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Short-dated enhanced income (SDEI) Strategies – our thoughts for insurers

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Short-dated enhanced income (SDEI) Strategies – our thoughts for insurers

Short-dated credit strategies can be designed to deliver an enhanced yield over money markets and defensive credit alternatives.

Key features for insurers

- Targets a higher yield than comparable alternatives with relatively low risk and solvency capital requirement (SCR) contribution
- Aims for price stability, such as implementing a minimum A- portfolio rating and duration under 2 years
- T+1 liquidity
- Vanilla instruments only (derivatives for interest rate and foreign exchange hedges only)
- Very low modelled drawdowns and volatility

Investment environment

Both SOFR and SONIA benchmark interest rates have risen more than 5% since 2022. The return of yield to the market and the continued inversion of the yield curve have brought insurers focus to shorter tenor investments. As insurers prepare for potential future rate cuts and make sure they are working investments as hard as they can within risk and capital appetites, SDEI strategies offer an option to improve the yield achieved on T+1 liquidity laddered assets.

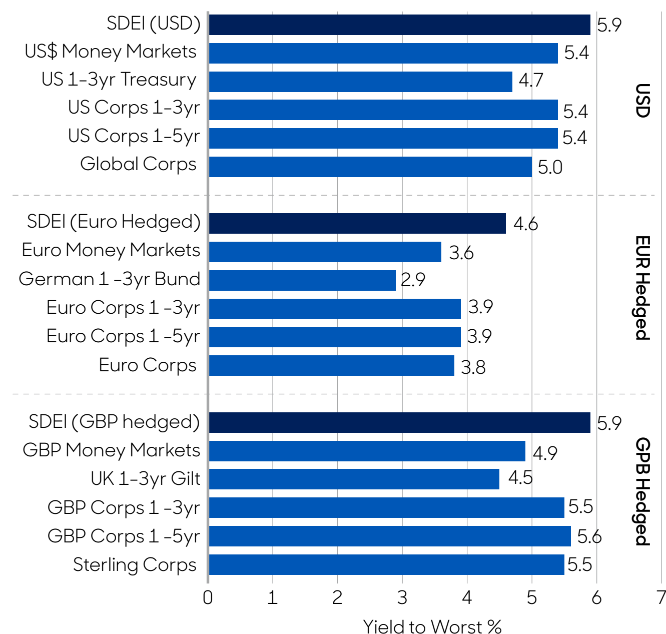
Delivering an enhanced yield

As demonstrated in Figure 1, SDEI strategies have the potential to generate significant yield pick-ups (including when currency hedged) compared to money markets and other short-dated credit options – whilst keeping price stability and liquidity front of mind. We believe that SDEI strategies should not compromise on these principles, avoiding the chase for yield in higher-risk market segments.

Taking a global approach unlocks a broader opportunity to seek investment in higher quality credits that can deliver a yield enhancement whilst balancing liquidity and price stability. For example, at the time of writing, UPL (the world's fifth largest agriculture/chemicals company) offers a 2% spread pick-up compared with Bayer for the same BBB-rated credit risk.

Yield curves are currently significantly inverted, with cash yields anchored to central bank rates. However, SDEI strategies can still target 0.5% to 1% a year (depending on share class currency) above money markets and in the long run, we expect the average yield enhancement over money markets to be +1.75% a year.

Figure 1: SDEI[1] yield to worst vs alternatives (29 February 2024)



[1] A typical SDEI strategy is used a proxy to provide SDEI indicative yield to worst.

Price stability

The investment guidelines of an SDEI strategy are essential. They should set the foundation for delivering liquidity and price stability, balanced with the flexibility to deliver an enhanced yield. We think the below factors are some of the most important to deliver this outcome:

- Portfolio duration of two years or less, generating significant pull-to-par effects and reducing volatility
- Core opportunity set formed of single A-rated credit or better, which supports a minimum average A-portfolio credit rating
- High yield allocations constrained, with quality remaining a focus:
  - Maximum of 20% of overall portfolio
  - Core opportunity set BB rated
  - Maximum of 5% for single B rated names
  - No CCC rated names allowed

To assess how SDEI strategies net asset value (NAV) risk might materialise in practice, we have constructed an index representing an average asset allocation and risk profile based on the guidelines discussed in this paper. We have compared this to global corporate indices (1–5 year and all maturity indices) and to a global government bond index. The results are shown in Figure 2.

Key takeaways from this analysis:

- SDEI strategies have the potential to offer an enhanced risk-adjusted outcome with a significant reduction in volatility
- 2008 was largest drawdown (3.8%) but much better versus alternative credit indices
- 2022 (one of worst periods on record for fixed income) saw 3.5% drawdown – a strong outcome vs alternative credit and government bond indices.

In practice, an active manager would aim to enhance the return and further reduce drawdowns. For example abrdn's SDEI strategy has a yield of c.6% compared with the proxy index of 5.3% (USD).

"abrdn's Insurance Solutions team would be delighted to help you assess the impact of an allocation to SDEI strategies, from a capital lens or otherwise."

Figure 2: Proxy index – maximising an SDEI strategy yields vs. volatility & drawdown (as at 31 December 2023)

	Proxy index	1-5 year global corps	Global corps	Global govt.
Yield (%)	5.3 (SDEI* c.6%)	4.6	4.8	3.0
Duration	1.3	2.6	6.0	3.7
Total return	2.9%	3.4%	4.0%	3.0%
Volatility	1.7%	2.6%	5.3%	3.7%
Sharpe ratio	1.8	1.3	0.8	0.8
Drawdown analysis				
Max drawdown	**-3.8%**	**-8.4%**	**-18.0%**	**-14.6%**
2022 (Russia/ Ukraine)	-3.5%	-8.4%	-18.0%	-14.4%
2020 (Covid 19)	-2.5%	-3.8%	-6.9%	-1.0%
2015 (energy selloff)	-0.2%	-0.7%	-3.1%	-3.3%
2013 (Euro sov crisis)	-0.3%	-1.2%	-3.9%	-2.7%
2008 (financial crisis)	-3.8%	-5.4%	-10.8%	-2.3%

*abrdn SDEI strategy. Performance USD hedged, gross of fees. Proxy index blend: 55% ICE BofA 1-3 Year Global Corporate Index, 10% ICE BofA US Treasury Bill Index, 10% ICE BofA 1-3 Year BB-B US Cash Pay High Yield Constrained Index, 20% ICE BofA 0-1 Year US Corporate Index, 5% abrdn US money markets fund.

Source; abrdn, 31 December 2023.

Liquidity

T+1 liquidity can be targeted by SDEI strategies when guidelines are carefully considered. The SDEI strategy discussed in this paper maintains 10% in treasury bills, which supports maintaining a minimum of 15% of assets inside a 1-year maturity (current allocation over 35%). This also serves to further drive the price stability objective of these strategies. Achieving T+1 liquidity is an improved outcome versus traditional short-dated credit funds, which are typically T+3 liquidity.

Solvency II capital treatment

SDEI strategies can offer an attractive investment for insurers in terms of Solvency II capital efficiency.

On a standalone basis (i.e., ignoring all other assets and liabilities), the abrdn strategy's standard formula SCR at 29/09/2023 was 9% of the investment value, significantly lower than the 12% or 20% from abrdn's short-dated and all-maturity corporate bond funds.

Notably, the increase in capital requirements from investing in SDEI would be materially lower than 9%, since this figure takes no credit for diversification with (i) other investments and (ii) non-investment risks. Furthermore, cash/money market investments attract a non-zero capital charge. Therefore, an insurer moving out of cash would expect to see their capital requirement increase by an amount much lower than 9% of the amount invested.

Case study

One of our UK insurance clients was looking for options to work excess EUR money market allocations harder. The insurer and abrdn's Insurance Solutions team performed an exercise whose objective was to generate more yield without materially increasing the insurer's SCR. The client's conclusion was to invest into our SDEI strategy. A summary of the output of the exercise is shown in Appendix 1.

Summary

At first glance, SDEI strategies might not look dissimilar to other short-dated options. However, through careful portfolio construction, a truly global approach and an understanding of insurance asset management, SDEI strategies can be constructed to blend the benefits of money market and credit options, providing an attractive option to insurance companies.

Appendix 1: Case study

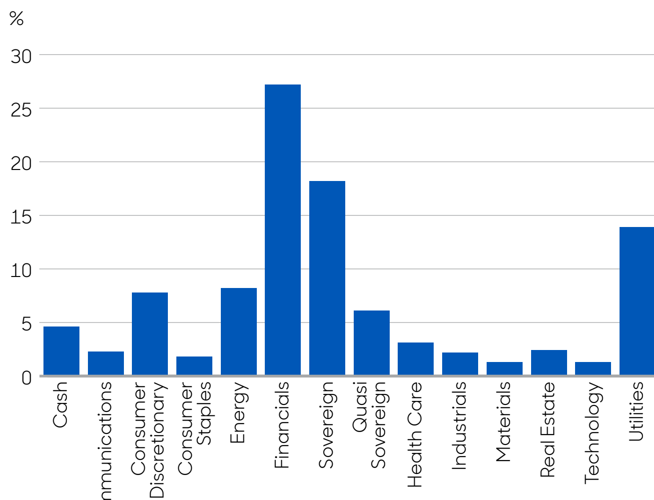
Strategy		Global Short Dated Corporate Bond	Global Corporate Bond	Short Dated Enhanced Income	Fund finance (example)	Money markets	Government bonds (example)
Duration (illustrative)		+/- 0.5 yr relative to index (approx. 2.5 yrs)	+/- 1.0 yr relative to index (approx. 7 yrs)	**Target <2.0 yrs**	Negligible / floating rate (1-4 year maturity)	Negligible / <1.0 yr	2 to 3 yrs
Illustrative returns (These are abrdn forecasts or targets and are not guaranteed)	**Index**	Barclays Global Agg. Corporate 1-5 Index ex-sub (FX-hedged)	Barclays Global Agg. Corporate Index (FX-hedged)	**SOFR**	SOFR / SONIA / EURIBOR	N/A	ICE 1-3 year Global Government Bonds
	Target outperformance	+0.5% p.a., gross of fees, over 3 years	+1.0% p.a., gross of fees, over 3 years	**+1.75-2.25% p.a.**	+2.2% p.a.	N/A	N/A
Credit rating		90% BBB or higher; B- minimum allocation, incl. off-benchmark high yield securities (max. exposure 10%)		**Minimum A-**	AA-	Most not rated; 46% A rated or better Accessed by AAA rated fund	Sovereign
Increase to solvency capital requirements (illustrative Sept. 2023; ex. currency) for this insurance client's specific situation		3.5% increase	9.1% increase	**1.5% increase**	Interest rate: negligible Spread: 0.8% increase Concentration: significant	[Nil / baseline]1	1.1% increase
Typical liquidity at strategy level		T + 3	T + 3	**T + 1**	None (typical 1-year term)	T + 0 available	T + 2

Appendix 2: abrdn SDEI strategy. Typical portfolio characteristics (as at 31 December 2023)

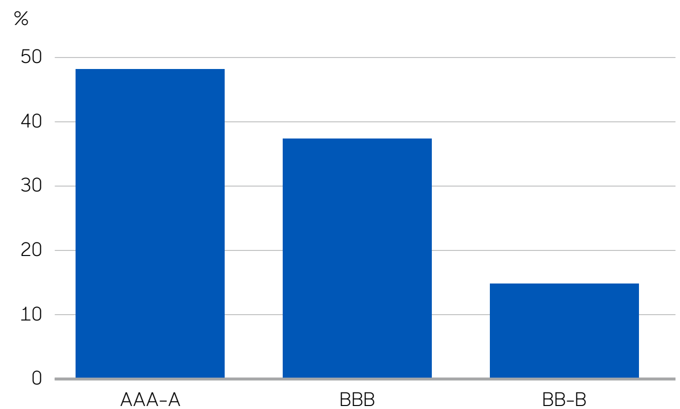
Characteristics

	Portfolio
YTW(USD) %	6.0
Duration (years)	1.3
Average rating	A/A-
Average price	97
Average spread (bps)	132

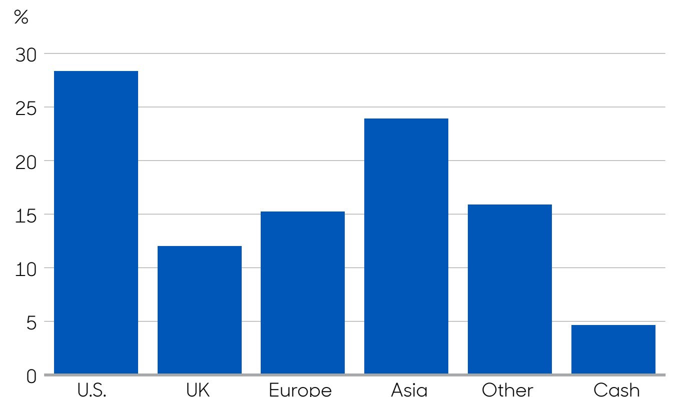
Sector



Market



Region



Important information

The value of investments and the income from them can go down as well as up and investors may get back less than the amount invested. Past performance is not a guide to future results.

Risk factors you should consider before investing:

Credit risk – The fund invests in securities which are subject to the risk that the issuer may default on interest or capital payments.

Interest rate risk – The fund price can go up or down daily for a variety of reasons including changes in interest rates, inflation expectations or the perceived credit quality of individual countries or securities.

High Yield Credit risk – The fund invests in high yielding bonds which carry a greater risk of default than those with lower yields.

Emerging Markets risk – The fund invests in emerging market equities and/or bonds. Investing in emerging markets involves a greater risk of loss than investing in more developed markets due to, among other factors, greater political, tax, economic, foreign exchange, liquidity and regulatory risks.

Convertible Securities and CoCos risk – Convertible securities are investments that can be changed into another form upon certain triggers. As such, they can exhibit credit, equity and fixed interest risk. Contingent convertible securities (CoCos) are similar to convertible securities but have additional triggers which mean that they are more vulnerable to losses and volatile price movements and hence become less liquid.

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