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The Changing Role of Investment Strategy in the Lloyd's of London Market

A review of the investment management function

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2010

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Proprietary research summary:

During the fourth quarter of 2009 and January 2010, the authors conducted one-on-one meetings with various stakeholders of Lloyd's of London. The authors' objectives were to learn how the Lloyd's stakeholders view the investment management function, how their view has changed over time and during the financial crisis, how they interact with one another and what they view to be the most important challenges facing the investment function. The findings from the authors' meetings are summarized in this report without specific attribution unless otherwise approved directly by the participant. The authors met with the following members of the Lloyd's of London community: 13 managing agents (including Finance Directors, Investment Managers, Treasurers and Chief Investment Officers), 6 individuals at the Lloyd's of London Corporation, David Osborne at Meridian and Keith Parker at Kay International. The authors also surveyed managing agents and the aggregate findings are included throughout this report.

From the authors: We would like to thank the many people who assisted us with our research. Without your kind response and support we would not have been able to write this report. In particular, we would like to extend a special thanks to Lord Peter Levene, Chairman of Lloyd's of London, Robert Jenkins at London Business School, David Osborne at Meridian and Keith Coutinho at Lloyd's of London.

a. Executive Summary

In September 2009 we began reviewing literature and interviewing executives associated with the Lloyd's of London market to learn how managing agents approach investment management and understand the challenges facing the industry. Our objective was to provide a holistic analysis of the organizational and strategic challenges facing the investment management function, beginning with the following high-level questions:

Initial Questions We Sought to Address	
Investment Strategy	• How do managing agents ensure that they balance liquidity, maturity and currency risk with optimal investment returns? • Given recent profitability of syndicates, how are managing agents' investment criteria evolving? • Is portfolio diversification increasing and, if so, has increased diversification led to a change in the risk-profile of investment portfolios?
Regulatory Impact	• Within Lloyd's of London and FSA regulations, how much flexibility do managing agents have in their investment decisions? • How should investment be optimally managed given existing regulatory capital requirements, and are there opportunities to employ a more diversified strategy if, for example, there is surplus regulatory capital?
Organisational Strategy	• Has the evolution in investment management kept pace with the evolution in underwriting discipline? • How has the investment decision-making process changed in the last two years? In the last ten years?

We faced a steep learning curve with respect to regulatory, operational and Lloyd's market-specific practices, and therefore sought to gain information from three comprehensive sources:

- **Secondary literature**: In order to gain an understanding of the structure and history of the marketplace, we reviewed the Lloyd's of London and individual syndicate annual reports, rating agency reports, and finance and insurance publications.
- **Primary interviews**: From October 2009 through January 2010 we spoke with 21 individuals who work in the Lloyd's of London market. Individuals ranged from Finance Directors and Chief Investment Officers at managing agents to Treasury Department executives within Lloyd's of London.
- **Proprietary survey**: We designed a 22 question survey to be completed by the executive responsible for investment management within the managing agents. The survey investigated organizational and strategic factors, investment management policies, and information sources. We received 11 competed surveys from a diverse range of managing agents, representing approximately 20% of the marketplace as measured by number of managing agents.

With no prior knowledge of the Lloyd's of London market, and with a goal unobstructed by experience in the industry, we hope to shed light on a highly traditional yet evolving function. Our findings about investment management at Lloyd's of London are summarized below:

Finding #1: ***Finance directors are open to optimizing the risk-return trade-off on investments, but the communication gap between the underwriting side of the business and investment side of the business is a roadblock for the advancement of investment sophistication.***
Most managing agents are led by underwriters, and finance directors struggle to manage expectations and find it difficult to communicate and quantify the risk-reward messages. With the exception of two interviewees, this was largely the case at all managing agents interviewed.
Finding #2: ***Solvency II creates an opportunity for those finance directors who want to raise the profile of investments on the organizational agenda.***
Solvency II, the European Union's updated regulatory framework for insurance companies, dictates that firms must have a view of organizational risk, and a method to analyse and manage risk across various downside scenarios on underwriting and investments. Those finance directors who wish to increase the investment function's profile can influence the development of risk models and participate in discussions on organizational risk tolerances.
Finding #3: ***Competition will pressure third party money managers to offer value-add services, in addition to investment management and standard performance reporting.***
While we found well known names, such as Credit Agricole and Blackrock, controlling significant assets in the Lloyd's market, we find room for improvement in services provided. As the investment management function evolves, spurred in part by regulations, managers who can excel at risk management, relationship management, and/or idea generation will gain ground in the market.
Finding #4: ***Enterprise risk management is the next frontier for investments and the understanding of organizational risk will be a clear differentiator for managing agents in the future.***
We identified a clear line of separation between those finance directors who actively participate in developing enterprise risk models (ERM) and those who take a passive approach to ERM system development. We believe that a commitment to developing robust ERM management systems will aid finance directors in bridging the communication gap between investments and underwriting.

Finding #5: ***Investment sophistication is a function of internal resources, not necessarily assets under management.***
While investment sophistication often correlates positively with assets under management, we found that sophistication depends more on a syndicate's value proposition, capital providers and employment of a full-time investment manager. Time is a limiting factor in finance directors' dedication to investment strategies, and with multiple responsibilities many cannot be full-time managers-of-managers.
Finding #6: ***Managing agents generally are happy with their third party investment managers, however there is room to improve service delivery.***
When measuring service delivery on a scale of 1 to 5, four of five criteria ranked below 4.0, or less than "good". We consider this to be an indicator of defection risk in relationships with current investment managers. Topics of conversation in this area centred on the lack of customized solutions for their business, a lack of idea generation from the manager, a lack of understanding of the Board's risk tolerance and uncompetitive investment returns.
Finding #7: ***Despite numerous competitors, nearly 60% of the managing agents that report using third-party managers use just one investment manager.***
With almost 40 investment managers operating in the Lloyd's of London marketplace, finance directors are not void of choice for investment managers. However, considering low differentiation across providers, we would expect to hear more switching of investment managers. Almost 50% of managing agents choose just one manager and this is often based on relationships or dictated to the managing agent from a parent company, rather than through a formalized manager search process.

b. Introduction to Lloyd's of London

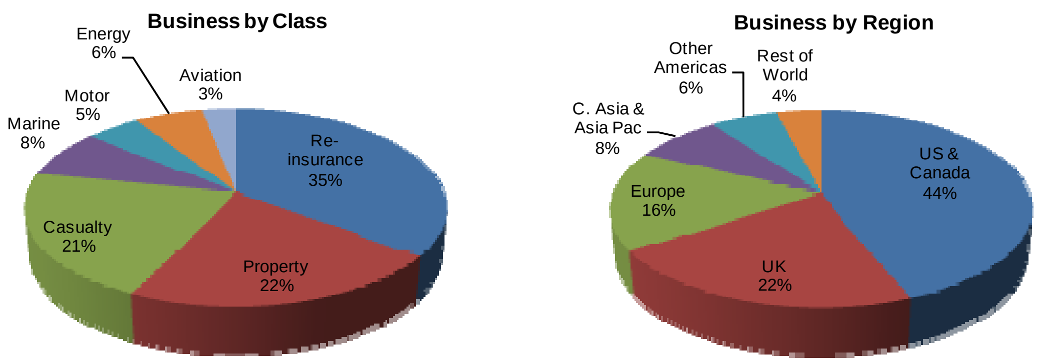
Lloyd's of London ("Lloyd's") is an insurance market offering specialised placement of risk. Lloyd's is not an insurance company, but rather a society of members, both corporate and individual, who supply capital to syndicates on whose behalf professional underwriters accept risk. Lloyd's comprises two main groups:

- *Members*: Conduct their insurance business in syndicates, each of which is run by a managing agent. Syndicates specialize in, and work across coverage areas including marine, aviation, catastrophe, professional indemnity and motor, and many syndicates customise solutions to the risks of their clients.
- *Managing agents*: Having their origins in the time when individual names (wealthy individuals) needed an agency through which to conduct business in the Lloyd's marketplace, managing agents were established for the sole purpose of managing a syndicate. Managing agents may

be responsible for more than one syndicate, and a number now are owned by the same entity as the syndicate, effectively making the managing agent and syndicate the same entity.

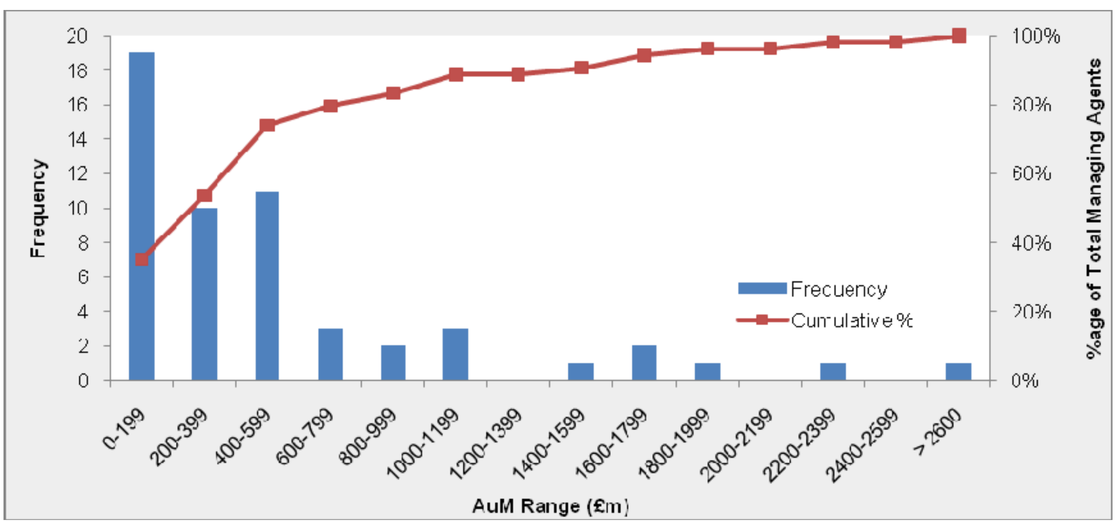
Lloyd's is home to 48 managing agents and 78 syndicates[1]. Founded in 1688 in Edward Lloyd's coffee house in London, Lloyd's now underwrites risk in over 200 countries and across many sectors.

Figure 1: Lloyd's of London Business Breakdown[2]



In addition to having a diverse business mix, the Lloyd's market is highly fragmented, with a majority of managing agents having less than £400 million in assets under management – 54% of managing agents have less than £400m, seen by the cumulative percentage in Figure 2 below. In contrast to traditional financial services markets, in which the top five firms claim a disproportionate share of assets, the Lloyd's market has a much lower concentration of assets among the top firms.

Figure 2: Lloyd's Managing Agent Breakdown by Number and Assets[3]



[1] Source: Lloyd's Members' Services, January 2009
[2] Source: Lloyd's of London, December 2008
[3] Source: Authors' research based on data in 2008 syndicate annual accounts

The Lloyd's of London market has a long and storied history, beginning in Edward Lloyd's coffee house. Indeed, the unique and active marketplace that Lloyd's was founded upon still exists today, and in many ways contributes to its ongoing success as a competitive source for niche policies.

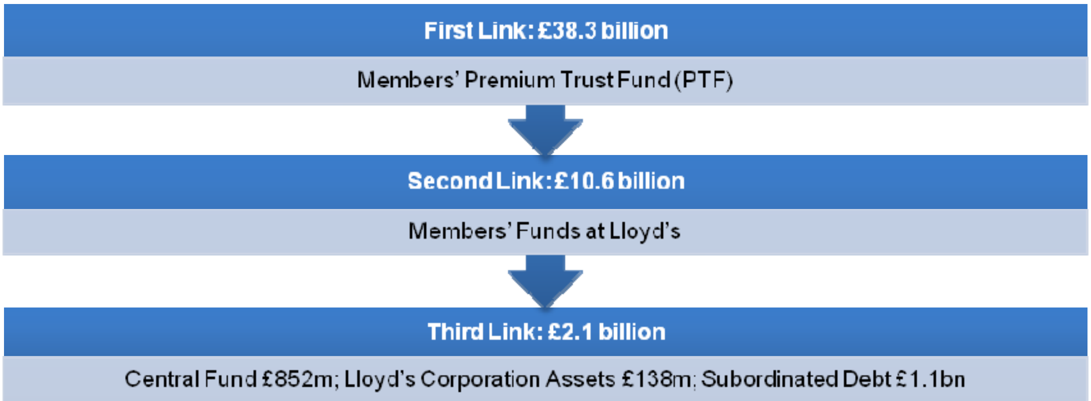
From slave ships to a vintner's nose: When Lloyd's of London was founded, risk insured through the Lloyd's market was backed by wealthy individuals, called 'Names', who held unlimited liability. Lloyd's started by providing insurance to overseas shipping, such as in the slave and tea trades, however over time expanded into many diverse and specialized areas. Because of the depth of this market and expertise gained over time, Lloyd's became the only reliable source to insure against losses stemming from niche risks, such as space satellite damage, earthquakes, and more recently, terrorism. Indeed, a £3.9m policy insured the nose of vintner Ilja Gort of Bordeaux's Chateau de la Garde, covering him against loss of both his nose and his sense of smell.

'Near death' for Lloyd's, Equitas and the end of unlimited liability: In the late 1980s and early 1990s, Lloyd's syndicates suffered terrible losses from claims caused by Exxon Valdez, the 1989 San Francisco earthquake and, most importantly, asbestos-related workers compensation. Over 1,000 of the 30,000 Names declared bankruptcy, and in 1994 Lloyd's opened the market to allow corporate members to underwrite risk with limited liability. Furthermore, Lloyd's instituted a Reconstruction and Renewal (R&R) Plan in 1996, which, in brief, aimed to end market-wide litigation and 'start again' by reinsuring all liabilities prior to 1992 under Equitas, which was eventually sold to Berkshire Hathaway. Today approximately 90% of the underwriting capacity is provided by corporations of various sizes operating with limited liability, and this will increase as no individual Names are permitted to enter the market. With some syndicates still maintaining legacy Names, the type of capital backing a syndicate continues to vary across the Lloyd's market, which we discovered leads to varying appetites for investment risk, a point that will be explored in detail later in this report.

Stability through turmoil: The total capital held at Lloyd's was £51 billion at year-end 2008, and the market has maintained profitability from 2008 through the first half of 2009. Lloyd's is rated A+, A+ and A by Fitch, Standard & Poor's, and A.M. Best, respectively, and is able to sustain these ratings by maintaining three layers of protection against member losses, the first two attributable to individual syndicates, and the third serving as a mutual layer.[4] This structure, which is dictated by Lloyd's regulation, is called the 'Chain of Security'.

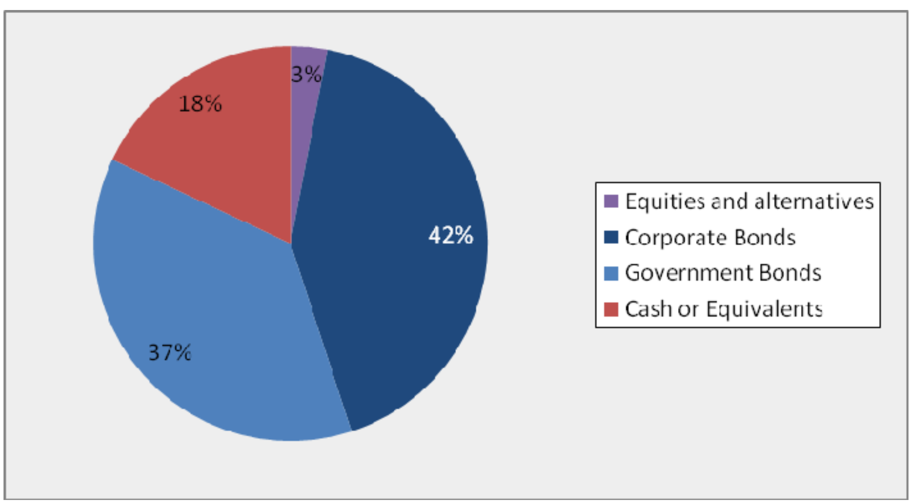
[4] Source: Lloyd's of London, as at 31 December 2008

Figure 3: Lloyd's of London Chain of Security[5]



The First Link: Premium Trust Funds (PTFs) are the deposit accounts for premiums written and the first layer of capital responsible for paying policyholder claims. PTFs comprise the largest proportion of funds within the Lloyd's capital structure, are invested mostly in liquid securities such as cash and government bonds, and are held in trust in the currency of the premium. In fact, just 3% of PTF aggregate assets are invested in equities. Currently premium trust funds comprise a Sterling, Dollar, Canadian, and an Asian fund (for a full listing of U.S. trust funds please refer to Appendix II).

Figure 4: Premium Trust Fund Asset Allocation[6]

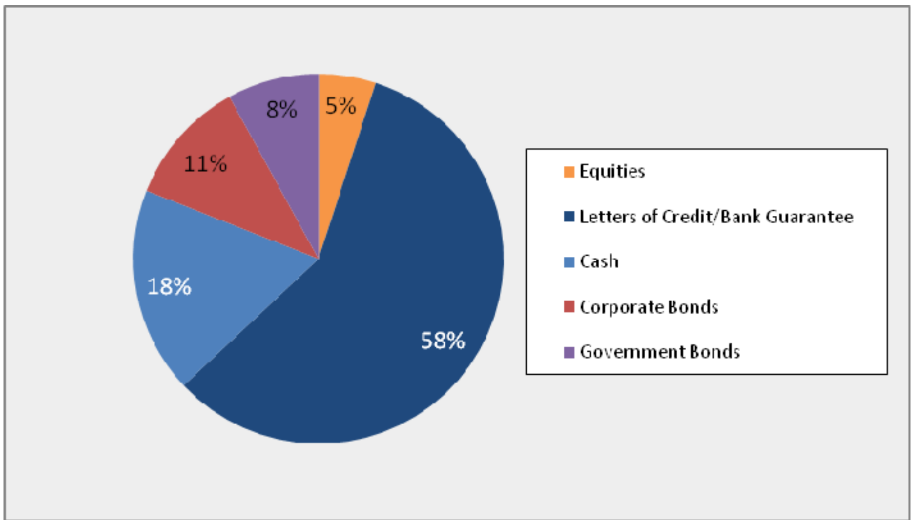


While PTFs are often administered by one custodian, such as Citigroup in the case of the U.S. Dollar Trust Fund, syndicate accounts must be held separately (not commingled), managed by the syndicate's managing agency. As the largest capital source at Lloyd's, PTFs account for the largest proportion of aggregate investment performance across the Lloyd's market.

[5] Source: Lloyd's of London, asset values as of December 2008
http://www.lloydsoflondon.de/NR/rdonlyres/6A342145-FDAE-4B75-8D50-A689D2847810/0/LloydsReview2008.pdf
[6] Source: Fitch Ratings, 31 December 2008

The Second Link: The second link, the Members' Funds at Lloyd's, is the capital each member must provide to support its underwriting activity at Lloyd's, and serves as a backstop for excessive losses for each syndicate. Therefore, the amount of Funds at Lloyd's for each member is dependent on the individual policies underwritten by each syndicate. Each year syndicates must conduct a capital adequacy test, called the Individual Capital Assessment (or "ICA"), which determines the adequate capital requirement for each syndicate for that year. Members' Funds at Lloyd's are administered by Lloyd's, although syndicates are able to provide letters of credit from their banking institution to supplement actual funds deposited, in effect allowing syndicates to leverage their underwriting business. Letters of credit comprise the majority of assets held in the Funds at Lloyd's, while equities comprise 5% of assets.

Figure 5: Funds at Lloyds Asset Allocation[7]



The Third Link: The Central Fund and Other assets act as the third layer of security at Lloyd's, and this capital is provided through members' annual contributions, which for 2009 was 0.5% of gross premiums written. Lloyd's has a target to maintain a minimum of £1.7 billion of Central assets, which comprise both central fund assets and subordinated debt. Because claims rarely require Central Fund support, the Central Fund invests in "riskier" and longer duration asset classes, such as equities and hedge funds, and uses the support of subordinated debt.

[7] Source: Fitch Ratings, 31 December 2008

Figure 6: Central Fund Asset Allocation[8]

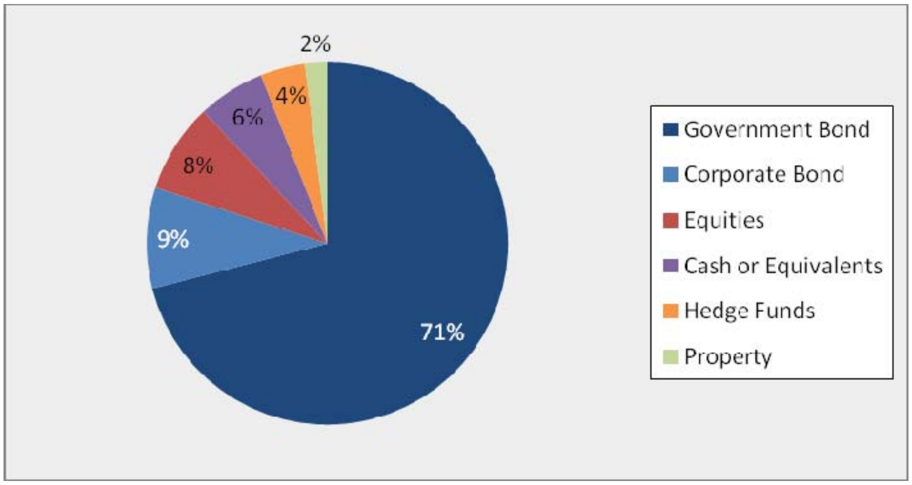
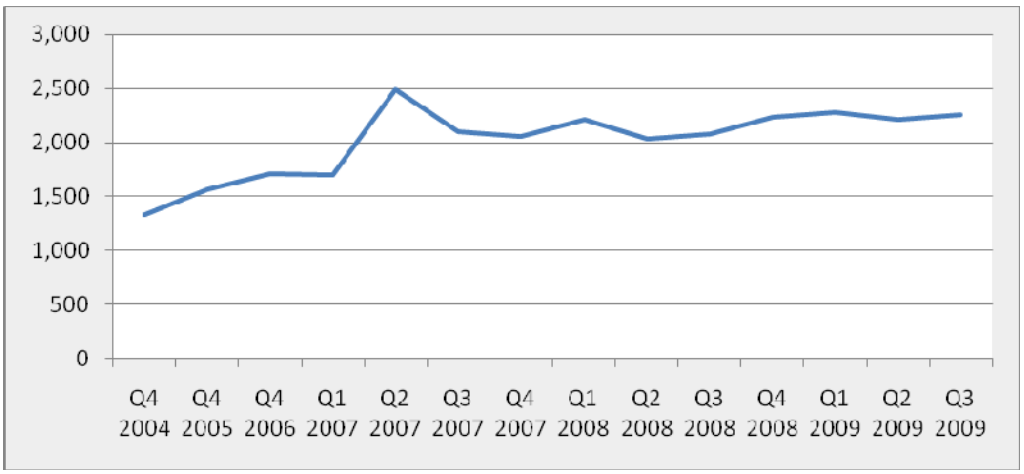


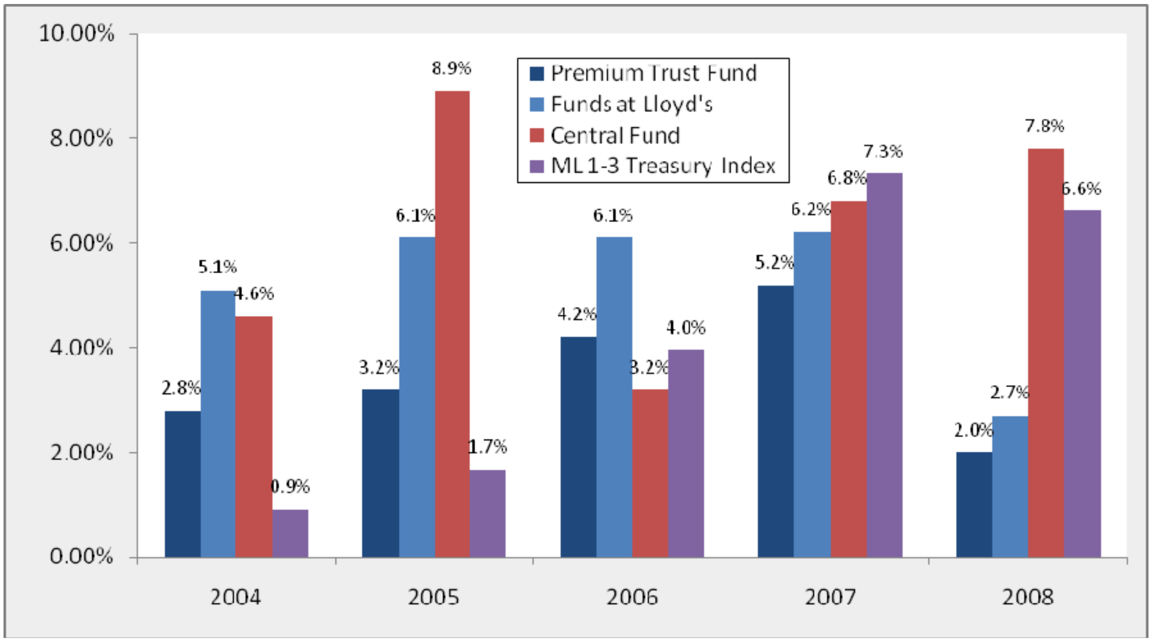
Figure 7: Central Fund Assets and Other, Q4 2004 to Q3 2009 (GBP)[9]



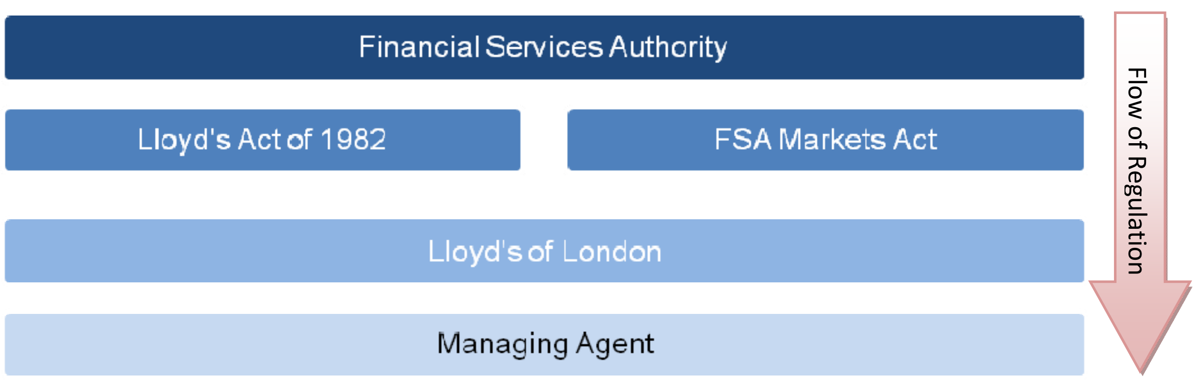
The performance of Lloyd's Funds: Lloyd's provides investment performance on an aggregate level in addition to reporting on each link, which is illustrated below for the calendar years ending December 2004, 2005, 2006, 2007 and 2008 (see Appendix III for additional performance figures). The historical performance generally reflects where the link stands in the capital chain, with PTF investment performance lower than Funds at Lloyd's, which in turn tends to be lower than Central Fund performance. This agrees with the expected level of riskiness and time horizon of each link's investment portfolio. The Central Fund generally is more volatile than the other capital pools because of a broader asset mix that includes hedge funds and high-yield securities. This led to high returns over the last 5 years, with an exception occurring in 2006 when the Central Fund underperformed the other links at Lloyd's due to its fixed income and unhedged currency exposure.

[8] Source: Fitch Ratings, 31 December 2008
[9] Source: Lloyd's of London

Figure 8: Lloyd's of London Chain of Security Investment Return, 2004 – 2008[10]



As discussed later in this report, investment policies are generally shaped by Lloyd's of London and United Kingdom regulatory frameworks, however managing agents have substantial freedom to invest across asset classes as long as they operate within the relevant guidelines. Broadly, Lloyd's and the Lloyd's managing agents are regulated by the United Kingdom Financial Services Authority ("FSA"), however the FSA provides Lloyd's with the freedom to self-regulate so long as the Lloyd's regulations are within the boundaries established by the FSA. The FSA has guidelines for insurance companies that cover market risk and counterparty risk, and these guidelines are written in section INSPRU 2.1.22R of the FSA Handbook.



[10] Source: Lloyd's of London

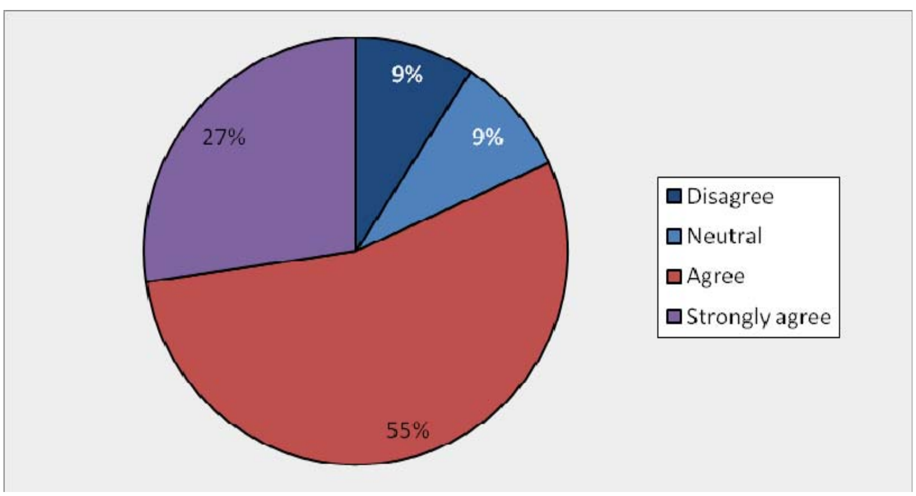
c. Lloyd's of London Syndicates' Approach to Investment Management

The volatility of the financial markets during 2008 and 2009 provided an interesting backdrop to be conducting research on the changing nature of investment management within the insurance business. The financial crisis led many professional investors to re-visit, if not fully readjust, their investment approaches. We find that the Lloyd's insurance market is no exception.

d. The Changing Role of Investment Policy

Lloyd's of London historically has been an underwriting-driven market, and reserve capital generally was held in short duration, highly liquid securities for distribution to policy-holders. Only over the last decade has the investment side of the business become more-actively managed and recognized as a potential source for improving profitability. While the investment management function has received substantial press coverage recently, mostly in reference to performance during the financial crisis, our discussions revealed a clear overriding theme: *managing agents are paid to accept risk on the underwriting side of the business and not on the investment side of the business*. Further, most managing agents believe the capital available to invest should be used to support underwriting and should not be used to support a sophisticated investment platform.

Figure 9: Survey Question – To what extent do you agree with the following statement: My company's primary function is underwriting, and the goal of the investment function is to support that objective.[11]



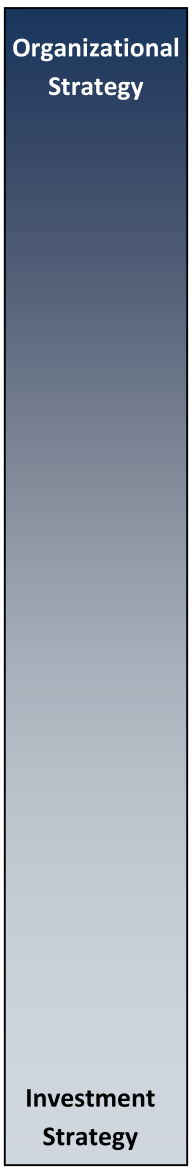
While this view largely reflects the Lloyd's of London culture and is evident at nearly all managing agents, we note that a combination of macroeconomics, regulations, and competitive forces are beginning to drive change in the investment management functions.

Managing agents' investment functions vary drastically in decision-making. The investment decision-making process varies widely across the Lloyd's marketplace and, although the managing agents have some common characteristics for making investment decisions, they are not mandated

[11] Source: Authors' survey of managing agents

to operate in a certain manner. Each have their own approach to 1) the number of people dedicated to investment management outside the Board of Directors, 2) the time and money allocated to investment-related functions, 3) the amount of capital dedicated to investments and 4) how that capital is invested. The variability in approach often is caused by the ownership structure of the managing agent and the source(s) of capital. For example, if a London-based managing agent is owned by a foreign company there will be people within both entities who opine on investment decisions, and while the U.K. entity is encouraged to have final say in its own operations, we learned that in reality decisions typically are influenced by the parent company. That being said, there are U.S. owned and London-based managing agents that operate independently with only loose affiliation with the parent company.

Managing agents have common investment oversight structures. Despite procedural differences, there are three common levels on which investment decisions are made:



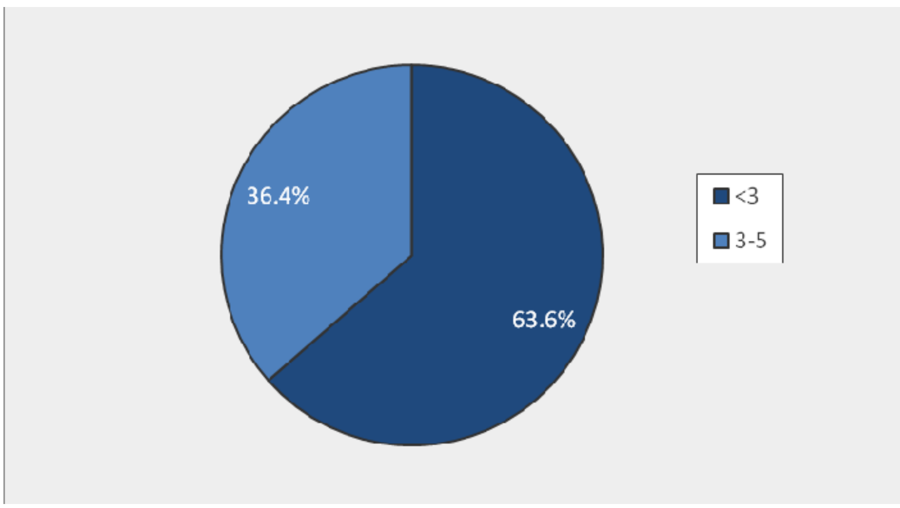
1) **Board of Directors:** The Board is responsible for setting overall strategy for the managing agent's activities. In addition to establishing corporate and investment strategy, the Board will provide guidance for organizational risk, which filters into the investment function. Most managing agents' Directors have spent their careers on the underwriting side of the business, therefore it is common for Boards to appoint non-executive directors who have investment knowledge or expertise to help guide the investment decision-making process. The Board will often set high-level investment strategy and mandate guidelines but will allow the finance director to maintain the day-to-day working relationship with the investment manager(s).

2) **Investment Committee:** The investment committee typically includes 4 to 12 people and is responsible for monitoring the managing agent's investment strategy, investment manager relationships and performance. Investment committees sit at a crucial junction between investments and underwriting strategy, and include members from both sides of the business. Discussions held at the investment committee level often include balancing long-term investment strategy with short-term opportunistic adjustments in asset allocation, which includes shifting bond sector exposure or duration and adding/reducing hedge funds or equities. We found that investment committees generally meet at a minimum of four times per year, but many meet on a monthly basis. We also discovered that many investment committees admit to being unsophisticated investors, but most include at least one member who holds a competency in an investment management field.

3) **Finance Director, Group Treasurer, or Chief Investment Officer** (or equivalent role, referred to throughout the rest of this report as the finance director). Depending on the managing agent's commitment to investment

management, this executive serves as either a full or part-time investment manager. Generally, we found managing agents with over $1 billion in assets employ at least one full-time investment manager, while smaller firms' finance directors are responsible for all finance-related activities, including investment management and working with asset managers. Regardless of managing agent size, however, the investment management function within syndicates remains a small composition of total staff, with the majority of managing agents having less than three employees tasked with managing investments.

Figure 10: Survey Question – How many people at your organization are tasked with managing syndicate investments?



We find that the larger managing agents with dedicated internal investment managers tend to hire finance directors from investment-related roles, rather than insurance roles, and provide them with autonomy and responsibility to manage and improve the investment management strategy.

e. Strategic and tactical asset allocation: Size Matters

There is a large degree of variability in managing agents' approach to strategic and tactical asset allocation, and we find that larger managing agents are more-willing to actively monitor asset allocation. This is due to having internal investment expertise and a greater willingness to accept market risk. At the most basic level, all managing agents employ some form of strategic, or long-term, asset allocation strategy, which is set by the Board of Directors. However, a small subset of managing agents also use a tactical asset allocation overlay to adjust to short-term (less than 12 months) market fluctuations. Active portfolio management requires dedicated investment resources, and we found that the managing agents using tactical asset allocation are those that employ dedicated internal investment professionals. One example of active management at a Lloyd's syndicate occurred when the managing agent shifted investment strategy during the first half of 2009 and invested in lower-rated corporate bonds because spreads over government bonds widened significantly. As spreads compressed and prices recovered throughout the remainder of 2009, this managing agent realized a gain on its investment portfolio. We discovered this type of tactical action is an exceptional activity rather than a normal activity, and most managing agents believe it is prudent to maintain a fixed asset allocation and not change overall investment risk, even though, from an investment perspective, it may be an appropriate strategy to shift investment policy due to market fluctuations. The following graphic provides an overview of investment decision-making process.

> ***"Investment returns are more controllable than underwriting returns. What's the value of control?"***
>
> - Representative Quote
>   Managing Agent Finance Director

Term	Decision lead	Secondary lead	Topics	Levers
Investment Strategy **(1 to 5 years)**	Board of Directors	Investment Committee	• What is our organization's risk tolerance in the long term? • What investment allocations and asset classes provide the optimal return in light of our tolerance? • At what point are we in the underwriting cycle?	• Lines of business • Fixed income sector and quality allocations • Cash/bond allocations • Equity allocation thresholds • Parent company capital
Investment Tactics **(6 to 12 months)**	Finance Director	Investment Committee	• What is the interest rate outlook? • How do current asset valuations compare with historic levels? • Where are current corporate bond spreads? • What expertise can we access to take advantage of investment opportunities?	• Equity allocations across geographies • Equity allocations across sectors • Credit opportunities in lower-rated debt or asset-backed investments • Alternative asset class investments, including absolute return hedge funds

Investment diversification – eyes wide shut? Despite finance directors recognizing that their investment portfolios are overly conservative from a risk-return perspective, many are hesitant to propose investing in riskier asset classes, especially in light of recent market turmoil. In fact, a few syndicates that employed broader diversification before the financial crisis, investing in hedge funds and/or equities, decided to reduce risk in the first quarter of 2009, in hindsight at exactly the wrong time, by shifting their strategy post-crisis to take much less investment risk. In our opinion, most syndicate assets are not invested based on diversification principals that aim to maximise expected return for given levels and types of risk, rather assets are invested on an emotional basis that often leads to an overly conservative strategy. This approach proved effective during the financial crisis of 2008, enabling Lloyd's to post a sound return for the year. However, on a longer-term basis, we believe that managing agents have room to optimise returns through asset diversification while reducing the probability of future loss. Although an important driver of asset diversification will be the source of capital, e.g. syndicate capital for future claims versus corporate capital with a long time horizon, we believe there is room to increase the understanding and use of diversification principals on both levels.

Managing agents' approach to asset allocation. The Financial Services Authority places restrictions on liquidity and market risk for investments, and this drives macro asset class allocations. The asset classes used by syndicates include cash (in the currency of the premium), government bonds (mostly Treasuries and Gilts), high-grade corporate bonds (A or higher), lower-rated or high-yield corporate bonds, absolute return hedge funds, equity long/short hedge funds and long-only equities. Some large syndicates have long-term asset allocations to volatile asset classes such as hedge funds and equities, and Mr. Osborne at Meridian believes approximately one-quarter of all syndicates have at least *some* capital invested in equities. We note that the "volatile" title applied to certain hedge fund strategies is debatable, and a fund's volatility is dependent on the mix of underlying investment strategies and whether or not the fund is directional or market neutral. In fact, a balanced hedge fund could be a very practical approach to achieving return within a pre-defined risk level. Most hedge fund strategies used by the Lloyd's syndicates are absolute return funds, trading debt securities, and market-neutral arbitrage strategies that aim to achieve a return above the risk-free rate regardless of market conditions.

Larger managing agents posted higher investment returns in 2009. As one can imagine, the number of asset classes acceptable for insurance company investment and the regulatory flexibility provided to syndicates for investing capital leads to a wide range of investment returns. Figure 11, below, reveals differences in investment returns by recording the six month investment returns (H12009) for the Lloyd's syndicates, ranked by size of the syndicate.

Figure 11: Six Month Investment Returns (H12009) for Lloyd's Syndicates[12]

Syndicate Size	Number of Syndicates	Investment Return
Above £1.5 billion	3	3.20%
£1bn to £1.5bn	6	2.10%
£500m to £1bn	10	2.40%
£100m to £500m	32	1.40%
Below £100m	58	1.00%

[12] Source: Lloyd's of London

Of note is the positive correlation between the size of the syndicate and the investment return for the period. In fact, larger syndicates earned more than three times the return of the smaller syndicates during this time period. To balance this data however, we note that the opposite occurred in Q42008, with larger syndicates reporting lower returns. Intuitively, the difference in the returns between large and small syndicates is attributable to larger syndicates' willingness to investing a higher amount in volatile asset classes, such as lower-rated debt, hedge funds and equities. We found that many smaller syndicates restrict their managers from owning any debt securities rated below AA or other volatile assets.

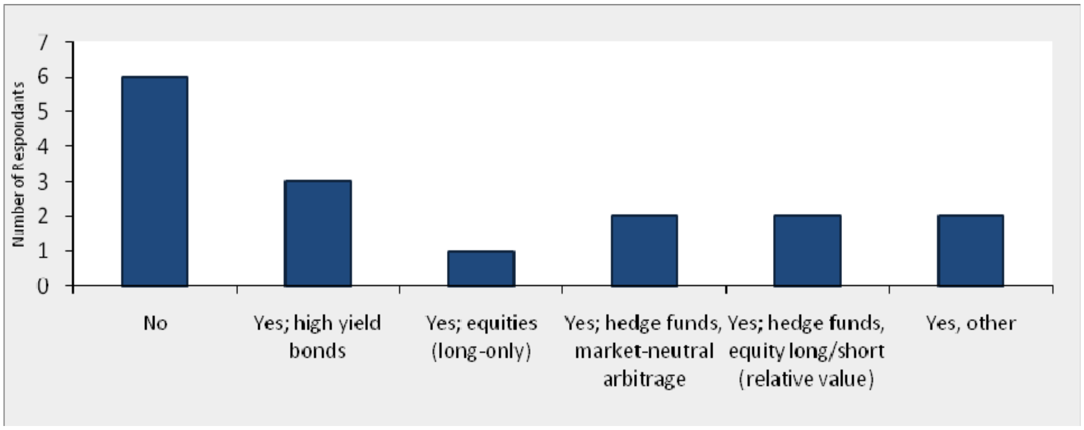
Larger managing agents and the benefit of scale. A managing agent's comfort with active management is a result of having 1) the Board's recognition that investment management is a key part of their corporate strategy, and 2) an internal team with investment expertise. As expected, larger managing agents are able to dedicate resources to the investment management function and, if the managing agent is owned by a large insurance or investment company, access any parent-company investment professionals. Typically, managing agents with over £1 billion in assets under management employ a Chief Investment Officer (or equivalent role), either independently at the managing agent or at the parent company. These individuals constantly can monitor the markets and move quickly to implement investment decisions because 1) they have the investment expertise to do so, and 2) the syndicate's Board will be more-willing to quickly approve a recommendation because they have taken the time and effort to hire internal investment staff members who are experts in their field.

The Board's changing view of risk capital. The Boards of Directors at some managing agents are beginning to view risk capital in a different light. As underwriting profits compress and short duration yields are near historic lows, Boards are beginning to have conversations about bolstering returns by taking an active stance around investing and potentially altering asset allocations. For example, we met with a finance director who stated that when a certain amount of capital becomes available to take risk, assume $300 million in this example, the Board of Directors would allocate $200 million to support underwriting and $100 million to support investing. The same finance director explained to us that 10 years ago this conversation never would have happened, but today it is more common. In order for the Board to feel comfortable using shareholder capital in such a manner, the managing agents that take this view tend to be more experienced investors with internal team members dedicated to investment management.

f. Use of Volatile Securities

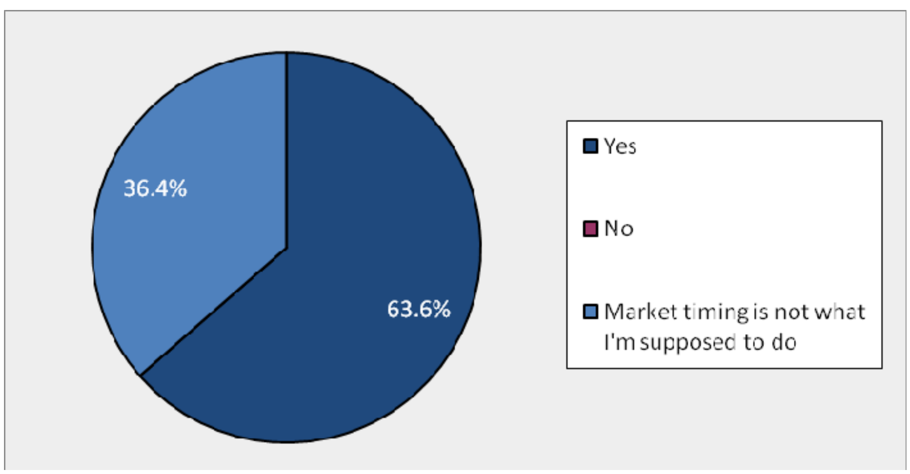
Lloyd's syndicates invest a small proportion of capital in volatile securities, such as lower-rated debt, hedge funds and equities, but the use of these asset classes is evolving. For example, over half of the managing agents we surveyed do not invest any capital in volatile asset classes, but across some managing agents there is exposure to high yield bonds, market neutral hedge funds, equity long/short hedge funds, long-only equities and term deposits (listed below as "other").

Figure 12: Survey Question – For your Lloyd's syndicate portfolio(s), do you allocate capital to riskier assets (assets other than cash and investment grade bonds)? (Select all that apply)[13]



Finance directors have the freedom to invest as they choose. Despite a firm grounding in protecting syndicates' capital, finance directors believe they have full freedom to invest in asset classes of their discretion (within regulatory guidelines) and take advantage of near-term investment opportunities. However, many managing agents believe their job is to preserve capital and not time the financial markets in order to achieve higher investment returns, which leads many to avoid making any near-term investment actions.

Figure 13: Survey Question – Do you believe you have sufficient flexibility to take advantage of short-term investment opportunities?[14]



Finance directors have many reasons to either avoid or invest in volatile securities. Given the regulatory flexibility of investing syndicate capital and the varying views on accepting investment risk, we discussed with finance directors the reasons for avoiding volatile securities as well as the reasons for investing in volatile securities. There are numerous reasons for both, and below we provide a summary of our findings.

[13] Source: Authors' survey of managing agents
[14] Source: Authors' survey of managing agents

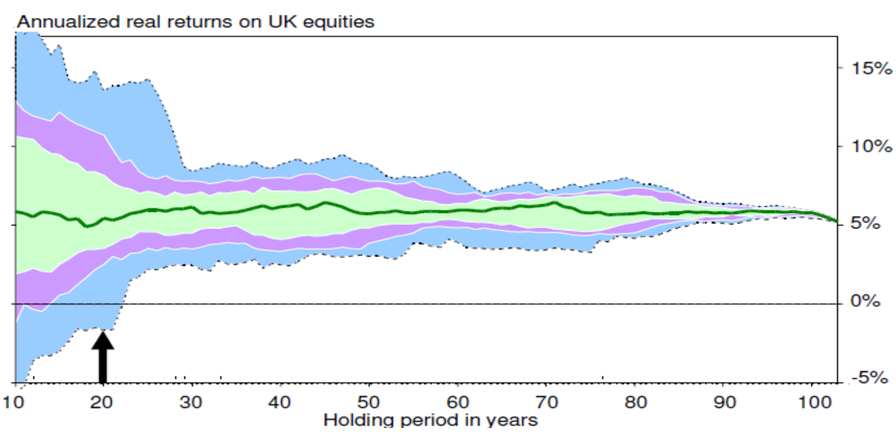
Reasons for <u>not</u> investing in volatile securities:

- **Market turmoil:** Assets such as high yield debt, asset backed debt, hedge funds, and equities can experience wide price swings, independent of the change in the fundamental value of the asset, and these changes can be detrimental to a syndicate facing claims. Models used to predict price swings proved to be inaccurate during the financial crisis, and many managing agents learned about mark-to-market risk the hard way. As a result, many managing agents have chosen to move back to cash and investment-grade bonds, and many see the recent market turmoil as confirmation that allocations to volatile asset classes are too risky.

- **Uncomfortable with equity investing:** Some finance directors are reluctant to explore investing in equity securities because they lack a general understanding of equity analysis. Many finance directors spend the majority of their careers in or around the insurance business, occupying positions in actuary or finance departments, and therefore are not comfortable investing in equities because they do not have an appropriate level of market knowledge. Furthermore, many managing agents view their investment time horizon as being too short to allocate capital to equities. The time horizon necessary in order to comfortably believe equity investment returns will be positive is longer than the typical Lloyd's syndicate time horizon, which means the asset class may not be an appropriate investment.

  To illustrate the variance in real returns of equities over time, below is data provided by Professor Elroy Dimson of London Business School showing the range of U.K. equity returns throughout history based on different holding periods. As the chart illustrates, even U.K. equities are not 'safe' over a 20-year holding period (the black arrow) because history shows there are 20-year holding periods that resulted in negative real equity returns, as seen by the return distribution at the 20-year holding period mark. The blue bands represent the top and bottom deciles and the purple bands represent the top and bottom quartiles.

Figure 14: Annualized Real Returns on UK Equities Based on Holding Period[15]



[15] Source: Elroy Dimson, Paul Marsh and Mike Staunton, London Business School

- **Board of Directors restricts equity investing:** As already mentioned, we often heard the saying, “we take risk on the underwriting side of our business and therefore we do not take risk on the investment side.” Many managing agents run their businesses for underwriting profit and avoid risky investments. The career path to Chief Executive of most managing agents is through the underwriting side of the business, so therefore this mentality permeates throughout the organization.

- **Accounting regulations:** One managing agent stated they have no appetite for equities because of the U.S. GAAP accounting treatment of capital gains. U.S. GAAP does not allow managing agents to recognize capital gains on their income statement, which incentivizes managing agents that report in accordance with U.S. GAAP to invest more heavily in interest bearing securities.

- **Underwriting cycle:** For those firms that actively adjust allocations between fixed income securities and variable yield securities, many consider the decision in light of the current or expected point in the underwriting cycle. For example, if the managing agent is expecting a soft pricing cycle, then firms will scale back their allocation to volatile assets in order to preserve capital. In hard markets firms will allocate more capital towards volatile asset classes.

  We found no common strategy to facilitate the conversations related to asset allocations and underwriting cycles, and note that much of the hesitancy stems from a communication barrier between underwriting and investment functions. Several executives developed formal approaches to address these points with the Board. However, the majority did not have a standard policy to discuss investment allocations, organizational risk and financial market outlook. More-sophisticated finance directors noted that this area is likely to develop substantially as a result of Solvency II frameworks, which will enable directors to have firm-wide view of organizational risk across both underwriting and investments.

Reasons for investing in volatile securities:

- **Interest rate environment:** Syndicates aim to match the duration of liabilities with the duration of investments. However, most managers admit to keeping duration overly conservative. With yields on corporate bonds below 2% for 2-year maturity AAA and AA bonds, a small but growing population of finance directors are exploring small allocations towards absolute return hedge funds in order to increase the overall expected return of their assets.

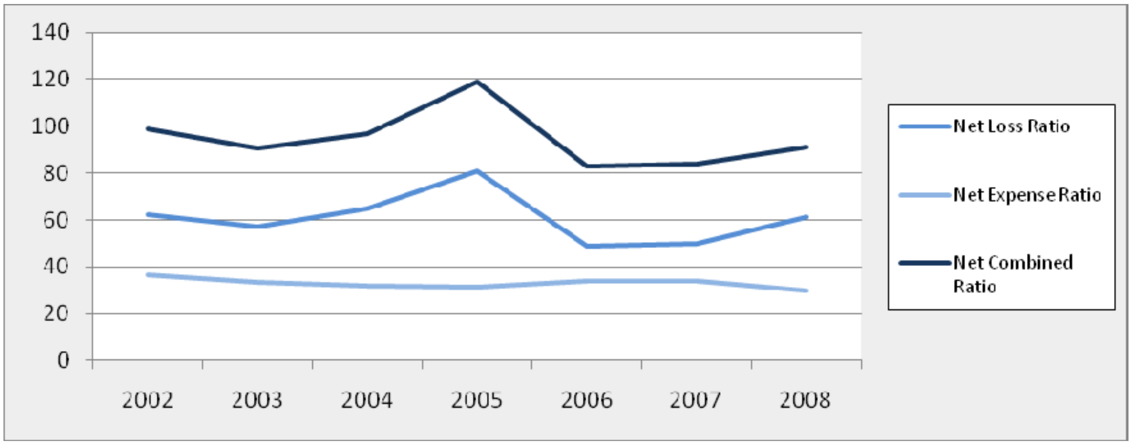
- **Equity valuations:** Finance directors with investment expertise were able to capitalize on the downturn in the equity and credit markets in 2008/09 by increasing allocations to these asset classes during the first half of 2009. While the percentage allocations were not substantially shifted, some finance directors were able to reap gains from the upward swing in the market and therefore improve overall investment returns. For some managing agents that currently do not invest in equities, one reason given for them to consider investing in equities is a sharp drop in prices leading to extreme undervaluations.

- **Professional investment experience:** Syndicates employing investment managers who have been career “investment professionals” (i.e. spending time working at asset management firms or investment banks prior to joining the managing agent) show less averseness towards riskier-asset investing. These executives largely saw the credit crisis as an investment opportunity and were able to convince their Board to add riskier assets to the investment portfolio.

- **Diversification of investments:** The diversification argument for equity, hedge fund or corporate debt investing is based on Modern Portfolio Theory, a Nobel Prize winning mathematic formula for determining the ideal portfolio structure based on a certain risk tolerance. While the aim of this report is not to delve into the arguments for or against Modern Portfolio Theory applications to syndicate investing, we note that there is room to unify the principals of this theory with organizational risk tolerances. The Modern Portfolio Theory concept states that there is a benefit of adding uncorrelated, or less correlated, assets to an investment portfolio, and in doing so expected portfolio returns can be increased without changing the overall risk profile.

Investments and underwriting predictions for 2010 will force investment optimization discussions. Strong underwriting profits and investment returns enabled the Lloyd’s marketplace to realize substantial profits from 2006 to mid 2008. Following substantial losses resulting from Hurricane Katrina and Ivan, the Lloyd’s market’s 2005 combined ratio increased to 119, and insured losses were second only to the World Trade Center attacks of 2001. As a result of higher prices, lower losses and improved investment environments, Lloyd’s syndicates were able to post impressive returns through the first half of 2008.

Figure 15: Lloyd's of London Loss Ratio, Expense Ratio and Combined Ratio[16]



However, in light of the 2010 interest rate and underwriting outlook, some Boards of Directors are beginning to discuss whether underwriting or investments will yield a higher return across the year, and in what proportion they should allocate capital towards riskier assets to compensate for low returns on fixed income investments. Those managing agents with frameworks for discussing organizational risk and returns will facilitate these discussions with greater ease.

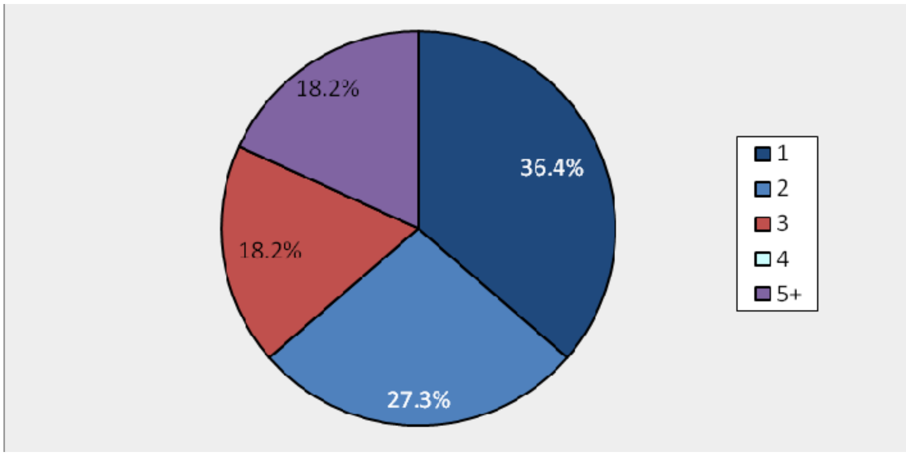
g. Third-Party Investment Managers

Thirty years ago it was uncommon for Lloyd's syndicates to employ external fund managers to invest their capital, but today nearly every syndicate employs at least one external fund manager. In 2008 around 38 third-party money management firms invested capital for Lloyd's syndicates[17], and the market is becoming increasingly competitive as more money management firms compete for syndicate clients.

One theme we identified during our discussions was that of "simplicity", and we found many finance directors prefer to consolidate investments with one or two managers. We found no consistent reason for a syndicate selecting more than one investment manager – some use more than one manager simply to diversify business risk, having both managers invest according to the same mandate, while others invest in multiple asset classes and hire specialist managers in each category. Additionally, half of respondents to our survey indicated that the number of third-party managers they employ has increased over the past three years. We believe the trend of employing multiple managers is increasing because 1) the demand for multiple investment styles is increasing, 2) managing agents can diversify business risk by using more than one manager, and 3) the competition for fees is increasing.

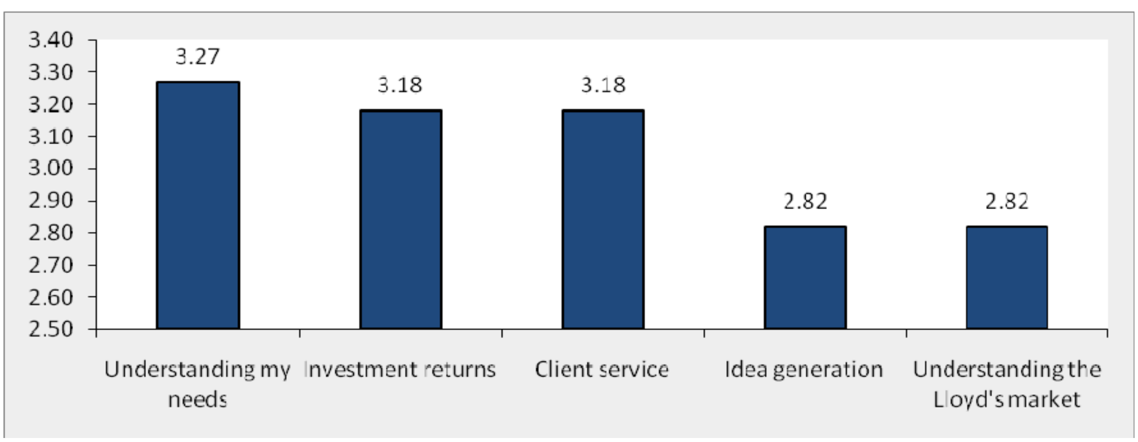
[16] Source: Lloyd's of London
[17] Source: Authors' research based on reviewing the 2008 Lloyd's syndicate annual accounts

Figure 16: Survey Question – How Many Third-Party Fund Managers Do You Employy?[18]



Finance directors require many things from investment managers. While size is not always correlated with needs, the size of a syndicate generally indicates what the finance director will seek in an investment manager. For example, smaller syndicates need an asset manager that understands the Lloyd's market, communicates regularly about portfolio investments and performance, and offers clear and transparent reporting. Smaller syndicates are also likely to hire fewer investment managers, and this was the case with many of the smaller syndicates we met. Alternatively, larger syndicates are more likely to hire multiple managers and use managers that specialise in certain asset classes. Finance directors at larger syndicates, which have dedicated investment management resources, care less about Lloyd's market knowledge and individual manager reporting capabilities because data likely will flow to a consolidated reporting platform.

Figure 17: Finance Directors' Ranking* of Criteria Sought When Choosing an Investment Manager[19]



**Respondents asked to rank criteria on a scale of 1 – 4, 1=irrelevant and 4=essential*

[18] Source: Authors' survey of managing agents
[19] Source: Authors' survey of managing agents

Historically, for both small and large syndicates, it was critically important for the investment manager to understand the Lloyd's of London market and the requirements of managing money within the system. This experience-based approach led Credit Agricole, which bought into the Lloyd's market in 2000, to build a large client base. More recently, however, syndicates seem to be reducing the importance they place on a manager's understanding of Lloyd's. In place of this requirement, finance directors are demanding more tailored understandings of their business and better client service.

For syndicates with lower assets under management, most finance directors commented that an understanding of the Lloyd's market is essential to winning mandates. We find that these individuals are time-pressed and often do not have the capacity to hand-hold investment managers through an introduction to Lloyd's. The Lloyd's market has many unique characteristics, such as the legal framework for the Premium Trust Funds established in different countries, and while the Lloyd's structure is not overly complex, managers will be faced with a steep learning curve if they do not understand the various accounts, regulations or reporting procedures. That being said, we discovered through our conversations that many investment managers do not have detailed knowledge of the Lloyd's market. Of the approximately 38 asset managers that invest capital for Lloyd's syndicates, Mr. Osborne at Meridian estimates only 7 or 8 of the managers *really* understand the Lloyd's market.

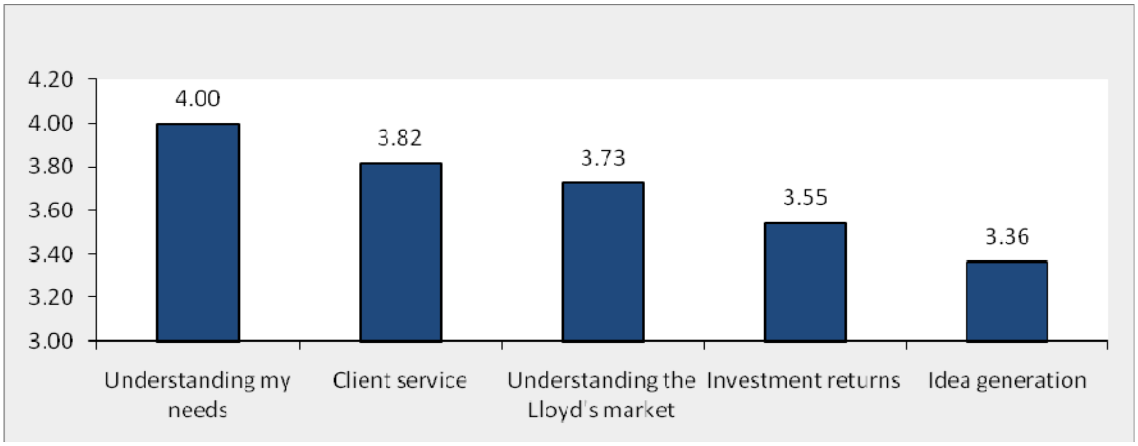
"Once you have set the mandate and established trust with your manager, worry about manager risk and not investment risk."

Representative Quote
Managing Agent of Lloyd's Syndicate

Some managing agents are willing to invest time in hiring a manager that does not have prior experience within Lloyd's, as long as the manager is exceptional in some other way. For example, one managing agent we met hired a well-known global investment management firm that stated they understood Lloyd's, but once the relationship began the managing agent's Treasurer quickly realized the manager had no experience with the Lloyd's market. The managing agent's staff spent a meaningful amount of time providing guidance to the investment manager as they learned the Lloyd's system, providing direction on paperwork, account opening and regulation. In this case the syndicate still employs the manager, but it was clear to us that the relationship did not begin on the right foot.

Managing agents are generally pleased with their investment managers' performance. In surveying 20% of the managing agents at Lloyd's, we found finance directors generally are satisfied with their investment managers' performance, however no criteria ranked "excellent" on average. This should be of concern to investment managers because they operate in a relatively undifferentiated market that is becoming more competitive.

Figure 18: Finance Directors' Evaluation* of Investment Managers' Performance[20]



**Respondents asked to rank criteria on a scale of 1 – 5 based on managers' performance against selected criteria, 1=poor, 3= neutral, 5=great*

We find it interesting that respondents score their managers well on "understanding my needs", however rank more tangible needs such as investment returns and client service lower. We believe this indicates a lack of follow-through when fulfilling needs. Furthermore, "investment returns" and "understanding my needs" are very basic criteria to score well against, however we anticipate that "idea generation" will become an essential distinction in the future as the market for investment management becomes increasingly competitive.

Managing agents are prepared to pay for quality service. Fees are a consideration for both large and small syndicates, but are not a primary factor when choosing investment managers. Mr. Osborne at Meridian estimates that the average fee of a Lloyd's fixed income manager is around 0.15% of assets under management per year. The Lloyd's of London Treasury Department offers one of the lowest fees for management, while those that are more expensive tend to offer specialized expertise or value-added services, such as a dedicated team for credit research or consolidated performance reporting, respectively.

A structured process for manager selection. The manager selection process for Lloyd's managing agents is not dissimilar to that of other institutional investors. The larger, more sophisticated managing agents employ a process that generally follows these four steps:

1) *Initial screening and short-list candidates* – Initial screening takes place through desk-top research (for managing agents who have an internal investment team) and/or with the use of an investment consultant. This stage focuses on identifying managers with a sound track record, clean compliance history, stable investment team and process and, for some, a reputation for managing investments for insurance companies or within the Lloyd's market.

[20] Source: Authors' survey of managing agents

2) *First round interviews* – This stage conducts additional due diligence on the manager's investment philosophy, portfolio management process, investment professionals and performance history. At the end of this stage the managing agent or consultant would aim to have a list of around five managers.

3) *Second round interviews* – This stage includes an on-site visit with the manager, and focuses on identifying and understanding the manager's value proposition and investment judgement and what it would be like to have an ongoing relationship with the manager. Additional operational due diligence is conducted at the manager's office. At the end of this stage the managing agent or consultant would aim to have two or three finalists to present to the Investment Committee or Board of Directors.

4) *Finalists present to the Board or Investment Committee* – The final stage allows the entire Board or Investment Committee to learn about the manager and make a decision. Until this point, it is likely that only the managing agent's CIO, Finance Director or Treasurer and one or two other staff members have met the manager.

The smaller managing agents who do not employ a team of internal investment professionals either use a refined version of this process, focusing on managers who have a solid reputation in the Lloyd's market, or rely heavily on an investment consultant to assist in the manager selection.

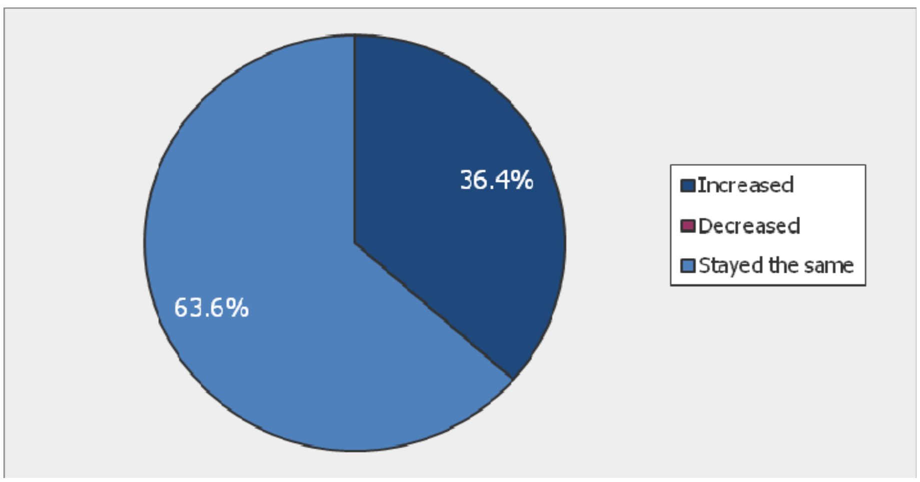
The hedge fund manager selection process. The hedge fund manager selection process is very different than the process for selecting fixed income or equity managers. Regardless of the size of the syndicate or the number of internal investment professionals employed, managing agents commonly outsource the selection of hedge funds to a hedge fund platform provider. Although similar to a fund-of-funds, the hedge fund platform provider is responsible for selecting a portfolio of single-strategy (and potentially some multi-strategy) funds. As a result, the syndicate is invested directly in a number of individual hedge funds rather than one investment in a fund-of-funds. This allows for 1) greater control of the allocation among different types of hedge fund strategies, 2) transparency to each hedge fund's investment approach, 3) greater control over the timing of subscriptions and redemptions, and 4) lower fees when compared to a traditional fund-of-funds manager. The managing agents we met that allocate capital to hedge funds typically invest in a minimum of 15 different hedge fund strategies in order to diversify investment risk, business risk, and reduce liquidity concerns. It is not only the managing agents that use this approach to hedge fund investing – the hedge fund investments made in the Lloyd's Central Fund also are invested using a hedge fund platform provider.

Parent companies can hold significant influence when choosing investment managers. Some managing agents that are subsidiaries of large foreign companies may have little say in the appointment of investment managers. For example, we met one syndicate that was bought by a large foreign company within the last seven years. Prior to the acquisition, two London-based managers invested the syndicate's assets. Following the acquisition, the parent company encouraged the

London-based managing agent to evaluate two of the parent company's investment managers, and within six months the two incumbents were replaced by the two managers used by the syndicate's new parent company. While the managers that were hired are large, well-known and likely capable of handling the mandate, the selection process was heavily influenced by the investment managers' relationship with the syndicate's parent company.

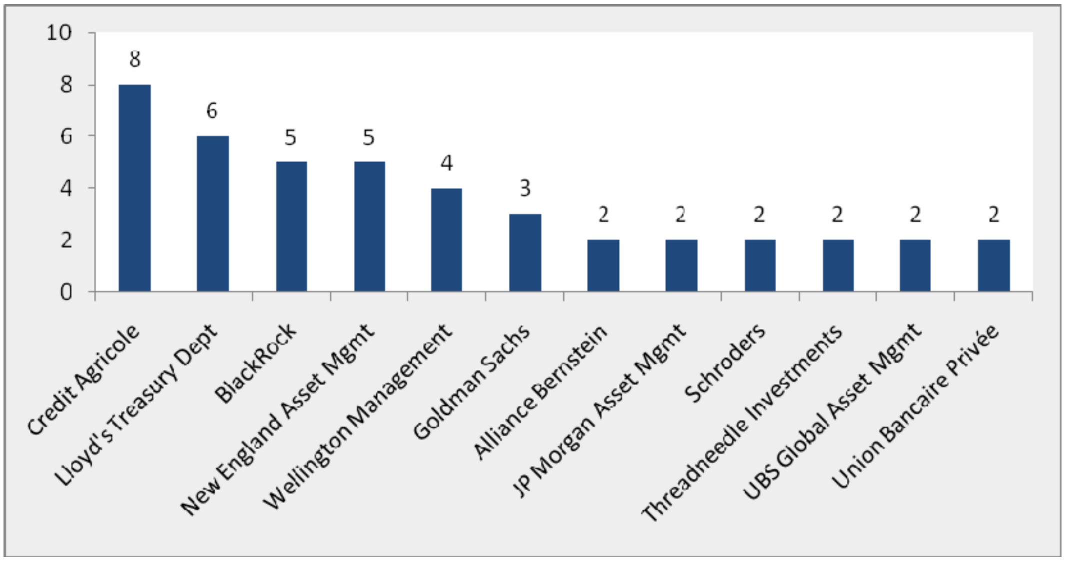
Third party money management is fragmented in the Lloyd's market. Lloyd's of London managing agents reported working with 38 investment managers at year-end 2008, and 42 out of 54 managing agents reported employing a third-party manager. While some managing agents spread investments across five managers or more, most prefer to hire one or two managers (64% of the managing agents we surveyed reported employing one or two managers). Further, for those managing agents that hire third party managers, there is a positive trend over the last 3 years for the number of managers employed.

Figure 19: Survey Question - How has the number of third-party fund managers you employ changed over the last 3 years?



The chart below shows the investment managers that have two or more relationships within the Lloyd's of London market.

Figure 20: Number of Relationships Held by Investment Managers[21]



While managing agent size is not always indicative of investment strategy, we find that smaller managing agents have a higher tendency to place their assets with just one manager. For example, while 50% of the Lloyd's market chose one investment manager, of those managing agents with less than $199 million in assets under management, fully 89% work with just one manager[22]. As discussed in the previous section regarding finance director needs, we found the discrepancy across managing agents is due to time constraints of the finance director, and a strong desire for simplicity.

Finance directors are also placing greater importance on third-party managers' ability to offer ancillary services in addition to their core competency in portfolio management. One example of this is Blackrock's ability to provide clients with consolidated performance reporting and risk measurement tools. For some clients, Blackrock collects portfolio information from other third-party managers and provides a consolidated view of investments along with the overall performance of the investments. In addition, the consolidation of investments allows for a more robust risk-measurement approach, allowing the finance director to view the entire pool of capital rather than only a single manager's mandate. Other managers have invested in back-office technology platforms that enable clients to view portfolio investments in real-time on the internet while also allowing clients to stress-test portfolios and run simulations on how portfolio characteristics, such as duration and credit quality, would change given buy or sell actions. It was clear to us that finance directors are demanding more from their investment managers, not only in providing pro-active investment advice but also in offering value-added services outside traditional money management.

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[21] Source: Authors' research based on investment managers listed in the 2008 syndicate annual accounts
[22] Source: Authors' research based on the 2008 syndicate annual accounts

A complete list of the investment managers that operate within the Lloyd's of London market is found in Appendix IV.

h. Use of Investment Consultants

Investment consultants are defined as a third-party person or group hired to provide advice to the managing agent's Board of Directors or Investment Committee regarding any aspect of the investment management function. In our survey of managing agents, 46% currently use an investment consultant to assist in some aspect of their investment selection process.

Investment consultants help time-pressed finance directors. Ten years ago managing agents seldom hired external consultants to provide advice to the Board or Investment Committee, however with increasing importance placed on investment risk and return, more managing agents use consultants to provide advice on investment policy issues. Furthermore, with many managing agents staffing just one finance director (or equivalent role), consultants can be influential in a syndicate's investment strategy. More specifically, we found consultants are hired for the following reasons:

- **Assisting in manager selection.** Consultants assist managing agents in locating investment managers for desired investment mandates, such as fixed income, equities and hedge funds. While larger managing agents will use investment consultants in the first stage of manager selection, usually distilling the list of thousands of managers to a short list of prospective candidates, smaller managing agents will use consultants throughout the entire manager selection process.

- **Identifying new investment strategies.** With limited time to monitor financial markets and research new investment strategies, managing agents can utilize investment consultants to provide information on new investment strategies or ideas that would fit within their risk parameters. Consultants can communicate these views directly to the Board or Investment Committee or by publishing timely white papers on prospective investment opportunities for all managing agents to read.

- **Bridging the Communication Gap.** A third task that investment consultants perform is influencing the Investment Committee and/or Board of Directors. As noted previously, a hurdle to gaining approval of a new investment manager or strategy is convincing senior executives who often have underwriting or actuarial backgrounds. As described to us during one of our interviews, an important role of the consultant is "translating insurance-speak to investment people and investment-speak to insurance people".

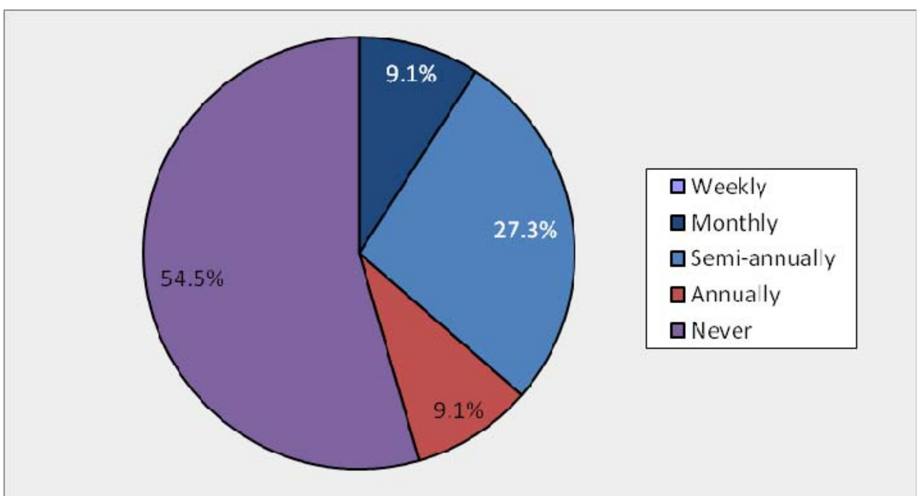
- **The importance of objective advice.** An investment consultant brings objectivity to a process that can be stricken with conflicts of interest. There are many reasons why investment managers are introduced to potential clients, and not all methods are entirely objective. We learned that managing agents who employ investment consultants generally pay them an annual flat retainer fee, which helps objectivity because the consultant is not incentivized to invest capital, turnover capital or constantly come up with new or innovative ideas. Furthermore, Investment Committees or Boards often find it helpful to have an independent view, which ensures they are considering all relevant information before making a decision.

Based on discussions with finance directors and executives at Lloyd's, we consider the leading investment consultant in the Lloyd's marketplace to be David Osborne at Meridian. In a market that places significant value on relevant experience, Mr. Osborne's 30-year career in the Lloyd's market is important for many managing agents. Each of the managing agents we met knew of Meridian and Mr. Osborne, although not all of the managing agents we met use Meridian's services.

i. Use of Conferences and Informal Networks

We find that finance directors at managing agents are generally insular, relying very little on outside networking to share investment management best practices. The majority of finance directors do not share investment practices with peers, and those who do engage in networking do so infrequently. Finally, many finance directors admit they could do a better job networking with colleagues and sharing best practices.

Figure 21: Survey Question – How often do you share investment management best practices with colleagues at other syndicates?[23]



- **Conferences and networking events.** With the Lloyd's syndicates holding over £30 billion of investable capital, asset managers and consultants are keen to be perceived as experts in managing insurance-industry investments. While no investment manager was mentioned specifically as an expert on the market, the one conference cited by most finance directors as being excellent was the Schroders annual investment conference. Many finance directors also cited meet-ups and events hosted by Meridian as being useful and timely. For many

[23] Source: Authors' survey of managing agents

individuals, the Meridian meetings are the only occasion when they interact with colleagues at other managing agents.

- **Trade journals and other publications.** To stay current on marketplace and financial market developments, executives cite using the following trade journals and publications.

General Information	Finance and Investments	Investment research	Macroeconomic Research	Insurance-specific
Reuters The Economist	Financial Times Bloomberg	Sell-side broker research Hedge Fund Review BCA Investment Research	Lombard Street Research Capital Economics	Risk Management Magazine

- **Thought leaders in the Lloyd's of London community.** There was a noticeable lack of responses when we asked executives to name thought leaders in the Lloyd's of London investment community. Most finance directors chose to abstain from the question, while others had no opinion (if forced to choose someone other than themselves). This could be a result of investment executives being reluctant to network and discuss pioneering strategies, or it could be a view that most people are not consistently thinking about achieving superior investment policy.

j. Views on Regulation

We found a wide range of views on the current and future regulatory environment. On one hand, executives felt that regulators are largely toothless, and investment product development will always be ahead of regulation. On the other hand, executives saw the new regulatory environment as the beginning of a new way to think about investing and enterprise risk management. The following points summarize views expressed regarding regulations.

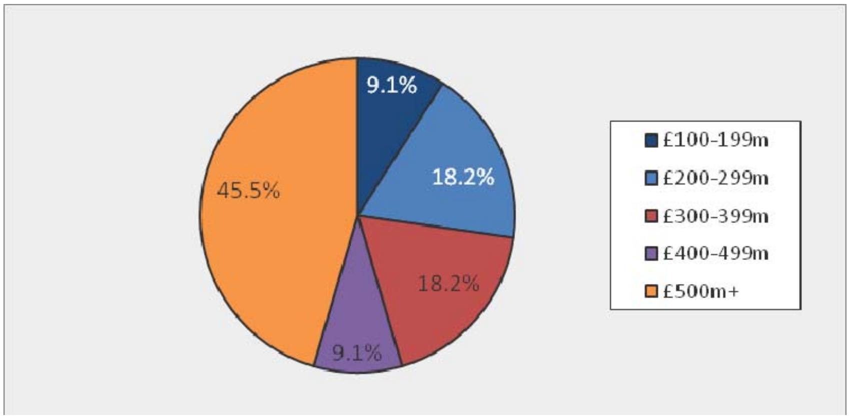
- **Regulators do not understand the insurance industry.** The Lloyd's market has been very proactive in self-regulation, and is a step ahead of generic financial services regulation. In fact, there is a risk that politicians could damage the Lloyd's market by proposing regulations without understanding the market. This view was expressed by only a few executives.

- **Regulators are toothless.** History has shown that financial regulation chases financial innovation. This point was cited numerous times in our discussions, with specific reference to the use of hedge funds in a portfolio, and the development of UCITS products that effectively circumvent these restrictions on "alternative" investments. Additionally, with many managing agents maintaining very conservative investment policies, new regulations will not significantly impact their overall strategy.

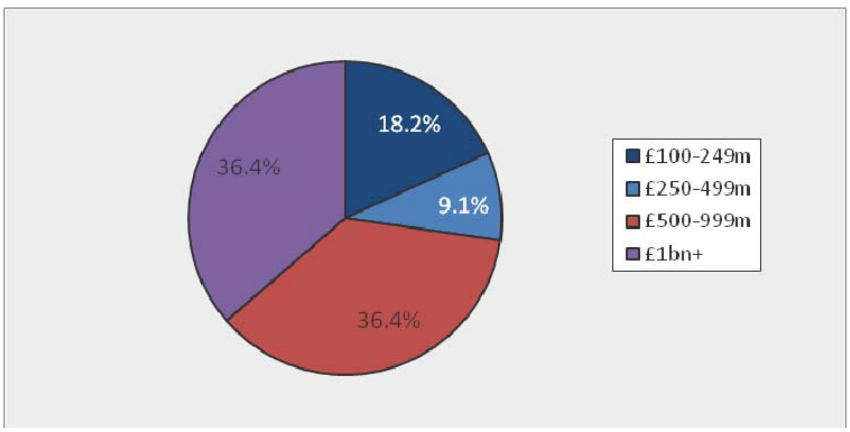
- **Regulations will spur a new way of thinking about investments.** There were a number of executives who, in our opinion, were thought-leaders and opined that the Solvency II Directive will bring sophistication to the investment function, by linking enterprise risk management to investments and underwriting. While much of Solvency II is administration-related, Solvency II compliant risk-management frameworks will force investment risk management to the Board level. Investment managers and/or finance directors interested in increasing the quality of their investment management programs can use this directive to communicate with the syndicate's Board of Directors.

Appendix I: Survey Respondent Profile

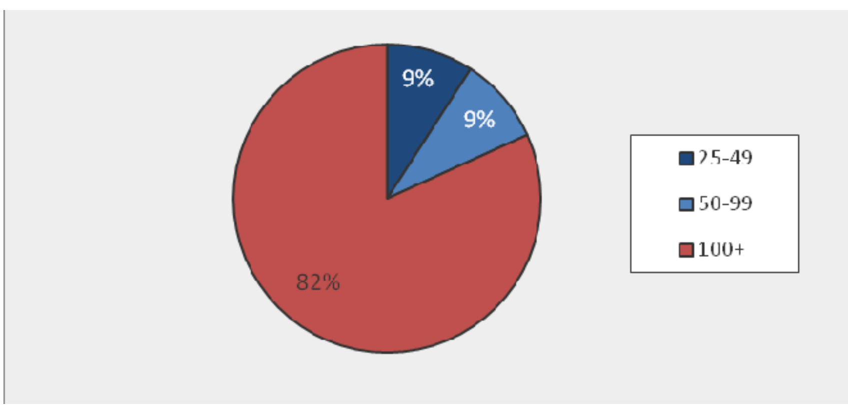
For your year-end 2008, what was the amount of gross premiums written by your syndicate(s)?



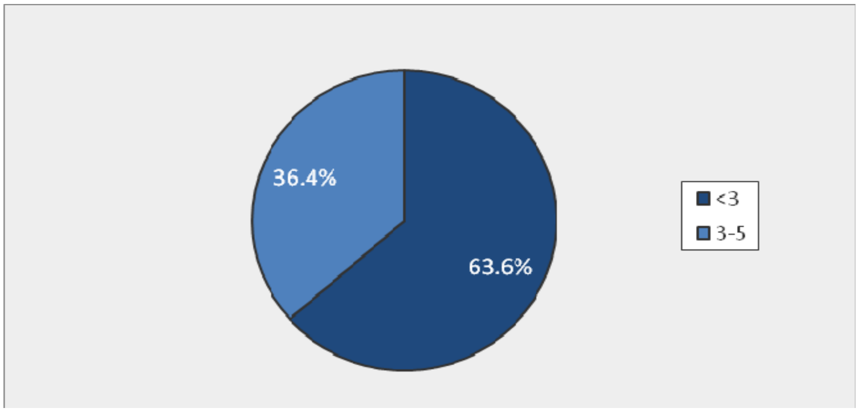
What is the range of assets under management attributable to your syndicate? (If more than one syndicate, the total amount of AuM attributable to all syndicates)



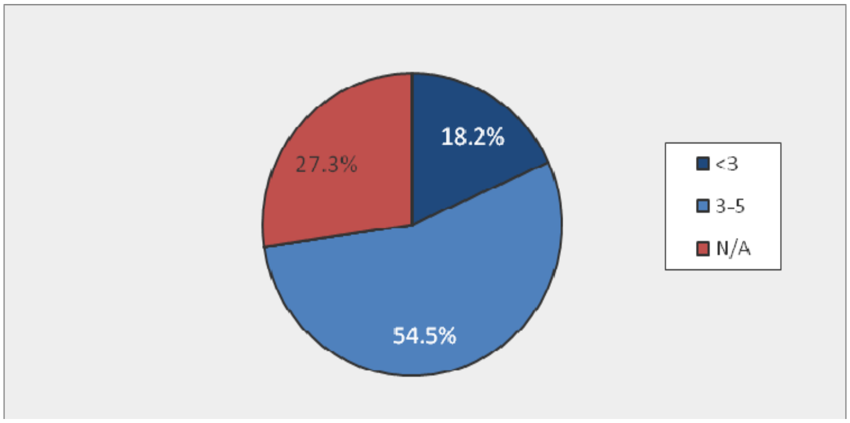
How many people are directly employed by your managing agent?



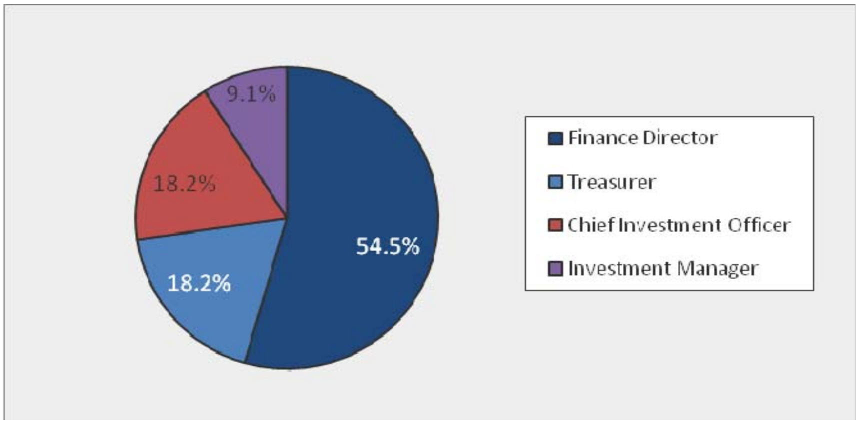
How many people at your organization are tasked with managing syndicate investments?



If the managing agent is part of a larger insurance group, how many individuals, including those at the corporate level, participate in managing syndicate investments?



What is the title of the person responsible for the syndicate's investment management?



Appendix II: Lloyd's U.S. Premium Trust Funds

a. Excess or Surplus Lines Trust Funds (SLTFs): hold assets equivalent to 30% of a member's gross US surplus lines liabilities, adjusted quarterly. This funding level is subject to the International Insurers Department (IID) policy, which can allow for an increase of up to 100% where policy criteria deem this applicable. They are maintained at syndicate level: a syndicate must establish an SLTF before it is permitted to appear on the National Association of Insurance Commissioners' (NAIC) quarterly listing of alien surplus lines insurers, and every member of the syndicate must accede to the syndicate's trust deed. Unlike alien and US domestic surplus lines carriers, syndicate SLTFs are not capped at $100m. These trust funds relate to business written by the syndicate on or after 1 August 1995.

b. Credit for Reinsurance Trust Funds (CRTFs): hold assets equivalent to 100% of a member's gross US reinsurance liabilities, adjusted quarterly. Like the SLTFs, they are maintained at syndicate level and relate to business written by the syndicate on or after 1 August 1995.

c. Joint Asset Trust Funds (JATFs): there are separate JATFs for surplus lines and for reinsurance business. They are held at Lloyd's level rather than by syndicates, although the syndicates (and therefore the members) fund the assets in the JATFs from their PTFs. The JATFs must be maintained by Lloyd's at $100m (the reinsurance JATF) and at $200m (the surplus lines JATF).

d. Trust funds in licensed states: as Lloyd's is licensed in Illinois and Kentucky, it maintains separate trust fund arrangements in each state. In Kentucky, there is a system of separate syndicate-level trust funds and also a JATF, relating to Kentucky situs direct business. In Illinois, there is a single trust deed, covering separate member-level trust funds. Both arrangements enable Lloyd's to maintain the assets required to ensure compliance with each state's insurance code.

e. Lloyd's American Trust Funds (LATFs): maintained by each member in the US for receipt of US dollar business (including non-US risks) written on or before 1 August 1995. Claims made on Lloyd's policies written on or before 1 August 1995 by US insureds are paid out of the LATFs.

f. Lloyd's Dollar Trust Funds (LDTFs): maintained by each member in London for the receipt of premiums in respect of US dollar denominated non-life business written or incepting on or after 1 August 1995. Claims made on Lloyd's policies incepting on or after 1 August 1995 by US insureds are paid out of the US dollar Premiums Trust Funds maintained in London. Should those funds be insufficient, the next available assets are those in the second link, described on page 16. The trust funds described in a, b, c and e above are maintained with Citibank N.A. in New York. The trust funds described in d above are kept by trustee banks in the states concerned and the dollar trust funds described in f above are held in Citibank, London. The trust funds described in a-d above are not available for the settlement of claims as they fall due but would be used to pay claims if Lloyd's security (including the Central Fund) did not do so. This, of course, has not happened in the history of Lloyd's.

Appendix III: Lloyd's Performance Results

	Q4 2004	**Q4 2005**	**Q4 2006**	Q1 2007	Q2 2007	Q3 2007	**Q4 2007**	Q1 2008	Q2 2008	Q3 2008	**Q4 2008**	Q1 2009	Q2 2009	Q3 2009
Total investments (£m)	31,412	35,032	35,091	35,952	35,153	35,960	36,981	36,022	36,112	38,727	44,370	45,693	43,766	45,635
Investment return (£m)	1,065	1,436	1,661	452	846	1,371	2,007	357	346	414	957	98	708	1,477
Return (%)	3.6%	4.3%	4.7%	1.3%	2.4%	3.9%	5.6%	1.0%	0.9%	1.1%	2.5%	0.2%	1.6%	3.3%
Quarterly Movement				452	394	525	636	357	-11	68	543	98	610	769
PTFS							**Syndicate level assets**							
Total (£m)	20,455	23,256	22,099	22,923	21,871	23,361	25,062	23,655	24,486	27,179	31,504	31,891	28,482	30,595
Return (£m)	532	705	957	277	480	836	1,226	290	302	263	521	131	633	1,157
Return (%)	2.8%	3.2%	4.2%	1.2%	2.2%	3.7%	5.2%	1.2%	1.2%	1.0%	**2.0%**	**0.4%**	**2.1%**	**3.8%**
FAL							**Funds at Lloyd's**							
Total (£m)	9,622	10,206	11,282	11,333	10,797	10,499	9,858	10,151	9,593	9,468	10,630	11,528	13,076	12,783
Return (£m)	487	602	651	161	350	500	653	36	64	141	271	-11	54	210
Return (%)	5.1%	6.1%	6.1%	1.4%	3.2%	4.6%	6.2%	0.4%	0.7%	1.5%	**2.7%**	**-0.1%**	**0.5%**	**1.7%**
Central & Other							**Central fund and other assets**							
Total (£m)	1,335	1,570	1,710	1,696	2,485	2,100	2,061	2,216	2,033	2,080	2,236	2,274	2,208	*2,257*
Return (£m)[1]	46	129	53	14	16	35	128	31	-20	10	165	-22	21	110
Return (%)	4.6%	8.9%	3.2%	0.8%	0.8%	1.8%	6.8%	1.4%	-1.0%	0.5%	**7.8%**	**-1.0%**	**0.9%**	**4.9%**

[1] Central fund and other assets Return (£m) during Q32009 includes amounts relating to the buy back of subordinated debt.
Source: Lloyd's of London

Appendix IV: Third Party Investment Managers in the Lloyd's market

Note: Investment managers working in Lloyd's of London (number represents how many managing agent relationships each manager holds)

Credit Agricole Asset Management	8
Lloyd's Treasury Department	6
BlackRock	5
General Re-New England Asset Management	5
Wellington Management	4
Goldman Sachs	3
Alliance Bernstein	2
JP Morgan Asset Management	2
Schroders	2
Threadneedle Investments	2
UBS Global Asset Management	2
Union Bancaire Privée	2
Aberdeen Asset Management	1
AIG Global Investment Management	1
Bank of NY Mellon	1
Barclays Global Investors	1
Brown Brothers Harriman	1
Camomille Associates	1
Conning Asset Management	1
EPIC Asset Management	1
Episode	1
FRM Investment Management	1
Gandhara	1
Hyperion Capital Management	1
Insight Investment Management	1
Invesco Asset Management	1
Markel Gayner Asset Management	1
Minster Court Asset Management	1
Morgan Stanley Investment Management	1
Oaktree Capital Management	1
OZ Overseas Fund	1
Payden & Rygel	1
Perry Partners International	1
Royal London Cash Management	1
Sumitomo Mitsui Asset Management	1
Syz & Co	1
The Travelers Indemnity Company	1
Weiss Peck and Grier	1

Source: 2008 syndicate annual counts

About the Authors

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David is a second-year MBA student at London Business School. Prior to his MBA, David served as senior research manager at the Corporate Executive Board, where he was responsible for the publication of strategic research reports, focusing on insurance and private banking industries, and managing an international team of research analysts.

David spent the summer of 2009 as an analyst at Millgate Capital, a $1 billion hedge fund. He was responsible for the evaluation of asset backed securities under the Term Asset Backed Security Lending Facility (TALF) programme, and the analysis of two venture capital investments.

David holds an undergraduate degree in Business Administration and German from Skidmore College.

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Eric is a second-year MBA student at London Business School. Prior to his MBA, Eric worked in the Investment Management Division of Lehman Brothers where he advised wealthy families on investment strategy and asset allocation, diversification and wealth transfer strategies and tax-efficient portfolio management. Prior to that, Eric worked in Morgan Stanley's Global Advisor Research and Institutional Investment Consulting groups.

Between the first and second years of his MBA, Eric worked as a Summer Associate on the Investment Team at Coller Capital, a leading investor in private equity secondaries worldwide. Eric will be joining Coller Capital full-time after completing his MBA.

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