

Aon Investment Research and Insights

Storms, Floods and Quakes

Capturing a timing opportunity in 2018

March 2018

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About Aon Investment Research and Insights

Aon's robust portfolio of ideas, tools and researched solutions support trustees and sponsors to anticipate their future investment requirements.

By beginning to identify investment research and communicate ideas before they are needed we can shorten the implementation times for our clients and act in a timely way when opportunities are correctly priced.

To learn more and to access other research and insights from Aon's investment experts, visit aonhewitt.com/investment

Executive summary

Insurance Linked Securities (ILS) funds have produced attractive returns that are uncorrelated to traditional assets classes. 2017 was a significant year for the ILS market given the occurrence of a number of significant natural disasters resulting in large losses; whilst this was negative for existing investors it presents an opportunity for investors currently considering this asset class or looking to increase existing allocations as yields have risen.

ILS funds earn premiums for insuring natural catastrophes such as storms, earthquakes and floods, and man-made disasters such as marine and aviation calamities. These catastrophes arise for very different reasons to financial crises and there is little reason to see impairment to ILS portfolio values following a period of systemic financial weakness. Conversely catastrophes and disasters tend to be regional, causing only small and temporary drops in global share prices, if at all. It is the independence of the asset class that is a key attraction for an investor looking to build a robust portfolio.

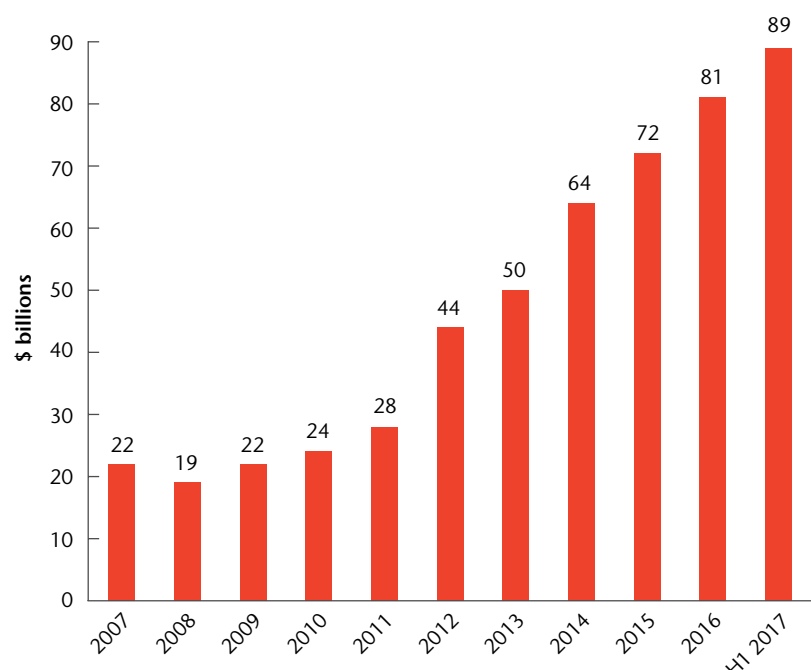
Investors should look for expert advice when considering ILS funds. Choosing the right manager is crucial, as it is at times when a catastrophe occurs that the differences in manager performance becomes apparent.

Introduction and growth

This note is intended to update our clients on the growing area of ILS funds. Since our last papers “Storms, Floods and Quakes” (December 2014) and “Reinsurance Investing” (June 2015), ILS funds have continued to perform as expected, with low levels of correlation with other asset classes.

As investors become more comfortable with the asset class, it has seen an increase in “alternative capital” as it is known, which is capital that comes from outside the reinsurance industry such as from pension funds. This growth is shown in the chart to the right and much of this capital has sought exposure via ILS funds.

Alternative reinsurance capital deployment to 30 June 2017



Source: Aon Securities Inc

Becoming a reinsurer

Insurance is about sharing risks. Everyone's premiums are pooled together to pay the claims of the few.

Sometimes a hurricane or an earthquake leads to a large number of claims, which could bankrupt an insurer. So insurers buy catastrophe protection from 'insurers of insurers', i.e. reinsurers. Investors can access this market via ILS managers who will sell protection to an insurer/reinsurer, on a collateralised basis, for those same catastrophes. Short of a catastrophe, ILS investors earn premiums and receive their capital back when the reinsurance contract matures, typically after one to three years. Capital (collateral) is kept in trust during the term of the contract and invested into high quality, short dated money market instruments.

The oldest known reinsurance contract covered the most dangerous part of a sea journey from Italy to Belgium during the Hundred Year War. It was written in Latin. The reinsurance market has gone on to mature and now has depth with efficient pricing of risk. Today, global reinsurer capital is worth over half a trillion dollars.

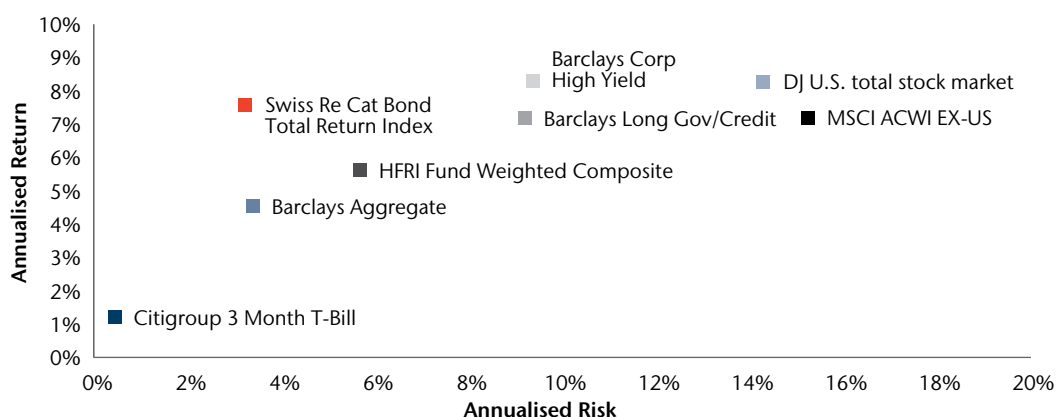
The rationale behind investing in ILS is quite simple: diversification and returns. Share prices, and other traditional asset prices, have been relatively immune to catastrophes and disasters. Falls in traditional assets are typically caused by economic or political shocks; catastrophes tend to be independent of these events.

ILS performance

With the exception of Q3 2017, ILS returns have been good over the last decade although, similar to many asset classes, we have seen yields falling in recent years as competition to allocate capital has increased.

Returns below are compared across asset classes, including a proxy for the ILS market, the Swiss Re Cat Bond index. On the face of it returns relative to risk look attractive. While it is a short history, it does include the significant events of Q3 2017, an earnings event for the industry that had a large impact on 2017 returns across ILS funds. The true risk of the asset class, however, lies in tail risk, as was evident during Q3 2017.

Risk and return: 15 years to December 2017



Source: Respective Indices

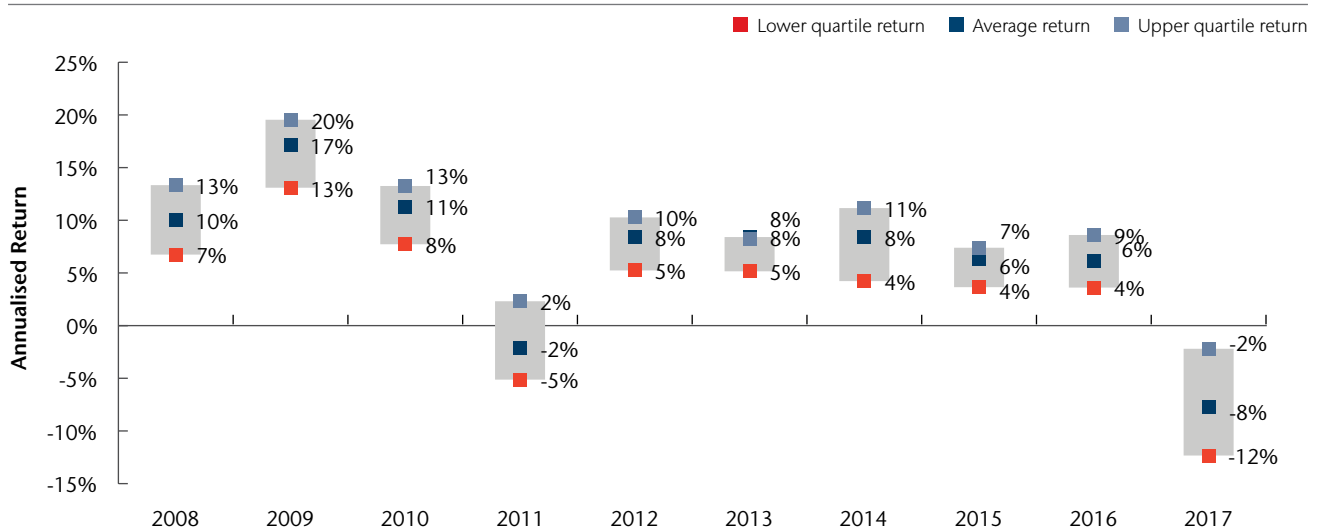
Considerations for investors

ILS returns tend to be stable and positive most of the time but they can fall sharply if a catastrophe happens. If the extent of the loss is not immediately known, investors may then find the exposed portion of their ILS portfolio is tied up as they wait for the damages to be assessed. This implies a loss of liquidity to the value of the exposed portion but in any case most investors hold ILS investments until maturity.

ILS investors make occasional large losses and so diversify their risks by reinsuring different types of peril across different geographies. After a significant event, it can be expected that premiums offered will rise as the industry has to attract new capital. This can offer new investors a good opportunity to invest and current market prices reflect this trend.

As with many specialist asset classes, the dispersion of returns provided by managers is large, particularly in years with more catastrophes such as 2011 and 2017. Investors should seek specialist advice when allocating to this asset class, to ensure that exposures to catastrophes are diversified and managed using a high quality manager, able to navigate the various risks.

Global ILS funds – Calendar year return dispersion



Source: Aon Buy rated ILS managers

2017 natural disasters and outlook

The 2017 hurricane season was particularly severe with hurricanes Harvey, Irma and Maria resulting in significant insured losses across North America. In addition, two large earthquakes in Mexico and a series of wildfires in California have added to those insured losses. The total industry loss for the year across all perils is expected to be in excess of \$120 billion¹. This industry loss figure is similar in magnitude to the losses incurred in 2011 after the earthquake and tsunami in Japan and in 2005 after hurricanes Katrina, Rita and Wilma in North America.

Returns for Aon's Buy rated ILS managers have been impacted by the events of 2017. Our more aggressive, higher target return managers are down between -12% and -19% for the year. These funds tend to be focused on North American perils that pay the highest premiums or "rates on line" due to the very large demand for insurance and reinsurance in that market.

Our more conservative funds have avoided severe losses through peril diversification and through risk structuring and they have returned between -1% and -6% for 2017. We also Buy rate some moderately aggressive funds with results that fall between these two ranges.

The events of 2017 and resulting losses have created opportunity moving forward. When the insurance industry suffers a year of unusually high losses, as was the case in 2017, the rates on line or premium for reinsurance protection rises. The large North American losses last year have resulted in increases of 10% in premiums for those perils in the most recent year end renewal period. Our Buy rated managers are therefore finding a number of significantly more attractive reinvestment opportunities as they build their 2018 portfolios. This hardening of the market is expected to persist at least through the mid-year 2018 renewal cycle and potentially longer. Thus we believe that now is tactically an attractive time to initiate or add to an investment in ILS.

Recommendation

We believe ILS funds present an attractive investment opportunity and should be of interest to a number of pension schemes and other investors. The significant disasters in 2017 have created a good timing opportunity for investors considering this asset class or looking to increase existing allocations.



We're here to empower results

Please contact your usual Aon consultant for more in-depth information and a discussion on whether and how to build up your exposure to ILS.

¹ "Reinsurance Market Outlook: Reinsurance Proves Its Worth", January 2018, Aon Benfield – page 1

Contacts

John Belgrove

Senior Partner
john.belgrove@aon.com
+44 (0)20 7086 9021

Kate Charsley

Partner
kate.charsley@aon.com
+44 (0)117 900 4414

Sion Cole

Senior Partner and Head of Client Solutions
sion.cole.2@aon.com
+44 (0)20 7086 9432
Follow me on twitter – @PensionsSion

Tim Giles

Head of UK Investment Consulting
tim.giles@aon.com
+44 (0)20 7086 9115

With thanks to our author

Callum Logan

Investment Consultant

Mette Charles

Senior Investment
Research Consultant

Chris Walvoord

Partner

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Registered Office:
The Aon Centre
The Leadenhall Building
122 Leadenhall Street
London EC3V 4AN

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