



INVESTOR INSIGHTS SERIES

SEEKING CERTAINTY IN UNCERTAIN TIMES

Regulatory pressures and market
challenges shape a new era for insurers



EXECUTIVE SUMMARY

Regulatory pressures, investment constraints, and the difficulties of managing the portfolio construction process are converging to challenge the insurance industry, putting decision makers on the precipice of significant and lasting changes. In this, our first survey of the insurance industry, Natixis Global Asset Management reached out to key decision makers to gain insight into what they think it will take to succeed in this new market reality.

Focusing on non-investment executives with an eye toward providing investment managers with an inside view of the business challenges that are affecting portfolio decisions, we found a broad range of factors coming into play:

- **Regulation:** The implementation of Solvency II in Europe and Dodd-Frank regulations in the U.S. raises the question not only of how well-prepared industry players are for these new standards, but also of how they view the associated costs of added compliance and the investment in new technology needed to ensure they are compliant.
- **Investment management:** New regulations also create new capital constraints that will affect how insurers meet liquidity requirements and address long-term liabilities at a time when ultra-low interest rates are forcing many to look beyond traditional fixed-income to find yield.
- **Portfolio management:** Looking further afield for the returns needed to meet underwritten obligations is leading many to consider outsourcing select investment functions to deliver specialized investment expertise.

Meeting all of these challenges and somehow satisfying the demand for profits and stock-price growth requires a combination of internal and external expertise that heightens awareness both inside and outside all firms' operating environments to achieve success.

These forces could impress significant changes for the industry at large, challenging long-held convictions about investment selection, the outsourcing of select asset management functions, and in some cases driving M&A decisions as some insurers look to remain profitable and competitive in this new business landscape.



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Seeking certainty in uncertain times

While all sectors of the financial service industry have been affected by the global financial crisis, most media attention has focused on banks, but insurers have been impacted just as hard as they look to manage investments, meet liabilities and operate efficiently in a more highly regulated environment.

The Natixis Global Asset Management 2015 Insurance Industry Survey finds that while at this point in time, many insurers may not be ready to take on all of these new challenges, they are making steady progress toward long-term success.

Focusing on non-investment personnel such as chief financial officers, actuaries and other critical managers, our study looks closely at both the business challenges and the investment implications presented by implementation of Solvency II in Europe and Dodd-Frank in the U.S.

“Two-thirds of the insurers we spoke with say they are not well-prepared for implementing these new standards within their organizations.

New regulations pose new challenges

In spirit, both sets of regulatory standards strive to set new liquidity and risk standards for insurers' house money with the goal of preventing the “too big to fail” organizations from putting undue stress on the global financial system. But in reality, they are creating significant challenges for insurers as they seek better strategies for balancing long-term liabilities and liquidity needs.

The study surveyed 200 respondents representing companies in France, Germany, the Nordics, the United Kingdom (U.K.) and Ireland, and the U.S. Their collective view demonstrates the complex orchestration it will take to achieve corporate financial goals while living up to new regulatory standards. Our results show:

- With Europe's Solvency II's January 1, 2016 deadline rapidly approaching and many regulations created under Dodd-Frank now implemented, two-thirds of the insurers surveyed say they are not well-prepared for implementing these new standards.
- In terms of investment selection, insurers say increasing yield is their top priority. With monetary policy presenting key challenges to traditional fixed-income assets, many insurers are turning to alternative investments¹ for income potential. On the return side of the equation they are looking to equities to provide the growth they need in 2016.
- In terms of portfolio management, two-thirds (68%) of our respondents say they are conflicted between generating alpha and protecting assets, and three-quarters (76%) say it is increasingly important to structure assets as efficiently as possible to cover long-term liabilities.

To help set the appropriate context for these issues, we have enlisted the support of industry thought leaders in Europe and the U.S. and incorporated their perspective into the broader picture of how these factors affect the investment decisions of insurers. While still not crystal clear, a picture of today's insurance industry is coming into sharper focus.

¹ An alternative is an investment that is not one of the three traditional asset types (stocks, bonds and cash). Alternative investments include hedge funds, managed futures, real estate, commodities and derivatives contracts. Alternative investments involve specific risks that may be greater than those associated with traditional investments, and there is no assurance that any investment will meet its performance objectives or that losses will be avoided.

Details on regulations

Solvency II

The Solvency II Directive is a set of guidelines designed to standardize how the insurance industry is regulated in the 28 member nations of the European Union and establishes new capital requirements, valuation techniques and governance and reporting standards. The directive's goals are to:

- Reduce the risk of insolvency in the insurance sector
- Improve consumer protection
- Reshape oversight of the industry
- Raise the international competitiveness of the region's insurance companies

To achieve those aims, Solvency II focuses on three areas, or pillars.

The first (and perhaps best-known) pillar governs the amount of capital held by insurance companies; Solvency II requires them to have enough capital on hand in relation to the risks they take. Whereas capital requirements previously were determined based on premiums and claims, or profit and loss, Solvency II adopts a balance sheet focused approach that addresses key risks affecting all aspects of the balance sheet including assets as well as liabilities.

The two remaining pillars impose stricter rules on risk management and governance, as well as transparency (covering issues such as reporting and disclosure). Solvency II is scheduled to come into effect on January 1, 2016. Given the industry's global nature, the Directive has a widespread effect, even on smaller companies based outside the European Union.

The Dodd-Frank Act

The Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law by President Obama in 2010. It is a sweeping group of laws that touch nearly every aspect of the nation's financial services sector and was pieced together to avoid a cataclysmic breakdown of the financial system such as what occurred during 2007-08.

While the law was mainly meant to influence the banking sector, it has important implications for the insurance industry. Dodd-Frank established the Federal Insurance Office, introducing greater federal regulatory involvement into what has traditionally been a state-regulated industry in the U.S. It also established a new category of financial institutions – systemically important financial institutions, or SIFIs – that are subject to heightened federal regulation, including the U.S. Federal Reserve's capital standards, requiring SIFIs to keep a layer of money to protect them from insolvency in the event of a crisis. So far, the Office has designated three insurance companies as SIFIs.

Implementation of Dodd-Frank has been a long process, with details of specific rule-making parsed among multiple federal agencies. Five years into its existence, many questions remain about setting enhanced standards for SIFIs and how those standards will affect non-SIFIs; how insurance holding company standards set by the Federal Reserve Board will affect state-enforced prudential standards for operating entities; and how international capital standards, such as Solvency II, will affect U.S.-based cross-border insurers.

ABOUT THE SURVEY

Natixis Global Asset Management commissioned CoreData Research to conduct a study of key decision-makers in the insurance industry, to provide insight into how they plan on facing the challenges of increased regulatory pressures, investment constraints, and the difficulties of managing the portfolio construction process.

The survey was conducted and hosted by CoreData Research in July 2015. The sample consists of 200 decision makers working in the insurance industry – 40 respondents from each respective country/region (U.S., U.K. & Ireland, France, Germany and the Nordics). The roles of the respondents in their organizations include Chief Financial Officer, Controller/Partner/Director, Accountant, Actuary, Audit, and Treasury.

The outlook on the insurance industry

Regulatory reform brought on by the global financial crisis is challenging insurers' ability to operate efficiently on both sides of the Atlantic. The Solvency II European Union Directive and the U.S. Dodd-Frank Wall Street Reform and Consumer Protection Act have created new demands on how insurers operate and use their capital.

While new regulations have a direct effect on how insurers will be able to operate and invest, many experts believe the long-term negative effect of low interest rates caused by many years of financially repressive central bank-imposed monetary policies may actually be the biggest issue facing insurers.

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The squeeze of financial repression

This financial repression of interest rates by the central banks of the four biggest economic areas in the world – the Federal Reserve, the European Central Bank, the Bank of Japan and the Bank of England – have kept rates close to zero for more than seven years. According to Andy Haldane, the Bank of England's chief economist, these are the lowest real interest rates in 5,000 years.²

The consequences of low interest rates have been at the center of economic concerns since John Maynard Keynes published *The General Theory of Employment, Interest and Money* in 1936. In it, he identifies “the euthanasia of the rentier” as a key consequence of this kind of low-rate environment. Keynes viewed the negative effect of low interest rates on lenders and owners of land as a side benefit of stimulating real economies by suppressing interest rates.

Rates too low for too long

According to John Fitzpatrick, the former head of the Geneva Association, the “rentiers,” or lending institutions, notably insurers, have suffered low interest rates for too long. Fitzpatrick, now a member of the Board of Directors for AIG and the chairman of White Oak Global Advisors, LLC, sees this financial repression as a critical issue to the health of insurers.

“This policy of financial repression,” says Fitzpatrick, “has as its objective to cause a robust recovery from the Great Recession following the ‘08–‘09 crash. However,” he adds, “keeping interest rates so low for so long hurts the insurance companies’ investment income and margins, making it nearly impossible for insurers to perform their function as a place for long-term savings for society.”

“Rather,” he says, “what the central banks have induced is a weak recovery, and new generations of industrial managers of companies who have put capital to work in low-return long-term projects often financed by these low short-term interest rates,

² Haldane, Andrew G. “Stuck.” Open University. London. 17 Oct. 2015. Speech.

subjecting themselves unwittingly to a disaster when rates rise. Even Keynes would question the use of these tools for such a length of time and to this low level of rates. Not surprisingly, rentiers are gasping for breath in such conditions,” concludes Fitzpatrick.

Volatility and uncertainty plague insurers

Volatile market conditions and a landscape that includes global conflict, climate change and cyber-risk among many critical issues are also challenging insurers’ ability to operate profitably. Pragmatic solutions are required to help insurers seeking certainty in an uncertain environment.

“Solvency II is a dynamic reform; it is not just a picture of the balance sheet,” says Maxime Druais, financial engineer with Paris-based Natixis Assurances. “We have to assess the evolution of the risk profile of the company. If we are in a low-rate environment and then suddenly rates increase in one year, it could have a big effect on the balance sheets and have a major effect on capital. That is why we have to have duration on the investment, which is lower than liability. We have to anticipate the evolution of the risk.”

Our survey findings demonstrate the concerns of insurers, as well as the pragmatic and resourceful manner in which good insurers operate. For now, understanding the risks and exposures is their first task. This broad approach is noted by Ian Coulman, the chief investment officer of U.K.-based Pool Re. “I can see that the pressure is on, given the very low interest rate environment, trying to generate a reasonable return. The only way to do that is to take on additional risk.”

The quest for yield pushes risk budgets

Coulman also points out that the question for insurers is looking at the additional risk of asset classes not normally in the insurers’ purview. As he put it, “going out to further risk on the credit spectrum, or even taking on more interest rate risk” is the question insurers are trying to answer. (Pool Re is a mutual reinsurer whose members constitute the vast majority of Lloyd’s syndicates offering commercial-property insurance in the U.K.)

Fitzpatrick agrees, noting that the quest for yield is causing insurers to invest at longer maturities and to accept ever more credit risk by buying lower-quality bonds. “I keep looking for an escape valve from this trend,” he says.

This all adds up to a critical point of change for insurers, one that could potentially challenge current business structures and stress existing resources. We see its impact across three critical areas: regulatory compliance, investment selection, and portfolio management.

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Regulatory compliance

Since ratified by the European Union in March 2014, Solvency II has been on the minds of Europe's insurers as Dodd-Frank has been on the minds of U.S. insurers for five years preceding our survey. But mere months before implementation of Europe's new regulations, two-thirds of respondents admit they are not fully prepared for the changing regulations.

European firms face Solvency II implementation effective January 1, 2016, with its pillars that represent "a comprehensive programme of regulatory requirements for insurers, covering authorisation, corporate governance, supervisory reporting, public disclosure and risk assessment and management, as well as solvency and reserving."³

“Mere months before implementation of Europe's new regulations, two-thirds of respondents admit they are not fully prepared for the changing regulations.

The U.S. insurers face the Dodd-Frank regulatory legislation being implemented piece by piece. As of midyear 2015, 271 rulemaking deadlines have passed.⁴ Of these 271 deadlines, 192 (70.8%) have been met with finalized rules. Additional rules have been proposed that would meet 46 of the rulemaking requirements, representing 17% more. As such, there are still many more Dodd-Frank challenges to go for those insurers, both domestic and international, operating in the U.S.

Preparedness varies by region

Respondents in each of the regions surveyed were asked, "How well-prepared is your organization for the changing regulatory environment?"

- The Nordics expressed the most confidence in their preparation, with 43% of those surveyed saying they were well-prepared; however, that still leaves a sizable majority of respondents in the Nordics stating they were only moderately or not very well-prepared.
- In Germany, 60% were either only moderately prepared or not very well-prepared, and 71% in France fell into those two categories.
- The least prepared were the U.S. and U.K., who both came out at 73% being only moderately or not very well-prepared.

LEVEL OF ORGANIZATIONS' PREPAREDNESS FOR CHANGING REGULATIONS, BY REGION

	U.S.	U.K. and Ireland	France	Germany	Nordics
Very well-prepared	28%	28%	30%	40%	43%
Moderately prepared	55%	58%	53%	45%	45%
Not very well-prepared	18%	15%	18%	15%	13%

³ "What Is Solvency II?" – Lloyd's, Web, 26 Oct. 2015.

⁴ Dodd-Frank Progress Report, 2015 Davis Polk & Wardwell LLP.

A likely reason for this lack of preparedness may be the sheer volume of regulatory changes that have swept Europe and the U.S. in the wake of the global financial crisis. Thousands of pages of rules, regulations and directives were crafted, presenting management teams on both sides of the Atlantic with a bewilderingly complex and costly compliance effort.

“Companies are still struggling to get their arms around a constantly changing and very unpredictable regulatory environment,” says Blain Rethmeier, former senior vice president for public affairs of the American Insurance Association. “In the U.S. in particular, there are still way too many open questions on Dodd-Frank implementation, and if the regulators don’t know, there’s no way for leaders to know. You have to plan for the worst and pray for the best.”

From least prepared to best prepared by region, the fact remains that a majority of experts surveyed are not expressing confidence in their firms’ abilities to manage the many facets of the new regulations.

“Some might get the impression that these issues are confined to the large multinational insurers,” observes Dr. Robert P. Hartwig, head of the Insurance Information Institute (I.I.I.). However, “The rubric of Dodd-Frank in the U.S. and Solvency II in Europe is particularly bewildering to the middle market and smaller insurers.”

Implications for capital requirements, compliance and investment strategy

Sixty-four percent of all respondents agree that capital requirements are among their choice for one of the top three threats facing the insurance industry. France ranks the capital requirements concerns highest at 78%. In the U.K. and Ireland it’s 71%, putting capital requirements at the top of their list, while German insurers put the concern at 56%, and the Nordics come in at the lowest, yet still significant, rate of 51%.

According to our survey respondents, almost seven in ten (69%) of U.S. insurers cite capital requirements as the biggest challenge to their business. “In the U.S. because we’re in a state-based system where capital requirements are at the legal entity level, it’s particularly tricky because we view capital standards from a bottom-up perspective vs. a top-down level,” said J. Stephen Zielezienski, senior vice president and general counsel at the American Insurance Association in Washington. “In the U.S., the capital is there at the legal entity level; in another jurisdiction that views it from a group level, capital may be held at the group level to support the legal entities.” The international insurer capital standard should not be designed to replace local capital standards. “You want a complementary approach that doesn’t add another layer of complexity,” Zielezienski concludes.⁵

“From least prepared to best prepared by region, the fact remains that a majority of experts surveyed are not expressing confidence in their firms’ abilities to manage the many facets of the new regulations.”

⁵ Hofmann, Mark. “U.S. Insurer Groups Wary of International Capital Standards.” Business Insurance. 15 Mar. 2015. Web. 29 Oct. 2015.

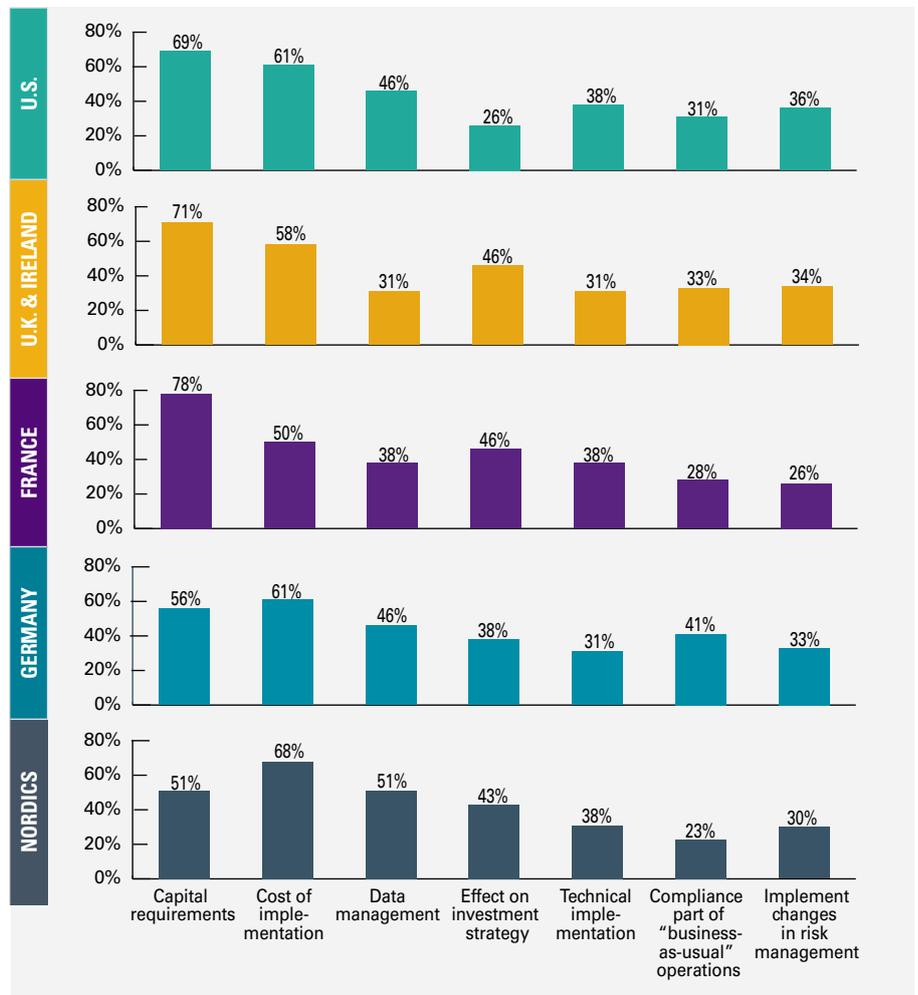
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Similar to the U.S. insurers, capital requirements and implementation costs are the biggest concerns in other countries as well. According to the survey, the Nordics are the only region where insurance firms view implementation costs (68%) as a bigger concern than capital requirements (51%); the same proportion (51%) also deems data management as one of their top three challenges.

Insurers in Germany also view data management as a threat at 46%, while also citing the need to establish compliance as part of “business-as-usual” operations (41%) as a concern.

Seventy-eight percent of the insurers surveyed in France and 71% in the U.K. and Ireland see capital requirements as their greatest concern, while almost four in ten (38%) of U.S. insurers view the need to make changes to their IT systems as a big threat to meeting regulatory deadlines.

BIGGEST CHALLENGES IN MEETING REGULATORY DEADLINES



This chart reflects % of insurers ranking each risk as one of the top three facing the industry.

Regulation and the bottom line

Outside of the companies, some industry analysts raise questions as to how insurers will maintain or increase profitability under the new regulatory rubrics. Share prices across the sector are vulnerable, says Gordon Aitken, analyst at RBC Capital Markets. “We see risk skewed to the downside from Solvency II,” he says. “Even in the best-case scenario of a benign result, we do not expect share prices to react positively.”⁶

“People in the industry want certainty. There is so much uncertainty and open questions in the regulatory environment that small- and mid-market companies are skeptical to offer innovative products,” according to Rethmeier. He adds, “They are risk-averse when it comes to putting forward an innovative product that might get flagged by the regulators.”

Hints at even more regulations

In a speech in September 2015, Daniel Tarullo, a member of the Board of Governors of the Federal Reserve System, indicated that the U.S. central bank is planning to raise the capital requirements for some large insurance firms. Tarullo described the current rules as failing to reflect all the risks that insurers could pose to the financial system, but provided few details of the specific changes he would propose.⁷

“The Federal camel has his nose under the tent, so to speak,” said Hartwig of the I.I.I. “The ultimate regulator for the large insurers, those considered systemically important, is the Federal Reserve. As such, many of the large insurers are concerned that they are going to be regulated like banks. Insurers fight this on the basis that while you can have a run on a bank, where everyone is demanding their money at once, you can’t have a run on an insurance company because insurance pays when a covered event occurs. The triggers can’t be pulled without a man-made or natural event.”

The 2010 Dodd-Frank law gave the Fed the authority to regulate some of the nation’s largest insurance companies, and the bank has been drafting new rules for the insurers it regulates. The insurance industry has been anticipating federal rules similar to the ones already in effect at the state level, but Tarullo suggests that the Fed’s new rules will be more stringent.

Tarullo also said that if an insurance company does not have an adequate level of capital and becomes distressed, its problems could spread to other parts of the financial system. According to Tarullo, current capital regulation does not seem to make relevant distinctions between traditional insurance operations, such as property/casualty, and activities such as derivatives, which have much greater implications for the financial system.⁷

“Outside of the companies, some industry analysts raise questions as to how insurers will maintain or increase profitability under the new regulatory rubrics.”

⁶ Gray, Alistair. “Crunch Time for Insurers on Capital Rules.” *Financial Times*, 31 Aug. 2015, Companies sec. Web. 26 Oct. 2015.

⁷ Tarullo, Governor Daniel K. FRB. *Capital Regulation Across Financial Intermediaries*. September 28, 2015. Board of Governors of the Federal Reserve System, 28 Sept. 2015. Web. 27 Oct. 2015.

Low rates, low returns lead insurers to consider alternatives

Regulatory changes may present significant operational and business challenges for insurers but implementation of new capital requirements also come at a time when market pressures are forcing insurers to reconsider investment selections.

“ We see two distinct areas where they plan to increase allocations: alternative investments and equities.

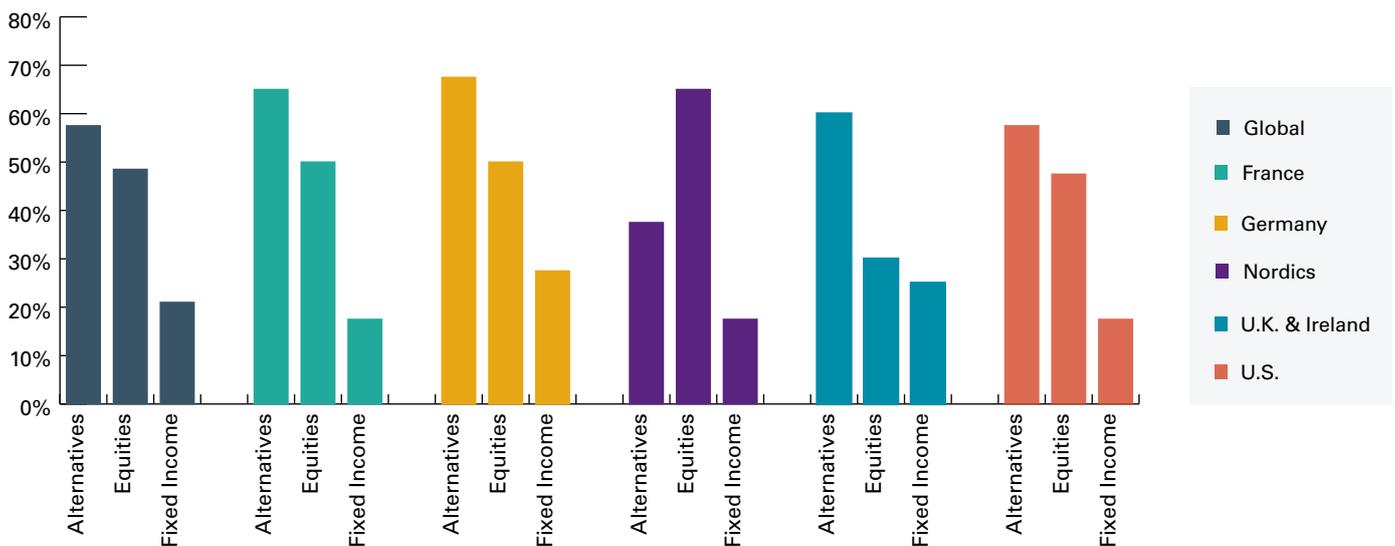
On one side of the equation are historically low interest rates, on the other are equity markets that have been volatile and unpredictable in recent years. Sentiment among the insurers we spoke with lands directly in the middle of these two forces. We see that 60% of respondents say increasing yield is their top priority in investment selection yet 68% also say they are conflicted between generating alpha and protecting assets.

As a result we see two distinct areas where they plan to increase allocations: alternative investments and equities.

Low rates driving insurers to seek alternative sources of yield

Nearly six in ten (57%) of respondents say they plan to increase allocations to alternatives in the next 12 months. But as in most instances, the term “alternative investments” encompasses a wide array of strategies and asset classes for insurers. Respondents listed twelve different classes that fit the bill ranging from the broad term “alternatives” to specific investments in private equity, hedge funds, and multi-asset strategies.

TOP ASSET CLASSES ANTICIPATED TO INCREASE IN THE NEXT 12 MONTHS





Commodity trading involves substantial risk of loss.

Natixis’s Druais sees this focus on alternative investments as a clear response to the market realities facing insurers. “It’s not just the reform,” he says. “It is the economic context as well. With rates so low, it is redefining the need so there will be a search for solutions.”

Among all the choices, it appears that insurers have the strongest inclinations to increase investments in those areas that can provide an alternative income source. These include many forms of real estate – including those defined broadly as real estate, and specifically as commercial property, REITs – and infrastructure investments.

Those insurers included in our 2015 Global Survey of Institutional Investors corroborate this focus on fixed-income alternatives in their predications for the worst-performing asset classes for the next 12 months. Like the rest of the institutional market we spoke with, they put commodities at the top of the worst performers list, but they believe that emerging market fixed-income (27%), domestic fixed-income (21%), and global fixed-income (17%) are likely to underperform in the year ahead.⁸

Real estate, infrastructure present opportunities globally

At a time when insurers, like most institutional investors, anticipate fixed-income investments to be among the worst performers in the year ahead, these two income-generating asset classes may be providing a timely play for yield replacements across the globe.

Urbanization in developing economies has driven demand for real estate globally. From the development of condominiums in China to construction of high-rise apartments in Nairobi, insurers may be finding a wealth of investment opportunity across the globe to suit their income needs.

⁸ Natixis Global Asset Management, Global Survey of Institutional Investors conducted by CoreData Research, October 2015. Survey included 660 institutional investors in 29 countries, 100 of whom are insurers.

Similarly, demographic forces may be making infrastructure an attractive income alternative. Investors in this area may find that growing demand for new construction in developing countries and the critical need to replace outdated facilities in the developed world mean that those seeking to enhance long-term income through infrastructure allocations are likely to find a diverse range of projects in which they can invest.

“As much as insurers are looking to alternative investments to enhance yield, they are still considering increased equity allocations to enhance overall portfolio performance.

Back to the roots

In some ways, the market pressures, along with the regulatory tightening, are forcing insurers back to their roots. Insurers were originally viewed as some of the biggest investors in everything from railroads to housing projects and office buildings. The insurers got out of those areas to a great extent in the 1990s.

“Met Life, for example, owned large apartment complexes in New York City that they helped build after World War II, though they’ve since sold off those assets,” says Hartwig. “The general thinking among institutional investors, not isolated to insurances, is that these were investments that were illiquid. Consequently, many institutional investors turned to products like real estate investment trusts rather than the actual assets themselves.”

Outliers in the Nordic region

While the quest for yield may be driving an increased appetite for yield among the majority of regions we studied, we do find one outlier in the Nordics. This region presents the smallest percentage of insurers calling for an increase to alternatives (37%) and the highest for equities (65%), so it would appear that the objective in increasing alternatives may be more about enhancing overall portfolio diversification with 15% planning to put more into multi-asset strategies in the next 12 months, substantially higher than other alternative investments identified among this cohort.

“Like all investors, insurers are coming to grips with the reality of low interest rates and constrained equity returns,” says David Lafferty, chief market strategist at Natixis Global Asset Management. “Starting yields are low and equity valuations globally are OK but not great. In this environment, alternatives have become an attractive option as insurers look to enhance risk-adjusted returns.”

Equities maintain their luster with insurers

Low interest rates are just one half of the investment equation for the insurers. And as much as insurers are looking to alternative investments to enhance yield, they are still considering increased equity allocations to enhance overall portfolio performance.

Large numbers (48%) also say they plan to increase allocations to equities in order to generate much needed returns. While many pundits have pointed to an economic slowdown in China and others say the recent bull market has run its course, insurers see stocks as likely to be the best performing asset class in 2016.

The insurers interviewed separately for our 2015 institutional survey call for equities to be the top performing asset class of the year ahead. Their enthusiasm for stocks appears to be unbounded by geography with Global Equities (41%), U.S. Equities (27%) and, albeit another alternative strategy, Private Equity (27%) as their predictions for next year's top performers.⁹

OUTLOOK ON THE BEST AND WORST PERFORMERS FOR 2016

Insurance companies surveyed in our 2015 Global Survey of Institutional Investors see equities as best performers for 2016

Best performers (%)	Worst performers (%)
Global equities – 41	Commodities – 33
U.S. equities – 27	Emerging market fixed income – 27
Private equity – 27	Domestic fixed income – 23

Source: Natixis Global Asset Management, Global Survey of Institutional Investors conducted by CoreData Research, October 2015. Survey included 660 institutional investors in 29 countries, 100 of whom are insurers.

Facing the challenge

Insurers, like most institutional investors, are faced with a wide range of investment pressures in today's complex markets. They need to strike a delicate balance between return generation and asset protection. They must be positioned to respond to short-term market movements while also staying on target to fulfill long-term liabilities. And they must be watching the horizon for new sources of alpha as correlations continue to rise and markets become increasingly efficient. Under the specter of increased regulation, they may be feeling the pressure with greater intensity. To satisfy investors and achieve profitability goals, insurers have more levers to pull including outsourcing and, more broadly, diversifying portfolios.

Insurance, after all, was created as a means of spreading risk. Diversification is in the DNA of the business. For the global players and especially the reinsurers, spreading risk and spreading the organizations' asset, liability and investment portfolios have a long tradition in helping to survive big hits, such as the losses of Hurricane Katrina in 2005, with insured losses of US\$41.1 billion.¹⁰ Therefore, diversity in the investment portfolio is now well anchored in the mindset of most insurers.

⁹ Natixis Global Asset Management, Global Survey of Institutional Investors conducted by CoreData Research, October 2015. Survey included 660 institutional investors in 29 countries, 100 of whom are insurers.

¹⁰ Hurricane Katrina Fact File. Insurance Information Institute, 1 Mar. 2010. Web. 12 Nov. 2015.

Managing the portfolio

Managing investments in this period of flux demands a high level of specialization. While traditionally insurers have looked internally for expertise, risk and investment management, they are beginning to look externally for capabilities that complement their own.

Uncertainty challenges confidence

When asked how confident the respondents are that their portfolio is working properly to manage both liabilities and investment risk, almost a third, 29%, indicated a lack of confidence. Looking at critical controls on portfolios, a higher number, 42%, are not confident that they are using risk budgeting appropriately, and 33% find that their organization does not fully understand the risk-budgeting process.

“ Only 51% of respondents globally believe they have all the information needed on the assets side as well as they do on the liabilities side.

Similarly, only 51% of respondents globally believe they have all the information needed on the assets side as well as they do on the liabilities side. France rates this level of confidence at 60%. In the U.S. and U.K. and Ireland, the figure is slightly lower at 56% and 53%, respectively. The Nordics track the lowest level of confidence in this regard at just 41%.

Diversification harder to come by

When it comes to diversification, a central component to minimizing downside exposures, nearly two-thirds (62%) of those we surveyed say: “It is increasingly a challenge to appropriately diversify our portfolio within our risk budget.” Further, 39% are not confident in the overall risk management process.

It also appears that while spending on risk management has increased 23% over the past five years, the insurers are not getting the bang for their buck in terms of keeping that spending in-house since 92% recognize the need for increased complexity in their portfolios to meet investment objectives.

Regulations put extra pressure on smaller players

“Many firms outside the top tier,” says I.I.I.’s Hartwig, “don’t have the resources within their own organizations to fully understand the new regulatory regimes, which clearly has implications for how they manage their investment portfolios. It is a daunting task to try to maximize profitability while facing increased costs of capital and new, tighter restrictions on how the firms are permitted to invest capital.” Rethmeier agrees: “Many of the small- to middle-market insurers are facing the regulatory hurdles without the internal expertise.”

“These insurers also need investment products that don’t leave any questions as it relates to the regulatory environments; products they can engage in that are not going to raise a red flag for regulators on either side of the Atlantic,” says Rethmeier.

To outsource or not?

The move into new asset classes and investment structures comes at a time when insurers must also grapple with the costs and practicalities of complying with new regulations, presenting insurers with a key question: “Should we take on the added costs of adding depth to in-house investment capabilities, or should our investment teams focus on strengthening compliance capabilities and building out the technology needed to ensure they can meet new regulatory standards?”

More than four in ten of our respondents say they are looking to outsource at least some, if not all, of their investment activities. While more than half (53%) believe that their internal teams are strong on traditional asset classes and strategies, they also believe the same teams have less strength in implementing more specialized and sophisticated solutions. This is likely why 45% of those surveyed have seen increasing interest from consultants.

Sixty-five percent are finding they will need to look for greater specialization as they look to live up to new regulatory standards. Not surprisingly, those firms that would outsource for specialist resources believe that an external manager’s compliance and reporting capabilities in accordance with Solvency II and/or Dodd-Frank are critical in the manager-selection process. Overall, 52% agreed with that statement in the survey, while in Germany the rank was highest at 61%.

Based on these results, internal investment, dependence on internal teams and a desire to develop expertise in-house appear to have resolved little in terms of reducing costs.

Where specialization comes into play

According to our research, 66% of firms will be looking toward capital-market innovations like insurance-linked securities and traded derivatives on insurance indexes as solutions to their needs.

Sixty-four percent of the respondents also rank such resourceful methodologies somewhat important, important or critical for the industry over the next five years.

Similarly, other capital-markets solutions (e.g., trading in futures, swaps and other derivative securities) are likely to be part of a broad mix of strategies. Thirty percent of firms are exploring the solutions, with 38% saying they plan on doing a few such transactions, and as many as 28% planning to make them a regular part of their business.

“I think there will be increasing demand for structured products with low volatility,” says Natixis’ Druais. “Structured investment targeted against the likes of inflation could well be popular.”

INSURERS LOOKING TO OUTSOURCE SOME OR ALL INVESTMENT ACTIVITIES

Country/Region	Agree
U.S.	33%
U.K. and Ireland	46%
France	48%
Germany	48%
Nordics	36%

NEW REGULATION HAS INCREASED THE NEED FOR EXTERNAL SPECIALIZED INVESTMENT MANAGERS

Country/Region	Agree
U.S.	63%
U.K. and Ireland	71%
France	66%
Germany	61%
Nordics	68%

Implications and considerations

Being an industry founded upon and dependent upon data, facts, precise contract language and long-range risk management, the complexity of changes facing insurers leaves only one choice: stay ahead of the curve or fail.

It is a complex and volatile economic environment we live in. Climate change and terrorism present tremendous uncertainty to the actuaries and underwriters. Regulation must reflect new risks and protect against another potential financial meltdown. There will be more regulatory changes in all regions, and insurers must be prepared to adapt. Each factor presents significant implications for individual insurers and the industry at large.

Managing risk across the business

The insurers have to adapt their asset allocations not only to protect against downside risk, but also to find opportunities in underutilized asset classes that offer a safer haven or new uses of capital market strategies to grow the asset performance and enhance overall sustainable profitability.

“ There will be more regulatory changes in all regions, and insurers must be prepared to adapt.

However, they also face challenges in managing their entire portfolio, particularly with emphasis on risk management. One-third (32%) of respondents put two issues in their list of insurers' three biggest concerns: 1) implementing changes in risk management and 2) managing the extra costs associated with establishing compliance as part of business-as-usual operations.

Other cost drivers are also a concern. One area requiring additional costs will be cyber-risk and control of one's information. Data management ranked high among the concerns of 42% of those surveyed. Meanwhile, 40% rated the effect on investment strategy among the top three issues, and technical implementation was on the list of 35% of the respondents.

Cyber-risk is a particular concern for insurers as they hold significant personal, business and financial information belonging to a diverse base of clients. A big data breach could hold not only financial risk, but reputational risk for insurers, and as a result, money is being spent across the industry to enhance information technology firewalls. Protecting client data is critical to risk management – not only in property and casualty insurers. In medical and life insurance, it becomes particularly sensitive not just to businesses but to individuals as well.

In our research, 70% of respondents agree that cybersecurity should be part of an Enterprise Risk Management (ERM) program. Cyber-attacks and data breaches raise the possibility of exposures to both first- and third-party liability.

Yet more than one-third of respondents believe their organization is not well-prepared for a cyber-attack. Getting it right is not only critical from a security standpoint, but 65% of the insurers surveyed believe cyber-insurance represents a potential growth area for their business.

Costs could impact profitability

These challenges present potential costs to the insurers that are significant enough to negatively impact profitability, if not managed well. Whether it's the impact of Solvency II in Europe or Dodd-Frank in the U.S., the regulatory changes, alone, could not have come at a more inopportune moment.

European insurers' capital ratios declined in 2014 on the back of low interest rates, a pressure expected to continue through 2015 and into 2016. Economic capital ratios have been under further pressure in 2015, while fresh chopiness in markets limits the ability to retain investment earnings and offset the full extent of this issue.

Is acquiring or being acquired the solution?

There are just a handful of ways to deal with costs: reduce spending, reduce services, sell out or merge.

In fact, there is a great deal of M&A activity going on today across all segments of the insurance world. This reflects the concern with a decline in earnings per share and in top-line premium growth, as well as the need to realize economies of scale in terms of the business and spending structures.

"To consolidate or not to consolidate, to acquire or not to acquire, that is the question that every management team is asking," notes Hartwig. "Generally that would imply that there are some efficiencies that are going to occur. That implies there would be a merging of investment portfolios."

Beyond taking the bold step toward a merger or acquisition, a major concern today is what looks like a moribund growth environment in the more mature markets. That includes the U.S., the U.K., Ireland and continental Europe.

Insurers must enhance both internal and external expertise

How to manage these challenges: In our survey, a top-three ranking of anticipated changes shows insurers wanting to strengthen their internal investment teams and increase specialist capabilities at 66%. Also, the need to adopt more sophisticated risk modeling and management strategies is at 64%; yet these same respondents rank cost reductions at 43% as one of the top ways they must change in this environment.

“ To consolidate or not to consolidate, to acquire or not to acquire, that is the question that every management team is asking,” notes Hartwig.

HOW ORGANIZATIONS NEED TO CHANGE IN ORDER TO ACHIEVE INVESTMENT RETURN TARGETS

	Global	U.S.	U.K. and Ireland	France	Germany	Nordics
Strengthen internal investment team and increase specialist capabilities	66%	65%	61%	58%	71%	79%
Adopt more sophisticated risk modeling and management strategies	64%	73%	76%	48%	66%	56%
Increase investment in technology	50%	46%	43%	61%	53%	46%
Reduce costs	43%	43%	54%	41%	44%	39%
Increase investment in human capital	41%	41%	40%	51%	35%	36%
Increase use of external investment managers	39%	35%	30%	46%	36%	51%

This chart reflects % of insurers ranking each item as a top way to change to achieve their investment return target.

“73% admit that it has become increasingly challenging to generate alpha while meeting regulatory requirements.

This conflict in cost reduction versus the demands to compete in the new environment continues as 50% of respondents recognize increased investment in technology among their top three concerns. Similarly, 41% chose increasing investment in human capital as one of their top three choices.

These findings raise a question as to whether firms see using external investment managers who provide specialized solutions to use assets more efficiently as an alternative to putting all of their efforts into their internal team. Further, it raises questions about the costs of investments in technology and other improvements versus cost reduction.

Pool Re's Coulman, when asked whether he thinks more groups will look to outsource to try and meet the technical, more challenging solutions, agreed that "certainly in specialized areas," he definitely sees the need. "We operate a fully outsourced model, so all our asset management is outsourced. But as to whether a team is in-house managing assets," added Coulman, "I think the specialized areas will certainly be alternative risk."

In the Nordics, more than 50% of those surveyed consider the external-resources option among their top three choices, while in the U.K. and Ireland, only 30% are thinking external. Across the board, the average is 39%. Looking deeper into the data, however, insurers' responses begin to indicate an understanding that specialization, whether internal or external, is likely required to achieve alpha.

Twenty-three percent would choose outsourcing investments, reflecting the fact that, of this same sample, 73% admit that it has become increasingly challenging to generate alpha while meeting regulatory requirements. However, regardless of the challenges of increased regulation, and the need to protect assets, as noted by 68% of respondents, alpha is still the target for 74% of the sample.

Improved underwriting and appropriate rates, fundamental keys to profitability

According to Hartwig, "Insurers have to cut costs by improving their underwriting performance and improving expense management. Some are looking particularly at increasing rates, which they did over a span of time. Commercial insurance rates are currently relatively flat, but they are still rising in personal lines. Both should lead to improved underwriting performance."

Rates alone cannot be the answer to improving the balance between expenses and returns. Further improvement is needed in underwriting performance. Wishing and hoping for higher rates is something that is not going to improve profitability at a speed necessary to ensure that companies are going to hit their earnings targets.

Through the first half of 2015, overall market conditions remained comparable with 2014, demonstrating ongoing competition, low interest rates and limited weather-related events. With persistently low interest rates providing just marginal investment returns, underwriting performance remains the leading driver of operating performance. Total investment income from both traditional and higher-yielding asset classes is needed to provide additional support to income and surplus.¹¹

“ Rates alone cannot be the answer to improving the balance between expenses and returns.

11 A.M. Best Special Report: U.S. Surplus Lines Profit From Underwriting Discipline and Core Competencies. Business Wire. September 2, 2015.

THE CHALLENGE OF GENERATING ALPHA

		U.S.	U.K. and Ireland	France	Germany	Nordics
It has become increasingly challenging to generate alpha while meeting regulatory requirements	Agree	68%	75%	78%	65%	76%
Generating alpha has become an increasing priority for my organization in this low yield environment	Agree	71%	70%	81%	70%	76%
There has been an increasing conflict between the need to generate alpha and the need to protect assets	Agree	66%	75%	75%	56%	70%
We need solutions that allow us to generate more alpha without increasing our risk budget	Agree	66%	76%	80%	60%	81%

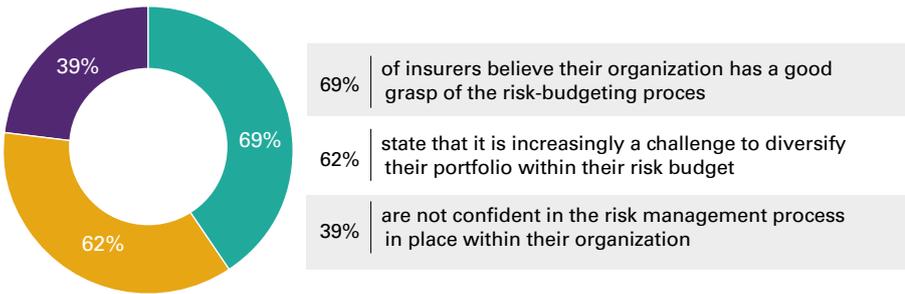
The insurance industry must adapt a variety of solutions; the global economy depends upon it

In many ways, insurance industry growth today is tied to the growth rate of the overall economy. Success in a cost-conscious and complex environment must include seeking the best returns possible, while regulators look on with a critical eye as to how far insurers go in seeking alpha in their returns. The bottom line when it comes to asset management for insurers across the U.S. and Europe is that they need pragmatic solutions that are resourceful without being overly costly or violating the regulatory frameworks coming into play.

Extracting existing risk-management knowledge from within an insurance company's own data is one such approach. According to a report by Milliman, one possible solution is to use knowledge from business experts to build up a complete picture of each risk, and then build a causal model to derive correlations between them. This approach allows information already within the business to be extracted and provides a multitude of options for sensitivity analysis and stress testing.¹²

¹² A casual approach to risk-based capital requirements, Cantle, Neil, August 12, 2015.

DEALING WITH RISK MANAGEMENT



Solutions, such as capital market innovations and insurance-linked securities, require expertise found both inside and outside of companies' existing risk management teams. Yet investment risk, according to the Natixis 2015 survey, is managed almost entirely in-house (98%). Sixty-nine percent of the insurers also believe they have a good grasp of the risk-budgeting process; however, 62% state that it is increasingly hard to diversify portfolios with their risk budget, and 39% are not confident in the risk-budget process put in place within their organization.

As the data from our new survey clearly shows and the commentary from many experts reflects, the multiple challenges present an inflection point for the success, sustainability and profitability of the entire insurance industry globally. The 200 survey respondents, as well as the input from highly experienced and credible experts, all lead to the conclusion that while the breadth of challenges facing the insurance industry is daunting, for creative and innovative firms there is opportunity.

By finding the right combination of efficient risk management and investment options including both alternative and traditional asset classes, the era of Dodd-Frank and Solvency II can be one where companies can generate strong returns while reducing the costs of risk management.

PROGRAM OVERVIEW

About the Durable Portfolio Construction Research Center

Investing can be complicated: Event risk is greater and more frequent. Volatility is persistent despite market gains. And investment products are more complex. These factors and others weigh on the psyche of investors and shape their attitudes and perceptions, which ultimately influence their investment decisions. Through the Durable Portfolio Construction Research Center, Natixis Global Asset Management conducts research with investors around the globe to gain an understanding of their feelings about risk, their attitudes toward the markets, and their perceptions of investing.

Research agenda

Our annual research program offers insights into the perceptions and motivations of individuals, institutions and financial advisors around the globe and looks at financial, economic and public policy factors that shape retirement globally with:

- **Global Survey of Individual Investors**
Reaches out to 7,000 investors in 17 countries.
- **Global Survey of Financial Advisors**
Reaches out to 2,400 advisors, consultants and decision-makers in 14 countries.
- **Global Survey of Institutional Investors**
Reaches out to more than 600 investors, consultants and decision-makers in 29 countries.
- **Natixis Global Retirement Index**
Provides insight into the environment for retirees in 150 countries based on 20 economic, regulatory and health factors.

The end result is a comprehensive look into the minds of investors – and the challenges they face as they pursue long-term investment goals.

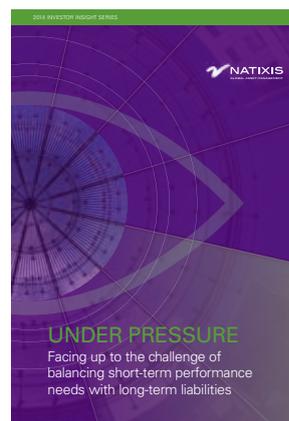
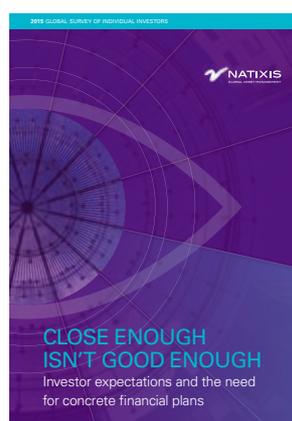
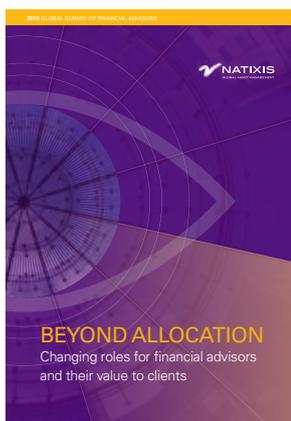
About the surveys referenced in this paper

2015 Global Survey of Institutional Investors – Natixis Global Asset Management commissioned CoreData Research to conduct a global study of institutional investors, with the aim of gaining insight as to how they are managing investments and meeting various challenges in today's world.

Interviews were conducted in October 2015. Globally, the study involved 660 decision-makers working in institutional investment in 29 countries.

Helping to build more durable portfolios

Natixis Global Asset Management is committed to helping advisors build better portfolios that stand up to the challenges of modern markets. To learn more about our **Durable Portfolio Construction®** philosophy, visit durableportfolios.com.





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