ILS rate increases outpace market-wide risk premia rise

Rising interest rates are expected to boost the returns available both on cat bonds and private ILS placements

Over 2022 there have been significant shifts in investment markets. The Ukraine war, the emergence of inflation, tightening by central banks, the squeeze on real incomes and the increased risk of recession have weighed on traditional assets. Given these movements, we therefore analyse the current risk premia available on traditional assets classes and compare them to that available on non-life ILS. **What is found is that even though the risk premia on many assets have increased, the potential returns available on ILS are more favourable still.**

With H1 2022 now behind us, in investment markets there are hopes that inflation may have peaked. Oil prices have recently declined, although it will likely be some time before inflation comes back down to central banks' targets. With prices squeezing consumer spending and increasing companies' input costs, GDP estimates show economies contracting in both the US and UK over Q2 2022.

Central banks remain focused on reining in inflation given its potential to constrain spending and increase the risk of a recession. Base interest rates have increased sharply this year and falls have been seen in traditional equity, sovereign bond and credit markets. All of these markets are now offering increased risk premia for those investors willing to take investment risk. However, for differing reasons, **the risk premium available on non-life ILS has also continued to increase, but even more so than for traditional asset classes.** With ILS markets continuing to harden through mid-year renewals, **the no-loss returns now available on both cat bonds and private placements have also become particularly attractive** – a trend that is expected to continue.

This can be seen in the first chart which compares the yields available on a range of asset classes with no-loss returns on ILS (including money market rates but net of expected losses, defaults, downgrades and fund costs for all asset classes). For reinsurance private placements a range of expected returns is shown depending on the level of risk that end investors may wish to target.

The outlook is bright for non-life ILS

Cat bonds

Cat bond issuance reached $8bn in the first half of 2022, taking the outstanding market to a new record high. There was positive net new issuance of around $2.9bn. The range of (re)insurance sponsors continued to expand, helping push yields and no-loss returns higher.

The prospects for investors improved due to this advantageous supply-and-demand imbalance. **Spreads both at issuance and in the secondary market rose for every peril, opening a window for investors to deploy capital at higher yields.**

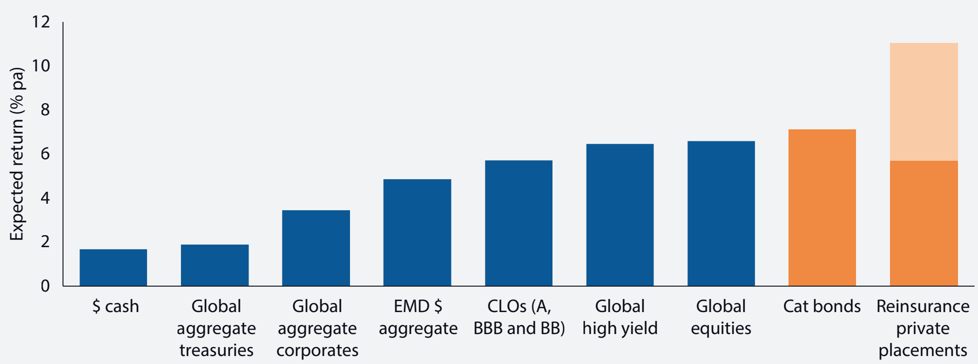
The average spread at issuance for 2022 stands at 7.3% per annum compared with 5.82% per annum in 2021. This is with average expected losses being unchanged at 2.5% per annum. Average secondary market spreads also rose in 2022 with cat bonds yielding roughly 8.5% per annum over money market rates at the end of H1 2022 (represented by the Swiss Re Global Cat Bond Index) compared to around 6% per annum at the end of 2021.

Looking ahead, these attractive market conditions are expected to remain in place with the current dynamic in the cat bond market continuing to be supportive for investors.

Private placements

During the recent mid-year renewals we saw **reinsurance premiums rise markedly with the**

The expected returns on ILS are attractive compared to the yields across wider markets (% pa)



Source: Leadenhall Capital Partners aggregation of different sources. Bloomberg fixed income index yields as at 31 July 2022 adjusted for expected long-term defaults, recoveries, upgrades downgrades and fund costs. The Palmer Square CLO Debt Index is used for CLOs. For ILS no-loss net returns including money market rates have been used adjusted for expected losses and fund costs. Swiss Re Global Cat Bond Index used for cat bonds (excluding distressed bonds less than 80 in price and over 30% in yield). For reinsurance private placements expected returns are shown across a range of potential non-life ILS portfolios. For equities the MSCI World Index is used: dividend yield plus inflation expectations and expected growth is shown (a dividend discount model)

Guy Carpenter US Property Cat Rat-On-Line Index going up by almost 15% over the year to June 2022. International also hardened but lagged peak zones.

This situation has resulted in **the current outlook for private placements also being very positive.** As a general trend, traditional reinsurers continue to diversify out of property cat risk into casualty and specialty lines, **pushing up the price of property cat reinsurance. This, in turn, has been passed onto the private placement market in the form of higher yields.** In addition, inflationary pressure is expected to result in increased exposure values. This is likely to result in **more risk being passed to ILS markets, further sustaining higher ILS rates.** We expect these trends to continue into 2023.

Rising interest rates are further expected to boost the returns available both on cat bonds and private placements due to the floating rate nature of the underlying instruments. In comparison, rising rates usually act as a headwind in more traditional asset classes where increased discount rates can bring down valuations.

The re-pricing of market risks and returns further favours ILS in strategic asset allocations

There has been a wholesale shift in the pricing of market risks and expected returns in 2022. In particular inflation, the risk of recession and tightening by central banks have seen the risk premia available on many assets shift significantly. Interest rates have risen with central banks reacting to inflation, credit spreads are now more elevated with the risk of a recession and dividend yields have risen with share prices falling.

As mentioned, **the potential expected returns on ILS have gone up even more than most other asset classes.** However, **comparing asset classes across both potential risk and return, the opportunity in ILS looks even more appealing still.** In the second chart, potential expected net returns are compared versus moderate levels of downside risk typically used by institutional investors when setting investment strategies – unlike (re)insurers which commonly use 1-in-200-year levels of risks. Yields, net of expected costs, are compared below against expected 1-in-20-year value-at-risk.

For the ILS strategies shown, no-loss target returns net of expected losses and costs are plotted versus 1-in-20-year value-at-risk for the cat bond market and for an example portfolio of private placements (with a similar target return). **ILS have an attractive potential level of risk and expected return having moved more towards the top left of the chart recently.** Consequently, when asset allocators are building diversified strategic asset allocations, **ILS now offers a particularly efficient building block within their wider investment strategy.**

As well as offering an attractive level of risk-adjusted return, non-life ILS also offers investors an extra diversification benefit. Investors now face an increased risk of a recession. When economies slow down performance across traditional asset classes often correlates and can struggle at the same time. Assets such as listed equities, corporate credit and commercial property can all come under pressure when companies' earnings falter.

As well as ILS now offering an attractive potential return profile the asset class offers a considerable diversification benefit that is much sought-after when there is the prospect of a recession and traditional markets falling. With (re)insurance often running on a different cycle to investment markets and being subject to different fundamental drivers of return, **now is a particularly attractive time for investors to make a strategic allocation to Insurance Linked Strategies.**

Leadenhall Capital Partners grants investors access to ILS as an alternative diversifying source of income. Leadenhall has a track record of more than 13 years and manages around $6bn of AUM (2022 Q2).

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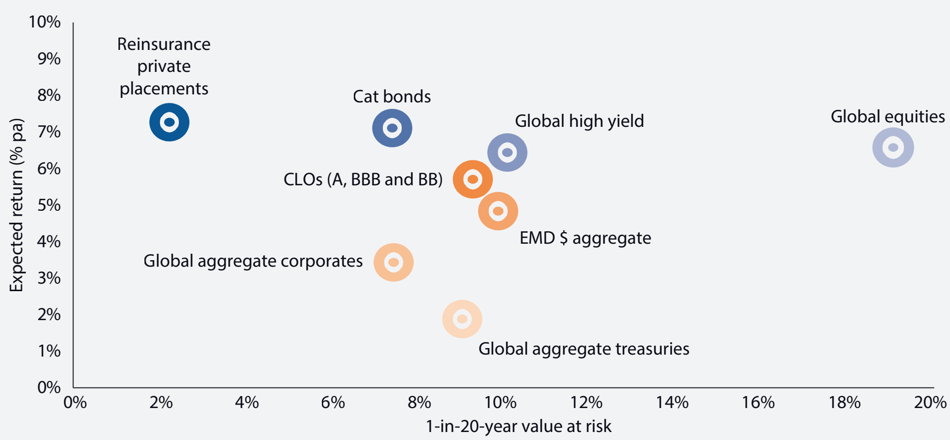
Current Expected Risks And Returns Across Asset Classes



Source: Leadenhall Capital Partners aggregation of different sources. Bloomberg for non-ILS assets (except for CLOs which use the Palmer Square CLO Debt Index), the Swiss Re Global Cat Bond Index for cat bonds and Leadenhall Capital Partners for reinsurance private placements. Yields (net of expected losses, costs, defaults, downgrades and upgrades) are shown from the previous chart versus expected downside risk. 1-in-20 downside Value at Risk shown for cat bonds and reinsurance private placements from Leadenhall Capital Partners' proprietary modelling. For other asset classes Value at Risk is based on realised volatility from 30 Sept 2000 (and from 31 Dec 2011 in the case of CLOs) to 31 July 2022