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CLEAR PATH ANALYSIS

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Managing the asset allocation mix, developing investment strategies for tomorrow

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[1] Cerulli Quantitative Update: Global Markets 2020 ranked Natixis Investment Managers as the 17th largest asset manager in the world based on assets under management as of December 31, 2019.

NATIXIS
INVESTMENT MANAGERS

2.2 INTERVIEW

The new core fixed income – an expanding set of investment opportunities

Interviewer

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Interviewees

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SUMMARY

- *The ongoing search for yield is leading investors to think outside the box and look at alternative income sources*
- *"New Core Fixed Income", including private corporate, real estate debt & infrastructure debt help address these needs*
- *These assets typically have similar criteria to traditional debt and defensive qualities*
- *From a regulatory perspective, these assets can be interesting in terms of Solvency II treatment*

Noel Hillmann: Tell us about the "new core fixed income." What is it?

Ouaile El Fetouhi: When we talk about new core fixed income, we quite often refer to a growing and expanding mix of private debt investments, and it generally includes the following three asset classes: senior secured private corporate debt, senior secured commercial real estate debt, and senior secured infrastructure loan. Several of these investments have generally low loan to values (LTVs), are quite defensive in nature as they benefit from strong and customised terms and are associated with high recoveries.

It is these defensive characteristics that has more insurers thinking about these investments as part of their core allocation, and hence the name the "new core fixed income".

Esty Dwek: We have seen that the search for yield is not over. Investors, especially on the institutional and insurance side, are starting to look outside the box for yield, and they are increasingly turning to alternatives and even illiquid alternatives. It is led by client requests and investors who need this yield and income, given the very low starting points that we are at in developed market bonds and expansion of fixed income needs.

CORE (FI CURRENT ANALYTICS)	NEW CORE (ALT CURRENT ANALYTICS)	ALTERNATIVE (ALTANALYTICS)
• Sovereign • Aggregate • Corpo IG • Munis • HY (satellite) • EMD (satellite)	• **Bank Loans** • **Senior secured private debt** • **CRE loans senior secured (low LTV)** • **Infra loans senior secured (low LTV)**	• Mezz & sub corpo debt • Aircraft loans • CRE loans & infra loan MEZZ or high LTV type

> THE SITUATION HAS WORSENED OVER THE PAST YEAR BY WHAT WE HAVE SEEN THROUGHOUT THE COVID CRISIS AND CENTRAL BANKS ACTIONS TO CUT THEIR BENCHMARK INTEREST RATE

Noel: What challenges does it seek to address?

Ouaile: This low interest rate environment has been a topic that has been on the agenda of insurers for some time and the negative interest rates has been seen as one of the greatest investment risks to their asset allocation. In reality, the situation has worsened over the past year by what we have seen throughout the COVID crisis and central banks actions to cut their benchmark interest rate. This has resulted in yield being even lower today whilst increasing the likelihood of a lower-for-longer scenario.

It is this low interest rate environment, and challenges to the supply dynamics on the buy-side, that has driven the growth of these assets in the past decade.

In an environment where every basis point counts, these new core asset classes offer a great opportunity for investors and insurers to enjoy illiquidity premia. This will increase the return on their balance sheet, all the while offering them new sources for diversification.

Most of these investments are usually based on floating rates, meaning they are going to be less impacted even if we were to see a rise in interest rates.

Olivier Trecco: Regulations can be an additional feature of why this new asset class is attractive. Insurers are keeping an eye on how much these investments will cost in terms of Solvency II. What we are seeing is that Solvency II is very conducive to investments in what we name the new core, unlisted assets, and the less liquid types of investments, because they are very much aligned with the capital charge that you would have on the more classic core type of investments. Because it is fixed income, it can have several preferential treatments such as infrastructure types of investment, or, it could have the unrated collateralised treatment. At the very least, the capital charge for unrated debt instruments remains attractive, just below that of a BBB-rated instrument. All in all, this makes the return adjusted by the cost of regulatory capital more attractive on these asset classes.

Noel: Why should investors consider it and what would investors be giving up by doing so?

Ouaile: From an asset allocation perspective there are several benefits that insurers should consider if they are to allocate to these asset classes. One of the most important factors is these types of assets generally offer a higher yield when compared to traditional fixed income assets with an equivalent rating on the public markets. Clearly, this yield is a reflection of the inherent credit risk associated with those investments, but also with the illiquidity premia that these assets will offer.

If I buy an instrument on the public market, I can liquidate it tomorrow and realise any inherent value. But if I make the choice to invest in of the private assets we're discussing, I need to be compensated for giving up liquidity, which generally offers a premium over public markets.

The second benefit to consider is because of its real diversification benefits these assets tend to offer insurers an opportunity to diversify and explore different sources of risk and returns. For instance, in the corporate sector this will potentially include parts of the market that are not necessarily available in the public market. It can also be different types of exposures, such as commercial real estate, or infrastructure debt, which is often why these assets exhibit a low correlation to traditional asset classes.

In terms of the regulatory capital requirements, some of these investments can potentially offer a return that is more attractive once you adjust for the cost of holding these assets in the balance sheet.

Esty: In a challenged yield environment that is set to continue, investors must think outside the box. If they are thinking long term, the starting point isn't very attractive in fixed income, and so it is a question of being creative to fill the gaps that you have in your traditional public market asset allocation.

Noel: How does this optimise portfolios with respect to Solvency Capital Ratios (SCR) and diversification?

Ouaile: While portfolio construction techniques are tried and tested when it comes to public markets, modelling and optimisation exercises including private markets present a variety of challenges. Clearly, the modelling of these private assets requires access to proprietary data and the use of sophisticated techniques to account for the stale pricing that is sometimes inherent to these asset classes. This is especially important if we want to assess public and private markets with one coherent risk framework.

Despite these challenges, insurers can really benefit from assessing these new core asset classes within an integrated approach alongside the traditional core and fixed income, as opposed to treating them as two separate markets. To do this, a risk premia framework can be very helpful to achieve this objective.

In a similar way that we can decompose the return of a public investment grade bond into various risk factors, we can actually decompose the return of a private debt instrument in a very similar way. It will definitely be exposed to a similar fundamental credit risk i.e. the inherent risk to compensate for the fundamental default risk versus risk free assets, in addition to elements related to carry and term premia, such as longer duration, convexity, etc.

One of the new elements that we have already touched upon is the liquidity premia, which can be related to both the underlying funding risk, as well as to the market liquidity risk, i.e. the ability to liquidate this instrument or the availability of a secondary market.

Within such a framework, an investor should be able to assess both the traditional and new core fixed income on an equal basis, and really quantifying how each risk factor is being compensated. By doing this, the insurer or investor will be able to realise that there are significant benefits to adding these asset classes to the portfolio, as it will be possible to enhance the expected return of without necessarily increasing the risk. This is because we will be benefiting from the diversification benefit of these asset classes, without necessarily increasing the Solvency II capital requirements, as some of these asset classes can have very favourable treatment.

Investors should look at the traditional and new core asset classes within this framework, as this can clearly lead them to increasing the returns on their portfolios, particularly in terms of yield. This is without necessarily increasing the risk at the portfolio level, as they can take advantage of the diversification benefits that these assets bring.

In the example below, we were able using a reasonable turnover of 20% (sell 10% and buy 10%), to increase the expected return of the portfolio by more than 20bp, while keeping the risk and risk-based capital at the same level.

Asset Class	Initial Allocation	Potential Allocation	Delta	LT Expected Return
Equities	17%	16%	-1%	6.0%
Govt Bond	31%	31%	0%	0.3%
IG Bonds	38%	28%	-9%	0.7%
HY Bonds	0%	0%	0%	2.6%
EM Debt	0%	0%	0%	2.6%
Private Equity	1%	1%	0%	2.8%
Real Estate	4%	4%	0%	3.4%
Infrastructure Equity	0%	0%	0%	7.3%
Corporate loans	0.7%	4%	3.3%	5.5%
CRE Debt	0.7%	4%	3.3%	2.3%
Infrasctructure Debt	0.7%	3%	2.8%	2.0%
Cash	7%	7%	0%	-0.1%

	LT Expected Return	Volatility	SCR
Initial Allocation	1.64%	4.8%	11.5%
Potential Allocation	1.87%	4.8%	11.5%

For illustration purposes only. Expected returns can change without notice.

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> WHILST INSURERS ARE VERY FAMILIAR WITH CREDIT AND MARKET RISK, PRIVATE DEBT INVESTMENTS CAN INTRODUCE A NEW SET OF RISKS

This was achieved by reallocating capital mostly from investment grade bonds and to a much lesser extent from equities and increasing the allocation across the spectrum of private debt asset classes (private corporate debt, commercial real estate debt & infrastructure debt).

Noel: Is there a maximum allocation or hidden risks?

Ouaile: There isn't really a maximum allocation per se, but there are two important elements that need to be taken into consideration before allocating to private markets. The first one is the liquidity risk. Insurers need to assess their allocation to private markets in terms of liquidity implication, with reference to their balance sheet levels, i.e., the projected run off the profile of their assets versus their liabilities under stressed conditions. This should provide a guide to what is the maximum allocation that their portfolio can handle.

The second element relates to additional sources of risk that insurers might not be familiar with. Whilst insurers are very familiar with credit and market risk, private debt investments can introduce a new set of risks, such as valuation, pricing, modelling, etc. The implementation of these strategies will require an investment from an insurer's perspective to guarantee that they have the right skill set to perform their assessments. They must also assure the proper risk management process is in place to assess the various risks that will be associated with such investments.

Within this context, outsourcing the investment to a dedicated asset manager can be preferable. Working with a solutions provider who can help the insurer to have a holistic assessment of their asset allocation, across both public and private markets, can help guide them through the journey in allocating into these assets.

Noel: Thank-you for taking the time to share your insights.

* Natixis Investment Managers Solutions is an expertise of Natixis Investment Managers. For more information on Natixis Investment Managers Solutions please visit visit im.natixis.com/en-institutional

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