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INCOME RESEARCH + MANAGEMENT

IR+M UPDATE

# Insurers' Needs in Today's Market Environment

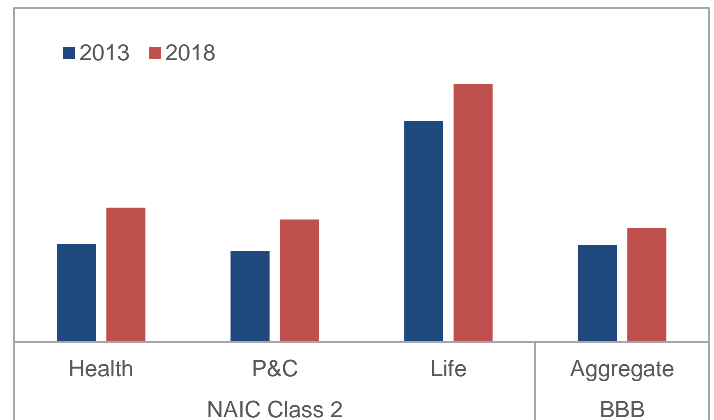
February 27, 2020

**Insurance companies – like many investors – are not immune to the challenges posed by the current market environment. Global rates are at historical lows, and compensation for risk has decreased. Insurers' portfolio requirements may be unique, but we believe that certain investment opportunities can address them. Specifically, securitized and taxable municipal bonds may help insurers moderate late cycle dynamics, maintain income, and increase capital efficiency.**

## BBBs ARE HERE TO STAY

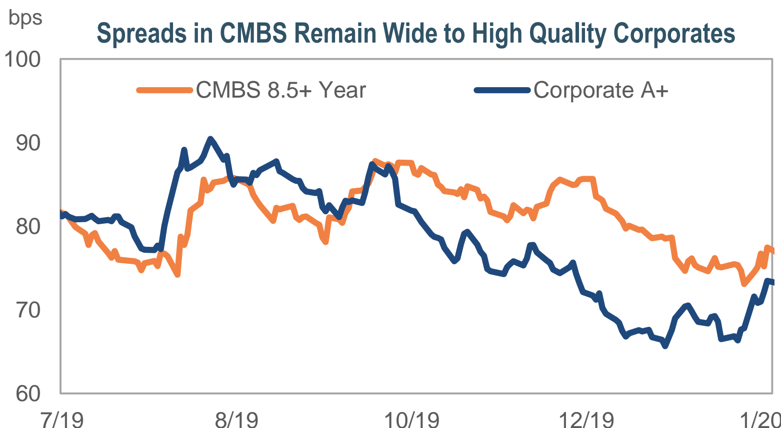
- The credit cycle is in the late stages, and the BBB segment of the investment-grade corporate bond market is on the rise. Corporate issuers, taking advantage of historically low interest rates and yield-starved investors, have leveraged their balance sheets.
- Many investors – insurance companies included – are sacrificing credit quality for higher yields. Overall, insurers have increased their exposure to NAIC Class 2 securities in order to maintain portfolio income.
- An economic recession could trigger a wave of downgrades. To mitigate the potential impact, insurers may want to consider less traditional securitized bonds, as well as taxable municipals.

**Fixed Income Quality has Decreased for Insurers, Market**




## OPPORTUNITIES ABOUND IN SECURITIZED ASSETS

- The role that securitized bonds played in the Great Financial Crisis (GFC) continues to shape investors' perception of these securities. While some insurers have long invested in this sector, the broader market has been more reluctant to do so.
- We believe this presents an opportunity. Since the GFC, the underwriting standards and regulation of securitized bonds have improved significantly. These bonds now often have stronger credit profiles, which may not be factored into pricing.
- Within asset-backed securities (ABS), a wider scope of ABS issuance has resulted in an expanded opportunity set. We believe that there is value in the senior tranches of on-the-run sectors such as prime auto, credit card, and equipment, as well as more niche sectors.
  - One example of a niche ABS subsector we invest in is handset receivables. With handset receivables, cellular carriers securitize customers' smartphone payments. This structure is insulated from carriers' idiosyncratic risk, and more correlated with consumers' strength.
  - These bonds are often shorter in duration (five years and in), and offer a spread of 40bps to 50bps over Treasuries for AAA senior tranche risk.




- Last-cash-flow commercial mortgage-backed securities (CMBS) may also offer attractive relative value.
  - CMBS fundamentals remain robust, driven by elevated commercial real estate values and low delinquency rates. Many seasoned bonds have appealing loan-to-value ratios due to higher valuations and strong loan performance. Additionally, senior tranches often have over 30% credit enhancement.
  - Despite these attributes, CMBS spreads lagged the rally in corporates in the second half of 2019. This resulted in a spread concession for AAA rated CMBS relative to A rated corporate bonds.

Sources: Bloomberg Barclays as of 1/31/20. S&P Global Intelligence as of 12/31/18. In the upper right-hand chart, Health, P&C, and Life correspond to insurance company types categorized by S&P Global Intelligence; Aggregate corresponds to the Bloomberg Barclays US Aggregate Index. In the lower left-hand chart, Bloomberg Barclays Corporate A+ Index Constituents limited to holdings with an average credit quality of A- or better. Bloomberg Barclays CMBS 8.5+ Year Index Constituents limited to Aggregate-eligible CMBS with a weighted average life of 8.5 years or longer. 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. 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.

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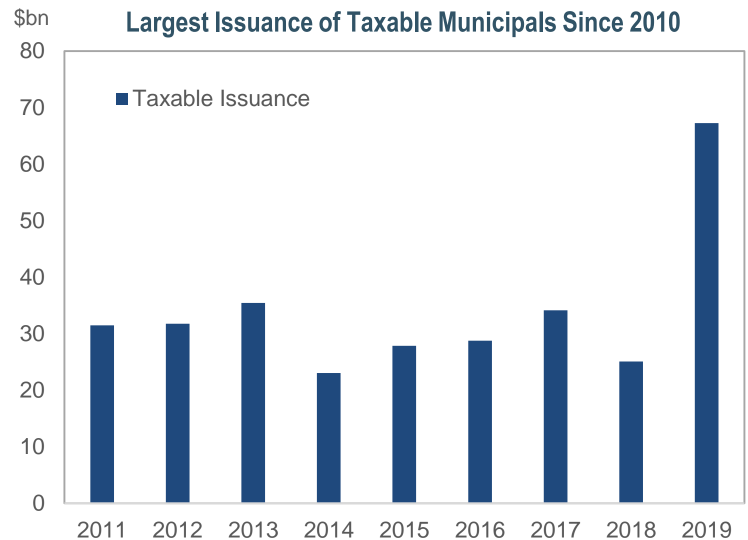
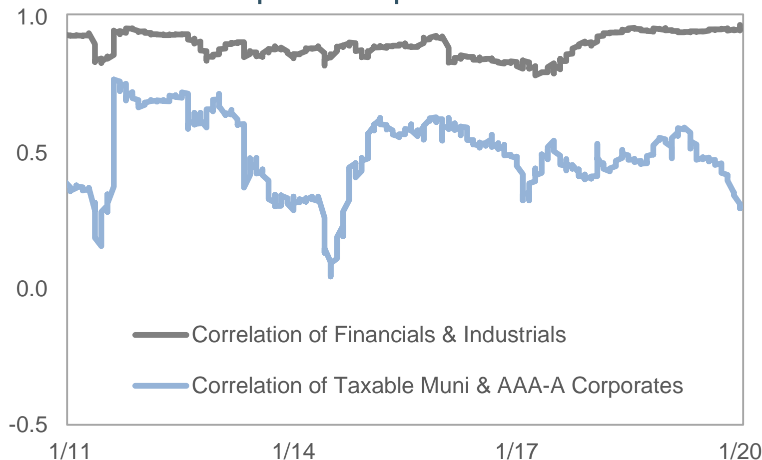
## MUNICIPAL ISSUERS PIVOT TO THE TAXABLE SECTOR

- In 2017, the Tax Cut & Jobs Act (TCJA) lowered the corporate tax rate from 35% to 21%, rendering tax-exempt municipals less attractive for numerous investors. In response, many insurers reduced their allocation to tax-exempt municipal bonds.
- Since TCJA, municipal issuers have increasingly relied on taxable municipal bonds to refinance existing tax-exempt debt. As a result, taxable municipal bond issuance has risen 150% year-over-year.
- Recent taxable deals have been shorter in duration as compared to previous trends, and offer investors with intermediate-dated liabilities a viable and attractive alternative to intermediate corporates.
- This wave of taxable issuance may allow insurers to maintain exposure to the sector, or further diversify their fixed income holdings.




## IMPROVEMENTS TO QUALITY, INCOME, & DOWNSIDE RISK

- Within municipals, taxable bonds have a sizable yield advantage over similarly-rated corporate bonds, stemming from modest liquidity differences. However, insurers may benefit from owning taxable municipals, given the potential for increased compensation without the need to sacrifice credit quality.
- In 2019, a AA- healthcare system issued 30-year bonds at a spread of 100bps over Treasuries. That same week, an A-rated corporation issued 30-year bonds at a spread of 80bps.




- Historically, taxable municipal bonds have been less sensitive to corporate earnings, have had lower default rates than similarly-rated corporates, and have exhibited less spread volatility during market corrections.
  - The correlation of excess returns between taxable municipals and corporates has been trending downward.
  - On the contrary, the correlation of rolling 52-week excess returns between corporate sectors, such as Financials and Industrials, has remained near a 10-year high.
- In the current environment, insurance companies may want to consider taxable municipals, which can help maintain or enhance portfolio income and credit quality.

**At IR+M, we recognize that insurance companies have specific investment needs, objectives, and risk tolerances. Current market conditions, which are characterized by low interest rates and tight spreads, are challenging – but they are not insurmountable. We believe that, for insurance companies, securitized and taxable municipal bonds may provide excellent relative value. Select securities within these sectors can help mitigate exposure to the credit cycle, while preserving portfolio income and capital efficiency.**

Sources: SIFMA, Bank of America as of 1/31/20. Correlations are calculated using rolling 52-week excess returns. 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. Copyright © 2020, S&P Global Market Intelligence. Reproduction of any information, data or material, including ratings ("Content") in any form is prohibited except with the prior written permission of the relevant party. Such party, its affiliates and suppliers ("Content Providers") do not guarantee the accuracy, adequacy, completeness, timeliness or availability of any Content and are not responsible for any errors or omissions (negligent or otherwise), regardless of the cause, or for the results obtained from the use of such Content. In no event shall Content Providers be liable for any damages, costs, expenses, legal fees, or losses (including lost income or lost profit and opportunity costs) in connection with any use of the Content. A reference to a particular investment or security, a rating or any observation concerning an investment that is part of the Content is not a recommendation to buy, sell or hold such investment or security, does not address the suitability of an investment or security and should not be relied on as investment advice. Credit ratings are statements of opinions and are not statements of fact.

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