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ALLOCATOR QUARTERLY

Investment Theme Analysis

Professional Investors

Editorial

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We have always suggested that investors need to take a medium-term, if not long-term, view on their asset allocation. If they don't, they may run the risk of becoming traders, always arguing with the markets over the next up and down swings.

Nothing could suit this view more than the Insurance Linked Securities asset class. A quasi fixed income type product with the added bonus of non-correlation to other major asset classes. At least in theory.

In this edition of Allocator Quarterly we wish to point out a few challenges this asset class faces following a phenomenal run over the past several years.

Our thoughts are mainly anchored on two key elements: (I) we have been surprised by the sheer volume of fund flow into the asset class and question how much of it is coming from naïve allocations, i.e. those who focus on past returns and do not take full account of the risk of the underlying insurance contracts, and (II) we are surprised that so many investors are willing to be exposed to the same perils, thus running a significant cluster risk should things go awry.

In our review of the sector and the general investment theme, we have discussed the potential for the asset class in Asia. No doubt we have encountered many views but most certainly the vast majority believe(d) that this asset class will not take off in Asia.

We beg to differ.

The editorial deadline for this piece was November 9th, 2015.

Asset Class Review

Focus on Opportunities beyond US Cat and ILS Bonds

- US CAT BONDS ARE OVERBOUGHT AND OWNERSHIP IS CONCENTRATED AMONG THE TOP 10 ASSET MANAGERS
- ASIA IS A GREENFIELD MARKET FOR ILS ASSET MANAGERS – A GOLDEN OPPORTUNITY

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Investors, rightly or wrongly, worry about their portfolio a great deal. Some actually lose sleep over it.

Not so much the Insurance Linked Securities portfolio managers one would think. Risks are specified upfront, mostly on an annual basis with a three year duration, deals locked-in and then the waiting game begins.

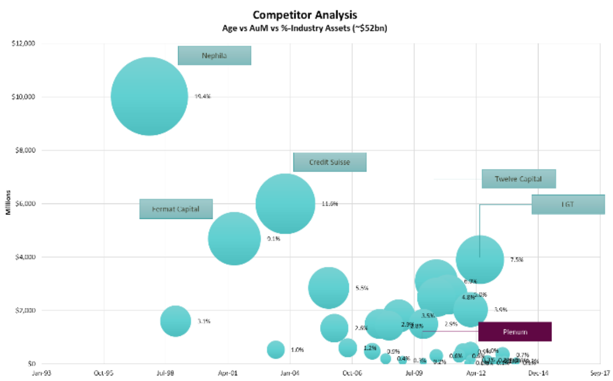
Will the hurricane season be as bad as last year, the year before or worse as ever recorded? Should we expect an earthquake in California next year, the year after, ever?

Well, that does not sound like a job that expends too much energy on behalf of the PM. Maybe the Cedants, mainly insurers and reinsurers, and with them the investors, pensions fund holders and other stakeholders, should be worried, too.

No doubt, the industry has done well over the past few years. Initially risk was priced somewhere in the region of 8-10% over Libor, meaning investors would clip a significant coupon in a low interest rate environment. It also provided the added bonus of tail-risk portfolio insurance.

As money flew into the industry, the increased competition for deals depressed risk premia, with some tranches only offering low single-digit returns to the investor, with the actual underlying risk remaining unchanged.

Figure 1 - ILS Asset Manager Competitor Analysis



So why is there still so much capital inflow in the sector and why are large Private Equity houses interested in asset managers operating in this sector?

A simplistic view would state that in the absence of choice, Insurance Linked Securities provide a great alternative to cash as a near-cash type instrument. For some, it is perceived as low risk-type investment. And therein lies one of the short-comings as we point out below.

Another challenge is that there is a significant capital overhang that is seeking a home. Investors have struggled with finding the balance between equity allocations and a conservative approach to preserving capital during a time when global risks have become more uncertain and less measurable.

The CIOs who have taken a conservative view have probably been punished as the market has kept moving up despite the global macro backdrop not painting a rosy picture. Indeed, it appears we are in a late cycle run but somehow the market does not want to reflect the economic reality, yet.

As a consequence, Insurance Linked Securities are likely to see further capital commitments in an already overhyped asset class when things do get tough. The number of deals coming to market is stubbornly at par with 2014 (see here for a list of announced deals). However there is evidence that underlying insured perils, are more diversified than a year earlier. Specifically, North American Wind has come down from some 65-70% to 50-55% whilst European Earthquake has been made an entry into the market.

In contrast to the argument above, with interest rate increases in the US and elsewhere likely in 2016, the marginal benefit of owning Insurance Linked Securities and Catastrophe Bonds in a portfolio diminishes, especially if the pricing remains strong.

So what to do?

Our recommendation with ILS Asset Managers has been to consider diversifying across other perils, and we are aware that some managers are working on solutions, to start focusing on risks in Asia.

We have had many conversations with portfolio managers, brokers and insurance specialists who shot down our suggestion as simply not viable. For one, the insurance risks in Asia are nowhere near the levels as they are in the US/ Europe.

Despite quake events supporting our argument for such type of product in Asia, we have to admit that there is still limited uptake for insurance products in the region. Also the insurance value of damaged assets and the resulting business interruption, where businesses were affected, is relatively low.

For example, the People's Insurance Company Group of China (PICC) paid CNY243m (ca $40m) in insurance claims following a 8.1 magnitude earthquake in Nepal, the largest such payment in the region's history. In contrast, in Japan, whose insurance market is more mature than the rest of Asia, the three largest non-life insurance groups are expected to pay around JPY100bn (ca $830m) for a series of typhoon related events earlier this year.

Asia

We first suggested Asia as a suitable geography for diversification to a client in April 2014.

Yes, we were early and that is exactly the point we were making. As the ILS and Cat Bond markets mature and capital inflows continue, a 'spill-over' destination somewhere else is needed to absorb that amount of capital.

Naturally, new markets tend to command a higher premium for the risk that is being taken. The main argument against our thesis at the time was that Asia does not have such a robust history of measuring and accounting for the insurance losses experienced, i.e. there are no databases that provide enough data for the insurance groups to back-test scenarios.

And here is our argument for Asia: although many suggest that there is a meeting of minds between insurance providers and capital markets, we disagree – this has not been the case for now. Capital Markets seek out risks to earn a decent return – many may look at it the other way round but the argument is the same. While insurers simply do not like risk that is non-measurable based on history.

We conclude that those investors who seek to earn a return stream that is anywhere near the traditional risk/ return promise of Cat Bonds/ Insurance Linked Securities should go East. At least, they may get the pricing of risks these deals deserve.

Since Katrina hit New Orleans in 2005, the Nat Cat industry had been free of a major catastrophe, resulting in a significant drop in insurance premiums, as well as investment returns related to those risks. It is time that investors in this asset class understand that they are taking up significant risks, and that they should be rewarded accordingly. ✦

Market Analysis

Does this asset class merit a second look – now that interest rates are deemed to rise

- INVESTORS BEWARE: INTEREST RATES WILL RISE, SOONER OR LATER
- DIVERSIFY YOUR CAT BOND AND ILS BASKET AND LOOK EAST: THE OPPORTUNITY SET IS PROBABLY COMPARABLE TO ILS IN US/EU IN THE LATE 1990S

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We would suggest that one needs to tread carefully. Interest rates around the world are likely to rise, sooner or later. This will provide significant headwinds for the asset class.

By the same token, we are positive that the asset class will mature. Other non-life perils will be looked at (eg pooling of automotive and household insurance, to name just two examples) and geographic depth and breadth are likely to develop. Those who take an early look may get rewarded handsomely, ceteris paribus.

We are still in an early review stage regarding other non-life perils stage, though we have had some interesting discussions with leading industry experts endorsing our outlook.

On geographic broadening of the investable universe, we are vocal about Asia, and, no doubt, Latin America and Africa are likely to follow suit, if we also include agricultural risks impacted by catastrophic events under our umbrella of non-life risks.

At the present time, we note that some of the largest asset managers in the ILS space are rumoured to have returned capital to investors, having been unable to deploy it satisfactorily. If true, a clear warning sign that there is a significant overhang of investor capital in traditional ILS and Cat Bond products.

Strategy

Strategically, we are making the point that there is no brand equity for any ILS asset manager in Asia. Even within their respective home markets, ILS and Cat Bond asset management houses are not well known outside a specialized circle of investors.

This presents a significant opportunity for a Tier 2 asset manager to launch a platform out of Asia, Hong Kong or possibly Singapore. The potential flow of Assets under Management may over time equal or even surpass those we have seen in Europe and the US over the past 20 years. But it takes relatively deep pockets, patience and a strong regional network.

Commercial Rationale

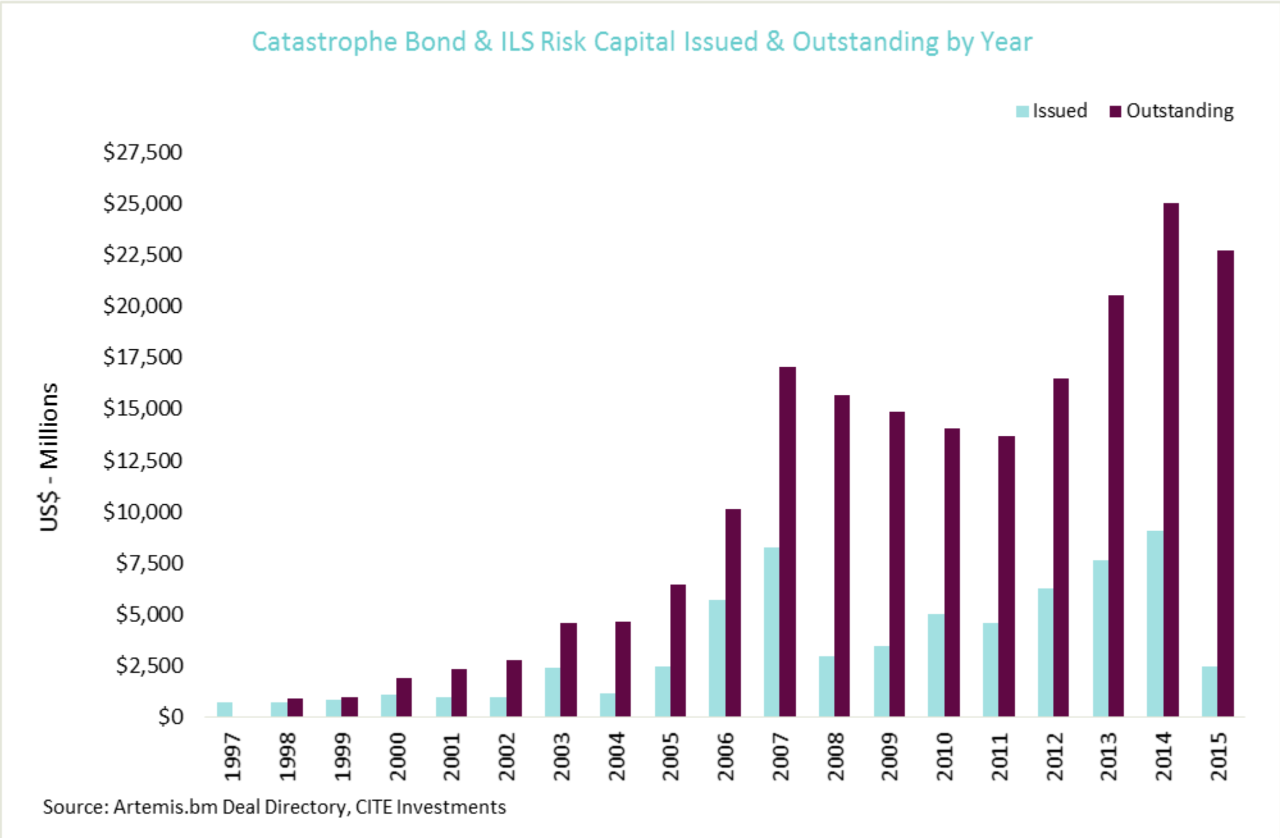
The rationale for a Tier 2 player is simple: for ILS managers with several USD billion of AuM, the benefit of investing time and resources into what is likely to be a rather small total portfolio makes no commercial sense. Adding, say $100m via an Asia ILS or Cat Bond product, to a $1bn+ portfolio simply does not make enough of a difference to the P&L.

However, a smaller, say sub-$500m AuM Cat Bond/ ILS Asset Manager would see a significant de-risking of its business model (with some higher operating costs in the short-term), whilst simultaneously opening avenues for future growth. This would also allow those managers to re-engage with investors, who have *traditional* exposure to US/ European ILS managers, and would not consider switching to a smaller fund, but who might consider allocating a small portion of their ILS allocation to a regional specialist, reducing their manager risk in the process.

Size of the Opportunity

Insured risks will increase in Asia, there is no doubt about it. Asset values have increased significantly over the past 10+ years, and it is only a matter of time before the commercial rationale will dictate to take out insurance against catastrophic events.

The graph below (including Q1/15) lists the historical development of ILS assets under management globally, starting in 1997. Being critical, it took the industry quite some time before lift-off. However, once it started moving it moved dramatically (what one should keep in mind is that the majority of issuance is rolled-over on an annual or three-year period).



If we infer a similar development pattern for Asia, we are at a very early stage indeed. However, we would expect that it will not take as long for the market to develop vs US/Europe, as investors have already walked down an experience curve, and are now more comfortable with the asset class as a whole.

Critical Path and Industry Drivers

What many industry participants and investors underestimate is the risk associated with the global supply chain when major events such as earthquakes, hurricanes and floods happen. The most prominent example is the Tepco (Fukushima nuclear plant) disaster in Japan, which forced global producers in a variety of sectors to slow down or even halt production, triggered by the inability to get products out of Japan for a significant period of time. This kind of risk is often beyond the scope of modern insurance contracts. ✦

Opportunity

Global market opportunity for the not so faint-hearted Pension Fund CIO

- THINKING STRATEGICALLY ABOUT ASSET LIABILITY PLANNING
- PREPARING TRUSTEES FOR THE CHALLENGES AHEAD AND HOW TO PROPOSE NOVEL SOLUTIONS AS AN OPPORTUNITY

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Having been engaged in the insurance industry for over 20 years, one thing is apparent: the same trends and themes come and go.

It is probably no surprise that large insurance groups acquired ILS asset managers to only sell them off at a later stage, probably at the wrong time in the cycle.

Here we go again

Recent industry moves such as Amlin Insurance acquiring Leadenhall Capital in two stages, only re-enforce that view. Amlin itself has now been acquired, though this is unlikely to be driven by the Leadenhall deal.

Simultaneously, we have seen insurers launch their own versions of Cat Bond/ ILS asset managers, if not to only demonstrate a capital market competence to their client base.

We have mentioned that Private Equity firms have taken note. For some, it may come as no surprise that KKR's acquisition of Nephila Capital in January 2013 actually supported their earnings and accounted for a significant part of KKR's income, as PE returns have tailed off.

Patience & Partnering

It would be arrogant to suggest that Pension Fund and Endowment CIOs take a deeper look at the industry drivers for Cat Bonds and ILS, as well as their own current portfolio allocations.

No doubt, portfolio reshuffling due to annual roll over towards the tail end of 2015/ early 2016 provides an opportunity to assess the duration liabilities on many investment books. With the income component still challenged, there is some hope on the horizon that interest rates will finally move easing some of that pressure.

However, that move is likely to be slow and measured and at a risk of curbing any hope for the world to rebalance and indeed to grow. Capital investments are likely to be shelved with the spare capital needing a home, if not some form of investment.

With the risk of GDP growth slowing globally, the investment universe will feel smaller.

Large asset managers do not have the Holy Grail, or better solutions at hand. Perhaps, they will be slower to adopt to that new cycle compared to smaller, more nimble players.

A case could be made that CIOs should prepare their trustees and investment committees for the next wave of potential underperformance. As difficult at this may sound.

There are alternative scenarios, no doubt. Specifically, there could be a surprise on global consumption, and in turn it could drive investment. It seems unlikely. But we are positive that the Asian (Emerging Market) consumer train is in motion, and is simply on a slight uphill at present.

We highlighted above that the ILS market moved significantly when the global risk seemed unbearable around the Bear Sterns, Lehman Brothers and Madoff crises. This time it will not be isolated events that may shock the system but the general lack of energy in the markets to keep supporting current levels.

Innovative thinking and novel solutions will be rewarded

A lot of time is spent satisfying paper requirement such as target asset allocation (TAA) and strategic asset allocation (SAA) models, often sponsored by pension fund consultants.

These models are allegedly helping to mitigate impact of losses, ensuring certain target returns can be achieved etc.

We are more critical in our views on investment allocation. Reshuffling a portfolio with long duration liabilities should be done with great care and aim to achieve both: income generation to ensure payment of current liabilities, and capital growth. The said capital growth cannot be achieved, in particular in a low growth, low interest rate environment, without innovative and perceivably risky investments.

In line with the theme of this Allocator Quarterly, we have already highlighted our stance toward potential solutions in the ILS space, with the idea of allocating a portion of the fixed income/ cash bucket to emerging Asia Cat Bond/ Insurance Linked Securities asset managers.

This type of allocation will be initially difficult to explain to many trustees and investment committees, although the precedent has been set by the US/ European asset managers. It will take some stamina and patience to see these investments through.

Equally, the initial investment will be small which may not sit well with typical minimum investment requirements allocators have to contend with. However, the objective is to scale into the Asian opportunity allowing that portion of the portfolio to grow to a significant size over time.

Dialogue

Whilst CITE does not offer products in the Cat Bond and ILS market, the team has spent significant time assessing asset managers in this space.

This is a call to those CIOs who wish to discuss our view in more detail, but who would also like to discuss concrete steps that could be taken.

The team has some significant relationships in the ILS space that could facilitate some of the objectives mentioned above.

Do not hesitate to reach out to myself, as I am more than happy to have a confidential discussion before taking any formal steps.

Best regards

Martin Schramm

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Hurricane Isabel by NASA Goddard Space Flight Center, April 21 2010