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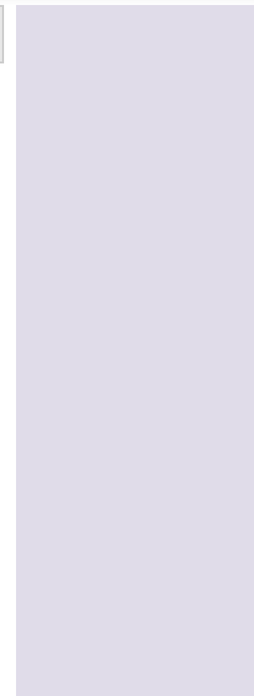

Julex Capital Introduces Full-Scale ETF Strategies For Insurers

(An IAM Exclusive)
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The post-crisis years have seen increasing interest in third-party management of insurance company assets by investment firms not previously connected with the insurance industry. Julex Capital Management, LLC is a unique example because the company is brand new.

The Boston-based firm was launched in February by founder Dr. Henry Ma, CFA and his partners, Brian Phelan and Tony Ash, CFA, all of whom have extensive experience managing insurance company assets. Their new company specializes in investment strategies using ETFs (exchange-traded funds), which are a relatively new asset class themselves.

A few months after Julex Capital's launch, as the second half of 2013 got under way amid continued volatility and uncertainty in the markets, IAM editor Alex McCallum met with Tony Ash to review the company's positioning and expand upon the opportunities for using ETFs in the portfolios of insurance companies.

IAM: Who was the inspiration behind the founding of Julex, and how did the three partners meet up to make this happen?

Ash: After the Great Recession, the "new normal" investment landscape became characterized by ultralow interest rates, increasing volatility and heightened risk of contagion. Our founder, Dr. Henry Ma, CFA, a former hedge fund manager at Geode Capital and director of quantitative research at major investment firms, realized that investors were looking for more certainties in their investment results. The traditional buy-and-hold or benchmark-centric approach and other alternative strategies did not provide enough downside protection or consistent returns in bear markets. In the meantime, the ETF market was growing quickly and the potential new uses for these new instruments were just beginning to be recognized.

In the course of testing out his quant models to solve this problem, he worked with me, a former colleague at Sun Life Financial, who was head of US portfolio management there and responsible for making asset allocation decisions across the US insurance business. A suite of risk-managed ETF strategies was developed and the partners sought out the final member of the team, a related colleague on the sell side, Brian Phelan, who was an institutional fixed income salesman for 30 years, with Paine Webber, Deutsche Bank, and others.

IAM: Julex's profile refers to your investment strategy thinking as another "arrow in the quiver" for insurance companies. You must be partly, if not entirely, referring to ETFs. Does this specialty distinguish you from other managers, and how is it working?

Ash: Insurance companies have a well-deserved reputation as buy-and-hold investors due to the relatively large weightings in illiquid investments such as private placements and whole loan commercial mortgages. In order to add incremental return or additional risk management benefits, insurance companies have typically resorted to alternative investments and derivatives. The trouble with this profile, of course, is that liquidity is sacrificed and complexity and accounting problems are increased.

Actively managing macro asset class ETFs within a dynamic asset allocation framework provides another way to generate alpha, without a commensurate increase in illiquidity or complexity – both things that are anathema to insurers. Our specialty is our quant model and executing it in the ETF market. We are long only, with no derivatives and no leverage and are able to produce a risk/return profile that has low correlation to the major asset classes. We actively monitor over 80 macro asset class ETFs for potential selection and inclusion in our model portfolios each month.

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IAM: ETFs were index funds until 2008 when the SEC approved actively-managed ETFs. Has this made a difference to how insurers are responding to them, and what are the prospects that ETFs, fixed income ETFs in particular, can become a dominant component of insurance company portfolios?

Ash: No one can doubt the success of BOND, the active bond ETF managed by Bill Gross at PIMCO. Certainly, for particular insurance company applications, this vehicle could work very well – for example, in situations where cash flow profiles do not need to be closely matched or where interest rate risk is not closely managed. Aside from the active variety, there is a large universe of fixed income index ETFs across all sectors including corporates, floating rate, inflation-linked, sectors, and sovereign/country/regional that can be combined into many customized combinations for both liability and surplus management.

Additionally, since the NAIC has made great progress helping fixed income ETFs qualify as rated investments, we expect insurance companies to continue to increase their ownership of ETFs in the future. Expense ratio pricing may still be a bit high for larger insurance companies, but for smaller companies it is a viable alternative.

The Julex strategies, however, do not own active ETFs. The value proposition for Julex is to trade beta to generate alpha, so we only buy index ETFs.

IAM: Typically, what size and type of insurance company are you targeting with Julex's ETF strategies, and as a Boston-based firm is your marketing focus in the North-East or wider afield?

Ash: The Julex strategies are scalable and would typically start at $10 million and could grow to $100 million or more. Because of the scalability, we are targeting small, medium, and large insurance companies, mostly in the Northeast. The strategies could work to fund the equity component of long tailed-liabilities or a portion of the surplus account dedicated to alternative investments or passive equity. Additionally, for companies with variable annuity (VA) books, these strategies could work very well as "self-hedged" vehicles within the VA product to reduce additional downside risk hedging that the insurer would do to protect guaranteed benefits.

IAM: Are ETFs better suited to general accounts or to sub-advisory accounts, or both? And do they offer operating cost savings not available with more traditional investment categories?

Ash: ETFs can be useful for both general accounts and sub-advisory accounts. Many index ETFs have very low expenses ratios. They can be good vehicles for insurance company to implement their strategies quickly or manage their assets more dynamically. The Julex strategies, which deliver consistent, low-correlated returns at a fraction of hedge fund fees, should be good fit for general accounts as well as sub-advisory accounts. In the context of general accounts, Julex strategies not only can enhance the risk/return profile of corporate surplus, but also can be utilized as a tail risk
hedging vehicle.

IAM: You have what you call a "three-step investment process" for insurer clients, starting with your "RiskSwitcher" as the first step. Can you explain how this works?

Ash: The Julex "RiskSwitcher" is a proprietary risk-on/risk-off indicator based on a combination of fundamental and technical indicators that is designed to capture major market disruptions. We believe that fundamentals drive the economy and capital markets, but entry time is determined by the technicals – that is why we have combined them into one risk state indicator. The real power of the RiskSwitcher, however, is not its standalone use, but its integration into the Julex "three-step investment process". Once the current risk state of the capital markets is determined, portfolio selection among the universe of risky or less risky assets is determined based on relative momentum algorithms. Finally, portfolio construction is performed with portfolio weightings determined based on a risk parity approach. The combination of each of these well-accepted investment approaches into one holistic investment process is a key strength of the Julex model.

IAM: There are now well over 1,000 index-based and actively managed ETFs, with total assets exceeding $1.3 trillion. Ten years ago, ETFs numbered about 100. Will this growth rate continue, do you think, and how much more important will ETFs become for insurers and their asset managers?

Ash: Traditionally, insurance companies invest assets internally or hire third-party managers through separately managed accounts to complement their internal investment expertise. But it may take a while

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to be fully invested. ETFs provide additional tools for insurance companies to implement their strategies quickly and more tactically given the ample liquidity in the ETF markets. There are two layers of liquidity in the ETF markets. One is from trading in the secondary markets. The other is from the ETF redemption and creation process. Insurance companies can definitely take advantage of the market liquidity. In addition, as the ETF markets grow, the ETF management fees are under pressure. Once the expenses ratios get lower, the ETFs will become more viable alternatives to the traditional separately managed accounts.

IAM: Thank you.

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