NOVEMBER 2022

AAM Insurance Investment Management

Bond ETF's: A Handy Tool in the Toolbox

Peter Wirtala, CFA | Insurance Strategist

The last several years have seen giant leaps in the investability of fixed income ETF's for insurers. A decade ago such ETF's were reported as equity, received mark-to-market accounting treatment, and punitive equity-like RBC charges. Today they have their own section on Schedule D Part 1 with the rest of insurer bond holdings, they receive "systematic value" accounting treatment (which results in lower volatility of surplus than mark-to-market would), and they can receive SVO ratings and corresponding bond-like RBC charges. While there are still a handful of items that would benefit from regulatory clarification (how should bond ETF's contribute to the issuer count used in calculating the adjustment factor applied to bond RBC capital charges?), the biggest hurdles to wider adoption have been cleared. So what benefits can bond ETF's bring to insurers, and what role should they play in portfolios?

As an asset manager for the insurance industry, AAM theoretically competes with bond ETF providers for insurer investment dollars. In practice, we often find that insurers readily understand that these ETF's are not suitable alternatives to core bond portfolio management services; many ETF's actually have higher fees than typical separate-account management (while lacking crucial client service elements like investment accounting, AM Best support, state deposit support, asset allocation strategy, liquidity management, board education, etc), and those with relatively low fees are typically passive index funds that lack the potential of active management to enhance returns and manage risk over time. While insurer bond ETF holdings have steadily grown, they constituted on average 0.6% of Life investments and 1.0% of P&C holdings at 12/31/21, and there were no companies in either industry with both total invested assets >$50M and >15% of investments in bond ETFs.

If bond ETF's aren't suitable for an insurer's core bond portfolio, what are they good for? A growing list of roles, thanks to ongoing efforts by ETF sponsors to adapt to the needs of the industry. Here are what we believe are some of the most important ones:

Liquidity Sleeves: For insurers who occasionally need lots of cash quickly (like those with catastrophe exposure), a broad market bond index ETF can be a useful alternative to simply holding elevated levels of cash earning little or nothing. While it could be challenging to sell a large fraction of a bond portfolio within just a day or two during a cash crunch if market conditions happen to be unfavorable, many of the largest ETF's have excellent intraday liquidity and can be fully liquidated with just a single trade. Admittedly this could sometimes require realizing a loss, but it also offers the possibility of earning a meaningful yield on assets that would otherwise be left idle.

Small/Startup Insurers: Separately-managed bond portfolios typically have minimum account sizes, and small insurers who fall below these thresholds may find bond ETF's make a useful stopgap solution. In particular, startup insurers with limited assets and intensive focus on developing their underwriting model may find bond ETF's a welcome simplification for the asset side of the balance sheet, and these ETF's can easily be swapped out for a separate account as the company grows enough to pursue more active management.

Transparency into Niche Markets: AAM and our 3rd-party partners offer custom portfolios built from a wide variety of bond subsectors, but there remain niches within global bond markets that we don't focus analytical resources on due to opacity, low liquidity, highly idiosyncratic risks, etc. Emerging market debt is a prime example. Bond ETF's help us keep tabs on the risk/return profile of these niches and evaluate their suitability for our clients without needing to first develop deep, granular familiarity with their particular quirks. This can enables greater strategic nimbleness and flexibility, and can provide all market participants great transparency into less-widely-held corners of the market.

Scaffolding: We're sometimes called upon to build a custom bond portfolio from an all-cash starting point. While this is certainly doable the old-fashioned way, one bond at a time, there may be advantages to a more gradual ramp-up, including enabling the portfolio to absorb attractive concessions on new issues over time instead of rapidly investing 100% of cash on secondary markets. To facilitate such an approach, bond ETF's can be used to temporarily absorb cash holdings while (for example) 20-25% of the portfolio per month gets invested deliberately and thoughtfully, capitalizing on attractive opportunities over time.

Related to this, certain sectors of the bond market may experience periods of below-average liquidity and/or low issuance, making it difficult to build up exposure to these sectors during periods of attractive relative value. Taxable municipal bonds, for instance, are notorious for their periods of low issuance and wide bid/ask spreads. In such situations, bond ETF's might offer a solution to bridge the liquidity gap and allow easier tactical adjustments.

Sector Access: As pooled investment vehicles ETF's can offer a pathway for smaller insurers to access sectors that might typically be reserved for those with larger balance sheets. An excellent example is collateralized loan obligations (CLO's), floating-rate structured securities backed by pools of bank loans. These have been a valuable holding in the current rising interest rate environment, but they are generally issued under SEC Rule 144a, prohibiting insurers with <$100M in assets from owning them. However, ETF's can easily meet this size threshold, and nothing prohibits insurers from owning such an ETF and gaining diversified exposure to the sector.

You may have noticed some recurring themes in the items above, especially that liquidity is a primary selling point for ETF's. For some time ETF adoption was slowed by concerns whether it was reasonable for a pooled vehicle to have better liquidity than its underlying assets, and fears of how such funds might consequently perform in a sharp market drawdown. With the relatively smooth performance of bond ETF's during the selloffs of 2020 and 2022 fresh at hand, these concerns are at least partly assuaged, though the point is worth keeping an eye on.

In conclusion, we at AAM view bond ETF's as a helpful tool in the toolbox of fixed income portfolio management, offering unique features that can complement a strong foundation of actively managed individual bond holdings. We appreciate the efforts that ETF sponsors have made to work with insurers and regulators in designing new products and refining regulatory treatment of ETF's. We'll continue to watch developments in this area closely, and identify opportunities to use these new tools to benefit our clients.

As bonus content to share with family around the Thanksgiving dinner table, here are some statistics on insurance industry holdings of rated bond ETF's:

P&C

- 41% of all P&C insurer bond ETF holdings are held by a single company, American Family Insurance. Their largest such position (an Xtrackers high yield bond ETF) is over $1 billion and singlehandedly constitutes the P&C industry's largest aggregate $ exposure to any single ETF.

- Among P&C insurers with bond ETF holdings, median exposure was 2.85% of investments.

- The most widely held bond ETF among P&C insurers is the iShares 1-5yr Corporate Bond ETF, with 23 holders. 2nd place is a tie between a Vanguard short-term bond ETF and an iShares MBS ETF, with 21 holders each. Of the 115 unique bond ETF's held by the industry, 41 have just a single holder.

- 88% of P&C bond ETF holdings by carrying value have a "Latest Investment" date in 2021 or 2022.

Life

- Although total Life industry investments are more than double those of the P&C industry, Life companies only hold 30% as much total bond ETF exposure by carrying value.

- 40% of all Life insurer bond ETF investments are held by the 2 largest holders: Allianz and Global Atlantic.

- Among Life companies holding bond ETF's, median exposure was 0.38% of investments

- The largest and most widely-held bond ETF among Life companies is a Vanguard long-term corporate bond ETF. The 3rd largest exposure is an ETF holding high-yield floating-rate senior bank loans rather than bonds. A mix of long-term and short-term corporate bond ETF's make up many of the other largest exposures.

- 72% of Life insurer bond ETF holdings have a "Latest Investment" date in 2021 or 2022.

All data sourced from S&P Capital IQ Pro. Data as of 12/31/21. While AAM may invest client assets in bond ETF's from time to time, AAM does not have any arrangements with ETF sponsors to advertise, promote, or direct investment towards their funds.

Peter Wirtala, CFA *is a Principal and AAM's Insurance Strategist with 17 years of investment experience. Peter's responsibilities focus on analysis of client insurance operations and reserves to aid in the development of customized investment solutions. Additionally, he develops ERM-focused asset allocation strategies for clients, conducts peer analysis and NAIC RBC / AM Best BCAR scenario analysis, and prepares educational papers and seminars on key issues facing the insurance industry. Peter also leads AAM's ESG integration effort for clients seeking to incorporate environmental, social, and governance-based principles into their portfolios. Previously he worked for Epic Systems as a Financial Accountant. Peter earned a BBA in Finance from the University of Wisconsin-Madison.*