BUY AND MAINTAIN

BUILDING DYNAMIC INSURANCE BOND PORTFOLIOS

By FARHAT SELMI, Head of Buy and Maintain Strategies for Insurance Portfolios

KEY POINTS

- Dynamic insurance bond asset management allows the portfolio to cushion inevitable declines in yield values over time
- We identify five sources of value-add associated with Buy and Maintain strategies: asset allocation, diversification, timing, risk management and arbitrage
- At Ostrum AM, we believe that Buy and Maintain strategies are well suited to sit alongside traditional and cautious long-term investment strategies

INTRODUCTION

Times are tough for insurance asset management, with the average value of portfolio yields coming down year after year. This trend is obviously a result of the never-ending low interest rate environment – which is set to persist for quite some time – but is unfavorable for portfolio optimization, leaving performance largely dependent on carry levels that are set over time. Is there a way for insurers to counter this trend? Is there a way to take advantage of periods of volatility on rates and credit spreads? Are there more dynamic solutions to consider that will continue to meet the primary aim of an insurance investment strategy (maintaining sound equilibrium between assets and liabilities on the balance sheet while ensuring a regular revenue stream)?

At Ostrum AM, we believe a solution investors can consider is to look beyond traditional “Buy and Hold”[1] strategies to “Buy and Maintain” strategies. Buy and Maintain strategies are designed to provide a more dynamic approach to insurance bond asset management, allowing the portfolio to cushion inevitable declines in yield values over time.

To illustrate how Buy and Maintain[2] strategies work, we provide an explanation of their characteristics and identify five sources of value-add: asset allocation, diversification, timing, risk management and arbitrage.

1. Buy and Hold is an investment strategy where the investor purchases debt securities and keeps them in the portfolio until maturity.
2. The Buy and Maintain strategy is subject to the risk of capital loss (default risk), interest rate risk and currency risk.

Buy and Maintain
Five sources of value-add

1. Asset allocation (traditional decision making between credit and sovereign debt)

We believe asset allocation remains the main driver, even in a low interest rate environment. Volatility is a driver of distortions in credit spreads relative to government bonds, implying the importance of having asset allocation guidelines. Well-structured asset allocation guidelines allow the portfolio manager to take advantage of different market configurations.

2. Diversification

Buy and Maintain strategies can be implemented in different ways, ranging from traditional geographical/sector diversification to diversification of investment strategies. Depending on volatility levels, investors can potentially benefit from investments in securities denominated in non-euro currencies but hedged by currency swaps. Diversification can also be achieved by investing in crossover issuers that benefit from a positive outlook. Diversification can also be achieved by investing in unrated securities and/or via private placements. That said, investing in crossover or unrated issuers requires strong conviction from Ostrum's portfolio managers, and insurance asset managers. Both teams are supported by the credit research team in issuer selection. More broadly speaking, in long-term conviction-driven insurance asset management, diversification can be applied to reduce average default risk in the portfolio. We can add value in diversification by extending the range of securities and moving away from benchmark, allowing us to add performance when the market is consolidating.

3.Timing

Building a Buy and Maintain portfolio requires successfully managing the initial ramp-up and also over the life of the strategy. For insurance portfolios, we are especially sensitive to an environment of falling rates. To counter this, we are reactive in periods of correction that provide opportunities to take exposure. To illustrate the potential benefit of successful portfolio timing optimization, we were able to lock in an additional 20bps on one of our largest Buy and Maintain portfolios over a period of two years thanks to portfolio timing and optimization techniques.

4. Risk management

Contrary to a Buy and Hold strategy, a conviction-based Buy and Maintain approach allows for securities to be sold before maturity. At Ostrum AM, the decision to sell a security is taken with the support of the credit research team. In addition, thanks to our proprietary rating methodology, credit analysts' are well positioned to challenge and pre-empt decisions coming from mainstream ratings agencies. During periods of credit market stress, a well-documented credit view can be extremely useful in deciding whether to reduce portfolio risk or to lock in additional yield.

5. Arbitrage

Ostrum AM's Buy and Maintain approach is managed with a dynamic bias, implying the portfolio manager will navigate the portfolio management with an opportunistic approach. For example, during a period of low interest rates, the investment team will review the range of securities held in the portfolio, looking at potential arbitrage opportunities that could be implemented. Strategies identified will range from trades between asset classes, sectors, maturity segments (curve arbitrage, etc.) and primary market vs secondary markets.

Arbitrage decisions taken are only those that fit within agreed insurance guidelines, ensuring the long-term investment horizon of the portfolio. The aim is to avoid short term tactical position taking. Maintaining a long-term investment horizon is consistently at the heart of our insurance Buy and Maintain strategy's arbitrage philosophy.

To illustrate value-add from arbitrage, we calculate that for one of our largest portfolios, during a period of two years (2017-2018), the contribution of adding duration as an arbitrage strategy was equivalent to 26bps in yield per year of duration. This additional yield acquired was much higher than the market average of 12bps (using the 7-9-year euro swap curve as a benchmark) over the same period. We also calculate that the contribution of arbitrage in our insurance bond portfolios is higher than the annual investment of inflows from coupon payouts, redemptions and net new business. Both these examples demonstrate how arbitrage can add value to insurance bond portfolios.

At Ostrum AM, we believe that insurance bond asset management deserves to be more than passive or inactive. Considering the current macroeconomic environment with little expectation for a rise in interest rates in the short term, we believe insurers may want to consider a more dynamic approach to lock in spread levels. We believe Buy and Maintain strategies are well suited to sit alongside traditional and cautious long-term investment strategies.

Ostrum AM manages €170bn in insurance assets, comprised of more than 80 bond portfolios managed for 25 clients[1].

1 Source Ostrum Asset Management at 12/31/2018.

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Ostrum Asset Management

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