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Twelve Capital's insurance-focused Multi Asset approach

# Addressing the Dilemma of Traditional Multi Asset and Fixed Income Funds

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# I. Looking for a viable alternative to the 60/40 approach

Recent years proved tumultuous for traditional Multi Asset funds. Fueled by sweeping economic and geopolitical events like the Ukraine conflict and the repercussions of COVID-19, stock-bond correlations went to one. The traditional 60/40 Multi Asset approach, a core tenet of many institutional and private portfolios, had relied on the predominantly negative correlation between stock and bond returns for the last two decades.

Central banks addressed global inflationary tendencies by abandoning their accommodating stances and implementing aggressive rate hikes. However, as the dust from these hikes is settling, the focus of investors has sharply turned back to the fact that traditional diversification between asset classes continues not to be working.

Amidst this landscape, we present an alternative: The Twelve Capital Multi Asset approach, which we'll unpack in the subsequent discussion.

# II. What it takes to build resilient Multi Asset portfolios

As outlined above, the negative stock-bond correlation has been a recent phenomenon. It was rarely observed in the prior century. In fact, macroeconomic shifts, especially rising inflation uncertainty, might reintroduce the positive stock-bond correlation observed in the 1970s to the 90s. This change could elevate portfolio risks or necessitate allocation adjustments, potentially reducing anticipated returns.[1] Key findings in that article highlight that equity and bond markets historically had opposite reactions to growth news and similar responses to inflation news. Instead of being influenced by inflation levels, the relative volatility between growth and inflation determines the stock-bond correlation. The author suggests that should inflation uncertainty continue to rise this decade, investors might bridge the diversification gap by increasing allocations to liquid alternatives.

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[1] https://www.aqr.com/Insights/Research/Journal-Article/A-Changing-Stock-Bond-Correlation

**Fig 1: 53-week rolling stock-bond correlations**


Source: Telekurs via https://everon.swiss/en/correlation-between-stocks-and-bonds/

5-year equity-bond correlations, particularly during increased inflation, have been largely positive [see Fig 1]. While extrapolating from the past may not be a particularly efficient method to predict the future, it highlights critical challenges for institutional investors to generate positive returns while obtaining diversification amid increasingly highly correlated markets.

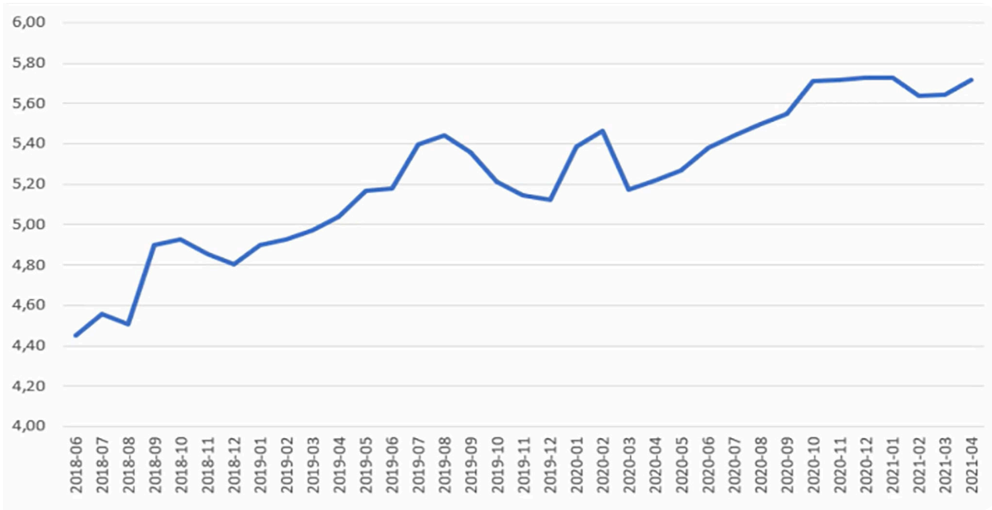
The demand for low-duration investments in uncertain times is in direct contrast to the recent development of bond durations [see Fig 2 on p5] in Multi Asset portfolios. Against this backdrop, the demand for alternative strategies complementary to the traditional Multi Asset portfolio offering diversification, low duration and attractive yields is as acute as ever.

This publication aims to introduce institutional investors to the Twelve Multi Strategy approach. In that context, we will explain our preference for Cat Bonds due to their low correlation with bonds and equity (after all, financial market distress has never caused an earthquake or a hurricane) as well as their compelling returns comprising of fixed insurance premiums and floating rate money market returns effectively eliminating interest rate risk.

Similarly, our preference for Insurance Bonds is based on them paying higher yields than other sectors while featuring the lowest default rate. Within a Multi Asset portfolio, they mitigate the tail risk associated with Cat Bonds, particularly concerning earthquakes and wind risks in the United States. →

## The demand for low-duration investments in uncertain times is in direct contrast to the recent development of Multi Asset bond durations.

**Fig 2: Bond duration in Multi Asset funds**




Source: Morningstar & Twelve Capital. Duration in years, data as at 30 April 2021. Past perfomance is not indicative of future returns. Performance figures are net of fees and costs. The money placed in the fund can both increase and decrease in value and you may not get back the full invested amount.

## The Twelve Multi Asset approach favours insurance equity for its seasonality and value investing characteristics.

Finally, the Twelve Multi Asset approach favours insurance equity for its seasonality and value investing characteristics. In a Multi Asset portfolio context, incorporating assets other than equities minimises the correlation to financial market risks and creates opportunities for relative value trades.

Overall, but particularly when compared to traditional Multi Asset portfolios, the strategy is less entwined with the economic cycle, exhibiting a reduced correlation with traditional asset classes, like equities and fixed income. It also considers climate change implications, leveraging the insurance sector's low carbon footprint and adeptly managing ILS's exposure to climate risks. All the while being more conservative than the traditional Multi Asset concept, it aims to complement or even replace.

May this publication serve as a practical guide to making informed portfolio decisions in a constantly evolving investment landscape.

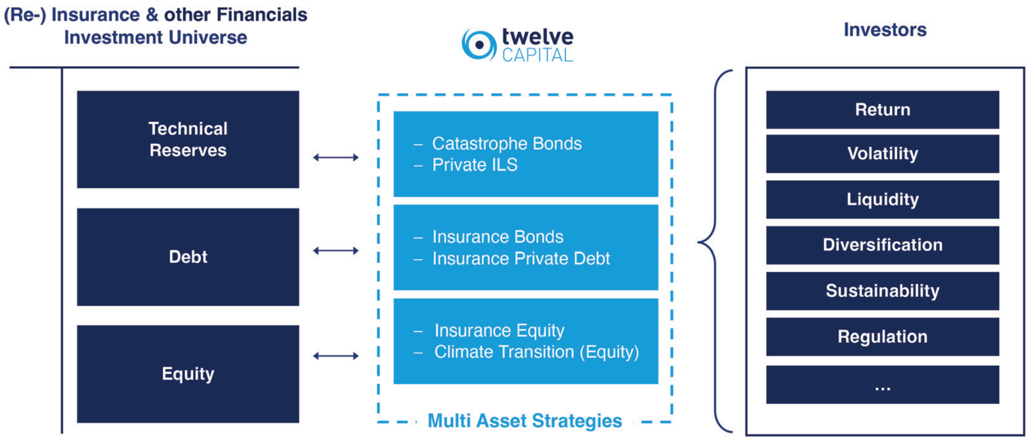
# III. The appeal of investing in the insurance sector

As a pillar of modern society, insurance offers protection against various risks, from automobile accidents and property damages to health issues and professional liabilities. Consequently, it generates consistent cash flow regardless of economic conditions, making it a defensive play for investors during economic downturns. Furthermore, as developing nations increase their financial sophistication and prosperity, the demand for insurance products grows, offering investors substantial expansion opportunities. Therefore, the insurance sector's inherent stability and potential for growth make it an appealing investment option.

The sector's wide-ranging business models offer broad diversification opportunities, from life to auto insurance and composite to reinsurance companies. Coupled with attractive relative spreads, high dividends, and a defensive nature characterised by low default rates, these attributes make the insurance sector attractive.

While the case for investing in the insurance sector is clear, a strategic approach is vital to unlocking its full potential. As we progress in this publication, we will dive deeper into Twelve Capital's Multi Strategy approach and address institutional investors' challenges, promising an exciting, in-depth exploration of insurance sector investments.

**Fig 3: Twelve Capital's whole balance sheet approach**




Source: Twelve Capital

# IV. Investing in the insurance sector: Cat Bonds, Insurance Debt, and listed Insurance Equity

As highlighted above [Fig 3], there are various ways to obtain exposure to the insurance sector's risk-return properties. The securities and instruments range across public and private markets.

In the remainder of the chapter, we will go into the specifics of each asset class Twelve Capital is active in and outline its specific merits as well as risks. In the next section, we will revisit them in the context of their role in constructing the Twelve Multi Strategy portfolio.

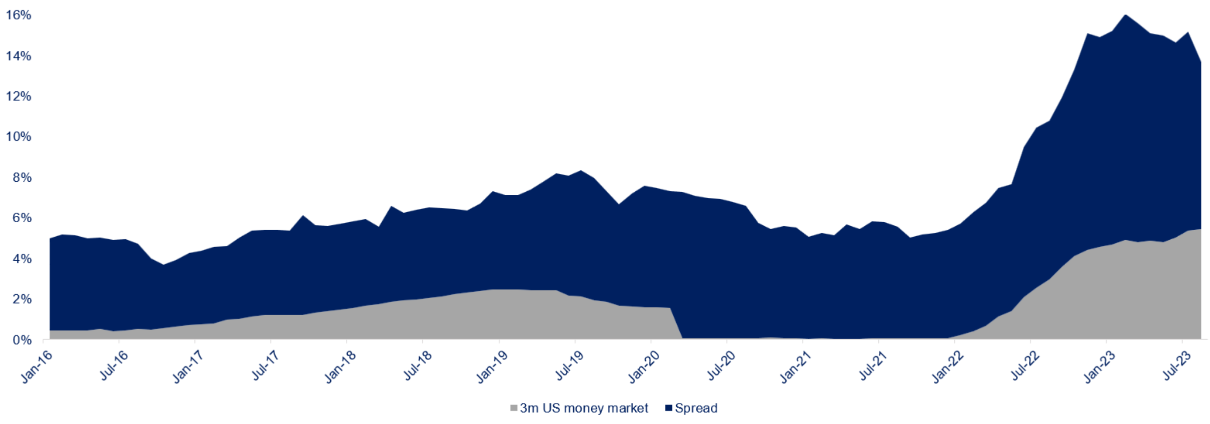
**Catastrophe Bonds (Cat Bonds)** are debt instruments issued by special purpose entities that predominantly (re-)insurance companies use to cede risks to capital markets to cover themselves against specific catastrophic risks, such as hurricanes or earthquakes.

Based on observed market rates [see Fig 4 on p8], Cat Bonds currently exhibit double-digit spreads, offering a tactical yield opportunity not observed for the last decade. →

### Why Cat Bond investors are unaffected by financial market events

Cat Bonds are usually issued from a Special Purpose Vehicle (SPV). This SPV also holds the collateral which is invested in the money market. Crucially, the SPV's sponsors place the necessary insurance premiums with the SPV upfront, eliminating any credit risk for investors even if the sponsor defaults.

## Fig 4: Cat Bond pricing




Source: Twelve Capital. As at 30 September 2023. Past performance is not indicative of future returns. The money placed in the fund can both increase and decrease in value and investors may not get back the full invested amount.

Taking a more strategic perspective, [Fig 5] below shows the performance of Cat Bonds over the last 20 years. The Index is largely unaffected by the different market cycles. Despite several earthquakes and hurricanes, the performance over the period amounts to approximately 7% p.a., and the annual volatility is slightly above 3%.

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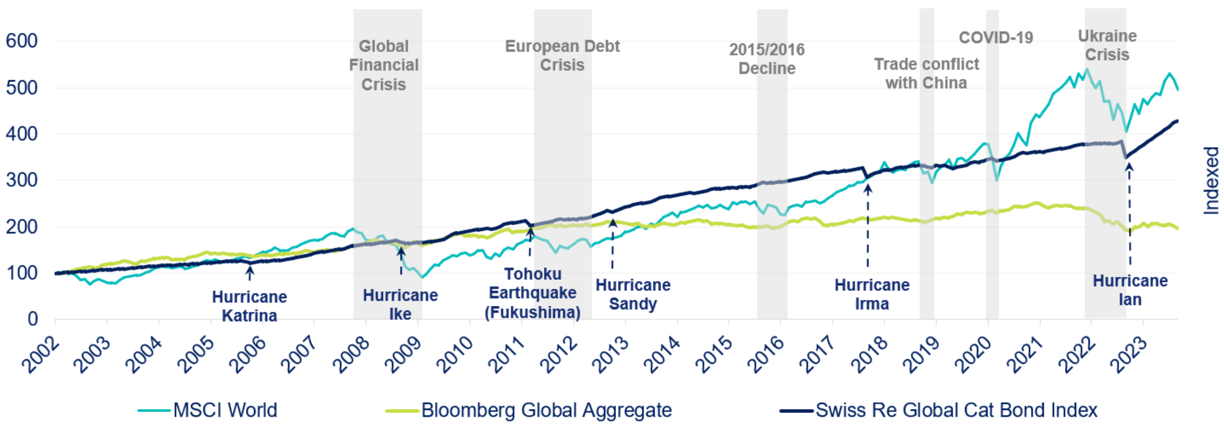
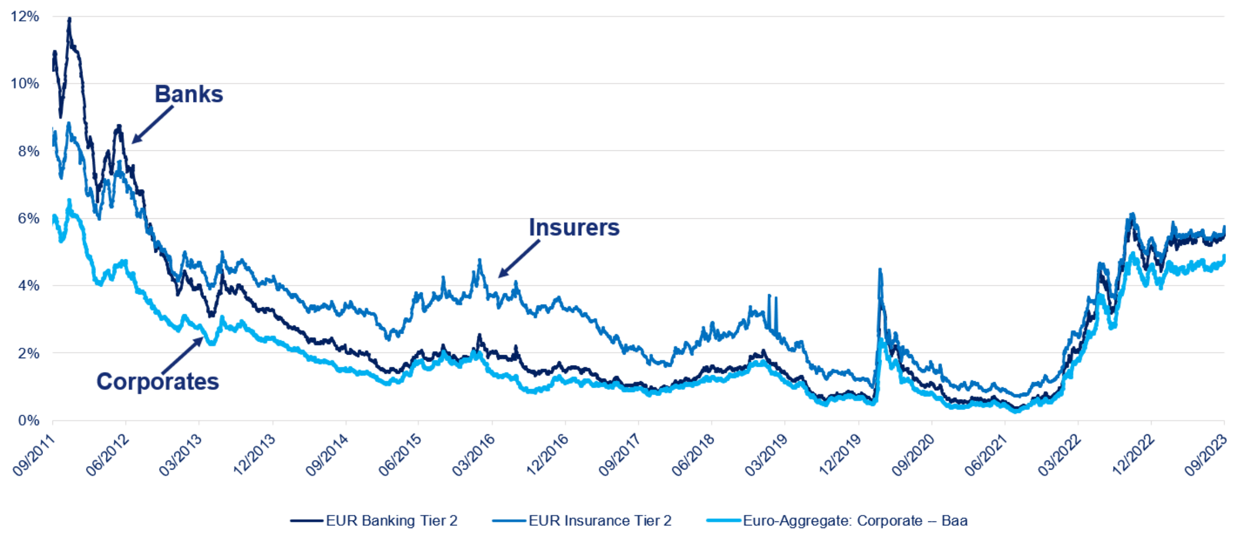
## Fig 5: Swiss Re Cat Bond Index against stock and bond markets since 2002




Source Twelve Capital, Bloomberg. As at 30 September 2023. Please refer to the glossary at the end of this document for an index description.

**Fig 6: European Insurance Bonds offer favourable yields**




Source: Yields of Insurance Bonds vs Bank and Corporate Bonds Barclays Live.
As at 30 September 2023. LT2 = Tier 2 Debt securities.

The effect of adding such instruments to a traditional equity and bond portfolio is correspondingly positive, primarily due to their low correlation. Besides being low, the correlation is also very stable over time and does not show the typical increase at times of market distortions, as other asset classes can.

As the name suggests, **Insurance Debt** is issued by insurance companies operating in one of the most heavily regulated sectors. Subordinated Insurance Bonds carry a complexity premium with a spread of currently up to 70 basis points compared to the banking sector and other corporate bonds. Even though Insurance Bonds are subordinated to policy holders claims they carry investment grade ratings and do not fall into the "high yield" category. Historical default rates in the insurance sector are among the lowest of all industries.[2]

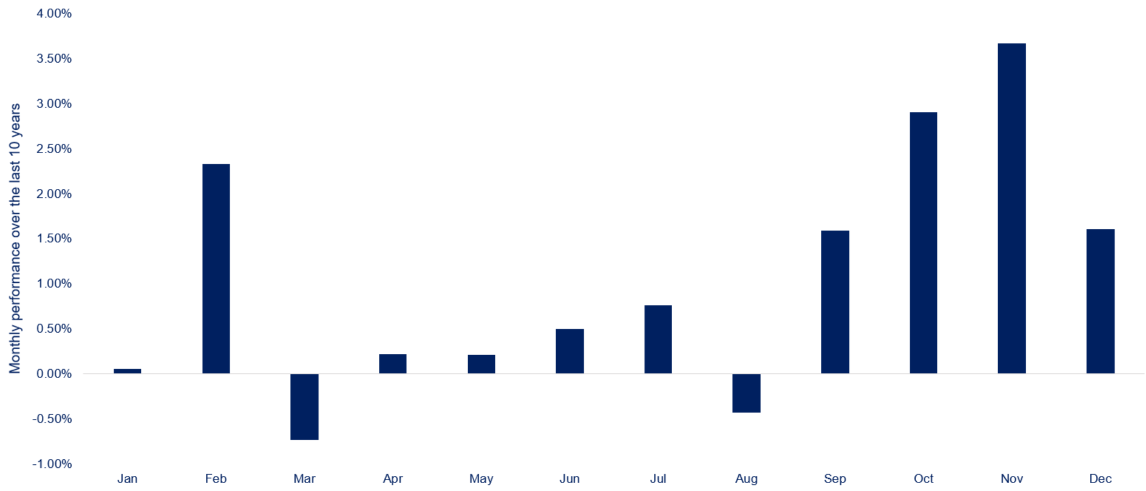
Historically, Insurance Debt has shown attractive risk premiums and has often exhibited lower credit risk than corporate bonds from other sectors.

**Listed Insurance Equity:** Investments in the equity of insurance companies offer the potential for capital appreciation and dividend income. The insurance industry is resilient and has demonstrated stable growth over time. However, a key property the Twelve Multi Strategy approach tries to capitalise on is the seasonality effect on insurance stocks. It builds on losses and damage expectations from the U.S. hurricane season, where, based on our ILS/Cat Bond expertise, we try to make use of an informational edge. This knowledge enables us to position ourselves early vis-à-vis a mild hurricane season for, say, (re-) insurance company x or y, well before the usual market participants who rely on those companies releasing their quarterly results at the end of October at the earliest. →

Historically, Insurance Debt has shown attractive risk premiums and has often exhibited lower credit risk than corporate bonds from other sectors.

[2]Past performance does not implicate positive future performance.

**Fig 7: Seasonality pattern of selected (Re-)Insurance stocks***




*Selected (Re-)Insurers: HANNOVER RUECK SE, MUENCHENER RUECKVER AG-REG, SCOR SE, SWISS RE AG, FEDNAT HOLDING CO, HCI GROUP INC, HERITAGE INSURANCE HOLDINGS, UNITED INSURANCE HOLDINGS CO, UNIVERSAL INSURANCE HOLDINGS, ARCH CAPITAL GROUP LTD, AXIS CAPITAL HOLDINGS LTD, EVEREST RE GROUP LTD and RENAISSANCERE HOLDINGS LTD.

Source: Twelve Capital, Bloomberg. Equal weighted returns from January 2010 to December 2020. This material does not constitute a prospectus, a request/offer, nor a recommendation of any kind, e.g. to buy/subscribe or sell/redeem investment instruments or to perform other transactions.

Share prices react positively in a mild hurricane season as the (re-) insurers' budget for losses exceeds the actual losses and earnings estimates are revised upwards. Further, even in years with high losses, the strategy can identify mispricing and capitalise on expected higher demand for policies and premiums going forward.

Since (re-) insurers are never equally affected by losses, there is an opportunity to specifically increase the allocation to securities for which Twelve Capital expects the most substantial positive effects from September to December.

Aside from strategically capitalising on their seasonality, Twelve Capital currently tactically considers insurance stocks favourably valued compared to the market. Solvency capital reserves for potential claims are high, and the average price/earnings ratio (P/E), relative to other sectors, is low.

Additional factors that currently contribute to the attractiveness of insurance equities are:

- Minimal exposure to Ukraine and Russia;
- a rising interest rate environment with a positive impact on life insurance companies;
- industry earnings power and balance sheets have been resilient through the pandemic;
- insurance prices are rising at a fast pace in years;
- high capital return via dividends and share repurchases and an active M&A environment provide catalysts to protect against value traps.

Twelve Capital further believes that a broad reflationary environment, including higher interest rates and inflation, will positively impact insurance industry fundamentals.

# V. Putting it all together – The Twelve Multi Asset Strategy

Twelve Capital's Multi Strategy approach is designed as a robust satellite investment within an institutional portfolio. It is implemented through high-conviction ideas that exploit industry themes and seasonality patterns. It also capitalises on structural mispricings across complementary liquid insurance assets that offer diversification opportunities, such as Insurance Bonds, Cat Bonds, and listed Insurance Equity.

### Combining strengths, attractive yield, low duration and improved diversification/low correlation

The overall portfolio demonstrates reduced correlation to traditional financial markets and limited exposure to large insurance events. It offers limited interest rate risk and a low portfolio duration due to the floating-rate nature of Cat Bonds and the Insurance Equity component.

### Commitment to sustainable growth

The strategy embodies strong ESG values. It leverages the insurance sector's societal contribution and low carbon footprint, with the underwriting process naturally incorporating climate change risks, presenting a rewarding and sustainable investment.

### Expert driven

The strategy is managed by Twelve Capital's experienced team of insurance and investment specialists. Their deep market insight and commitment to astute security selection underpin the strategy's strength and consistent return potential.

**Fig 8: Overview Twelve Multi Asset Strategy**

| Twelve Multi Asset Strategy | Why this asset class? | Why in a multi asset portfolio? |
|---|---|---|
| Cat Bonds | + Low correlation to financial markets<br>+ Low duration<br>+ Attractive spreads<br>+ No credit risk | + Limit tail risk/catastrophe risk by adding Insurance Debt and Equity<br>+ Income diversification<br>+ Seasonality |
| Insurance Debt | + Attractive relative spreads<br>+ Defensive sector<br>+ Low default rate | + Limit credit risk by adding Cat Bonds<br>+ Lower duration by adding Cat Bonds and Equity<br>+ Avoid "blue chip" bonds by diversifying across asset classes |
| Insurance Equity | + Attractive valuations<br>+ High dividend yield<br>+ High upside potential | + Reduced correlation by adding Cat Bonds & Insurance Debt<br>+ Improve fund liquidity<br>+ Relative value & Opportunistic shifts |

Source: Twelve Capital.

# VI. Portfolio properties

The foundation of this conservative portfolio comprises 40-60% mostly subordinated insurance bonds, predominantly investment grade, that exhibit attractive spreads and historically low default rates.

### 1. Attractive relative yields

The strategy offers a running yield through coupon and dividend payments, complemented by equity upside potential. Optimally balancing each component's inherent advantages, it seeks to maximise yield, minimise volatility, and target a return of 5-7% p.a. in EUR (gross) above the risk-free rate with relatively low volatility. The current yield, based on the yields for Insurance Bonds, Cat Bonds and the dividend yield for equities, is at 10% in EUR.

With more than 15% yield in EUR, Cat Bonds overall currently provide the most significant yield contribution. However, looking at the broader Cat Bond market [Fig 9], it's worth noting that certain perils cannot be modelled adequately, so Twelve Capital is not considering them for investment. Instead of diversification within the Cat Bond universe, by adding perils that are not adequately modelled, the diversification is done across asset classes. Incidentally, the diversification across the other two portfolio constituent asset classes offers two benefits: In addition to lowering the tail risk, it also may improve portfolio returns, as in the case of subordinated Insurance Bonds.

### Harnessing the performance potential of seasonality

By adjusting the allocation throughout the year [Fig 10], the portfolio aims to generate additional value by taking advantage of seasonal effects.

For instance, the allocation to wind-exposed U.S. Cat Bonds increases during the hurricane season, from June to November. Outside the hurricane

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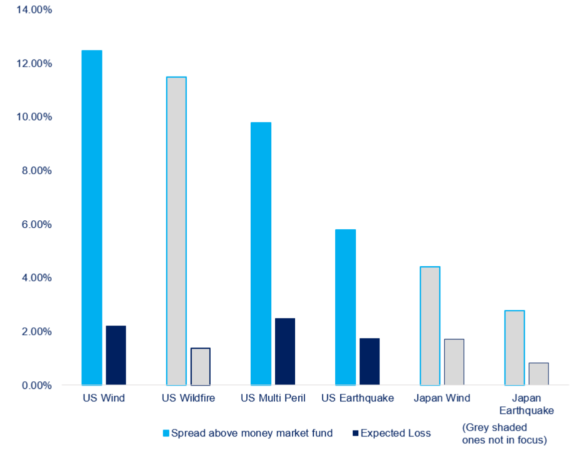
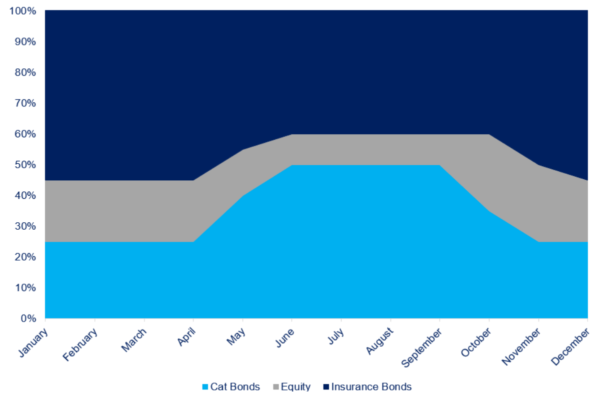
**Fig 9: Attractive spreads**




Source: Cat Bond Market Portfolio by Twelve Capital. As at 30 September 2023.

**Fig 10: Illustrative portfolio allocation throughout the year**

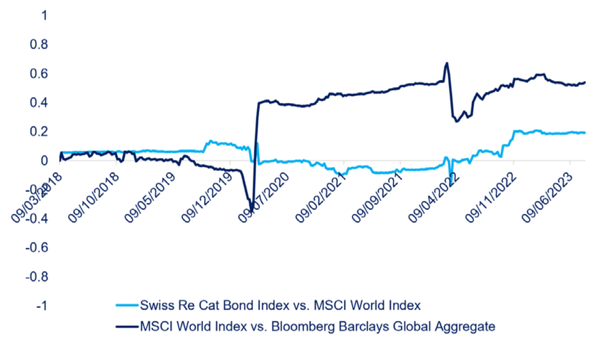



Source: Twelve Capital.

**Fig 11: Duration of the Twelve Multi Strategy portfolio**


Source: Bloomberg, Twelve Capital. As at 31 July 2023.

**Fig 12: Rolling correlation (36 months) – correlation coefficient**




Source: Twelve Capital. As at 31 July 2023.

season, the strategy has limited exposure to wind Cat Bonds and focuses on other attractively priced segments such as earthquakes.

As mentioned previously, on the Insurance Equity side, there are also seasonal effects. After the hurricane season, earnings expectations for exposed insurers are typically revised in autumn. This often leads to stock price reactions, which Twelve Capital tries to capitalise on.

### 2. Cat Bonds push the overall portfolio duration below two years

Remember the initial finding of increasing bond durations over the last years (section II)? A feature of Cat Bonds worth highlighting in this respect is the floating rate nature of the instruments, which can reduce the portfolio's duration to significantly below two years [Fig 11].

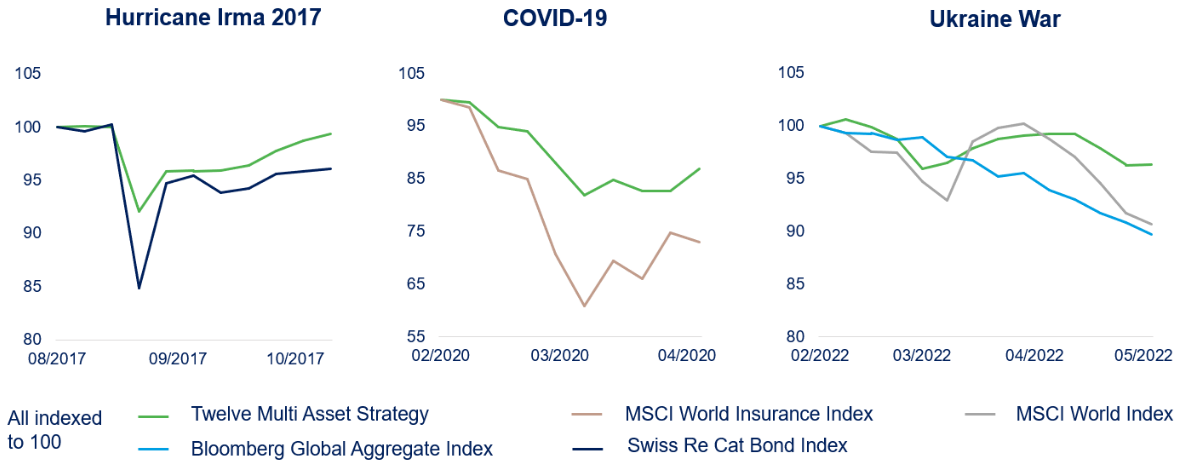
### 3. Improved diversification/low correlation – even during market disruptions

In addition to the exciting specifics of the individual asset classes, a diversification effect can be achieved when combined into a Multi Asset portfolio, which is particularly effective in market disruptions.

During the COVID-19-related market collapse in March 2020, Cat Bonds proved again that they have a low correlation to financial markets [Fig 12]. →

During the COVID-19-related market collapse in March 2020, Cat Bonds proved again that they have a low correlation to financial markets.

**Fig 13: Complementary asset classes**




Source: Bloomberg. Please refer to the glossary at the end of this document for an index description.

## During the last quarter of 2022, natural catastrophe events and market shocks converged to impact all asset classes uniformly.

**Diversification across asset classes helps significantly reduce the tail risks of Cat Bonds**

The volatility and particularly tail risk observed in Cat Bonds largely stems from its exposure to natural catastrophe events, i.e. the risk of losses from extreme events [Fig 13]. This risk, which, as previously explained, often cannot be diversified away entirely within the asset class itself, can be significantly reduced in a portfolio by combining them with subordinated Insurance Bonds and Equities. Cat Bonds exhibit a distinct advantage in portfolio diversification, maintaining a low correlation to Global Bonds and Global Equities, especially during market turmoil. Unlike the typical trend where the correlation between Equities and Bonds intensifies during stress scenarios (observed during events like the Ukraine War), Cat Bonds remain relatively unaffected.

However, it should be noted that if, as it was the case in the last quarter of 2022, natural disasters and market shocks occur simultaneously, this will naturally affect all asset classes.


## The insurance sector and climate change

### 1. Low carbon intensity footprint:

The insurance sector, by virtue of its business model, inherently carries a low carbon intensity footprint. Unlike many sectors of the economy, insurance is not directly involved in production or manufacturing activities that contribute significantly to greenhouse gas emissions. Thus, investments in Insurance-Linked Securities, such as those in the Twelve Multi Strategy approach, offer investors a way to mitigate their portfolios' carbon exposure, aligning with increasing demands for more sustainable investment practices.

### 2. Climate change impact on selected perils:

Climate change presents profound implications for the insurance sector, particularly in terms of its impact on selected perils. More frequent and severe weather events, rising sea levels, and higher temperatures all have potential to alter the risk landscape for insurers. For instance, areas prone to wildfires or hurricanes may see increased losses. On the other hand, evolving climate patterns might reduce risk in some areas, for instance by lowering the frequency of cold weather events. Navigating this evolving risk landscape requires deep expertise and robust risk modelling capabilities, which Twelve Capital brings to its Multi Strategy approach.

### 3. Implications for returns and risk premiums:

Climate change also carries implications for returns and risk premiums in the insurance-linked securities market. As risks associated with certain perils rise, so too may the premiums charged by insurers, potentially boosting the return potential for insurance-linked investments. However, this also emphasises the importance of robust risk assessment and management practices. The need for sophisticated modelling and risk management, to correctly price these changing risks, is more critical than ever. Twelve Capital's deep industry expertise and sophisticated risk management capabilities ensure that these factors are duly considered, aiming to secure attractive risk-adjusted returns for its Multi Asset Strategy.


# VII. Conclusion

The Twelve Capital Multi Asset approach emerges as a beacon of resilience and innovation in a challenging investment environment marked by unprecedented economic shifts, geopolitical tensions, and the now-defunct traditional 60/40 concept.

The approach, driven by the deep expertise of Twelve Capital's seasoned team, optimises diversification through a blend of Cat Bonds, Insurance Bonds and listed Insurance Equity. Together, these components harness attractive yields, seasonality benefits, and a dedication to sustainable growth.

Uniquely poised to navigate future uncertainties and a continually evolving investment landscape, Twelve Capital's Multi Asset approach continues to be anchored in its low correlation to traditional financial markets, ensuring both risk mitigation and potential for robust returns.

## About the author

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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.

## Index

**Bloomberg Global Aggregate Total Return Index** – The index is a measure of global investment grade debt from 24 local currency markets. This benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers. (LEGATRUU)

**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)

**MSCI World Index** – The index is a market cap weighted stock market index of more than 1'550 companies throughout the world in USD. (NDDUWI)

**Swiss Re Cat Global Bond Index** – The index calculated by Swiss Re Capital Markets, is a market value-weighted basket of natural cat bonds tracked by Swiss Re Capital Markets, calculated on a weekly basis. (SRGLTRR)

**S&P 500 Index** – The index is a stock market index that measures the stock performance of 500 large companies listed on stock exchanges in the United States. (SPX)

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