The importance of handpicking investments in the insurance space

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Executive Summary

- The insurance sector offers attractive returns as its complexity for generalist investors translates in a premium that can be harvested by specialist managers.
- Key topics such as climate change, inflation, rising interest rates as well as geopolitical uncertainties are overall manageable by the sector. However, they can affect insurance companies and sub-sectors differently.
- These elements translate into a wide dispersion of returns when investing in insurance equity and fixed income.
- Therefore, great emphasis should be put in the selection of securities and the handpicking of investments in the insurance space.
- With a team of professionals with extensive insurance and investment backgrounds, Twelve Capital is well positioned to generate attractive risk-adjusted returns for investors in this complex, resilient and under-researched sector.

A complex sector with wide dispersions of achievable returns

Twelve Capital provides access to a wide spectrum of investments in the insurance sector: from more plain vanilla investments in Insurance Equity and Debt over bespoke insurance capital solutions to more complex ILS transactions.

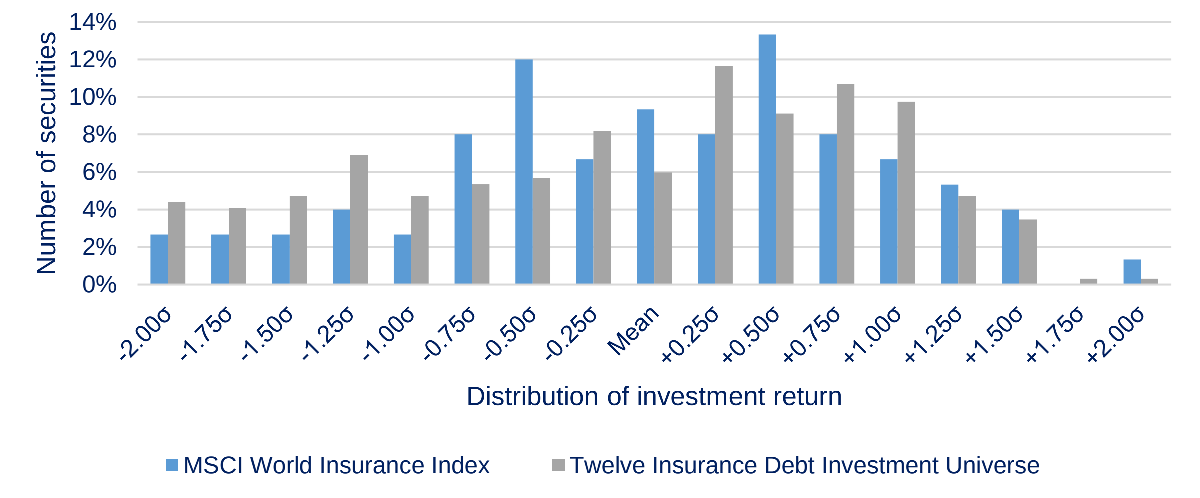
While offering attractive risk-adjusted returns, the insurance sector presents challenges to general investors given its complexities. Insurers operate in a highly regulated environment which is constantly evolving and differs substantially by jurisdiction. They have specific cash flow profiles which vary from corporates in other industries, and there are distinct commercial dynamics and product offerings in each country. These elements translate into peculiarities for each line of business and geography.

Therefore, given the specific characteristics of each company and sub-sector, insurers show different sensitivities to systemic elements such as inflation, interest rates, geopolitical tensions or ESG aspects. For example,

- rising interest rates are a positive for the sector's fundamental credit quality, and we believe traditional life and savings insurers are the sub-sector better placed to profit from this trend. Within this group, we see French savings players as the best positioned.
- while inflation is typically a challenge for the entire sector, retail non-life players are the most negatively exposed. Amongst them, motor players are more vulnerable and particularly those operating in competitive markets like the UK, in our view.
- ESG is a key topic for the sector. We see large multiline players as subject to investor's scrutiny and hence more sensitive to ESG thematic.

Based on historical cumulative returns since January 2021 we observe a relatively large dispersion of returns achievable in direct investments in insurance equities and bonds. Chart 1 shows their distribution around the respective index average. For example, around one fifth of insurance bonds showed a return that is lower than the index by 1.25 standard deviations or more. This dispersion confirms the importance of active portfolio management and security selection.

Chart 1: Distribution of investment returns across insurance securities since 1 January 2021



Past performance is not indicative of future returns. Please refer to the end of this document for details on the indices used.

Source: Bloomberg, Twelve Capital. As at 31 August 2022.

Deep sector understanding is essential to differentiate between investment opportunities

In this section we focus on two themes that matter to investors and are the most discussed amongst the investment community during conference calls with insurance groups. At the 2022 half-year reporting these were inflation and interest rates.

Inflation was mentioned 409x in June transcripts available for analysis by Bloomberg. That is over twice the number of times interest rates were mentioned, 2.5x the talk of dividends, and more than COVID-19 in its peak.

We will focus on one example for each theme and highlight how investors in fixed income and equities can benefit from an active security selection.

Insurance Debt: selecting companies with credit fundamentals that are positively correlated to interest rates

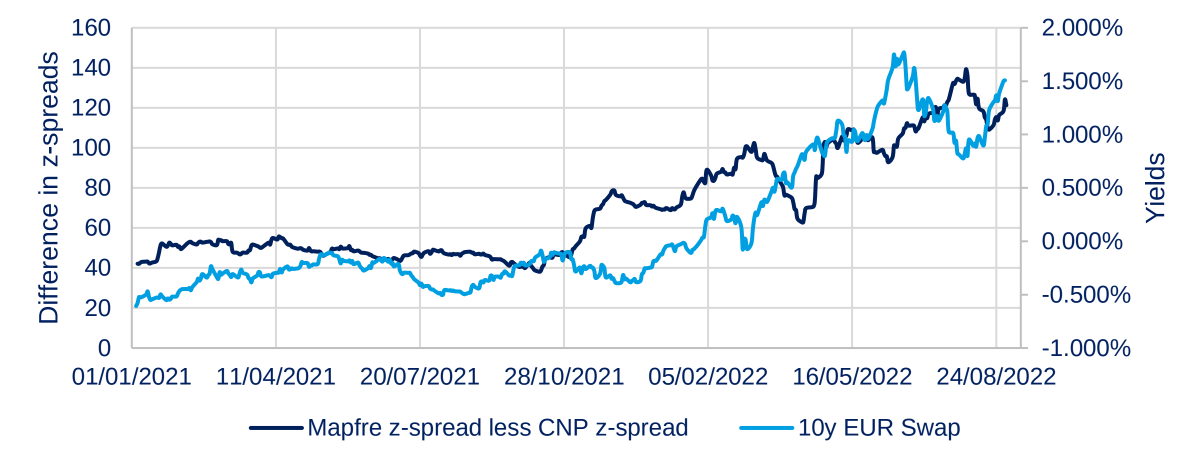
Our first example[1] highlights the fact that changes in interest rates affect certain insurance players differently and that this can have a significant impact on potential returns. Both companies we look at are mid-cap insurers operating in Continental Europe and South America. These are CNP, a business positively geared toward rising interest rates, and Mapfre, which in turn is negatively correlated to interest rates.

CNP is a life player that mainly writes business in France, Brazil and Italy. 60% of its premiums are savings/pensions while 40% protection. Mapfre is a multi-line player that writes mainly business in Iberia and Latin America. 85% of premiums are non-life and a more limited 15% is life.

In the chart below we compare two Solvency II compliant Tier 2 bonds with very similar duration and similar structure (they both mature in 2047 and present a call date in 2027) issued by CNP and Mapfre.

[1] The examples made are not recommendations to hold, buy, sell any of these securities and reflect Twelve Capital's view and this could change any time. The examples may or may not translate into actual positions in funds managed by Twelve Capital.

Chart 2: Mapfre and CNP Tier 2 bonds



Source: Bloomberg. As at 31 August 2022.

None of the information contained herein should be regarded as a recommendation to buy, sell or deal in any security.

CNP has been outperforming Mapfre since 2021 with the difference in the spreads paid by the two bonds widening from 42bps as at 1 January 2021 to 121bps as at 31 August 2022. We believe this outperformance is strongly correlated to the 90bps rise in interest rates recorded over the same period.

CNP's solvency ratio and hence creditworthiness benefits from higher interest rates in two ways:

– Capital requirements decrease: Higher interest rates increase the gap between policyholders' guarantees and insurers' running yield, allowing insurers to better absorb losses under stress scenarios.

– Own funds increase: Liabilities often have a longer duration than assets (due to constraints in finding long dated assets) and are therefore more sensitive to changes in interest rates. An increase in interest rates will lower both assets and liabilities with the latter being more impacted.

CNP increased its solvency ratio by 32pp in 2022 (from 217% in FY 2021 to 249% in H1 2022). During the same period, Mapfre's solvency coverage increased only by 3% on a like-for-like basis[2].

A higher solvency ratio suggests lower chance of bondholders incurring losses. This was ultimately reflected in the relative spread development.

Therefore, in a rising interest rate environment it is paramount to differentiate between insurers by adopting an active allocation. An investor with an overweight position in CNP relative to Mapfre would have outperformed by 2% since 2021.

Insurance Equity: managing inflation risk thanks to a deep knowledge of market dynamics

Our second example aims to demonstrate excess return potential in the equity space by differentiating between two non-life insurers based on their resilience to claims inflation.

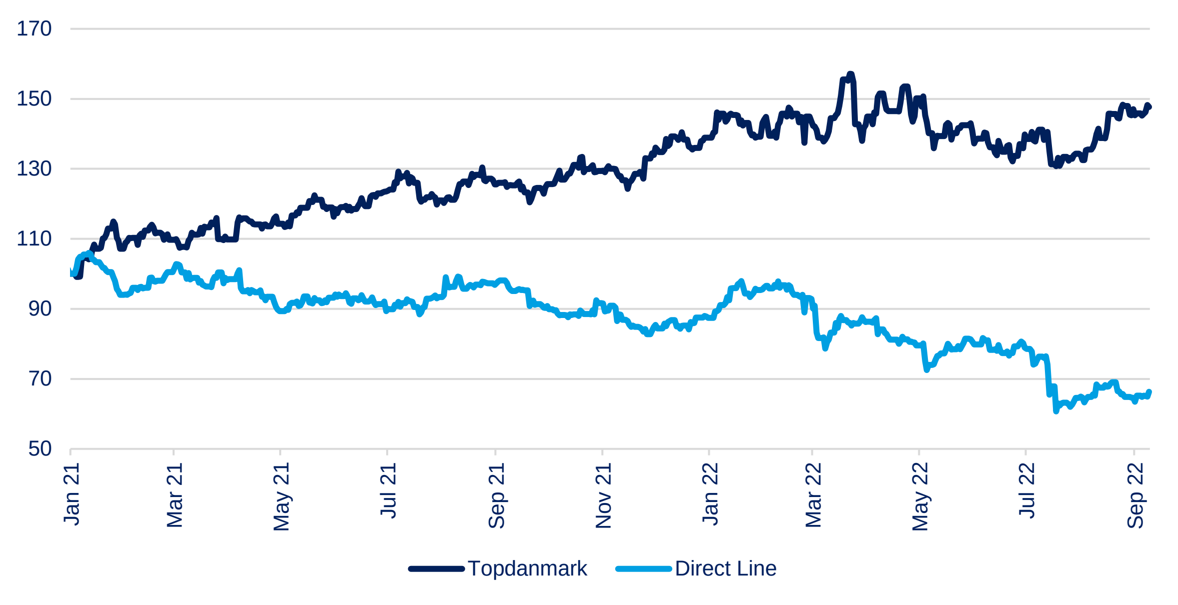
Direct Line is a leading motor and home insurer in the UK. Similarly, Topdanmark is a motor and property insurer operating in Denmark.

[2] Mapfre's reported solvency ratio was at 220% as at H1 2022 including the Tier 3 bond they issued in April 2022. Excluding the Tier 3 bond, solvency ratio would be at 209%.

Motor and property insurers generate the bulk of their earnings from underwriting profits rather than investment returns. Personal policies are mandatory and typically renewed each year. Claims costs are broadly correlated with consumer price inflation and earnings are vulnerable to sharp and unexpected inflationary spikes as experienced in the first half of 2022.

An insurer's ability to weather the negative impact of claims inflation depends on the product mix offered, the degree of pricing power and other underwriting mitigants.

Chart 3: Relative share price performance (LCY. 31 December 2020 = 100)



Source: Bloomberg, Twelve Capital. As at 9 September 2022.

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The chart above demonstrates the marked difference in share price performance which we believe is strongly correlated with the two companies' resilience to inflation.

The Nordic countries are characterised by a high degree of concentration and profitability is structurally better where insurers have a high degree of pricing power. On the contrary, the UK Motor market is highly competitive, and pricing power is therefore limited.

The differences between the two companies are amplified by the distribution channels: Topdanmark fosters customer loyalty through direct distribution channels, while Direct Line competes with rivals on price comparison websites (a highly price sensitive distribution channel).

Reported results at half-year suggest that Topdanmark has been able to adequately anticipate and pass inflationary pressures to its customers and maintain operational profitability, while the operational deterioration in H1 2022 forced Direct Line to issue a profit warning ahead of its interim earnings.

For an equity owner, the difference has manifested itself in a circa 30% performance differential.

Twelve Capital remains well positioned to generate attractive risk-adjusted returns for its investors

While Twelve Capital has been vocal in promoting the long-term return opportunities in the resilient and under-researched insurance sector as a whole, as highlighted in the previous paragraphs, the complexity of the sector asks for specific skills in order to distinguish between issuers, capitalise on existing opportunities, and avoid areas of hidden risks.

Twelve Capital has a holistic approach to investing in insurers' balance sheets, with dedicated offerings covering fixed income, equity, collateralised reinsurance and multi-asset products combining them. The cross fertilisation of expertise of people with insurance and investment backgrounds allows for handpicking attractive opportunities, combined them in actively managed portfolios and thus generate attractive risk-adjusted returns for investors.

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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

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

MSCI World Insurance Index – The index is an index focused at measuring the equity performance of the c.80 largest listed global insurance companies weighted by free-float of market capitalisation. (NDUWINSU)

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