Understanding risk when building ILS portfolios

Interview with Dr Jamie Rodney

After suffering considerable losses in 2017, investor faith in insurance-linked securities (ILS) might have been dented. However, investor appetite and demand for the asset class persisted as trustworthy managers with robust investment processes have shown clients they understand the risks within the portfolios they construct.

"Successful managers tend to be those who don't chase return but have a focused risk-based approach to investing in ILS," explains Dr Jamie Rodney, Executive Director, Twelve Capital. "The main factor ILS managers need to keep in mind is to ensure there are no surprises. If investors see a headline loss in the papers, then they are more likely to understand a hit on performance.

"However, losses which are not expected are harder to accept, especially if they are due to the way contracts are underwritten and therefore don't cover risks appropriately. With losses like these, it can be easy for investors to lose faith in the manager and potentially in the asset class."

The ILS market has seen significant dispersion in terms of performance and Dr Rodney stresses the importance for investors to understand the product: "Investors need to acknowledge that because one manager or product has negative performance, it doesn't necessarily mean that the whole segment will perform poorly.

"Investors have been spurred to assess the type of ILS allocation they are making. After 2017, everyone put ILS in the same bucket when actually they present a diverse set of risks and opportunities. However, the performance differentiation has made investors question what kinds of losses they are taking and how their portfolio is constructed. Managers who delivered strong performance over the last two or three years would have built their portfolios in ways to mitigate the underlying risks. Spread levels reached multi-year highs in 2020 and well-constructed portfolios are well positioned to deliver improved risk-adjusted returns when compared to previous years."

Diversification benefits

Risk is a critical element ILS managers need to consider. "We invest a lot of time trying to understand risk. Our part of the industry, at its core, is extremely risk aware," states Rodney.

He also highlights that the last two years have seen new risks coming to the market – risks like wildfires, floods and terror. This year has also seen the launch of the first catastrophe (cat) bond for volcano eruptions, which shows the potential for growth in new areas.

These new risks being identified also improve ILS's potential for diversification, which is the asset class's primary role within investor portfolios. This is particularly relevant for cat bonds.

"In 2020 cat bonds showed their diversification benefit, which is driving some of the current demand from investors. They have been relatively insulated from the worst of the losses and performance has been attractive. Also, the pandemic has had very little impact on cat bonds which breeds confidence among investors," Dr Rodney outlines.

"The primary selling point of ILS has always been the diversification benefits they offer within wider investment portfolios and this is not due to change. It's easy for people to comprehend that financial market distress does not cause a natural disaster. Therefore, they understand that an ILS allocation can provide diversification and enhance the risk adjusted return of their entire portfolio."

However, although the role of ILS within portfolios is well established, investors need to be aware of the way they manage the ILS risk within their wider asset allocation. "Unless you have a highly diversified ILS portfolio, it can be very tail heavy. So investors need to make sure their allocation is managed well from a risk perspective."

Ahead on climate risk

As sustainability and environmental concerns continue to rise on investors' agenda, Rodney draws attention to the fact that ILS managers are ahead of the game in some respects: "ILS might be one of the most risk aware industries especially with regards to climate change and its impact on financial instruments.

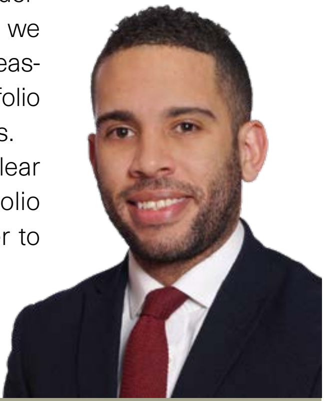
"Climate change has always been the hot topic in the ILS space. It's very easy to associate the risks we invest in with climate change; a risk which is very simple for investors to label. Further, regulatory and administrative pressures around ESG have been rising in the last year or two, which have led to additional considerations.

"It's increasingly challenging to communicate complex ideas in a simple way, especially with regards to climate change. An important part of our job is to give investors comfort to understand concepts which appear to be very complex. As managers, it's our role to educate our clients and build processes and transparent procedures to help people get a grip on this complexity in a straightforward manner."

In evidence of its commitment to assessing climate change risk, Twelve Capital has partnered with reask, a catastrophe analytics specialist providing global solutions for tropical cyclone risk management and forecasting. The firm's climate-aware Tropical Cyclone risk framework provided Twelve Capital with a view of what to expect for hurricane risk under a warming climate.

Rodney comments: "Technology like this can help us understand what happened in the last 20 years and what could have happened within different scenarios. Once we have the understanding of the pure risk these factors pose, we can build processes to incorporate those measures into what we communicate to our portfolio managers and turn them into useful metrics.

"We need to make sure this process is clear and transparent. It must enable the portfolio manager or the investment decision maker to interpret those results and make an investment decision by incorporating the latest science into those choices." ■



Dr Jamie Rodney
Executive Director, ILS Analytics, Twelve Capital

Dr Jamie Rodney joined Twelve Capital in February 2018. Prior to joining the firm, Jamie worked at Willis Re where he was a team leader responsible for developing analytical solutions to model natural perils and reinsurance programs in Africa, the Middle East and Turkey. Before joining Willis Re Jamie was a pricing analyst at Tokio Millennium Re specialising in pricing property treaties across multiple territories. Jamie started his professional career as a model developer at Risk Management Solutions (RMS), in 2012, where he developed state-of-the-art catastrophe modelling tools for assessing the financial cost of natural disasters. Jamie holds a First Class BSc degree in Mathematics and a PhD in Applied Mathematics both from University College London.