Twelve Market Perspectives 2014

January 2014

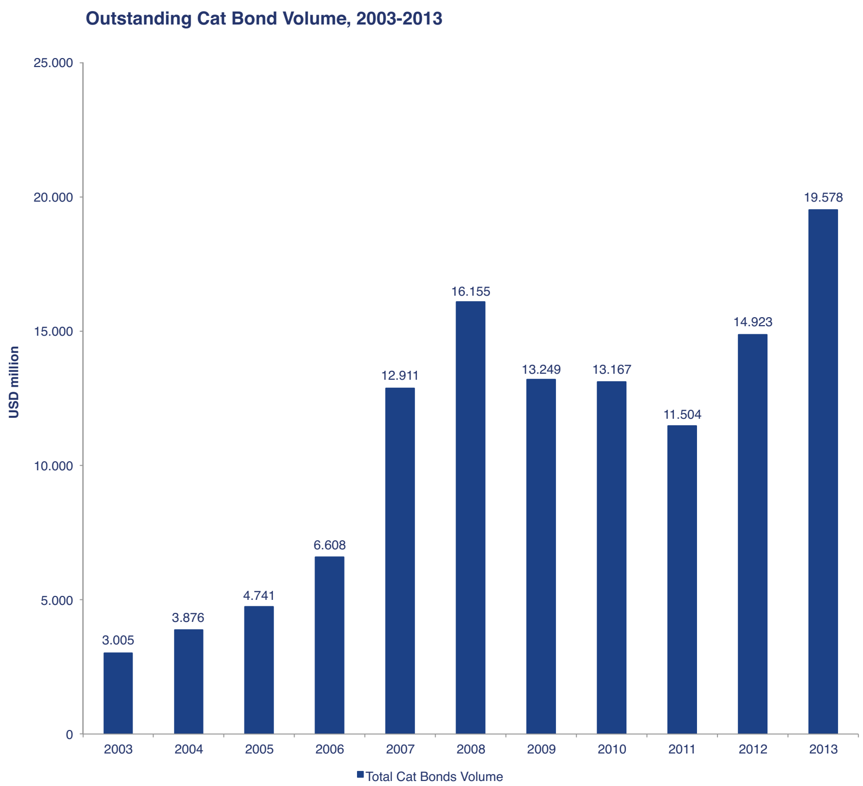
# Review 2013

The performance of all our portfolios in 2013 was excellent. Our Insurance Bond funds and mandates returned between 11.9% and 13.6%, ILS mandates between 8.5% and 10.1%, and Cat Bond funds between 4.3% and 6.7%.

A general tightening of spreads in fixed income markets helped drive performance gains in our Insurance Bond portfolios. In what is still an exceptionally low interest rate environment, investors searching for yield are buying riskier assets and pushing yields down further. We also captured gains by taking positions in a number of securities that we deemed were mispriced based on our in-depth fundamental credit & legal research, our understanding of the insurance industry, and regulatory developments. Our evaluation of each issuer's standing in the market, which is such a vital part of our ILS research, also benefited the performance of our Insurance Bond mandates.

The performance of our ILS mandates was driven partly by spread compression in the Catastrophe Bond markets due to significant demand and capital inflows from large institutional investors searching for yield. The gross yield of the overall Cat Bond market is currently 4.8% compared with 7.4% a year ago, while the expected loss remains around the same level of 200bp. Besides looking for yield, institutional investors are seeking the diversification benefits the asset class provides thanks to its lack of correlation to financial markets. The absence of any large insured losses from natural catastrophes in 2013 was also positive for performance.

In the Private ILS segment, we successfully sourced numerous transactions. Alongside our core portfolio of transactions exposed to natural catastrophes, we were active in encouraging new specialist classes to the ILS market. Our expert knowledge and sourcing ability enabled us to achieve attractive returns in an environment of falling reinsurance prices. For example, we generated double-digit returns from two transactions exposed to the US crop market, which is a well regulated sector backed by first-rate data. We saw an opportunity to benefit from favourable prices in the wake of a loss-paying year. We also generated excellent returns from a transaction exposed to global terrorism. The "terror" market is the best performing segment of the reinsurance market over the past ten years, and this was the first transaction of its type in the ILS space.




Source: Twelve Capital (CatEye) as of December 2013; and Swiss Re Capital Markets as of July 2013.

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## Outlook for 2014

We anticipate a challenging investment environment in 2014. Although interest rates are still at exceptionally low levels, they are likely to edge higher, especially at the long end of the curve. Investors will continue to search for yield in riskier assets, although risk premiums decreased significantly in 2013 and some markets already appear vulnerable to correction. Investors will also continue to look for uncorrelated investments and will want to keep the duration of portfolios as short as possible.

We see most value in more illiquid assets, as illiquidity premiums are still high compared to levels seen prior to the financial market crisis. Investors who do not need highly liquid investments, such as pension funds and life insurance companies, will seek to capture attractive illiquidity premiums.

**Insurance, BBB-Corporate and Bank Bonds Ask - Yields 2011 - 2013**


Source: Twelve Capital, data from Bloomberg. As of 31st December 2013.

## Insurance Bonds

We still see good value in bonds issued by insurance companies, as they offer higher spreads than bonds in most other sectors. The insurance sector also has an exceptionally low default history. Insurance bonds currently offer a yield of around 6% p.a., an average bond rating of BBB and relatively short non-hedged duration at 3 years.

There is still significant value in some of the Solvency I bonds that do not qualify under Solvency II and will have to be replaced by new Solvency II compliant bonds. The Solvency I bonds tend to trade below par and there is still a potential capital gain of 5% to be made in addition to the coupons. We believe some of the Solvency II bonds also offer very good value, especially those trading below their 2013 issue price.

The main performance drivers for our Insurance Bond portfolios in 2014 will be coupon income and further capital gains triggered by accelerated repayments of Solvency I bonds. We will continue to manage these portfolios actively and to leverage our in-depth understanding of credit risks in order to benefit performance.

Fundamental research and a sophisticated understanding of investment risks are key to achieving superior returns in this market environment. We will be highly selective and invest only in transactions offering attractive risk premiums. Finally, we will continue to treat market corrections as buying opportunities and will keep the duration of our portfolios short.

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## Private ILS

Each year around 65% of traditional reinsurance contracts are renewed on 1st January. The 2014 renewal season has been one of the most challenging in recent years, with rates in the traditional reinsurance market between 15% and 20% lower than a year ago. Even though premiums are on average lower than last year, we have still been able to secure some attractive transactions. Barring a large natural catastrophe, we expect our ILS mandates to produce high single-digit returns and portfolios with higher single event limits low double-digit returns.

We maintain and continue to refine our core property catastrophe portfolio, but are adding to it with participations in specialist classes where we still see good performance potential from business that is more complex to source. More specifically, we have entered the property fire market to complement our focus on positions in the terrorism and crop segments of the market.

In light of general market softness, we have adopted a highly defensive investment strategy. Our sourcing activities have been focused on a core list of high quality protection buyers showing strong performance in their respective fields. Capital is allocated across a range of first and second or subsequent event transactions in order to vary the attachment probability of the portfolio. We negotiate non-price related contract terms very carefully. Despite the pressure on margins, our portfolios remain focused and well structured.

As we move into more specific lines of business we are enhancing our research on natural perils. We are using the latest scientific models for predicting the intensity and frequency of US and European storms in the upcoming season in order to position our portfolios favourably.

## Cat Bonds

We do not see Cat Bond spreads tightening much further. In fact, some investors are even taking profits from their Cat Bond portfolios and shifting into Private ILS portfolios. New Cat Bond issuance volumes will remain strong as coupon levels for new bonds are attractive for (re)insurance companies. Investors will continue to seek out the diversification benefits Cat Bonds offer because of their non-correlation to financial markets. In the absence of major catastrophe events, the main driver of Cat Bond returns in 2014 will be coupon income.

A core activity for us in 2014 will be the development of Private Cat Bonds – small to medium-size transactions accessible only to us on the primary market. Our enhanced reinsurance network and proprietary modelling framework allows us to do state-of-the-art transaction sourcing and analysis, which generates more attractive returns and better diversification (e.g. through non-conventional lines of business such as aviation) than publicly traded Cat Bonds. In combination with our legal expertise, this allows us to package the bonds so that we can ultimately sell them in the secondary market. We are about to launch the Private Cat Bond Dodeka I, which we expect to achieve a double-digit return within the peak risk peril category: US Natural Catastrophe risk.

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## New Products

We successfully launched our Insurance Private Debt offering in November 2013. Our portfolios aim to capture the premium on offer because of the relative illiquidity of Insurance Private Debt assets. In the first two months following inception, the portfolios registered gains of up to 2.7%.

In Europe alone there are more than 5,000 insurance companies, many of which will need more regulatory capital when Solvency II comes into effect in January 2016. During and since the financial crisis, banks have tended to retreat from financing insurance companies and private equity. Quota share reinsurance is expensive. We therefore see an increasing need for debt financing of smaller insurance companies over the next 2 years.

Through our Private Debt offering we provide regulatory capital for small and medium-sized insurance companies. These financing arrangements will typically qualify as Tier II capital under Solvency II. In addition to a number of private placements sourced in the secondary market, we also participate in primary placement issues. Yields for Insurance Private Debt are very attractive as the illiquidity premium is around 300bp, which leads us to expect average gross yields of 8–9% in our Private Debt portfolios.

At the end of 2013, we also launched three Best Ideas mandates. These portfolios have the flexibility to invest in transactions and securities offering the best risk-adjusted returns across all asset classes in the insurance industry. The portfolios are more diversified than pure ILS and pure Insurance Debt portfolios but offer similar returns.

Our Best Ideas portfolios are currently positioned in high yielding Insurance Bonds and Insurance Private Debt transactions, as well as selected Private ILS transactions. We will buy Cat Bonds exposed to US hurricanes ahead of the wind season in June, which will allow us to capture the entire risk premium these instruments offer but to do so in only a few months of the year.

Our Insurance Debt, ILS and Best Ideas offerings allow us to profit from significant asset class synergies, particularly in relation to the sourcing and analysis of transactions, for the benefit of all our clients. Our standing as a broad provider of capital to the (re) insurance industry is increasing all the time.

**Your Twelve Capital Team**

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