INVESTMENT

Avoiding catastrophe

Lynn Strongin Dodds **explains the advantages of investing in catastrophe bonds and the overall outlook for the insurance-linked securities market in 2016**

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The impact of climate change may be increasingly important criteria in the investment decision-making process but ironically it is the lack of weather-related events that has impacted the catastrophe bond market. Other parts of the insurance-linked securities (IS) market look more attractive but the risks are also higher due to the illiquidity.

This is borne out by the recent study conducted by Willis Capital Markets & Advisory, the investment banking business of global advisory company, Willis Towers Watson. The overall ILS market hit a new high of $70 billion last year, up from $65 billion in 2014. The most active part were collateralised reinsurance agreements, bespoke private transactions that are drawn up between the reinsurer and individual investors and to a lesser extent, sidecars. These are special purpose vehicles a reinsurer will use to facilitate third-party investors to participate in collateralised reinsurance deals.

Catastrophe or cat bonds, which are roughly 30% of the overall market, remain the most popular part of the market with pension funds due to liquidity. However, issuance dropped to $6.2 billion in 2015 compared to the record $8 billion

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level of issuance the previous year. Part of the reason was the lack of headline-grabbing deals such as Citizens Property Insurance Corp's $1.5 billion bond, which bumped up 2014 numbers.

In addition, yields slid to around 5% from the loftier 10% plus levels in 2013. Overcrowding is one answer but it is not the full explanation. "Although many investors think the mass amounts of money going into asset class has pushed yields down, the main reason is the cyclical nature of the reinsurance industry whereby premiums tend to be highest immediately after a large disaster," Schroders investment director, product manager insurance linked securities Tim van Duren says.

"The last two years has been relatively quiet, particularly in the US, which is the largest chunk of the market. There was a rally during hurricane season, which is August to mid-October, but then things moved sideways."

These securities had once been the preserve of specialist hedge funds and asset managers endowed with disaster risk acumen, but as interest rates plummeted they attracted yield-hungry institutions. They are not that easy to understand though and there needs to be more education around their particular nuances.

Parametric triggers

For example van Duren notes many use 'parametric triggers' which means that the insured event is not linked to actual claims made, but rather to the occurrence of a specific and measurable incident, such as wind-speed reaching a certain level in a specific location, or the occurrence of an earthquake of particular strength in a given area. They incur losses only in the event of disasters and the performance of cat bonds and more generally ILS is linked to the frequency and severity of natural catastrophe events.

AXA IM head of ILS Francois Divet also explains that although a large proportion of the bonds issued are linked to hurricanes in the US, there are also assets exposed to earthquakes and storms. Assessing the risk and damage of these requires complex cat models and associated software as well as in-depth knowledge of the different building codes in each country.

Climate change

At the moment the effects of climate change are not really integrated into the analysis. One reason is the contradictory picture that has been painted. For example, research published last May by Florida State geography professor Jim Elsner and Namyoung Kang, deputy director of the National Typhoon Center in South Korea, found that warmer ocean temperatures, caused by climate change, may be fuelling stronger hurricanes, while at the same time, creating fewer storms.

In addition, analysts at Schroders also argued that due to various factors, including the short-term nature of ILS and reinsurance transactions, climate change's "impact on insurance-linked instruments is more limited than one would expect at first glance". Typically, a catastrophe bond offers protection over a three-year period, while private catastrophe bonds only have a one-year contract. In some cases the duration of an ILS transaction can be even less.

"Investors are not really looking at

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climate change when investing in cat bonds," Mercer principal Robert Howie says. "Climate change requires a 10-year plus view while cat bonds are typically short contracts and pricing is determined by events or lack of events in developed markets such as North America, Europe and Japan. The last major event was the earthquake in Japan in 2011 and even though there has been an increase in flooding in Europe, this is not considered a major catastrophe."

Industry participants, though believe more attention should be paid to the inherent advantages of the asset class. "At 5%, they are not a screaming opportunity but you need to take the 10,000 feet view of cat bonds," Russell Investments head of fixed income research Adam Smears adds. "Yields may be relatively low compared to historical levels but that is because risk premium is low due to fewer weather events. However, over the long term, it has a total return profile similar to high yield, which is one of the best performers of the fixed income sector but with a lower volatility experience."

For example, Swiss Re figures show that its Global Cat Bond Total Return Index, which tracks the performance of the outstanding catastrophe bond market over time, generated an average annual gain of 8.33% between 2002 and the beginning of 2015, which was slightly above the Barclays Ba US High Yield performance of 8.24% and much higher than the S&P 500 Total Return Index of just 6.54%.

Volatility and diversification

In terms of volatility, Global Cat Bond Total Return Index gave investors a much smoother ride in that it had not dipped into negative territory during the time period and only moved a little over 10% from its lowest period in 2005 to its highest point in 2007. By comparison, the Barclays Ba US High Yield index jumped around 65% between 2008 and 2009, while the S&P index shifted over 70%, having dropped a massive 40% in one year.

Other benefits often highlighted are diversification. Twelve Capital AG executive director and head of catastrophe bonds Roman Maraviev, points out that these bonds are attractive because they have a low level of correlation to other financial risks and can reduce tail risks in other parts of an investor's portfolio, whilst at the same time offering attractive potential returns.

"The other differentiated feature for catastrophe bonds is that there is reduced credit risk associated with such investments, as these are all collateralised transactions where the collateral is generally invested in high quality securities such as US T-bills. Also, unlike many traditional bonds, price fluctuations based on non-quantifiable external factors such as strategic decisions from company management are of a lower concern," he adds.

Adopting a wider horizon could also improve returns. "In a lowly correlated asset class, there is a big opportunity to construct global portfolios but you need to pay attention to the underlying risk of the bond," Lombard Odier Investment Managers chief investment officer Jan Straatman says. "The modelling and analysis to do so are time consuming but it allows you to get diversification to regions with different catastrophical and geographical risks."

Looking ahead, analysts believe that rising interest rates in the US and another year of benign catastrophe losses in the rear-view mirror will translate into growth for the ILS market in 2016 but not at the same pace as previous years. The view is that established investors who have a strong grasp of the asset class, a long-term investment horizon as well as well-diversified portfolios will be the main players. They are expected to increase their allocation although overall cat bonds typically account for 1% of the total portfolio with ILS representing no more than 5%. ■