Angel Oak
CAPITAL ADVISORS

Q&A: Alternative Investment Strategies for Insurance Investors

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Insurance companies face unique challenges in today's market. Angel Oak Capital Advisors is helping insurance company clients meet these challenges with vertically integrated origination platforms and access to unique assets that provide diversification to corporate credit.

In the following pages, Manish Valecha, head of client solutions, Adam Beeler, head of institutional sales, and Emma Quigley, senior vice president of institutional business development, provide an overview of the increase in allocations to alternatives among insurance companies, diversification opportunities in commercial and residential real estate, and how insurance companies can take advantage of these timely opportunities.

Q: What challenges are insurance companies facing in terms of reaching their return targets and managing downside risk in today's market?

A: The challenges are primarily driven by what has been a persistently low-yield environment. Although rates are increasing, finding attractive risk-adjusted yield is top of mind for insurance companies when trying to meet their liabilities. We have seen insurance companies of all sizes try to push into private debt and alternatives when looking to diversify away from traditional fixed income. These companies want to optimize the performance of their general accounts, meet future liabilities, generate growth, and improve profitability in a very competitive environment. On top of that, they must meet regulatory ratings-driven and capital treatment constraints. Angel Oak has spent a lot of time thinking about what we can do to help insurance companies solve this problem.

Q: The increase in illiquidity and complexity in insurance portfolios is tied to an increase in allocations to alternatives. Why is that? Are there particular sectors within alts that seem to be trending?

A: Asset classes such as asset-backed securities (ABSs), collateralized loan obligations (CLOs), private loans, and other alternative credit have benefited from a push away from traditional fixed income. These are asset classes in which banks have taken a step back and alternative asset managers have stepped in to fill the void. Managers are able to generate credit profiles with attractive risk-adjusted returns under conservative credit metrics. Structured credit, particularly asset classes like CLOs and RMBS, has demonstrated its resiliency through a range of economic environments, and that has encouraged insurance companies to increase their allocation in this area.

Q: Which asset classes within the broader alternatives universe offer diversification from the primary risk exposures found within insurance portfolios?

A: The residential mortgage space offers very attractive diversification, particularly given the metrics around which mortgages are being originated today in the non-QM market. These metrics include FICO scores above 740 and LTVs in the low 70s, with a weighted average coupon that continues to climb in a rising rate environment. From the inception of our program in 2015 to present, the coupon has been between 4.5 and 7.5% depending on the securitization market. This asset class offers a good risk-adjusted yield on a levered or unlevered basis. We also see many opportunities in financials credit and commercial real estate (CRE); the financial sector has been very resilient after the credit crisis, with higher capital levels. Within CRE, we are focused on the middle-market space, which we find to be less competitive.

Q: Angel Oak has unique experience in residential mortgage credit. What are some benefits of allocating to residential credit within insurance portfolios?

A: There has not been any style drift in our non-QM loan origination since we began buying these loans from our affiliates in 2015. Our attention and dedication to underwriting quality non-QM loans has not wavered, and this consistent, quality credit underwriting should provide confidence to insurance companies that partner with Angel Oak. Since 2015, our average LTVs have been in the low 70s and average FICOs have increased 60 points to 740+. Over that time, we have originated more than $11B across more than 27,000 individual loans. Currently, we see unlevered coupons of newly originated non-QM loans in the 6%+ range with a strong fundamental backdrop in both U.S. residential housing and consumer markets. We believe this asset class could be a good diversifier away from corporate bond exposure. In addition, the beneficial capital treatment and potential financing available via the Federal Home Loan Bank have been positive tailwinds for our insurance company clients when pledging non-QM loans.

Q: How is Angel Oak integrating ESG principles within these asset classes?

A: ESG has been integral to Angel Oak's investment thesis since our early years, as we moved into non-QM and sought areas where we could provide credit to an underserved borrower base. We became a UNPRI signatory in 2017 and have worked diligently to map the United Nations Sustainable Development Goals to areas in which we are very active within our verticals, including non-QM financials and CRE. We have made an impact within the financial space by working with financial institutions and small banks to disclose their carbon footprints and the impact they have on the E part of the ESG framework. We continue to invest heavy resources in this area, and we expect to continue making progress here.

Q: What solutions has Angel Oak provided to insurance companies to help them access alternatives in the face of the high capital charges often seen in typical LP structures?

A: We have both a deep origination platform and a great deal of experience on the capital markets side. In terms of capital efficiency and optimizing insurance company portfolios, we have spent a lot of time thinking through rated note structures and pass-through securitizations. Angel Oak seeks to deliver some of the raw material that we manufacture in-house from an origination perspective in a way that optimizes capital efficiency for an insurance company. The regulatory environment is evolving, and we strive to be a partner to insurers with holistic strategies.

Q: CRE has been a stable allocation in insurance portfolios for quite some time. What unique opportunities does Angel Oak see within the U.S. CRE market today?

A: Angel Oak Commercial Lending is a small-balance commercial and bridge lending originator. Given our national footprint with in-house underwriting and origination, we have the capabilities to underwrite to a box or provide access to markets that may be overlooked and then create specific SMAs—complementing, perhaps, an existing in-house strategy that may have higher balanced loans. Our custom solutions, which are a direct result of our vertical integration, allow us to provide true value as an investment partner. We believe our access to the national footprint of our originators brings an enormous amount to the table. For example, there are secondary and tertiary markets that insurance companies might like to participate in, but they may not have the bandwidth or the capabilities to underwrite and originate effectively and efficiently.

Q: Given Angel Oak's ability across mortgage credit, its vertically integrated platform, and, in particular, how whole loans have the potential to be a capital-efficient solution for insurers, what investment strategies has Angel Oak thought of around that opportunity?

A: We have dedicated a lot of time to listening to the needs of insurance companies in our effort to become a true outsourced partner as a vertically aligned originator. We are originating non-QM, other non-agencies, prime-jumbo, high-balance agency, small-balance commercial, and commercial bridge products, among others, each of which provides efficient capital treatment for insurers. Angel Oak's ability to provide this solution to insurance companies, proactively look ahead to the products of tomorrow, and secure proper financing for loans is where we truly add value.

Q: Angel Oak has been an active investor in regional and community banks and other financial institutions for some time. We have a broad platform across mutual funds, publicly traded closed-end funds, private CDOs, and securitizations around these asset classes. Do you think insurers would find financials credit attractive in today's market?

A: Absolutely. Insurance companies are participating in new-issue regional community bank subordinated debt as an asset class. Post-crisis, banks have generally had clean balance sheets because they have de-risked and de-levered. They are often flooded with assets and have the opportunity to grow in their markets. We have already mentioned the ESG side of what community banks are currently

doing and what they will need to do, and our team is at the forefront of that movement. Angel Oak Capital Advisors is arguably one of the most active participants and buyers of new-issue regional community bank subordinated debt in the U.S. From an accounting standpoint, these deals offer unique structures; they are often ten-year bonds with a five-year no-call period. This asset class can also provide low volatility, and banks and financials are historically the two sectors that tend to outperform in a rising rate environment, which appears to be the direction we are headed. This sector is arguably the most de-levered in the current marketplace. While it's a niche market, it is rapidly growing and giving investors what we consider high-yield type returns with a potential IG credit rating.

Q: What is Angel Oak Capital Advisors' and Angel Oak Insurance Solutions' value proposition for insurance companies? How might they think about taking advantage of the opportunities covered here?

A: Our value proposition for insurance companies is our ability to source, underwrite, originate, and build custom solutions, be it on the residential or commercial loan side. On the origination side, with our retail and wholesale mortgage originators, Angel Oak is one of the largest single-licensed mortgage originators in the country. We provide insurance companies with access to rated feeder structures and non-QM loan SMAs. In addition, our conduit programs allow us to source agency-backed pools, including high-balance agency, second homes, and agency CMOs. We also offer support to mortgage desks at the top of the funnel, such as designing programs for very specific mortgage products that help offset some liability need. Designing these programs and staying in conversation with insurance companies as changes occur in the landscape are things we are dedicated to doing. We know a one-size-fits-all product does not work here. Insurance companies are increasingly looking at alternatives, new ways to source products, and new and interesting structures, and Angel Oak has built a platform that supports them in these efforts.

Manish Valecha, CFA®
Head of Client Solutions

Adam Beeler
Head of Institutional Sales

Emma Quigley
Senior Vice President of Institutional Business Development

DEFINITIONS AND DISCLOSURES

ABS: Asset-backed security.

CDO: Collateralized debt obligation.

CLO: Collateralized loan obligation.

CRE: Commercial real estate.

FICO: Fair Isaac Corporation.

Non-QM: Non-qualified mortgage.

RMBS: Residential mortgage-backed security.

Loan-to-value (LTV): A calculation to determine the ratio of a loan to the value of an asset purchased.

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