

Solvency II could be a Unique Opportunity for Hedge Fund Strategies, latest Lyxor Research shows

There is growing empirical evidence that the complexity of financial markets makes it increasingly challenging for institutional investors to manage their asset/liability profiles efficiently. Changes in the regulatory framework and in accounting rules make this even trickier for insurance companies. Against this backdrop, insurers - especially those with long-term liabilities - have no choice but to fully rethink their overall investment policies and long-term strategic allocation. Contrary to the conventional wisdom, Solvency II may thus create a sound opportunity for hedge fund strategies to find their way into insurers' core portfolios.

While the benefits of hedge fund strategies in asset liability management have been documented in the academic literature, the integration of these strategies into the global asset allocation of insurance companies may be jeopardised by recent developments on the regulatory front. Since the Solvency II framework aims to improve the understanding, and in turn, the control of different types of risk, Lyxor's research starts with a discussion on how to gain a proper understanding of the embedded risks of hedge fund strategies, arguing that it is now possible to perform a reliable risk/return analysis on hedge fund strategies, similar to that carried out on traditional asset classes.

New forms of investment vehicles such as separate or managed accounts make it possible for insurance companies to gain exposure to hedge fund strategies with sufficient transparency and liquidity to perform a reliable risk/return analysis. As a consequence, Lyxor argues that there is no reason why hedge fund strategies should be placed in the "other equities" category, next to "emerging equities", "private equity" or "commodities",

and suffer such poor treatment as in the standard approach.

The Solvency II directive appears to be very much influenced by traditional investors' practices, and certain risk mitigation techniques turn out to be somewhat ill-suited for actively-managed long/short portfolios. A Solvency Capital Requirement of 49% then would clearly not be representative of the risks embedded in hedge fund strategies. A capital charge of no more than 25% would deem to be appropriate for a well-diversified hedge fund allocation.

Bespoke solutions are increasingly considered by institutional investors in an attempt to maximise the benefits they derive from hedge fund investing. In this respect, this research suggests that the Solvency Capital Requirement of the different hedge fund strategies can be easily factored into the portfolio construction process, and a solution may be designed that is optimal from both a risk-adjusted performance and a capital efficiency standpoint.

The results of this research show that hedge fund strategies not only appear to provide insurance companies with an appealing solution from an investment perspective, but they also look to be efficient from a capital efficiency standpoint. Against all expectations, hedge fund strategies could end up playing a greater role in the future investment policy of insurers.

Reference:

Vaissié M. (2012), Solvency II: A Unique Opportunity for Hedge Fund Strategies, *Lyxor Research Paper*, January, www.lyxor.com



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