TWELVE CAPITAL LETTER FROM THE CIO

Downside protection in volatile market conditions

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Urs Ramseier, CIO & Founding Partner at Twelve Capital, comments the current market situation and the expected impact on the insurance industry.

"Twelve Capital's deep sector understanding is key to navigate these turbulent market conditions."

Executive Summary

- Persistent core inflation, uncertain economic growth, and rapidly raising interest rates have led some company-specific issues to surface. In turn, these have caused widespread market volatility in both equity and fixed income markets.
- We witness concerns around the liquidity positions of banks and insurers. We believe banks and life-savings insurers to be more exposed to liquidity risk, albeit in most cases liquidity buffers are adequate.
- The Swiss regulator's decision to impose losses on Credit Suisse AT1 bonds requires a re-assessment of regulatory risks. Spill-over risk could affect the insurance RT1 space.
- In the current environment insurers are better positioned than banks. Still, we believe that in both sub-sectors there are defensive names and structures that are well positioned to show resilience in the current markets. Albeit cautious, buying opportunities could also arise.
- In the fixed income space, we currently favour dated Tier 2 instruments with limited going concern loss absorption features issued by large and well diversified multi-line insurance companies with solid investment grade ratings. In equities we underweight banks in relation to insurance and diversified fee-based financials.
- Twelve Capital's strong fundamental analytical capabilities and a selective investment approach are key in the current environment.

The current environment exposes banks and insurers to potential risks

Household savings in the US and EU have risen during the past years and through the Covid pandemic, with these savings largely placed into liquid assets such as cash and bank deposits. Insurance life savings also benefitted from positive inflows. As a result, the assets of financial companies grew.

Both insurance companies and banks manage significant securities portfolios. Insurers tend to match policyholder liabilities with similar duration high-quality fixed income assets. Banks will typically deploy deposit funding via their traditional lending activities but also manage liquidity needs with fixed income assets.

As interest rates have increased, customers have more opportunities to deploy their liquid assets in higher-yielding investments. This might incentivise them to potentially reallocate bank deposits or (the insurance corollary) surrender their life savings products. We flag that surrendering a life insurance policy would be more complex than exiting a bank deposit as there are typically costs of doing so, including surrender penalties in the first years, the loss of accumulated tax or inheritance benefits, as well as market-value adjustment features that would protect the insurer. Insurers monitor this lapse risk carefully and most major listed insurers had not seen significant changes in policyholder

behaviour when asked on FY22 results calls. Differences exist, however, depending on the type of distribution networks (bancassurance and financial advisors networks show higher lapsation than agent networks) or type of clients (affluent showing higher lapsation than retail).

Another consequence of the rapid increase in interest rates is that the value of the fixed income investments falls and result in unrealised mark-to-market losses. These losses, depending on the reporting standards used, may not be fully reflected on accounts. This situation would not be problematic if assets would be carried to maturity and the notional repaid in full. Moreover, if we look at well-matched insurers' economic balance sheets, movements in assets would typically be mirrored by similar movements in the value liabilities, thus neutralising the effect on own funds. The risks come if banks and insurers experience unforeseen increases in client money withdrawals requiring the disposal of assets to generate cash.

Should a situation happen where clients massively close their accounts or lapse their policies, banks and insurers would be required to crystallise unrealised investment losses. This would, in turn, reduce their liquidity buffers and potentially affect their capital position. To a certain extent this is what was seen at Silicon Valley Bank in the US.

We reiterate that insurers are better positioned than banks in the current environment. The average insurance average sector solvency levels are high, and in most cases well above the upper bounds of their prudent internally-set long-term target ranges. We estimate the average solvency ratio of 67 companies under our coverage that have recently reported to be above 2.2 times the required minimum, or a large EUR 462bn buffer. For Banks, the US industry aggregate CET1 ratio[1] was 12.1% with the largest banks carrying significant additional precautionary capital buffers. In Europe, banks had comfortable capital positions and a good average ratio of high-quality liquid assets to stressed deposit outflows of 148%. Banks were all reporting low levels of delinquency.

However, we have observed specific cases of banks with weaker risk and asset-liability management practices. This is true, for example, for some US regional banks, a sub-sector where regulatory oversight tends to be lighter than for larger counterparties. In the insurance space we have witnessed, in specific cases, more aggressive risk tolerances and product design that proved to be more exposed to changes in the macroeconomic environment.

Market concerns emerged and regulatory risk increased as the situation at some banks deteriorated

In the current market environment, underpinned by persistent core inflation, uncertain economic growth and rapidly raising interest rates, some company-specific issues have started to surface. In turn, these have caused widespread market volatility in both equity and fixed income markets.

The recent spikes in market volatility stemmed mostly from the collapse of Silicon Valley Bank in the US, and liquidity concerns at Credit Suisse that led to UBS to take over its domestic rival in a move orchestrated by the Swiss Regulator (FINMA), the Swiss National Bank and the Swiss government.

In both cases, the regulator/central banks intervened to ensure that sufficient liquidity was made available to honour depositors and prevent contagion. US policy makers are resolute in their commitment to take all necessary steps to ensure that depositor's savings remain safe. We believe regulators' main focus in Europe and the US is to reassure market participants around the remoteness of contagion across the banking sector.

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However, in trying to strike a balance between reassuring depositors and guaranteeing the stability of the Swiss financial marketplace, FINMA decided to impose losses on Credit Suisse's deeply subordinated bonds. This means that their holders are worse-off than equity holders. This unorthodox move has inverted the typical pecking order of capital structure and pushed the market to reassess the risk of regulatory intervention. It also raises

[1] Common Equity Tier.

the risk of negative read across for the more subordinated insurance Restricted Tier 1 debt (the insurance equivalent of banking AT1).

Moreover, the authorities' push for a swift merger between the two Swiss banks without going through the standard practice of submitting the transaction to shareholders' vote has, as well, contributed to higher perceived regulatory risk.

The events at SVB and CS raised some concerns around banks and insurers' liquidity positions. Within the financial sector we believe that banks and life-savings insurers are more exposed to liquidity risk, albeit in most cases liquidity buffers are adequate. In fact, the issues of SVB appear company-specific while Credit Suisse's problems appear more linked to the long-term standalone viability of the group, shareholders' treatment and losses incurred by bondholders. On the other hand, major North American and European banks have better asset and liability diversification and comfortable liquidity positions, in our view. Further, Twelve Capital monitors insurers' level of cash and high-liquid asset closely, as well as news concerning development of lapse for savings contract. For property and casualty, health, and protection insurers, liquidity risk is remote.

Twelve Capital implements a defensive approach as mid-term uncertainty is likely to persist

Policymakers' will need to strike a delicate balance between reducing inflation and avoiding exacerbating concerns on the financial sector in the next months: they have been forced to inject liquidity into a system where they are still tightening policy. Inflation, though showing signs of moderating, is still high and real rates negative.

Moreover, investors will need to adapt to higher perceived regulatory-intervention risk, something that could increase the long-term risk premium required to allocate to financials.

Twelve Capital's focus during this period of market uncertainty is to position the portfolios it manages in a defensive way. We currently prefer insurers to banks, while we believe that in both sub-sectors there are defensive names and bond structures that are well positioned to show resilience in the current market volatility. Moreover, albeit cautious, buying opportunities could arise.

In this context, Twelve Capital's focus on strong fundamental analysis on each issuer and instrument together with a selective investment approach are key. Overall, in the fixed income space we favour dated Tier 2 bonds that have limited going concern loss-absorbency features (contrary to AT1 and RT1). We also favour instruments issued by large and well diversified multi-line insurers with solid investment grade credit ratings. In our equity portfolios our top-down conclusion on banks is to stay on the side lines with an underweight positioning relative to insurance and diversified fee-based financials.

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