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Higher Interest Rates Can Aid Insurer, Pension Portfolios – If They are Ready

RICHARD SEGA, CHIEF INVESTMENT OFFICER, AND **OWAIS RANA**, HEAD OF INVESTMENT SOLUTIONS, CONNING

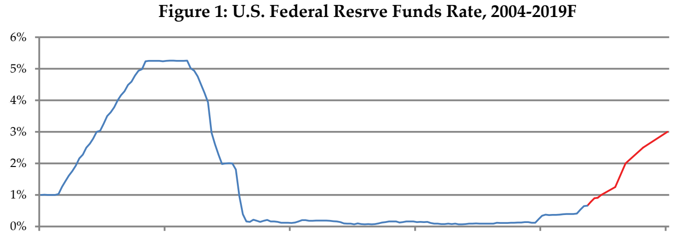
The Board of Governors of the Federal Reserve System (the Fed) raised the Fed Funds rate on June 14, 2017, the third 25-basis-point increase in six months, and expects a number of similar increases through 2018 (see Figure 1). This confirms a long-anticipated theme: interest rates are on the rise.

Despite expectations of this message, investors had been far more focused on finding greater yield than hedging against rising rates. Since the elections in November, however, views of U.S. tax and regulatory reform spurring economic growth have coincided with a growing concern about the effect of rising rates. Interest in "taking gains before they disappear" is growing, and shorter-duration or floating-rate products, such as CLOs, have drawn increasing interest.

Higher Rates, Lower Liabilities, Protecting Gains

Corporate defined benefit (DB) pension plan sponsors have been desperate for higher yields, particularly at the longer end of the curve, as pension obligations are very long-dated. Obligations have about a 14-year duration, which means that a one-percent decline in interest rates increases the value of the liabilities by about 14%. Over the last 10 years, the 30-year Treasury yield has fallen almost two percent (to three percent from nearly five percent - see Figure 2), considerably increasing corporate DB liabilities. While the recent Fed action may help increase short-term rates, economic growth and inflation are often the main drivers for higher yields on longer-term bonds. Sponsors who hoped for a rise in longer-dated rates but did not invest in matched assets (i.e. longer-dated bonds) have seen their plans suffer lower funding levels, often requiring them to divert cash to their plans that could have been reinvested in operations or distributed to shareholders.

Figure 1: U.S. Federal Resrve Funds Rate, 2004-2019F



Prepared by Conning, Inc. Sources: Board of Governors of the Federal Reserve System (US), Effective Federal Funds Rate [FEDFUNDS], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/FEDFUNDS, June 15, 2017 and The Board of Governors of the Federal Reserve System, Federal Reserve Press Release dated June 14, 2017, https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20170614.pdf, regarding Economic projections of Federal Reserve Board members and Federal Reserve Bank presidents under their individual assessments of projected appropriate monetary policy, June 2017

It has been more than 10 years since we've had an environment of rising rates, and much has changed in that time. Insurers' portfolios now are generally more diversified into a broader array of asset classes, particularly among larger firms. Insurers are carrying fewer assets leveraged to interest-rate changes (such as special investment vehicles, sub-prime ABS, and other highly volatile structured products). Also, since rates have been at historically low levels, insurers' current debt service is lower. Meanwhile, many pension plan sponsors and their advisers have attempted to de-risk their portfolios. Working with experienced asset managers, these sponsors have adopted asset-allocation strategies to better match their liabilities, a process known as liability-driven investing (LDI). Rising long-term interest rates can lower the value of plan liabilities and thereby improve plan funding status, and an LDI strategy can help protect and maintain funding status in adverse market conditions.

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Some plans are also applying interest-rate triggers to their de-risking. For example, a sponsor may see the 30-year Treasury reaching 3.5% as a time to shift a segment of the plan's growth assets into matching long-dated bonds, hedging a portion of plan liabilities from a potential interest-rate decrease. Even though we anticipate interest rates going up, sponsors are developing a greater appreciation for protecting the downside during unforeseen events.

Prepare – and Stay the Course

One reminder of the last decade is that investors need to be prepared for unforeseen changes in market conditions. This is why Conning places a premium on risk management and asset-allocation strategies that align with liabilities.

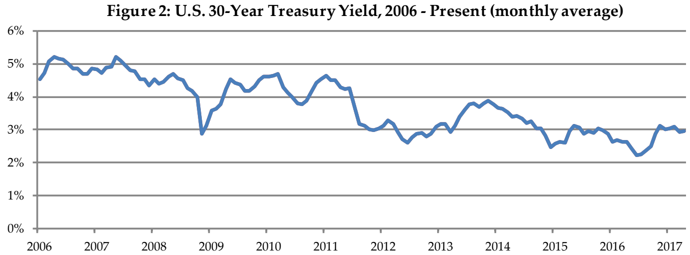
Higher Interest Rates

Insurers' portfolios are structured to support obligations to policyholders, and unforeseen events can wreak havoc on underprepared portfolios. An insurer that must pay out more than anticipated may be forced to liquidate holdings under adverse conditions – a sure destroyer of value. A robust discipline that matches a portfolio with the liabilities it supports is the best way to avoid this and maintain adequate liquidity.

Conning has a similar message for pension plans. The coming months may present opportunities to reach funding-level or interest-rate triggers, allowing plans to reduce their growth assets in exchange for longer-dated fixed-income assets. We recommend sponsors stay the course and not veer from their de-risking programs based on a feel about the market, as these scenarios can be short-lived. Staying disciplined will remove the human judgement from the equation and help plans incrementally take risk off the table as interest rates rise and funding levels improve.

Will it Rise?

Figure 2: U.S. 30-Year Treasury Yield, 2006 - Present (monthly average)



Prepared by Conning, Inc. Source: The Board of Governors of the Federal Reserve System, 30-Year Treasury Yield as of June 15, 2017, https://www.federalreserve.gov/datadownload/Chart.aspx?rel=H15&series=42ebb0d7e12040e88e235393ae1148e6&lastobs=&from=02/01/2006&to=06/30/2017&filetype=csv&label=include&layout=seriescolumn&pp=Download

Additionally, as plans de-risk, more sponsors will be buying long-dated high quality bonds and Treasurys. This will likely raise demand for long-dated credit, increasing its price and reducing yield. Conning suggests sponsors work with asset managers skilled at valuing credit to help avoid overpaying for the risk.

Planning for No Sure Thing

A prominent view of the market environment today is that tax and regulatory reform will spur enough growth to support a rise in inflation and interest rates. Among the risks Conning sees is that the pace of reform will be slower than anticipated, and that adverse trade policy could offset any benefits we get from tax and regulatory reform. In our view, the best hedge is a diversified portfolio based on sound fundamental analysis, structured according to a robust plan that matches assets with the liabilities they support.

About Conning®

Conning (www.conning.com) is a leading global investment management firm with nearly $113 billion in global assets under management as of March 31, 2017*. With a long history of serving the insurance industry, Conning supports institutional investors, including pension plans, with investment solutions and asset management offerings, award-winning risk modeling software, and industry research. Founded in 1912, Conning has offices in Boston, Cologne, Hartford, Hong Kong, London, New York, and Tokyo.

*As of March 31, 2017, represents the combined global assets under management for the affiliated firms under Conning Holdings Limited, and Cathay Securities Investment Trust Co., Ltd. ("SITE"). SITE reports internally into Conning Asia Pacific Limited, but is a separate legal entity under Cathay Financial Holding Co., Ltd. which is the ultimate controlling parent of all Conning entities.

About Liability-Driven Investing (LDI) at Conning

Conning's LDI team leverages three decades of combined experience managing and developing customized asset-liability focused investment mandates, deep expertise in the U.S. credit markets, and the company's award-winning risk modeling software. Learn more about Conning's LDI approach at Conning's LDI page.