A Note on the Use of High-Yielding Fixed-Income Sectors for Insurers

Introduction

The insurance industry continues to feel the impact of low interest rates on investment portfolio yields, product design, and reported profitability.

Recently, Western Asset has written at length about fixed income sector opportunities to meet investors' desire for higher yield and income in the current low-rate environment.

Insurers must evaluate asset allocation recommendations within the context of their overall business. This brief note supplements Western Asset's investment sector recommendations with considerations specific to the insurance industry, such as insurance liability characteristics, regulatory capital requirements, and rating agency considerations.

We review the investment objectives and constraints faced by many insurers and outline a framework to evaluate the use of higher-yielding sectors in an asset allocation strategy that is appropriate for the unique needs and objectives of each company.

The Importance of Income

A recent Western Asset paper, "The Importance of Income," reviews the current opportunities and merits of high-yielding fixed-income sectors, including:

- **High-yield debt**
- **Emerging market debt (dollar sovereign, corporate and local currency)**
- **Bank loans**
- **Non-agency MBS**
- **Investment-grade debt of strategically important banks**

The paper concludes, "Based on historical analysis, as well as current fundamentals and valuations, we believe that investors should consider allocating to high-yielding fixed-income sectors as an equity alternative and an attractive investment opportunity." [1]

The Insurance Company Context

Insurance investment portfolio strategies must incorporate a firm's liability characteristics as well as regulatory, rating agency and other considerations. Insurance companies are leveraged investors. They "borrow" policyholder premiums to purchase investment assets and service their "debt" by paying policyholder

[1] Other recent Western Asset publications that discuss these sectors include:
"Key Investment Ideas for 2012", Western Asset Management Company 2012
"Emerging Market High Yield: Understanding an Evolving Asset Class", Western Asset Management Company 2012
"Emerging Market Corporate Bonds: Seizing Opportunities in the 21st Century", Western Asset Management Company 2012

benefits. Each investment strategy seeks to optimize the risk/return profile of the difference between asset and liability values and returns, i.e., of shareholder equity.

Before a customized asset allocation strategy can be formulated, the creation of a market proxy for insurance liabilities is required. The market proxy is a set of traded instruments that replicates expected liability cash flows and risk exposures. As insurance liabilities are not traded in a liquid market, the market proxy provides an estimate of their market factor sensitivities and return performance. Asset allocation strategies then maximize excess return over the liability proxy for specific levels of risk.

Asset Allocation Framework

An asset allocation framework seeks to optimize an objective function within a company's specified constraints. Several examples of measures used to specify an objective function and relevant constraints for insurance portfolio strategies are shown in the table below.

Return Measures	Risk Measures	Other Considerations
Economic income/ROE Accounting income/ROE	Total return volatility Accounting income volatility Downside stress test loss Value-at-risk	Economic capital requirements Rating agency capital requirements Regulatory capital requirements Realized gains/losses Accounting income
Objective Function Examples	**Constraint Examples**	
Maximize total ROE per unit of risk Maximize after-tax reported income	Minimum capital ratios Minimum income levels Maximum stress test loss Maximum ROE volatility	

Customization

Each company's objective function and constraints are management decisions that can vary significantly from company to company. Even within the same company, goals can change over time depending on the market environment and developments in the company's business. In today's low-rate environment, for example, companies may put more of an emphasis on maximizing yield and income versus total return.

Conclusion

Optimization models can be used as tools to identify asset allocation strategies that meet an insurance company's stated objective function within desired constraints. This allows insurers to take advantage of higher-yielding sectors by selecting and sizing positions appropriately for their liability characteristics and risk appetite. Western Asset works regularly with insurance clients to construct investment sector risk/return assumptions and develop customized investment strategies tailored to each client's objectives and constraints.