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Want to take a risk on 'catastrophe bonds'?

David Stevenson
Adventurous Investor

Of all the lessons of the financial crisis, arguably the most important is that supposedly "alternative" assets are not very alternative. Only government bonds have proved to be genuinely "uncorrelated" with equity markets – ie, unlikely to move in the same direction.

However, this dawning disappointment hasn't stopped institutional investors looking for a "new" asset class that can provide true diversification – and their latest candidate is catastrophe insurance, or reinsurance.

In recent years, a number of pension funds have started betting against the end of the world – or, more accurately, the end of California via an earthquake – by taking on insurance risk.

Now, there are specialist reinsurance funds listed on the London Stock Exchange. CatCo Reinsurance issued two classes of share, in 2010 and 2011, in a catastrophe fund (ticker symbols CAT, CATC). Next week, it will be joined by the Iris fund, put together by hedge fund specialists Dexion (DCG) and Credit Suisse, arguably the biggest player in this niche sector.

On paper, they have their attractions for private investors. DCG Iris will offer an income of 4.75 per cent at launch. CatCo's shares yield around 5 per cent. With all of them, there is also the chance to participate in the uptick of the reinsurance cycle as the major insurers push up premiums to compensate for their worst year of natural disaster claims. That gives the potential for absolute returns regardless of equity market conditions.

They do this by taking on reinsurers' risks. Major reinsurers look to share the risk of paying out for natural disasters by issuing publicly tradeable "catastrophe bonds" or via private placements, where a specific risk is reinsured with a catastrophe fund, such as DCG Iris.

Crucially, this sharing of risk is not structured in a traditional insurance way, where the insurer is on the hook for all potential claims. Most catastrophe funds have what are called "synthetic triggers", where a number of conditions must be met before a claim is paid out.

It means that not just any old earthquake can be covered, only one that has specific features and, for example, a cumulative cost of more than $40bn.

If these triggers are activated, the fund must pay out an agreed portion of its capital to the insurer. But the fund is compensated for this risk in the form of insurance premiums that can be between 5 and 25 per cent of the sum insured.

A catastrophe fund will also diversify its risk. With Credit Suisse and CatCo, you'll never be on the hook for more than 25 per cent of the value of the fund for one disaster, and lots of different risks are underwritten within the portfolio.

Are the risks worth taking, though? Disasters might be uncorrelated with equity markets and the euro but that doesn't stop them clustering together – or being affected by other global trends, such as climate change.

CatCo's first share class, for example, was badly hit by a string of disasters including the New Zealand earthquakes – but its later C-shares largely avoided these claims. This highlights the importance of understanding the risk profiles. CatCo's shares are higher up the risk spectrum, targeting returns of 12 per cent above Libor (the London Interbank interest rate). DCG Iris, by contrast, is avowedly lower risk – it lost only 5 per cent after the disasters in Japan and New Zealand last year – and is targeting a return of 5 to 6 per cent above Libor. It is also coming to the stock market at the start of a new underwriting cycle, with premiums on the increase as the industry rebuilds its capital buffers after last year's catastrophes.

But even adventurous investors need to remember that catastrophes don't come in easy to spot cycles. Probability suggests these funds will enjoy many years of decent steady returns, and then something truly unpredictable and horrible will come along. As the ancient Greeks realised many years previously, it's mother nature who holds all the cards.

adventurous@ft.com

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Capital reserves

Earthquakes in New Zealand, a tsunami hitting Japan, bush fires in Australia . . .

Over the past few years there has been a clustering of major, costly catastrophes that have caused damage worth $100bn in aggregate.

Traditionally, large insurers such as Munich Re, or even our own Lancashire Holdings, have carried much of the risk of paying out for them using their own capital, with some of the risk reinsured with other institutions or on Lloyd's of London.

But pressure to improve capital reserves has left many of the big institutions in a quandary: how to improve funding and protect against the biggest natural disasters?

As the risks get greater, the more there is a need for costly funding: capital must be tied up to cover against unusual risks, but it could be used in more predictable businesses, such as car or home insurance.