TOM DILLEY

mosaic moment

EPISODE_04

BRAVING THE BEAR MARKET

RUSSELL BÜSST

INTRO

0:01 **Got a moment? Fast changing risks affect people, businesses, and economies in today's turbulent world. Perils like cybersecurity, political violence, or threats to financial institutions. Listen in as Mosaic Insurance specialists quiz fellow experts on trending industry topics. Welcome to this Mosaic Moment.**

0:22 Hi, I'm Tom Dilley, Head of Financial Institutions underwriting for Mosaic Insurance. It's a privilege to speak today with Russell Büsst of leading global investment management firm Conning. Russell is Chief Executive Officer and Chief Investment Officer for Conning's European operations. He's responsible for corporate governance, and all portfolio management oversight and investment strategy decision-making. Russell, thanks a lot for joining me today.

0:46 Good to speak to you, Tom.

0:47 Let's talk about what's on everyone's minds these days, whether you're in an investment sector or not – rising inflation and interest rates. Can you give us a little bit of an oversight into how you're seeing the economic outlook right now?

0:59 Sure. When we're assessing our investment decisions, we are looking at three main risks and then what drives those risks. The three risks are: interest-rate risk, credit risk, and equity risk. When we look at the backdrop to the economic backdrop, the political backdrop, we are, of course, always driven by what central bank policy is, and right now inflation is driving central bank policy.

We have different types of inflation. We have demand-side inflation, so that's when economies are growing, strong demand pushes prices up. We have supply-side inflation, which all of us are very aware of at the minute, driven by energy prices. And of course, we have social inflation, which I will pass on to you as that's something that is driving claims, etc. The financial markets really work on the demand and supply side, and what the central banks are doing about that, of course, that's the insurers trying to price the latter. We have a bunch of drivers right now, which are very similar to some of the periods we've had over the past 60, 70, 80 years and even longer, when we've got economies coming out of forced lockdown, strong growth driving that demand side. And those postwar years 1919, 1920, 1946, 1947, drove much higher inflation levels than we'd ever seen before, even higher than today. Then we had the energy crisis of the 1970s, Suez Crisis, etc, pushing up that supply-side inflation and particularly driven by energy prices.

We've had one other inflationary effect of late, which is really the reversal of the globalization which we saw back in the '80s, '90s and 2000s. China pushing out very large volumes of very cheap goods and the ability to have strong economic growth, but very low inflationary periods when central banks really didn't have to do that much. But, that's all changed, we now have bond yields up at 16% in 1991, have now troughed at 0.3%. Credit spreads peaking at around 6% above risk-free rates in 2008, now troughing at 1% in June 2021. So, we've had falling yields, tightening spreads, and that really is the gold-lock environment for bond investors as spreads fall, as rates fall, generating unrealized gains, allowing us to generate really positive returns pretty much in any market, irrespective of the credit outlook. Having said that, we are now in this uprising side with rates increasing, spreads increasing. And not only that, we start with close to zero protection, i.e. very low income levels, whereas income helps offset naught losses in normal environments, we started off with income levels of close to zero, so that is why we're seeing some very negative interest rates and negative investment returns in this period.

3:54 Thanks, Russell, some really valuable insights there. These are certainly largely unseen times for many of us in the FI underwriting market space, making the risk-selection process really important right now as we navigate through volatile and uncertain markets. Given this, perhaps you could talk a little bit about some of the factors that Conning take into account when assessing and scoring respective markets.

4:16 Sure. We've already mentioned that what's perplexing and challenging the central banks right now, and that mix of fiscal policy and monetary policy, what actually drives markets is almost inevitably monetary policy and credit risk. So, when we look at the types of risk, we're managing, it's interest-rate risk, it's credit risk, and it's equity risk. I'm going to focus on the first two a little bit here, and for each one of those risks, we look at four factors. We look at the macro fundamentals, we look at valuations, we look at technicals, and we look at sentiment. And at any one time, one or two or more of those will have a much bigger impact factor on our valuations and our risk assessment. If we look at the macro fundamentals, that is economic background for economies, it's fundamental balance-sheet strength and business environment for corporates. When we look at valuations, that is a relative value play between risk free or risk assets or other asset classes, for example, mortgage backs versus corporates, corporates versus autos, etc.

The technical drivers have been significant over the past several years, they would typically have been driven by market supply, bond issuance, etc. But the major factor in the technical argument of the past 10 years or so, has actually been the actions of the central banks buying bonds in the market to support their quantitative easing programmes. And then lastly, but not least, is sentiment. Sentiment for us is either all or nothing. Sentiment can drive markets in one direction, irrespective of the macro outlook, the valuation levels and the technical background. Or, sentiment means absolutely nothing. And right now, we have quite a lot of sentiment driving markets. And that sentiment is either fear, or it's greed. And I have written on my whiteboard in the office, which changes pretty frequently right now, the words 'fear' and 'greed.' If greed is writ large, then valuations essentially mean nothing, and markets will buy any asset class almost at any price for a return. Whereas, if fear is writ large, then the

opposite happens: bond markets, equity investors will sell asset classes, investing only in risk-free assets and buying treasuries. Right now, that fear-greed component is largely driven by fear on the interest-rate side, but driven by a little bit of greed to offset some of the fear in the corporate bond market. And we haven't really seen a credit-driven bear market since 2001, or indeed 2008, 2009, post-global financial crisis. So, current focus is on interest rates and the potential impact on corporate credit.

7:07 Thanks, Russell, particularly love the sentiment aspect there. And as well, of course, the whiteboard as well. And some real synergies as well with kind of current FI underwriting conditions and how we view both portfolio management and individual risk underwriting. We've come through a period in our market of pretty hard-market conditions due to a decade of underperformance, as well as the added uncertainty from COVID. Interestingly, we've seen the market stabilized in 2022. In terms of capacity and rate, despite the deteriorating economic climate and the political uncertainty we're seeing, could you talk a little bit of what you feel is driving the current economic phenomenon?

7:49 Yeah, so this is almost entirely around uncertainty. When we look at the background where we are today, when we look at the background that occurred in global financial crisis, we saw a major shift in the way in which central banks intervene with the onset of quantitative easing—quantitative easing, no one knew what that meant, before the global financial crisis—and the concept of a central bank, doing the, in quotes, 'whatever it takes,' meant that there were buyers of last resort for almost any asset class. And that underlines everything we think about now in terms of economic outcome, because we always think the central banks will step in, governments will step in, they'll cap energy prices, they'll buy bonds, they'll cut interest rates. So, that's the background of the central banks will always be there.

When we look at the existential threats that we have in the moment—and you, amongst most others in the insurance industry, will be acutely aware of this—what's happening in Ukraine? Is that a three-month, is that a six-month is it a one-year, is it a never-ending guerrilla war, does it continue to choke off supply of energy suppliers, etc? The threat in Taiwan, I suspect that very few people realize that in the last, just in the last few weeks, we've seen US battleships sailing up the Straits of Taiwan, and the Taiwanese actually shooting down so-called civilian drones over some of the disputed island territories. Who mentioned North Korea recently? Very few. And of course, we mustn't forget that COVID is still with us, whether it's new variants in Europe, or indeed whether or not the Chinese continue to keep a shutdown under any zero-tolerance strategy, which potentially shuts down again, the supply side. All of these things, and more are on our minds right now. And when there's uncertainty in macro effects, and existential threats, all it takes is a very small change in economic outlook to drive asset prices either up or down, and that's our biggest challenge. What central banks are going to do, what's going to be challenging us next in terms of risk. And of course, I'm sure there are plenty of other black swan events out there, which we haven't thought of. So, it really is about uncertainty.

10:01 Yeah, absolutely. And thanks a lot. It's amazing how that resonates with the way in which we price in terms of our market, the premiums and huge amount of political uncertainty, huge amount of economic uncertainty, you know, potentially pushing

towards a global recession, really, from our perspective, making sure that we're pushing for sufficient rate adequacy across our class of business, making sure that we're here in 10 years' time to pay the claims that our clients might face in the next couple of years is more important than ever. In terms of adapting and what's ahead, how do you kind of see this in the near future?

10:38 Well, you've just mentioned a couple of things there, actually, which are very important for us. Because you're an insurance company, you have liabilities to match, and you have balance sheets to protect. And so, when we're looking forward, we have to try to weigh up what we're getting paid for, in terms of risk reward. We know that over the next year or two, we'll probably see returns better than we've seen for the past few years, this year will be pretty awful. For any fixed-income investor, many of our property casualty companies are probably returning at best three minus three to 4%, at worst minus 10–11%. That's assuming that interest rates continue to follow the forward path we're expecting. So, we're very conscious that returns will be better, but because of the types of risks we've just talked about, whilst we do want to target strong credits, look at illiquid assets as they get priced correctly, we do understand we have to manage that liquidity for the types of risks that you're underwriting. So, what are we focusing on, we're balancing that liquidity risk, we're trying to invest in illiquid assets, which have higher returns, we're trying to minimize interest-rate risk, because we still think that could be one of the largest drivers of absolute returns over the next 12 to 24 months. So, we're buying floating-rate products, which are largely protected from any interest-rate hikes whilst taking some credit spread. So, it's this balance between maximizing the investment returns, which will probably be looking at illiquid assets, but then we have to continue to hold liquid assets to make sure that the assets you have are there to pay your liabilities as and when they fall due.

12:18 Thanks, Russell for your insights and time today.

12:21 It's my pleasure, Tom, good to speak to you.

OUTRO

12:23 Thanks for listening. Feel free to download, follow and share on social and recommend us to colleagues and clients. See you here next time for another Mosaic Moment.

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