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STRATEGY INSIGHT
LONG-ONLY CONVERTIBLE BOND INVESTMENTS FOR INSURANCE COMPANIES

The current macroeconomic environment is increasing pressure on insurers to move towards growth-generating strategies. In this space, we believe convertible bonds can provide risk diversification and lead to strong balance sheet characteristics.

In summary

We discuss the asymmetric return profile of convertible bonds and why we believe this makes them a good fit for the business model of traditional life insurance companies.

We reflect on the opportunity to position balanced convertible bonds within an insurers' return-seeking portfolio rather than the matching portfolio, and demonstrate that they can represent a valid alternative to equity and high yield corporate bonds providing not only diversification benefits but also efficiency from an accounting and regulatory balance sheet perspective.

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A match for an asymmetrical business model

The business model of traditional life insurance companies is characterised by a clear asymmetry between shareholders and policyholders. The claims (or financial guarantees) of policyholders must be honoured regardless of the insurance company's investment returns and profitability:

- When an insurer's investment returns are sufficiently high, policyholders are paid their guaranteed return and a potential bonus (with-profit business) while shareholders benefit from the profitability of the business through dividend payments and capital appreciation
- Conversely, if the investment returns of the insurer are insufficient then the balance sheet (and by extension, the shareholder value) is damaged by the use of the capital base to match the claims of policyholders.

There is a clear case of asymmetry, since there is a contrast between the guaranteed minimum return of policyholders and the fluctuating nature of the insurer's financial investments.

Given their asymmetric return profile, convertible bonds are often seen as a natural candidate to deal with the insurer's conundrum.

In essence, a convertible bond is a hybrid instrument composed of a bond and an option to be converted into an underlying share. From an insurer's perspective, we can see the parallel between their needs and the structure of the convertible bond. The fixed income component can be used to cover the claims and financial guarantees of policyholders. The equity call option gains value in equity upturns (and rising volatility), and can help grow the insurer's assets.

We believe insurers will naturally prefer the most solid credit profiles within the convertible bond asset class, in order to guarantee the long-term asymmetry of their investment, while portfolio managers specialising in long-only convertible bond strategies should look to maximise the asymmetric return profile of their portfolios to attract assets from insurers.

In most market conditions the search for asymmetry will lead to a focus on "balanced" convertible bonds. These maximise the convexity of the instrument through a combination of a high level of bond protection (the bond floor) and meaningful correlation to the underlying share through the call option (the delta).

In our view, balanced convertible bonds should be part of the return-seeking portfolio

Most insurance companies tend to segment their investments between a matching portfolio and a return-seeking portfolio. The matching portfolio backs the liabilities and is mostly composed of high-quality bonds (generally government and investment grade corporate bonds) plus interest rate swaps and options for duration/convexity risk management. The return-seeking portfolio is intended to generate growth and is typically made up of equities, alternatives and other less liquid instruments.

Convertible bonds, thanks to their asymmetrical profile, have the advantage of offering both matching and return-seeking characteristics. The question is: where do they fit best?

We believe the positioning of convertible bonds within the investment portfolio should depend on their equity exposure, clearly the growth-engine of the instrument:

- **"Defensive delta" convertible bonds** are characterised by low equity sensitivity and a fixed income profile. We think they naturally belong to the matching portfolio (assuming they are high-quality issuers).
- **"Balanced" convertible bonds,** on the other hand, provide a degree of protection in market downturns but have a meaningful sensitivity to the underlying stock price. We think they naturally belong to the return-seeking portfolio.

Over the past few years, Quantitative Easing (QE) policies have led to exceptionally low interest rates. As a consequence, the yields offered by high-quality government bonds have frequently been insufficient to enable insurers to match obligations to policyholders. Insurers have therefore participated in the general herding towards credit and less-liquid assets.

In the current macro-economic environment, and given the importance of the guarantees offered in the past, there is an increased need for insurers to generate growth within their balance sheets.

While most have used equities and alternatives as the growth engine within their investment portfolios, many have begun to see convertible bonds as an attractive option. An allocation to convertible bonds will not only increase diversification within the return-seeking portfolio but also provide growth potential in an equity upturn. Besides their asymmetrical profile and the diversification benefits, we think convertible bonds also prove to be efficient from a balance sheet standpoint.

While achieving risk diversification, convertible bonds offer strong balance sheet characteristics

As we have seen, insurers need to generate growth within their balance sheets. However, since most return-seeking strategies tend to have reduced matching benefits, they can easily lead to significant balance sheet volatility and high regulatory capital charges. With a reduced regulatory capital charge and solvency ratio volatility, we think "balanced" convertible bonds should be looked at much more closely by regulated investors such as general and life insurers.

Figure 1 compares balanced convertible bonds with equities and high-yield corporate bonds over the past 10 years.

From the **regulatory** balance sheet perspective, we consider the following metrics:

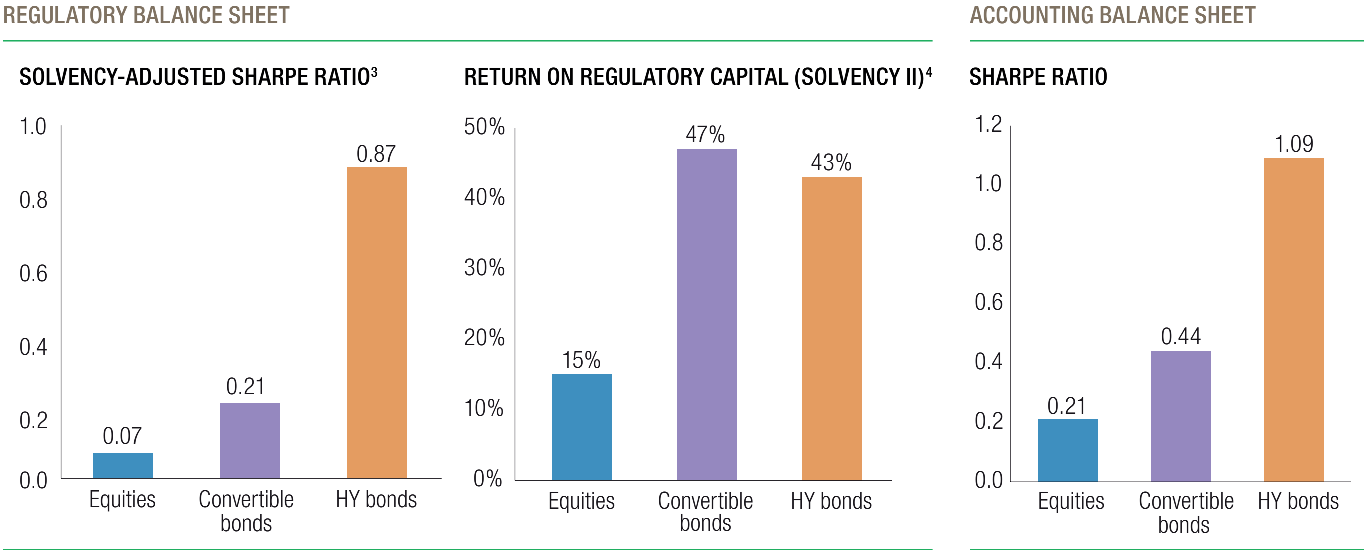
- **Solvency-adjusted Sharpe ratio**, measuring the return of the investment versus the level of solvency ratio volatility it generates.
- **Return on regulatory capital under Solvency II**, measuring the return of the investment versus the Solvency II capital charge it implies.

From the **accounting** balance sheet perspective, we look at:

- **Sharpe ratio**, measuring the investment's return versus the level of net income volatility it generates.[1]

[1] We assume all investments are recorded as Fair Value to Earnings.

FIG. 1 – REGULATORY AND ACCOUNTING BALANCE SHEET CHARACTERISTICS[2]



High yield corporate bonds have had an exceptional decade. They were the top-performing asset class in terms of risk-adjusted returns outperforming investment grade corporate debt, sovereign debt, equities and convertible bonds.[5] However, in our opinion, these results will not be easy to repeat. The exceptional rally of the asset class appears to leave high yield corporate bonds with limited potential in terms of spread-tightening and carry-trade. At current market levels, the risk-reward potential of this asset class may not be obvious with the carry not necessarily compensating for the level of volatility.

Some insurers have therefore already reviewed and reduced their allocation to high yield corporate debt and some have already added an allocation to convertible bonds, reflecting a wish for positive diversification in the investment portfolio. In addition to diversification, an allocation to convertible bonds provides a number of other benefits:

- A lower exposure to rising interest rates (lower sensitivity to interest rates) than straight debt
- A generally better quality of the issues (lower credit risk) than high yield bond portfolios
- A higher return on regulatory capital than both equities and high yield corporate bonds.

For an increasing number of insurance companies convertible bonds have thus become an attractive alternative within their return-seeking portfolio, particularly at a time of tight spreads, rising volatility and demanding regulation.

For illustrative purposes only.

[2] Source: Bloomberg and Barclays POINT. January 2005 to July 2015. For Equities we use the MSCI Europe EUR Index, for Convertible Bonds we use the Thomson Reuters Europe Focus Hedged Convertible Bond Index, for HY Bonds we use the Barclays EUR High Yield Index.

[3] The Solvency–Adjusted Sharpe ratio is computed assuming a 60% hedging ratio and a duration of 10 years for the liabilities. It is defined as the excess return (in excess of the liability benchmark) divided by the volatility of the solvency ratio.

[4] Average annual Return on Capital over the period considered. The Solvency Capital Requirement (SCR) is the aggregate of the SCR for equity risk, interest rate risk, spread risk, and the diversification benefit under Solvency II.

[5] Source: Barclays Global High Yield Corporate Credit index, Barclays Global Corporate Credit index, MSCI Total Return index and JPMorgan Aggregate Bond index (all currency-hedged).

When compared to long-only equity investments, convertible bonds can provide protection in market downturns (bond floor) and correlation to equity upside through the embedded conversion option. It is therefore not surprising to see that balanced convertible bonds lead to superior accounting and regulatory balance sheet characteristics.

Conclusion

We believe that there is a strong rationale today for insurers to include convertible bonds within their balance sheets. Faced with challenges such as a low-yield environment and the importance of guarantees to policyholders, they are coming under increasing pressure to move towards growth-generating strategies.

Our view is that convertible bonds can be an answer for insurers – an asset class which fits their business model well, which increases diversification, and leads to strong characteristics on both a regulatory and an accounting balance sheet perspective.

Find out more at www.loim.com or email us at loim-funds@lombardodier.com

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