Twelve Capital Letter from the CIO

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Urs Ramseier, CIO & Founding Partner at Twelve Capital, provides an outlook for 2023 for insurance investment opportunities across various asset classes.

"The current market environment offers an attractive entry point for investors."

An attractive entry point

"When written in Chinese the word crisis is composed of two characters. One represents danger, and the other represents opportunity".

This famous quote by John F. Kennedy reminds us that opportunities present themselves in challenging times, such as the year that just ended.

In fact, in 2022 the world was confronted with a number of challenges, including the war in Ukraine, disruptions in supply chains, the escalating energy crisis, rising inflation as well as severe natural catastrophes and climate change related events. All these factors led to outsized, and in many cases excessive, swings in asset prices. However, the current market dislocation brings new investment opportunities in many asset classes and Twelve Capital believes this is now one of the best entry points for investors in decades.

Moreover, growth in demand for insurance will be supported in the following years as the impacts of climate change become more pronounced and actors seek to close protection gaps for natural catastrophes, complementary health and pension products. In this context, financial markets and alternative capital providers such as Twelve Capital are vital in supporting and offering solutions.

Twelve Capital is looking forward to continuing delivering attractive risk-adjusted returns for investors in 2023 and beyond. We present our outlook for the asset classes Twelve Capital is active in the coming paragraphs.

Key Market Risks
– Continued geopolitical uncertainties – Length and severity of recession, and implications on credit spreads and equities – Increasing frequency and severity of climate events – Emerging insured risks such as cyber
Main Opportunities
– High bond yields, cat bond spreads and attractive equity dividend yields – Secular trends such as climate change and protection gaps increasing insurance demand – Historical resilience of the insurance sector and positive gear to higher interest rates – Tighter reinsurance capacity leading to higher pricing and margins

Insurance-Linked Securities (ILS)

Low correlated returns benefitting from historically high spreads levels

During 2022, ILS have shown their value again as a diversifying asset class thanks to a positive start into the year, when other financial markets exhibited significant volatility. However, diversification does not mean risk free, as was shown by the impact of Hurricane Ian in September, which has brought some losses for the ILS and Cat Bond markets. Fortunately, with loss estimates of around USD 50-60bn, the overall impact for the asset class appears to be manageable.

However, another year of relatively high insured catastrophe losses further increased the overall shortage of capital in traditional (re-)insurance markets. This had driven Cat Bond spreads to record levels towards the end of 2022, as capacity in global reinsurance markets was further reduced due to Hurricane Ian and other natural catastrophe losses during the year.

As at December the average Cat Bond yield in the market stands at around 14% in USD. The increase compared to previous years was driven by both a significant increase in money market rates and a substantial increase in the spread.

In the Private ILS sector, we see highest premium levels for decades. In addition, there is a significant improvement in contract language, terms and conditions.

The current market environment presents an interesting opportunity for new investors to enter the ILS market or for existing investors to top-up on their holdings.

Insurance Bonds

Rebound in an investment grade asset class

Insurance Bonds start 2023 with yields last witnessed in 2010 and 2011 after the global financial market crisis. Fast forward to today and the fundamentals of the insurance sector have never been healthier, also thanks to the upgraded and conservative regulatory regimes put in place over the past years. For example, in Europe, solvency ratios remain comfortably high at around 225% on average across the industry. Looking ahead we expect these ratios to remain resilient and well above regulatory minimums.

> ***"We think insurers can once again show resilience to headwind in the current market environment."***

At the forefront of investors' minds going into 2023 is growing concerns of a broader macroeconomic slowdown and how best to navigate what could still be a challenging year ahead.

In 2023 we expect Insurance Bonds to appeal to those investors who are seeking to protect their portfolios from the slowing economic backdrop given the industry's more defensive nature. An allocation to Insurance Bonds offers a sensible solution for the need to have a reliable coupon, higher quality credit whilst protecting portfolios from defaults or ratings downgrades. In Twelve Capital's view this sheer demand will keep Insurance Bonds' spreads relatively contained while there is potential for capital gains due to spread decompression in addition to a very attractive running yield.

Insurance Private Debt and Enhanced Credit

Resilient creditworthiness and a very healthy pipeline

We believe 2023 to be an interesting entry point for investors in Insurance Private Debt and Enhanced Credit. We think that smaller and mid-sized insurers can once again show resilience to an inflationary and recessionary environment, in contrast to general corporate issuers.

In past years there was an influx of affordable capital into the mid-market corporate sector: corporate indebtedness increased and lending standards became more lax. We see both higher borrowing costs and lower revenues driven by a recessionary environment as risks for these highly levered corporates.

Conversely, insurers have maintained lower debt ratios on average and they benefit from highly cash generative businesses. They managed to pass on most of the claims' inflation to policyholders and show revenues that are resilient in a recessionary environment. In fact, many lines of business are mandatory and policyholders tend to stick to their insurance covers in times of economic uncertainties.

Lastly, the deal pipeline remains healthy. Twelve Capital sees a rich pipeline of sub-benchmark[1] insurance deals allowing to lock-in attractive yields[2] in the 8%-12% range in EUR for defensive credits. Inflows and the natural churning of the funds we manage allow us to take advantage of these opportunities while maintaining well diversified portfolios by both line of business and geography.

[1] Sub-benchmark size deals defined as transactions smaller than EUR 300m in size.

[2] Past performance is not indicative of future returns. The money placed in the fund can both increase and decrease in value and you may not get back the full invested amount.

Insurance and Financials Equity

Addressing the funding gap to reach net zero

Twelve Capital's Climate Transition Equity Strategy was classified as Art. 9 based on the EU SFDR in the last quarter of 2022. We believe enabling the reallocation of financial capital from high carbon to low carbon activities will remain at the forefront of policymaker and investor debates in 2023.

Economic conditions will be challenging at the start of 2023 with recessions expected in many major markets. Monetary policy likely remains tight as central banks grapple with inflation and fiscal supports will roll-off post-pandemic. However, there are reasons to be optimistic into this cycle: labour markets have remained resilient and household indebtedness is reasonable. Credit growth has been restrained in past years and capital levels in the banking system are reasonable.

Earnings expectations have been significantly reduced and now valuations could be seen as compelling. Insurance equities demonstrated their defensive characteristics in 2022 and we believe that this can continue in 2023. Solvency levels are high. Moreover, with generally healthy cashflows company dividends are sustainable and we see potential for incremental capital returns to shareholders. Broader financials' fundamentals are in a more resilient position than in prior cycles and have been benefiting from higher interest rates.

Insurance and other financial companies play an increasing role in the intermediation of capital during the energy transition. Energy security and cost concerns are on the rise and will likely remain a theme in 2023. This will ultimately accelerate the energy transition and will require a vast mobilisation of capital via the financial sector.

Multi Asset

Actively selecting the most attractive opportunities in the insurance space

Our Multi Asset strategy has proven its resilience in the difficult year of 2022. After a challenging year for almost all asset classes, the outlook for a dynamic Multi Asset strategy in the insurance sector looks very compelling.

While insurance premiums are rising overall, across all sectors and geographies, we see the biggest opportunities in the area of natural catastrophe risks. Following years of relatively large insured losses and shortage of reinsurance capital, we expect to see higher risk-adjusted premiums that will benefit not only Cat Bonds, but also the large reinsurers that are a core allocation within the equity portion of the Multi Asset strategy in 2023. In fact, in today's market environment, reinsurers can already achieve stronger profitability thanks to significantly higher reinsurance premiums. We believe current market dynamics will remain supportive throughout 2023.

> ***"While insurance premiums are rising, we see the biggest opportunities in the area of natural catastrophe risks."***

In the area of insurance subordinated debt, where fundamental creditworthiness is still very strong, we see a compelling catch-up potential following a year characterised by macroeconomic volatility. In particular, we see significant opportunities in oversold higher duration bonds. While increasing the portfolio duration, we aim to maintain the defensive character of the insurance bond allocation by remaining on average investment grade.

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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 Multi Asset portfolios. 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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