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IR+M UPDATE
Insurance Company Fixed Income Portfolio Trends

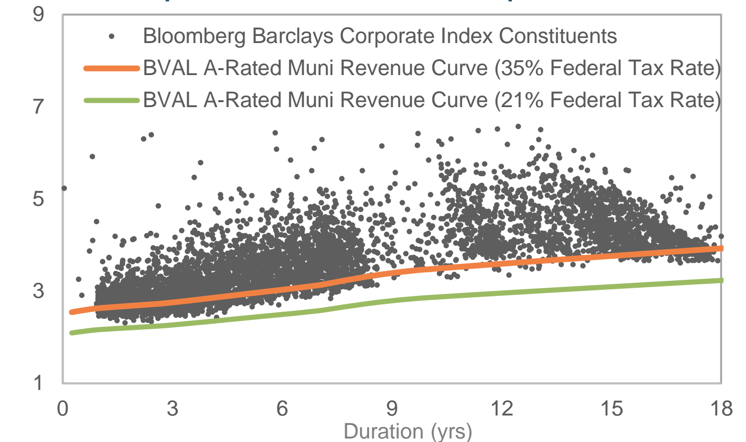
May 14, 2019

Insurers have long been heavily invested in the fixed income markets. Within the asset class, allocations continually evolve as market dynamics shift and new reforms are implemented. However, given the many nuances insurance companies face when investing, changes have historically been enacted over an extended period of time and at a gradual pace. In this mailer, we analyzed the recent 2018 filings to examine how insurers repositioned their fixed income portfolios, and what trends we expect going forward.

IMPACT OF THE TAX CUT AND JOBS ACT (TCJA)

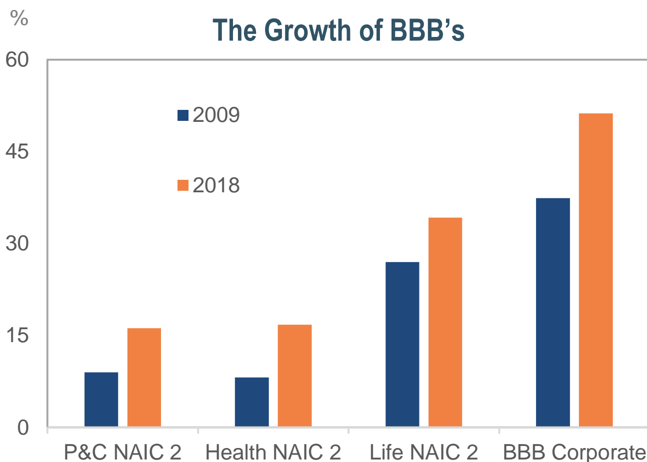
Municipal holdings trended lower by almost 4% for Property & Casualty (P&C) and Health insurance companies year-over-year; whereas Life insurers kept allocations relatively constant.

- Due to the passage of the TCJA, tax-exempt munis lost some attractiveness for P&C and Health insurers at the new, lower effective tax rate. Meanwhile, the tax code surrounding tax-exempt income for Life insurers was simplified, and the additional clarity made municipals relatively more attractive.
- The relative value pendulum between municipals and taxable alternatives is currently tilted far away from munis. Across the curve, investors are able to achieve a higher after-tax yield by investing in taxable bonds at a 21% tax-rate. Strong retail demand and lower supply have been a tailwind for munis, and have pushed the 10-year muni/Treasury ratio to an all-time low.
- Despite this, municipals continue to play an important role within taxable fixed income portfolios. Although investors could potentially pick up additional yield by selling municipals and investing elsewhere, there are other factors that impact this decision. We believe the sector still provides critical diversification benefits, evidenced by the lower correlation to corporates and equities, in addition to lower historical default rates versus similarly-rated corporates.



RISK-ON OR FOLLOWING THE MARKET?

NAIC 2 / BBB bonds make up a sizable portion of insurance portfolios, and this has increased broadly since the crisis.



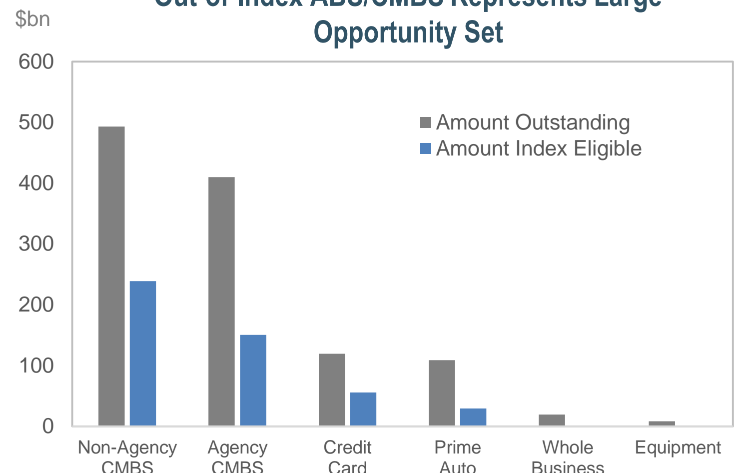
- The increased allocation to BBB-rated securities coincided with the overall growth of the BBB corporate market, which now stands at more than half of the investment-grade universe. The Bloomberg Barclays Corporate Index yield has fallen substantially since 2009 – by over 100bps to 3.6% – causing insurers to look for ways to maintain their portfolio's overall investment yield.
- Insurers could historically maintain the yield in their portfolio by increasing the amount of NAIC 2 rated issuers. Investors were able to pick up additional yield by going down in quality from A to BBB corporate bonds. However, this basis has recently dropped below the five-year average of 70bps, and currently stands under 60bps.
- With the growth of the BBB segment of the market, we believe it is important for investors to choose their BBBs wisely. Not all BBBs are created equal, and we believe that avoiding credits with unrealistic deleveraging plans and outsized downgrade risk is prudent. Proper due diligence and experience in security selection can help insurers avoid credit impairments and realized losses. Additionally, we believe in positioning the majority of lower-rated BBB exposure towards the front of the curve, where widening spread movements are less impactful to the overall portfolios.

Sources: Bloomberg and Bloomberg Barclays as of 4/30/19. Bloomberg Barclays Corporate Index Constituents limited to holdings with a duration less than 18 years. S&P Global Intelligence as of 3/31/19. 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. No part of this material may be reproduced in any form, or referred to in any other publication, without express written permission from Income Research & Management.

SECTOR IN VOGUE

On average, insurers increased allocations to securitized bonds, particularly asset-backed securities (ABS). Health insurers grew securitized allocations within their overall investment portfolio by 4%, P&C by 2% and Life by 1%.

- With municipals no longer as compelling for P&C and Health insurers, and the potential risks surrounding BBB corporates growing, insurance companies increased their allocation to securitized bonds. The sector offers insurers additional diversification and attractive after-tax yield, while often providing favorable capital treatment.
- Due to index inclusion rules, a large part of the investable universe is not represented in traditional benchmarks, such as more esoteric ABS or collateralized loan obligations (CLOs). Managers may add incremental value by investing in issuers and structures that do not have the same level of sponsorship that an index eligible bond may have.
- Although there are appealing diversification benefits to adding securitized exposure, investors should be aware of growing trends in the sector. Specifically within the CLO market, typical investor protections, such as loan covenants, are becoming "light," increasing underlying credit risk to the investor. Diversifying into collateral types across the securitized market, such as ABS equipment or ABS whole-business franchise deals, can complement corporate credit and other securitized exposure. As a way to help mitigate risk, we focus primarily on high-quality, senior bonds with solid credit enhancement levels.



ON THE HORIZON

We expect that several themes could impact insurance portfolios going forward, such as:

- **The Potential Turn of the Credit Cycle:** The current economic expansion has continued for over 118 months, and some investors are preparing for this to end. The recent temporary inversion of the 3-month and 10-year Treasury yield has substantiated this claim. However, we believe fundamentals remain healthy across corporate credit, and that each sector and issuer is at a different stage in the cycle. We believe bottom-up security selection should help mitigate the potential idiosyncratic weakness that may emerge.
- **Risk-Based Charges (RBC) Proposed Changes:** There is an ongoing discussion about increasing the granularity of NAIC designations from 6 to 20 categories. With the change, some NAIC categories will receive more favorable treatment than others, which could incentivize insurers to revisit their fixed income allocations.
- **Environmental, Social, and Governance (ESG):** Although European insurers have been active in ESG and sustainable investing for several years, US insurers are just starting to explore integrating ESG factors within their portfolios. Although this may not immediately show up in regulatory filings, over the long-term, it may impact asset allocation decisions across sectors when investment managers make decisions through an ESG lens. ESG is also beginning to spread to municipal and securitized sectors.

At IR+M, we understand that each insurance company has specific, unique needs and objectives. As a result, each insurer is impacted differently by current market events and will likely be affected dissimilarly by future developments. Through our experience managing high-quality fixed income portfolios for insurance companies, we believe that closely partnering with clients to routinely revisit their investment needs is the most efficient approach to navigating these changes.

Sources: Bloomberg, Bloomberg Barclays and Bloomberg Index Services Limited as of 4/30/19. S&P Global Intelligence as of 3/31/19. 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, or projected returns for any particular IR+M product. No part of this material may be reproduced in any form, or referred to in any other publication, without express written permission from Income Research & Management. BLOOMBERG® is a trademark and service mark of Bloomberg Finance L.P. and its affiliates (collectively "Bloomberg"). BARCLAYS® is a trademark and service mark of Barclays Bank Plc (collectively with its affiliates, "Barclays"), used under license. Bloomberg or Bloomberg's licensors, including Barclays, own all proprietary rights in the Bloomberg Barclays Indices. Neither Bloomberg nor Barclays approves or endorses this material, or guarantees the accuracy or completeness of any information herein, or makes any warranty, express or implied, as to the results to be obtained therefrom and, to the maximum extent allowed by law, neither shall have any liability or responsibility for injury or damages arising in connection therewith.