Where Insurers Can Capture Uncommon Value Amid Market Dislocation

Mike Pagano
Head of Insurance Portfolio Management

Pivoting from Defense to Offense

When confronted with today's combination of investment challenges, it is natural and prudent for an investor of insurance assets to retreat into a defensive posture to protect and preserve capital.

However, at Voya Investment Management, we think it is possible (and advisable) also to remain actively engaged in trying to deploy cash. Indiscriminate selling creates fertile ground for capturing uncommon value.

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The supply and demand side disruption to the global economy resulting from the combination of the COVID-19 pandemic and the price war between Russia and Saudi Arabia has resulted in significant concerns about the credit-worthiness of an array of borrowers underlying the fixed income instruments owned on insurance balance sheets.

The efficacy of the three-legged policy stool of monetary policy (Federal Reserve), fiscal policy (White House and Congress) and a public policy (patchwork of constituencies at federal, state and local levels of government) will go a long way toward determining the letter shape the economic recovery.

Our base case calls for a W-shaped recovery, meaning we expect a swift recovery followed by choppy and uneven growth thereafter. While there will certainly be a period of significant disruption from the social distancing edicts central to the patchwork of uncoordinated public policy strategy, the phase that will follow will feature a resumption of the U.S.'s consumer-driven, service economy, albeit with some risk of both short-term frictional and longer-term structural economic damage.

For investors focused on capital preservation, avoiding ratings downgrades that result in incremental RBC C1 requirements and expected OTTI can become a full-time job. This focus can also cause investors of insurance portfolios to assume a very defensive posture.

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The focus on protecting the embedded book yield of the portfolio and avoiding involuntary turnover into a shallow Street bid is understandable. However, sourcing uncommon value across an array of fixed income markets is achievable for investors with a combination of available risk envelope, an eye for long-term value and the intestinal fortitude to deploy available liquidity.

When pivoting from defense to offense, there is no need to be a hero. Amid the current market dislocation, higher-quality, more loss remote investments offer attractive spreads and robust risk profiles, a combination that should help insurance investors simultaneously enhance their yield profile and avoid incremental capital strain from negative ratings migration and credit impairments.

Here are some of the places we see opportunity:

Private Credit

This market has historically lagged its public credit counter-part, both tighter and wider, and its new issue market typically goes dormant during periods of extreme volatility.

When it does reopen, we expect there to be extremely attractive opportunities for intrepid investors to provide funding, to both investment grade and below investment grade borrowers, at uncommon spreads and structure relative to public credit, even for a market that regularly delivers those characteristics to investors in the sector.

Public Credit

Despite the recent widening in credit spreads, the disappearing risk-free rate has helped maintain all-in coupons that make issuing new debt an attractive proposition for corporate Treasurers.

When supply is plentiful and the future has the potential for significant storm clouds to form, investors have historically been able to extract attractive new issue concessions relative to secondary spreads to absorb new issue volumes.

The other consequence of such an environment can sometimes be contorted credit curves whereby the front-end of the market (1-5 years) gets neglected, which leads to inverted credit curves.

In both cases, one should resist the temptation to reach for yield and spread in credits. With notable storm clouds hanging over the global economy, it is prudent to avoid issuers with balance sheets that appear less sturdy.

Securitized Credit

The recent disruption in the fixed income markets hit the full array of securitized sub-sectors (CLO, ABS, CMBS, and RMBS) and has lingered longer than in other public markets.

While various elements of the recently enacted CARES Act specifically target segments of this market, the recent signs of the return to more normally functioning markets has been uneven at best.

CLOs continue to offer an opportunity to source high quality, loss remote risk exposure to the leveraged loan market with structural protection that give us great comfort. While we continue to favor risk down to the single-A rated tranches, the recent spread widening has enabled investors to upgrade their risk profile as AAA and AA rated tranches offer similar spreads.

The ABS market underperformed notably at the height of the market strain in March, mainly under the technical pressure caused by heavy selling. In times of stress, investors sell what they can sell, not what they want to sell. The higher liquidity and price transparency of many asset-backed securities made these instruments more susceptible to the recent technical dislocation. While the recovery of this sector is well underway, the public policy initiatives like the TALF Program promise to provide both a tailwind to valuations and an opportunity for eligible investors to lever high-quality consumer-oriented assets.

The comparison between TALF and FHLB advances as delivery mechanisms for levering low volatility, high quality assets will be a prudent and natural one and we expect pursuing one will not preclude pursuing the other given some of the differences in the characteristics of these two sources of investment leverage.

CMBS, along with the CRE Whole Loan market, will be a key sector to watch as the public policy initiatives evolve toward a reopening of the U.S. economy. While there will certainly be a lot of cross-current and layer risk to consider when evaluating exposure to this systemically important segment of the U.S. economy, we continue to believe that well-informed security selection will enable investors to invest in high-quality, loss remote exposure at attractive spreads compared to recent levels.

Mortgage Derivatives

While not an asset class that is broadly understood or owned on insurance company balance sheets, we continue to believe this asset class is attractive as much for what it is not (corporate credit) as for what it is (uncorrelated with everything else on most insurance balance sheets, capital efficient and yieldy).

Uncertainty related to the economy, the effect of public policy initiatives on borrowers' prepayment behavior and the threat of continued unwinds of leveraged bets in this sector mean that uncommon value can be had through the careful deployment of capital into this sector.

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