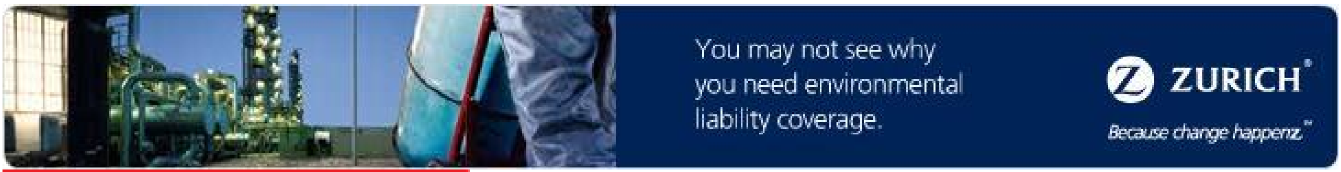

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NEWS: ANALYSIS & COMMENTARY

How Hedge Funds Are Taking On Mother Nature

If 2006 is a quiet year for hurricanes, Greg Hagood stands to make a ton of money. But if more Katrina-size storms rip into the U.S., he and the investors in the hedge fund group he co-manages, Bermuda-based Nephila Capital Ltd., could get their shingles blown off.

That's a gamble Hagood and other hedge-fund managers are happy to make. Awash in capital, hedge funds hope to cash in on catastrophe insurance, whose price has zoomed since Katrina wreaked $38 billion in insured losses. They don't sell policies to companies or homeowners. Instead, they absorb some of the risk of future megadisasters from shell-shocked insurers.

The infusion of money from hedge funds, as well as from other sources, is helping to keep catastrophe coverage available, while preventing rates -- which in some cases have more than doubled -- from going even higher. By contrast, after Hurricane Andrew devastated a chunk of South Florida in 1992, fresh capital was scarce at first, sending commercial rates soaring and putting pressure on the homeowner market. Some household insurers even pulled out of Florida after the state blocked them from raising rates sufficiently.

This time, hedge funds are changing the dynamics. True, they still account for a relatively small fraction of total catastrophe protection; estimates range from 1% to around 10%. And hedge funds supplied less than half of the $9 billion raised by reinsurers since Sept. 1. Nephila, for instance, has just a dozen employees. (It's named after the genus of a spider that, according to Bermudian folklore, can sense approaching hurricanes.)

Collectively, though, hedge funds have huge sums available for catastrophe protection. That means much more hedge money is likely to flood in if rates remain high. Among the funds that have already entered the sector are Kenneth C. Griffin's Citadel Investment Group in Chicago, George Soros' Soros Fund Management, HBK Investments in Dallas, and Louis M. Bacon's Moore Capital Management.

For insurers, the hardest risks to price are the greatest disasters, because there's little experience to draw on. That's where hedge funds, with their appetite for risk, are making the biggest difference, says Albert J. Pinzon, a senior partner in the law firm of Mound Cotton Wollan & Greengrass in New York, who works with hedge funds. Last year a pioneering hedge fund committed itself to pay one insurer $10 million in the seemingly unlikely event of two hurricanes in one season each costing the industry $10 billion or more, according to Enda McDonnell, CEO of Access Reinsurance Inc. in Westfield, N.J., who brokered the deal. The premium for the policy was $600,000. But after the payout was almost triggered in 2005, the quoted premium has soared to $1.5 million. The increase might have been even bigger without the added participation of hedge funds, McDonnell says.

It's still not clear whether catastrophe insurance is a good deal for hedge funds. On the plus side, it's a new basket for them to put some of their eggs in, since the returns from the sector are uncorrelated with those of stocks, bonds, or other assets. And by moving into an area of high risk, they can make good returns.

The big danger, of course, is that Mother Nature will be nastier than the funds expect. The problem with catastrophe reinsurance is that you don't discover until it's too late that you've underpriced it, says James Ellman, president of hedge fund Seacliff Capital, which has avoided the sector. Even Nephila's Hagood says that for hedge funds that lack underwriting expertise, the pricing is "extremely opaque."

Is betting against hurricanes risky? Sure. But if hedge funds want to take the chance, insurance companies and businesses that need insurance are happy to let them ante up.

By Peter Coy

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