Allianz Global Investors

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The Case for Short Duration Credit Strategies for Insurers

Within public credit markets, insurance companies allocate significantly to corporate bonds as part of their core book to provide a pickup over government bonds. As of end of 2023, insurers in the main EEA's markets[1] have been directly invested in Government bonds and Corporate bonds with almost 1/5th of their General Account. Additionally, about a third of their indirect investments have been in fixed income funds. Looking at the last available data for the UK, the direct investments in Government and Corporate bonds have been roughly 1/8th and 1/6th, respectively, only. However, the additional indirect allocation to public debt is more significant. Typically, the main focus is on investment grade bonds so that credit risk is not significantly increased. Sometimes there is an allocation to high yield, but this is usually low. This type of asset allocation—apart from being sensible from an economic risk-return standpoint—may also be driven by the amount of capital that needs to be allocated against an investment under the spread risk module of Solvency II. In the Standard Model, these capital charges are simplistically a derivation of credit rating and duration.

We find it interesting that with inverted yield curves and relatively tight credit spreads, a short dated, broadly diversified credit strategy, that includes some Solvency II unfriendly instruments such as high yield or securitised assets, could provide a higher yield and spread per unit of capital than a more traditional investment grade index. It is likely that a dedicated mandate could optimise this further.

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Figure 1: Yield & OAS/Capital Charge under Spread Module

USD	Duration	Charge	Yield %	Spread bp	Yield/ Charge %	Spread/ Charge bp	Bloomberg mean 30-day 5y volatility %
A index	6.07	6.97	4.35	88	0.62	12.6	5.7
BBB index	5.90	12.39	4.69	125	0.38	10.1	5.7
BB index	3.92	15.52	5.92	224	0.38	14.43	5.0
Allianz Global Multi-Asset Credit	2.95	9.02	5.60	202	0.62	22.4	1.7

Source: ICE indices and Bloomberg Spread Risk Model 27th August. Note the spread risk calculation is Bloomberg derived and applied to each line item. The calculation may differ from other calculation methods but has been applied consistently across the indices and the sample fund. The spread risk module is only one part of a SCR calculation.

For illustration only, we have looked at Allianz's Multi Asset Credit Fund, which has an average rating of BBB- but includes some high yield and securitised instruments (hence a higher charge than one would expect from vanilla BBB with 2.9 years modified duration) but by virtue of its short duration compared to standard indices benefits from a lower capital charge as well as showing lower volatility of returns over the last 5 years (Fig.1).

Our analysis of current market levels, below, suggests that there is a compelling reason to take spread risk on the short end of the curve, while taking duration rather by investing in, for instance, Core Infrastructure Debt to keep the duration gap between assets and liabilities closed. Given both economic and political uncertainties, we believe that insurers can benefit from such a barbell strategy in steering their fixed income portfolio compared to investing in long-dated credit instead.

The barbell also helps those insurers who are actively steering their IFRS or local GAAP financial results each year. Taking longer-dated public credit obviously exposes them to higher spread and rates volatility and hence to mark-to-market volatility. Even under book value accounting, those employing a buy-and-hold strategy can be caught off guard like in 2022 when larger portions of the fixed income books have become de facto illiquid given the size of unrealised losses accumulated. The risk of "fallen angels" and other credit events that can force some of these investors to reduce positions at the worst time possible is also quite high. Hence, insurers who invest into longer-dated credit need to reserve an annual "P&L buffer" for situations where they are forced to sell positions at a loss. Short-dated credit positions, in contrast, do not drop as much in case of a credit event given their lower spread duration facilitating P&L stability and a smoother steering thereof.

Many insurers today are still suffering from unrealised losses on their fixed income books that were caused by the steep rise in base rates over the past 2 years. With time passing, they rebuild their ability to trade their whole fixed income book more actively. But during this multi-year process, many remain focused on liquidity as well as accounting-stability of their new investments. Short-dated credit can provide exactly this: Low spread- and low interest rate-induced mark-to-market risks.

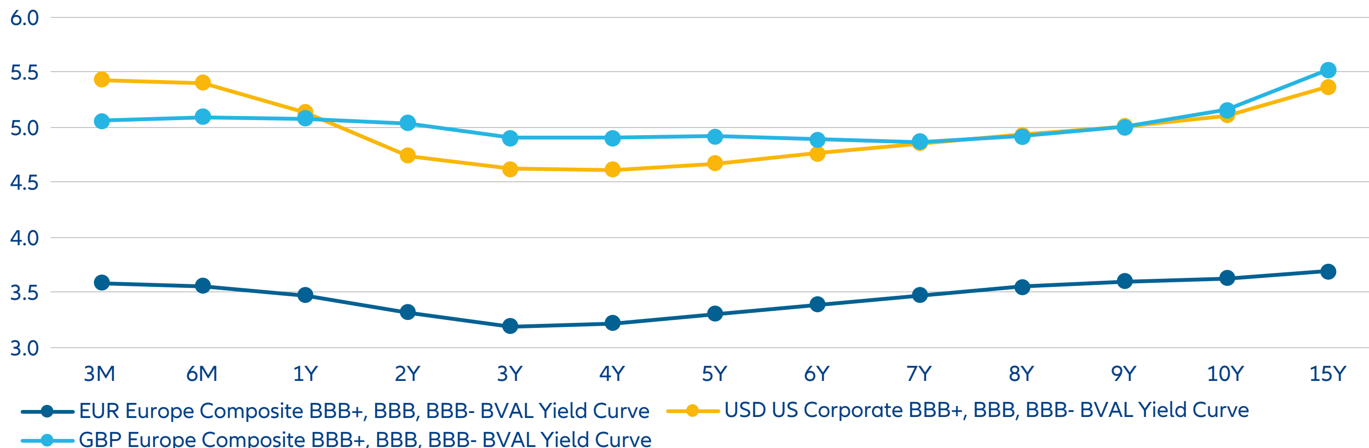
An update on The Case for Short Duration Credit

In May 2024, we made a case for short duration credit strategies compared to longer duration credit on the premise that credit spreads were close to tights, yield curves were inverted with more momentum expected in the front end of curves than the long end, and general geopolitical risks.

Since then, longer-dated strategies have outperformed, driven by the interest rate duration element, while credit spreads have widened. This interest rate-driven performance was due to the narrative in global markets shifting again, with interest rate cut expectations being pulled forward in response to less robust economic data. The discussion has also begun to look at the unwinding of the Japanese Yen carry trade. While we do not believe this is an immediate threat to credit; if we do see an unwind, it would put pressure on credit spreads.

In summary, the recent news flow has been marginally negative for credit risk and underlines our view that if short-dated credit yields are supported by the shape of the yield curve, one does not need to extend duration just to capture more spread. As can be seen in the chart below (Fig.2), in both the US and Europe, 2-year credit yields are similar to 5-year yields and the incremental yield to extend to 10 years is marginal.

Figure 2: BBB USD and Euro Credit Curves



Source: Bloomberg, as of 27th August 2024. Past performance does not predict future returns.

No decision is as easy as a simple chart. It is important to separate spread duration and rate duration – the sensitivity to a move in credit spreads and the sensitivity to a move in interest rates.

Taking interest rate duration first, a simple way to look at this is the 1-year forward curve (Fig.3).

Figure 3

USD Treasury Forward Curve

		Forwards		
Tenors	**Spot**	**6 months**	**1 year**	**2 year**
1 month	5.31135	3.84258	3.38717	3.32951
3 months	5.10152	3.85494	3.39677	3.33878
6 months	4.88517	3.79106	3.43935	3.38039
1 year	4.34325	3.6167	3.40702	3.35881
2 years	3.88328	3.49899	3.38332	3.45078
5 years	3.65404	3.54719	3.55266	3.65721
10 years	3.82595	3.80325	3.8425	3.97406

EUR German Sovereign Bond Forward Curve

		Forwards		
Tenors	**Spot**	**6 months**	**1 year**	**2 year**
1 month	3.35812	2.65724	1.95444	1.89195
3 months	3.20376	2.62464	1.95763	1.80766
6 months	3.17135	2.48043	1.97859	1.80421
1 year	2.82802	2.23075	1.96246	1.77851
2 years	2.39975	2.05482	1.87132	1.9682
5 years	2.1743	2.04041	1.97078	2.01999
10 years	2.27815	2.25996	2.27781	2.37492

Continued overleaf...

Figure 3 (cont'd.)

GBP UK Gilt Forward Curve		Forwards		
Tenors	**Spot**	**6 months**	**1 year**	**2 year**
1 month	4.05531	4.07613	4.07682	3.74384
3 months	4.9742	4.09004	3.95954	3.75557
6 months	4.90111	4.07733	3.90815	3.69117
1 year	4.49338	3.99356	3.82572	3.36632
2 years	4.16601	3.85771	3.60005	3.42587
5 years	3.90034	3.74585	3.67441	3.74899
10 years	4.0019	3.97622	3.99676	4.09379

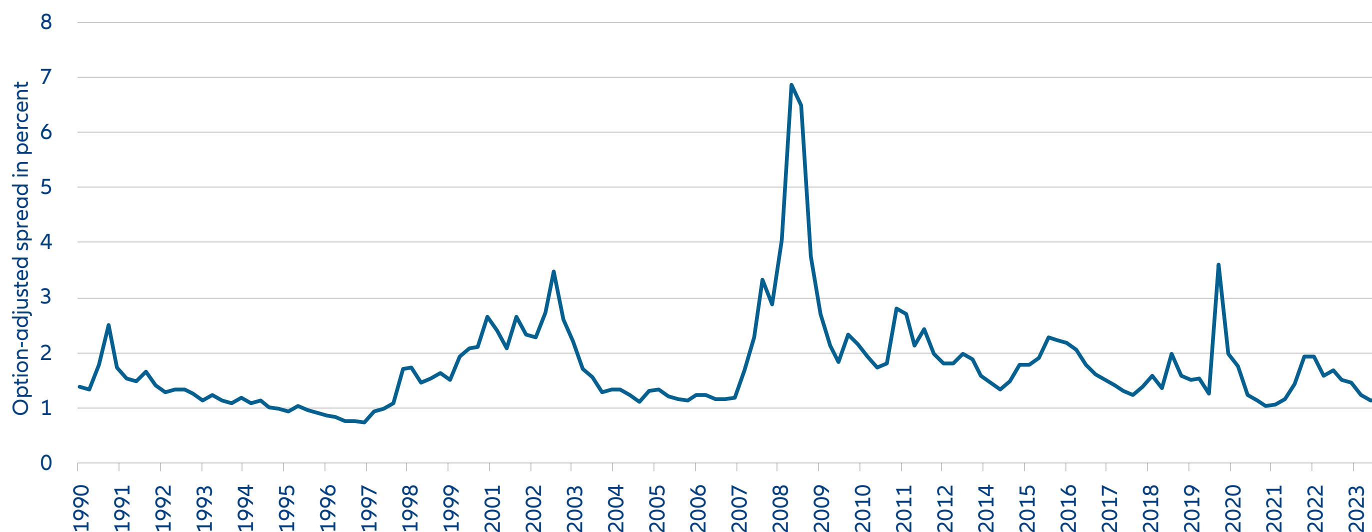
Source: Bloomberg, as of 27th August 2024. Past performance does not predict future returns. Securities mentioned in this document are for illustrative purposes only and do not constitute a recommendation or solicitation to buy or sell any particular security. These securities will not necessarily be comprised in the portfolio by the time this document is disclosed or at any other subsequent date.

Using the term points above, if we compare the 2-year, 5-year and 10-year points for the USD Treasury Forward Curve (tenor rows on the y-axis) of current spot yields (Spot column on the x-axis) with the forward yields starting in a year's time (1-year column on the x-axis), the market expects 2-year yields to be 50bp lower, the 5-year to be 9bp lower and the 10-year 2bp higher. Similar trends can be seen in the Euro and Sterling curves.

The expected benefit to returns of the move lower in rates is simplistically the maturity times the move, i.e., 100bp, 45bp and -20bp respectively, although forward curves are not always the best predictor of returns. Combining the bigger impact with higher yields at 2 years than 5 years should favour the 2-year point. While yields are the same between 2 and 10 years, there is still more of an impact from the forward curve at the 2-year point. So, from a rates perspective, forward curves are suggesting that one shouldn't underperform by investing at the 2-year point.

If a concern is that yields are high and one should lock them in, a quick review of estimated 5- or 10-year yields in the future (Fig. 3), shows that currently the market expects these to be higher in USD and Euros, so there should not be a fear of missing out from a rates perspective away from some a small opportunity in GBP two years out.

Figure 4: BBB USD spreads OAS bp June 1990-present



Source: Bloomberg, quarterly data, as of 30th June 2024. Past performance does not predict future returns.

Moving to the credit part of the discussion. Generally, a credit investor should maximise spread duration when credit is cheap and reign it back when expensive. Looking at BBB spreads since 1989 (Fig.4), the average was 168bp and the low 72bp. Since 2011 (to exclude the Great Financial Crisis), the average was 167bp and the low 100bp respectively. Today, we are at 124bp, so at the tighter (but not egregious) end of ranges. This suggests that there should be little fear of missing out by not being at the long end of spread durations and if one is more bearish on the economic/political outlook there is a reasonable case to be at the shorter end of spread durations.

Summary

With attractive yields and spreads per unit of capital, we believe a barbell short duration approach makes sense for many insurers as a long-term allocation. Strategically, market uncertainty and the shape of the yield curve makes this more compelling on a yield basis but we believe the spread argument is likely to last longer due to the way capital charges are calculated. In addition, a global multi-sector credit strategy typically is more diversified than a more traditional index, possibly allowing less exposure to regional economic or interest-rate cycles or any inherent index biases, and it may benefit from lower volatility due to lower spread- and interest-rate duration than standard indices. While we have shown a fund for illustrative purposes, it is relatively simple to adapt this approach specifically for insurance clients by avoiding securities with penal solvency charges and optimising returns within the investment universe to match individual solvency regimes.

1 Source: EIOPA, Insurance Statistics; Markets: AT BE DE DK FI FR IT NL NO SW; as of December 2023

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