For professional clients only
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Institutional investment

Measuring the effect of diversification into foreign credit

The challenges for investors from the insurance sector are clear, but the solutions sometimes less so. We are living in a world where interest rates will remain low for a considerable time and where the pandemic recovery will likely be uneven and volatile for issuers. In addition, regulation and accounting regimes are constantly evolving while insurers are also expected to be at the forefront of the transition to a new era of sustainability.

At AXA IM we have long and deep expertise in managing insurance assets, for our parent group of course, but also for a large and growing roster of third-party clients. We believe that this kind of optimised diversification can deliver effects (such as lengthening duration and potentially higher returns) that assist with asset liability management, without negatively impacting financial statements under IFRS9 or requirements around regulatory capital.

In all, we manage around €450bn in insurance assets, most of which is in fixed income, and our scale allows us breadth. We manage corporate debt assets from offices across Europe, Asia and North America, and in this truly global position we see potential advantages for our institutional clients. At a recent webinar hosted by Hans Stoter, Global Head of AXA IM Core, we explored this theme of diversification. AXA IM Core Chief Investment Officer Chris Iggo set out the macro backdrop for insurance investors, and our specialists Arnaud Lebreton and Sebastien Proffit, detailed how investors might put this into practice.

Spread the word

We all know that we appear locked into an environment where yield is hard to come by, and where central banks remain active in bond markets. In 2022, the US Federal Reserve may well reduce bond buying activity – a less likely scenario for the European Central Bank – but for now they have become the largest buyers in the market. That has affected the availability of long-duration assets, pushing private investors deeper into credit, where spreads have narrowed. And that pressure on spreads, we believe, should prompt investors to consider expanding allocations to non-domestic credit where opportunities may be present.

Taking Europe and the US as an example, US credit spreads over government bonds tend to be wider. The asset-swap spread on US investment grade corporate bonds is more than 40 basis points (bps) higher than in Europe . But we see potential advantages beyond any spread and yield differential.

First, investors can massively increase their credit universe. The US accounts for about 60% of the global corporate bond market, and it also hosts around three times more individual bond issues, giving greater scope for diversification. The chance could also be there to extend duration with the US average at about eight years against five years in Europe.

Other things to consider include the possibility to adjust a portfolio's risk profile more easily – as well as the simple observation that the scale of the US market implies there can be opportunities here with no equivalent elsewhere. For investors pursuing ambitions linked to environmental, social and governance issues, or seeking a better climate profile for portfolios, diversification should be able to assist with that process too.

Standing against these potential advantages lies some significant portfolio inertia. That's not to say behaviour hasn't changed. Insurers have moved down the rating scale in pursuit of yield, have sought longer maturities to keep pace with liabilities or have dipped their toes into more niche assets such as private equity, loans or infrastructure, while nudging down debt allocations.

In those still-huge debt holdings however, there remains a notable home bias, most obviously in holdings of government bonds, but also clear in corporate bonds. In many European countries, insurers' holdings of European Union/European Economic Area credit assets still exceed 80% (see graphic below). This is understandable. Adjustments should always be measured and gradual, but there may a lingering – and we believe misplaced – perception that diversification away from domestic markets carries a complexity that is difficult to manage.

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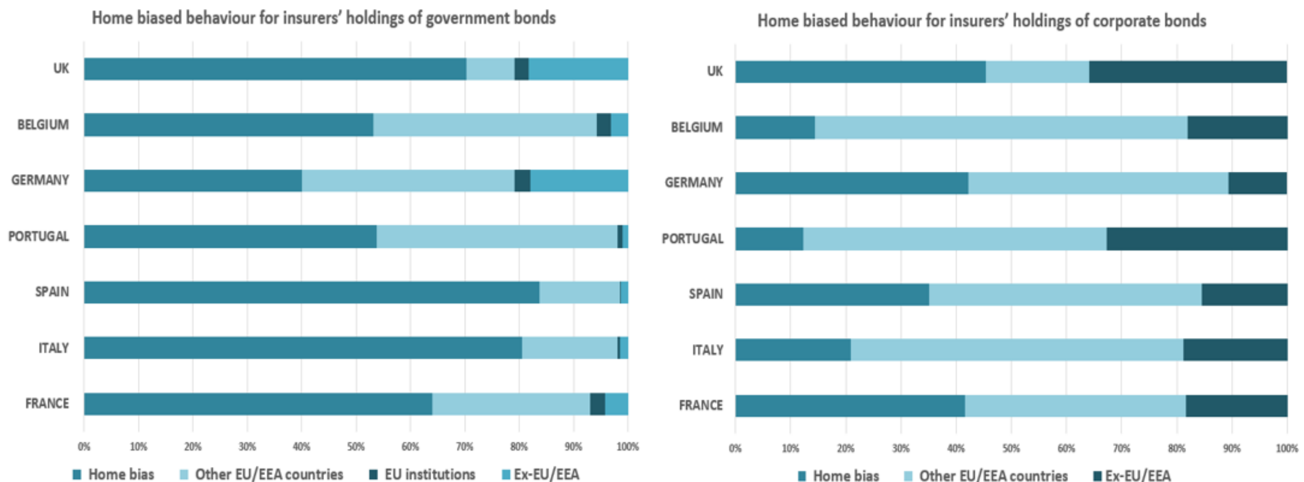
This adaptation has been slow

... And the domestic bias remain strong



Source: EIOPA 2020 Financial Stability Report

Testing the ground

To examine this in more detail, we built a reference portfolio to reflect the status of a typical European insurer's corporate credit allocation. Our simple reference portfolio was 100% senior corporate bonds, and 100% Euro investment grade (IG) credit. The average rating was A- and average duration at six years.

We then assessed the effect on the full typical European insurance investment portfolio of switching 50% of the corporate bond reference portfolio to US investment grade credit, with interest rate and currency risks hedged out to maturity using fixed cost currency swaps.

In this hypothetical scenario, the adjustment led to an increase in the overall portfolio's expected annualised return to 1.5% from 1.44%, with little impact on risk-adjusted returns as measured by the Sharpe ratio or on the return-on-SCR (Solvency Capital Requirement) ratio. It also allowed for a reduced duration gap, useful for life insurers in particular. And when 50% of the corporate bond portfolio was diversified into both US and emerging markets IG credit, the effect was more striking, with an overall annualised return at 1.6% and with the Sharpe and return/SCR ratios both improving.[1]

[1] *These scenarios are presented as of this document's date. They do not constitute a representation or guarantee as to future scenarios nor performances. AXA Investment Managers disclaims any and all liability relating to these scenarios' description and can modify these scenarios according to market evolutions and taking into account the regulations in force.*

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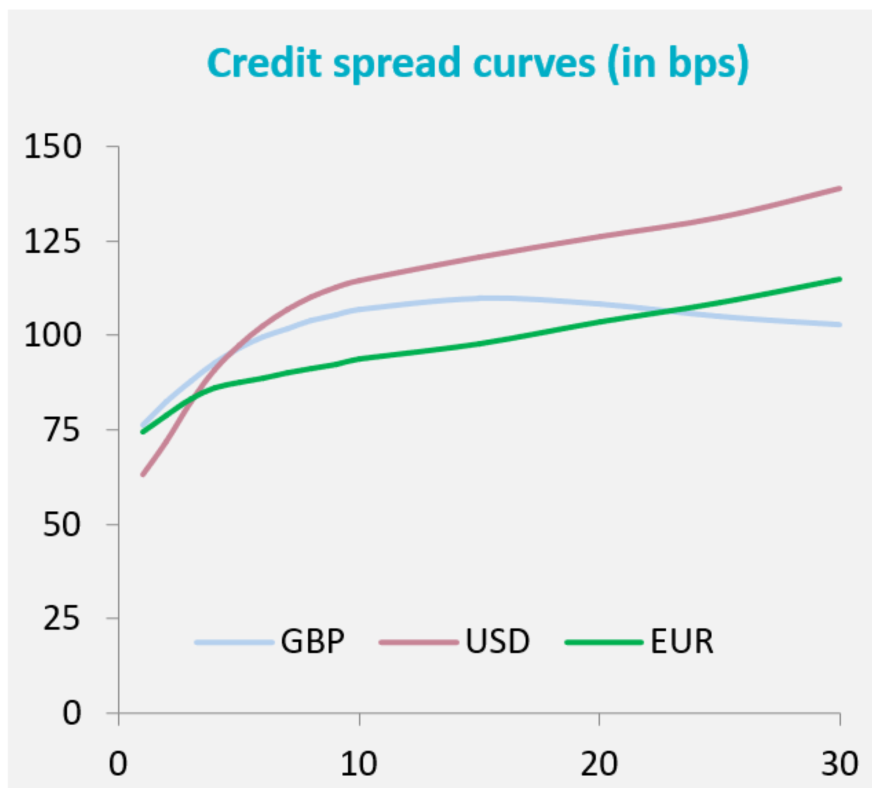
This top-down analysis does appear to show potential strategic benefits from diversification, but it is based on some long-term assumptions and broad market indices. That's why we also sought to understand the implications of non-domestic credit diversification from a bottom-up perspective.

Digging deeper

The first thing to note when adopting this approach is that hedging costs would tend to dilute away any yield pick-up. That means spread should be the focus for investors considering this form of diversification. We think that there are clear opportunities here, as illustrated by the spread curves shown in the chart below, which demonstrate the opportunities that might exist to capture wider spreads, and to exploit differences in the shape of the curve between markets.



Source: AXA IM as of June 2021

And with the benefit of global credit research coverage behind them, we think that insurance investors can potentially gain more by seeking out the differentials at the level of individual names and in the variety – in terms of both duration and currency – that may be available from larger issuers. Relative value, we believe, is best assessed by reference to credit spread, and at a macro and a micro level.

Using our reference portfolio as a starting point again, we examined the potential effect of this approach. The table below details our process, from the normal bond-picking designed to enhance performance from the entire universe, as seen in column two, to applying our bottom-up credit selection in columns three and four.

The first of these helps to demonstrate the potential advantages from what on the surface are quite limited changes. We kept the names in the portfolio the same (as we did for ratings and duration) but looked for instances where there might be spread pick-up by swapping the euro credit for dollar- or sterling-denominated issuance from the same issuer and with similar maturity.

That process led to 15% of the portfolio being diversified into 'foreign' credit with a spread pick-up net of transaction costs at 6bps. Return on capital increased by roughly 70bps. That 6bps may not seem a lot, but it equates to a 10% spread pick-up for the exact same risk, in our hypothetical example.

Bottom-up portfolio construction

Inclusion of foreign asset in a typical credit portfolio

	Initial universe (100% Euro - EIOPA)	Initial portfolio (100% Euro)	Portfolio 1: 15% non-Euro (value only)	Portfolio 2: 40% non-Euro (value and diversification)
PERFORMANCE				
Hedged Yield (%)	0.27	0.35	0.41	0.51
Credit spreads (bps)	72	80 (+8)	86 (+14)	96 (+24)
Return-On-Capital (%)	**8.5**	**9.4**	**10.1**	**11.3**
RISK METRICS				
Duration (yrs)	6.1	6.1	6.1	6.1
Non-Euro (%)	**0**	**0**	**15**	**40**
SCR (%)	8.5	8.5	8.5	8.5
Average rating	A-	A-	A-	A-
# of issuers	785	130	130	145
RATING ALLOCATION				
AAA/AA (%)	21	21	21	21
A (%)	44	44	44	44
BBB (%)	35	35	35	35

- **EIOPA universe**: typical credit exposure of European insurers, according to the latest EIOPA survey
- **Euro portfolio**: 100% of Euro bonds, with same ratings, duration and SCR as EIOPA universe, but with an optimised Return-on-Capital
- **With non-Euro (value only)**: inclusion of 15% of non-Euro, with the exact same credit exposure (i.e. names, ratings, duration) as the 'Euro portfolio'
- **With non-Euro (value & diversification)**: inclusion of an additional 25% of non-Euro, identifying new names/sectors offering a better risk-return (i.e. ROC) profile

Source: AXA IM as of 28 June 2021

In the second part of the process, the effect of which is detailed in the fourth column above, we sought not only to boost value further but also to actively seek out diversification and reduce risk. Our method for doing that centred on looking to US and emerging credit once we had reached the lower end of our selections in euro issuance. In other words, could we find a better, higher-quality, non-domestic

alternative that would generate some spread pick-up? The results in our model were clear again – more spread pick-up, better return on capital and little to no effect on duration, rating or the SCR ratio.

This is a hypothetical example and should not be taken as an indication of potential future performance, but you might boil down the rationale at the heart of it to this: Why pick the 10 best apples from one tree, when you can pick the best five from two trees?

And those apples might be a tastier variety too. As mentioned, the sheer scale of the US and emerging credit markets opens up unique opportunities alongside that well-known improved access to longer duration assets and the potential to better manage the risk of impairments or defaults.

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