	1.3	102.82	105.85	105.85
	WR Berkley	49.51	1.1	(3.4)	(3.4)	48.99	51.26	51.26
	XL	35.80	3.8	4.2	4.2	34.49	34.37	34.37
Other	AON	$96.42	7.1	1.7	1.7	$90.05	$94.83	$94.83
	AIG	52.10	6.6	(7.0)	(7.0)	48.87	56.01	56.01
	Assurant	66.35	4.5	(3.0)	(3.0)	63.51	68.43	68.43
	Fidelity National	35.77	1.9	3.8	3.8	35.10	34.45	34.45
	Hartford	40.28	3.5	(3.4)	(3.4)	38.90	41.69	41.69
	Marsh	55.43	3.1	(3.2)	(3.2)	53.77	57.24	57.24
Health	Aetna	$94.54	3.0	6.4	6.4	$91.82	$88.83	$88.83
	Cigna	111.70	4.6	8.5	8.5	106.83	102.91	102.91
	Humana	147.74	0.9	2.9	2.9	146.44	143.63	143.63
	United	107.60	1.3	6.4	6.4	106.25	101.09	101.09
Monoline	Assured	$25.50	4.4	(1.9)	(1.9)	$24.42	$25.99	$25.99
	MBIA	8.68	8.2	(9.0)	(9.0)	8.02	9.54	9.54
	MGIC	9.02	5.9	(3.2)	(3.2)	8.52	9.32	9.32
	Radian	16.96	7.6	1.4	1.4	15.76	16.72	16.72
	XL Capital	35.80	3.8	4.2	4.2	34.49	34.37	34.37

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Major Market Variables		**Change %**			**Prior**		
	Close	**Week**	**QTD**	**YTD**	**Week**	**Quarter**	**Year**
Dow Jones Ind	17,824.29	3.8	0.0	0.0	17,164.95	17,823.07	17,823.07
S&P 500	2,055.47	3.0	(0.2)	(0.2)	1,994.99	2,058.90	2,058.90
S&P Financial	324.93	4.8	(2.5)	(2.5)	310.01	333.32	333.32
S&P Insurance	294.73	5.1	(4.0)	(4.0)	280.42	307.04	307.04
US Dollar $		**Change %**			**Prior**		
/ Euro	$1.13	0.3	(6.4)	(6.4)	$1.13	$1.21	$1.21
/ Crude Oil bbl	52.13	9.1	(3.2)	(3.2)	47.76	53.83	53.83
/ Gold oz	1,236.60	(3.7)	4.6	4.6	1,284.00	1,182.10	1,182.10
Treasury Ylds %	%	**Change bp**			%	%	%
1 Year	0.25	0.10	0.03	0.03	0.15	0.22	0.22
10 Year	1.96	0.32	(0.21)	(0.21)	1.65	2.17	2.17
30 Year	2.53	0.31	(0.22)	(0.22)	2.23	2.75	2.75
Corp Credit Spreads -bp		**Change %**			**Prior**		
CDX.IG	12.00	(7.7)	2.7	2.7	13.00	11.69	11.69

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Major Insurer Bond Yields				**Weekly Change**						**YTD**
				Price			**Spread over UST**			**Spread**
	Company	**Coupon**	**Maturity**	**Current**	**Change**	**Yield**	**B.P.**	**Change**		**Change**
Life	Aflac	8.500%	5/15/2019	$125.91	($0.77)	2.11%	74	(17)		(17)
	Ameriprise	5.300%	3/15/2020	$114.71	($1.09)	2.23%	65	(16)		(9)
	Genworth	6.515%	5/15/2018	$101.19	($0.38)	6.11%	495	(16)		58
	Lincoln National	8.750%	7/15/2019	$125.69	($0.96)	2.53%	111	(10)		(3)
	MassMutual	8.875%	6/15/2039	$166.84	($4.72)	4.38%	195	(11)		1
	MetLife	4.750%	2/15/2021	$112.95	($1.34)	2.42%	74	(10)		(2)
	New York Life	6.750%	11/15/2039	$145.28	($2.85)	3.89%	150	(16)		(5)
	Northwestern Mutual	6.063%	3/15/2040	$136.74	$0.66	3.78%	138	(33)		(11)
	Pacific Life	9.250%	6/15/2039	$163.62	($1.76)	4.79%	236	(26)		(9)
	Principal	6.050%	10/15/2036	$127.55	($3.93)	4.12%	179	(7)		5
	Prudential	4.500%	11/15/2020	$110.68	($0.90)	2.50%	83	(19)		(16)
	TIAA	6.850%	12/15/2039	$142.44	($0.44)	4.11%	171	(28)		5
P&C	ACE INA	5.900%	6/15/2019	$115.72	($1.07)	2.10%	66	(13)		(18)
	Allstate	7.450%	5/15/2019	$121.39	($1.17)	2.17%	78	(8)		(6)
	American Financial	9.875%	6/15/2019	$128.63	($1.02)	2.82%	147	(7)		1
	Berkshire Hathaway	5.400%	5/15/2018	$112.68	($0.49)	1.41%	28	(15)		(12)
	Travelers	3.900%	11/15/2020	$108.49	($1.32)	2.31%	67	(9)		6
	XL Group	6.250%	5/15/2027	$121.04	($2.31)	4.05%	180	(13)		(3)
Other	AON	5.000%	9/15/2020	$112.34	($1.51)	2.63%	100	(7)		4
	AIG	5.850%	1/15/2018	$112.16	($0.50)	1.59%	57	(13)		(11)
	Hartford	5.500%	3/15/2020	$114.55	($0.76)	2.47%	93	(18)		(7)
	Nationwide	9.375%	8/15/2039	$166.51	($0.39)	4.75%	236	(28)		(10)
Health	Aetna	3.950%	9/15/2020	$107.75	($1.22)	2.45%	83	(10)		(10)
	CIGNA	5.125%	6/15/2020	$112.46	($1.40)	2.61%	104	(6)		10
	United Healthcare	3.875%	10/15/2020	$109.03	($1.34)	2.18%	50	(10)		(14)
	Wellpoint	4.350%	8/15/2020	$110.33	($0.89)	2.34%	76	(15)		(15)