Insurance-linked strategies – A real alternative

For over 10 years, institutional and private investors have been benefiting from attractive returns on securitized insurance risks, known as insurance-linked securities (ILS). Unlike the traditional cat bond and ILS market that emerged in the late 1990s, current insurance-linked strategies cover a much broader investment universe and more complex investment vehicles. They are also remarkable for a peerless low correlation to the financial markets and therefore create a high diversification effect. During the recent market turbulence, ILS strategies have again proven that they deserve their reputation as a genuine alternative investment strategy.

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As an asset class, ILS products have demonstrated in recent years – and especially in the past few quarters – that they can deliver on their promise. Through the lack of, or extremely low, correlation to the financial markets, ILS products have achieved stable and positive returns, thereby proving that they have greater autonomy than traditional asset classes. With performance largely being independent of the financial market, it is well worth including this asset class in a portfolio. In recent months and quarters, insurance-linked strategies have been one of very few investment classes to successfully generate positive returns month on month.

Diversification reduces risk of loss

Including ILS products in a modern portfolio provides stability in tough market conditions. The asset class is not affected by financial market performance because negative returns are only triggered by insurance events. Since the timing of major claims, whether caused by natural or man-made disasters, is purely a matter of chance, there is no direct link to financial market performance.

Many investors suspect that insurance risks which are transferred to the capital market are bad risks that the insurers do not want to cover themselves. These fears are unfounded: Insurers have always needed to hedge risk. In the modern insurance world, outsourcing and decoupling risk from the balance sheet is essential, as this is the only way to manage capital efficiently.

Intelligent evolution of cat bonds

Originally, investments in the ILS segment were catastrophe bonds, known as cat bonds. The disadvantage, however, was that these first-generation ILS products had a very restricted investment universe in terms of volumes (US$ 5 billion in 2005, US$ 15 billion in 2008) and the variety of risk. The limited diversity of risk meant that by their nature cat bond portfolios contained concentration risks, while returns were very much determined by demand, as supply was relatively limited (US$ 15 billion).

From 2003 to 2005, higher demand saw cat bond returns fall dramatically until a temporary turnaround in August 2005 in the wake of Hurricane Katrina. Demand was largely driven by hedge funds, which had discovered insurance-linked strategies in their search for alternative sources of return. Hence the development of the second-generation products. The new product range provided access to far larger market volumes, whilst also reducing concentration risks considerably through diversification.

Aviation, shipping, oil platforms, satellites

Credit Suisse has continued to develop its ILS product range in recent years. The integration of new risk categories from the aviation and shipping industries, oil platforms, crop failures and satellites has substantially increased diversification. As a result, the pure cat bond investment universe (market volume approximately US$ 15 billion) has been expanded to include new insurance-linked derivatives, creating a market volume of over US$ 400 billion. These derivates have reduced the cost of transferring insurance risks to ILS products.

Second-generation products also achieve significantly higher returns. While these products are subject to larger fluctuations, the maximum potential losses in the event of major disasters are substantially smaller.

In the case of a cat bond, investors factor in the likelihood of the specific natural disaster being insured, which in some cases results in a total loss. With a “basket solution” like that offered by Credit Suisse, the risk is shared between a whole range of completely different risk classes and insurance claims. Thus the weighting and diversification of individual risk classes is very important when determining asset allocation. Equally, individual risks within a risk class should be limited, and ideally any potential claim should not impact multiple individual risks. When structuring ILS products, great care is taken to ensure that neither counterparty risk nor investment risk of non-insurance risks are included in the products. It is this targeted structuring that has allowed ILS investments to remain unscathed during the current financial crisis.

Innovation and knowledge

Innovation and a sound understanding of the reinsurance business are crucial when tapping new risks for the capital market. The insurance-linked securities team at Credit Suisse have made a significant contribution to market developments in the past, but they also pick up new ideas, such as crop failure insurance, and tap into them as a potential source of return for investors. Minimizing the risk of losses through diversification, the lack of correlation to financial market trends, low volatility and not least the attractive returns all go to make insurance-linked products attractive for institutional and private investors alike, offering a genuine alternative to other asset classes in both good and bad times.

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