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Rethinking the Fixed Income Playbook for Insurers

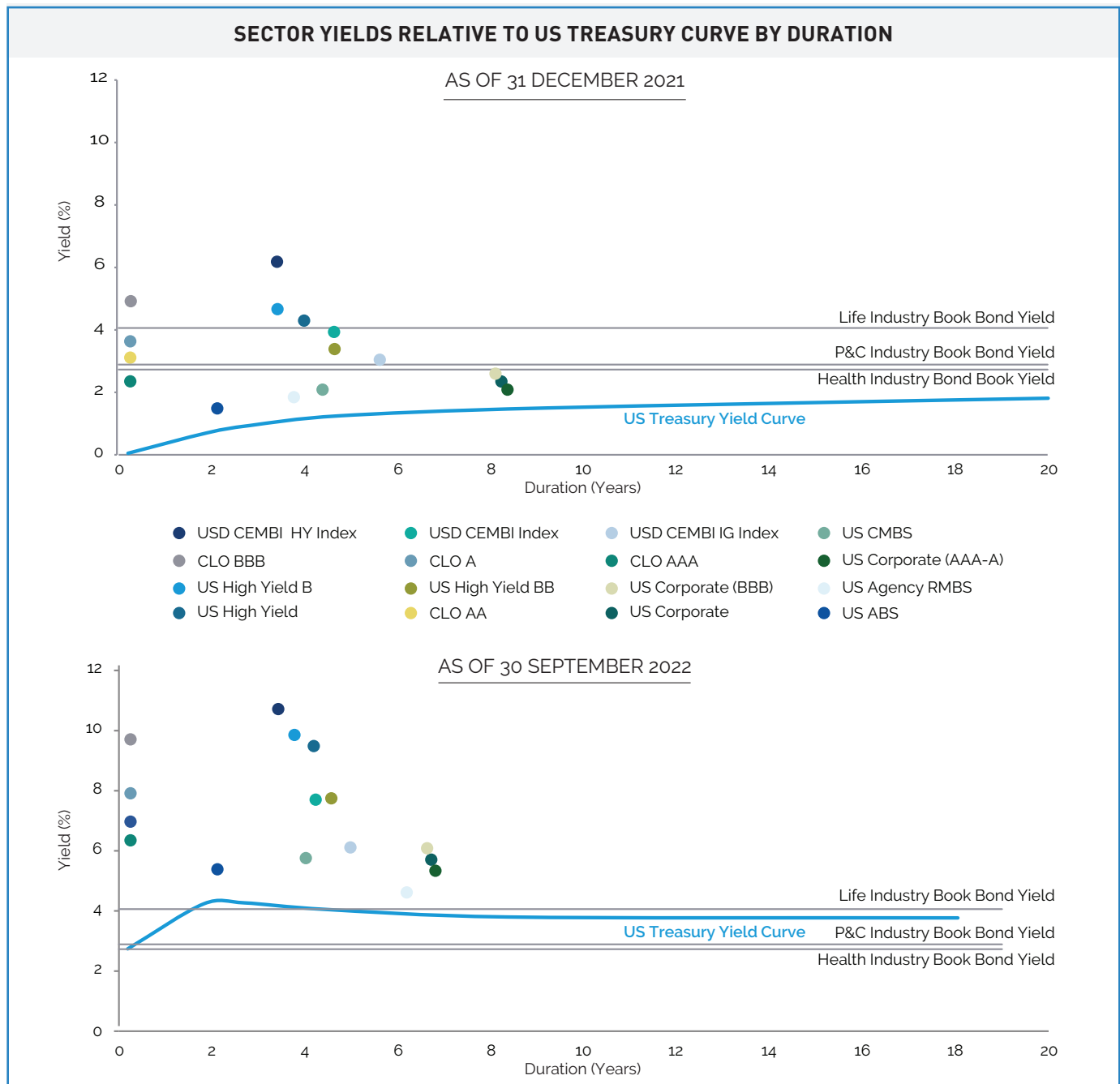


It's been an interesting year for fixed income markets, to say the least. The surge in interest rates and the Treasury market selloff have left a lot of insurers with material unrealized losses in their investment portfolios.

In this new regime of high inflation and volatility, we think there's a more thoughtful way to approach fixed income allocations in insurance portfolios. In our view, removing some of the traditional guardrails, such as narrow guidelines and benchmark constraints, can provide insurers with more tools to help manage duration and quality exposure through the credit cycle. We believe this broader, more flexible approach can open up the return potential of an insurance portfolio without significantly adding to its risk profile.

Fixed Income Markets Have Significantly Repriced

Changing the core fixed income playbook may seem like a major shift, but we believe a more flexible mandate better fits the opportunity set that exists today. Until recently, markets were operating in a very low-inflation, low-volatility environment supported by accommodative central bank policies. These conditions limited yield and opportunity for bond markets, and manager dispersion was low.

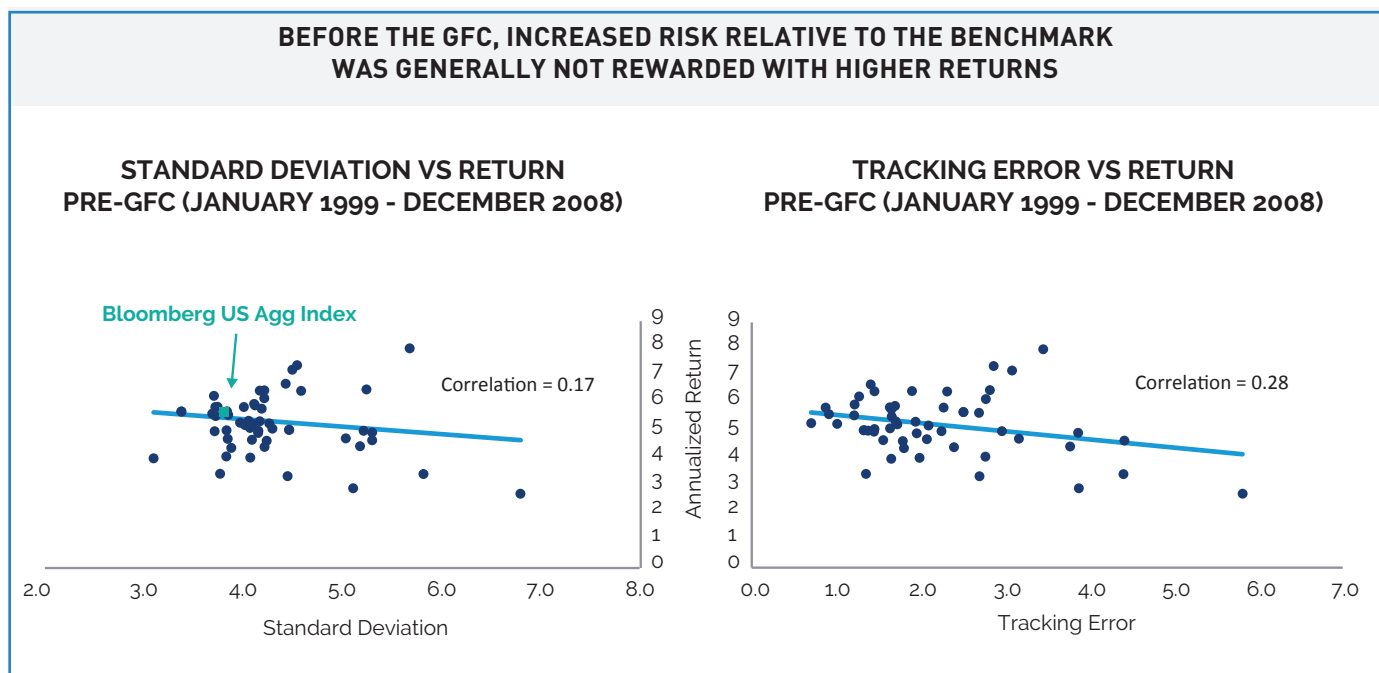


Source: ICE Bank of America, JP Morgan. | Book bond yield as of 31 December 2021. Peer median bond book yield is reported annually. The charts presented above are shown for illustrative purposes only as a sample of market indices. Indices are unmanaged and do not incur fees. It is not possible to invest directly in an index. Some or all of the information on this chart may be dated, and, therefore, should not be the basis to purchase or sell any securities. The information is not intended to represent any actual portfolio. Past performance is no guarantee of future results.

Today, we're in the opposite situation. Bond markets are operating in a high-inflation, volatile environment and have significantly repriced. Ten-year US Treasury returns fell more than 16% in the first nine months of 2022.¹ In our view, the bond market currently offers yield and opportunity again, and can help defend against the potential for higher interest rates.

The Case for a Flexible, More Diversified Approach

Throughout the late 1990s and much of the 2000s, more than 50% of the top-quartile managers in the eVestment US Core Plus universe had a low ex-post tracking error of 2% or less.² During this era, interest rates were in decline and many managers were able to avoid taking duration bets and ride the yield curve rolldown. In the years following the 2008 global financial crisis (GFC), none of the top-quartile managers had an ex-post tracking error below 2%. After the GFC, interest rates were largely range-bound and managers with the flexibility to invest outside of their benchmarks were largely rewarded.



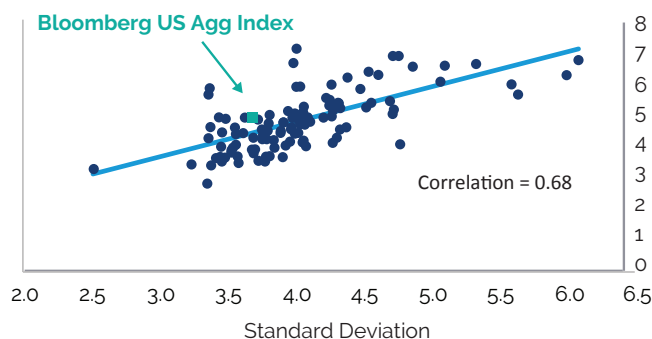
Source: eVestment. Analysis uses eVestment Core Plus Fixed Income Universe. GFC = Global Financial Crisis. Indices are unmanaged and do not incur fees. It is not possible to invest directly in an index. Any investment that has the possibility for profits also has the possibility of losses, including loss of principal. There is no guarantee that the investment objective will be realized or that the strategy will generate positive or excess return. Tracking error is a range and the strategy may not always be able to remain within it. Past performance is no guarantee of future results.

¹ Source: Bloomberg, Bloomberg US 10-Year Treasury Index, from 1 January 2022 to 30 September 2022.

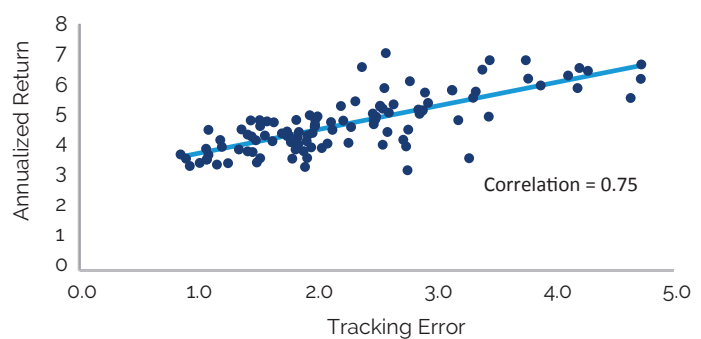
² Source: eVestment US Core Plus Universe. Pre-GFC period from 31 December 1998 to 31 December 2008. Post-GFC period from 31 December 2008 to 30 June 2022.

**IN THE POST-GFC ERA OF RANGE-BOUND INTEREST RATES, MANAGERS TAKING MORE RISK
RELATIVE TO THE BENCHMARK WERE LARGELY REWARDED WITH HIGHER RETURNS**

**STANDARD DEVIATION VS RETURN
POST-GFC (JANUARY 2009 - JUNE 2022)**



**TRACKING ERROR VS RETURN
POST-GFC (JANUARY 2009 - JUNE 2022)**



Source: eVestment. Analysis uses eVestment Core Plus Fixed Income Universe. GFC = Global Financial Crisis. Indices are unmanaged and do not incur fees. It is not possible to invest directly in an index. Any investment that has the possibility for profits also has the possibility of losses, including loss of principal. There is no guarantee that the investment objective will be realized or that the strategy will generate positive or excess return. Tracking error is a range and the strategy may not always be able to remain within it. Past performance is no guarantee of future results.

Going forward, we expect slowing growth and stubborn inflation to keep US Treasury rates broadly within their current range, though we anticipate some volatility. And with yields currently at compelling levels in many corners of the fixed income market, sticking to the traditional guardrails of core fixed income markets may end up hurting a portfolio's return potential.

We believe current market dynamics call for a different, more flexible approach to portfolio construction—one that involves diversification beyond the core fixed income sectors. Accessing a broad range of sectors and geographies can help increase portfolio yield and lower risk potential with a more balanced approach to interest rate and spread risk. In the insurance world, the word “flexible” tends to trigger worries about high turnover, gains and losses, and less focus on book yield. However, we believe experienced managers with deep research teams can manage trading costs through diversification, a focus on seeking best ideas at attractive entry points and executing relative value trades that can be book yield neutral.

Broadening the Opportunity Set

There are many ways to broaden a portfolio's opportunity set, but a few sectors stand out to us in the current environment. We think non-agency residential mortgage-backed securities (RMBS) currently look attractive. In addition to the shorter duration and competitive yield profile of many of these securities, monthly principal paydowns can give cash infusions to portfolios, which can be reinvested at higher interest rates in the current environment. We're aware that some insurance companies struggled with RMBS exposure during the GFC, but we believe both the consumer and commercial sides of the market have matured since then. In our view, expanding the quality parameters within the sector beyond the traditional higher-rated buckets could open up the number of potential opportunities to pick up some meaningful yield.

We also like sectors that can offer a yield advantage versus traditional core fixed income sectors, such as collateralized loan obligations (CLOs) and some BBB-rated corporate bonds. Higher-rated portions of the CLO market are currently yielding between 6% and 10%.³ In our view, higher-yielding sectors can offer more income potential, helping to insulate a portfolio from volatility over time.

A Playbook That Can Open Up Return Potential

The last ten months have shaken the traditional core fixed income playbook. Many of the current guardrails were designed to protect insurance portfolios, but they haven't prevented portfolio losses in this environment of volatility and high inflation. We think it's time to consider a more thoughtful approach to fixed income allocations in insurance portfolios. In our view, removing some of the traditional guardrails, such as benchmark constraints and restrictive guidelines, can help to open up an insurance portfolio's return potential and add diversification benefits. With access to a broader toolkit of fixed income securities, a manager can add flexibility to duration and quality, and seek out value. We believe this approach helps to optimize income and price appreciation potential over time, and could be a nice playbook for years to come.

For more on Loomis Sayles' insurance capabilities, contact [Colin Dowdall](#), CFA, VP, Director of Insurance Solutions.

³ Source: ICE Bank of America, JP Morgan, as of 30 September 2022.

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Disclosure

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