

STRATEGY FOCUS

A monthly publication focusing on specific hedge fund strategies

August 2006

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Insurance-Linked Securities

Perspective

August and September are the heart of the US hurricane season, although the technical start of the season is June 1. June and July are typically quiet.

Karsten Bromann of ISPartners Risk Advisors, one of the managers Infovest21 spoke with, says the hurricane season has started very slowly. He believes the season will end up with above average activity. "Something like last year is improbable but not impossible," he says.

Hurricane Katrina and its ripple effect

Hurricane Katrina in 2005 was the biggest hurricane in US history, as measured in terms of pure insured damages. It cost insurers \$45 billion (see table on page 11).

Hedge fund managers saw this environment as an opportunity, as insurance companies were overburdened with incoming claims. Hedge fund managers rapidly came in looking for returns that were uncorrelated to other investments.

Catastrophe bonds tend to cover a few extreme events, such as earthquakes, hurricanes, and typhoons. A type of insurance-linked security, they pay higher yields – usually between 5-15% per year, depending on the bond – because investors may lose their entire stakes in the event of a disaster. The higher rate makes them attractive to hedge funds.

Generally, cat bonds are held by 100 to 200 investors, are issued with BB or marginal ratings, and have four-year maturities.

If a covered event of a large enough size occurs, the investors stand to lose part or all of their principals. If nothing happens, the investors get their principal and an allotted return at maturity.

In some cases, the hedge fund managers are dedicated to insurance-linked securities, while, in other cases, they are multi-strategy managers. Some hedge fund managers are investing in start-up reinsurance companies, including sidecar reinsurers (see page 12).

Hedge fund manager activity in the area is expected to grow in light of diminishing trading opportunities in other markets and the diversification it brings to the managers' holdings.

According to a report by Guy Carpenter, there was unprecedented growth across the catastrophe bond market in

Year	Risk Capital Issued (\$M)	Number of Transactions
1997	633.0	5
1998	846.1	8
1999	984.8	10
2000	1139.0	9
2001	966.9	7
2002	1219.5	7
2003	1729.0	7
2004	1142.8	6
2005	1991.1	10

Source: Guy Carpenter, "The Catastrophe Bond Market at Year-End 2005."

2005, largely driven by US hurricane activity. The catastrophe bond market recorded total issuance of \$1.99 billion in 2005, a 74% increase over 2004. In addition, total risk capital outstanding had increased to \$4.9 billion by the end of 2005, a 21% increase from 2004.

In addition to record growth, the catastrophe bond market suffered its first significant loss to a publicly disclosed bond in 2005. "Hurricane Katrina's devastation is expected to have caused a

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total loss of the KAMP Re 2005 Ltd Issuance, a \$190 million transaction,” says Claire Wilkinson of the Insurance Information Institute.

Catastrophe bond issuance in 2006 could be double that of 2005. So far in 2006, insurers have raised \$2 billion. In June 2006, Swiss Re, the world’s largest reinsurer, sold \$950 million of catastrophe bonds, the largest offering ever. About \$467 million of that will protect against hurricane claims. The bonds contain options that can expand the issue to \$16 billion over the next three years.

Among the ripple effects in the catastrophe bond market from the 2005 US hurricane season, according to the Guy Carpenter report, were:

- ▶ rating agencies revised their capital requirements upward for insurers and reinsurers with catastrophe exposures
- ▶ natural hazard modeling firms announced their intent to revise their models, taking into account the new information gleaned from the 2004 and 2005 storm activity
- ▶ a substantial increase in the degree of uncertainty concerning 2006 renewal pricing and capacity available from traditional reinsurance and retrocession writers of catastrophe lines
- ▶ a dramatic rise in the cost of reinsurance for companies that had suffered catastrophe losses in 2005

Sidecars

Since November 2005, more than \$3.2 billion of hedge fund money has been invested in sidecars (see page 12).


Sidecars – separate limited purpose companies that share the risks of certain policies with the underwriter in exchange for a portion of the premiums – have a higher potential return than those of catastrophe bonds. As premiums sky rocket, hedge fund managers are attracted to the potential return. Sidecars also give investors more control over what they are buying. Whereas catastrophe bonds are prepackaged, take-it-or-leave-it investments, sidecars are individually negotiated.

Investing in a reinsurance company exposes hedge fund managers (and other investors) to all kinds of insurance risks. A sidecar allows them to be more selective.

If disaster strikes, the capital is tapped. If not, investors get their money back plus the premiums paid by policy holders.

Weather Derivatives

Over the past two years, the weather derivatives market has increased ten times to \$40 billion. Weather derivatives are used as a hedge against high-probability, low-risk events, such as a dry spell.

In many businesses, weather is related to the volume of sales transacted. Examples are a ski resort, which would attract fewer skiers when there is little snow, or an amusement park, which would attract fewer visitors when it rains. 



DIEGO WAUTERS
Coriolis Capital Limited

Lois Peltz: Describe your company, track record, assets, etc.

Diego Wauters: Our company, Coriolis Capital Limited, has assets of about \$330 million under management. We are regulated by the Financial Services Authority in London.

The firm was founded in June 2003 following a management buy-out from Société Générale. The firm focuses its activities on insurance-related derivatives, such as natural catastrophe bonds and weather derivatives, as well as long and short positions in the stock of insurance, reinsurance, and insurance brokerage companies.

Our objective is to provide our investors with a defensive alternative investment tool. In general, our hedge funds offer a lack of correlation with the financial markets and low volatility.

Lois Peltz: How are you different from other managers in this space?

Diego Wauters: We tend to concentrate on very low-risk natural catastrophes and, then, leverage our portfolio or diversify it through the use of weather derivatives, which are uncorrelated to the natural catastrophes. Also, we are one of the few portfolio managers who offer access to a global weather derivative portfolio.

Lois Peltz: What is covered in catastrophe bonds? Weather derivatives?

Diego Wauters: Catastrophe bonds tend to cover a few extreme events caused by Mother Nature. These include earthquakes, hurricanes, and typhoons. Events of the size required to affect a catastrophe bond tend to occur once or twice a century. Investors typically subscribe to the bonds and receive a return on their principal of Libor plus a spread, which compensates them for the risk they are taking. If a covered event of a large enough size occurs (as measured by either some physical measurement, such as the magnitude of an earthquake, or by the size of insurance losses under a particular set of contracts), the investors stand to lose part or all of their principal. Otherwise, if nothing happens, the



KARSTEN BROMANN

ISPartners Alternative Risk Advisors

Lois Peltz: What differentiates you from other managers?

Karsten Bromann: First, we have reinsurance or insurance background. While some of the other dedicated event-linked securities funds have this background, it is rare with multi-strategy funds; they may have one bucket dedicated to the area without fully understanding the details of the risk. Second, size-wise we are not that big. That means we have the possibility to select what we want to include in our portfolio. Others who are bigger need to take everything that the market offers. Third, we try to be very open with our investors. An investor who is interested in information can get individual positions and extensive feedback on our evaluation of riskiness of the individual positions or different risk buckets.

Lois Peltz: What is the history of the firm?

Karsten Bromann: ISPartners Alternative Risk Advisors (ISPARTNERS ARA), the sub-manager of the ISP Event Linked Securities Fund, is a joint venture between ISPartners Investment Solutions and the managing partners of ISPARTNERS ARA, Stefan Mueller, and myself. ISP was founded in 2003. ISPARTNERS ARA was founded in 2004 and the fund launched in December 2004. Stefan has an economics degree with a focus on alternative risk transfer and capital markets. He used to work with Center Solutions, a special insurance entity within Zurich Insurance Group. After that, he worked for Zurich Reinsurance, which, later, was spun-off to become Convergium. There, he was responsible for capital market interaction and relationships with hedge funds.

I am a PhD in physics and a qualified actuary. Since 1998, I worked with Zurich on the corporate business side, where I served as head of quantitative analysis in a consulting business for Zurich's corporate customers and, later, became responsible for actuarial pricing and underwriting of alternative risk transfer transactions for Zurich Corporate Solution's portfolio in Europe.

Lois Peltz: What is the firm's focus?

Karsten Bromann: We do cat bonds, as well as other securitized instruments that are available to access insurance risk. That includes catastrophe derivatives, derivatives on "normal" reinsurance contracts, or industry loss warranties. The latter are

derivatives that are based on the loss that the whole insurance industry suffers in a given event. For example, a reinsurance contract that pays out if the loss to the whole insurance industry from a hurricane in the US exceeds \$30 billion.

The market of industry loss warranties is roughly twice the size of the cat bond market. We have \$5-6 billion outstanding limits in catastrophe bonds. We have \$10-12 billion outstanding in insurance loss warranties and other types of derivatives.

Lois Peltz: How many positions in the fund?

Karsten Bromann: We have roughly 40 different positions in our portfolio that can be broken down into a dozen risk buckets. Emphasis within the portfolio lies on property catastrophe risk. So, we have the usual suspects – hurricanes, earthquakes, floods, and windstorms. Property catastrophe constitutes about 65% of our book. But, there are other buckets for aviation, liability risk, energy risk, etc. We have, as well, a little bit of extreme mortality.

We like to link the returns that we achieve to the insurance of real headline events.

Lois Peltz: What are the factors that you look at?

Karsten Bromann: Our underwriting and portfolio construction is based on reinsurance and insurance underwriting principles. We take into account every piece of information that we can get. This starts with factual risks on the individual contracts that we analyze and ends with general questions, such as "What will global warming do to the industry?" and "Is it a good idea to invest in hurricane insurance?"

There is not a single subject that is key and core to our thinking. It is scientifically-based with sound underwriting practice and portfolio construction guidelines.

Lois Peltz: Is it based on quantitative models?

Karsten Bromann: You need to have quantitative models. There are a few vendor models that you can license – Risk Management Solutions, EQECAT and AIR Worldwide. We license part of those. In addition, we developed in-house models for our type of contracts which we can't directly model in the vendor models, or where we have different understandings of correlations between risk, or where we underwrite structures that you can't get into the systems.

Our approach is relatively scientific and based on actuarial principles. We believe that, as important as they are, you can't rely blindly on the output of the vendor models but need to critically question them. There has to be an additional step where you question the output of the models, compare the different models, and compare the models to what you think or what the academics say.

For example, you gain a lot if you compare the output of the three main vendor models in different areas of different risk. Why does model A show loss figures that are only 50% of what models B and C give? Is it due to a different understanding of the physical risk (i.e., number and strength of hurricanes, earthquakes, etc.), or do they work with a different database of insured values? All these critical questions have to be asked.

It is based on the most information that you can get, what you believe, and whether there is room for improvement.

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BROMANN (continued from page 3 column 2)**Lois Peltz: Are returns seasonal?**

Karsten Bromann: They are because the underlying risks are partly seasonal.

Cat bonds pay a fixed coupon quarterly. Coupon payment doesn't change. What changes is the riskiness-to-maturity. Take a hurricane bond with one year to maturity in early June. If it survives the hurricane season, you have approximately nine months of interest with nearly no risk. The price of the bond will reflect this. It will go up so that the spread-to-maturity will be similar to the risk-free rate. If you have this bond in your portfolio, your return will get a positive contribution.

Sometimes, these price movements don't reflect the true change in riskiness-to-maturity of a bond. The reason is that the market is rather illiquid and most of the investors have a hold-to-maturity philosophy.

It is different with the derivatives that we write. There, you get the reinsurance premium upfront, but you need to earn it into the fund's profit in accordance to the seasonality of the risk. Suppose you write a derivative that covers hurricane risk and it runs one year from January until December. Then, only those investors who are with the fund during the hurricane season should earn this premium because only they are exposed to losing their investment. This is done by allocating a contract's profit to each month according to each month's riskiness. In our hurricane example, hardly anything is to be earned in February, March, or April because there is hardly any hurricane risk. The bulk of the returns are earned from mid-June to October, making returns seasonal. In order to exclude any arbitrariness from this process, we calculate the earning pattern for each derivative before it is added to the portfolio and the administrator follows this earning pattern without the possibility of the manager to interfere with the schedule.

Lois Peltz: What was the impact of Katrina?

Karsten Bromann: We lost one derivative and had marked-to-market devaluations on other holdings. We fared better than most of our competitors in the full-scale event-linked securities area and were, as well, less affected than most of the Bermuda-based reinsurers, whose business risks are in some way similar to ours. However, we fared worse than the cat bond-only funds, who had the luck that most hurricane-exposed bonds were not structured to cover events in the Louisiana /Mississippi area.

On the positive side, the event was a proof of concept of our internal processes and exposure controls. When Katrina entered the Gulf, picked up strength, and did not move directly northward as initially expected but headed for New Orleans, we informed our investors before Katrina hit land and told them what the potential impact on the portfolio could be. When the first estimates of losses from the modeling agencies were out— a few days after the event – we communicated again to our investors the estimated impact on the portfolio. In retrospect, we were right by about 20 basis points, a precision that is the consequence of an exact knowledge of the exposure to the portfolio. In addition, we remove any reserve uncertainty by fully separating any potentially affected derivative from the main fund. That way, there is clarity about the performance of the remaining portfolio and losses cannot be "smeared out" over months by gradually increasing loss reserves or writing down of assets. New investors are protected from picking up prior losses.

Lois Peltz: Any thoughts on the 2006 US hurricane season?

Karsten Bromann: It started very slowly, but we still believe that it will end up as an above average activity season. Our estimate is similar to what you will read on the more reasonable forecasting sites. However, something like last year is improbable but not impossible.

We expect to see something similar to 2004, where we had four hurricanes in Florida, which created market losses in the area of \$3.5-8 billion. We believe the season will be active but not catastrophic.

Lois Peltz: Is the best thing for the portfolio if no event happens?

Karsten Bromann: Under normal cases, no event is good news. Still, we have the possibility of being "short in risk," i.e., we can buy reinsurance protection from another company if we believe something is heavily underpriced. In such a case, if an insurance event were to happen, we could collect on that contract.

In 95% of the cases, however, it is the other way around. We operate similar to an insurance company. For every insurance company, no news is good news.

Lois Peltz: What are the probabilities of nothing happening?

Karsten Bromann: It depends on how you structure your portfolio and whether you buy only risk remote bonds or whether you are very active and aggressive and give reinsurance protection at very risky levels. We tend to go a middle way here.

We model our portfolio every month based on our risk models. As such, we get an understanding of what might happen in a given year and the corresponding probabilities. Two figures that give an understanding of the riskiness of our portfolio are the expected loss and the probability of having a negative return over the next 12 months. Currently, these figures are 3.4% for the former and 4.1% for the latter. The probability of nothing at all happening is roughly 50%. In that case, we expect to earn something between 15-18%.

With roughly 50% probability, something might happen, but, in most cases, it will have only a small impact on performance. For

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ISPARTNERS ALTERNATIVE RISK ADVISORS

- Inception: 2004
- Assets: Not disclosed
- Headquarters: Zurich

KARSTEN BROMANN

- Title: Managing Partner and Chief Risk Officer
- Prior Experience: Zurich Insurance Company

BARNEY SCHAUBLE

Nephila Capital

Lois Peltz: What differentiates you from other managers in this space?

Barney Schauble: First, Nephila has been managing funds since April 1998. This is not a new business for us as a firm, and the three partners have been involved in this sector since its inception. Second, we are dedicated to insurance risk, such as catastrophe bonds. We don't also have a natural gas trading desk or a long/short equity fund.

Third, we are based in Bermuda, which is the world center for property, catastrophe, and reinsurance. It is a big advantage. If you have a big, unusual, or difficult risk to place in the insurance or reinsurance market, you have to come to Bermuda. By being here, we're a part of that community.

Fourth, we have 18 people and a robust infrastructure. We own our own Bermudian reinsurance company, Poseidon Re, which has been in operation for over four years and is the vehicle by which we can participate in reinsurance directly.

Lois Peltz: How does the general concept of catastrophe bonds work?

Barney Schauble: It varies by transaction. Generally speaking, catastrophe bonds or the other investments we invest in provide coverage for insurance and reinsurance companies against one or more large natural catastrophe events – hurricanes, earthquakes, typhoons, etc. These are large when measured in terms of insured losses, not necessarily in terms of pure physical size; for example, a tragic event like the Asian tsunami of 2004 would not have a large impact on our business. We're not covering lawsuits, casualty, liability, or directors insurance. We cover property catastrophe business.

If the event causes over a certain level of loss to a (re)insured, they want us to help them pay for that loss. We do that by buying a catastrophe bond issued on their behalf or by a direct contract. As an example, Swiss Re is the biggest issuer of catastrophe bonds. If they want to buy \$100 million of protection, we and other investors put \$100 million into an account, of which they are the beneficiary. If the coverage lasts for a year, the money stays in that account for a year. Swiss Re doesn't take any credit risk to the investors. The structure removes the element of credit risk from the classical reinsurance transaction, and this is a key advantage of capital markets participation in reinsurance.

Swiss Re (or any other buyer of protection) knows if anything happens, the money is there to pay them. At the end of the time period, if nothing happens, the money returns to investors; and, they are also paid a premium for taking that risk.

Lois Peltz: You don't include terrorist events?

Barney Schauble: We don't cover terrorism, but there are insurance and reinsurance companies that do, and some catastrophe bonds have been issued linked to terrorism risk.

Lois Peltz: What does your portfolio consist of?

Barney Schauble: We have a number of different portfolios that we manage on behalf of institutional investors. Different vehicles represent different risk profiles. Each portfolio consists of a large number of individual positions. They are diversified by counterparty; by peril – earthquake versus typhoon versus hurricane; by geography – windstorm in US and Europe; and within regions, such as windstorm in Cape Cod vs. Texas.

Lois Peltz: How many positions are typically in a fund?

Barney Schauble: On average, our largest funds typically have between 100 and 200 positions.

Lois Peltz: How many funds do you have?

Barney Schauble: We have two mainstream funds and a number of other vehicles that are more specialized. The two flagship funds have been in existence since 1998 and 2001.

Lois Peltz: Does concentration of risk and seasonality exist?

Barney Schauble: US property exposure to hurricanes is probably the single biggest insured exposure. The amount of total insured residential property, particularly homes on the US coastline, is significant and, therefore, a meaningful exposure in the fund.

Typically concentrations of risk arise anywhere where you have an intersection of natural hazard and a high level of insured values. For example, in Brazil and China, while there is a high level of natural hazard, currently there is not the same level of insured value. The insurance industry that exists is capable of handling the risk. Where our funds participate is where the insurance industry does not have sufficient capital to support the level of risk.

Risk does vary by season: hurricane season runs from June 1 through the end of November. The European windstorm season starts late in the fall and continues to spring. Earthquake exposure has no seasonality.

Lois Peltz: Any thoughts on the upcoming hurricane season?

Barney Schauble: June 1 is the technical start of the season; June and July typically are quiet. August and September are the heart of the season. So far, it has been quieter than last year.

Lois Peltz: How did Hurricane Katrina impact you?

Barney Schauble: Katrina was the biggest hurricane in the history of the US, as measured in terms of pure insured damages. We manage funds that invest in instruments that have a higher risk and return than catastrophe bonds to reflect the appetite of our investors, and so our exposure in some vehicles is more akin to that of a reinsurance company. Katrina had an impact on some of the contracts that we wrote in the funds. The impact depended on the type of fund and the particular exposure of each vehicle.

Because of the storms in 2005, some of our funds made payments to our counterparties; for compliance reasons, we do not disclose any detail about our track record except to potential and existing investors.

Lois Peltz: How often are there large losses?

Barney Schauble: It certainly doesn't happen every year; we've been in business nine years and one or more major natural

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SCHAUBLE (continued from page 5 column 2)

catastrophes don't happen every year, but they will happen over time. It is a business where our investors have a risk and investment profile over a medium-term horizon.

Lois Peltz: What if there are two or three major events in one year?

Barney Schauble: Last year, there were two hurricanes after Katrina: Rita in Texas and Wilma in Florida. Multiple events can occur in one year, but the likelihood of that is obviously smaller than that of any one event. The most likely outcome in a given year is that you have no event large enough to impact a portfolio, given how these portfolios are constructed.

Lois Peltz: Can you provide an example of how it works?

Barney Schauble: Let's say that last year we had a fund that only wrote US risk with 10 contracts. One was in the Northeast US, one was in MidAtlantic, one was in Georgia, one was in Florida, one in Texas, one in California, etc. Each contract provided \$10 million of protection.

Investors are paid a premium to provide that protection, much like a bond coupon or insurance premium. We assume, in this example, that the fund was paid a premium of 20% on the overall portfolio; on each contract, a buyer of protection pays \$2 million to access \$10 million worth of risk on the 10 different exposures. The fund would, in this example, have a "top line" gross revenue of \$20 million.

If one large catastrophe event occurred, and that event caused a total loss to one contract (for example, to the Louisiana contract from a Katrina-like event), that would mean the fund would make a \$10 million payment to the counterparty. So, the net income for the year would have been 10%, plus the return earned on collateral (US treasuries), less fees and expenses.

Lois Peltz: When you make a payment, does that result in negative performance or reduced positive performance?

Barney Schauble: It depends on the magnitude of the event(s) impacting the portfolio. It could reduce the return for the year or it could result in negative performance.

Lois Peltz: How do you manage that risk?

Barney Schauble: One way that we manage it is by diversifying the exposure we take. And, we make sure we are paid better over time than what we believe we are going to pay out over time. It is

Risk Capital By Specific Peril (\$M)					
Year	US Earthquakes	US Hurricanes	European Windstorms	Japanese Earthquakes	Japanese Typhoon
1998	145.0	721.1	0.0	0.0	80.0
1999	327.8	507.8	167.0	217.0	17.0
2000	486.5	506.5	482.5	217.0	17.0
2001	696.9	551.9	431.9	150.0	0.0
2002	799.5	476.5	334.0	383.6	0.0
2003	803.8	416.1	474.1	691.2	277.5
2004	803.3	660.8	220.3	310.8	0.0
2005	1269.0	994.0	830.1	138.0	0.0
Total	5443.7	5229.7	29399.9	2197.5	391.5

Source: Guy Carpenter, "The Catastrophe Bond Market at Year-End 2005."

NEPHILA CAPITAL

- Inception: 1998
- Assets: Not disclosed
- Headquarters: Bermuda

BARNEY SCHAUBLE

- Position: Partner
- Prior Experience: Goldman Sachs, & Co

not like being equally long and short in equities – we are not purely market or event neutral. On average, we believe, and the reinsurance industry generally is predicated upon the belief, that there will be more years when no major event occurs than years where there will be significant losses; and, thus, the cumulative return over time for investors will be positive.

Lois Peltz: Is global warming a consideration?

Barney Schauble: It is a consideration if it creates specific effects relevant to catastrophe events. If the ocean is warmer, the sea surface temperature can have an impact on the potential strength of the hurricane – that varies not only year by year but also week by week, depending on whether it is warmer off the coast of Boston or not warmer off the coast of Boston.

There are climatic factors that are important, but any assumption of warming will not impact every place in exactly the same way. If the globe is warming, it is not clear whether it means there will be more or less hurricanes and whether they are going to hit the Northeast or the Southeast or Mexico or Japan. We clearly pay close attention to the science on the topic, and we have people who think about it here as well as externally and follow the latest research.

Lois Peltz: What are other factors? Themes?

Barney Schauble: One area we are expanding into is weather risk. We provide protection linked to temperature and rainfall levels and how that may impact the energy or agricultural sectors. For example, is it going to rain, and what impact will that have on hydroelectric plants? An owner of such facilities may want to buy protection against a low amount of rainfall.

Lois Peltz: What are the return patterns like?

Barney Schauble: Returns in this asset class are naturally skewed. Relatively low probability catastrophe events mean that the return pattern tends to be steady unless there are events. A simulated probability distribution will indicate that, more often than not, investors will earn the premium and not be impacted by any events. The left "downside" tail of the distribution reflects that, if there are events, you can have some volatility. Returns are not normally distributed.

Lois Peltz: How quantitative is the approach?

Barney Schauble: We take a very quantitative and statistical approach – we start with licensing the standard models for the

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SCHAUBLE (continued from page 6 column 2)

insurance and reinsurance industries. These modeling firms spend a lot of time thinking about where properties are located and how to assess risk exposure. We, then, feed that input into our own proprietary systems.

Lois Peltz: Can you describe the different return/risk profiles?

Barney Schauble: A contract might have a one in 100 year probability of being impacted, which could mean that an event would have to be a truly gigantic storm, and that contract would have a certain premium. Another contract might have a one in 10 probability of being impacted and have a much greater premium. There are some vehicles that we manage on behalf of investors that want to be relatively conservative and would invest in the former type of contract. Other investors who are seeking higher returns and want to be more aggressive would prefer our higher risk / return vehicles.

Lois Peltz: Do you hedge?

Barney Schauble: We do. We view the ability to be able to go long and short the different instruments as important, though, by the nature of the business, we are a net provider of reinsurance. We are not equally long and short. We are in the business of selling protection.

Lois Peltz: How much do you manage and are there capacity constraints?

Barney Schauble: We do not publicly disclose our assets under management. Rough estimates of the total amount of catastrophe reinsurance transacted in a given year are in the range of \$150-200 billion. We remain a small fraction of that overall market. We don't feel there are capacity constraints anytime soon.

Lois Peltz: What do the 18 people in the firm do?

Barney Schauble: About one-third focus on analytics – the quantitative assessment of individual risks and overall portfolios; one-third are on the portfolio side – evaluating specific transactions, dealing with intermediaries and counterparties, and managing the funds; and one-third are in operations – processing and dealing with the cash flows. We all live and work in Bermuda.

Lois Peltz: Do you have a weatherman?

Barney Schauble: We prefer to contract with outside experts. There are excellent people who specialize in that area in the academic world and elsewhere. Rather than bring in one person and depend on a single view, we would rather have broad access to multiple opinions.

Lois Peltz: Originally, you were part of Willis?

Barney Schauble: The two founders of the company, Greg Hagood and Frank Majors, founded the firm in 1997 and started the fund in 1998. At the time, it was majority owned by Willis (WSH:NYSE), an insurance brokerage company. It is one of the four top insurance and reinsurance brokers.

Frank and Greg bought out Willis' share in October 2003. We've been independent for almost three years.

Lois Peltz: What does 'nephila' mean?

Barney Schauble: It is the Latin name for a type of spider. Bermuda folklore has it that the spider can tell when a hurricane is coming.

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investors get their principal back at maturity. Such bonds are normally issued by insurance or reinsurance companies (and occasionally corporations) to cover their exposures to such catastrophes. More recently, "man-made" catastrophe bonds and options have been issued to cover aviation or car accidents, mortality rate, etc., or other property/casualty or life insurance risks.

Weather derivatives, on the other hand, protect corporations in such industries as energy, agriculture, food and beverage, and construction against day-to-day fluctuations in the weather – namely rain, snow, temperature, etc. By their nature, weather derivatives are closer to the money, as they are priced to protect those corporations against extremes which could happen every five to twenty years or, sometimes, even more frequently.

Weather derivatives work similarly to other derivatives on indices, except the index in question here is an official weather statistic (for example, the average temperature at London, Heathrow airport for the period November 1 to March 31, as measured by the UK Meteorological Office). More complex indices can be constructed and we are seeing more and more deals based on complex indices. An example of a more complex index is the number of days where the daily rainfall at Paris's Orly airport is greater than 5 mm. This kind of index might be of interest to an ice-cream company, for whom too many rainy days dent demand during the summer months.

Both types of instrument show little or no correlation with the financial markets. Only the very largest earthquakes or hurricanes hitting a large city could possibly have a lasting influence on interest rates or equity markets. Otherwise, changes in the temperature in Brussels should have no measurable influence on the level of the Dow Jones (and certainly not the other way round).

Most catastrophe bonds based on different perils tend to have zero correlation, and weather derivatives can even have negative correlation (for example, cold weather risk in Paris and warm weather risk in London). This makes diversification a powerful tool.

Lois Peltz: What does your typical portfolio look like?

Diego Wauters: At any time, we tend to hold between 40 and 50 cat bonds and options and a similar number of deals in our weather portfolio, which can be diversified over 20 countries.

Lois Peltz: Can you give a general breakdown by type of peril, country, etc.?

Diego Wauters: When it comes to natural catastrophes, we have created a dozen categories, which include earthquake – west-coast US, earthquake in Japan, earthquake in the mid-west US, earthquake in Europe, hurricane – east-coast US, European wind storms, typhoons in Japan, etc. These categories have no correlation with each other and we limit the exposure to any category to a pre-defined portion of the fund.

Similarly, we have constructed a diversification matrix for weather derivatives, which is made of eight geographical regions (such as Europe, Japan and Korea, US and Canada east-coast, etc) and five weather types (temperature, rain, snow, etc). Here again, we make sure that we never allocate more than the maximum proportion of the fund into one box of this matrix to ensure that our exposures are uncorrelated to each other.

Continued on page 8 column 1

CORIOLIS CAPITAL

- Inception: 2003
- Assets: \$330 million
- Headquarters: London

DIEGO WAUTERS

- Title: Chief Executive Officer
- Prior Experience: Societe Generale

WAUTERS (continued from page 7 column 2)

Lois Peltz: What was the impact of Hurricane Katrina?

Diego Wauters: Last year, our return on a cat bond portfolio was flat while our weather books were profitable. Otherwise, since their inception eight years ago, our funds have shown positive returns.

We have tried to take as much advantage as possible from the increase in the coupons of new cat bonds post-Katrina. While the probability of loss may have increased, the corresponding surge in new coupons has been even higher.

Lois Peltz: What are your expectations for the 2006 hurricane season in the US?

Diego Wauters: Forecasts for hurricanes in 2006 have changed for the last three months and it is difficult to say how the season will end up. The price for cover is substantially higher than last year and should at least cover the most dramatic scenario, still leaving us with a profit.

Lois Peltz: What are the key factors that you consider?

Diego Wauters: When it comes to weather derivatives, we have developed our own pricing models in the last eight years. They were originally started while we were at Societe Generale, then reviewed and stress tested by the risk management group of the bank, who now uses them to value our positions. They are sophisticated, statistical models taking into account, among other things, trends and volatilities of historical weather data.

We are uncomfortable with forecasting the weather and have concluded a long time ago that practically no one can compute good quality forecasts beyond two to three weeks. When it comes to natural catastrophes, we rely on one of the three main rating agencies which have sophisticated statistical models analyzing the probability of earthquakes, hurricanes, typhoons, etc. Here, our modelling concentrates more on the risk management of a diversified portfolio of such exposures.

Lois Peltz: What are the current themes/outlooks?

Diego Wauters: While the natural catastrophe bonds and weather derivatives market are getting more mature, new insurance and reinsurance risks are getting packaged to the capital markets. I refer to the new instruments we have been buying, such as mortality/longevity options, automobile accidents, etc.

There is a clear trend of reinsurance companies trying to manage their balance sheet in the same fashion as banks have been doing for the last 20 years. This implies the shift of some risks to the capital markets and the packaging of those in bonds or options.

Lois Peltz: Can you describe a position/situation that you find interesting?

Diego Wauters: When trading weather derivatives, our counterparties are not only energy companies, agricultural cooperatives, retail and distribution groups but also leisure companies. Among these, we have sold options to cover sports events, music festivals, etc.

Lois Peltz: Does seasonality exist?

Diego Wauters: Clearly, our business is very seasonal, as hurricanes, typhoons, etc. only happen in certain months of the year. Also, our weather book is completely seasonal, with the portfolio renewing itself four times a year. Earthquakes, on the other hand, have no seasons.

Lois Peltz: What are other risks? How is risk managed?

Diego Wauters: We use not only the traditional risk management tools, such as loss exceedence curves, VAR, etc., but also portfolio diversification models akin to those used in the reinsurance industry.

Lois Peltz: Do you hedge?

Diego Wauters: We only occasionally hedge our positions either through reinsurance for our cat bond book or on the Chicago Mercantile Exchange for our weather book.

Lois Peltz: What is your infrastructure like?

Diego Wauters: We use SG Hambros, our former employer, as administrative agent, trustee, and independent valuation provider for our funds. This way, we have sub-delegated most of the operational activities of our business to a highly experienced business partner.

Lois Peltz: What does Coriolis mean?

Diego Wauters: Gustave Coriolis was a French scientist who discovered the effects of the rotation of the earth. One of the better-known consequences of the "Coriolis force" is the rotation of water as it goes down the plughole of a sink, either clockwise or anti-clockwise, depending on your location in the southern or northern hemispheres.

Lois Peltz: At what point do you have capacity constraints?

Diego Wauters: We are currently managing over \$300 million. If you combine this with our leverage facility, our investment portfolio can, at times, be as large as \$500 million. Our ambition is to grow smoothly at the rate of 15-20% per year in parallel with the market.

Lois Peltz: Who are your typical investors?

Diego Wauters: Our investors tend to be large financial institutions in Europe and offshore. We intend to approach the US market some time at the end of this year.

Continued on page 9 column 1

Sentiment Indicator

Managers' views tempered

In a significant departure from last quarter's survey, managers have tempered their views on markets, moving up significantly over the next three months, 12 months, and five years.

24% feel Nymex Oil will move up significantly over the next three months - this was the highest percentage for the 13 markets in the survey regarding markets that would move up significantly.

In 12 markets, the highest percentage of managers surveyed for each group feel the markets will move up slightly. In rank order, they are 75% for the Consumer Price Index, 48% for DJ Stoxx, 46% for the Euro, 45% for the Dow Jones Industrial Average, 44% for the 30-Year

Three-Month Outlook								
	New Highs (%)	Up Significantly (%)	Up Slightly (%)	Neutral (%)	Down Slightly (%)	Down Significantly (%)	New Lows (%)	Total (%)
Dow Jones Industrial Average	0.0	3.0	45.0	21.0	24.0	6.0	0.0	100.0
Nikkei 225 Stock Average	0.0	10.0	41.0	31.0	14.0	3.0	0.0	100.0
FTSE 100 Stock Average	0.0	0.0	41.0	34.0	17.0	7.0	0.0	100.0
DJ Stoxx	0.0	0.0	48.0	24.0	21.0	7.0	0.0	100.0
10-Year Treasury	0.0	14.0	31.0	31.0	21.0	3.0	0.0	100.0
30-Year Fixed Mortgage Rate	0.0	9.0	44.0	34.0	12.0	0.0	0.0	100.0
Dow Jones Corporate Bond Index	0.0	3.0	32.0	35.0	26.0	3.0	0.0	100.0
Consumer Price Index	0.0	6.0	75.0	12.0	6.0	0.0	0.0	100.0
Euro (in dollars)	4.0	4.0	46.0	29.0	14.0	4.0	0.0	100.0
Yen (per dollar)	0.0	17.0	38.0	24.0	17.0	3.0	0.0	100.0
Pound (in dollars)	3.0	10.0	41.0	31.0	10.0	3.0	0.0	100.0
Nymex Oil (spot month)	3.0	24.0	41.0	10.0	21.0	0.0	0.0	100.0
Comex Gold (spot month)	0.0	13.0	37.0	23.0	27.0	0.0	0.0	100.0

Fixed Mortgage Rate, 41% for the Nikkei 225 Stock Average, 41% for the FTSE 100 Stock Average, 41% for the Pound, 41% for Nymex Crude, 38% for the Yen, 37% for Comex Gold, and 31% for 10-Year Treasury Note (tied with the same percentage for neutral).

Only in one market did the highest percentage of managers feel the markets would be neutral. 35% feel the Dow Jones Corporate Bond Index will be neutral over the next three months.

Over the next 12 months, the strongest manager sentiment is seen with the

Continued on page 10

WAUTERS (continued from page 8 column 2)

Lois Peltz: What is your background?

Diego Wauters: I am chairman and CEO of Coriolis Capital Limited. CCL was created in July 2003, following the management buyout from SG, the French bank.

Prior to the management buyout, I was global head of insurance and weather derivatives at SG. I joined the London office of the French bank in February 1998, after spending four years with AIG. I was founder, president, and CEO of AIG Combined Risks, a wholly owned investment bank subsidiary of the group, which specialized in insurance derivatives. AIG Combined Risks, among other things, has been a pioneer in catastrophe bonds and weather swaps. Prior to this, I spent 11 years at JP Morgan, both in New York and London, where I became managing director in charge of M&A insurance and financial reinsurance. I was involved in the creation of some of the biggest start-up insurance companies established offshore, such as ACE, XL, SCUUL, Centre Re, etc. My group also structured some of the largest financial reinsurance transactions ever closed in this specialized segment of reinsurance.

BROMANN (continued from page 4 column 2)

example, reinsurance pricing increases further and we have marked-to-market devaluations on the cat bond portfolio. Normally, the more severe an event might be, the lower is its probability. To gain a quantitative understanding of severe events in the portfolio, we model, as well, Value-at-Risk figures at various return intervals.

We look at these figures on a monthly basis because the portfolio characteristics change, partly because of additions or disposals or due to the seasonality of risk. As we try to position ourselves in a particular spot in the risk/return space, we need to constantly be aware of where we stand.

Lois Peltz: What is the risk profile of your investors?

Karsten Bromann: From the return and riskiness perspective, we are like mezzanine financing. We are definitely not the crusader underwriters who only look for very high coupons and disregard the associated risk figures. But, we neither are in the "Libor-plus-200-with-40-basis-points" risk league. Expected loss to the portfolio is 3-4%. If nothing happens, we expect 15-18%. It is more risky than a normal cat bond fund but less risky than an equity-like investment, such as the sidecar deals that are currently pushed into the market.

SENTIMENT INDICATOR (continued from page 9)

Nikkei 225, Yen, and Pound, where 23% of the managers feel those markets will move up significantly.

In six categories, the highest percentage of managers surveyed for each group feel the markets will move up slightly. In rank order, they are 62% for the Consumer Price Index, 38% for the 30-year Fixed Mortgage Rate (the same percentage for those who feel it would be neutral), 34% for the Dow Jones Industrial Average, 31% for the Yen (the same number feel it will be neutral), 31% for DJ Stoxx, and 31% for Nymex Oil.

In nine categories, the highest percentage of managers feel the market will be neutral. 38% of the managers feel this way about 10-Year Treasuries, the 30-Year Fixed Mortgage Rate (the same percentage feel it will be up slightly), the Dow Jones Corporate Bond Index, and the Pound. 35% of the managers feel this way about the FTSE 100 Stock Average, Comex Gold, and the Euro. 31% of the managers feel that the Nikkei 225 and the Yen (the same percentage feel the Yen would be up slightly) will be neutral.

Over the next five years, 28% of the managers feel that gold will move up significantly (the same number who feel it will move up slightly). Another 24% feel gold will move up significantly.

In six categories, most managers surveyed feel the market will move up slightly. In rank order, they are: 48% for the Consumer Price

Index, 40% for the FTSE 100 Stock Average, 38% for the Dow Jones Industrial Average, 36% for DJ Stoxx, 32% for the Nikkei 225 Stock Average, and 28% for Comex Gold (the same number who say it will move up significantly.)

Most managers feel that, over the next five years, seven of the 13 markets surveyed will be neutral. In rank order, these are: 52% for 30-Year Fixed Mortgage, 52% for the Dow Jones Corporate Bond Index, 48% for 10-Year Treasury, 38% for the Pound, 36% for the Yen, 32% for the Nikkei (the same number say it will be up slightly), and 28% for the Euro.

Twelve-Month Outlook								
	New Highs (%)	Up Significantly (%)	Up Slightly (%)	Neutral (%)	Down Slightly (%)	Down Significantly (%)	New Lows (%)	Total (%)
Dow Jones Industrial Average	0.0	10.0	34.0	21.0	14.0	21.0	0.0	100.0
Nikkei 225 Stock Average	0.0	23.0	19.0	31.0	23.0	4.0	0.0	100.0
FTSE 100 Stock Average	0.0	12.0	27.0	35.0	19.0	8.0	0.0	100.0
DJ Stoxx	0.0	12.0	31.0	27.0	19.0	12.0	0.0	100.0
10-Year Treasury	0.0	12.0	23.0	38.0	19.0	8.0	0.0	100.0
30-Year Fixed Mortgage Rate	0.0	8.0	38.0	38.0	12.0	4.0	0.0	100.0
Dow Jones Corporate Bond Index	0.0	4.0	35.0	38.0	19.0	4.0	0.0	100.0
Consumer Price Index	0.0	4.0	62.0	23.0	12.0	0.0	0.0	100.0
Euro (in dollars)	8.0	15.0	23.0	35.0	15.0	4.0	0.0	100.0
Yen (per dollar)	0.0	23.0	31.0	31.0	12.0	4.0	0.0	100.0
Pound (in dollars)	0.0	23.0	27.0	38.0	8.0	4.0	0.0	100.0
Nymex Oil (spot month)	8.0	19.0	31.0	27.0	8.0	8.0	0.0	100.0
Comex Gold (spot month)	8.0	12.0	27.0	35.0	12.0	8.0	0.0	100.0

Five-Year Outlook								
	New Highs (%)	Up Significantly (%)	Up Slightly (%)	Neutral (%)	Down Slightly (%)	Down Significantly (%)	New Lows (%)	Total (%)
Dow Jones Industrial Average	0.0	35.0	38.0	15.0	8.0	4.0	0.0	100.0
Nikkei 225 Stock Average	4.0	28.0	32.0	32.0	4.0	0.0	0.0	100.0
FTSE 100 Stock Average	0.0	28.0	40.0	28.0	4.0	0.0	0.0	100.0
DJ Stoxx	0.0	28.0	36.0	32.0	4.0	0.0	0.0	100.0
10-Year Treasury	0.0	12.0	24.0	48.0	12.0	4.0	0.0	100.0
30-Year Fixed Mortgage	0.0	12.0	20.0	52.0	12.0	4.0	0.0	100.0
Dow Jones Corporate Bond Index	0.0	12.0	28.0	52.0	4.0	4.0	0.0	100.0
Consumer Price Index	4.0	4.0	48.0	32.0	12.0	0.0	0.0	100.0
Euro (in dollars)	8.0	24.0	20.0	28.0	16.0	4.0	0.0	100.0
Yen (per dollar)	8.0	20.0	28.0	36.0	8.0	0.0	0.0	100.0
Pound (in dollars)	0.0	29.0	21.0	38.0	12.0	0.0	0.0	100.0
Nymex Oil (spot month)	8.0	24.0	20.0	16.0	20.0	12.0	0.0	100.0
Comex Gold (spot month)	4.0	28.0	28.0	24.0	8.0	8.0	0.0	100.0

Methodology: Infovest21 conducts this survey on a quarterly basis. This quarter, 60 managers responded.

Statistics-At-A-Glance

INSURED LOSSES - US CATASTROPHES, 1996-2005 ⁽¹⁾				
Year	Number of Catastrophes	Number of claims (millions)	\$ when occurred (millions)	In 2005 \$M ⁽²⁾
1996	41	3.9	7.375	9.180
1997 ⁽³⁾	25	1.6	2.600	3.164
1998	37	3.5	10.070	12.065
1999	27	3.3	8.321	9.754
2000	24	1.4	4.600	5.217
2001	20	1.6	26.548	29.276
2002	25	1.8	5.850	6.351
2003	21	2.6	12.885	13.676
2004	22	3.4	27.300	28.225
2005	24	4.0	61.200	61.200

(1) Includes catastrophes causing insured losses to the industry of at least \$5 million in 1996. Data for 1997 to 2005 includes catastrophes causing at least \$25 million in losses.

(2) Adjusted to 2005 dollars by the Insurance Information Institute

(3) 1997 was the first year that ISO increased its dollar threshold, defining catastrophes from \$5 million to \$25 million. The number of catastrophes fell from 41 in 1996 to 25 in 1997, mostly due to reclassification.

Sources: ISO; Insurance Information Institute

THE MOST COSTLY WORLD INSURANCE LOSSES, 1970-2005 ⁽¹⁾				
Rank	Date	Country	Event	Insured loss in 2005 \$B ⁽²⁾
1	8/24/2005	US, Gulf of Mexico, Bahamas, North Atlantic	Hurricane Katrina: floods, damage to levees and oil rigs	45.000
2	8/23/1992	US, Bahamas	Hurricane Andrew	22.274
3	9/11/2001	US	Terrorist attacks on WTC, Pentagon, other buildings	20.716
4	1/17/1994	US	Northridge earthquake (magnitude 6.6)	18.450
5	9/2/2004	US, Caribbean: Barbados, et al	Hurricane Ivan; damage to oil rigs	11.684
6	9/20/2005	US, Gulf of Mexico, Cuba	Hurricane Rita; floods, damage to oil rigs	10.000
7	10/15/2005	US, Mexico, Jamaica, Haiti, et al	Hurricane Wilma; torrential rain, floods	10.000
8	8/11/2004	US, Caribbean: Cuba, Jamaica, et al	Hurricane Charley	8.272
9	9/27/1991	Japan	Typhoon Mireille/No. 19	8.097
10	1/25/1990	France, UK, Belgium, Netherlands, et al	Winterstorm Daria	6.864

(1) Property and business interruption losses excluding life and liability losses

(2) Adjusted to 2005 dollars by Swiss Re

Note: Loss data shown here may differ from figures shown elsewhere for the same event due to differences in the date of publication, the geographical area covered, and other criteria used by organizations collecting the data.

Sources: Insurance Information Institute; Swiss Re; Sigma, No 2/2006

The Reinsurance Route

An increasing number of hedge funds are going further than buying catastrophe bonds – they are backing, investing in, or opening reinsurance firms or sidecars. They are attracted by the potential for substantial returns and they have the cash to invest.

Reinsurance is coverage that insurance companies buy in order to pass on some of their risk to a third party, i.e., an insurance policy for an insurance policy.

Sidecars are usually private reinsurance firms backed by a small group of investors that underwrite specific parts of the insurance contracts and, often, cover losses from big events, like hurricanes.

Investors in sidecars have been primarily hedge funds or private equity funds. Hedge funds are estimated to be between 1-2% of the reinsurance market.

Reinsurance startups have the advantage of not being burdened with huge catastrophe losses from Hurricane Katrina and, as a result, can keep rates under control. In contrast, some of the more established reinsurers have big hurricane losses and want to charge as much as possible for coverage to help rebuild capital.

Ron Bobman of Capital Returns LP sees a number of differences between cat bonds and reinsurance companies. “A cat bond is structured and marketed by an intermediary and the hedge fund is simply the buyer of the security. Cat bonds are currently private negotiated instruments with no public listing but very high expected yields. A cat bond has a finite life, while a reinsurance company may have a longer or indeterminate life.”

Elliott Kroll, partner at the law firm of Herrick Feinstein in New York, says three reasons exist why a hedge fund manager would set up a reinsurance or insurance business. “One, to increase assets. Two, to increase the amount of business done. Three, to keep costs down.”

Kroll points out that with a bond, there may not be a lot of costs. “But, unless you are going out there to sell the bonds, it is hard to drum up the business and it will depend on market conditions; you’re not going to accrete/accumulate assets. If you set up a reinsurance company, you’re going to accumulate assets and you’re probably going to do it offshore – and, if you’re a hedge fund manager, you’re probably a smart investor with your money.”

Bobman observes a number of pluses for catastrophe bonds. “A cat bond’s results are less correlated to public equity averages than a publicly traded reinsurance entity would be. In addition, there are organizational costs, transactions costs, regulatory implications in organizing any corporation, let alone a reinsurance corporation.”

Both vehicles are growing. The formation of insurance companies typically spikes following dramatic catastrophic events, e.g., post-Hurricane Katrina in 2005 and post-9/11 in 2001. Those dramatic industry losses have spurred the dramatic formation of reinsurance companies.

Bobman observes that cat bonds have had a much more consistent growth and are growing by leaps and bounds year over year. “As far as growth, without regard to which is most profitable or which is the better vehicle, in my estimation, longer-term the cat bonds have more promise primarily as a result of their ultimate appeal to the broadest number of capital market investors.”

Below is a sampling of some hedge funds that have backed or started reinsurance companies:

Sampling of some hedge funds investing in, backing, or starting reinsurance companies	
Arch Capital, Goldman Sachs, Farallon Capital	Flat Iron Reinsurance
Citadel Investment Group	CIG Reinsurance Ltd
Citadel Investment Group	New Castle Reinsurance
DE Shaw et al	PXRE Reinsurance
Highfields, XL Capital	Cyrus Reinsurance
Magnetar Capital	Pulsar Reinsurance
Moore Capital	Max Reinsurance Capital
Och Ziff, Fairholme Capital, Third Avenue Capital, Leucadia	Olympus Re (sidecar)
Ritchie Capital Management	Ritchie Risk Linked Strategies of Bermuda
Soros Fund Management, HBK Investment Management	Glacier Reinsurance AG of Switzerland
Highfields, XL Capital	Cyrus Reinsurance
West End Capital Mgt	RockRidge Reinsurance

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