The future of 'illiquid' investments

Isn't it always more exciting to talk about the future than about the past? Indeed. Hordes of risk managers and actuaries keep modelling the future, imposing constraints on new investments.

By *Teoman Kaplan* and *Florian Ueltzhöfer*

As of June 2024, the European Central Bank (ECB) has announced 26 rate hikes and 22 rate cuts (deposit facility[1]) since commencing operations in 1999. Looking at the 14 years from June 2008 to June 2022, however, the 'cuts' win against the 'hikes' with a score of 13-2 and the game had been decided by 2012 already.

For ten long years, every insurance company had been dreaming of higher rates and 'team hikes' to score again. Finally, the bright future has begun. Or hasn't it?

The hunt for yield

Certainly, the decade of low yields has been a catalyst for the emergence and evolution of private markets. After all, it is hard to break with 'tradition', especially when it is a guarantee for success over a very long time and a fundament of an industry's business model. But given an unprecedented pressure to hunt for every single basis point of investment income, 'alternatives' have been the only place to harvest substantial or, at least, acceptable spread.

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Hidden reserves and gains on traditional fixed income as well as rallying public equities have been utilised to steer the profit and loss (P&L), leaving insurers with an abundance of liquidity to invest or commit into private markets. The abundance of liquidity in the market had also led to a deterioration of the risk-adjusted return on real assets so the desperation for higher rates has been growing strong.

The gloomy present of high rates

Leaving politics aside, which give enough material to talk about a 'gloomy present', the yield hikes of 2022 and 2023 have not brought the immediate bright future insurers had dreamt of. Defining a new Strategic Asset Allocation (SAA) has been a struggle for many over the last 18 months. Liquidity is suddenly scarce! But as a matter of fact, the lack of liquidity stems less from 'illiquid' private markets and real assets: their illiquidity has always been accounted for either way.

The real culprits are those 'traditional' liquid government and corporate bonds, which have never fully vanished from balance sheets and which are now de facto illiquid, for there are significant (hidden) losses. When deciding on re-investing the little liquidity still arising from positive insurance cash flows (for instance in health insurance) and maturing public and private assets, the relative overweight in private markets stemming from the 'denominator effect' makes it tempting to simply go back to 'old school' investing.

So, if you were to wonder whether this is a valid

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option, we strongly advocate against it and continue to see value in investing in private markets.

The new 'traditional' universe

While private equity (PE), infrastructure equity (IE), and private placements (PP) have truly been considered 'alternatives' in their early stages, namely the late 1990s and 2000s, even the 'newer' forms of private market investments, like infrastructure debt (ID; ranging from senior core all the way to value add) and private credit (PC), like corporate direct lending, across various regions and market segments have evolved and matured over the last five to ten years.

Benefitting from the higher rates in lock step with their liquid counterparts, these can truly be considered a part of the traditional investment universe by now. The protection against short-term market volatility as seen during the Covid-19 market turmoil and the lower price sensitivity experienced despite the rate hikes and revaluation of traded/ listed assets prove to be valuable benefits for insurers also in the future.

Sustainability and true impact

The 'newest' (sub-)asset classes continue to play an important role. With the momentum gain in sustainability and ESG regulation, it is also evident that private markets are key to achieve true impact. Leveraging capabilities in the aforementioned 'new traditionals' like ID and mid-market PC and creating synergies across an investment platform breathing the insurance heritage which has driven its evolution, we are also dedicated to pioneer sustainable private credit investments.

In this area, not only blended finance strategies with an impact on emerging markets, but also direct lending impact investments with a focus on OECD-domiciled corporates can support a wide range of investment objectives.

Solvency review

Another important aspect in the evaluation of the attractiveness of equity investments is the finalisation of the '2020 Solvency review'. The European commission has clearly stated its aspiration for unlocking the financing of long-term sustainable growth in the EU.
A key lever is seen in the relaxation of the criteria to classify a portfolio of equities as long-term equity investments (LTEI). In so far, we do expect some comeback also for PE and IE albeit maybe in lower relative allocations compared to their debt counterparties.

Deep dive outtakes

The available investment universe for insurers is very diverse and sometimes complex as you have seen from our description above. Nonetheless, each asset class deserves its own spot-light to discuss its relevance in today's market environment.

But more than ever, private markets financing may help tackle the societal and environmental challenges ahead of us, leading to better risk-return sustainability profiles.

When looking back, private market investments have been extremely innovative and if you look at the constant flow of new investment ideas which evolve, it's an asset class that will drive change by innovating continuously. ■

1 European Central Bank, Key ECB interest rates (ecb.europa.eu), not counting temporary exceptional measures

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Teoman Kaplan

Actuary DAV, Head of Global Insurance Specialists, Allianz Global Investors

Dr. Florian Ueltzhöfer

Actuary DAV/IVS, Senior Insurance Strategist, Allianz Global Investors

SUMMARY

The low yields in the 2010s have been a catalyst for the rise of private markets.

Private equity, infrastructure equity and private placements, as well as newer forms of 'alternatives' like infrastructure debt and private credit can be considered as part of the traditional investment universe by now.

Private markets are key to achieving true impact in ESG-related challenges.

The newest (sub-)asset classes in the private markets universe, like blended finance and direct lending, can support a wide range of investment objectives.

Private markets have the capacity of innovating continuously.

PHOTOS: ARCHIVE ALLIANZ GLOBAL INVESTORS