A general insurer's guide to absolute return bonds

Steps you can take to make your bonds more resilient

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The combination of soft underwriting conditions and the low interest rate environment presents a major challenge for insurers.

Over the last few years, many insurers have found themselves following a downward trend into lower quality bonds, just to maintain the same level of yield. Before the financial crisis, you could generate a 4% pa yield by holding cash or high quality government bonds; now you would need to be holding BBB rated bonds, just one step above "high yield" (what we used to call "junk" bonds).

Continuing to lower the quality of your bonds may well end in serious losses. There is a chance that you end up buying the worst quality bonds when yields are at their lowest - ie just before the market crashes. This leaves you most vulnerable at precisely the wrong time. Regulators have recognised this risk, with Mark Carney warning that the Bank of England is being vigilant in monitoring insurers' moves into these riskier investments.

But if you don't join that race to the bottom, then what else can be done to achieve decent investment returns?

A fair bit, as it turns out. The insurers that we work with typically want to retain their corporate bond exposure. However, they want their bonds to be more resilient, particularly given the prospect of interest rates rising. We have researched a number of different options and one that fits the bill well is "absolute return bonds".

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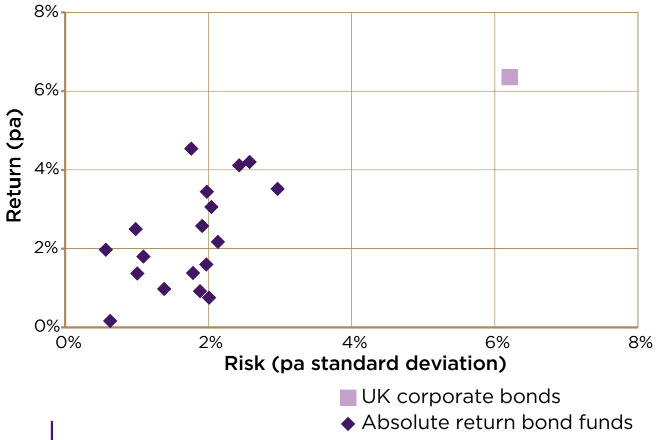
An absolute return bond approach typically:

- Diversifies your investments, across a wide range of different types of bonds;
- Aims to generate a stable 2% pa to 4% pa above cash returns. This objective – relative to a cash benchmark rather than a bond market index – is important, as it means that managers are not tied to an index that may fall if interest rates are rising;
- Focuses explicitly on not losing money when bond markets are falling, by giving the manager flexibility to reduce risk quickly in tough market conditions; and
- Helps you capture opportunities quickly and avoid overheated areas of the market, which may improve governance.

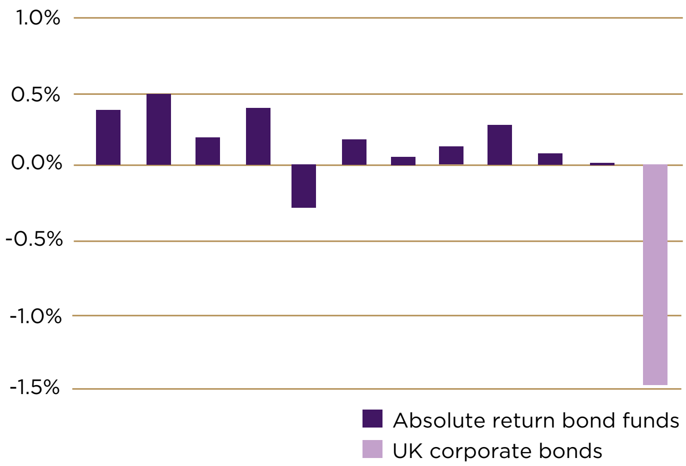
Risk vs return on absolute return bond funds over 3 years to 30 June 2015



Corporate bond markets have had a strong run recently, returning close to 7% pa over the last 3 years, so reducing risk by switching into absolute return bond funds would help bank those profits.

Rule #1 – don't lose money! Absolute return bond managers have proved resilient in months when the corporate bond market has fallen in value.

Average monthly return when corporate bond returns are negative (3 years to 30 June 2015)



There are a number of well-established products in the market, with long and successful track records. In our view these products offer attractive terms – such as weekly liquidity and fees of around 0.5% pa.

The key challenge is in the execution, and some managers are a lot better than others. Whilst all absolute return bond managers may be aiming to achieve broadly the same outcome, they can take very different approaches to delivering that goal. Some managers have more experience than others in working with insurers, enabling them to provide the reporting information you need. It is, therefore, essential to identify the right manager to fit your specific requirements.

Solvency II – rewarding you for acting responsibly

Solvency II, which comes into force from January 2016, could make absolute return bonds particularly attractive to insurers. This is because the "look through" principle underlying Solvency II may allow you to take credit for the diversification and careful risk management that are at the core of these portfolios.

For example, we have identified absolute return bond products that may have a stand-alone market risk capital charge of around 10% under the Solvency II Standard Formula (compared to perhaps 20% or more for high yield bonds). That looks attractive, particularly given all the other good economic reasons to consider investing in absolute return bonds.

As different managers favour different areas of the bond market and apply different techniques to manage risk, the market risk capital charge could vary significantly between products. This is another reason why choosing the right manager to meet your specific requirements is essential.

With our team of 100 investment professionals and a wealth of experience working with general insurers, we can help you find an approach and manager that suits your needs.

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