Twelve Capital Insurance Bond Strategy

Q3 2022 Review

October 2022

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Marketing material for professional/qualified investors only

Dinesh Pawar, Head of Insurance Bonds at Twelve Capital, provides an update on the Insurance Bond market.

"The entry point for Insurance Bonds has just got even more compelling"

September 2022 has been a very volatile month for credit investors, with Investment Grade and High Yield funds down in excess of -8%. Clearly markets are dealing with a lot of issues, from the war in the Ukraine, high energy costs, recession, Hurricane Ian and central bank induced rates volatility. In addition, in the last week of September margin calls for liability driven UK pension funds led to wide spread selling of credit across Europe. For UK based insurers this number of bad developments is less of an event despite the fact that they are significant users of interest rate swaps, margin calls were comfortably met and there was no cause for concern given the high liquidity buffers inherent in all such entities.

None of the issues mentioned above have had or are expected to have material impact on credit fundamentals for the insurance sector. We have discussed in detail the benefits of rising rates for the insurance sector in previous research papers, and in particular the benefits for life insurance companies who reported higher and very healthy solvency ratios in Q1 and Q2 this year on the back of higher excess capital and/or lower capital requirements. Higher spreads do impact insurers' marked to market fixed income assets but we must bear in mind that a significant proportion of these fixed income assets are facing liabilities with similar duration and are held to maturity. Insurers are therefore protected against temporary market volatility.

In our opinion the aggressive moves of central banks are key to understanding credit going forward. Ultimately the credit sell off or spread widening was initially triggered by expectations of higher interest rates and whether that would trigger a recession. The point is that central banks have been reacting to inflation. Once central banks find a balance or a reason to no longer act aggressively credit is expected to immediately stabilise. Hence this is why we believe increasing exposure to Insurance Bonds makes sense now as despite the higher beta once we see inflation stabilising, we will also get more clarity on future rates rises.

The last Fed hike on 21 September moved the Fed's Fund rate to 3.25% with forward guidance suggesting rates will get to 4.25%-4.625% by the end of the year. Nearly all rates' strategists are forecasting that we are not far from that point. In Europe the current base rate is 1.25%, although clarity is needed regarding how far Europe will go in increasing rates as the underlying driver is energy costs. In fact, recent inflation data in Europe suggest that European inflation hit 10% in September.

Why now

Insurance Bonds are at levels last witnessed at the time after the Great Financial Crisis 2007/2008 and the European Sovereign Crisis. High quality names have been unfairly penalised. After these crises Europe at least was dominated by the "Draghi Put" (do anything to save Europe), that essentially triggered a monumental rally that lasted all the way up to COVID-19 and was reincarnated to a certain degree to help get through this period.

From a fundamental credit perspective, insurers are strong enough and well positioned to face higher inflation, higher rates and risks of recession. We have seen clear signs of hardening markets in 2022 with property and casualty players being able to significantly increase their premium rates without reducing the volume of business underwritten (e.g., commercial lines, property risk, motor). This trend has been confirmed at the Monte Carlo's reinsurance conference in September. Life insurers with traditional savings books including guarantees which had been suffering during low interest environments can now reinvest at higher rates and increase their profitability on these books.

Insurers are also well positioned to face potential higher interest charges since their financial leverage remain at a comfortable level (25% based on economic balance sheet) compared to other industries.

Nevertheless, we acknowledge that there is still some dispersion of returns when investing in insurance fixed income and a great emphasis should be put in the selection of securities and the handpicking of investments in the insurance space.

Looking at the yields both in table 1 and table 2 the extent of the opportunity is apparent. Table 2 highlights the cash price of recently issued Insurance Bonds, including some issued by the highest rated players within the sector. Finally, chart 1 displays the extent of the move vs other crises.

Table 1: Current yields

Structure/YTBB	GBP	EUR	USD
Solvency II - T1	YTBB = 9.84% Duration = 4.43	YTBB = 7.11% Duration = 4.29	YTBB = 7.71% Duration = 2.59
Solvency II - T2	YTBB = 7.98% Duration = 5.25	YTBB = 5.62% Duration = 4.87	YTBB = 6.68% Duration = 6.88
Solvency II - T3	YTBB = 8.01% Duration = 3.14	YTBB = 4.20% Duration = 3.63	N.A.
Senior	YTBB = 5.93% Duration = 7.16	YTBB = 3.52% Duration = 4.70	YTBB = 5.09% Duration = 6.04

Source: Twelve Capital. As at 3 October 2022.

Table 2: Insurance Bonds issued in 2022

Issue date	Capital classification	ISIN	Bond name	Currency	Amount issued (in m)	First call date	Credit rating	Duration	Mid Price	YTC	YTM	2W change in ZTC
27/01/2022	Solvency II - T1	XS2434427709	UTMOST 6 1/8 PERP	GBP	300	15/12/2028	BB+	4.49	65.17	14.93%	11.36%	+217.83
10/01/2022	Solvency II - T2	XS2431029441	AXASA 1 7/8 07/10/42	EUR	1,250	10/01/2032	A-	8.31	71.09	6.04%	5.68%	+42.11
04/02/2022	Solvency II - T2	XS2434439548	CSNLN 4 3/4 08/04/32	GBP	200	04/08/2032	BBB-	7.33	78.74	7.90%	7.90%	-96.54
27/01/2022	Solvency II - T3	FR0014007YA9	CNPFP 1 1/4 01/27/29	EUR	500	27/10/2028	BBB+	5.72	78.86	5.43%	5.26%	+35.76
15/06/2022	Solvency II - T1	XS2485268150	AVLN 6 7/8 PERP	GBP	500	15/12/2031	BBB	6.41	80.29	10.23%	9.35%	+80.48
13/04/2022	Solvency II - T3	ES0224244105	MAPSM 2 7/8 04/13/30	EUR	500	13/04/2030	BBB-	6.31	81.23	6.05%	6.04%	+42.69
23/08/2022	SST Capital	XS2523960719	ZURNVX 5 1/8 11/23/52	GBP	1,000	23/08/2032	A	7.30	82.35	7.71%	7.83%	+48.51
31/05/2022	Solvency II - T2	XS2487052487	AXASA 4 1/4 03/10/43	EUR	1,250	10/09/2032	A-	7.57	86.42	6.11%	6.17%	+40.97
15/06/2022	Solvency II - T2	AT0000A2XST0	VIGAV 4 7/8 06/15/42	EUR	500	15/06/2032	A-	7.20	86.80	6.77%	6.82%	+46.60
02/06/2022	Solvency II - T2	DE000A30VJZ6	ALVGR 4.252 07/05/52	EUR	1,250	05/01/2032	A	7.55	88.63	5.88%	5.86%	+39.57
30/08/2022	Solvency II - T2	XS2526486159	NNGRNV 5 1/4 03/01/43	EUR	500	30/08/2032	BBB	7.61	90.36	6.61%	6.72%	+42.74
31/05/2022	Solvency II - T2	XS2468390930	ATHORA 5 3/8 08/31/32	EUR	500	31/05/2027	BBB-	3.90	91.30	7.67%	7.43%	+81.10
04/04/2022	Senior	CH1170565712	ZURNVX 1 1/8 07/04/29	CHF	400	04/04/2029	A+	6.35	91.41	2.58%	2.52%	+6.10
09/09/2022	Solvency II - T2	FR001400CHR4	MACIFS 6 1/4 09/09/33	EUR	500	09/09/2033	BBB+	7.56	92.88	7.21%	7.21%	+47.15
31/08/2022	Senior	CH1210198136	SLHNVX 3 1/4 08/31/29	EUR	700	31/05/2029	A-	6.00	93.15	4.47%	4.42%	+17.60
06/07/2022	Solvency II - T2	XS2468223107	ASSGEN 5.8 07/06/32	EUR	500	06/01/2032	BBB	7.09	94.86	6.56%	6.52%	+51.64
07/09/2022	Solvency II - T2	DE000A30VTT8	ALVGR 4.597 09/07/38	EUR	1,250	07/06/2028	A	5.02	95.71	5.50%	5.52%	+33.88
23/05/2022	Solvency II - T2	USD5558XAA66	MUNRE 5 7/8 05/23/42	USD	1,250	23/11/2031	A	7.05	96.12	6.45%	7.07%	+64.28
24/06/2022	Senior	CH1194000332	HELNSW 1.95 06/25/29	CHF	150	25/03/2029	A	6.18	96.37	2.56%	2.54%	+4.87
24/06/2022	Senior	CH1194000324	HELNSW 1.45 06/25/26	CHF	250	25/03/2026	A	3.56	97.43	2.23%	2.17%	+10.01

Source: Twelve Capital. As at 30 September 2022.

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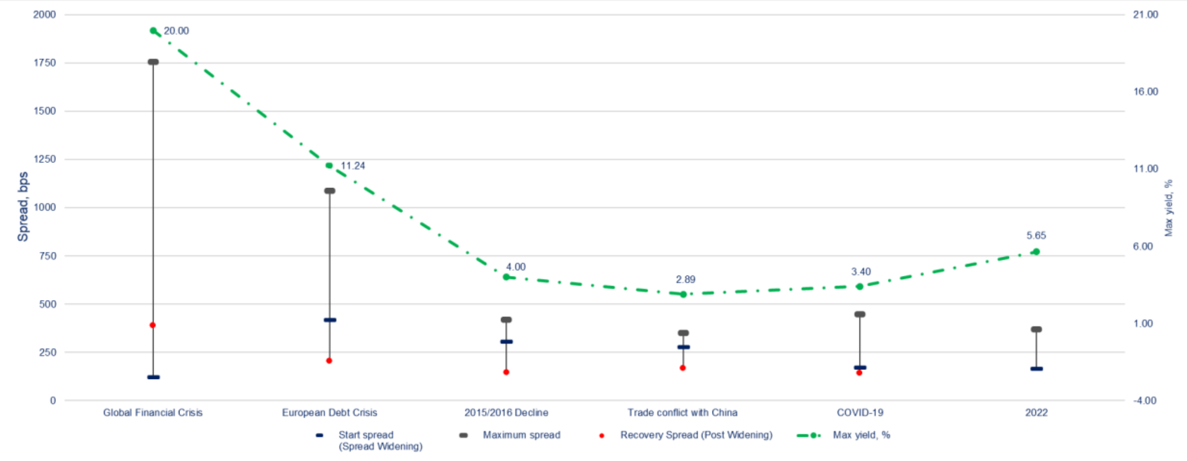
Chart 1: Insurance Bond Spreads in distressed markets



Source: Twelve Capital. As at 3 October 2022. Past performance is not indicative of future returns.

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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