A benchmarking approach to optimal asset allocation for insurers and pension funds

Andrew Lim
Department of Industrial Engineering and Operations Research, University of California, Berkeley.

Bernard Wong1
School of Actuarial Studies, University of New South Wales, Australia.

Abstract: We solve the optimal asset allocation problem for an insurer or pension fund by using a benchmarking approach. Under this approach the objective is an increasing function of the relative performance of the asset portfolio compared to a benchmark. The benchmark can be, for example, a function of an insurer's liability payments, or the (either contractual or target) payments of a pension fund. The benchmarking approach tolerates but progressively penalizes shortfalls, while at the same time progressively rewards out-performance. Working in a general, possibly non-Markovian setting, a solution to the optimization problem is presented, providing insights as to the impact of benchmarking on the resulting optimal portfolio. We further illustrate the results with a detailed example involving the an option based benchmark of particular interest to insurers and pension funds, and present closed form solutions.

Keywords: Asset-Liability Management, Portfolio Optimization, Benchmarking.
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Main References

1Presenting Author. Email: bernard.wong@unsw.edu.au