Navigating volatility

Lorenzo Volpi, managing partner and head of business development at Leadenhall Capital Partners, says that 2019 is a year for investors to review their ILS requirements

Catastrophe risk is all about being paid to take on volatility, and disaster events over the past two years have provided a fresh reminder of that tenet.

But within the asset class, investors are able to leverage some control over the level of volatility that they're taking on – and some are making adjustments to their targets, with various results.

"Investors are calibrating return aspirations with a volatility that their strategies can accept, which is also a function of the investment horizon," says Leadenhall Capital Partners head of business development Lorenzo Volpi.

"For some, less volatility in exchange for a fixed income-style return is very attractive," Volpi explains.

"For others who put ILS in an alternative bucket targeting returns in the high single digits or in the low teens, the higher return for riskier strategies is more palatable.

"Whilst this comes with greater volatility, the higher returns would support a faster pay-back time after very active years like 2017 and 2018."

Although the past two years have brought an unprecedented accumulation of events, they followed a long period of below-average cat loss activity for US hurricanes, since Katrina, Rita and Wilma in 2005.

The experience fits into an anticipated pattern for ILS investors – years of above-target returns, followed by years of above-average losses.

Rates have risen in response to the unprecedented accumulation of events in the past two years, helping to offset the losses incurred – or in insurance industry jargon, offering "payback".

"Existing investors who have reloaded would accelerate the payback over those who have reduced their exposure," Volpi notes.

Meanwhile, there are signs of some increased demand for more remote risk strategies.

At this end of the spectrum, Leadenhall has seen inflows of just over $100mn in the past year into its new Remote Risk Fund, which Volpi says reflects a momentary shift in perspective from some investors.

"If you still love the asset class for its low correlations with broader financial markets, some investors are thinking that the way to look at it is to go into more risk-remote strategies."

But this trend is not just about investors trying to avoid messy loss years from frequency risks.

Their second angle is motivation to look for higher relative spreads on remote-risk reinsurance layers, where effectively they benefit from a pricing floor.

No matter how low the modelled risk, it would not make sense to write reinsurance cover for less than the yield on cash alternatives. That means premiums can offer a much higher multiple of the projected risk level than at higher risk-return equivalent layers.

Historically, net yields of 4 to 5 percent were considered typical of low-risk ILS segments. But as some investor appetite moves further away from the money, ultra-remote risk strategies might involve targeting reinsurance business with net yields of around 3 percent or lower.

Given that the bulk of Leadenhall's investors are pension funds, foregoing higher absolute yields is something that some of them are willing to consider – especially when they are also observing potential downturns and volatility in the global equity and bond markets.

"For the pension funds, their primary goal is about preservation of capital in the long term."

However, there are geographical considerations that limit the appeal of this play to some ILS investors. So far, most of the take-up has been from US dollar and UK sterling allocators, Volpi says.

For Swiss and European investors, the costs of hedging (at nearly 200 to 300 basis points) are almost in line with the net yields available from ultra-low-risk ILS portfolios – making it a difficult strategy to justify relative to alternatives.

However, leverage can change the case for these investors as well.

"The other way of making returns interesting is providing the element of leverage," Volpi says, explaining that collateral "overlays" are possible if investors are already invested in treasuries or cash that could be deployed as collateral against their ILS commitment.

This would usually entail the fund pledging to capital top-ups if catastrophe events erode cash and counterparties require fresh security.

"To do this, you need investors with huge balance sheets and perhaps ratings – their credit standing is very important," Volpi notes.

However, with leverage, net returns of 3 percent or less from remote risk strategies can be boosted to the 6 to 7 percent range, possibly higher.

The other classic leverage model used in the reinsurance sector is for a rated carrier to "take back tail risk" by committing to meet obligations if ILS collateral has been fully wiped out.

"Selling the tail risk can be attractive for investors unable or unwilling to provide a top-up pledge, but then you're giving premium away," Volpi explains.

Sidepockets or out of pocket?

As investors study ILS manager performance over the past year, treatment and transparency of side pocketing has become more of an issue.

"We are pro-side pockets where there is significant potential loss volatility," affirms Volpi.

But he also says that, with no standard way of handling side-pocketing procedures in the industry, investors need to get involved in the dialogue to express their preferences.

For the while he believes that investors are generally accepting of side pockets to help managers treat both existing and new investors fairly. Some have begun to express a desire to limit illiquid side pockets where possible.

"The question mark I have is how far do you want to mitigate volatility," he says. "Some investors don't want side pockets unless there will be volatility of more than 5 percent in the valuations".

"You can never be sure in this asset class that something from the past won't hit you in the future – but you do worry about mitigating that risk."

For its own part, Leadenhall was able to cap the impact of rising 2017 claims within its side pockets "with a decent buffer" according to Volpi.

This means new investors have not taken any of the hit from rising Irma losses associated with private placements.

Financing deals boost life ILS options

Leadenhall's life ILS strategies have been one step removed from the turbulence of natural disaster losses in the past couple of years.

Volpi sees the life segment as another area that is drawing more attention at the moment – due to the demand for capital driven by a favourable regulatory environment that is encouraging life insurers to transfer risk off their books or monetise the value locked up in profitable business lines.

The emphasis within life ILS is also shifting from a focus on mortality risk to seeing more financing deals.

"It's becoming more recognised as a good complement to a credit or private debt portfolio."

These deals are enabling life ILS investors to chase higher yields – in the high single-digit range, compared to low single-digit mortality yields – at the cost of locking up capital for 5 to 10 years.

The diversification of life ILS is not as lowly correlated as in the non-life market, but Volpi says the correlation of lapse risk in times of financial stress has often been less dramatic than investors might initially anticipate, and the financial impact on transactions of such one-off spikes can often be small.

Having exposure to a geographically diverse portfolio of trades can further help stabilise any underlying lapse and mortality risks.

Overall, balancing different ILS strategies is just one of the ways that investors are seeking to control the volatility of taking part in the asset class author Michael Lewis dubbed "Nature's casino".

Benefits of ILS side pockets

Side pockets are designed to contain the valuation volatility associated with investment positions potentially affected by recent cat events. By leaving those potentially impaired investments in the main fund rather moving them into side pockets, the Fund would risk:

- Penalising new investors if any loss developed at levels higher than expected; or
- Penalising existing investors if a conservative reserve had been created for the loss which was subsequently released in the main fund for the benefit of both existing and new investors.
- Penalising remaining investors if any loss developed at levels higher than expected and the fund has experienced redemptions as they would share a higher share of the creep.

By allocating potentially impaired investments to side pockets, investors in the fund at the time of an event are the only ones to benefit from a recovery should the loss be lower than originally anticipated or to suffer any adverse loss development on the assets in question.