

Due to low interest rates, asset owners seek to replace traditional fixed income with alternative fixed income

February 2020



Government bonds, quasi-government bonds, covered bonds, and other liquid bonds in the high-quality space with AAA to A ratings have always been the core of traditional life insurances with guarantees or defined benefit pension plans in Germany. These assets serve more than one purpose: a) they help match the duration of the liabilities, b) they require very little capital (Solvency II) c) even long-term bonds are liquid assets.

Alternative fixed income comes in many forms, such as trade receivables, factoring, invoices, etc. While they can be in the non-investment grade space, they also exist in the investment-grade space or, if necessary, can be engineered into investment grade. Due to the very short nature of these assets, Solvency II capital requirements are very low.

What this kind of alternative fixed income cannot provide is the right duration management needed for the liabilities. Depending on the proportion left in traditional fixed income, the duration can be managed by the remaining liquid bond portfolio. Once the alternative fixed income portfolio exceeds 15% - 20% of the portfolio, it becomes increasingly challenging to match the duration of the liabilities without creating substantial distortions on the yield curve. Therefore, it is necessary to complement the yield curve management with derivatives; in our case, mostly receiver swaps.

There are also more traditional alternative assets like mortgage loans, which are very useful. In Europe, for instance, mortgage loans in The Netherlands, France, and Belgium still pay a sufficient spread over Swap (130 - 170 bps), which compares nicely with any other high-investment grade bond, even BBB corporate bonds.

Often, alternative investments are seen as niche markets and somewhat illiquid. A closer look at trade receivables or mortgage loans easily shows that these markets are of considerable size and, therefore, not a niche at all in that regard. Estimates for the market of trade receivables globally - with a heavy US bias- are around 2 trillion USD. Liquidity is an issue; it takes time to source a portfolio, but the typical duration of a portfolio is between one month and one year. Mortgage loans are option-adjusted between 7 and 10 years, still rather short given the long-term liabilities. The market size in The Netherlands alone is 730 bn euros.

In the European real estate market, there are interesting alternative fixed income segments like the senior, whole, and mezzanine loans, that have remained a niche as well as an illiquid investment. The US market, on the other hand, is more liquid, but on a like-for-like risk profile the premiums are squeezed too much by the hedging costs back into the euro.

How to invest in alternative assets? The public bond market is highly standardized and features an advanced infrastructure regarding trading, settlement, reporting, etc. This is not true for alternative investments, and it presents an unusual challenge for a traditional asset owner like Gothaer. The sheer number of small investments needed to invest a meaningful amount cannot be managed without third party infrastructure and hence with a third-party manager.

Nowadays, there are fund structures in Luxemburg, Dublin as well as in Germany that allow investments in alternative fixed income up to 100%. This improvement is vital, but not enough. As an insurance company, we have to carefully analyse selected funds at a micro level to comply with our reporting requirements and risk assessments. This is only possible if the provider knows the requirements of solvency reporting, and can deliver accurate and timely reports. Not many managers can show a good track record for this kind of service. Typically, managers who source efficiently, are well connected to banks and know how to conduct a transaction. Traditional asset managers often know their clients better, understand their requirements, and can provide a good service continuously. They are successful because of their stable infrastructure and highly qualified teams.

As an asset owner looking to invest in alternative fixed income, we often have to choose between a capable and proven asset manager with limited sourcing capabilities and a good sourcing machine with a limited infrastructure to serve the very demanding requests of clients like us. We have found some managers that possess all the necessary skills, but there are still too few. Given the trend of fees in the traditional asset management industry, I reckon it is worthwhile for a good asset manager to expand into the alternative space and team up with their long-term clients in this endeavour.