

Compiling Your Options: Portfolio Management

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Cat Risk Management – Marcus Evans

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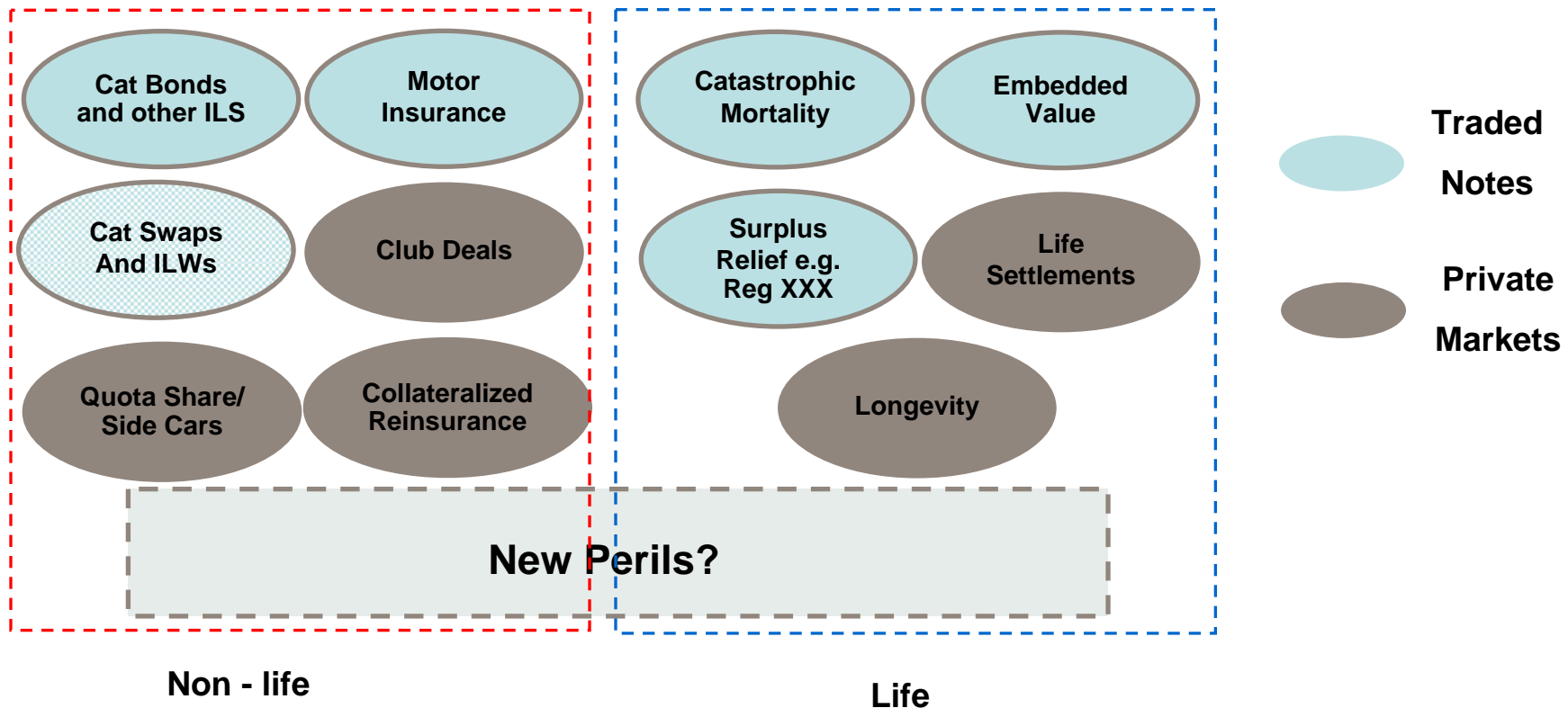
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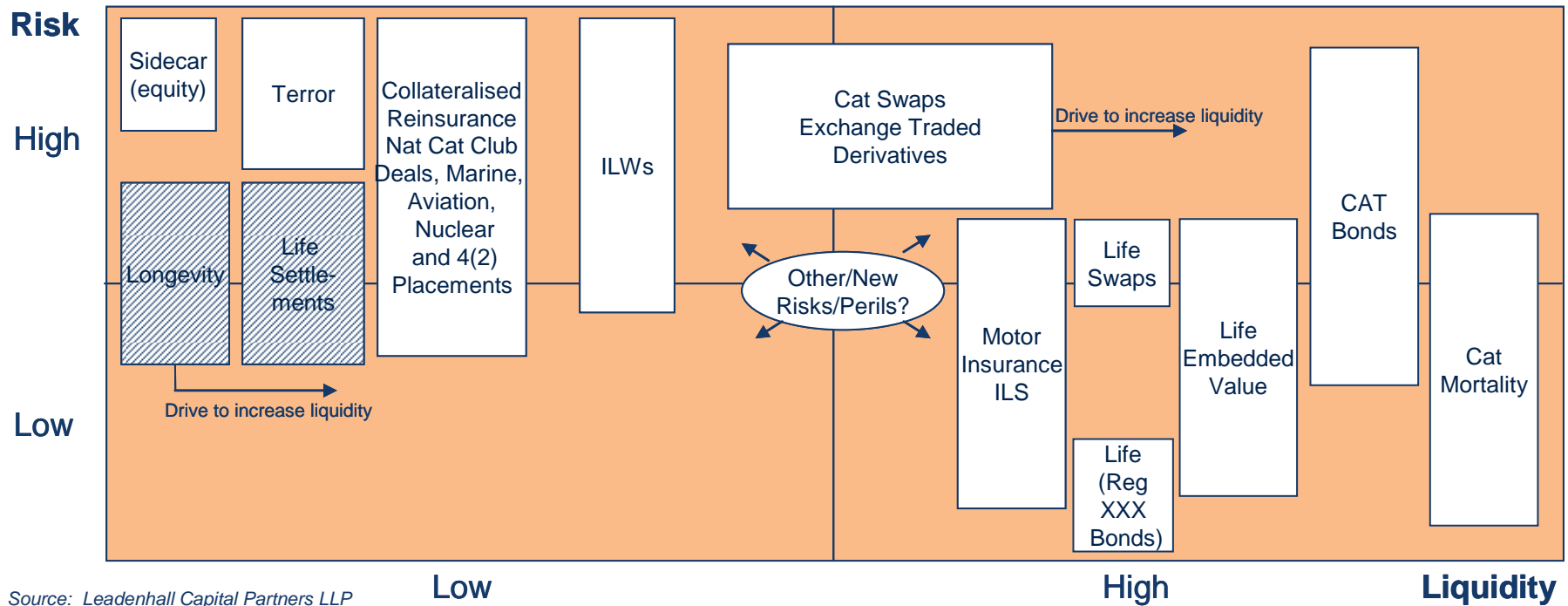
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- The sustained growth of the insurance linked investment market led to a number of developments:
 - Different types of **protection buyers** with different needs approach insurance capital markets
 - Different types of **instruments** have been developed to address specific needs of protection buyers
 - A **dedicated investor base** with specialised knowledge has been developed, also preventing contamination from the turbulent status of the securitised markets
 - **Modelling and analysis** of insurance capital markets instruments have expanded, and **rating agencies** have further developed its methodology for insurance capital markets instruments
 - **Portfolio management tools** for insurance risk have been developed (albeit with a focus on non life in current status) to facilitate the monitoring of insurance linked investments
- The total market (between public and private transaction in life and non life sectors) backed by capital markets investors has grown to the size of a large reinsurance company and has become an integral part of the reinsurance industry landscape
- The new insurance linked investments landscape poses investors new challenges and opportunities

- Many instruments are being used to transfer insurance linked risk to the capital markets
- We believe all instruments play a role in a portfolio strategy to ensure liquidity, profitability and growth



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- Leadenhall initial strategies have a greater focus on non life and have **no longevity or life settlements exposure**



Source: Leadenhall Capital Partners LLP

Note: Leadenhall does not invest in the above 'shaded' instruments

- For many years, the common theme has been that ILS was:
 - more expensive than traditional reinsurance for traditional buyers, and
 - competitive for retrocession buyers (but in the latter case it needed to be in parametric form, thus adding basis risk to the cover)
- Extra premium/cost payable by traditional buyers was justified (among other things) by:
 - Lack of counterparty risk (full collateralisation)
 - Multi year cover at fixed price (committed capacity)
 - Alternative capacity (post Katrina capital markets supported many programs)
- Extra premium on ILS products has increased around the financial crisis
- Investors in ILS had reasons to be pleased with ILS performance and liquidity during the financial crisis:
 - Sellers found a home for their bond at acceptable prices unlike traditional assets classes
 - The low correlation to traditional capital markets was proven in one of the most severe tests in history
 - Underlying sector profitability has increased, whilst structural risks have diminished

- Having observed ILS behaviour in the financial crisis new investors entered the market
- Investors included large pension funds which have injected significant fresh capital in strategies looking for low risk ILS
- Issuance size and diversity has increased but at times demand for low risk and for diversifying investments has been strong and outpaced supply
- As a result pricing of ILS and traditional reinsurance have converged
- There have been instances in which ILS have been placed several percentage points below the price of the same layer in collateralised reinsurance form

- Since 2007 we have lived through some exceptional times, and some markets and market behaviour are likely to have changed for good
- The notorious concept of ILS premiums being higher than those of traditional reinsurance has been very much true up to very recently (and with some significant gaps) and now the opposite is true for diversifying and non diversifying perils
- Implications for Insurance Linked investors:
 - Be flexible: keep on comparing traditional vs bond pricing and ensure your portfolio has the best combination of risk and return, BUT
 - Ensure you always have sufficient amount of liquid asset to allow yourself a portfolio approach and to be able to meet your funds obligations
- Implications for protection buyers
 - Capital markets are an alternative source of cover, which comes very useful after a major nat cat event: it is always good to have the ability to be able to quickly tap into it
 - Price sensitive buyers should be keeping an eye on the market which (unlike traditional pricing) shows different pricing trends each month-end: need to spot opportunities for attractively priced covers and to be able to tap it quickly before the price moves

- The capital markets and alternative markets have provided a wide range of risks to Insurance Linked Investors, but not all risks are fit for capital markets due to (among other things):
 - Tail
 - Lack of modelling
 - Risk profile

- Remote layers of peak perils have crowded the insurance linked market and so portfolios have a number of investments in the same peril (e.g. US Wind or US Earthquake), but which may behave differently in different loss scenario

- Capital markets require fast decision time and prompt information on the correlation of a new opportunity with the rest of the portfolio is key

- Insurance linked investors can access software from the key modelling agencies to monitor correlation. In addition such model can give a second modelling opinion on transactions not originally modelled by the same agency or not modelled at all

- Exposure monitoring is not only static, but also dynamic
- Capital markets opportunities (in bond and derivative form) can come throughout the year and do not necessarily have a 12 month risk period.
- Exposures must be monitored by also assessing:
 - The shape of your portfolio after key contracts expire or are up-for roll over
 - The combination of short term commitments (i.e. less than 12 months), yearly commitments and multi-year commitments
 - Possible portfolio reshaping to take advantage of new relative pricing opportunities
 - The need to change your portfolio due to new available cash in the fund or due to a reduction in capacity due to redemptions in the fund
 - **Foreign exchange volatility** (big impact in 2010)

- Investors in insurance linked investments have different risk and return appetite
- Observed investor behaviour is:
 - Cat bond only investors (mostly mirroring the cat bond index...by default)
 - Low risk, lower return and diversified strategies
 - Less diversified strategies with at least double digit return targets
 - And finally you have those looking for very high risk and high return strategies
- The higher the risk and the target return profile, the lower the concentration of ILS in the target portfolio
- Managed accounts vs. Fund investments
 - Control
 - Liquidity
 - Seeding
 - Bespoke portfolio profiles
 - Cost

- Investors and protection buyers have now a range of tools which they can use for their portfolio construction / protection needs
- The financial crisis has challenged many capital markets products, but insurance linked capital markets products have performed well and addressed some structural issues to become even more robust in an event of the crisis
- The ILS sector has grown post Lehman year on year, with over USD5bn of notional being issued in 2010.
- The number of innovative deals released in 2010 points to the possibility for investors to have wider choices available to them and eventually escape the need to follow the index if supply follows
- The technology for catastrophe swaps and private placements of collateralised reinsurance allows investors to manage the risk and the return profile of their portfolio by tapping a much wider market
- Solvency II and credit risk management has pushed more protection buyers to look for collateral for part of their reinsurance buy

- In summary:
 - Investors can tap different instrument to offer protection, thus having access to a multi-billion market (important in a **soft market** or in a market with no sufficient diversification in a single instrument)
 - Protection buyers can tap different pockets of capital, thus having access to trillion of dollar of capital (important in a **hard market** post a large event which affects the traditional sources of capital)
 - Capital markets money is flexible and can migrate elsewhere if the insurance linked market softens too much thus effectively supporting a pricing floor
 - Large reinsurers can follow a similar behaviour through share buyback programs
 - The convergence of capital markets and insurance linked markets should therefore be one of the elements supporting cycle management in the industry

QUESTIONS?