A rejuvenated market

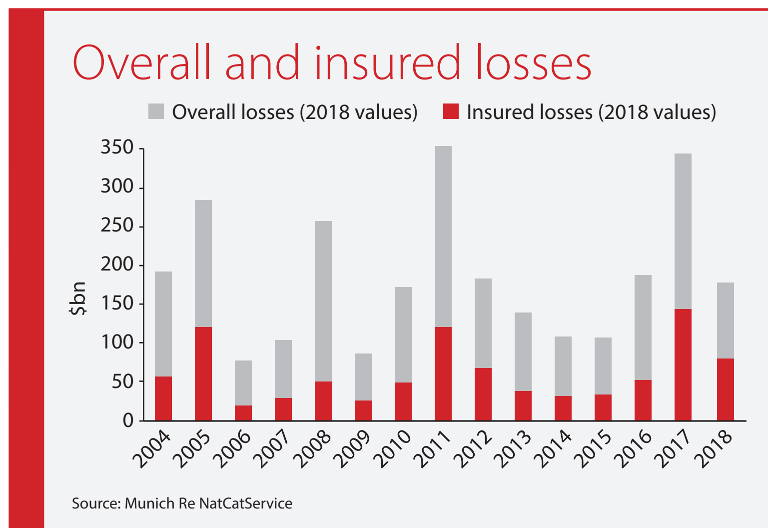
2017 and 2018 were the first and fourth costliest years for insured losses in history, with $144bn and $80bn of estimated losses respectively (see chart below).

These back-to-back major loss years have provided an opportunity for the industry to improve the risk-adjusted returns and terms and conditions of insurance-linked investments.

Natural catastrophes are known to have an uneven distribution of losses over time, and the last two years followed eight years of uninterrupted positive returns for our funds. Insurance-linked investments therefore continue to provide an attractive, lowly correlated return source independent of equities, fixed income or real estate. Through organic cash flow (the no-loss expected income is linked to predictable insurance premiums), insurance-linked investments have delivered returns which, over the last 15 years, have been broadly in line with those of equities. Measured between January 2005 and July 2019, the Swiss Re Global Cat Bond Total Return Index and the S&P 500 index have recorded annualised returns of 6.93 percent and 8.25 percent respectively.

Preservation of capital, stability of returns and low volatility are key characteristics of insurance-linked investments, which sophisticated institutional investors such as pension funds, sovereign wealth funds, endowments and retirement schemes, continue to rate in the context of their long-term strategic asset allocation.

Recent market research from Preqin shows that institutional investors have increased their allocation to alternative assets by around 23 percent over the past three years, due to their ability to improve the efficiency and optimisation of the investors' resulting portfolio. The diversifying effect is sometimes recognised as so powerful that some investors will hold lowly and or uncorrelated assets even when their long-term returns are lower than core holdings. A recent increase in appetite for lower-risk/lower-yielding insurance-linked investment strategies is complementing the historical appetite for higher-yielding reinsurance investment strategies.



> "After these past two years it is important to step back and appreciate the development and maturity of the insurance-linked investment market"

While 2017 proved to be the costliest year for insured losses in history, the chart opposite shows the number of natural disasters in 2017 was below average for the period from 1980-2018. This raises an important point: it is not just the frequency and severity of catastrophic events occurring over an annual period that matter when considering the potential impact to the results of insurance-linked investment portfolios but, most importantly, whether those events occur in highly populated areas with a high concentration of insured residential and commercial properties. A Category 2 hurricane making landfall in the centre of Miami is likely to cause more insured losses than a very severe Category 5 hurricane making landfall in a deserted area.

Positive premium momentum built up throughout the first six months of 2019, culminating in a strong Florida renewal. But investors, who by nature are slightly further away from the coalface, are waiting to see the impact of these improvements in returns and the outcome of the 2019 hurricane season before taking advantage of the yields on offer.

Market transformation

Since its peak in July 2017, the Eurekahedge ILS Advisers Index, which measures returns from a group of 33 ILS funds, has declined by 12.5 percent over almost two years. In May 2019 it reached levels last seen in September 2014.

At the same time, property reinsurance and retrocession pricing has increased to levels last seen in 2014.

In the intervening five years, the insurance-linked investment industry has nearly doubled, from $50bn

at the start of 2014 to about $93bn, according to Aon.

Most importantly, alternative capital, as it is called relative to traditional capital from (re)insurance companies, has grown not just in assets under management, but also now covers a greater diversity of products, perils and geographies. While cat bonds, the original transformation method of the ILS industry, are still a fundamental piece of the overall market, growing by 50 percent between 2014 and 2018, it is collateralised reinsurance which is now the biggest component of the ILS market product suite, having expanded by over 100 percent in the same period.

This evolution has led insurance-linked investments to be seen more and more as a fundamental complement within a property reinsurance buyer's protection, and a voice to be listened to in driving both pricing and terms and conditions – which was evident during the recent reinsurance renewals.

What a difference a year makes

No two years are ever the same, and 2018 and 2019 are a perfect example.

Last year saw the "Great Reload", where a large amount of capital entered the asset class. This more than offset capital lost following the events of 2017 and lifted total assets under management in insurance-linked investments to an all-time high. However, rate changes expected by both managers and investors did not materialise due to the volume of fresh capital which entered the market, and return expectations were hit by losses including Typhoon Jebi and California's Camp Fire, the largest ever insured losses in their respective peril regions.

Driven by a combination of the 2017 and 2018 cat losses, collateral trapping and, in some cases, capital outflows (mostly among the private wealth investor base, which has proven to be less sticky than pension funds), 2019 will be remembered as the year where the total amount of available alternative capacity reduced for the first time in a decade.

This capital reduction resulted in an improvement in investment and underwriting discipline by both capital market investors and traditional reinsurers, and as a consequence, premiums have increased to levels not seen since 2014.

Underwriting discipline led to clear pricing differentiation between counterparties buying protection based on performance and prior behaviour, with better quality counterparties attracting more capital with rate changes below the average. Those that had performed poorly struggled and often had to agree side deals or shortfall covers, or offer improved pricing beyond the average movement in order to complete their placement.

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This was coupled with improved terms for capacity providers and improved underwriting conditions including narrower event definitions and tightening on coverage for perils and territories.

Taking stock

After these past two years it is important to step back and appreciate the development and maturity of the insurance-linked investment market.

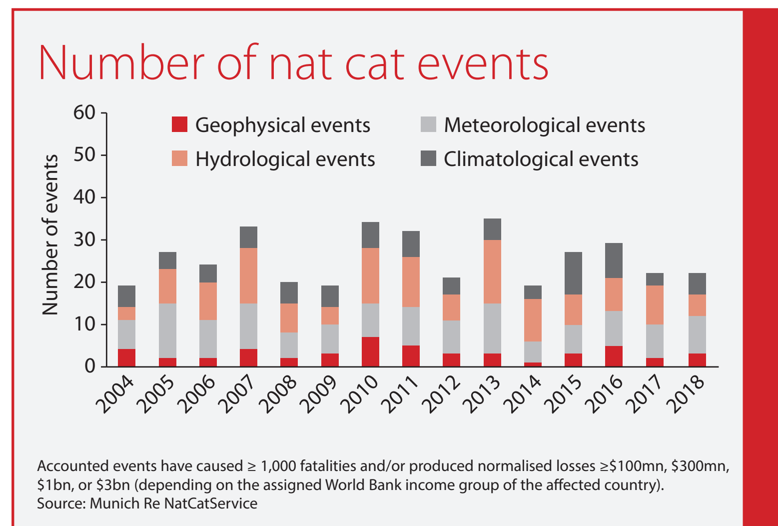
The first cat bond, George Town Re, came to market in 1996. After hurricanes Katrina, Rita and Wilma in 2005, the sudden premium increase and lack of traditional reinsurance capacity prompted a rapid increase in investor interest, which helped the market to grow from $11bn in 2004 to $22bn in 2007.

After 2005, early bird investors enjoyed stable and attractive returns over 10 relatively benign years, only to be reminded, through the 2017 and 2018 experience, that insurance-linked investments are not risk free; tail risk does play an important role and premiums are paid for a reason.

However, the past two years have been instrumental in helping the market to further develop. Investors, while requiring increased transparency and communication, have been able to better benchmark ILS managers across different key quantitative metrics such as post-event track records and more complex qualitative metrics such as the use of side pockets and drag on expected investment returns caused by collateral trapping.

All the above should contribute to the advancement of a better understood asset class which is becoming more and more an integral part of any institutional investor's portfolio, with greater future interest expected.

Capacity figures from Aon and premium estimates from Guy Carpenter.



Accounted events have caused ≥ 1,000 fatalities and/or produced normalised losses ≥$100mn, $300mn, $1bn, or $3bn (depending on the assigned World Bank income group of the affected country).
Source: Munich Re NatCatService