AUGUST 2024

TIME FOR P&C INSURERS TO INCREASE THEIR FIXED INCOME ALLOCATIONS?

P&C insurance investors responded to the zero-interest rate (ZIRP) era by reducing fixed income allocations in favor of equities and private investments. But, as rates have risen, we have not seen a corresponding upswing in fixed income allocations. We believe there is the potential to improve risk-adjusted returns by increasing exposure to public fixed income.

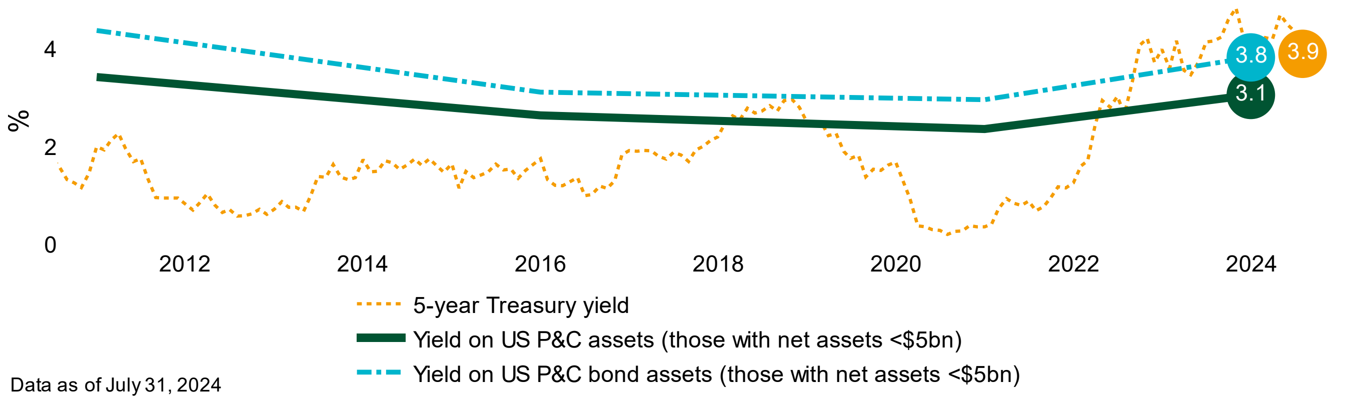
TIME FOR P&C INSURERS TO SHIFT BACK INTO FIXED INCOME?

Seeking an increased level of return, P&C insurance companies strategically shifted their fixed income allocations lower in favor of equities, alternatives and, more recently, cash. With investment grade fixed income representing insurers' largest portfolio allocation, there was little choice but to reach for income and return when the fed funds rate was close to zero (Figure 1).

Figure 1: We have reached the peak of the rate cycle, but P&C insurers have not increased their fixed income allocations[1]

Now that interest rates have risen, five-year Treasury yields are currently higher than the yield on P&C insurers' invested assets (Figure 2). With investment grade assets now offering competitive yields, we think this signals an opportunity for increasing fixed income allocations seeking to benefit from the higher yield environment and lock in sustainable high-quality income.

Figure 2: Five-year Treasury yields have moved above insurance portfolio yields[1]



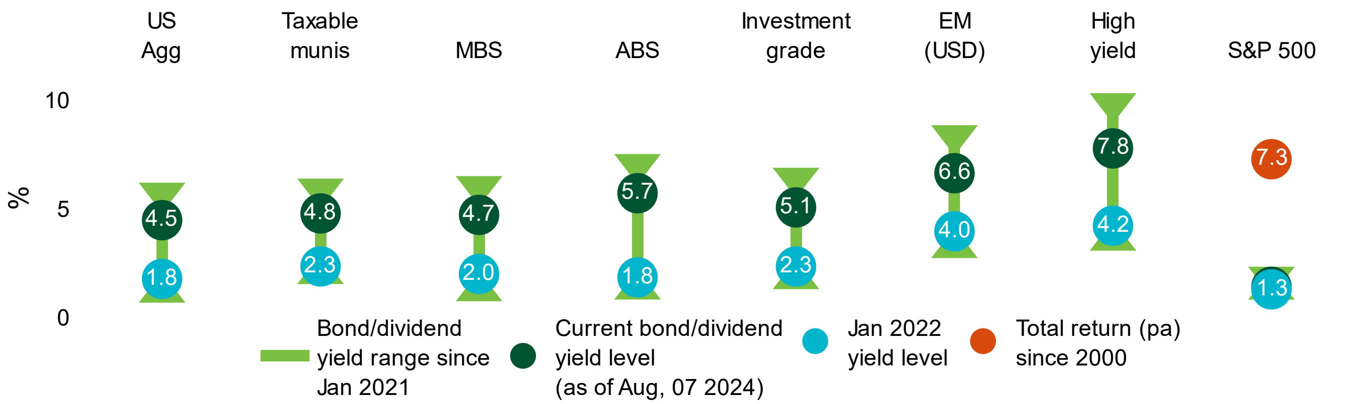
Data as of July 31, 2024

[1]S&P Global Market Intelligence, Bloomberg, July 2024. **Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.**

SHIFTING FROM EQUITIES MAY HAVE A SMALLER IMPACT ON EXPECTED RETURNS THAN BEFORE

Fixed income yields are currently at levels not seen since prior to the 2008 global financial crisis. At today's yields, income returns are close to average annualized equity total returns since 2000 (Figure 3). This suggests that allocating from equities to investment grade credit may mean less of a reduction in expected long-term total returns than it would have a few years ago.

Figure 3: Across multiple fixed income sectors, yields remain close to their post-pandemic highs[2]



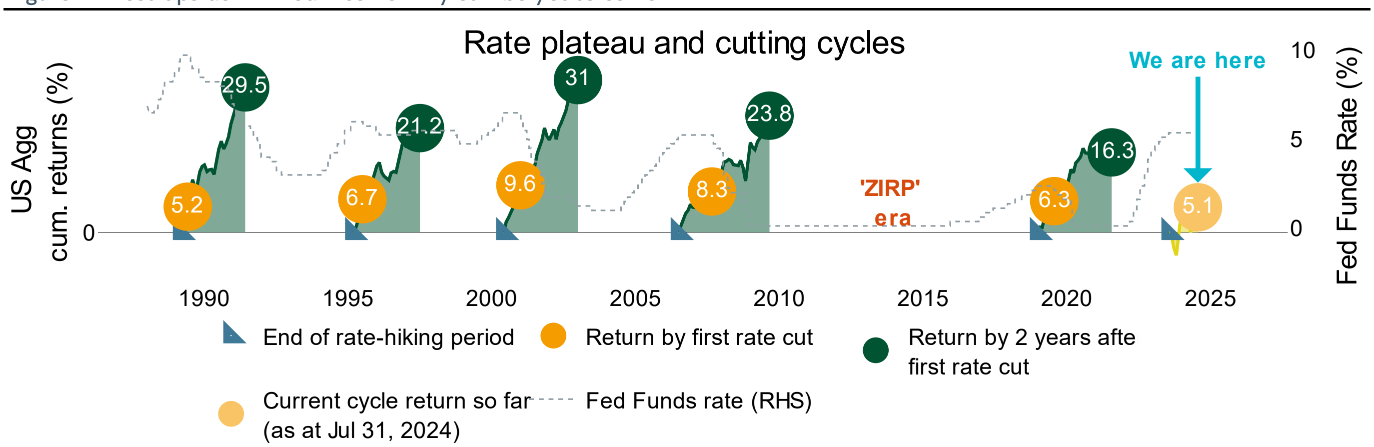
The US equity market continues to post record highs, contributing to strong investment results for insurance companies. Yields in fixed income are now sufficiently high that investment grade credit can once again have diversification benefits alongside an equity portfolio, with the potential for solid positive returns in the event of a meaningful market correction in equities.

NOW MAY BE A COMPELLING TIME TO ALLOCATE TO FIXED INCOME

Given that we are at the top of the interest rate cycle, it may be a compelling time to lock in contractual income-based return streams. While not our base case, yields could of course trend higher. However, with yields starting from relatively high levels, income can help buffer against price declines.

If (as we currently expect) yields instead decline, investors may benefit from both capital appreciation and income. The Bloomberg Aggregate Bond Index has delivered total returns of 16% to 32% cumulatively during the last five rate cutting cycles (measured from the end of the last rate hike of each cycle to two years following the first rate cut). So far this cycle, fixed income has delivered 5%, implying potential upside remains (Figure 5).

Figure 4: Most upside in fixed income may still be yet to come[3]



[2] Bloomberg, Insight, July 2024. **Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.**

[3] Bloomberg Aggregate Bond Index, Insight calculations, July 2024. **Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.**

INVESTORS MAY WANT TO CONSIDER PUBLIC FIXED INCOME OVER CASH AND ALTERNATIVES

Instead of cash, investors may wish to consider high quality, liquid, investment grade fixed income

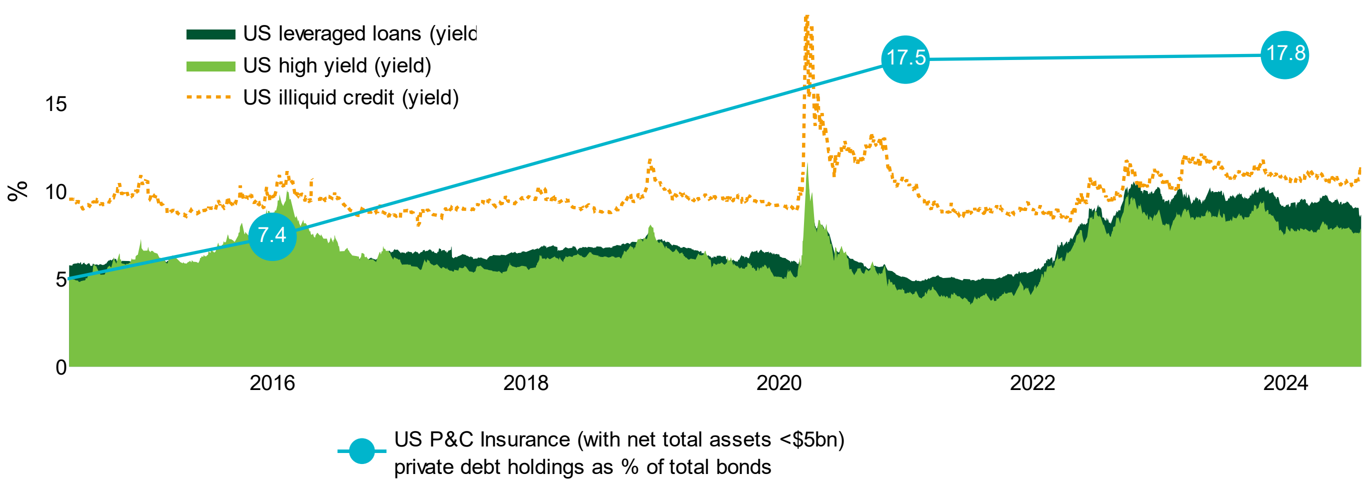
With rate cuts on the agenda, we believe that investors should review their cash allocations and consider reducing exposure and reinvesting further out the yield curve. We do not believe investors need to assume material credit risk to target attractive yields. We believe investors can currently construct an A-rated investment grade portfolio with a 4.5% average yield, for a 3-year duration[4].

Yield seekers now have options beyond just alternative private and illiquid assets

Over the last few years, insurers have ramped up their illiquid credit holdings, as private fixed income offered income yields above those in the public market.

This is no longer the case. Since 2022, public fixed income yields have risen, narrowing the "illiquidity premium" significantly (Figure 5). Since then, insurers' allocations to illiquid fixed income have remained relatively constant at ~18%.

Figure 5: The compressed illiquidity premium is making insurance companies hesitant to raise private debt allocations[5]



In our view, insurers no longer need to sacrifice liquidity to achieve their income objectives. Given relatively attractive yields, we would expect insurers to increasingly consider investing their next marginal dollar in liquid fixed income rather than alternatives.

CONCLUSION – DON'T OVERLOOK PUBLIC FIXED INCOME

Investment grade fixed income has traditionally been the anchor of P&C insurance investment due to interest earnings, favorable regulatory treatment, and lower balance sheet volatility from amortized cost accounting.

We believe the rise in yields has created an opportunity to rebalance portfolio allocations and lock in attractive income streams for the long-term, increase portfolio downside protection, and ultimately allow P&C insurance companies to achieve their investment objectives with greater certainty.

FIND OUT MORE

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[4] Insight calculations, July 2024
[5] Bloomberg, Credit Suisse, MarketVector, Insight, July 2024

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