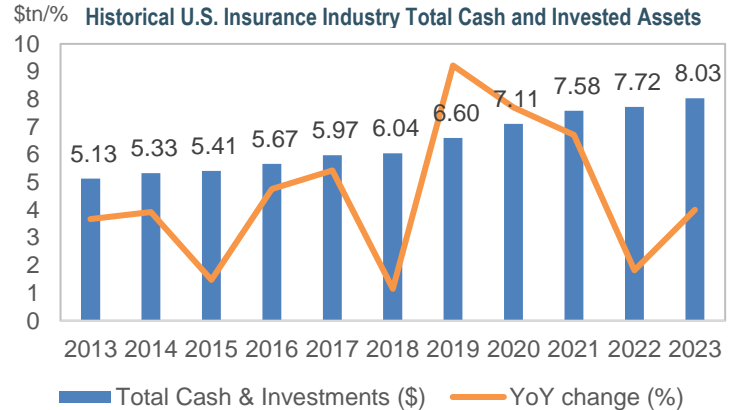


Every spring, Income Research + Management (IR+M) delves into insurance company filings and extracts the previous year's key investment portfolio trends. In 2023, the overarching theme was reminiscent of that in 2022. Similar to 2022, insurers continued to benefit from higher new money yields, but unlike 2022, had the added benefit of strong equity returns in 2023, with net investment income reaching a new pinnacle. Today, with elevated yields, we believe that insurers can further optimize their investment portfolios.

### 2023 Allocation Lookback

- Insurers benefited from a combination of favorable equity market returns and higher new money yields. In 2023, U.S. insurers' total cash & investments grew by \$309 billion to over \$8 trillion, a 4% increase year-over-year (YoY).
- Insurers' net investment income set a record for the second consecutive year. For life insurers, net investment income increased a record-setting 9.6% YoY, achieving a new high of \$225 billion.
- After a weak 2022, insurers reported an improvement in their unrealized gain/loss position of \$82 billion in 2023 and realized gains of \$38 billion.
- Life insurers' total realized capital losses reached a 15-year high of almost \$39 billion. In 2023, insurers actively sold their securities with lower book yields and reinvested the proceeds at higher rates, resulting in a nearly \$7 billion increase in capital losses, albeit with enhanced book yield. The impact of those realized losses was understated due to life insurers' ability to defer certain realized gains and losses to their interest maintenance reserve (IMR).
- Asset allocation changes were modest. Insurers' allocations to bonds marginally decreased and equity allocations slightly rose due to significant equity inmarket strength.
- Insurers' allocations to cash/short-term vestments increased as insurers reinvested proceeds from maturing holdings into shorter-duration, higher-yielding bonds.



(\$bn)	2019	2020	2021	2022	2023
Net Investment Income	254	251	271	282	299
Realized Capital Gains	4	0	12	-7	38
Unrealized Capital Gains	106	47	117	-130	82

\*Table includes the total insurance industry (Life, Health, and P&C insurers)  
 \*Unrealized Capital Gains shows the change in net unrealized capital gains less capital gains tax and includes equity in undistributed income.

(%)	Bonds	YoY Change	Equity	YoY Change	Loans	YoY Change	Cash/ST Investments	YoY Change	Other**	YoY Change
Life	70.8	-1.4	1.2	0.0	17.1	0.5	3.6	0.8	7.2	0.1
P&C	59.2	-1.3	25.2	0.2	1.5	0.0	9.1	1.3	5.0	-0.2
Health*	61.1	-0.3	8.0	0.0	0.2	0.1	34.8	1.1	7.3	0.0

\*Health data as provided by S&P SNL does not sum to 100% due to different filing methods. \*\*Other includes Real Estate and Other Investments.

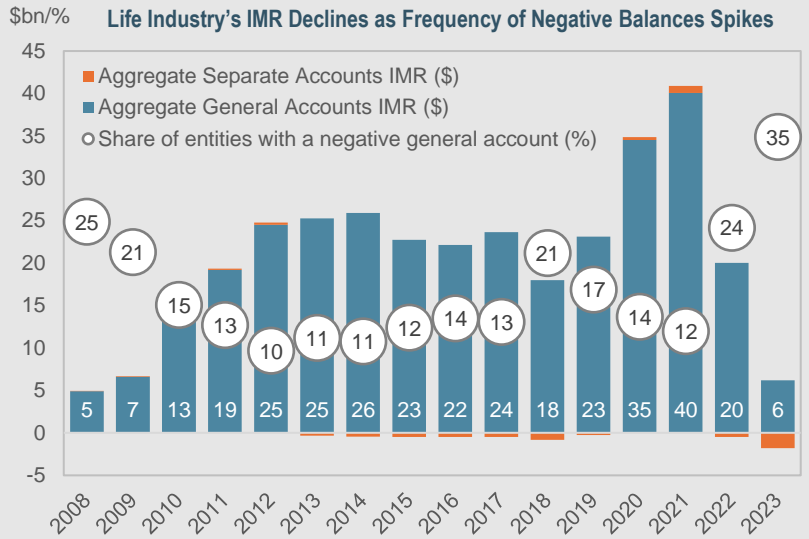
### Fixed Income Observations

- Allocations to fixed income were relatively stable YoY. While still remaining the largest asset class at 60.8%, allocations decreased 1.5% YoY, and roughly 9.2% since 2010, as insurers have sought higher yields in other alternative asset classes amidst a prolonged low interest rate environment.
- In 2023, overall credit quality based on the temporary National Association of Insurance Commissioners (NAIC) designations continued to improve as the yield advantage between investment grade and high yield bonds remained well below historical averages. Investment grade bonds (those with NAIC 1 and 2 designations) accounted for 95% of bonds, up a marginal 0.3% since 2022. Below investment grade bonds (those with NAIC 3 designations and below) decreased to 5% of total bond exposure, after reaching 6.1% in 2020.

Sources: All data, charts, and tables sourced from S&P SNL Financial as of 12/31/23, but retrieved on 5/7/24.

**What is IMR & the new temporary NAIC rule?**

- Held on insurers’ balance sheets in accordance with statutory accounting principles (SAP), IMR allows insurers to defer realized gains and losses to smooth the impact associated with interest-rate fluctuations.
- The balance of IMR for the life insurance industry decreased by 50% in 2022 and another 50% in 2023 because of the higher interest rate environment that led to realized losses. Under SAP, net negative IMR is treated as a non-admitted asset, which means it cannot count toward capital. If an insurer were to rotate out of a lower-coupon security into a higher-coupon bond, it would have been immediately dilutive to regulatory capital for insurers with negative IMR.
- The NAIC implemented a new temporary NAIC rule for life insurers that allows them to temporarily admit negative IMR up to 10% of their regulatory capital, providing additional flexibility for rotating into higher-yielding assets if their loss budgets allow for it.
- In 2023, 35% of life insurers reported a negative IMR in their general accounts, up 11% from 2022. Some large life insurers could admit additional amounts of negative IMR, but given the limited duration of this temporary rule through the end of 2025, insurers are cautiously proceeding.



**Fixed Income Observations Spotlight:**

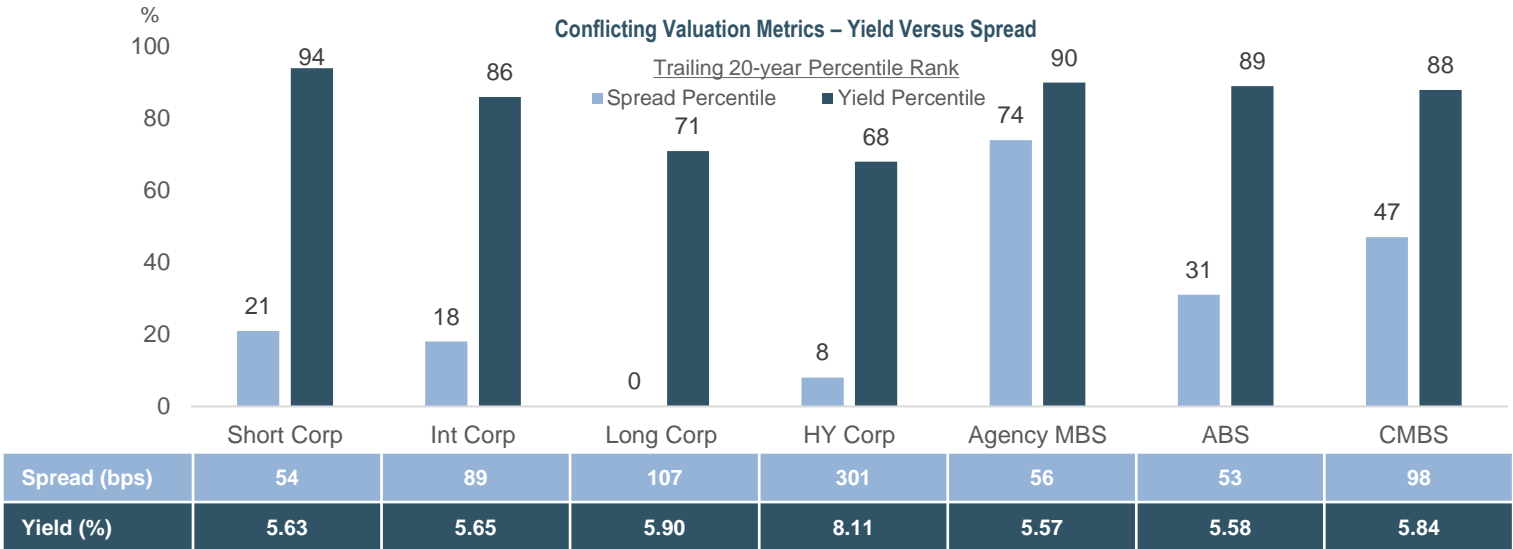
**NAIC’s Principles-Based Bond Definition Project’s Impact on Asset-Backed Securities**

- In 2023, the NAIC voted to update the accounting treatment rules for a new “principles-based” definition of a bond, which will become effective on January 1, 2025. Insurance regulators want to ensure that structured securities provide the stable and predictable cash flows typically characterized by debt.
- The current NAIC definition of a bond is quite broad, whereas the new rule requires that a bond be either 1) an issuer credit obligation or 2) an asset-backed security (ABS).
- This new definition may cause investments to be reclassified between investment schedules, which could impact asset valuation reserves’, Risk-Based Capital (RBC) charges, and ultimately the broader ABS market.
- The new definition for ABS stipulates that:
  - The holder of a debt security issued by an ABS issuer must be in a different economic position than if the holder owned the ABS issuers’ assets directly (“Substantive Credit Enhancement”). This is most likely the case for investment-grade tranches.
  - ABS backed by cash generating non-financial assets must meet a “Meaningful Level of Cash Flows” test. In analyzing whether a security passes the test, investors must consider both the contractual cash flows in place, as well as the price volatility of the underlying asset (among other factors). As a practical expedient to passing the test, securities that repay more than 50% of the bond balance through contractual amortization of the debt are considered to have a ‘meaningful’ level of cash flows.
  - The NAIC is also changing RBC charge requirements for all ABS residuals – the RBC charge on residual tranches is increasing from 30% to 45% for life insurers and may also increase to 45% for health and P&C insurers.
- Given that ABS and other structured securities have been the fastest growing bond types in recent years, this new definition may change how insurers invest going forward, as well as the pace of new investment within the sector. We believe these changes further underscore the importance of fundamental credit research and a solid understanding of both the underlying collateral and structure.

Sources: Data and charts sourced from S&P SNL Financial as of 12/31/23, but retrieved on 5/7/24.

IR+M's Take On 2024 & Opportunities in the Current Market Environment

Conflicting Valuation Metrics – Yield Versus Spread



- Amid continuing rate volatility and uncertainty regarding the timing of the Federal Reserve’s first rate cut, we believe we can partner with insurers to further optimize their investment portfolios.
- Over the last year, we have seen significant spread compression, with corporate spreads near or close to record tights. Although spreads remain narrow across sectors, the overall yield environment remains high, and opportunities persist, particularly within:
  - **Asset-Backed Securities (ABS) (Non-traditional):** We favor high quality non-traditional ABS subsectors from programmatic issuers. We believe these subsectors offer insurers attractive spreads, yields, and capital treatment. These sectors also provide diversification, stable cashflows, and strong structural protections.
  - **Commercial Mortgage-Backed Securities (CMBS):** Given market concerns around commercial real estate (CRE), we believe CMBS spreads offer a meaningfully attractive entry point; however, security selection and credit analysis must be heavily emphasized. New issue deals and seasoned securities backed by low office exposure, diversified property types, favorable geographic footprints, and high levels of structural credit enhancement offer attractive risk/reward characteristics. As investors within the AAA-tranche, our primary concern is around extension risk, rather than principal loss, due to the strength of the structure and significant credit enhancement that can build as a deal seasons and de-levers. Understanding potential extension risk is top of mind and a key part of our valuation framework when assessing potential investment opportunities within this sector.
  - **Small Business Administration Loans (SBAs):** At IR+M, we invest in pools backed by loans issued under the SBA’s 504 Loan Program. Guaranteed by the full faith and credit of the US Treasury, we believe SBAs offer insurers diversification benefits with attractive spreads, yields, capital treatment.

**With elevated yields and uncertainty around rate cuts, we believe that robust, bottom-up security selection is more essential than ever. Through our experience of managing high-quality, fixed income portfolios, we feel we are well-positioned to partner with our insurance clients in optimizing their book yield and limiting financial statement volatility.**

Sources: S&P SNL Financial as of 12/31/23, but retrieved on 5/7/24, and Bloomberg as of 04/30/24. Conflicting Valuation Metrics chart is based on Bloomberg Indices (Short = Bloomberg 1-3yr Corporate Index, Intermediate = Bloomberg 3-10yr Corporate Index, Long = Bloomberg Long Corporate Index, Bloomberg US High Yield Index, Bloomberg US MBS Index, Bloomberg ABS Index, and Bloomberg CMBS Index, respectively). Percentile calculated using monthly spread and yields back 20 years. The views contained in this report are those of Income Research + Management (“IR+M”) and are based on information obtained by IR+M from sources that are believed to be reliable but IR+M makes no guarantee as to the accuracy or completeness of the underlying third-party data used to form IR+M’s views and opinions. This report is for informational purposes only and is not intended to provide specific advice, recommendations, or projected returns for any particular IR+M product. Copyright © 2024, S&P Global Market Intelligence. Reproduction of any information, data or material, including ratings (“Content”) in any form is prohibited except with the prior written permission of the relevant party. Such party, its affiliates and suppliers (“Content Providers”) do not guarantee the accuracy, adequacy, completeness, timeliness or availability of any Content and are not responsible for any errors or omissions (negligent or otherwise), regardless of the cause, or for the results obtained from the use of such Content. In no event shall Content Providers be liable for any damages, costs, expenses, legal fees, or losses (including lost income or lost profit and opportunity costs) in connection with any use of the Content. A reference to a particular investment or security, a rating or any observation concerning an investment that is part of the Content is not a recommendation to buy, sell or hold such investment or security, does not address the suitability of an investment or security and should not be relied on as investment advice. Credit ratings are statements of opinions and are not statements of fact. “Bloomberg®” and Bloomberg Indices are service marks of Bloomberg Finance L.P. and its affiliates, including Bloomberg Index Services Limited (“BISL”), the administrator of the index (collectively, “Bloomberg”) and have been licensed for use for certain purposes by IR+M. Bloomberg is not affiliated with IR+M, and Bloomberg does not approve, endorse, review, or recommend the products described herein. Bloomberg does not guarantee the timeliness, accuracy, or completeness of any data or information relating to any IR+M product.