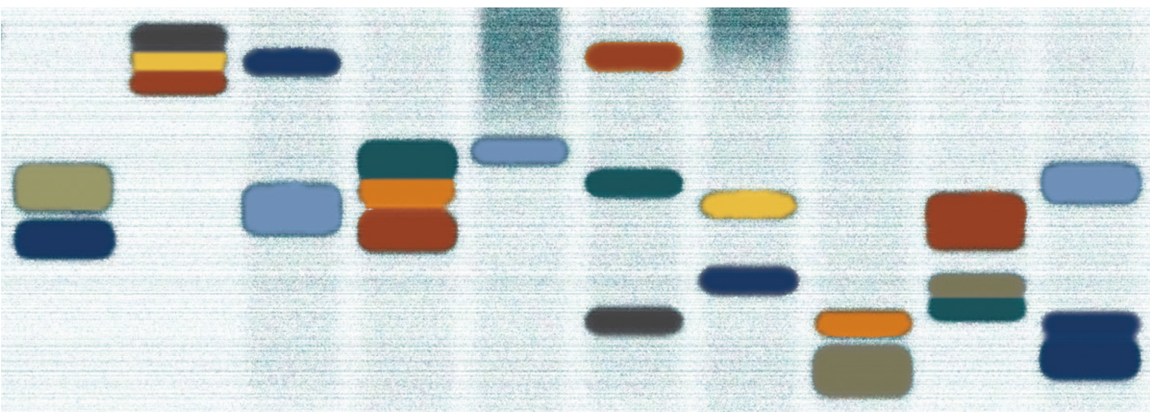
Asset
Management

A Reversal in Expectations



GSAM
Insurance
Survey

GSAM INSURANCE ASSET MANAGEMENT

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I. Executive Summary

In a rapidly shifting market environment, this year's GSAM Insurance Asset Management survey reveals a dramatic turn in expectations regarding the credit cycle, inflation, rates and equity returns. However, with rates low and equity valuations high, insurers' dominant concern remains achieving adequate returns. In April 2017, GSAM Insurance Asset Management conducted its sixth annual survey, which synthesizes perspectives from 317 Chief Investment Officers (CIOs) and Chief Financial Officers (CFOs), representing over $10 trillion in global balance sheet assets.

Over 80% of insurers anticipate an increase in 10-Year US Treasury yields and 88% of insurers believe S&P 500 Index returns will be positive in 2017. In a dramatic reversal, only one-third of insurers now believe we are in the late stage of the credit cycle compared to three quarters of respondents last year, expressing a view that the credit cycle has lengthened. Moreover, only 2% of the respondents feel that credit spreads will widen significantly this year. The "back-pedaling" view on the credit cycle has seen an increase in corporate credit allocations with a third of insurers planning to increase their exposure to credit risk. Brent crude oil prices are anticipated to be range bound between $50 and $75.

Political event risk jumped to the top of macroeconomic concern in 2017, whereas previously it was at the bottom of the list. Considering macroeconomic risks, inflation dominated deflation as a concern, also a significant reversal from the prior two years. Reflecting the improving macro backdrop, we have seen a dramatic shift in inflation expectations with concerns around deflation in the next 3 years declining 39 points to 16% of respondents, while concerns around inflation over the next 3 years rose 31 points to 62%.

This year, insurers expressed a more optimistic view of investment opportunities; only a third of survey respondents believe investment opportunities are getting worse, compared to 48% in 2016. Insurers showed a modest inclination to increase overall portfolio risk, expressing views to increase equity and credit risk. Insurers are looking to extend duration as years of low rates persist. With a significant decline in concern about growth prospects for China, Asia Pacific insurers indicated a strong preference to increasing portfolio risk. Insurers have expressed confidence in the expected returns of growth-related asset classes (private equity, US equities and emerging market equities). Similarly, they anticipate increasing their asset allocations to higher yielding assets such as middle market corporate loans, infrastructure debt and collateralized loan obligations.

Inadequate capital is not a concern for the industry, as over 90% of the respondents believe the industry is adequately or over-capitalized. The adoption of Solvency II regulations has become an investment consideration as noted by nearly 70% of European-based insurers. Environment, Social, and Governance ("ESG") continues to grow as an investment consideration.

II. GSAM Insurance Survey Background

MARKET ENVIRONMENT

Last year started with volatility as a further economic slowdown in China and sharply declining oil prices led to a selloff in global equity and credit markets. Safe haven assets rallied, with investors paring down risk. Markets recovered during the spring, but volatility returned after the surprising outcome of the Brexit vote. Markets quickly recovered post-Brexit and accelerated their strong performance after the US Presidential election. Central bank policy divergence remains a core theme this year with differing economic conditions across the globe, but investors are growing fearful that accommodative monetary policies are losing effectiveness.

The Federal Reserve ("Fed") hiked rates at the March 2017 meeting. We expect another two hikes this year. Animal spirits—John Maynard Keynes' term for the confidence to invest that is essential for growth—have rebounded since November's US election and, in the early days of the Trump Administration, sentiment may have a bigger impact than actual policies. An agenda of fiscal expansion, deregulation and potential trade protectionism, combined with a narrowing output gap, poses upside risks to US inflation. Markets have priced in much of the positive growth outlook, and they still face the challenge of rising rates. We see pockets of value in corporate credit, though we are wary of a pickup in defaults at this later stage of the cycle.

We see European growth slowing, with political uncertainty and the impact of Brexit posing additional downside risks. While we think a break-up of the monetary union is unlikely, we believe that rising populism poses a significant risk to European cohesion. Inflation lacks momentum and although overall unemployment is declining, youth unemployment remains high. As a result, we think the European Central Bank (ECB) is unlikely to withdraw monetary stimulus before 2019.

Japanese growth has potential to surprise to the upside. The recent advance has been led by an improvement in net exports and investment in housing. However, subdued wage growth and weak consumer confidence are creating headwinds for consumption. Inflation is likely to rise in 2017 due to energy base effects and currency weakness, but it remains well below the Bank of Japan's 2% target. We expect the 'Quantitative and Qualitative Easing with Yield Curve Control' framework, which aims to tether the 10-year yield, to remain in place for some time.

China's stabilization in economic activity and rapid policy response to signs of weakness has helped to allay concerns about a near-term crisis. We do see potential for policy adjustment missteps in the effort to maintain stability in the lead-up to the November 2017 leadership transition, as policymakers continue to rely on credit expansion to support growth. Policy makers are trying to manage the competing objectives of opening the capital account, maintaining currency stability and the need for lower interest rates.

INSURANCE OPERATING AND REGULATORY ENVIRONMENT

The evolving global political landscape affected insurers' operating environment throughout 2016. In the US, the Department of Labor fiduciary rule and its potential delay or replacement have had strong implications for Life insurers. The outcome of the EU Referendum in the United Kingdom (UK) may challenge the ability of European insurers to operate across the continent out of a single hub. Potential corporate tax reform in the US could affect the relative attractiveness of offshore domiciles for reinsurance companies.

Non-life reinsurers and commercial line writers, while operating in a highly competitive market with soft pricing, have benefited from low catastrophe losses.

Low interest rates in Japan, Korea and throughout Europe remain a critical challenge for insurers operating in these markets. Asset reallocation and hedge overlays have been employed to generate sustainable investment income needed to support guaranteed rates in traditional life policies.

M&A activity remained strong in 2016. The consolidation of runoff blocks, both in the life and non-life sectors, has been exploited to generate cost and capital efficiencies.

One year in, the introduction of the Solvency II framework has transformed the investment and risk management practices of European insurers. Beyond the compliance requirements of the new regulatory standards, insurance companies have sought to mitigate the impact of credit and government spread volatility on their solvency ratios through asset reallocation, asset/liability management action and a new design for their asset management mandates.

SUMMARY OF SURVEY RESPONDENTS

Against this backdrop, GSAM Insurance Asset Management continued its partnership with KRC Research, an independent research provider, to conduct its sixth annual global insurance investment survey. The survey provides valuable insights from Chief Investment Officers (CIOs) and Chief Financial Officers (CFOs) regarding the macroeconomic environment, return expectations, asset allocation decisions, portfolio construction and industry capitalization. We received responses from 254 CIOs and senior investment professionals, 50 CFOs and senior finance managers and 13 individuals who serve as both the CIO and CFO. This year, our survey included insurance companies that invest over $10 trillion in balance sheet assets, which represents over one-third of the balance sheet assets for the global insurance sector. The participating companies represent a broad cross section of the industry in terms of size, line of business and geography. The table below summarizes the profile of this year's respondents.

Type	CIO	CFO	Both	Total
Life	95	14	5	114
P&C / Non-Life	85	23	5	113
Multi-Line	40	5	0	45
Reinsurance	15	3	1	19
Health	13	3	2	18
Captive	6	2	0	8
Total	**254**	**50**	**13**	**317**

Region	CIO	CFO	Both	Total
Americas	148	26	5	179
EMEA	53	19	8	80
Asia Pacific	53	5	0	58
Total	**254**	**50**	**13**	**317**

III. Key Survey Findings

MACRO RISKS

This year, political risk was the top macroeconomic risk (26% of respondents) with more than 50% of insurers placing it among the top three risks. This is in stark contrast to the 2015 survey where political risk was not selected as a top macroeconomic risk by any survey respondent and 2016 when only 3% of respondents identified it as the top risk.

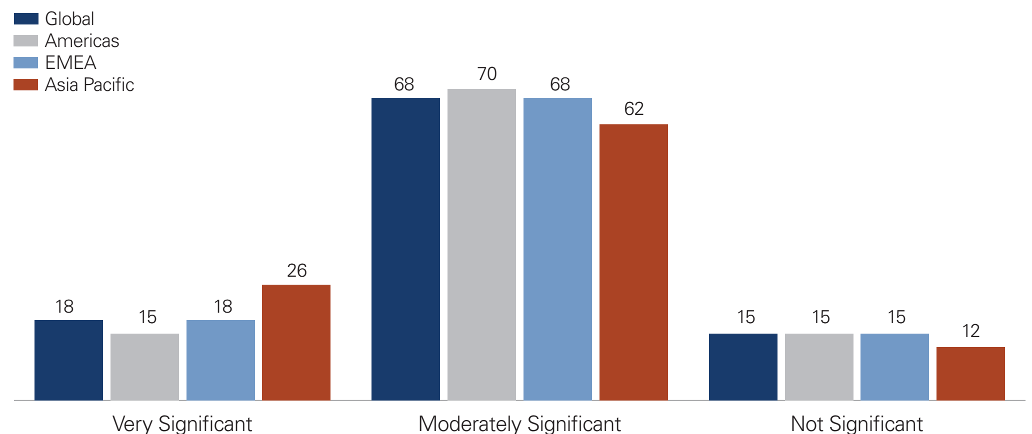
A US recession along with credit and equity market volatility remain the top three concerns for insurers. Fears about a recession in China have dissipated, especially in Asia Pacific where only 7% ranked it as a top risk compared to 28% last year.

Similar to last year, the majority (68%) of insurers believe interest rate hikes implemented by the US Fed will pose a moderately significant impact to their investment portfolios over the course of the year. Asia Pacific insurers believe the rate increases will have a very significant impact (26%) on their portfolios (which reflects concerns about hedging costs associated with the Federal Reserve increasing interest rates), relative to the Americas-based insurers that expect a significant impact (18%).

Which of the following issues pose the greatest macroeconomic risk to your investment portfolio? Please select and rank your top 3. (%)

2017 Macroeconomic Risks	% Ranked First Choice	% Total Ranked (1-3)
Political events	26	56
Economic slowdown/recession in the US	25	54
Credit & equity market volitility	18	54
US monetary tightening	9	29
Inflation	7	25
Deflation	5	16
Economic slowdown/recession in China	3	24
Deteriorating liquidity conditions	3	17
Economic slowdown/recession in Europe	3	16
Changes in ecb monetary policy	1	5
Large scale cyber event	0	4

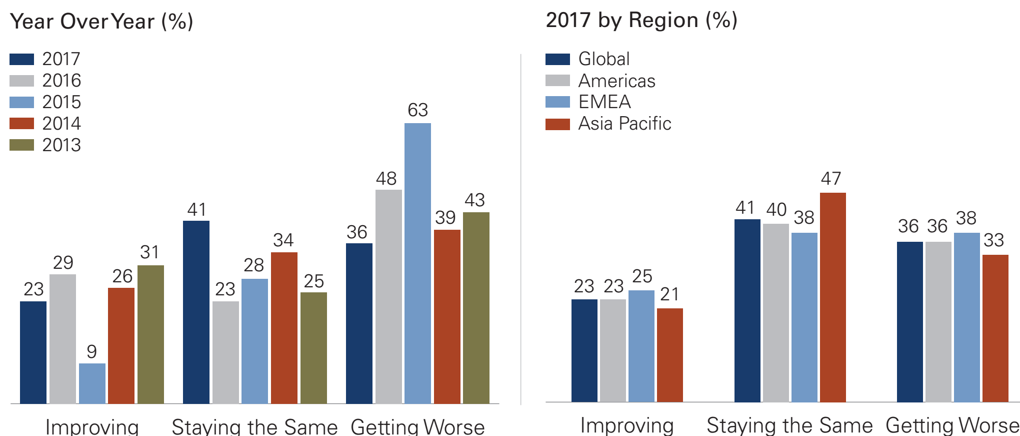
How significant do you think the impact of the Federal Reserve target interest rate hike and potential future hikes will be on your investment portfolio over the next 12 months? (%)



INVESTMENT OPPORTUNITIES

This year's survey illustrated rising optimism surrounding the investment opportunity universe. Only 36% of survey respondents felt the investment opportunity set was getting worse—representing the lowest level of underlying pessimism since the inception of the survey in 2013.

Overall, do you feel that investment opportunities compared to a year ago are improving, getting worse, or staying the same?

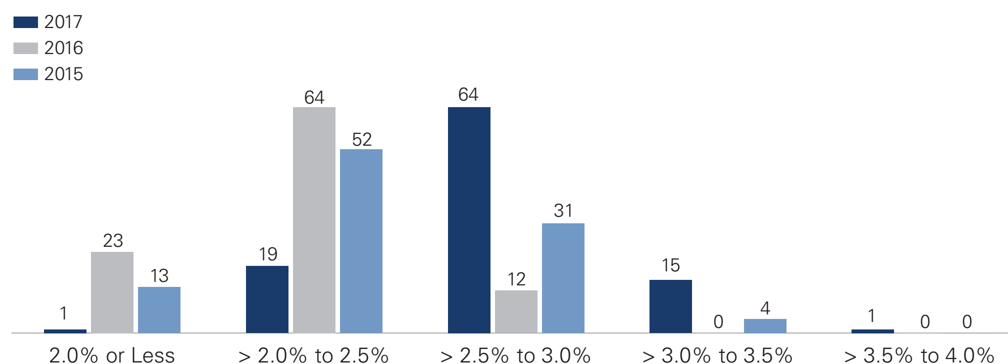


MARKET OUTLOOK

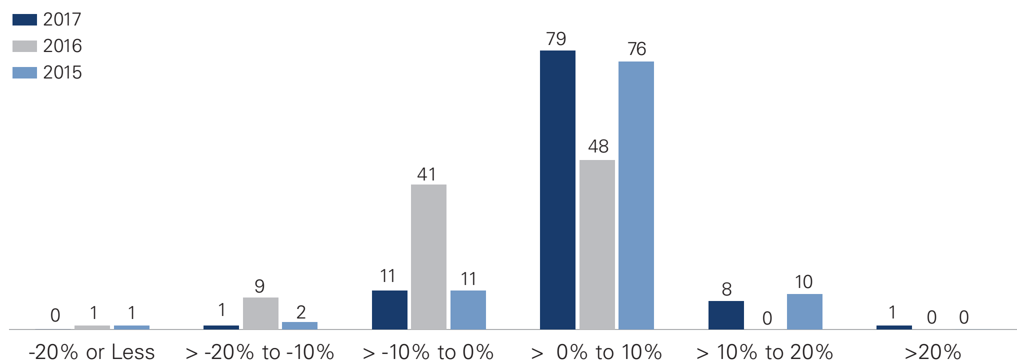
10-year Treasury, S&P and Oil

Insurers expressed a greater optimism around rates, equities, and credit. Eighty percent of insurers believe the 10-Year US Treasury yield will exceed 2.5% this year and 16% believe rates will end the year above 3%. A majority (88%) of insurers expect the S&P 500 index to have a positive return this year, compared to last year when more than half of insurers anticipated negative returns. Eighty percent of respondents believe Brent crude oil prices will be between $50 and $75 at the end of the year.

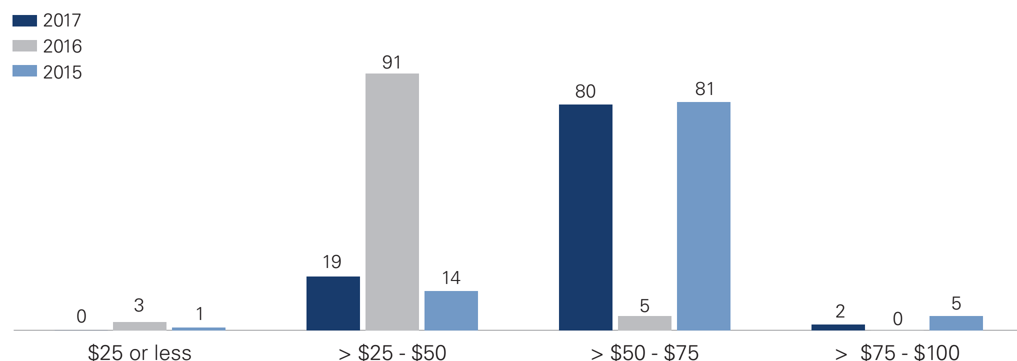
Where do you expect the 10-Year US Treasury yield will be at year-end 2017? (%)



What do you expect the 2017 total return will be for the S&P 500 Index? (%)



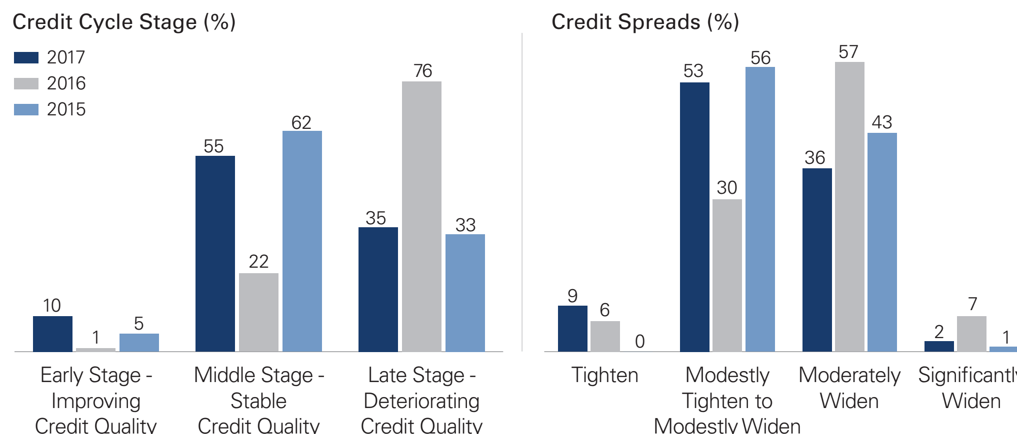
Where do you expect Brent crude oil (USD/bbl) will be at year-end 2017? (%)



Credit Cycle

This year we saw a substantial shift in credit cycle expectations. A total of 55% of insurers believe we are in the middle stage of the cycle with stable credit quality while 35% believing we are in the late stage with deteriorating credit quality. Last year, 75% of respondents felt we were in the late stage of the credit cycle. Consistent with these views, a majority (53%) of insurers believe credit spreads will modestly tighten to modestly widen this year and 36% believe spreads will moderately widen. Only 2% of respondents feel that credit spreads will widen significantly this year.

Where do you think we are in the credit cycle? What do you think will happen to credit spreads in 2017?

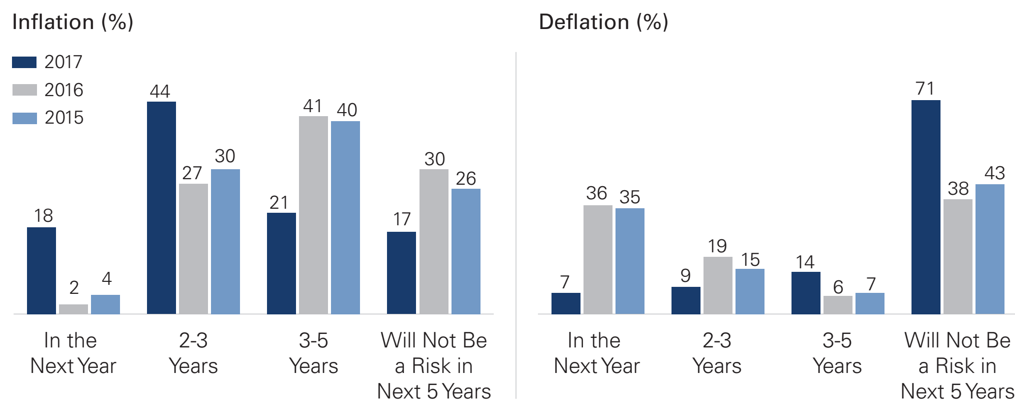


Inflation / Deflation

Echoing the anticipated changes in US government spending and economic policy, 18% of insurers noted inflation as a near-term concern; compared to only 2% and 4%, respectively, over the two prior years. Almost half (44%) of insurers believe inflation will be a concern in their domestic market in the next 2 – 3 years; these observations are striking compared to last year when only a quarter of insurers believed inflation would be a concern over the 2 – 3 year period.

Illustrating a similar trend, 71% of survey respondents indicated deflation would not be a risk in the next five years, a significant change from the last two years indications of 38% and 43% respectively.

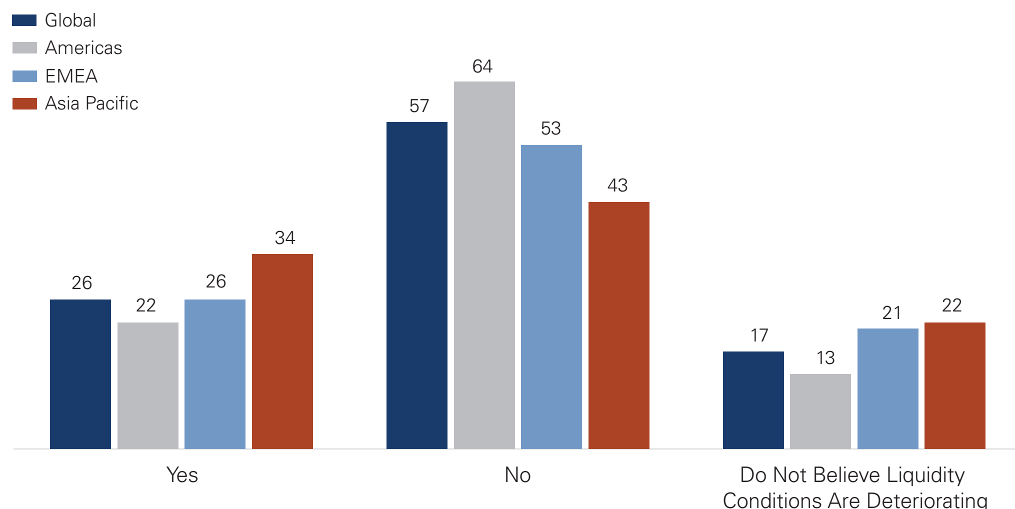
When do you expect inflation/deflation will be a concern in your domestic market?



Liquidity Conditions and Management

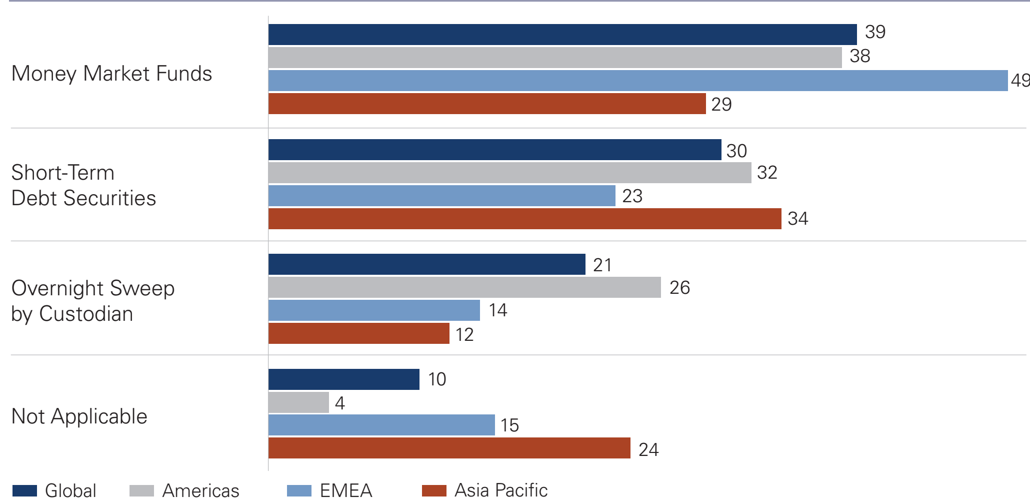
Over half of insurers globally do not believe deteriorating liquidity conditions will have a significant impact on their investment portfolios, although 40% of Health insurers believe it will have a significant impact on their portfolios.

Do you think deteriorating liquidity conditions will have a significant impact on your investment portfolio? (%)



Despite their benign views on liquidity, insurers continue to re-evaluate their cash and liquidity management strategies. This is, in large part, due to the low-to-negative short-term interest rates and charges for cash balances held in accounts. The use of money market funds continues to grow with 39%, up 5% from last year, of insurers indicating funds as their primary cash management strategy. Over the past year, European insurers increased their use of money market funds (+12% year over year) and continued to phase out the use of overnight sweep by custodians (-5%) and short-term debt securities (-4%). Another third (30%) use short-term debt securities for their needs.

What is the primary strategy you currently employ for cash/liquidity management? (%)



PORTFOLIO CONSTRUCTION

The survey reveals a modest shift to increasing portfolio risk. Twenty-six percent of insurers plan to increase risk, while 10% intend to reduce risk. Asia Pacific insurers exhibited the largest appetite for increasing risk with 59% indicating they intend to increase overall investment risk.

Are you planning to increase, decrease, or maintain the overall risk in your investment portfolio in the next 12 months?

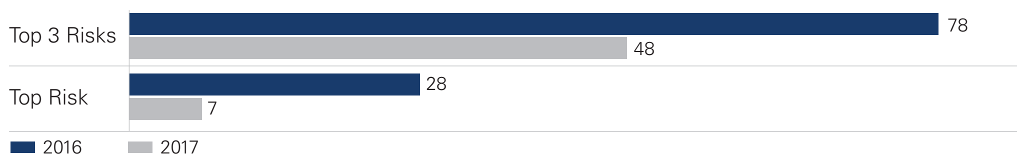
Region	Decrease (%)	Increase (%)
Global	10	26
Americas	11	20
EMEA	11	18
Asia Pacific	9	59

Global Year Over Year	Decrease (%)	Increase (%)
2017	10	26
2016	16	25
2015	12	33
2014	8	35
2013	7	41

Globally, insurers are looking to increase equity risk (+7% net), credit risk (+17%), and duration (+8%). Insurers are planning to reduce ("sell") portfolio liquidity (-7% net). Asia Pacific insurers are the most optimistic with 55% intending to increase credit risk compared to 31% last year. They also intend to increase their equity risk (+41%) and duration (+36%). This is likely due, in large part, to the dissipation over the last year of regional fears over a recession in China.

Economic recession / slowdown in China as a top risk (%)

Asia Pacific



Are you planning to increase, decrease, or maintain the equity risk, credit risk, liquidity, and duration in your investment portfolio in the next 12 months?

Global	Decrease (%)	Increase (%)	Net (%)
Equity Risk	15	22	7
Credit Risk	13	30	17
Liquidity	22	15	-7
Duration	13	21	8

Equity Risk by Region	Decrease (%)	Increase (%)	Net (%)
Global	15	22	7
Americas	13	16	3
EMEA	16	23	7
Asia Pacific	19	41	22

Credit Risk by Region	Decrease (%)	Increase (%)	Net (%)
Global	13	30	17
Americas	12	22	10
EMEA	19	29	10
Asia Pacific	7	55	48

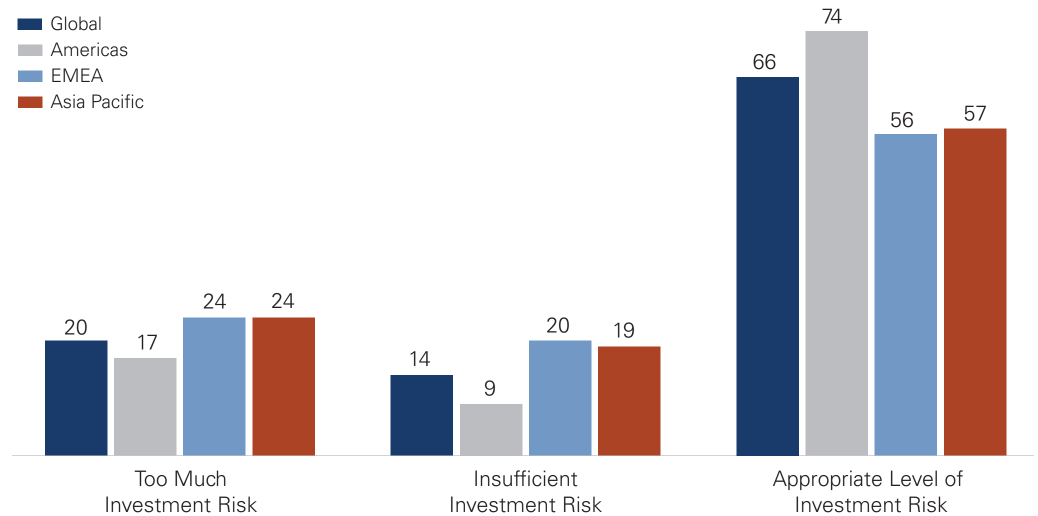
Portfolio Liquidity by Region	Decrease (%)	Increase (%)	Net (%)
Global	22	15	-7
Americas	20	13	-7
EMEA	28	18	-10
Asia Pacific	24	16	-8

Duration Risk by Region	Decrease (%)	Increase (%)	Net (%)
Global	13	21	8
Americas	11	21	10
EMEA	19	11	-8
Asia Pacific	10	36	26

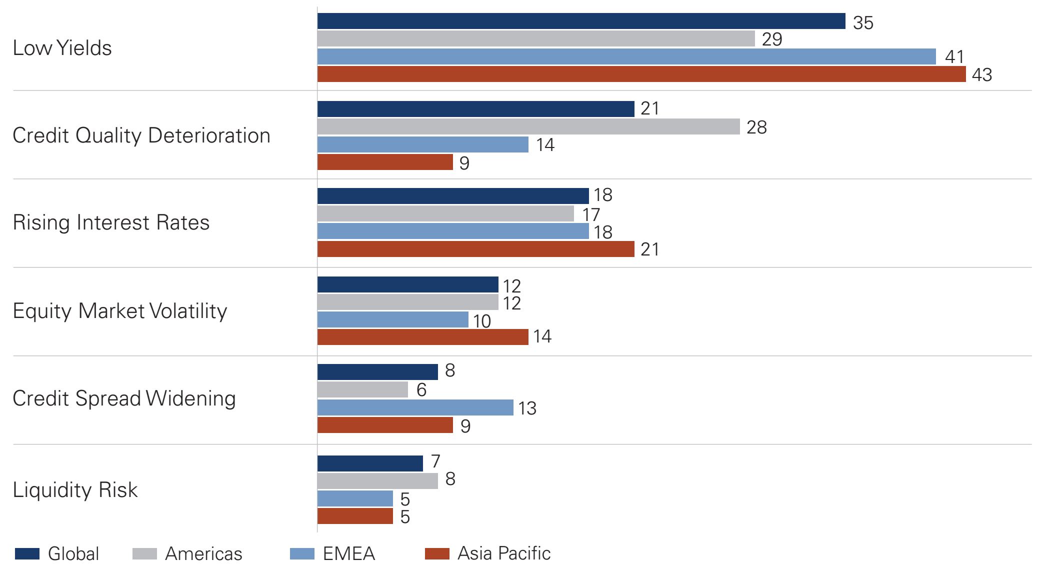
PORTFOLIO RISKS

Low yields continue to pose the greatest risk to insurers' investment portfolios (35%). The risk is particularly pronounced in Europe and Asia where over 40% of survey respondents selected the yield environment as their top portfolio concern. Insurers based in the Americas were split in terms of the investment risk about which they are most concerned — with 29% indicating the low yield environment and 28% indicating deteriorating credit quality as top risks. Insurers generally believe their peers are taking on an appropriate level of investment risk (66%).

Do you think your industry peer group is currently taking on too much, an appropriate level of, or insufficient investment risk? (%)



Please select the investment risk that you are MOST concerned about. (%)



ASSET CLASS RETURN EXPECTATIONS

For the fourth consecutive year, private equity (27%) is expected to be the highest returning asset class. US equities and emerging markets equities, which were among the lowest expected returning asset classes last year, are expected to be high returning asset classes this year.

Please rank the 3 asset classes that you expect to deliver the highest and lowest total returns in the next 12 months. (% Ranked First Choice)

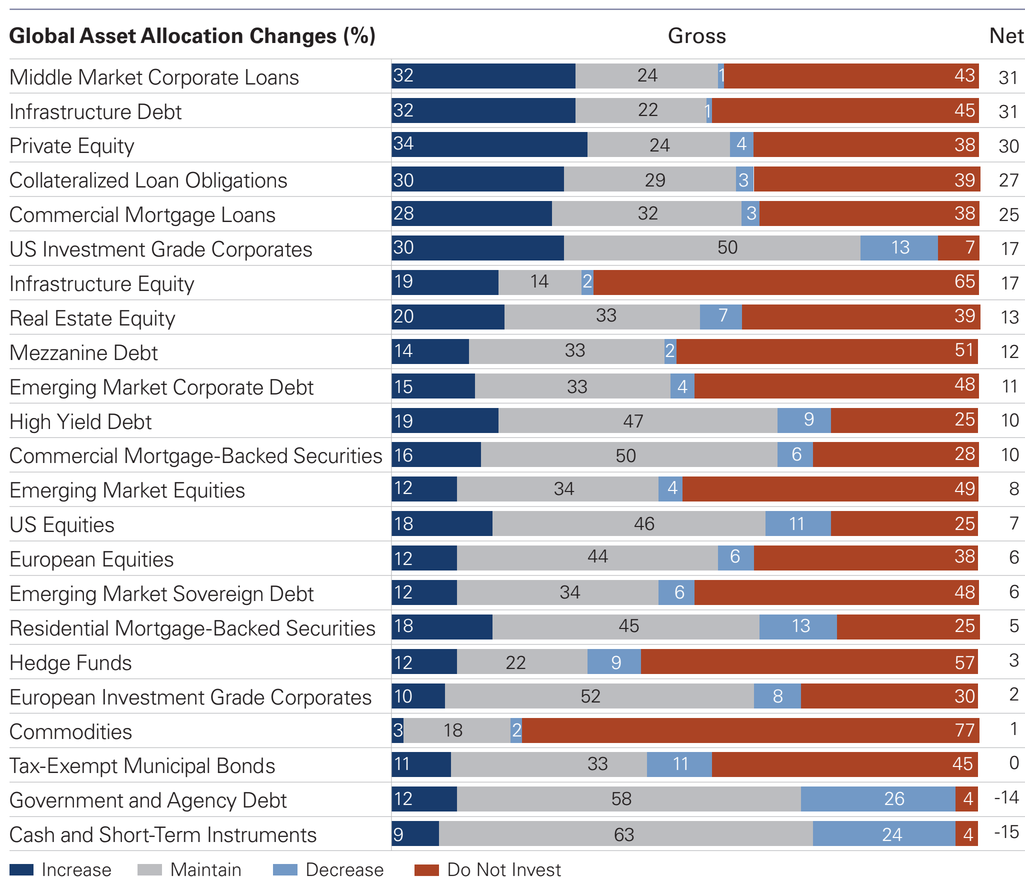
	Highest Total Return (%)	Lowest Total Return (%)
Private Equity	27	1
US Equities	20	2
Emerging Market Equities	13	3
Commodities	5	3
European Equities	5	2
High Yield Debt	4	5
Hedge Funds	4	2
Mezzanine Debt	4	0
Middle Market Corporate Loans	4	0
Infrastructure Equity	3	1
US Investment Grade Corporates	2	4
Collateralized Loan Obligations	2	0
Government and Agency Debt	1	32
Tax-Exempt Municipal Bonds	1	6
Emerging Market Sovereign Debt	1	3
Residential Mortgage-Backed Securities	1	3
Emerging Market Corporate Debt	1	2
Real Estate Equity	1	2
Commercial Mortgage Loans	1	0
Infrastructure Debt	1	0
Cash and Short-Term Instruments	0	26
European Investment Grade Corporates	0	2

Last year, given the bearish economic view, insurers anticipated government and agency debt to be among the top returning asset classes. This year only 1% of survey respondents anticipate this to be the case. One third of insurers anticipate government and agency debt to be the lowest returning asset class. Another quarter of insurers expect cash and short-term instruments to be among the lowest returning asset classes. For the second year in a row, insurers have fragmented opinions on high yield debt with 4% anticipating it to be among the highest returning asset class and 5% indicating it will be among the lowest returning asset classes.

ASSET ALLOCATION PREFERENCES

Insurers continue to express interest in higher returning, less liquid asset classes such as middle market corporate loans (31%), infrastructure debt (31%), private equity (30%) and collateralized loan obligations (27%). For the second consecutive year, insurers also plan to increase their allocation to US investment grade corporates (17%), which provide higher yields relative to other high quality assets. They intend to decrease their allocations to government and agency debt (-14%) and cash and short-term instruments (-15%).

Are you planning to increase, decrease, or maintain your allocation to the following asset classes in the next 12 months?



Regional Nuances

With expected increases in government spending, nearly a third of US and European insurers anticipate increasing their asset allocation to infrastructure debt. Over half (59%) of Asia Pacific based insurers intend to increase their allocation to US investment grade corporates, up from 48% last year. US and European insurers also show interest in commercial mortgage loans with 34% and 21%, respectively, indicating they plan to increase their allocation to the asset class this year.

Regional Net Asset Allocation Changes (% Increase - % Decrease)

Americas Top 5

Asset Class	Net Change
Collateralized Loan Obligations	36
Middle Market Corporate Loans	34
Private Equity	33
Commercial Mortgage Loans	32
Infrastructure Debt	28

EMEA Top 5

Asset Class	Net Change
Infrastructure Debt	35
Middle Market Corporate Loans	34
Real Estate Equity	23
Commercial Mortgage Loans	21
Infrastructure Equity	21

Asia Pacific Top 5

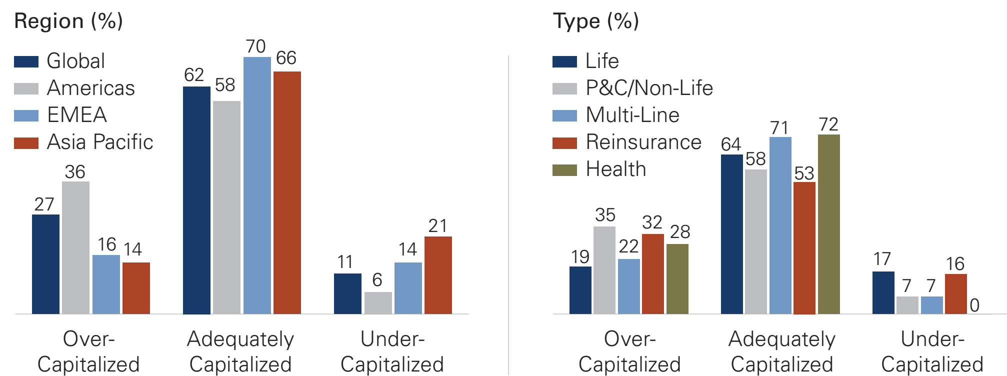
Asset Class	Net Change
US Investment Grade Corporates	57
Private Equity	43
Infrastructure Debt	37
US Equities	32
Infrastructure Equity	26

CAPITALIZATION

Insurers generally believe that their industry peer group is adequately capitalized (62%). Regulatory capital, as well as internal and economic capital, are the main capital constraints impacting insurers' investment strategy.

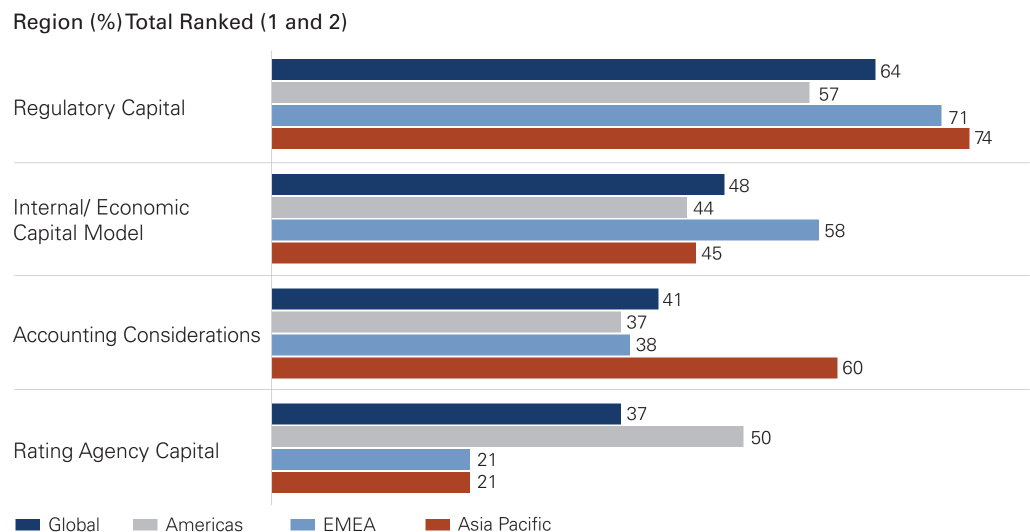
Health and multi-line insurers in particular have a strong conviction with 72% and 71% indicating their peer group is adequately capitalized. Similar to last year, one third (35%) of P&C/non-life and (32%) of reinsurers insurers believe their peer groups are over capitalized. Insurers continue to look at merger and acquisition opportunities as well as dividends as strategies to deploy excess capital.

Do you believe your industry peer group is currently over-, adequately, or under-capitalized?



Regionally, the vast majority of European insurers believe regulatory capital (71%) and internal/economic capital models (58%) will be the main constraints impacting their investment strategies. This is driven in part by Solvency II which became effective in early 2016. Three-quarters (74%) of Asia Pacific insurers also believe regulatory capital will be the primary constraint on reinvestment strategy. In the Americas, where rating agency capital requirements and models are closely aligned with the regulatory Risk Based Capital (RBC) requirements, insurers identified rating agency capital (50%) as one of their main capital constraints.

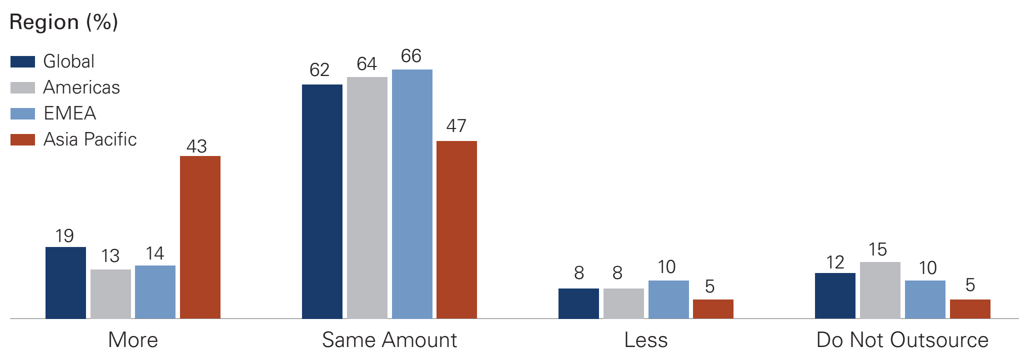
What do you expect to be the two main capital constraints affecting your investment strategy in 2017? Please select two.

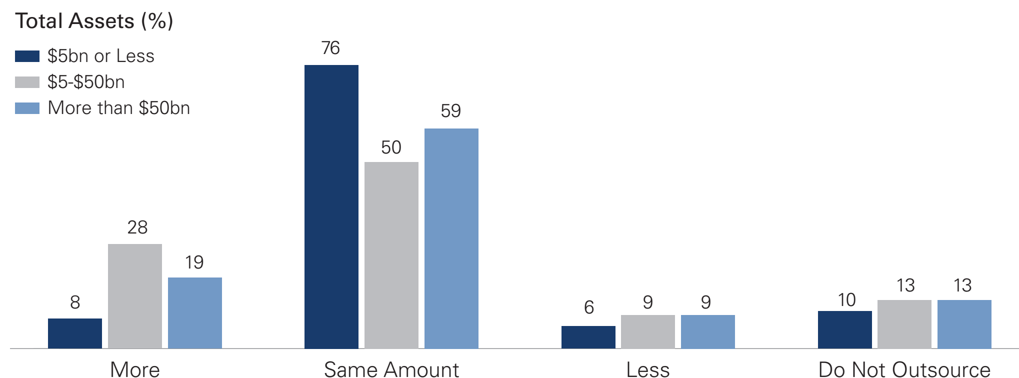


OUTSOURCING

Similar to last year, a majority of insurers (62%) anticipate outsourcing the same amount of their investment portfolio this year. An additional 19% plan to outsource more of their portfolios. However, over 40% of Asia Pacific insurers intend to outsource more of their investment portfolios over the same time period.

Do you anticipate outsourcing more, the same amount, or less of your investment portfolio in the next 12 months?





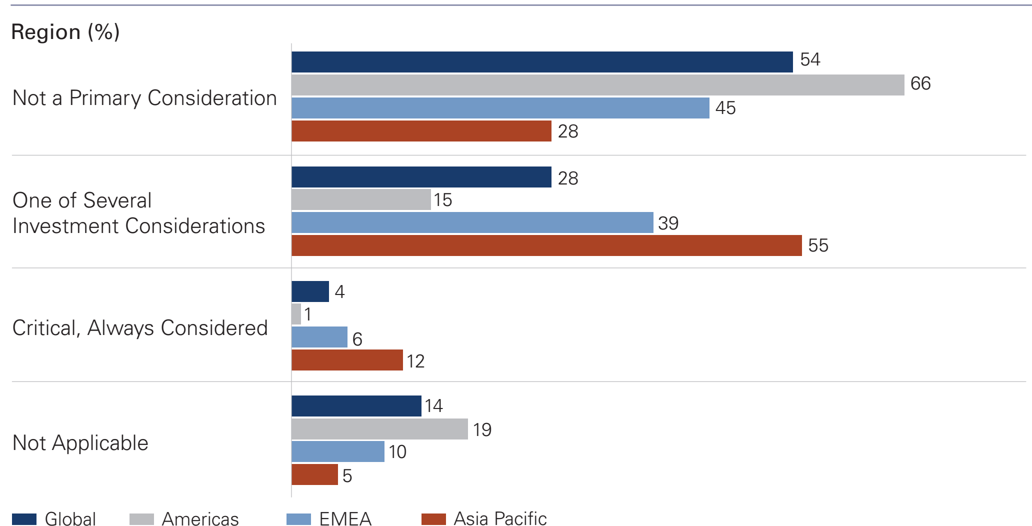
Insurers are looking to third party managers for the management of US investment grade corporates (29%), private equity (26%), high yield debt (24%), infrastructure debt (22%) and middle market corporate loans (21%). Infrastructure debt is a particular interest for European insurers where 25% of survey respondents indicated they plan to outsource the asset class over the next 12-months, up 12% from last year.

Which of the following asset classes are you considering outsourcing to a third party asset manager in the next 12 months? Please select all that apply. (%)

ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG)

Environmental, Social, and Governance (ESG) factors play a role in insurers' investment strategies and have become an important part of the investment decision making process. Sixty-seven percent of Asia Pacific insurers use ESG as an investment consideration (+12% year over year) driven by stakeholder considerations and corporate governance policies.

To what extent is ESG (Environmental, Social, and Governance) and/or Impact Investing an investment consideration?



IV. Conclusion

While remaining cautious on political uncertainty and the low level of real rates, insurers are decidedly more optimistic than in preceding years' surveys. Insurers showed a modest inclination to increase overall portfolio risk, expressing views to increase equity and credit risk. Views surrounding rates and equities reflect a more optimistic view of global growth and potential for reflation, particularly in US dollar assets. The "back-pedaling" view on the credit cycle has seen an increase in corporate credit allocations with a third of insurers planning to increase their exposure to credit risk. Asia Pacific insurers demonstrated a greater risk appetite and plan to increase overall portfolio risk and in particular, credit risk and duration.

In summary, the global insurance industry expressed rising optimism about their investment prospects, and intention to pursue sources of yield enhancement. Reflecting the improving macro backdrop, we have seen a dramatic shift in inflation expectations with concerns around deflation in the next 3 years declining 39 points to 16% of respondents while concerns around inflation over the next 3 years rose 31 points to 62%. Coincidentally insurers have expressed confidence in the expected returns of growth-related asset classes (private equity, US equities and emerging market equities). Similarly, they anticipate increasing their asset allocations to higher yielding and less liquid asset classes such as middle market corporate loans, infrastructure debt and collateralized loan obligations. Depending upon the risk tolerance, these asset classes provide some insurers the flexibility to "sell liquidity" and earn incremental returns over more liquid assets.

Disclosures

2017 survey results as of February 22, 2017.

2016 survey information as of February 24, 2016. 2015 survey results as of February 25, 2015. 2014 survey results as of March 6, 2014. 2013 survey results as of March 5, 2013. 2012 survey results as of May 24, 2012.

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5.3 Executing firms
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5.4 Relevant factors
In circumstances where a client has been classified as a professional client, subject to any specific instructions that Goldman Sachs AG accepts from clients, Goldman Sachs AG takes into account a range of factors that allow Goldman Sachs AG to comply with its requirements in relation to best execution as they apply to investment firms providing services of reception and transmission of orders. These may include price, costs, speed, likelihood of execution and settlement, together with any other consideration relevant to the order.

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The policy provides that in certain circumstances it may be appropriate for Goldman Sachs to disclose the general nature of a conflict of interest to aclient.

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8. COST AND ASSOCIATED CHARGES

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