BEST'S REVIEW®

ISSUES & ANSWERS:

NEW DIRECTIONS IN ASSET MANAGEMENT AND POLICY ADMINISTRATION

Industry experts discuss the state of the municipal bond market post-COVID, investment opportunities in the current low interest rate environment and insurers' ongoing move to digitalization.

Interviewed Inside:

Mark Paris
Invesco

Reed Nuttall
AAM

Kurt Diederich
Finys

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Municipal Bond Considerations Post-COVID

Mark Paris, CIO and Head of Municipal Strategies for Invesco, said the COVID-19 crisis created significant volatility in the municipal bond market at the beginning of the pandemic. One year later, things are moving in a positive direction. "The combination of $1.9 trillion in federal stimulus, with a large chunk of that going to state and local governments, along with COVID-19 vaccines getting to more people, the outcome should continue to be positive for municipal credits," he said. Following are excerpts of an interview.

Mark Paris
CIO and Head of Municipal Strategies
Invesco

"The U.S. economy is also poised for a comeback, especially as vaccines become even more widespread."

What is the current state of the municipal bond market?

At the height of the pandemic the picture in munis appeared to be pretty grim, with mandatory lockdowns reducing revenue-generating projects for states and local municipalities. What we now know is that state and local budget projections that were made early in the pandemic proved to be largely overly pessimistic, and many key revenue drivers outperformed those estimates. For example, throughout 2020 states' rainy-day funds remained at elevated levels. After the strain of the 2008 financial crisis, state governments devoted themselves to building reserves in preparation for another unexpected economic crisis. States have been successful in that regard with the current median rainy-day fund balance standing at 8% of state expenditures, which is almost double what it was in 2008.

From a technical perspective the municipal market has benefited from investor optimism regarding the U.S. economy, and widespread perception that taxes might be on the rise. This widespread speculation about the possibility of future tax hikes seemed to enhance the appeal of tax-free income, helping to drive investment inflows into the asset class.

How has the American Rescue Plan impacted near-term municipal fundamentals?

This second round of federal stimulus should further stabilize state finances since $195 billion is earmarked for states. The U.S. economy is also poised for a comeback, especially as vaccines become even more widespread. In addition to stimulus, it is important not to overlook the fact that states and localities can raise taxes, and we think we will see tax increases in 2021. We view the current period as a multiyear budget rebuild, the same way the first few years after the global financial crisis were a time of economic rebuilding.

Do you think a Democrat-led federal government could yield benefits for municipal bonds?

We expect the Biden administration's latest legislative initiatives to benefit the municipal bond market in 2021 and beyond. For example, the American Jobs Plan, better known as Biden's $2 trillion infrastructure bill, involves an accelerated investment over four years, with funding and jobs spread out across every state in the Union. The plan is expected to provide flexible federal investments to state and local government transportation departments, with the goal of providing every American city with 100,000 or more residents with high-quality, zero-emissions public transportation options. We expect the municipal bond market to be one of the various funding vehicles used to finance the expansive infrastructure improvement project. This could be a net positive for state and local government fundamentals, as increased federal funding should lead to higher employment, economic conditions, and tax receipts.

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Investing in Alternatives

Reed Nuttall, Principal and Chief Investment Officer at AAM, said with low interest rates there are ways to add yield through alternative asset classes. For example, he points out that convertible bond issuance last year was at a 20-year high. "There was $110-plus billion issued in 2020 with another $40 billion in the first quarter of this year. That gives us plenty of attractive investment opportunities in this sector." Here are excerpts of his interview.

Reed Nuttall
Principal and Chief Investment Officer
AAM

"Both history and our models suggest that diversification and being disciplined about adding risks lead to higher returns and more stability. That's our strategy."

Go to the Issues & Answers section at *bestreview.com* to watch an interview with Reed Nuttall.

What strategies does AAM employ to help your clients alleviate the loss of income due to low interest rates?

We focus solely on the insurance industry. As such, we have an eye toward maximizing income for any given level of risk. We're trying to maximize income whether the 10-year Treasury is at 6% or whether it's at 1%. However, what we're seeing down here at 1% is that risk assets tend to be mispriced, as everyone crowds into the same risk in search of yield. We have a disciplined approach to evaluate each client's risk profile and suggest asset classes that improve income within each client's specific profile. We found private placements, commercial mortgage loans, convertible bonds, bank loans, and high yield, all stand out as opportunities in this environment if managed with a focus on risk mitigation.

What value do you find in convertible bonds over just investing in stocks outright?

A portfolio consisting of both common stock and convertible bonds provides a great mix of market upside with some downside protection. A convertible bond has two components, a bond and an option on the stock price. What you're doing is buying exposure to the underlying stock price movement. It comes with a floor on the downside, and that floor is established by the price of the underlying bond. It's this bond component that gives convertibles favorable capital treatment in insurance company portfolios. A properly managed convertible portfolio can provide both the upside of the stock market and the stability of bonds in a capital-efficient way.

How do private placements and mortgage loans contribute to client portfolios?

We've been investing in investment-grade private placements for decades. We found that they offer superior yield and more credit stability than public securities, and they fit well for both P&C and Life portfolios. In March of last year corporate bond spreads significantly widened versus Treasuries and then retraced pretty quickly in the second quarter. Private placements, because of their nature, tend to be less liquid and less volatile than public bonds, yet offer higher yields for similar risks.

What can companies do to limit the negative effect of rising interest rates on their portfolios?

If you have callable bonds in your portfolio, when rates rise, those call options may not get exercised. This causes durations to extend in portfolios with excess call risk. At AAM, we're very disciplined about duration management. What we saw in the first quarter of 2021 is that the duration of mortgage backed securities (MBS) moved from 2.3 to 4.1, so a lot of extension. We stayed away from the MBS sector last year, and it's even less attractive this year. We do find that higher quality bank loans, collateralized loan obligations or CLOs, provide both additional yield and price stability because their coupons reset as interest rates go up and the prices stay around par. Also, some of the strategies that we talked about—being disciplined about your approach to duration, adding yield where you can in a high-quality fashion—have really helped us enhance the income to our clients' portfolios. There's no such thing as a free lunch.

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Opportunity Amid Chaos

Kurt Diederich, President and CEO of Finys, said it would be an understatement to say that 2020 was both difficult and challenging for just about everyone. "Despite those challenges, and perhaps as a result of them, we're continuing to put an incredible amount of money into research and development to improve the platforms with a bigger move toward digital," he said. Following are excerpts of an interview.

finys

- Founded in 2001.
- A platform of integrated modules for processing P/C insurance.
- Meeting the needs of the insurers now and into the future.

What are the lessons of 2020?

First and foremost, you want to try to get ahead of the curve. A lot of companies were well positioned for this situation. For those that were, 2020 paid dividends for them. One of my favorite quotes from Sun Tzu is, "In the midst of chaos is also opportunity." An example of that comes from an insurance carrier client who told me they just came off their most profitable year ever.

What, if anything, can or should insurers do in the face of this kind of uncertainty?

It's important that you put yourself in a position to take advantage of the turmoil. Following a process like the OODA loop will help—OODA loop being observe, orient, decide, and act. Having the right systems in place will help in this endeavor. Carriers can focus on bringing more digital channels to their platforms, modernizing their systems, and making sure they can respond.

What can policy admin vendors like Finys be doing to be more effective?

For the insured, they need to be given a better digital experience and offered excellence in call centers for anything that can't be serviced in the digital channels. Agents need to be given the tools to sell more and process less. Finally, for the carriers, give them the information they need to make the right decisions and the systems they need to react quickly in the face of uncertainty. To address that, we're continuing to put an incredible amount of money into research and development to improve the platforms, with a bigger move toward digital.

Kurt Diederich
President and CEO
Finys

"As we move forward, the ability to bring in insurtech technology is going to be a must."

Go to the Issues & Answers section at *bestreview.com* to watch an interview with Kurt Diederich.

Are there things that policyholders might want or expect, especially given their experiences in 2020?

Clearly, I think policyholders desire a touchless experience. They want to be given the ability to self-service. I also think that agents need to transition to what may become the new normal. People are not visiting their agents as much, so online servicing is something carriers need to bring to the table. They should find ways to add value and remain relevant.