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Understanding the value of traditional GICs: A research- and return-based perspective

Putnam believes guaranteed investment contracts (GICs) can often be an attractive investment for a stable value strategy, offering diversification and the ability to structure the timing of cash flows.

Our conviction to use GICs is backed by dedicated research from our insurance analysts who provide industry, company, and security-specific research and recommendations to our portfolio management team.

We continue to have a stable credit outlook for life insurance companies that issue GICs, especially given their resilience through the recent inflationary environment and market volatility.

We believe GIC markets can often be inefficiently priced, often offering a return premium to cash investments. We seek to exploit these opportunities within our stable value portfolios.

Guaranteed investment contracts (GICs) offer many attractive benefits for a stable value strategy. First, they can act as diversifiers to many of the underlying securities in the synthetic components used in stable value portfolios. Second, they provide the opportunity to customize the timing of cash flows while adding a desirable level of stability to the overall crediting rate of stable value portfolios. Third, GICs can offer a return premium over cash bonds in many interest-rate and market environments.

Despite these potential advantages, questions about the use of GICs persist as part of a legacy of misunderstanding about how the instruments work and the history of their use. In this paper, we explain why we believe GICs should play an important role in stable value portfolios. To better understand these instruments, Putnam's insurance analysts offer a "specialist's perspective" on GICs, the overall insurance industry, Putnam's process for research and selection, and potential return benefits for investors.

GICs and the life insurance industry: Brief history

The insurance industry has changed very modestly in the past 20 to 30 years in terms of its basic function. At the highest level, it's a protection business. The life

insurance industry, specifically, offers products that aim to give its customers peace of mind by providing income and payouts that can stabilize a household's finances particularly during difficult times. This important aspect of the business has not changed.

What has changed is how insurance companies manage their balance sheets on both the asset and liability side. Up until the late 1980s, firms managed assets in what may be described as an uneventful fashion. However, from the early 1990s through the 2008 financial crisis, some companies took on greater risk to boost their value, pushing into sectors that proved volatile and ultimately detrimental to their standing. This led to a small number of insurance company defaults in the 1990s and heightened earnings and balance sheet stress during the Great Financial Crisis in 2008/2009. Additionally, many well-known insurance companies shifted from being "mutual" companies (policyholder-owned) to becoming public companies around the year 2000. With shareholders to satisfy, this gave some of these firms an incentive to attempt to increase profits by focusing more on short-term results versus long-term stability.

As part of this short-term focus, some new products were introduced with particularly attractive features for customers in order to drive new sales, such as guarantees tied to "high-water mark" stock market levels. Many of these products proved very complicated for firms to manage effectively and increased operating leverage. During the 2008–2009 financial crisis, when stock market values dropped more than 40%, some of the product guarantees became very costly to the firms and undermined their once robust capital positions. This scenario exposed balance sheets that were not sufficiently capitalized, requiring them to absorb losses on the guarantees, which negatively impacted equity holders and subordinated bondholders. However, policyholders (like life insurance customers and GIC contract holders) were protected from adversity and losses in this scenario, owing to them being at the top of the liability capital structure.

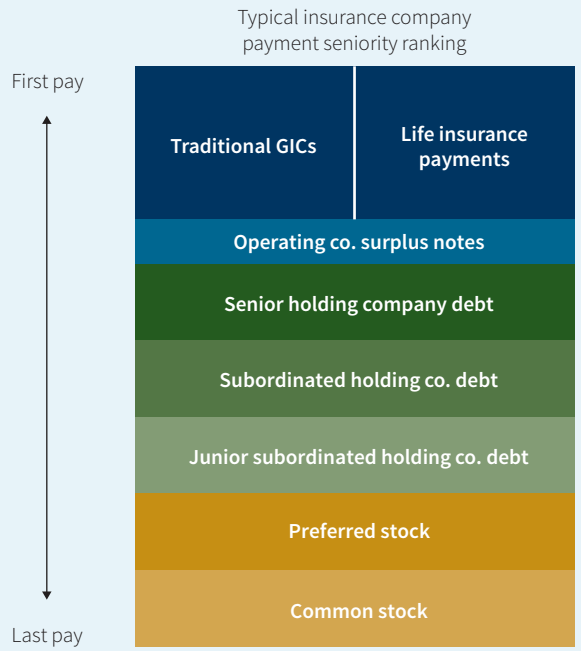
Fortunately, the industry learned some important lessons from the fallout of these two episodes and made changes to its investment and capital building strategies. Today, insurance companies have reduced risk in their products and services, which we expect to allow the industry to navigate economic uncertainty more effectively going forward. Since the 2008 period, insurance companies — both mutual and publicly owned firms — have built a much more stable profile, in our view. Many phased out their more complicated and potentially volatile products, and they have taken risk off of their balance sheets by more actively accessing the services of reinsurance companies. In particular, we believe that the insurance companies we purchase GICs from have solid balance sheets and continue to offer a wide variety of safer

What is a traditional GIC?

A traditional guaranteed investment contract (GIC) is an investment contract issued by an AA-rated or A-rated insurance company or its affiliate. The buyer, or contract holder, pays the insurance company/issuer for the contract, which then invests those proceeds in its general account.

The interest rate — known as the crediting rate in the stable value context — may be fixed or floating and is based on the assets available for investment by the issuer as well as that issuer's assessment of the risk associated with the plan(s) and the specific investment manager purchasing the contract.

The "guaranteed" portion of the name indicates that principal and interest are guaranteed by the insurance company. In other words, the guarantee is as good as the credit risk of the issuer. Stable value funds using GICs typically develop a diversified exposure employing a number of issuers.



products that are both useful to customers and profitable for the issuer.

As noted, a key advantage for GIC contract holders continues to be their position at the top of the capital structure. Contract holders are effectively equivalent to insurance policy holders, supported and backed by an insurance company's general account assets, ranking above all senior unsecured bondholders. In a few cases, where regulators have been asked to step in to assist in resolving insurance company issues, regulators have upheld the stated contract provisions and logically treated GIC holders as "pari passu" ("equal" on the capital structure) to life insurance policy holders. As a result, GIC holders have historically received their full principal plus accumulated interest. Said differently to date, GIC contracts have never experienced a loss following an insurance company default.

Insurance sector credit quality remains resilient

Putnam continues to have a stable credit outlook for its approved list of insurance companies that issue GICs. In our opinion, the companies have healthy capital positions and diversified asset profiles, notably composed of Treasuries and Federal Home Loan Bank securities, as well as high-quality corporate, structured credit, mortgage loans and municipal bonds, that they use to back up their guaranteed products. Owing largely to their profiles, the life insurance industry has successfully navigated recent challenges, including the pandemic era and volatility across capital markets. We believe the sector should remain well prepared to absorb possible future events, including a recession and its potential impacts to asset quality and earnings. Rating agency downgrades of investment positions during periods of stress have applied pressure to capital ratios and will likely continue to do so but diversification and strong capital positions have allowed companies to weather the events. GIC issuer balance sheets also maintain strong liquidity characteristics with manageable exposures to less-liquid investments, including alternatives.

As mentioned, the product mix that insurers offer today is more conservative than in the past. Riskier strategies featuring products with excessive and overly generous guarantees have been closed in favor of more conservative product offerings. Similarly, product crediting rates (coupon rates paid to policyholders) had been reset lower over the past several years following the decline in marketwide interest rates, cushioning margins and cash flow. We continue to believe such operational flexibility as well as steady sources of investable monies are important attributes of these entities and will have favorable implications in future periods. Guaranteed products like GICs remained in demand during the period of declining interest rates, owing to their features and benefits, and should remain attractive even with interest rates having reset higher, owing to the ability of insurers' investment teams being able to source accretive opportunities to match against higher borrowing costs. In this way, disintermediation risk remains modest, especially considering the unique ability of life insurers to provide guaranteed income streams across a range of products. We continue to believe these factors are important with respect to the long-term outlook for these firms.

We also maintain strong conviction that insurers will continue to manage their liabilities effectively. We believe the actuarial analysis that supports their liabilities offers a high degree of certainty with respect to numerous scenario outcomes. As noted on the investment side above, our GIC issuers also exhibited good management on the liability/policyholder side through prior periods of stress such as the pandemic, not experiencing any material claims payments stemming from the health crisis. Furthermore, despite frequently volatile capital markets and episodic crisis events such as the pandemic, our insurers have been able to absorb financial impacts and claims while continuing to maintain strong and stable credit profiles for quite some time. Overall, this performance reinforces our view of operational and financial stability.

Evaluating GIC issuers: Bottom-up fundamental analysis is the key

At Putnam, rigorous fundamental bottom-up analysis is the underpinning to developing a set of rankings for the GIC issuers on our Approved List. We track numerous capital ratios and try to understand how the corporate management teams are thinking about them. The purpose is to understand a given firm's liquidity profile today and where it may go in the future. We analyze the firm's product offerings to gain an understanding of which ones are working and which

appear challenged. Underwriting performance is also important. We look at the level and types of risks that each firm is insuring. Here, our research focus also examines expenses, specifically how much is utilized in claim costs. With this framework, we endeavor to compare which companies carry greater risks in their liability base.

Key metrics for evaluating GIC issuers include:

- Capital ratio analysis
- Liquidity analysis
- Underwriting analysis
- General account analysis

On the asset side of the balance sheet, we closely monitor investment and asset quality performance as well as potential impacts to capital levels. Examining realized and unrealized capital gains and losses, particularly as they relate to credit events versus interest-rate impacts, and speaking with the insurers on any disclosures are useful as part of this process. Additionally, we evaluate various qualitative aspects of the life insurance companies' business. These include the use of mergers & acquisitions as a business development and growth strategy, and consistency from year to year.

With the insights from this research, we develop an Approved List of issuing companies, and we invest assets only with the firms on this list. We segment the approved issuers into three tiers and set specific limits on how much of the portfolio can be allocated to a given issuer, depending on the tier in which they reside. Our focus is ultimately on the quality of each company's credit profile.

Tier	Quality level	Maximum investment
1	Strongest credit profile, high level of business diversification	12%
2	Strong credit profile, albeit lower quality than tier 1	8%
3	More regionally focused, less business diversification	6%

For illustrative purposes only. Putnam's specific approach and positioning may change based on numerous factors. Diversification does not assure a profit or protect against loss.

We actively manage the Approved List by formally revisiting our views of each company every quarter. The list is fluid so changes can happen quarter to quarter; however, in general, movements are infrequent given the long-term stability of most issuers. Companies can change tiers, but it usually only happens when there is a major event and a substantial part of their business experiences a positive or negative development.

It's also worth noting that beyond our fundamental research, understanding the macro environment and its effect on the insurance sector overall is also very important. We stay informed about the industry and individual companies through industry conferences and meetings/conference calls with company executives. The quarterly calls with the companies give us an opportunity to ask direct questions about individual performance as well as the macroeconomic concerns of the management teams.

Formal review of GIC issuers: A team effort

Our dedicated insurance analysts work in partnership with our Stable Value Portfolio Management team in the research and selection process for our portfolios. A calendar of weekly and monthly meetings structures their formal interactions. The insurance industry analysts communicate research views and any other relevant information in these meetings to the broader investment team, including portfolio managers who invest in other debt securities issued by insurance companies. As part of the process, collaboration with the rating agencies also takes place to help ensure we obtain timely information for investment decisions, especially around potential ratings changes. Interactions are also ad hoc, particularly if pertinent information may affect the fundamental backdrop of a company on the Approved List or when there is a new entrant in the GIC market.

The quarterly industry updates prepared by our corporate research analysts also drive further interaction between analysts and portfolio managers. As a part of the industry updates, analysts ordinally rank each company they cover within the sector based on their fundamental profile. As it relates to the insurance industry, quarterly industry updates typically align with any changes to the GIC issuer Approved List. It's a collaborative process with an established structure for communicating key information on a timely basis.

The case for GICs in a stable value strategy

We believe GICs can provide a number of advantages to stable value portfolios. They can offer stability and flexibility in the areas of credit risk and term structure risk, and, more importantly, they possess critical characteristics important to stable value funds: liquidity, diversification, and crediting-rate enhancement. Here is a summary:

Senior in the capital structure

A GIC is a senior security in an insurance company's capital structure, while a corporate bond typically is not. In other words, GICs have a higher claim on an insurer's assets, equivalent to life insurance policies, while corporate bonds generally come behind first- or second-lien bank loans. When comparing a corporate bond rated single A or AA with a similarly rated insurance company, the credit risk is lower for the GIC due to its structural advantage of residing at the top of the payment hierarchy.

Customizable term structure

Investors can select varied principal, interest, and maturity payment dates for each GIC they purchase. This is important to managers who prize liquidity as a key component of the overall stable value strategy; they can structure cash flows for when they are most needed, such as in the case of known plan events. The maturity can be made on designated dates of the manager's choice at the time the contract is negotiated.

Liquidity

Traditional GICs are private placement securities and cannot be sold on a secondary market. However, that does not render them illiquid. Indeed, for all participant activity and select plan-level activity, traditional GICs are 100% liquid due to their contractual provisions, which allow them to be "sold" back to the issuer at par.

Source: Putnam.

Diversification potential

Traditional GICs are backed by long-tenured, major U.S. insurance companies. Robust capacity parameters guide their traditional GIC issuance. This means that even modest GIC exposures can offer possible diversification benefits to investors in terms of quality, sector rotation, and security selection.

Crediting-rate stability

Traditional GICs are always held at par. Therefore, they do not fluctuate in price when interest rates move, and for that reason, they are insulated from term structure risk. In this respect, traditional GICs are excellent stabilizers for the crediting rate and market-to-book ratio of stable value funds. This feature serves to offset some of the volatility in synthetic GICs, which fluctuate in value due to interest-rate changes and other factors.

Return potential

We believe traditional GICs provide return advantages over cash bonds held in synthetic GICs in various interest-rate and market environments. Inefficiencies exist in the GIC market to the investor's advantage that rarely exist in cash bond markets.

GIC investment return potential: An inefficient market in the investor's favor

In many interest-rate and market environments, GICs have provided a return advantage over the cash bonds that are utilized in wrapped synthetic strategies. Further, in many situations a higher-rated firm has offered more attractive terms than a lower-rated firm; for example, an AA-rated firm can offer a higher rate than an A-rated firm. This allows the manager to potentially enhance the average quality of the portfolio while increasing total return at the same time. This phenomenon rarely occurs in the cash bond markets, as any anomaly that exists is quickly arbitraged away. While we clearly understand that past performance is not always indicative of future results, we argue that the persistence of these advantages and inefficiencies cannot be ignored.

We have always believed that stable value is the same as any other investment discipline: It is important to use as many independent strategies/securities as possible in order to have a better chance of maximizing the long-term return potential for clients. Prudently allocating to GICs when the yields exhibit premiums over cash bonds helps us in pursuit of this goal.

Putting it all together: GICs — A positive component of stable value strategies

As discussed, we believe GICs offer very compelling features to a stable value strategy that are unavailable in other assets and types of securities. The investment performance record of these securities has been historically attractive over many different market environments, in contrast to the lingering misperceptions surrounding their safety and stability. Life insurance companies have weathered many crises in the past, and we believe the industry has evolved and is much healthier today. In our view, many life insurance companies offer highly compelling products and manage their balance sheets well. They also operate within a strict regulatory regime that is designed to reinforce and protect the senior capital structure status of GIC contracts. With our primary focus on liquidity management for stable value, a differentiator for Putnam, we expect to continue to utilize these important instruments where appropriate as a core component of our diversified stable value strategy.

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