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Quarterly insurance update

Q3 2024

Summary

Welcome to the Quarter 3 2024 investment update designed for insurers and produced by Royal London Asset Management. Throughout the quarter, markets were once again dominated by interest rates, despite little or no movement in this area. 2024 started with expectations that central banks would cut early and cut often. However, as the year has progressed, those expectations have changed. Inflation has generally not come down quite as fast as hoped, with services inflation proving sticky, particularly in the UK, while growth has generally not been as weak as feared – particularly in the US. Interest rates were cut just once across the Federal Reserve, European Central Bank and Bank of England, with the ECB cutting rates in June.

In addition, reviews of the regulatory frameworks within both Europe and the UK have continued to progress. In the UK, the Prudential Regulation Authority (PRA) gave a speech covering the evolution to date and the proposed reforms to the bulk purchase annuity market, as well as an update to the 2025 Life Insurance Stress test. Additionally, the PRA published its latest Policy Statement (PS) concerning the proposed reforms to the Matching Adjustment (MA) regime as a result of the broader regime change to Solvency UK. In Europe, the Insurance Europe publication called on the European Commission to ensure that the upcoming technical work on Solvency II fully reflects the agreement made in 2023. As well as this, the European insurance industry called on the European Union to prioritise delivering the Capital Market Union (CMU) to drive growth, prosperity, and improve its global competitiveness.

Within this quarterly update, we cover developments in the two main areas most prevalent to the asset side of insurers' balance sheets - investment markets and regulations. In addition, we highlight investment themes we believe are pertinent to many insurers at the present time.

Market update:

- Government yields generally rose over the quarter, particularly following poor US inflation data released in April with yields largely range-bound through May and June.
- Global corporate bonds saw broadly flat returns over the quarter, with the impact of higher underlying government bond yields and slightly wider credit spreads mitigated by the positive carry on the asset class. In local currency terms, US and euro investment grade markets outperformed sterling equivalents.
- Global equities continued to rally over Q2, with stronger than expected earnings growth fuelled by AI demand helping markets look through the risk of fewer than previously expected 2024 interest rate cuts.

Regulatory update:

The regulatory environment for insurers continued to develop. Over the quarter:

Europe

- Insurance Europe (IE) called on the European Commission to ensure that the upcoming technical work on Solvency II fully reflects the agreement made in December 2023. IE also outlined what the regulators key priorities should be.
- The European insurance industry called on the European Union to prioritise delivering the Capital Market Union (CMU) to drive growth, prosperity, and improve its global competitiveness.

UK

- The PRA gave a speech covering: the growth of the bulk purchase annuity (BPA) market, the proposed reforms to Matching Adjustment (MA - covered separately below), the potential for 'sandbox' assets in MA portfolios and what insurers can expect from the 2025 Life Insurance Stress Test (LIST).
- The PRA published its latest Policy Statement (PS) – PS10/24 concerning the proposed reforms to the MA regime as a result of the broader regime change from Solvency II to the new Solvency UK system.

We explore these areas in more detail, also highlighting what these could mean for insurers going forward.

Insurance investment themes:

We set out an investment theme for insurers that we believe is well placed, and relevant, relative to the future economic and regulatory environment. For this quarter's publication we include:

- **Enhancing Cash Yield:** Most insurers will have some allocation to cash – whether this is for pure liquidity purposes, to match against very short-term liabilities, or as part of a more strategic allocation to aid diversification. As a result of recent market movements and the anticipated interest rate cuts, we highlight what insurers should now focus on and how best they can meet their continuing requirements for security and capital preservation within their cash holdings.

Market update

	Yield (%)*		Total 3 month return	
	31 March 2024	28 June 2024		
Euro Treasuries†	2.94	3.20	-0.99% (GBP)	-1.33% (EUR)
UK Gilts†	4.20	4.43	-0.99% (GBP)	
US Treasuries†	4.43	4.57	0.01% (GBP)	-0.31% (EUR)

	Spread (bps)*		Total 3 month return	
	31 March 2024	28 June 2024		
Global IG Corporates†	100	103	0.12% (GBP)	-0.21% (EUR)
Euro IG Corporates†	109	114	0.13% (EUR)	
UK IG Corporates†	107	107	-0.12% (GBP)	
Emerging Market Debt†	341	391	0.04% (GBP)	-0.29% (EUR)
Global High Yield†	272	261	1.31% (GBP)	0.97% (EUR)

	Price index*		Total 3 month return	
	31 March 2024	28 June 2024		
Global Equities†	20448.91	20972.93	2.59% (GBP)	3.45% (EUR)
Euro Equities†	5083.42	4894.02	-3.73% (EUR)	
UK Equities†	4338.05	4451.92	3.73% (GBP)	
Emerging Market Equities†	646.2	678.05	5.21% (GBP)	6.10% (EUR)

	Index*	
	31 March 2024	28 June 2024
Volatility†	13.01	12.44

* Source: Bloomberg, IHS Markit.

† See appendix for details on index used and returns quoted.

Past performance is not a guide to future performance. The value of investments and any income from may go down as well as up and is not guaranteed. Investors may not get back the amount invested.

Overview

Markets have once again been dominated by interest rates during the quarter, despite little or no movement in this area. 2024 started with expectations that central banks would cut early and cut often. However, as the year has progressed, those expectations have changed. Inflation has generally not come down quite as fast as hoped, with services inflation proving sticky, particularly in the UK, while growth has generally not been as weak as feared – particularly in the US. Interest rates were cut just once across the Federal Reserve, European Central Bank and Bank of England, with the ECB cutting rates in June. Most central bank forecasters now only expect one or two cuts from each of these banks over the course of 2024 as a whole.

Ahead of the US Presidential elections in November, snap parliamentary elections were called in the UK and France, providing reminders that voter dissatisfaction with the seeming consensus on economic policy and ongoing lack of consensus on longer-term issues such as climate change create an uncertain backdrop for businesses and consumers alike.

The US Federal Reserve continued to keep rates on hold at 5.25-5.50% over the quarter against a still resilient labour market backdrop, and the relatively strong core CPI inflation seen over January to April. The May data (released in June) was more reassuring both from a CPI and core PCE perspective. As of their June meeting, the median forecast of participants changed from showing 75 basis points of rate cuts for 2024 to only 25bps of cuts.

The ECB lowered rates by 25bps in June, following good inflation progress and previous hints from ECB members. Further rate moves after June are less certain and depend on data. Euro area CPI went up from 2.4% to 2.6% year-on-year in May, which was unexpected, and services inflation rose above 4.0%. The European elections saw incumbent parties suffer a loss of support and prompted President Macron to call an early parliamentary election. This uncertainty saw French government bonds weaken in relation to German government debt.

Data released in the UK in the second quarter confirmed that the country bounced out of technical recession in Q1 and painted a picture of continued positive economic growth. The Bank of England kept rates at 5.25%, even though headline inflation dropped. This reflected concern about services inflation and pay growth, both of which remain elevated. The calling of UK general election, which has resulted in a change of government, had a minor impact on sterling asset prices, reflecting a view that there would be little shift in economic policy.

Government bonds

Government yields generally rose over the quarter, particularly following poor US inflation data released in April, with yields largely range-bound through May and June. In the US, 10-year treasury yields rose from 4.21% to 4.40%, while German 10-year bunds similarly saw yields rise from 2.30% to 2.50%. Benchmark 10-year gilt yields rose from 3.94% to 4.18%.

UK index-linked markets saw similar increases in yields and as a result saw negative returns for the quarter at -2.09% (FTSE Actuaries All-maturities). Real yields on UK 10-year bonds rose from 0.28% to 0.60% with 30-year real yields rising from 1.13% to 1.36%. Looking at index linked returns on a global basis, markets in the US and Japan posted positive returns for the quarter, while the UK, Australia and notably France were negative.

Credit

Global corporate bonds saw broadly flat returns over the quarter, with the impact of higher underlying government bond yields and slightly wider credit spreads mitigated by the positive carry on the asset class. In local currency terms, US and euro investment grade markets outperformed sterling equivalents.

The sterling investment grade credit market (iBoxx non-gilt index) returned -0.13% over the quarter, with the average sterling investment grade credit spread widening marginally from 1.02% to 1.03% (iBoxx). Given the modest rise in yields, sectors with a greater proportion of long-dated bonds performed less well, including utilities and social housing. Of the major sectors, supranationals and banks produced positive returns, while insurance lagged.

In the high yield market, the ICE BofAML (BB-B) Global Non-Financial High Yield Index (sterling hedged) returned 1.31% in the quarter as spreads hit 282bps. At the end of the period, the index's yield-to-worst stood at 6.97%, in line from 7.05% at the start of the year. In the broader-based high yield index, which includes CCC rated bonds, spreads tightened to 358bps, with a yield-to-worst of 7.74%.

Equities

Global equities continued to rally over Q2, with stronger than expected earnings growth fuelled by AI demand, helping markets look through the risk of fewer than previously expected 2024 interest rate cuts. US stocks saw the best returns in the first half of an election year since 1976. Meanwhile European shares underperformed amid political risk arising from French snap elections. Emerging markets and Asia Pacific ex Japan were the best performers.

Some of the same trends that were driving markets during the first quarter continued into the second quarter of 2024. While the technology sector has continued to outperform, there has been underneath a rotation in markets where sectors like financials and utilities also performed well.

The technology sector has remained the best performing sector driven by AI, which is triggering significant investments in technology infrastructure, particularly semiconductors. The financial sector benefitted from the diminished expectations of interest rates cuts. Finally, utilities benefitted from increased demand for electricity driven by the growth of datacentres. Cyclically sensitive sectors like industrials and consumer discretionary were among the worst performers and impacted by deteriorating activity data.

Regulatory updates

1. EU must stay on course to deliver Solvency II

On 22nd April 2024, Insurance Europe (IE) called on the European Commission to ensure that the upcoming technical work on Solvency II fully reflects the agreement made in December 2023.

Whilst IE welcomed the Solvency II review, in particular, the improvements in the areas of capital and volatility, it disappointed on the resultant higher operating burdens and costs associated with proportionality arrangements for small and non-complex insurers.

Cheerleading the ongoing development of the Solvency II regulations and the necessary steps to ensure alignment with the overarching goals, IE shared what it thought the regulators key priorities should be:

- **Treatment of long-term business:** Recognising the excessive capital requirements and volatility associated with long-term products, any changes, in particular to the risk margin and the volatility adjustment, should avoid the introduction of additional volatility into the framework.
- **Equity investment:** The industry welcomes a simplified criteria for long-term equities, such as ensuring equity collective investment undertakings are assessed at fund level and not at the individual security level.
- **Proportionality:** Improving proportionality was one of the primary aims of the review. Whilst the general view was that this hadn't been progressed far enough, recognition was given to the increased thresholds for the application of Solvency II and allowing small insurers to automatically benefit from simplifications and proportionality measures.
- **Reporting and disclosure:** Continue to reduce additional reporting and other regulatory burdens, recognising that despite a 25% reduction, there will be a net increase in operational and reporting requirements for most insurers.
- **Sustainability:** Whilst supporting the drive towards sustainability, avoid creating overlaps and inconsistencies that can create confusion, increase unnecessary costs and operational burden given sustainability drives already in existence.

What does it mean for insurers?

The technical review and proposed steps will play an important role in helping insurers better serve customers, unlock more investment, and support progress towards completing the EU's Capital Markets Union. However, in order to realise the potential benefits, the technical review needs to be fully aligned with the ambition resulting from the agreement made in the December 2023 review. While the upcoming regulations will likely cover mostly technical details, they can have a significant impact and getting them right is essential for the overall outcome of the review. In developing the details, the industry also urges the legislators to always keep in mind its commitment to reduce the overall reporting burden.

2. Insurance industry shares recommendations to unleash investment in Europe

On 30th May, the European insurance industry called on the European Union to prioritise delivering the Capital Market Union (CMU) to drive growth, prosperity, and improve its global competitiveness. The CMU was launched ten years ago as a plan to create a single market for capital, increasing the flow of investments and savings across the EU.

The paper, published by Insurance Europe, highlighted the insurance industry's contribution not only by providing financial protection, but also as an institutional investor by offering pensions and savings products. European insurers invest close to €9.5tn in the economy and 69% of their investments in equity, corporate and sovereign bonds are within the EU.

Insurance Europe highlighted **six areas** it feels the CMU should focus on:

1. Making it easier for consumers to invest in savings and pension products.
2. Improve prudential rules which act as barriers. The ongoing Solvency II Review needs to address current excessive capital and volatility, which is resulting in unnecessary barriers for long-term, guaranteed and profit sharing products, as well as investment.
3. Improve financial and insurance education. This is vital to ensure Europeans are equipped with the knowledge, confidence and skills necessary to improve their understanding of financial products.
4. Increase insurers' access to small and medium-sized (SME) equity, venture capital, SME debt and infrastructure. Such funds provide the scale and access for a wide-range of insurers to invest in these asset classes.
5. Facilitate greater cross-border investment.
6. Reduce the EU regulatory overload. The European Commission should deliver its commitment to reduce regulatory reporting by 25%. The industry also calls for new regulation to only be introduced when truly needed and that it be simple, proportionate, and avoid unintended consequences.

What does it mean for insurers?

As one of Europe's largest institutional investors, insurers play an important role as providers of stable and long-term funding. As such, they are well positioned, through their investments, to contribute to sustainable economic growth, and can help finance the transition to a greener and more resilient economy. In addition, improvements to prudential rules and the removal of unnecessary barriers should allow insurers to unleash more capital to help deliver better financial outcomes for the EU as a whole.

3. Europe's insurance and pension fund sectors stay resilient amid tense risk landscape

On 27th June 2024, EIOPA published its June 2024 Financial Stability Report which provided an update of key developments and risks in Europe's insurance and pensions sectors. We have noted the main insurance takeaways below:

- Insurers are navigating a macroeconomic environment that includes high geopolitical tensions, a number of elections in large economies, uncertainties about the economic outlook and waning support for globalisation and international cooperation.
- Europe's insurance sector has remained resilient overall and is well capitalised. Median solvency capital requirement (SCR) ratios for life and composite insurers have improved throughout the shift from low to higher interest rates, as have profitability levels.
- Insurers' liquid assets ratio has remained stable over the past years although there is considerable variation across countries.
- In response to the near zero-interest rate environment of the past decade, insurers searched for higher yields in alternative assets.
- European insurers continue to invest a large part of their portfolio in European assets. 87% of their sovereign bond investments, 80% of their equity holdings and 75% of their corporate bond investments go towards European countries and companies. The overall portfolio is heavily skewed towards fixed-income assets like government and corporate bonds, however, a significant part (16%) of their investments is in alternative assets, with real estate investments and private debt-related investments as the largest exposures.

What does it mean for insurers?

The latest Financial Stability Report is a timely reminder of the continued challenges the insurance industry faces, however, at the same time highlights how the industry in aggregate has remained resilient. From an asset allocation perspective, whilst the majority of insurers' portfolios continue to be heavily fixed income orientated, in recent years there has been a growing trend towards alternative assets. The report re-iterates some of the potential risks insurers should be mindful of, such as lower credit quality and higher leverage inherent in such investments, which could impact returns during downturns. As always, and with any investment, insurers should ensure any risk taken is proportionate to the level of business they underwrite and in line with solvency and liquidity requirements.

1. What's next? Bulk annuity insurers – PRA Speech

On the 25th April Lisa Leaman (Head of Division, London Markets at the PRA) gave a speech covering: the growth of the bulk purchase annuity (BPA) market, the proposed reforms to Matching Adjustment (MA - covered separately below), the potential for 'sandbox' assets in MA portfolios and what insurers can expect from the 2025 Life Insurance Stress Test (LIST).

The speech noted the improved funding positions of defined benefit pension schemes, in part a result of the new interest rate environment, and how this has contributed to an increase in demand for BPAs beyond what was forecasted just a few years ago.

Additionally, bulk annuity writers have utilised the capital released by risk margin reform to fund this increased demand. Complexity of transactions within the BPA space is also increasing, as some transactions now feature long price locks, deferred premiums and in specie premiums. These features can bring additional sensitivities to a firm's balance sheet and risk management challenges.

Sandboxes were noted as a recurring topic from the engagements between the PRA and the broader insurance industry. Here sandboxes are defined as creating an environment to explore, learn and develop assets for MA eligibility without obtaining full approval. Sandboxes are new proposals which were not considered in the PRA's consultation on MA reforms. One proposed model is to use a sandbox to obtain MA benefit for assets that a firm considers to be MA eligible, but for which the streamlined application process might be either too slow or costly. Another suggestion is a way to explore future eligibility for assets that are currently ineligible for the MA but which the firm nevertheless considers suitable to back annuity liabilities.

Before these sandboxes are introduced there are two hurdles:

1. the PRA has emphasised that the priority is to implement the existing proposed reform package fully before adding new complex features, and
2. there would need to be careful consideration that any additional benefits would add value to insurers' ability to invest productively in the UK economy without introducing unacceptable prudential risk.

To further explore this proposal, the PRA have convened a new Subject Expert Group with a panel of insurers. The purpose of the group is to explore the industry's suggestions on how to potentially develop proposals where there could be a strong benefits case with confidence of a broad take-up across the industry.

The 2025 LIST is set to include new exploratory features – one of the more significant components will be the inclusion of a sector-wide stress test of a firms' use of funded reinsurance. This is typically utilised by insurers to invest in a wider range of assets which may not be eligible for MA. This creates potential risks and capital strain on recapture if the collateral is not eligible for the MA. The stress test will assess the ability of firms to measure the risks associated with the recapture of funded reinsurance arrangements in stressed conditions.

What does this mean for insurers?

Where the BPA market has outgrown expectations and has evolved in complexity, insurers should be cautious of the additional attention that this will draw from the PRA in the future. Whilst, for now, the sentiment is one of expansion and facilitation through the reforms to MA, if this sector continues to grow as it has been, regulators may become more concerned by the size and evolution of risks held on insurers' balance sheets.

Sandboxes offer an exciting opportunity for insurers to potentially experiment with a wider range of investment assets in their MA portfolios. However, the PRA seems to be cautious around the timing and the extent of the rollout of this feature. Insurers should monitor the developments of the Subject Expert Group to assess when and how they will have these additional opportunities provided to them.

The key additions to the 2025 LIST that were included in the speech are of an exploratory nature and as such will only be published at an aggregate level. This removes a granular level of scrutiny, however the increased operational burden to provide this data will remain all the same. Life insurers should be prepared to manage the increased operational burden and any costs associated with this. Beyond the initial scope of the 2025 LIST, this may also indicate an increased level of scrutiny from the PRA concerning the assets held in funded reinsurance – namely their eligibility for MA. Life insurers utilising funded reinsurance should be aware of any further developments in case this may materially alter the assets that the funded reinsurer can hold.

2. Review of Solvency II – Reform of the Matching Adjustment

On the 6th June 2024 the PRA published its latest Policy Statement (PS) – PS10/24 concerning the proposed reforms to the MA regime as a result of the broader regime change from Solvency II to the new Solvency UK system. This PS was published taking into account the feedback from the earlier Consultation Paper (CP) – CP19/23, which outlined the initial proposed package of reforms enabling broader and quicker investment by insurers in their portfolios, while improving responsiveness to risk and enhancing firms' responsibility for risk management.

The resultant package of reforms outlined in this PS maintains most of the existing methodology and calibration of the fundamental spread (FS), broadens the MA eligibility criteria to allow assets with highly predictable (HP) cash flows, reforms the powers of the PRA where firms breach MA eligibility conditions and creates space for the PRA to make rules on other specific MA policy aspects. The reforms came into force as of 30th June 2024 and are intended to improve the way that the MA supports investment and to maintain a high level of prudential standards for the insurance sector and protection of insurance policyholders.

By means of a reminder, a high-level summary of the proposed reforms to MA in CP19/23 can be seen below:

Improving business flexibility

- Widening the range of investments that firms can hold in MA portfolios, with the intention of incentivising insurers to invest in a wider range of long-term, productive assets which have construction phases.
- Expanding the types of insurance businesses that can claim MA and removing some of the limits that may be claimed from sub-investment grade assets.

Being more responsive to the level of risk

- Established a streamlined MA application process for a range of suitable assets, proportionate to risk.
- Made the regulatory treatment of breaches of MA conditions more proportionate.
- Increased the granularity of the FS, reflecting differences in credit quality of firms' assets by rating notch and to improve the risk sensitivity of the FS used to calculate technical provisions.

Enhancing firms' responsibility for risk management

- Introduced an attestation process for the amount of MA benefit being claimed, to ensure that firms are accountable for the level of MA.
- Introduced the new Matching Adjustment Asset and Liability Information Return (MALIR), formalising the data submitted to the PRA by firms on the assets and liabilities in their portfolios.

As a result of the feedback received from CP19/23, below is a summary of the material changes made to the regulatory reform package:

- More flexible calibration of the additional matching tests to accommodate additional investment capacity in assets with HP cash flows.
- Amendments to the MA Statement of Policy for firms submitting MA applications, including reduced documentation requirements.
- Clarification that firms may perform an initial top-down analysis of assets by homogenous risk groups in MA attestations, followed by an examination of specific assets where necessary, to strike a balance between practicality and granularity.
- Removal from the MALIR instructions of the requirement for firms to submit detailed cashflow data extending beyond 50 years within the reporting.

What does this mean for insurers?

The changes proposed in CP19/23 were generally met with positive feedback from insurers. Additionally, the further changes made in this PS are fairly consistent with any constructive feedback received. As such, the new policy regime for MA should be positively received by insurers. Some commentators noted that the overall controls framework for assets with HP cash flows was too onerous, and that the PRA should have proposed wider criteria for asset eligibility. As such the PRA has permitted an even more flexible calibration of the additional matching tests, however some in the industry may still feel that this yet still does not go far enough.

The impact on the operational burden to insurers will be negligible (compared to the original set of reforms outlined in CP19/23) - the PRA considers that the ongoing compliance costs to firms will be reduced due to the simplifications to the MA attestation requirements for homogenous risk groups and corporate bond portfolios, simplifications to the MALIR template and widening of the MA liability eligibility criteria to include Group Dependant Annuities. However, costs are estimated to marginally increase due to a change in policy regarding auditors' focus on the correct application of mandatory FS additions.

Ultimately, the final package of reforms for MA will likely be received positively by the industry, permitting increased investment flexibility and accommodative reporting to match. Given that these reforms are already in place, insurers should be proactively reviewing their MA portfolios to assess how they can best capitalise on the broader range of eligible assets that can be included.

Insurance investment themes

Enhancing cash yields

The liquidity needs of any investor requires careful management and with the added oversight of regulators and overarching regulation, it is even more challenging for insurers. This together with near zero interest rates means cash has had its own challenges since the global financial crisis over a decade ago. However, on the back of soaring inflation and high-profile bank failures, the more elevated level of interest rates over the past two years have brought opportunities for yield enhancement. As inflation becomes more manageable and more stable around the long-term 2% target, global markets are beginning to price in interest rate cuts (our base case is one or two cuts for the UK before the end of 2024).

Most insurers will have some allocation to cash – whether this is for pure liquidity purposes, to match against very short-term liabilities, or as part of a more strategic allocation to aid diversification. As a result of recent market movements and the anticipated interest rate cuts, we highlight what insurers should now focus on and how they might best be able to meet their continuing requirements for security and capital preservation within their cash holdings.

Differentiation and diversification within cash

Cash, as an asset class, can describe many instruments or holdings – from bank deposits to very short-term bond instruments such as covered bonds, government paper, commercial paper and asset-backed securities (ABS). It is only through diversification across both counterparties and instrument types that investors have the potential to increase yield whilst simultaneously managing downside risk and volatility.

Figure 1 showcases three of Royal London Asset Management's cash solutions and highlights how the composition of a conventional liquidity portfolio, made up of high-quality deposits, could enhance yield in a risk aware manner by selectively adding different cash securities to the investible universe.

Figure 1: Cash and short term fixed income solutions

Liquidity	+	Plus	+	Enhanced
• Invest in a range of high quality banks – Consider liquidity versus return – Strong relationship with issuers – Robust ratings based approach – Monitor bank ratios and news flow • Strength and security through diversification		• Covered bonds Floating Rate Notes (FRNs) and Fixed • Short-dated corporate bonds (FRNs & Fixed) • Sovereign and Supranational bonds • Short-dated UK government bonds (Conventional & Index-Linked)		• Asset-backed securities (ABS)
Target SONIA		Target SONIA + 0.5%		Target SONIA + 1.0%

Source: RLAM

Past performance is not a guide to future performance.

Whilst the yields achieved on the spectrum of funds has been largely similar in recent months, the expected interest rate cuts on the horizon may provide additional opportunities to enhance yield for the more nimble investor.

In building our cash solutions we target instruments and exposures that are not subject to 'bail in' risk. Bail in was introduced in 2015 post the Global Financial Crisis by the EU Bank Recovery and Resolution Directive (BRRD) and aims to minimise taxpayers' exposure to banking failures. This means that if a bank gets into difficulty, bank assets are not 'bailed into' the wind-up process but ringfenced and remain liquid and available to pay cash flows to the bond holder. Fundamentally, this provides the investor with additional security in the event that anything were to go wrong. Secured bond obligations, like covered bonds, are a key cash instrument to our solutions' investable universe, and are exempt from this treatment under the BRRD. Covered bonds describe bonds backed by a large number of identifiable, high quality prime residential mortgages (with property as collateral). In these bonds, dual recourse means that bondholders have two sources of repayment: the issuer of the bond (a bank or building society for example), and the pool of mortgages that the bond is backed by. If the issuer defaults, bondholders have recourse to the mortgage pool, which is typically over-collateralised with low loan tovalue ratios.

Having these protections means insurers can potentially look to take the additional credit risk and slightly longer duration risk within their portfolios, but do so on a secured basis. In addition, the Standard Formula approach allows insurers to recognise this embedded security and reduces the capital requirements accordingly.

Embedding ESG within our cash solutions

All cash solutions at Royal London Asset Management integrate ESG risk assessment as part of the security selection process. We firmly believe that in-depth credit research, and considering a firm's ESG ethos, is fundamental in effective counterparty risk management. Such an integrated process enables us to not only manages the risk of default but can also help to deliver strong risk-adjusted returns for our clients. (ESG integration refers to the consideration of ESG risk as part of the investment process. It does not mean a strategy is trying to achieve a particular positive ESG outcome.)

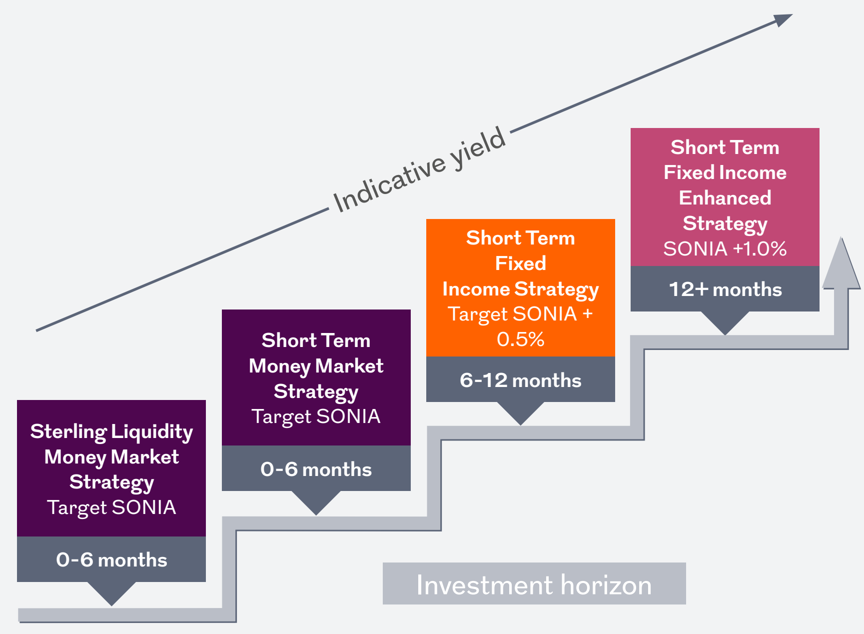
Preparing for the unexpected

The importance of cash as an investment asset for insurers coupled with anticipated interest rate cuts may prompt a review of short-term investments. However, we share a word of caution. If cash is being held in part to manage asset-liability mismatches then any potential gains, or indeed losses, need to be considered at the total balance sheet level, to allow for corresponding gains/losses in the liabilities. On the other hand, if investors are holding cash due to the benefits the market presented some 18 -24 months ago (low risk and 5%+ yield) then now may be a time to adjust positioning accordingly.

Whilst rates are not expected to fall back to the low levels seen before the pandemic, substantial cuts or cuts at a pace or magnitude larger than already priced into the market, may have a detrimental impact on yield which could impact future returns significantly. Nonetheless, investors need to consider the inverse relationship of price and yield (as yields fall, bond/cash prices rise). Consequently, interest rate (or yield) falls more than that priced in the market could give rise to significant portfolio gains that could be banked. Anecdotally, we have seen clients move to longer-dated cash strategies in an attempt to enhance the impact of larger than expected interest rate cuts if, and when, they were to occur.

Figure 2 shows how we visualise our spectrum of cash solutions at Royal London Asset Management and how robust yields could be maintained whilst seeking to ensure sufficient day-to-day liquidity through blending a mix of strategies, or liquidity laddering.

Figure 2: Liquidity laddering



Source: RLAM
Past performance is not a guide to future performance. For illustrative purposes only. This is not an investment recommendation.

Recent years have demonstrated the need to be ready for unexpected eventualities and risk events. While interest rates are expected to decline in the coming 6-18 months, there are a number of factors that could change this trajectory, including elections in the US and France, the new Labour government's Autumn Statement in the UK, and the risk that geopolitical conflict in the Middle East and Ukraine could disrupt supply chains again and prompt upward pressure on inflation. As such, an alternative view could be that central banks opt to leave rates higher for longer. Indeed, we have seen some policymaker votes for exactly this. In this scenario, insurers may want to be invested more in floating rate instruments, in which the coupon received by the investor is linked to the underlying interest rate plus a spread; another benefit of considering increasing the cash investable universe.

Investment risks

Past performance is not a guide to future performance. The value of investments and the income from them may go down as well as up and is not guaranteed. Investors may not get back the amount originally invested.

Credit Risk: Should the issuer of a fixed income security become unable to make income or capital payments, or their rating is downgraded, the value of that investment will fall. Fixed income securities that have a lower credit rating can pay a higher level of income and have an increased risk of default.

Interest Rate Risk: Fixed interest securities are particularly affected by trends in interest rates and inflation. If interest rates go up, the value of capital may fall, and vice versa. Inflation will also decrease the real value of capital.

EPM Techniques: The strategy may engage in EPM techniques including holdings of derivative instruments. Whilst intended to reduce risk, the use of these instruments may expose the strategy to increased price volatility.

Counterparty Risk: The insolvency of any institutions providing services such as safekeeping of assets or acting as counterparty to derivatives or other instruments, may expose the strategy to financial loss.

Stable NAV Risk: The strategy is not the same as a bank deposit account. It is designed such that it will seek, for the Distribution Classes, to maintain the Net Asset Value per Share at a fixed value by distributing income from the strategy as it arises. However, whilst the strategy's investments are reasonably believed by the Investment Manager to be of high quality, there is always a risk that an underlying issuer could default or otherwise fall in value, resulting in the strategy being unable to maintain the Net Asset Value per Share at a fixed value and therefore a loss of capital will occur. The risk of loss is to be borne by the investor. There is no representation or warranty that the strategy will be able to maintain a stable Net Asset Value per Share.

Inflation risk: Where the income yield is lower than the rate of inflation, the real value of your investment will reduce over time.

Money Market Strategy Risks: A Money Market strategy is not a guaranteed investment and is different from an investment in deposits. The principal invested in the strategy is capable of fluctuation and the risk of loss of the principal is to be borne by the investor. The strategy does not rely on external support for guaranteeing the liquidity of the strategy or stabilising the NAV per share.

Responsible Investment risk: The Royal London Sterling Liquidity Money Market strategy can only invest in holdings that demonstrate compliance with certain sustainable indicators or ESG characteristics. This reduces the number of securities in which the strategy can invest and there may as a result be occasions where it forgoes more strongly performing investment opportunities, potentially underperforming nonsustainable funds.

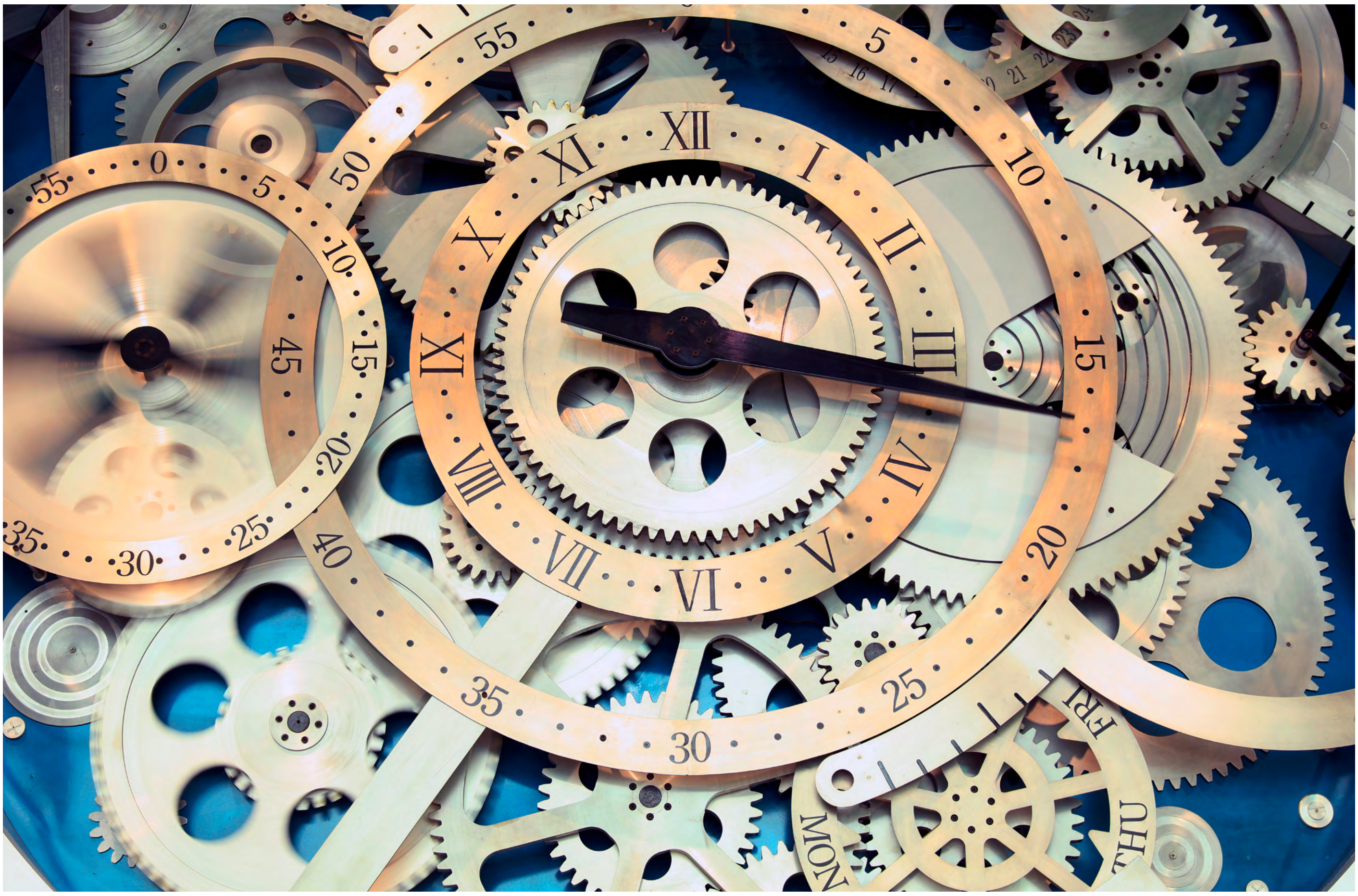
Appendix

Fixed income	Index used	Returns quoted
Euro Treasuries	Bloomberg Barclays Euro Treasury Index	EUR Hedged
US Treasuries	Bloomberg Barclays US Treasury Index	EUR Hedged
Euro IG Corporates	ICE BofA Euro Corporate & Pfandbrief Index	EUR Unhedged
Global IG Corporates	Bloomberg Barclays Global Aggregate Corporate Index	EUR Hedged
EMD	JPM GBI-EM Global Diversified Index	EUR Hedged
Global High Yield	ICE BofA BB-B Global Non-Financial High Yield Constrained Index	EUR Hedged

Equities	Index used	Returns quoted
Euro Equities	Euro Stoxx 50 Index	EUR unhedged
Global Equities	MSCI World Net Total Return GBP Index	EUR unhedged
EM Equities	MSCI Emerging Markets Net Total Return GBP Index	EUR unhedged

Volatility	Index used
Volatility	Cboe Volatility Index (VIX)

Source: Bloomberg, HIS Markit



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Royal London Asset Management
80 Fenchurch Street
London EC3M 4BY

For any queries or questions coming from UK or non-EEA potential investors, please contact:

institutional@rlam.co.uk
+44 (0)20 7506 6500

For any queries or questions coming from EEA potential investors, please contact:

Arnaud Gerard
FundRockDistribution S.A.
5 Heienhaff L-1736
Senningerberg
+352 691 992 088
arnaud.gerard@fundrock.com

We can provide this document in braille, large print and audio.

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