Insurance Asset Management

Summer 2022

Japanese yen
The competitive, economic benefits of a lower exchange rate

Credit markets
Navigating this area given low yields and rising interest rate duration risk

Portfolio optimisation
How insurers can be helped with their asset allocation

Turbulent times

The true fallout from Russia's invasion of Ukraine may have only just begun. How will insurers respond?

COMMERCIAL PROPERTY
Market commentary on the latest developments in this area

SUSTAINABLE INVESTMENT SUMMIT
An overview of the one-day conference for institutional investment delegates

US AND GLOBAL EQUITIES
The latest trends and what these mean for insurers

Editorial Comment

> The invasion has triggered turmoil in the financial markets, and drastically increased uncertainty about the recovery of the global economy

On 24th February 2022, Russia invaded Ukraine, and the atrocities that have followed continue to dominate global headlines. War must always be avoided if possible, and the invasion has triggered turmoil in the financial markets. Uncertainty about the recovery of the global economy has also intensified.

Our cover feature (p.22) for this issue looks at the effects of the war on the global insurance industry. Although the majority of the West's insurance industry has not yet felt the pinch from the war, the conflict has added fuel to the fire started by the COVID-19 crisis, with the spectre of stagflation now hanging over the global economy. It remains to be seen just how long this war will pan out, but it's pretty safe to say that it doesn't look as if it will be over any time soon.

This issue also covers the credit markets in depth (p.30) and how to navigate this area given yields have fallen to low levels over the past decades, whilst interest rate duration risk has continued to rise.

I'm also delighted to have conducted a video Q&A with Ardea Investment's head of research Dr Laura Ryan, about the investment manager's insurance asset allocation optimisation tool and the reasons for developing it. Innovation and development in the area of asset allocation is absolutely crucial given the extremely volatile environment creating huge issues for insurance companies.

The issue of sustainable investing never disappears and nor should it. We are in a real race against time to save our precious planet. Our Sustainable Investment Summit held in March, offered the institutional investment space the opportunity to both learn and network alongside their peers at such a key time for the sustainable investment industry.

Delegates heard from a host of keynote speakers including UNEP head, climate finance unit, Ivo Mulder, and Bank of England senior adviser Michael Sheren, who both offered their expert views on exactly where we stand, what needs to be done and the outlook going forward. We can expect to hear a lot more about sustainable investing throughout 2022, and it can only be a good thing for the insurance industry to keep integrating ESG thinking within investment portfolios.

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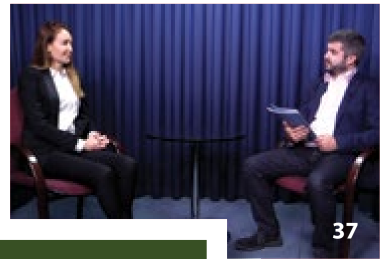
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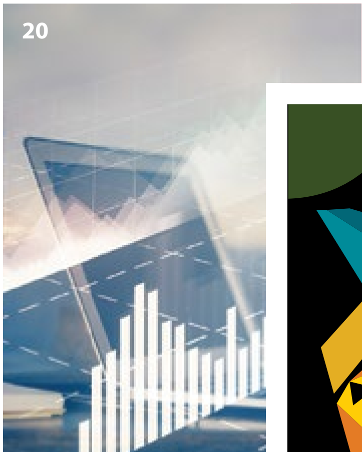
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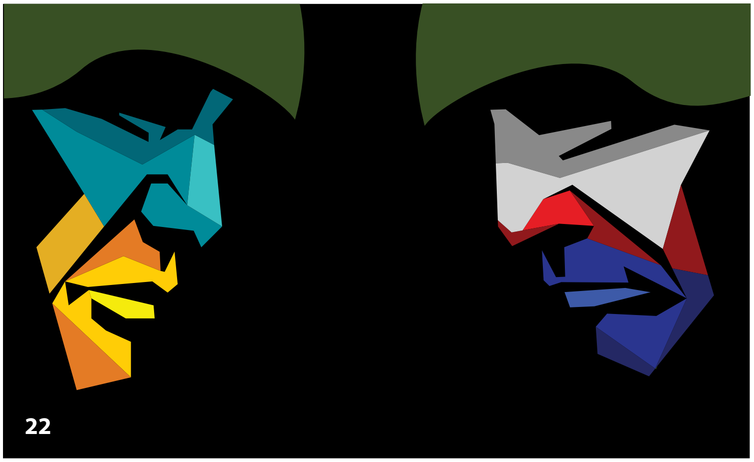
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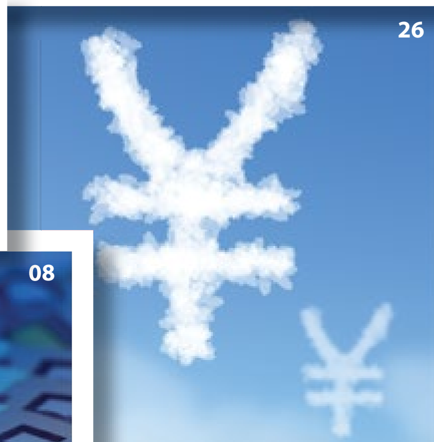
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Summer 2022

News focus

UK govt powers on with Solvency II reforms through launch of consultation

Latest move to 'cement the UK's position as a global hub for financial services'

Written by **Adam Cadle**

The UK's insurance industry will be able to invest tens of billions of pounds more in long-term UK infrastructure and green projects under proposals published recently.

The government said the consultation on reforms to the Solvency II regime capitalises on the UK's post-Brexit freedoms to spur a vibrant, innovative and internationally competitive insurance industry.

> Our reforms will unlock tens of billions of pounds of investment in the UK economy

It added that it cuts EU red tape and unlocks investment, helping to create jobs while also maintaining a high level of protection for policyholders. The reforms will also help to increase access to market for new insurers and offer greater consumer choice.

The move is part of government commitment to go further and faster to capitalise on the benefits of Brexit.

Economic Secretary to the Treasury John Glen said: "The consultation demonstrates our commitment to go further and faster to deliver the benefits of Brexit.

"Our reforms will unlock tens of billions of pounds of investment in the UK economy, spur innovation in the market while protecting policyholders - and will cement the UK's position as a global hub for financial services."

> The consultation demonstrates our commitment to go further and faster to deliver the benefits of Brexit

The Economic Secretary to the Treasury announced the government's intention to reform Solvency II legislation in a speech to the Association of British Insurers in February 2022. The consultation sets out detail on the reforms, including:

- A substantial reduction in the risk margin for long-term life insurers, including a cut of around 60-70%, and consulting on the appropriate level for general insurers. This step will release capital on insurers balance sheet.
- A more sensitive treatment of credit risk in the matching adjustment. The matching adjustment provides incentives for insurers to issue long-term life insurance products by 'matching' them against assets with similar characteristics, helping to increase the availability of this type of product on the UK market.
- A significant increase in flexibility to allow insurers to invest in long-term assets such as infrastructure.
- A meaningful reduction in the current reporting and administrative burden on firms, removing EU bureaucracy including by doubling the thresholds for the size of insurers before the Solvency II regime applies.
- Deliver further reforms to EU derived legislation, which will increase access to the market for new insurers and offer greater consumer choice. For instance, the government will introduce a new mobilisation regime to encourage new insurers into the market to boost competition, drive growth and create jobs.

The proposals form part of wider changes proposed by HM Treasury to the UK's financial services regulatory framework. Furthermore, the consultation will run for 12 weeks closing on 21 July and the government will then consider and publish a response to the consultation in due course.

The PRA will also publish a consultation of its own at a later date.

News in brief

- French life insurance net inflows reached a level not seen in more than 10 years in Q1 2022, according to France Assureurs. Inflows in March hit €2.2bn, against €2.5bn in March 2011, and for Q1 2022, inflows were recorded at €8.4bn, against €9.6bn in Q1 2011.

- PIC has completed a £130m debt investment with Raven Housing Trust, which will be used to finance the development of 630 homes by 2026. Fifty-eight per cent of the homes will be used for social or affordable rent and 30% will be for shared ownership accommodation.

- Nationwide Pension Fund, the closed defined benefit scheme for Nationwide Building Society, has completed a £172m buy-in with Canada Life. The buy-in relates to pensioners in the fund's Cheshire and Derbyshire section, and insures the fund against changes in the cost of providing benefits to those members.

- CNP Assurances has recorded a group SCR coverage ratio of 217% in 2021 (+9pts versus 2020), with the rise mainly due to higher interest rates and bullish equity markets. Own funds eligible for inclusion in the group SCR calculation totalled €39.1bn at year-end 2021, including a policyholder surplus reserve of €12.7bn.

- MEAG has launched a new European core office property fund, with Munich Re and MAPFRE partnering as seed investors. The fund focuses on high-quality office properties in prime locations in Europe's top venues.

European insurance sector resilient but macro-related risks are main concerns

Profitability and solvency risks remain at a medium level, EIOPA's risk dashboard outlines

Written by **Adam Cadle**

The European insurance sector remains resilient, but macro-related risks are currently the main concern for the industry, remaining at a high level in current assessment reflecting the Russian invasion of Ukraine, EIOPA's latest risk dashboard has revealed.

Forecasted GDP growth at a global level decreased until Q4 2022 and inflation forecasts for main geographical areas show an upward trend, with an average above 5%. Market risks overall did not increase compared to the previous assessment, notwithstanding the significant impact of the Russian invasion of Ukraine. Volatility in the bond market and the equity market increased in the first quarter of 2022 reflecting uncertainties related to the geopolitical situation. The median insurers' exposure to bonds, equity and property remained hovering around previous levels.

Profitability and solvency risks remain at a medium level. The solvency position for groups increased, while the SCR ratio for solos' life and non-life undertakings slightly dropped.

> Climate risks are at a medium level, with transition risk and physical risk stable

Return on excess of assets over liabilities and return on assets decreased, remaining above the 2020 levels.

Market perceptions remain at a medium level, with the life and non-life insurance sector underperforming the stock market and the median price-to-earnings ratio decreasing.

Climate risks are at a medium level, with transition risk and physical risk stable. The median growth of insurers' investment in green bonds has slightly increased. The y-o-y growth of green bond outstanding has also been volatile.

EIOPA said digitalisation and cyber risks increased to a high level. The materiality of these risks for insurance as assessed by supervisors increased given the resurge of cyber security issues and concerns of a hybrid geopolitical conflict.

US insurance companies' total cash and invested assets rise by 7% to $8trn

Bonds represent 61.4% of total cash and invested assets

Written by **Adam Cadle**

US insurance companies reported $8trn in total cash and invested assets at year-end 2021, an increase of 7% compared to year-end 2020.

According to the National Association of Insurance Commissioners (NAIC), US insurance companies have consistently invested in the same types of assets y-o-y. Bonds continue to be the largest component, representing 61.4% of total cash and invested assets at year-end 2021. Asset-backed securities (ABS) and other structured securities and bank loans were two of the fastest growing bond types in 2021, with exposure increasing by 11% and 30%, respectively, compared to the prior year. Common stock investments are the second largest holding for the industry at 14.6% of total cash and invested assets, followed by mortgages at 8.3% and Schedule BA assets at 6.5%.

In 2021, US insurers continued to invest in less liquid assets like mortgages and Schedule BA assets, with exposure increasing 6.9% and 14.7%, respectively, compared to 2020.

Similar to previous years, life and property/casualty (P&C) companies accounted for more than 95% of the industry's assets. Life companies held 64.2% of the industry's total cash and invested assets in 2021, while P&C companies accounted for 31.7%.

> Asset-backed securities and other structured securities and bank loans were two of the fastest growing bond types

US insurers' EM bond/ stock exposure at $42.1bn

Latest value part of decreasing trend since 2018

Written by **Adam Cadle**

US insurers' EM investments totalled $42.1bn in bonds and stocks at year-end 2021, representing an approximate 2.5% decrease from $43.2bn at year-end 2020 and a decreasing trend in total exposure since 2018.

According to the National Association of Insurance Commissioners (NAIC), almost all EM exposure (96% of the total), has been in bonds, which have been in the $40bn range since 2013. For the US insurance industry, EM investments have historically accounted for less than 1% of total cash and invested assets.

At year-end 2021, similar to prior years, life companies accounted for the majority of US insurers' EM investments, at 87% of the total, or $36.5bn, followed by P&C companies, at 12% of the total, or $5bn.

Market preparedness for IFRS 17 in MENA region varies

Maturer regulatory environments show greater readiness

Written by **Adam Cadle**

Preparation for the new IFRS 17 regime varies significantly by country and insurer in the MENA region, analysis by AM Best has shown. In general, AM Best noted that companies operating in the region's more-mature regulatory environments show greater readiness for IFRS 17. There is a less consistent picture among the region's small carriers and in markets with less oversight. AM Best said it does not expect the introduction of IFRS 17 to have a direct impact on credit ratings, as AM Best targets the underlying economics of insurers, which is normally unaffected by the accounting regime they report under. AM Best said it will continue to monitor the potential disruption that a lack of preparedness for this fundamental change could cause; for example, to the reporting of accurately stated figures and to the availability of timely management information. In this regard, AM Best said it views having robust enterprise risk management practices as central to being able to manage the transition successfully.

UKEB approves adoption of the IASB's IFRS 17 Insurance Contracts

Marks 'major milestone' in the work of the UKEB during its first year of operation

Written by **Adam Cadle**

The UK Endorsement Board (UKEB) has approved the adoption of the International Accounting Standards Board's (IASB) IFRS 17 Insurance Contracts for use by UK companies.

It is the first major standard adopted by the UKEB since the UKEB received delegated powers from the business secretary on 22 May 2021.

UKEB chair Pauline Wallace said: "The UKEB has carefully considered the statutory criteria for adopting new IFRS for use in the UK and is satisfied that IFRS 17 meets them all. Overall, the UKEB considers that the adoption of IFRS 17 will lead to substantial improvements in financial reporting for insurance contracts and that its application will be conducive to the long term public good in the UK.

> The UKEB considers that the adoption of IFRS 17 will lead to substantial improvements in financial reporting

"The adoption of IFRS 17 marks a major milestone in the work of the UKEB during its first year of operation. I am grateful for the extensive and constructive engagement from UK stakeholders during the consultation process, the detailed analysis carried out by the UKEB staff, and the thorough consideration given by board members to each of the statutory criteria. The UKEB looks forward to continuing to engage with UK stakeholders during the implementation and initial application of the Standard."

72% of institutional investors expect crypto regulatory environment to improve

Germany and the UAE expected to take huge leap forwards as market leaders in this space

Written by **Adam Cadle**

Seventy-two per cent of institutional investors expect the regulatory environment for crypto/digital to improve and become more constructive over the next two years, according to Nickel Digital Asset Management.

However, the study of 200 professional investors from across seven countries, which collectively manage around US$329bn in assets, also found that 23% expect no change in the regulatory environment, and just 7% anticipate it will deteriorate.

Some 62% of professional investors expect Germany and the UAE to take a huge leap forward as market leaders in the crypto/digital asset space because of their proactive stance in developing a constructive and robust framework for the crypto/digital asset sector. However, this is likely to lead to other major countries following their lead as they fear missing out – this is the view of 63% of professional investors surveyed.

In terms of when professional investors believe financial regulators will agree a global framework for crypto/digital assets, 23% expect it to happen this year, 29% in 2023 and 28% in 2024, with the remainder anticipating it will take longer.

Overall, as regulation of the crypto/digital asset market develops, 20% of professional investors believe it will be a catalyst for a dramatic increase in wealth managers, pension funds and other institutional investors increasing their allocation to crypto and digital assets. A further 36% believe it will lead to a slight increase in their allocation.

> We are only at the very beginning of the digital asset sector, and the most exciting developments have yet to happen

Nickel Digital head of business development Henry Howell said: "We are only at the very beginning of the digital asset sector, and the most exciting developments have yet to happen. Record inflows of venture capital in 2021, continued product innovation at the blockchain level and ongoing adoption of the largest players in traditional finance all point to growth of the already multi-trillion-dollar asset class."

In January this year, Nickel Digital Asset Management revealed that forty-three per cent of institutional investors and wealth managers now have a much more positive view of cryptocurrencies, and 35% said it has improved slightly.

When asked to pick their three main reasons for developing a more positive view of cryptocurrencies since the crisis started, 58% of professional investors cited strong capital growth, and this was followed by 53% who said it is because many crypto and digital assets have shown attractive diversification benefits when compared to mainstream asset classes.

Over half of European insurance asset managers look to grow strategic partnerships with insurers

> Across Asia, regulatory relaxation is spurring product partnerships among asset managers

Asset managers aiming to secure such strategic partnerships told to accept fee cuts

Written by **Adam Cadle**

More than half of asset managers in Europe intend to prioritise growing the number of strategic partnerships they have with insurers over the next three to five years, Cerulli's latest issue of *The Cerulli Edge - Global Edition* has shown.

Cerulli defines a strategic partnership as one that comprises a wide range of services beyond basic investment management, including strategic asset allocation optimisation, Solvency II optimisation, risk and scenario analysis, technology provision, and specialised investment accounting and reporting services. Under the strategic partnership model, insurers have relationships with fewer managers and each manager has wide discretion. Cerulli said nearly 20% of German and French insurers surveyed anticipate decreasing the number of asset managers they work with over the next 12 to 24 months. They are more likely to seek strategic partnerships with asset managers than insurers in other insurance markets in the region. UK insurers offer the fewest opportunities to build strategic partnerships.

However, Cerulli said asset managers aiming to secure such strategic partnerships need to be prepared to accept fee cuts, often between 10% and 20%. Insurers' growing demand for add-on services and greater customisation, especially in relation to ESG sectors, provides opportunities for managers to charge higher fees – or at least not reduce fees to the same extent as might otherwise be necessary, Cerulli added. However, Cerulli said managers' abilities to do this will diminish as it becomes standard practice.

The research also showed that in the US, climate change considerations are not yet driving insurers' investment decisions, although demand for responsible investment is developing. Insurers are looking for ESG products to hedge against potential regulation or climate risks. Asset managers that can offer ESG-friendly products with strong performance and capital efficiency can expect increasing demand from insurers. Across Asia, regulatory relaxation is spurring product partnerships among asset managers, with interest focused on thematic equities and sustainable strategies.

EMEA-based insurers cite green/ impact bonds as favoured asset class

Americas/Asia investors to target private equity over next 12 months

Written by **Adam Cadle**

Increased allocations to green or impact bonds are most expected among insurers in the EMEA region over the next 12 months, latest research has shown, while insurers in the Americas and Asia are expected to choose private equity as their favoured asset class.

Goldman Sachs Asset Management's eleventh annual global insurance survey, which surveyed 328 insurance company participants, representing over $13trn in global balance sheet assets, found that 59% of investors in EMEA expect to increase allocations to green and impact bonds. In the Americas and Asia, 53% of investors expected to increase allocations to private equity.

> Consolidation continues to be a growing trend

Additional key areas where global insurers plan to increase their allocation over the next 12 months include middle market corporate loans (37%), infrastructure debt (36%), real estate equity (31%), infrastructure equity (30%) and US investment grade private placements (30%).

Globally, 92% of investors said they now consider ESG throughout the investment process, nearly a three-fold increase from 2017 (32%), and more than one-in-five (21%) say it is now a primary investment consideration.

More than half (55%) of global insurers expect ESG considerations to have a large impact on asset allocation decisions over the next few years, ranking in equal importance to regulatory capital requirements for the first time. Consolidation continues to be a growing trend among global insurers, and nearly all insurers (96%) expect transactions to continue at their current pace or accelerate. Investments in insurtech rose across all regions, with operational efficiency being the top driver for the fourth consecutive year. As the crypto market continues to mature, 11% of American insurers say they are invested in or are considering investing in cryptocurrencies, compared to 6% of Asian insurers and just 1% of European insurers.

The survey found that in a sharp reversal from the past two years, insurers now see rising inflations and tighter monetary policy as the largest threats to their portfolios, with rising interest rates displacing low yields as the primary investment risk cited by insurers.

Aviva's Blanc to co-chair new UK Transition Plan Taskforce

'Gold standard' for UK businesses targeted

Written by **Adam Cadle**

Photo by: Ascannio / Shutterstock.com

> All of us depend on shifting the economy to net-zero as soon as possible

HM Treasury has launched a new UK Transition Plan Taskforce (TPT), with Economic Secretary to the Treasury, John Glen, co-chairing alongside Aviva CEO Amanda Blanc, to develop the "gold standard" for UK businesses' climate transition plans.

Glen said the TPT would be responsible for developing a new regime that would force UK financial institutions and listed companies to develop and publish rigorous and robust transition plans that detail how they will adapt and decarbonise as the UK moves towards a net-zero economy by 2050.

Under the rules announced by Chancellor Rishi Sunak at COP26, the UK government is requiring large companies and certain financial sector firms to publish a transition plan from 2023. These new requirements will build on the latest implementing guidance of the Taskforce on Climate-related Financial Disclosures (TCFD).

Blanc said: "Everyone in the UK will be touched by the climate crisis, so all of us depend on shifting the economy to net-zero as soon as possible. Preventing the worst impacts of climate change will take all businesses developing ambitious, consistent transition plans to get us to a low carbon future. I'm delighted to be co-chairing this crucial work alongside the Economic Secretary and hope that the UK will set the gold standard, for everyone's benefit."

China is the new second-biggest climate investment market after Europe, according to a Morningstar report.

Climate funds domiciled in China hit a high of $46.7bn, a 149% increase on 2020 figures according to the report. US climate fund assets grew by 45% to $31bn in 2021, by comparison.

Europe remains the largest climate funds market, accounting for more than three quarters of global assets ($325bn).

Morningstar had identified as many as 860 mutual funds and exchange-traded funds (ETFs) with climate mandates by the end of 2021, with assets doubling throughout the year to $408bn as product developments and new regulations bit.

"Fund investors globally have a growing number of choices to mitigate climate risk in their portfolios and invest in climate opportunities," report author and Morningstar global director of sustainability research Hortense Bioy said. However, the report noted that concerns still remain over the consistency of available data, and how data can align to standards of reporting, with measures such as the EU's taxonomy being criticised, especially in light of the current global situation.

> The entity wants to be an active part in the necessary and urgent transformation towards a low carbon economy

MAPFRE joins Net-Zero Insurance Alliance to eliminate emissions by 2050

Carbon footprint to be reduced by 50%

Written by **Adam Cadle**

MAPFRE has joined the Net-Zero Emissions Insurance Alliance (NZIA) with the aim of achieving greenhouse gas emission neutrality by 2050.

The ambition to reach net-zero emissions by 2050 requires demanding targets in the short, medium and long term. The 2022-2024 Sustainability Plan and the 2021-2030 Corporate Environmental Footprint Plan of the insurer include objectives that reflect that the entity wants to be an active part in the "necessary and urgent transformation towards a low carbon economy". In this regard, by 2024, the company has committed to neutralising MAPFRE's carbon footprint in eight countries and by 2030, the challenge is to reduce the group's carbon footprint by 50% (compared to 2019) and neutralise the carbon footprint remainder for the group as a whole.

Currently, the company contributes to decarbonisation with different initiatives, such as applying ESG criteria in investment. In this sense, it does not invest in companies in which 20% or more of their income comes from energy produced from coal. In 2021, the insurer announced it achieved carbon neutrality in Spain and Portugal and obtained Zero Waste certification.

The Hartford targets net-zero by 2050

Corporate reputation and regulatory requirements key drivers

Written by **Adam Cadle**

The Hartford has announced a goal to achieve net-zero greenhouse gas emissions (GHGe) for its full range of businesses and operations by 2050, in alignment with the Paris Climate Accord.

This goal is in addition to the company's existing targets to operate with 100% renewable-energy-source consumption for its facilities by 2030 and to reduce select GHGe by at least 2.1% each year starting in 2015 for a total reduction of 46.2% by 2037.

"The Hartford is proud to be a leader in helping address the extensive and crucial challenge of climate change, drawing on our centuries of experience managing risk and our legacy of sustainability," The Hartford's chairman and CEO Christopher Swift said. "We recognise some critical metrics and standards still need to be established to measure progress toward our net-zero goal, but we are focused on doing the essential work and necessary due diligence over the next few years to position us to meet this societal imperative."

People on the move

ACHILLES SOFRONIOU

Chief Investment Officer, Ethniki Insurance

Greek insurer Ethniki Insurance has appointed Achilles Sofroniou as chief investment officer. Sofroniou is an investment specialist with over 15 years' experience in the pensions and insurance asset management industry. He previously worked as interim head of Lloyd's treasury and investment management, and prior to that worked at Canopius Group as co-chief investment officer.

RAF CHOUDHURY

Asia Pacific Multi-Asset Investment Solutions Director, abrdn

Raf Choudhury has been appointed as abrdn's investment director on the Asia Pacific multi-asset investment solutions team. In the newly created position, Choudhury will manage abrdn's Australian multi-asset funds and its growing managed accounts capability. Choudhury joins from State Street Global Advisors where he held a range of portfolio manager roles.

AMANDA BLANC

Co-chair, UK Transition Plan Taskforce

Aviva CEO Amanda Blanc is to co-chair a new UK Transition Plan Taskforce (TPT) that has been launched by the Treasury. She will chair the TPT alongside Economic Secretary to the Treasury John Glen. Blanc said she hopes the work can set the "gold standard" for the climate transition plans of financial institutions in the UK, with firms required to detail how they will adapt and decarbonise.

JOSHUA CRABB

Head of Asia-Pacific Equities, Robeco

Robeco has promoted Joshua Crabb to head of Asia-Pacific equities, who will take over responsibilities from Arnout van Rijn as of 1 July 2022. Crabb, who moved to Hong Kong in 2001 and has worked closely with van Rijn over the past three years, will succeed him as fund manager of Robeco Asia-Pacific equities, while van Rijn will join Robeco's sustainable multi-asset team as portfolio manager.

MARKUS AHO

Chief Investment Officer, Varma

Markus Aho has been appointed Varma's new chief investment officer and is now a member of the Finnish insurer's executive group. In assuming the role of CIO, Aho will leave his position as Varma's head of private investments, where he has also previously served as head of private equity. Prior to his career at Varma, Aho worked at Pontos and Accenture, among other companies.

RANA MODARRES

Impact Director, M&G Investments

Rana Modarres has been appointed by M&G Investments as impact director within the firm's Catalyst team. Modarres has almost a decade of experience in impact investing and joins Catalyst from Oxfam GB where she was director of investing and social impact. Her new role will see her work with portfolio companies to lead the development of the Catalyst team's impact strategy.

Opinion

On climate risks potentially dragging down UK insurers' profits by 15%

"Early action is important to lower the cost of the transition. If we are ever to reach net-zero, a number of sectors are going to have to adapt their business models on a fundamental level. It will be in the collective interests of financial institutions to support counterparties that have credible plans to adapt – and ultimately reduce their exposures to those sectors of the economy that are inconsistent with a net-zero policy."

Sam Woods
PRA chief

On Lloyd's of London appointing Waystone as platform operator for its global investment platform

"The Lloyd's investment platform is being established to enable the many different providers of capital within the Lloyd's insurance market to co-invest in funds tailored to their requirements. We are delighted to partner with Waystone to support the delivery of fund vehicle solutions to meet the needs of our broad investor base, which is a key milestone for Lloyd's."

Eleanor Bucks
Chief Investment Officer
Lloyd's of London

On Aviva's latest financial results

Amanda Blanc
CEO
Aviva

"We remain very well positioned to benefit from the long term growth trends in our markets, and to meet our upgraded financial targets. This is underpinned by our strong capital position which benefits from rising interest rates. Our financial strength and market leadership give us confidence that we can successfully navigate the current uncertain economic conditions."

On SCOR announcing its first underwriting exclusions on oil

Lindsay Keenan
European Coordinator
Insure Our Future

"SCOR has taken an important step at its annual general meeting by announcing underwriting exclusions on oil, but it still has a long way to go to bring its policies in line with climate science and the urgent need for a full transition to renewables. SCOR's CEO Laurent Rousseau needs to keep this policy under revision and to update it again as soon as possible."

On the ICS potentially augmenting the analysis of insurers' capital

Picture by: Osugi / Shutterstock.com

Fitch Ratings

"The ICS could augment the analysis of insurers' capital by serving as a comparator benchmark across geographies. In theory, it should improve comparability between groups that operate under different solvency regimes. However it will only be effective if all major jurisdictions implement it consistently."

Soapbox

All change

Written by **Adam Cadle**

It appears to be all change in Australia. The Liberal-National coalition has been ousted in favour of the centre-left Labor Party, with researchers cautiously optimistic that the new government will take stronger action than its predecessor to reduce greenhouse gas emissions.

In his victory speech, new Prime Minister Anthony Albanese promised to end "the climate wars" that have plagued the nation's politics for more than a decade. He said Australia had the opportunity "to be a renewable energy superpower". Indeed, Labor has committed to reducing emissions by 43% of 2005 levels by 2030 and to boosting the share of electricity produced from renewable sources to 82% by 2030, up from 31% in 2021.

> It's at this point where institutional investors in Australia, such as insurers, need to ramp up their efforts in supporting a sustainable environment

Furthermore, during the election campaign the Labor Party made a welcome commitment to increase investment to better improve the resilience of communities through a $200 a year Disaster Ready Fund, with co-funding from the states and territories. The initiative is in line with the Insurance Council's election policy platform Building a More Resilient Australia, which called for a range of measures to better protect households and communities from the impacts of extreme weather and put downward pressure on premiums. The Insurance Council said it looks forward to working with the Albanese Government, the cross bench and the Opposition on these important matters, including the implementation of the Northern Reinsurance Pool.

Finance has a crucial role to play in tackling climate change and broader ESG issues. It's at this point institutional investors in Australia need to ramp up their efforts in supporting a sustainable environment. The backing of new government policy and targets around sustainability will hopefully create a wave of new thinking in Australia from now on, and chief investment officers of the country's leading insurers need to accelerate investment in renewable energy sources for example. In the UK, the BoE recently published its Climate Biennial Exploratory Scenario (CBES) stating that the "lack of available data on corporates' current emissions and future transition plans is a collective issue affecting all participating firms." PRA chief Sam Woods stated that climate risk over time could lead to an average drag on ananual profits for UK insurers and banks of around 10-15%, particularly if these risks are not managed effectively. "Early action is important to lower the cost of the transition," he argued. "If we are ever to reach net-zero, a number of sectors are going to have to adapt their business models on a fundamental level."

It is evident that there is still a long way to go in the UK, but Australia would do well to read the recommendations in the latest report published by the BoE, and start planning how it can better its risk management in the institutional space with regards to climate change.

BOND INVESTORS NEED TO UNDERSTAND THE VOLATILITY CYCLE

Fixed income markets have become increasingly volatile, a trend that looks set to continue. Investors need to adapt themselves.

WRITTEN BY **JON MAWBY, HEAD OF INVESTMENT GRADE CREDIT, PICTET ASSET MANAGEMENT**

The recent surge in bond yields has rocked fixed income investors. Losses on one benchmark bond index from its 2021 highs have already exceeded their near 11 per cent drawdown during the global financial crisis in 2008. What's more, this sort of volatility isn't going away – indeed, it has jumped sharply in recent weeks. Investors will need to learn a different, more active approach to fixed income investing.

An era of unconventional monetary policy – which drove yields to exceptionally low levels – is coming to an end amid a broadly global inflationary surge. This suggests bonds are no longer the safe haven for investors they once were, with particularly significant risks for those holding longer-dated securities, an investment staple for institutional investors with long-term liabilities, such as pension funds.

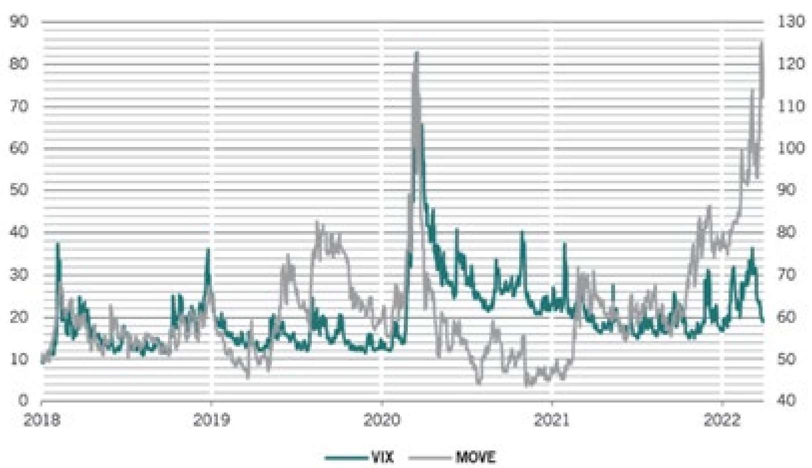
The roots of this predicament are 30 years in the making. It has been a period of ever-intensifying financial repression, with central banks deliberately holding interest rates below the rate of inflation. The result was not only that yields were artificially compressed, but also that the ups and downs of credit and economic cycles were far less pronounced.

When, in 2006, then-UK Chancellor Gordon Brown claimed to have ended economic 'boom and bust', he was right – to a point. But the side effect of smoothing these cycles through highly interventionist policies was periodic and severe bouts of volatility. These have included the 1987 stock market crash, the economic and property crisis in Japan, the tech bubble bursting, the sovereign debt crisis, Grexit, Covid. Common to each of these episodes is that central banks stepped in to 'save' markets, resulting in volatility cycles caused by investor herding and subsequent market tightening and repricing.

Another side-effect financial repression is that traditional credit markets have become more highly correlated with equities, shrinking investors' margin for error. Which means future return characteristics of fixed income assets will not be the

VOLATILE VOLATILITY

CBOE SPX S&P 500 volatility (VIX), Merrill Lynch Move 3-month bond volatility, price indices



Source: Datastream. Data from 01.01.2018 to 30.03.2022.

> Investors who can avoid making mistakes - like chasing returns - and yet exploit opportunities that present themselves will tend to succeed

benign ones of the past four decades. Add in routine spikes in volatility and investors now face difficult periods.

In light of these dramatic changes, how should investors approach fixed income selection and portfolio construction? In his 1998 book, Winning the Loser's Game, Charles Ellis offered an insight by looking at investing through the lens of sport. Successful professional athletes, he argued, tend only to be defeated by those with superior skills. By contrast, amateurs, defeat themselves through poor play, such as unforced errors in the case of tennis. By extension, investors who can avoid making mistakes – like chasing returns – and yet exploit opportunities that present themselves will tend to succeed.

That's especially true now. The sheer number of credit investors is staggering, not least because of the ever-growing number of passive products that are available. This has increased volatility as an ever-larger number of investors move in and out of the market simultaneously, particularly through exchange traded funds. Meanwhile, there has been a huge accompanying deterioration in the credit quality of company issuing bonds. As a result, investors' risks have grown significantly.

This idea of not chasing returns will inevitably feel alien to investors. Reducing risk when valuations are stretched and taking opportunities to add risk when other investors are fearful is indeed contrarian. Yet, it is this contrarian, value-focused mindset and objective assessment of the state of credit markets that offers the strongest basis on which to navigate these volatility cycles.

The Covid pandemic and the events of March 2020 are salient examples. Many high yield bond investors suffered significant losses during the worst of the crisis. But for those who had previously taken steps to minimise risk and were therefore well placed to take advantage of the value that was on offer, there were many good quality credit securities available at multiple percentage points below their par values.

Today, interestingly, it is investment grade credit that appears particularly risky. That's because in this part of the market, asset allocation decisions come with very little margin of error and much of the generational high risk previously outlined. In contrast, rising stars within the high yield bond market – sub-investment grade companies whose financial prospects have been improving – offer much better risk-adjusted prospects.

Given how markets have behaved in recent times, it is inevitable that there will be many more bouts of intense bond market volatility, accompanied by severe peak-to-trough declines. Interestingly, bond volatility has spiked even as equity market volatility has remained relatively well behaved, an anomalous condition that few fixed income investors would have been prepared for (see Chart).

Though we can produce a list of potential risks in store, we can't predict the specific catalyst. What we can do, however, is position ourselves to take advantage of these events when they happen. This means understanding what reflects fair value in asset allocation decisions and then trying to realise as much of the total return available as possible – but without becoming greedy and chasing returns unnecessarily.

In association with

PICTET 1805 Asset Management

Turbulent times

WRITTEN BY **MAREK HANDZEL, A FREELANCE JOURNALIST**

Although the majority of the West's insurance industry has not felt the pinch from the Russia-Ukraine war yet, the conflict has added fuel to the fire started by the COVID-19 crisis, with the spectre of stagflation now hanging over the global economy

It did not take the West's insurance giants long. Within two weeks of Putin's tanks rolling over the Ukrainian border on 24 February, they had followed the lead set by the political establishment and begun to withdraw business and investment from Russia.

The gesture has sent a message, but not one that has caused the likes of Aegon much financial pain — if any. In its 2022 first quarter report, the Dutch insurer disclosed a 7 per cent net result profit increase compared with the first quarter of 2021 to €412 million. "Aegon's exposure to Russia is negligible as we don't have direct operations in Russia and our general account investment exposure is around €25 million in book value as per end of March," explains Carolien van der Giessen, Aegon's head of external communications.

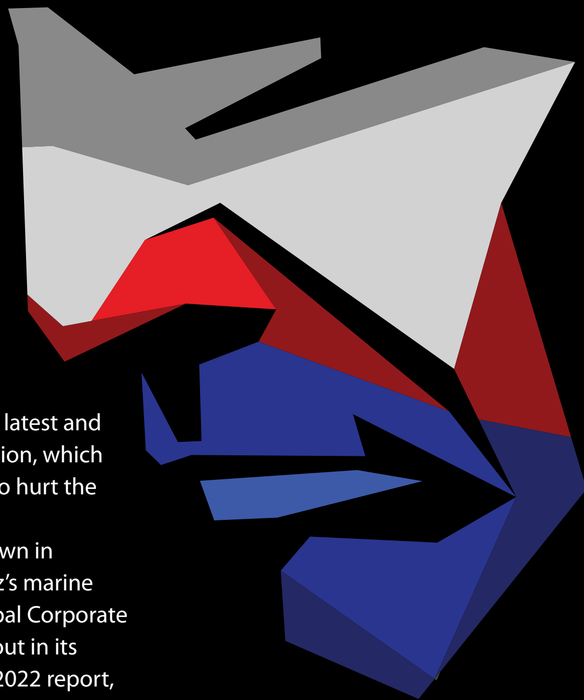
AXA, which has stopped all new investment and underwriting in Russia and reinsurance renewals of Russian insurers, says that it is too early to provide precise guidance on the financial implications of its withdrawals. "[However], based on our current assessment and the current scope of the conflict, we currently expect the net underwriting losses from the crisis to be akin to a mid-sized Nat Cat event," it revealed in its first quarter statement for the year.

Nicolas Jeanmart, head of personal and general insurance at Insurance Europe, believes that the impact of a cessation of business activity in Russia will, in line with AXA's estimations, have a "very small" impact on the overall portfolios of the European insurance industry, both in terms of underwriting and investment. "It is, therefore, manageable, even for European insurers with more significant activities in Russia and Ukraine," claims Jeanmart.

Jeanmart also cites figures from the European Insurance and Occupational Pensions Authority (EIOPA) that confirm a very limited aggregate industry liability, with the direct exposure of European Economic Area (EEA) insurers to Russia, Belarus and Ukraine totalling 0.1 percent of holdings. As Márton Bekker, a spokesperson for EIOPA explains, this means that even supposing a 100 percent loss on all of those assets, the impact on insurers' SCR ratios would be marginal. "Similarly, exposures of liabilities for both life and non-life are even more limited," says Bekker. "This is also true for the groups with subsidiaries in the three mentioned countries."

But the real concerns from the conflict's ramifications were never going to centre on insurance companies' decisions to shun Russia. As Bekker warns: "Second-round effects from the macro side and spillovers from other parts of the financial sector could become a potential source of risk."

In other words, the war could eventually be the straw that broke the quantitative easing and COVID lockdown camel's back.



Inflationary dangers

In terms of the macroeconomic picture, it is inflation that has concentrated minds the most in the past year or so. Now, the conflict in Ukraine has the potential to fuel more inflation globally.

"Both oil and natural gas prices are off their initial post-invasion peaks, which suggests there is still potential for them to move higher than current levels," says Daniel Morris, chief market strategist at BNP Paribas Asset Management. "The impact of the conflict on energy prices may become more pronounced later in the year as winter approaches, as investors worry about adequate supplies. Agricultural prices are also likely to remain under pressure as the conflict prevents farmers from planting and harvesting their crops. At a minimum, base effects will ensure that commodity inflation remains high at least through the rest of the year."

EIOPA is concerned about continued rising prices as well. "Russia's invasion of Ukraine has caused higher commodity prices and increased geopolitical tensions, which negatively affect growth through lower consumer and business confidence as well as supply and demand shocks," says Bekker. "These effects, coupled with potential constraints in gas and oil supplies, do further amplify existing inflationary pressures."

There is no doubt in Jeanmart's mind that the war has prolonged and amplified current economic woes that were initiated by supply chain disruptions created by lockdowns. The question now is what the impact of this all will be on the global economy as a whole. "For insurance specifically, these impacts can negatively affect the demand for insurance, the cost of claims and insurers' investment returns," he warns.

The domino effect

In addition to the inflation threat, there could be a myriad of economic consequences from Putin's latest and most brazen act of aggression, which will inevitably come back to hurt the insurance sector.

One of those is a slowdown in shipping activity. As Allianz's marine insurance arm, Allianz Global Corporate & Specialty (AGCS) points out in its Safety & Shipping Review 2022 report, which was released in May, the war has added to a growing number of costly issues involving larger vessels; crew and port congestion challenges resulting from the shipping boom; and managing challenging decarbonisation targets.

To being with, the conflict could result in a number of new claims. The report's authors foresee an expanded ban on Russian oil having the potential to push up the cost of bunker fuel and forcing ship owners to use alternative fuels. If such fuels are of substandard quality, this may result in machinery breakdown claims in future. At the same time, security agencies continue to warn of a heightened prospect of cyber risks for the shipping sector such as GPS jamming, Automatic Identification System spoofing and electronic interference.

"The insurance industry is likely to see a number of claims under specialist war policies from vessels damaged or lost to sea mines, rocket attacks and bombings in conflict zones," says Justus Heinrich, global product leader, marine hull, at AGCS. "Insurers may also receive claims under marine war policies from vessels and cargo blocked or trapped in Ukrainian ports and coastal waters."

> "Second-round effects from the macro side and spillovers from other parts of the financial sector could become a potential source of risk

In addition, the invasion has compounded the shortages that the global maritime industry was already facing. Russian seafarers account for just over 10 per cent of the world's 1.89 million workforce, according to AGCS, while around 4 per cent come from Ukraine. These seafarers may struggle re-join ships at the end of contracts.

Construction is another crucial

sector that may be impeded. Along with Chinese mobility restrictions, the Russia-Ukraine conflict will prolong global supply chain disruptions. As Nicholas Fearnley, head of global construction forecasting at Oxford Economics says in a recent paper, this has a disproportionate effect on the construction industry.

Another, perhaps somewhat forgotten repercussion is the damage that will be inflicted on companies that sell into Russia. BNP Paribas Asset Management's Morris cautions that the impact for companies with operations and revenues coming from Russia should not be forgotten. "It is difficult for markets to assess the effect on assets as it may not always be possible to find buyers and one does not know at what price," he says. "Services providers will likely see their sales fall significantly, though goods may still end up being available in the country via indirect channels."

Damage limitation

Despite it being almost impossible to accurately predict what the full consequences will be for insurers from a prolonged war, Jeanmart believes some comfort can be drawn from the past.

"Over the course of past extreme events — such as recessions, Nat Cat events, financial crises, and COVID-19 — insurers have shown great resilience, due to their financial strength and ability to react quickly to changing circumstances, notably through their on-going focus on risk management," he says.

Nevertheless, even if insurers find themselves well shielded, the invasion could negatively impact important priorities that cannot be protected to any reasonable manner, such as net-zero pathways. Jeanmart says that the conflict has shone a light on Europe's need to reduce its reliance on fossil fuels from Russia, and while this is an opportunity to accelerate the transition towards a more sustainable economy, it could also mean a shift away from the EU's climate and environmental agenda. "The insurance sector's view is that events such as the pandemic or the war in Ukraine should not result in reduced efforts to fight climate change, as this is a challenge which will not go away and which must be tackled as a matter of priority."

Further volatility

Just as the full consequences of the war remain obscured, so do the fortunes of the financial markets.

It is difficult to prejudge future levels of volatility as conditions highly depend on the duration of the military aggression and on whether the situation will further escalate, argues Bekker. Nevertheless, the uncertain and highly dynamic current situation, including the effect of sanctions, does little to suggest that volatility levels will fall in the near future. "Market resilience will critically depend on the ability of markets and financial institutions to deal with the Russian invasion in Ukraine and its consequences, and to withstand changes in public policy support on the monetary or fiscal side without material disruptions," he says.

> "Events such as the pandemic or the war in Ukraine should not result in reduced efforts to fight climate change

"Ukraine is only one of the factors driving higher equity market volatility," says Morris. "Lockdowns in China and uncertainty about the monetary policy outlook in both the US and the Eurozone are also key contributors. None of these seems likely to disappear in the near term, so we would expect volatility to remain elevated."

Within this environment, it can be easy to be drawn into paralysis due to over-analysis.

In a white paper on the conflict's ramifications, called *A New Cold War?* Aviva Investors laments the lack of clarity facing asset allocators. The OECD estimated back in March that the war could take more a percentage point off global growth in 2022, while

adding two and half percentage points to inflation. However, Aviva Investors says that "gauging what this means for financial markets is not straightforward".

Firstly, how deeply entrenched inflation actually is remains to be seen. Secondly, government and central bank behaviour can no longer be taken for granted in a post-GFC world. "With budgets already stretched and deficits sky high, it remains to be seen whether governments will try to claw back the money from elsewhere," says the report. "As for monetary policy, while central banks have been keen to talk up their inflation-fighting credentials, the need to help governments continue funding deficits could trump their enthusiasm to raise interest rates."

In its *Asset Allocation Outlook* report for May 2022, PIMCO asserts that the economy is in the later stages of expansion. In a world of slowing growth and tighter financial conditions, it states that investors should focus on higher-quality companies, both in equity and debt markets, whose business models appear likely to withstand coming recessionary winds. Exposure to assets such as commodities and emerging market currencies, which have the ability to mitigate further price pressures, are also recommended. Investors can also prepare for further market volatility by further diversifying portfolios. "This late-cycle playbook requires careful portfolio construction and the ability to stay nimble as risks and opportunities evolve," write the report's authors.

> This late-cycle playbook requires careful portfolio construction and the ability to stay nimble as risks and opportunities evolve

Stocks surprise, bonds stumble

For Aviva Investors, weakening US Treasuries, widespread stagflation in emerging markets and a "Japanification" of Europe are three concerns that are dictating asset allocation decisions.

Ian Pizer, Aviva Investors' head of multi-strategy funds, believes that corrections in the US government bond are likely to continue, despite them losing 5.6 per cent in the first quarter of 2022, a record drop since record-keeping began in 1973. "The market may have priced quite a lot of tightening, but the peak in rates is expected to be in line with the last cycle. Given the inflationary dynamic, a peak in US rates of 275 to 300 basis points, with cuts then priced in to 2024, seems optimistic," he states in the A New Cold War? report. "Expect further re-pricing."

At the end of April, when the report was released, Pizer said that European bonds appeared attractive when compared with US debt, although he would be wary of owning them outright, "since no other G10 rates market would be likely to escape unscathed were US Treasury yields to rise appreciably further".

His colleague, Liam Spillane, head of emerging market debt, has expressed concern about stagflation in established as well as emerging markets — particularly those in Eastern Europe, who depend heavily on Russian energy. "The region is heavily reliant on trade with Russia and Ukraine," he states. "Commodity prices are rising sharply at a time when domestic factors had already led to higher inflation. That will require a much greater response from central banks."

As a result, he tends to favour debt issued by countries whose central banks have acted sooner and more aggressively than others, and where rates may be closer to peaking as a result: "Latin American nations such as Brazil potentially stand out as offering value in that regard."

Given the turbulence seen in commodity markets and the sharp rise in bond yields, equities might have been expected to drop off a cliff by March, but they remained resilient until late April, perhaps reflecting, as Pizer says, the fact that there are few viable alternative destinations for investor capital at present.

PIMCO's paper reveals the manager's preference for less cyclical, higher-quality businesses that have steady cash flows. Consequently, it has pivoted towards sectors such as healthcare and pharmaceuticals. It is also staying faithful to semiconductor companies despite their traditionally cyclical nature. PIMCO says that they have improved balance sheets and should benefit from "strong secular tailwinds that will make them less sensitive to headline economic growth through the next cycle".

How the world's various power structures will emerge from the conflict during the next cycle is another question.

Insurers may well decide to renew business with, and in, Russia once sanctions are lifted and peace is secured, but the political backdrop could be a very different one. "Putin's actions have fundamentally changed the level of trust and the nature of the relationship with Russia," says Jeanmart. "This will, therefore, impact the level of interest and willingness to re-engage with Russia commercially — even when the war is over."

In any case, with allies in China and India, Russia may decide to pivot decisively towards the East. In such a scenario, the true fallout from the Russian invasion of Ukraine may have only just begun.

A safe haven?

WRITTEN BY **DAVID ADAMS, A FREELANCE JOURNALIST**

David Adams looks at whether insurers should be ignoring the competitive, economic benefits of a lower exchange rate

In years gone by, when the global economic and political outlook was unpredictable and concerning – certainly a fitting description of mid-2022 – one thing you could be fairly sure would happen was a flight by investors to the yen, among other safe havens. The yen's status as an investor's sanctuary was created by the unique qualities of the Japanese economy: a wealthy, economically stable country that was also the world's largest net creditor, with a strong yen, known in Japanese as a state of endaka.

But the usual pattern has not been repeated this year, despite the war in Ukraine, ongoing pandemic-related disruption to global business activity; and unpredictable volatility in global equity markets. Instead, during the first half of the year, the yen fell in value, as the governor of the Bank of Japan, Haruhiko Kuroda, kept yields of Japanese ten year bonds close to zero – while bond yields in the US and Europe were increased in response to inflationary pressures there that were barely visible in Japan. As soon as it became apparent what the Federal Reserve intended to do with US interest rates in late 2021, the yen began to fall against the dollar.

At the same time, high commodity prices have increased the cost of imports to Japan, including energy imports upon which the country relies. Those costs – particularly of imported gas – have pushed Japan's current account into deficit and hurt the economy, because businesses have tended to absorb the costs rather than passing them on to consumers. The economy has also been slower than those of some other countries to recover from the impact of the Omicron variant of COVID-19; and it has been characterised by low inflation for more than 20 years.

These factors are all reasonable justifications for the Bank of Japan's current monetary policy – indeed, they may help that policy to achieve its ultimate aim: a fundamental economic revival and reflation of an economy that has been in the doldrums since the 1990s. But those same factors have also led to the yen falling 12 per cent against the US dollar during the first four months of 2022. It has been outperformed by a wide range of currencies during the year to date, including, for example, those of Turkey and Argentina.

A state of enyasu

This state of weakness in the currency is called enyasu in Japanese; and it will have had an impact on external investors holding Japanese assets, particularly if they were not well-hedged against currency fluctuations. By May, analysts were noting that the yen had not been so weak since the 1980s and that this state of affairs could continue for a long while yet.

However, they were also starting to see signs of change appearing on the horizon, in part because the US dollar faces multiple problems over the coming months; and in part because of likely developments within Japan itself. There are reasons to think that the time will come when investors – particularly those with long horizons like insurance companies – start considering opportunities linked to the undervalued yen that could help them protect their capital and find some real returns. That's significant, because at present, with inflation and interest rates rising elsewhere, negative real yields in bond markets; and both rising property prices and some over-expensive equity valuations in many markets, real returns have been particularly difficult to find.

One reason why the situation in which the yen finds itself at present will change at some stage is that if global inflationary pressures remain high – Japan is one of a few countries where inflation is still low – the Bank of Japan will eventually allow bond yields to rise, rather than let the yen spiral downwards indefinitely.

In late May, Prime Minister Fumio Kishida made clear the government's desire to stabilise the currency's movements in forex markets. "A rapid change in foreign exchange rates is undesirable from anyone's point of view," said Kishida, during an interview with Nikkei. "The lives of people and operations of businesses are impacted by elevated prices of commodities amid the weak yen." He outlined a number of factors that would help to strengthen the currency, including a reduction in oil imports, further development of renewable energy capacity, the possible reopening of nuclear power facilities and an increase in income from tourism (which might also be boosted by the weak yen).

At the same time, the Bank of Japan is not currently under any great pressure to increase interest rates, in part because so much government debt is financed domestically; although the relatively small inflationary pressures starting to build may persuade the Bank to start increasing rates to some degree during the next few months. It may also be notable that Kishida said Japan was "maintaining close communications with the currency authorities of other countries". The Japanese economy may also benefit over the longer term if US Treasury yields and commodity prices both fall.

“ The potential for new opportunities around the yen has not yet been seized upon by insurers in the Asia Pacific region outside Japan

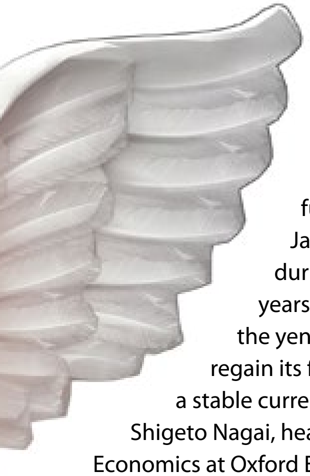
In the meantime, the fact that inflation is still low in Japan will boost the competitiveness of its exports. This could help to drive "an increase in underlying real value", according to an International Equity Investment Outlook paper published by Mondrian Investment Partners in April. Coupled with an undervalued currency – the yen is more than three standard deviations and over 25 per cent undervalued, according to Mondrian's purchasing power parity – this could create significant opportunities for investors to find real returns.

Mondrian's view is that Japan's current account deficit will prove only temporary. The paper's authors declare themselves to be "surprised that as the market focusses on the possibilities of higher interest rates elsewhere, it is ignoring the competitive, economic benefits of a lower yen exchange rate." They note that Japanese equities have continued to perform relatively well throughout this period. There are caveats though, particularly in the case of Japanese companies that have offshored some manufacturing and other business processes so will be vulnerable to external inflationary pressures; and because domestic consumer demand is likely to remain sluggish for some time.

The potential for new opportunities around the yen has not yet been seized upon by insurers in the Asia Pacific region outside Japan, says Chris Howells, head of insurance solutions, Asia Pacific, at Schroders. "We are not seeing any particular demand for yen strategies in APAC except from Japanese insurers, some of whom are switching from hedged foreign bond strategies to domestic strategies, to take advantage of cheap markets and to cut their hedging costs," he reports.

However, he continues, even among Japanese insurers, "We have not identified any real trend even within the domestic Japanese market, with different insurers indicating a range of different investment intentions."

External investors may also be wise to continue to limit exposure to Japanese government bonds, because while some sort of inflationary activity will surely come during the next few months, monetary policy is likely to continue to keep yields low.



A return to endaka?

But as these different factors influence the future of the Japanese economy during the next few years it is possible that the yen will eventually regain its former status as a stable currency, suggests Shigeto Nagai, head of Japan Economics at Oxford Economics.

"The US dollar has been over-valued and the yen has been under-valued," he says. "In the short run this depreciation is almost at the bottom, because with the [US Federal Reserve] rate hike, the market is starting to have doubts about its sustainability. I think the US is going to see a slowdown in economic growth and the Fed will be more cautious about hiking [rates] in the current period. But although we do not deny that the yen will come back to this long-term equilibrium, which means appreciation of the yen, it will take a long time." Oxford Economics expects a state of enyasu to persist until at least the final quarter of 2022.

"There are very limited prospects to think about yen appreciation in the coming two years," Nagai continues. "The interest rate differential is not likely to drive the yen to appreciate in the foreseeable future. But it is possible that the trade balance will recover, which will lead to an appreciation significant enough to bring the yen back to equilibrium."

Similar expectations have been expressed elsewhere: in March Fitch predicted that the yen would be likely to continue to depreciate against the dollar throughout 2022 but "should enter a slow appreciation phase in 2023" – with the caveat that "much sharper increases in US interest rates than we expect would keep the yen under pressure throughout 2023".

> " The trade balance will recover which will lead to an appreciation significant enough to bring the yen back to equilibrium

Nagai also thinks Japan's economy will benefit from Japanese investments in foreign securities, particularly US equities. "People are becoming more bullish about US equities and a rise in the US dollar is encouraging them to take more dollar-denominated investment positions, with less risk in hedging," he says. "Investment in US equities will slow down, but if you talk about the medium term or the long run, we think it's more likely that [retail investors] will increase investment in equities."

Nagai thinks Japanese investor behaviour may also be influenced by changes to the country's pensions systems, which could encourage younger people to move away from the risk-averse investment strategies more often used by older people.

"This change will be gradual, because a huge proportion of financial assets are held by older people," he says. "But younger people have a longer investment horizon. They are likely to take on investment positions with less hedging. So this structural shift in household investment behaviour, if it takes place, will create persistent yen depreciation pressure.

"The yen will regain its competitiveness as a funding currency," he concludes. "But at present I can't think of strong factors driven the yen back to long term equilibrium rates or appreciation."

Yet in theory this still presents canny long-term investors with some potential opportunities, in Japan and elsewhere, because as long as the yen remains weak it will effectively export deflation to any economy buying reasonably priced Japanese goods and services. That will help to dilute inflationary forces those countries. So even when the yen is in a state of enyasu, not fulfilling its traditional role as a safe haven, its influence can still help to bring some calm to troubled markets – and investors – elsewhere.

PODCAST: Navigating credit markets

Adam Cadle speaks to Jon Mawby, Head of Investment Grade Credit at Pictet Asset Management, about navigating the credit markets given yields have fallen to low levels over the past decades, whilst interest rate duration risk has continued to rise

IAM: **Governments have launched huge efforts to underpin their economies in the wake of the COVID-19 crisis. What are the most important implications for bond investors?**

MAWBY**:** I think one of the key changes from an economic perspective which obviously then feeds through to the bond world, is that governments for the first time over the COVID-19 crisis indulged in transfer payments underwritten by the central banks. The tentacles of the central bank put even entered the corporate credit markets, which although ultimately the central banks didn't buy that many corporates, I think it set a new precedent for where central banks may go in the next crisis. If you look at it through the lens of hindsight, the second round of fiscal support, especially in the US, has arguably set the scene for what we are seeing today for bond investors. You have higher inflation, shorter supply chains and now a decreasing fiscal impulse. The second wave of the transfer payments really starts to wane and that has left us in an unprecedented position over the last 40 years, where we now have higher yields and that obviously leads to shorter term pain for bond investors. However, the volatility cycle - which has largely replaced the traditional credit and economic cycles, as we see now yields approaching 3% in the US and the dislocation of the global yield complex everywhere except for Japan for the moment - has historically over the last 10-15 years generally proved to be a very attractive entry point for bond investors. It is this volatility cycle that you must try and take advantage of and not be captive to it. That's all very well and good if you have a flexible remit, but it obviously creates issues for more captive investors like the passive cohort that we have seen grow so precipitously over the last decade. I think we are well along the way to a bond sell-off, and I think the next area bond investors will have to start turning their attention to, is not just the sensitivity to inflation, but also the sensitivity of their portfolios to declining growth, because the adage is the cure for high prices is ultimately high prices.

IAM: **Over the past decade, the duration of corporate bonds has been increasing whilst yields have been decreasing. Investors are forced to take more risk for less return. Is that the new reality for you?**

MAWBY**:** The reality of the central bank put effectively was created by Greenspan in the late 1980s, essentially leveraging the myth of Paul Volcker. The reality of what Volcker did versus what people think he did is quite interesting, but Greenspan really leveraged that ability of "don't fight the Fed because look at what Volcker did and we can stand in the face of anything". Greenspan created the Central Bank put. I like to call the continual erosion of yields that was driven by this counter cyclical monetary policy and the narrative of don't fight the Fed, as 'the dirty little secret'. Not just of bond investing, but for the whole of capital markets. Unfortunately, the negative

> "The adage is the cure for high prices is ultimately high prices

asymmetry of outcomes at the end of that experiment, which is probably where we are approaching now, is particularly acute for bond investors. Long dated bond indices are down north of 15% and the traditional safe IG corporates are facing a drawdown in excess of 10%. That is the new reality, and ultimately with counter cyclical monetary policy, the terminal point is historically high duration and historically low yields. That has obviously been alleviated by the recent re-pricing, but still, if you look at the duration versus the yield, and you look at it through the concept of break even and through the lens of volatility, it is still a challenging environment for bond investors.

IAM: Where do you think we are in the credit cycle and how do you gauge position within this? How do you work with today's volatility?

MAWBY: We are in the later stages of the credit cycle. The problem with the credit cycle is that we haven't really had one for over a decade and a half. Given the previous interventions by central banks, the ever-lower yields have repressed not just yields but the economic and credit cycles. Today, we have a less traditional economic and credit cycle and more of a volatility cycle. In practice, this means that you must have the flexibility to work with that much shorter cycle. That cycle tends to occur every 18-24 months, and it is largely driven by investor psychology, by herding if you like. This in turn is driven by the central bank put and fiscal intervention. We have several screens and monitors that try and give us a broad idea of cycle positioning, ranging from investor positioning to broader valuations, to monetary contraction and expansion measures. You must be proactive in using these in a forward-looking manner. If you wait until you have 100% transparency, you are generally at the end of the cycle and probably sitting on a 20% drawdown. In practice, you must have the discipline to start taking risk off the table even when competitors are chasing yield. This was seen with the performance of CCCs, and how everybody chased that yield to historically low levels.

> “ You must have the discipline to start taking risk off the table even when competitors are chasing yield

IAM: Turning our attention to the market outlook, where do you see the main threats?

MAWBY: Obviously inflation is front and centre and is a worry. I believe the cure for high prices is high prices, and what you will start to see over the course of the year is that central bank policy error will morph into that inflation threat. The central banks are desperate to hike rates. The Fed is really worried about moving into a recession which they see coming, and I think this goes for the BoE and ECB as well. Basically, the Fed are terrified of not having got to neutral and then wandering into a recession where they potentially must take yields negative. I think they'd rather hike into a recession than be perceived to be even more behind the curve than they necessarily already are. I think the Bank of Japan is wholly underestimated in terms of a potential catalyst for the last leg of a bond sell- off. I think if you look at what is happening with the Renminbi and the Yen something must break there. Either they must release the yield curve cap or allow the Yen to depreciate further. Given that they are probably going to have a cost-of-living crisis, they will increase the yield curve cap and that will be the last leg of the yield sell-off globally. Finally, the credit impulse out of China is also a threat. The Renminbi is acting in a very similar way to how it did in 2015 prior to the growth shock in 2016 and in 2018 prior to the Powell pivot in 2019. Geopolitical risks on the horizon are also a worry.

IAM: Where do you see the main opportunities? You have got a return target of 5% per annum net of fees with low volatility. Is that achievable in the current environment?

MAWBY: Patience is key with investment and asset allocation. If you have the patience to wait for bouts of volatility, then ultimately you can achieve this return profile. As we look across the spectrum of opportunities now, we are seeing dispersion and dislocation increasing, which is great for our strategy. We see great opportunities in low cash price long dated investment grade bonds. Opportunities exist from investments that have been issued at very low coupons when everybody was being herded into risk and forced to chase yield through 2021. Rising stars is another area where we think there is substantial opportunity particularly to insulate yourself against a wider sell-off or a spread widening if we do move into recession. The fact that inflation is going to squeeze disposable income will throw up opportunities to move up in quality and to rotate the portfolio. ESG is another area for opportunity and that is fully embedded in our process. We use ESG as a screen, and if you think about credit generally from a risk management perspective, if you haven't used ESG in the past 20 years you haven't been doing your job. In addition, you may not have avoided Wirecard, Banco Espirito Santo and Steinhoff.

IAM: Insurance companies are natural investors in corporate bonds but are always mindful of doing so in a capital efficient way. Could you share your thoughts on how and why your strategy would fit into a client's strategy?

MAWBY: The insurance sector has very specific needs particularly from a credit portfolio. The average SCR for our strategy has been around 14% with the range broadly within the 12-18% area. We run the strategy in an extremely transparent way. So, whilst we are a fixed income asset allocation vehicle, we are very transparent in terms of how we move exposures and why and when we move them. The process is based on common sense and market observation for the last 25 years. From that perspective, the strategy is quite easy to model, and we tend to use volatility as a key input. As volatility drops, risk drops and when volatility increases, risk increases. This is contrary to how a lot of other strategies view markets. Our view is that as volatility is dropping, it tends to be a key indication that investors are being herded, that people are chasing risk and that is driving forward looking returns lower and lower. In that instance, you want to become more cautious, you want to use the cycle to your advantage to become more defensive and that can be from the interest rate perspective or from the credit perspective. Our philosophy and process is designed to be overlayed on any kind of mandate. We as a team run everything from quasi government strategies, through to investment grade strategies to hybrid strategies that encompass high yield and IG, and an unconstrained strategy where we can be negative 3 years to plus 8 years in terms of duration and unconstrained on the credit side. We also have a very strong history of ESG at Pictet Asset Management. The E and the G have always been important factors for credit. The social factor is the 'new kid on the block' if you like and we are cognisant that those social factors will probably be a key driver of your ability to deliver forward looking returns in combination with the E and the G over the next decade or two.

> We see great opportunities in low cash price long dated investment grade bonds

In association with

PICTET 1805 Asset Management

> Real assets such as property have also proven to be a reliable hedge against inflation

Market commentary

Commercial property

Written by **Michael Griffiths**

The ongoing recovery from the global pandemic and geopolitical tensions are continuing to create significant uncertainty for investors concerned with the long-term future of commercial real estate.

A model of hybrid working now appears to be the favoured approach for companies across all sectors, meaning as the world emerges from lockdown, commercial property will continue to be in demand.

In the UK, the RICS Commercial Property Market Survey for Q1 2022 shows a 30% increase in demand for office space compared to the end of 2021. Real estate sectors, including those such as logistics, have benefitted from structural changes within the retail market, picking up the lost revenue from the high street.

Co-fund manager at TIME Investments Roger Skeldon believes that real estate assets will remain a "valuable long-term investment option".

"In such challenging times, it is understandable that investors seek a flight to safety, abandoning volatile assets such as equities in favour of real assets," Skeldon said.

"Real assets such as property have also proven to be a reliable hedge against inflation and commercial property tenancy agreements, for example, normally include inflation-linked rent increases, making them a valuable addition to a portfolio for today's long-term investors."

Sectors that are less cyclical such as healthcare and social housing properties, where demand is less influenced by the economy, have also seen continued performance in the commercial property market. According to Skeldon, such sectors are indicating long-term trends, highlighting increased demand in the future. However, they are also now "heavily undersupplied" in terms of quality real estate available.

Low interest rates have helped to prop up the real estate market, although Skeldon believes the real estate market will not follow the same trend as they start to rise, with commercial property markets instead to be negatively affected.

"Property yields and interest rates have a relatively low correlation, as seen after the financial crash of 2008 when interest rates fell, property yields did not follow the same path," he commented.

"At certain points in the economic cycle, the ease with which you can buy or sell property will vary. Market shocks and other events can mean it costs more to withdraw from property investments, as we saw during the financial crisis and post-Brexit.

"However, liquidity varies across the assets within real estate and the markets in which they are based. By investing in a diversified portfolio of real estate assets through a fund, it can be easier to access listed real estate securities as well as investing in direct property."

> Equities should still provide a robust source of income, now that balance sheets have been repaired following the worst of the pandemic

Market commentary

US and global equities

Written by **Michael Griffiths**

Economists' forecasts of inflation have remained above the Federal Reserve's stated target and continue to indicate sustained inflation over the medium-term.

In a matter of months, the change in the interest rate environment has caused investors to focus on valuation.

According to analysis by Amundi Asset Management, year-to-date through to 17 May, the least expensive quintile of S&P 500 stocks returned 6% – despite the overall decline in the S&P 500 – while the most expensive fell 23%.

Head of equities and US portfolio manager at Amundi, Marco Pirondini, said that excessive growth in money supply, underinvestment in "physical capital" in the past, and strong labour markets are likely to keep inflation above the central bank target in the long-term.

"Valuations of long-duration growth stocks that depend significantly on cashflows way into the future are affected by increases in interest rates and, hence, their cost of capital," said Pirondini. "The move from growth to value – particularly high quality, less cyclical – should be supported by high valuation premiums of growth, a mild upward repricing of core yields and rising inflation."

Pirondini also warned that this rotation towards value, international, less-expensive markets in a post-pandemic environment is "unlikely to be linear".

On a global scale, it could also be affected by extreme market events, such as Russia's invasion of Ukraine, when investors might prefer the resilience of the US over Europe.

Events in Ukraine are set to dramatically redefine the global order, with the short-term financial shocks from the conflict exacerbating global inflation pressures.

Fidelity International has stated that the hit to overall confidence is "likely to be meaningful, but its magnitude and duration uncertain". Europe is the most exposed region, with at least a modest recession very likely. The US is relatively insulated for now, but not immune either, particularly from the inflationary impacts of the war.

"Equities should still provide a robust source of income, now that balance sheets have been repaired following the worst of the pandemic," commented global CIO at Fidelity International, Andrew McCaffery.

He warned to be cautious around European equities but added that there could be the potential to diversify in some emerging markets, particularly areas that are benefitting from the commodity price surge.

"We have a more positive outlook for emerging market equities, including China, and Asia Pacific stocks excluding Japan, given the diversification potential and possible support for commodity exporters," he added.

"We expect interest rate differentials to support the Dollar as the Fed remains focused on inflation, and for its defensive characteristics to provide protection, should market conditions deteriorate in the shorter-term."

Portfolio optimisation in today's challenging market environment

Adam Cadle speaks to Dr Laura Ryan, Head of Research at Ardea Investment Management, about the firm's insurance asset allocation optimisation tool and the reasons for developing it

WRITTEN BY **ADAM CADLE**

Q Can you explain why your team decided to develop an insurance asset allocation optimisation tool?
The problem for insurance companies is that asset allocation is incredibly difficult. So, not only do they have to consider matching their assets with their liabilities, but they have also got to generate a positive return often for their shareholders, and on top of that there is the regulatory capital problem. The low yield environment that we find ourselves in and the extremely volatile environment also creates a huge problem for insurance companies to solve and we want to help out.

Q Conventional optimisation tools focus on 2D optimisation, (strong return for low risk). How does Ardea's insurance portfolio optimisation tool differ from this 2D strategy?
We've worked with the University of Sydney to develop a multi objective optimisation tool, and that takes into consideration market risk/return but also regulatory capital. We have also built liabilities into the optimisation as well. We will be making this available to clients very soon through a web interface.

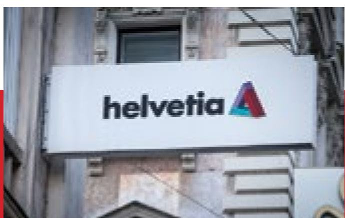
Q How is ESG being incorporated into the optimisation tool given there are already three competing objectives of capital, market risk and return?
There are a couple of ways to do this. We've started to incorporate the draft Solvency II climate charges into the tool but then also recently we have published a paper with the University of Technology in Sydney on how climate change impacts government bond yields and we are working that into the scenario modelling that we can include in the optimisation tool as well. I think in this very uncertain environment, modelling different outcomes and different regulatory environments is the way to go.

Q What do you see as the main challenges going forward for insurers?
It's this uncertainty about the regulatory environment. It imposes some very stringent constraints, and you want to make sure you are prepared for that. That's why we are building different regulatory environments and configurability into the tool so that you can see how the portfolio performs in different scenarios, even if it is a regulatory one.

Around the globe

Insurance Asset Management looks at the latest insurance developments happening around the world

Photo by: BalkansCat / Shutterstock.com



1 Swiss insurance group Helvetia has reported a SST ratio of 260% for 2021, up from 193% the prior year. The insurer said "good performance in 2021 had a positive impact on the group's capitalisation, and positive capital market developments such as the rising risk-free interest rates and strong performance of equities and investment properties were also reflected in higher solvency". Moreover, the SST ratio benefitted from the introduction of a new standard model for credit risks, resulting in a rise of eight percentage points.

2 German insurance company Gothaer is to invest an additional €200m in impact investments every year, it has announced in its latest sustainability strategy. The strategy also detailed how a pathway to completely phase out coal has been adopted, and how the insurer will achieve net-zero emissions in its investment portfolio by 2050 and in its insurance business until 2045. "Of the estimated €11bn that the entire industry has invested in renewable energies, €1.4bn came from Gothaer alone," Gothaer Group CFO Harald Epple said.

3 Varma has reported a negative return of -1.9% in the first quarter (Q1) of 2022.

Publishing its interim results, the pension insurance company said the value of its investments amounted to €57.6bn at the end of March, compared to €59bn at the end of 2021. However, it said its solvency capital remained strong at €5.8bn (€16.9bn end 2021), equating to 1.8 times the solvency limit. Commenting, Varma CEO Risto Murto said: "The war in Ukraine is a deep social and humanitarian crisis, the effects of which on the investment market have so far remained quite limited, considering the devastation of the war."

4 Dutch institutional investors, including insurers, have increasingly turned their attention to riskier high-yield (HY) bonds over their investment grade counterparts over the past two years, with most of the former abroad, according to De Nederlandsche Bank. These HY bonds include corporate bonds as well as government bonds issued by emerging market economies. For corporate bonds, the vast majority of investments are made in US firms. In February 2022, Dutch institutions had €27.4bn outstanding in these HY bonds, representing more than 30% of their bond holdings at that time. US firms dominate the global HY corporate bond market, with notable issuers such as Ford, Kraft Heinz and Occidental Petroleum. For government bonds, the HY government bonds of the BRICS countries Brazil and South Africa have attracted heavy investment. Whereas allocated assets stood at €7.2bn in early 2020, they had grown by more than 70% to €12.3bn by February 2022.

5 Sanlam and Allianz have agreed to combine their current and future operations across Africa to create the largest Pan-African non-banking financial services entity on the continent. The entity is expected to have a combined total group equity value (GEV) in excess of 33bn South African rand (approx. €2bn).

Sanlam and Allianz will leverage each other's strengths to unlock synergies and provide customers with "best-in-class, innovative insurance solutions and technical excellence". Allianz added: "The joint venture will create value for all stakeholders through greater economies of scale, broader geographic presence, larger combined market share, and a more diversified product offering."

6 The solvency ratio of the Italian insurance sector reached 260% at the end of 2021, compared to 243% in December 2020, and total premium income rose by 4%, Banca d'Italia's *Financial Stability Report* has said. The average ROE for the sector (around 9%) was down on the previous year; in the life sector, it remained basically unchanged, while in the non-life sector it instead declined, partly owing to the rise in the ratio of claims plus operating expenses to premium income.

" The joint venture will create value for all stakeholders through greater economies of scale

7 Mediterráneo Vida (MedVida) has signed terms to acquire CNP Partners, the Spanish subsidiary of the French group CNP Assurances. MedVida is expected to take effective control of CNP Partners in the fourth quarter of 2022, following regulatory approvals. With this acquisition, MedVida will double the size of its balance sheet, to manage total investments of approximately €5bn, and enter the Italian insurance market where CNP Partners has several bancassurance agreements. The company will keep "Partners" in its new name.

8 Macif has reported a turnover of €5.9bn for 2021, up 6.8% on the prior year. According to the insurer's latest annual results, its net income rose by 66% in the same period to €148.5m. "With nearly €2.8bn in equity and solvency rates of 284% for Macif SAM and 238% for Mutavie, Macif's financial solidity, recognised in particular by the A2 rating awarded by Moody's in March 2021, is confirmed," it said.

9 German insurer, Barmenia, has chosen Schroders Capital to manage a €100m multi-private assets impact portfolio. The portfolio, which will be classified as Article 9 in accordance with the EU's SFDR regulations, will be composed of impact-focused investments in private equity, sustainable infrastructure and climate insurance. Schroders Capital said the portfolio will aim to be fully invested within the next 36 months and the sustainability and impact objectives will be "reinforced by investments into two funds managed by impact investment pioneer BlueOrchard, part of the Schroders Group".

Photo by: Chrispictures / Shutterstock.com

10 Vienna Insurance Group (VIG) recorded a total green bond volume of €436m at the end of 2021, representing an increase of more than 83% compared to the previous year, its latest financial results have shown. The share of green bonds has thus increased more than six-fold since 2018, when they accounted for €70m. Premium volumes were recorded at €11bn (+5.5%) along with a profit before taxes of €511m (+47.8%).

11 PIC has directly invested a further £50m of debt in the London School of Economics and Political Science (LSE), to fund sustainable projects.
This includes the development of the LSE's first carbon neutral building, 35 Lincoln's Inn Fields (35 LIF). The investment is a key part of the LSE's sustainable finance framework. The transaction follows PIC's £129m investment with the LSE and DIF Capital Partners to fund the development of a 676-bed student residence in Southwark, London, in January 2022.

Photo by: lentamart / Shutterstock.com

12 Moldovan insurance companies accumulated gross written premiums amounting to 1,926.3m lei in 2021, an increase of 32.6% compared to 2020. State news agency Moldpres said the advance is "unprecedented in the history of Moldovan insurance, especially since it took place after a 10.6% decline in gross premiums written in 2020 as a result of the COVID-19 pandemic". According to the National Financial Market Commission (CNPF), data for 2021 shows that the sector remains oriented towards non-life insurance, which has a share of 94.8%, while life insurance accounts for 5.2% of the total volume of premiums.

13 Hong Kong multinational insurance and finance corporation AIA achieved a 31.4% decrease in the carbon footprint of its directly-managed, listed-equity portfolio in 2021, with performance recorded from 2018. It also recorded investments of US$8.6bn in healthcare bonds and US$3.6bn in ESG bonds, representing a 100% increase year-on-year, with plans for this to grow materially in the years ahead. Last October, AIA completed the divestment of directly-managed, listed equity and fixed income exposures to coal mining and coal-fired power businesses.

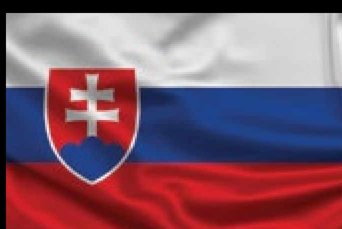
Photo by: Casimiro PT / Shutterstock.com

> “The insurance company was found to be non-compliant with Solvency II rules in relation to technical provisions, capital requirements, investments and systems of governance

15 Sompo has become the first Japanese insurer to rule out insurance for the development of new oil sands and exploration of Arctic National Wildlife Refuge (ANWR). Updating its coal policy, the insurer has also committed to stop underwriting and investing in new and existing coal-fired power plants and coal mines. However, the policy gives exemptions for new and existing coal power plants using technologies such as Carbon Capture and Storage (CCS), Carbon Capture, Usage and Storage (CCUS) or ammonia co-firing.

14 Australia’s general insurance industry recorded a significant investment loss of A$942m for the year ended 31 March 2022 – driven by unrealised losses on interest bearing investments due to a sharp increase in bond yields during the March quarter. A net profit after tax of A$1.3bn was reported in the same period, however, and a return on net assets of 4.3% during the year ended 31 March 2022 was recorded, according to the Australian Prudential Regulation Authority (APRA).

16 The European Insurance and Occupational Pensions Authority (EIOPA) has issued a recommendation to a Slovakian insurance company under the supervision of Národná banka Slovenska (NBS) over non-compliance with Solvency II rules. The recommendation was issued in accordance with EIOPA’s powers laid down in Article 17 of the EIOPA Regulation concerning breach of union law. The insurance company was found to be non-compliant with Solvency II rules in relation to technical provisions, capital requirements, investments and systems of governance.



17 The return on Swedish life insurance companies and occupational pensions was -4.1% in Q1 2022, according to Insurance Sweden. The association said that this is among the lowest returns in a single quarter in the past 10 years. To compare the Q1 result, the return during the fourth quarter of 2018 was also around -4.1% and during the first quarter of 2020 at the beginning of the pandemic it was -5.9%. The average annual return for the past 10-year period (2012 - 2021) of 8% falls to around 7% if the first quarter of 2022 is included.

Sustainable Investment Summit 2022

Our conference updated investors and asset managers with the latest views surrounding sustainability within the institutional investment space

WRITTEN BY **MICHAEL GRIFFITHS**

Following last year's virtual outing, the Sustainable Investment Summit made its first appearance as a physical event this year to offer insurance companies, as well as pension funds, charities and corporates, the opportunity to both learn and network at what is a critical time for the sustainable investment industry.

On 24 March, delegates gathered at the Waldorf Hilton, London, for a day filled with key presentations delivered by leading professionals and policymakers from across the investment universe.

A packed agenda covered many angles of the sustainable investment space, from climate related risks and opportunities in impact investment, to the roles of stewardship and governance, as the industry ultimately came together to discuss the next steps of the transition towards a sustainable global economy.

This year's conference was chaired by Richard Howitt, a strategic adviser on corporate responsibility and sustainability, business and human rights. Howitt warmly welcomed a room filled with investment expertise before introducing head of the climate finance unit at the UN Environment Programme, Ivo Mulder, to deliver the day's first keynote speech.

"What is at stake is a liveable and sustainable future for all," Mulder told the room. "We have eight years until 2030 and the financial sector needs to wake up to the reality that change must happen now. Not in a few years, and definitely not in a few decades. A liveable world depends on making urgent and widespread changes to ensure both nature and climate risks, and opportunities, are embedded into

Follow the latest news and updates about the Sustainable Investment Summit on Twitter: **#SI_Summit** our financial system."

Mulder also warned that a race to net- zero is "not going to be enough".

"To achieve a liveable and sustainable future for all, we need to decarbonise our entire economic system," he added. "Risk management is not the only way to go about this. We also need an overhaul in how banks, institutional investors and impact investors are financing clients in this space."

'Ambition to action'

In his role as chair of the summit, Howitt featured in a presentation alongside BlackRock global head of investment stewardship Sandra Boss, as he interviewed Boss on stage before the delegates about the role of investment stewardship. She responded by stressing the importance of where the sustainable investment space currently finds itself.

"This is a pivotal moment where we're moving from ambition to action in how companies and sovereigns are approaching the energy transition," Boss said. "Our investment conviction is very much routed in the belief that this is inevitable, but timing is the challenge. We know that the energy transition will transform the way that other companies invest in their capital allocation and their business models.

"This is a fundamental shift in how the entire capital stock of the world operates, but there's a lot of uncertainty around how policy will happen, uneven pace of policy, and macro-economic events. So from our perspective, optimally, we will pursue and actively manage an orderly transition."

In another speech, delivered by

"This is about finding opportunities that are investible and not just aspirational

principal sustainable investments – Europe at Mercer, Hill Gaston, similar sentiments around action were echoed.

"We believe it is really about investing in businesses with impactful products and services providing the solutions to our most pressing challenges," said Gaston. "This is about finding opportunities that are investible and not just aspirational. We need to get to a place where action leads to the desired results."

Gaston presented on impact investment opportunities and suggested that such opportunities are driven by a "growing need" for solutions to tackle environmental and social issues.

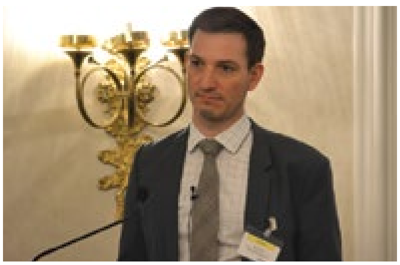
"The UN's Sustainable Development Goals (SDGs) are essentially a blueprint to achieve a better and more sustainable future for all," he added. "They address the global challenges that we all face – from poverty and inequality to climate change and environmental degradation – and they are the closest thing we have to a masterplan that can get us to the world we want to achieve.

"A lot of asset owners and asset managers agree this framework is useful. It makes our lives easier by providing a common language and way of approaching impact, and it makes impact accessible to more investors."

Sustainable Development Goals

The UN's 17 SDGs were a common theme in several of the day's presentations, with HSBC Asset Management head of global emerging markets debt Bryan Carter suggesting that in emerging markets, they should not be used solely as a framework for investments.

"We can either screen investments from a bottom-up perspective on low carbon transition consistent with Paris



goals, and demonstrate our progress towards achieving those goals, or we can design our portfolio from the top-down to be net-zero aligned," Carter commented.

"A net-zero aligned strategy consistent with the EU taxonomy would require a net-zero EU compliant benchmark, which of course does not exist for emerging markets and won't for some time. So, by process of elimination, we end up with the UN SDGs here.

"The SDGs are not an investment framework. They have benefits on focusing our teams on the specific outcomes we want, but they're really designed for selecting securities or building portfolios. That's an issue that all asset managers must wrestle with."

Asset Management One International head of equities EMEA Anca Vasilov whose presentation brought the Japanese perspective to the conference, added: "From a broad sustainability perspective, we aim to align our engagements as much as possible with the UN SDGs. We focus primarily on the goals that we view as directly linked to corporate value creation, and these include engagements on climate change, product liability, diversity, labour standards and health and safety.

"Engagement on diversity has increased on the previous year, and given the latest developments in Japan, especially the stipulations of the latest revisions of the corporate governance code, we are expecting that to continue and accelerate in the next year."

Another speech, delivered by

> We want to see large scale capital building a world that works for everyone

head of impact at the Big Issue Invest, Joshua Meek, focused in particular on increasing sustainability through the social aspect within an impact investment.

"We want to see large scale capital building a world that works for everyone, and that means doing more to understand not just ESG screening, but also what our money is doing in terms of promoting inclusive growth around the globe," Meek told delegates.

"We work through due diligence, we collect primary data, and we collaborate with entities to understand what their primary aims are as a social enterprise or charity. We then align this to the UN SDGs, but we go beyond just the line to a goal. We look at what targets there are, which are macro-level targets for countries, but with the right level of patience and collaboration we can identify if a company is aligning well and contributing towards a certain target of people."

He added: "Our hope is to support others moving into that social investment sector and to do more to help the whole social economy deliver support to those who are most marginalised.

"We tend to partner with mission aligned asset managers who contribute to our mission to build a world that works for everyone, now and for the future. We work across a spectrum of

asset classes which has a range of impact intensity, and we bring the impact management practices from our direct investing to the asset management teams in the mainstream markets."

Approach

Talk of a greater need for collaboration among those responsible for the climate transition became a running theme across this year's Sustainable Investment Summit agenda. But with billions of pounds worth of investment required in the coming years for the insurance industry to decarbonise and transition to a sustainable economy, a variety of different potential approaches were brought to the conference.

In a presentation around climate government bonds, senior investment manager global bonds at Pictet Asset Management, Ella Hoxha, also spoke of dissecting the environmental, social and governance aspects of ESG, and said that "tailored solutions" are required.

"We prefer to be broadly right rather than precisely wrong," Hoxha said. "The best way is to take a focused approach. In terms of solving problems, while it's great to focus on the E, S and G aspects of ESG, we think we can provide much better tailored solutions by focusing on particular issues that are much more problematic.

"With that in mind, we believe on the environmental aspect of ESG, climate change is the most essential problem that we face going forward. We believe one should focus on specific, reliable metrics, and the reason for that is that you can then have good quality data, and by using that you can then make an informed decision."

She added: "We want to do our homework, rather than take an exclusion approach."

Another presentation saw head of market intelligence at the Climate Bonds Initiative, Krista Tukiainen, discuss the role of bonds in financing the net zero transition. Tukiainen highlighted estimates that sustainability-themed bonds now comprise at least 5% of all debt issuance, before using her speech to emphasise the importance of conducting a climate transition at speed.

"It is top of mind for everybody in this industry that it is not just about getting to net-zero, but the aim is also to build a resilient world," she told delegates. "What this means is maintaining a liveable planet to 2050 and beyond. We must move away from fossil fuels to be able to do that at scale and at speed, and we also have to adapt to the worst effects of climate change.

"The problem we have is that while it is commendable that investors have decarbonisation plans in place, they will fail to deliver the reduction of real carbon economy emissions at speed, because a lot of them currently still rely heavily on a technological optimism and offsets.

"The other thing is that transition investments are not going to be linear. We know there are going to be socio-economic shocks, such as the ongoing war in Ukraine, that will make things move either slower or faster. At least one positive to come out from this, for example, is that we now have an opportunity to move away from fossil fuels quickly in this crucial region and beyond."

M&G Investments fund manager Randeep Somel also discussed the different approaches that investors are taking to manage the risks and opportunities presented by the climate crisis. Somel's presentation focused on "science-based targets", as he suggested the trend of companies adopting science-based targets is now "gaining more credence".

"This is a not-for-profit organisation made up of many partners that tries to

help identify companies on what they need to do in order to get onto that 1.5-degree pathway," Somel said. "It requires a lot of reporting, companies to provide scope one, scope two and scope three emissions, and the capital of the policies that they put in place to reduce those emissions.

"Once a company has a science-based target, they are on that path for their own operations and their supply chains to be hitting that 1.5-degree pathway. So, this will be a very good independent reference point in terms of the businesses that you are investing in, to ensure that they are, at least, a low-carbon company or working towards that for the future."

Challenge

Another presentation that came with a scientific-based approach was delivered by director, market relations and climate change lead at the World Gold Council, John Mulligan. He explained how to calculate gold's carbon footprint and summarised the climate impact of gold on the global economy, before discussing some of the challenges that alternative asset classes are facing in the transition to net-zero.

"There's a big challenge when it comes to several asset classes, because very frequently those methodologies and those benchmarks struggle to consider anything beyond equities, corporate bonds and increasingly now sovereign bonds too," Mulligan told delegates. "But other assets are often excluded, which makes the diversification potential within a climate risk perspective more of a challenge."

A joint presentation from head of unit linked investment solutions at Standard Life, Gareth Trainor, Phoenix Group head of climate change, Tim Lord, looked at more challenges of investing in decarbonisation, how to remove these challenges, and what needs to happen from a policy perspective to drive a step change in investment volumes.

"Other assets are often excluded, which makes the diversification potential within a climate risk perspective more of a challenge

Trainor started by introducing a study recently carried out by Standard Life, focusing in particular on what is driving investor choices.

"When we asked clients what they take account of when investing, the first thing people said every single time was return," Trainor said. "The second thing people said to us was risk. As you go through the numbers, then various other bits and pieces such as corporate governance and climate started to come out.

"The number one takeaway from this is that we cannot forget whose money it is we are investing. The return aspect is most commonly the primary goal."

Lord added: "We often talk about climate as a risk and as an opportunity, but the challenge for me is about how we make the opportunity a real one. Research by the ABI last year showed that we need £2.7trn of investment in the UK between now and 2035 to hit our net-zero target. The UK insurance industry can potentially provide about a third of that investment, and £900bn would go a long way to the overall investment requirement.

"As Gareth said, however, the challenge is if you ask people to choose between returns and protecting the environment, people will always prioritise returns, and you're never going to get £2.7trn of investment in that way. What we have to do is make it so that in five years, this question is a very hard one to ask, where the two can go hand in hand."

The closing keynote speech on the day was delivered by Bank of England senior adviser Michael Sheren. He spoke to delegates through one last presentation which centred on the coming steps in the transition to a sustainable global economy.

"Financial firms have committed $130trn of assets to support net-zero carbon," Sheren highlighted. "But that $130trn is currently parked in bonds, in stocks, real estate, private equity, and it's not moving out of it particularly fast.

"I was convinced for the last few year that it would be transition risk that would rock the valuations around assets and investments. Unfortunately, the acceleration around physical risk has been striking," he said, adding that some scientists are "terrified".

"In Antarctica, temperatures were recently 30 degrees warmer than its normal temperature. As the ice melts or slides off the land in Antarctica it displaces the water and gives us huge

sea level rises. Last year, we saw the manifestation of physical risks all over the world in the form of droughts, forest fires and floods. There's a real sense of urgency amongst climate scientists, not just among those of us who drive policy or the tech people who drive transition risk.

"I believe we need a catalyst – something that gets that $130trn to physically move itself and into the areas it needs to go into. A catalyst could be a variety of things. It could be a carbon price. It could also be other forms of regulation or legislation. Right now, however, most things in the climate and ESG space are still voluntary, so we need this catalyst, and then we need new sustainable investments."

> Whoever has the gold makes the rules, and the investment community has the gold

Sheren closed on a positive note about the future of the sustainable investment space, with a message for investors and asset managers who can drive the transition towards a more sustainable world.

"This is the opportunity of a lifetime if you are doing your homework now," Sheren told the room. "It's a job creation opportunity, the biggest since the Industrial Revolution, and if you're an investor this is the alpha opportunity of your life.

"It's a huge challenge because we've never thrown the whole global economy up in the air at the same time, changing energy, agriculture, mobility and housing, but that's where we're at. It means everyone has to work harder, but if we do we deliver a sustainable world with positive externalities.

"That's my challenge to you, because it's in your hands until carbon is legislated in the price. Whoever has the gold makes the rules, and the investment community has the gold."

Current ponderings on industry themes

On the news that 72% of institutional investors expect the crypto regulatory environment to improve

We are only at the very beginning of the digital asset sector, and the most exciting developments have yet to happen. Record inflows of venture capital in 2021, continued product innovation at the blockchain level and ongoing adoption of the largest players in traditional finance all point to growth of the already multi-trillion-dollar asset class.

HENRY HOWELL
Nickel Digital head of business development

On PIC investing £130m in Raven Housing Trust

The purpose of PIC is to pay the pensions of our policyholders over many decades, so by continuing to invest in long-dated, secure cashflows, such as our Raven investment, we are securely backing future pension liabilities. It has been a pleasure to deal with the team at Raven. We are proud to be able to help them develop much-needed homes, whilst at the same time securing the pensions of our policyholders.

VLADAN MARTINOVIC
PIC debt origination manager

On the UK Endorsement Board approving adoption of IFRS 17

The UKEB has carefully considered the statutory criteria for adopting new IFRS for use in the UK and is satisfied that IFRS 17 meets them all. Overall, the UKEB considers that the adoption of IFRS 17 will lead to substantial improvements in financial reporting for insurance contracts and that its application will be conducive to the long term public good in the UK. The adoption of IFRS 17 marks a major milestone in the work of the UKEB during its first year of operation. I am grateful for the extensive and constructive engagement from UK stakeholders during the consultation process, the detailed analysis carried out by the UKEB staff, and the thorough consideration given by board members to each of the statutory criteria. The UKEB looks forward to continuing to engage with UK stakeholders during the implementation and initial application of the Standard.

PAULINE WALLACE
UKEB chair

On the Government halting plans to force corporates to disclose environmental impacts, removing the proposals from the Queen's Speech

Whilst leadership continues to be shown in some areas, namely through the COP26 Presidency and the work undertaken by the Transition Plan Taskforce, the postponement of the SDRs is a sorely missed opportunity for the UK to further reaffirm its position as a global environmental leader, uphold the commitments made in Glasgow last year and make good on its ambition to become the first 'net-zero aligned financial centre'.

PIETRO BERTAZZI
CDP global director of policy engagement and external affairs

On the gap between responsible investment assets in equity and fixed income to narrow

Managers will find new ways to implement ESG considerations in fixed income. The increased availability of green bonds indices has contributed to growth in the market. Interest in the sustainable credit market has also been supported by increased product development activity across Europe by asset managers and exchange-traded fund (ETF) issuers operating in the region.

FABRIZIO ZUMBO
Cerulli Associates, director, European asset and wealth management research

On NN group completing the acquisition of MetLife's businesses in Poland/Greece

We have achieved an important milestone for NN in Poland and Greece, as this transaction strengthens our positions in these attractive growth markets. In the coming months, we will integrate MetLife's businesses into the local NN organisations. While combining the strengths of the two companies, we are committed to respecting the talents and experience of employees in both organisations and applying a fair and transparent approach. During this process, we will continue to focus on delivering an excellent service to our customers and improving the performance of the combined company, by capturing the opportunities of these markets and realising the expected synergy benefits. We welcome MetLife Poland and Greece's employees, customers and partners and look forward to a successful joint future.

DAVID KNIBBE
NN Group CEO

On Zurich expecting to exceed all 2022 financial targets

The positive operating trends in the first quarter, together with the group's very strong balance sheet, give us confidence that we will successfully conclude the current strategic cycle later this year.

GEORGE QUINN
Zurich group chief financial officer