“Timing the market” versus good tactical decision-making

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Given the extent of the damage insurers’ portfolios have faced in 2022, many clients are understandably gun shy of the markets. It certainly is tough for insurance investment committees or their boards to watch fixed income portfolios, the bulk of an insurer’s assets, decline while the investment grade bonds markets posts a -13% YTD returns (-1.5% in 2021). While this represents an unrealized loss, insurance company financials are strained, and collateral sufficiency issues may arise. While most insurers know the value of “staying the course”, many are loath to add to their fixed income market positions at this time.

Much of 2022’s paper losses can be expected to disappear as bonds move toward maturity at their face value. That does not ease the pain of looking at quarterly statements for the last several quarters. And, we expect another quarter or two of high volatility and potentially more negative returns.

Timing the cyclical change in interest rates, that is when the Fed stops rising and perhaps begins a downward trend, is not a winning strategy. Interest rate anticipation strategies are not favorable ones for insurers to pursue as they can imbed significant market value volitility in returns. Interest rate anticipation strategies require guessing the direction, the timing, and the magnitude of interest rate changes and getting all three correct. Even professional bond traders’ have low probabilities of success as they are more likely to miss market/rate cycle tops and bottoms. There simply are too many unpredictable factors affecting the Fed’s decisions and the corresponding market reactions to be able to predict behaviors accurately and consistently.

Many insurers are cautiously adding to cash and cash equivalent positions or exploring short duration strategies that permit reinvestments to ride up with interest rates and will limit market value damage during the remaining interest rate rising cycle. While this appears logical and can perhaps preserve principle, or minimize paper losses, it will require a “timing the market” decision at some point. Specifically, when does the investment committee “green light” a reallocation of these liquid funds into their bond portfolio of a duration that matches their mid to longer term liabilities?

Recently, we have witnessed some preliminary progress towards taming inflation resulting from the severe interest rate rising cycle implemented by the Fed. This will probably be interpreted as a sign that we can expect slower rate increases, and perhaps fewer increases, out of the next few FOMC meetings. Of course, that would require the development of a continued solid trend in reducing the rate of inflation.

Is the Fed throwing a curve ball?

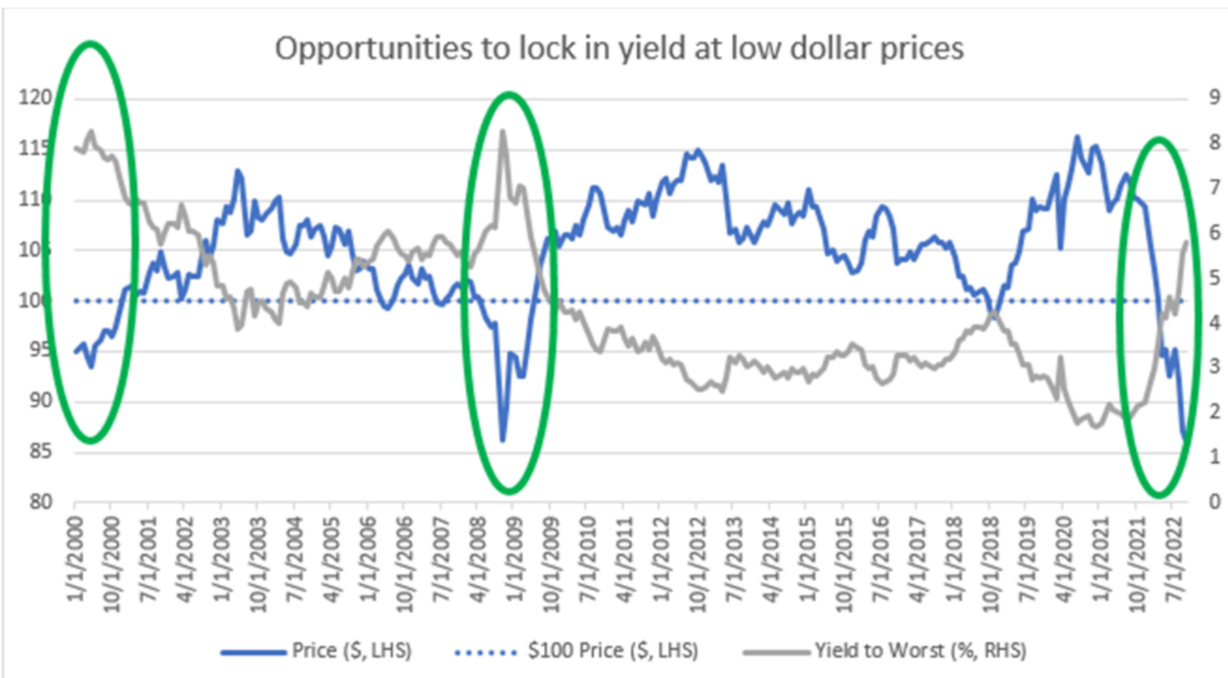
The markets generally understand that there is a lag between a rise in rates and the desired effect of bringing down inflation. This is due to many factors, such as the time it takes for businesses and consumers to make adjustments to their behaviors related to the changes in the cost of capital. Another factor is that much of the data that guides the Fed’s decisions is historical and indicates economic trends that may be several months in the making. Therefore, there is a danger that the Fed could over-steer. That is rates could be raised too high, or for too long, pushing the economy into recession.

So, are we approaching the peak of the interest rate cycle?

Well, maybe! However, what if after the next rate increase or two, the economy has decelerated to a point where recession is certain or upon us? The slowing economy is already creating major layoffs particularly in the technology industry, but a recession could create more widespread layoffs and rising unemployment, even with the significant slack in the labor market. Since exercising control over the inflation rate and employment levels are the Fed's primary objectives, will they be pressured to rapidly decrease rates to reinvigorate the economy to stimulate the labor markets and employment and to either shallow out a recession or avoid a depression? Clearly, the near future presents a potential timing trap.

We believe that superior tactical decisions don't rely on accurately timing the markets. Insurance company investment committees and boards might be better served to consider taking money off the sidelines and adding to their duration matched bond portfolios before actual realization of the peak rates, since that may be very difficult to predict. Current yields are more attractive than they have been in years. Locking in at least a portion of sidelined cash at these higher yields appears to be a tactically sound decision. Averaging into the bonds markets over the next two quarters to "lock in" the higher yields might be the best way to acknowledge that recognizing the peak, and then reacting quickly enough before everyone else does as prices get bid up, are perhaps unlikely events. It also allows for limiting further possible unrealized losses on the portion remaining in cash. Some may call it hedging your bets. This process should also allow for flexibility, speeding up or decelerating investments, as the economic and market environment ahead becomes clearer.

The chart below is provided by our friends at Wellington Management. It indicates this concept of identifying potentially superior entry points for sidelined cash.



Source: Bloomberg Credit index. Data begins January 2000 and ends October 2022.

Conclusions

It is important to accept that timing the market is not a sound strategy. It is also important that when liabilities are inflating at or near the inflation rate, portfolios need to optimize performance to avoid future potential hits to surplus. However uncertain the future economy and markets appear, there are clearly more or less opportune times in a market cycle to put money to work. While these "opportunities" are nonetheless bets on the future, they are backed by data, reasoning, and forethought. If markets were predictable, one would simply buy at the bottom and sell at the top of the cycle. In our view today, we believe that within the next two quarters, investment committees should consider moving back into the bond markets and avoiding the ultimate performance drag that cash and cash equivalents create in an insurer's portfolio. Adjusting tactical investment strategy through the lower (or higher) points in the cycle is easier than trying to accurately time to the cycle!