MAY 2019

AAM
Insurance Investment Management

Improving Investment Income Within the Medical Professional Liability Industry

Michael McLaughlin, CFA | Portfolio Manager

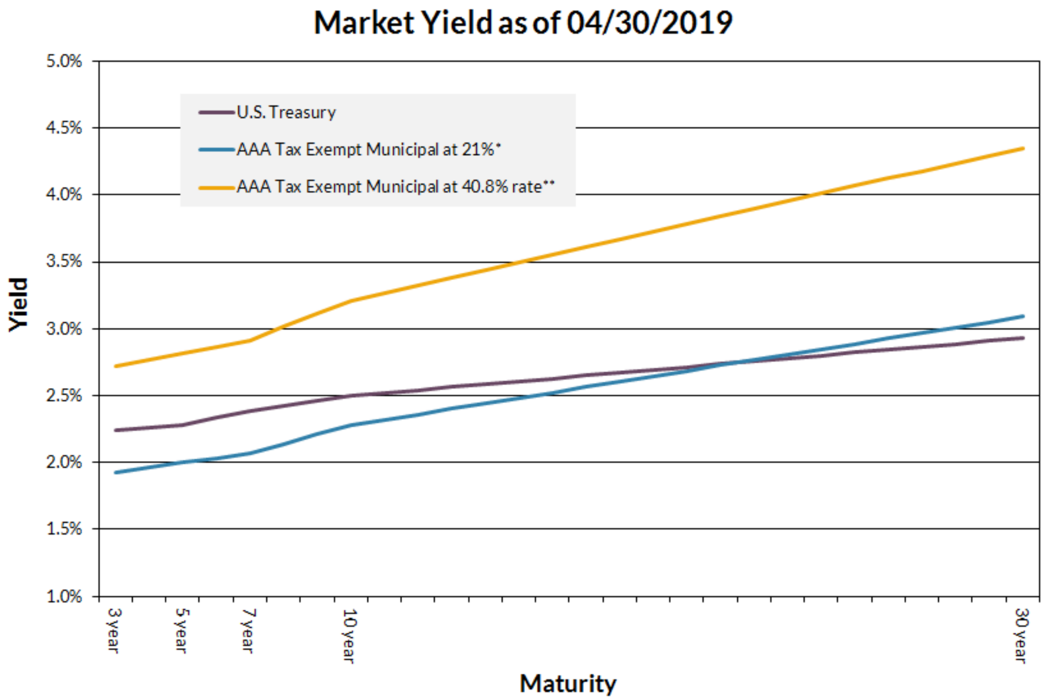
Industry transitions

The medical professional liability (MPL) industry has been going through a period of tightening margins, soft pricing, and decreasing investment yields as detailed in AAM Insurance Strategist's Peter Wirtala's AAM Insight published in February 2019. As these factors are pressuring profitability throughout the industry, there are ways to improve the investment income generated from the fixed income portfolio that could benefit MPL insurers. The industry owns an allocation to tax exempt municipal bonds that have become unattractive versus other taxable sectors after the tax law change in 2018.

Tax law change

As part of the Tax Cuts and Jobs Act that was passed at the end of 2017, the tax rate for corporations was lowered from 35% to 21%. This change reduced the after tax yield on tax exempt municipal securities making them unattractive for insurance companies in relation to other taxable fixed income sectors. The largest buyers of the tax exempt municipal debt are retail investors. Since individual tax payers have a higher tax rate relative to corporations, they receive a larger tax advantage for owning tax exempt securities. Exhibit 1 shows the difference in tax adjusted yields for AAA rated tax exempt municipals for individuals and corporations.

Exhibit 1: Market Yield - Individuals vs. Corporations



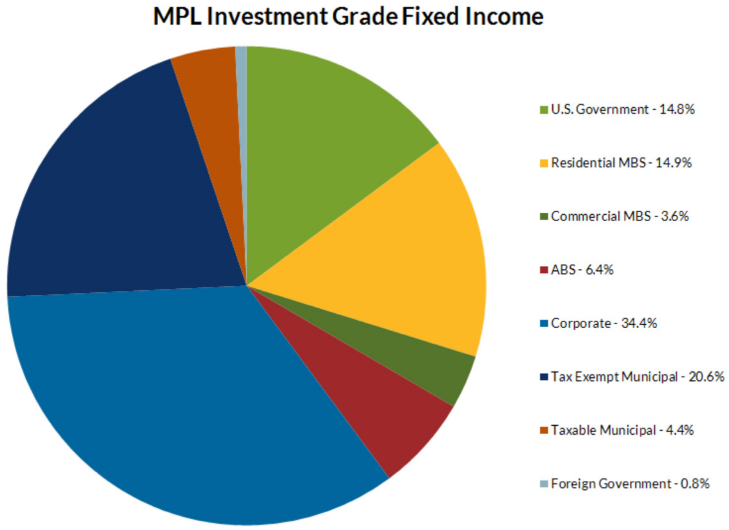
** Tax Exempt Yields are grossed up to the taxable equivalent using a 1.1994 factor. **40.8% tax rate includes 37% federal tax rate and 3.8% Medicare surtax. Tax Exempt Yields are grossed up to taxable equivalent using a 1.68919 factor. Source: AAM, Bloomberg, Thompson Reuters.*

The new tax rate for corporations translates to tax adjusted yields that are lower than U.S. Treasury securities for maturities that are 20 years and shorter while the tax benefit at the highest tax bracket for individuals makes the sector attractive across the curve.

MPL fixed income allocations

At the end of 2018, the MPL industry had an allocation of 20.6% to tax exempt municipal securities in their fixed income portfolios. Exhibit 2 details the investment grade fixed income allocations of the industry according to their year end statutory filings.

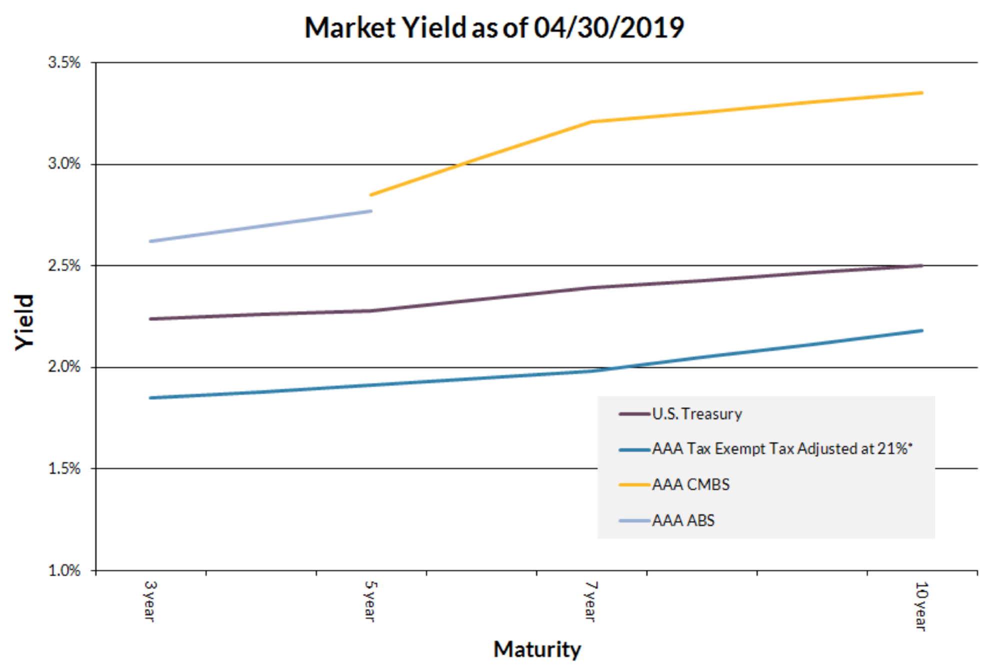
Exhibit 2: MPL Sector Breakdown



Source: S&P Global Market Intelligence, Bloomberg, Factset. Data as of 12/31/2018.

Given the current unattractive yields in tax exempt municipal bonds, the MPL industry would benefit by redeploying assets into high quality taxable sectors such as Asset Backed Securities (ABS), Commercial Mortgage Backed Securities (CMBS), and Corporate bonds, which provide a substantial yield advantage versus tax exempt securities today. If you dissect the tax exempt allocation of the MPL industry further, there is 4.5% of the fixed income portfolio that is under yielding U.S. Treasuries as of 04/30/2019. Exhibit 3 illustrates the yield advantage of 3-5 year AAA rated ABS and 5-10 year AAA rated CMBS versus similar tenor tax exempt securities.

Exhibit 3: Market Yield - ABS/CMBS vs. Tax Exempt Securities



Source: AAM, Bloomberg, Thompson Reuters.

ABS and CMBS are high quality sectors that are under allocated in the MPL industry. Their yield advantage over tax exempt municipals offers a way to improve the income profile of the fixed income portfolio. As of 4/30/19, 3-5 year AAA rated ABS securities provide an additional 75-100 bps and 7-10 year CMBS provides 100+ bps of additional yield versus AAA tax exempt securities. There are other factors to consider such as each company's tax situation and the effect of realizing gains/losses from sales, but the MPL industry should be reviewing their tax exempt holdings due the unattractive nature of the sector today.

Conclusion

Lower corporate tax rates has reduced the benefit of tax exempt municipal bonds for insurance companies. With the challenging underwriting environment, MPL insurers can increase investment income by reviewing their allocation to tax exempt municipal bonds and reallocating to higher yielding taxable sectors.

Michael McLaughlin, CFA *is a Portfolio Manager at AAM with 16 years of investment experience. Mike is responsible for constructing portfolios based on client-specific objectives, constraints, and risk preferences. He is also responsible for communicating market developments and portfolio updates to clients. Prior to becoming a Portfolio Manager, Mike was an Assistant Portfolio Manager at AAM and began at the firm as an Investment Accountant. Mike earned a BS in Business Administration and a BS in Accounting from Illinois State University.*