Tim Antonelli

Episode 197: Wellington Management's 2024 Insurance Outlook

GUEST Q & A

Stewart: My name's Stewart Foley, I'll be your host. We have got a phenomenal podcast for you today. A four time guest, four times, Tim Antonelli, Managing Director Insurance Multi-asset Strategist and Portfolio Manager at Wellington. Tim, welcome back, brother. How are you.

Tim: Stew, it is phenomenal to be back as the sole member of the four-time club. I can't tell you how much of an honor that is to me. I'm excited to chat with you as always.

Stewart: And we've been down the path of where you grew up and whatever else. And I'm a finance geek, right? I am. And I'm sorry if the word... I'm a finance nerd. I don't know what the right word is, but I can bore you to death talking finance, let's put it that way. The title of this is 2024 Insurance Outlook: Position Portfolios for the Unexpected, but I would like to call it groundbreaking finance theory. You are bringing up some things here that are very different and apart from what is traditionally done in finance in ways that you're looking at risk, and there's a whole bunch of other things here that you've written, and this piece is actually going to be on our website, but it's really good work, man. Congratulations. And I want to talk about the various pieces.

Tim: Yes, Stew, first of all, thank you. That's high praise and I really appreciate it. Second of all, I think a goal for us with these annual insurance outlook pieces is to basically survey the landscape and say, "What are insurance companies not thinking about that they should be thinking about?" The investing world tends to operate with a herd mentality, and quite frankly, in a beta market or a market of easy money and consistent monetary policy, I think that you could get away with that. But really, as you alluded to, the purpose of this piece is to drill into some of the larger tail risks while recognizing opportunities and saying, "Don't overlook some of these things. These aren't too big to consider."

Stewart: So one of the things that you write about first is doubling down on diversification. And I've taught finance and theory and all of that. And so when finance guys talk about diversification, everybody kind of knows what you're talking about. But that's not what you're talking about. You actually have a different definition of diversification. So can you just start with what you mean when you are using the word diversification? Because I think it's different and it's worth calling attention to.

Tim: Yeah, absolutely. So when I think about this next year ahead and I think about all the uncertainty that's in the market, and we can throw out the fact that 45%, 50% of the market expects a soft landing, there's still a lot of ways to run before that's the case, I think you have to think about the interplay across your invested assets in a more intentional way than you had to have done in the past. And I think to your point on traditional diversification, it was the singular view of asset class level diversification.

And so you and I have chatted about reserves and surplus and the assets that underpin those before, but I think about equities and bonds and how that had served as a correlation benefit historically for insurance companies. But quite frankly, that relationship hasn't worked out in recent years. And so when we look at rolling three-year correlations between equities and bonds, we're seeing something like a 0.7 correlation between the two. So you're certainly not

getting a benefit of offsetting return profiles there. And 2022 was perhaps the largest recent example of that very story. And so my view of diversification takes this two and three steps further. The second step is intra asset diversification.

Stewart: So you're talking about a chart that's in this paper, and I want to talk about the chart for a second. So you're saying it's 0.7 is the correlation where we are today, which is a point that's labeled in late '23. But if you go back to '13, that number is -0.4. If you go back to '02, that number is -0.4. In fact, it doesn't break north of 0.6 until 2023. Right? So I mean, I'm with you on the fact that the correlation's high, but I think that the reference point that historically it's actually not been here since the seventies is worth noting.

Tim: Yeah, absolutely. And if you think about the careers of most of our colleagues and contemporaries right now, they've all occurred in this part where it was largely a negative correlation benefit or an almost zero interplay between bonds and equities. So they haven't really been used to an environment with a significant positive correlation between the two asset classes. And I think that should warrant some reconsideration of how they're positioned versus how you were positioned historically.

Stewart: I'm looking at this chart and I'm not liking where I fall into that category, just to be honest.

Tim: Come on. 2013, I think you started your career, it's only 10 years ago, Stew.

Stewart: That's exactly right. Yeah. It's the 30th anniversary of my 10-year anniversary. So you talked about asset class level diversification and you bring up cross asset class and intra asset class. And then you talk about implementation diversification, which I want to talk about separately, but can you talk a little bit about cross and intra asset class diversification?

Tim: Sure. So I think the cross asset class, so the decision you make about how much fixed-income to be in, how much equity risk to take and what you're doing from an alternatives perspective, which by the way, due to risk capital charges, the diversification benefit that comes with some alternative asset classes hasn't been in favor. And if you think about that, if I'm an insurance company, a life insurer, and I have to hold 30% schedule BA capital in the United States against an alternative asset class and you're telling me it'll give me not correlated return of high single digit or I can be in early stage private equity with much higher potential returns, I think on a risk adjusted capital basis, you have to probably pick the private equity and the industry has certainly done that. But outside of the capital charges, having that more nuanced conversation within asset classes is where I think we need to be going.

And we've seen some of this story play out in recent years, although not for the reasons that we'll dig into today, but if you think about the expansion of what used to be just traditional corporate credit in an insurer's portfolio to now include a lot more non-agency securitized, asset-backed securities and collateralized loan obligations in particular, I mean, you're getting a diversification benefit there that quite frankly you may not be aware of to the degree that you should be. And we have a number in the paper just using some of what we use in our strategic asset allocation process of 0.35 correlation between AAA CLOs and A or better intermediate credit. And that's a substantial correlation benefit when you're talking about entering a cycle that's likely to be much more volatile than the cycles that we've just come out of or have been in for the previous decades. And you can say the same thing across every flavor of the fixed-income spectrum and then down the credit quality spectrum as well.

And then just moving on to equities and alts, but in that same intra asset convention, I think equities having a home bias has been the main focus of insurance companies over the last few years. And quite frankly, it's worked, but if you believe that there will be substantial central bank divergence moving forward as central banks aren't all hiking rates similar to the time they were all easing, if you believe in divergence there, I don't think you want to be exclusively overweight your domestic market across all your asset classes.

And then alternatives, we've talked about this before. It is a very hard asset class to paint with one picture, so to speak. I think the idea between using illiquids to diversify against your liquid assets is part of the puzzle Now that needs to be more intentional when insurance companies are considering assets and you're thinking about balancing your P&L volatility.
Stewart: Yeah, I want to go back to this idea that you're bringing up about, and I want to just say it again, so the correlation between AAA CLOs and intermediate A or better credit is 0.35. I would've thought that number was 0.96.

Tim: Exactly.

Stewart: Off the top of my head, you go, I say I can throw a hula-hoop over fixed-income returns. They are highly correlated. And you're saying, "Uh-huh, not really." And as you know well, when those correlations is what drives the bus with regard to diversification, and a 0.35 just shreds vol off of a portfolio, right?

Tim: Exactly right.

Stewart: It just shreds the vol off of it because that 0.35 negates so much volatility. And I was astonished to see that low of a correlation between two fixed-income asset classes that I would've thought would've had a super high correlation on their face.

Tim: And if you couple that with the fact that you're still able to get AAA, AA exposure there where we just talked about A better credit, but almost 60% of the credit market is BBB at this point, I think being able to get this diversification on the asset class level, but also make your overall average credit quality still pretty compelling, it makes a continued case for that asset class to not only be part of an insurer's toolkit, but to likely grow in size relative to traditional corporate credit moving forward.

Stewart: And if I keep quoting your numbers, I'm going to look smart here. So watch this. The correlation between long-dated tax-exempt munis, which is historically where the value is, and ABS CMBS is 0.32. Again, I'm shocked at that. And it makes sense, but it's surprising.

Tim: Yeah, exactly. And I think for me, the muni case is interesting in that you're also getting the high credit quality skew, but you're also diversifying your borrower base in what you're adding in terms of your risk. And we know municipalities have been in great position in recent years and their balance sheets have looked pretty strong. And while we're not going to discuss today the likelihood of tax change implications over the next presidency, they're certainly not off the table. And so if we were to see any sort of tax change, increased rates on the margin, that's an asset class that you can see insurers rushing to get back into. And as we know, it can take a little while to build up that exposure because most people don't end up selling out of it.

Stewart: It's really interesting. I was the treasurer of the City of Columbia, Missouri, which was, at the time, a standalone AA. And the challenges associated with getting debt issued by a municipality is unbelievable. The public hearings and the people who show up and just out of the woodwork. And the result of that, the difficulty of getting debt issued is that it doesn't get issued a whole lot. And the credit profile is phenomenal as a result. And as I used to tell my students, the City of Dallas is not going to lever up and take over the City of Fort Worth. Those are things you can scratch off your risk list in muni land. Right?

Tim: That's absolutely right. Yep.

Stewart: So you go in here and you say, I'm quoting you now, it says, "I think insurers should first ensure that they're not double dipping equity beta by investing in high yield bonds and public equities if they don't have adequate risk tolerance." This is a great point, and I'd love for you to expand on that a little bit?

Tim: Sure. So I think it's pretty intuitive when you think just about the risky nature of both those investments, but because we're throwing out figures, we assume a 0.7 correlation between high yield bonds and public US large cap equity. And I think that's a reasonable figure based on what we've seen historically. Yet we see insurance companies tend to not only have a significant equity allocation, but to be adding high yield bonds purely because of a capital efficiency view and not necessarily based on the economics of what that allocation should be.

Interestingly enough, I see a lot more concern from the insurance community about high yield bond names and potential defaults than we do with taking on significant equity market risk where the values could also go to zero. When you look at historical losses after recovery in the high yield market, it's not as low as when equity markets totally sell off or there's a big implosion. So it's interesting to me how high yield bonds, because they've been fixed-income in nature, I think get a little bit of a different look when companies are thinking about where to allocate their risk chips.

And as we head into this next year and just given where spread levels are today, if I'm in the high yield market or I'm thinking about how much I want to allocate to either one of those risk assets, I'm asking myself, okay, what is the maximum drawdown that we could stomach either from a surplus perspective or from a overall capital perspective? And is it worth

being invested at such rich valuations if we have a low sensitivity for 2024 to be a bad year? And again, I think those risk assets to be looked at in context of your surplus and not just oh, my fixed-income risk and my equity risk.

Stewart: As you well know, you can say to a board of directors that the equity portfolio can be down 30% and they'll nod and say they understand. When it's down 27%, that's a whole different conversation. I mean, it gets back to risk tolerance and really risk capacity. And because it's down 27% and everybody's going, "It's going to zero," everybody's going crazy. And at the end of the day, those end up being some of the best buying opportunities. So I think you make a great point here. And so I just want to level set people to kind of where we are. In your paper, you mentioned doubling down on diversification and we're defining what that diversification is. And the second piece of it that I thought was interesting is implementation diversification. Can you talk a little bit about what you mean when you're talking about implementation diversification and why it matters?

Tim: So I think this is actually potentially the best lever for insurance companies to use because you can put it to work tomorrow. So this really basically is how you're getting that asset class exposure on your balance sheet. And I think the easiest and most tangible demonstration of that is the classic choice of active versus passive. And I think the case for active versus passive and how there's efficient markets and inefficient markets and you're better off using your active budget in less efficient markets, I think that is a story that every insurance asset owner is comfortable with.

But beyond that, I think that there's ways you can play implementation diversification that can offer you a different return stream, that can be poised to better capture outperformance in dislocated markets, that are ripe for active management and fundamental research in times of uncertainty. And so these can include something like a concentrated portfolio of best ideas. It can be a tactical or opportunistic style mandate where you're basically giving the mini SAATA decision to the portfolio manager who's operating within risk parameters that the insurance company's dictating to the asset manager. And so you're aware of what the upside downside capture would be. And you also know that in a bull market that's led by seven tech names, maybe we're going to lag a little bit, but in 2022 when everything sells off, we need to hold in because we don't have the appetite for drawdowns. So again, that's one way to play it.

And then the other element here is just the choice between private and public markets. And so when you think about an asset class that can be used to back reserves, so something like investment grade private placements and how those can compliment core fixed-income, while they're both very highly rated, they both have similar underlying borrowers, although they can be different industries, issuers and have different covenants certainly, but the advantage, and you can argue about if it's the economic volatility or not, but the advantage of private assets in that context is that you get the delayed mark to market that comes with those private assets. So if there is a selloff in a given quarter, you're not taking that all through your reserve backing fixed-income at the same time. You're able to amortize it in, so to speak, over time, over multiple quarters and dampen a single period drawdown.

And as we know, in a world where accounting standards are increasingly becoming more mark to market, having more of a cushion on the downside, I think is again, something insurers need to be considering as part of the risk management and diversification and not just a benefit of investing in illiquids on their own.

Stewart: Yeah, I mean, you make a good point here. And the point is, I don't want to put words in your mouth, these are my words, it's pretty darn hard to be opportunistic unless you're sitting in front of a screen and you know that market. It's pretty hard, you're going to meet once a quarter and you're not neck deep. And you know and I know, I mean, there's people who trade these markets that they live it and breathe it every day. And it's not just at Wellington, there's other firms too. But it's like those folks have real expertise and they're sitting in seats looking at screens and information, that it is a dedicated pursuit and not something that somebody's looking at once in a while, right?

Tim: That's right.

Stewart: And I think that's an important point to make when you say, well, some people get queasy about, well, I don't want to give away the asset allocation decision, but at the end of the day when it's an opportunistic mandate, you're costing yourself money in a way if you don't put it in the hands of the people who are closest to the CUSIPs.

Tim: That's right. And I think just two things from my perspective that should really make this be front and center for insurance companies. So our earlier comments were about the market that was and consistency of returns. And quite frankly, if we could go back in time before 2022 and we said, "All right, what's our best ideas?" You and I could just invest

in the riskiest parts of the market, we could weather the small bouts of market volatility, and we would've absolutely crushed it because it was a beta market and it was easy money. And other than a couple blowups of singular asset classes of the speculative variety, there was very little that went wrong.

If you believe as I do that going forward, we're going to see more variation, frequent cycle changes and environments that aren't going to be good growth and low inflation as the only macro environment to withstand, then I think we need to be thinking more tactically and opportunistic than we've had to over the last few decades. And I always point to the example of March of 2020 when the high yield spreads blew out to record levels at the beginning of COVID and the buying opportunity there, we're talking days where people that actually either had their own high yield desks sitting on cash for these opportunities or had outsourced opportunistic allocation through a specific mandate, were able to get money to work in that market and be providers of liquidity at amazing spread levels. And these generational opportunities, and my hands, I'm using air quotes for your listeners, these generational opportunities in my mind are going to be more and more frequent if you're building in the ability to capture them. And quite frankly, you haven't had to do that looking back.

Stewart: That's a really good point. So I want to go, again, your paper, it's labeled Figure Four and it's titled Global Equity Themes and Sectors Correlation to the Cycle. And what you've got here, if I can describe it, is you have global equity sectors that are laid out the way that everybody who has their CFA charter considers it, which is industrials, financials, real estate, materials, utilities, consumer discretionary, info technology, consumer staples, telecom, energy and healthcare. And the average sector correlation there you quote is 0.167. And then you go traipsing over and the next thing, and you list a bunch of stuff I've never heard of or seen, which is called Global Equity Themes and you lay out food, agriculture, clean energy, ecology, water, lifestyle, climate, clean living, infrastructure, solidarity, biotech generation, robotics and wellness, which I don't even know what to do with that. But the average theme correlation is 0.095, which is materially lower. So how did you get there? Because this flies in the face of a lot of heady finance, the white curtain finance.

Tim: Yeah, absolutely.

Stewart: This is the white curtain finance. And so talk to me about the themes idea because this is really a different way to consider risk, right?

Tim: Yeah, absolutely. And I think this whole idea of thematic investing is a lot more common with insurance companies outside the United States, but should be common with insurance companies regardless of region. And if you think about thematic investing at its core, if a thematic investor is doing their part and their philosophy and process is strong, they've identified long-term structural themes that in theory would be agnostic to any point we're at in the cycle. And so if you think about inefficient markets in particular, and for me, emerging markets are a prime example of this. And you think, okay, here are some regions that are still growing that still need to develop, what are the key themes in risks that they'll face that they must address or that the private sector must create answers for, for them to be viable in 10, 20 years? You isolate those themes and then you look for structural winners there.

So there's an element of easier said than done, and I totally agree with that. But at our firm, we take future themes research incredibly seriously. And so what we like to do is tease out what those structural themes are and where can we look for opportunities. And when you think about the correlation benefit or the diversification benefit here versus cycle, it kind of makes sense because we're investing in these long-term themes that are playing out whether or not the market's in a recession or a bull market or anything in between. And the difficult thing, and I think some reason that insurance companies have been hesitant to embrace this approach historically, at least in the United States, is that you do have to consider measuring this with secondary benefits as well. I don't believe that this is a thing you want to make a return concession on, but I do think you also need to monitor is the theme playing out the way that the portfolio manager believes it should be? And if they're worth their time, they're going to be able to justify that to you.

So I think having a thematic allocation in addition to it being something that's diversifying from a traditional cycle also could help fulfill things like financial commitments around sustainability or diversity or all of those other considerations that are factoring into portfolio construction at this point. So you actually get what we call secondary benefits of considering diversification by looking for these opportunities on the margin. And I think you're going to see this part of the market, in particular in places that are less efficient, grow substantially.

And one last thing on this idea of secondary benefits, I think things that can be either explicit or quasi hedges to inflation, not just necessarily owning commodities directly, I think you could also seek those out when you're considering your

overall diversification. Because if you believe as I do, and I think today's inflation print, even though it matched consensus, was still higher than some folks wanted, I think structurally higher inflation is something we need to be prepared for moving forward. And I don't believe the insurance industry is positioned well for that at all.

Stewart: So I'm mindful of time, but I want to get this in too. Geopolitical risk too big to ignore. And I think that is, if I may read between the lines a little bit there, you're saying, "Hey, you've been able to ignore this largely to this point, but no more. Ignore it at your peril." Give me some background?

Tim: Yeah, I think that's absolutely right. And I think there's this element of, well, if these big events happen, if these tail events happen, what can I do? They're inevitable in some ways or they're unpredictable in others. And I actually think that that's a dangerous precedent to have moving into the world that we find ourselves in today. And so as I think about how insurance companies are exposed, I don't even think that there's really a good risk assessment being done through traditional enterprise risk management to even know how they're most exposed and how are you tracking what the trigger points are for your largest country pairs in your portfolio? How are you hedging tail risks through investments in something like a gold ETF that maybe you carry on a structural basis that serves as a geopolitical risk hedge?

But as we consider the world and how we're seeing the issues of deglobalization brought in part by geopolitical risk only starting to grow, I think you're going to see continued onshoring, you're going to see fighting for the best technology for the best workers, for the fastest spend in places like AI and climate transition. All of those feed into national security in some way.

And so while I think it's critical and essential to recognize the risks in the downside that certainly exist within the geopolitical arena, and I think it's safe and sad to say the left tail is much larger than the right tail, I do think you can be opportunistic here as well and say, "Okay, what's structurally important to these countries? How can I make investments on the margin where I know, similar to what we just talked about from a thematic perspective, there's going to be significant spend by a government to onshore something that's systemically critical?" And so I just think about the CHIPS Act in the United States or the aptly named Inflation Reduction Act that went along with climate spending, but all of this spending offers investors and insurers, in particular, those that can hold longer duration assets, substantial alpha in the face of looming risk. And quite frankly, I don't think it's being done nearly enough.

Stewart: I really appreciate you being on. It's a great paper. It's a very interesting work. I mean, I so respect people who are willing to challenge the status quo in terms of the way that we think about things, and I really appreciate that. I want to throw in one personal off the wall personal question for you because we haven't done any of that and we've been just talking business. So off the top of my head, what was your first concert?

Tim: Oasis.

Stewart: Oasis?

Tim: Yeah. And truthfully, I'm still a fan till today, but yeah, I was in elementary school and as they were known to do at the-

Stewart: Elementary school.

Tim: ... as they were known to do at the time-

Stewart: I was 38 and you were in elementary school. Okay, go ahead, Tim. Tell me some more.
Tim: So my mom took my friends and I, which is true. And actually it was their last show for a while because I believe one of the brothers threw a bottle at the other mid set, so they actually walked off. And I remember being a little kid being like, so this is what music's like.

Stewart: Wow.

Tim: That was my first concert. How about you? I have to ask.

Stewart: It was Billy Squire and Pat Benatar.

Tim: Oh, that's great.

Stewart: I was in the sixth row in front of the stage left speaker stack, and I couldn't hear for three days, but I didn't care. It was amazing. I couldn't drive yet.

Tim: That's awesome.

Stewart: Yeah, it was cool.

Tim: See?

Stewart: You know what I mean? Some people, my wife is a big music person and she's seen all these interesting shows, and I've got the same lame list on movies too. Still the same. So listen, man, thanks for being on today. I really appreciate it. I've learned a lot. And I love your work and thanks for being back on. You're in a very rare society of folks who've been on four times, so thanks for being on, man.

Tim: It's a pleasure. Looking forward to the fifth, and love being on, Stew. Thank you so much.

Stewart: Good deal. We've been joined by Tim Antonelli, Managing Director Insurance, Multi-Asset Strategist and Portfolio Manager at Wellington Management. Thanks for listening. If you have ideas for a podcast, please shoot me a note at podcast@insuranceatum.com. Please rate us, like us and review us on Apple Podcast, Spotify, Amazon, Google Play, or wherever you listen to your favorite shows. My name's Stewart Foley, and this is the InsuranceAUM.com podcast.