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INSURANCE INSIGHTS

# FOUR THEMES FOR INSURANCE ASSET MANAGEMENT IN 2021

FEBRUARY 2021



FROM THE DESK OF

*Ann the Actuary*

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Insurers have fared relatively well through the pandemic, but there is likely a long and uneven road to recovery ahead. With this in mind, there are four key themes worth considering for insurance company investors in the months to come:

- 1. EFFICIENT DEPLOYMENT OF CAPITAL:** Regulatory capital requirements can have a material impact on the attractiveness of various asset classes—but there continue to be opportunities for insurers to achieve their investment targets through the careful consideration of these constraints.
- 2. PRIVATE ASSETS FOR YIELD ENHANCEMENT:** Private assets can offer diversification as well as a potential illiquidity premium, while still maintaining credit quality—and may become an even larger part of insurance portfolios going forward.
- 3. MULTI-ASSET STRATEGIES AND A BOTTOM-UP APPROACH:** Conducting bottom-up analysis and making relative value calls across an expanding line-up of platforms requires large, global teams with a comprehensive view across public and private markets.
- 4. ESG:** ESG is growing in importance, but must also be balanced with the investment goals of insurers' portfolios.

Dwight D. Eisenhower famously noted: “plans are worthless, but planning is everything.” This has perhaps never rung truer than in 2020—a year that brought widespread devastation and unceremoniously turned even the most carefully constructed plans on their heads.

The economy took a hard hit from the pandemic, and while the recovery in many ways looks within reach, it also looks uneven and unpredictable, with variations likely among sectors. In times of heightened uncertainty, like we’re in today, we often look to the past for guidance. It is perhaps unsurprising, then, that COVID has drawn comparisons to the Global Financial Crisis—although the Spanish Flu of 1918 is perhaps a better comparison when attempting to gauge potential economic fallout. Thomas Garrett of the St. Louis Federal Reserve Bank published a paper in 2007 that described the economic effects of the 1918 pandemic, including the implications for a modern-day pandemic.<sup>1</sup> His observations and predictions were almost eerily prescient.

“... while we are all weathering the same storm,  
we are almost certainly in different boats.”

For one, Garrett predicted that despite advances in medicine, pandemic-related deaths would be significantly impacted by race, income and place of residence. He also suggested that governments—federal, state and local—would be unable to minimize the effects and/or provide meaningful protection, suggesting it would instead come down to health departments, hospitals, volunteer services, private businesses and personal responsibility.

Economic data from the time of the 1918 influenza is scarce, although several articles from that year shed light on both the immediate impact and longer-term recovery. For instance, there are suggestions that partial quarantines imposed by local authorities negatively affected businesses—from retail shops and industrial plants to transportation services and hospitals—and slowed the spread of the virus but were ineffective in stopping it. Beyond the immediate impact, most evidence indicates that the economy bounced back fairly quickly as the virus receded, similar to what the market is expecting on the back of COVID. The more permanent impact of the 1918 pandemic may have been its human one, which has interesting modern-day implications. As Garrett noted, “society as a whole recovered from the 1918 influenza quickly, but individuals who were affected by the influenza had their lives changed forever.” That is to say—while we are all weathering the same storm, we are almost certainly in different boats.

## THE PANDEMIC: UNEVEN IMPACT AND UNEVEN RECOVERY

The pandemic certainly presented, and continues to pose, unparalleled challenges for the insurance industry. But overall, insurers have fared relatively well—continuing to protect consumers against catastrophic losses despite facing heightened uncertainty. As Ike said, “planning is everything,” and even though insurers couldn’t foresee this specific disaster, the careful planning for a multitude of contingencies paid off. Indeed, insurance company investment portfolios have largely withstood the economic, accounting and capital impacts of the pandemic, suffering minimal to no material losses or downgrades.

Insurer share prices continue to reflect uncertainty in the market and longer-term reduced earnings expectations. Property & Casualty (P&C) company share prices, for instance, declined initially but then recovered, with some notable exceptions depending on insurers’ mix of business, COVID interruption and protest-related claims. While higher-than-expected claims during 2020 were certainly a challenge, they will likely be offset by favorable pricing longer-term. Health insurers have also experienced mixed results—due to factors like premium deferrals, the uneven demographic impacts of COVID, delays in elective procedures/office visits, and uncertainty surrounding 2021 premium calculations—but, as with P&C companies, the impact is more likely to be short-term. By contrast, life and annuity insurers set premiums based on long-term expectations, and investment yields are a larger driver of the premium calculation and resulting profitability as compared to P&C and health insurers.

1. Source: Federal Reserve Bank of St. Louis. As of April 2008.

Looking ahead, while the Fed signaled prolonged near-zero rates, additional stimulus, combined with an economy that continues to recover, could result in rates moving higher. Even so, expectations for a prolonged period of low investment yields continue to shape the outlook for both life and P&C insurers—with low rates likely to amplify the headwind to insurers’ book yield going forward. The prolonged low-rate environment could cause life insurers, in particular, to miss pricing targets/income expectations and could make it difficult to offer attractive pricing, especially for annuity products. Based on data from 13 life insurers, estimated book yields have slowly declined across the board, with a few exceptions. That said, a look at book yields over the last several years indicates they are subject to ups and downs—suggesting insurers are relying at least partially on variable income produced by private equity and real estate equity, which could continue to provide support in a prolonged low-yield environment.

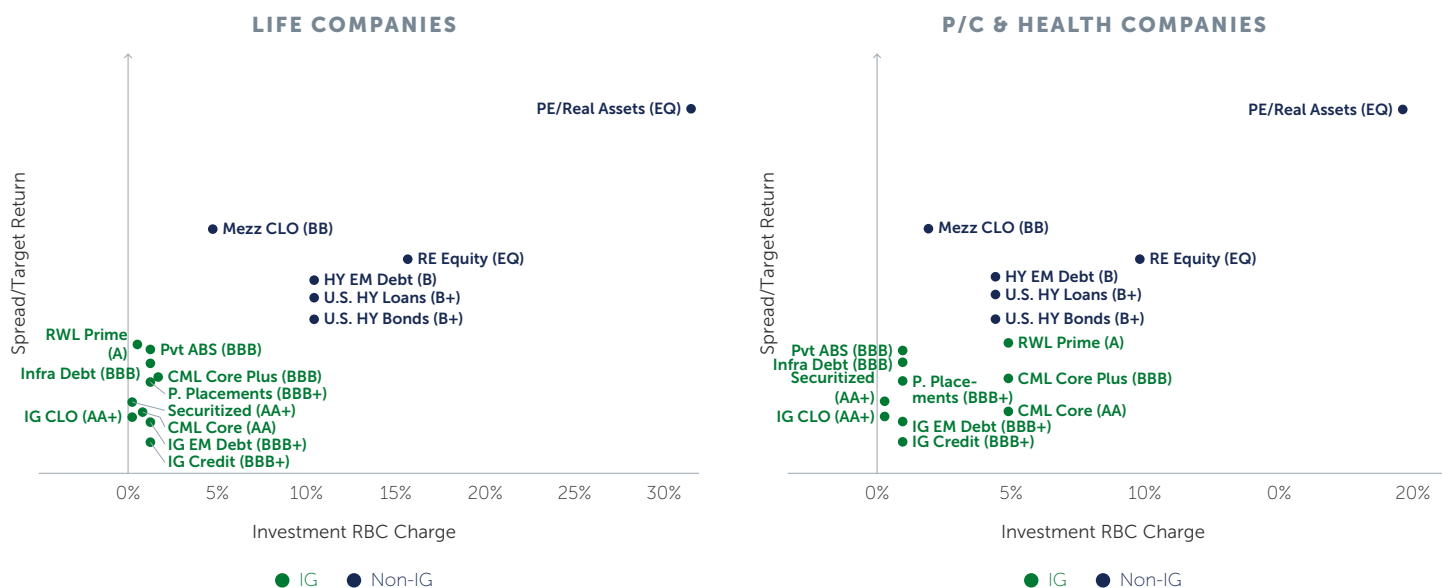
With this as a backdrop, and as we consider the varied impact of the pandemic, **four key themes** for insurance company investors come to mind:

## 1. EFFICIENT DEPLOYMENT OF CAPITAL

Planning is nothing new for insurers, and Eisenhower’s quote—“plans are worthless, but planning is everything”—continues to be the prevailing mantra. Indeed, as noted earlier, careful planning for a wide variety of contingencies resulted in limited losses and relatively low volatility for insurance company portfolios during the pandemic. Ideally, insurance company portfolios are built to withstand extreme market and environmental conditions—including yet unknown black swan events—while still capturing market opportunities and relative value.

Each insurance company has a unique mix of yield, capital (various types), liquidity and other considerations. Recent modeling studies and industry headlines have shown the trend toward an increase in private asset allocations is likely to continue. Regulators recognize the benefits of high quality private assets via favorable capital treatment as illustrated below. In the U.S., and depending on liquidity needs and capital constraints, model output also suggests securitized and structured assets are often favored due to the attractive spread/capital/volatility relative value tradeoffs. U.S. regulatory rules require capital to be held based on asset type and quality. The factors are often referred to as “C1” as part of a larger RBC formula that includes factors for other risks.

**FIGURE 1: RELATIVE VALUE ACROSS ASSET CLASSES**



SOURCES: Barings internal data; Bloomberg Barclays; J.P. Morgan; Credit Suisse. As of December 31, 2020.

Solvency rules have been adopted in the U.K., Europe, Canada, Bermuda and other countries and are set to be adopted in many parts of Asia—and the particulars of the rules vary by country. In general, as in the U.S., the rules require capital to be held based on the type and risk associated with the assets. In addition, under solvency rules, the discount rate used to calculate the liability reserves can sometimes benefit from the asset yield, or a portion of the yield. In some countries such as the U.K., the predictability of the asset cash flows is also an important consideration. Figure 2 provides a general sense as to the asset types that work well under Solvency II.

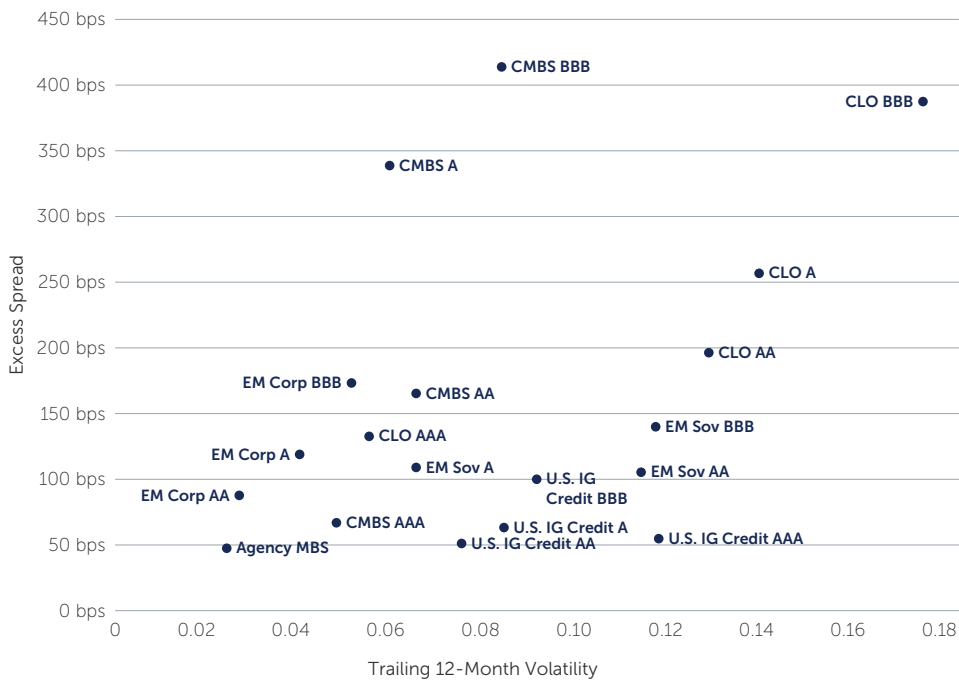
**FIGURE 2: RELATIVE VALUE FOR INSURANCE COMPANIES SUBJECT TO SOLVENCY II**



SOURCE: Bloomberg Barclays; J.P. Morgan; Barings. Data compiled in 2020.

Figure 3 provides the trade-off between spread and volatility for IG publicly traded assets. Of note, the relative value trade-off is different for capital considerations as compared to volatility in some cases—especially for securitized and structured investments. Volatility is typically not as great a concern as the potential for ultimate realized losses or capital, but this varies for each company based on its own unique circumstances.

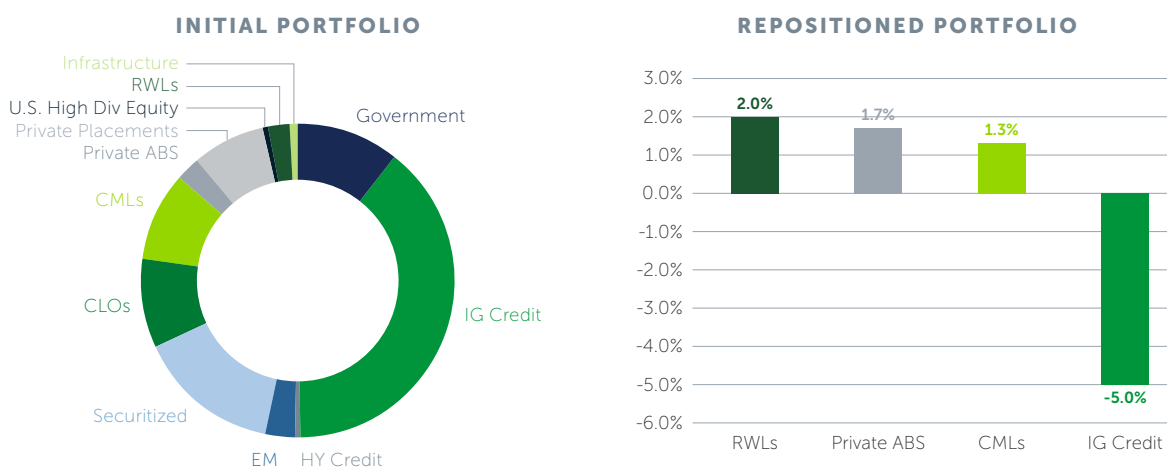
**FIGURE 3: INVESTMENT GRADE SPREAD/VOLATILITY**



SOURCE: Bloomberg Barclays; J.P. Morgan; Barings. Data compiled in 2020.

Taking all of these considerations together—liability structure, capital and volatility, as well as accounting considerations and a maze of compliance constraints—within a strategic asset allocation framework can provide interesting insights. For instance, Figure 4 provides an example in which 5% of an existing portfolio is repositioned to improve anticipated book yield and total return without sacrificing quality or increasing capital requirements. The model output suggests selling a portion of the IG credit allocation in favor of private ABS, residential whole loans (RWLs) and commercial mortgage loans (CMLs).

**FIGURE 4: REPOSITIONED PORTFOLIO WITH MAXIMUM 5% TURNOVER**



| Characteristics       | Initial Portfolio | Repositioned Portfolio |
|-----------------------|-------------------|------------------------|
| Book Yield            | 4.2%              | 4.4%                   |
| RBC                   | 1.0%              | 1.0%                   |
| Return Assumption     | 3.1%              | 3.3%                   |
| Volatility Assumption | 4.8%              | 4.9%                   |
| Duration              | 6.7 years         | 6.7 years              |
| Average Quality       | A3                | A3                     |

SOURCE: Barings; FactSet; Credit Suisse; Merrill Lynch; Cliffwater; Giliberto-Levy. As of April 20, 2020.

Insurers, of course, face a unique challenge in that they must navigate the waters of regulatory capital charges. These charges vary by geography and insurer type, but can have a material impact on the attractiveness of various asset classes.

## 2. PRIVATE ASSETS FOR YIELD ENHANCEMENT

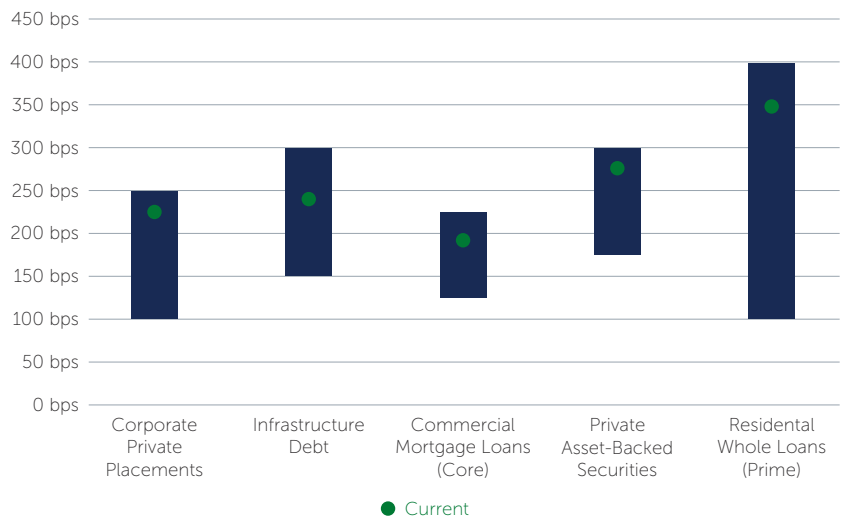
Due to market depth, diversification, duration, capital and liquidity needs, investment grade public corporate bonds and securitized assets remain a core investment, globally, for all types of insurance company portfolios. The allocation to non-investment grade assets typically ranges from 5-10%. Allocations to investment grade private assets—such as commercial mortgage loans, residential loans, and private ABS—have steadily increased in recent years, as the buy-and-hold nature of long life and annuity liabilities, in particular, allows for significant allocations to private illiquid assets. For instance, based on an assessment of large life insurers, the average CML allocation grew from 8% five years ago to over 10% today. P&C and health insurers are also allocating to shorter duration private assets such as ABS and floating-rate mortgages.

Private assets can offer diversification as well as a potential illiquidity premium while still maintaining credit quality. As tends to happen in times of crisis, the liquid credit markets froze as the pandemic took hold, and spreads widened materially. Although spreads recovered and liquidity returned as the Fed took action, this served as a reminder that systemic crises can render liquid investments illiquid—but unlike private assets, there is no illiquidity premium on offer in the public markets.

“Private assets can offer diversification as well as a potential illiquidity premium while still maintaining credit quality.”

As private markets continue to grow in both size and diversity, and offer an expanding set of investment opportunities to help insurers achieve their investment targets, we expect them to become an even larger part of insurance portfolios. We have already seen this to an extent with the continued growth of the direct lending and private ABS markets and anticipate such proliferation of private assets to continue.

**FIGURE 5: TYPICAL SPREAD RANGES FOR PRIVATE ASSETS**



SOURCE: Based on Barings internal analysis and market observations.  
As of December 31, 2020.



### 3. MULTI-ASSET STRATEGIES AND A BOTTOM-UP APPROACH

Just as the impact of the pandemic has been uneven (who would have guessed puzzles, RVs, and trampolines would be hot commodities?), the recovery is also shaping up to be uneven, with many unknowns still on the horizon. As follows, a bottom-up approach to investment selection is crucial within asset classes and sectors. Using real estate as an example, office space **will almost certainly change** as remote work will likely not disappear. Likewise, the trend toward online purchasing has accelerated, but local retail in densely populated areas is likely to make a comeback. Business hotels could continue to lag while leisure hotels will likely benefit from pent-up demand. As prices have shifted in public and private markets, bottom-up evaluation will be key to uncovering bargains and avoiding calamities.

The challenge of bottom-up analysis—and making relative value calls across an expanding line-up of public and private asset platforms—is that it typically takes large global teams of investors dedicated to specific asset classes to conduct in-depth, credit-by-credit or security-by-security analysis. It also requires having a broad enough view across public and private markets to have the appropriate context for identifying value. For this reason, and due to the complexity of these asset classes, there has been a trend toward outsourcing, or relying on the asset class specific expertise of external managers to conduct such analysis.

One of the challenges, however, with the outsourcing of this bottom-up analysis is that it can potentially slow decision-making and the execution of asset allocation changes. This is leading some insurers to structure multi-asset separate account investment mandates with asset managers. Such separate accounts can include a combination of public and/or private asset classes, investment grade or high yield. The idea is to shape the mandate and the investment guidelines to meet specific needs and to capture value by supplementing the capabilities of the insurer's internal investment team. This approach allows the manager to more quickly and efficiently capture opportunities and react to crises as they arise. Of course, insurance investors may have limited capacity for these more strategic-level relationships and so manager selection is critical.

|                               | Corporate Private Placements | Infrastructure Debt | Commercial Mortgage Loans (Core) | Private Asset-Backed Securities | Residential Whole Loans (Prime) |
|-------------------------------|------------------------------|---------------------|----------------------------------|---------------------------------|---------------------------------|
| <b>Credit Quality*</b>        | A/BBB                        | BBB                 | AA/A                             | A/BBB                           | A/BBB                           |
| <b>Spreads</b>                | T + 100–250 bps              | T + 150–300 bps     | T + 125–225 bps                  | L + 175–300 bps                 | T + 100–400 bps                 |
| <b>Illiquidity Premium</b>    | 50–100 bps                   | 75–175 bps          | 25–75 bps                        | 50–200 bps                      | 100–200 bps                     |
| <b>Maturity</b>               | 5–30 years                   | 5–30 years          | 5–15 years                       | 3–7 years                       | 0–10 years                      |
| <b>Duration</b>               | 3–25 years                   | 3–25 years          | 3–10 years                       | 3–4 years                       | 1–4 years                       |
| <b>Structure</b>              | Fixed                        | Fixed               | Fixed or Floating                | Fixed or Floating               | Fixed or Floating               |
| <b>Predictable Cash Flows</b> | Yes                          | Yes                 | Yes                              | No                              | No                              |
| <b>Prepayment</b>             | Make whole                   | Make whole          | Make whole                       | Yes                             | Yes                             |

\*Internal Credit Rating

SOURCE: Based on Barings internal analysis and market observations. As of December 31, 2020.

### 4. ESG IN FOCUS

2020 brought a renewed focus on environmental, social and governance (ESG) issues—from social unrest to numerous natural disasters—underscoring the importance of establishing best practices when it comes to people and the planet. While this renewed focus on ESG has affected organizations across industries and geographies, the insurance industry may be particularly well-positioned to adapt. At their core, insurers are experts at identifying and understanding many forms of risk, and ESG may be another useful lens with which to view potential investment and reputational risks within their portfolios.

Within the insurance industry, European insurers have led the way thus far on incorporating ESG into their business models. However, amid increasing awareness of both the positive and negative effects of ESG factors on investments, the rest of the world is expressing increased interest in certain aspects of ESG. Although U.S. companies are in different places, some are developing enterprise-wide ESG policies and, in many cases, are seeking guidance on how to integrate ESG information into investment decisions across their public and private investments. While ESG is growing in importance, insurers' efforts are balanced with the investment goals of their portfolios, especially at this relatively early stage of data collection and interpretation. Many insurers are initially focusing on particular aspects of ESG and are asking targeted questions, including:

- What ESG information is relevant and available? How does this vary across asset classes?
- Are ESG scores meaningful?
- Are there trade-offs between an investment's ESG profile and performance? If so, is it worthwhile?
- How are regulations shaping ESG considerations for institutional investors in Europe? The U.S.?
- What are the key ESG questions to ask of asset managers?
- How could ESG topics help shape portfolio planning and allocations?
- Are there potential investment opportunities arising from the increased focus on ESG?

At Barings, we believe investors can benefit from actively engaging with their managers when it comes to ESG. This includes conducting thorough due diligence to ensure that the processes managers have in place are indeed robust and—importantly—aligned with clients' goals. The market is continuing to rapidly evolve and insurers need to be confident that their managers are actively monitoring ESG developments across asset classes, understand their clients' specific ESG-related goals, and have adequate resources in place to execute on those goals.

## CONCLUSION

Looking ahead over the next several months, the vaccine certainly presents a case for optimism. But there is a long and **uneven road to recovery ahead**. While insurers have fared relatively well thus far—with investment portfolios largely weathering the economic, accounting and capital impacts stemming from COVID—the industry will likely face continued challenges as the search for yield persists.

Against this backdrop, as we consider the impact of the pandemic and path toward recovery, four key themes for insurance company investors come to mind:

- 1. EFFICIENT DEPLOYMENT OF CAPITAL:** Insurers face a unique challenge in that they must navigate regulatory capital requirements, which can have a material impact on the attractiveness of various asset classes. In our view, there continue to be opportunities for insurers to achieve their investment targets through the careful consideration of these constraints.
- 2. PRIVATE ASSETS FOR YIELD ENHANCEMENT:** Private assets can offer diversification as well as a potential illiquidity premium, while still maintaining credit quality. As private markets continue to grow in both size and diversity, we expect private debt, as well as securitized and structured assets, to become an even larger part of insurance portfolios.
- 3. MULTI-ASSET STRATEGIES AND A BOTTOM-UP APPROACH:** A bottom-up approach will be crucial within asset classes and sectors. But making relative value calls across an expanding line-up of asset platforms requires large, global teams with a comprehensive view across public and private markets—and the ability to quickly and efficiently capture opportunities and react to crises.
- 4. ESG:** From social unrest to natural disasters, 2020 brought with it a renewed focus on ESG issues—which, while growing in importance, must also be balanced with the investment goals of insurers' portfolios.

Each insurance company has a unique mix of yield, capital, liquidity and other considerations. And while there continue to be opportunities on offer that can help insurers meet their specific pricing targets/investment outcomes, it is imperative to partner with a manager that has a wide frame of reference across public and private markets, as well as the capability to navigate this challenging new environment.



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*\*Assets under management as of December 31, 2020*

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