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Insurance Investment Strategy: Spread the love, love the spread

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Few need to be reminded how difficult it is to find attractively-priced assets in current markets. It's a particular problem for any provider of pension transfers. To fund such deals and remain competitive, providers need assets that outperfom the gilts and swaps that are the basis for pricing pension risk transfer deals. But despite the recent bounce in yields, spreads remain wafer-thin, particularly in assets favoured for annuities, such as investment grade bonds, infrastructure and prime property loans.

Help, however, is at hand. There are still pockets of value in some less obvious corners of the fixed income market for those with the expertise and experience to exploit them successfully. In this short paper, we suggest three assets that still offer value:

1 US commercial real estate (CRE) debt
2 Dollar-denominated emerging market investment grade debt
3 Mature private equity deals.

All offer advantages for annuity and pension providers, boasting attractive spreads over risk-free assets, diversification potential and reasonable levels of security when used as part of a carefully-constructed portfolio. The first two also offer regulatory attractions, as they are likely to meet the Matching Adjustment (MA) requirements of the Solvency II Directive. Moreover, at its current level, the sterling-dollar long-term cross-currency basis is historically high, meaning that all three investments can be hedged cheaply.

We summarise these attractions below in the table in Figure 1 and discuss them in more detail on the following pages.

US commercial real estate: opportunities await in less popular areas

Direct lending to US property developers may not be on the radar of many UK pension schemes or insurance companies, but probably should be. The main draw here is long-term, secure and fixed cash flows generated on yields of around 5% at spreads of anywhere between 200 and 250 basis points over US Treasuries. The loans offer good security, with loan-to-value (LTV) levels usually not exceeding 70% and strong prepayment protection, typically at the Treasury curve (Figure 2 overleaf). Moreover, they have particular attractions in terms of Solvency II requirements (Figure 3 overleaf).

The property market in major cities in the US has enjoyed very strong capital flows in recent years, leading to high market valuations and tight spreads for lenders. The "non-major" cities are catching up, but valuations still remain

Figure 1: Three assets of interest for pension and annuity providers

	US commercial real estate loans	Emerging market debt	Mature private equity deals
Main features	Long-term loans secured on US commercial property	Investment grade sovereign and corporate debt	Older private equity assets with short payback periods bought in the secondary market
Spread/return	Treasuries + 200–250bps	Treasuries + 220–270bps	6%–8% net internal rate of return (IRR)
Matching Adjustment category	**Component A**	**Component A**	**Component B/C**
Schroders' edge	Direct origination from borrowers	Depth and breadth of EMD experience	Access to a wide range of mature funds

Source: Schroders as at April 2018.

Figure 2: The attractive attributes of the US secondary property market

	10-yr fixed rate CRE loan	15-yr fixed rate CRE loan	20-yr fixed rate CRE loan	10-yr fixed major market
Loan size	\$2m–\$30m	\$2m–\$30m	\$2m–\$30m	\$50m+
Loan-to-value level	50%–70%	50%–70%	50%–70%	50%–70%
Loan to Treasury spread	180–220bps	200–240bps	200–240bps	140–180bps
Interest rate duration	7.1 years	8.7 years	8.3 years	7.1 years
Weighted average life	8.8 years	12.1 years	11.8 years	8.8 years
Fundamental spread	30–70 bps	30–70bps	30–70bps	N/A

Source: Schroders as at April 2018. Fundamental spread calculated based on Schroders' interpretation of the Solvency II rules, based on EIOPA tables as of 31/12/2017, for illustration only.

attractive in comparison. In fact, our own lending model ranks many non-majors highly, based on projected rental growth, occupancy rates and liquidity.

The non-major market has been traditionally dominated by regional banks, which have lent large amounts since 2008. However, recent pressure from regulators has forced these banks to curtail their lending, creating a financing gap for property developers and an opportunity for long-term investors.

Schroders offers particular advantages in terms of the origination of loans. In conjunction with a national US lender, which has offices in many cities, we source the loans directly from borrowers, rather than relying on mortgage brokers whose lending packages tend to be highly competitive. Our partner also offers vertical integration, providing one point of contact for borrowers throughout the life of the loan. This tends to result in higher-quality borrowers.

Figure 3: 10-year fixed-rate non-major US CRE Matching Adjustment considerations

Fixed cashflows	Loans pay a fixed coupon plus amortization of capital.
Prepayment risks	Prepayment lock-out for the first two years, Treasury curve flat thereafter.
Credit rating	Loans unrated, internal rating required. Schroders has a **robust credit scoring process** to assist.
Currency hedging	Cashflows need to be hedged to GBP. Collateral liquidity considerations.
Internal model	Can incorporate other eligibility criteria, as required by insurer's internal model.

Source: Schroders.

Emerging market debt: improving returns

With yields and spreads still low in developed market debt markets, pension and annuity providers need to look further afield. Emerging market (EM) investment grade (IG) debt should be one port of call. Spreads over US Treasuries remain more than 200 basis points at the longer end, while real yields still remain positive, something that has not been the case for the developed economies for a long while now (Figure 4). As with US non-major property lending, EM debt can also be useful from a regulatory point of view (Figure 5).

Emerging markets have changed tremendously over the last couple of decades. More than 50% of the sovereign bonds in the JP Morgan Emerging Market Bond Index now have an IG designation, compared with only 3% in 1993. Another important consideration is that credit exposure in EM is affected by different risk factors than in the developed world credit universe. The latter is typically exposed to competitive pressures and negative industry trends, while the former is driven by macroeconomic factors, like sovereign and banking crises. The differences provide important diversification within a fixed income portfolio.

Schroders' longstanding experience in EMD, combined with our proprietary Sovereign Credit Model, enables us to select the best companies in the best countries to create sustainable, long-term portfolios. Our portfolio construction process also allows us to take account of MA-related regulatory constraints, for example, by restricting non-IG bonds. That said, we believe that such bonds can selectively add value, particularly in Components B or C of the MA portfolio.

Below we demonstrate a model portfolio, created for the purposes of an MA book:

Figure 4: Features of a model EM portfolio

Yield to maturity	5.0%
Portfolio spread	220 bps
Fundamental spread	70 bps
MA Spread	150 bps
Spread SCR (standard formula)	12%
Duration	8.0
Average rating	BBB

Source: Schroders; for illustrative purposes only. Data as of April 2018. Fundamental spreads calculated based on Schroders interpretation of Solvency II rules, based on EIOPA tables as of 31/12/2017, for illustration only. Spread SCR calculated assuming the portfolio is held within a matching adjustment portfolio.

Figure 5: EM debt Matching Adjustment considerations

Fixed cashflows	Fixed coupon bonds.
Prepayment risks	No callable bonds.
Credit rating	Investment grade portfolio created at outset. Selectively incorporate non-IG bonds, if add value on the regulatory basis.
Currency hedging	Cashflows need to be hedged to GBP. Collateral liquidity considerations.
Internal model	Can incorporate other eligibility criteria, as required by insurer's internal model.

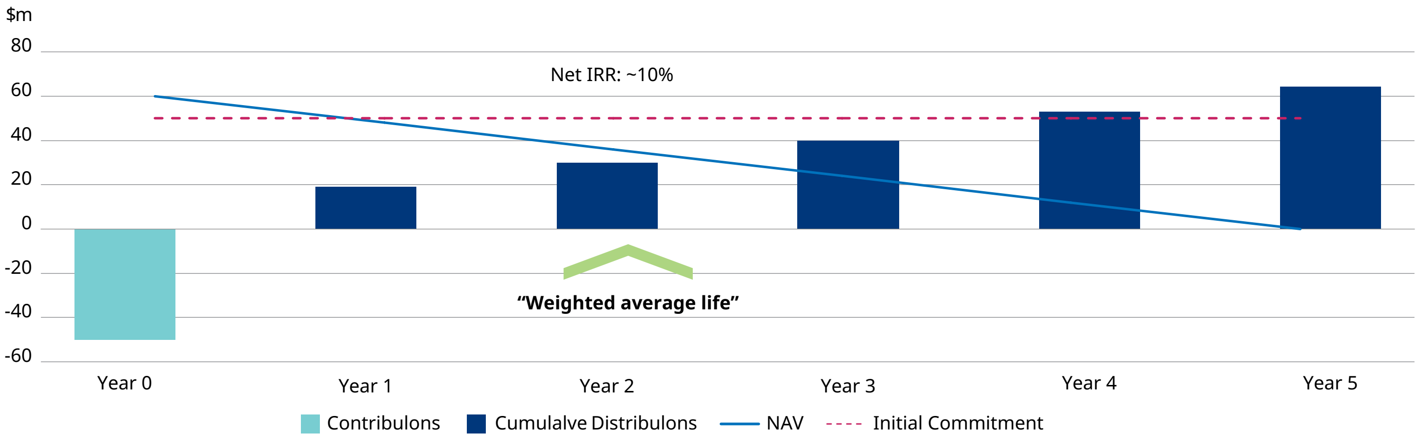
Source: Schroders.

Mature private equity deals: secondaries that can offer first-class returns

Components B/C in an MA portfolio are not subject to the same strict regulatory requirements and thus there is more freedom to seek high returns, albeit without taking unnecessary risks. We would argue that mature private equity deals fit these requirements rather well. Investors can reasonably expect annualised gross internal rates of return of around 10% over five years. And because these deals are typically acquired late in the life of private equity funds, they are that much closer to realisation. Cash flows therefore typically come earlier than in traditional private equity investments, providing a higher measure of security for investors (Figure 6). Here again, though, expertise is needed in sourcing, negotiating and managing such deals, not least because the investor is effectively locked-in over the life of the contract.

This is a propitious moment for anyone seeking to exploit the secondary market for private equity deals. Many of the funds that resulted from the large wave of capital raising in 2006-2008 are now in liquidation mode, having reached the end of their natural lives. These vintages still hold significant value, providing an opportunity for investors looking to earn a liquidity premium over the medium term. Much of the secondary market is concentrated on younger vintages, so the matured deals that are now around the 10-year mark are often available at substantial discounts to net asset value. The actual size of this discount depends, amongst other things, on the type of the underlying exposure (for example buy-out or venture capital) and the future growth potential of the investment. Schroders Adveq has long experience in sourcing, investigating and negotiating such deals, and then managing them in portfolios.

Figure 6: Returns tend to be high and cash flows early in mature private equity deals...



...making them a rather attractive investment to support pensions or annuities

Market size	Attractive return	Unique structure
– Large supply of mature funds – Small and mid size portfolios are the sweet spot	– Short-term duration – High expected return – Initial discount mitigates market risk – Ideal for surplus asset	– 5-year maturity – Single capital call – Potentially Solvency II capital of Type I equity

Source: Schroders. Weighted average life represents the average expected number of years for the initial investment amount to be outstanding.

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