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NEUBERGER BERMAN

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Time to Get Strategic: Emerging Markets Debt as a Core Insurance Portfolio Allocation

We believe that the size, diversity and fundamental robustness of emerging markets debt make it a suitable strategic allocation in any institutional investor's portfolio, including any type of insurance company.

There is growing recognition of the benefits of emerging markets debt investing among insurers, and our own conversations indicate a rapid change in the way they think about the strategic role of the asset class. Nonetheless, right now our analysis of U.S. insurers' holdings suggests that they still tend to treat emerging markets debt opportunistically, as a tactical source of yield. We present these findings in this paper, discuss the risks associated with this opportunistic approach, and restate the case for a dedicated and strategic allocation to emerging markets debt.

Executive Summary

- **How Does Emerging Markets Debt Justify a Strategic Allocation?**
  Underlying fundamentals have been improving for many years
  The asset class is large, diverse and flexible
  Yields are high relative to credit quality and duration
- **How Do Insurers Invest in Emerging Markets Debt?**
  Insurers are under-invested and highly concentrated
  Insurers are heavily biased to Latin America—especially Mexico
  Insurers favor investment grade, long-duration, hard-currency and corporates
- **The Story of the Data: Insurers Are Missing Out on Strategic Potential**
  Current allocations fail to take advantage of some of the key characteristics of the asset class
  Ongoing conversations indicate to us that this could be about to change rapidly

At Neuberger Berman, we believe that emerging markets debt is a large, diverse, established and flexible asset class that warrants a strategic allocation in any institutional investor's portfolio, including any type of insurance company.

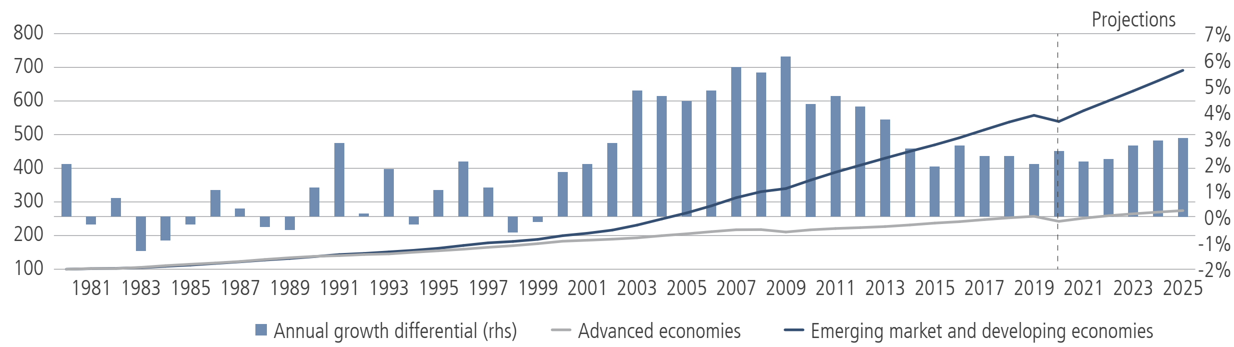
In this paper, we briefly outline the justifications for a strategic allocation to the asset class before delving into U.S. insurance company holdings in emerging markets debt to assess whether they are investing strategically.

How Does Emerging Markets Debt Justify a Strategic Allocation?

Underlying Fundamentals Have Been Improving for Many Years

Even with the impact of the coronavirus crisis, the emerging world's economies continue to grow at a much faster rate than the developed world. China was the only major economy in the world to end 2020 larger than it began.

FIGURE 1. CONTINUED OUTPERFORMANCE IS PROJECTED FOR EMERGING MARKETS
Real GDP, rebased to 100 in 1980



Source: International Monetary Fund. Data as of November 20, 2020.

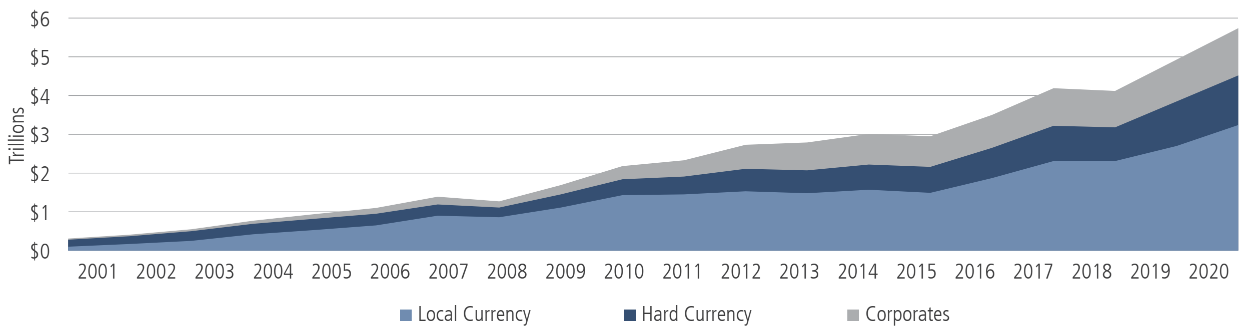
This story is not only about economic growth, but also economic robustness. One reason the value of outstanding emerging markets debt has grown from a few hundred billion dollars to more than $4 trillion over the past 20 years is that more and more countries have embraced orthodox macroprudential policies, including independent central banks with mandates to manage inflation, which have lowered their cost of borrowing and given them more tools with which to manage cycles. A large part of this debt issuance has been denominated in local currencies, reducing issuers' exposure to the U.S. dollar and helping to build foreign exchange reserves. And while emerging economies remain exposed to cyclical forces such as commodity prices, demand from the developed world and dollar strength, they are increasingly geared to positive structural developments, such as an expanding middle class, improving infrastructure and the emergence of China as a dominant economic power.

All of this has had a positive impact on the average credit quality in emerging markets debt, to the extent that almost 55% of the J.P. Morgan EMBI Global Diversified Index—which tracks hard-currency government bonds—was investment grade by the end of 2019. In the mid-1990s it was less than 20%.

The Asset Class Is Large, Diverse and Flexible

The emerging markets debt universe is now worth more than $4 trillion, and is well diversified between sovereign and corporate issuers, and local- and hard-currency denominations.

FIGURE 2. A LARGE AND DIVERSE ASSET CLASS



Source: J.P. Morgan. Indices used: JPM GBI-EM Broad (EMD Local Currency); JPM EMBI Global (EMD Hard Currency); JPM CEMBI Broad (EMD Corporate).

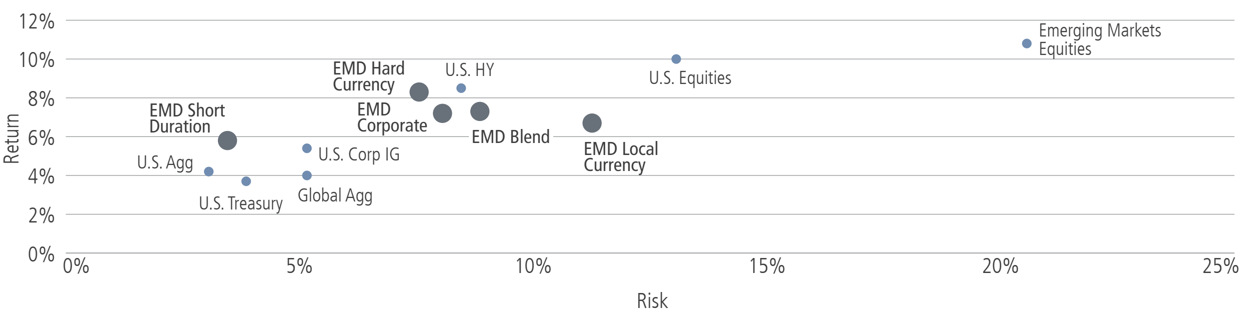
This means that emerging markets debt presents a range of sub-asset classes, each with a distinct risk and return profile.

Local-Currency Bonds are largely issued by sovereigns, and offer investors exposure both to local-currency duration and foreign exchange—and therefore the closest exposure to the growth dynamics of the emerging world. They represent the best return potential over a longer investment horizon, but tend to be more volatile.

Insurers tend to be invested in *Hard-Currency Bonds*, primarily denominated in U.S. dollars—but even on its own, this market is large and diversified. Hard-currency bonds are issued by both sovereigns and corporates and the benchmark J.P. Morgan CEMBI Broad Diversified Index of corporate bonds covers more than 600 issuers in 52 countries. The risk and return profile of hard-currency emerging markets debt means it is often regarded as a comparable alternative to U.S. corporate credit.

FIGURE 3. EMERGING MARKETS DEBT OFFERS AN ATTRACTIVE AND DIVERSE RANGE OF RISK-RETURN PROFILES

Annualized return and risk, January 2003 to November 2020



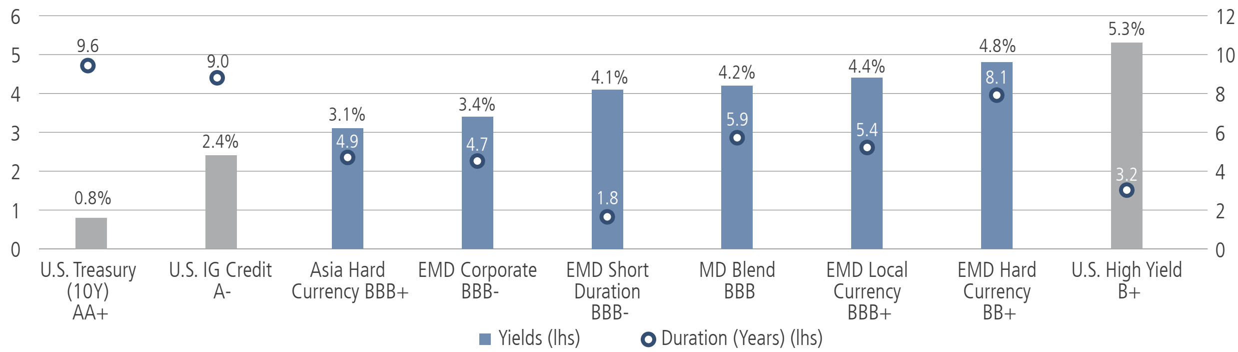
Source: Bloomberg. Indices used: JPM CEMBI Broad (EMD Corporate); JPM EMBI Global (EMD Hard Currency); JPM GBI-EM Broad (EMD Local Currency); 25% CEMBI, 25% EMBI Broad, 50% GBI-EM (EMD Blend); 50% EMBI Global Diversified 1-3yr, 50% CEMBI Diversified 1-3yr (EMD Short Duration); United States Benchmark 10 Year Government Index (U.S. Treasury); Barclays Global Agg Total Return Index Unhedged (Global Agg); Barclays U.S. Agg Corporate Index (U.S. Corp IG); Unhedged Barclays U.S. Corporate HY (U.S. Corp HY); S&P 500 (U.S. Equities); MSCI Emerging Markets Total Return (Emerging Markets Equities).

Yields Are High Relative to Credit Quality and Duration

Next to developed market fixed income, the various kinds of emerging markets debt offer attractive yields, particularly relative to their credit quality and interest rate sensitivity.

FIGURE 4. ATTRACTIVE YIELD WITHOUT SACRIFICING QUALITY

Weighted average yields, duration and credit rating



Source: J.P. Morgan, Bloomberg. Data as of November 30, 2020. Indices used: United States Benchmark 10 Year Government Index (U.S. Treasury); JPM U.S. Liquid ex-Emerging Markets (U.S. IG Credit); 50% EMBI Global Diversified 1-3yr, 50% CEMBI Diversified 1-3yr (EMD Short Duration); JPM CEMBI Diversified (EMD Corporate); JPM EMBI Global Diversified (EMD Hard Currency); JPM GBI-EM Global Diversified (EMD Local Currency); 25% CEMBI, 25% EMBI, 50% GBI-EM (EMD Blend); JPM U.S. HY (U.S. HY); J.P. Morgan Asia Credit Index (Asia Hard Currency).

How Do Insurers Invest in Emerging Markets Debt?

We focused on the U.S. insurance industry, where CUSIP-level data is available through regulatory filings, analyzing each line of available data to identify emerging markets debt exposure. As of December 31, 2019, the total book value of unaffiliated cash and invested assets of the U.S. life and P&C industry was $5.8 trillion, and this analysis covers $5.6 trillion.[1]

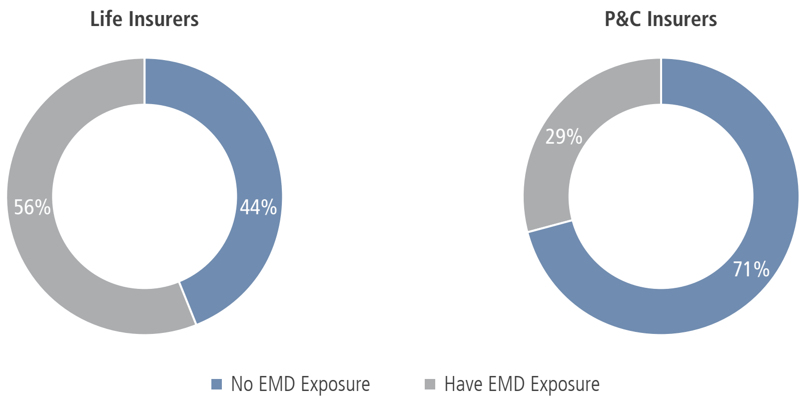
Insurers Are Under-Invested and Remain Highly Concentrated

We found that insurers are not only under-invested in emerging markets debt, but that they also invest very differently than the market as a whole.

More than 40% of life insurers don't have exposure at all, and that rises to 71% for P&C insurers. The larger the insurer is, the larger its emerging markets debt allocation tends to be, but even the 25 companies with the largest proportions of their total assets invested in emerging markets debt allocated an average of just 4.4% and 3.9%, for life and P&C insurers, respectively.

[1] Source: SNL Financial, using insurers' regulatory filings. Data as of December 31, 2019.

FIGURE 5. A LARGE PROPORTION OF INSURERS HAVE NO EMERGING MARKETS DEBT EXPOSURE



Source: SNL Financial, J.P. Morgan, FactSet, Bloomberg.
Note: 0.1% is used as cutoff, i.e. companies with an EMD allocation greater or equal to 0.1% are counted as "Have EMD," and companies with an EMD allocation less than 0.1% are treated as "No EMD."

We compared the average emerging markets debt allocation of the 50 largest life and P&C insurers with an illustrative portfolio that we believe represents a typical hard-currency EMD portfolio, as well as a custom index that combines the J.P. Morgan EMBI and J.P. Morgan CEMBI to represent the total hard-currency market. We found marked differences in concentration (insurers hold far fewer bonds), region and country diversification, issuer type, duration, rating and yield.

FIGURE 6. INSURERS' EMD INVESTMENTS ARE DIFFERENT THAN THE MARKET OR A TYPICAL PORTFOLIO

	Life Industry Top 50 Companies	P&C Industry Top 50 Companies	Index Data (CEMBI/EMBI)	Illustrative EMD Portfolio (IG-Only)
Average Market Value Weights	3.3%	2.8%	NA	NA
Average Number of Securities	123	62	1450	315
Average Number of Countries	18	12	81	32
Average Number of Corporate Issuers	59	30	631	216
Average Number of Sovereign Issuers	8	5	69	44
Average Ratings	BBB+/BBB	A/A-	BBB-/BB+	A-/BBB+
Average Number of IG Issuers	50	28	411	260
Average Number of HY Issuers	17	8	289	0
Average Maturity	11.3	6.8	10.8	15.2
Average Duration	7.1	4.7	6.4	8.9
Average Spread Duration	7.1	4.7	6.4	8.8
Average YTW (%)	2.5	1.9	3.6	2.4
Average YTM (%)	2.5	1.9	3.8	2.5

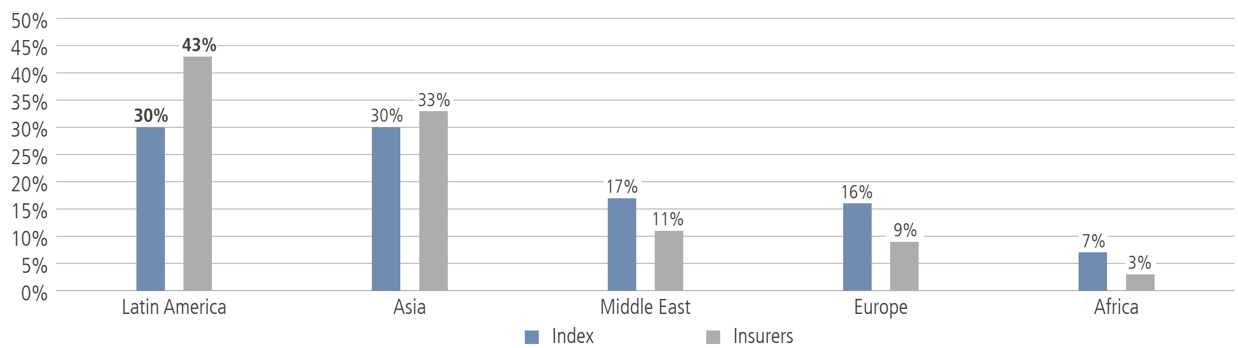
Source: SNL Financial, J.P. Morgan, Bloomberg. The Index is constructed by combining JPM CEMBI Diversified Index and JPM EMBI Global Diversified Index. The Index and the illustrative portfolio data are as of December 31, 2020. Insurance industry holdings are as of December 31, 2019, but the yields shown reflect the yields of those holdings as of December 31, 2020.

Insurers Are Heavily Biased to Latin America—Especially Mexico

Compared with index weights, U.S. insurers tend to be biased to Latin America. This is despite the fact that the average credit rating is lower here than in Asia or the Middle East—and because insurers favor higher-rated bonds, this means they are particularly concentrated in a small proportion of issuers in this region.

Over the past three years, since we last looked at this data, insurers' Latin America weighting has declined slightly while their Asia weighting has increased—but due to the evolution of the market, they have become still more concentrated in both regions, relative to the index.

FIGURE 7. INSURERS ARE SUBSTANTIALLY OVERWEIGHT IN LATIN AMERICA



Source: SNL Financial, J.P. Morgan, FactSet, Bloomberg. The Index is constructed by combining JPM CEMBI Diversified Index and JPM EMBI Global Diversified Index.

In every region except emerging Europe, insurers are substantially more concentrated in one or two countries than the index. Within Latin America, allocations to Mexico and Chile account for more than 50% of the industry total, compared to 27% of the index. In Asia, 31% of the allocation is to China and 13% to South Korea (22% and 6% of the index, respectively). In Africa, South Africa predominates. In the Middle East, they allocate 36% to United Arab Emirates and 32% to Israel, versus the index with 20% and 7% in those two countries, respectively.

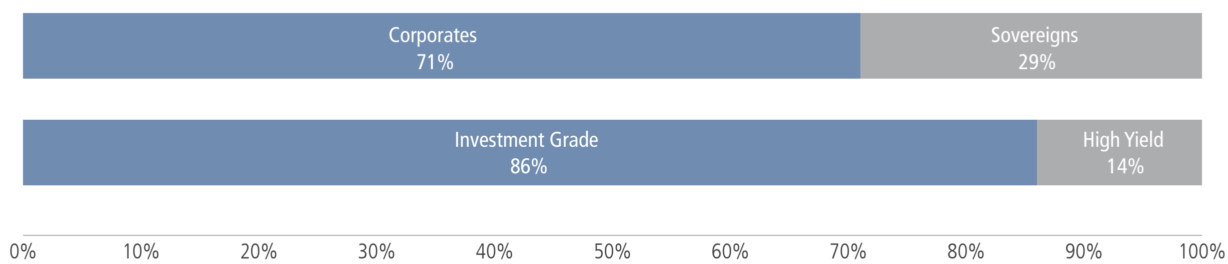
In aggregate, this results in a marked, 10-percentage-point overweight to Mexico at the global level. Further analysis confirmed that this was true, on average, across all sizes of insurer—this is not an anomaly skewed by one or two very large allocators. While still large, that overweight to Mexico has declined over the past three years, mostly in favor of a growing overweight to China.

Insurers Favor Investment Grade, Long-Duration, Hard-Currency and Corporates

A little under half of the emerging markets debt universe is rated investment grade, but life and P&C insurers of all sizes are overwhelmingly biased toward investment grade issues. They are also heavily biased toward corporate issuers, which make up only around one-fifth of the market. Unsurprisingly, given that corporates tend to issue in U.S. dollars, we found that almost all insurance company exposure was hard-currency.

FIGURE 8. INSURERS FAVOR INVESTMENT GRADE AND CORPORATE BONDS

Insurers' Emerging Markets Debt Allocations



Source: SNL Financial, J.P. Morgan, FactSet, Bloomberg.

These biases, together with the fact that insurers tend to be concentrated in a small number of well-bid bonds, mean that insurance companies' emerging markets debt portfolios have a lower yield, on average, than the market (2.5% and 1.9% yield-to-worst for life and P&C, respectively, versus 3.6% for the market, as shown in figure 6). This is despite the fact that life insurers, in particular, tend to favor longer-duration bonds as a closer match for their liabilities (7.1 years versus 6.4 years for the market).

The Story of the Data: Insurers Are Missing Out on Strategic Potential

In our view, our analysis of this data indicates that, while insurers have some emerging markets debt exposure, they are not truly invested in the asset class.

The data, supported by anecdotal evidence and our own qualitative observations, suggests to us that insurers may be seeking better yields, opportunistically, from a fairly limited, higher-quality subset of the market—perhaps focused on issues included in the global benchmarks they are familiar with, such as the Bloomberg Barclays Global Aggregate Index.

This may seem like a low-risk allocation to emerging markets, but looked at as a dedicated emerging markets allocation, it reveals itself to be highly concentrated in terms of number of issuers, region, country and interest rate sensitivity.

Just as important, this kind of allocation fails to take strategic advantage of some of the characteristics of the asset class, such as: exposure to long-term growth differentials (for which higher-yielding bonds and local currencies would likely be best); the potential for portfolio diversification (for which domestically driven sovereign returns have been better than globally driven corporate returns); or its favorable yield-to-volatility and yield-to-duration ratios (for which short-duration emerging markets debt is well suited, particularly for P&C insurers with shorter-dated liabilities).

We believe there are clear opportunities for insurers to develop and utilize tailored emerging markets debt solutions to improve their portfolio yield and return potential while respecting risk and regulatory requirements. Given the latest data, the big question is whether we think we will find insurance companies taking the same approach to emerging markets debt when we revisit the numbers in another one or two years' time.

The volume of inquiries that we have seen from the industry over the past six to eight months, as well as our subsequent conversations with these investors, strongly suggests to us that things are changing. The rapid and decisive response of the major developed world central banks to the coronavirus crisis, which pushed government bond yields to new lows and tightened developed market credit spreads remarkably quickly, could be the catalyst that finally persuades insurers to take a long-term strategic approach to this higher-yielding, diverse and growing asset class.

As the index data shows, the emerging markets debt universe today is massive. And as our data on insurers' allocations indicates, this is an area in which insurance investment teams and committees may have limited familiarity or direct experience. We believe that by leveraging a large, dedicated and well-resourced emerging markets debt platform—ideally one paired with dedicated insurance capabilities—insurers can bridge the information divide and truly take advantage of the strategic potential of this asset class.

Neuberger Berman's dedicated Insurance Solutions Group plays a key role in our engagement with insurance clients.

We leverage our experienced team for a range of special projects, including:

- Peer analysis—Providing clients with insights into their portfolio based on exposure and risk trends we see globally in the insurance industry
- Strategic asset allocation reviews—In-depth analysis of insurers' general account allocations relative to their liabilities, evaluating investment objectives and constraints

These types of engagements position us well to assess the impact of allocating to sectors such as EMD across the spectrum of insurance risk. Importantly, we actively engage with our portfolio management resources to help determine portfolio allocation ideas that are executable in an effort to provide actionable ideas.

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