

ETFs Can Keep You Out of the Bunker

By Dick Goff

Having worked with many captive insurance owners I can pretty accurately generalize about their abilities and characteristics. For example, most are strategically astute and entrepreneurially vigorous. But few are what I would describe as meticulously analytical.

That's probably why the most ignored element of many captives is the investment portfolio. Most captive owners think of it as the mattress containing the liquidity required by law and by operational necessity.

Many owners become timid in the face of the regulators' squinty-eyed attention. For example, some exhibit what I call a "bunker mentality" in the face of market downturns, and find safety for their capital in cash or the like. Then when the market turns up again they are the proverbial deer in the headlights, unable to make a move.

Other captive owners may take the line of least resistance and let their bank manage their portfolios. While it may be convenient, this approach seldom optimizes investment performance.

It's investment management 101 to prescribe a long-term strategy that can help reduce the effects of market volatility. But that medicine is sometimes difficult to find. I have recently heard about captives investing in exchange traded funds (ETF) that mimic selected market indices.

Not being an expert in this field, I sought one out to give me a short course in ETFs. Joshua Magden is vice president of insurance and institutional marketing at Sage Advisory Services of Austin, Texas, which has made captive investment management a specialty.

Josh compared ETFs with familiar mutual funds but less costly. "Management fees are lower because ETFs are not actively managed but built to track an index," he said. And that's an advantage in itself, he pointed out, because adherence to a selected index allows no "style drift" as can happen in actively managed funds. An additional

financial benefit of ETFs is interday liquidity, meaning transactions are closed as they occur rather than being held to be posted at the close-of-business share price.

Significantly to captive owners, there is a whole long list of ETFs that hold advance approval from most captive domicile regulators. That's a very important consideration come audit time.

Most important, in Josh's view, is that ETFs allow captives to adjust their tactical exposure among asset classes or even categories within asset classes. I asked him for a hypothetical example of that.

"Say in 2008 when markets were tumbling you put your captive's portfolio into the iShares Barclays 1-3 Year Treasury Bond Fund shown as SHY on the ticker – that was the 'flight to quality' trade. In 2008, of course, the S&P 500 index fell 37 percent, but SHY earned 6.64 percent.

"Now, for simplicity's sake, assume that going into 2009 you felt a little bit better about how the economy was sorting itself out but wanted to stay short in the 1-3 year range. You also wanted to stay in fixed income but simply change asset class categories and move into high-grade corporate bonds. You could cost-effectively trade out of SHY and buy the iShares 1-3 Year Credit Bond Fund – ticker: CSJ – which earned a 10.73 percent return in 2009. Both SHY and CSJ are rated NAIC Level 1."

Josh admits this is an oversimplified example to give us the idea of how tactical shifts in allocation can be executed based on market outlook. Of course, an investor or investment manager can still make the wrong call on sectors or allocation mix, but what ETFs offer insurers is a way to build a diversified portfolio if they are small and, no matter their size, one that can be tactically rotated without transaction costs eating away much of the returns.

About this time in our conversation a little light bulb blinked on over my head. What Josh was describing was a method to invest on the same playing field as the biggest boys on Wall Street with a dynamic investment analysis process that looks vastly superior to the ordinary Main Street investment manager's. In short: greater performance at less cost.

This would be an ideal method, I concluded, for a captive to operate a portfolio to fund, for example, a group annuity product that would be unique in the ART world. But that, as they say, would be a story for another day.

Dick Goff is managing member of The Taft Companies LLC, a captive insurance management firm and Bermuda broker at dick@taftcos.com. Joshua Magden may be reached at JMagden@sageadvisory.com.