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Strategy Alert

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ASSET MANAGEMENT | WHITE PAPER

Portfolio Income Opportunities Amid Market Distress

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Summary

Insurers should consider, given current dislocations in the fixed-income market, opportunities that may potentially enhance income without committing new cash by borrowing through FHLB programs and re-investing the proceeds in highly rated structured securities.

Through the Federal Home Loan Bank (FHLB) network and its competitively priced lending and liquidity programs, insurers may be able to supplement portfolio income through investments in highly rated (AAA and AA) structured securities that are trading at unsually wide spreads due to current market dynamics. Specifically, by borrowing from the regional FHLB and investing the proceeds in highly rated structured securities of similar maturity and matching cash flows, insurers may potentially enhance income without having to invest additional cash or add significant risk.

The Market Opportunity

With the market dislocations driven primarily by the COVID-19 pandemic, equity markets fell more than 25% between February 19 and March 20[1], and credit spreads have widened significantly. Large securities dealers are hesitant to take additional balance-sheet risk at a time when many asset managers are facing redemptions and many funds are being forced to delever. This has resulted in a supply-demand imbalance for certain structured securities, and their recent price declines may make them an appealing asset for long-term investors such as insurers.

Recent purchases of highly rated structured securities that are relatively short in duration (less than two years) have produced yields in excess of 4-5%. As Treasury yields have dropped, borrowing rates from regional FHLBs have also moved significantly lower. The higher yields and lower FHLB lending rates are creating an opportunity for insurers to potentially earn greater income without a need to commit more cash or add significant portfolio risk.*

Recommendations

For those with access to the FHLB advances, we suggest they consider using these advances to fund purchases of the AAA and AA structured securities. Companies could potentially earn attractive net spreads (investment yield minus the borrowing rate) which could lead to additional annual portfolio income.

For those without an FHLB relationship, Conning would be happy to educate and facilitate conversations between companies and their regional FHLB to execute on this recommendation.

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Paul Norris, is a Managing Director and Head of Structured Products overseeing the team involved in the research and trading of structured securities. Prior to joining Conning in 2017, he was a hedge fund portfolio manager focused on mortgage derivatives. Previously, Mr. Norris was head of securitized products at Dwight Asset Management, where he led a team of portfolio managers, traders and analysts, and also has served as director of mortgage and non-mortgage investments at Fannie Mae. Mr. Norris earned a BS in finance from Towson University and an MBA from the University of Maryland.

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A membership in a Federal Home Loan Bank (FHLB) could be a valuable benefit for insurers. Conning works with clients to leverage FHLB programs and believes mid-size firms should join the growing number of larger insurers to take advantage of the opportunities. Click here to read this Viewpoint.

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