

# Viewpoint

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## Course Correction: As investment environment becomes “risk off,” insurers revisit portfolio strategies

By Rich Sega, Global Chief Investment Strategist, Conning

For years the insurance industry has dealt with margin pressure from low interest rates, leading to income-seeking, risk-bearing approaches that have worked well in a non-inflationary, strong corporate earnings environment. However, the experiences of the past year signal that a change, perhaps even a reversal, of some of those strategies is underway.

### A Decade of Financial Repression

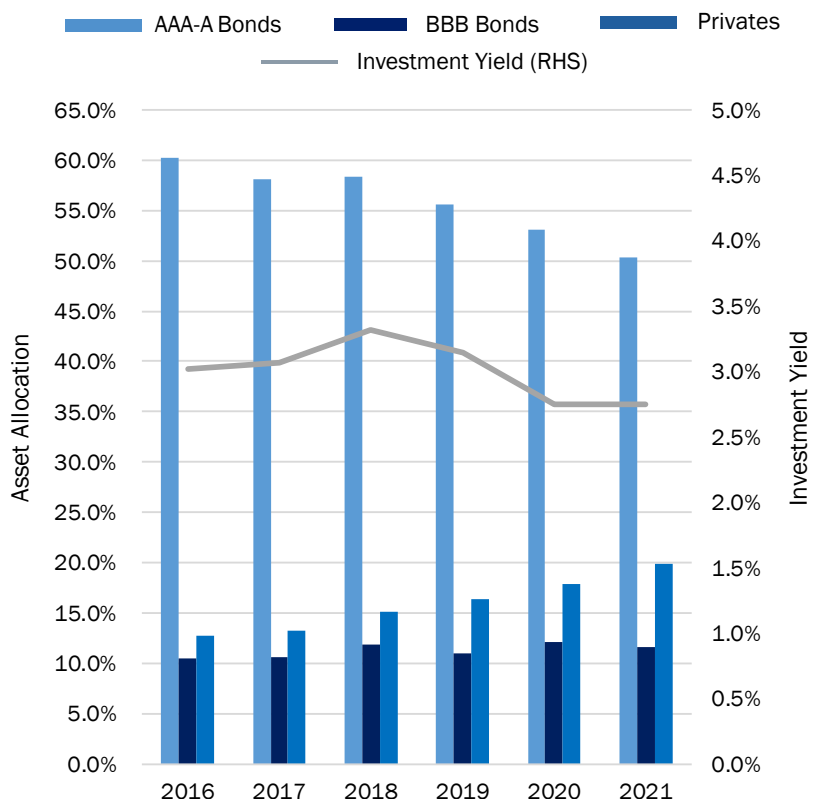
Insurers have faced many disruptors to the business and investment strategies that supported them since the so-called Great Recession ended in 2009. During that time, insurance portfolios were under pressure to produce the income and contribute to the margins necessary to support the companies’ financial strength and meet obligations to policyholders.

Chronically low interest rates and changing consumer preferences gradually pushed insurers’ allocations away from long-favored high-grade corporate bonds and government securities. Modern insurance portfolios for the most part tend to be far more diversified, although corporate credit still dominates. Insurers have gone lower in credit quality, longer on the duration spectrum, and down in available liquidity.

As an example (see Figure 1), the P&C industry’s allocation in bonds rated AAA-A was down to 50.3% in 2021 from 60.2% in 2016. The allocation to BBB, which had been rising for several years, reached 12.1% in 2020 before slipping back to 11.6% in 2021. Private bonds are also on the rise and reached 19.9% in 2021, up from 12.8% in 2016. Despite these changes, the average investment yield for P&C insurers in 2021 was 2.75%, flat from 2020 and down 57 basis points from 2018.

In the life industry, the challenge has been greater for the smaller and mid-sized firms, which comprise most of Conning’s client base. We have helped many life companies diversify into less traditional asset classes, but their larger peers appear further along. (For example, as illustrated in Figure 2, life insurers with more than \$20 billion in assets have about 15% of their GAs invested in mortgages/real estate, while those with less than \$10 billion have less than 8%.) Those smaller insurers have been making ever-increasing allocations to corporate bonds rated BBB but are having difficulty keeping up.

**Figure 1 P&C Industry Allocations, Investment Yield, 2016-2021**



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Overall, these actions have barely held insurers' portfolio earnings rates on an even keel as valuations have climbed and market rates fallen.

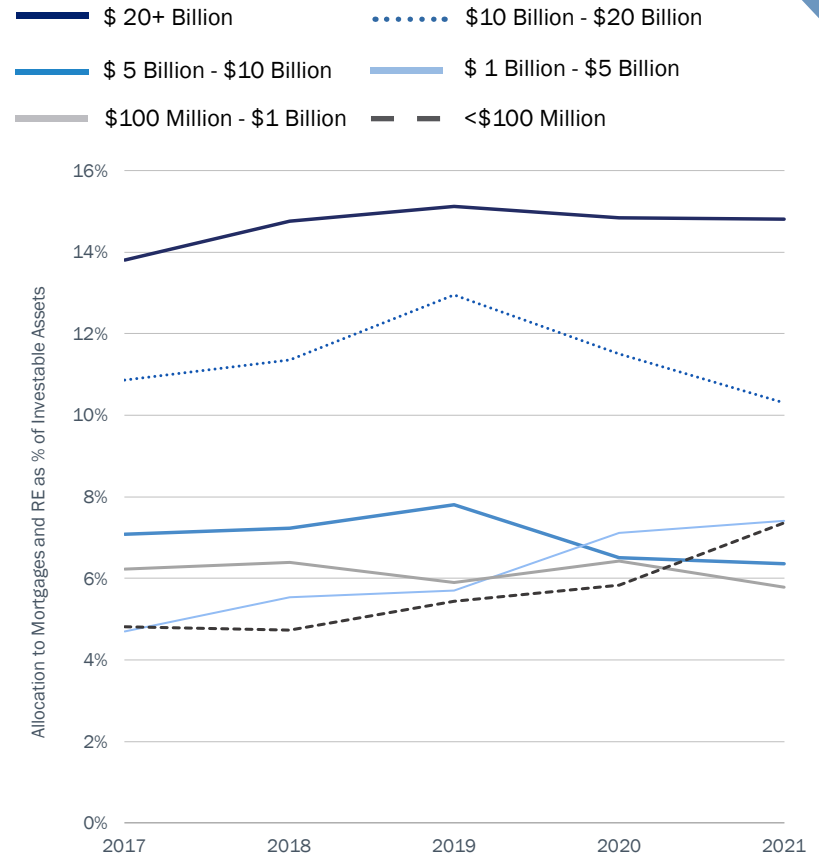
### A Series of Shocks to the System

Three major disruptors have hit the investment world since early 2020: the severe effect of the COVID-19 lockdowns; the fallout of an enormous policy imbalance between supply-side interruptions in the production side of the economy and strong demand support from income-replacement; and lastly, the terrible impacts of Russia's invasion of Ukraine.

The implications for insurers' portfolios are several, including volatile cash flow, erratic liquidity needs, and a shifting risk appetite among policyholders leading to changes in demand for insurance products. But the two main concerns for managers of insurance portfolios are the threats of persistent inflation and rising interest rates.

The past year poses a threat to the high valuations in both stocks and bonds that insurers hold, eroding their unrealized capital gains, widening credit spreads, and reducing gain from operations. Insurers have reacted by shedding risk, leaning toward higher quality, shortening duration, and improving liquidity and marketability of their positions.

**Figure 2 Life/Annuity Industry Mortgage/Real Estate Allocations by Company Size, 2017-2021**



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While reducing interest rate sensitivity is likely high on everyone's mind, actual portfolio duration in the insurance industry has been fairly stable over the past year, with some long-tailed life insurers maintaining their slight upward trend due in part to duration extension in the residential mortgage-backed security sectors. It is true for both life and property-casualty companies but there has been some divergence, with the latter being more muted driven by their lower MBS allocations. Also, portfolios in support of short-tailed liabilities respond to market conditions more quickly than longer tenors and have experienced less of the extreme price volatility that the bond market has dished out this year.

### The Shape of Things to Come

So, what might insurance portfolio managers plan for next? Monetary policy is poised to tighten, inflation has been stubbornly high, and rates are trending upward. This suggests that rate-sensitive securities and real assets will perform well. Certain real estate-based sectors, infrastructure, floating-rate notes, CLOs and leveraged loans all will participate in the rate-rising trend. When risk falls out of favor, valuations across the risk spectrum fall. That's an environment where security selection is critical.

The portfolio diversification lessons of the past decade have been to many insurers' benefit and are not likely to be easily dismissed. They will more likely be subject to fine tuning as insurers modify their exposures to match their tolerance for risk.

A newer aspect that may also drive change is the growing interest related to environmental, social and governance (ESG) concerns. As Conning's recent survey suggested, insurers are rapidly adding ESG considerations to their investment strategies. Climate change is one of the better-known ESG issues and it is likely that some - maybe many - insurers will adjust not only their investment portfolios but even their business models to address climate concerns. That could lead to changes for insurance portfolios at both the security and sector level.



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