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Insurance Investing: 15 March 2021

Riding the Global Reflation Trade

Executive Summary:

- Twelve expects the impact of a broad reflationary environment, including higher interest rates and inflation, to be positive for insurance industry fundamentals
- The most positively levered business models to rising interest rates can be found within the US and European life insurance sectors
- Property & Casualty (P&C) companies should also benefit the ability to reinvest assets at higher new money yields
- Twelve expects the risk to P&C underwriting margins of rising general economy inflation to be moderate given a robust pricing environment and only approximate correlation between loss cost inflation and general economic inflation
- Twelve Capital investment strategies are generally well positioned to benefit from these positive impacts on insurance company fundamentals

Insurance investing in a reflationary environment

The combination of re-opening economies following vaccine roll-outs around the world, pent-up consumer and business demand, potentially still constrained supply chains, and continued fiscal and monetary stimulus is causing many market participants to increasingly focus on a return of inflation. Such shift in sentiment is driving broad shifts in global financial markets and is likely to emerge as one of the most significant investment themes in 2021.

Inevitably, this reflation dynamic will have many and varied impacts on insurance investments managed by Twelve Capital. In aggregate, Twelve expects the impact of reflation to be positive for insurance sector fundamentals.

In this note, Twelve discuss the direct fundamental impacts of rising inflation and concomitant higher interest rates on different areas of the insurance sector as well as implications for different asset class investments in the sector.

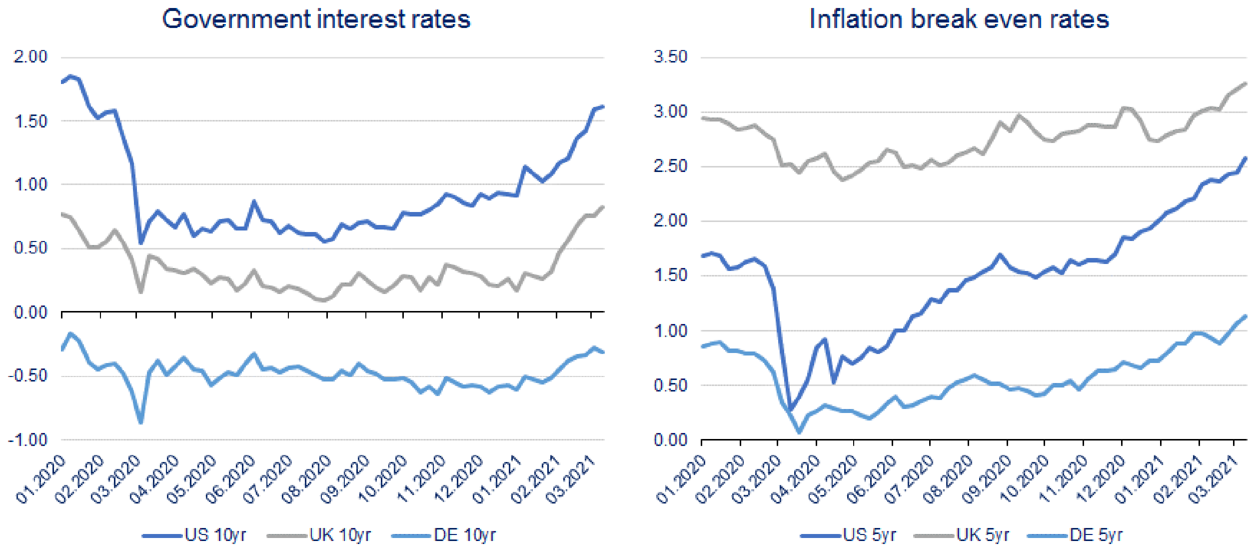
Reflation backdrop

A combination of post-pandemic recovery and ongoing fiscal and monetary support are driving interest rates and inflation expectations higher. This is particularly the case in the US. For example, the US ten year treasury yield has increased by 70bps from year-end 2020 to 1.61% currently, and the five year inflation break even, a measure of market expectations for average inflation over the next five years, has increased by 62bps to 2.58%, above the Fed's 2% long-term target.[1]

Interest rates and inflation expectations in the UK and Europe have moved up similarly. The yield on UK 10 year Gilts has risen by 63bps year-to-date with 5 year inflation break evens up over 50bps. In Europe, the yield on 10 year German government debt has increased from (0.57)% to (0.32)% while the five year inflation break even has increased 41bps to 1.13%.[1]

[1] Source: Bloomberg. As at 15 March 2021.

Figure 1: Government interest rates and inflation break evens



Source: Twelve Capital, Bloomberg. As at 15 March 2021.

While Twelve does not endeavour to take a direct view on macro-economic factors, these moves signal a shift in market consensus expectations of near and medium-term economic conditions.

Impact on insurance industry fundamentals

Life Insurance

Higher interest rates are a meaningful net benefit for many life insurers. While hedging, investment strategy shifts, product repositioning, and business line exits have reduced sensitivity to lower rates for this subsector, higher interest rates would still alleviate key pressures.

First, reinvestment yields remain generally below running yields on surplus capital, representing an earnings headwind which would lessen as the yield environment improves.

Second, many life companies, particularly in the US and many countries in continental Europe maintain legacy books of spread-based business where crediting rates are largely at minimum guaranteed levels, creating additional pressure.

Third, higher interest rates would lift pressure on balance sheets for products with unhedged long-term implicit or explicit interest rate guarantees, e.g. long-term care and universal life with secondary guarantees. Such balance sheet benefits would be reflected more in improving solvency ratios or less reserve pressure rather than a near-term lift in operating earnings.

While mostly positive, a rapid rise in interest rates could cause a spike in lapses as existing products would have to compete with newly more competitive uses of capital. However, Twelve believes this is likely to be a long way off given high guarantees on older products and surrender charge protection on more recent production.

For life reinsurers, interest rates are generally less of a focus as these businesses have avoided many of the more onerous guaranteed rate businesses and generally focus on reinsuring less interest rate sensitive risks such as mortality, morbidity, and longevity.

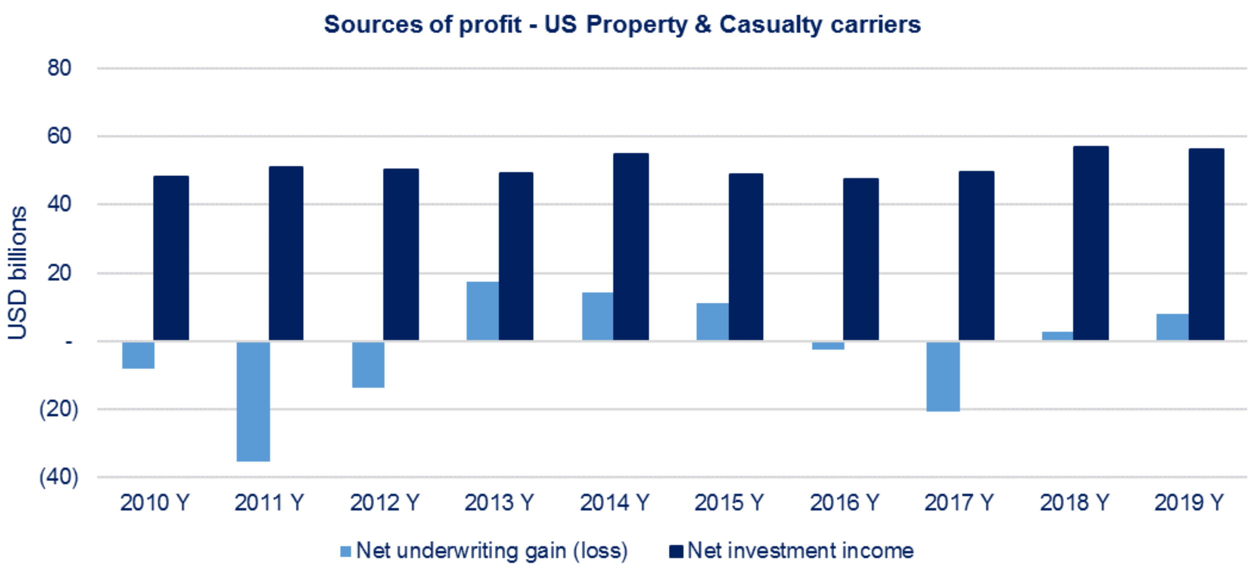
P&C Primary and Reinsurance

Inflation trends could, in general, present a headwind to property and casualty underwriting earnings via an increase in loss cost inflation. However, in practice, insured loss cost inflation is only loosely related to general market inflation. For example, social inflation, or the increasing involvement of litigation in claims and higher jury awards, has been a key driver of claims severity trends in the past five years despite subdued overall inflation. This source of inflation has been an important factor in the positive move higher in (re)insurance rates observed particularly over the past 12-18 months.

Still, a very rapid and unexpected spike in inflation could have some negative effect on underwriting profits through, for example, higher wage or materials costs on property repairs. Twelve believes the trading environment is sufficiently positive to support the necessary premium rate increases to offset this impact. Also, most P&C policies are re-priced every six to twelve months, giving underwriters the ability to react to changes in the inflation environment so long these changes are relatively gradual and well telegraphed.

While the focus of investors tends to be on underwriting performance for P&C names due to the more volatile nature of this source of income, investment returns remain a significant component of overall profits for the industry, as illustrated in Figure 2 below.

Figure 2: Sources of profit



Source: Twelve Capital, S&P Market Intelligence. As at 15 March 2021.

While rising rates could cause negative mark-to-market impacts on existing assets, most P&C companies maintain relatively short-duration asset portfolios. Low interest rates, therefore, have been a headwind to investment income for the industry over recent years. A move higher in rates would quickly feed into higher interest income for most companies, particularly in short-tail lines such as personal auto as well as personal and commercial property.

Impact on insurance related asset classes

Cat Bonds and ILS

- Cat Bonds and ILS have minimal sensitivity or exposure to interest rates or broad inflation trends
- Cat Bonds are generally short duration with collateral invested in cash equivalents or floating rate securities, thus the risk free component of returns moves with risk free rates
- Higher inflation in the broader P&C market, such as that driven by social inflation recently, has also fed into higher risk spreads on Cat Bonds and ILS

Liquid Credit

- Fund duration in Twelve Capital-managed liquid credit strategies at roughly 4.5 years, currently, is kept relatively short compared to the broader corporate bond market at 7.16 years, insulating mark-to-market performance from rising interest rates
- Credit spreads generally benefit from the overall positive impact of higher interest rates and higher inflation on the fundamental outlooks and solvency ratios of issuing companies

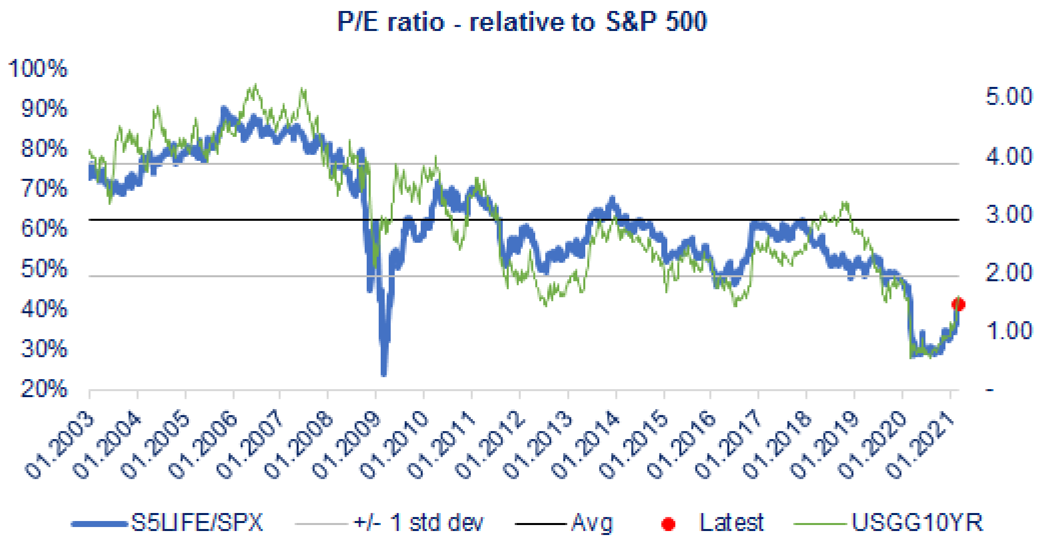
Illiquid Credit

- Funds average duration in Twelve Capital-managed illiquid credit strategies is kept very short at below 3.5 years supported by: the allocation to floating rate transactions; the negligible weight of undated securities; allocation to bonds with expected buyback within at most 10 years from their issuance
- The credit quality of transactions generally benefit from progressively higher interest rates and higher inflation. Specifically, solvency ratios of issuing companies are typically positively correlated to higher rates, while negative the impact of inflation on non-life liabilities is limited given the focus on short-tailed line of business

Equity

- Prices of insurance equities benefit generally from the positive impact on fundamentals, including higher earnings and lower costs of equity capital as balance sheet tail risks recede with higher interest rates
- Some equity portfolios managed by Twelve recently increased exposures to companies which should benefit fundamentally in a reflationary environment, such as US Life Insurance businesses
- The relative valuation of US Life Insurance stocks have historically shown a strong positive correlation to yields on US ten year treasuries, as shown in Figure 3 below

Figure 3: Relative P/E Ratio between S&P 500 Life Insurance and S&P 500 vs 10 year US Treasury Yield



Source: Twelve Capital, Bloomberg. As at 15 March 2021.

Multi-Asset

- Twelve multi-asset strategies benefit from each of the dynamics described above, including relatively short duration fixed income investments, exposure to improving risk spreads in ILS and Cat Bond investments, and exposure to insurance equities positively geared to rising interest rates

- In addition, Twelve multi-asset strategies have the ability to shift assets between asset classes as risk/reward opportunities change, and also benefit from natural diversification between differing exposures.

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About Twelve Capital

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