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A With Intelligence Company

Insurance CIO Whitepaper

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Contents

Welcome to CAMRADATA's Insurance CIO Whitepaper

Last year may have been one that investors will want to forget. Asset managers may indeed prefer to shine the light on their five and ten-year track records rather than the conventional three, given the severity of losses in 2022.

For insurance CIOs, one major headache was that bonds generally fared worse than equities. Some insurance portfolios drew comfort from alternatives such as exposure to real assets and absolute return strategies.

And so to 2023, where the attractiveness of US equities has once again drawn capital in spite of the record lows of the equity risk premium.

General insurers and reinsurers won't need to chase the same level of returns as the wider market. A return to normal interest rates means that at least there is a running yield on standard highly-rated fixed income. Those alternatives such as private credit and absolute-return bonds should likewise retain their usefulness as diversifiers.

But for all investors, doubts remain about what sort of economy we are heading towards. The fear of stagflation has not entirely dissipated. In part, this is because the flexibility of supply and supply chains, developed via globalisation, has been tested by war, disagreements between the superpowers of China and the US; and the pandemic. Central banks are no longer willing to soothe markets in the face of these tests.

In sectors that can be mostly digitalised, the inhibitors are not so obvious. The promise of growth emanating from tech, most recently the buzz around AI, still carries the day. But invariably physical sectors such as commodities, including energy, do transmit shocks.

The CAMRADATA Insurance CIO whitepaper will find out how optimistic CIOs are for the years ahead; and how their portfolios reflect this outlook.

Meet the Team

Natasha Silva
Managing Director, Client Relations

Amy Richardson
Managing Director, Business Development

Sam Buttress
Associate, Business Development

Sarah Northwood
Marketing and Events Coordinator

Orin Ferguson
Associate, Business Development

Insurance CIO Roundtable

The CAMRADATA Insurance Roundtable took place in London in September 2023

The CAMRADATA insurance CIO roundtable for 2023 began by asking senior investors to lay out their liabilities and risk tolerance. For MS Amlin, CIO Paul Amer noted that it has multiple clients with multi-currency liabilities. "We're in the 0-5 years part of the curve with some liabilities further out," he said. "We are tightening risk tolerances at the moment, bringing assets closer to liabilities given our expectations of where we are in the investment cycle."

Daniel Dixon, chief investment officer at Brit Insurance, said its portfolio's average duration was approximately three years. Brit's liabilities are predominantly US-denominated (75%), then some Canadian (10%) with a spread across smaller currencies. "We have a medium risk profile," said Dixon. "We can take active interest-rate risk but have a cautious approach to credit risk given where we are in the business cycle. Going into Covid we were shorter duration and stayed short given the risk of rising yields but since last year have been extending."

Dixon said it was difficult to call the top of the rate rising cycle. "We've been thinking it is close, only to see it climb again." He pointed out that it's difficult to get such timing right but what matters is the relationship between your positioning and your risk profile.

Reena Malharkar, senior manager of strategic partnerships and research at Phoenix, the UK's largest commercial retirement provider, said that in its General Account the key was to match cashflows, interest rate and inflation risk. "Asset-Liability management is incredibly important. Risks are allowed within regulatory bounds," she said. "For example, we do not take currency risk, so all investments are hedged back to GBP."

Phoenix's General Account is mostly invested in public and private credit, cash, gilts and equity release mortgages.

For Pool Re, Ian Coulman, CIO said the truth was that there was a lot of uncertainty surrounding the organisation's liabilities.

Pool Re was set up in the 1990s by the Government and the insurance industry to provide reinsurance in the event of a terrorist attack on commercial property on the UK mainland. There have been fewer than 20 terrorist events on mainland UK that have affected Pool Re since it was created, which does not make a rich universe of data.

Modelling with the help of several academic institutions has helped Pool Re contextualise its risks, including after potentially more severe non-conventional attacks. Two and a quarter years is now regarded as a likely average life payment profile. Therefore, the majority of the portfolio is in

> ***"Modelling with the help of several academic institutions has helped Pool Re contextualise its risks, including after potentially more severe non-conventional attacks. Two and a quarter years is now regarded as a likely average life payment profile"***

highly liquid Investment Grade and government bonds, with maturities out to 5 years.

Pool Re also allocates a minority of capital to risk assets such as global equities, Alternative Risk Premia, High Yield and Emerging Markets.

Performance in 2023

The CAMRADATA panel then heard from asset managers how their investment strategies had performed year-to-date (YTD).

PineBridge Investments's Hani Redha, portfolio manager, Global Multi-Asset, said: "We have been sceptical about returns for risk assets. The markets are now coming towards us."

Shayne Dunlap, portfolio manager on Pacific Asset Management's G10 macro rates strategy, said performance to the end of August had been just shy of 6%, with volatility of just over 5%. "That is cash plus alpha," he said.

abrdn's head of private placements, Albane Poulin, said her multi-sector private credit funds had achieved 3-4% YTD, which was on target to be 1% higher than the Investment-Grade corporate bonds index. For third-party insurance mandates, the focus is not on return but on matching liabilities with stable assets, generating additional income return vs public bonds (i.e. trapping an illiquidity pick-up at the outset), maintaining a portfolio of secure income designed to avoid credit-rating downgrade and default.

For the asset owners, Dixon said that Brit's portfolios had achieved approximately 2.4% for the first six months of 2023, generated from an allocation with 65% in government bonds, mostly US Treasuries. He said it was wise to remember that two years ago, T bills were yielding six basis points. Moving into the current environment, Dixon noted that bond investors have been able to pick up very attractive yields with limited interest rate and credit risk.

Looking ahead, Dixon said that a big question remains as to how to manage exposure given the potential for rates to fall, although this may be less of a risk than markets had been pricing in at the beginning of the year.

Coulman agreed that running yields had been a positive surprise. For Pool Re, Alternative Risk Premia, which it first mandated in 2018, has come good in recent years, after a disappointing start. "Since 2021, the managers have produced some very strong returns – especially one focussed on Value equities," he said.

The awkward surprise for Coulman has been the stickiness of inflation.

Amer said that MS Amlin's recent performance had been 2-2.5% depending on clients' risk profile. He said that real assets, including infrastructure, property and farmland had all surprised on the upside, as had Absolute Return Fixed Income exposure.

Malharkar said that bright spots so far in 2023 for Phoenix had included deploying into private assets at relatively attractive spreads for its book and benefitting from switching between public credit and

> *Markets are only ever between crises - we don't know when or what the next one is going to be," observed Malharkar. "We are mindful of credit risk, focussing on the 'quality' end of the spectrum"*

government bonds. But she noted the importance of monitoring collateral demands on hedges during periods of rates volatility, as it may cause stress. Poulin said that bright spots included the ability to deploy on the private placement debt market despite volumes of new transactions down c.20% year-to-date. "Borrowers need to get used to this new high-rate environment and they are still living on the liquidity raised to get them through Covid," said Poulin. She felt issuers were deferring not only refinancing but also capex as the macro-economic environment was uncertain.

abrdn had also benefited from cross currencies being in favour of sterling investors by taking greater exposure to highly-rated deals in Europe and particularly in the U.S. Outside of the private debt market, Poulin said UK REITs equities have surprisingly outperformed versus Northern European peers as European valuations are somewhat behind the UK in their valuation cycle. She explained that European REITs typically exhibit higher leverage than UK REITs and so are more sensitive to rate increases.

As a provider of retirement savings, including defined benefit and defined contribution pensions, Phoenix is a long-term investor.

For Brit, in the context of less liquid strategies,

Dixon noted that different capital providers have different risk appetites and different approaches to illiquid strategies are required. This feeds through into the conviction of the position that is appropriate for that particular portfolio.

Dunlap picked up on Coulman's point about sticky inflation. "Inflation caught us on the wrong side," said Dunlap. "It's been a real learning experience. We were wrong on the narrative but fortunately, the rest of the portfolio has been diversifying enough."

He explained that the Pacific AM macro strategy doesn't do just a handful of big conviction trades like traditional macro funds. Dunlap and his team concentrate on pricing idiosyncrasies across a lot of markets, including a bit of FX; looking for these smaller trades to contribute incrementally over a three to six -month horizon.

"We do curve trades, spread trades and cross-currency trades," he said. "We like volatility and have monetized it by and large."

Puzzling Debt

At the macro level, Redha said that there are puzzles to be worked through. One was markets' reaction to the surge in fiscal policy, which he said explained much of the last 12 months' behaviour, especially what is going on in yields. "This has been the largest expansion of fiscal deficit outside wartime," said Redha. "The US has avoided a recession – so far! - and risk assets have been supported. The dark side is that there is a bill to pay. The US government has to issue US $1.8trn; US $1trn in the second half of 2023 alone. Financing the deficit is taking the market by surprise."

In terms of its multi-asset strategy, PineBridge has not got into duration but feels yields are becoming attractive on a five-year horizon.

Dixon shared some of Redha's views. He said that the features and consequences of COVID are still to unwind. "In the US there is a large part of the population who are going to have to restart payments, possibly at the same time that excess savings are starting to run down." For Dixon, such headwinds translate into an important question: "is the potential future weakness in the US economy a driver to increase duration?"

Redha said PineBridge believes fundamentals will be grinding lower. "We have to manage the near term because those factors are still working their way through. Quantitative tightening adds to net supply so the Treasury is issuing but the Fed isn't buying."

He said that technical factors (mainly excess issuance relative to demand) kept PineBridge cautious about what will move the long end of the curve. He warned that while the US Federal Reserve thinks its interventions are over, financial markets worry that it hasn't done enough.

He continued that in the regime we are heading to, rates are going to be higher than the previous regime and that there would be less upside from yield compression or duration. Redha cautioned asset owners to be patient in adding duration.

Dunlap echoed these views. "Inflation will stabilise higher. Debt financing becomes a larger part of the overall budget. There is plenty of time for bad things to happen," he warned.

"What will be the metaphorical car crash?" pondered Coulman. "I have many concerns, including levels of government debt over the next two years, the higher cost of servicing that debt and the potential for contagion from High Yield percolating up into BBBs."

Poulin said moving higher in the capital structure by switching out of equity into fixed income was a 'no-brainer' given the convergence of dividend yields and bond yields. "We expect fixed income to attract flows and Investment-grade private credit to capture a significant part of this flow given the ability to generate higher return than public bonds and get stronger security and/or better covenants," she said. "Default rates remains muted for Investment-grade but is increasing rapidly for speculative-grade and smaller companies."

Dixon said refinancing needs to occur. "Covid was a time when property in the US was easily refinanced. Banks are now not in a position to do that."

He noted that in both public markets and private markets, there haven't been too many signs of real stress thus far, but signs of weakness resulting from higher rates are starting to emerge. The panel discussed shocks such as the UK's mini-Budget crisis and the rushed take-over of Credit Suisse, Switzerland's second largest bank. Poulin noted that in the case of Credit Suisse, regulators had "changed the rules": equity investors were bailed out while bond-holders had to take the pain. This inverts the traditional risk capital structure.

"Markets are only ever between crises - we don't know when or what the next one is going to be," observed Malharkar. "We are mindful of credit risk, focussing on the 'quality' end of the spectrum." Given the struggles in major economies with high inflation and low or negative growth, Phoenix is concentrating on security. In spite of the Credit Suisse debacle, Malharkar said bonds were preferred to equities under current regulatory requirements and market conditions. "In private credit, we emphasise the importance of financial covenants," she said.

Dixon agreed that security and quality was important in positioning. It may be more appropriate to be a lender with security than assets owner. "Equity will need to refinance its debt at higher rates," he pointed out. "This has still to play out."

Remembering the gilts crisis of a year ago, Dunlap admitted that it brought him out in sweats. The challenge for traders was that the Bank of England chose to save only one part of the curve. As a relative value strategy, the Pacific AM macro team were trying to find what else was moving at the same speed as 10-year gilts.

Asked about communication with clients – a major criticism of LDI providers and consultants by pension funds during the crisis – Dunlap said that there were direct phone calls between Pacific AM and some clients. He also noted that his strategy was fairly transparent on an ongoing basis, with approved parties able to download data on trades and positions.

Malharkar said that the gilts crisis last year caused a liquidity strain across the market but this had been well-navigated by Phoenix. She pointed out that rising gilt yields mean pension funds were in better shape now than ever in terms of their funding levels. The pensions risk transfer market, in which Phoenix is a leading participant, is extremely busy.

Regarding communications with managers, Malharkar said that this was essential in credit strategies, where many covenants were tested during Covid. "When do you enforce the covenant or a revised policy to bring cashflow back on track? It's a dialogue governed by pragmatism," she said.

Amer's one gripe regarding communications with managers was that many obscure causes of performance, even during RfP processes. He said it could be frustrating when an asset owner wanted to get a fair sense of attribution.

The CAMRADATA insurance CIO panel finished with the topic of ESG. Redha described PineBridge'sfull integration of ESG into its multi-asset strategy and more broadly into its Capital Market assumptions. This covers 50 different markets, with a present view but also a sense of where these markets are headed in terms of ESG, for example its effects on cashflow costs.

Redha responded that ESG integration was not a return-generator. "When you are modeling an asset class, the question is what impact ESG will have on

> *Governments are leaving the financial sector, especially asset owners and managers, to police ESG"*

discounting cashflows," he said.

For Pacific AM, Dunlap said that by virtue of trading high-quality sovereign debt, the global macro strategy was awaiting Article 8 status under the European Union's Sustainable Financial Disclosure Regulation.

Amer said MS Amlin clients were focused on regulatory requirements. He said that whilst it's an exceptionally important topic, he was not convinced that ESG screening added significant value to the return-generating process, given the industry is only just reaching the mature phase.

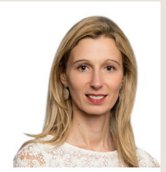
Malharkar described ESG as essentially a risk process, embedded into price expectations. Phoenix has priority exclusions for its investments, regarding diverse activities such as cluster munitions, exposure to drilling in the Arctic Circle and corporate profits from tobacco. They form part of a greater worldview, including the insurer's own Net-Zero trajectory.

With responsibility for strategic partnerships with external asset managers, she did recognise the polarisation regarding ESG between US and Europe-based managers.

Coulman said that ESG has taken on "a life of its own." His opinion was that any well-run company should think about its impact on the environment and society.

But he argued that governments are leaving the financial sector, especially asset owners and managers, to police ESG. He wanted governments instead to implement more categorical rules. "Don't leave shareholders and bondholders to achieve society's sustainability goals," he concluded.

Roundtable Participants



Albane Poulin
Head of European Private Placements

Personal Profile

Albane is Head of European Private Placements at abrdn, based in London. She is responsible for the origination and underwriting of new transactions as well as the portfolio management of existing private placement investments across the different portfolios.

She is also the fund manager of Multi-Sector Private credit funds investing in a range of private credit asset classes including Private Placement, Infrastructure Loans and Commercial Real Estate Debt.

She Joined abrdn in 2011. Prior to abrdn, Albane was at Insight Asset Management as credit analyst covering Utilities and Transportation. Albane has 16 years of experience on the credit markets. She has a Master's Degree in Economics and Finance from the University of Bordeaux (France).

Company Profile

abrdn is a global investment company that helps clients and customers plan, save and invest for the future. Our purpose is to enable our clients to be better investors. abrdn manages and administers £496bn* of assets for clients.

Our strategy is to deliver client-led growth. We are structured around three businesses – Investments, Adviser and Personal – focused on their changing needs. Our capabilities in our Investments business are built on the strength of our insight – generated from wide-ranging research, worldwide investment expertise and local market knowledge. Our teams collaborate across regions, asset classes and specialisms, connecting diverse perspectives and working with clients to identify investment opportunities that suit their needs.

Our Investments business manages £368bn* on behalf of clients - including insurance companies, sovereign wealth funds, independent wealth managers, pension funds, platforms, banks and family offices.

*As at 30 June 2023

abrdn

Shayne Dunlap
Portfolio Manager – G10 Macro Rates

Personal Profile

Shayne Dunlap is a Founding Portfolio Manager of Pacific's G10 Macro Rates team.

Prior to joining, Shayne worked as the Lead Fund Manager at Standard Life Investments. He has worked in fund management and investment banking for 29 years and has actively managed portfolios since 1999 with an excellent track record in G10 government bonds, interest rates and FX.

Company Profile

Pacific Asset Management (PAM) is an independent asset manager responsible for more than $5.3bn* of assets. Fresh and progressive, PAM is rethinking the conventions of how asset management works.

Its single manager business focuses on high-conviction investing in less efficient markets, where it believes active managers can outperform.

Alongside the G10 Macro Rates strategy, it also offers Emerging Market Equity, North American Equity, high quality Global Credit and Longevity & Social Change solutions.

*As at 31st August 2023

PACIFIC ASSET MANAGEMENT

Roundtable Participants

Hani Redha, CAIA

Managing Director, Portfolio Manager, Global Multi-Asset

Personal Profile

Mr. Redha joined the firm in 2012 and leads Strategy and Research for the Global Multi-Asset team. Mr. Redha also contributes to manager selection and monitoring, with a particular focus on alternatives.

Prior to joining the firm, Mr. Redha was an Investment Manager with the Sovereign Wealth Fund of the Kingdom of Bahrain, Mumtalakat where he built and managed their global multi-asset class investment portfolio and oversaw strategic and tactical asset allocation, as well as manager selection across all asset classes.

Prior to that, Mr. Redha held positions as Deputy Head of Global Fixed Income and Deputy Head of Hedge Funds at NCB Capital. He holds a Master's in Chemical Engineering, with First Class Honours, from Imperial College of Science, Technology and Medicine in London and holds a diploma in actuarial techniques from the Institute of Actuaries (UK).

He also is a Chartered Alternative Investments Analyst (CAIA) charterholder.

Company Profile

PineBridge Investments is a private, global asset manager focused on active, high-conviction investing. We draw on the collective power of our experts in each discipline, market, and region of the world through an open culture of collaboration designed to identify the best ideas. Our mission is to exceed clients' expectations on every level, every day. As of 30 June 2023, the firm managed US$148.5 billion across global asset classes for sophisticated investors around the world.

AUM as of 30 June 2023 includes US$48.5 billion (US$19.3 billion equities, US$21.3 billion fixed income, US$7.9 billion multi-asset) of assets managed by joint ventures or other entities not wholly owned by PineBridge Investments. Includes PineBridge Benson Elliot Real Estate AUM of US$3.8 billion.

Daniel Dixon

Chief Investment Officer

Personal Profile

Danny has been at Brit for 15 years and Chief Investment Officer for the last 5 years. He is also responsible for the Treasury function.

Prior to being at Brit he was Head of Investment & Treasury at Equitas Ltd, the run off vehicle set up to manage Lloyd's.

He has an Economics degree from Manchester University, is a Chartered Accountant and Associate Member of the Corporation of Treasurers.

Paul Amer

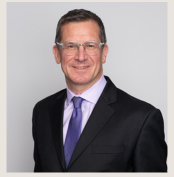
Chief Investment Officer

Personal Profile

Paul has been MS Amlin's Chief Investment Officer since 2019 having joined the firm in 2015. As CIO, he is responsible for the development and implementation of the firm's strategic asset allocation and external manager monitoring.

Prior to joining MS Amlin, Paul fulfilled numerous senior portfolio management roles at Insight Investment and Barings Asset Management with a focus on multi-asset investing. He started his career at State Street Global Advisors. He holds a degree in Economics and Statistics from Birmingham University and is a CFA Charterholder.

Roundtable Participants



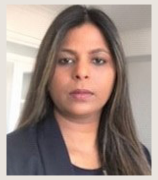
Ian Coulman

Chief Investment Officer

Personal Profile

Ian has been Pool Re's Chief Investment Officer since joining in 2011. As CIO he is responsible for the development and implementation of investment strategy, strategic asset allocation and the monitoring of the range of managers through whom Pool Re invests.

Prior to joining Pool Re as CIO, Ian fulfilled a number of senior investment roles with Butterfield Bank in Bermuda and AIG in London, Boston and Tokyo. Ian began his investment career with the private Swiss bank Lombard Odier.



Reena Malharkar

Senior Manager in the Strategic Partnerships & Research team

Personal Profile

Reena Malharkar has over 20 years' experience in asset management and insurance. She was Head of Portfolio Management at Legal & General Assurance before joining Phoenix Group in 2020.

She is now a Senior Manager in the Strategic Partnerships & Research team, responsible for asset management partner relationships and supports the execution of the Policyholder and Shareholder Investment Strategy.

Reena has an MBA from Cranfield School of Management and a CAIA.

Moderator

Brendan Maton

Freelance Journalist

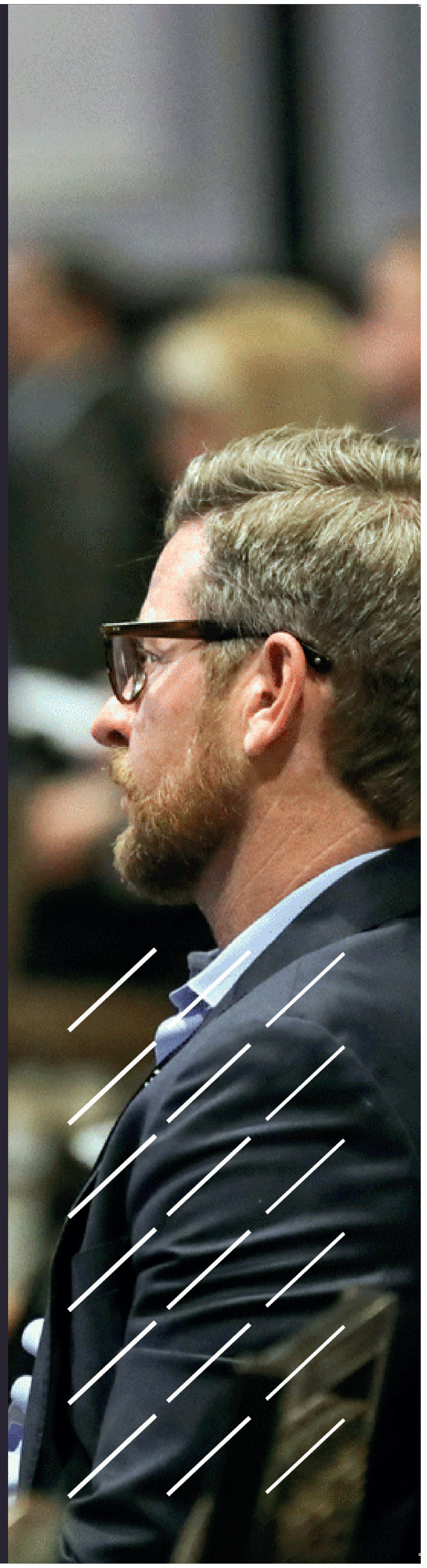
Personal Profile

A highly experienced financial journalist with an expansive network of contacts in the UK and across Europe. Brendan has written about pension schemes and national welfare systems from Finland to Greece for 18 years and understands the retirement savings industry in each European country.

Brendan has interviewed EU commissioners and national ministers; central bankers; pension scheme heads; insurance chief executives; chief investment officers; actuaries; union officials; professional and lay trustees.He worked at Financial Times Business for eight years, finally as editor-in-chief of all international pensions titles.

Brendan has spent the last ten years as a freelancer for a number of publications, including Financial Times, Responsible Investor, Nordic region pensions news and IPE. He is also Chief webcast host for IPE.

Brendan has acted as conference chair for Financial News, the UK National Association of Pension Funds, Dutch Investment Professionals Association (VBA), Corestone, Insight Investment, Marcus Evans, Robeco Asset Management, Sustainable Asset Management (SAM), Towers Watson.



Fund finance: a marriage of convenience for asset owners

> *"Today's environment is a good time for a strategic allocation to assets offering attractive yields with some protection against negative rate"*

Author:

Shelley Morrison, Head of Fund Finance and Asset-Backed Securities

A marriage of market forces has made this an opportune time for asset owners to consider fund finance as an alternative to cash or money-market funds.

This type of finance comprises short-term loans to private market investment funds in areas such as private equity, private debt, infrastructure and real estate. It can benefit both the managers/general partners (GPs) of funds as well as a fund's investors.
GPs require liquidity to fund investment activity and support portfolio companies during various stages of a fund's lifecycle.

One type of fund finance – subscription line loans – are a form of short-term credit used by funds to bridge their investment activity – delaying the drawdown of capital from investors. It offers clarity on the timing of capital calls so investors can manage their cash productively.

Today's environment of high inflation and rising interest rates has driven up yields. That makes this a good time for a strategic allocation to assets offering attractive yields with some protection against negative rate movements – such as from floating rates.

In fund finance, interest 'coupons' are reset in line with a floating reference rate. Frequent interest resets mean floating-rate loans have near-zero duration. If reference rates continue to rise, so do the interest coupons paid on underlying loans – increasing income to investors.

In the United States, the three-month Secured Overnight Financing Rate stands at 5.30%[1], leading to all-in yields of around 6.71% for certain investment grade, short-maturity subscription line facilities.

Importantly in fund finance, rising yields don't necessarily equate to a deterioration in credit risk. Subscription line loans are largely short-tenor, investment-grade assets where credit risk is diversified across a large group of high-quality institutional investors.

Moreover, over-collateralisation – more than enough capital to cover potential losses – and first-ranking senior security are features of most subscription line facilities. Senior debt is paid out first if a fund runs into financial trouble – one of the best defences a debt investor can have.

The diversification of credit risk in a subscription line also frequently equates to low levels of correlation with other asset classes, providing potential diversification benefits for investors at a portfolio level.

Growing demand

Market dynamics drove global demand for subscription financing to more than $900 billion annually by the end of last year[2], and we see reasons to believe this demand will grow.

Allocations to alternative assets, including private market funds, continues to expand. Globally, fundraising in private equity markets reached an estimated $1.3 trillion last year.[3]

Large banks have been the main providers of fund finance. But they have found it difficult to keep pace with demand amid tighter capital constraints from regulators. Many banks have hit internal lending limits and been forced to
syndicate part of their fund finance facilities.

Consequently, banks are reaching out to lending partners including asset managers so that they can continue to support private market clients while meeting their capital requirements.
Recent bank failures in the US and Europe have also removed supply from the fund finance market. As a result, GPs and financial sponsors have become more sensitive to bank counterparty risk and are also seeking to diversify by working with non-bank lenders.

This contraction in supply has been positive for fund-finance providers, enabling them to capture more attractive liquidity premiums. Since the first half of last year, loan margins for short-tenor, investment-grade transactions have risen by about 30 basis points.

Marriage potential

Fund finance is well-suited to asset owners with capital efficient investment objectives due to its credit quality, short duration, yield enhancement potential, uncorrelated returns, low volatility, structural protection and bespoke cash flows that can be used to match liabilities.

But overseeing investments can be challenging given the complexities of credit underwriting and loan documentation, allied to the time-consuming demands of due diligence and cash management.

Institutional investors might turn to asset managers with fund finance experience and broad capabilities in credit and liquidity management, currency hedging and operational, legal and structuring expertise. Well-connected managers can also offer access to bank lending programs for loans in different currencies with a range of tenors and pricing options.

Ultimately, we think now is a good time to participate in fund financing at a time when opportunities are increasing and risk-adjusted returns have become more attractive. It offers potential as a marriage of convenience for institutional investors and asset managers.

[1] Federal Reserve Bank of New York August 2023
[2] abrdn 31 December 2022
[3] Cadwalader – Behind the numbers: the 2022 Fund Finance Market

Unsung Heroes - Cash and Liquid Alternatives?

PACIFIC ASSET MANAGEMENT

After decades of declining government bond yields, fiscal and monetary stimulus implemented during the pandemic years propelled prices higher, as supply struggled to catch up with demand. We have just witnessed one of the sharpest rate hiking cycles by Central Banks in history, which wreaked havoc for bond prices and returns. Now, with yields at highs not seen for over two decades, is it time for investors to increase exposure to government bonds? Or is there a better way to approach this environment?

"At Pacific we take a relative value approach to government bonds, isolating stretched relationships across forward interest rate curves in the G10 currency economies."

In this piece, we will adopt a retrospective approach to evaluate the advantages of employing an alternative investment strategy in bonds.

Government bonds exhibit or are expected to exhibit several characteristics:

- **Guaranteed income that offsets future liabilities** – Asset Liability Management (ALM) has evolved into a stand-alone industry, where future liabilities are calculated and offset with a portfolio of assets providing guaranteed payments. While these calculations are rarely straight-forward, the key takeaway is that bonds price fluctuations aren't the key driver of the investment process.

- **HQLA** – Post 2008 banks and other financial institutions are required to hold a higher amount of High Quality Liquid Assets (HQLA). This has resulted in greater allocations to Central Bank reserves and an increase in treasury holdings on banks' balance sheets. Nevertheless, the buying decisions are not primarily influenced by HQLA prices."

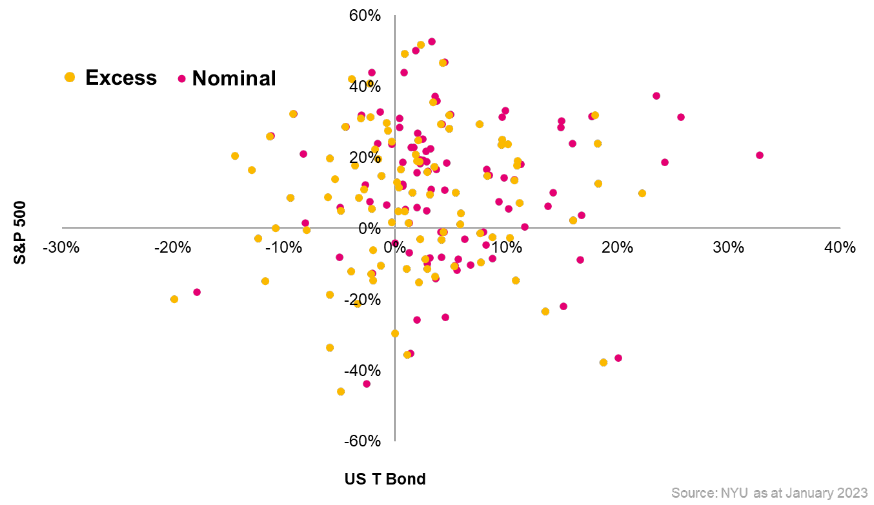
- **Income and Capital Appreciation** – Analysing the data spanning the last 100 years of nominal, real and excess returns generated across different assets reveals a strong correlation between returns generated by US Treasuries and the prevailing cash rate. Median excess returns of US Treasuries have only been positive when risk-free cash returns were below 2%. During a typical year in which cash returns exceeded 2%, excess returns of US Treasuries were negative.
Additionally, when cash returns were greater than 4% the standard deviation of US Treasury returns increased significantly.

Shayne Dunlap, Portfolio Manager – Pacific G10 Macro Rates.

- **Diversification** – The diversifying qualities of government bonds became a generally accepted way to protect portfolios over the last four decades. These qualities worked relatively well through periods of low and stable inflation but capitulated in 2022. Looking again at the last century, when comparing US Treasuries to the S&P 500, the diversification benefit appears clear with US Treasuries generally performing strongly during equity market weakness. However, the picture changes dramatically when cash is considered. As illustrated opposite, the excess return profile of US Treasuries is notably more symmetrical, and the diversification benefit is significantly diminished.

PACIFIC ASSET MANAGEMENT

EXCESS VS. NOMINAL RETURNS



Source: NYU as at January 2023

As indicated above, the diversification benefit provided by investing in government bonds is reduced when return is considered in excess to cash. When cash returns are high, excess returns of government bonds diminish and exhibit much higher levels of volatility.

Available cash returns must not be ignored even when government bond yields are reaching multi-decade highs. History shows that during periods of high interest rates, government bonds do not necessarily enhance portfolio returns or provide diversification when compared to cash.

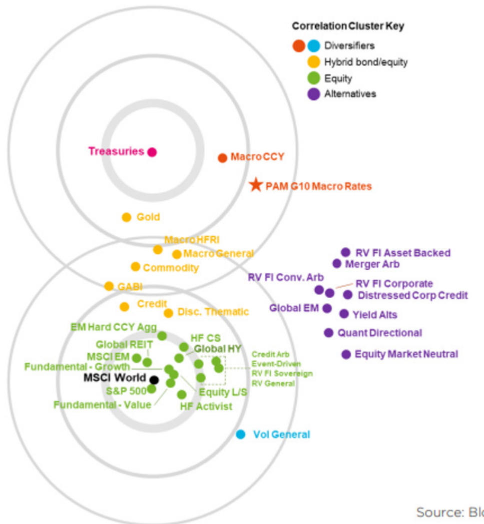
The attractiveness of bonds must be viewed holistically and in the context of cash returns. As we have discussed, a high-rate environment which we currently find ourselves in suggests more volatile and disappointing excess returns from government bonds.

At Pacific we take a relative value approach to government bonds, isolating stretched relationships across forward interest rate curves in the G10 currency economies. Inflation markets and volatility surfaces also provide opportunities for excess returns and diversification that can be exploited in a relative value context. Unlike a long only proposition, our approach facilitates the ability to maintain cash reserves, picking up the overnight cash rate while targeting a "cash-plus" absolute return. As shown below, this results in a return profile uncorrelated to major asset classes and well-known liquid alternatives.

SOME ALTERNATIVES PROVIDE BETTER DIVERSIFICATION THAN OTHERS

Correlation 2 polar system (more distance = better diversification)

From 2006 to 2021



Source: Bloomberg and Pacific Asset Management

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Private Credit Direct Lending: Durability to Weather Challenges

"We view experience as a critical differentiator in the current environment, along with highly disciplined credit and sector selection and strong partnerships with private equity sponsors."

The historically durable "all-weather" attributes of US private credit direct lending, which has successfully weathered challenging macro periods in the past, have come to the fore in the current high-interest-rate environment. While merger and acquisition (M&A) activity is expected to cool somewhat, private equity sponsors appear to be pivoting toward lending opportunities with existing portfolio companies in support of growth. New vintages in mid-market private credit also look poised to benefit from pullbacks in regional bank lending.

Overall, we believe the opportunity set of deals remains robust and deep enough to enable a selective approach, including both new and add-on lending opportunities. We view experience as a critical differentiator in the current environment, along with highly disciplined credit and sector selection and strong partnerships with private equity sponsors.

Lenders employing an approach that focuses on safety, selectivity, and market leadership are believed to drive stable performance through challenging market conditions, and over time. With current yields of roughly 12% in lower-middle-market direct lending[1] and a more lender-friendly environment (with better pricing and tighter terms), market participants see the asset class as well positioned for the rest of the year and continues to offer attractive risk-adjusted return potential.

Current Key Convictions of Sophisticated Lenders

1) Lower-middle-market companies with long operating histories, leadership positions in their market segments, and seasoned management teams remain compelling investments.

While private credit provides many different "flavors," historically, lower-middle-market companies (with EBITDA of $7.5 million to $30 million) that have long operating histories, leadership positions in their market segments, and seasoned management teams at the helm have shown to be compelling investments. Given this history, many long-tenured market lenders have focused on this traditional lower-middle-market direct lending – with conservative structures, traditional sectors, and investing alongside experienced private equity sponsors.

Businesses that have shown stability and durability during both stronger and weaker environments and that benefited from real cash generation and a competitive "moat" – i.e., distinct relevance and value to their client base – have been viewed as stable, quality opportunities.
When paired with a conservative approach to portfolio construction and underwriting, lenders who target these types of opportunities have historically stood to garner durable risk-adjusted return potential across macroeconomic environments.

Sector selection also matters – and those service-oriented business models have tended to perform better in a high-inflation environment (as they are generally less sensitive to inflation relative to manufacturing companies). Broadly speaking, the companies with the strongest prospects appear to be those with long operating histories (measured in decades, not years) that display leadership in their market segments, with seasoned management teams and leading private equity sponsors at the helm.

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2) M&A is likely to weaken, but lending opportunities are still plentiful.

A weaker macroeconomic backdrop and the resulting hit to earnings is likely to curb M&A, with PE sponsors expected to have longer holding periods for their investments and to be slower to sell portfolio companies into an environment in which lower earnings mean companies command lower valuations in the market. Counteracting this has been more stable activity with first-time buyouts, where family-owned businesses continue to need access to growth capital.

Given these dynamics, valuations for quality businesses are expected to remain high given the slower M&A environment, with fewer high-performing companies coupled with high demand for quality assets. That said, lending opportunities to companies in the lower-middle-market appear to remain open and positive – especially when including add-on volume as sponsors pivot to opportunities with existing portfolio companies. Approximately $120 billion of core and lower-middle-market loan volume closed in the 12 months through the end of March 2023 alone[2] a level of deployment that denotes a deep opportunity set. Further, when considering the level of private equity fund dry powder, combined with debt maturities coming due for existing middle-market loans, the financeable opportunity set in the next five years represents approximately $200 billion of new loan demand in the lower-middle-market segment.

This depth enables a selective approach with high standards for quality that seeks to deploy a small fraction of the total volume on an annual basis.

3) In light of current macro challenges, lenders must look under the hood at a portfolio's "cushion" – namely, fixed-charge and interest coverage, variable versus fixed costs, and leverage ratios.

Liquidity and transparency remain top of mind for lenders, with a focus on companies' earnings and cash flow, and three key aspects of an investment's "cushion" are considered critical.

First, fixed charge and interest coverage ratios largely determine whether a company can cover its debt service – in addition to capex, working capital, and other operating expenses – if conditions become more challenging. Many view an interest coverage ratio at or above 2x and a fixed-charge ratio of at least 1.25x as healthy and providing the flexibility needed to weather a downturn.

Second, variable cost structures, which can be flexed as needed to preserve margins and free cash flow, can be a positive relative to high-fixed-cost businesses in today's environment, when inflation and remaining supply constraints may make it difficult to cut costs.

And third, investments with robust equity cushions and moderate leverage are expected to fare better. In transactions with a more significant equity investment, the sponsor is more inclined to focus on supporting that investment with additional equity capital. Moreover, the higher the leverage, the greater the interest rate sensitivity. While private credit direct lending typically benefits from a "higher" rate environment (as a floating-rate strategy based on a spread over a base rate), excessive leverage can compress earnings and strain liquidity. The asset class appears well positioned in the current rate environment, assuming no further significant increases.

4) Insurers are well positioned to reap private credit's potential benefits.

Insurers' strong capital positions, high-quality investment portfolios, and predictable liabilities put them in a strong position to capture the illiquidity premium of private credit. To optimize their private credit allocations, insurers must partner with managers who prioritize income generation and capital preservation and who can meet insurers' reporting and accounting requirements. For firms seeking to leverage their Bermuda-based balance sheets, partnering with managers that can deploy capital-efficient vehicles or secure ratings on the underlying loans from recognized external rating agencies can better align regulatory capital with the underlying loans' economic risk.

Footnotes: 1 Source: KBRA Direct Lending Deals. March Q1 2023 Insights & Outlook U.S. Sponsored Deals. Represents yield for lower-middle-market deals, defined as those companies with less than $20.0 million in EBITDA.
2 Source: Refinitiv LPC's 1Q'23 Middle Market Sponsored Private Deal Analysis. As of April 2023.

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