



Research Report:

The Silent Erosion of Insurance Surplus: Why Strategic Asset Allocation is the New Fiduciary Frontier

“When claims inflation exceeds portfolio yield by 100–400 basis points, surplus is not being preserved—it is being liquidated in slow motion.”

“The investment portfolio is not a sidecar to underwriting; it is the primary engine of long-term financial strength.”

The global insurance landscape is currently defined by a profound and widening disconnect between the conventional wisdom of conservative portfolio management and the volatile economic reality of the mid-2020s. For the boards of directors, investment committees, and senior executives of small to mid-sized mutual insurers, risk retention groups (RRGs), and captives, the fundamental assumptions that have governed balance sheet management for decades are no longer merely sub-optimal—they are increasingly hazardous. Historically, the P&C insurance industry has relied on high-quality, investment-grade bonds to serve as the "reserve" portfolio, providing the necessary ballast to ensure that future claims obligations can be met with certainty. In this framework, fixed income often represents between 70% and 95% of total invested assets for small to mid-sized P&C insurers. However, this "safe" approach is currently being undermined by the dual pressures of persistently low real yields and a secular acceleration in claims inflation that outpaces general consumer prices.

With bond returns remaining compressed while claims inflation accelerates, the industry now stands at a defining fiduciary crossroads. The stewardship of an insurance company's investment program is not a secondary concern to underwriting; it is the primary engine of long-term financial strength and the ultimate guarantor of policyholder security. The following analysis examines the **structural return deficit** undermining insurance surplus, the legal and ethical mandates of fiduciary responsibility, and the technical necessity of Strategic Asset Allocation (SAA) optimization as the most prudent path forward for the modern insurer.

The Economic Siege: Yield Starvation and the Structural return deficit

The most significant threat to the solvency of small and mid-sized insurers is not a single catastrophic event, but rather the slow, silent erosion of capital caused by negative real investment returns. For much of the last decade, and persisting into the current environment, nominal bond yields have remained structurally low. Recent research highlights a striking reality: nearly 90% of the entire global universe of public bonds outstanding trade at a yield lower than



5%. When these nominal yields are adjusted for even modest levels of headline inflation (CPI), the resulting real returns are marginal. With inflation hovering near 3%, holders of traditional public fixed-income instruments are often capturing roughly a 2% real return annually—a payoff that barely compensates for macroeconomic uncertainty.

The Disparity of Real Returns

For an insurance company, the relevant measure of "real" return is **not** the Consumer Price Index (CPI), but rather the rate of change in the costs associated with settling claims. The "**structural return deficit**" effect occurs when the growth rate of liabilities (claims inflation) exceeds the growth rate of assets (investment yield). Data from the WTW Claim Cost Index demonstrates that composite insurance inflation has consistently outpaced general headline CPI, creating a structural deficit for insurers who remain tethered exclusively to traditional bond portfolios.

Metric	2024 Level/Change	2025 Preliminary/Projected
U.S. Headline CPI (General Inflation)	2.95%	2.89%
Composite Insurance Claim Cost Inflation	4.42%	4.76%
Homeowners Insurance Inflation	5.78%	4.84%
Auto Physical Damage Inflation	4.77%	5.39%
Medical Trend (North America)	8.10%	8.70%

Source: WTW Claim Cost Index; Insurance Information Institute (Triple-I)

This data reveals that an insurer whose portfolio is yielding 4% is effectively losing ground. In the homeowners line, for example, the cost of labor, materials, and repair has risen at a rate nearly double that of general inflation in recent periods. When an investment-grade bond portfolio yields less than the rate of claims inflation, the insurer is not "preserving" capital; it is presiding over its gradual liquidation. Relying on bonds alone will simply not enable insurers to



meet future claims payments if the purchasing power of their reserves is being compromised by 100 to 400 basis points annually.

The Reinvestment Risk and Benchmark Dilemma

For small mutuals, RRGs, and captives, the challenge is amplified by the specific nature of their benchmarks. Unlike institutional investors that may look at the long end of the Treasury curve, these insurers typically manage portfolios benchmarked to the **Bloomberg U.S. Intermediate Aggregate** or **Intermediate Government/Credit** indices [User]. These indices are structured with shorter durations to better align with the "tail" of P&C liabilities, yet they currently highlight the acute nature of yield starvation.

Relevant Bond Benchmark (YE 2025)	30-Day SEC Yield	Effective Duration
Bloomberg U.S. Intermediate Aggregate	3.70%	4.37 Years
Bloomberg U.S. Intermediate Gov/Credit	3.74%	3.72 Years

Source: Bloomberg; iShares/BlackRock Characteristics

The "real yield dilemma" is that these core benchmarks—offering yields in the 3.7% range—fall 70 to 100 basis points short of even the *composite* rate of claims inflation (4.42% to 4.76%). For insurers in high-inflation lines like medical or homeowners, the deficit is even more severe. This environment demands a transition from "benchmark-hugging" bond thinking to a "total portfolio" approach that incorporates asset classes capable of providing inflation-sensitive returns.

Benchmarking the Status Quo: Asset Allocation for the Small to Mid-Sized Insurer

In the \$1 million to \$2,000 million asset range, investment portfolios are heavily influenced by size-specific liquidity needs and regulatory constraints. While industry-wide P&C data might suggest a broad move toward equities, the reality for small mutuals, RRGs, and captives remains rooted in the traditional high-fixed-income model.

Typical Allocations for Small Insurers



Historical and peer data confirm that as P&C insurers decrease in size, they tend to hold more conservative, **less complex portfolios**. Peer analysis of small insurers shows a heavy concentration in fixed income and cash, with limited exposure to alternative asset classes.

- **Bonds and Cash Primacy:** For insurers with assets under \$10 billion, and particularly those in the \$1 million to \$2 billion range, bond holdings typically account for approximately 69% to 75% of total invested assets on a book-value basis. When cash and short-term investments (averaging 13% to 17%) are included, the "conservative core" often exceeds 85% of the total portfolio.
- **The Stock Allocation Gap:** Common stock exposure for small P&C insurers historically averages near 11%. This stands in contrast to the broader industry, which maintains higher equity and "Schedule BA" (alternative) allocations.
- **Size as a Constraint:** Research indicates a strong correlation between company size and asset complexity. Smaller insurers (<\$100 million) often maintain simpler, more liquid profiles. As insurers grow into the \$100 million to \$1 billion tier, they tend to reduce cash and equity holdings slightly in favor of investment-grade (IG) corporate bonds and mortgage loans.

Mutuals, RRGs, and Captives: A Comparative View

The "reserve" mentality is most pronounced in mutuals and captives, though for different strategic reasons.

- **Mutual Insurers:** These entities are consistently identified as having more conservative fixed-income portfolios than their stock company counterparts. Because policyholders are the owners, mutuals prioritize solvency and "mutuality" values over the aggressive ROE targets seen in the stock segment.
- **Captives and RRGs:** Data for captives—particularly those under \$100 million—is frequently non-public, but typical models show a streamlined allocation of roughly 60% bonds and minimal public equity (~2%). Captives often enjoy greater regulatory flexibility than traditional insurers but may be limited by the investment philosophy of their non-insurance parent companies.
- **Alternatives Scarcity:** Diversification into "Schedule BA" assets (private equity, hedge funds) is rare for insurers with less than \$1 billion in assets, largely due to the high minimum investment thresholds and the internal expertise required to monitor these holdings.



This concentration in traditional 80/20 or 90/10 bond-to-stock allocations validates the observation that these stewards are operating within a "simpler" but increasingly risky paradigm given the current inflationary environment.

The RBC Prism: Capital Efficiency in Asset Selection

For any U.S.-based insurer, Strategic Asset Allocation is not just a quest for return; it is a management exercise within the constraints of **Risk-Based Capital (RBC)**. RBC requirements prescribe the statutory minimum level of capital an insurer must hold in proportion to the inherent riskiness of its financial assets and operations. For fiduciaries, the objective is to maximize "Return on RBC" (RORBC)—ensuring that every dollar of capital "consumed" by the investment portfolio is generating a sufficient premium over the cost of capital.

The Cost of Assets: P&C RBC Risk Factors

Under the NAIC framework, different asset classes carry specific "risk charges" that reduce the company's RBC ratio. While investment-grade bonds are capital-efficient, higher-yielding assets require significantly more "cushion" on the balance sheet.

Asset Class	NAIC Designation	P&C RBC Risk Factor (Pre-Tax)
U.S. Gov. Bonds	NAIC 1	0.00%
IG Corporate Bonds	NAIC 1	0.40%
IG Corporate Bonds	NAIC 2	1.30%
Unaffiliated Common Stock	N/A	15.00%
Schedule BA (Private Equity/Credit)	N/A	20.00%
Below-IG Bonds	NAIC 4	10.00%
Below-IG Bonds	NAIC 6	30.00%

Source: NAIC RBC Reporting Blanks; American Academy of Actuaries



The Covariance "Free Lunch"

A common error among board members is looking at these risk charges in a vacuum. The RBC formula for P&C insurers uses a **covariance adjustment** that recognizes that all risks—underwriting, credit, and investment—are unlikely to fail simultaneously. The formula is structured as:

$$\text{Total RBC} = \sqrt{R_0^2 + R_1^2 + R_2^2 + R_3^2 + R_4^2 + R_5^2}$$

Where, for P&C insurers:

- **R₀** = Affiliate risk
- **R₁** = Asset risk – fixed income (credit risk)
- **R₂** = Asset risk – equity & other invested assets
- **R₃** = Credit risk (reinsurance recoverables & receivables)
- **R₄** = Underwriting risk (reserve & premium risk)
- **R₅** = Catastrophe risk

Because the terms are squared under the square root, adding a diversified "risk asset" (like 15% stocks or 20% private credit) often has a much smaller marginal impact on the *total* capital requirement than the raw factor would suggest. For a typical insurer where underwriting risk () is the dominant factor, an incremental move into equities may improve diversification benefits significantly—sometimes by as much as 90 basis points—without a commensurate increase in total required capital.

Modeling RORBC for Optimization

At CapVisor, we utilize sophisticated modeling to estimate the **RBC impact of various optimized asset combinations**. This transition from a two-dimensional "Risk vs. Return" chart to a three-dimensional "Efficient Surface" (Risk, Return, and Capital Charge) allows boards to identify the "sweet spot" where they can stay ahead of claims inflation without triggering regulatory intervention. In many cases, a slightly higher RBC charge is a prudent trade-off if it earns a 100-200 basis point return premium that preserves the long-term purchasing power of policyholder surplus.

The Liability-Side Bias and the Profitability Myth

A persistent cultural challenge within the leadership of small and mid-sized insurers is an over-emphasis on the liability side of the balance sheet—specifically underwriting discipline and claims management—to the detriment of the asset side. While a low combined ratio is a hallmark of operational excellence, it is rarely the sole driver of long-term surplus growth. In fact, for the vast majority of the P&C industry, the investment portfolio provides the lion's share of total profitability.



Underwriting Gain vs. Investment Gain

Historical data confirms that underwriting profits are elusive. The U.S. P&C industry has experienced only a handful of years of underwriting profit since the late 1970s. In most years, insurers pay out more in claims and expenses than they collect in premiums, relying on investment income to achieve a positive net return on equity (ROE). While captive insurers generally fare better, underwriting profitability is inconsistent and unreliable for captive growth and financial strength.

Year	Net Underwriting Gain/Loss (\$B)	Net Investment Income (\$B)	Net Operating Income (\$B)
2020	12.1	53.5	59.3
2021	(0.4)	56.1	54.6
2022	(22.4)	71.5	47.9
2023	(20.3)	72.7	49.9
2024	26.2	86.7	110.1

Source: Insurance Information Institute (Triple-I)

The record underwriting gain in 2024 was a rare "return to profitability" driven by corrective rate actions, yet even in that stellar year, investment income (\$86.7 billion) still contributed more to the bottom line than underwriting activity (\$26.2 billion). For fiduciaries, this highlights a critical reality: the investment program is not a "sidecar" to the insurance operation; it is the core engine of the firm's financial viability.

The Stewardship of "Other People's Money"

This misallocation is not just a strategic error; it is a fiduciary failure. Board members and investment committees must internalize the fundamental truth that the capital they oversee does NOT belong to them, nor does it belong to the management team. It belongs to the policyholders. In a mutual company, the policyholders are the owners, and their surplus



represents the collective security of the membership. In a captive or RRG, the members have committed their capital to ensure the long-term availability of coverage.

When fiduciaries permit a portfolio to languish in low-yielding bonds while claims inflation erodes the value of that capital, they are failing in their duty to preserve the assets meant to pay future claims. The investment portfolio exists for the exclusive purpose of providing benefits and paying claims; any strategy that does not maximize risk-adjusted real returns relative to those liabilities is a breach of the trust placed in the board by the policyholders.

The Risk Calibration Paradox: Navigating the Boundary of Appropriateness

Even with the most sophisticated tools, the amount of investment risk that is truly "appropriate" for an insurer—given its unique liability structure—remains one of the most perplexing questions for boards and investment committees. This is the frontier where the theoretical "efficient frontier" must be translated into the lived experience of the company's capital constraints and regulatory obligations.

Traditional risk target models often fail because they treat the portfolio as an isolated engine, divorced from the volatility of the underwriting book. To resolve this paradox, fiduciaries are increasingly moving toward a comprehensive **Enterprise Risk Management (ERM)** approach. This methodology identifies risk not just as a standard deviation of returns, but as a potential failure to deliver on the firm's long-term mission of policyholder protection.

A critical component of this calibration is the use of proprietary analytical systems that rely on a client's specific **IRIS ratios**—the financial report card used by regulators to monitor solvency. By integrating these ratios into the modeling process, stewards can gain a prospective view of how different asset mixes might impact their regulatory standing. When this internal analysis is viewed across comparative industry averages and peer group trends, a clear, objective range of risk becomes visible. This evidence-based approach removes the ambiguity from risk-taking, replacing "gut feel" with a mathematically structured and industry-benchmarked target range that honors the fiduciary duty to preserve surplus.

Beyond the Median: Quantifying Tail Risk in SAA Optimization

Expected return is merely the mean of a range of potential outcomes. For the insurance board, focusing only on the "expected" number provides a false sense of certainty that ignores the volatility inherent in institutional markets. Informational excellence requires fiduciaries to evaluate the "Tail Risk" of an optimized Strategic Asset Allocation—specifically, what happens to the portfolio during periods of extreme market stress.



By modeling returns up and down **1 and 2 Standard Deviations (SD)**, boards can move beyond the median to understand the statistical boundaries of their capital preservation mission. In a normal distribution, ± 1 SD encompasses approximately 68% of probable outcomes, while ± 2 SD captures 95% of potential results.

Probability Level	Description	Illustrative Return Scenario (Optimized SAA)
+2 Standard Deviations	Tail Event (Positive)	+18.5%
+1 Standard Deviation	Probable High	+12.0%
Mean (Expected)	Average Outcome	+5.5%
-1 Standard Deviation	Probable Low	-1.0%
-2 Standard Deviations	Tail Event (Negative)	-7.5%

Source: CapVisor Associates Modeling; Conning Stochastic SAA Framework

Understanding these thresholds is critical for capital-constrained entities like captives and RRGs. For instance, a "-2 Standard Deviation" event represents a "1-in-20 year" loss. Fiduciaries must determine if their surplus is resilient enough to absorb such a drawdown without breaching regulatory IRIS ratios or necessitating an immediate capital call from members. Providing this full spectrum of return paths allows the board to select a portfolio that not only targets the needed return to stay ahead of claims inflation but does so with a documented awareness of the downside boundaries.

The Active Management Paradox and the Alpha Illusion

While board members are often enamored with "top quartile" active managers, the reality of manager performance is sobering. The S&P Indices Versus Active (SPIVA) reports provide a consistent, data-driven verdict: the vast majority of active managers underperform their benchmarks over the long term, and when they do outperform, that success rarely persists.



The Persistence Failure

For a board member, chasing a "top quartile" manager is often a pursuit of past luck rather than future skill. S&P's 2024 Persistence Scorecard found that among top-quartile domestic equity funds in 2020, **not a single fund** remained in the top quartile over the subsequent four years.

Asset Class (Fixed Income)	% Underperforming Benchmark (15 Years)
General Investment Grade	80% - 90%
Government Short/Intermediate	96.4%
High Yield Bonds	93.1%
Loan Participation Funds	100.0%

Source: S&P Dow Jones Indices (SPIVA) Persistence Scorecard 2024

The data is particularly damning for fixed-income managers, where 15-year underperformance rates frequently exceed 90%. For an insurance board, this means that the "alpha" they are paying for is frequently non-existent or, worse, negative after fees and transaction costs are considered.

Implementation: The Fiduciary's Action Plan

As stewards of policyholder capital, the board has a mandate to move from passive oversight to active optimization. The following steps constitute a "best practice" framework:

1. **The Use Test:** Integrate sophisticated modeling into core decision-making to meet regulatory expectations.
2. **Redesign the Investment Policy Statement (IPS):** Customize the IPS to the company's specific liability tail and risk budget.
3. **Manager Monitoring:** Evaluate managers on a risk-adjusted, after-tax basis rather than nominal returns.



4. **Independence:** Separate "investment consulting" from "investment management" to eliminate the conflicts inherent in the traditional broker/manager model.

Conclusion: The Path Forward for Financial Stewards

The "real yield dilemma" and the "structural return deficit " are powerful forces, but they can be countered through disciplined, expert-led Strategic Asset Allocation optimization. Leadership must elevate the importance of the asset side of the balance sheet to its rightful place alongside underwriting. They must embrace their role as fiduciaries of "other people's money" and recognize that the investment portfolio is the primary engine of the company's financial strength and policyholder security. By moving away from a passive reliance on low-yielding bonds and toward an optimized, liability-aware SAA, boards can ensure that their organizations remain resilient, profitable, and ready to meet the claims of the future.

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