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An Insurers' Guide to Below-Investment Grade Exposure: The Platform Approach

Insurance companies have been broadening their below-investment grade allocations to include loans and tranches of collateralized debt obligations (CLOs) alongside high yield bonds. This has clear advantages, providing greater degrees of freedom with which to tailor portfolio yield, duration and credit quality to investment objectives. However, many still allocate only to local markets, and most allocate to asset class-defined silos benchmarked against traditional market indices. In this paper, we argue that many of the advantages of a broader credit universe are realized only when investors take a "platform" approach, breaking down the silos and considering all asset classes, regions, currencies and access routes through the same fundamental lens, unconstrained by traditional market index benchmarks. We call this "thinking like an issuer": corporate treasurers will tap into different credit markets to get the best deal from their perspective, and investors ought to do the same.

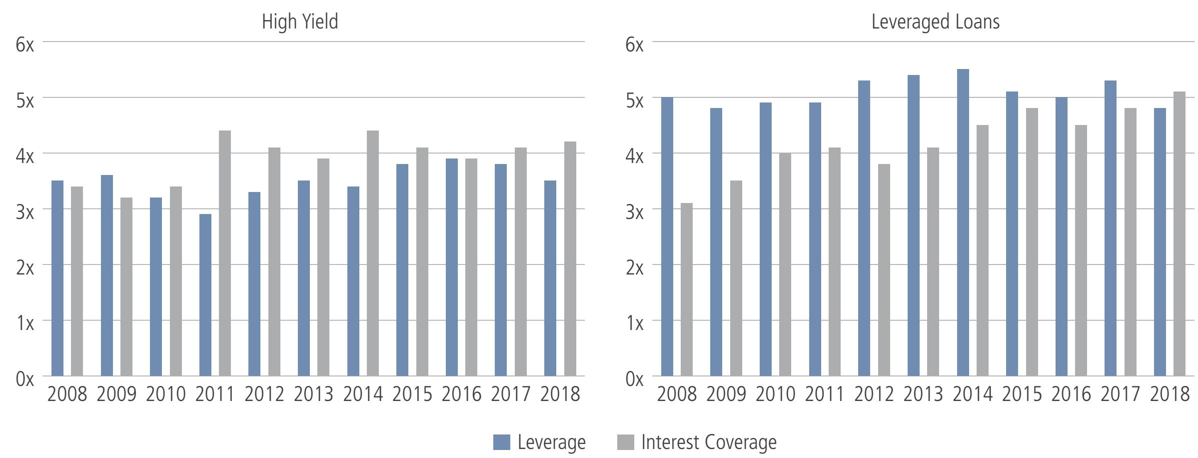
Executive Summary

- Insurance companies have grown their exposure to below-investment grade credit during a decade of benign default rates.
- Our central scenario is for a soft landing for the economy; nonetheless, we are entering the later stages of a cycle that is likely to see increasing default activity, but more importantly, lower recoveries than historical averages.
- This increases the challenges of credit investing and raises some key questions for insurers:
  - Should insurance companies hold below-investment grade credit primarily for income or total return, and can a broader universe help to achieve their goals?
  - Is it better to allocate to below-investment grade sectors in separate silos so that a portfolio manager can focus entirely on a single asset class, or are there benefits to managing portfolios with the flexibility to allocate across the spectrum of bonds, loans, CLOs and other asset classes?
  - What are the risks associated with the traditional focus on generating alpha measured against a standard market benchmark?
- We show that broadening the below-investment grade credit universe brings greater degrees of freedom with which to tailor portfolio yield, duration and credit quality.
- We argue that investors should go further and adopt a "platform" approach: breaking down the silos and considering all asset classes, regions, currencies and access routes through the same fundamental lens.
- We call this "thinking like an issuer": corporate treasurers will tap into different credit markets to get the best deal from their perspective, and investors ought to do the same.
  - Why allocate to a highly leveraged, B rated loan when a USD-hedged, BB rated EUR-denominated bond from a less leveraged issuer offers the same yield?
  - Why force capital to B or CCC rated bonds if a more reliable yield exists from BBB and BB rated CLO mezzanine debt?
- Breaking down the asset-class silos also breaks an investor away from traditional market-index benchmarks: it focuses an investor on its own risk profile and credit fundamentals rather than on tracking-error risk, which, particularly as a cycle matures and credits begin to deteriorate, should mitigate forced exposure to weak credits.
- Customized benchmarks and the platform approach to credit markets are a challenge to governance: insurers need to get the most out of their experienced credit portfolio management partners in order to realize the benefit.

Insurance companies have benefitted from growing their exposure to below-investment grade credit in many forms over the past decade. The sector has helped combat persistently low yields and boost net investment income, as well as overall return potential. Total exposure among U.S. insurance companies has increased from approximately $230bn in 2013 to just over $300bn in 2017.

During this period, insurers have enjoyed a reasonably benign default environment; the 2015–16 commodity-led sell-off and the growth scare of late 2018 have been the only significant bumps in the road. Notwithstanding trade tensions and periodic bouts of market volatility, the macro picture for 2019 and beyond continues to be reasonably supportive for credit, in our view. We do not see any obvious catalysts for an end to this exceptionally long credit cycle. We expect the slow pace of interest rate hikes in the U.S. to enable a soft landing even as growth moderates from recent levels. U.S. corporate borrowers have been proactive in successfully terming out debt maturities during a period of stable-to-improving economic fundamentals, with an added earnings boost from tax reform. Maturities for both high yield bonds and loans do not materially pick up until 2021, alleviating the pressure on issuers for access to capital markets, while leverage appears to have peaked in both bonds and loans, and interest coverage is rising. Default expectations are therefore likely to remain low over the near to medium term.

FIGURE 1. LEVERAGE APPEARS TO HAVE PEAKED, INTEREST COVERAGE IS RISING



Source: ICE Bank of America Merrill Lynch, S&P LSTA. As of 12/31/2018.

Nonetheless, as the current cycle matures and idiosyncratic credit volatility has begun to affect even high-profile investment grade names, such as General Electric, Pacific Gas and Electric and Kraft/Heinz, there is ever-increasing investor scrutiny on credit risk in general, and below-investment grade credit risk in particular. We expect issuers will continue to grapple with challenges related to M&A, growth, capex and costs related to their industries and business models. Investors, for their part, recognize that we are emerging from a lengthy period of somewhat lax credit discipline, and that any future downturn is likely to result in increasing default activity, but more importantly, lower recoveries than historical averages.

Over recent months, several questions have been coming up in our conversations with insurance companies regarding credit risk, sources of yield and late-cycle market dynamics. These questions get at the heart of the role that we believe below-investment grade exposure should play in insurance portfolios in the months ahead.

Exposure

- Should insurance companies hold below-investment grade credit primarily for income or total return, and can a broader universe help to achieve their goals?

Management

- Is it better to allocate to below-investment grade sectors in separate silos so that a portfolio manager can focus entirely on a single asset class, or are there benefits to managing portfolios with the flexibility to allocate across the spectrum of bonds, loans, CLOs and other asset classes?

Performance Measurement

- How critical is preservation of capital, relative to deviating from the market return, and what are the risks associated with the traditional focus on generating alpha measured against a standard market benchmark?

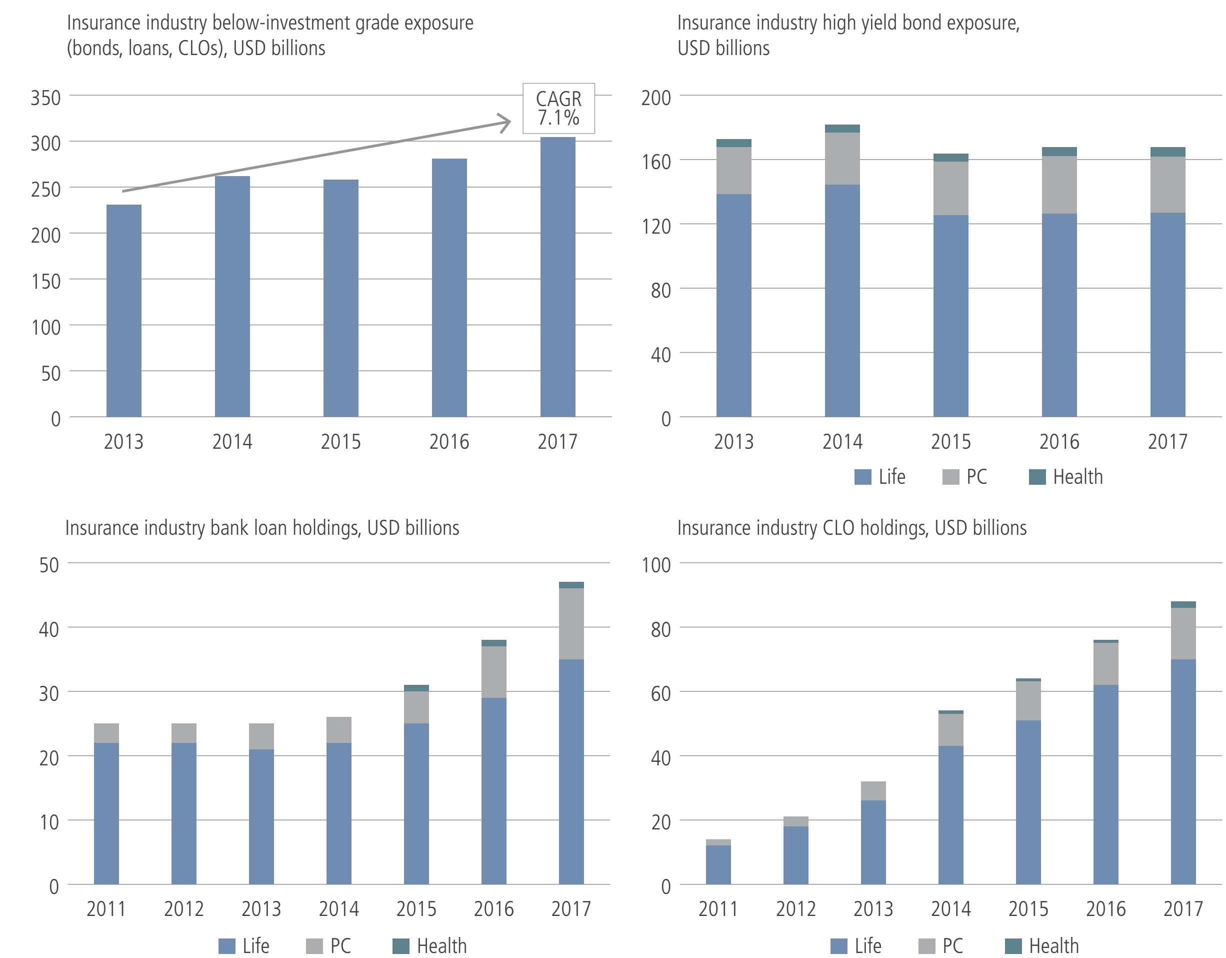
For insurers in particular, yield remains an important objective. However, balancing the benefits of attractive income and the avoidance of credit deterioration is more of a focus now that the cycle is maturing and monetary policy is starting, gradually, to move beyond the quantitative-easing era. In order to manage through the cycle successfully, we believe more flexibility is required if investors are going to avoid credit deterioration and defaults in order to maintain the benefits of enhanced yield. For us, that flexibility comes in two forms: a willingness to leave the silo approach behind and manage portfolios across the entire below-investment grade spectrum; and a willingness to move away from conventional market benchmarks, which these silo allocations tend to be managed against.

A maturing but elongated cycle, characterized by higher volatility and more idiosyncratic credit events, will leave investors facing complex challenges. We believe a "platform" approach to managing below-investment grade portfolios can mitigate these challenges.

The Changing Composition of Insurers' Below-Investment Grade Credit Exposure

As we mentioned above, between 2013 and 2017, the total exposure of U.S. insurance companies to below-investment grade credit grew from $230bn to more than $300bn (figure 2). It is interesting to note that much of that growth came, not through allocations to high yield bonds, but through allocations to bank loans and Collateralized Loan Obligations (CLOs).

FIGURE 2. U.S. INSURANCE COMPANY HOLDINGS IN BELOW-INVESTMENT GRADE CREDIT, 2013–2017



Source: SNL.

It is clear that insurers have been diversifying their credit exposure away from traditional high yield bond exposure. However, they have tended to achieve that diversification via silo-type mandates to the individual asset classes, benchmarked against traditional market indices. We think that investors can get a broader and more detailed view of the opportunity set when they consider the below-investment grade credit universe as a whole, purely basing their selections from any sector through fundamentals and expected risk and return. We call this the "platform" approach to credit investing.

Think Like an Issuer: The "Platform" Approach to Credit Investing

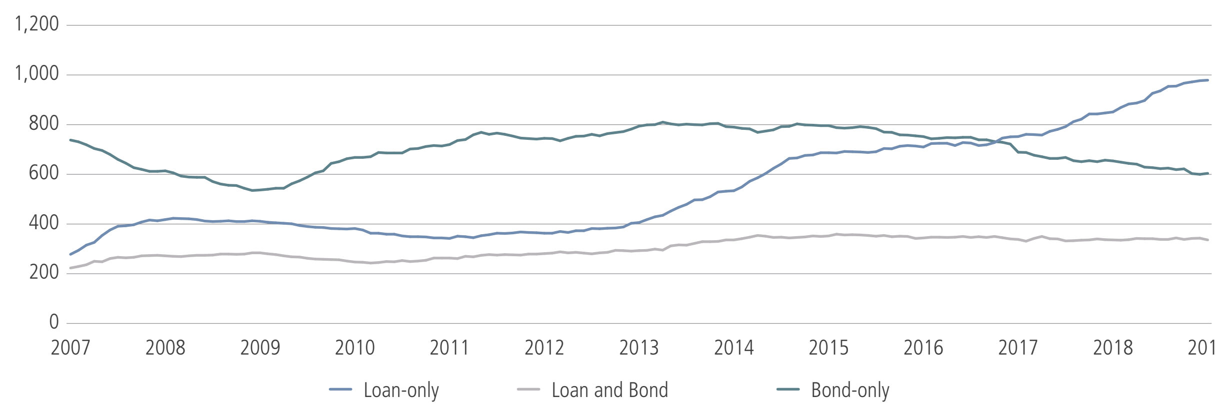
Nowadays, many issuers consider the full spectrum of capital markets for below-investment grade to be interchangeable: they issue debt in whichever market is providing them the best cost of capital, considering what they believe to be an optimal capital structure.

For example, U.S. companies with global revenue streams can issue in non-USD currencies: for some time, they have been issuing in EUR to take advantage of persistently low interest rates in the euro zone.

Similarly, as we saw in in 2018, some companies have decided to eliminate unsecured bonds from their capital structure, while pushing their secured leverage to post-financial crisis highs. The reason was simple: a relatively hawkish U.S. central bank policy created insatiable institutional and retail investor demand for floating-rate assets. As the Federal Reserve shifted to a more dovish narrative in 2019, demand drivers have transitioned from the loan market back to the high yield market; issuance of unsecured bonds has surged, as has issuance of senior secured bonds, with proceeds used to refinance leveraged loans.

FIGURE 3. ISSUERS HAVE BEEN ELIMINATING UNSECURED BONDS FROM THEIR CAPITAL STRUCTURES

Number of issuers in U.S. high yield bonds and loans



Source: JPMorgan U.S. High Yield and Leveraged Loan Strategy. Data as of January 28, 2019.

In other words, issuers are taking advantage of investor demand to negotiate the best transaction for them, which means the cheapest cost of capital with the least amount of covenants or investor protections. Our view is that a prudent investor should think like an issuer, viewing below-investment grade credit markets interchangeably and taking advantage of corporates' demand for capital to negotiate the best transactions from their own point of view.

Many investors would view a successful outcome as achieving an attractive total return through the preservation of capital and the attainment of attractive yields. In that case, why allocate capital to a highly leveraged, single B secured loan, which may have a lower recovery due to a thinner cushion of unsecured credit? Instead, short-term interest rate differentials currently provide an opportunity to allocate to a similar yield from a USD-hedged, EUR-denominated, BB-rated unsecured bond from an issuer with a more conservative leverage profile. Why force capital to B or CCC rated unsecured debt if a more reliable yield exists from BBB and BB rated CLO mezzanine debt?

FIGURE 4. HEDGING EUR CREDIT BACK TO USD CURRENTLY ADDS ALMOST 300 BASIS POINTS PER ANNUM TO BB RATED EUR ISSUES, WHICH REPRESENT NEARLY 15% OF THE EUR HIGH YIELD MARKET

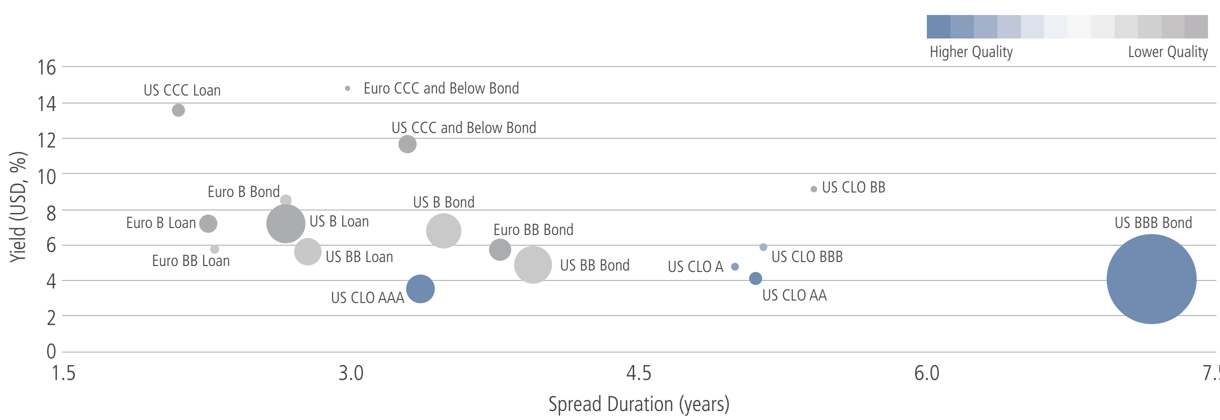
Issuer	Description	Duration (years)	Local Yield	USD Yield
Elis	Diversified provider of commercial services across 28 countries	2.47	1.21%	4.33%
FCAIM	Top 10 largest automobile OEM with a global sales footprint	3.25	1.27%	4.38%
Leonardo Finmeccanica	Top 10 largest defense contractor globally	3.47	1.17%	4.28%
Repsol	One of the leading oil and gas companies with upstream and downstream operations in 50 countries	3.67	2.03%	5.14%
Telecom Italia	Leading mobile and fixed-line telecoms operator in Italy	5.63	2.71%	5.82%
Telefonica	Provides telecommunications services across 25 countries throughout Europe and Latin America	3.57	3.30%	6.42%
Tesco	Largest UK food retailer (~30% market share)	5.83	1.56%	4.68%
Virgin Media	Leading UK cable operator	0.77	2.75%	5.87%

Source: ICE Bank of America Merrill Lynch Euro High Yield Index. USD-hedged yield calculated using 12-month forward rates.

Investors that think in this way recognize that this is not about timing exposure to these different parts of the market correctly. They instead acknowledge that the fundamentals-based risk-return trade off that is critical to the portfolio construction process is not just a matter of comparing different asset classes and regions, but also about managing exposure across the capital structure of particular issuers. This underscores the rationale for a more flexible, "platform" approach to the below-investment grade credit universe. As figure 5 illustrates, this universe includes a broad spectrum of opportunity across credit quality, duration and coupon structure: investors clearly have more tools available today with which to build portfolios with the best possible expected risk-adjusted return outcomes.

FIGURE 5. AN INVESTMENT UNIVERSE THAT IS DIVERSE IN YIELD, DURATION AND QUALITY

Size of bubble is proportional to universe size



Source: JPMorgan, ICE Bank of America Merrill Lynch, S&P Capital IQ LCD.

Widening the below-investment grade universe in this way can make it much easier to achieve investor objectives. The three hypothetical allocations shown in figure 6 demonstrate possible solutions for investors.

Portfolio 1 represents a U.S.-centric option, with a mix of high yield bonds and bank loans. In addition, higher quality CLO exposure can enhance yield and limit interest rate risk. CLOs offer both liquidity and complexity premium for investors despite the fact that their credit enhancements and de-levering mechanisms have ensured a very low 0.38% cumulative default rate over the past 25 years, among those securities rated by Standard & Poor's.

Portfolio 2 provides an enhanced yield with a more defined, USD-hedged allocation to European markets and a mix of investment grade and below-investment grade CLO exposure. Insurers have generally focused on higher-rated CLO tranches because of their relatively low capital charge, but we would argue that lower-rated tranches are an attractive alternative to some BB rated bonds and loans.

Finally, Portfolio 3 is more global in nature, with a larger allocation to European high yield bonds and loans and BB rated CLO tranches.

FIGURE 6. THREE PORTFOLIOS, THREE DIFFERENT PROFILES

Characteristics	Portfolio 1	Portfolio 2	Portfolio 3
USD Yield	6.15%	6.62%	7.23%
Duration (years)	1.70	1.77	1.77
Quality	BB	BB-	BB-
Volatility	4.42%	4.96%	5.58%
Allocations (MV%):			
US HY	25%	15%	30%
SD US HY	15%	20%	
Euro HY	10%	20%	15%
US Loans	25%	25%	
European Loans			30%
CLO A	10%		
CLO BBB	15%	10%	
CLO BB		10%	25%
Total	**100%**	**100%**	**100%**

Source: ICE Bank of America Merrill Lynch, JPMorgan, S&P LSTA, Neuberger Berman. Indices used: ICE BofAML US High Yield Index; ICE BofAML 0-5 Year US High Yield Constrained Index; ICE BofAML Euro High Yield Index; S&P/LSTA Leveraged Loan Index; S&P/LSTA European Leveraged Loan Index; JPMorgan CLO Index. Yields represent Yield-to-Worst for high yield bonds and Current Yield for loans. Non-USD exposures hedged back to USD; Yields shown include the current 300 basis points additional yield from hedging. Volatility shown is five-year annualized standard deviation of monthly returns. Data as of March 31, 2019. For illustrative purposes only.

These options show how a broader investment universe can enhance an investor's ability to toggle a portfolio's yield, its duration or its credit quality while maintaining similar levels in the other portfolio metrics. Given the current late-cycle environment, the ability to maintain an attractive portfolio yield while limiting interest rate risk may be one of the more attractive strategies for the near term, indicating that the flexibility to build something like Portfolio 3 may be advantageous. This allocation lowers interest rate risk with an average credit quality commensurate with the broader below-investment grade universe.

All three make use of USD-hedged allocations to non-USD credits. Short-term interest rate differentials currently provide USD-based investors with an opportunity to earn almost 300 basis points extra yield per annum from their currency hedge (this is an annualized gain based on rolling three-month foreign exchange swaps—it is subject to changes in policy rates and market rate expectations and is therefore not a guaranteed return). Short-duration credit is also used, as the current flatness of the curve means that investors can reduce interest rate risk and liquidity risk with little or no sacrifice in yield. This shows that broadening the universe is not only about looking across sectors and regions, but also at different access routes.

Platform Investing Means Breaking Free of Traditional Benchmarks

An investor should not force capital into whichever below-investment grade credit market a company decides is most attractive for them to raise capital or to put capital to work at the best time for issuers and the worst time for themselves. The only reason this happens with such regularity is that too many investors have tied themselves and their asset managers to a single credit market with a silo allocation, managed with a tight tracking error against a conventional benchmark. Particularly as a cycle matures and credit fundamentals begin to deteriorate, these tracking-error constraints can force exposure to weak credits, dragging down performance and even contributing to a negative total return, or leading to an excessive focus on relative underperformance during periods of late-cycle exuberance.

Today, as market risks shift, simply underweighting riskier names while managing tracking error against a market index may not be the best solution for insurers concerned over credit deterioration and risk of capital loss. The ability to evaluate the entire market landscape across bonds, loans and CLOs allows managers to break the link between risk-management and market benchmarks, turning their focus toward "real" fundamental risks. This should help to achieve a higher conviction on portfolio credits, and ultimately a more reliable portfolio yield.

Without traditional market benchmarks, however, the measurement of the success of a more flexible approach to below-investment grade credit requires retooling. Whether an investor asks managers to implement an absolute return or some other customized framework for its credit portfolios, objectives around income and volatility need definition. Life companies may think they have the freedom to pursue higher yield with higher volatility in order to support their spread objectives. Property & Casualty or Health insurers, by comparison, may consider overall total return as the primary definition of success, particularly since they have to mark their below-investment grade holdings to market and will see the underlying volatility on their balance sheets. Among credit portfolio managers, depth of credit resources, market access and experience will be critical when it comes to adjusting exposure to quality, tenor or capital structure across the spectrum of below-investment grade markets, while respecting client-defined risk management parameters.

Conclusion

Insurers should not feel that their options are limited simply because markets are in the later stages of the cycle. Quite the contrary—we argue that understanding the full range of sectors and identifying the best places to invest capital based on fundamentals can reveal ways to maintain or even improve income while potentially mitigating risk of capital loss. While it's neither novel nor unusual to include a small allocation to loans within a high yield mandate or vice versa, leveraging the full spectrum of the market with an absolute return bias does require a rethink of how these assets can contribute to the goals of an organization, and how to measure their performance relative to those goals.

With more idiosyncratic credit activity on the horizon, experienced credit resources are as important as they have ever been. Insurers should be looking to get the most out of these resources in order to navigate the full landscape of opportunities and benefit accordingly. As part of our $140 billion global fixed income platform, Neuberger Berman manages over $40 billion in below-investment grade assets alone, making us one of the largest managers of high yield bonds for insurance companies globally. We believe our organization, due to our size, breadth and experience, is able to advise insurance companies when managing their below-investment grade credit markets, and provide useful, actionable insights as we continue through 2019 and beyond.

The **ICE BofAML U.S. High Yield Index** tracks the performance of below investment grade, but not in default, U.S. dollar-denominated corporate bonds publicly issued in the US domestic market, and includes issues with a credit rating of BBB or below, as rated by Moody's and S&P.

The **ICE BofAML 0-5 year U.S. High Yield Constrained Index** tracks the performance of short-term U.S. dollar-denominated, below-investment grade corporate debt issued in the U.S. domestic market with less than five years remaining term to final maturity, a fixed coupon schedule and a minimum amount outstanding of $250 million, issued publicly.

The **ICE BofAML Euro High Yield Index** tracks the performance of below investment grade, but not in default, euro-denominated corporate bonds, and includes issues with a credit rating of BBB or below, as rated by Moody's and S&P.

The **S&P/LSTA Leveraged Loan Index** is designed to measure the performance of the U.S. senior loan market.

The **S&P/LSTA European Leveraged Loan Index** is designed to measure the performance of the European senior loan market.

The **J.P. Morgan CLO Index** tracks floating-rate CLO securities in 2004–present vintages, indexing them on a market-value weighted basis.

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