Insurance AUM Journal
The Industry's Investment Resource

Q2 2020
VOL 4 | ISS 2

May You Live in Interesting Times

INTERVIEW

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Thought Leadership for the Insurance Investment Community

Making Insurance Assets Work Harder with a Tactical Credit Allocation

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Loomis Sayles
May 2020

KEY TAKEAWAYS

- Globally, government bond yields are at historically low levels—$10 trillion with negative yields.
- Covid 19 pandemic has provided a truly exogenous shock to the global economy and helped drive the global credit cycle into a downturn regime.
- The pandemic response contributed to credit spreads increasing dramatically, while government yields decreased, resulting in unchanged or lower credit yields across most US investment grade fixed income sectors.
- Insurance companies are left still grappling with the challenge of meager yield potential as they strategically allocate large percentages of assets to investment grade fixed income spread sectors.
- We believe insurers' existing assets could work harder through incorporation of a tactical credit portfolio within their strategic asset allocations.

The Covid 19 pandemic has helped cause a global recession and a corresponding dramatic decrease in government yields. Just under $10 trillion dollars in global government debt is currently trading with negative yields, with the average yield across the $32.5 trillion of US, Japan, Europe and UK government debt at only 28 basis points (bps). This reflects central banks' efforts to stimulate growth and a pandemic infused flight to quality as investors sold risky assets to buy government debt. Both the 10-year and 30-year US Treasurys hit new all-time lows in March 2020.

Despite continued low yields, insurers have continued their structural commitments to fixed income spread sectors for a variety of reasons, including asset liability management (ALM), regulatory constraints and capital preservation requirements. However, the yield erosion has been painful. Consider some current data points relative to those of 10 years ago:

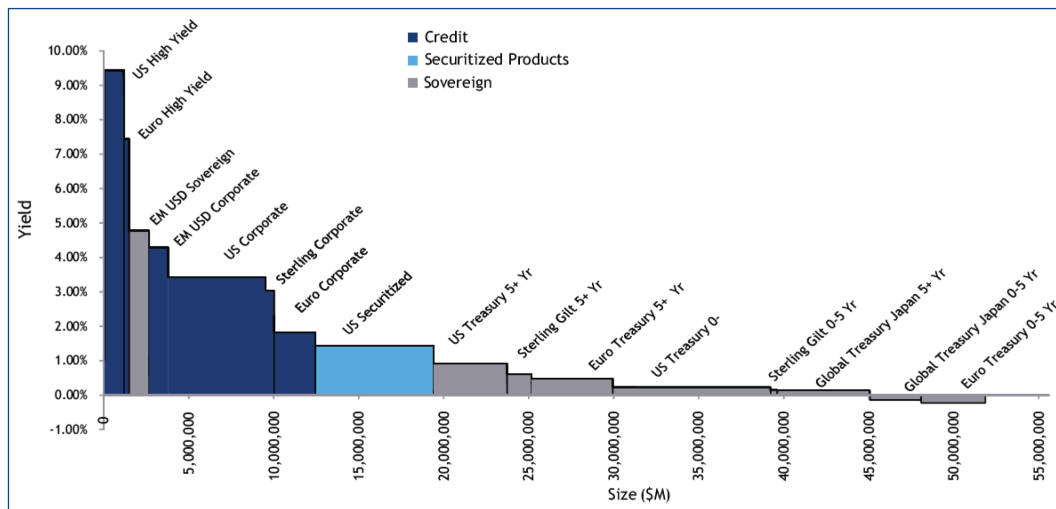
- 21% decline in book yield: 5.3% to 4.2%[1]
- Dramatically flatter yield curve: spread between 2-year and 10-year Treasurys down from 281 to 42 basis points—providing little yield advantage in longer-dated securities.[2]

LIMITATIONS OF A BROADER INVESTMENT UNIVERSE

In response to these market dynamics, or maybe despite them, insurers have explored yield-boosting strategies, including increasing allocations to lower-quality fixed income (BBBs and non-investment grade), private debt/equity, real estate, commercial mortgages, infrastructure and other more esoteric asset classes.

While many of the newer, more obscure sectors can potentially offer advantageous risk and return tradeoffs and correlation dynamics, another aspect of them can weigh on results. Significant institutional buying can contribute to supply and demand imbalances and lead to further spread compression and lower expected returns. As the famous investor

EXHIBIT 1: Yields vs Market Size Across Fixed Income



Source: Bloomberg, Barclays, JP Morgan as of 3/31/2020. Size represents market value of the index. Yield represents yield to worst. **Past performance is no guarantee of future results.** All indices are unmanaged and do not incur fees. You cannot invest directly in an index.

Barton Biggs said once, "There is no asset class that too much money can't spoil."[3] After many years of this challenging investment environment, numerous insurers are at risk limits and have pushed into sectors that are capacity-constrained. They have essentially turned over every rock (sector) they can find to help enhance potential portfolio yield and return. While at the time of this writing it is too soon to analyze the results from this push into diversifying asset classes, there will likely be portfolio stress in illiquid private markets caused by the Covid-19 exogenous shock.

Strategic asset allocations use longer time period assumptions, however there are often potential shorter-term market opportunities or dislocations that can appear. These opportunities may not align with a predetermined strategic asset allocation. Additionally insurers' investment approval processes have response time limitations.

The pandemic has helped the global economy to slide into recession. The reaction of global markets was a dramatic sell off in all risk assets. On February 29, the US corporate bond index yield was 2.47%, 23 days later it was 4.72%, a 90% increase. This presented a potential opportunity for insurers. However, only 23 days after this event the US corporate bond index yield fell back to 2.97%, a 37% decrease. Insurers have many constraints on their investment portfolios that would limit rapid movements in large changes in their portfolio. However a tolerance for a small position within the overall portfolio could allow for these more tactical opportunities to be used to seek added value in the insurer's portfolio.

This leads us to the question, "can insurers' existing assets work harder?" We believe they can by incorporating a tactical credit portfolio within a strategic asset allocation framework.

TACTICAL CREDIT ALLOCATION: HELPING INSURANCE ASSETS WORK HARDER

Insurers regularly determine strategic asset allocations based on the economic environment and asset opportunities relative to risk tolerances and their business needs. This is done within ALM, regulatory and business constraints. Typically, the resulting strategic allocation centers largely on investment grade fixed income, with lesser investments in non-investment-grade sectors and alternatives, such as private equity, real estate and commercial mortgages.

The table in Exhibit 2 highlights how various fixed income sectors' total returns have performed in different parts of the economic cycle.

Based on the potential for different sector total returns across the economic cycle, we believe that insurers should consider incorporating a tactical portfolio within their overall strategic asset allocation. The intention would be for the tactical portfolio to dynamically shift among investment grade and non-investment grade sector betas. Within the non-investment grade credit sectors, the portfolio would have the flexibility to invest in sectors such as BB/B high yield corporate credit, emerging market debt, bank loans, collateralized loan obligations and high yield securitized credit. In our view, this could be done in an attempt to increase total return potential while maintaining a risk profile similar to that of the strategic asset allocation.

Consider a hypothetical insurer that has the ability to dynamically allocate across investment grade credit, bank loans and high yield credit. We assume the insurer has a strategic fixed income portfolio allocation of 90% investment grade and 10% non-investment grade. The illustration in Exhibit 3 is a snapshot of how the strategic portfolio could be structured before and after a tactical credit allocation.

REALLOCATING A TACTICAL CREDIT PORTFOLIO

We assume the following analysis begins in the late-cycle stage of the credit cycle and the hypothetical portfolio is reallocated based on the economic cycle to capture potential incremental market return. The benchmark for this tactical portfolio has a static allocation of 50% investment grade / 25% high yield / 25% bank loans.

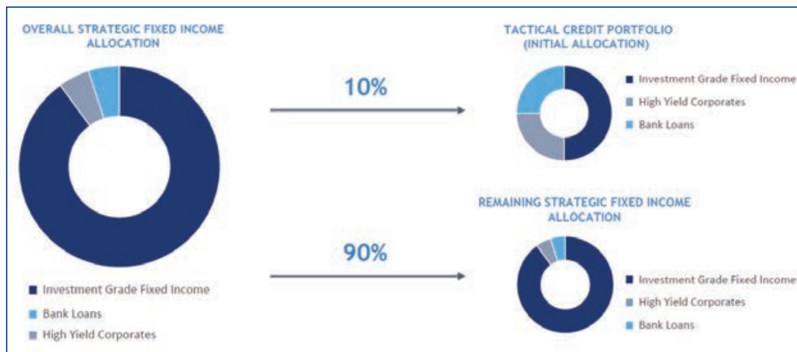
We consider four scenarios across the economic cycle, defined by Loomis Sayles' global macroeconomics team. Since forecasting economic cycles is not an exact science, we lagged the new allocations by zero, one, two and three months after the beginning of the cycle. For example, if the economic cycle changed from expansion/late-cycle stage to downturn in month 12, the insurer would not reallocate until month 15 in a 3-month lag scenario.

EXHIBIT 2: Annualized Return 3/31/2000 to 3/31/2020

	20 YEARS	EXPANSION/ LATE CYCLE	DOWNTURN	CREDIT REPAIR	RECOVERY
ICE BOFAML US CORPORATE INDEX	5.78%	4.49%	3.27%	17.60%	3.71%
ICE BOFAML US CORP. AAA-A INDEX	5.58%	4.67%	4.53%	14.76%	3.19%
ICE BOFAML US CORP. BBB INDEX	6.08%	4.29%	1.46%	22.06%	4.33%
ICE BOFAML US HIGH YIELD 2% CAP	6.34%	3.76%	-10.15%	34.60%	9.10%
ICE BOFAML US HIGH YIELD BB 2% CAP	6.92%	4.44%	-1.76%	25.70%	7.79%
ICE BOFAML US HIGH YIELD B 2% CAP	5.56%	3.35%	-10.90%	30.40%	9.14%
S&P/LSTA BANK LOAN INDEX	4.09%	2.32%	-5.76%	20.64%	5.66%

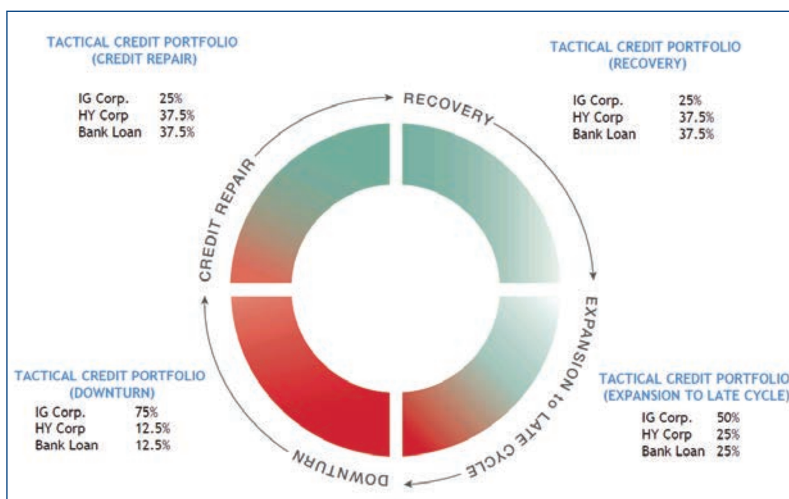
Source: Loomis Sayles analysis, as of 3/31/2020. Past market performance is no guarnatee of future results. Indices are unmanaged and do not incur fees. It is not possible to invest directly in an index.

EXHIBIT 3: Hypothetical Allocation to Tactical Credit



Source: Loomis Sayles. For illustrative purposes only. The information is not intended to represent any actual portfolio.

EXHIBIT 4: Hypothetical Tactical Portfolio Asset Allocation



Source: Loomis Sayles analysis, as of 12/31/2019. Inv. grade corp. = ICE BofA US Corporate Index, high yield corp = ICE BofAML US High Yield Index, bank loans = S&P/LSTA Bank Loan Index. This material is provided for informational purposes only and should not be construed as investment advice. Investment decisions should consider the individual circumstances of the particular investor. This reflects the current opinions of the authors and views are subject to change at any time without notice. Other industry analysts and investment personnel may have different views and opinions. See Disclosures for dates of cycle stages.

The graphic in Exhibit 4 is an illustrative example of how a hypothetical tactical portfolio could have been allocated during an economic cycle.

With perfect information and timing on the cycle shift, the tactical portfolio would have outperformed a static allocation by around 1.05%. A more realistic scenario assumes identification of a cycle shift within three months of its starting point. This would have led to approximately 0.63% of incremental performance with relatively lower volatility, which we believe is significant for a low-return environment. While the ability to accurately predict the timing and extent of cycle shifts is not possible, the exercise shows the impact of tactical allocation during cycle changes.

OTHER CONSIDERATIONS

We believe success for these mandates would hinge on the ability of a tactical portfolio manager to accurately forecast an economic cycle shift and position a portfolio effectively. Other dimensions that would need to be considered when implementing a tactical allocation include the impact of realized gains/losses, book yields and transaction costs. Our research suggests that tactical portfolios may not exhibit substantial turnover as the economic cycle has shifted a mere eight times in the past 20 years. Further, since "credit repair" and "recovery" tactical credit portfolios have the same allocations, only six of the cycle changes would have resulted in reallocations within the portfolio.

We believe an insurer who marginally loosens allocation constraints would have the potential to generate meaningful incremental return with a slightly improved level of portfolio risk.

EXHIBIT 5: 20 Years Ending 3/31/2020 Hypothetical Tactical Credit Portfolio

	HYPOTHETICAL TACTICAL CREDIT PORTFOLIO				
	STATIC PORTFOLIO 50/25/25	(LAG=0 MONTHS)	(LAG=1 MONTH)	(LAG=2 MONTHS)	(LAG=3 MONTHS)
HYPOTHETICAL TOTAL RETURN (ANNUALIZED)	5.57%	6.62%	6.33%	6.29%	6.20%
STANDARD DEVIATION (ANNUALIZED)	5.81%	5.75%	5.54%	5.52%	5.50%
	TACTICAL CREDIT PERFORMANCE RELATIVE TO STATIC PORTFOLIO				
TOTAL RETURN CHANGE (ANNUALIZED)	-	1.05%	0.76%	0.72%	0.63%
STANDARD DEVIATION CHANGE (ANNUALIZED)	-	-0.05%	-0.26%	-0.29%	-0.31%

Source: Loomis Sayles analysis, as of 3/31/2020. All return information shown is hypothetical and is being provided for illustrative purposes only. The use of hypothetical return examples has inherent limitations. They are created after periods shown and therefore could be deemed to have elements of "backtesting" as they are derived from the retroactive application of a model with the benefit of hindsight. Hypothetical results do not reflect all material economic and market factors that may have affected investment decisions if these were actual accounts. The hypothetical results do not reflect the impact of actual trading which may affect the price and availability of securities, nor do they reflect the impact of management fees, brokerage fees or commissions and other expenses. We make no representation that this represents the actual or expected return of any portfolio and you should expect actual performance to differ. You cannot invest directly in an index. Investments carry the possibility for loss as well as profit. **Historical returns are no guarantee of future results.**

CAPITAL CONSUMPTION

We acknowledge that the described tactical allocation could increase the capital consumption requirements. Current regulations could require a large increase in risk-based capital consumption for US insurers moving from investment grade to non-investment grade bonds (see Exhibit 6). For example, a Ba1 bond results in over three times the capital consumption for a life insurer than a Baa3, which is only one rating notch higher.

EXHIBIT 6: Current US National Association of Insurance Commissioners (NAIC), Risk-Based Capital Bond Charge

NAIC	BOND RATINGS	LIFE PRE-TAX	P&C	HEALTH
1	AAA-A3	0.40%	0.30%	0.30%
2	Baa1-Baa3	1.30%	1.00%	1.00%
3	Ba1-Ba1	4.60%	2.00%	2.00%
4	B1-B3	10.00%	4.50%	4.50%
5	Caa1-Caa3	23.00%	10.00%	10.00%
6	Below Caa3	30.00%	30.00%	30.00%

Source: US NAIC, as of 12/31/2019.

EXHIBIT 7: NAIC Proposed Pre-Tax Life C-1 RBC Bond Charges Risk-Based Capital Bond Charges

RATING	CURRENT	PROPOSED	DIFFERENCE
AAA	0.40%	0.31%	-23%
Aa1	0.40%	0.43%	8%
Aa2	0.40%	0.57%	43%
Aa3	0.40%	0.72%	80%
A1	0.40%	0.86%	115%
A2	0.40%	1.06%	165%
A3	0.40%	1.24%	210%
Baa1	1.30%	1.42%	9%
Baa2	1.30%	1.69%	30%
Baa3	1.30%	2.00%	54%
Ba1	4.60%	3.75%	-18%
Ba2	4.60%	4.76%	3%
Ba3	4.60%	6.16%	34%
B1	10.00%	6.35%	-37%
B2	10.00%	8.54%	-15%
B3	10.00%	11.82%	18%
Caa1	23.00%	17.31%	-25%
Caa2	23.00%	23.22%	1%
Caa3	23.00%	30.00%	30%
Below Caa3	30.00%	30.00%	0%

The NAIC C-1 Working Group has proposed a new set of bond factors for life insurers. The implementation date has not been set for the new rules, but we would not be surprised if there is a renewed push given the expectations around downgrades in Baa rated securities. The change should reduce the ratings' cliffs shown in the table (Exhibit 7). Further, the new charges should utilize more granular rating buckets to determine the corresponding charge.

The table in Exhibit 7 shows dramatic increases for low single-A-rated bonds and low-Baa-rated securities. Notably, there will be sizable decreases for many non-investment grade buckets, such as the B1 bucket that would decrease from 10% to 6.35%.

This change in the capital consumption landscape could enable portfolio managers to tactically allocate across investment grade and non-investment grade sectors more efficiently in terms of use of capital per unit of risk, return or yield. We believe the change has the potential to expand the opportunity set for allocations in a tactical credit portfolio.

CONCLUSION

In the midst of the pandemic-induced downturn and continued low yield environment, we believe a tactical credit portfolio is worth consideration as part of an overall strategic asset allocation. We believe a tactical credit approach has the potential to:

- Enhance portfolio return,
- Leave overall portfolio risk dynamics unchanged, and
- Not dramatically alter the RBC capital consumption of the asset portfolio—especially when the revised Life NAIC RBC C-1 charges go into effect.

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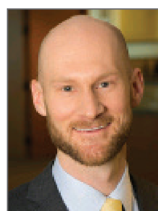

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Director of Insurance Solutions

STAGE	START	END
Recovery	6/1/2003 6/1/2011	2/28/2006 12/31/2013
Expansion/Late Cycle	4/1/1997 3/1/2006 1/1/2014	8/31/2000 12/31/2007 Present
Downturn	9/1/2000 1/1/2008	10/31/2002 3/31/2009
Credit Repair	11/1/2002 4/1/2009	5/30/2003 5/31/2011

ENDNOTES

1 Source: Standard & Poor's Global, NAIC Statutory Data: Gross Yield – Bonds. Data as of 12/31/2018 (most recent data available) compared to data as of 12/31/2009.

2 Source: Bloomberg US Treasury Curve #111. Data as of 12/31/2019 compared to data as of 12/31/2009.

3 Bloomberg.com, 12/2/2019.

DISCLOSURE

Regime periods as shown on the credit cycle chart are determined by Loomis Sayles based on a variety of subjective and objective factors, including past economic and asset performance metrics. Views and opinions expressed reflect the current opinions of the investment team, and views are subject to change at any time without notice. Other industry analysts and investment personnel may have different views and opinions.

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