LDI 2025

A roadmap for European asset owners

JANUARY 2025

Communication for professional investors in Italy, France, Austria, Germany, Spain, Portugal and Luxembourg

The evolving market dynamics of 2025 are set to redefine the landscape for insurance portfolios, with diverging monetary policies, rising geopolitical risks, and the increasing importance of energy transition risk at the forefront. In this outlook, Generali Asset Management's LDI investment team explores strategic approaches to address these challenges, from optimizing duration and spread management under Solvency II to leveraging private assets for enhanced yields and stability.

- The recent transatlantic spread widening reflects divergent US and Euro Area economic paths, creating opportunities in euro government bonds and credit curve steepening.
- LDI portfolios must balance duration and spread duration positioning. Assessing the right entry level on credit and rates, while looking at opportunistic tactical hedging will be key for yield enhancement and Solvency II efficiency.
- Rising geopolitical risk in the Euro Area suggests diversified sovereign strategies and alignment with EIOPA portfolio metrics to ensure solvency stability.
- Transitioning to low-carbon investments will mean balancing ESG opportunities with legacy high-carbon yields amid evolving Solvency II regulations.
- Private assets continue to offer stable income and diversification, provided careful due diligence and expertise to mitigate risks and optimize returns.

The recent widening of the transatlantic spread points to a remarkable divergence between the US and the euro area (EA) economies. In the EA, subdued survey data, tariffs threats, and lower growth, coupled with political risks, point to a much steeper path of easing compared to the Fed. While this is reflected in repriced terminal rates across the Atlantic, any pull back in US rates, leading to a corresponding adjustment in EA rates, would create an attractive entry point for European government bonds (EGBs). Meanwhile, we see scope for further steepening in Euro rates.

On the geopolitical front, a further spread correction in France is likely to be needed to shift more debt to domestic investors.

Beyond sovereigns, Euro investment grade credit remains an appealing carry opportunity, supported by sound technicals and resilient fundamentals.

In this context, we think the credit curve steepening should be monitored to extend the spread duration of portfolios, given heavier capital requirements for insurances portfolio under Solvency II. We are looking for an additional 20 bps of steepening as a fair entry point.

While Euro high yield remains well supported by supply/ demand dynamics, historically stretched valuations require an extremely disciplined issuer selection over the medium term.

Chart 1: 10yr Treasury 10 Yr German Bund Yield Differential

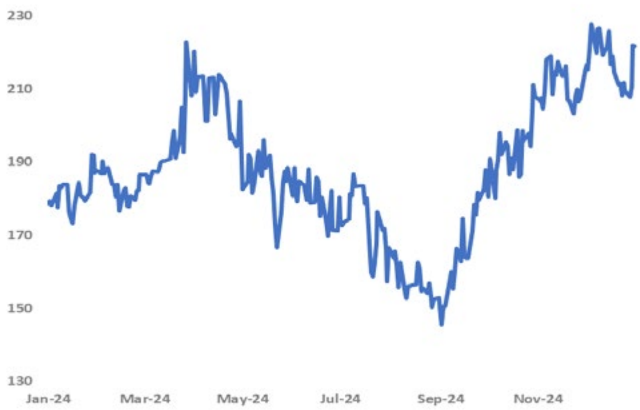
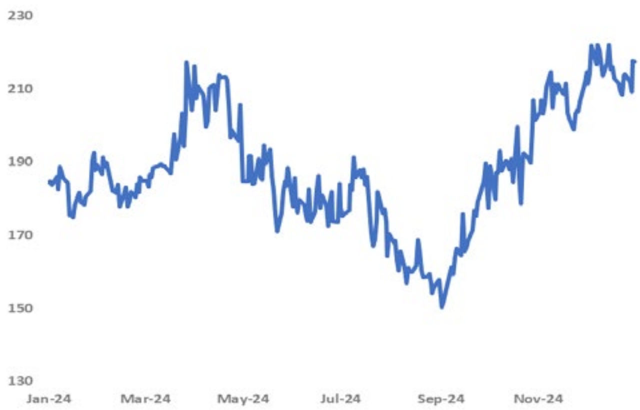


Chart 2: 30yr Treasury 30 Yr German Bund Yield Differential



[1]The European Insurance and Occupational Pensions Authority (EIOPA)
Chart 1 source: January 2025, Bloomberg
Chart 2 source: January 2025, Bloomberg

RISK-REWARD ACROSS DURATION AND SPREAD DURATION POSITIONING

Duration and spread duration positioning remain key for insurance portfolios. Successfully calibrating the two should aim to exploit yield enhancement opportunities, while preserving an adequate matching of liability flows, and to take advantage of any dislocation, to improve the available room for maneuver. Graduality will still be key in 2025.

In the EGB market, as we approach entry levels (ie 2.6 - 2.7% for 10-year Bund rates), improving cash flow matching in the intermediate tenors with asset liability matching (ALM) gaps would allow the relative exposure to curve risk to be minimized where it exists.

A constructive stance on duration could also help manage specific gaps with the EIOPA portfolio[1], minimizing own funds volatility (see below). To this end, and more generally, to shape duration positioning while yield enhancing returns, portfolio rotations, with predefined P&L budget are an efficient solution for LDI players.

In credit, the absolute yield and carry offered make corporate bonds a good candidate for LDI reinvestment strategies in 2025. While increased exposure to high quality credit would also be instrumental to managing the re-emerging sovereign risk in the EA, tactical hedging to reduce excessive spread duration exposure and free up solvency capital requirement (SCR) in the lower quality/rating pockets should be considered.

SOLVENCY AND LATE CYCLE CAPITAL STRUCTURE AND ISSUER RATING RISK

As is typical in late-mid cycle environments, higher beta credit clustered in the lower part of the capital structure has outperformed lower beta in total return terms in 2024. This has left pricing of extension risk for callable subordinated bonds across the capital structure on average more in line with valuations through the cycle, with little excess compensation for future non-call risk. This is even truer for low-coupon/low-reset bonds. Extension risk, which leads to higher duration to worst, should be monitored against the resulting higher capital charge under Solvency II.

As the credit cycle progresses, the tail risk of a gradual deterioration in credit fundamentals will increase. In Europe, cycles characterized by weaker PMIs have typically been associated with a pick-up in negative rating drift for euro investment grade credit before 2022. While this seems unlikely in a context of a still positive rating migration, we can't rule out a similar trend slowly resurfacing in the future.

Chart 3: Eur IG Net Rating Migration vs EA Composite PMI

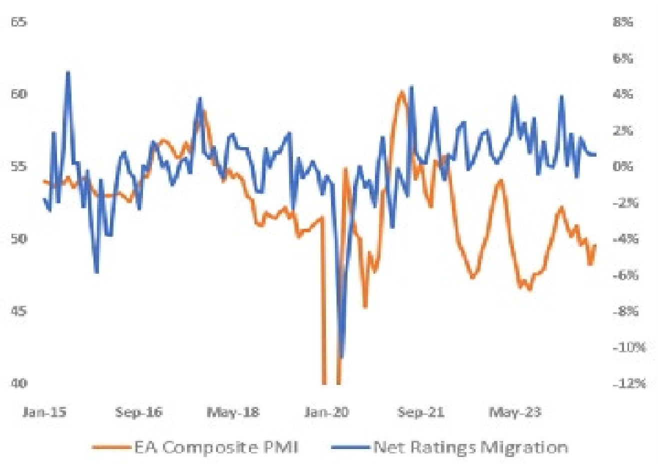
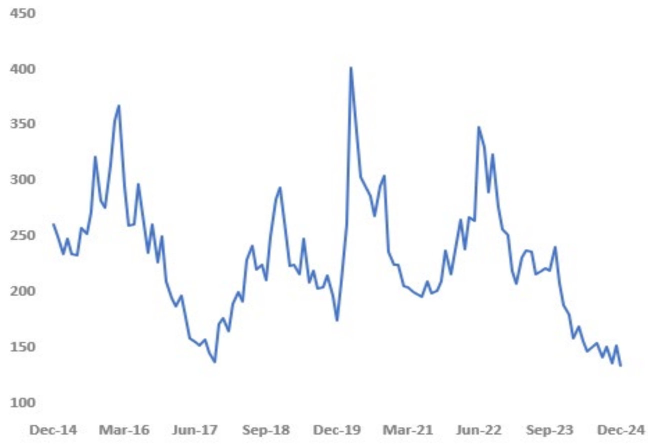


Chart 4: Spread Euro HY vs Euro IG



In fact, even if only few non-financial cyclical sectors have been hit by a structural wave of downgrades so far, the auto industry is a good example of how quickly things can escalate, impacting issuer fundamentals and causing rating agencies to rush to catch up.

Meanwhile, the banking sector continues to show strong rating resilience, with more potential upgrades than downgrades in the pipeline. This divergence could support an allocation that favours capital structure risk over pure HY risk, especially for LDI portfolios that can better weather short-term spread volatility instead of rating migration.

Preventing credit deterioration leading to downgrades and contagion risk will remain key for LDI investors in 2025. This requires active management to mitigate both the market and the solvency impact of potential credit deterioration.

We manage the latter through a strong rating migration probability assessment performed on single names by our internal credit research team and through quantitative market-implied contagion risk tools, aiming to anticipate the prevailing credit trends.

In this context, widening the investable universe will be key. Tranched structured finance instruments (euro CLOs, which are usually underrepresented in insurance asset mixes) should be evaluated, especially if they offer a relative value proposition versus euro IG.

SOVEREIGN RISK IN A PIVOTAL MOMENT: HOW TO RETHINK COUNTRY MIX

Rising EA political risk and unsolved geopolitical fractures around the world in a higher debt/low growth environment, needs a strategic rethinking of the sovereign asset mix, especially for long term investors.

The ongoing need to tackle ALM mismatches across the curve, and to minimize yield dilution when looking at potential alternatives, requires exploiting different levers and increasing diversification. Scalability is the obvious constraint, so multiple alternatives and non-Euro denominated opportunities should be explored.

Among the alternatives to a more traditional sovereign mix are supranationals. Given the expected issuance needs and a broad coverage across the curve, EU debt is an interesting candidate as well as providing an important source of ESG-labelled paper for investors aiming to reach pre-defined targets.

At the same time, evaluating cross-currency-hedged exposure to USTs, UKTs and JGBs, based on a close assessment of the relative value dynamics of both nominal and inflation-linked bonds (swapped into fixed rates), could be an attractive high-quality substitute for more traditional sovereign exposures.

Chart 3 source: 10th January 2024, MS, S&P Global
Chart 4 source: 31st December 2024, Bloomberg, ICE Bank of America

Chart 5: France 10YR CDS recent evolution

LIQUIDITY MANAGEMENT IN INSURANCE PORTFOLIOS

In a still volatile rate environment, managing liquidity in insurance portfolios remains crucial. This involves incorporating a liquidity ratio into ALM frameworks and performing extensive suites of liquidity stress scenarios as part of enterprise risk management (ERM) frameworks.

Effective liquidity management is the mark of a good balance between yield enhancement and the ability to meet policyholder obligations without incurring significant losses. Some capital regimes, such as Solvency II, explicitly account for three key components: the probability of policy surrender, changes in asset and liability values, and the liquidity of existing assets. However, their primary focus remains solvency. These regimes do not provide a quantitative measure or specific requirement for a company's liquidity position, but they do require comprehensive liquidity risk management practices. While it is clear that liquidity risk and required capital are interrelated (exposures that increase liquidity risk can have capital implications, and a stronger capital position can help manage liquidity risk) the explicit liquidity needs of a given liability portfolio are not directly addressed by capital alone. It is therefore critical to consider both capital and liquidity, rather than focusing solely on capital. We consider both liquidity and capital optimization in our LDI investment process, which allows us to effectively manage various market and liability stress scenarios.

BEWARE THE EIOPA CURVES: DEVIATE FROM THE EIOPA PORTFOLIOS WITH AWARENESS AND DISCIPLINE

Nevertheless, calibrating the best asset mix for an insurance portfolio is a complex alchemy that must embrace multiple dimensions, among which the solvency profile remains paramount. Not only must the overall solvency be evaluated in its static dimension, but its foreseeable trajectory under less normal market conditions must also be duly assessed. Solvency ratios that appear solid could in fact deteriorate rapidly due to adverse Own Funds volatility. In such situations, a swift portfolio repositioning is often not feasible due to adverse market conditions and accounting constraints that discourage the crystallization of losses.

Moreover, the static and dynamic dimensions of insurance solvency are often at odds with each other, as efficient asset mixes in terms of the overall SCR, both in the standard formula and internal model, can prove extremely fragile in the face of tail-end market scenarios affecting the most capital-light portion of the portfolio. Consider, for example, the most acute episodes of the sovereign crisis in the Eurozone over the last 15 years.

With this in mind, all possible scenarios for 2025 deserve to be evaluated in light of the main misalignments between the current portfolio composition and the EIOPA currency portfolio. Such misalignments could reduce the effectiveness of the volatility adjustment (VA) in adjusting the discount rate applied to liabilities, resulting in unexpected hits to the Own Funds and the solvency of the company.

Worryingly, sovereign risk is resurfacing in forms that are substantiallychanging geographies in eurozone. While the French political crisis is the most obvious epicenter, it is not the only factor of a risk that is unfolding across Germany and shaking the countries potentially most exposed to the new US tariff regimes. Reading the new map of geopolitical risk, understanding how portfolios are positioned for it, and making strategic changes to protect stability is a crucial exercise where repositioning with respect to the EIOPA could be a key aspect.

As we believe that the French sovereign risk does not yet fully reward for the potential risks of a slippery political transition, we recommend a neutral exposure to the EIOPA curves in terms of DV01, favoring a positioning that would protect against a potential bear flattening of OAT spreads. Moreover, such positioning would potentially make the resulting portfolio rebalancing more P&L bearable, as longer-term OATs are more likely to be deeply loss-making than short and intermediate ones.

Driven by multiple factors, including concerning expectations for the sovereign bond pipeline, the widening of swap spreads also comes with its solvency bill, which threatens to have a greater impact on portfolios underexposed to credit (especially IG) and overexposed to government bonds due to the greater resilience of the former.

It is therefore even more important to measure the main asset-liability mismatches in relation to the EIOPA portfolio.

This is why we have developed a simple DV01 based approach which considers the tail correlation between each cluster of the EIOPA portfolio and the main source of risk identified by the portfolio gap analysis. The overall misalignment is then estimated by a simple indicator, the *adjusted mismatch factor*:

$$\sum_i Corr_{i,OATs} * DV01Gap_i$$

The "adjusted mismatch factor" is equal to the sum of the products of the correlation of each cluster with the main source of risk (the French OAT in this case) and the DV01 gap of the selected cluster. Although correlations are inherently subject to estimations, hypotheses, and methodological assumptions, they do not allow each gap to be treated in terms of its absolute size, but rather capture the role that correlation can play for Own Funds stability.

TRANSITION RISK AND SECTOR ALLOCATION: HOW TO REINVEST

Transitioning to a low-carbon economy poses varying risks across sectors. Insurers must adjust strategies to mitigate losses and capitalize on greener investments. Strategies can range from a run-off approach to abrupt portfolio rebalancing, but the economics of these options cannot be fully defined in advance due to market dependencies and the unpredictable nature of transition risks. There may be a trade-off between prolonged exposure to high-carbon portfolios and the dilution of returns from rapid divestment. Although the market returns of carbon-intensive sectors such as oil and gas are not significantly different from the average investment grade market, legacy high carbon exposures can often be associated with higher book yields. As such, the negative impact of reducing exposure to transition risk sectors is more related to investors' specific positioning and book yields than to market yield differentials.

Regulatory shifts, such as Solvency II revisions, could increase capital charges for high-carbon assets, pushing demand toward ESG-compliant investments. As a Net Zero Asset Owner Alliance member, Generali

Chart 5 source: 10th January 2025, Bloomberg

Asset Management favors gradual reinvestment in maturing high-carbon exposures, while engaging with carbon-intensive issuers to support sustainable and virtuous decarbonization paths, and maintaining exposure to issuers with credible transition strategies.

CLIMATE RISK AND SOLVENCY II

As part of the ongoing Solvency II review, and within the broader topic of market risk capital requirements, EIOPA is analyzing the potential link between equities, spreads and real estate risks and transition risks. EIOPA has found that bonds and equities linked to fossil fuels present a higher risk than those exposed to other activities, justifying a prudential approach, and recommending additional dedicated capital charges for fossil fuellinked assets. Although no immediate formal capital adjustments are yet required, insurers may need to adapt their investment strategies to optimize holdings for new sustainability-linked charges.

EIOPA's evidence shows that insurance companies still hold a low share of EU Taxonomy-aligned assets, likely due to the strict taxonomy KPIs. From a market impact perspective, the strong focus on ESG risks could shift preferences towards assets with strong ESG credentials and EU Taxonomy-aligned issuers, driving demand for the new EU Standard Green Bonds. Capital charges mitigation through the instrumental use of green bonds for climate-exposed companies is an open debate; referencing the EU Taxonomy can support transparency and a more accurate identification of the degree of sustainability for specific securities. Rigorous analysis of issuers' business and transition plans therefore remains crucial for assessing sustainability-linked market risks and capturing opportunities in transitioning sectors.

THE STRUCTURAL ROLE OF PRIVATE ASSETS

Private assets will continue to be essential in 2025.

Stable and recurring income distributions, coupled with resilience and the advantage of low to negative correlation with public markets remain compelling features of private asset investments.

On the debt side, floating rate-cash coupons, opportunistically chosen equity-kicker components, senior ranking in the capital structure and security package, and covenants, are valuable features if liquidity risk is wisely managed at a holistic level.

Although limited liquidity has often been seen as a constraint, this is where opportunities lie, as private debt still benefits from a hefty premium over public assets. Investors are fairly compensated for their willingness to tie up capital for 5 to 15 years, the typical lifecycle of private debt and private equity investments. A market study by the Journal of Alternative Investments in 2020 found that US private equity buyouts, including management fees, outperformed the S&P 500 by 2.3% to 3.4% a year between 1986 and 2017.

Despite the scarcity of academic literature on private debt, a market study run by Vlerick Business School in 2022 looked at the performance of private debt funds by collecting timed cash flow data on 448 funds with vintages years from 1986 to 2018. On average, these vintages of private debt funds realized a 9.2% IRR net of fees for investors between 1996 and 2020. Comparing the performance of private debt funds with public IG and HY bonds, private debt outperformed by 8% and 6%, respectively over the period. Interestingly, there is a material dispersion of this premium across the underlying asset classes, reflecting a variety of factors such as customization, idiosyncratic assets properties, lack of price conveyance, as well as complexity caused by asymmetric information, cost of analysis, origination, and negotiations.

As private asset strategies require highly specialized skills, indirect investment (through specialized asset managers) can be a helpful deployment option as the fees are more than compensated by the additional returns.

In this case, proper due diligence should aim to assess that:

- The investment is structured by reasonable fund Investment guidelines to filter deals, but avoid material and unreasonable restrictions that could lead to concentration or prevent rapid deployment.

- Fund governance ensures protective rights of investors while preserving the discretion of the asset manager.

- The market momentum assessment allows the right choice of fund strategy to maximize returns and deployment.

- The structure of the asset manager, team and track record ensures regular deployment, deal quality, active management, error mitigation, capital preservation, and extra-returns. Underwriting, structuring, speed, and workout capabilities are key.

- The asset manager's market footprint which, alongside track record, ensures proper fund raising, origination, geographic diversification, and the ability to be selective.

- The structure of the asset manager, team and track record ensures regular deployment, deal quality, active management, error mitigation, capital preservation, and extra-returns. Underwriting, structuring, speed, and workout capabilities are key.

- The asset manager's market footprint which, alongside track record, ensures proper fund raising, origination, geographic diversification, and the ability to be selective.

In short, the insurance portfolio management toolkit in 2025 must be as complex as the financial, regulatory and accounting dimensions that drive it. If more ordinary market phases and political cycles allow strategic management of the portfolio within sometimes wide margins, more complex phases - such as 2025 promises to be - require a more sophisticated approach in a context where constraints and uncertainties can lead to very dispersed payoffs.

2025 is likely to be a year of strategic changes in LDI portfolios, affecting geographical dimensions, interest rate and spread dynamics, and overall sustainability, which in terms of climate and transaction risk is increasingly instrumental for sound solvency.

AUTHORS

Sebastiano CHIODINO
Head of Liability Driven Investing

Amir FERGANI
Head of Credit - LDI

Giulio FAVARETTO
Head of Fixed Income - LDI

Matteo SOLIN
Head of Government Bonds - LDI

Stefano MANSERVISI
Head of Indirect and Alternative investments - LDI