Reciprocal relationship

Increased market volatility has raised asset allocator demand for private credit strategies, particularly structured credit. *Hildene Capital Management* explains how structured credit and insurers can work together in today's volatile market.

Insurance companies are among the investors leading the way in understanding how this unique asset class – known for its enhanced yields and credit protections – can help them diversify away from traditional corporate bond-based insurance portfolios as well as increase returns without meaningfully sacrificing credit risk. And yet, the insurance companies are not the only beneficiaries of such investments. The relationship between structured credit asset managers and life insurance companies is hardly one-sided; rather it is a reciprocal relationship. Structured credit managers benefit from the insurers' persistent capital base by deploying that capital in assets complementary to existing core strategies, and insurers benefit from the capabilities and expertise of seasoned structured credit investors who meet their unique regulatory and operational needs.

Such a reciprocal relationship can exist given that structured credit assets – namely collateralized loan obligations (CLOs), asset-backed securities (ABS), mortgage-backed securities (MBS), and trust-preferred collateralized debt obligations (TruPS CDOs) – offer insurers favorable risk-reward profiles stemming from material structural protections like overcollateralization and credit enhancement, layers of portfolio diversification, and cashflow profiles aligned with their liabilities.

For example, many structured credit securities have embedded triggers that force the rapid return of principal during times of distress, a feature that 'vanilla' corporate bonds typically do not offer. Additionally, in many cases, structured credit assets represent diversified pools of underlying debt obligations, providing additional diversification into a single tradable security. Finally, the cashflow profile of typical structured credit assets is well-suited to match longer duration life insurance liabilities, allowing insurance companies to obtain stable and consistent cashflows over an extended time period, which is difficult to achieve with similarly-rated corporate bonds.

Among structured credit assets, TruPS CDOs stand out for life insurance managers due to their fundamental credit security, long duration nature and potential for enhanced yields. TruPS CDOs are particularly attractive given that senior and mezzanine TruPS CDO tranches remain discounted relative to other structured credit assets. Backed by the debt of highly-regulated entities like regional and community banks, TruPS CDOs have benefitted from the decade-plus economic recovery, which has de-levered and de-risked the legacy securities. As credit enhancement has built in these deals, it has fostered credit ratings upgrades, in turn making a significant portion of TruPS CDO bonds attractive for insurance investment mandates.

With this in mind, insurers can leverage asset managers to source alternative credit assets that maintain or improve capital efficiency and increase returns through structural enhancements. In particular, experienced structured credit managers can provide insurers access to complex and differentiated assets like TruPS CDOs via bespoke investment solutions tailored to their clients' unique regulatory constraints and liquidity hurdles. Furthermore, an asset manager with an active management strategy can also generate book gains through active trading and event driven opportunities, further enhancing total returns.

It is clear, particularly in today's unpredictable market environment, that traditional 'vanilla' insurance portfolios concentrated in investment grade corporate bonds are ripe for disruption. In such a market, structured credit can offer excess returns as well as meaningful diversification and structural protections not found in similarly-rated investment grade corporate bonds.

The end result: insurers are equipped with an optimized portfolio that is well-suited for their long- and short-term needs, while structured credit managers receive a stable, persistent capital base ready for deployment into an addressable market.

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