

In our annual analysis of insurance company filings, we examine trends and changes that occurred in fixed income portfolios during the course of 2019. Although overall portfolio allocations were relatively stable, we saw a continuation of some trends identified last year, including a decrease in municipal allocations. Given the current elevated downgrade risk, we also look at fallen angels and the potential impact on NAIC 3 exposure.

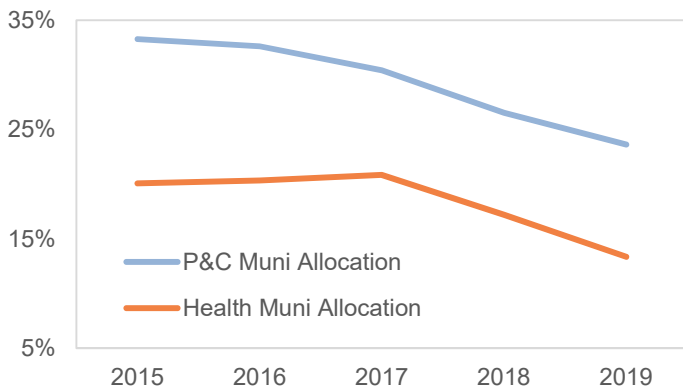
2019 Allocations In Review

- Though it may seem like the distant past, 2019 was a good year for insurance company investment portfolios. Strong equity and fixed income returns led unrealized gains to increase at record levels.
- Despite the prolonged low interest rate environment, Net Investment Income (NII) was fairly stable year-over-year.
- As is typical, overall asset allocation moves across insurance company types were small and primarily on the margin.
- Equity allocations, particularly within P&C insurers, ended the year at their highest levels, while bonds were at their lowest. This positioning likely benefited results in 2019, but may have decreased asset values in the first quarter of 2020.

| (\$bn) | 2015 | 2016 | 2017 | 2018 | 2019 |
|------------------------------------|------|------|------|------|------|
| Net Investment Income | 223 | 224 | 237 | 250 | 250 |
| Realized Capital Gains | 7 | -2 | 12 | 6 | 6 |
| Change in Unrealized Capital Gains | -62 | 48 | 55 | -117 | 155 |

| (%) | Bonds | YoY Change | Equity | YoY Change | Loans | YoY Change | Cash/ST Investments | YoY Change | Other** | YoY Change |
|---------|-------|------------|--------|------------|-------|------------|---------------------|------------|---------|------------|
| Life | 73.5 | -1.2 | 1.2 | 0.0 | 16.7 | 0.3 | 2.8 | 0.2 | 5.8 | 0.7 |
| P&C | 63.0 | -3.8 | 24.2 | 3.7 | 1.3 | 0.0 | 6.8 | 0.2 | 4.6 | -0.1 |
| Health* | 63.3 | 0.5 | 10.5 | 0.7 | 0.1 | 0.0 | 30.9 | -1.0 | 7.4 | 0.0 |

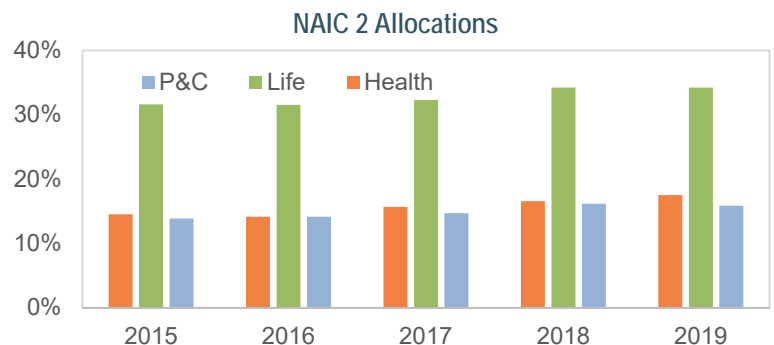
*Health data as provided by SNL does not sum to 100% due to different filing methods. **Other includes Real Estate and Other Investments.



- P&C and Health insurers reduced their allocations to municipal bonds, a continuing theme since the passage of the Tax Cuts and Jobs Act (TCJA) in 2018, which made municipal bonds less attractive relative to taxable bonds at the 21% corporate tax rate.
- However, we feel it is important that portfolios retain the flexibility to be opportunistic. The 10-year muni/Treasury ratio reached record highs of over 350% in March during the market volatility, presenting an attractive relative value opportunity to selectively add back to the sector, even with a 21% tax rate.

Fixed Income Ratings Observations

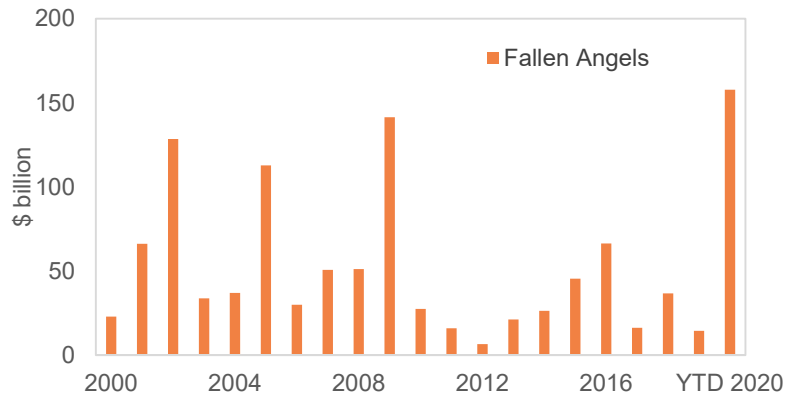
- Despite relatively stable allocations to NAIC 2 rated securities in 2019, the growth in both the overall BBB market and exposure to BBBs on insurance company's balance sheets continues to draw headlines.
- While an important source of yield, these allocations should be monitored closely, given the elevated risk of downgrades. Approximately 9% of the IG universe has been downgraded this year, with more expected.



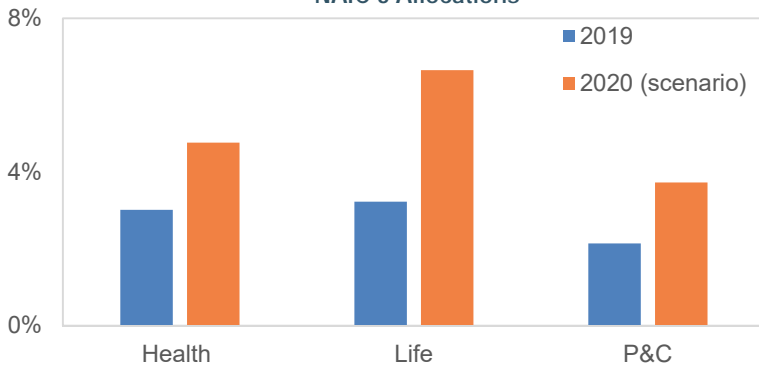
Bloomberg, Bloomberg Barclays, SNL Financial and IR+M Analytics as of 5/11/2020. The views contained in this report are those of IR+M and are based on information obtained by IR+M from sources that are believed to be reliable. This report is for informational purposes only and is not intended to provide 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. 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.

Fixed Income Ratings Observations (cont'd)

- There have been over \$150 billion of Fallen Angels (investment-grade bonds that have been downgraded to high-yield) year-to-date, more than any full year period in the last two decades. Most estimates call for \$250 - \$350 billion by year-end, with some predicting \$500 billion or more.
- Collateralized Loan Obligations (CLOs) are also a candidate for downgrades. Moody's put over 800 CLOs on downgrade review in April, and S&P placed over 150 US CLO tranches on watch. Although most of the tranches are below IG, this effects approximately 30-50% of the BBB-rated CLO universe.



NAIC 3 Allocations

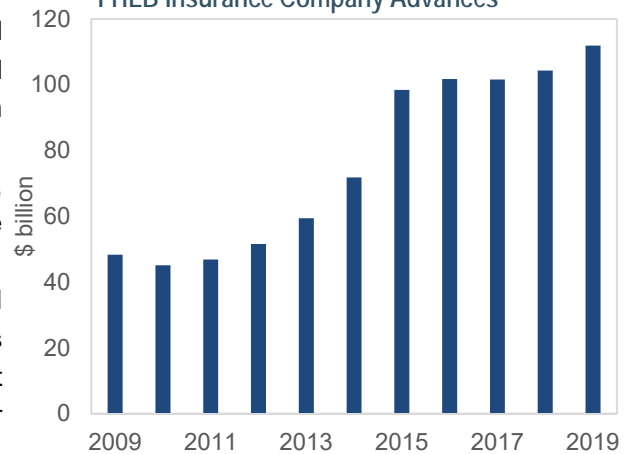


- These downgrades have the potential to impact insurance company investment portfolios. For example, the amount of Fallen Angels in 2020 could easily exceed 10% of the current universe of BBB-rated corporate bonds.
- If insurance companies were to experience a similar level of downgrades in NAIC 2 assets, NAIC 3 allocations could increase substantially assuming insurers don't sell pre- or post-downgrade. This might present concerns with rating agencies and lead to additional RBC charges.

Managing Liquidity and FHLB Usage

- Insurers face a number of potential liquidity headwinds as a result of the current crisis. For example, health insurers are challenged by additional claims, reduced premiums, and a potential backlog created by the deferral of elective procedures. Some P&C insurers face potential pressure from event cancellation and business interruption policies.
- While some insurers have been harvesting income and raising cash, another option that may help address liquidity needs is the Federal Home Loan Bank (FHLB).
- Advances to insurance companies from the FHLB have more than doubled over the last 10 years to over \$100 billion last year. Insurance companies can use advances from the FHLB as a ready source of liquidity to augment lower investment yields, and mitigate the need to sell securities at a loss or miss out on investing opportunities when cash is low.

FHLB Insurance Company Advances



While volatility is likely to persist for the near future, at IR+M we think this presents opportunities for insurance companies. We believe as credit allocations become more important with prolonged low interest rates, so does the need to focus on bottom-up security selection, particularly with increased downgrade concerns. Through our experience managing high quality fixed income portfolios and partnering with insurance clients, we think we are well-positioned to help fulfill investment needs during these challenging times.

Bloomberg, Bloomberg Barclays, SNL Financial and IR+M Analytics as of 5/11/2020, JP Morgan as of 4/23/2020, FHLB Consolidated Financial Reports. NAIC 3 2020 scenario is calculated by adding 10% of 2019 NAIC 2 allocations to 2019 NAIC 3 allocations. 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. 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.