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Executive Summary

- Financial markets are experiencing increased headwind with the worsened geopolitical environment and prospects for longer-lasting inflation.
- Nevertheless, insurers' creditworthiness is resilient and it is underpinned by stable credit ratings and increasing solvency ratios.
- We believe that the resilience of the sector in periods of protracted stress makes insurance debt a reliable component of every fixed income allocation.
- The current mispricing of insurance debt offers investors an excellent entry opportunity in the asset class.

Insurers' fundamentals prove once again resilience in period of stress

Since our publication in February 2022, we believe that the headwind for financial markets has increased. This is mostly a consequence of the protracted geopolitical uncertainties and the prospects for longer-lasting inflation. In this context, the insurance sector remains resilient and largely insulated from systemic shocks. If we look forward, we believe the sector is strongly positioned to maintain its investment grade credit quality and low default rates.

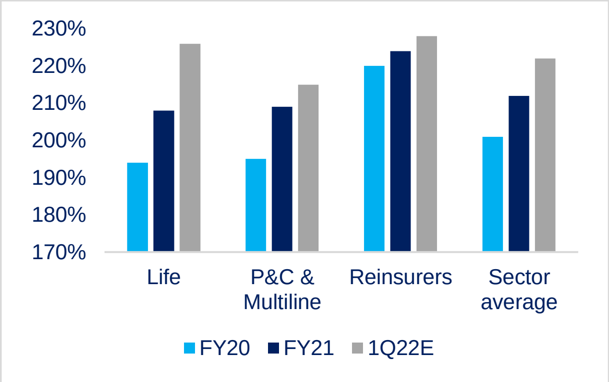
When focussing on recent events, the size of insured losses in Ukraine and Russia remains a topic of debate for the insurance sector. These claims will mostly stem from aviation, marine cargo and energy policies and it will take time before we will be able to get to a precise estimate of the total losses. Current ranges are typically between USD 10bn and USD 20bn.[1]

While the amount might seem large in absolute terms, it compares to a mid-size natural catastrophe and is therefore well manageable by the strongly-capitalised sector. In other words, we believe these claims to potentially erode 2022 earnings for some players but not to significantly hamper their capital levels nor their ability to fund growth in what remains a market underpinned by positive pricing momentum.

The geopolitical tensions have pushed gas and agricultural prices up, while the Zero-Covid policy in China continues to represent a threat to the global supply chain. Both factors have contributed to increase the risk of longer-lasting inflation, potentially translating into a much-feared stagflation scenario (high inflation and low economic growth) that would complicate monetary policy decisions. Sustained inflation could be a threat for some insurers underwriting long-tail risks (such as income protection or casualty), but should be manageable for the majority of players (at least two thirds of the universe under our coverage), which are mostly retail-oriented, diversified or short-tail.

Despite these uncertainties the capital ratios of (re)insurers under our coverage have increased by another 10 percentage points in the first quarter of 2022 to a very comfortable 220% of the level required by their respective regulators (Chart 1). The increase was mostly a consequence of higher rates and positive earnings.

Chart 1: Solvency ratios estimates by sub-sector



Source: Twelve Capital, companies' reporting. As at 9 May 2022.

[1] Twelve Capital market insight. As at May 2022.

In addition, we note that all major credit rating agencies maintain stable outlooks on the vast majority of the insurance groups, and they assign them financial strength ratings that are in the solid "A" range, on average.

In addition, despite geopolitical risks and inflation, we highlight that most of the positive elements that we flagged beginning of the year as tailwind for the sector continue to hold true. These include the positive impact of higher rates on solvency and reinvestment yields, improved direct and reinsurance pricing, a lower Covid-related mortality, and M&A aimed at reducing balance sheet risks related to legacy capital heavy contracts. To these we can add the result of the French presidential election – which provides continuity in one of Europe's biggest markets, and supportive comments made by the UK government on potential upgrades to their domestic solvency regime.

Significant opportunities in an attractive asset class

We believe that the resiliency of the sector through periods of market stress and volatility makes insurance debt a reliable component of every fixed income allocation.[2] We flag the excellent credit track record of the sector through the global financial crisis, the European peripheral debt crisis, the Covid pandemic and the actual geopolitical situation.

In fact, insurers maintain one of the lowest default rates in the corporate sector and are supported by manageable leverage ratios, no reliance on short-term liquidity financing, strong and holistic risk management practices and tight regulation.

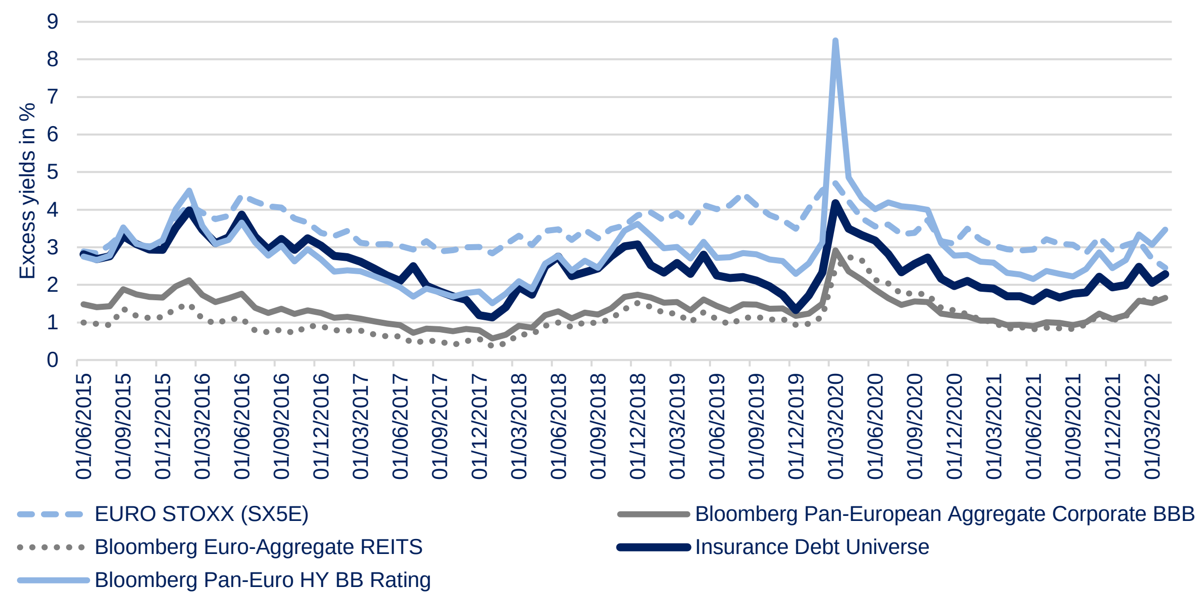
Insurance is likely to be the most mispriced sector within fixed income markets, creating an excellent entry point

The spread paid by insurance debt increased by close to 80% to 260 basis points since the low point recorded at end of the third quarter of 2021 (12.05.2022 compared to 30.09.2021). The current levels, together with the attractive structural features of insurance debt (mostly dated bonds with fix-to-floating coupons) present an excellent entry point for investors looking for yield and security.

In fact, insurance debt continues to offer attractive returns in absolute and relative terms. The following chart (Chart 2) compares the excess yield of various asset classes above the 10-year generic Eurozone government bond (as a proxy of risk free for European investors). It highlights how bonds issued by insurance companies, which are intrinsically investment grade at BBB on average, yield well above investment grade corporates and REITS. Their yield is on average closer to BB bonds but showing materially less volatility. Moreover, the duration of the insurance debt universe is typically lower than for corporates.

[2] None of the information contained herein should be regarded as a recommendation to buy, sell or deal in any security. This is not an investment advice and does not take into consideration an investor's specific circumstances.

Chart 2: Yields in excess of 10y Eurozone Government bonds



EURO STOXX 50 index dividend yield. Shown in the chart is the index yield to worst of the following indices: **Bloomberg Pan-European Aggregate** corporate BBB total return index unhedged. **Bloomberg Euro-Aggregate REITS** total return index unhedged. **Bloomberg Pan-Euro HY BB Rating** only total return index unhedged. **Insurance Debt Universe** in EUR. Please refer to the end of this document for details on the indices used.

Source: Bloomberg, Twelve Capital. As at 29 April 2022.

We believe that specialised investors such as Twelve Capital are well positioned to capitalise on the opportunities offered by this dislocated market where bond prices often do not reflect credit fundamentals.

For example, when looking at segments of the Insurance Bond market, we highlight interesting relative value opportunities in:

- Life insurers based in continental Europe with capital ratios highly geared towards rising rates

- Bonds with short call dates, where there is a high incentive to redeem for the issuer

- Companies for which we believe the market reaction following the Ukraine invasion was overdone.

Twelve Capital's deep sector understanding and its active portfolio management approach are key factors in order to benefit from the current investment opportunities.

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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.

Indices

Bloomberg Euro-Aggregate REITS Total Return Index – Der Index measures the performance of European REITS.

Bloomberg Pan-European Aggregate Index – The index is a subset of the Bloomberg Pan-European Aggregate Index and tracks fixed-rate, investment-grade securities issued in different European currencies.

Bloomberg Pan-European HY – The index measures the market of non-investment grade, fixed-rate corporate bonds denominated in different European currencies.

EURO STOXX 50 Index – The index is composed of 50 large, listed companies in the euro area. It is considered one of the leading stock market barometers in Europe.

Insurance Debt Universe is Twelve Capital's compiled investable universe of subordinated debt issued by mostly European insurance groups.

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