Time to shine for Insurance Linked Strategies

Shorter-term geopolitical and financial risks further underscore opportunities for ILS versus other asset classes

Over the last decade the central-bank playbook of ultra-low base rates and ultra-loose quantitative easing during economic shocks has resulted in a **particularly paltry outlook across fixed-income assets** as we exit the pandemic. Traditional **return-seeking assets** have also been drawn into this world of **meagre prospective returns**.

The spread pick-up over government bonds has been lowered by investors' insatiable chase for yield compressing credit spreads, as well as by the effect of credit assets being included in quantitative-easing programs. Furthermore, in the case of equities earnings yields, dividend yields and related future prospective returns all fell through the pandemic. S&P 500 equity price/earnings multiples are at highs last achieved in the financial crisis and tech bubble. They are now the third highest in history. We still await these to return to pre-Covid-19 levels.

There has already been a wholesale shift in the macro-economic backdrop this year, particularly with regards to the inflationary regime. As we emerged from Covid-19, inflation began to rise with the kickstart to the pandemic-stunted economy. **However, higher inflation has now become stickier and more entrenched** and is expected to be longer-lasting. Russia's recent invasion of Ukraine has meant a further increase in the prices of oil, energy and commodities which have significant effects on inflation baskets.

The fast turnaround in inflation has spurred central banks into action and with it projected interest rates. **The Federal Reserve expects to raise interest rates in 2022 and continue this over the next few years**.

However, even here there remains considerable uncertainty with the current volatility seen in fixed-income markets. Meanwhile, quantitative-easing asset purchases are expected to be reduced before holdings then start to be sold.

Rising rates are not usually supportive for fixed-interest assets including corporate bonds, high-yield debt, EMD or for growth-oriented equities. In February 2022 there were falls across these traditional markets. In an environment where interest rates are rising and traditional asset classes falling, **ILS' linkage of returns to floating rates provides a further attractive characteristic**.

Looking longer term, and at the sheer quantum of central-bank stimulus, this effect has at some point much further to run.

Why insurance-linked strategies?

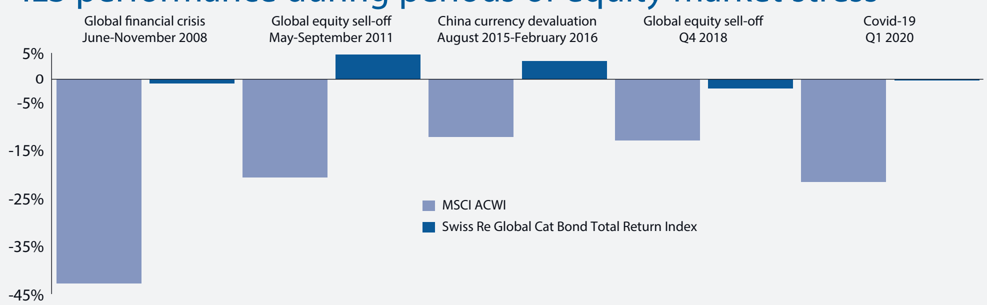
Non-life

In the **non-life space** there has been a noticeable **increase in the rates of return on offer**, or rate hardening over the last few years, **and tightening of terms and conditions. Primary cat bond issuance has continued to increase** yet again year on year, reaching a record $12.5bn over 2021. Secondary market spreads have widened, influenced by Hurricane Ida and flood events last year. **Yields and no-loss-net-returns** (net of expected costs) **look increasingly more attractive**.

Even more attractive dynamics have been seen in reinsurance private placements.

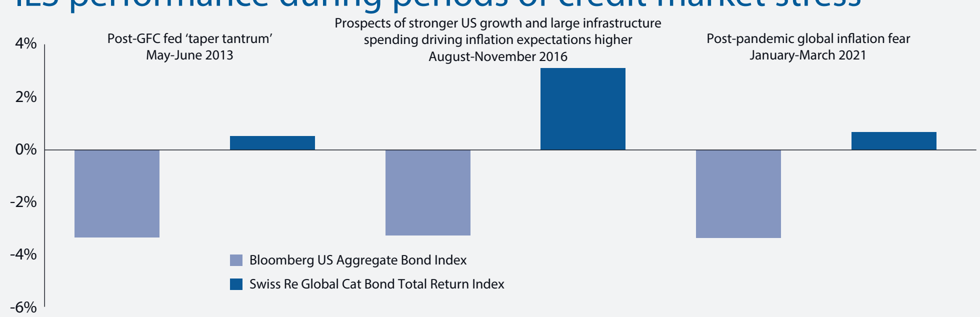
Property catastrophe reinsurance rates continue to increase year on year. The Guy Carpenter Global Property Catastrophe Rate-on-Line Index

ILS performance during periods of equity market stress



Source: Leadenhall, Swiss Re, MSCI, Bloomberg fixed income indices

ILS performance during periods of credit market stress



Source: Leadenhall, Swiss Re, MSCI, Bloomberg fixed income indices

increased 10.8% year on year as of 2021 year end with higher rises being seen on heavier loss-impacted areas. **This continues the compounding trend that has been observed from 2017.**

There is broad market consensus that this activity is likely to continue and that **a further hardening in rates is expected at the 1 June and 1 July renewals.**

While the outlook and attractiveness for such a strong diversifying asset class are clear for ILS, **the same cannot be said for the rates of return on offer in other asset classes.** In addition to this, **rising interest rates** that may negatively impact some asset classes **are fully captured by the floating rate nature of ILS.** Also, as shown in the chart, **when traditional equity and credit markets have suffered recent dramatic falls, the ILS market has often held up** due to its diversifying properties.

Life and alternative credit

In the **life and alternative credit space**, opportunities to provide **insurance finance to the highly regulated insurance sector are very compelling**. Managers able to **source and originate funding and risk-transfer solutions used by insurers across the capital structure** (from senior secured debt to hybrid debt/preferred equity, down to common equity) **are very well positioned to offer investors access to a diversifying asset class that has proven to be very resilient during periods of market shocks.**

Why the insurance sectorial approach?

- **Insurance carrier default rates have historically been low for companies rated by credit-rating agencies S&P and Moody’s.** This is in part due to not suffering “runs on the bank”, in that their primary liabilities are illiquid (some lines, such as property carriers exposed to natural catastrophes, are an exception).
- Insurers typically operate in heavily regulated environments where their capital structure and quality are highly governed. They are also monitored by regulators with **capital shortfall risks that are transparent** and provide time to be cured. Therefore, for regulated carriers, **compliance and regulatory solvency ratio are of the utmost importance.**

Authors

Lorenzo Volpi
Managing Partner / Head of Business Development

Alistair Jones
Managing Director

Ramifications for institutional portfolios

Institutions regularly review their strategic asset allocations, taking stock of the current environment and their own targeted risk-return goals. Unlike an insurer, unregulated institutions do not ordinarily need to hold capital reserves for extreme tail events in isolation.

In a downside market event, the wider institution and business is often able to pick up the mantle. Risk and return are often considered by institutions at around 1-in-20-year risk levels (rather than say at 1-in-200-year which is more common in non-life insurance reserving).

However, the exact risk level can be tailored to the strength of each institution.

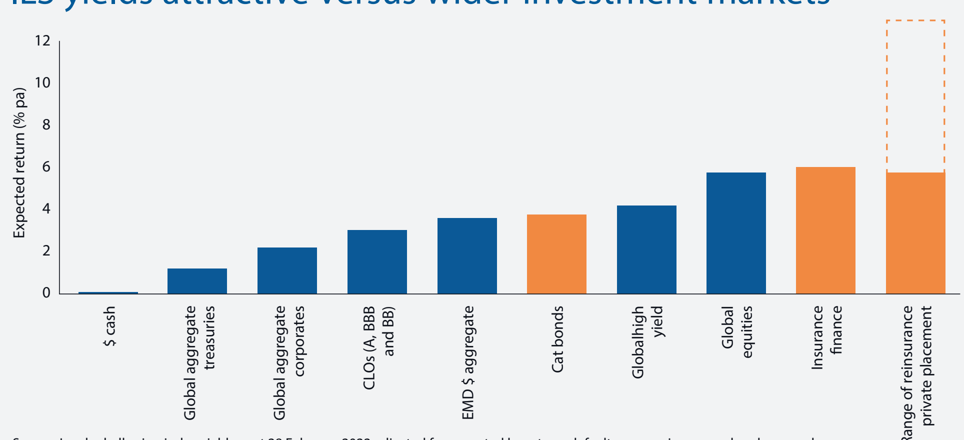
When developing an efficient investment strategy in this context, **ILS across non-life, life and alternative credit strategies compares favourably, particularly in today’s economic environment.** The expected-return chart shows the yield of each asset net of expected costs and losses. What can be seen is that, today, non-life **ILS is particularly attractive across asset classes.**

In today’s environment the attractive qualities of ILS relative to other assets are increasingly impossible to ignore.

In a world of uncertain rising interest rates and low prospective returns on traditional assets, **ILS provides investors with a ray of optimism.**

With the **yield pick-up** in no-loss-net-returns **at multi-year highs**, the draw of ILS is increasingly impossible to ignore for institutional investors. This is particularly the case given the **strong diversification ILS has historically shown.** If ILS meets an individual institution’s required risk and return needs, it should certainly be considered when **ILS compares so favourably on a relative value basis.**

ILS yields attractive versus wider investment markets



Source: Leadenhall using index yields as at 28 February 2022 adjusted for expected long term defaults, recoveries, upgrades, downgrades, expected losses and fund costs. Palmer Square CLO Debt index used for CLOs. Bloomberg Fixed Income Indices used for liquid bonds. The Effective Fed Funds Rate used for cash. No-loss-net-returns adjusted for margins over expected losses and fund costs for ILS yields. Swiss Re Global Cat Bond Index used for cat bonds (excluding distressed bonds less than 80 in price and over 30% in yield). Leadenhall data used for reinsurance private placements. For equities the MSCI World Index is used: dividend yield plus inflation expectations and expected growth is shown (a dividend discount model)