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Insight INVESTMENT

Emerging opportunities for insurers

Pushing the boundaries

Chengdu IFoA Asia Conference 2019

9–10 May, Chengdu, China

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Insight INVESTMENT

Simon Richards

Insight Investment

Chengdu

Agenda

- Introduction
- Core Fixed Income
- High Yield
- Illiquid assets
- Emerging markets
- China
- Conclusions
- Q&A

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Introduction

Introduction

- European insurers have been reconsidering their approaches to investment
- This has been driven by changing liabilities, regulations and investment markets
- Generally, insurers have been increasing their risk profiles, particularly on fixed income assets
- Many insures have allocated to (or are considering) non-mainstream assets
- What are the advantages and disadvantages, myths and realities?

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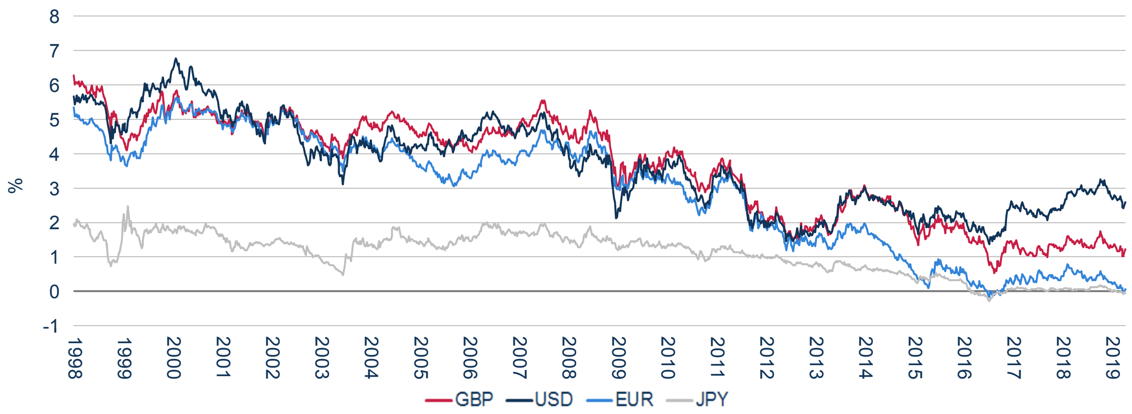
Fixed Income yield curves



Source: Bloomberg as at 31 March 2019.

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Core fixed income

Core fixed income

- Increased allocation to Corporate bonds
- Global allocation (hedged)
- Buy & maintain
  - align with liabilities
  - incorporate insurer-specific constraints

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Adopt a buy and maintain philosophy

Starting principles

1. Invest only in companies we know and understand
2. Only buy bonds that can be held to maturity
3. Avoid unnecessary turnover and forced-selling
4. Diversify the portfolio

On-going management

- Seek to avoid material loss
- Acknowledge poor market liquidity

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Avoid the flows of index tracking

Market	Top 10 issuers	Financials	Supranationals
GBP credit[1]	22%	26%	24%
EUR credit[2]	22%	19%	33%
EUR corporate[3]	13%	41%	0%
USD corporate[4]	15%	36%	0%
Global credit[5]	13%	28%	25%
Global corporate[6]	12%	37%	0%

Top 10 issuers	iBoxx GBP Non-Gilt
European Investment Bank	5.6%
KFW	4.5%
Electricité de France	2.0%
Lloyds Bank	2.0%
HSBC	1.9%
Barclays	1.4%
FMS Wertmanagement	1.3%
Heathrow	1.2%
AT&T Inc	1.2%
Santander UK PLC	1.1%
Total	**22.1%**

Source: iBoxx/Barclays as at 31 December 2018. [1] iBoxx Sterling Non-Gilt index. [2] iBoxx Euro Non-Sovereigns index. [3] iBoxx Euro Corporates index. [4] Barclays US Aggregate Corporate index. [5] Barclays Global Aggregate Credit index. 6 Barclays Global Aggregate Corporate index.

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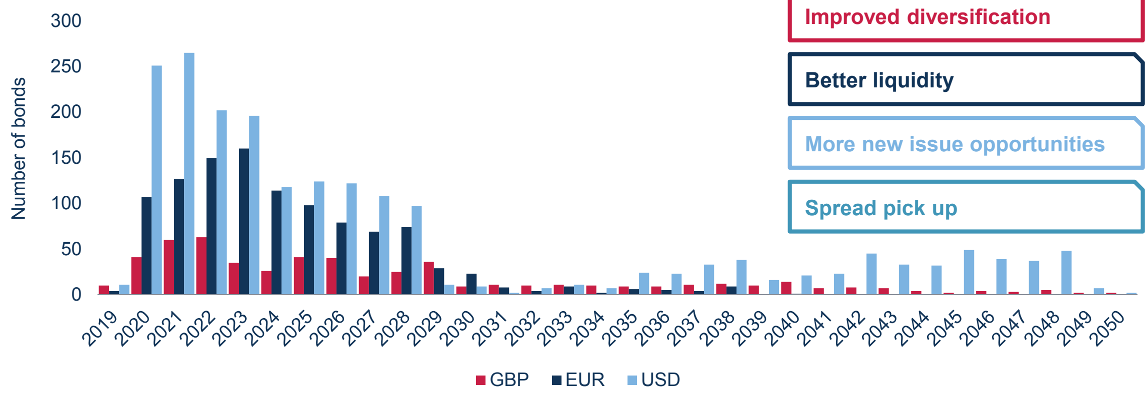
Invest in global credit hedged back to base currency

Number of buy and maintain suitable bonds



- Improved diversification
- Better liquidity
- More new issue opportunities
- Spread pick up

Source: Insight and Bloomberg as at 31 December 2018. Issue size 500m or larger.

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Setting up objectives and constraints

Objective: maximise risk-adjusted yield

Parameters
- Expected outflows
- Unexpected outflows
- Allowance for default
- Regulatory buffer

Precision of matching
- Nature of liabilities
- Total PV01
- PV01 across the curve
- Cash flow matching

Risk budget
- Average credit rating
- SCR budget
- Available spreads

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Security selection: landmine checklist

- Liquidity
- Contingent liabilities
- Regulatory risk
- Environmental, social, governance (ESG)
- LBO risk
- Event risk

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Core fixed income

- Improved risk-adjusted returns
- Improved diversification and liquidity
- Focus on holding the best bonds
- Manage credit risk and currency risk separately
- Need to measure performance in a different way

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High yield bonds

High yield bonds

- Bond with credit ratings below BBB-/Baa3
- Also known as sub-investment grade or 'junk' bonds
- More risky than investment grade (IG) bonds, but with higher yields (HY)

Spot the high yield company

Myths about high yield companies:

- Poor cash generation
- Stretched capital structures
- Limited access to capital markets
- Exposed to EM risks

Telecom sector

EUR	Company 1	Company 2	Company 3	Company 4
Free cashflow	0.6bn	0.8bn	1.4bn	2.7bn
EBITDA margin	31%	28%	45%	45%
Free cashflow/debt	6.8%	1.2%	9.6%	4.0%
Years of liquidity	2	4	7	4
Earnings sourced from EM	39%	36%	0%	43%

For illustrative purposes only. This is not a recommendation to buy or sell the securities mentioned.

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Spot the high yield company

Myths about high yield companies:

- Poor cash generation
- Stretched capital structures
- Limited access to capital markets
- Exposed to EM risks

Telecom sector

EUR	Telias (A-)	Vodafone (BBB+)	Virgin Media (B)	Telefonica (BBB)
Free cashflow	0.6bn	0.8bn	1.4bn	2.7bn
EBITDA margin	31%	28%	45%	45%
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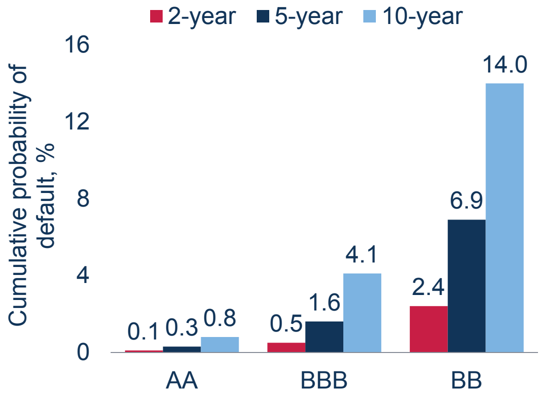
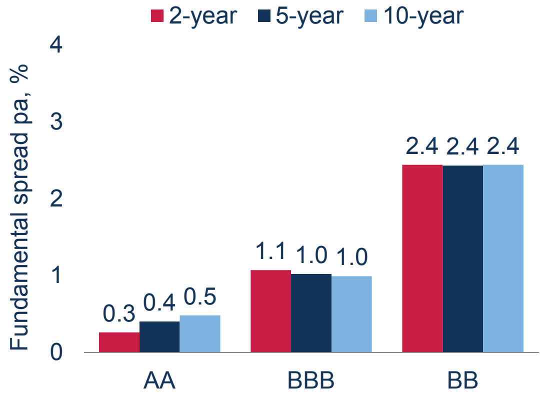
High yield bonds

Risk and return





Source: European Insurance and Occupational Pensions Authority (EIOPA), as at 31 March 2019.

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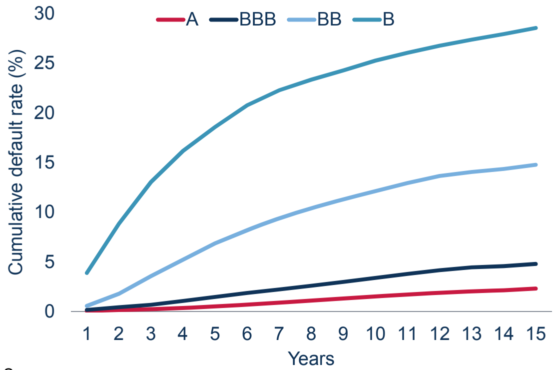
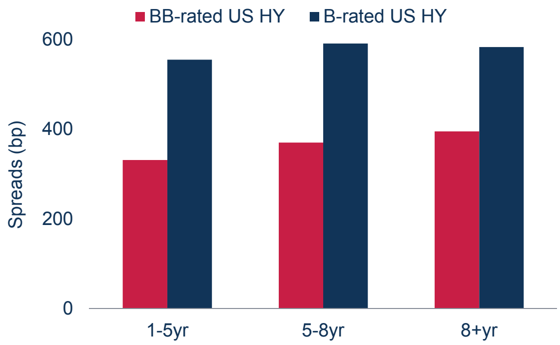
Balancing risk and reward

High yield can be attractive at shorter-dated exposures

Defaults rise over time, especially for HY issuers[1]



But spreads do not materially increase for maturity[2]



Source:
[1] S&P – Annual default Study – global corporate average cumulative default rates (1981-2017)
[2] Bloomberg, data as at 31 December 2018. Average 6 week hedging costs (USD-GBP) are c.-3bp.

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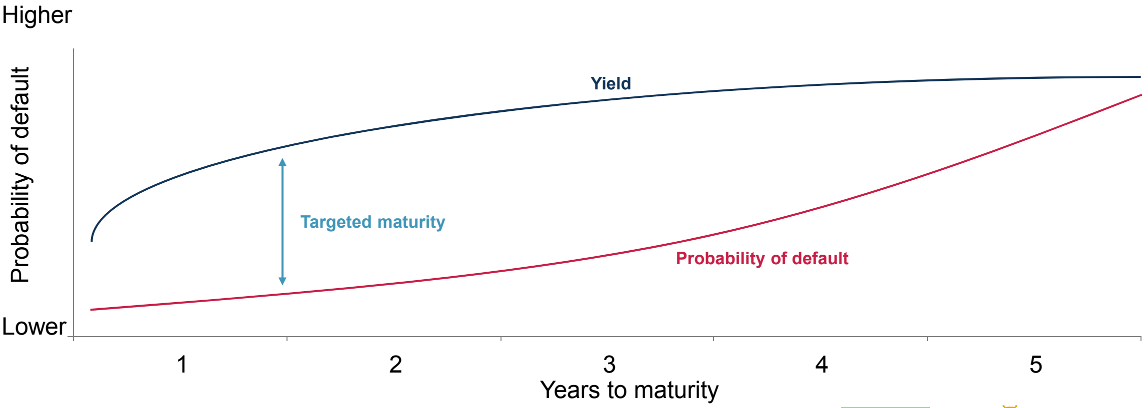
Mis-match between rating and duration

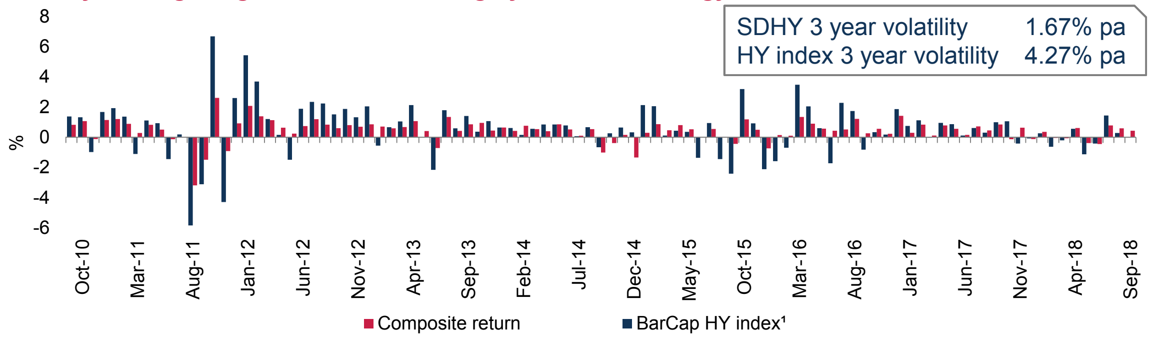
Rating agencies assign a rating for the whole issuer curve regardless of maturity



Why invest in short-dated high yield bonds?

High income, low volatility potential. Short-dated HY has much less volatility than normal HY

Volatility of Insight's global short-dated high yield bond strategy versus HY index



Please refer to the risk disclosures at the back of this document.
Source: Barcap and Insight as at 30 September 2018. The short duration high yield bond composite (C0810) is gross of fees and in GBP. All returns over one year are annualised. Benchmark: 3 Month GBP LIBID. Inception: 30 November 2009. A copy of a fully compliant GIPS presentation is available at the back of this document. Fees and charges apply and can have a material effect on the performance of your investment. [1] The BarCap Pan Euro High Yield 3% Issuer Constrained ex. Financials index in EUR.

Investment risks… and how we manage them

Risks

- Credit risk
  - Credit rating (BB-CCC) gives some indication of default risk. Less applicable in short maturities
    - risk can be mitigated through fundamental research, cashflow analysis, landmine check list etc
- Capital structure risk
  - We look for temporal seniority
  - Secured, unsecured, subordinated: typically secured is safer than unsecured but if a sub bond matures ahead of other senior obligations it has better risk characteristics

Risk mitigants

- Bond covenants
  - Tight covenants protect investors
  - We like to see:
    - debt restrictions
    - cash use restrictions
    - asset disposal restrictions
  - Covenants can have a material impact on the bond in cases of 'change of control', put-able bonds, corporate actions
- Bank covenants
  - Loose maintenance covenants provide companies flexibility – good for short maturity bondholders
  - Additional liquidity facilities give companies access to liquidity when it's most needed

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Investment risks… and how we manage them

Tender/call clues

- Covenants hindering management activity i.e. selling assets or paying dividends
- Management feelings about leverage
- Reduce debt cost by refinancing
- Extend the average maturity of debt
- Change of ownership

Timing/extension risk

- Extension risk
  - Tenders and calls are done at the issuers convenience
  - Bonds may not be called if the company is deteriorating or can not refinance more cheaply
  - Conditional call bonds – called subject to event like merger or asset sale
- Timing risk
  - Bullet maturities have a limited refinancing window
  - Flexibility over when a bond is repaid can help companies avoid default

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Illiquid assets

Illiquid assets

- Focus on lower liquidity, not lower credit quality
- Internal IG credit rating
- Strong underlying security
- May benefit from a ‘complexity’ premium
- Require specialist capabilities to fully assess the risks
- Hold to maturity

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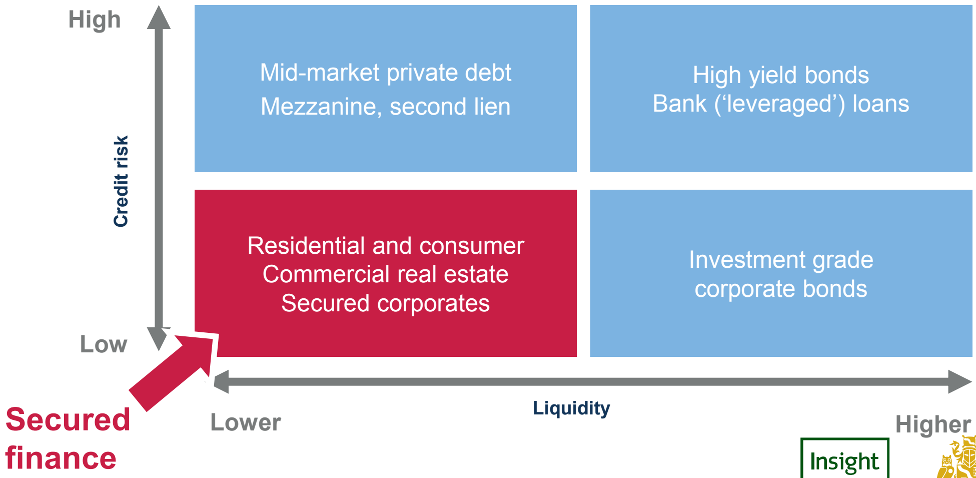
Widen the investible universe to secured loans



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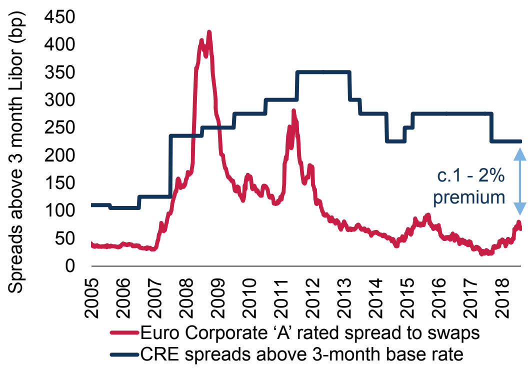
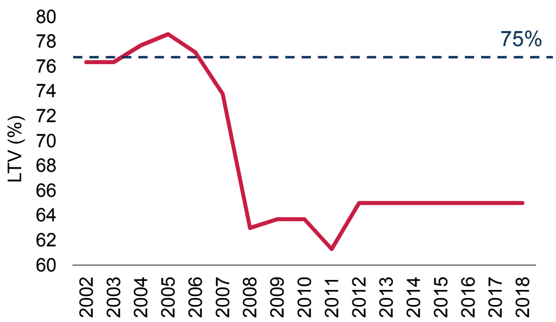
Commercial Real Estate loans

Spreads on senior loans versus high quality corporate bonds[1]



Average maximum LTV ratio[2]



Source: [1] Bloomberg and Insight Investment as at 31 January 2019. Euro Corporate 'A' spread to swaps represents Bank of America Merrill Lynch Economic and Monetary Union Corporates A Rated ER30 index. [2] Source: Insight Investment as at 31 January 2019.

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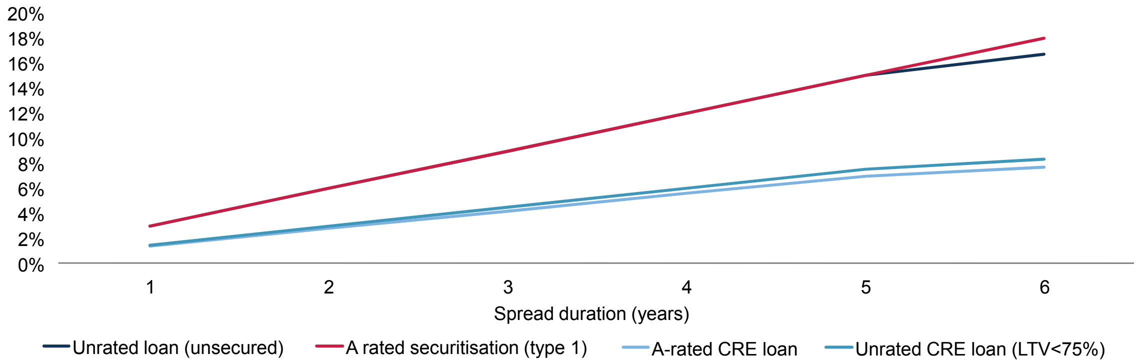
Solvency II capital treatment of CRE loans

Capital charges under the Standard formula approach[1]
Solvency II capital charges



[1] European Commission Delegated Regulation (EU) 2015/35 of 10 October 2014 supplementing Directive 2009/138/EC.

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Illiquid assets

- Insurers may already have excess liquidity
- Take advantage of higher spreads compared to IG bonds
- Need to consider the amount to be allocated and the ability to diversify exposures

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Emerging markets

Emerging markets

- EM debt encompasses a range of different assets
- Government versus corporate bonds
- Hard currency versus local currency
- IG versus HY
- Need to manage country risk, credit risk and currency risk

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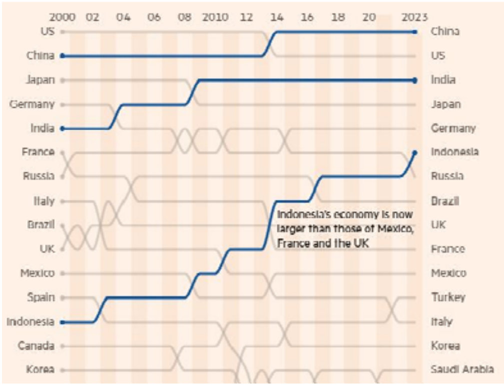
EM corporate debt – significant USD asset class

Asian economies climb the global ladder

Rank of global share of GDP of selected Asian economies (based on PPP, actual and forecast)



Source: BAML, JPMorgan as at September 2018.

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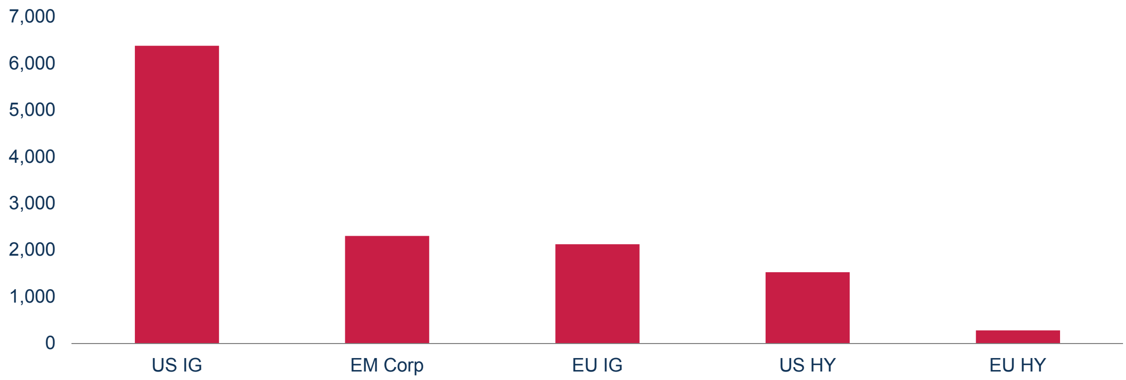
EM corporate debt – significant USD asset class

USDbn outstanding



Source: BAML, JPMorgan as at September 2018.

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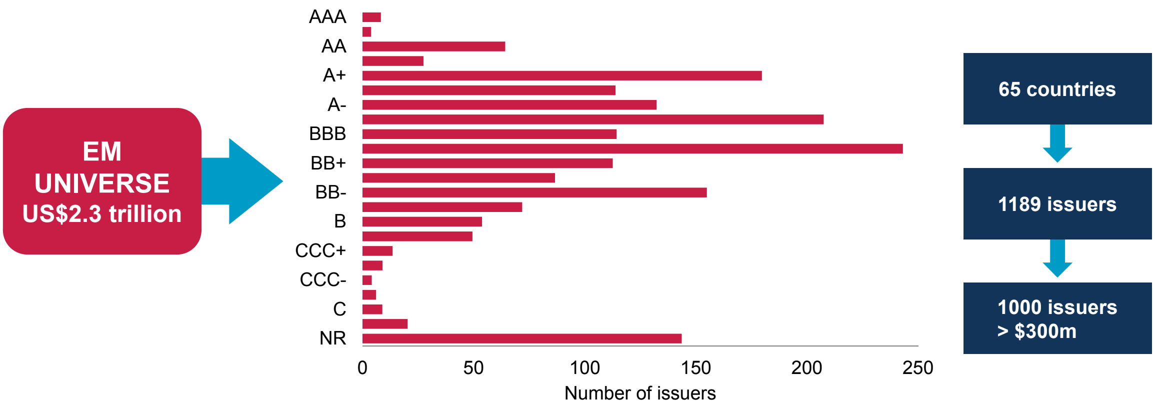
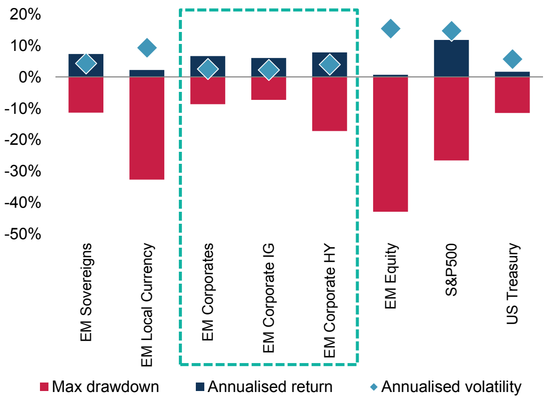
The EM universe is comprised of 57% IG issuers

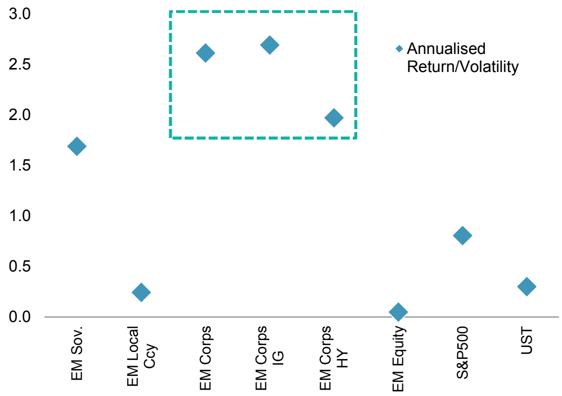


Source: JPMorgan as at November 2018.

Compelling historical risk-adjusted returns

Historical return and volatility since 2009





Source: JPMorgan and Insight as at 31 January 2019. Daily returns since 2009.

EM corporates compared to EM sovereigns

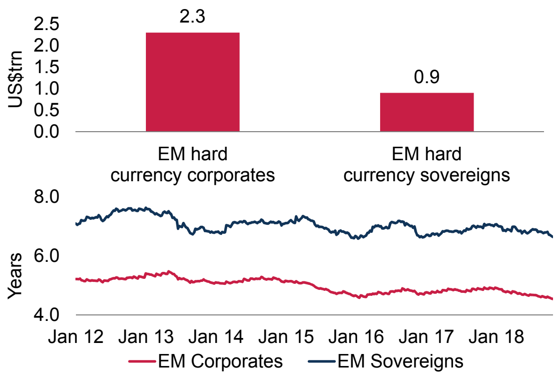
Why emerging markets corporates?

1 Considered to be the largest and fastest growing asset class

- EM hard currency corporates are more than 2x the size of the EM hard currency sovereigns universe

2 Lower duration

- 4.5yrs for EM corps versus 6.5 years for EM sovereigns



Source: BAML as at 31 October 2018.

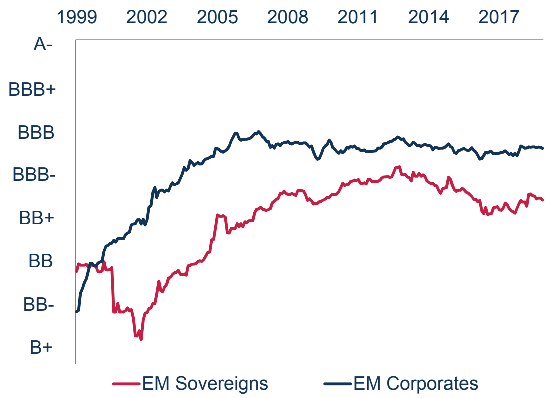
EM corporates compared to EM sovereigns

Why emerging markets corporates?

3 Better credit quality

- Credit quality for EM corporates has been improving

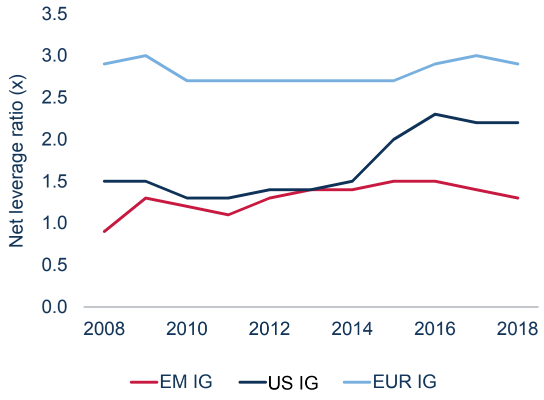
4 Net supply lower than sovereigns



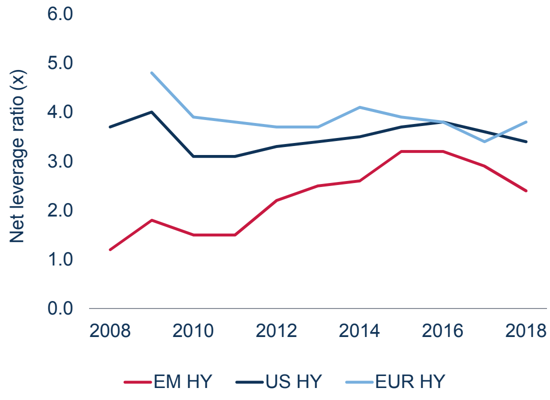
Source: BAML as at 30 November 2018.

EM corporates are deleveraging

Global IG net leverage comparison



Global HY net leverage comparison



Source: JP Morgan as at December 2018.

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Long-term valuation of EM corporate debt still attractive

Percentile of spreads over history: EM corporates

Source: Insight and Bloomberg as at 25 April 2019. 100% = tightest spreads, 0% = widest spreads.

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Attractive yield and less interest rate sensitivity

Yield and duration across comparable asset classes

	Base FX	Yield in base FX	Hedged Yield – 3m FFX (%) GBP	Hedged Yield – 3m FFX (%) EUR	Duration (yrs)
EM total return debt strategy (average BBB-)	**USD**	**7.50%**	**5.28%**	**4.42%**	**5.7**
Barclays Indices					
Global Aggregate credit	USD	2.90%	1.08%	-0.18%	6.6
Euro-Aggregate credit	EUR	0.84%	2.10%	0.84%	5.1
Sterling Aggregate credit	GBP	2.63%	2.63%	1.37%	7.8
U.S. Aggregate credit	USD	3.69%	1.87%	0.61%	7.4
JPM EM Indices					
EM corporates	USD	5.70%	3.87%	2.62%	4.6
EM IG corporates	USD	4.46%	2.63%	1.38%	5.2
EM HY corporates	USD	7.39%	5.57%	4.31%	3.9
External IG sovereigns	USD	4.34%	2.52%	1.26%	8.0
External HY sovereigns	USD	7.77%	5.94%	4.69%	5.9
Local sovereigns	USD	6.14%	4.32%	3.06%	5.2

Source: Insight, Barclays and JP Morgan as at 2 April 2019.

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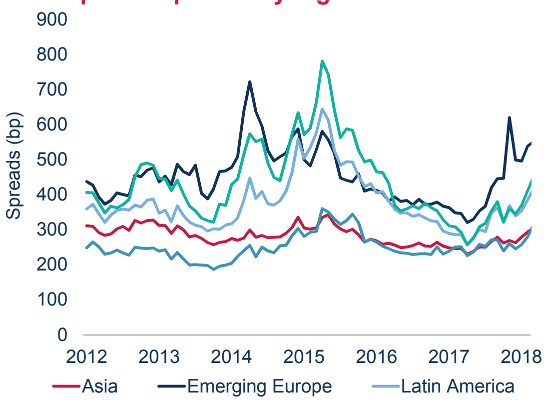
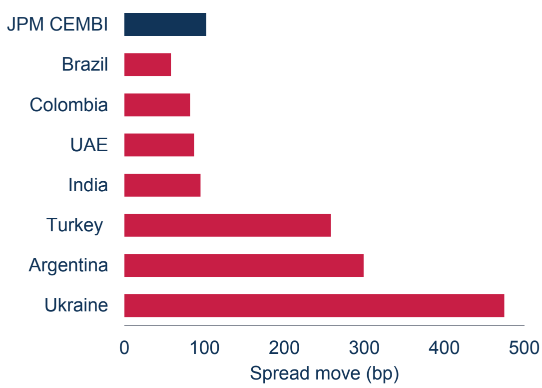
Idiosyncratic risks – country selection is key

EM corporate spreads by region



Select country corporate spreads (YTD)



Source: Insight and Bloomberg as at January 2019.
Source: Bloomberg and JP Morgan as at January 2019.

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Emerging markets

- EM debt is often considered to be high risk
- Lots of different types of EM debt
- Need to focus on country-specific risk
- Provides diversification from core assets
- Risk-adjusted returns might be better than DM
- Requires specialist asset management capabilities
- Need to manage both credit risk and currency risk

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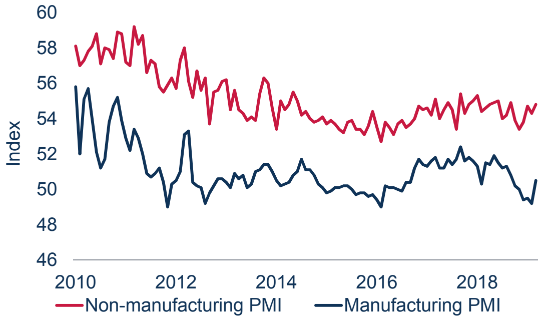
China

Macroeconomic themes: China

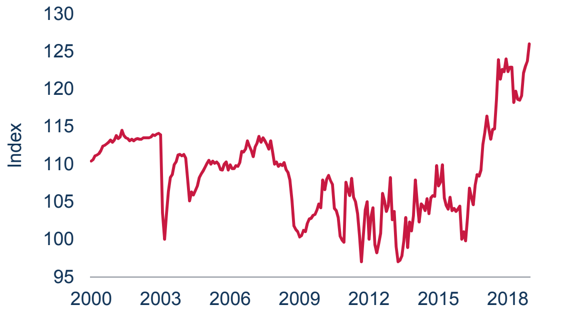
Fiscal and monetary stimulus focused on the private sector

China purchasing manager's indices



Stimulus to offset tariff impact, domestic recovery focus

China consumer confidence at highest levels ever



VAT cuts supporting consumption

Please refer to the risk disclosures at the back of this document.
Source: Bloomberg as at March 2019. China's growth targets are 6-6.5%.

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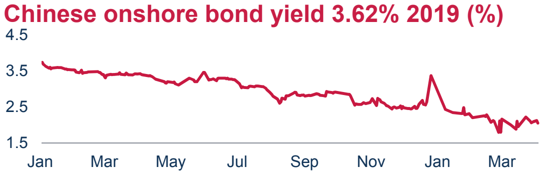
Market allocation: China

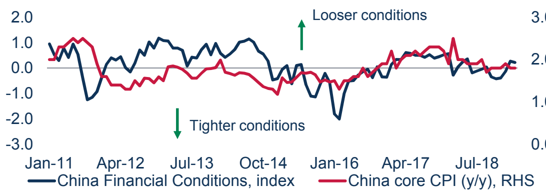
Trade tariff impact likely mitigated by domestic stimulus measures

- **Market:** Front-end local bonds remain supported by slower growth and People's Bank of China (PBoC) easing
- **Outlook:** Both domestic and external pressures have pushed down growth in recent months. The authorities have incrementally eased through last year and stepped up efforts in the latter part of 2018
- In order to co-ordinate monetary and fiscal policy PBoC and government will ensure yields remain low
- Focus on ensuring financing in the economy is adequate will keep liquidity ample and support for bonds high

Chinese onshore bond yield 3.62% 2019 (%)



Financial conditions have started to ease



Please refer to the risk disclosures at the back of this document.
Source: Insight, Citibank, Bloomberg as at 28 March 2019.

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Foreign access to China bond market

- China government bonds to be included in major global indices:
  - Implementation over 2-3 years
- Improved bond market liquidity:
  - Large inventory to be kept in Chinese Bank HTM book
- Introduce more products:
  - Mostly cash bonds for foreign investors
- Improve credit rating credibility:
  - Major rating agencies to establish entities in China

Source: Citibank

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Foreign access to China bond market

Barclays-Bloomberg	• From April 2019, Bloomberg-Barclays Global Aggregate Index will include Chinese RMB-denominated government and policy bank bonds, phased in over a 20-month period • The index will include almost 400 Chinese bonds representing around 5.5% of the index (c.US$3 trillion)[1]
Yield Book – FTSE Russell	• From February 2018, Chinese onshore bonds are included in[2]: - EM Government bond Index (EMBI) - Asian Government Bond Index (AGBI) - Asia Pacific Government Bond Index (APGIB) - Emerging Markets Government Bond Index-Capped (AGBI-Capped) - Asian Government Bond Index-Capped (AGBI-Capped)
JP Morgan	• China onshore bonds placed under review for inclusion in JPM's fixed income indices • Possible inclusion in JPM Government Bond Index (GBI) series and other IG indices

Please refer to the risk disclosures at the back of this document.
[1] Source: Bloomberg announcement, 23 March 2018. [2] Source: the Yield Book announcement, 31 January 2018.

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Conclusions

Conclusions (1)

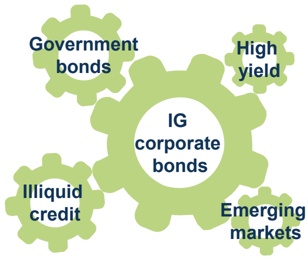
- The asset allocation of insurers has changed materially in the last 10+ years
- In part due to a search for yield as risk-free rates remain low
- Insurers are increasingly using a ‘buy & maintain’ approach to managing credit
- Insurers are also taking more risk and have more diversification within their fixed income portfolios
- Allocations to high yield bonds, illiquid credit and emerging market debt are not uncommon
- These allocations do not have to be high risk to offer attractive upside and can provide significant diversification benefits

Portfolio strategy for insurers: evolution

1 Liquidity management portfolio: Cash flow management

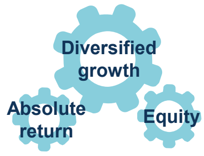
- Managing expected and unexpected cash flows
- Money market funds offer liquidity and capital efficiency

2 Core portfolio: Liability management



- Portfolio tailored to client's liabilities and objectives
- Low yield environment means need to increase risk profile

3 Growth portfolio: Volatility management



- Capital efficient long-term growth with low volatility
- Increased diversification and capital efficiency

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Conclusions (2)

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- Insurers need to fully understand the risks inherent in different asset classes
- Insurers should work with specialist asset managers who understand these new asset classes and can structure bespoke solutions that take account of:
  - the insurer's specific investment objectives and constraints
  - the insurer's liabilities
  - the insurer's regulatory framework

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Q&A

Questions

Comments

Expressions of individual views by members of the Institute and Faculty of Actuaries and its staff are encouraged.

The views expressed in this presentation are those of the presenter.

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Biography

Simon Richards – Head of Insurance Solutions

- Simon joined Insight's Financial Solutions Group in June 2008. He is now Head of Insurance Solutions in the Client Solutions Group and has overall responsibility for the design, implementation and monitoring of investment strategies for insurance clients in the UK, Europe and Asia. Simon works closely with the relevant portfolio managers to ensure that the investment solutions are tailored to the needs of each client and remain efficient and appropriate given changing market conditions and evolving regulatory requirements.
- He began his career in 1994 and has held actuarial positions at NPI, Pearl Group and at JPMorgan, where he was responsible for structuring derivative solutions to UK and European insurance companies.
- Simon holds a BSc (Hons) in Mathematics from the University of Exeter and is a Fellow of the Institute of Actuaries in the UK.

GIPS® firm-wide disclosures

- The GIPS® firm is defined as Insight Investment and is the corporate brand for the companies managed or administered by Insight Investment Management Limited.
- Since the firm's creation in 2002, the firm has added a number of investment teams under its brand. These include the Pareto brand and the Cutwater Asset Management brand. In all cases, the decision making processes of the investment teams that have transitioned under the brand remain substantially intact and independent within Insight Investment.
- Insight claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS® standards. Insight has been independently verified for the periods 1 January 1998 to 31 December 2016. The verification reports are available upon request. Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS® standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS® standards. Verification does not ensure the accuracy of any specific composite presentation.
- The assets under management figure is the most up-to-date available, and is subject to change. A complete list of composites and their descriptions is available on request.
- Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.
- The measure of dispersion is represented by the lowest and highest annual returns of accounts that have been included within the composite for a full calendar year. Three-year annualised ex post standard deviation measures are not presented when there are less than 36 monthly observations available.

GIPS® compliant presentation

Fixed Income, Short Duration High Yield Bond as at 31 December 2018

	Total return (%)									
Calendar year	Composite gross (weighted average) return	Benchmark return	Arithmetic difference	Highest value	Lowest value	Rolling composite 3yr std. dev.	Rolling benchmark 3yr std. dev.	No. of portfolios (throughout period)	Market value at end of period (m)	Total firm assets at end of period (m)
2018	-0.41	0.60	-1.01	-0.41	-0.41	1.87	0.05	1(1)	503	262,677
2017	5.23	0.23	5.00	5.23	5.23	1.61	0.03	1(1)	517	252,122
2016	7.95	0.38	7.58			2.05	0.02	1(0)	364	213,087
2015	4.06	0.45	3.61	4.06	4.06	2.07	0.01	1(1)	332	169,756
2014	1.54	0.42	1.12	1.54	1.54	2.20	0.05	1(1)	357	146,122
2013	7.62	0.39	7.23			3.33	0.06	1(0)	467	102,059
2012	11.74	0.70	11.04	11.74	11.74	3.47	0.05	1(1)	185	91,882
2011	1.39	0.75	0.64	1.39	1.39	-	-	1(1)	200	67,259
2010	8.96	0.58	8.38	8.96	8.96	-	-	1(1)	95	52,579
2009 Dec	1.69	0.04	1.65	1.69	1.69	-	-	1(0)	73	46,504

C0810 - Base Currency GBP - Inception Date 30 November 2009 - Creation Date 28 October 2010

- This composite comprises actively managed portfolios following the Insight Short-Dated High Yield Bond strategy, investing in a range of fixed income and inflation-linked securities, as well as other money market instruments.
- The composite is benchmarked against 3 Month GBP LIBID index.
- The standard annual management fee for this type of mandate is 0.50% per annum. Fees are variable and depend on the asset class or Fund being invested in and the value of the investment
- Portfolios within this composite are permitted to use leverage, derivative instruments and/or short positions for efficient portfolio management. The extent to which these instruments may be used for investment purposes may vary over time and may be material. More detail on the degree of leverage/derivative/short position usage within this composite is available upon request.
- Accounts below £10m are excluded from the composite, as they are not considered able to be fully invested in the Insight style. To avoid frequent changes to composite membership, existing accounts need to fall below £9m in value before being excluded and excluded accounts need to rise above £11m before being included.

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Important disclosures

Risk disclosures

- **Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.**
- The performance results shown, whether net or gross of investment management fees, reflect the reinvestment of dividends and/or income and other earnings. Any gross of fees performance does not include fees and charges and these can have a material detrimental effect on the performance of an investment.
- Any target performance aims are not a guarantee, may not be achieved and a capital loss may occur. Strategies which have a higher performance aim generally take more risk to achieve this and so have a greater potential for the returns to be significantly different than expected.
- Portfolio holdings are subject to change, for information only and are not investment recommendations.

Associated investment risks

Fixed income

- Where the portfolio holds over 35% of its net asset value in securities of one governmental issuer, the value of the portfolio may be profoundly affected if one or more of these issuers fails to meet its obligations or suffers a ratings downgrade.
- A credit default swap (CDS) provides a measure of protection against defaults of debt issuers but there is no assurance their use will be effective or will have the desired result.
- The issuer of a debt security may not pay income or repay capital to the bondholder when due.
- Derivatives may be used to generate returns as well as to reduce costs and/or the overall risk of the portfolio. Using derivatives can involve a higher level of risk. A small movement in the price of an underlying investment may result in a disproportionately large movement in the price of the derivative investment.
- Investments in emerging markets can be less liquid and riskier than more developed markets and difficulties in accounting, dealing, settlement and custody may arise.
- Investments in bonds are affected by interest rates and inflation trends which may affect the value of the portfolio.
- Where high yield instruments are held, their low credit rating indicates a greater risk of default, which would affect the value of the portfolio.
- The investment manager may invest in instruments which can be difficult to sell when markets are stressed.
- Where leverage is used as part of the management of the portfolio through the use of swaps and other derivative instruments, this can increase the overall volatility. While leverage presents opportunities for increasing total returns, it has the effect of potentially increasing losses as well. Any event that adversely affects the value of an investment would be magnified to the extent that leverage is employed by the portfolio. Any losses would therefore be greater than if leverage were not employed.
- While efforts will be made to eliminate potential inequalities between shareholders in a pooled fund through the performance fee calculation methodology, there may be occasions where a shareholder may pay a performance fee for which they have not received a commensurate benefit.

Other disclosures

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For a full list of applicable risks and before investing, where applicable, investors should refer to the Prospectus, other offering documents, and the KIID which is available in English and an official language of the jurisdictions in which the fund(s) are registered for public sale. Please go to www.insightinvestment.com

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