



HOW TO BUILD AN EFFICIENT PRIVATE MARKETS PORTFOLIO FOR INSURERS, PART TWO

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This is the second installment of a multi-part series on portfolio construction for insurance general account portfolios. It follows our [first piece](#) on building and maintaining a private markets allocation for insurance general account portfolios. In this edition, we focus on enhancing a fixed-income allocation with opportunistic credit. Next, stay tuned for NEPC's take on optimizing public equity allocations for taxable insurance portfolios.

Insurers overlooking opportunistic credit within their fixed-income allocation could be leaving money on the table.

While investment-grade fixed income has historically represented the largest allocation for insurance general account portfolios, we believe other diversifying credit asset classes such as commercial mortgage loans, high yield debt and private placement bonds can add value. These opportunistic credit asset classes can bolster investment income and improve total returns, while only modestly increasing capital charges. However, it is vital for insurers to understand the underlying benefits and risks associated with each of these asset classes before carefully selecting investment managers that are specialists in these areas. At the same time, insurance companies should size these allocations appropriately and ensure they have the right tools in place to measure the success of these investments.

At NEPC, we can help build this part of your portfolio, all the way from determining a strategic allocation target to identifying the appropriate asset classes and, ultimately, selecting the right strategies. While we expect traditional high-quality fixed-income investments, such as government bonds and investment-grade corporate debt, to remain a significant portion of general account assets, we believe opportunistic credit may fill a gap that currently exists in many portfolios.

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THE OPPORTUNITY SET

We use the term *opportunistic credit* to cover a wide range of asset classes that are not commonly found within core investment-grade allocations. As a result, we want to make sure insurers are deliberate about including target allocations to these assets.

We separate the investment opportunity set for insurance general account portfolios into four categories (see table below). The typical general account portfolio has exposure to core investment-grade fixed income and public equity; [private markets](#) are also increasingly being used. We believe opportunistic credit may be underrepresented in portfolios and adding dedicated exposure can potentially enhance income and grow surplus with only a modest increase in credit and liquidity risk.

INSURANCE GENERAL ACCOUNT OPPORTUNITY SET

Core IG Fixed	Opportunistic Credit	Public Equity	Private Markets
Cash	High Yield Corporate	U.S. Large Cap	Private Debt
Gov't/Agency	Bank Loans	U.S. Small Cap	Infrastructure
IG Corporate	Emerging Market Debt	Non-U.S. Developed	Real Estate Equity
Municipal	Private Placement Debt	Emerging Markets	Private Equity
MBS Pass Through	Commercial Mortgage Loans	High Dividend	Hedge Funds
Structured (ex. MBS Pass Through)		Defensive	
CLO Debt			

For illustrative purposes only. There may be other asset classes that are appropriate for portfolios.

The opportunistic credit categories typically have one or more of the following characteristics:

1. Higher yield relative to investment-grade fixed income
2. Less liquidity than Treasuries or publicly traded corporate bonds
3. More liquidity than traditional private market asset classes

Given that many of these asset classes are less liquid, we recommend insurers not rely on these asset classes to meet their cashflow needs. Although these assets have a somewhat active secondary market, we prefer a buy-and-hold approach, particularly with private placement debt and commercial mortgage loans (CMLs). The other opportunistic credit asset classes in the table have liquid secondary markets allowing for more flexibility, if desired.

SETTING A TARGET ALLOCATION

From our perspective, a minimum allocation of 5% is needed to have any material impact at the total portfolio level. Depending on the specific asset classes used and/or the organization's surplus position, allocations can be as high as 10%-to-15%. For example, an insurer might be able to tolerate a larger allocation to double-B/single-B-rated high-yield corporate bonds than one that includes triple-C-rated bonds. Similarly, private-placement bonds and commercial mortgage loans tend to carry investment-grade ratings and can warrant larger allocations if the organization can tolerate less liquidity.

We recommend setting a broad target allocation to opportunistic credit over discrete target allocations to individual asset classes. This provides greater flexibility during implementation, while also recognizing that the opportunity set may evolve over time. It can also be hard to manage target allocations to individual asset classes given the reduced liquidity of many of the asset classes.

MANAGER SELECTION

Our preference is to use specialist managers to implement these asset classes. While it may be possible to allocate to these asset classes within a broader core investment-grade mandate, we believe that distinct mandates with asset class specialists are appropriate. This approach provides more accountability along with the flexibility to consider a wider range of strategies.

With private placement debt and CMLs, we find it helpful to utilize specialists who have dedicated teams and a history of participating in these markets. We find that managing a consistent and dedicated pool of capital in these asset classes allows for better deal flow; managers that only participate in these markets occasionally may have less access to deals resulting in more concentrated portfolios.

Within the other opportunistic credit categories, we believe flexible mandates that allocate to two or more asset classes, for instance, high yield and bank loans, are most efficient. Specialists that have expertise in allocating to below investment-grade asset classes can often tactically rotate between high-yield bonds and bank loans (while being mindful of portfolio turnover and any tax considerations). On occasion, these flexible mandates might also include investment-grade bonds, primarily in the crossover triple-B/ double-B-rated space, to round out the portfolio.

VEHICLE SELECTION

Insurers often prefer to invest in separately managed accounts where they own individual securities. This is especially true for investment-grade allocations as owning the securities directly results in far better capital treatment. Within opportunistic credit, we find that using a combination of separate accounts and fund vehicles often makes the most sense, even for the investment-grade asset classes such as private placements and CMLs. There are several considerations when making this decision, including ensuring adequate diversification and the ability to hold these securities on the balance sheet. With target allocations of 5%-to-10%, the overall dollar amount is sometimes not large enough for most insurers to warrant a separately managed account. Additionally, with CMLs, insurers may not want to hold the loans directly on their balance sheet and, as a result, would be better off with a more diversified fund vehicle.

Investing in a fund does not automatically lead to worse capital treatment. In some cases, funds in these asset classes have received ratings from the National Association of Insurance Commissioners (NAIC) that allow for capital treatment consistent with the underlying loans or securities. Although the type of vehicle and capital treatment are important to understand, our preference is to first select an appropriate investment manager/strategy, before proceeding to vehicle selection. In other words, don't forsake investment strategy for better capital treatment.

BENCHMARKING

For the more traditional asset classes, such as high-yield bonds, bank loans and emerging market debt, there are a number of appropriate benchmarks available. Insurers should attempt to select a benchmark that aligns credit quality and duration with the strategy mandate. For example, a short-duration high-yield mandate focused on double-B/ single-B credits should be measured against a benchmark with those characteristics (as opposed to a generic high-yield index).

The less traditional asset classes, such as private placements and CMLs, are more difficult to benchmark. We believe that public market indexes are the best solution. An investment-grade corporate bond index, for example, would be an appropriate benchmark for an investment-grade private placement mandate. Again, credit quality and duration can be matched by using a blend of public market benchmarks.

Above all, insurers should focus on income generation and total return for the opportunistic credit asset classes. Finally, insurers should closely monitor the increase in credit risk and illiquidity that comes along with allocating to these asset classes.

To learn more about opportunistic credit investments, or to conduct an asset allocation or enterprise risk management study to determine an appropriate target allocation for your portfolio, please contact your NEPC consultant.

IMPORTANT DISCLOSURES

Past performance is no guarantee of future results.

All investments carry some level of risk. Diversification and other asset allocation techniques do not ensure profit or protect against losses.

This memo should not be considered customized investment advice. Please contact NEPC for advice specific to your investment program.

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