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Marketing material for professional/qualified investors only **February 2022**

Insurance Bonds show Resilience

Executive Summary

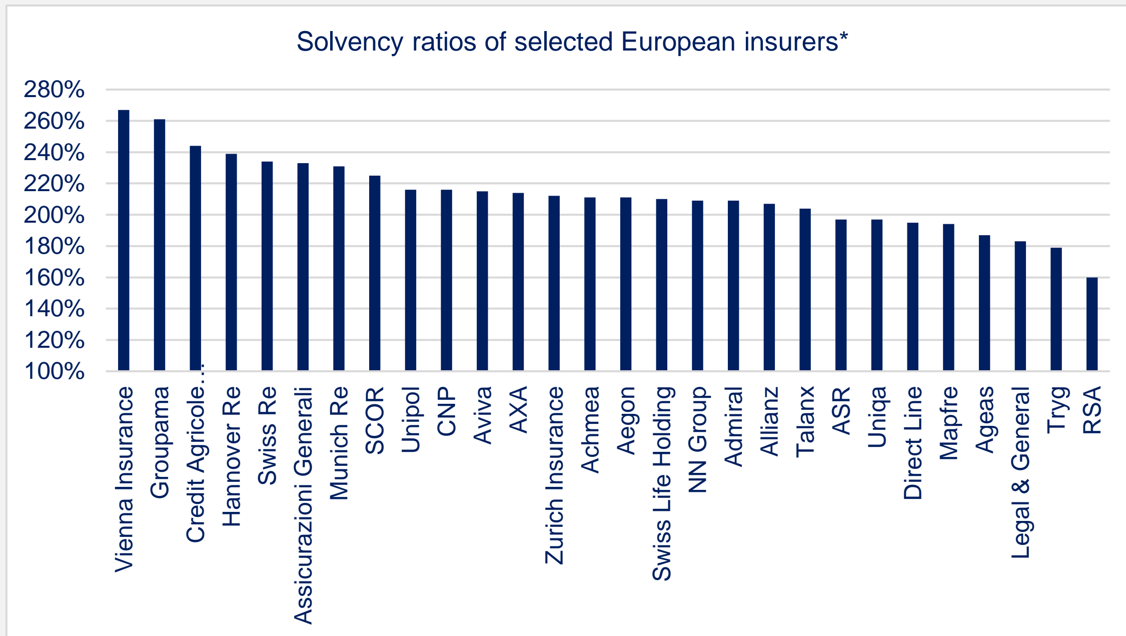
- Insurance Bonds have been one of the most resilient subsectors of credit markets throughout periods of crises and uncertain market conditions. Many investors due to the complex nature of the sector simply chose to ignore it; instead, they focused on the very high beta crowded segments of credit. As consequence, Insurance Bonds are attracting the attention of a broad investor base seeking compelling yields, eager to find a sector that benefits at its core from a rising rate environment and a sector that does not rely on low rates to fund growth.
- Twelve Capital remains firmly focused on its strong approach of deep fundamentals analysis and long history in investing in Insurance Bonds, especially in volatile markets. We firmly believe the sector starts 2022 from a position of fundamental strength, quality in assets and strong earnings generation.
- The recent market turmoil (January 2022) has affected spreads across the entire credit universe and sets the stage for a very interesting period for markets. For Insurance Bonds, spread levels have reset to levels last seen in 2018/2019, and this is creating a new opportunity.
- RT1 issuance has continued to grow; the spread offered on these structures can no longer be ignored by the wider credit community. We expect RT1 to become more mainstream in 2022, whilst we expect the supply of T2 bonds especially from European insurers to be limited in 2022, this should insulate T2 structures from any further spread widening.
- 2021 saw the issuance of EUR 12.9bn T2 and just under EUR 5bn of RT1. New issuance in 2022 has started well with just over EUR 2bn in Insurance T2 and one inaugural GBP 400m RT1 with a coupon of 6.125%. The relative value of Insurance Bonds versus banks and high yield is at compelling levels, especially when compared on price, spread and ratings. Insurance Bonds remain on average BBB rated, with only handful of BB rated RT1 bonds.

Starting with a solid Capital Position

The resilience of the insurance sector during the heightened pandemic demonstrated to investors just how resilient the capital position of the insurance sector was. The sector remained financially healthy throughout the pandemic and to the best of Twelve's knowledge there were no rating downgrades or defaults. The insurance industry benefits from a very strong capital position. The average regulatory capital ratio of the sector is expected to stand at 216% at FY21 according to Twelve Capital's estimates.

Please also refer our recent note on insurance fundamentals.

Figure 1: European solvency ratios



Source: Twelve Capital. *Latest available data.

Recent Market Volatility

2022 has started on a volatile footing, geopolitical risk, the re-emergence of Covid in the form of the Omicron variant and the emergence of rapidly increasing inflation are risks that are currently dominating investor sentiment. At the time of writing the risks of an escalation of war in East Europe is a very much alive.

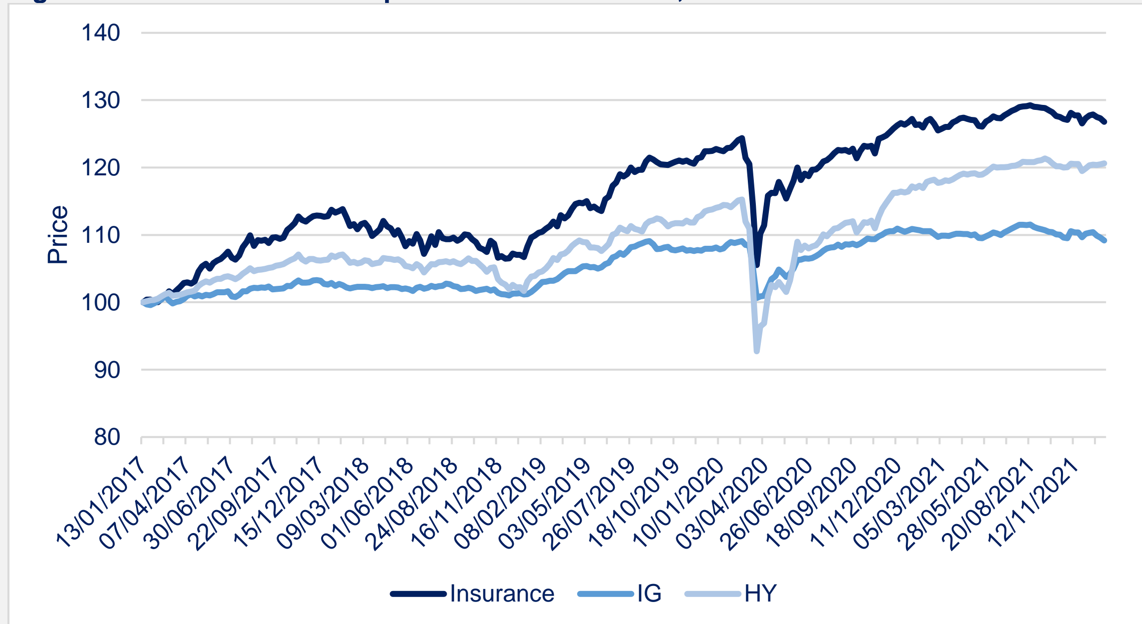
We expect to have clarity from Italian and French elections, which will neutralise country specific risk. This should bode well for an allocation in H1 2022 to Insurance Bonds, specifically Italian risk which Twelve believes will benefit from compression in H2 2022.

Insurance Bonds have rewarded investors who have had a long-term view on the sector. Relying more on the fundamentals of the sector rather than playing short-term technicals is a preferred way to achieve solid returns from Insurance Bonds.

Going back as far as 2017, subordinated Insurance Bonds have consistently outperformed both High Yield and Investment Grade bonds, and we expect that given the continuously improving fundamentals and strong solvency capital position, the sector should continue to perform and deliver appropriate returns. Please refer to figures 2-4 where we compared the outright performance of subordinated insurance bonds since 2017, which have outperformed both EUR IG and EUR HY.[1]

[1] Past performance is not indicative of future returns.

Figure 2: Performance development Insurance vs. IG, HY



	Return
Subordinated Insurance[2]	26.29%
EUR IG[3]	9.54%
EUR HY[4]	20.44%

Source: Bloomberg. As at 7 January 2022.

[2] Bloomberg Barclays Insurance Subordinate Total Return Index Hedged USD: No official description available.
[3] The Bloomberg Euro-Aggregate: Corporate Index is a rule based benchmark measuring investment grade, EUR denominated, fixed rate, and corporate only. Only bonds with a maturity of 1 year and above are eligible.
[4] The Bloomberg Pan-European High Yield Index measures the market of non-investment grade, fixed-rate corporate bonds denominated in the following currencies: euro, pounds sterling, Danish krone, Norwegian krone, Swedish krona, and Swiss franc. Inclusion is based on the currency of issue, and not the domicile of the issuer. The index excludes emerging market debt.

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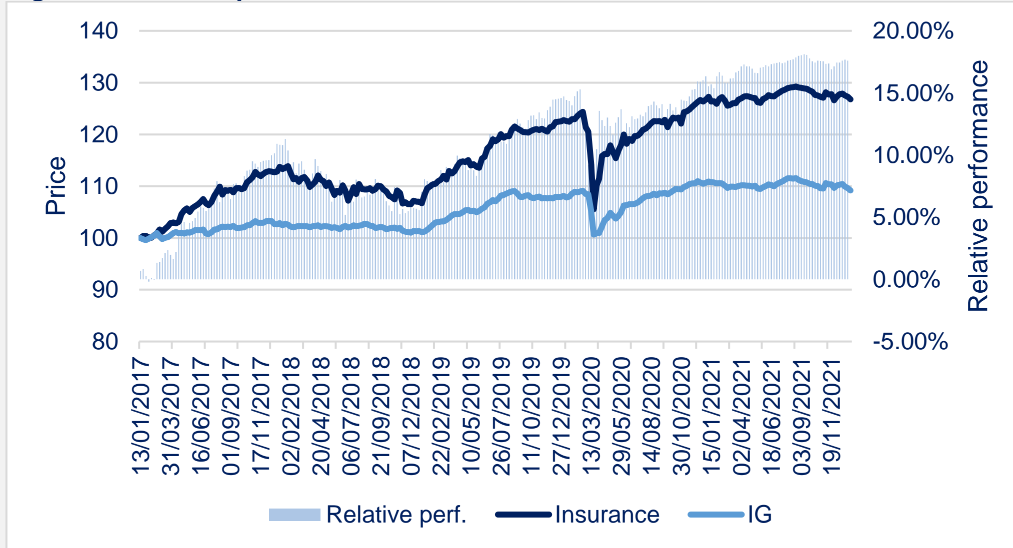
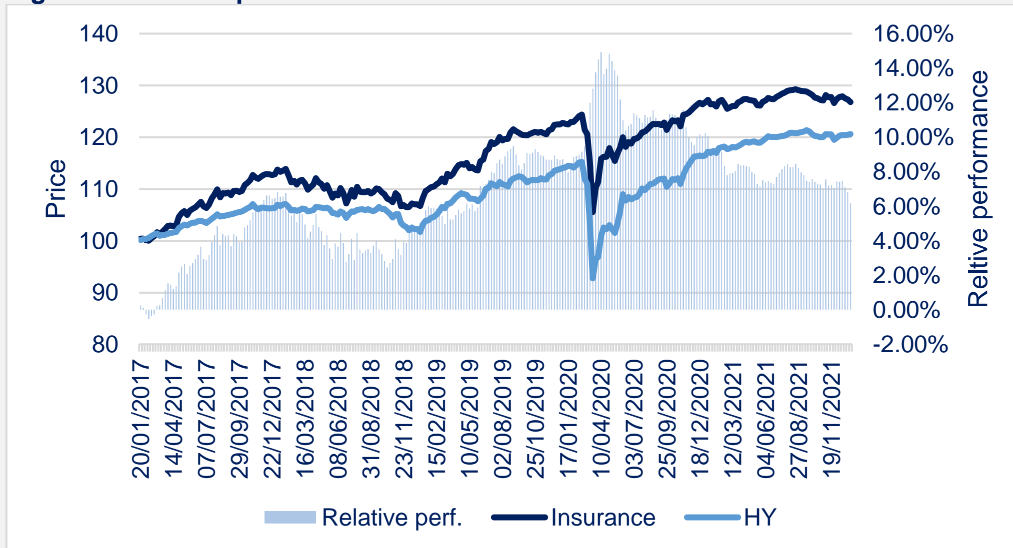
Figure 3: Relative performance Insurance vs. IG



Source: Bloomberg. As at 7 January 2022.

Figure 4: Relative performance Insurance vs. HY



Source: Bloomberg. As at 7 January 2022.

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Where are we now

Long-term value in Insurance Bonds

1. Insurance continue to offer a reliable income

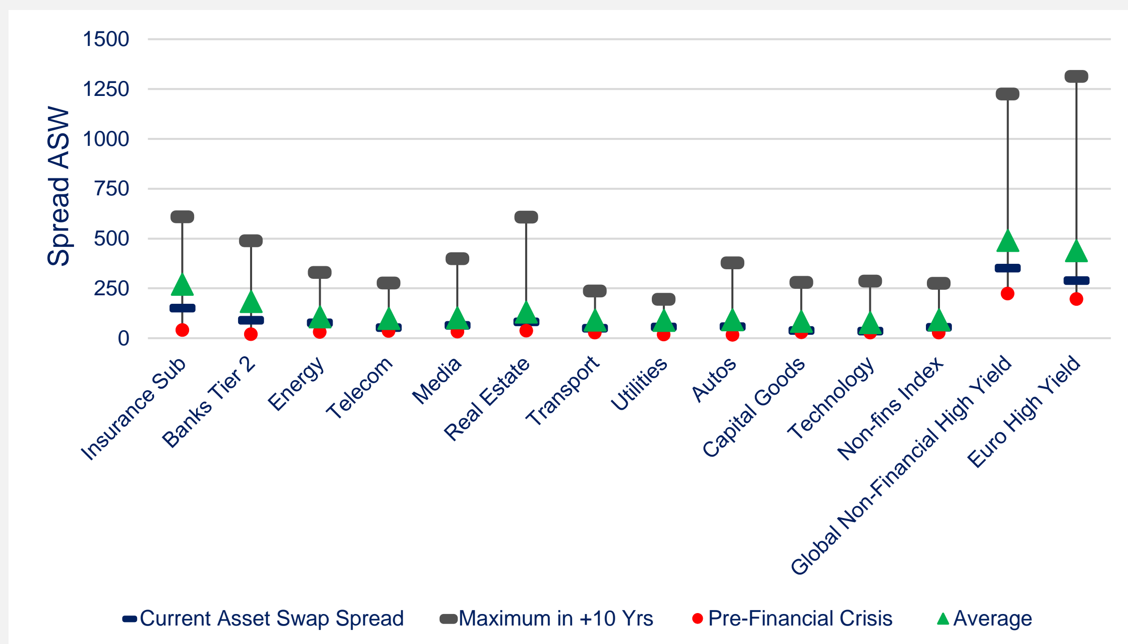
Historically, Insurance Bonds have been a reliable source of income through periods of uncertainty. This was the case during the Financial Crisis in 2007/08 and during the European Sovereign Debt Crisis in 2012. In fact, during the Sovereign Debt Crisis only one coupon was missed across all Insurance Bonds issued in Europe. Furthermore, only one insurer had to restructure their debt during this period.

We are seeing a similar trend during this current bout of instability. When the pandemic started, central banks took action to stabilise financial markets to maintain credit lines and access to liquidity for the broader corporate bond market.

This however, also led to negative yields affecting more than EUR 800bn in corporate bond issuance. Fortunately, Insurance Bonds were one of only two sectors (banking being the other) which did not see yields get artificially compressed as they were not eligible for central bank bond buying programmes. As can be seen from the below spreads remain meaningfully compressed for the broader segments of the credit universe.

This has meant that many sectors, unlike the insurance sector, are trading at or near 10-year historical tight spreads.

Figure 5: 10-year sector sights for the asset swap spread



Source: Twelve Capital, BOA Indices, Bloomberg data in EUR. As at 31 December 2021.

2. Central Banks

We expect the ECB to take no meaningful action in the near term with respect to rates. Despite the US and the UK (at the time of writing the latter already raising rates 50bps and the former announce a rate hike of similar nature in March 2022) the path to high rates of the past is still very much in limbo, particularly in Europe. Regardless fixed income investors still face the problem of achieving a compelling yield without a detrimental reduction in rating and overly exposing themselves to excessive duration in rising rate environment. Fixed income investors can no longer rely on the thematic of a central bank induced rally in credit, but will have to be very acute in their security and asset allocation.

3. Where is the value

RT1 Structures

Even more compelling, the recent market volatility has meant that the RT1 segment of the insurance capital structure is set to benefit the most from spread compression or alternatively deliver an exceptionally compelling running yield.

Yield to Call Insurance Bonds GBP, EUR, USD Structures:

Structure	GBP Yield to Call	EUR Yield to Call	USD Yield to Call
RT1	550bps	388bps	480bps
T2	320bps	160bps	470bps

Source: Twelve Capital. As at January 2022.

RT1 Structures with Investment Grade Ratings

January 2022, Moody's upgraded the ratings of restricted tier one-capital instruments issued by four European insurance Groups:

Security Name	Coupon	YTC	Rating	CCY
Bupa Finance	4%	5.2%	BB	GBP
Direct Line	4.75%	5.5%	Baa3	GBP
Legal & General	5.625%	4.9%	BBB	GBP
RSA Insurance Group	4.75%	5.14%	BBB	SEK
***CNP**	4.75%, 4.875%	3.3%, 5.15%	BBB	EUR, USD

Source Bloomberg, As at 31 January 2022. *CNP Assurance restricted tier one placed on review for upgrade.

Insurance Bonds the relative opportunity and technicals

Insurance Bonds have remained a strong paying sector versus investment grade rated European corporate bonds. Although they do generally lag market rallies, there is a mistaken belief that they are underperformers.

This is not the case, technical factors, such as market liquidity, have been poor in times of stress as investors typically shift their focus to higher beta segments of credit. The insurance sector has a very small representation (approximately 3%) in the mainstream credit indices that are tracked by credit investors. This means that when it comes to Insurance Bonds the vast majority of the universe is neglected, and hence tends to lag market moves vs other sectors.

Twelve coined the term "complexity premium", that is the excess spread investors can achieve over and above for investing in subordinated Insurance Bonds. Here, investors are overly compensated for assuming this risk, despite the strong fundamentals that already support the insurance sector. Overall, Insurance Bonds remain largely overlooked and under researched, which contributes to the "complexity premium" on offer, even more so in times of market stress.

When comparing Insurance Bonds to those issued by the banking sector, the insurance sector pays in excess of 100 bps more than the banking sector most of the time.

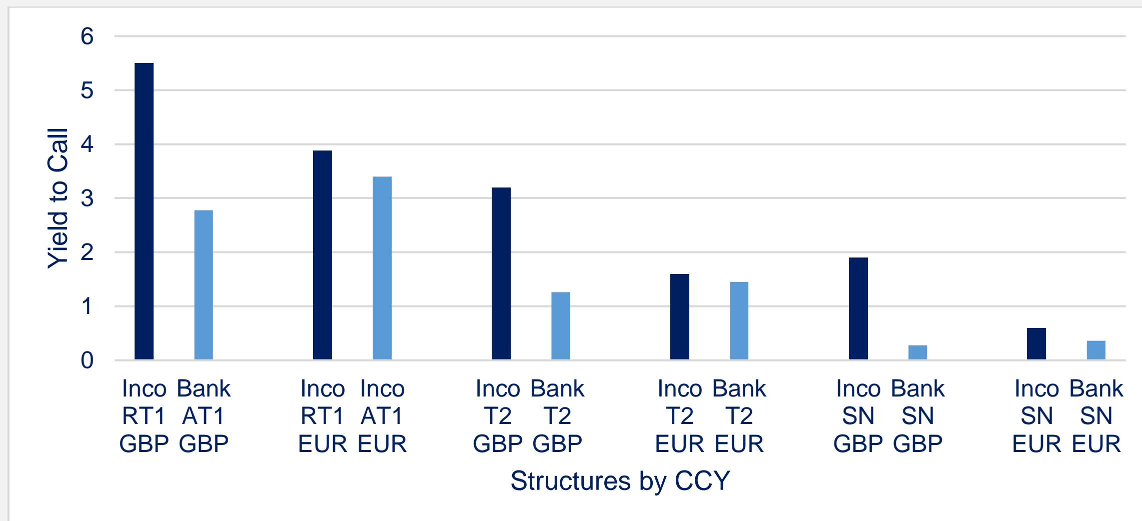
4. Supply Technicals

Supply technical will also be a dominating factor. Looking at the graph, we expect the absolute amount of subordinate Insurance Bonds on the lower end compared to upcoming years such as 2024, and 2025, which draws to the close of the end of the grandfathering period. Therefore supply of new bonds or refinancing of vintage bonds this year is expected to remain low keeping spreads contained and demand for existing subordinated Insurance Bonds high in Twelve's view.

Figure 6: Subordinated Insurance Bonds Maturing Profile

Source Twelve Capital. As at 31 January 2022.

Figure 7: Insurance Bonds versus bank bonds one of the largest differentials



Source: Twelve Capital. As at 31 January 2022.

This can be seen when comparing GBP restricted tier 1 (RT1) bonds between both the insurance and banking sector. Here the difference is in excess of 160 bps. Meanwhile, comparing Tier 2 euro bonds is equally interesting, with a difference of 60 bps. For pound sterling Tier 2 bonds there is a difference of 139 bps, while for senior pound sterling debt, there is a difference close to 160 bps.

We firmly believe that the insurance sector should trade inside the banking sector; therefore, there potentially remains significant spread tightening to come for the insurance sector.

5. Less Rate Sensitivity than Investment Grade and better Rated than High Yield

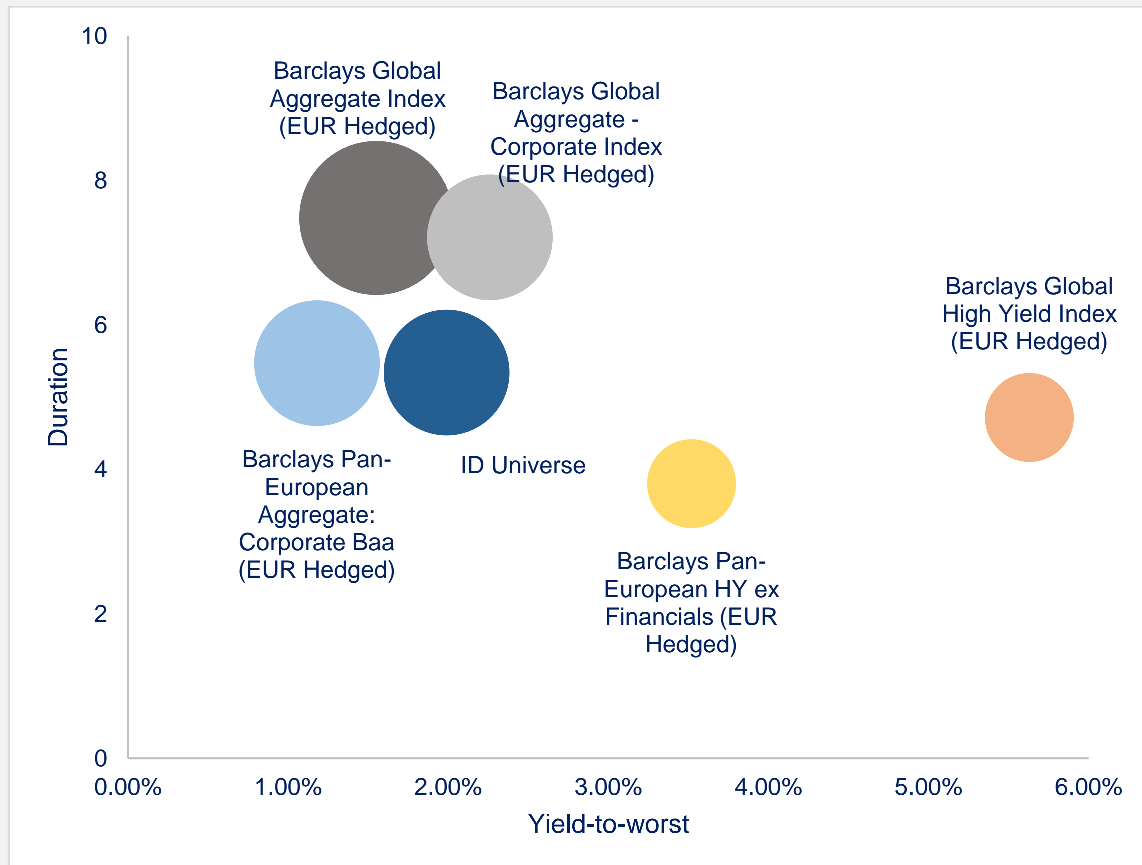
A diversified portfolio of Insurance Bonds as a standalone strategy can offer an efficient means to navigate the duration risks faced due to expansionary monetary policy and the current inflationary risks that markets are concerned with.

Insurance Bonds should continue to benefit from higher and more attractive yields versus other corporate bonds. Moreover, they should also benefit from spread compression in the Insurance Bond sector over time.

Even short-dated Insurance Bonds, can offer yields comparable to long-dated corporate bonds, but with less duration risk. Ultimately, these bonds offer a high-yield bond-like return despite being investment grade rated.

Figure 8 below shows the yield-to-worst versus duration risk. What is notable is that Insurance Bonds have exhibited a shorter duration and better yield than any other mainstream credit index.

Figure 8: Yield-to-worst vs duration Insurance Bonds vs credit indices



Source: Bloomberg, Twelve Capital. As at 31 January 2022.

ID Universe: Insurance Debt Universe.
Barclays Global Aggregate Index (EUR Hedged): The Bloomberg Global Aggregate Bond (EUR Hedged) index tracks bonds issued in emerging and developed markets worldwide.
Barclays Global Aggregate - Corporate Index (EUR Hedged) is a measure of global investment grade, fixed-rate corporate debt. This multi-currency benchmark includes bonds from developed and emerging markets issuers within the industrial, utility and financial sectors.
Barclays Global High Yield Index (EUR Hedged) is a multi-currency measure of the global high yield debt market. The index represents the union of the US High Yield, the Pan-European High Yield, and Emerging Markets (EM) Hard Currency High Yield Indices.
Barclays Pan-European Aggregate: Corporate Baa (EUR Hedged) is a subset of the Bloomberg Barclays Pan-European Aggregate Index and tracks fixed-rate, investment-grade securities issued in different European currencies.
Barclays Pan-European HY ex Financials (EUR Hedged) is a subset of the Bloomberg Barclays Pan-European High Yield Index and measures the market of non-investment grade, fixed-rate corporate bonds denominated in different European currencies.

Execution

What does this mean for Insurance Bonds in 2022?

- If inflation remains persistently high, markets will factor aggressive rate hikes from central banks. This will lead to meaningful yield moves in very long dated bonds.
- Insurance Bonds structures have the gravitas to provide portfolios from the above rate-induced volatility, there are myriad of structures from legacy floating rate bonds such as CMS, short-dated call instruments, dated and bullet structures that can all be used to mitigate this duration risk, while still paying an attractive coupon.
- An allocation to RT1 structures offers attractive rating/risk adjusted spreads and should no longer be ignored. Some RT1 bonds with investment-grade rating pay even higher spreads than high yield bonds.
- Despite the very challenging market volatility, European insurance companies have released strong and improving solvency regulatory ratios over the past couple of years.
- It is one of the very few sectors that an increase in interest rates ultimately leads to an improvement in credit metrics, in this case Solvency II.

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About Twelve Capital

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