Twelve Capital Insurance Bond Strategy

H1 2022 Review

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Executive Summary

- The first half of 2022 will no doubt be remembered for severe fixed income volatility.
- Markets are now reacting to the end of unconventional monetary policy, which for the past several years has supressed the peaks and troughs of traditional economic cycles.
- Going forward, asset allocation within credit will be highly important, as the margin for error is very acute and will be costly given the deterioration in credit quality for some sectors away from insurance.
- Insurance Bond spreads remain at unjustifiably elevated levels, despite the sector's strong fundamentals underpinned by Solvency ratios on average at 216%, which provides protection in a deteriorating macro backdrop.
- The sector is one of the best paying from a yield perspective, with significant upside potential.

Dinesh Pawar, responsible for the Insurance Bond strategies at Twelve Capital, provides an update on the Insurance Bond market.

"Investing in Insurance Bonds has always rewarded those investors who take the complexity premium the sector offers. Additionally, they benefit from investing in high quality capital in one of the most defensive sectors.

Recent market dynamics have created one the most compelling entry points for the insurance sector."

Widening spreads

Since the start of 2022 Insurance Bond spreads have widened at a record pace. Spreads started on average at 165bps, and widened almost 200bps to reach a recent level of approximate 370bps as shown in figure 1. In this recent bout of sustained volatility, the Insurance Bond universe has in Twelve Capital's view been unjustifiably penalised. Yields have also widened to historical levels, also due to the moves in underlying government bond markets.

Figure 1: Z-Spread Bloomberg Insurance Subordinated Total Return Index

Source: Bloomberg, Twelve Capital. Bloomberg Insurance Subordinated Total Return Index Value EUR. 9 December 2019 - 30 June 2022.

As monetary stimulus is withdrawn and central banks change their stance at tackling inflation, uncertainties for credit investors have increased and credit spreads have swiftly repriced. It is still uncertain if central banks will be able to engineer a soft landing. Corporates can no longer rely on cheap sources of funding, particularly for sub-investment grade companies who typically show higher dependency on debt financing, and where we see a visible increase risk premia for primary issuances.

With markets now pricing in a recession and with limited flexibility from central banks, we believe that the importance of correctly assessing credit quality, ratings migration risk, sensitivities to macro factors and portfolio volatility are even more paramount for credit investors than they were in a more positive economic back drop.

Insurance sector specific merits – resilience in fundamentals and past crises

Twelve Capital believes an allocation to Insurance Bonds is a prudent way to navigate what is currently unfolding across markets, as the sector not only benefits from regulatory oversight, but has historically proven a safe haven especially in times of market volatility. In fact, in past market crises Twelve Capital would point to the sector's resilience. For example, throughout the global financial and peripheral European sovereign crises of 2007 to 2012, only one coupon was missed to credit investors in European insurers and only one insurer had to suspend coupon payments (which were accrued and paid at a later stage), to the best of Twelve's knowledge. We further believe that at current levels the potential upside for performance is meaningful, given how stretched yields have become, and therefore an attractive entry point has now emerged.

Furthermore, an allocation to Insurance Bonds provides a way to mitigate several structural problems investors will very likely be facing over the short and long term. These features are listed below:[1]

– **Yield:** No other sector offers such a convincing risk reward for rating to yield, the average sector yield is now at 5%.

– **Low defaults:** Solvency ratios averaging 216% as at Q1 2022, strong fundamentals, earnings and stable balance sheets translate into a lower default rate compared to any other sector.

– **Credit quality**: Insurance Bonds remain firmly investment grade with more than 95% rated BBB or above. We believe that these ratings are likely to remain investment grade even if we saw a slowdown in growth.

– **Debt leverage:** Low levels and laddered maturities compared to other sectors. Importantly, insurers do not require senior debt financing for liquidity purposes, thus making them less dependent to debt market conditions.

– **Insulation from systemic shocks:** The insurance sector maintains a conservative asset allocation and benefits from well diversified revenue sources.

– **Flexible structures:** Short-dated call instruments, fixed-to-floating and variable structures can be used to mitigate this duration risk while still paying an attractive coupon.

– **RT1** structures offer attractive rating/risk adjusted spreads and are becoming a more mature asset class.

– **Strategically defensive**: The Euro area has reported two consecutive quarters of negative growth. Downside risks continue to grow. Sectors most exposed are expected to be Banking, Consumer Cyclicals and some Industrials, whereby the insurance sector is inherently defensive.

Insurance Bonds in past crises

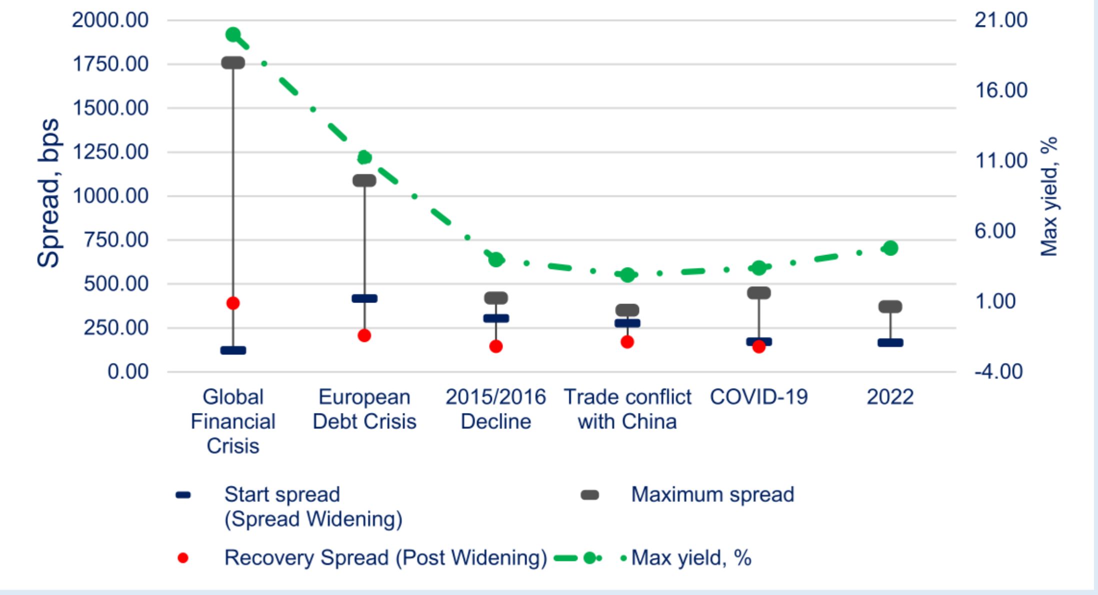
When comparing today's moves to past crises, figures 2 and 3 show the magnitude of the spread still being relatively contained. However, what has been a prominent driver in this crisis is severe underlying volatility in government bond markets. At the start of 2022 the German 10yr Bund yield was -17bps and in its recent peak (21 June 2022) the yield hit 177bps. Similarly, US 10yr treasuries started the year at 150bps and peaked mid-June 348bps.

[1] Bloomberg, Twelve Capital as at 30 June 2022.

Putting this into context, the repricing of Insurance Bonds has been driven by a combination of rates and spreads widening at the same time. Historically, as shown in figure 2, the sector yield is close to 5%, and is even greater than that seen in the commodity sell off 2015/2016. These periods of higher yield from the insurance sector are seen on limited occasions. Yields for the sector have only been higher on two occasions: the Great Financial crisis and the European Debt crisis. We point out that yields did not stay elevated for very long.

Twelve Capital believes that uncertainties around yields will persist as long as inflation will remain elevated and that most of the spread widening for insurance debt have already occurred. In fact, we believe that spread levels similar to those recorded during the great financial crisis or the peripheral European crisis are unlikely to materialise now, considering the improvements in the financial strength of the sector over the past years, which include higher solvency positions and improved enterprise risk management.[2]

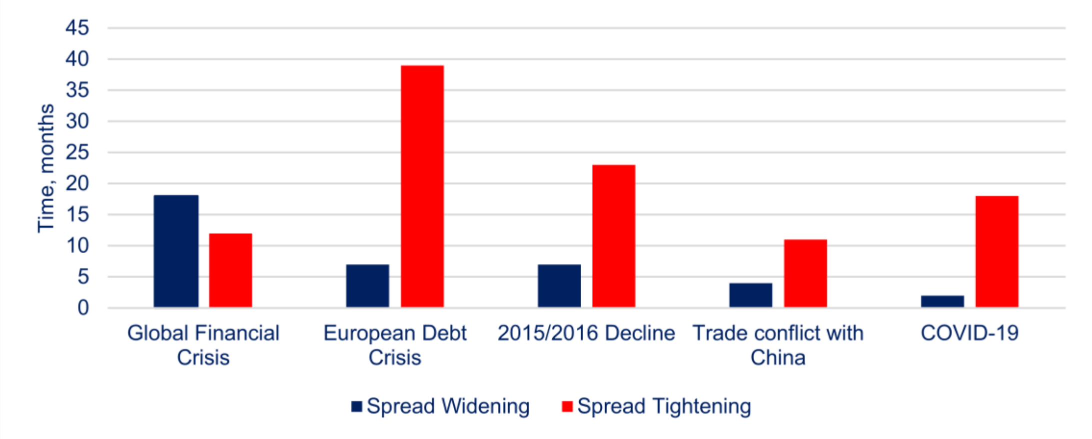
Figure 2: Spreads Analysis of Economic Event



Source: Bloomberg, Twelve Capital. Bloomberg Insurance Subordinated Total Return Index Value June 2022.

[2] This is Twelve Capital's opinion only. The future cannot be predicted, nor can any developments be guaranteed to happen.

Figure 3: Spread Widening and Tightening Cycles



Source: Twelve Capital. As at June 2022.

The first half of 2022 has clearly been testing for investors, given mark-to-market losses driven by higher rates and some spread widening. Despite this, Twelve Capital believes there is value in Insurance Bonds both from a positive yield and fundamental perspective. In this context we believe investors should tilt their portfolios towards being more defensive in nature and hence Insurance Bonds cannot be ignored.

Risk factors

Investments in bonds can fluctuate in value, and there is no guarantee that bonds can be sold for the original capital amount invested.

The value of bonds can be affected by factors specific to an individual company or issuer, as well as general market and economic conditions. Corporate bonds usually carry a higher risk than government bonds. The lower the quality rating given to a debtor by a rating agency, the higher the risk. Nonrated bonds can be riskier than bonds with an investment grade rating.

These factors mean there is no guarantee that all issuers will be able to meet their payment obligations in full and on time. The value of bonds is furthermore affected by changes in interest rates. This is the risk that the value of a bond may fall, so when such an investment is sold, its value may be lower than the original purchase price.

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About Twelve Capital

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