

Accelerating out of the crisis

2021 insurance outlook

Investor insights



That was the year that was ...

At the beginning of 2020, our view was that the next 12 months was likely to see a continuation of the geopolitical, economic and market uncertainty we had seen in recent years.

We concluded that insurers would strive to find the right balance between the impact of the low-for-longer market environment, the evolving regulatory regime, and the execution and operational risks that characterise increasingly complex investment strategies.

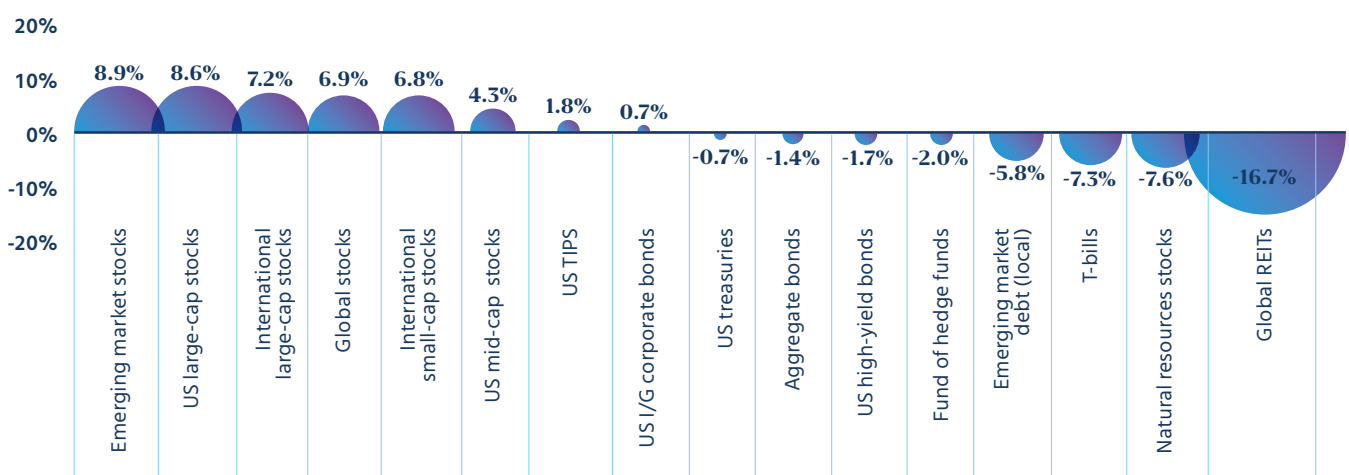
No one predicted a global pandemic that would trigger one of the deepest recessions in modern history. The saving grace for financial markets was a monetary and fiscal response that provided a boost to risk assets, but also put further downward pressure on interest rates. Although the net effect has been to intensify the search for yield that characterises insurers'

investment strategy, some insurers have decided to take less risk given the uncertain economic outlook.

The Covid-19 crisis has provided a catalyst for many insurers to revisit their investment strategy not only in the context of their business environment, but also with regard to the resilience (or otherwise) of their asset portfolio.

So as we move into 2021 and plan ahead for the next few years, we highlight what we see as the key issues likely to impact insurers' investment portfolios. In particular, we focus on allocating to long-term themes — including international diversification, private markets strategies, credit sector opportunities and responsible investing — all of which we believe insurers will come to rely on more heavily as they seek to generate sustainable and resilient sources of return. At the same time, insurers must seek to align to evolving regulatory regimes that will inevitably mean more scrutiny of their businesses' ability to weather future shocks.

Figure 1. Asset-class returns 2020



Source: Datastream, Bloomberg as of Dec 31, 2020. Euro returns.



Private markets

As long-term investors, insurers have the benefit of being able to look beyond the present and deploy “patient capital” in the search for yield and capital appreciation today.

The outlook for the long-term thematic drivers for investing in private markets remains positive as investors adapt to a range of structural shifts as well as an increased focus on environmental, social and governance (ESG) factors, with increasing attention being paid to the “S” and the “G” going forward.

For insurers — while there may be regional differences — there remain opportunities to optimise their asset portfolios to include infrastructure, real estate and private debt. Indeed, given continuing low rates and regulatory changes, insurers will likely remain at the forefront of private markets investing given the illiquidity premium they generate over listed assets alongside their diversification benefits.

Infrastructure

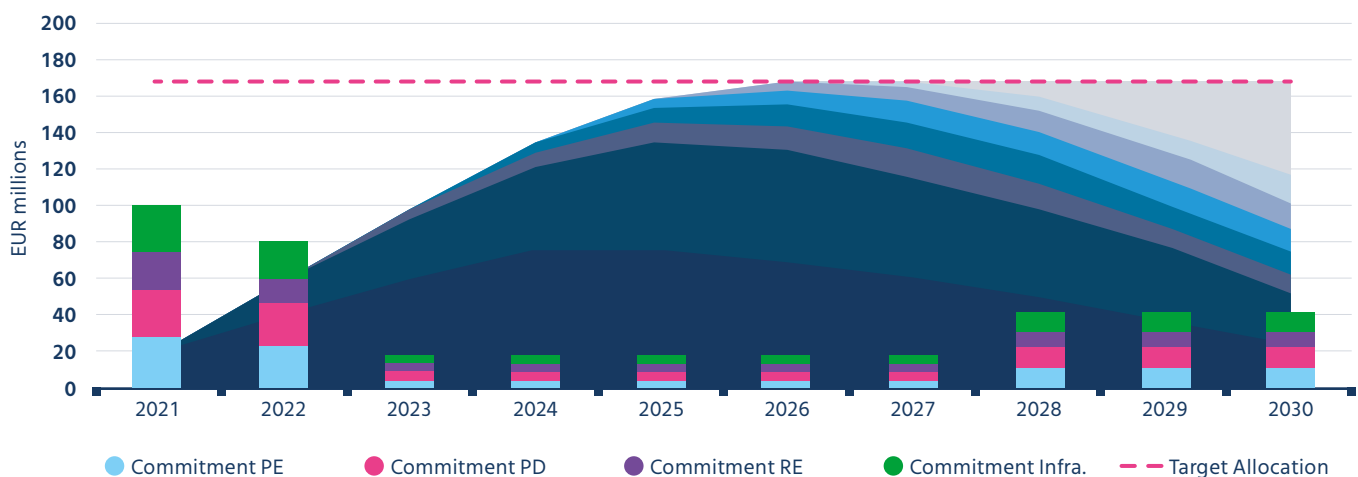
The flow to infrastructure — both debt and equity — will likely continue well beyond 2021, with an expected increase, should governments embrace social infrastructure investment as one of the tools to help lift economies out of Covid-related depression. A number of interrelated factors have driven investor demand over both the short and long term, including the need for diversification, the hunt for yield, the focus on real returns and the emphasis on sustainable investing that has attracted insurers across the world.

However, the challenge for many insurers will remain origination and deployment of investments. In many cases, the in-house expertise or resources to source, research and execute individual transactions is simply not there. Deal sizes can be substantial, so insurers seeking to allocate capital to private markets strategies will therefore seek to work with managers and platforms that can help implement strategies which are by definition large, complex and often carry a high maintenance factor.

Given the characteristics of the underlying strategies, including the need to be fully committed as well as ongoing governance requirements, investing in private markets should be considered as a programme rather than a one-off transaction. In practice, such a programme is built up over several years and requires specialist management and resources.

Although maintaining a private markets programme may seem daunting, with the right support, insurers have the opportunity to reap the benefits that are available in terms of risk, return and (in the case of European-based Solvency 2 insurers) return on regulatory capital.

Figure 2. Example of a private market cash-flow management programme



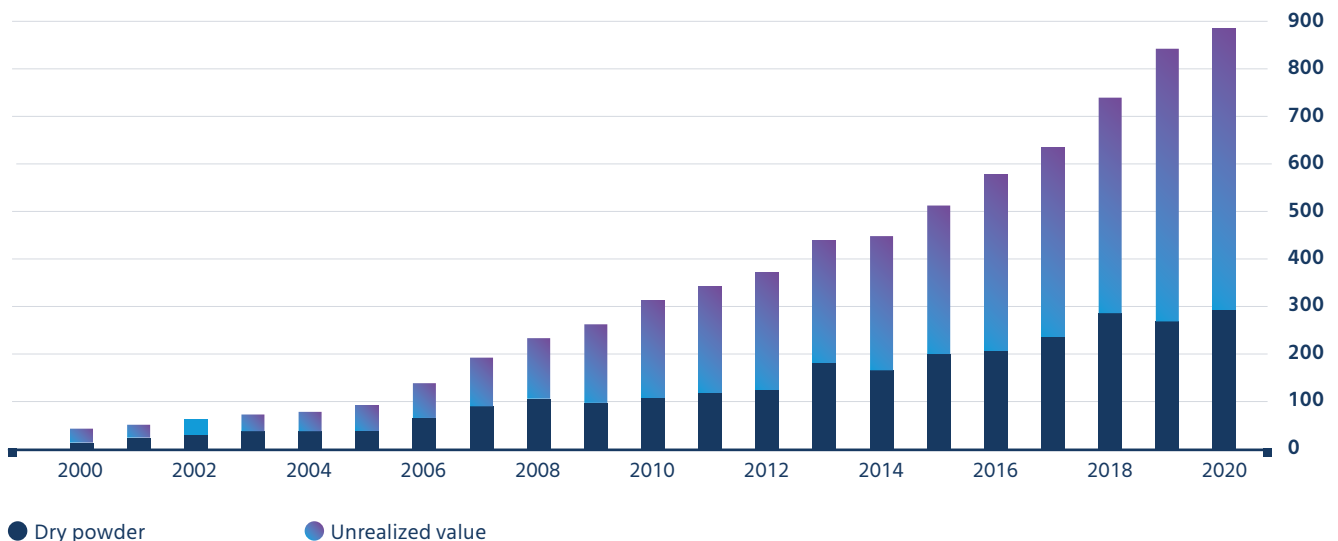
Source: Mercer Private Markets, cash flow model PIP V — programme planning. For illustrative purpose only.

Private debt

In 2020, global private debt faced its first substantial test since the global financial crisis (GFC). Going forward, managers that maintain standards of credit underwriting and portfolio construction will potentially be more likely to outperform — despite mounting competitive tensions.

It's worth noting the significant momentum private debt gained in the wake of the GFC. It makes sense: the ensuing regulatory crackdown on bank lending activity required new capacity to fill the void, propelling private debt assets under management (AUM) to US\$887 billion, more than doubling in just over seven years (see Figure 3).

Figure 3. Private debt AUM (US\$ billion) as of June 30, 2020¹



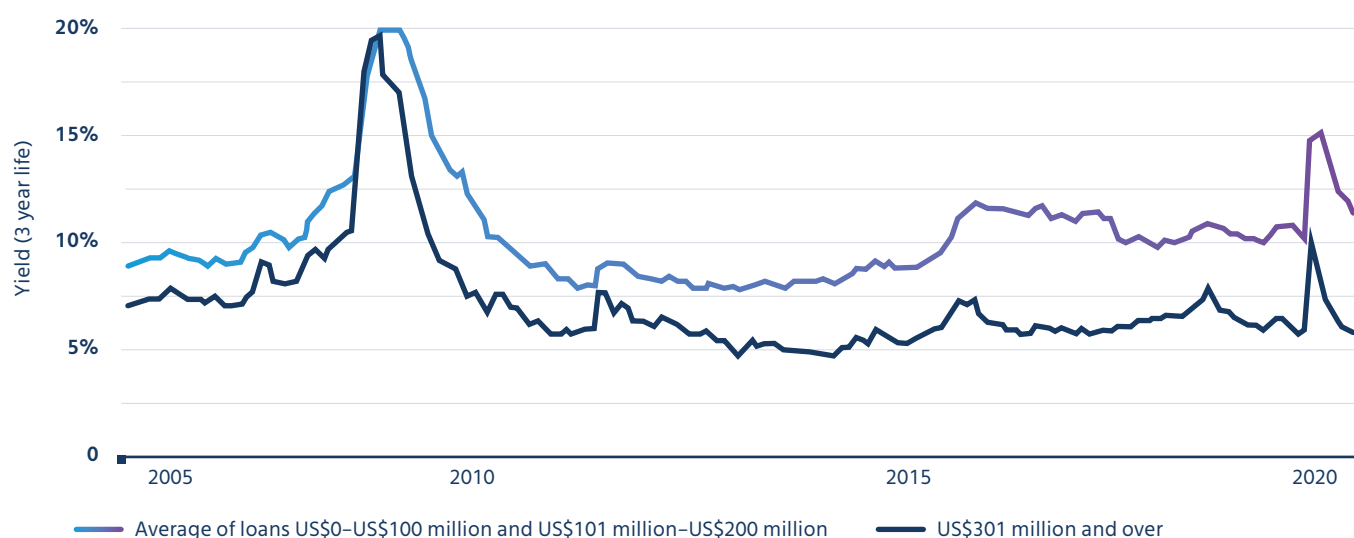
Source: Preqin.

¹ "Dry powder" refers to the amount of committed, but unallocated capital a firm has on hand — in other words, unspent cash waiting to be invested; unrealised value represents invested capital — the sum is a proxy for assets under management.

From a return perspective, private debt investors have enjoyed a consistent average yield premium. Figure 4 shows, as a proxy for this, the difference in yield for leveraged loans of different sizes. The spread between the yield on loans under US\$200 million, generally provided by private debt lenders, and loans greater than US\$300 million, generally provided by the syndication market, has averaged over 300 basis points (bps) since 31 December 2005.

Illiquid asset classes, therefore, remain of significant interest, particularly in the private loans sector, with (for life insurers) a focus on long-dated, investment-grade equivalent lending characterised by a fixed rather than floating rate structure.

Figure 4. Yield differential leveraged loans by size



Source: Credit Suisse Leveraged Loan Index.

Credit risk

Continuing one of our major themes of 2020, the market value of the Bloomberg Barclays Global Negative Yielding Debt Index² (see Figure 5) rose above \$17 trillion in early November ahead of the (ultimately much-disputed) US presidential election — this was at the time the highest level ever recorded just ahead the August 2019 peak. By end-December 2020, the index had breached \$18 trillion.³

Insurance investors have, in effect, been forced to take on more risk in fixed income, despite this giving rise to a higher governance tariff when selecting managers, sectors or individual securities.

Figure 5. Negative yielding bonds still at high levels

Bloomberg Barclays Global Aggregate Index — Percentage of negative-yielding debt



Source: Datastream, Bloomberg.

² The Bloomberg Barclays Global Negative Yielding Debt Index tracks negative yielding debt and the index is not an investable product.

³ Bloomberg.

To put this into context within the credit space, the concentration of BBB-rated fixed income in investment grade indices has risen from a third in 2007 to almost half as of end of December 2020.⁴ The leveraged loan market is currently twice the size it was in 2008,⁵ with covenant-lite borrowing more frequent, and borrowers more heavily indebted.

For core fixed income in 2021 and beyond, as insurers seek to reduce concentration risk associated with sovereign bonds (for so long perceived as risk-free) and reallocate towards corporate bonds, active sector and security selection assumes even greater importance in ensuring the degree of caution that insurers are seeking as they push for income.

With interest rates remaining at historically low and even negative levels, both life and non-life carriers will increasingly pursue yield. The market dynamics created by the introduction of Basel III and ongoing deleveraging by banks will continue to create investment opportunities for insurers. Indeed, there appears to be an increasing willingness from public authorities to incentivise insurers to replace bank financing.

At the same time, continuing dislocation in the credit markets will likely lead to opportunities for those insurers able to move quickly — something that is not always within insurers' reach under existing governance or closed architecture models. Nonetheless, special situations and distressed debt strategies are likely to feature given the attractive return expectations in this environment and insurers should be positioning to take advantage.

⁴ Bloomberg.

⁵ Bloomberg. Showing the change in market value of the Credit Suisse LL benchmark from December 2008 to December 2020.



Accelerating ESG

To position portfolios for the transition to a low-carbon economy, many insurers are aiming to align their portfolios to manage the risks associated with the potential for increasing damage to the planet caused by climate change. We believe interest will continue to accelerate through 2021 and beyond, with increasing flows to sustainability-related strategies and funds, over and above trend.



In an environment where strategy selection could well prove as important as asset-class allocations, strong investment governance is rapidly gaining ground as a sign of good corporate governance.



In particular, Covid-imposed lockdowns highlighted what was possible as many polluted areas saw dramatic increases in air quality while exponential growth in the use of video-conferencing could (at least partially) replace internal combustion-dependent commutes and air miles.

Insurers will pay a lot more attention not only to what risks they are underwriting but also to where they are taking them. This is especially true for multi-jurisdictional, multi-line insurers who will seek to understand the carbon footprint of their asset portfolios through modelling and stress testing.

Within an ESG framework the focus to date has, arguably, been rather skewed to the “E”, as opposed to the “S” and the “G”. This is hardly surprising given the tangible aspects of climate change, for example. Historically, insurance businesses have focused on investing premiums with financial returns as a key consideration, without necessarily considering the social impact of their investments. It appears that, going forward, insurers will likely deploy more assets to investments that have positive social implications.

In an environment where strategy selection could well prove as important as asset-class allocations, strong investment governance is rapidly gaining ground as a sign of good corporate governance. With more dynamic, active approaches being employed to capitalise on attractively priced opportunities as and when they arise, the decision-making processes within insurers often act against rapidly deploying into tactical or short-term opportunities because of selection or due diligence requirements. Immediate access to established governance processes can mean the difference between missing out and capturing opportunities as they arise.

Conclusion

Most insurers entered 2020 well-capitalised and were able to withstand the stresses brought about by the Covid-19 crisis. That is not to say that all insurers emerged unscathed from the resulting market turmoil. While a few de-risked — either too early or too aggressively — those who had already built resiliency into their portfolios appeared to be well-placed to take advantage of the opportunities that arose.

Insurers continue to plan actively for different underwriting and investment scenarios as 2021 begins. Seeking to capture opportunities as they arise, they are also aiming to protect their overall financial position by ensuring their investment portfolio plays its full part in the overall corporate strategy.

Access, flexibility and speed of implementation will assume greater importance as assets tend not to stay cheap for long and investors will need to be quick to take action — waiting for the next investment committee or board meeting may not serve insurance clients well.

In this context, going into private markets deserves serious consideration as the highly rated fund managers can often act on opportunities more quickly than investors in public markets.

Finally, reviewing the operating models and resourcing levels that underpin asset management within insurance companies is likely to accelerate with the adoption of more flexible third-party implementation options or even the speeding-up of plans to outsource management of all or part of the asset portfolio.

Whatever 2021 brings, it will mark the beginning of a transition from a pre- to a post-Covid environment. While the geopolitical, economic and market uncertainties have taken a back seat to the pandemic, they certainly have not disappeared.

From an investment strategy perspective, insurers will continue to try to find the right balance between risk, return and capital in the context of a low-rate environment. They will aim to both harness the opportunities available in the public credit markets and deploy precious capital into private markets in search of incremental returns while working with well-resourced external partners to originate difficult-to-access assets.

The trend towards implementing investment strategy through third parties — either through partial or total outsourcing — is likely to continue and insurers will continue to evolve their operating model to remove operational and implementation risks while freeing up internal resources to focus on decision-making.

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⁶ The Insurance-Focused Investment Consultant Compendium, October 2020. \$423 billion under advisement across 118 clients globally.

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