CapVisor Research Report - Spring 2025

The Strategic Case for Private Debt in Small to Mid-Size Insurance Company Investment Portfolios

Summary

- **Today's strategies offer shorter lockups and lower minimum allocations**
- **Some offer 85% "A" rated,15% high yield/equity for better RBC treatment**
- **Low correlations improve overall risk-adjusted returns**
- **High returns 8-12% are a welcome fixed income asset class**

The investment landscape is in constant flux, prompting institutional investors to explore a wider array of asset classes to meet their objectives. A persistent challenge, particularly in periods of low interest rates, has been the search for adequate yield to meet intermediate or longer-term liabilities. A declining interest rate environment has spurred increasing interest in alternative asset classes, and private debt has emerged as a compelling option, if not the leading contender for insurance companies. Small to mid-size insurance companies, while sharing the overarching goals of their larger counterparts, often face unique challenges and opportunities in managing their investment portfolios. These may include resource constraints, specific regulatory considerations, and the need to balance yield enhancement with capital preservation. Even a small strategic allocation to private debt can offer significant benefits for small to mid-size insurance companies. These advantages include the potential for enhanced yields compared to traditional fixed income, valuable diversification benefits that can contribute to a more resilient portfolio, and with proper selection provide the liquidity required to maintain a proper asset liability management program. However, the illiquid nature of historical private debt strategies had concerned both insurance company board members and regulatory authorities.

We have undertaken an extensive analysis of many current strategy offerings, many of which have been adapted to insurance company acceptance. But first, some basics:

Defining Private Debt:

Private debt, also known as private credit, represents the provision of debt financing to companies by non-bank entities, such as investment funds, rather than through traditional banks, bank-led syndicates, or public markets. This form of lending typically involves direct, bilateral negotiation of terms and conditions between the borrower and the lender, tailored to meet the specific needs and objectives of both parties. While private debt can be extended to companies of various sizes, it often targets middle-market firms, which may have limited access to public capital markets or traditional bank financing. A key characteristic of private debt is its less illiquid nature than publicly issued debt. To compensate investors for this illiquidity, as well as the complexity often associated with structuring these deals, private debt offers higher spreads and yields compared to publicly traded debt instruments with similar credit risk profiles.

Various Forms of Private Debt:

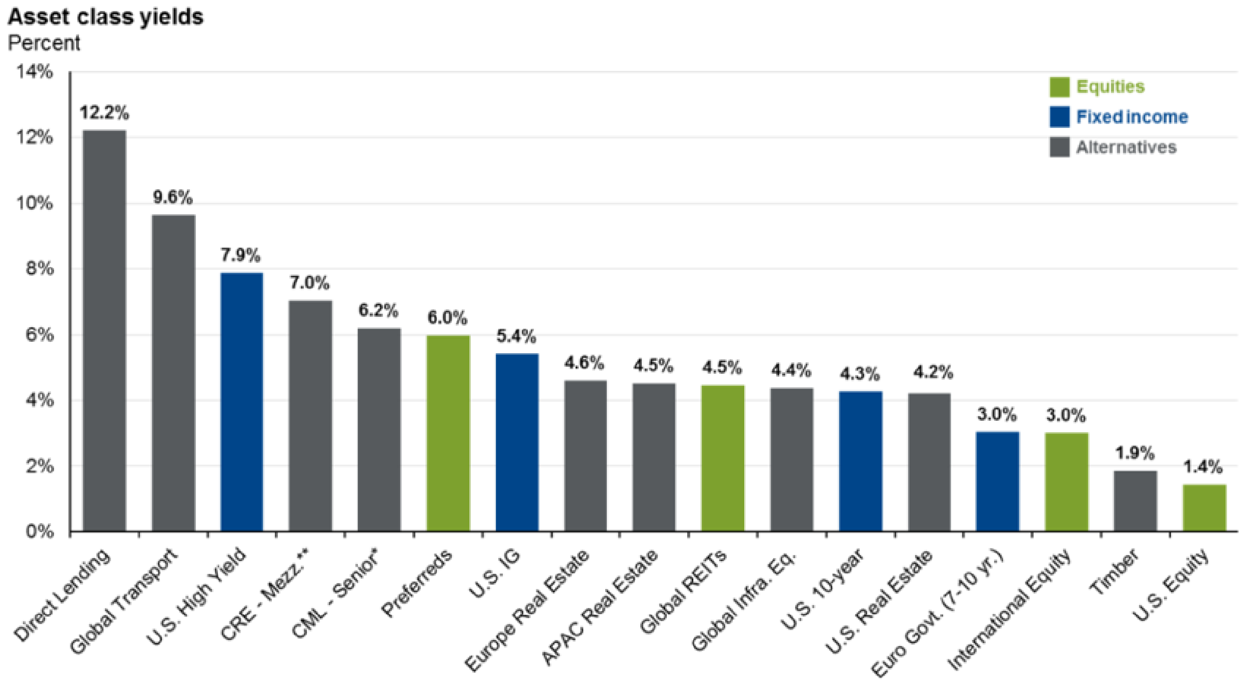
The private debt landscape encompasses a diverse range of strategies and instruments, each with its own risk and return characteristics. Understanding these various forms is crucial for insurance companies considering allocation to this asset class.

- **Direct Lending:** This strategy involves non-bank lenders directly issuing loans to companies, often small and medium-sized enterprises (SMEs). The type of debt issued can range from senior secured loans, which sit at the top of the capital structure and have the first claim on assets in case of default, to subordinated debt, which is repaid after senior debt. Direct lending funds often tailor the loan terms to the specific needs of the borrower, providing capital for growth, acquisitions, or refinancing. This segment of private debt is significant due to the large number of companies, particularly SMEs, that rely on non-bank lenders for financing.
- **Other forms of Private Debt: these strategies include**
    - **Mezzanine Debt**
    - **Distressed Debt**
    - **Venture Debt**
    - **Special Situations** and
    - **Other Forms: unitranche debt**, **infrastructure debt**, **real estate debt**, and **asset-**

Focus on Direct Lending

Significant Yield Advantages over Direct Lending:

A primary driver for insurance companies considering Direct Lending is the potential for higher yields compared to traditional public debt instruments, e.g. US Investment Grade (IG) Bonds- see below. Recent market dynamics, particularly since the start of 2022, have further amplified this trend. For instance, new-issue senior secured private loans have been registering yields of approximately above 10% on an unlevered basis, presenting a compelling opportunity given the relatively low risk associated with this segment of the market. This enhanced yield potential is particularly attractive for insurance companies facing pressure to meet their liability obligations in an environment where traditional fixed-income yields may be insufficient.



JP Morgan: Guide to Alternatives Q1 2025

Debt and Equity

Beyond the higher interest income, certain forms of Direct Lending offer the potential for additional returns through equity participation. While it is attractive to have a large percentage of the strategy NAIC rated as investment grade most Direct Lending deals, also have a small equity share, often referred to as an "equity kicker,". This feature further enhances the potential returns and allows for any significant upside as the borrowing company grows.

Low Correlation with Public Markets: Enhancing Portfolio Diversification and Reducing Overall Risk

Incorporating Direct Lending into an insurance company's investment portfolio can offer significant diversification benefits due to its historically low correlation with traditional public market assets such as equities and bonds. Correlation measures the degree to which the returns of two different asset classes move in tandem. A low correlation, particularly with assets that constitute a significant portion of the existing portfolio, can help to reduce overall portfolio volatility. The contractual nature of repayments in Direct Lending means that its performance is often driven by factors specific to the borrower and the loan agreement, rather than the broader market sentiment or technical fluctuations that can impact publicly traded securities. This relative independence from public market dynamics makes Direct Lending a valuable tool for diversifying sources of risk and return within an investment portfolio.

CORRELATIONS	U.S. Equities	Non-U.S. Equities	Emerging Markets	Global High Yield	Aggregate Fixed Income	Private Equity	Private Infrastructure	Private Debt	Private U.S. Real Estate
U.S. Equities	1.00								
Non-U.S. Equities	0.89	1.00							
Emerging Market Equities	0.80	0.85	1.00						
Global High Yield	0.41	0.44	0.39	1.00					
Aggregate Fixed Income	0.26	0.27	0.25	0.65	1.00				
Private Equity	0.41	0.42	0.40	0.04	0.00	1.00			
Private Infrastructure	0.46	0.52	0.50	0.14	0.11	0.66	1.00		
Private Credit	0.33	0.36	0.31	0.78	0.20	0.06	0.14	1.00	
Private US Real Estate	0.37	0.33	0.28	0.07	0.08	0.53	0.60	0.03	1.00

Source: Russell Investments, 2023

Access to a Broader Range of Issuers and Sectors:

Direct Lending provides insurance companies with access to a wider spectrum of investment opportunities beyond the realm of publicly listed companies. A significant portion of the Direct Lending market involves lending to small and medium-sized enterprises (SMEs) that may not have the size or desire to access public capital markets. This opens an investment universe that is largely uncorrelated with the public equity and bond markets, offering diversification across different types and sizes of businesses. By investing in this broader pool of debt issuers and across various sectors not readily available in public markets, insurance companies can reduce concentration risk in their traditional bond portfolios and potentially benefit from less competitive deal environments.

Potential for Downside Protection:

Direct Lending investments often come with structural features that can offer enhanced downside protection compared to some public debt instruments. These protections typically include robust loan documentation with covenants that provide lenders with early warning signs of borrower distress and allow for proactive intervention. Many Direct Lending loans, particularly in the direct lending space, are secured by collateral, giving lenders a claim on specific assets of the borrower in the event of default. Senior debt, which often forms a significant part of Direct Lending portfolios, holds a priority position in the capital structure, meaning it is repaid before more junior debt and equity holders in case of liquidation. The ability for private lenders to work directly with borrowers allows for customized structuring of deals, potentially incorporating features that further mitigate risks.

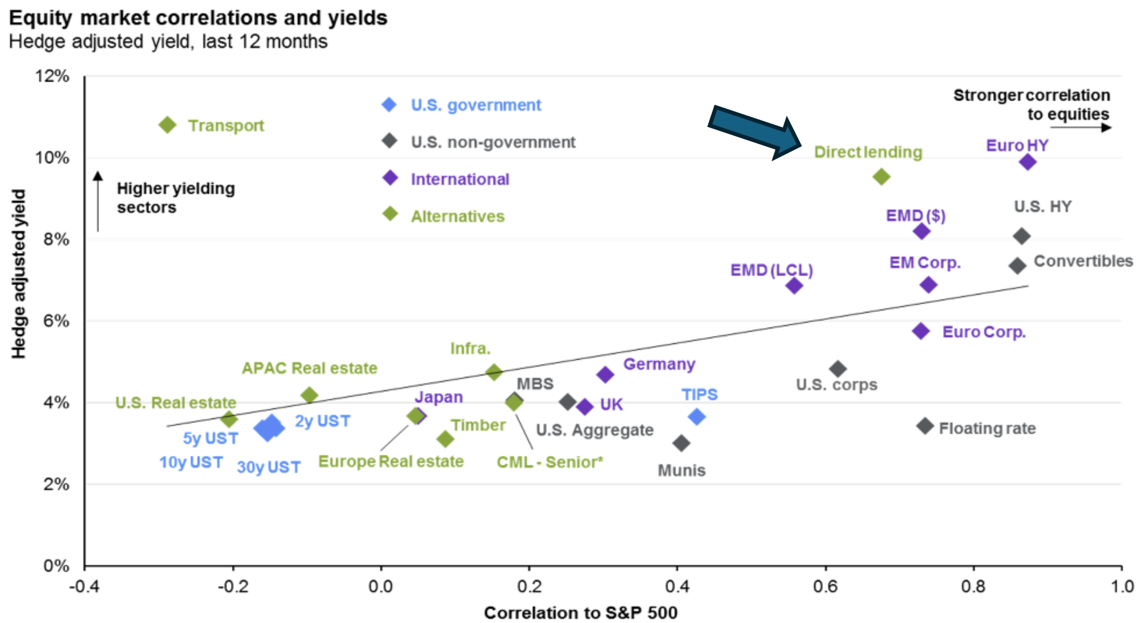
Assessing default rates in the Direct Lending market can be more complex than in public markets due to the lack of standardized reporting and public ratings. However, available data suggests that default rates in private credit have historically been comparable to, and in some cases even lower than those observed in public debt markets. Some reports indicate a convergence of default rates between private and public credit in recent periods. The inclusion of financial covenants in many Direct Lending agreements, coupled with tighter documentation and closer relationships between lenders and borrowers, can facilitate earlier intervention when a borrower faces financial difficulties, potentially leading to better outcomes and lower ultimate default rates compared to broadly syndicated loans with fewer covenants. While credit risk is inherent in any form of lending, the evidence suggests that the default experience in Direct Lending is not necessarily worse than in public markets and may even be mitigated by the structural protections and closer monitoring often associated with private loans.

Historical Outperformance and Risk Metrics:

Historical performance data indicates that Direct Lending has generally delivered attractive risk-adjusted returns when compared to traditional asset classes. Over the past decade and longer, private credit has shown annualized returns that have often outperformed both high-yield and investment-grade public bonds, frequently with comparable or even lower levels of volatility.

Equity market correlations and yields

Actions

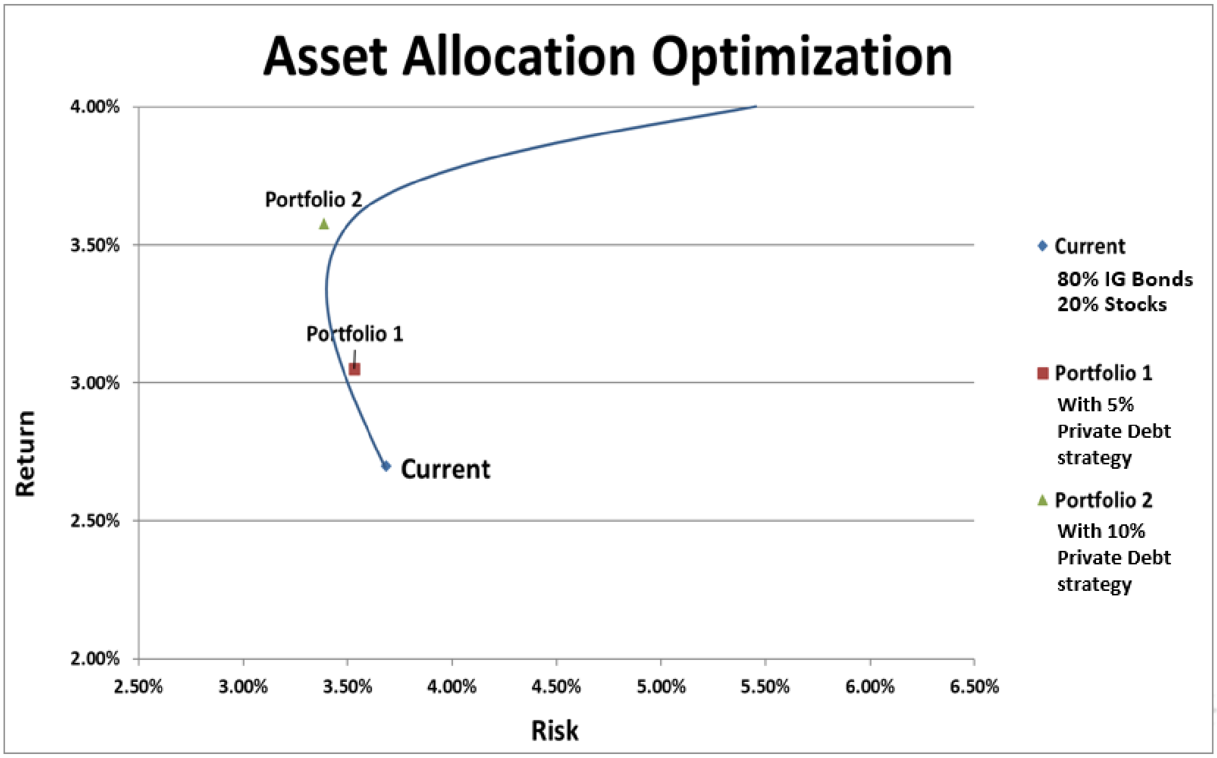


Since the global financial crisis, direct lending, the most common form of private credit, has provided higher returns and lower volatility compared to both leveraged loans and high-yield bonds in the public markets. This track record suggests that allocating to Direct Lending has the potential to enhance overall portfolio returns without necessarily taking on proportionally higher levels of risk, leading to a more efficient risk-return profile for insurance company portfolios.

Strategic Asset Allocation Optimization

A notable characteristic of Direct Lending is its generally lower volatility compared to publicly traded markets. The buy-and-hold investment strategy common in Direct Lending, where loans are typically held until maturity, contributes to less price fluctuation compared to publicly traded bonds that are subject to daily market sentiment and trading activity. This lower mark-to-market volatility can be particularly appealing to insurance companies, which often prefer stable asset valuations to match their long-term liabilities and manage regulatory capital requirements. While the underlying credit risk remains, the perceived stability in value due to less frequent marking can provide a smoother investment experience and potentially reduce the impact of short-term market fluctuations on the balance sheet.

This price stability, coupled with the significant yield advantages over public debt, produces a compelling argument for the addition of Direct Lending to typical insurance portfolios.



Source: Forward looking data based upon JP Morgan LTCMA 2022
CapVisor Strategic Asset Allocation Analysis

The low correlation to public securities, both Investment grade bond and S&P 500 stocks produces the much sought after “free lunch”: higher returns at lower risk levels.

Illiquidity: some should be tolerable

A fundamental aspect of Direct Lending is its inherent illiquidity. Unlike publicly traded bonds or equities, Direct Lending instruments typically do not have an active secondary market where they can be easily bought and sold. Traditionally, investors had to be prepared to commit their capital for a period range from several years to over a decade. Today, many strategies, and particularly those designed for insurers, have lockups ranging from 1-7 years. This amount of liquidity desired is a key trade-off for the higher yield premium that Direct Lending typically offers compared to more liquid public market alternatives. Therefore, insurance companies considering allocating to Direct Lending must carefully assess their liquidity needs and ensure that they have a sufficient portion of their portfolio allocated to more liquid assets to meet any unforeseen obligations or operational requirements. Most insurers can easily find the portion of their liability structure, within their reserve portfolio, that can accommodate the illiquidity features. If not, the return profile of Direct Lending warrants consideration for a portion of the surplus portfolio.

While Direct Lending is inherently less liquid than publicly traded securities, insurance companies can employ several strategies to mitigate the potential risks associated with this characteristic. Diversifying investments across different vintages/tranches (the year in which a fund makes its initial investments) and various types of Direct Lending funds can help to stagger the maturity dates of the underlying loans, providing some degree of flexibility over time. Insurance companies need to ensure that their overall portfolio maintains an adequate level of liquid assets to cover short-term needs and unexpected outflows, while allocating a portion to less liquid, higher-yielding assets like Direct Lending that align with their less time sensitive or "front line" liabilities. Partnering with experienced Direct Lending managers who have a deep understanding of the insurance market and can provide guidance on portfolio diversification and liquidity management is also essential.

Overview of Relevant Regulations:

Insurance companies operate within a comprehensive regulatory framework that governs their investment activities. These regulations aim to ensure the solvency of insurers and protect policyholders. When considering investments in alternative asset classes like Direct Lending, small to mid-size insurance companies must pay close attention to these regulatory, accounting and reporting requirements.

To facilitate insurance company investment in Direct Lending while adhering to regulatory requirements, capital-efficient investment vehicles have emerged. These structures are designed to optimize risk-adjusted returns while considering the regulatory and risk-based capital (RBC) treatments specific to insurers, allowing them to access the benefits of Direct Lending within their regulatory limits. In the US, some Direct Lending managers have obtained NAIC ratings for their strategies facilitating lower RBC charges. These strategies have features that can simplify accounting and reporting treatments, particularly the avoidance of recording portions of a private debut investment on schedule BA. Understanding the applicable regulations in their specific domiciles is crucial for small to mid-size insurers when evaluating Direct Lending investments.

Of course, the specific regulatory landscape will vary depending on the jurisdiction. For example, non-admitted carriers like captive insurers need to understand the position of their domicile regulator. In Europe, the Solvency II framework has recognized private credit as a potentially lower-volatility asset class with favorable treatment in terms of return on capital, which has encouraged European insurers to allocate to this asset class.

Importance of Due Diligence and Risk Management:

Given the less transparent nature of Direct Lending compared to publicly traded assets, robust due diligence and risk management practices are paramount for insurance companies. Regulatory bodies expect insurers to conduct thorough assessments of the risks associated with their investments, and this is particularly critical for illiquid and less standardized assets like Direct Lending. This includes in-depth analysis of the fund manager's expertise, track record, and investment process, as well as a careful evaluation of the underlying borrowers and the terms of the loan agreements. Establishing robust risk management frameworks is essential to identify, measure, monitor, and control the risks associated with Direct Lending, including credit risk, liquidity risk, and operational risk. Partnering with consultants who can objectively evaluate asset managers who possess strong internal credit rating methodologies can be beneficial for insurers in assessing the risk profiles of Direct Lending investments and ensuring compliance with internal governance and regulatory requirements.

Matching Liability Profiles with Direct Lending Characteristics

A significant advantage of Direct Lending for insurance companies lies in its potential to effectively match their long-term liability profiles. Many insurance companies, especially those in the life insurance sector, have liabilities that extend over long periods. Certain segments of the Direct Lending market, such as infrastructure and real estate debt, often offer investment opportunities with long durations that can closely align with these extended liability timeframes. Furthermore, Direct Lending investments typically generate a predictable stream of income through regular contractual interest payments. This stable and long-term cash flow can be instrumental in meeting the projected future obligations of insurance companies, contributing to sound asset-liability management. Even within asset-based finance, a growing area within Direct Lending, the cash flow generating and amortizing nature of the assets can be well-suited for matching liabilities.

Customization to Meet Specific Needs:

The Direct Lending market offers a high degree of customization, allowing insurance companies to structure investments that precisely meet their specific needs and objectives, particularly in relation to their liability profiles and risk tolerance. Unlike the standardized nature of many public debt instruments, the terms and conditions of Direct Lending deals can be negotiated directly between the lender and the borrower. This flexibility enables insurers to tailor the duration, interest rate structure, and other features of the investment to align with the specific characteristics of their liabilities. Moreover, the Direct Lending market offers investment opportunities across the credit ratings spectrum, providing options for insurers that need to maintain a predominantly investment-grade portfolio while still seeking enhanced yields. By lending at different leverage points and against various types of real assets, insurers can further fine-tune the risk-return profile of their Direct Lending allocations to match their investment objectives and liability requirements.

Initial Vetting Criterion

Higher returns with strong risk controls	✓
Investment-grade rated structure	✓
Low RBC Impact/simple accounting considerations	✓
Low minimum capital investments	✓
Limited lock-up/ improved liquidity	✓
Experienced, trusted, fully-vetted management firm	✓
Alternative optimizes/improves asset allocation	✓

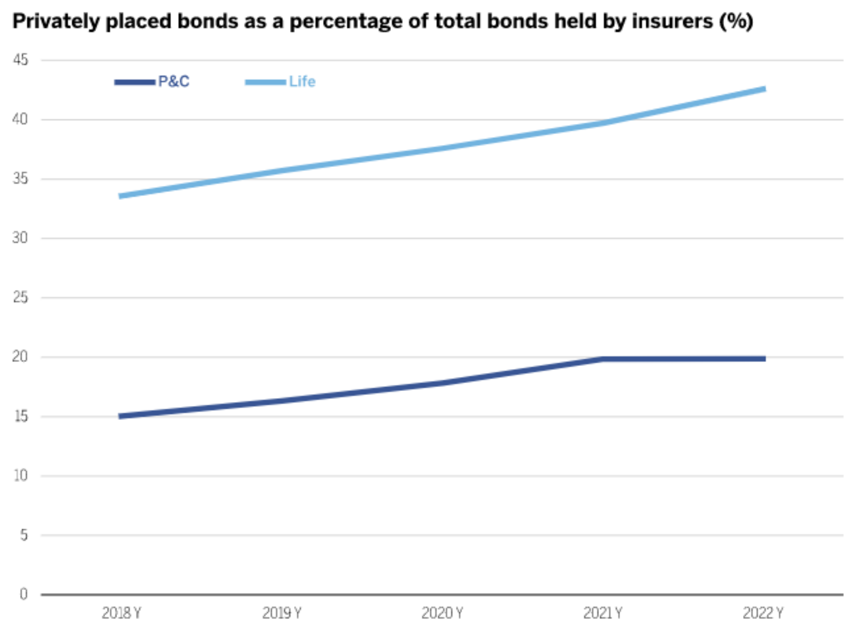
CapVisor Summary

Expert opinions and industry reports generally highlight the suitability and numerous advantages of including Direct Lending in insurance company investment portfolios. These advantages include:

- the potential for significant diversification benefits,
- higher risk-adjusted returns compared to public market equivalents,
- flexibility to tailor risk and return profiles to meet specific investment objectives,
- the stable income streams,
- improved downside protection due to longer holding periods and non-marketability,
- credit enhancement through Direct Lending covenants,
- the dampening of overall investment program volatility, particularly from non-fundamental fluctuations in public markets,
- the ability to access opportunities that are not readily available in public markets, including various types and sizes of companies.

While the growth in Direct Lending allocations has been largely driven by larger institutional investors, the benefits are increasingly being recognized and becoming more accessible for smaller and mid-sized insurance companies as well. Although these firms may face challenges such as limited resources for extensive due diligence or smaller allocation sizes, the potential for diversification and yield enhancement offered by Direct Lending remains highly relevant. The emergence of fund structures and capital-efficient investment vehicles specifically designed for insurance companies can provide a more accessible route to Direct Lending investments for smaller and mid-sized insurers. By pooling capital with other investors through these structures, smaller firms can gain exposure to a diversified portfolio of Direct Lending managed by experienced professionals, potentially overcoming some of the hurdles associated with direct investments.

This dynamic and expanding landscape suggests that Direct Lending will likely remain a relevant and increasingly important asset class for insurance companies of all sizes, offering a growing array of investment options to meet their diverse needs and objectives.



Source: S&P Capital IQ, based on preliminary 2022 US statutory data. Chart data as of 31 December 2022.

In conclusion, our analysis strongly supports the strategic inclusion of Direct Lending within the investment portfolios of small to mid-size insurance companies. However, it is crucial to acknowledge and address the challenges associated with Direct Lending, particularly its inherent illiquidity and the complexities of the regulatory landscape. Small to mid-size insurers must approach this asset class with careful planning and due diligence.

Next Steps

Based on the analysis, the following strategic recommendations are provided for small to mid-size insurance companies considering allocations to Direct Lending:

- **Start with a Strategic Allocation:** Begin with a modest and well-considered allocation to Direct Lending, based on a thorough understanding of the company's risk tolerance, liquidity needs, and specific regulatory constraints.
- **Focus on Diversification:** Prioritize diversification across different types of Direct Lending funds and strategies to mitigate risk. Initially, consider focusing on

segments like direct lending, infrastructure debt, and potentially investment-grade Direct Lending, which may offer a more familiar risk profile.

- **Partner with Experienced Consultants:** Select reputable and experienced Direct Lending fund consultants who can quantitatively and qualitatively evaluate managers who have a strong track record, a deep understanding of the market, and ideally, experience working with insurance companies and navigating the relevant regulatory requirements. These consultants should conduct thorough due diligence on both the fund managers and the underlying investments. Understand the risks involved, the valuation methodologies employed, and the alignment of interests between the manager and the investors. They should also be cognizant of evolving regulatory requirements related to Direct Lending investments for insurance companies in their specific jurisdiction and work with insurance company accounting and compliance staff to ensure that any allocation to Direct Lending remains compliant with all applicable rules and guidelines.

To explore investment options through capital-efficient vehicles that are specifically structured to optimize risk-adjusted returns for insurance companies while considering regulatory and capital requirements, please contact us for more information at travis.terzer@capvisorassociates.com or call 973-665-6370 ext. 4.