Untapped Potential: The Case for ILS, Insurance Credit and Equities in 2024

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Executive summary

Twelve Capital sees 2024 as the year of normalisation for insurance investments and as an opportunity for investors to achieve interesting risk-adjusted returns.

- For **ILS**, where Twelve Capital focuses mainly on peak peril risks[1], our expectation is for a longer-lasting heightened pricing environment (so called hard insurance cycle). This is to be sustained by factors such as disciplined deployment of capacity from market participants and new issuances that are likely to go hand in hand with increased investors' interest in the asset class. Given ILS‘ short duration, lower risk-free rates will present a headwind for total returns for investors, however, given the attractive spread levels we believe investors can achieve returns in the USD 10% area for liquid Cat Bonds and >15% for our Private ILS offering, in the absence of major events. We also expect the ILS market growth and a promising year in new Cat Bond issuances.
- In **insurance credit** Twelve expects tailwind from a progressive normalisation of interest rates and some 30-70bps of spread tightening, leading to higher total returns for investors. These should support base case EUR net returns in the 5.5-7% area for liquid insurance debt in 2024, in a normalised market scenario. As we move closer to the end of the grandfathering period for bonds issued under the Solvency I regime, we expect to see a significant pick up in total bond issuance for the sector in both Tier 2 and more subordinated RT1 structures. Yields in insurance credit are interesting and offer investors a good entry point despite the intense rally across markets in the last weeks of 2023. Defaults remain almost non-existent in the insurance sector, and we expect more investors to move further into high-quality investment-grade credit with resilient fundamentals.
- Twelve continues to see **insurance equities** as a resilient sector of the market, where stable or increasing dividend yields together with repatriation of excess capital remain attractive elements for investors, despite the more challenging economic backdrop for equities in general given subdued economic growth and higher asset risk. Merger and acquisition (M&A) activity has been on a decline since 2022 mainly due to macroeconomic factors. However, as increases in interest rates and inflation ease, pent-up activity may drive an upsurge in deals into 2024, particularly in the insurance services and InsurTech subsectors.
- The outlook for Twelve's **multi asset** offering, where we commingle some or all of the above asset classes, is positive. The actively managed multi asset strategy focuses on the highest-paying most attractive ILS transactions on a risk-adjusted basis, high conviction insurance bond trades, as well as seasonality and idiosyncratic themes for insurance equity.

In summary, a normalised market environment is expected to offer a tailwind for the asset classes where Twelve Capital is active. Markets' deepness and liquidity will benefit from a healthy pipeline of new deals while achievable risk-adjusted returns will remain attractive following the positive performance in 2023.

ESG remains a cornerstone of Twelve Capital's investment approach. The insurance sector's strong ESG credentials and active role in closing the protection gap make it a suitable asset class for those investors that are sensible to these themes. Moreover, while climate change represents a challenge, we believe the sector is rapidly adapting to it while adopting mitigating actions in underwriting, pricing and risk selection.

We still, however, operate in a fragile geopolitical context. Elections in some key geographies as well as potential surprises from central banks may have significant impact on future developments.

[1] Peak perils are defined as perils such as US hurricanes and California earthquakes.

Review of 2023 Performance

All of the strategies managed by Twelve Capital reported positive performance in 2023.[2]

- Investors in Twelve's **ILS** offering benefitted from record-high spreads, sound risk-free returns, in addition to a benign US hurricane season. Twelve Capitals's focus on peak perils sheltered investors from losses stemming from non-peak perils such as wildfires (Hawaii and Canada), severe convective storms in the US or earthquakes in areas with lower insured values.

- Our liquid **insurance credit** offering demonstrated resilience in the first half of the year and recorded a sound return in the last quarter. This was thanks to active management of duration and conservative allocation to riskier deeply subordinated bonds that underperformed after the Credit Suisse AT1 write down.

- Our investments in **equity**, be it in products focused on climate transitioning to a low carbon economy or as part of commingled funds, performed well, with a solid rebound recorded in the last quarter of 2023.

- **Multi asset** sound performance is a reflection of the active asset allocation and securities selection and the leveraging on themes such as hurricane seasonality.

Average Performance in 2023 of asset classes managed by Twelve Capital:

Sharpe Ratio (since inception)	Negative	0%-2.5%	2.5%-5.0%	5.0%-7.5%	7.5%-10.0%	10.0%-15.0%	15.0%-20.0%	20.0%-25.0%
1.0-1.25				Private Debt				
0.75-1.0								
0.50-0.75							Cat Bonds	
0.25-0.50					Insurance Debt		Multi Asset	
0-0.25						Equity		Private ILS

2023 USD Net-Returns*

*Performance is the average of multiple investment vehicles managed by Twelve Capital and is aimed at providing an indicative level of return of the asset class in 2023.

In the following sections we will cover some key macro and sector specific themes that we believe to be relevant for investors in ILS, insurance credit and equity. Via a star system (from most positive 5 stars to less positive 1 star) we provide Twelve Capital's view of how these themes will affect dynamics in the sector and returns achievable to investors.

[2] Past performance is not indicative of future returns.

Macro Themes

	Twelve Capital View	Insurance-Linked Securities	Insurance Credit	Insurance Equity
Interest Rates	Progressive decrease	★★ Reduces the overall yield to investors as ILS are typically floating rate instruments with short duration.	★★★★ Support bond price rally. There is potential upside from faster than expected actions by central banks, albeit large part of the movement was already reflected in 4Q23.	★★ Tends not to be supportive for financials stocks. However, policy rates settling in the 2-3% area should support insurance fundamentals (capital and investment income).
Inflation	Progressive decrease	★★★ Should benefit indemnity type of deals and index linked bonds, where the payout is linked to paid losses.	★★ Positive for property players (such as motor). However, elevated social inflation is negative for the creditworthiness of casualty insurers and other long-term lines.	★★ Should lead to a normalisation of earnings for personal lines insurers that were most affected in 2021-2023.
Economic Growth	Slowdown in growth / Modest recession	★★★ No immediate impact, although slower GDP growth might lead to more modest increase in insurable values in the long term.	★★★ Insurance Bonds and companies' fundamentals are relatively insulated from short term trends in GDP.	★★★ Limited negative impact on earnings. However, lower growth results in lower requirements to reinvestment in the business and thus potential return of excess capital to shareholders.

Asset Risk and Insolvencies	Modest increase	★★★★★ ILS are insulated from the credit risk of the issuer. Therefore, increase in asset risk and insolvency should have no impact.	★★★ Credit migration, potentially higher defaults and weaker real estate prices are negative. However, insurers have conservative asset allocations and average bond portfolios ratings in the "A" category.	★★★ We do not expect significant increase in impairments and realised losses that would dampen earnings. However, life insurers with large asset gearing might suffer.
Geopolitical Tensions	Persisting uncertainties	★★★★ ILS are insulated from the risk of geopolitical tensions. Some Private ILS contracts and sidecars might be exposed to political violence and war related risk. However, Twelve Capital focuses on excluding these risks.	★★ Albeit not our central scenario, a worsening or spreading of current conflicts might have repercussions on supply/ demand dynamics and energy with secondary implications on inflation and rates.	★★ In line with credit investors, and potentially more so, a worsening or spreading of current conflicts might have broader repercussions on supply/ demand dynamics and energy prices that could affect investors.
Elections	Persisting uncertainties	★★★★★ ILS are mostly insulated from the uncertainties emanating from elections. At times, elections in geographies such as California and Florida were pivotal to the introduction of needed insurance market reforms.	★★★★ As Twelve's offering mostly focus on European issuers, US elections are a less relevant driver of credit spread volatility. Elections in the UK are more relevant.	★★★ Twelve expects increased volatility around key election dates in both the US and UK.

Climate Change	Progressive increase in insured losses	★★ A progressive increase in climate related insured losses is negative. However, Twelve Capital focuses on peak perils with higher attachment levels (less exposure to more frequency-driven losses and less well modelled risks). Moreover, ILS short repricing cycles allows to price-in climate change. Climate change, on the other end, supports market growth as more cedants seek to buy protection.	★★★★ Credit issuers typically have very well diversified business that make them resilient to the impact of catastrophe losses, particularly in Europe. Nevertheless, most businesses are starting to incorporate climate change consideration in their asset allocation and underwriting.	★★★ Insurance equity investors are more exposed than credit investors to weather events and climate change. Many primary insurers have increased their risk retention in recent years, thus exposing earnings to potentially more volatility.

Sector specific Themes of Focus for 2024

	Insurance-Linked Securities	Insurance Credit	Insurance Equity
Supply (new issuances)	★★★★ We expect another positive year in terms of supply in the Cat Bond space (USD 16.5bn in 2023), coming from both existing and new cedants. We also expect the diversity of perils covered to increase (i.e., more cyber), together with more parametric types of deals.	★★★★ We expect EUR 15-25bn of supply from European insurers under our coverage in different types of structures (from senior to deeply subordinated). This is a consequence of refinancing needs and new issuers tapping the market.	★★ Capital raising and new listings in the insurance space have been limited in 2023, and we expect to remain so in 2024. This is mostly a reflection of large existing capital buffers in the industry and limited space for new entrants in mature markets.

Inflows of capital	★★★★ Many investors are (re)entering the space thanks to attractive spreads and improved contract conditions. We see capital allocated to ILS to grow from the current c.a. USD 100bn at a high single-digit pace in the next years. This will have positive liquidity implication for investors.	★★★★ We expect material net inflows in credit funds in 2024. Our insurance credit offering should benefit from this trend. We see ample room for the strategy to grow without capacity constraints.	★★ Generalist equity investors tend to maintain a modest allocation to the insurance sub-sector as they focus on large household names. Specialised investors are likely to maintain their hedge and competitive advantage.
Spread/excess returns achievable	★★★ We expect a progressive normalisation albeit towards an elevated level. While improving, capacity remains constrained by the discipline of (re)insurer, leading to a longer positive cycle.	★★★ We expect a spread compression or around 30-70bps towards levels observed in 2021.	★★★ We expect the sector's dividend yield to remain overall attractive in the 6% area for European insurance. We see potential for one-off capital repatriation via share buybacks and special dividends.
ESG/ESG integration	★★★★★ ILS can serve as sustainable investment. Unlike other asset classes the collateral is ringfenced for a specific purpose, i.e., in the event of a disaster to be used to rebuild a specific set of properties. This narrow focus allows us to understand who is the beneficiary and how the investment aligns with ESG goals.	★★★★ Issuers are putting more emphasis on ESG. We expect better and broader quality of disclosure in 2024. However, we do not expect a significant increase of so-called "green" bonds.	★★★★ Like in Credit we expect the quality of disclosures to increase in 2024. However, we see US players (more relevant for our more global equity offering) as lagging behind on ESG themes.

	★★★★★	★★★★	★★★★★
Regulatory and supervisory frameworks	Limited exposure to regulatory risk as the collateral of ILS securities is ringfenced in an SPV that would be exempted from losses in case of regulatory intervention on the cedant.	Themes such as the European and Swiss grandfathering are positive for investors. Convergence to harmonised regulatory frameworks is also a positive. Offsetting these is the push by some regulators towards bonds' economic call.	Convergence to harmonised regulatory frameworks is positive. Past overhang for the sector (such as the Unit Linked mis-selling cases in the Netherlands) have faded thus providing lower uncertainties for investors.

In summary, a normalised macroeconomic environment and idiosyncratic elements is expected to offer tailwinds for the asset classes where Twelve Capital is active. Markets' deepness and liquidity will benefit from a healthy pipeline of new deals while achievable risk-adjusted returns should remain attractive after a sound performance achieved in 2023.

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About Twelve Capital

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