EXPLORING ABSOLUTE RETURN FIXED INCOME

OUR PANEL OF EXPERTS DISCUSS THE SIGNIFICANT OPPORTUNITIES ON OFFER FOR INSURERS WITHIN THE ABSOLUTE RETURN FIXED INCOME MARKET

CHAIR

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Daniel is head of insurance investment & ALM at Hymans Robertson. He is an experienced actuary with a background in industry and consulting. Daniel's insurance industry experience includes the role of head of capital management at L&G Capital, as well as four years in the group investments team at Friends Life.

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Ella joined Pictet Asset Management in December 2018 as a senior investment manager on the global bonds team, focusing on global rates and FX. Ella joined Pictet from Wellington Management where she was a managing director and fixed income portfolio manager for over seven years. Prior to that she worked at Invesco Asset Management.

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Tim joined Pictet Asset Management in 2017 as a senior business development manager. Based in London, Tim focuses on developing the institutional business in the United Kingdom and Ireland. Tim joined from Allianz Global Investors where he was, director, institutional business development.

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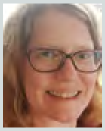
William is a principal within Mercer's insurance investment team. He is responsible for advising insurers on asset allocation, investment strategy and portfolio design, and building investment solutions for them. He joined Mercer in July 2020 from PwC, where he was a director in the ALM and investment advisory business.



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Catherine is the senior investment analyst at Brit Insurance. Her role incorporates all aspects of the management of the group's assets. Prior to Brit, Catherine was a senior investment consultant, in the Mercer insurance investment team, providing customised advice to institutional investors including asset allocation and investment strategy.

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CHAIR: How does current market sentiment feed into your thinking Ella, and more specifically your investment allocation within absolute return fixed income (ARFI)?

HOXHA: In a year where we have been hit with such a large economic shock, the biggest since the Second World War effectively, on a global scale one can look at fixed income returns and think 'what's the problem?'. So it's not necessarily been such a bad year for a bond manager, but there have been some sleepless nights however. A lot of the moves we have seen this year in fixed income have been mostly driven by core duration, Treasuries, the Fed cutting rates and new quantitative easing programmes launched across the board. In addition, we have had other Central Banks joining the more loose Central Banks, such as the ECB or the Bank of England, which have been on the loose side for quite some time. Places like New Zealand and Australia have also joined the yield curve control experiments.

We are seeing things that we have not grown accustomed to in fixed income markets despite the very bullish run that we have had over the last three to four decades, and certainly over the last 10 to 12 years. In excess return terms, emerging markets have actually not had a very steady year, despite the recovery we saw in Q2 and Q3, and ditto for US high yield, and European high yield to some extent. We are seeing an increase in debt levels and a collapse in interest rates at the zero bound. In fact, a lot of the macro discussion now is around what happens next? The macro community has two sides of debate within it at the moment. One side expects more of the same, so, deflation, loss of output, loss of capacity, unemployment and even

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more piles of debt across both the public and the private sector. Counter-intuitively, that tends to drive interest rates even lower, and effectively you are talking about more of the same except in regions such as Europe where you are actually starting to tick more of the boxes with regards to a Japanification. If you look at regions such as the US or the UK, where we are seeing a greater embrace of larger fiscal expenditure combined with very loose monetary policy, you bring in the other side of the debate and those who think well maybe something has shifted, maybe this is the end of the great bull run for fixed income, and maybe we will start to look at interest rate pricing very differently. We tend to think thematically about how we allocate risk in our portfolios. We have four key structural themes. The first is rates lower for longer. So that would embrace this deflationary path and basically looks at interest rates staying low because of this challenging growth environment, challenging debt dynamics and challenging demographic dynamics that we have across the world. The second theme is the European crisis which is an unresolved not fully formed structure, and one which will be tested across the different cycles as we have seen this year around April to May. The third theme is the Chinese transition. This is the shift in the Chinese growth model and one which is moving up the chain in terms of GDP per capita and one

which looks at more internally focused growth models, less export oriented and one which is moving up in terms of technology, R&D and innovation etc. The last theme is Abenomics which came to the fore in 2013, which is the idea of running loose fiscal policy with reforms, with loose monetary policy, which so far has failed to generate inflation and solve the big structural problems that Japan faces.

For us, the pandemic has accelerated these trends that are key to our four structural themes, the demographic issue and the growth concerns etc. We favour duration when allocating capital. In the US particularly, the curve still has the potential to collapse lower and we have seen a little bit of that play out recently as we engage in the second wave of the pandemic. That makes us want to own investment grade credit. We are running a fairly stimulative set up of policy that should keep supporting credit, equities and fixed income more broadly, and that makes us find value in emerging markets in dollar-denominated terms. A lot of the debt within those emerging market countries is actually coming via the IMF, so via the public sector, therefore leaving an attractive pool for private debt investors such as ourselves. It makes us like Chinese bonds in local denominated terms. We like the duration in China in unhedged currency because the policy setup in China is one which has effectively been running slightly tighter monetary policy YTD, but faces the same challenges as the rest of the world - peaking inflation, challenging demographics and increased debt. Relative to other interest rate markets, China is very attractive especially in terms of positive real rates and it's a deep market that is likely to be the second largest bond market in the world and therefore keep attracting inflows.

BIRD: Chinese debt also has a great diversification benefit. Is that still the case within broader fixed income markets as well?

HOXHA: The correlation factor is what has made it more attractive for us. It has tended to be a little bit counter cyclical, certainly in this crisis, mostly because China emerged from the pandemic crisis before the rest of the world, and therefore the recovery there was more expedient and rates moved up. That gave us the opportunity to buy the sell-off, whilst rates elsewhere were moving lower. Chinese rates effectively outperform in a market where interest rates elsewhere were actually selling off. It does have good properties in terms of a diversification point of view. Chinese real estate is also an area that we have been invested and we have increased allocations during the sell-off. Why? Because the policy setup in China is quite favourable to real estate bonds and the real estate sector in general. Real estate is too important a savings tool for the Chinese citizen, so therefore it makes it a good policy target for government support. We like the valuation argument here.

In terms of Europe, we were able to increase our allocations around March and April to Spain, Portugal and Italy. The only country we have left at the lower risk level is Italy, where we are overweight. The ECB is taking away a lot of the funding needs for governments, so we have very positive net supply dynamics in Europe over the course of this year and next. In Germany, we have a preference for the long end of the curve, however in terms of the two to five year part of the curve in Germany, the valuations are starting to become increasingly difficult.

The way we use FX in our portfolios is as a hedging mechanism. The dollar plays a huge role in hedging a portfolio that's running spread risk and duration risk. Not only it is proven quantitatively speaking, it tends to have a counter trend effect. We maintain our dollar longs, mostly versus emerging market shorts, and this has been our position in line with our Chinese transition theme for a long time now. We like to have allocations to the anti-fragile currencies, again with the idea of hedging the portfolio to unforeseen risks. Therefore we like Swiss francs, Japanese yen and over the last three to four months the Euro as well.

Going forward we are very alert to this newfound experiment which is basically the Central Bank directly funding new issues from the government in order to boost demand. We have been told it is short term here. All this debate around the new monetary theory, which has basically been occurring between economists and central bankers for the last two to three years, has in reality played out and in the space of a couple of weeks we saw big policy shifts. Policymakers on the government and the central banking sides actually took hold of this idea of easing fiscal policy and monetary policy simultaneously. We don't think this is a game changer for long-run trends in rates at the moment, but if this becomes increasingly popular going forward as we deal with the aftermath of this pandemic, it can shift the pendulum for fixed income, and hence why we are alert.

CHAIR: Do any of these broad themes resonate with you William in terms of the solutions you are putting together for your clients?

GIBBONS: We very much recognise this picture drawn out by Ella here, around low yields and Japanification, which has been talked about for around 10 years now. Coming out from the global financial crisis it has been a theme, and some people thought yields would start to rise gradually as we move towards a recovery and a reversion back to pre-2008 days, but that clearly for whatever reason hasn't happened in Europe. It does feel as if we are stuck in this lower rate scenario for a while. Our thinking on fixed income is broadly similar, although there are some differences. We are a bit more sceptical about global sovereigns in terms of whether they will continue to perform and we see potential for inflation to increase. The yields are where they are because that's where the market has priced them and there are two ways of looking at this. One scenario is where yields stay low or indeed fall, and you have another scenario where yields will start to rise. There is a bit of risk around inflation picking up. Credit spreads have tightened from where they were. The interesting question now is what happens going forward. Have credit spreads tightened sufficiently at investment grade? High yield is an interesting one perhaps where spreads are a bit more elevated, so maybe there is more spread income there, but equally you have risks. You have the risk of a second COVID-19 wave, you have the US election and in the UK you have the context of Brexit as well which will affect some assets. The picture for credit seems somewhat uncertain overall. The challenge of having to earn a return in your portfolio is absolutely there and clients are very focused on this, but at the same time, logically, a lot of people would say we don't want to increase our risk budget versus where we were. Some clients are even saying they may want to take less risk given the uncertainty.

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CHAIR: Catherine, how do you see the risk/return trade-off at the moment in relation to your own portfolio?

BERMINGHAM: We look at it, and we think are you getting paid appropriately for the risk that you have taken. If we take extra risk are we getting paid for it, and it is very difficult to see that from a long term perspective. We have risks from COVID-19, risks from the US elections, risks from the geo-political approach from US/China and wider tensions from other nations with China. The influence of Central Banks and fiscal policy has really been driving where spreads and yields are.

CHAIR: Has that led to any changes in your portfolio over the year or is it a case of sitting tight?

BERMINGHAM: There's two bits to it really. Early on in March when you saw yields decrease but saw credit spreads move out quite substantially, that made us think there are opportunities in credit, but obviously then that came back quite quickly, and with risks where they are at the moment, you have to think will there be better opportunities coming up?

BIRD: One of the benefits of thinking about global bonds as we do, is the ability to be quite nimble in terms of how we express these in the portfolio. Are we entering a world where nimbleness and making quick decisions is becoming more relevant or is holding true to a longer term strategic asset allocation view still going to persist?

HOXHA: The ability to be nimble is now more important than ever. We are in an environment where we could be

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faced with a lot of volatility. If anything shifts over the next three to six months, like for example a vaccine development or a combination of that and a removal of some tail risk on the election in the US, we will have a more pro-cyclical set-up going in to 2021. In that environment we have a re-pricing of rates, so clearly being nimble and managing duration accordingly is a huge advantage. It is slightly harder to do when you are purely invested in a sectoral basis in credit, but in a portfolio that has the ability to take market rates risk and FX risk, you can actually exploit those volatility mispricings and we have been doing this certainly in FX and in rates markets as well via options predominantly. In terms of this inflation expectation component, we have been buyers of Treasury Inflation-Protected Securities (TIPS) over the last couple of months in the US. So far the market is giving the Fed the benefit of the doubt. Our only reservation on inflation is that it is a bit of a mysterious creature. It takes time to creep up and we think it is a multi-year process. We can get swings around the cycle, but are not convinced that we actually will see a three to four per cent inflation going forward persistently but it is difficult to say for certain. We are prepared when the change comes, but for the time being the problems around growth and the macroeconomic setup we have is very challenging. That will take a couple of years at least to play out with a big push from the Central Bank.

CHAIR: For insurers, it is always desirable to be nimble, but obviously they are regulated entities and have their own internal governance. Catherine, is it easy for a regulated insurer to take advantage of these opportunities, and are there any trends in where regulation is going which is making that harder or easier to do?

BERMINGHAM: As a Lloyd's insurer we have a number of different regulations that we have to sit under. We have a lot of assets that are held in US trust funds which have their own rules and their own regulations, as well as then having assets at Lloyd's which fall under Solvency II type regulation and also Bermuda regulations. Having these different regulations can make it difficult to be as nimble as you might want to be. Within our operating model we are able to have areas where we take advantage when opportunities arise. If mandates have been set up correctly you can leverage the ability to take advantage, but if you don't have flexibility it becomes very difficult to invest in a new asset class quickly. Where I think some of the messaging out of the PRA from a regulatory perspective has been helpful, is increasing focus on ESG and understanding different ESG risks in portfolios.

ESG

CHAIR: William, has ESG been rising up the agenda among your clients as the regulator places more attention on it, along with focus on TCFD disclosures?

GIBBONS: It has been, but I'm not so sure it is solely regulatory driven. A lot of the focus on ESG we are seeing is about firms trying to figure out what is the right thing to do. If you wind back 10 years, did firms think about how their fixed income or equities were invested in the context of ESG? Only in a more limited way. Firms now know that they need to put into place their own thinking on this. Regulation does feed in to this, but there is definitely something bigger going on about what is the right thing to do.

CHAIR: Ella, how do you express ESG thinking in your ARFI strategies?

HOXHA: This has been a big objective for us since the 1990s. We have had the setup in place for all the ESG screening that we have needed. For us, when we think about ESG in terms of our process in global bonds, we monitor it constantly and we filter through it. When we think about ESG, we try not to just look at the scores and the parameters of the holdings that we have present, we try to think beyond this. On the sovereign side, we have increased allocation to Chinese duration. China would score as a sovereign under a more concerning element. Why? Because one of the big factors that's driving that scoring is the democratic system. Clearly this is something we value very highly in the West, however it's less of a concern in China. So for us it is about are we getting compensated for this risk and how do we think about a country that is now part of the majority of the bond indices and likely to be the second largest bond market in the world. This is not something we can afford to be completely out of. You become part of the solution by participating and broadening your investment knowledge and expertise in that region. On the corporate side, if you take the example of financials, it tends to be a little backward looking because banks got severely punished for the 2008 financial crisis and since then a lot of reforms have been carried out in the banking sector and a lot of the balance sheets are now not the same proposition as your ESG screens would suggest. For us, we know about ESG scoring, but we have a value proposition to bring to the table. We don't see it as a defined science in our eyes, we are still figuring it out. We must understand why we have an allocation relative to ESG screening and that is important to us.

CHAIR: Does the engagement angle echo with you as well Catherine? That it is not just about screening out assets, but also about taking the opportunity to be at the table one way or another.

BERMINGHAM: It does. I think we can be far more impactful by integrating ESG thoughtfully into our portfolios rather than just screening out. We want to invest in sustainable, 'good' ESG companies but are also willing to look at investments that are not currently 'good' from an ESG perspective but are improving. There are many conversations out there at the moment talking about the cost of capital and adjusting the cost of capital for different ESG perspectives. On our insurance side you hear industry conversations that are taking place

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about whether you should adjust insurance pricing for ESG risks, and obviously insurance is about pricing risk. If you are not at the table how can you have the discussion?

ARFI opportunities

CHAIR: We have talked quite a lot now about risks and constraints. It would be good to talk about specific opportunities for insurers investing in ARFI. What does ARFI offer at the moment?

HOXHA: Our ARFI proposition was designed with an insurance client in mind. The idea being, give me a product that will try to capture most of the upside available in bond markets,

but try to allow me to sleep at night when times are bad, for example March 2020 and June to December 2018. Our proposition to try and provide 3-4% returns annually but minimise the bad times has been reflected by the performance of the strategy and we have a good six to seven years' experience and performance behind this strategy now. It isn't a strategy that performs in all fixed income markets but it is a strategy that will give you a cushion because we balance the portfolio for different outcomes and we hedge exactly with this view in mind. We try not to predict the future. We try and build portfolios that will withstand the test of time and the shocks that the markets will bring.

BIRD: We talk about ARFI as if it is a homogeneous asset class but actually there are very many different styles of ARFI. Some absolute return funds are credit beta focused but we take a broader approach. It is a balanced portfolio and we offer clients in this strategy daily liquidity and therefore we know we have to be able to provide that.

CHAIR: The point that resonates with me through this discussion is around not necessarily trying to predict the future. There is such a diversity of opinion around future outcomes, and just in term of interest rates, no one can really predict what will happen.

HOXHA: The reason we follow a thematic approach is so that we are not prone to short term noise. If you take a look at the big trends in the US 10 year part of the curve, it has been clearly downward trending for a long time. If you took smaller slices of time from that 10 year part of the curve, you would have a lot of noise around it. That's why we do this, so we don't get distracted by the noise of 'will or won't there' be a deal on Brexit for example. We care about probability

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weighted outcomes and we care about value. This is how me minimise the error in outcomes. The absolute return strategy is actually an evolution. It is an evolution of the global ag strategy and that's why it tries to capture most of the bond market's upside. The diversification in the strategy is the key differentiator. It is allocating top down across a broad array of alpha streams so you can capture opportunities where they may lie. A strategy that uses FX as well as spread and interest rates is effectively a more robust strategy that can give you better protection but also has the agility to manage duration. As we entered the recent crisis nearly 70% of our portfolio was in government bonds giving us the ability to exploit the opportunities created by markets during the sell off. We could take advantage of the repricing in spreads in EM and credit.

BERMINGHAM: The low yields and low spreads do make it difficult at the moment. Your forward looking returns are lower as you have lower income components, so you have to think do I have the flexibility in the portfolio to gain additional bits of return from different areas. Appropriate liquidity is also very important to us.

CHAIR: William you must be working with a range of insurers. Are there any key objectives you are pulling out with regards to what ARFI can achieve?

GIBBONS: Clearly firms are struggling with low returns on cash and low returns on 'safe' assets like short duration core fixed income in Europe. ARFI is one potential solution to this.

You also have multi asset credit and there are various short duration bond funds as well. The question is how should you weight these? People are looking to see how much they should have in ARFI versus multi asset credit, versus investment grade, versus something more vanilla. There is also a key point around the diversification of ARFI strategies. Some managers are predominantly more carry driven and some managers are more active in the market. One approach is to do all of that in one fund, but another approach is to identify funds which are best in class in each of these areas and pull them together, taking advantage of diversification.

CHAIR: What are the key characteristics of ARFI versus MAC?

GIBBONS: ARFI will be more Solvency II friendly in terms of the capital requirement and it's more towards investment grade. MAC will perhaps be a little bit riskier, so maybe towards the high yield end of the market and towards securitisations which would be less favourable under Solvency II but nevertheless can offer attractive returns.

BIRD: Our ARFI strategy which we speak of has had a low SCR score of just under 10% under a standard model and has reached as high as 22%, but more generally sits around the 14-17% range. The thing that changes it is the fact that it is a high yield weighting in the portfolio. This is a framework, a fund within a strategy but we recognise for many insurance companies they want to have more visibility. We have the flexibility to turn down certain parts and turn up certain parts. MAC strategies are framed around a cash plus type return. There is an ability to compare both from a performance perspective but also from a risk return profile as well.

HOXHA: Just a third of the alpha in the ARFI strategies for us come from spread which would be quite different to MAC.

BERMINGHAM: No two ARFI strategies are the same, so you really need to think about what can I have in the strategy. If I wanted to place it as a segregated account within funds at Lloyd's, I would have to say well you can't do any of your FX trading or have any of the heavy derivative strategies. If I wanted to place it outside of that, then I might say I'm ok having some derivatives in it but I also need to be cognisant of how that adds up from a capital perspective and what risks I'm adding to the portfolio.

CHAIR: How easy it to tailor these ARFI portfolios and how much of a knock-on impact on other factors does that have?

BIRD: We have the flexibility. The size of the opportunity dictates this as well. This is in part due to the fact it's fixed income, derivatives are in there and these are difficult mandates to run sometimes. They use the full remit of all the instruments, so custody costs and operational costs are all baked in, but they do have the flexibility.

CHAIR: William, what principles do you apply when you are thinking about how to select an ARFI manager and how to measure performance?

GIBBONS: The start point for us is finding best in class managers and we rely on our dedicated global research team for this. Then it becomes a question of implementation. Clients can choose to access that research directly (either by using our proprietary research tools or taking advice), or we can implement for them either via funds or bespoke solutions.

When it comes to implementation, our portfolio management team look to build diversified portfolios by allocating to high quality managers with complementary styles and skill sets. We think that is important for asset classes such as ARFI where the opportunity set is broad and there are distinct differences in management style.

CHAIR: Catherine, we have talked a lot about quantitative factors, are there any more practical considerations, perhaps on the relationship side, that make the manager relationship work well for you?

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BERMINGHAM: We look at the value the manager can add. That includes the value through the investment process, and how robust and repeatable that value is. In something like ARFI, it is very important that a manager is able to articulate how they add that value. Then there is the point around how you add value on the reporting side. Are you able to provide transparency and can that feed in to the insurance company systems? As insurance companies we like to be demanding of our investment managers.

BIRD: We recognise that transparency is key. We build a strategy that is transparent, and we put all of our funds through a standard SCR model and make that available to clients, but likewise we are very happy to share information.

HOXHA: It is very important to offer a strategy that is doing what it says on the tin for insurance companies.