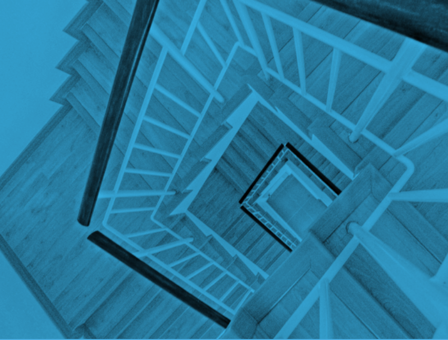

NEAM VANTAGE POINT

Perspectives

JULY 2023

OUR VIEW ON INSURANCE CAPITAL MANAGEMENT TOPICS

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2022 P&C Industry Investment Highlights: Reversing the Declining Trend?

The P&C industry experienced sustained investment yield decline over recent years. Could the elevated interest rate environment reverse the trend?

EXECUTIVE SUMMARY

With the Fed's aggressive tightening policy, 2022 turned out to be a historic outlier year in terms of the magnitude of market value declines for both fixed income securities and equities. However, the sharp rise in yields had a positive impact on income. On a statutory accounting basis, the U.S. P&C insurance industry experienced meaningful net investment income growth while maintaining elevated liquidity as companies dealt with inflationary pressures and high replacement costs.

The industry's allocation to risk assets declined in 2022, largely due to broad stock market depreciation. Fixed income book yield saw an increase of 64 basis points (bps) while the portfolio's overall credit profile improved and duration moderately extended. The tax-exempt municipal allocation has steadily declined in recent years and has been replaced by increased allocations to corporate bonds, asset-backed securities (ABS), and commercial mortgage-backed securities (CMBS).

NET INVESTMENT INCOME CLIMBED, DESPITE SIGNIFICANT MARKET VALUE DECLINES

Table 1 highlights the P&C industry's total cash and investments and earned investment income on a gross and net basis. Although the market value of fixed income securities and equities declined significantly in 2022, the industry's statutory book value of cash and investments ($) remained relatively unchanged. *The industry's annual net investment income (%) increased by 60 bps[1], the highest annual increase in the last 10 years.*

Table 1. Earned Invested Income $ Billions and %

Category	2022	2021	2020	2019	2018	2017	2016	2015	2014	2013
Total Cash/ Investments($)	2,140.5	2,166.2	1,945.7	1,811.5	1,644.9	1,630.0	1,527.0	1,463.9	1,461.6	1,413.6
Gross Earned Investment Income($)	76.1	60.4	57.3	60.2	61.1	53.1	50.6	51.4	57.5	52.0
Investment Expenses($)	6.2	5.9	5.6	5.6	5.5	5.0	4.8	4.6	4.6	4.4
Net Investment Income($)	69.9	54.5	51.8	54.6	55.6	48.2	45.8	46.8	52.9	47.6
Net Investment Income(%)	3.25%	2.65%	2.76%	3.16%	3.40%	3.05%	3.06%	3.20%	3.68%	3.48%

Source: NEAM, S&P Capital IQ Pro

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We further examine the industry's earned investment income contribution from major asset classes in Table 2. In 2022, the contribution from alternatives[2] outpaced those from taxable and tax-exempt bonds. The contribution to net investment income from tax-exempt bonds decreased from 21% in 2013 to 7% in 2022. This decline reflects the industry's ongoing reduction in holdings, due to diminished tax advantages from the 2018 tax law changes.

Table 2. Earned Investment Income Contribution by Asset Class

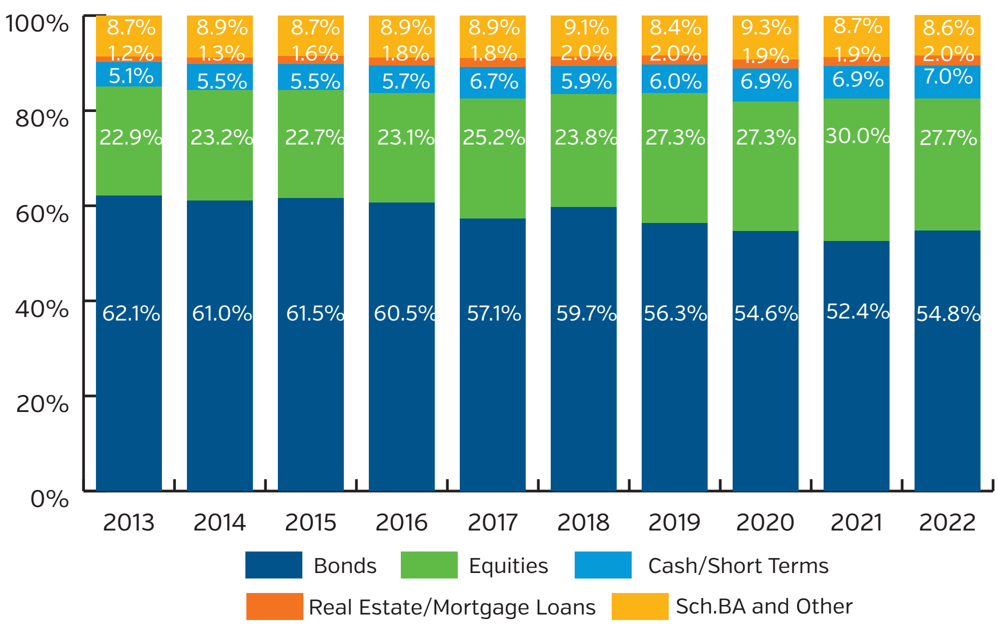
Asset Class/Sector	2022	2021	2020	2019	2018	2017	2016	2015	2014	2013
Taxable Bonds	39%	43%	47%	46%	40%	41%	42%	41%	37%	42%
Tax-Exempt Bonds	7%	10%	11%	12%	13%	17%	19%	20%	18%	21%
Equities	17%	20%	18%	17%	20%	16%	18%	16%	26%	16%
Sch. BA (Alternatives)	29%	20%	17%	15%	19%	18%	14%	17%	14%	15%
Mortgage/Real Estate	4%	5%	5%	5%	5%	5%	5%	4%	4%	4%
Cash/Short-Term	2%	0%	1%	4%	3%	2%	1%	0%	0%	0%
All Other	1%	1%	1%	1%	1%	1%	1%	1%	1%	1%
Total Gross Earned($)	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%

Source: NEAM, S&P Capital IQ Pro

BOND ALLOCATION REMAINED THE MAJORITY, ALTHOUGH TRENDING DOWNWARD

Chart 1 shows the industry's statutory asset allocation across broad sectors over the last decade. Faced with inflationary pressures, high replacement costs and relatively attractive short-term yields, the industry maintained its liquidity through additional cash and short-term holdings. Bonds continued to represent the majority of total invested assets, although the allocation declined from 62.1% to 54.8% over the last decade. The allocation to equities, reported as fair/market value under statutory accounting, exhibited a meaningful reduction in 2022.

Chart 1. Broad Sector Asset Allocation

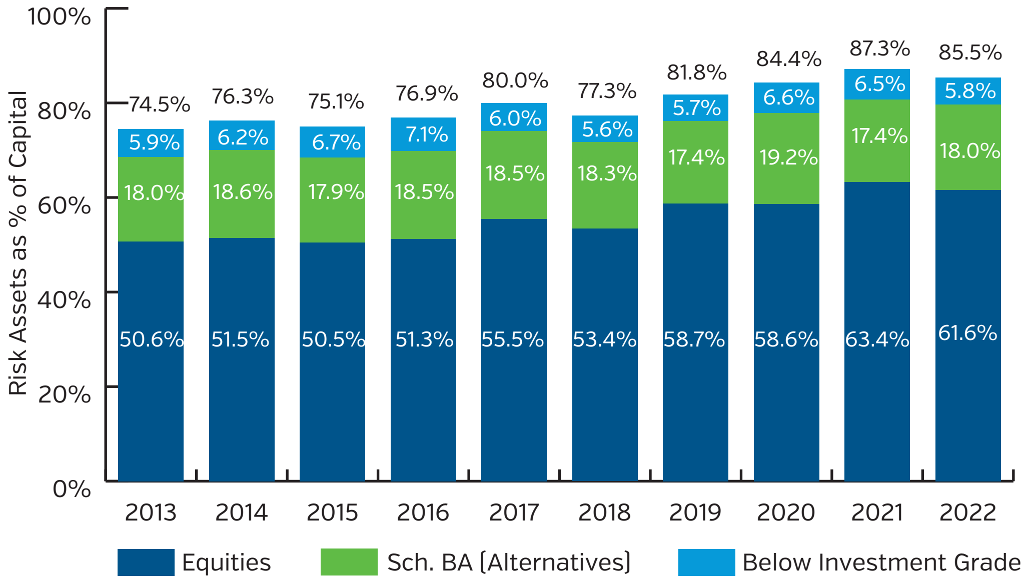


Source: NEAM, S&P Capital IQ Pro

RISK ASSET ALLOCATION DECLINED, THANKS TO THE BROAD STOCK MARKET DRAWDOWN

The industry's allocation to risk assets, reported as fair/market value under statutory accounting, declined after reaching its high (87.3% of surplus) at year-end 2021 (Chart 2). Allocation to equities represented 62% of the industry's surplus, while Schedule BA and below-investment-grade allocations remained less than 25%. In 2022, the S&P 500 price index experienced a negative 19.6% return, consequently leading to a reduction of over 6% in the P&C industry's capital and surplus (Table 3).

Chart 2. Risk Asset Allocations



Source: NEAM, S&P Capital IQ Pro

Table 3. Industry Statutory Capital and Surplus $ Billions and %

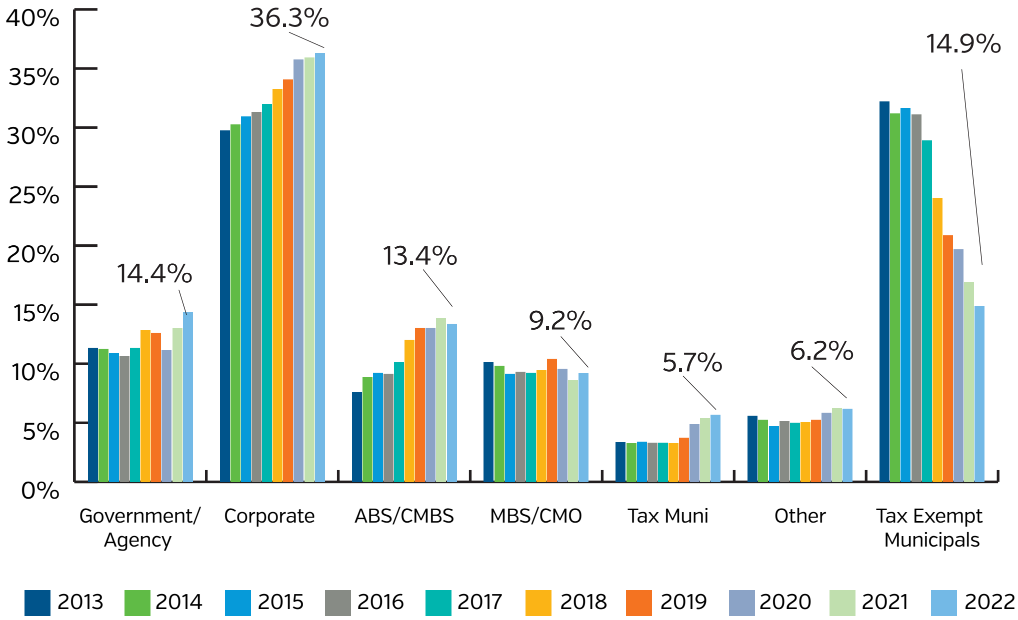
P&C Industry	2022	2021	2020	2019	2018	2017	2016	2015	2014	2013
Capital and Surplus ($)	961.8	1,026.7	904.9	841.2	733.6	740.2	688.2	658.6	659.5	639.5
Annual Change (%)	-6.3%	13.5%	7.6%	14.7%	-0.9%	7.6%	4.5%	-0.1%	3.1%	N/A

Source: NEAM, S&P Capital IQ Pro

FIXED INCOME ALLOCATION: TAX-EXEMPT MUNICIPAL DIMINISHING

Chart 3 displays secular trends in fixed income sector allocations over the past decade. Corporate allocations continued to grow and accounted for more than one-third of the industry's fixed income holdings at year-end 2022. The tax-exempt municipal sector, on the other hand, has exhibited a steady decline, and reductions have accelerated since the 2018 tax law changes. The industry's allocation now represents less than half of its allocations from a decade ago. ABS and CMBS allocations have risen and partially offset the reduced allocation from the tax-exempt municipal sector. Taxable municipal allocations show steady increases and represent more than five percent of the industry's fixed income holdings at year-end 2022. Government and agency allocations rose meaningfully in 2022 and are now approaching the level of tax-exempt municipal allocations.

Chart 3. Fixed Income Sector Allocation 2013-2022



Source: NEAM, S&P Capital IQ Pro

BOOK YIELD (AND UNREALIZED LOSS) BOOSTED BY FED'S TIGHTENING POLICY

In 2022, the Federal Reserve Bank raised the Federal Funds Rate seven times and the 10-year Treasury yield reached 4.35% in October 2022. As a result, the industry's book yield saw a meaningful increase of 64 bps in 2022, after a long and steady decline (Table 4). Moreover, book yields across all sectors rose in 2022, with ABS and CMBS showing the greatest increase of 158 bps. On the other hand, elevated market yield translated into lower fair/market values, which fell below their statutory book values for the first time in the last decade (Table 5). To understand the tradeoffs or the implications between yield pickup versus (un)realized losses, we encourage insurers to utilize a holistic enterprise framework that incorporates underwriting characteristics and business profiles in their asset allocation analysis.

Table 4. Fixed Income Book Yield (%)

Asset Class/Sector	2022	2021	2020	2019	2018	2017	2016	2015	2014	2013
TAXABLE										
Gov't/Agcy	2.24	1.32	1.65	2.23	2.39	1.94	1.80	1.92	1.98	2.04
Corp	3.56	3.09	3.39	3.71	3.77	3.58	3.67	3.73	3.77	3.90
ABS/CMBS	3.98	2.40	2.74	3.29	3.42	3.04	2.98	2.91	2.88	3.07
MBS/CMO	3.02	2.27	2.49	3.20	3.54	3.45	3.72	3.56	3.81	3.89
Taxable Muni	3.10	2.87	3.09	3.82	4.12	4.11	4.19	4.28	4.40	4.49
Other	4.33	3.16	3.64	3.90	4.19	3.97	3.70	4.11	3.73	3.85
Total Taxable	3.37	2.62	2.95	3.36	3.50	3.28	3.33	3.37	3.40	3.53
TAX-EXEMPT										
Exempt Muni (Raw)	3.05	2.99	3.05	3.18	3.22	3.20	3.30	3.52	3.71	3.87
Grand Total	**3.31**	**2.67**	**2.96**	**3.32**	**3.43**	**3.25**	**3.32**	**3.41**	**3.49**	**3.63**

Source: NEAM, S&P Capital IQ Pro

Table 5. Industry's Bonds Book Value and Fair Value $ Billions

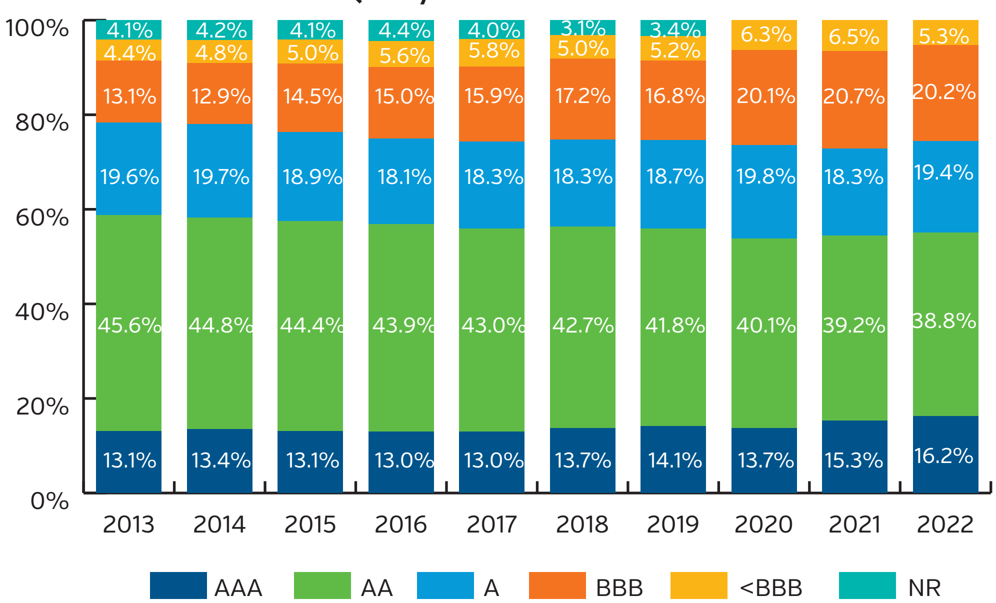
P&C Industry Bonds	2022	2021	2020	2019	2018	2017	2016	2015	2014	2013
Book Value ($)	1,173.5	1,136.5	1,063.5	1,020.5	979.6	930.9	923.7	900.1	891.5	877.7
Fair Value ($)	1,087.1	1,174.5	1,134.6	1,060.7	980.6	952.0	938.7	923.8	929.7	900.0
Fair Value - Book Value ($)	(86.4)	38.0	71.2	40.2	1.1	21.1	15.0	23.7	38.2	22.3

Source: NEAM, S&P Capital IQ Pro

CREDIT QUALITY IMPROVED

Chart 4 displays trends in fixed income credit quality.[3] Over the past decade under the low interest rate environment, the industry increased credit risk, evidenced by rising allocations to BBB and high yield (<BBB) rated bonds. These allocations reached their highest allocations at year-end 2021 (Chart 4). In 2022 with the Fed's aggressive tightening policy, the industry took advantage of rising rates, improving its credit profile by increasing AAA and A rated bonds and reducing BBB and BIG bonds. The increased allocations to government/agency, and MBS/CMO sectors (Chart 3) contributed to this overall improvement in credit profile.

Chart 4. Fixed Income Credit Quality



Source: NEAM, S&P Capital IQ Pro

DURATION RELATIVELY UNCHANGED

Table 6 displays option-adjusted duration (OAD) by fixed income sector. The OAD statistics are based upon CUSIP level holdings extracted from Schedule D statutory filings and exclude any bonds held at the holding company level, derivatives, and private placement securities. The industry's aggregate OAD has remained relatively unchanged since 2018. In 2022, the aggregate OAD lengthened slightly, driven by a meaningful duration extension observed in the tax-exempt municipal. Taxable bonds, on the other hand, exhibited consistent duration shortening across most sectors, except for MBS/CMO securities where their OADs tend to extend in periods of rising interest rates.

Table 6. Fixed Income Option Adjusted Duration (Years)

Asset Class/Sector	2022	2021	2020	2019	2018	2017	2016	2015	2014	2013
TAXABLE										
Gov't/Agcy	4.0	4.4	4.1	4.2	3.9	4.1	4.4	4.3	4.3	4.5
Corp	4.7	5.0	4.9	4.5	4.5	4.5	4.5	4.5	4.4	4.5
ABS/CMBS	3.3	3.4	3.4	3.6	3.6	3.9	3.5	3.8	3.1	3.4
MBS/CMO	6.2	4.6	3.7	4.2	4.8	4.7	5.0	3.6	3.8	4.5
Taxable Muni	6.9	7.1	7.0	5.6	5.0	5.4	6.0	6.2	6.5	7.0
Other	3.0	3.4	3.7	3.6	3.5	3.8	4.0	3.9	3.9	3.8
Total Taxable	4.6	4.7	4.5	4.3	4.3	4.4	4.5	4.3	4.2	4.5
TAX-EXEMPT										
Exempt Muni	6.0	4.9	5.8	5.8	6.4	6.8	6.6	6.2	5.8	6.5
Grand Total	**4.8**	**4.7**	**4.8**	**4.6**	**4.8**	**5.1**	**5.2**	**5.0**	**4.8**	**5.2**

Source: NEAM, S&P Capital IQ Pro

KEY TAKEAWAYS

- In 2022, the P&C industry experienced the most annual net investment income (%) growth over the last decade, although its statutory cash and invested assets declined slightly.
- Faced with inflationary pressures and high replacement costs, the industry maintained its liquidity by holding sufficient cash and short-term holdings. Risk asset allocations, after reaching their new high in 2021, declined in 2022 and continued to be dominated by equity.
- Within the fixed income portfolio, the tax-exempt municipal allocation has been steadily declining and currently represents less than half of its level from a decade ago. In 2022, the industry's book yield rose by 64 bps while the overall credit profile improved and duration extended slightly.
- Capital market uncertainty, including an elevated interest rate environment, persists. We encourage insurers to adopt a holistic enterprise framework to assess, among other things, their asset risk budget, tradeoffs from securing higher yields versus realized losses, and ideal strategic allocation targets.

Please contact us if you would like to receive a customized enterprise comparative assessment, which facilitates in-depth comparisons and contrasts of asset and liability characteristics of your company relative to peer organizations. The assessment supports decisions with enterprise risk preferences and investment strategies.

ENDNOTES

[1] The net investment income (%) for the P&C industry excluding Berkshire Hathaway declined in 2022.

[2] The outsized schedule BA contribution to the industry's earned investment income was driven primarily by Berkshire Hathaway, of which Schedule BA income increased from $5.3 billion in 2021 to $16.8 billion in 2022.

[3] Starting from 2020, the NAIC credit rating reporting expanded from six to twenty categories. The NR category shown for 2019 and prior years consists of mostly true private placement securities.

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