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Marketing material for professional/qualified investors only **February 2022**

Positive Outlook for Investments in the Insurance Sector in 2022

Executive Summary

- Twelve Capital believes the insurance sector will benefit from macroeconomic and idiosyncratic tailwinds in 2022. These include higher interest rates, an improving pricing environment, legacy portfolio optimisations and an increased focus on ESG factors.
- Twelve sees attractive investment opportunities in insurance fixed income thanks to credit spreads that are higher than those of corporates despite insurers' very low default rates and strengthened fundamentals.
- Higher solvency and capital generation also present an opportunity for equity investors that can profit from high and sustainable dividend yields from a sector that keeps trading at discount to the broader market.
- The key uncertainty for the sector remains geopolitical risk and the introduction of new accounting standards that will initially increase the sector's opacity.

Positive Sector Outlook

Macroeconomic trends as well as idiosyncratic factors are expected to support stronger insurance fundamentals in 2022, which is positive for both credit and equity investors in the sector. In particular, we see the rising yield environment in the USA and UK, and to a lesser extent in the European Union, as the key positive driver from a macroeconomic standpoint. Higher rates alleviate the capital pressure of legacy life contracts with guarantees (also known as back-book) and support capital releases. Moreover, higher interest rates will also have a positive impact on ongoing operating capital generation (OCG) for both life and non-life insurers as their investment income increases and the capital strain of new business reduces.

Despite the positive yield outlook, we observe that life insurers are still rightfully continuing to steer new business towards more capital-light products with higher shares of Unit Linked and hybrid products, while property and casualty (P&C) insurers keep focussing on underwriting discipline.

Rising inflation could pose a threat to P&C (re)insurers. However, Twelve Capital believes that the cost of short-term inflation can be passed on to policyholders thanks to the ability to reprice (typically annually) most retail contracts. Higher long-term inflation (and social inflation) would represent more significant headwind for long-tail lines (such as general liability, D&O, and casualty) although we do not expect it to cause sector-wide reserve strengthening.

Twelve Capital believes that uncertainties around Covid-related losses will continue to fade thanks to tighter wording in business continuity and event cancellation policies, higher vaccination rates with consequent lower excess mortality, and a continuation of benign claim frequency in motor and property possibly driven by more working-from-home.

From an idiosyncratic standpoint, we see positive momentum for M&A, disposal of back-books, and investments in technology. The sector remains relatively fragmented and we see areas of potential consolidation, for example, in the Lloyd's space and in the UK motor market. We also see potential for simplification in the structure of some groups that would probably benefit from breaking up. The disposal of capital heavy legacy back-books with low profitability is also a catalyst for strengthening insurer solvency and improving cash and capital remittances. Digitalisation and technology remain a key topic for the sector. A modern IT infrastructure not only translates in better customer retention, data and therefore pricing, but also allows groups to be more agile when making acquisitions.

In recent years, uncertainty for the reinsurance sector was largely driven by earnings revisions caused by understated natural catastrophe budgets. Reinsurance pricing was slow to react to the increased frequency of catastrophic events over the past five years. However, an overall benign pricing environment with hardening rates, a reduced appetite for higher frequency structures, and changes in the overall risk appetite (with higher diversification in some cases, and higher protection with lower retention levels in others) are all supportive factors for 2022.

With more clarity provided around the Solvency II review, potential for regulatory risk has reduced, in Twelve Capital's view. The impact of the review will likely be broadly neutral in the long term. Short-term positive elements, such as a better adapted Volatility Adjustment calculation, a lower and less volatile risk margin, and lower capital charges for long-term equity holdings will be partially offset by changes in the extrapolation methods of long-term rates and the inclusion of negative interest rates in the standard formula. Companies with long tail businesses in core-European countries could be marginal losers from the reform.

Lastly, we see the sector making important progress when it comes to ESG. A high 65% of the companies under our credit and equity coverage are signatories of the United Nations' Principles for Responsible Investments, and the number is growing. Also, fifteen of the world's leading (re)insurers came together to create the Net-Zero Insurance Alliance, committing to individually transition their underwriting portfolios to net-zero greenhouse gas emissions by 2050.

We believe the key potential risks to the sector in 2022 could come from geopolitical uncertainty and the introduction of new accounting standards. Geopolitical risks, which are likely to represent a threat not only for insurers but for the broader financial markets, are related to scheduled or potential elections in some European countries and the rising tension in Eastern Europe that could escalate into a conflict.

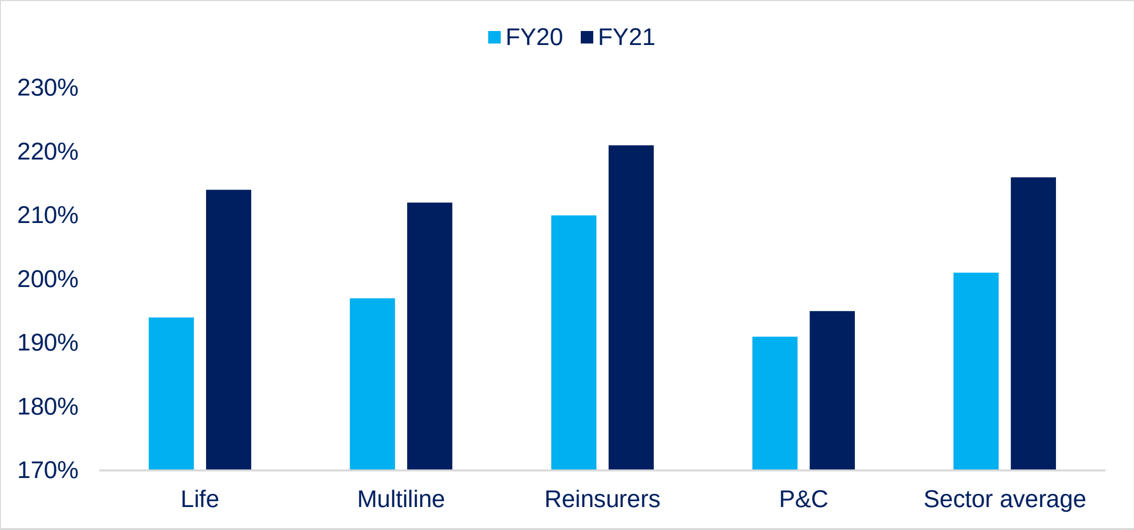
From an accounting standpoint, the introduction of IFRS 17 will revolutionise the way P&L and shareholders' equity are presented and will likely increase the opacity of the insurance sector for generalist investors. We believe non-life short-tail insurers will likely be best positioned to face these accounting changes, while we expect more uncertainty for life players and particularly bulk-annuity players. The Dutch market, which has long focussed on Solvency and cash metrics rather than IFRS ones, will likely show good resilience.

Insurance Fixed Income: Solid Capital Position, low Defaults and attractive Spreads

Strong fundamentals, underpinned by stable earnings and a solid capital position which translate into historically low default rates, support our investment thesis in insurance fixed income that continues to yield in excess of other corporate sectors. The insurance industry benefits from a very strong capital position. The average regulatory capital ratio of the sector is expected to stand at 216% at FY21 according to Twelve Capital's estimates, with no insurer under our coverage sitting below 150%. This represents a material increase compared to the already robust ratios at FY20 when the sector had resources twice the minimum capital required by the regulator. Moreover, the sector shows a manageable leverage ratio at around 30% calculated based on Solvency II metrics.

The main driver of the improvement in 2021 was the rise in risk-free rates, with which solvency ratios are positively correlated. This is especially true for insurers with life guaranteed business as the cost of the guarantees decreases as risk-free rates go up. This explains why the upward move in solvency ratios was larger for life and multiline players (+20pts and +15pts respectively), as shown in figure 1.

Figure 1: Estimated regulatory solvency ratios by sub-sector



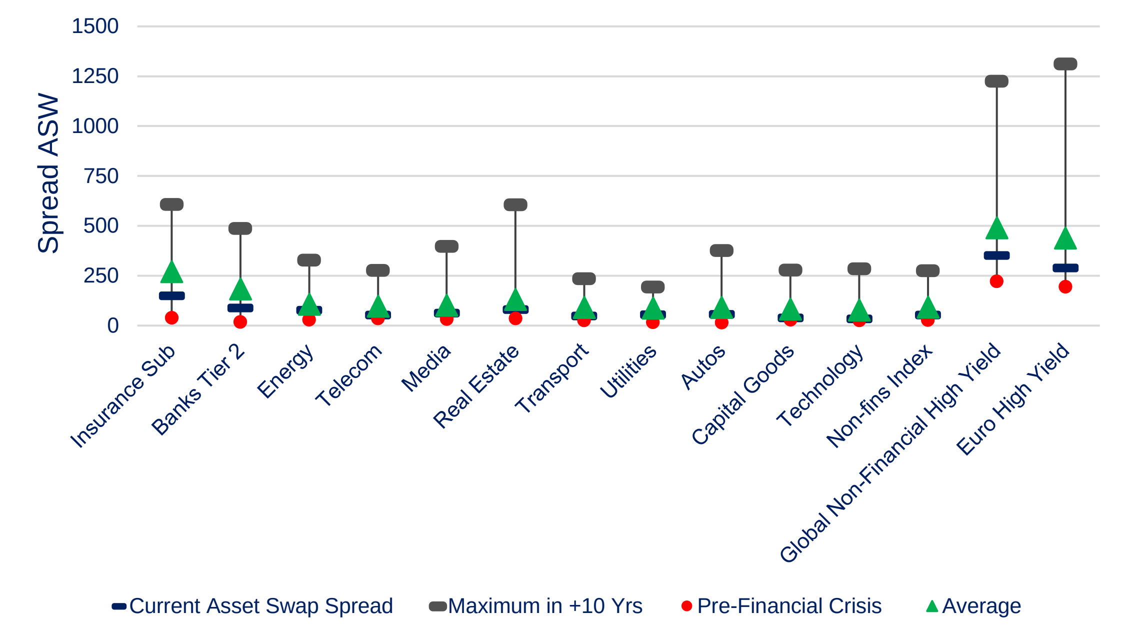
Source: Twelve Capital, companies' reporting. As at 31 December 2021.

In addition, solvency ratios somewhat benefitted from management actions, such as debt issuance and disposals of some capital-heavy legacy life back-books (the latest example being Zurich, which disposed of part of its life business in Italy with a benefit of 11pts on its solvency ratio). We also note that the increase in rates will translate into higher organic capital generation for the industry going forward, as reinvestment yields will rise.

High solvency ratios and a tight regulatory framework have translated into historically very low levels of default for the sector. In the benchmark-size space, we recall only a handful of missed coupons and no principal lost through the great financial crisis, the European peripheral debt crisis, and the Covid pandemic.

Despite solid fundamentals and low default rates, the insurance industry offers attractive and higher credit spreads than other investment grade sectors, as shown in figure 2. Twelve Capital believes that this excess spread is mostly due to the industry's complexity for generalist investors.

Figure 2: Asset swap spreads range current and pre-financial crisis



Source: Twelve Capital, BOA Indices, Bloomberg data in EUR. As at 31 December 2021.

Insurance Equity: attractive Discounts and dependable Yield

The reliability of insurers' cash flow generation and dividend capacity, together with the attractive valuations at which the sector trades sustain our positive view on investments in insurance equity.

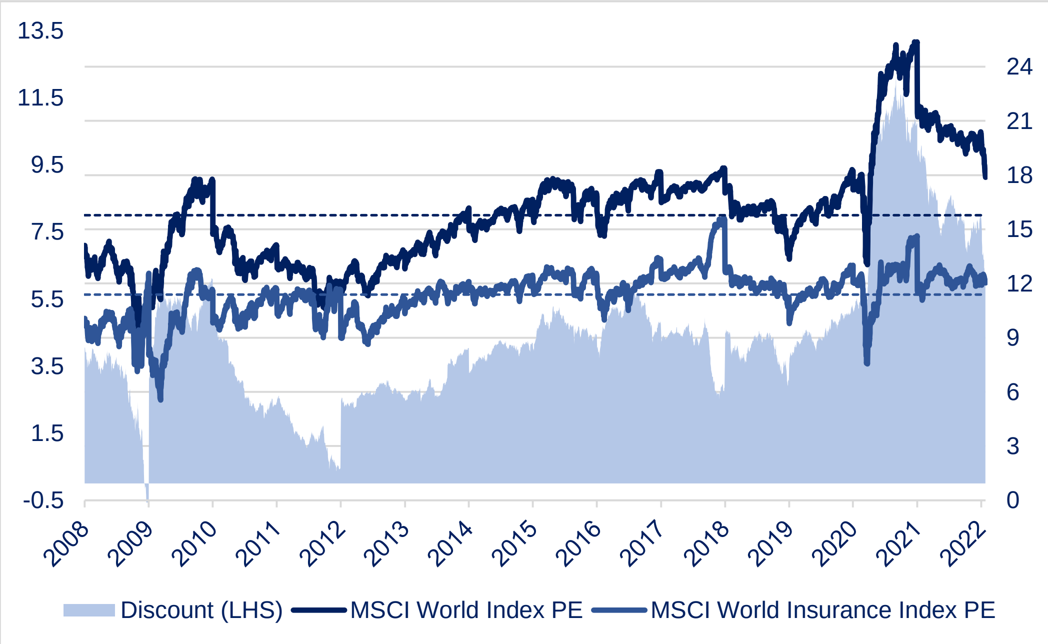
The MSCI Insurance World Index[1] registered a good total return of 18.8% in 2021, but still underperformed the MSCI World[2] by 3.5%. We believe generalist investors' focus was mostly towards sectors that were expected to benefit more from the reopening of the economy. Still, we believe the reliability of the insurance sector did not receive the credit it deserved, as the sector proved resilient in 2020 and still showed small increases in earnings forecasts during 2021.

Going into 2022, we believe insurance equities look attractive as they trade at relatively low multiples and are supported by positive sector and macro outlooks. After 2021, the sector trades at a high discount to the wider market; the MSCI World Insurance is trading at a Price to Earnings (PE) ratio discount of 5.8X PE versus the MSCI world index, compared to an average discount of 4.4X when taking into consideration 2008 to 2021 as illustrated in figure 3. As market attention moves away from the theme of recovery, we believe the insurance sector's offering to be an attractive one, with solid dividend and capital distribution, a reasonable earnings growth levered to rising rates and a robust solvency and balance sheet position (please see figure 4). In particular, the sector's characteristic reliable yield positions it well against other sectors and should appeal to investors in a still low-yield environment.

[1] The MSCI World Insurance Index is an index focused on measuring the equity performance of the ca. 80 largest listed global insurance companies weighted by free-float of market capitalisation.

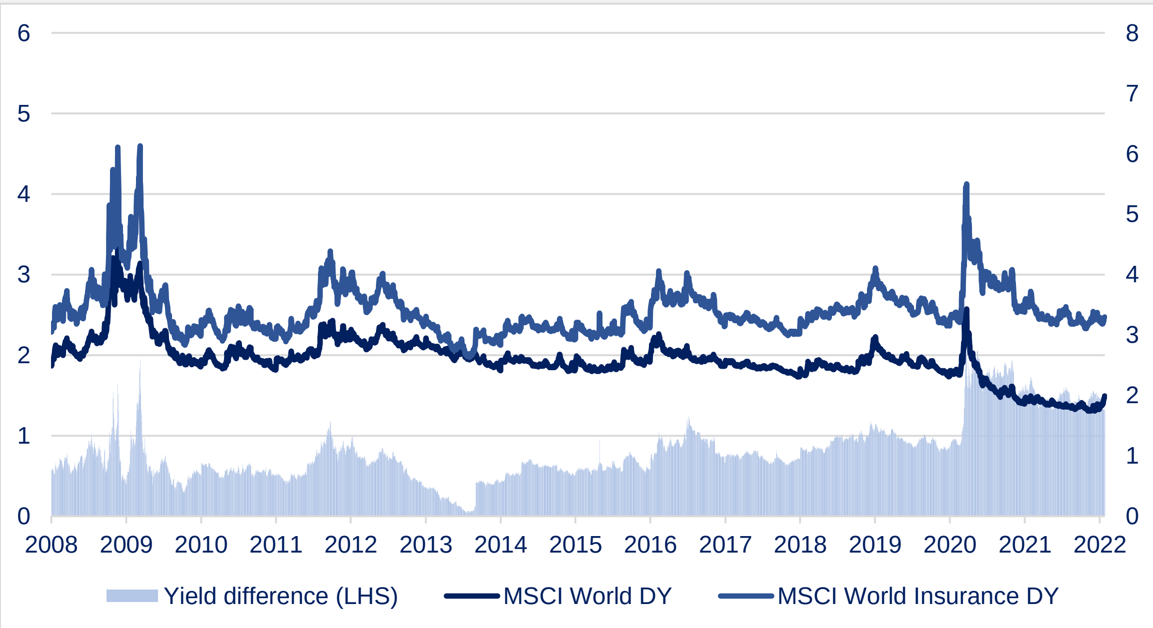
[2] The MSCI World is a market cap weighted stock market index of more than 1'550 companies throughout the world.

Figure 3: Insurance vs market price to earnings



Source: Bloomberg. As at 25 January 2022.

Figure 4: Insurance vs market dividend yield



Source: Bloomberg. As at 25 January 2022.

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About Twelve Capital

Twelve Capital is an independent investment manager specialising in insurance investments for institutional clients. Its investment expertise covers the entire balance sheet, including Insurance Bonds, Insurance Private Debt, Catastrophe Bonds, Private Insurance-Linked Securities and Equity. It also composes portfolios of its Best Ideas. It was founded in October 2010 and is majority-owned by its employees. It has offices in Zurich, London and Munich.

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