CAMRADATA

Insurance CIO Whitepaper

Sponsored by: BARINGS Muzinich & Co Payden&Rygel

Clear and Independent Institutional Investment Analysis

We provide institutional investors, including pension funds, insurance companies and consultants, with data and analysis to assess, research and report on their investments. We are committed to fostering and nurturing strong, productive relationships across the institutional investment sector and are continually innovating new solutions to meet the industry's complex needs.

We enable institutional investors, including pension funds, insurance companies and consultants, to conduct rigorous, evidence-based assessments of more than 5,000 investment products offered by over 700 asset managers.

Additionally, our software solutions enable insurance companies to produce consistent accounting, regulatory and audit-ready reports.

To discuss your requirements
+44 (0)20 3327 5600
info@camradata.com

Find us at camradata.com

Join us on LinkedIn

Follow us on Twitter @camradata

Contents

Welcome to CAMRADATA's Insurance CIO Whitepaper

As the world emerges from the Covid-19 pandemic in staggered stages, insurers have their sights set on opportunities further along the risk curve amid improving economic conditions.

Previous business models will no longer suffice for a post-Covid age given the rapid digital transformations that have taken place, and insurers must also provide products and services that are desired by their customers, or economics 101.

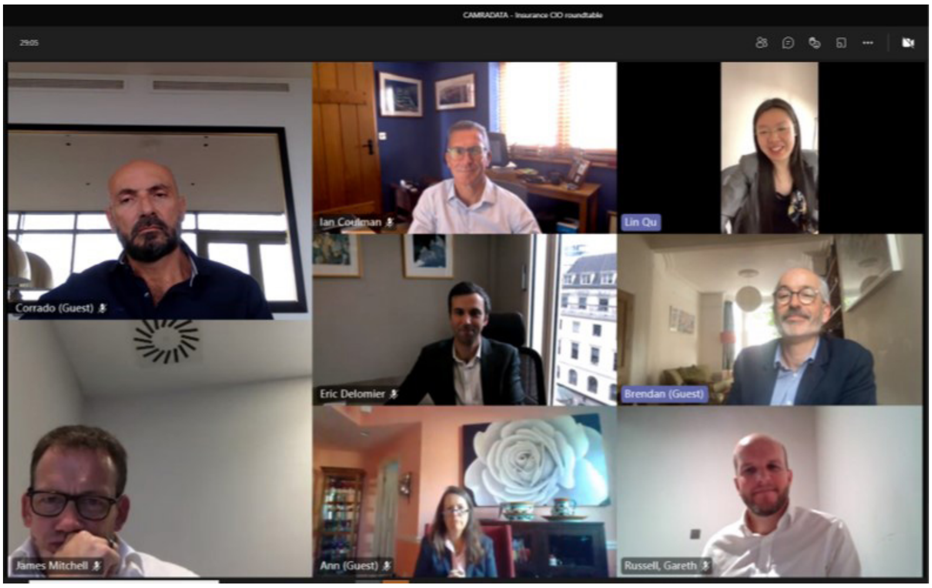
One obvious starting point is ESG integration across equity and debt portfolios. 2021 saw an explosion in interest around ESG from governments and the public at large, and investors are beginning to reflect on the importance of sustainable technologies, the case for sustainable alpha generation and changing consumer preferences of their strategies. But it's not just pandering to the public, for insurers are very well aware of the risks and impact of climate change – and increasingly biodiversity loss – on their physical assets.

As always, insurers will be keeping a close eye on policy and regulation – particularly with the UK's departure from the EU and the deviation that could follow in a bid to demonstrate the dividends of Brexit. One example includes data reform and the UK government's plans to do away with the EU rule whereby humans review certain decisions made by computer algorithms.

Another key issue is the case for change when it comes to regulation such as Solvency II, the European framework for insurance regulation. The Association of British Insurers (ABI) has welcomed the government's announcement to reform Solvency II in order for the sector to maximise its contribution to climate change investment and driving green investment.

Insurance CIO Roundtable

The CAMRADATA Insurance CIO Roundtable took place virtually in London on 23 September 2021.



" The tough, low-rate environment for sovereign issues and cash rates alongside extremely tight Investment-Grade credit spreads had inspired a shift of almost 20% of the portfolio into AAA and AA-rated Collateralised Loan Obligations"

Fears of the consequences of COVID-19 for society and the economy drove some insurers and reinsurers to make major asset allocation switches last year. The CAMRADATA 2021 Insurance CIO roundtable heard first from Ian Coulman, CIO of PoolRe, that both its equity and credit portfolios were cut by 25% in July 2020. The UK's reinsurer against terrorism damage to commercial property was concerned at that time that the global economy had not recovered from the effects of the pandemic; and no vaccine had yet been approved. PoolRe decided to move into short-duration gilts.

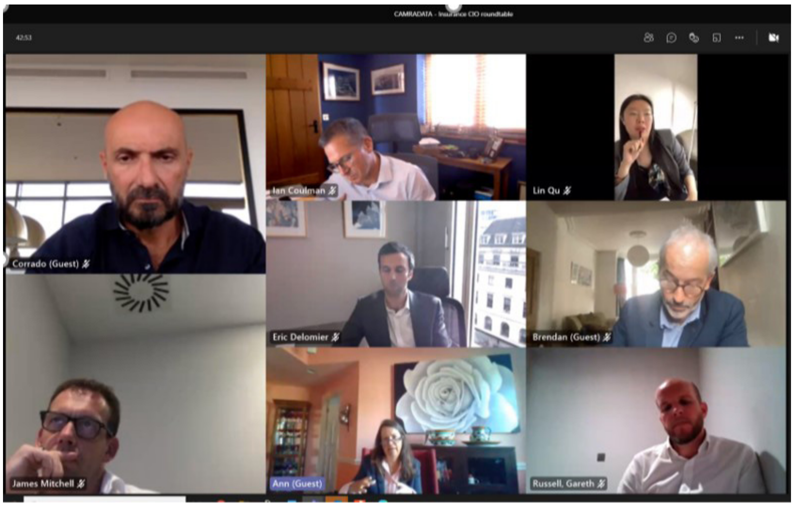
At Canopius, a speciality lines (re) insurer, given its low risk investment portfolio, COVID-19 was not the biggest driver of strategic change, although it did take advantage of market dislocations in April to make tactical allocations into shorter-dated credit. Gareth Russell, CIO, told the CAMRADATA panel, that the tough, low-rate environment for sovereign issues and cash rates alongside extremely tight Investment-Grade credit spreads had inspired a shift of almost 20% of the portfolio into AAA and AA-rated Collateralised Loan Obligations (CLOs). Although he described them now as a part of the insurer's core asset allocation, Russell said that it had been a learning process for the board to understand the nature of CLOs, notably on drawdown and dislocation. "The mark-to-market volatility of CLOs is significant, even for AAAs," he said.

To fund the purchases, which will eventually represent two-thirds of the entire allocation to securitised investments, Canopius exited Investment Grade corporate credit and cash.

At the other two insurers represented around the table, allocation changes have not been so profound. For Phoenix's Shareholder assets, James Mitchell, head of External Manager Oversight, said the focus away from UK to global less liquid assets continued. Phoenix has a stated ambition for £3-4bn of Bulk Purchase Annuities (BPA) business annually. The shareholder book, worth c. £43bn, has c. £10.7bn in private assets. Mitchell said that Phoenix was looking for the same credit perspective but pursuing geographic diversification with the US and Asia as potential targets.

A secondary asset allocation trend for Phoenix is towards venture capital and private assets. Mitchell said it is challenging to move in scale here and Phoenix was at the early stages of investments. The long-term insurer has hundreds of millions of pounds currently in Private Equity, Infrastructure and VC, Mitchell predicted that commitments would grow and emphasised societal impact as one motivation for this trend.

For Foresters Friendly Society, Corrado Pistarino, CIO, said that its move into alternative assets continued last year with an allocation to two trade finance funds. He described the objective as "giving members of the Society



" The managers at the CAMRADATA roundtable then gave an update on how they saw insurers acting"

access to an investment portfolio diversified across asset classes alternative to those widely available to retail investors."

Meanwhile, the equity exposure in Foresters' flagship fund was reduced. This move began pre-COVID-19, but as at Pool Re accelerated by the reach of the pandemic in early spring, as markets plunged. "Hindsight is a wonderful thing," admitted Pistarino, "but at the time Foresters' overriding concern was to protect the interest of its members against severe losses."

The managers at the CAMRADATA roundtable then gave an update on how they saw insurers acting. For Payden & Rygel, senior vice president, Eric Delomier said clients' appetite for credit and yield enhancement had them looking at Emerging Market Debt, structured credit and higher quality High Yield. He did not see value in extending duration given today's low real yields. From a credit perspective, Delomier reckoned that insurers in stronger capital positions could find attractive opportunities in CLOs given their better valuation relative to corporate bonds. In addition, he said that the demand-supply dynamic in Residential Mortgage-Backed Securities (RMBS) was very supportive for the sector, creating opportunities in non-agency RMBS. Furthermore, "commercial real estate has attracted a lot of bad headlines but the commercial property bond sector is wider than just retail and office collaterals," noted Delomier. In particular, he picked out CMBS backed by industrial properties as an interesting sub-sector. "Single Asset Single Borrower (SASB) transactions also offer specific exposure and more control to CMBS investors," he said.

For Muzinich, Lin Qu, head of investment solutions, discussed three drivers of yield enhancement in the current low-yield market environment: illiquidity premium, dislocation opportunities and complexity premium. For example, Private Debt can provide a yield pick-up from liquid credit markets, especially if exploited in newer markets such as Asia. Aviation Finance offers potential dislocation opportunities. Finally new markets and asset classes can be structured with specific balance sheet drivers in mind in order to pin-point desired credit exposures, exploiting a potential complexity premium.

Looking at shorter term market positioning, Qu said short duration credit could be attractive with potential rate rises and inflation expectations in the developed markets. She suggested that EM Short Duration Credit in particular can provide diversification as well as yield premium versus the ultra-low yield front end of the curve in developed markets. This can also be attractive for insurance companies not applying matching adjustment to portfolios due to the capital efficient treatment under Solvency II.

Ann Bryant, head of Barings' Global Insurance Solutions group, then observed that for all the talk of major asset allocation switches, insurance companies are typically buy-and-hold investors and tend to move allocations slowly as a result. Where bottlenecks start to appear, such as the move into private assets, she referenced the fierce competition for attractive assets.

She told the CAMRADATA panel that when it comes to allocating to private assets, being able to negotiate additional credit covenants, as Barings can in infrastructure debt, is valuable.

Elsewhere, now that spreads have tightened again, Bryant is seeing opportunities in CLOs, yield pick-ups in Emerging Markets Debt,

and more and more attention being paid to capital arbitrage.

Among securitized niches, she was cautiously supportive of RMBS: "You have to be diligent on the underwriting because some RMBS are quasi-private issues – they typically don't trade frequently."

Most supportive assets

The next theme of the CAMRADATA roundtable was bedrock assets, a moot discussion these days given the miserly opportunities in the traditional bedrock of short-dated sovereigns.

"Canopius's bedrock allocation has always been US Treasuries, but by at the end of 2020 the 5-year nominal was yielding only 35bps," explained Russell. "So we moved $500m into T-bills to avoid mark-to-market losses and haven't yet rotated back into Treasuries, although with recent yield-curve steepening a move back looks more interesting."

Pistarino explained that, like any insurer, Foresters is heavily exposed to rates and credit assets, while they continue to explore the market for alternative sources of income and return. If not a bedrock, nominal gilts are there as a hedge against tail events. "The Global Financial Crisis showed a divergence between Nominal and Linkers," said Pistarino. "Nominal gilts outperformed Linkers because of easier access to repo facilities and superior market liquidity. In essence, nominal gilts provide investors with an embedded option that gets triggered in those extreme scenarios."

Coulman admitted that he didn't have the answer on bedrock assets. By simple percentage, Investment Grade credit could be the answer: it's 60% of Pool Re's Strategic Asset Allocation and even after last year's derisking, still stands at 45%. Holding so much now in short-dated gilts, Pool Re avoids interest rate risk and can also easily trade those gilts, reducing liquidity risk.

Regarding inflation and its influence on asset values, Coulman was anxious. His fear is that major Central Banks will continue to "do whatever it takes" to keep markets stable, introducing a false sense of security. "With rates where they are, Central Banks will run inflation hot for a while," he said. If equity markets have been left in a bullish mood and bond rates continue to make record lows, will the punchbowl be taken away as inflation reappears?

Delomier picked up on the false sense of security as it relates to private assets. He acknowledged their rising popularity with investors, which makes sense for those with long-dated liabilities. He nevertheless cautioned: "My concern is that there are more and more players; some can't give up that liquidity," he said. "Prices in public markets contain a lot of valuable information about the credits you hold in a portfolio. You don't have that price signalling in private markets so the build-up of some problems does not get recognised until it's too late."

Qu responded that the question was whether investing in government bonds would be sufficient to meet the target return of insurance companies. Many of these bonds yielded over 10% 20 years ago and used to be the default allocations for insurers. In the context of the low-yield environment and in combination with a better understanding of market risk, institutional investors initially shifted into 'alternative assets classes' such as liquid credit markets to build more diversified portfolios. With much of the developed market credit universe now exhibiting low or negative yields, Qu argued that the focus had shifted to illiquid credit exposures. Given the aforementioned information 'disadvantage' of private markets, active management would also be more important in the alpha generation process.

Bryant said default risk is different to volatility or liquidity risk. "You can be a forced seller but not run default risk. It's important to weigh the risks: no one asset class is bad or good."

Mitchell commented that all insurers, including Phoenix, had been impacted by the by the heightened risk of downgrades both in the US and UK during the

" Regarding inflation and its influence on asset values, Coulman was anxious."

Covid-19 pandemic. Delomier agreed that being selective within any asset class was crucial. He gave the example of Emerging Markets, which has been attracting a lot of headlines on the Chinese real estate sector. However, compared to the 2013 'taper tantrum' episode, Emerging Markets are overall much better prepared to withstand rising Fed Funds rates given improved current account positions.

This has been the case for Canopius with CLOs. Russell noted that for AAA-rated products, even version 1.0 CLOs suffered no defaults. Post Dodd-Frank, version 2.0 CLOs have better credit enhancements and diversification, plus greater manager experience for insurers to leverage. But he still expressed caution about CLOs behaviour during market stress. "Fundamentally, they are not as esoteric as ten years ago but will sell off," he said.

Payden & Rygel manages over US$25bn in structured credit and Delomier echoed the points made by Russell. Quoting S&P data, Delomier said AAA and AA-rated CLOs had experienced a 0.0% default rate in the last 25 years. "We agree with Gareth that right now CLOs offer better value than straight corporate bonds," he said, before explaining that periods of market stress can create opportunities: "AAA tranches in March 2020 performed worse than subordinated tranches because AAA was what people could sell in that exceptional market environment," said Delomier.

While on the topic of risk protection, Delomier noted Lloyd's introducing tougher strategic asset allocation requirements for Funds at Lloyd's. His reading of the changes was that greater exposure to structured credit and short-dated hard currency Emerging Market debt would be an attractive source of yield enhancement as a replacement to 'non-core assets' such as equities.

Pistarino then gave more on the rationale for Foresters' selecting trade finance funds. Regarding market timing, he noted that trade finance is pro-cyclical and the rebound in economic activity post-Covid provided a strong rationale for investing. Foresters selected two funds, each with a focus on a different market segment to increase diversification and further mitigate risks. The first he described as a fin-tech AI manager, with a highly diversified portfolio and significant infrastructure for data analysis; the other, more a 'feet-on-the-ground' manager, with a smaller portfolio and a documentation-heavy investment process." Pistarino added that both funds offer quarterly redemptions, which helps maintain a sound liquidity profile in Foresters' portfolios.

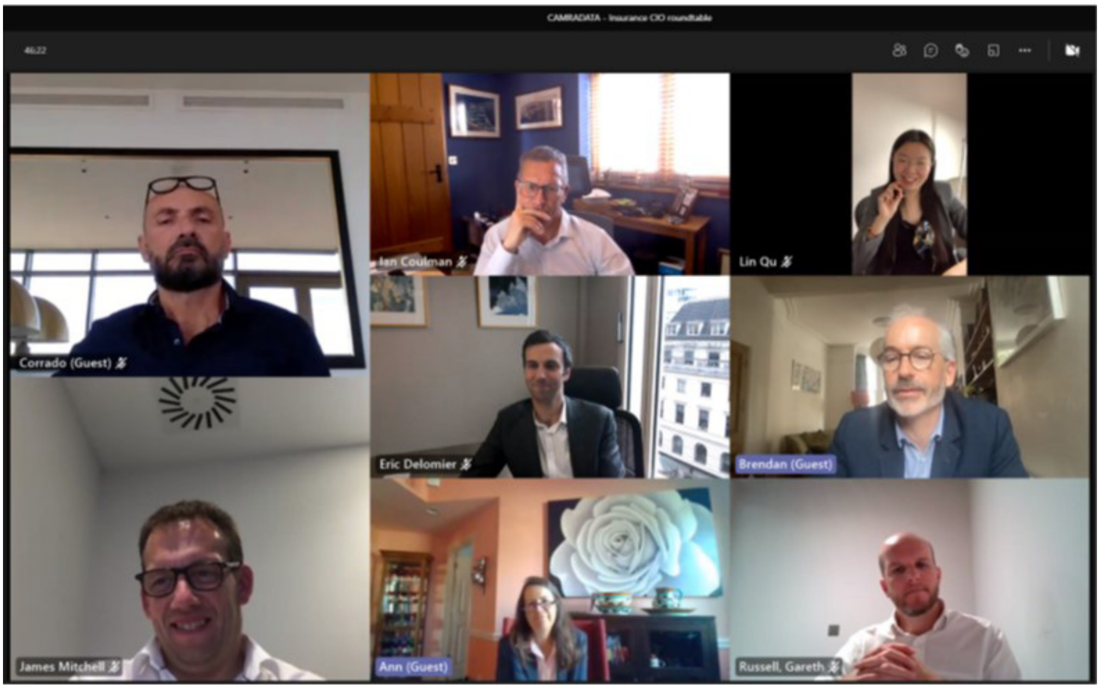
Qu noted the role of third-party asset managers in assisting insurers to deploy capital not only to good quality transactions but moreover with sufficient deployment speed. She reiterated the value of private debt in terms of stability and yield pick-up, but acknowledged that insurers might not have the resources to source the best deals. "Muzinich is working in partnership with insurers on solutions for private debt portfolios," she said, adding that providing solutions includes recognising the particular balance-sheet constraints.

Bryant said that private debt is a broad term. She told the CAMRADATA panel that for some investors in infrastructure debt, funds make more sense than separate accounts because funds are a quicker way to access these markets in a diversified manner. She noted the different cashflow characteristics, with cash coming out the back of funds giving insurers the facility and also obligation to redeploy.

She explained that Barings' parent, MassMutual, tends to participate in deals, and that aligns with third-party investors. As an alternative to funds, separate accounts can bring more control. Private placement club deals in particular (as opposed to syndicated deals) offer the ability to negotiate covenants. Bryant said that one issue for asset owners is how quickly capital can be deployed. "If you have a high yield hurdle, it takes longer," she said. "It just depends on a client's preferences."

Bryant was asked finally whether she expected a greater volume of opportunities given the transformational spend on infrastructure currently under debate in Washington DC. She replied that change on the ground

" Trade finance is pro-cyclical and the rebound in economic activity post-Covid provided a strong rationale for investing."



had not yet come through but noted that infrastructure is being redefined by the Biden administration. "Now it extends to social infrastructure, such as childcare and safety nets against situations such as COVID-19. At the same time, there are more and more upgrades of roads, bridges and reservoirs slated. That is necessary too."

"An increasing number of catastrophic events now occurring such as snowstorms in Texas are proving harder to model, and that is a worrying trend for insurers."

Insuring the world against catastrophe

Coulman then turned the debate to ESG. "Asset owners should take more responsibility and challenge corporates about their ESG," he said. "Pool Re has been developing its policy for four to five years; it has been a step-change."

He rejected the argument from debt managers who say they can't vote at AGMs. "Pool Re believes debtholders can have a greater say as repeat financiers in the policies of a company," said Coulman.

"We believe in engagement not exclusion. Some companies are not recognising the need for change. It's a long process but they must look after stakeholder value. We hold our managers to account. We challenge them on investments." Coulman pointed to TCFD as a means for companies to demonstrate that they are doing something about climate change - and calibrate it.

Russell noted that an increasing number of catastrophic events now occurring such as snowstorms in Texas are proving harder to model, and that is a worrying trend for insurers.

Mitchell agreed that floods, fires and droughts had led managers to ramp up their research but he said Phoenix was continually challenged by the variability of ESG data and the differences in standards across providers. This was especially a challenge for Phoenix's third-party collective investments (c. £50bn) where Phoenix has less influence on ESG policies than in dedicated mandates.

Qu agreed with the gaps in data availability. She mentioned a case study for a client that showed that over 10% of the US High Yield universe wasn't covered by MSCI ESG ratings.

On the private debt side, she recognised that the bilateral nature of investing provides an opportunity for asset managers to have impact. For example, negotiating with issuers can result in the inclusion of specific ESG criteria into covenants. It is not only about investing in assets with strong ESG scores, but also to encourage improvements and therefore investing to exert a positive influence.

Bryant said that insurance companies are gravitating toward climate change, where they can get data. "It's not just about what a company is doing now: as a large investor, we can influence progress and attempt to bring about lasting change," she said.

Although she felt ESG was progressing more slowly in the US than Europe, Bryant said that climate change has become a huge focus for Americans. Regarding the challenges of modelling extreme weather risk, she noted that there have been private-backed opportunities in reinsurance.

Delomier concluded the roundtable by saying that Payden & Rygel engaged with issuers both directly on behalf of its clients and also via industrywide initiatives such as the UNPRI or the Sustainable Accounting Standards Boards (SASB). In particular, he pointed out that SASB provides worthwhile standards that give clear ESG disclosure metrics directly relevant to each industry. He said that engagement is more complex with sovereign issuers, making the need for industrywide coordination critical. To accelerate this industrywide engagement, Payden & Rygel has signed up to the Net Zero Asset Managers Initiative whereby managers partner with their clients on decarbonisation goals, consistent with an ambition to reach netzero emissions by 2050.

Roundtable Participants

Ann Bryant

Head of Insurance Solutions Group

Barings

Personal Profile

Ann Bryant is the Head of Barings' Insurance Solutions Group. Ann collaborates with colleagues across Barings' global investment platform to provide capital-efficient investment outcomes to meet long-term liability needs for the firm's insurance clients.

Prior to joining the firm in 2019, Ann was VP and Senior Portfolio Manager at Reinsurance Group of America, Inc. Prior to that, she was VP, Capital Markets at Summit Strategies Group and a Principal at Mercer.

Ann holds a bachelor's degree in Mathematics from The University of Wyoming and is a Fellow of the Society of Actuaries.

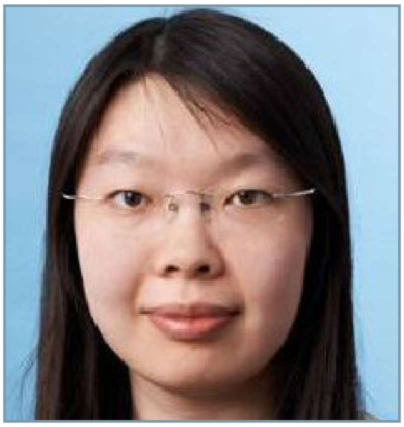
Company Profile

Barings is a $387+ billion* global investment manager sourcing differentiated opportunities and building long-term portfolios across public and private fixed income, real estate, and specialist equity markets.

With investment professionals based in North America, Europe and Asia pacific, the firm, a subsidiary of MassMutual, aims to serve its clients, communities and employees, and is committed to sustainable practices and responsible investment.

*As of September 30, 2021

Roundtable Participants



Lin Qu, CAIA,

Head of Investment Solutions

Personal Profile

Lin Qu is an experienced investment professional with extensive knowledge of institutional balance sheet management and a wide variety of investment asset classes. She is responsible for the design and implementation of global investment solutions for Muzinich, a global asset manager providing a wide range of credit solutions since 1988, with AUM over US$40billion.

Prior to Muzinich, she worked on various projects in the field of insurance and pension fund balance sheet management, global investment and (re)insurance transaction strategies for clients such as Apollo and British Columbia Investment. Prior to that, Lin was the CIO of Legal and General Reinsurance, where she helped develop the company and overseeing all the investments of the firm. Before that, Lin was Vice President and a portfolio manager in BlackRock's London office, where she managed liability driven investments, fiduciary and non-linear portfolios for segregated insurance and pension fund clients. Lin joined BlackRock from ING Investment Management, where she was the lead investment manager of the global derivative and overlay hedging desk. Alongside managing and advising the derivative and hedging activities for ING insurance globally, she was responsible for the overlay marco portfolios for ING insurance Benelux. Lin started her career life in AEGON Group as a risk manager mainly working on pricing of global investment-linked insurance products and market risk management.

Muzinich & Co

Muzinich & Co

Company Profile

Muzinich & Co. is a privately-owned, institutionally-focused investment firm specializing in public and private corporate credit. Our established track record stretches back over 30 years, highlighting our ability to deliver what we believe to be superior risk-adjusted returns in a variety of market conditions with no style drift. Since the beginning, we have focused on a relationship-based institutional business that has stressed the importance of seeking to produce consistently attractive risk-adjusted returns.

Founded in 1988, the firm's AUM was $39.6bn as of 28th February 2021. We have 227 employees in 14 offices, across US, Europe, Asia and Emerging Markets, including 104 investment and risk professionals.

Our advantages include a clear, consistent, risk-managed investment approach for 30 years, an integrated and collaborative platform across public and private markets, and a focus on developing intelligently-crafted credit solutions to meet investors' needs.

Over the years the firm has broadened its credit-based investment programmes and leveraged its credit expertise. Our global presence and depth of resources allow us to offer a broad range of corporate credit investment strategies across developed and emerging markets in public and private debt.

Eric Delomier

Senior Vice President

Personal Profile

Eric Delomier is a Senior Vice President at Payden & Rygel. Eric works with institutional investors with a focus on insurance companies and sovereign institutions.

Prior to joining Payden & Rygel, Eric worked for seventeen years with J.P.Morgan Asset Management and the Capital Group as a fixed income client portfolio manager in Singapore and Hong Kong.

He started his career as a quantitative research analyst in London with J.P.Morgan Asset Management.

Eric Delomier holds a MSc in Economics from the London School of Economics and an MSc in Banking, Finance and Insurance from University Paris Dauphine. Eric holds the Chartered Financial Analyst® designation.

Payden & Rygel

Company Profile

Payden & Rygel manages in excess of £100 billion in assets for sophisticated institutional clients including Insurance Companies, Pension Funds, Central Banks and Sovereign Wealth Funds. We manage over £15 billion for insurance entities across life, non-life and reinsurance liabilities.

Founded in 1983; Payden & Rygel is now one of the largest employee-owned global investment management firms offering a full array of investment strategies. We focus on delivering superior risk-adjusted returns in highly customised portfolios including Investment Grade Corporate, Emerging Market and Municipal Bonds

Roundtable Participants

Gareth Russell

Chief Investment Officer

Gareth is currently Chief Investment Officer at Canopius, a global speciality lines (re)insurer. The Canopius group operates through the following underwriting platforms:

• Canopius Managing Agents Limited, which manages Lloyd's Syndicate 4444
• Canopius US Insurance, Inc., a US excess & surplus lines insurance company
• Canopius Reinsurance Limited, a Bermudan class 4 Reinsurance company

Gareth leads the in-house investment team which is responsible for managing a $3.5bn largely outsourced investment infrastructure.

Gareth has 20 Years of Consultancy and Investment experience with a particular focus on asset research, portfolio construction, manager selection and operations. He is a qualified Actuary, holds an Executive MBA from Cass Business School and has a BSc in Mathematics from the University of Nottingham.

Corrado Pistarino

Chief Investment Officer

Corrado Pistarino has more than 20 years experience in capital markets. He is Chief Investment Officer at Foresters Friendly Society.

Previous to his current positions, he was Head of Insurance LDI at Aviva Investors, responsible for over £10bn of insurance funds and £30bn of derivatives exposure.

His previous employers include Deutsche Bank, Dresden Kleinwort and ABN AMRO Bank. He worked in structuring/trading and client coverage, with a focus on ALM and capital management solutions.

Corrado has a degree in Physics from Turin University and a Masters in Finance from London Business School.

Ian Coulman

Chief Investment Officer

Ian has been Pool Re's Chief Investment Officer since joining in 2011. As CIO he is responsible for the development and implementation of investment strategy, strategic asset allocation and the monitoring of the range of managers through whom Pool Re invests.

Prior to joining Pool Re as CIO, Ian fulfilled a number of senior investment roles with Butterfield Bank in Bermuda and AIG in London, Boston and Tokyo. Ian began his investment career with the private Swiss bank Lombard Odier.

James Mitchell

Head of Manager Selection & Oversight

James ran the Transition Management businesses at Barclays Invest Bank (1yr) and previously Goldman Sachs (10yrs), he started his career at Goldman in Equity Portfolio Trading in 2000. He has lead and executed more than 50 multi billion pound transition management exercises, achieving significant investment portfolio change for large institutional asset owners whilst mitigating market risk and cost.

Over this time his clients have included many European Governments, the majority of the largest DB Pension Funds in the UK, UK Insurers (Zurich, LV), and Large Family offices, with an estimated value of transition assets of more than £250bn across global Fixed Income, Equity, Derivatives and Foreign exchange markets. Has over 20 years of experience in the physical execution of asset transitions between Asset Managers and has deep understanding of Asset Manager capabilities, both investment outcomes and operational capabilities.

POOL Re
REINSURING TERRORISM RISK

PHOENIX GROUP

Moderator

Brendan Maton

Freelance Jounalist

A highly experienced financial journalist with an expansive network of contacts in the UK and across Europe. Brendan has written about pension schemes and national welfare systems from Finland to Greece for 18 years and understands the retirement savings industry in each European country.
Brendan has interviewed EU commissioners and national ministers; central bankers; pension scheme heads; insurance chief executives; chief investment officers; actuaries; union officials; professional and lay trustees.He worked at Financial Times Business for eight years, finally as editor-in-chief of all international pensions titles. Brendan has spent the last ten years as a freelancer for a number of publications, including Financial Times, Responsible Investor, Nordic region pensions news and IPE. He is also Chief webcast host for IPE.
Brendan has acted as conference chair for Financial News, the UK National Association of Pension Funds, Dutch Investment Professionals Association (VBA), Corestone, Insight Investment, Marcus Evans, Robeco Asset Management, Sustainable Asset Management (SAM), Towers Watson.


BARINGS
GLOBAL INSURANCE SOLUTIONS
BUILT ON DEEP EXPERIENCE & PARTNERSHIP
Barings, a subsidiary of MassMutual, is built to serve the unique needs of insurance companies. Our team of specialists develops customized solutions, leveraging the firm's deep insurance experience across public and private asset classes.
BARINGS.COM
21-1825706

The Staying Power of Commercial Mortgage Debt

This piece was adapted from an article published on Barings.com. To read the full piece, please visit: https://www.barings.com/viewpoints/the-more-things-change-the-more-they-stay-the-same

> ***" The potential yield enhancement offered by private assets is particularly evident by comparing two portfolios of similar duration and credit quality "***

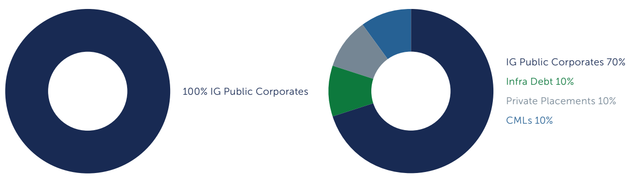
Amid the prolonged low-rate environment of recent years, many insurers have looked for ways to enhance yield without taking on more risk. While there are no magic assets, and "high" yield might not be realistic for "low" risk, there are ways insurers can enhance yield without diminishing quality—namely through allocations to certain types of investment grade (IG) private assets, such as commercial mortgage loans (CMLs).

Yield Enhancement & Strategic Portfolio Benefits

Relative value between public and private IG asset classes tends to shift over time. Even so, IG privates have consistently provided opportunities and added yield. Over the last five years, for instance, CMLs provided roughly 50 basis points (bps) over corporates, on average[1]. Although certain real estate sectors have experienced spread compression more recently amid heightened deal volume, CMLs continue to represent a material premium over public corporates—suggesting that while the specific opportunities on offer can and do change, the bottom-up, fundamentals of private market value remain consistent.

The potential yield enhancement offered by private assets is particularly evident by comparing two portfolios of similar duration and credit quality—one with a 100% allocation to IG public corporate debt and one with a 70% allocation to IG public corporates, along with an allocation of 10% each to CMLs, private placements and infrastructure debt.

THE PORTFOLIO IMPACT OF PRIVATE ASSETS



	Duration 3		Duration 8	
Portfolio Allocation	100% IG Public Corps	70%/30% IG Public/Private	100% IG Public Corps	70%/30% IG Public/Private
Gross Yield	1.01%	1.21%	2.82%	3.02%
Average Credit Quality	A-/BBB+	A-/BBB+	A-/BBB+	A-/BBB
NAIC Life RBC	0.85%	0.90%	0.85%	0.90%
NAIC P/C RBC	0.65%	1.08%	0.65%	1.08%
AM Best BCAR	3.34%	3.75%	5.52%	5.52%
Bermuda SCR	2.25%	2.52%	2.25%	2.52%

SOURCE: Barings data and market observations.

As demonstrated, including a 30% allocation to private IG assets is estimated to increase overall portfolio yield by 20 bps—based on long-term achievable spread assumptions—with only a small increase in required capital. In Solvency regulatory regimes including the U.K., Europe and Bermuda, the asset yield can be a factor in determining the reserve discount rate, thus further reducing the overall reserve/capital requirements. Each company's yield assumption/target should be set in a manner consistent with other objectives, including the time to put money to work, diversification within the allocation, tenor, and specific quality constraints.

[1] Source: Based on Barings data. As of March 31, 2021.

BARINGS

The lower risk of the 70/30 portfolio is less due to low correlation to other asset classes, and more a result of the strong covenants and high-quality collateral typical of private assets. While the expenses for managing private IG assets are higher than public asset expenses, the expected defaults are lower. Core CML defaults, for instance, are expected to be zero[2].

Finding Tactical Value Post-COVID: A Closer Look at CMLs

When it comes to real estate, location is of paramount importance. Commercial mortgage loan originators are familiar with their respective territories and understand their local dynamics, typically visiting and inspecting each property to underwrite the mortgage. From the borrower's perspective, the relationship with the lender is also important. Specifically, the lender's ability to execute the mortgage in a timely fashion and to provide consistency in servicing capabilities, as well as flexibility with regard to negotiating contractual provisions like refinancing and prepayment, are critical. Indeed, such considerations could motivate high-quality borrowers to work with non-CMBS lenders.

Author:
Ann Bryant
Head of Insurance Solutions Group

Favorable Capital Treatment

High-quality CMLs tend to receive favorable capital treatment under most regulatory systems. Outside the U.S., the solvency rules vary and require differing levels of stress tests and modeling—however, the liability matching characteristics as well as the historically low risk have resulted in a favorable view under many regimes. Additionally, CMLs allow for "make whole" provisions in the event of prepayment, which is particularly important under the U.K. Solvency II rules, to meet the Matching Adjustment criteria. For these reasons—and with the added benefits of enhanced diversification and a quicker ramp period—there can also be benefits to including CMLs originated in the U.S. as well as those originated in the U.K./Europe.

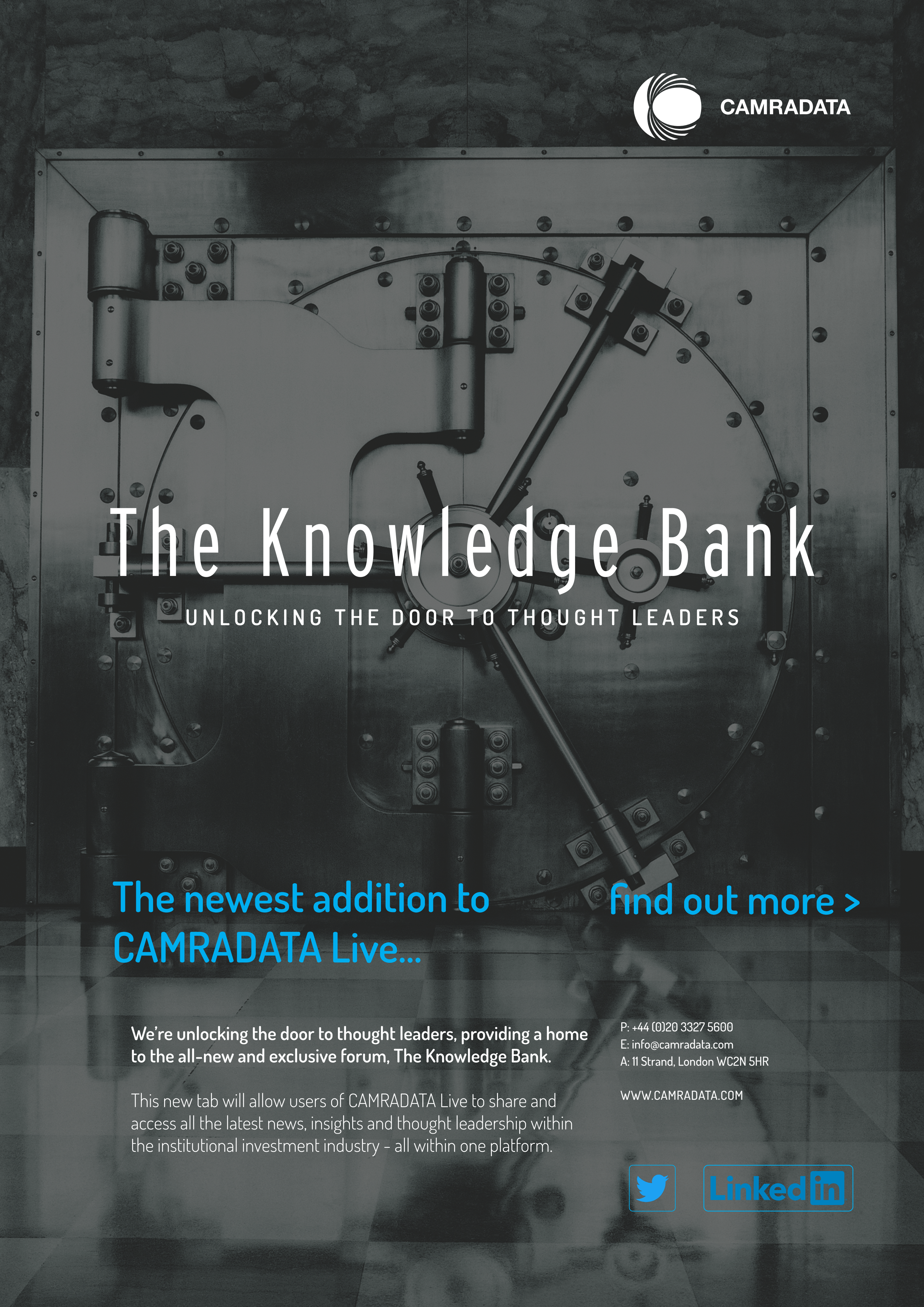
Historically Low Delinquencies

At the end of 2020, life insurers held roughly 15% of all outstanding CMLs[3]. Over time, the high-quality nature of insurance company CMLs has resulted in extremely low delinquency rates, even in times of turmoil. In fact, delinquency rates for CMLs have not exceeded 0.5% since 2000, remaining below 0.5% during the GFC and just above 0% in the wake of the pandemic—well under their peak of roughly 7% in the 1990s. In contrast, CMBS delinquencies were 7.5% as of the end of last year, having peaked at 9.5% during the financial crisis[4]. And while these delinquency rates are not directly comparable among investor groups, as the risk/reward trade-offs and credit quality differs, the rates do serve as a helpful reference point to contextualize the low risk associated with insurance company-owned CMLs.

Key Takeaway

IG privates have consistently provided opportunities for insurers to add yield without diminishing quality. Core CMLs, in particular, can offer a number of benefits—from a material spread premium over similarly rated corporates, to low historical defaults and delinquency rates, to diversification. However, market access and relationships with market participants, alongside fundamental, bottom-up underwriting, is key to uncovering the best risk-adjusted opportunities. Further, given the tendency of relative value to fluctuate over time, partnering with a manager that has a wide frame of reference and visibility across public and private markets is critical.

[2] Based on Barings data and market observations.
[3] Source: Mortgage Bankers Association Quarterly Databook. As of December 31, 2020.
[4] Source: Mortgage Bankers Association Quarterly Databook. As of December 31, 2020.


CAMRADATA
The Knowledge Bank
UNLOCKING THE DOOR TO THOUGHT LEADERS
The newest addition to CAMRADATA Live...
find out more >
We're unlocking the door to thought leaders, providing a home to the all-new and exclusive forum, The Knowledge Bank.
This new tab will allow users of CAMRADATA Live to share and access all the latest news, insights and thought leadership within the institutional investment industry – all within one platform.
P: +44 (0)20 3327 5600
E: info@camradata.com
A: 11 Strand, London WC2N 5HR
WWW.CAMRADATA.COM
LinkedIn

Payden&Rygel

"New FAL investments in Irish mutual funds will resume from the 1st of January 2022 : funds are an operationally efficient way for syndicates to maximise total return opportunities in FAL"

Lloyd's (of London, not Christopher) is reforming and modernising its infrastructures. As part of this broader initiative, changes are being implemented in the way the Corporation expects Funds at Lloyd's (FAL) to be invested. After several revisions to the regulation, the final version will have limited asset allocation implications for syndicates. Separately, **Lloyd's just announced that new FAL investments in Irish mutual funds will resume from the 1st of January 2022**. While this has attracted less attention, it is an important development for syndicates: it will help them be more flexible and reduce the operational burden in the management of their FAL. Interestingly, at this stage, Luxembourg domiciled mutual funds are still not allowed for new investments.

There has been a fair amount of back and forth on Lloyd's new Strategic Asset Allocation (SAA) requirements. The initial version released to the market on the 24th of September 2021 as part of its Membership & Underwriting Conditions and Requirements (M&UR) would have had a meaningful impact on FAL asset allocations: the introduction of a 40% cap on non-core assets (equities, alternative assets, high yield and A/BBB-rated securitised bonds) would have forced syndicates with a more aggressive FAL portfolio to look for higher yielding alternatives within core assets (essentially investment grade bonds and AA-or-better securitised). The revised version published in the market bulletin Y5353 a month later however has greatly diluted the rules: the SAA requirements now apply to each member's aggregate capital (ie, including Funds in Syndicate and sub-funds at syndicate level) rather than FAL in isolation. Since non-FAL, portfolios are dominated by high quality fixed income assets, this new version of the regulation will have limited implications on FAL asset allocations.

More broadly, FAL's attractive capital treatment implies it can be a good place to hold higher Solvency II (SII) capital charge assets – securitised is an obvious candidate. When it comes to securitised, the CLO market is often the first port of call for insurers. With spreads of approximately 100-110bp on AAA-rated tranches and 160-170bp on AA-rated tranches, they currently offer compelling value relative to competing alternatives. **Beyond their yield pick-up, CLO 2.0's improved structures and their extremely low default history strengthen the case.** In addition to CLOs, securitised markets offer a wide range of collaterals: Consumer Asset-Backed (ABS) and Commercial MBS (CMBS) have grown significantly, and relatively new markets in the U.S. for Single Family Rental (SFR) and Agency RMBS Credit Risk Transfer (CRT) bonds continue to grow. **Taking advantage of this wide range of collaterals beyond CLOs can strongly diversify an insurer's credit exposure, and allows for a range of durations, maturities, and credit risks.** The loan level data of many structures also provides an interesting opportunity for ESG and impact investment screens with more details than provided by vague corporate commitments.

Separately, for many syndicates with large CRTF/SLTF portfolios, the geographic exposure tends to be very US-centric given the 10% cap on non-US issuers in the New York Insurance Law. FAL can therefore be a good place to diversify a syndicate's geographic exposure. In particular, because **EMD has matured and broadened as an asset class, it is today possible to build diversified short maturity EMD allocations suitable for non-life insurance portfolios.** Specifically, the EM corporate bond market that developed in the last ten years is generally much shorter maturity than traditional EM sovereign bonds: according to JPMorgan EM Indices, the average maturity of EM corporate bonds is approximately six years, about half the average maturity of EM sovereign bonds. In addition, the average spread on US dollar-denominated investment grade EM corporate bonds was 149bp on the 25th of October 2021 versus 86bp on the corresponding Bloomberg US investment grade corporate index.

Authors:

Eric Delomier
Senior Vice President

Erinn King
Managing Director

Eric Hovey
Senior Vice President

These wider credit spreads are at odds with stronger credit fundamentals for EM corporate issuers relative to their US peers: according to JPMorgan, the average net leverage of EM investment grade issuers is 1.7 times EBITDA versus 2.7 times for US investment grade issuers. From a macro perspective, Fed tapering talk has revived parallels with the 2013 'taper tantrum' episode which had triggered a period of volatility in several EM countries. Significant improvements in the current account position of emerging countries however make them much better positioned to withstand higher US rates today. Finally, EM corporate bonds are attractive under SII: they offer a significant yield pick-up for the same capital charge as US corporate bonds.

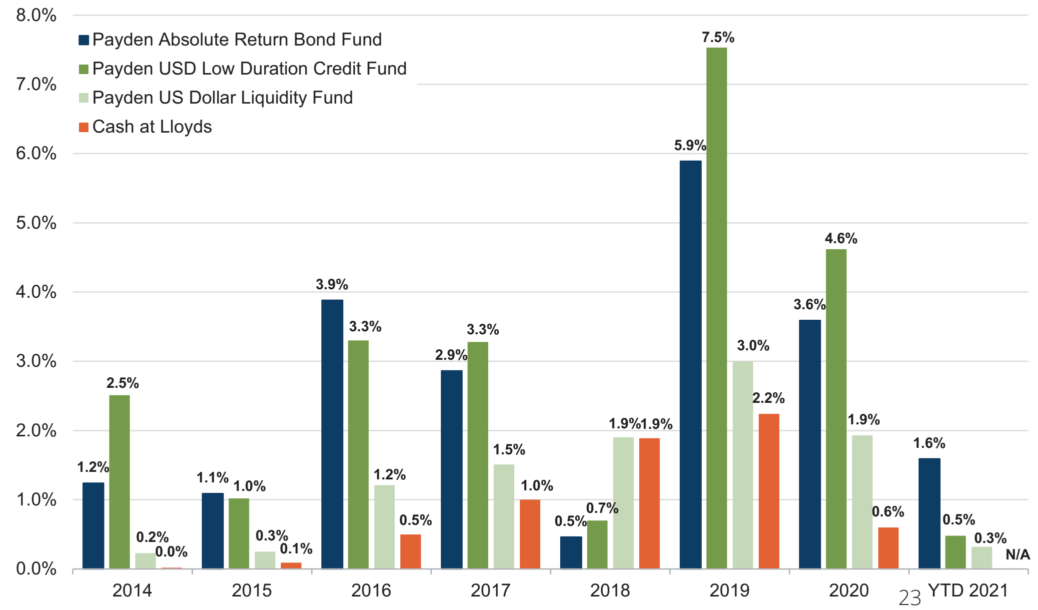
UCITS for FAL: Back to the Future

Lloyd's has recently announced that new Irish UCITS investments will be allowed from the 1st of January 2022. This will be a welcome return for syndicates given the flexibility and operational benefits mutual funds bring. Lloyd's will be looking through to the underlying mutual fund holdings (for funds providing this transparency) so that they are treated on par with directly held assets.

A number of syndicates who had set up their FAL UCITS accounts before the summer 2020 actively use Payden's Irish UCITS line-up. In particular, the Payden Absolute Return Bond Fund targeting 2-3% above cash has been an effective way for syndicates to build a diversified exposure to short maturity credit sectors. For syndicates sharing our favourable view on securitised, the fund has had a 40% to 60% allocation to the sector in recent years across various collaterals and seniority. Different funds will however be suitable for different risk-return objectives. For instance, the Payden USD Low Duration Credit Fund is better suited for syndicates focusing on short maturity investment grade corporate bonds. Likewise, the Payden US Dollar Liquidity Fund works well for conservative syndicates aiming to outperform Cash at Lloyd's: it has returned an average of 52bp net of all fees over Cash at Lloyd's between 2009 and 2020 without experiencing any negative return year. The below chart shows how the three funds mentioned here have consistently outperformed the US dollar cash at Lloyd's offering. Finally, **Payden's range of seventeen UCITS offers a lot of operational flexibility to blend different funds and tailor FAL allocations to the desired risk-return profile over time**. This can be achieved in the six eligible FAL currencies (USD, EUR, GBP, JPY, CAD or AUD) since our entire range of Irish UCITS is available in any of these currencies.

FAL is an attractive part of the capital structure to hold higher SII capital charge assets such as securitised. It can also be a good place for syndicates with large CRTF/SLTF portfolios to diversify their geographic exposure away from the US. Irish UCITS, once again open for new FAL investments, are an operationally efficient way for syndicates to maximise total return opportunities.

Performance of Select Payden UCITS vs Cash at Lloyds (Net of all fees at 30/09/2021)



Meet the Team!

Sean Thompson

Managing Director

Natasha Silva

Managing Director,
Client Relations

Amy Richardson

Senior Director,
Business Development

Natasha Fletcher

Senior Associate, Client Relations
and Business Development

Sam Buttress

Associate, Business Development

Sarah Northwood

Marketing and Events
Coordinator

Mithursha Kesavan

Database and Publication Support
Associate

CAMRADATA

CAMRADATA
5th Floor, 11 Strand,
Charing Cross, WC2N 5HR

+44 (0)20 3327 5600
camradata.com

Join us on LinkedIn

Important Notice

This document is produced by CAMRADATA Analytical Services Ltd ('CAMRADATA'), a company registered in England & Wales with registration number 06651543. CAMRADATA is neither authorised nor regulated by the Financial Conduct Authority in the United Kingdom nor the Securities and Exchange Commission in the United States of America.

This document is not intended to constitute an invitation or an inducement to engage in any investment activity. It is not intended to constitute investment advice and should not be relied upon as such. It is not intended and none of CAMRADATA, its holding companies or any of its or their associates ('CAMRADATA Group') shall have any liability whatsoever for (a) investment advice; (b) a recommendation to enter into any transaction or strategy; (c) advice that a transaction or strategy is suitable or appropriate; (d) the primary basis for any investment decision; (e) a representation, warranty, guarantee with respect to the legal, accounting, tax or other implications of any transaction or strategy; or (f) to cause the CAMRADATA Group to be an advisor or fiduciary of any recipient of this report or other third party.

The content and graphical illustrations contained in this document are provided for information purposes and should not be relied upon to form any investment decisions or to predict future performance. CAMRADATA recommends that recipients seek appropriate professional advice before making any investment decision.

Although the information expressed is provided in good faith, the CAMRADATA Group does not represent, warrant or guarantee that such information is accurate, complete or appropriate for your purposes and none of them shall be responsible for or have any liability to you for losses or damages (whether consequential, incidental or otherwise) arising in any way for errors or omissions in, or the use of or reliance upon the information contained in this document. To the greatest extent permitted by law, we exclude all conditions and warranties that might otherwise be implied by law with respect to the document, whether by operation of law, statute or otherwise, including as to their accuracy, completeness or fitness for purpose.