



## League Table Edition

2018

Insurance Investment Outsourcing Report

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*For Insurance Asset  
Management Professionals*

# EM Debt Investing: Considering the Right Approach

Emerging-market (EM) debt’s strong returns and outlook have attracted flows from wide-ranging investors. Insurers calculating the expected returns of EM debt subsegments must adjust for the cost of capital, so that they can fairly assess opportunities versus other investments in their asset allocations.

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## Renewed Insurance Interest Bolsters Inflows

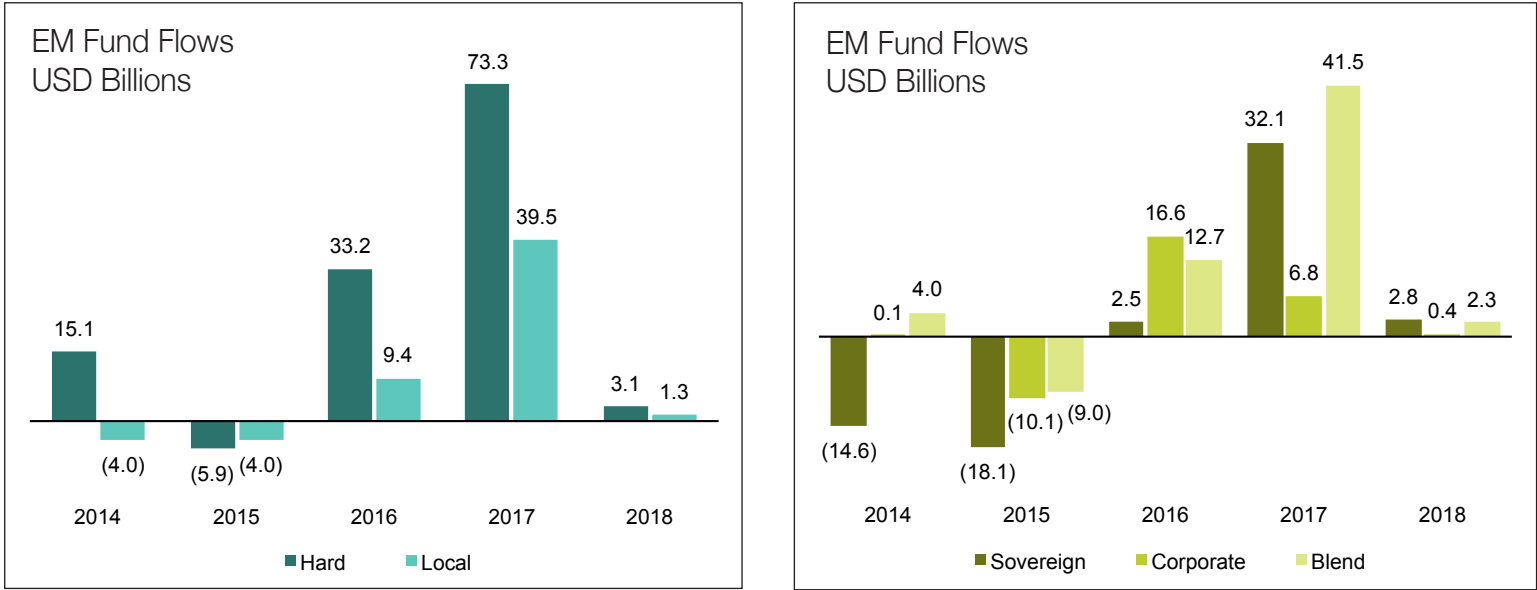
For investors looking for yield in an environment of low interest rates and compressed credit spreads, EM debt offers an attractive range of opportunities. Insurers have resumed their activity in this space, contributing to recent inflows. Insurance interest has picked up from a low point in 2013, when a spike in market volatility during the “taper tantrum” curtailed investment.

The flows into EM debt have spanned market segments. Hard- currency debt, local-currency debt, sovereigns and corporates have all benefited (Display 1). Hard-currency debt has led the way, with over \$106 billion invested from 2016 to 2017. Local-currency debt has seen almost \$50 billion in inflows during that period, as investors’ fears of another taper tantrum have decreased.

From a sector perspective, sovereign-bond and corporate-bond fund inflows totaled over \$34.6 and \$23.4 billion, respectively, while blended funds experienced even greater flows: over \$54 billion. Even in 2018, which is off to a volatile start, trends in EM debt asset flows have remained positive.

Retail investors are generally agnostic about individual EM debt segments, focusing primarily on absolute returns. Institutional investors, in contrast, generally take a more granular approach. They tend to invest more selectively in specific subsectors of the market, as dictated by asset-allocation plans, risk appetite and—in the case of insurers—applicable regulations and capital charges.

Display 1: EM Flows Continue To Be Positive



As of January 11, 2018. Not all hard-currency and local-currency flows fit into categories in left-hand display  
Source: EPFR, J.P. Morgan and AB



### Hard-Currency EM Debt: Charges are Similar to Developed Corporates

For insurers with liabilities denominated in the US dollar, investing in hard-currency debt (US dollar-denominated, for simplicity's sake) is a natural extension of their corporate-bond allocation, so hard-currency debt may be a significant part of their allocation.

The required capital-charge rate for an EM hard-currency bond (either sovereign or corporate) is similar to the capital charge for a developed-market corporate bond with the same rating. This holds true under the supervision of many regulatory bodies, including the National Association of Insurance Commissioners (NAIC) for insurers in the US, and Solvency II for European insurers.

Under the NAIC Risk-Based Capital (RBC) framework, non-US sovereigns and corporates are effectively treated the same as US corporates (Display 2). There is no explicit country or region input into the formula. As is the case with US credit, the NAIC's designation is directly derived from ratings assigned by a NRSRO for a particular issue. The rules are very similar under Solvency II.

Display 2: Required Capital Charges for Non-US Sovereigns and Corporate vs. US

	NAIC RBC	Solvency II
Non-US Sovereign Bond BBB 5-Year	1.30%	12.5%
Non-US Corporate Bond BBB 5-Year	1.30%	12.5%
US Corporate Bond BBB 5-Year	1.30%	12.5%

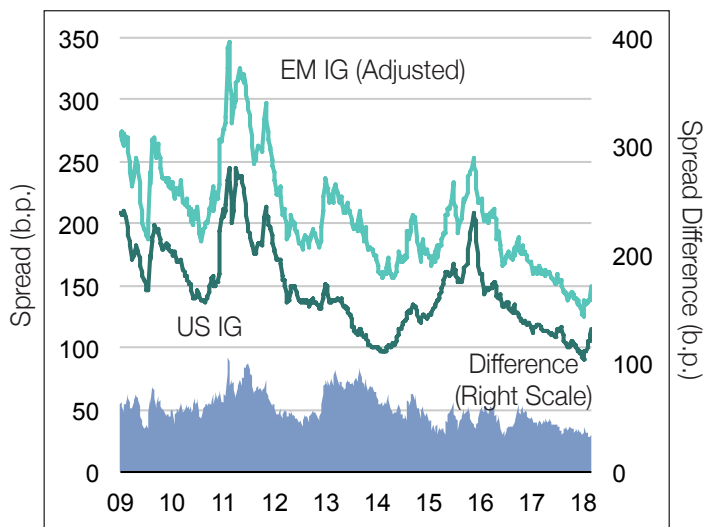
Source: AB

For insurers that hold liabilities in another currency—such as the euro, pound sterling or yen—investing in hard-currency EM debt is also a natural extension of their credit allocation. However, these insurers now have to account for the currency-hedging cost, too, just as they would when investing in US corporate bonds.

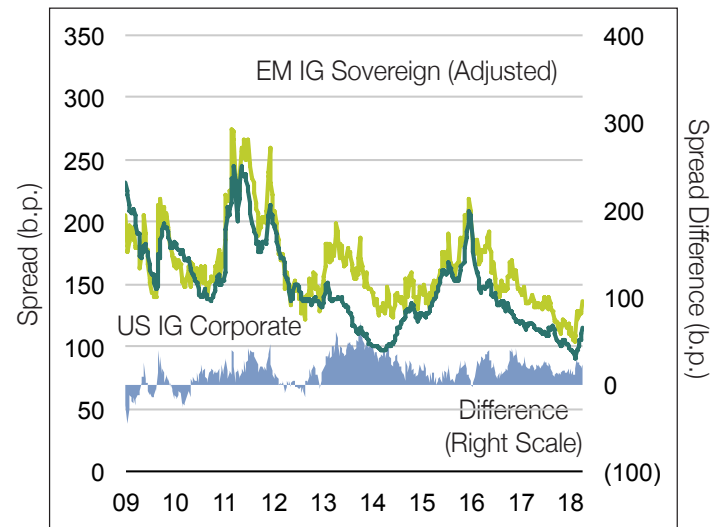
When currency-hedging costs are elevated, as is the case today for European and Japanese investors, the extra yield spread that EM investment-grade debt typically offers versus US corporate bonds (Display 3) may help overcome that added cost.

Display 3: EM Investment-Grade Corporates and Sovereigns Offer Relative Value | Spreads & Spread Difference

#### EM IG Corporate vs. US IG Corporate



#### EM IG Sovereign vs. US IG Corporate



Through March 23, 2018. Spreads are adjusted prior to June 30, 2017. Source: Bank of America Merrill Lynch and AB. Not for inspection by, distribution or quotation to the general public.

## Local-Currency EM Debt: Cost Considerations

Insurance companies shouldn't overlook the potential of EM local-currency debt. This segment does bring currency risk, which may result in an additional capital charge under certain regulatory regimes. However, it can offer attractive return potential in the right environment.

Under Solvency II, the capital-charge rate for currency risk is 25%; for NAIC-regulated insurers, there is no explicit capital charge. Under NAIC RBC, a US dollar-denominated BBB-rated bond has the same capital charge as a bond of the same rating issued in South African rand—even though the underlying economic, credit and interest-rate environments may be quite different.

For US-domiciled insurers, local-currency EM debt investments can bring greater internal complexities—and potentially more volatile financial results. Also, under both NAIC RBC and Solvency II, systematically hedging the currency risk of EM local-currency bonds is very likely to be expensive, with the future cost of hedging more unpredictable than for hard-currency hedging. As a result, insurers investing in local EM debt may prefer to simply bear the currency risk.

The implication for insurance investors: the expected returns from local-currency EM debt must compensate for the added cost of capital and the complications from currency risk. Positioning in this market segment becomes less about substituting for corporate bond exposure and more about having an allocation to a total-return strategy, especially compared with riskier and more capital-intensive asset classes like equities or hedge funds.

## High-Yield: Potential, But Adjust for Cost of Capital

In the hard-currency EM debt segment, as mentioned earlier, the discussion of capital charges is similar to the one happening with developed-market corporate bonds.

In accordance with local regulations, high-yield bonds are either significantly more expensive than investment-grade bonds from a capital point of view, or they're simply inadmissible. In the US and Europe, where high-yield bonds are admissible, it's important to adjust yields for the cost of capital when comparing the relative value of investment-grade and high-yield EM debt.

Where it's appropriate, insurers should consider adding higher-rated high-yield bonds because of the potential for price gains if the issuer's fundamentals improve. For example, a BB-rated issuer with strengthening fundamentals could be on the verge of an upgrade to investment-grade bonds. The bond could see substantial price appreciation before the official rating upgrade takes place. A portfolio that ignores higher-rated high-yield issuers will miss out on these opportunities.

## Understanding Potential Credit Risks Is Key

However, insurance companies should also be aware of the risk of mark-to-market volatility, as well as credit impairment (or default) risk. Even in these cases, though, having a keen understanding of such risks can still allow insurers to invest prudently in the EM debt space.

One example of these risks was the impact of declining crude-oil prices in 2015 and 2016. This development put tremendous pressure on oil and gas companies, many

of which were domiciled in EM countries. Even some investment-grade issuers defaulted. It required deep active research to evaluate the macro environment, understand businesses from the bottom up and determine which were at risk and which were being unfairly punished. The judicious use of stress testing provided insight into which companies were best equipped to survive.

Another instance was Brazil's sovereign-debt downgrade to below investment grade—the result of a corruption scandal in 2015. Brazilian corporate bonds also suffered, and only careful monitoring of sovereign developments and an in-depth knowledge of individual issuers provided insight into which issuers could weather the storm. In general, exporters were the better bet, because their businesses were less closely tied to the Brazilian economy.

## The Big Picture

Overall, EM debt has posted impressive performance over the past few years, attracting substantial inflows. Given the continued strong fundamentals across many countries, there are wide-ranging opportunities in this market for discerning investors.

Insurance companies should also consider that capital-charge rates for many EM debt sectors aren't far removed from the charges for US bonds with the same credit rating. In addition, the more capital-intensive sectors may be worth a closer look, especially relative to other investments in their overall asset allocation. ❀



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