IR+M INCOME RESEARCH + MANAGEMENT

IR+M UPDATE

Managing Insurance Portfolios Post-Tax Reform

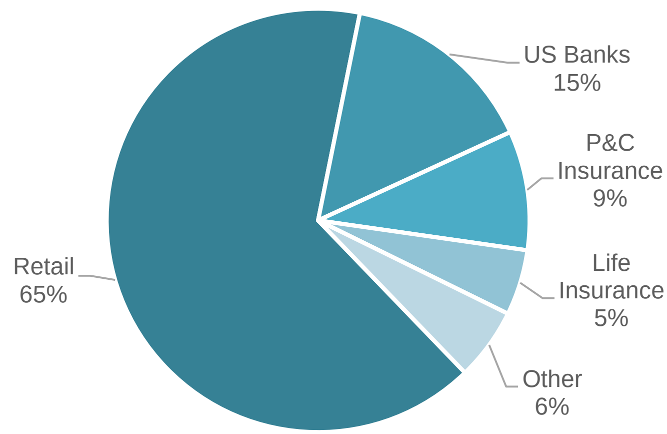
March 14, 2018

The Tax Cuts and Jobs Act (TCJA) has been in effect since January 1st, but many investors are still assessing its impact. Overall, we expect tax reform to be positive for corporate profits and fundamentals. However, the effect of tax reform on the municipal bond market is more complex due to its close relationship with the tax code. In this piece, we discuss tax reform's impact on the relative attractiveness of municipal bonds to insurance companies. We also review what we have seen in the municipal bond market so far in 2018.

Municipal Bond Market Composition and Why It Matters

Historically, the municipal bond market has been retail-oriented, given that the tax-exemption is most valuable for high-net-worth individuals. The TCJA preserved the municipal exemption and lowered the top individual tax rate, from 43.4% to 40.8%. As such, we do not expect retail investors, who comprise roughly two-thirds of the market, to meaningfully change their municipal bond allocations. We believe this should provide support to the municipal market.

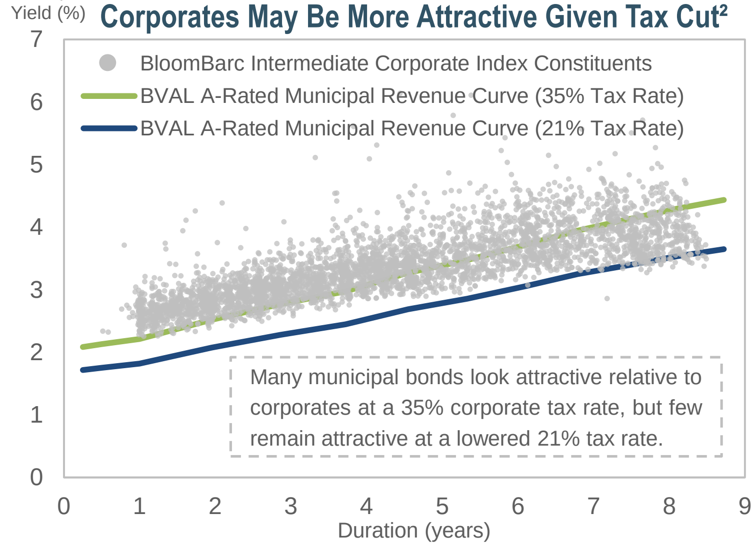
Municipal Market Investors[1]



In contrast, corporate investors, such as banks and insurance companies, experienced a dramatic decline in their tax rate, from 35% to 21%. In response, municipal bonds are now less attractive versus other spread sectors, which could prompt extensive municipal selling. However, there may be compelling reasons for corporate investors to preserve their allocations to municipals, which we examine in further detail below.

How Do Municipals Compare Post-Tax Reform for a Typical Insurance Company?

Corporates May Be More Attractive Given Tax Cut[2]



To compare relative value between municipal and taxable bonds, investors often calculate a tax-equivalent yield for their municipal holdings. The exhibit to the left compares tax-equivalent yields for A-rated municipals at 35% and 21% tax rates (green and blue lines). The gray dots represent corporate bonds. When the dots are above the line, they offer a higher tax-equivalent yield. As tax-equivalent yields are adjusted for the new corporate tax rate, municipals become less attractive relative to corporates, reflected by the number of dots that remain above the blue line.

While the decline in relative value may lead some P&C insurers to reduce their allocations to municipals, we do not expect P&C insurers to exit the municipal asset class completely due to its diversification benefits and high-quality nature. For example, the average quality of the municipal index is Aa2/Aa3, while the corporate index quality is multiple notches lower at A3/Baa1.[3] This quality difference could impact insurance companies from a risk-based capital and rating agency perspective. Additionally, life insurers may increase their allocations to municipals in response to the newly simplified proration rules.[4]

[1]Federal Reserve as of 12/31/17; Retail includes households, money market funds, mutual funds, closed-end funds, and ETFs; Other includes broker-dealers, state and local governments, and nonfinancial businesses. [2]Bloomberg, Bloomberg Barclays, and IR+M Analytics as of 2/22/18; tax-equivalent yields take into account proration. [3]Bloomberg Barclays as of 2/28/17. [4]Proration refers to the practice of allocating income between insurance companies and policyholders for the purposes of tax calculations.

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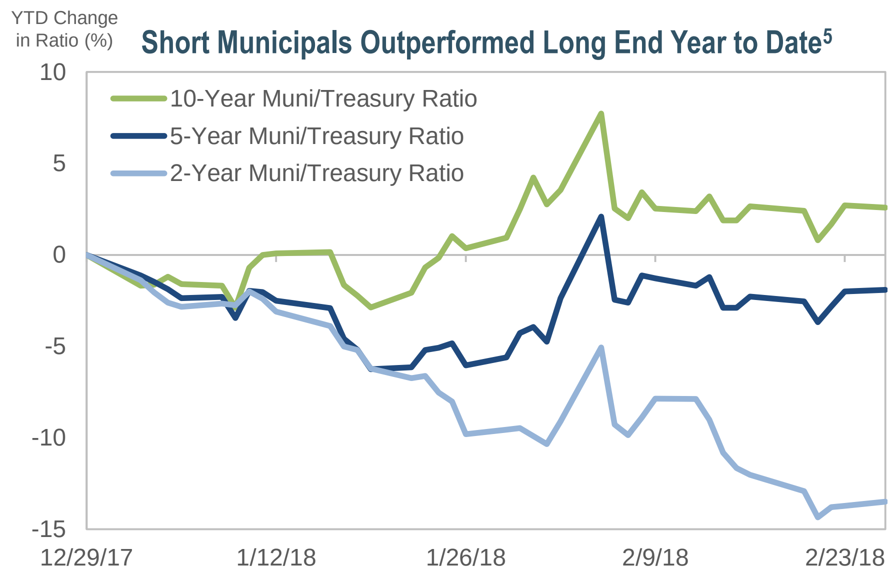
Year-to-Date Activity in the Municipal Market

Municipal market performance was challenged in late 2017, as the market digested a record amount of December supply, prompted by the uncertainty associated with the various tax reform proposals. To offset this, market participants expected lighter-than-usual January supply and a rebound in municipal market performance.



Year-to-date, the prospect for extremely light supply has been realized, and market performance has been solid. On a top-line level, municipals have outpaced Treasuries and corporates, but there has been a significant bifurcation between front-end and long-end returns. The front end outperformed as the municipal curve steepened. This may have reflected selling by insurance companies, who have a tendency to buy longer-maturity municipals, as opposed to retail investors, who tend to buy shorter-maturity municipals. With interest rates 25-50bps higher across the curve, the value of tax-exemption has increased, potentially muting any additional selling by insurance companies. However, as supply comes back online, technicals could be challenged if fund flows, which have been fairly resilient during the year, reverse.

IR+M Approach and Positioning

Bloomberg Barclays Indices[6] As of 2/28/17	1-10 Yr Muni Index	Interm Corporate Index	Securitized Index
Pre-Tax Yield	2.19%	3.38%	3.35%
Tax-Equiv Yield (35%)	3.19%	3.38%	3.35%
Tax-Equiv Yield (21%)	2.63%	3.38%	3.35%
Duration (years)	4.09	4.38	5.20
Average Quality	Aa2/Aa3	A3/Baa1	Aaa/Aa1

We understand that our insurance clients have unique investment objectives, and we routinely discuss opportunities across taxable and tax-exempt markets. Municipal bonds now look less attractive relative to taxable sectors on a tax-equivalent yield basis. As a result, we have been opportunistically reducing our allocation to municipals in our insurance client crossover portfolios, redeploying proceeds into a mix of high-quality corporates and AAA-rated securitized bonds in order to preserve similar credit quality. While making these shifts, we factor in individual client considerations such as gain/loss restrictions, book-yield targets, guideline constraints, and risk-based capital requirements.

Tax reform has had a disproportionate impact on retail and corporate holders of municipal bonds. While the appeal of municipal bonds has remained largely unchanged for retail investors, their attractiveness has declined for corporate investors. At IR+M, we continually assess our clients' objectives, and how we can work together to achieve them, in the context of the market. As such, for our insurance crossover clients, we have used the municipal bond market's solid year-to-date performance to sell into strength and redeploy proceeds into more attractive opportunities. We believe that our steadfast commitment to bottom-up security selection and sector rotation will help us deliver excess returns.

[5]Bloomberg as of 2/26/18. [6]Bloomberg Barclays. The views contained in this report are those of IR+M and are based on information obtained by IR+M from sources that are believed to be reliable. This report is for informational purposes only and is not intended to provide specific advice, recommendations for, or projected returns of any particular IR+M product.