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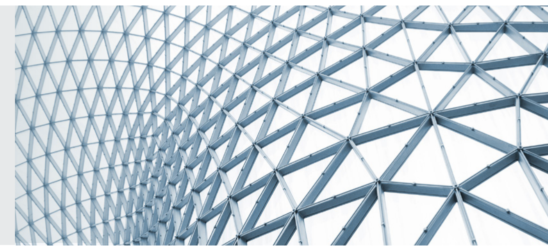

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Finding yield: how insurers are employing new approaches

Insurers swapping out bond portfolios for higher-yielding credit instruments found deep in the capital structure

Key Takeaways:

- Insurers' needs are not always easy to articulate, which is why many are turning to asset managers with deep knowledge and experience of both their industry and yield-seeking assets.
- There is no shortage of solutions to the yield challenge in credit markets. It's just a question of how to access them and how insurers can evaluate the risks.
- The major change in recent years is within fixed income. There has been wide-scale adoption of BBB bonds, emerging market debt, securitisations and private assets. Depth and breadth of credit research will be crucial to capturing yields in these instruments.

The search for yield is intensifying. US insurer book yields for life insurance companies have plummeted from 7% to 4.5% in the last 15 years, while property & casualty yields have fallen from 6% to just over 3%.

In the life insurance market, competition for yield has been exacerbated by the growing presence of private equity dollars flowing into the industry displacing traditional life insurers with long-tenure in the industry. The trend, while most prevalent in North America, has been growing in northern Europe as well.

Traditional public core bond allocations are no longer the answer to meet the yield hurdles required for private capital.

Insurers are leaving no stone unturned in their mission to uncover new sources of yield. The risk is that some insurers follow paths which lead to considerable investment and regulatory risk.

Let's be clear: there is no shortage of opportunities and solutions to the yield challenge in credit markets. It's just a question of how to access them and how insurers can comprehensively evaluate the risks.

Colin T. Dowdall, CFA
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Estelle Castres
Head of Global Key Insurance Clients (KIC)
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Changing profile of corporate bond portfolios

There has been a tangible shift in allocations to asset buckets in the past 15 years, as insurers have pulled back from high allocations to public fixed income while adding progressively to their alternatives buckets.

One of the big changes is also within buckets and, in particular, within the fixed income bucket.

Despite falling yields, insurers are maintaining allocations to fixed income for a variety of reasons, including asset

liability management (ALM), regulatory constraints and capital preservation.

But how they are allocating is changing. In corporate bonds, there has been wide-scale adoption of BBB bonds, with issuance rising to match the considerable demand. BBB bonds now make up around 35% of insurers' bond portfolios.

"There is huge growth in this segment of the market," says Colin Dowdall, Director of Insurance Solutions at Loomis, Sayles & Company, an affiliate of Natixis Investment Managers. "The key going forward is to recognise that the challenges to the BBB market will not be behind us even when the pandemic has eased. Depth and breadth of credit research will be crucial to maintaining yields in the BBB space."

Another big move within the corporate bond space is to emerging market debt. EMD has historically offered a premium to comparably rated US corporate bonds and that premium – if securities are properly selected – is still available despite the huge growth in and sophistication of emerging market economies.

Shift towards securitisation

Then there is the securitisation market, to which US insurers have increased allocations in recent years, swapping out corporate debt for securitised loans in order to eke out higher yields.

Securitised debt instruments are financial securities created by securitizing individual loans. By securitising loans into tranches, different levels of risk can be created, allowing insurers to invest at the risk and return level they need. It also allows them to diversify away from traditional corporate exposures into areas such as consumer credit and real estate.

Securitised loans are a complex and fragmented market and barriers to investor participation are high, so securitized spreads are wider than for comparably rated corporate securities. That's a key benefit to investors. However, given that securitized credit is a structurally leveraged bet on underlying fundamentals, investors must also have the capabilities to assess the prevailing macro-economic environment to mitigate downgrade risk.

Optimal securitisation allocations require analytical sophistication and experience, and investors should have scale and relationships with issuers, the sell-side, advisors, and others to originate, analyse and monitor investments. It is important to note that European insurers are largely prohibited from investing in this pocket of the market due to unfavourable Solvency II capital treatment.

Don't dismiss munis just yet

Whereas securitised opportunities can access excess spread to hedge shorter liabilities, municipal bonds are sought for longer-term exposures. US insurers in particular are still strong buyers of munis despite recent stress among pockets of the market as US states with high pension obligations and weak revenues from COVID-19 lockdowns come under fiscal pressure.

However, defaults are still historically low, both in absolute terms and compared to similarly rated corporate bonds. Munis also have a higher historical recovery rate compared with corporate debt. So while municipal bond defaults may rise, they compare favourably to corporate bond defaults.

Nevertheless, municipal investors should focus on credit selection, seeking issuers with a wide stream of revenue sources and strong balance sheets. Relatively low default rates should not lull market participants into complacency given that major sectors of the US state and local markets are facing extreme fiscal challenges.

In short, it pays to do your homework when investing in munis. "Let's just say that a BBB-rated muni is not at all the same beast as a BBB corporate bond," notes Dowdall.

Insurers no longer wary of alternatives

Whereas, once, the insurance community was a reluctant investor in alternatives, this is changing fast. "The move from public to private assets is accelerating and the private debt market in particular has grown by leaps and bounds since the great financial crisis," says Estelle Castres, Head of Global Key Insurance Clients.

Once the preserve of smaller companies, private debt is now issued by the largest corporates in most geographic locations of the world. Large issuers are increasingly attracted to the private placement market because it allows them to diversify their capital structure, and reduces their obligation for public disclosure. In addition, investors in private debt, such as insurers, are more willing than banks to offer very long maturities.

Premiums on private debt are 30bp or higher for a similar risk profile to corporate bonds. However, investors should pay close attention to issuers, and how they define their financials, and to the covenants agreed by both parties.

Combining credit expertise with knowledge of insurance market

While opportunities in credit are plentiful, expertise in deep value credit is in less plentiful supply.

"At Loomis Sayles, aside from portfolio managers and analysts, we have over 55 corporate analysts on our credit research team, and they assess issuers across the capital structure" says Dowdall. "That's rare for an investment house and means we can build better networks and make investments deeper into the capital structure in credit markets."

Worldwide capabilities are important for credit research and portfolio management across jurisdictions, and also for assessing insurers' needs. "We have resources who can sit down with insurance companies in the US, Europe and Asia," says Dowdall.

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Local knowledge of jurisdictions allows for broader asset allocation work and better assessment of regulatory considerations. Capital charges on types of debt instruments vary by jurisdiction and investing is high-charge assets can be expensive.

Dowdall adds: "You have to be close to clients in their own jurisdiction to know what they need and how to bring our depth of research and resources to get the right solution.

The right solution might be tailor-made, or fund-based, or a mix of different credit types and geographical exposures. Or all of these. "Frequently today, it involves ESG integration and, for most advanced insurers, an allocation to impact investing," adds Castres.

Conclusion: find the strategies which suit your needs

Having a range of differentiated fixed income strategies is becoming more important to insurers. It is a natural reaction to uncertainty, volatility and persistent low yields.

Insurers must be confident that each strategy has a clear and consistent investment philosophy and matches a business need. Insurers' needs are complex and not always easy to describe, which is why many are turning to asset managers with deep knowledge and experience of both their industry and the yield-seeking assets they require.

Written in March 2021

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