RISK FACTORS AND TOTAL-RETURN OPTIONS FOR INSURERS

AUTHORS

ERIK TROUTMAN, CFA, FSA, MAAA

VP, Insurance Strategist

COLIN DOWDALL, CFA

VP, Director of Insurance Solutions

YIELDS TRENDED HIGHER IN THE FIRST QUARTER OF 2021.

Investors appear to be focused on the government's pandemic-related stimulus and vaccination programs, and are questioning inflation expectations and the implications for real yields.

Despite this yield environment, we believe insurers continue to face challenging prospects. Rates are still low on a historical basis and negative in many parts of the world/curve.

RESEARCH & PERSPECTIVES

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Insurance Companies

Insurers are large fixed income investors due to the nature of their business objectives and regulatory requirements. While they focus primarily on yield potential and stable investment income, we may be seeing a shift in this trend with some insurers starting to have a total-return viewpoint.

Life insurance companies focus on asset-liability matching (ALM) within their reserve assets. However, for surplus assets not directly backing product-specific liabilities, life insurers have been considering additional sectors for their total return potential, such as high yield (HY), emerging market debt and securitized debt.

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Fixed Income Risk Factors

We believe fixed income risk factors, measures of yield potential, can offer a framework for insurers looking to enhance total return.

INTEREST RATE RISK: SEEKING TO EXPLOIT THE CURVE

Many insurers manage interest-rate risk in their fixed income portfolios with an ALM-focused view, aligning overall duration, partial duration and convexity between assets and liabilities. However, we believe insurers could introduce reinvestment-rate risk into their reserve portfolios by actively positioning fixed income assets longer or shorter than their liabilities.

An upward sloping yield curve implies longer-duration assets can yield more than shorter-duration assets. We believe one advantage of longer-duration yields is that they typically erode more slowly in falling rate environments.

Shorter-duration assets typically allow an insurer to reinvest assets more quickly in a rising rate environment. But there is normally a yield “give up” all else being equal. But, if an insurer can alter the portfolio positioning via sectors or quality, it may help minimize the yield sacrifice.

QUALITY RISK: CREDIT ALLOCATION

Insurers have often looked to add credit risk to enhance yield opportunities. In fact, holdings of lower-quality bonds have steadily increased across the industry during the past low-yield decade.

We believe the best way to think about this risk positioning is in terms of DTS (duration times spread). Looked at separately, spread level and spread duration only tell part of the story (i.e., a short-duration low-quality, high-spread asset can have as much volatility as a longer-duration high-quality, low-spread bond). During the past low-yielding years, insurers have strategically tilted their portfolios to a higher DTS than their liability or benchmark in order to reap higher yields.

In terms of the effectiveness of DTS as a tactical tool, we believe nimbleness is critical. This requires an asset manager that straddles the investment grade (IG) and HY sectors. In our view, the manager should have a base allocation that represents the strategic IG/HY allocation of the insurer and DTS positioning relative to the liability/benchmark. The manager can then actively shift the allocation as the market moves through the credit cycle seeking to take advantage of the opportunities that could arise. We believe this approach can offer a process that takes a more "tactical total-return" approach versus a pure yield focus.

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STRUCTURE/CASH-FLOW RISK: POTENTIAL BENEFIT OF PARSING TRANCHES

Insurers continue to shift some assets from corporate bonds to the securitized sector. Many have already established large allocations to AAA securitized assets, including agency RMBS, CMBS, ABS and CLOs.

The structural risks of securitized assets—multiple tranches with different ratings and cash-flow volatilities—typically translate into higher spreads versus similarly rated corporate debt. (Potential opportunities are typically found in the three- to five-year space.) In our view, the additional structural risk spread is why insurers, looking to allocate to higher-quality assets, have turned to securitized assets.

Notably, insurers have steered away from lower-quality tranches that would require expending resources to gather large loan-level data and implement cash-flow analysis and modeling. For example, amid pandemic market pressures, the US Federal Reserve began supporting not only the US Treasury and agency RMBS markets, but also initiated buying US corporates (IG/HY) debt. It also reinstituted the Term Asset-Backed Securities Loan Facility (TALF) that helped support new issue high-quality securitized assets. However, lower-quality securitized debt was left out of the demand stimulus programs. With limited buyers, securitized assets rated AA and below came under pressure. At the time of this writing, this ignored tier continues to post wider spreads relative to similarly rated corporate bonds.

ILLIQUIDITY RISK: PRIVATE PLACEMENTS

Private placements have been sleepy areas that life insurance companies have invested in for a long time. It is a source of supply beyond what's available in the public credit markets. The typical issuers of private placements are corporations interested in maintaining confidentiality when it comes to their purchases and financials. In the US, professional sports leagues are often issuers in the private debt market. Issuing debt in the private market allows the leagues to raise capital while avoiding reporting their financials to the broader investment community.

Relative to similar public securities with comparable risk, private placement premiums are typically 20 to 30 basis points. There was a period in the middle of the COVID-19 pandemic, around July, when private placement premiums reached 100 basis points relative to comparable public securities. From a risk perspective, the investor needs to know if the premium reflects the correct risk level. We believe it is important to have the internal resources to complete the necessary due diligence.

A key part of private placements is the covenant package attached to the issue. If there are challenges with a particular issuer, you want protection. For example, if there is a problem, certain covenants can help protect a debtholder by paying fairly meaningful fee income that can boost the overall yield potential. However, "working out" of private placements can be arduous and can require a legal team working with the debtholder. Usually the lead investor drives the workouts. The investment group is often dominated by some of the largest life insurance companies.

Typically, the change in private placement spreads lags that of public securities by a quarter or two because of the time it takes to complete the deal and price it.

IDIOSYNCRATIC RISK

Building on the concept of illiquidity risk is the idea of being in a position to invest and take issuer-specific risk when others are selling. We believe one of the potentially biggest areas for these opportunities is the BBB/BB crossover space—although it can exist anywhere in the capital structure.

An allocation to a crossover/credit event idiosyncratic portfolio would be more transient. The insurer would have to be proactive and have a plan in place with managers to monitor the market for potential opportunities, have access to capital to allocate to an opportunity and a plan for holding or exiting the investment. Upon exiting, the money could be reallocated to more opportunities if they were available.

> In our view, a more concentrated portfolio would actively seek to garner a good amount of return potential from the idiosyncratic/issuer-specific risk exposure.

DIVERSIFICATION

Diversification can be looked at in two ways: sector and degree. Increasing the number of potential sectors to consider can offer a larger opportunity set with the potential to increase yield and/or total return. For example, we have seen insurers add taxable municipal bonds and emerging market debt instead of US corporate debt.

Diversification can also be viewed by position sizing. An insurer could have a manager run a “best-ideas” portfolio with large position sizes. Typically, the broad diversification often seen in many insurance portfolios can mean that any one credit has a muted impact. In our view, a more concentrated portfolio would actively seek to garner a good amount of return potential from the idiosyncratic/issuer-specific risk exposure.

MUNICIPAL BONDS

We believe municipal issues, including taxable municipal bonds, can augment the limited availability of long-duration debt. However, insurers are not always well equipped to do the critical research necessary when selecting tax-exempt and taxable municipal bonds. We believe this is key since many municipals are tied to specific revenue streams and municipal ratings are not always equivalent to similar corporate ratings.

EMERGING MARKET DEBT

We are seeing insurers showing interest in emerging market debt. We believe this debt can offer a potential spread premium relative to US corporate bonds with lower defaults. Also, a sovereign's rating can work to limit the quality rating on corporates in that country. There are instances where this can mean likely opportunities exist for additional yield with potentially better fundamentals versus similarly-rated US corporates. Insurers with long liabilities can find opportunities in our view. The crossover nature of the EM debt space can also offer a potential source of idiosyncratic risk through fallen angel and rising star opportunities.

Conclusion

We believe the opportunities presented in this piece offer insurers a way to think about total-return prospects in addition to potential yield opportunities. This is not to say an insurer replaces a yield objective with total return, but that an allocation could be made that has a tactical total-return focus. In a volatile yield environment, we believe such a shift in attention could potentially benefit performance.

Many of these ideas necessitate that an insurer be proactive. This can mean assessing ideas before they arise, communicating frequently with asset managers, resolving details like investment management agreements, custody agreements and other back office/account details to enable a manager to seize an idea when it arises.

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