Paul Benson

Episode 240: Revolutionizing Fixed Income: Systematic Fixed Income in Insurance Portfolios

GUEST Q & A

Stewart: Welcome to another edition of the InsuranceAUM.com podcast. My name is Stewart Foley. I'll be your host. Thanks for joining us. I got to tell you, just from a personal standpoint, that I'm always excited when we get to talk about fixed income. And as any insurance investment professional has got to have a little bit of a love affair with fixed income, I mean, if not, you're just not trying. And today, we're joined by Paul Benson, CFA and CAIA designations, head of systematic fixed income at Insight Investment. Paul, thank you very much for taking the time with us today.

Paul: Really excited to be here.

Stewart: It's awesome. We just got done shooting the breeze about the weather and whatnot. You're out in the Bay Area, and I'm in central Texas today, so very happy to have you on. I want to start us off like we always do, which is where did you grow up and what was your first job? Not the fancy one.

Paul: Yeah, not the fancy one. So I grew up in Copenhagen, Denmark.

Stewart: Oh, you're kidding.

Paul: And no. Nope. So I'm Danish. Spent quite a while here in the US, though. So, as most of your participants here, I grew up delivering newspapers, but this is inner city Copenhagen. So if you can imagine, all the buildings are about five stories, no elevators. So it's a kid, 10 years old, running up and down stairs for a couple hours. A lot of fun and a lot of work.

Stewart: That's super cool. I mean, I don't know if maybe you don't know this, but Lindy O'Brien, our CMO who is listening to this podcast being recorded, was also a paper person as well, and I used the term paperboy. And one of our clients corrected me and said, "Hey, be careful with your gender over there." And I said, "Okay." So she was a paper delivery person as well. And so that has got to be one of the most common first jobs we've had on the show. But welcome, and we're thrilled to have you.

I want to start us off if you can give us a little bit of background on income investment first. But the question I want to begin with is really focused on systematic fixed income, which has recently hit the mainstream. But insight has been fine-tuning this approach since 2001.

Can you talk a little bit about the key developments and innovation in your approach to systematic fixed income over the past two decades?

Paul: Yeah. No, that's great because there are different approaches within systematic fixed income. And certainly, we've taken one approach that we think works well, but other firms might have different avenues. So that's a good place to hollow out.

Also, yeah, I'll echo that. It's a wonderful time to be in this space given that suddenly you've got this very steep adoption, a lot of growth within this space, primarily because of the proliferation of data, just the amount of data, the quality of the data, and it's continuous expanding now. But there were a lot of years where it was tough going just because, if you go back 20 years, there really wasn't a lot of investor interest in quantitative approaches on the fixed income side. On the equity side, it was well baked in, but on the bond side, it was slower going. And so we started our approach and back in right after the turn of the millennium.

And so we were definitely early in that game. I think we were able to do that because our whole firm was, at that time, very quant-oriented. So before our team joined Insight Investment, we were part of Mellon Capital Management, which actually sort of led the revolution here in the Bay Area on things like indexing, on quantitative equity approaches, and on... I think we trademarked the global tactical asset allocation approach, this kind of global macro-quant approach.

So we had a large research department that could then take all that knowledge and say, "Huh, nobody's really tried this on the bond side before. Let's see what transpires here." And we certainly were pretty amazed in those early years at just how strong those models can be.

On the equity side, there's a lot of market saturation. On the bond side, there's so little of the marketplaces using any kind of quant approach. So you could see really strong results from your models. But I will caveat that at that time, you had these great simulations, wasn't always so easy to implement the models given the lack of liquidity in areas like corporate bonds.

Stewart: And maybe it's helpful, and I probably should have started there. Can you define for us with some reasonably large crayons how you, in particular, would define systematic fixed income?

Paul: Yeah, absolutely. So we think of systematic fixed income as how can we find asset classes, areas, markets within bond land where we can take these model-driven approaches. So contrast that with the discretionary approach that most managers are adopting. How can we take model-driven approaches to deliver very consistent exposures to the asset classes our clients want, as well as delivering alpha on top of those benchmark exposures?

And systematic can mean a lot of things to a lot of different people. Like today, a lot of people are probably thinking, "Oh, AI and all that stuff." For us, systematic investments really starts with the concept of, "Can I take the common wisdom? What seems to work," and, "Can I make that more robust, more disciplined, more data-driven?" And what I mean with that is we start with this concept of creating intuitive economic models and testing those out. Then we see if that works in a systematic framework. So it's never the other way around. It's not like back-testing or data mining just to sort of find the answer that you're looking for.

Stewart: That's super helpful. So let me change gears just a little bit. So inside investment pioneered credit portfolio trading in an effort to improve liquidity in high-yield markets, can you talk a little bit about how this approach enhances access to the full spectrum of high-yield risk premiums, and what advantages does it have over traditional credit analysis?

Paul: So let me start with a simple answer which is high-yield is an area that's very illiquid. If you take the whole US high-yield market, it's a couple thousand bonds in the broad indices. And most of those don't print a trade on any given day. So maybe a certain percentage of the third of those might trade on any given day. The rest of them aren't trading.

And so for a traditional investor that's trying to buy these bonds one at a time in the traditional ways, going through the broker dealer, looking for a block of XYZ, that can be really hard, really time-consuming, and really expensive. And a lot of times, you're just not going to find what you want. And so credit portfolio trading means that we can go out. I can take a list of a thousand high-yield bonds. And I can send that out for competitive bids. And I can get six responses within the hour. And say, "Okay, this is where we'll price those thousand bonds." And then I'm going to sell or buy every single one of those thousand bonds at that time. So the whole transaction's done in 90 minutes flat. And so that can be for a total block of $5 million, or it can be a total block of $500 million. I mean, there's just incredible flexibility in this space.

So this is one of the biggest advantages I would say to investors in today's world. If you harness this technology, something like credit portfolio trading just really expands the borderlines in terms of what you can achieve for your portfolios in terms of liquidity, in terms of breadth, diversification. It's an arrow every investor should have in their toolkit.

Stewart: That's super interesting. So let's talk a little bit about insurance companies and high-yield. So rising interest rates have narrowed the illiquidity premium between private credit and high-yield. In the end of QE-driven strategies, how do you see high-yield fitting into the income-focused strategies of an insurance company, especially considering what they've got to deal with on the regulatory side? There's all these externalities that insurers deal with that nobody else does. I think we always want our guests to take those into account when we're talking about particular markets.

Paul: Yeah. So I know you've spoken to Kerry from our team, who has been managing insurance assets for more than 30 years. And so we really try and stay on top of what is it our clients want and need, or what do we think they will need in the future, so we can provide them with all the best solutions to match their needs. And one of those things certainly is, I think, access to all aspects of the entire efficient frontier within bonds. And so maybe it's worthwhile to think, "Well, what's driven this explosive interest in private credit that you mentioned in the past years?" I would certainly point to quantitative easing. That zero rate environment meant that anyone who had any kind of hurdle or return objective had to go out in terms of complexity or illiquidity risk premium, anything, in order to get that additional juice.

And certainly, private credit seem to offer a lot of that because it is very complex. It is very concentrated risk, so idiosyncratic risk as you're taking that on, and then you've got massive illiquidity risk, so you should get paid for that. Now, recently, what we've seen is as that space has gotten really sort of pummeled with a lot of cash, that spread that you're collecting between private credit and public credit has certainly diminished to the point where I think a lot of people are asking the question, "Hmm, could we get our same return hurdles in a better way?"

Traditionally, I think insurance companies have not done too much in the high yield side. They've done a lot on their own, even in the investment-grade side. A lot of these insurance companies have very strong investment-grade management teams within their companies. But high yield has traditionally been a lot more difficult to manage. There's a lot of… Traditionally, you needed to have a large analyst team who can really cover all the different areas. If you're going into the lower echelons of the junkier stuff, you probably need to have some distressed skills in your team. And then there's this whole rating problem with these bonds whenever you start thinking about how to package these in something that's much more liquid, like an ETF.

So we've tried to respond to a lot of those hurdles. And we think that we've overcome them with our systematic approach. So for example, the systematic approach, as we talked about earlier, can get you this really liquid access to a very broad, diversified set of higher bonds that can match or even beat these very hard-to-beat benchmarks out there. And then we package this. So we've been running ETFs in my team since 2008. And so we've been packaging that same strategy in an ETF BKHY, where now you're delivering it in an equity-like vehicle, so you can get that immediate, very, very low cost of transaction trading for any kind of insurance company that's looking for tactical opportunities.

They're not the sleepy giants of the old days. They're very interested in tactical opportunities from a macro perspective or taking advantage of relative value opportunities. And so they need vehicles that they can get in and out of. But traditionally, these ETFs, they had some capital penalties, capital regulatory penalties because they didn't have the right bond ratings. And so we've worked hard to make sure that our ETF does have an NAIC rating, which we think... or what you're hearing from our clients is very helpful for them.

Stewart: Yeah. I mean, I want to touch on that specifically in just a minute. I just want to focus on customization and optimization for insurance investors. And the question kind of goes if that systematic approaches offer significant potential for customization around unique investor constraints, and God knows insurance companies have constraints, and there's a lot of reasons for them, a lot of good reasons, but the ability to handle those is really important, right? And so there's things like capital charges, duration ratings, buckets, and so forth. Can you talk a little bit about some examples of how Insight Investments insurance clients have leveraged the systematic strategies to optimize their SAA?

Paul: Yeah, no. So this is where the beauty of systematic approaches. And I say diversified, systematic approaches really come to play. At the end of the day, our models are benchmark-agnostic. So what that means is that we really rely on our clients to tell us what are their constraints. What are they worried about? What do they need to think about in the market landscape that we can help to optimize? And so frankly, we may have a European insurance client who has a capital penalty that's very highly correlated to the maturity of the underlying assets or the duration. And so we can go, and we can define. And we can look at what those capital charges are, and we can build a systematic, diversified portfolio of high-yield bonds that's concentrated in bonds that have maturity less than three years, for example. Or if there's a similar client that has an aversion to triple-C, for example, we can construct a portfolio that has only double-B and single-B bonds in a very diversified manner.

But the important part here is this concept that we're not tied to whatever a traditional analyst team may have as their strengths. We are given the systematic approach. We can customize that to whatever it is. As long as the bonds are available somewhere in the marketplace, we can customize around that.

Stewart: And so I want to talk a little bit about the role of ETFs in SAA. And so insurance companies have been trending toward increasing their allocation to ETFs, part of it is SAA, but it's also the case that there's some inconsistencies in the way that ETFs are treated by state regulators from an issuer concentration perspective, even though some are given look-through by the NEIC. And so, can you talk a little bit about the benefits and the challenges that insurance companies face when integrating ETFs into their portfolios?

Paul: Okay. So I would start with thinking about the fact that ETFs at the end of the day... I agree with ETFs are probably one of the most amazing beneficial things that have happened to fixed-income investors in this century, for sure. But having said that, when you use ETFs, you are constrained to whatever that ETF is investing in. And so, for example, take our high-yield ETF BKHY as an example. That targets a certain benchmark. That you're limited now to those specific criteria. Whereas, obviously, if you have a separately managed account, you can define it however you want. You can get much more fine-tuned customization. So the ETFs benefit, I would say, is that there is massive liquidity, and that liquidity portion cannot be overstated.

A couple of ways that we think about it that really blows my mind is in high yield, the illiquidity risk premium is rampant, right? You're getting paid not just for the default risk of high-yield bond. You're getting compensated a nice spread because there's also illiquidity risk in a lot of those bonds. But when, as soon as you take those same bonds, just like you said, you package them into this equity vehicle, all of a sudden you're getting an ETF that trades a thousand times a day at pennies whitebait as spread in as much depth as you want, as much liquidity as you want. Does that work? How is it that you can get compensated for an illiquidity risk premium, and yet you're trading it in an eminently liquid vehicle? I think that's a really, really interesting advantage that not many investors have fully thought about yet. But the benefit is that you can take a lot of those liquidity concepts and you can translate them into a non-ETF vehicle. So we run the same strategies as we do in our ETF, or in commingled fund vehicles, or in separately managed accounts.

We have accounts that are $20 million in size. And the same exact strategy is run in accounts that are billions of dollars in size because it's systematic. And what we've done is we've said, "Well, what is it that makes ETFs so liquid?" Well, we can replicate that in our standard segregated portfolios as well. Really, it's down to portfolio trading. And so what we've done is we've said to the marketplace, "Hey, treat our funds, our strategies, our client strategies as if they're ETFs." So when we go out to marketplace, here's the basket of 500 or 1000 bonds that we want to trade just like we were in ETF.

Stewart: So you touched on this a minute ago, but receiving an NEIC designation on a bond ETF, as I understand it, allows for the ETF to be treated from a capital charge perspective based on the underlying assets of the ETF. Without that NEIC designation, ETFs get treated as equity, which is a high capital charge. So can you talk a little bit about what was the process like getting rated? And can you talk a little bit about how this designation has impacted the adoption of insight investments high yield and fall on angel strategies with insurance companies? And just walk us through that area of what it's like to get an ETF rated, for one thing.

Paul: Yeah. So, I mean, I think that had a lot to do with our long history of working with insurance companies. So we knew that when we were launching this ETF on high yield, which back in 2020... Separate funny story we launched that in April of 2020, so right during the heat of the COVID crisis, which is a fun separate little conversation.

But when we launched it, we knew that this could have great appeal to the insurance industry if we could make sure that we get that look-through so if we made sure that it doesn't get treated like an equity. And of course, that's one of the things from the last question that I think a lot of investors still have a hard time getting their head around. So these ETFs are, at the end of the day, equity ETFs, but they represent bonds. And so they should, for all intents and purposes, be treated as a collection of bonds. And that is what getting an NAIC rating. NAIC rating really has to do with. So it means working with the SBO and making sure you go through it.

It's a lot of paperwork, essentially. And getting it to reflect the underlying basket of bonds and so that it comes out at the end of the day something that overcomes those regulatory reporting challenges that the underlying investor may have.
Stewart: That's awesome. I've learned a tremendous amount today. I'd love to know this. If you could give us two or three bullet-point takeaways on systematic fixed income for insurance companies, what would they be? And then I've got a couple of fun ones for you at the door.

Paul: A couple bullet points would be, first and foremost, I would say we're at the end of quantitative easing now. It's in our past. Rates have normalized. And high yield is a space that offers amazing benefits, sitting at right at the edge of that efficient frontier. And so you can collect 7%, 8% yield with an asset class that really has a lot lower defaults than one thinks. And you don't have to have this idiosyncratic risk from a concentrated portfolio if you invest in one of these well-diversified ETFs or in a well-diversified separately managed account. That's one bullet point I would say people should be aware of.

Number two is this concept that high yield is not the high yield market people think of when they think of the Michael Belkin days, and the junk bonds, and the LBOs, and all that. I mean, high yields are very... It's a much safer environment today. When I think of double-Bs, I think of double-Bs as the new IG, if anything. These are just very solid companies with robust underlying financials. We have oodles of data that showcase historical default rates run at like 2.5%, less than 2.5%. So really, very, very manageable.

And then the third thing I would say is they really allow you to access this full-risk premium that this asset class embodies ETFs, that is. And to the extent that insurers are prioritizing income and capital preservation, this seems like a great place to be in the next 10 years. We've seen countless of studies from consultants that say, "Hey, given where rates are now, given where we are in the economic cycle, we think that equities are going to deliver about the same over the next 10 years as high yield bonds are." So given those two, and given that high yield has about 50% to 60% of the volatility that equities have, which would you rather be in?

Stewart: Yeah, I think it's an interesting point. And yeah, I really appreciate you being on. It's been a great education. I want to see if we can talk about a little bit of fun stuff on this side. So my notes tell me that you got your undergraduate degree at Michigan, right? At the University of Michigan. Did you walk at graduation?

Paul: I did not. So I had to leave early, so I missed my own graduation.

Stewart: No, listen, man-

Paul: Get started on my job.

Stewart: Yeah, listen. Well, see. That's what I always tell my students. I'm like, "Listen. Take some time between graduation. You're never going to get four to six weeks off again for years, man. Go out and go to Europe. I don't care if you can't afford it, just go."

But I want to take you back to when you got your undergraduate degree, and when you left early, and you started your work right away. And just to ask you, what advice would you give a 21-year-old Paul Benson or anyone else who's kind of starting out in the institutional asset management space? What advice would you give them? I mean, you got a CFA. I got a CFA. You've also done CAIA. Like, what do you think about the professional designations, and what would you advise somebody today?

Paul: Yeah. For me, those were a necessity because of the mistakes that I made early in my career... could make my column mistakes. And it's funny because this is advice I'd give myself as a 20-year-old, but not maybe the young people that are coming to our firms these days are just so talented. And they're so thoughtful about their direction, about their whole progression, maybe to a fault, almost knowing what they want to do from when they're 14, 15 years old, which was not my case. So-

Stewart: Don't mind me.

Paul: ... to answer your question earlier, instead of going to the U of M graduation, my first job was not a traditional investment managers job. I went out, and I sold tires in Japan.

Stewart: Wow.

Paul: So that was quite interesting. I did that for about three years at Bridgestone. And then I realized that I love math. I love finance. I want to get back into it. And so yeah, I had to roll up my sleeves, start thinking about how do I break into that. How do I break down that door to get into the asset management industry?

Stewart: That's super cool. I think I love the stories of how people get to their seats. It's always interesting. My story's crazy. And it's definitely... It's inspiring to people. People come into my office, students, and they're 19. And they're stressed out. And they're like, "You know, I don't know what I want to do." And I'm like, "Listen, me either. I'm pushing 60 pretty hard. And it's like I'm still creating."

And there was a gentleman, a senior gentleman, who told me years ago, he said, "I always tell young people don't plan too far ahead because particularly, the pace of change... I mean, Betsy Ziegler, who's the CEO at 1871 in Chicago is the tech incubator. She said this at a CFA Chicago event. And it's true. She said, "Today is the slowest pace of change you're ever going to face for the rest of your life," right?

Paul: So true.

Stewart: And it's like things are changing. And it's like you don't necessarily have to get locked into something. There's new opportunities happening all the time. And I just think it's an incredibly exciting time right now in particular. But here's my fun one I'm rambling on. Here's my fun one on the way out the door. So a lunch table of four, you can invite up to three guests. Who would you most like to have lunch with, alive or dead?

Paul: Yeah. Oh, my God. So I've heard this question from some of your other podcasts, and I... This is probably the one I struggled with most. So thinking about all these titans who really created our industry, right?

So I'm thinking of Markowitz or Eugene Fama. Some of them I've worked with, like Bill Faust, right? Who's widely recognized starting the first sort of quant index fund? He used to come to our Christmas parties back in the day. And I realized that, well, if I sat down at a table with one of these folks, I probably wouldn't. I'm not smart enough to really understand what's going on in their genius hits. And so I thought, "Well, who would I really benefit and have a good time with?" And I thought…

And no disrespect in terms of intelligence level, but I thought there's a Titan, who in my mind, stands out above all else in terms of creating this opportunity that we have today. And that came down to Patricia Dunn, who led BGI and really fought to get ETFs acknowledged. And that could have gone south.

ETFs may not have been a widely recognized tool today if, I think, she hadn't blazed the trails. And I want to sit down at a table with her and understand all the challenges she went through in sort of managing her team, managing her seniors, how to convince them about this new technology that they have to embrace. She just seems like such an interesting, talented leader.

Stewart: Wow, that's a great one. That's a first on our show, to my knowledge. And it's just the ETF space is just been such an important tool. I mean, I know, I'm sure you remember too when they first came out and when they first started to trade. And it is like they've just... They've become such an integral part of the capital markets today that we almost feel like they've always been here, but they weren't. And so that's a great... I'm glad you called them out.

And I'm also happy to hear you call out some folks from the University of Chicago. A lot of people don't know if you go to the future center in downtown Chicago on the sixth floor. They have the pictures of all the Nobel laureates. And Markowitz and Fama are both there, along with many, many others. So that's good stuff too. So I'm really enjoying having you on, Paul. I really appreciate you taking the time. And thanks for the lesson on systematic fixed income.

Paul: Really wonderful to be here. Thanks so much for your time, Stewart.

Stewart: Our pleasure. Thanks for listening. If you have ideas for a podcast, please shoot me a note at stewart@insuranceaum.com. Please rate us, like us, and review us on Amazon, Apple, Spotify, Google Play, or wherever you listen to your favorite shows. My name is Stewart Foley. We'll see you next time on the InsuranceAUM.com podcast.