JANUARY 2017

HOW MAVERICK CAN INSURERS BE?

BROADENING THE SCOPE OF INVESTMENT POSSIBILITIES IN A LOW-RATE WORLD

Robert Absey
Senior Managing Director—Insurance Business Development

Arnaud Mounier
Managing Director—Insurance Business Development

IN THIS PAPER: Income is scarce, markets are more turbulent, and many assets look set for a run of below-average returns. Insurers, like all investors, are thinking more creatively about their investment choices. We see three paths they can take to enhance portfolio returns while still staying within a capital-efficient framework.

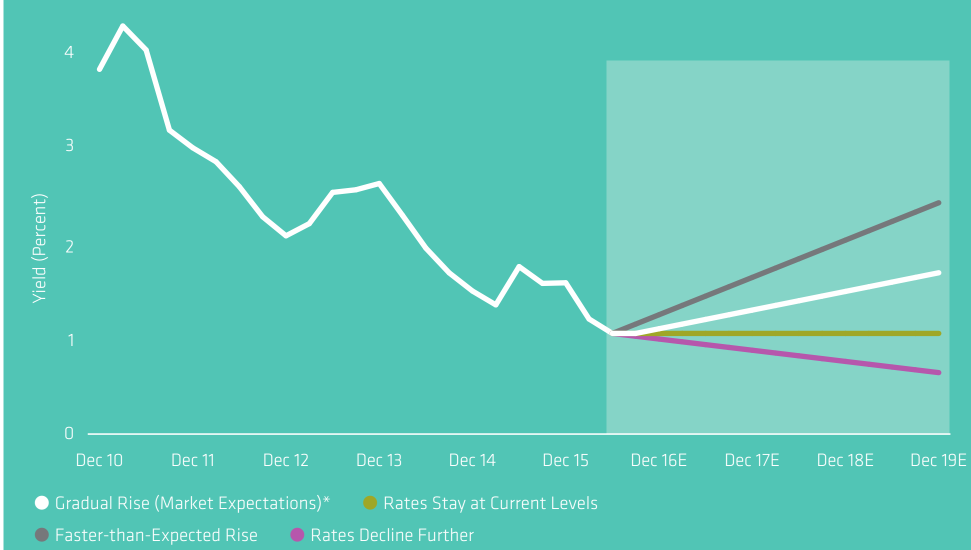
HOW MAVERICK CAN INSURERS BE?

In this era of structurally low yields and stricter regulatory oversight, earning investment income is tough—and it's probably going to stay that way. Insurance CIOs realize that the traditional investing strategies they've relied on in the past are unlikely to meet their future needs (*Display 1*).

These challenges are encouraging insurers to think creatively about a wider range of investments. For most, however, the quest for higher returns means moving out on the risk curve. The big question is: Just how far off the beaten path can insurers go?

DISPLAY 1: INSURERS' ASSETS NEED TO WORK HARDER

Future Yields for a Hypothetical Bond Portfolio Under Various Interest-Rate Scenarios



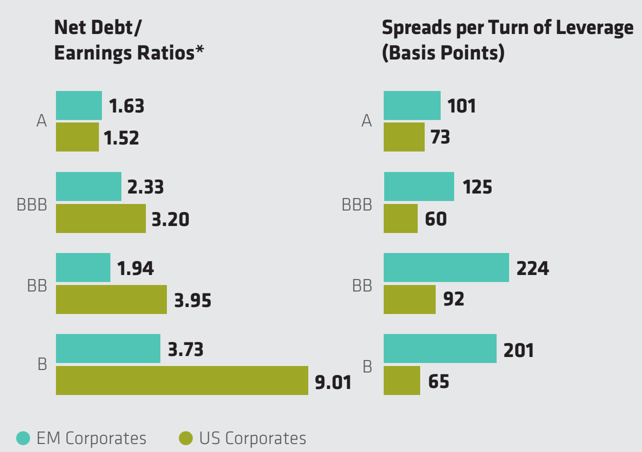
Historical information is provided for illustrative purposes only.
As of June 30, 2016
Based on swap rates with five-year durations, averaged over rolling 10-year periods. Display depicts the impact of various interest-rate scenarios on a typical life insurance fixed-income portfolio as maturing bonds are progressively replaced with fresh investments.
***** Base case; as reflected in current market yield curve
Source: AB

There are no easy answers. Like many investors with long-term horizons, insurance companies need their capital to go the distance—and with as little volatility as possible. How they "spend" their risk budget involves tricky trade-offs, hinging on how much liquidity they need to operate their businesses and their tolerance for realized losses, and potentially large unrealized losses, relative to their liability streams and excess capital. While the recent market turbulence has opened up attractive entry points across many riskier asset classes, it has also magnified the risks involved in capturing these opportunities.

As they start investing in these nonconventional strategies, insurers must also secure the necessary expertise to evaluate how these asset classes behave under various market conditions and how they are likely to affect the specific regulatory, accounting and ongoing business challenges insurers face.

It's a complex balancing act, requiring new ideas and new solutions. After evaluating the full spectrum of investment options, we suggest three paths insurers can take to improve their return profiles while staying within a capital-efficient framework.

DISPLAY 2: CORPORATE FUNDAMENTALS ARE STRONGER IN EMERGING MARKETS



Historical information provided for illustrative purposes only
Leverage data as of December 31, 2015; spread data as of May 31, 2016
EM corporates are represented by the BofA Merrill Lynch Emerging Markets Corporate Plus Index and US corporates are represented by the BofA Merrill Lynch US Corporate Master Index.
* Net debt to earnings refers to the ratio of debt capital (bank loans, bonds, etc.) to EBITDA (earnings before interest, taxes, depreciation and amortizaton) over the last 12 months.
Source: Bank of America Merrill Lynch and AB

PATH 1: EMBRACING THE NEW CORE IN FIXED INCOME

New fixed-income "core" strategies offer insurers attractive ways to add income and diversification. These include strategies that provide global bond exposure and those designed to capture the upside of the high-yield market with much less downside. As part of a holistic approach, these solutions can help improve the risk/return characteristics of an insurer's total portfolio.

FOCUS ON: EMERGING-MARKET INVESTMENT-GRADE DEBT

By providing access to a large and growing share of the global economy, investments in emerging markets, via hard currency, have an important role to play in a well-diversified portfolio.

Emerging-debt markets are broadly riskier than developed-world debt markets. Corporate governance in emerging markets tends to be weaker (with fewer protections for creditors and shareholders), politicians and policymakers are more unpredictable, and currency fluctuations are more frequent. These risks are also why investors in emerging markets can collect a premium relative to the comparably rated securities of companies in developed economies.

Emerging-market (EM) risk can lurk in a wide variety of individual bonds, and it often doesn't matter whether the borrower hails from Shanghai, São Paulo or Seattle. What's more, the market often misprices this risk. A broad, top-down approach that groups credits into developed-market (DM) and EM buckets, and assumes that the latter are always more risky, may not pick up on this distinction.

Investors who focus on ratings and on how a bond is trading might conclude that the risk isn't worth the reward. But those who drill down more deeply may find that they're getting paid more than they should be, since the market tends to gauge a firm's level of risk based on its country of origin, not its business profile.

In a low-growth, low-yield world, the opportunity in EM debt beckons.

On balance, fundamentals in developing markets are also stronger, thanks in large part to significant external adjustments made over the past few years. Economic growth has started to stabilize, driven by positive momentum in Latin America and Europe, albeit from a low base, and buoyed by improved commodity prices. EM companies have been paring capital expenditures and reducing debt, and they now have lower debt burdens than their DM counterparts with similar credit ratings (*Display 2, page 1*). Moreover, credit quality is improving in the developing world, while the credit cycle is entering its late stages in most developed countries.

Of course, even well-run companies in some EM countries may be subject to risks that a firm in the developed world wouldn't face. But these potential perils underscore the importance of looking at emerging markets through a global lens and understanding the varying political and economic dynamics at play throughout the world. These risks also show why it's so critical to invest on a company-by-company basis and take a deep dive into each individual bond, regardless of the issuer's home country.

DISPLAY 3: EMERGING-MARKET (EM) CREDIT SPREADS OFFER AN ATTRACTIVE ENTRY POINT

Spread Differences

Through June 30, 2016
Source: J.P. Morgan and AB

In a low-growth, low-yield world, the opportunity in EM debt beckons. Compared to DM securities with similar ratings and maturity—and, hence, similar capital charges—EM corporates provide an attractive spread pickup (*Display 3*) and, in turn, a higher return on capital than US investment-grade credit. Spreads for EM BBB corporates, on average, are now 0.4% higher than those for US BBB corporates.

FOCUS ON: SHORT-DURATION HIGH YIELD (SDHY)

High-yield bonds provide investors with a consistent income stream that few other assets can match. This income—distributed semiannually as coupon payments—gets paid in bull markets and bear markets alike.

But during periods of volatility, high-income assets often get whipsawed by changes in market sentiment and outlook. That can expose insurers to more downside risk than they're comfortable with. Yet abandoning high yield altogether is also risky. Sizable corrections aren't unusual, but high-yield bonds tend to rebound quickly (*Display 4, page 3*).

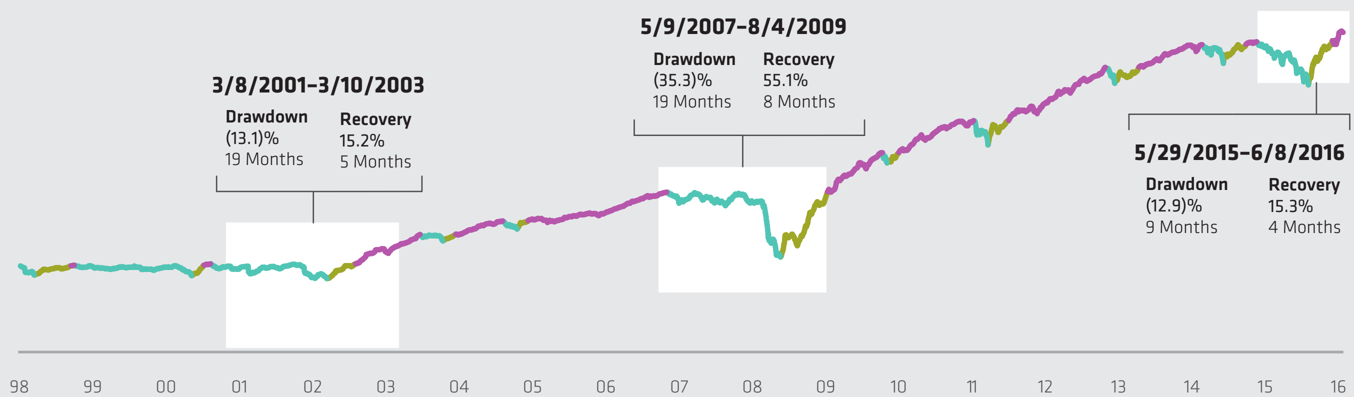
To generate the income they need without undue risk, insurers should consider a two-pronged strategy: one that shortens duration and focuses on quality. As we discussed in our recent report, *A New Path Forward: Income with Less Volatility*, we believe that a barbell approach that combines short-duration high-yield bonds with some long-dated risk-free assets (government bonds) may be a particularly good fit for insurance companies. Like any other strategy, a short-duration one can suffer an unrealized, or potentially realized, loss, but it generally loses much less than strategies with a longer duration and additional risk do.

By excluding CCC-rated bonds, which we think don't offer enough reward to justify their relatively high risk of default, this barbell strategy can become a capital-efficient way to capture the higher returns insurers need, while also creating duration. Shorter-duration high-yield securities are also less sensitive to shifts in interest rates than their longer-duration cousins.

Our research showed that a barbell strategy mixing SDHY and long government bonds produced a higher spread pickup than an investment-grade bond portfolio most of the time, while requiring a lower capital charge. The result was a better return on capital.

DISPLAY 4: HIGH-YIELD DRAWDOWNS HISTORICALLY RECOVER QUICKLY

Three Largest Drawdowns and Recoveries*



Past performance is not a guarantee of future results.

Through July 31, 2016; US high yield is represented by the Bloomberg Barclays US High Yield Index.

***** Recovery is defined as a return to the level of the prior peak.

Source: Bloomberg Barclays and AB

PENDING REGULATORY CHANGE COULD INCREASE HIGH YIELD'S APPEAL

For US life insurers, proposed changes to risk-based capital (RBC) requirements, expected by year-end 2017, could further enhance the relative capital-return advantages of high-yield bonds. These changes generally lower the capital charges for high-yield and very-high-quality bonds (AA+ and AAA), while largely increasing the capital charges (sometimes considerably) for BBB to AA bonds. Specifically, capital charges on BB+ and BB bonds will decline from 4.6% to 3.6% and 4.4%, respectively. Charges on B+ and B bonds will drop from 10% to 6.0% and 7.9%, respectively. Even AAA government bonds are affected, with the factor moving from 0.40% to 0.34%. Combined, these RBC charge reductions will further enhance the attractiveness of the short-duration high yield/long government barbell approach.

The main drawback of this strategy is the reinvestment risk of the short-duration high-yield sleeve, which exposes the insurer to the chance of rolling over into lower spreads in three or four years. While this risk is real, we would argue that the strategy still buys the insurer time for an eventual rise in interest rates and the gradual drawdown of existing liabilities.

The balance between returns and downside protection will vary depending on insurers' needs and comfort levels. However, using an approach that combines higher credit quality and shorter-maturity bonds should help insurers capture most of the income upside of the high-yield market, but with a lot less of the downside risk. At the very least, it should enable investors to stay the course in the high-yield market without losing too much sleep.

PATH 2: TAPPING THE ILLIQUIDITY PREMIUM

The trend toward bank disintermediation has gathered pace across global markets since the financial crisis, as alternative providers of capital—insurance companies, asset managers, pension funds and specialty finance firms—move to fill the void left by regulation-restrained banks retreating from certain lending activities. We expect this trend to persist, opening up attractive investment opportunities in direct private credit for well-capitalized institutional investors.

As ready providers of liquidity with long investment horizons, insurers are well positioned to capture the above-average risk-adjusted returns available in illiquid assets, including directly originated private credit.

We've identified three main pillars of private-credit investing: direct middle market corporate lending, direct US prime residential mortgage lending, and direct commercial real estate lending.

These share a number of characteristics that insurers should find particularly appealing:

+ **Enhanced Return Profile.** Given the lack of a deep secondary market for private credit, investors receive a yield premium over comparable public credit investments (*Display 5, page 5*).
+ **Rising-Rate Defenses.** Middle market loans and commercial real estate debt, by virtue of their floating rate characteristics, provide excellent protection against rising rates; residential mortgages are fixed rate but offer a yield premium to cushion the impact of a rate rise.
+ **Capital-Charge Friendly.** These investments provide capital efficiency across different jurisdictions. In terms of Solvency II, they allow for the matching adjustment, which may provide additional capital relief. In accordance with RBC, middle market loans are rated by a national rating organization for efficient treatment.
+ **Accounting Benefits.** Private credit also enjoys favorable accounting treatment (booked at cost rather than marked to market).

While private-credit lending represents a substantial opportunity, it is not without its distinct risks. There are also specific political, geographic, market and regulatory risks associated with each strategy. It is important to be mindful of these implications and to employ specific expertise to manage them appropriately. Navigating these less liquid lending markets requires strong sourcing, due diligence, credit-risk management and asset-servicing capabilities, as well as experience in investing across end markets, geographies and business cycles.

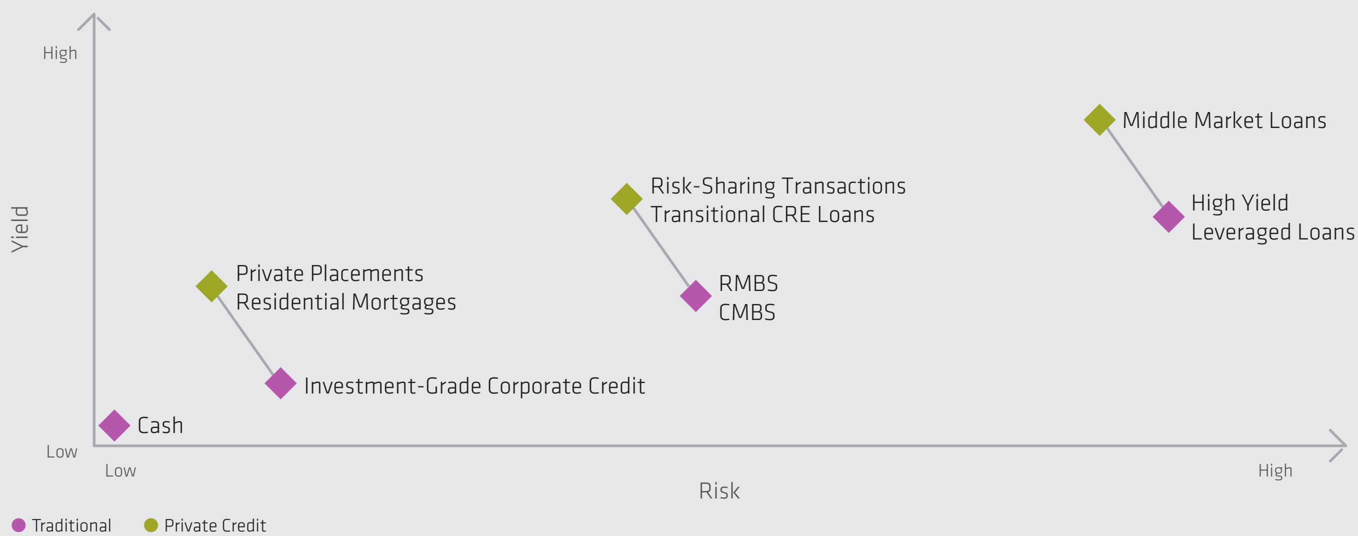
FOCUS ON: DIRECT MIDDLE MARKET CORPORATE LENDING

Middle market businesses are a vital component of the US economy, generating roughly one-third of private sector GDP. Yet they have far less access to financing than their larger counterparts. Stiffer banking regulations and capital requirements have further magnified this supply/demand gap.

Insurers have an opportunity to tap the higher return potential available in this large, highly fragmented but scalable corner of corporate financing, which generates robust transaction volumes that are not highly correlated to the capital markets generally.

DISPLAY 5: PRIVATE CREDIT HAS ENJOYED A PERSISTENT YIELD PREMIUM

Range of Indicative Yield Premiums (Basis Points)



For illustrative purposes only

CRE: commercial real estate; RMBS: residential mortgage-backed securities; CMBS: commercial mortgage-backed securities

Source: AB

Loans to middle market companies typically provide larger yield spreads compared with larger, broadly syndicated loans. This market also offers the chance for attractive returns on RBC, which are higher than returns on high-yield bonds, as the yield premiums on these loans more than compensate for their capital charges.

And because these loans feature strong collateral packages, low leverage levels and other protective characteristics—including customized affirmative, negative and financial covenants—this market also benefits from downside risk protection. This gives investors greater influence over holding-company actions in the event of an adverse credit event, and differentiates middle market loans from broadly syndicated loans and high-yield bonds, which don't often offer this protection.

Many such loans are written with floating-rate terms, so they can potentially offset the impact of rising interest rates, a feature that differentiates them from most high-yield bonds.

FOCUS ON: DIRECT US PRIME RESIDENTIAL MORTGAGE LENDING

The US residential mortgage market is on a strong fundamental footing, supported by an improving economy, a much diminished supply of homes for sale, and healthier borrower credit trends. At the same time, mortgage-credit availability has tightened, as government-sponsored enterprises Fannie Mae and Freddie Mac continue to curb their involvement. Alternative credit providers are filling in the gap.

Prime jumbo residential mortgages offer a yield premium over investment-grade corporate credit and agency mortgage-backed securities. Because they receive favorable NAIC[1] RBC treatment,

1 National Association of Insurance Commissioners

these loans are also attractive on a return-on-invested-capital basis. (Prime jumbo residential mortgages are filed and classified on Schedule B.) Finally, because the mortgage market is at a much earlier stage in the credit cycle than corporate bonds generally, these investments also help to diversify away from corporate credit.

We believe that a strategy focused on prime residential mortgage lending (which maintains high minimum standards for loan-to-value ratios, FICO scores, debt-to-income ratios and overall documentation) represents an attractive investment opportunity for those insurers that can sacrifice liquidity in exchange for a yield premium over investment-grade corporate credit while still maintaining favorable regulatory treatment.

FOCUS ON: DIRECT COMMERCIAL REAL ESTATE LENDING

While bank and nonbank lenders have reentered the US commercial real estate market, their activities have been largely confined to the highest-quality, most stable assets in specific property types and geographies. Across the rest of the market, lending volume remains well below recent peaks.

As important, a historically high volume of loans—roughly $1 trillion worth—is set to mature over the next couple of years. We believe this runoff will generate ample credit demand in the underserved "transitional" loan space of borrowers in need of flexible debt capital. The resulting imbalance between higher loan demand and low supply has created what we view as an attractive opportunity for alternative credit providers who can step in and provide much-needed financing. These investments also offer the potential for high returns on RBC, as their required capital charges are modest.

PATH 3: CONSIDERING INSURANCE-SENSITIVE EQUITY SOLUTIONS

In today's ultralow-interest-rate environment, some insurers are realizing that sidelining the higher return potential of equities in favor of fixed-income assets is putting them in a financial straitjacket. It also risks overexposing them to an eventual rise in interest rates.

We don't see insurers making dramatic increases to their equity allocations, given the significantly higher capital charges and the potential impact of equity volatility on their earnings and balance sheets.

However, for insurance companies rethinking their equity allocations, we believe that there are several insurance-appropriate equity strategies that may make sense—if assessed holistically from a risk/return perspective.

Some insurance CIOs may find an equity strategy that explicitly targets fundamental quality and downside-risk protection to be particularly attractive. Other insurers may believe that the full equity capital charge warrants a concentrated, high-alpha strategy that meets their risk/return requirements. Supported by differentiated research, an active approach can help mitigate unwanted risks, including the already significant rate sensitivity arising from insurers' business lines and sizable fixed-income investment holdings.

FOCUS ON: HIGH-QUALITY, LESS VOLATILE EQUITY STRATEGIES

Like many investors, insurance companies cannot tolerate wild equity market swings, let alone the prospect of losing money. For them, equity strategies that expressly focus on capital preservation and long-term outcomes are worth a look.

TRANSITIONAL LOANS DEFINED

Transitional loans are senior mortgages secured by high-quality commercial real estate assets that need to be renovated or repositioned in their market in some way. Loans are made to institutional borrowers—typically well-capitalized and well-known opportunistic or value-added real estate private equity managers—who are using the loan proceeds to acquire and fund improvements to these transitional properties before they sell the assets into the core market. The typical loan-to-value ratio on these loans is 70%.

Equity downside protection and outperformance can coexist.

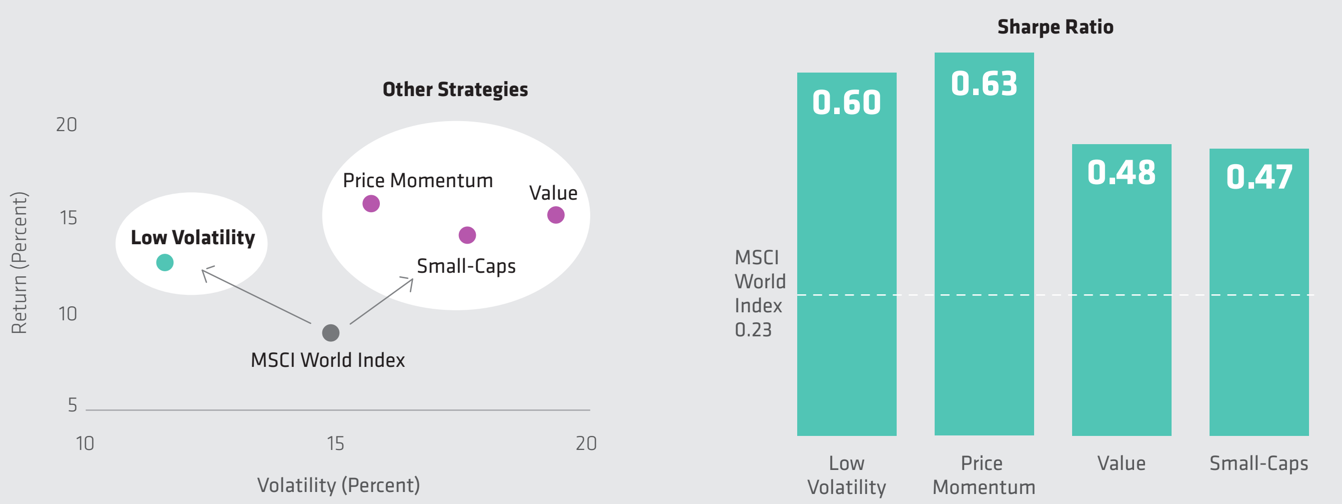
These solutions get their performance power from the simple mathematics of lower risk drag and compounding: Stocks that fall less in market downturns have less ground to retrace when the market recovers—and they're in a better position to compound returns off those higher levels in subsequent rallies. Over time, this gentler pattern of returns can end up ahead of the market.

Research dating back to the early 1970s shows that the long-term returns of less volatile stocks (based on beta) have matched or outperformed the market and more aggressive equity strategies over four decades (*Display 6*). Based on absolute risk (aka the Sharpe ratio), the less volatile portfolio delivered significantly more return per unit of risk.

Upside/downside capture is another way to illustrate how preserving capital over the near term can beat the market over time. Imagine a hypothetical global stock portfolio that captured 90% of every market rally and fell only 70% as much as the market during every sell-off over the past 40 years. What would the long-term returns of a portfolio with this 90%/70% upside/downside capture ratio look like?

DISPLAY 6: THE PARADOXICAL OUTPERFORMANCE OF LOWER-RISK STOCKS

Efficient Frontier and Sharpe Ratios



Through June 30, 2016
Results represent top quintiles within the MSCI World Index as sorted by low two-year trailing volatility, high price momentum, low price/book value and low capitalization since January 1, 1973. Sharpe ratio includes cash; capitalization-weighted MSCI World Index, gross in USD, unhedged. This is not intended to portray the performance of any AB-managed portfolio.
Source: MSCI and AB

You'd be forgiven if you thought it would underperform. It didn't. As *Display 7* suggests, starting with $100 in January 1975, this "gaining more by losing less" hypothetical portfolio would build up capital of nearly US$13,000 over the subsequent 40 years. That's more than 2.5 times the capital (US$5,100) generated by the MSCI World Index in this example.

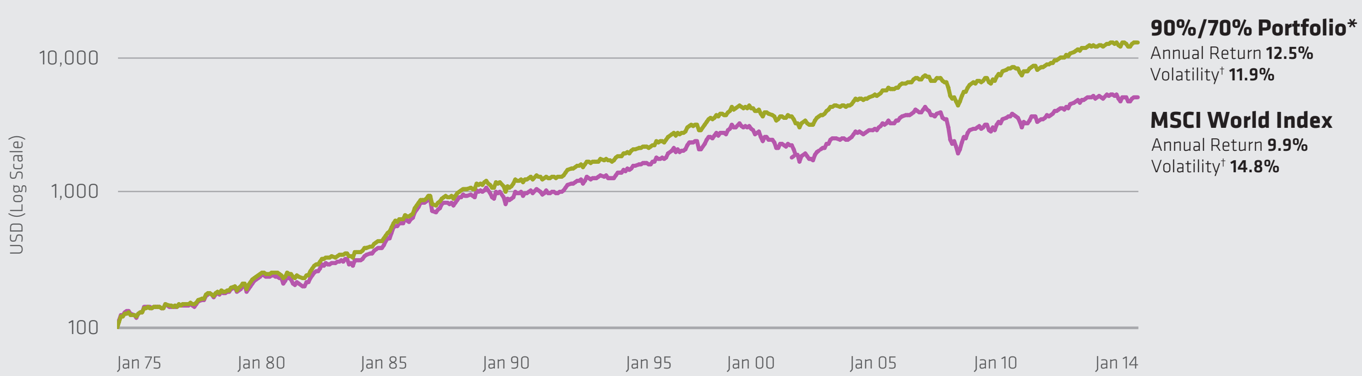
There is one caveat: To harness the full benefits of this approach, investors must accept that its performance will differ significantly from that of the market. That's easy to overlook when the portfolio is holding up in a crumbling market; the true test comes when it's trailing in a roaring market rally. Investors must keep their eye on the long-term prize.

They also need to bear in mind that it's incredibly hard to build a portfolio that can capture more upside during market upturns than it loses during downturns over time. Simple checklists won't do. Our guiding principle: Target profitable and resilient business models at attractive prices. Finding these companies takes skill, research, and a wide-ranging, responsive view of risk and return. That flexibility allows the portfolio to pivot when opportunities arise (sometimes in unexpected places) or when the world throws curve balls.

But identifying these high-quality, shock-resistant companies isn't enough. To tilt the scale even higher to the upside, the next step is to determine whether those characteristics are being fully appreciated by the market. Staying alert to valuation is another way to improve return potential and to avoid expensive, vulnerable pockets of the market.

DISPLAY 7: YOU CAN GET DOWNSIDE PROTECTION AND STILL BEAT THE MARKET

Growth of US$100



Through June 30, 2016

* Performance calculated by multiplying all positive monthly returns (0% or greater) of the MSCI World Index by 90% and all negative returns (less than 0%) by 70%; shown in logarithmic scale.

† Annualized standard deviation

This is not intended to portray the performance of any AB-managed portfolio.

Source: MSCI and AB

Because of its risk-taming and countercyclical benefits, the 90%/70% equity strategy is an especially attractive choice for insurance companies seeking more efficient uses for their risk capital. Depending on the insurer's unique liability horizon, risk appetite and capital-management objectives, this strategy can be used within an equity or a multi-asset allocation for more efficient risk management or to enhance returns by:

+ Pairing with an allocation to more aggressive but higher-return equity strategies
+ Allowing a shift from bonds into higher-returning equities

Either way, the portfolio gets higher return potential without adding to overall risk (*Display 8*). Moreover, because of this lower absolute risk, we believe that an active approach is a more efficient way to access this extra equity return than passive, cap-weighted strategies. While passive strategies confine their underperformance to the cost of their fees, they do nothing to guard against downside risks.

Our research also found that smoother-ride equity strategies can help temper earnings and balance-sheet fluctuations, addressing another major concern among insurance companies about equity allocations.

A smoother ride that's easier on the nerves can help keep investors on course when turbulence strikes, and ultimately improve the odds of getting to their desired investment destination. But insurers must be willing to free themselves from the tyranny of benchmarks and adopt a new way of defining equity investment success that leans on absolute risk and return potential in the pursuit of long-term goals.

DISPLAY 8: SMOOTHER-RIDE EQUITY STRATEGIES CAN SERVE MANY PURPOSES

	Pair Quality/Stability/Price (**QSP**) with High-Return Equities		Shift to **QSP** from Bonds	
	100% Passive	65% **QSP**/ 35% High-Return	50% Bonds/ 50% Passive	40% Bonds/ 60% **QSP**
Return	5.8%	7.1%	3.9%	4.8%
Volatility	14.6	15.1	8.2	8.0
Return/Risk Ratio	0.39×	0.47×	0.47×	0.60×

More Return,
Same Risk

More Return,
Same Risk

Assumptions		
	Returns	Volatility
Passive Equities	6%	15%
QSP Equities	7	13
High-Return Equities	8	20
Bonds	2	6

This analysis is for illustrative purposes only and is based solely on the set of return and volatility assumptions listed. It is not intended to represent any particular portfolio or strategy, and is not a guarantee of any future results. We have assumed no diversification benefit between a quality/stability/price equity portfolio and a high-return equity portfolio, though it has been observed in practice. Correlation between bonds and passive is assumed at 0.11, in line with the returns of the S&P 500 Index and Bloomberg Barclays US Aggregate since 2001; correlation between the quality/stability/price stock portfolio and the bond portfolio is assumed at 0.9, based on the MSCI USA Factor Mix A-Series and the Bloomberg Barclays US Aggregate since 2001.
Source: Bloomberg Barclays, MSCI, S&P and AB

NEW YORK

1345 Avenue of the Americas
New York, NY 10105
(212) 969 1000

LONDON

50 Berkeley Street, London W1J 8HA
United Kingdom
+44 20 7470 0100

SYDNEY

Level 32, Aurora Place
88 Phillip Street
Sydney NSW 2000, Australia
+61 2 9255 1299

TORONTO

Brookfield Place, 161 Bay Street, 27th Floor
Toronto, Ontario M5J 2S1
(416) 572 2534

TOKYO

Marunouchi Trust Tower Main 17F
1-8-3, Marunouchi, Chiyoda-ku
Tokyo 100-0005, Japan
+81 3 5962 9000

HONG KONG

Suite 3401, 34/F
One International Finance Centre
1 Harbour View Street, Central, Hong Kong
+852 2918 7888

SINGAPORE

One Raffles Quay
#27-11 South Tower
Singapore 048583
+65 6230 4600

GI–7465–0117
www.abglobal.com