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In focus

Free lunch? ILS investors can benefit from diversification and insurance market dislocations

July 2020

Diversification is viewed by many as the only "free lunch" available to investors, and insurance-linked securities have a history of providing diversification alongside traditional asset classes. Catastrophe (or Cat) Bond investors may have the opportunity to eat lunch twice for free, as significant insured losses from 2017, 2018 and the ongoing COVID-19 pandemic have created stress on insurance companies. All of these have combined to push rates – and yields available to investors – higher. We believe that these market dynamics represent a unique opportunity for investors to enter the asset class or add to existing allocations.

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A Free Lunch: Diversification through ILS

Harry Markowitz is credited with noting that "Diversification is the only free lunch" in investing. Insurance-linked securities (ILS) have long been used as a diversification tool for investors. The ILS market is estimated at about $100 billion in size and is comprised of both liquid and illiquid segments, with the liquid portion consisting of Catastrophe, or Cat Bonds. Representing approximately 40% of the ILS market, Cat Bonds have an active secondary market that facilitates trading. The income stream from Cat Bonds is driven by insurance risks, such as major earthquakes or landfalling hurricanes, which are uncorrelated with financial markets. As shown in Figure 1, this allows investors to benefit from an asset class which has low correlations to traditional assets such as stocks and bonds.

The diversification benefits of insurance-linked securities have been tested many times over the past two decades. As shown in Figure 2 (on the next page), while traditional assets such as equities, fixed income and commodities have exhibited meaningful volatility, ILS have provided a stable and uncorrelated source of income for investors. The diversifying nature of insurance-linked securities was seen most recently in March 2020, as financial markets showed concern about the global spread of COVID-19 and the impact on the world economy. While correlations across traditional asset classes moved higher and asset prices moved lower, the ILS market continued to provide diversification.

Figure 1: Catastrophe Bonds have achieved low correlations with other asset classes

	Cat Bonds	Global Equities Developed	US Bonds	Global High Yield	Commodities	Emerging Market Debt
Cat Bonds	1.00					
Global Equities Developed	0.15	1.00				
US Bonds	0.12	0.02	1.00			
Global High Yield	0.23	0.78	0.23	1.00		
Commodities	0.15	0.52	0.03	0.50	1.00	
Emerging Market Debt	0.19	0.62	0.57	0.83	0.39	1.00

Source: Schroders, using Morningstar data for the January 1, 2002, through December 2019 period ended December 31, 2019. Asset classes used reflect unmanaged, widely used proxies: Cat bonds: Swiss Re Global Cat Bond TR Index, US Bonds: BofA Merrill Lynch US Treasury. MSCI World, Emerging market equities: MSCI Emerging Markets. High yield bonds: BofA Merrill Lynch Global High Yield Index, Commodities: S&P GSCI. Emerging markets bonds: JP Morgan EMBI+.Investors cannot invest directly in any index. Correlations reflect performance coefficients and range from +1 to -1, with the former being highly correlated, a 0 being uncorrelated, and a -1 being negatively correlated.

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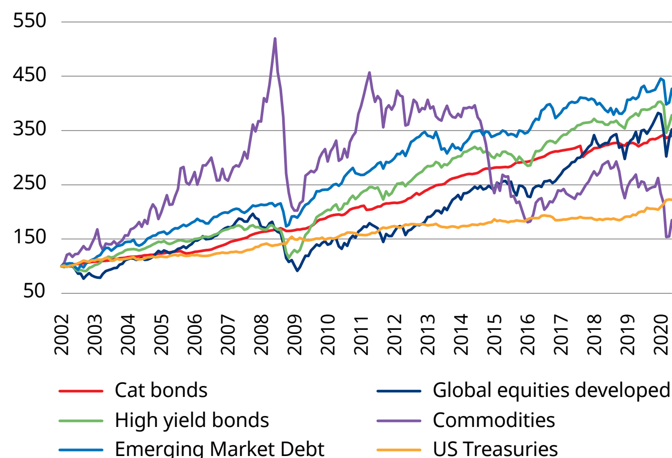
Figure 2: ILS and other asset class returns since 2002

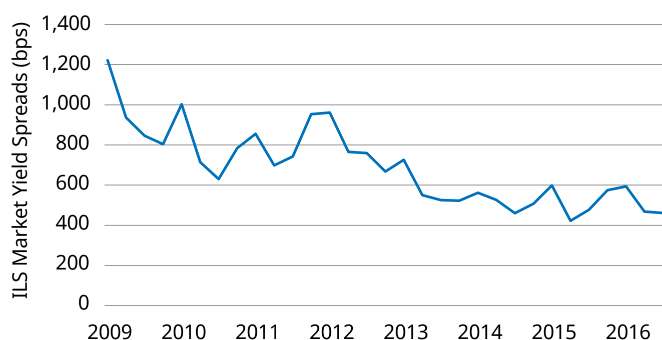


Source: Schroder Secquaero. Schroders, Bloomberg, monthly returns from January 31, 2002 to May 31, 2020 in USD. Cat Bonds: Swiss Re Global Cat Bond TR Index, US Bonds: BofA Merrill Lynch US Treasury. MSCI World, Emerging market equities: MSCI Emerging Markets. High yield bonds: BofA Merrill Lynch Global High Yield Index, Commodities: S&P GSCI. Emerging markets bonds: JP Morgan EMBI+. Past performance is no guarantee of future results. Actual result will vary from those shown above.

ILS market structure and recent trends

The ILS market serves as an important tool for insurance and reinsurance companies as they underwrite risks. As a reinsurance company writes policies it may access the reinsurance market to balance their liability portfolios by entering a risk transfer agreement. For example, a homeowner insurance company in Florida may be overly exposed to hurricane risk and could be compelled to transfer some of this risk for risk management or regulatory reasons. Total global reinsurance capital stood at $625 billion in 2019 and alternative capital, or insurance-linked securities, comprised approximately $95 billion of that total. The insurance market prior to 2017 was characterized by falling rates. Because the southeastern US had not seen a major hurricane make landfall since 2008, spreads on catastrophe bonds fell from over 1,200 basis points (bps) in mid-2009 to almost 400 bps in 2015. As shown in Figure 3, rates trended lower or remained range bound through 2017.

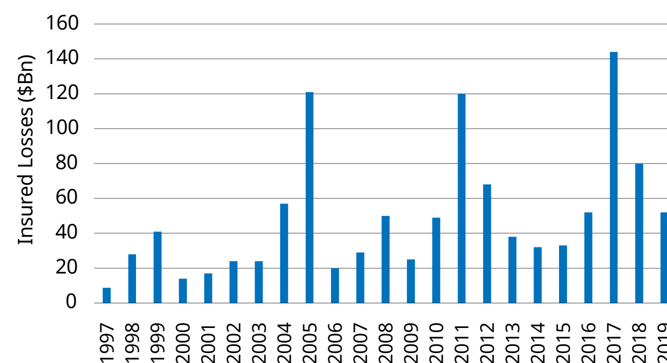
Figure 3: ILS spreads trended lower through 2017



Source: Lane Financial LLC, Lane Financial Insurance Return Index (LFIRI), Cat Bonds Only, "Annual Review and Commentary for the Four Quarters, Q2 2019 to Q1 2020", through March 2020. Intentionally shown through 2017. Please refer to Figure 7 for current spreads.

2017 saw a gradual shift in the market which has since continued and accelerated. Driven by large losses from Hurricanes Harvey, Irma and Maria, along with the devastating California wildfires, the insurance industry saw over $140 billion in losses in 2017 alone. In 2018, the insurance industry was impacted by disasters including Hurricanes Florence and Michael and additional wildfires in California, which contributed to another $80 billion in insured losses (Figure 4).

Figure 4: Global Annual Insured Losses, 1997 - 2019



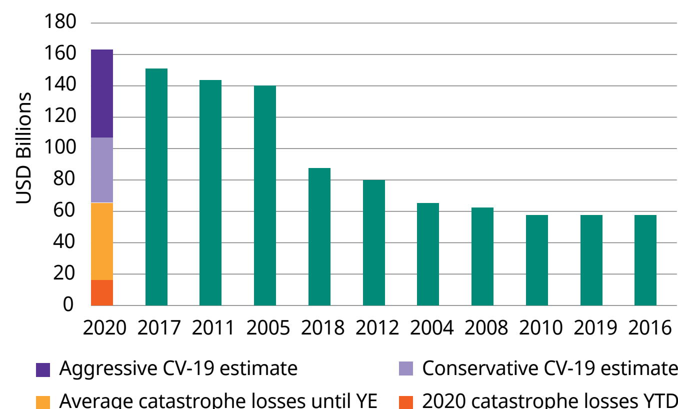
Source: Munich Re NatCatSERVICE, through 2019.

The $220 billion in combined losses in 2017 and 2018 resulted in market dislocations. Investors absorbed losses, some made the decision to exit the asst class, and an additional $10 billion of capital was "trapped" until the severity of losses associated with certain events was determined. Insurance rates – or the yields available to ILS investors – began increasing as a result.

The impact of COVID-19 on the ILS market

As the ILS market was in the process of absorbing the losses of 2017 and 2018, COVID-19 created uncertainty. The insurance industry is likely to see material losses across several lines of business, including mortality risk, pandemic risk and business interruption insurance. Business interruption policies represent the bulk of anticipated COVID-related claims; these are typically an extension to a commercial property policy and offer coverage for a loss of profits. Property policies tend to require that there be physical loss or damage to insured properties as a prerequisite to a business interruption claim. As shown in Figure 5, estimated losses from COVID-19 vary widely, from a low of $40 billion to a high of over $100 billion. As a result, 2020 could see the worst losses in the history of the insurance industry.

Figure 5: Estimate of 2020 Insured Losses compared to highest loss years on record



Source: Guy Carpenter, Swiss Re, Lloyds of London, BofA Securities, Downling & Partners. Aqua bars reflect realized losses. 2020 values reflect forecasted losses.

At the same time, insurance companies are seeing stresses elsewhere in their business. In addition to creating uncertainty around insurance company liabilities, recent financial market upheavals have created pressure on assets. Investment portfolio losses, growing economic uncertainty, and active global central bank policies have resulted in yield curves falling and flattening globally. This has put pressure on insurance company fixed income portfolios, which may be unable to provide similar levels of investment income going forward.

Taken together, the volatility in the assets and liabilities of insurance company balance sheets has resulted in a diminished capacity to absorb risk. As a result, we believe insurance companies are likely to seek additional reinsurance capacity over the coming months. Our belief is that this increased supply is likely to outstrip investor demand – at least temporarily – and result in continued increases in yields available for ILS investors.

A second free lunch: rising yields without additional risk

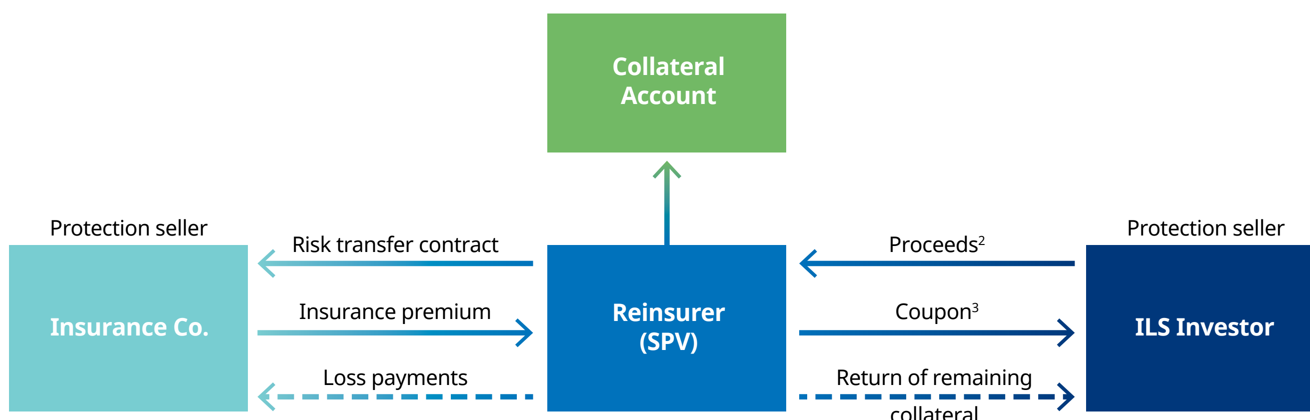
We believe the confluence of insurance market dynamics offer investors a unique opportunity to enter the market, or to add to their allocations. Significant losses in 2017 and 2018, combined with large potential losses from COVID-19, are creating stress on insurance balance sheets and driving insurance rates higher due to a lack of capital. As a result, spreads on new issues of Cat Bonds have increased over the past two years and will likely continue higher. This offers a second "free lunch": investors can potentially benefit from increasing yields on Cat Bonds while not taking on additional risk[1].

While COVID-19 has created issues for insurance and reinsurance company balance sheets and potential liabilities as a result of business interruption exposure, we believe this will have little, if any, impact on Cat Bonds, as they largely provide coverage for only specific perils such as earthquakes, hurricanes, or other severe storms. Of the bonds currently outstanding, we estimate that a very small number – approximately 5% – could be exposed to losses from business interruption insurance given their structure.

It's worth reviewing why this is the case. The structure of Cat Bonds also provide investors with protections. As shown in Figure 6, Cat Bonds are structured outside of the issuing insurance company and a collateralized account is created to fund the payment of coupons and principal repayment. As a result, investors are protected not only from any concerns about the credit of the underlying insurance company but also duration risk because collateral proceeds are generally invested in money market funds.

1 While Cat Bonds may provide a level of non-correlated performance relative to other assets like stocks and fixed income bonds, like all other investments, Cat Bonds carry risk, including the risk of loss of principal.

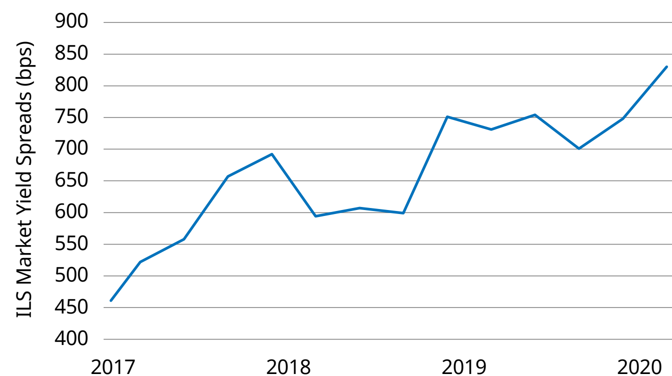
Figure 6: The typical structure of a Cat Bond



Source: Schroders. Notes: 2 Proceeds from share or debt issuance. 3 Coupon = risk premium + money market return. SPV refers to special purpose vehicles. Graphic for illustration only. Protection refers to capital allocation within an investment structure. All investment structures involve risk, including the risk of loss of principal.

When yields on other fixed income securities such as high yield increase by large amounts, this typically signifies that risks have increased. Investors may believe that economic conditions have become more opaque, concerns of a recession affecting the ability of borrowers to repay have increased, and default risks are rising. As we see in Figure 7, spreads on Cat Bonds have increased 400 bps since 2017. While investors should understand and weigh associated risks before making investments and there is no certainty that major catastrophes won't occur in the coming months, the risks associated with Cat Bonds have not increased. Investors are being compensated with a higher yield despite the fact that the likelihood of an earthquake, hurricane, or other insurance event has not changed.

Figure 7: ILS spreads from 2017 to present



Source: Lane Financial LLC, Lane Financial Insurance Return Index (LFIRI), Cat Bonds Only, "Annual Review and Commentary for the Four Quarters, Q2 2019 to Q1 2020" through March 2020.

In conclusion, what is known with certainty is that the dynamics of the insurance industry and the supply and demand of capital have materially increased the yields that investors are paid for taking Cat Bond risk. As a result, the ILS asset class potentially offers investors a second free lunch, and 2020 represents a fantastic entry point into a uniquely diversifying asset class at a time when other asset classes struggle with a combination of low rates, high valuations, and potentially rising credit risks.

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