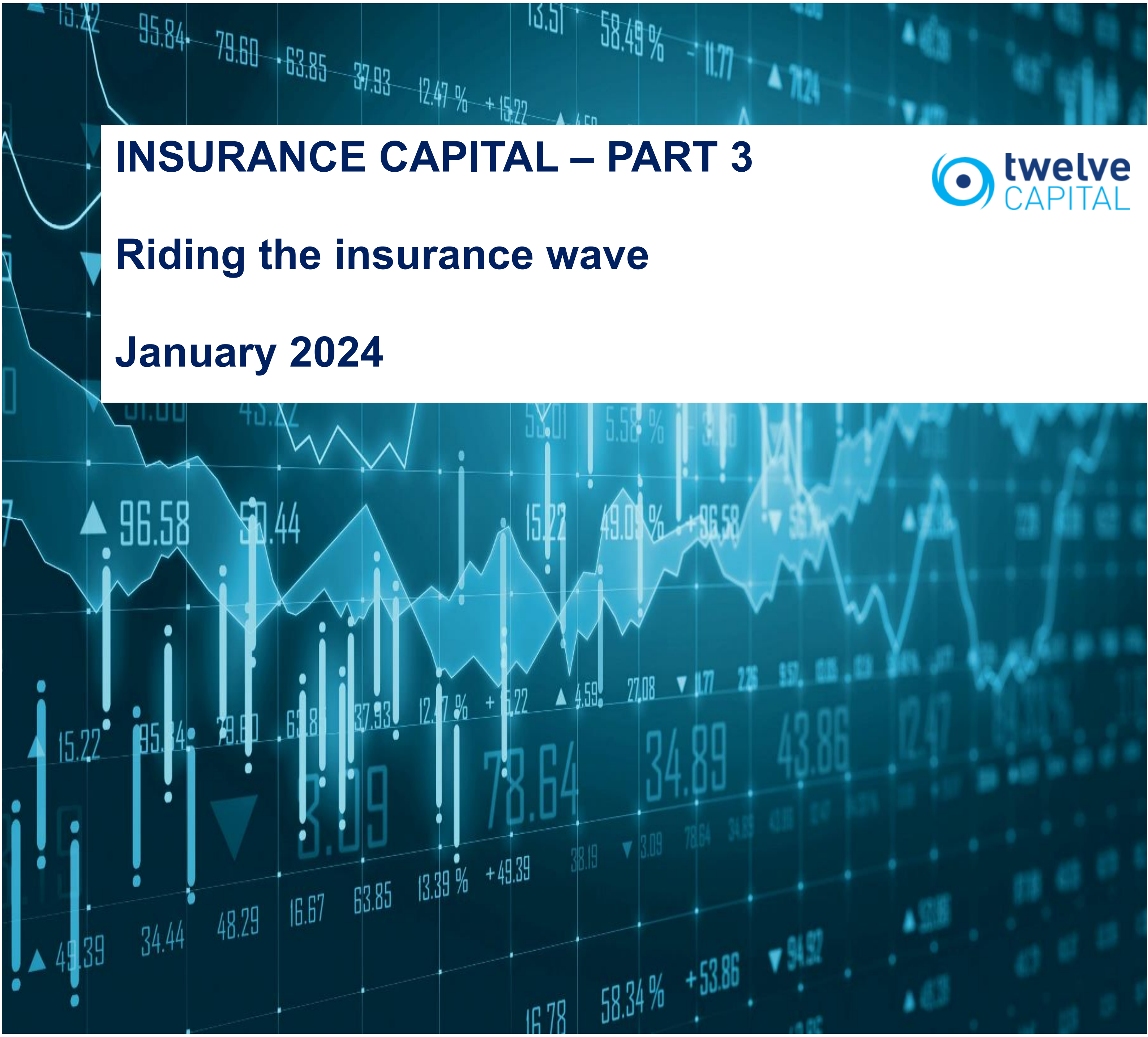
INSURANCE CAPITAL – PART 3

twelve CAPITAL

Riding the insurance wave

January 2024



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This is the third article of the trilogy in which Twelve Capital initiates readers to the different ways capital markets participants can invest in the (re)insurance sector. The first one delved into the distinctive features of equity, debt and Insurance-Linked Securities (ILS). The second focused on secular trends such as climate change and population dynamics, exploring their implication for the insurance sector and investors. This article explains the so-called insurance cycle and provides an outlook for investors.

Executive summary

- The insurance markets are susceptible to distinct cycles
- The shape and length of insurance cycles are changing over time, driven by secular industry trends and capital dislocation in the sector
- While secular trends highlighted in our previous article provide tailwind, the sector remains heterogeneous and there can be significant deviations in performance between asset classes, subsectors and also companies within those subsectors
- Twelve Capital's domain knowledge and ability to invest across the entire insurance balance sheet allows investors to leverage this market cyclicality and select the most attractive investment opportunities

A cyclical industry

The insurance sector is exposed to cyclicality driven by elements such as the availability of capital and the time lag between premium collection and claims settlement. Insurance markets dynamics depend on several factors influencing supply and demand, including economic, financial, competitive, regulatory aspects as well as catastrophes (natural or man-made) or loss frequency environments.

Figure 1: Illustrative insurance market cycle

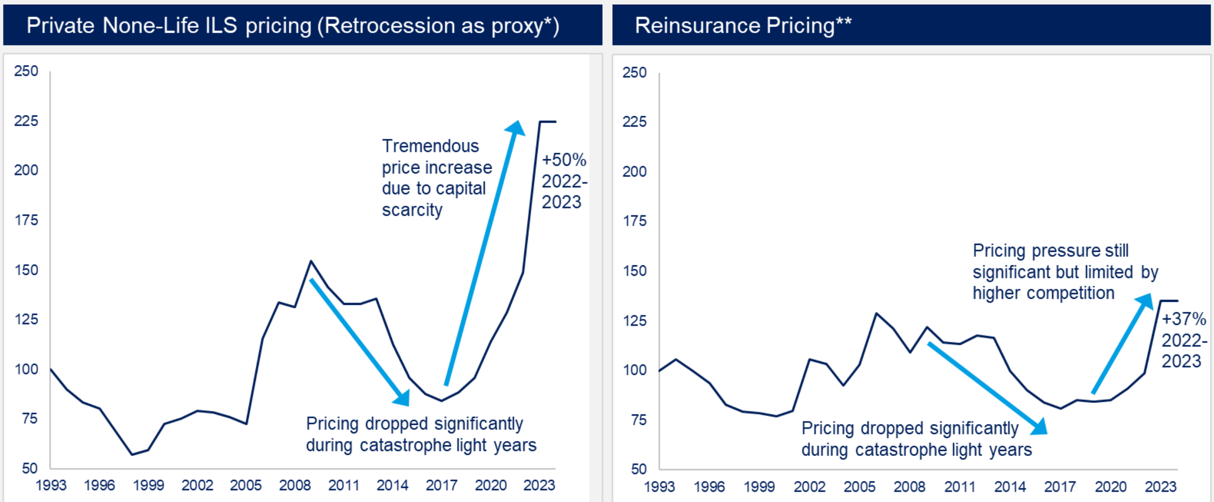
Source: Twelve Capital.

At the trough of the insurance cycle, underwriters exit or cease business as it becomes unprofitable, resulting into a reduction of available capacity. Often a shock, or series of shocks, have to occur to trigger a reversal of the cycle (a market hardening), an example of this being a large catastrophic event. This often causes a sharper contraction of capacity due to monetary losses. Before underwriters re-enter the marketplace, prices have to rise and contractual language needs to become more stringent. This leads to improving returns and thus companies flourishing. The cycle concludes when new capital floods in, causing rates to compress and underwriting standards to widen. Prices peak before entering a phase of decline. Cycle management is crucial for investors in the sector, minimising soft market issues while taking advantage of hardening markets.

For instance, an example of supportive "hard-market" is the one that ILS investors are currently experiencing. Spreads achievable in the asset class have jumped in recent years, specifically from 2022, when reinsurers and ILS investors were able to impose higher prices, stricter terms and conditions and were able to be more discerning of the exposures they assumed.

This was possible after several years of heavy natural catastrophes and, more recently, high levels of inflation. Reinsurers are remaining disciplined and cautious not to deploy too much capital given a desire to improve profitability. Meanwhile the mobilisation of third-party capital has been limited, particularly for lower attaching layers.

Figure 2: Reinsurance and Retro rate changes



Source: *Howden Risk-Adjusted Non-marine Retrocession Catastrophe and Global Direct and Facultative Rate-on-Line Index – 1993 to 2024. **Howden Global Risk-Adjusted Property-Catastrophe Rate-on-Line Index – 1993 to 2024. As at 1 January 2024.

Unlike previous positive market cycles, such as those in 1992, 2001, 2005, and 2020, the year 2023 has experienced a more subdued influx of new capital. Approximately USD 13bn of additional capital has been deployed, a notable difference compared to the typical "hard-market surge" of around USD 40bn, leading us to expect a prolonged positive cycle. Moreover, reinsurers are emphasising capital discipline, with the largest European reinsurers focusing on enhancing profitability rather than simply expanding volume.

Twelve Capital's knowhow on investing across the entire insurance balance sheet allows investors to capitalise on market cyclicality. Moreover, Twelve Capital's broad offering caters to the needs of investors with different risk-return targets as well as different tolerances around drawdown, volatility, and liquidity.

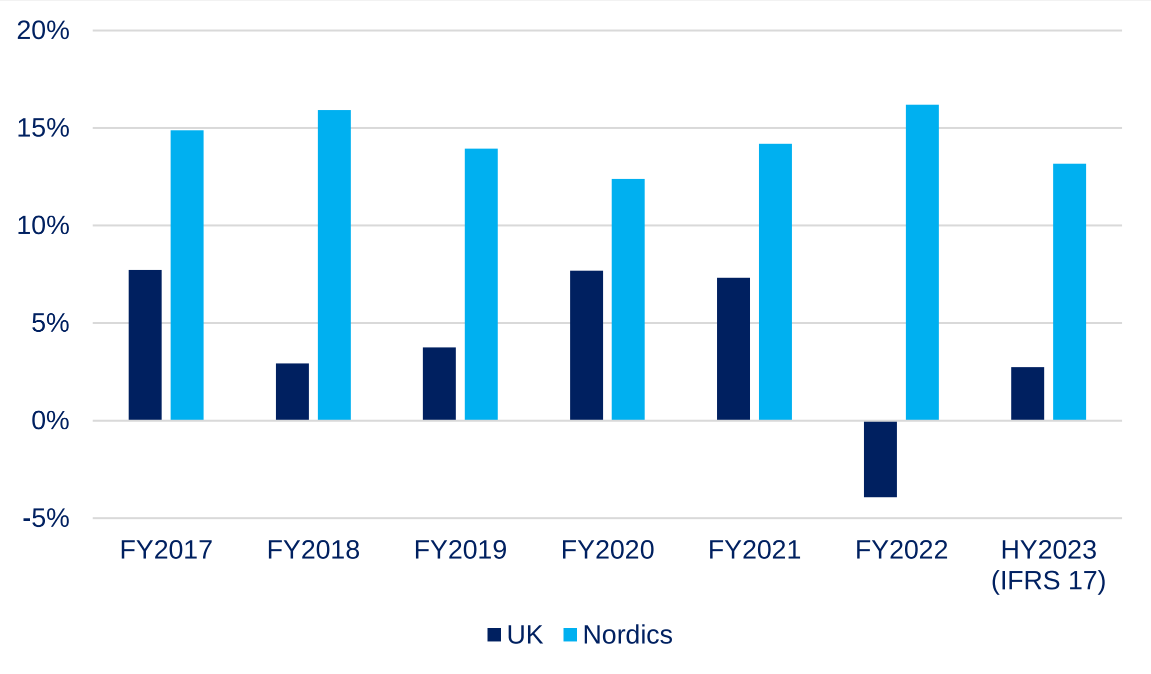
Cyclicality and investment opportunities

Equity

Each subsector of the insurance industry is affected differently by the timing of the cycle and its resilience can vary depending on the ease with which capital can access the market. Also, idiosyncratic factors such as insureds' behaviour and how policies are distributed can have an influence.

Taking retail motor insurance as an example over the last 18 months, the unexpected changes in driving behaviours due to Covid-19 related lockdowns, compounded with the ensuing inflation, have posed challenges for insurers in maintaining profitability. In highly competitive, price-sensitive markets like the UK, where capital flows relatively easily and client retention is relatively low as the majority of policies are sold via (or at least checked against) price comparison websites, pricing proved to be inadequate and this led to a weak market and underwriting losses. In contrast, in Denmark insurers were able to maintain profitability without significant customer dissatisfaction thanks to a more concentrated market where policies are distributed via brokers, customer retention is high, and insurers are able to increase rates.

Figure 3: Combined ratios for UK players (Aviva, Admiral, Direct Line, Esure) and Nordics players (If, Tryg, Topdenmark, Storebrand).



Source: S&P CapIQ, Twelve Capital.

This example illustrates the diverse nature of the insurance sector that translates in significant deviation in performance between subsectors and companies within those subsectors. A specialised and deep domain knowledge is required in order to identify the best opportunities.

When focussing on different sub-sectors, certain overarching conclusions can be drawn:

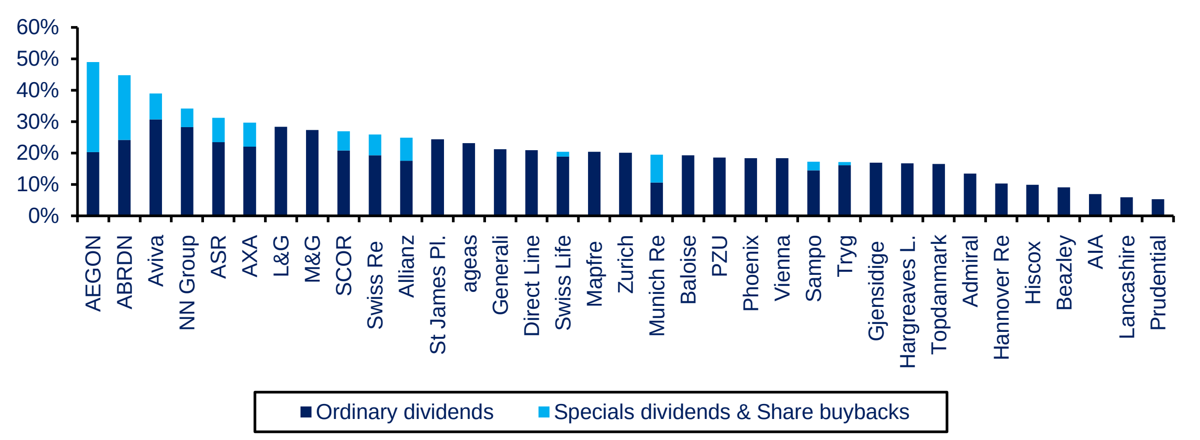
- In the absence of major catastrophic events, the current non-life reinsurance market's strength and higher returns on investments should translate into earnings growth and improved RoE. Major reinsurers will look to potentially return capital to shareholders and to build reserves buffers.

- Commercial line markets are in the late stages of a sound market. Most commercial insurers are showing positive results as rate adequacy has improved and loss trends stabilised. However, rate increases are starting to slow or even decrease in some lines. Nevertheless, there are indications of a potential extended peak of the cycle given a number of extenuating circumstances such as inflation creating underwriting uncertainty.

- Retail lines have faced challenges such as rampant inflation in motor and property segments and delay in cost pass through mechanisms that have seen some players reporting underwriting losses. In the US, several high-profile insurers have reduced capacity in some states (notably California and Florida). Nevertheless, we are now starting to see a trend of loss ratio improvement beginning to materialise.

When it comes to investing in insurance equity, most investors will be limited to public markets. Today, insurance companies are well capitalised. Increasing interest rates support high investment incomes. Further, broad price increases and a prudent growth in risk exposures results in generation of excess capital. Insurance equities typically offer generous returns to shareholders, whether by dividend or through share buyback as highlighted in Figure 4. This compares well to other industries.

Figure 4: Expected dividend yield incl. share buybacks FY23-25 for European insurers



Source: Autonomous Research, Bloomberg, Twelve Capital. Past performance is not indicative of future returns.

Debt

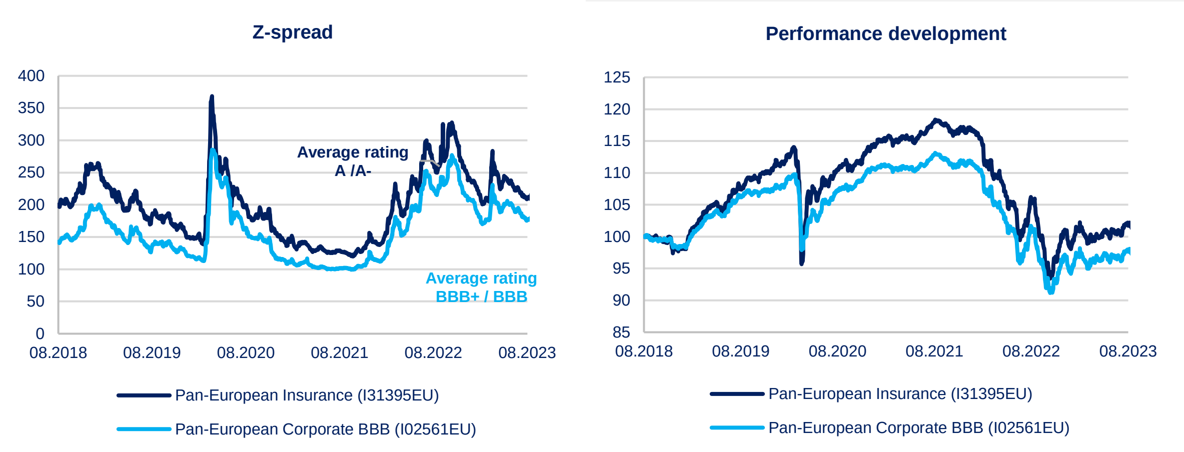
Cyclicality in the insurance debt space is perhaps of lower relevance. Debt investors tend to rightfully focus on the sector's long-term solid creditworthiness across different cycles.

The asset class presents attractive yields within a defensive, well capitalised and tightly regulated sector that exhibits solid credit ratings. (Re)insurers' financial stability has generally benefited from higher rates, as evidenced by the sector's average solvency ratio that increased by more than 20 percentage points since FY2020 to reach 223% as of FY2022. Improvements in regulatory supervision, including more jurisdictions transitioning to Solvency II equivalent regimes should enhance comparability and provide investors with confidence in the underlying risks and offer potentially attractive entry opportunities.

Investors seeking creditworthiness, higher yields, and actively managed duration compared to many corporate and financial indexes may find the Twelve Capital insurance credit offering appealing. The wider spreads witnessed in the sector result primarily from the complexity premium associated with this specialised sector, where we observe a natural barrier to entry. Allocating to insurance debt provides investors the possibility to diversify their portfolios and potentially enhance their risk-adjusted returns. Over the past five years Insurance Bonds have outperformed BBB corporate bonds while maintaining a higher credit rating (see Figure 5). Currently the outlook is positive and spreads for insurance debt exceed their five-year average. Investing in Insurance Debt includes certain risk factors such as counterparty or interest rate risk.

Twelve Capital offers access to both liquid and less liquid debt investments in the insurance sector, through primary and secondary market. The liquid debt proposition is available in UCITS format with daily liquidity. The less liquid one can be accessed via open-ended and closed-ended vehicles and typically bears higher credit risk (target rating in the BB area) as well as lower liquidity, compensated by adequate credit risk and liquidity premia.

Figure 5: Insurance vs Corporate BBB



Source: Twelve Capital, Bloomberg. As at 23 January 2024. Past performance is not indicative of future returns. Pan-European Insurance index is a subset of the Bloomberg Pan-European Corporate Index and measures the market of bonds issued by insurance companies and denominated in different European currencies. Pan-European Corporate BBB index is a subset of the Bloomberg Pan-European Corporate Index and measures the market of corporate bonds rated in the range [BBB+, BBB, BBB-] and denominated in different European currencies.

ILS

As shown in Figure 2 pricing levels for reinsurance, retrocession, and Cat Bonds have not been so high for the past 30 years. Moreover, there is a tightening of contractual language and increasing retention of protection buyers. While no-one can predict how the market will change in the next years, or what shocks/events may happen, assuming the status quo we predict the market to remain in a supportive/hard state.

Twelve Capital believes that the secular trends we covered in our previous article (see here), together with industry specific themes will influence the shape of the insurance cycle going forward. Specifically, we expect better conditions for investors in ILS with a longer-lasting supportive cycle ("hard market").

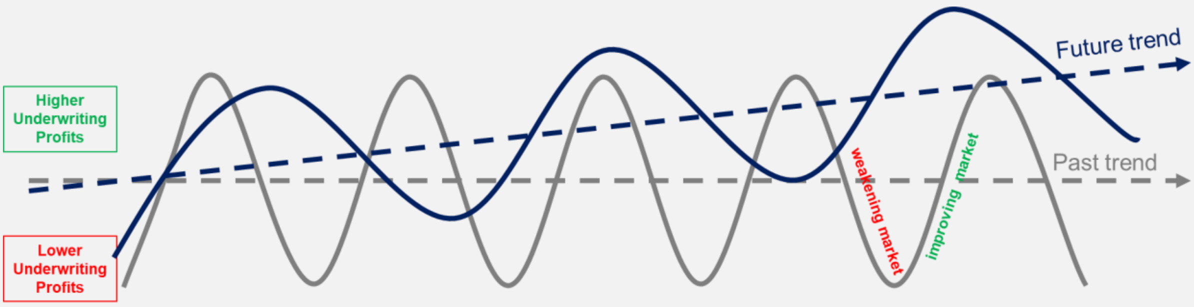
The main driver that should support a longer lasting hard market and improved profitability is the enhanced discipline of market participants. Reinsurers' narrative has shifted towards more prudent underwriting and management of exposure, particularly after years of disappointing investors with larger than budgeted catastrophe losses. This comes together with a focus on higher-attaching layers, lower exposure to frequency losses and materially improved terms and conditions of contracts.

The acknowledgement by the market of very relevant themes such as climate change has prompted players to add buffers in their pricing to offset potentially higher loss trends and has pushed for better underwriting of risks in areas that are more exposed to the effect of climate change.

Lastly, we believe that Cat Bonds will represent a higher proportion of the ILS market as their features and a solid track record are appealing to investors. This might have, in the mid-term a narrowing impact on spreads. However, we think this could be offset by the fact that risks other than property will be offered in Cat Bond format (such as cyber), thus maintaining high the demand of coverage from cedants and hence spreads in the asset class.

The asset class's performance should continue to remain highly uncorrelated to broader financial markets.

Figure 6: Illustrative market development



Source: Twelve Capital.

Depending on an investor's appetite there are a number of ways to take advantage of these positive market features, the decision is primarily driven by considerations of risk-return and liquidity preferences.

Cat Bonds are a collateralised reinsurance product allowing for trading on the secondary market. The risks covered in Cat Bonds have a heavy focus on US Hurricanes (event risk). Should no major events take place in a calendar year to affect the general performance, Cat Bonds are able to offer a favourable entry point in the space for investors. Should an investor be willing to take additional risk, collateralised retro transactions, where attachment risk levels are generally lower and returns higher, become a viable alternative. These often focus on the "peak perils" of US Hurricane, US Earthquake, Japan Typhoon, Japan Earthquake, and European Windstorm, in non-proportional format. The core difference between a Cat Bond and a privately structured collateralised retro transaction is that the latter are illiquid 1-year transactions, often carrying higher risk, but offering greater compensation.

Taking advantage of the space

Twelve Capital provides investors with the possibility to access the entire spectrum of investments in the insurance space, whether in a standalone or commingled format.

The regulated nature of the insurance sector, along with its comfortable capital buffers, strong cash generation, and robust fundamentals, allows insurers and investors in the sector to capitalise on and adapt to secular trends such as climate and demographic changes. This is expected to lead to solid growth prospects and profitability.

Conclusion

In this under researched and attractive sector, Twelve Capital's extensive domain knowledge and expertise translate into profound understanding of risks and a meticulous selection of securities. Depending on each investor's risk tolerances, return objectives and liquidity needs, Twelve Capital can offer a suitable solution via its diverse offering.

Figure 7: Complementary strategies and genuine diversification opportunities

Source: Twelve Capital.

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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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(1) to an institutional investor or to a relevant person or to any person arising from an offer referred to in Section 275(1A) or Section 276(4)(c)(ii) of the SFA,
(2) where no consideration is or will be given for the transfer;
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