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Positioning captive portfolios for the next phase

Ed Goard, chief investment officer at Yousif Capital Management, reflects on how the Fed's recent rate cut signals a crucial turning point for captive insurers

The Fed recently began its rate-cutting cycle with a 50 basis point cut in interest rates (moving the target rate from 5.50 to 5.00 per cent), signalling a critical turning point in the investment landscape — one that presents both risks and opportunities for captive insurers.

In recent years, numerous captive portfolios have implemented a laddered Treasury Bill strategy at the lower end of the market, capitalising on an inverted yield curve to generate returns of at least five per cent on their fixed income allocations.

However, now that the Fed has kicked off its rate-cutting cycle, it is time to reassess. Captive insurers should consider rebalancing their portfolios to capitalise on the evolving financial climate and protect themselves against risks associated with falling interest rates.

A dynamic approach to portfolio allocation is becoming crucial for captive insurers, particularly with an expected 200bps rate-cutting cycle. Experts suggest that captive boards should adjust their portfolios and adapt their investment strategies to align with the evolving financial landscape.

Impacts of rate cuts on captive portfolios

The Fed's decision to reduce rates by 50bps marks the beginning of what could be a prolonged period of monetary easing. Historically, such cycles of rate cuts have averaged between 200-300bps, suggesting that further reductions are likely to come. Understanding how these cuts affect the investment landscape is critical for making informed decisions.

For fixed income investments, which play a significant role in captive portfolios, falling rates generally lead to higher bond prices. However, the response varies across different types of bonds. While a laddered Treasury approach at the short-end of the yield curve or floating-rate notes worked well during rising rates, it may now offer diminished returns as rates fall. Longer-duration bonds, which are more sensitive to interest rate changes, tend to benefit the most in a falling rate environment as their prices increase more significantly.

For captives with surplus capital that can invest in equities, the potential for equity returns to be more broadly distributed will likely increase as rates decline, moving beyond the concentration in mega-cap stocks.

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Lower borrowing costs provide relief not only to large corporations but also to smaller businesses and consumers, especially those whose borrowing is tied to the prime rate. The Fed's policy rate cuts will finally provide some relief to this segment of the economy, burdened by high inflation and elevated interest rates.

In light of the current concentration risk in the S&P 500, where the top ten mega-cap stocks make up approximately 36 per cent of the index, smart beta strategies offer a compelling alternative for captives with surplus capital to invest. One approach is a fundamental weighting methodology, which selects and weights stocks based on factors like sales, cash flow, dividends, and book equity value.

By emphasising these fundamental metrics rather than market capitalisation, this strategy avoids overexposure to inflated stock prices that can occur in traditional cap-weighted indices. In a market where concentration risk is high, a smart beta approach focused on fundamental strength can provide more balanced exposure across sectors and companies, reducing reliance on a few large names.

This method can help captives achieve better diversification, capitalise on companies with solid finances, and potentially avoid the volatility that can arise from market corrections in overvalued sectors.

In this environment, a dynamic portfolio allocation strategy becomes indispensable. Unlike a static approach, which maintains a fixed allocation across asset classes, dynamic rebalancing adjusts the portfolio based on market conditions and economic trends. This responsiveness is key in capturing opportunities and mitigating risks as the interest rate cycle evolves.

Captive insurers can benefit from this strategy due to their unique investment goals and liability structures. As insurance companies, captives must strike a balance between long-term stability, the ability to pay claims, and the need for investment growth.

A rigid, unchanging asset allocation can expose the portfolio to unnecessary risks or missed opportunities, especially in a rapidly changing environment like the one we are entering now.

Rebalancing portfolios for a falling rate cycle

With the Fed signalling more rate cuts ahead, captive boards should consider the following rebalancing strategies:

Shift from short treasury ladders to longer duration notes and bonds

One of the most straightforward adjustments is increasing the allocation to longer-duration notes and bonds (durations and maturities between 5 and 10 years). These have higher interest rate sensitivity, meaning their prices rise more significantly as rates fall. By reallocating capital into these securities, captives can capture price appreciation while locking in yields that may no longer be available as rates continue to drop.

However, captives must carefully assess their liability streams to ensure that this strategy aligns with their long-term obligations. Longer-duration notes and bonds can be advantageous for insurers with predictable liabilities but may expose portfolios to risk if liquidity needs are higher in the short term.

Monitor credit markets for opportunities

Rate cuts also present opportunities in the credit market. As the Fed eases monetary policy, the spread between corporate bonds and Treasury yields may widen, offering higher compensation for taking on credit risk. Following any widening, it could be an opportune time to increase exposure to high-quality corporate bonds, asset-backed securities, or other credit instruments.

However, it is essential to balance the pursuit of yield with credit quality, ensuring that the portfolio remains diversified and resilient to potential economic shocks.

Historically, credit spreads have offered compelling opportunities following rate cuts, but captives must remain vigilant to avoid overextending into riskier credit sectors.

Consider smart beta strategies

In light of the potential concentration risk in traditional cap-weighted indices, captives should consider smart beta strategies as part of their portfolio rebalancing where surplus capital is available. One such strategy is fundamental indexing, where stocks are selected and weighted based on key financial factors such as dividends, cash flow, and book equity value, rather than just market capitalisation.

This approach offers diversification benefits by avoiding overexposure to overvalued mega-cap stocks, which currently make up a significant portion of traditional indices like the S&P 500. By focusing on companies with solid fundamentals, captives can reduce portfolio volatility while capturing upside from underpriced and high-quality companies.

Smart beta strategies can enhance risk-adjusted returns, especially in periods of market correction or when broader equity returns begin to spread across more sectors and market segments.

Managing risk in a rate-cutting environment

While rebalancing for a falling rate environment offers potential for higher returns, it also comes with risks that captives must manage carefully. Investors' reactions to monetary policy changes can increase market volatility, and we cannot rule out the risk of economic downturns or inflation spikes.

To mitigate these risks, captive boards should have their investment managers employ stress testing and scenario analysis to evaluate how different market conditions might affect their portfolios. By anticipating potential outcomes and adjusting asset allocations accordingly, captives can safeguard their portfolios while still pursuing growth opportunities.

A strategic pivot for captives

The Fed's 50 basis point rate cut is likely the beginning of a broader easing cycle, and captive insurers should respond by dynamically rebalancing their portfolios.

By shifting to long-duration bonds, prudently adding credit exposure, and incorporating smart beta strategies, captives can position themselves to capture upside potential while effectively managing risk.

Historical precedent shows that those who adapt quickly to changing interest rate environments stand to benefit, while those who remain static may miss crucial opportunities. In this new phase of the investment cycle, a proactive, dynamic approach to asset allocation will be key to maintaining both financial stability and growth.

For captive boards, the call to action is clear: "Engage with your investment managers, assess your current allocation strategy, and prepare to pivot as the rate-cutting cycle unfolds." ■