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Conversations with…

Jason Pratt, Portfolio Manager and Head of Insurance Fixed Income

Late-Cycle Investing for Insurance Companies

If the economy continues to grow into mid-2019, the current business cycle will be the longest on record. Cycles do not die of old age—the fatal blow usually comes from a financial shock or a struggle to control inflation, and we see no obvious signs of that over the next 12 – 18 months. Nonetheless, the prudent investor positions for late-cycle as well as end-of-cycle dynamics. Easy, market-beta returns are likely already behind us as interest rates are trending higher and credit spreads have the potential to widen off what have been historically tight levels. **Jason Pratt, Head of Insurance Fixed Income**, explains why this is particularly challenging for insurance investors that have little tolerance for capital loss—and what they can do to prepare for it.

Why are late-cycle dynamics so tricky for insurance investors?

Almost by definition, the end of a business cycle involves inflation, which pushes up interest rates and bond yields. As policy influence on the markets wanes, we should expect increased risk of debt default, continued higher volatility and a pick-up in return dispersion as assets start to re-price back in line with fundamentals. This type of transition is challenging for any investor because it means the days of index-level returns are over. As we know, insurance portfolios that are anchored to fixed income markets, where total returns have benefitted from declining rates and tightening credit spreads for almost 10 years. While this has been a net positive for property & casualty insurers and health companies, life insurers have been starved for higher yields as their book yields have trended lower. Very recent market volatility aside, interest-rate and credit risk have been unrewarding for some time, and insurers' risk-management constraints leave little tolerance for capital loss. Add to this how much fixed income markets have changed shape during the past decade, and it all underscores the importance of thinking about capital preservation, managing credit exposure and absorbing the impact of rising rates.

What is your basic checklist for getting ready?

Each insurance enterprise is different, so there's no single formula to apply. Having said that, some issues are specific to this environment.

Focusing on credit exposure should be a priority at this mature juncture in the cycle. A smarter approach to credit risk means shifting from beta to something more selective in public debt markets.

Second, with this heightened focus on credit exposure, we believe insurers should continue their growing efforts to seek opportunities in less-liquid markets. These markets can be a strong complement to public credit for both diversification and yield enhancement, but it's important to be aware of potential complexity when investing here.

Third, recognize how markets have evolved to offer return sources that are not correlated to interest-rate or credit risk—typically the dominant asset-side risks on an insurance balance sheet.

And finally, demand more idea generation from your asset managers that recognizes the unique needs of insurers. Developing more flexibility to allocate across a wide range of global fixed income markets will facilitate this, and is much more important in this environment.

Why is it so important to be selective in public debt markets?

We are emerging from a unique period of policy influence, which has helped support credit as economies recovered after the crisis. As that fades, credit underwriting has regained its relevance again. Our credit research team has been addressing this point, particularly in the U.S. BBB sector.[1]

Demand for yield has driven capital toward BBBs. That market is now 30% larger than the entire high-yield market. As we have noted in our recent white paper, currently this sector trades in a relatively uniform manner, but this belies the huge diversity of the issuers. Financials, for example, have meaningfully delevered and arguably do not present the same risk as similarly rated issuers. BBB rated utilities tend to have business models better able to support higher debt burdens, especially at the lower cost available recently. By contrast, several traditionally defensive sectors, such as health care, pharmaceuticals, consumer staples and cable and media, may have stretched themselves to finance acquisitions. As rates rise and downgrades occur, performance dispersion could be considerable, underscoring the importance of credit discipline.

You spoke about favoring securities with a lower risk of default. But how can investors do that while maintaining the yield they need?

It may sound counterintuitive, but by investing in the subordinated securities of high-quality issuers, where you implicitly accept higher losses in the event of default, we believe that it is possible to maintain yield without increasing the risk of default. It's about moving down the capital structure instead of moving down the credit spectrum.

Corporate hybrids are an example of one of these subordinated markets, issued mainly in Europe. These non-financial hybrids pay coupons the same as bonds do, but issuers get meaningful equity credit, which is attractive because it lowers their cost of capital and they maintain more flexibility as an issuer. These bonds are typically callable at the point that they lose the equity credit (typically five to seven years) and the issuer cannot pay a dividend on the equity if the coupon on these hybrids isn't current.[2]

The average corporate hybrid is rated BBB or BBB-, but the parent issuer is typically rated two or three notches higher. That represents a unique opportunity to invest in higher-quality issuers while picking up additional spread in return for the subordination.

Investors are effectively trading the risk of loss in the event of default for the higher-rated issuer's lower probability of default, so it's important to note that these issuers have never missed a dividend, let alone a coupon payment, in many cases over decades. Our Corporate Hybrids team has never found an example even of a missed coupon payment on a corporate hybrid, even during the 2008 – 09 global crisis and the 2011 European crisis.

[1] See "BBBs: Beyond the Headlines" at https://www.nb.com/_layouts/www/transfer.aspx?URL=/insights/bbbs-beyond-the-headlines.aspx
[2] See "Corporate Hybrids: No Call for Concern" and "The Corporate Hybrid Market: A High Quality Opportunity in a Low Rate Environment" at https://www.nb.com/_layouts/www/transfer.aspx?URL=/insights/corporate-hybrids-no-call-for-concern.aspx and https://www.nb.com//_layouts/www/transfer.aspx?URL=/insights/the-corporate-hybrid-market.aspx

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You mentioned the importance of fully understanding the risks of lending in private markets. What do you mean by that?

Many insurers have turned to the private markets in search of an illiquidity premium, but terms like "private debt" and "private lending" can cover a wide range of strategies. At one end of that spectrum we have leveraged loans to private equity-owned companies. That's great if you're looking for a high single-digit or low double-digit yield profile and have the tolerance for the attendant risk. Some of that yield reflects illiquidity, for sure, but a lot of it is compensation for "covenant-lite" structures and complex legal and credit risks. While insurers have certainly taken on these forms of private credit, there are limits to this type of exposure in their portfolios.

By contrast, in post-crisis Europe there is still a regular flow of less-liquid, longer-dated private lending coming off bank balance sheets from well-established, often family-owned companies with longstanding relationships with their lenders.[3] These loans often have investment-grade credit profiles—leverage around 2.5-times earnings—and they tend to come with tight covenants and bond-like legal structures. In these circumstances, investors can be more confident that the extra spread they offer is a pure liquidity risk premium, and that they will be happy to hold them to maturity.

Given this is an illiquid, private market, are these loans easy to find?

No, and that is an important point. You have the ability to be truly selective and diligent with regard to your credit underwriting in private markets, but a manager throws that advantage away if it raises a huge private debt fund without the resources and relationships on the ground to see the requisite deal flow. That makes it difficult to put all the money to work without exposing yourself to cov-lite terms, unitranche or mezzanine, or indeed everything that drops onto your dealing desk. At Neuberger Berman, we partner with at least one well-established corporate lending bank in every European region, and our team regards that as absolutely critical.

Why do you think asset-manager discretion and more flexible investment mandates are more important late in the cycle?

A couple of factors are at play here. For one, it is important to recognize that asset classes across fixed income have evolved over the past decade. The drivers of returns are likely to be different now that some asset classes such as certain types of mortgages have all but disappeared, while others are constrained by supply or other factors. This will surely impact fixed income strategies, particularly "Core" and "Core-Plus."

In addition, as central bank policy evolves, investors need to consider the effect of higher rates on fixed income portfolios, particularly the higher potential for negative total returns. We think this has implications for how insurers focusing on total return think about fixed income benchmarks and performance expectations. It may be possible to outperform your benchmark while generating a negative absolute return. Adding flexibility to explore a more global range of exposures and tools may allow insurers to address this risk and prevent loss of capital.

Flexibility requires a broad set of capabilities across fixed income, both to execute tactical shifts when opportunities arise and to develop solutions that are appropriate within insurers' risk, asset-liability and regulatory constraints. Having pre-agreed flexibility to allocate across the widest possible range of liquid markets with one or two managers makes sense at any stage in the cycle, really, but it comes into its own later on, when capital preservation is the priority.

Do insurance investors feel comfortable giving their managers *carte blanche* like this?

It's imperative to work closely with an insurance client to find the optimal trade-off between the flexibility of the investment mandate and the client's constraints—whether those are defined by Solvency II, the Swiss Solvency Test, or some other risk-based capital or accounting regime. Flexibility does not equal *carte blanche* when you respect risk culture and regulatory discipline. That's why we believe there's an important advantage to partnering with managers who can combine ideas across fixed income markets with an expertise in asset-liability modelling and regulation to develop appropriate solutions for insurers.

[3] For more on the opportunities opened up in the wake of post-crisis banking regulation, see "The Changing Banking Landscape: Opportunities and Risks for Investors" at https://www.nb.com/_layouts/www/transfer.aspx?URL=/insights/the-changing-banking-landscape-opportunities-and-risks-for-investors.aspx

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Isn't tactical asset allocation just market timing?

No, not at all. It's more to do with making sure you can take advantage of the full range of options across global fixed income. If your investment universe includes the full complement of U.S., Europe, Japan and emerging markets, investment grade and high yield, bonds, loans, senior and subordinated or hybrid capital, hard currency and local currency, short duration and market duration, fixed and floating and index-linked, then you have the necessary tools to navigate through the very different environment we are stepping into.

For example, think about the varied components of markets, such as the segmentation of non-investment grade into bonds and loans. Most think of loans as more defensive than high yield bonds because they are senior and secured, but the huge inflows into loans during 2017 and 2018, which resulted in high yield bond issuance drying up, has led to a substantial decline in loan coupons and an erosion of the junior capital underneath them. An investor might regard short-duration high yield as the better risk-return opportunity, and a flexible mandate would enable that switch. Similarly, consider the surprisingly safe harbor that short-duration emerging markets bonds provided during the emerging markets sell-off in 2018. And did you know that, by August, investors could get a wider spread from emerging markets hard currency bonds than from U.S. high yield, while sitting two notches higher in credit rating?

As you mention, one set of options investors have is at the country level. How does currency exposure affect that?

Insurance investors tend to view foreign-exchange risk conservatively. Many investors regard it as unrewarded and, in any case, it is very capital-intensive; under Solvency II, for example, currency risk effectively incurs a capital charge of 25%. As a result, many insurers fully hedge their currency risks.

Now, we believe currencies can be a source of return, and also a useful source of diversification. Furthermore, 2018 has reminded us that hedging can impose substantial carrying costs. As U.S. short-dated interest rates have pulled away from those in Europe, euro-based investors have paid enormously—as much as 3% annualized—just to hedge their dollar-denominated investments.

So you would argue that a 100% hedge may be sub-optimal?

Under certain circumstances, for certain currencies, definitely. That's why our dedicated Global Currency team in London has developed a more dynamic approach to currency risk management, which we call the Dynamic Ideal Hedge Ratio (DIHR)[4] DIHR seeks to identify the hedge ratio with the best forward-looking risk-to-return payoff for a portfolio by taking into account three important aspects of currency exposures: excess return expectations, defined by long-term valuation; diversification potential; and the effect of interest-rate differentials on the cost of, or gains from, hedging. Simply put, DIHR is more likely to signal a reduction in the hedge ratio for foreign currencies when they are undervalued, costly to hedge and diversifying against the investor's portfolio assets—and vice versa.

Our Global Insurance Analytics team has tested this framework rigorously in a Solvency II context, with the corresponding capital charges implied by the Standard Formula. We published our results in June and, for typical euro- and sterling-based insurance portfolios, they showed a significant improvement in volatility-adjusted return for each marginal unit of solvency capital required.[5] An additional source of return from one of the most liquid markets, which brings no marginal credit or duration risk, would be of great benefit to most insurers.

[4] See "Managing Currency Risk: An Opportunistic Framework for Institutional Portfolios" at https://www.nb.com/_layouts/www/transfer.aspx?URL=/insights/managing-currency-risk-an-opportunistic-framework-for-institutional-portfolios.aspx

[5] "Optimizing Currency Exposures Under Solvency II" at https://www.nb.com/_layouts/www/transfer.aspx?URL=/insights/optimizing-currency-exposures-under-solvency-ii.aspx

You have talked about late-cycle risks and opportunities, but what about end-of-cycle and turn-of-cycle opportunities, such as Special Situations and Distressed Strategies?

This brings us back to the key question: how much longer will the cycle carry on? It feels like the seventh inning in baseball, or extra time in soccer when it was played with a "golden goal"—you knew the game was in its last half-hour, but the end could come at any time. Many distressed funds have been raised over the past several years in anticipation of a turn in the cycle, but a combination of central bank policy, limited leverage and slow growth has constrained investment opportunities. One of the most important structural differences of this cycle from previous ones has been the limitations imposed by leveraged lending guidelines, which go a long way in explaining how the current cycle got to be more than 110 months long, and counting.

As fiscal and monetary policies continue to shift, we will no doubt see interesting opportunities across credit markets again. How investors access that market is important because timing the cycle just isn't a reliable endeavor. Instead of the standard closed-ended, seven-year structures that charge fees on committed capital, investors could ask for open-ended vehicles that only charge on invested capital, for example. That helps free you up to engage now, and be ready, without incurring fees or opportunity cost.

In the meantime, we still believe this cycle has a year or more to run, and that leaves us with plenty to solve with our clients. In many ways, I think this late-cycle phase is actually the more intellectually challenging for all of us.

AT A GLANCE

Neuberger Berman Working with Insurance Companies[6]

- More than 20 years working with insurance companies
- 191 insurance company clients from 31 countries
- $34 billion in insurance assets under management and committed capital
- 17 insurance professionals worldwide, including a dedicated insurance analytics team and a dedicated Head of Insurance Fixed Income

[6] All information is correct as at 30 June, 2018

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