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Creative Investments

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Page 8

Risk of disaster brings chance for returns

John Bonaccolta on satisfying investors' search for profits and insurance firms' hedging of risk

June 1 marks the beginning of hurricane season in the Atlantic basin, and after last year's tragic, record-breaking performance – more than 2,280 deaths and over $100bn of damages – residents of Bermuda may well be monitoring developments closely this year.

Not only does Bermuda lie in this vulnerable region but it is also home to 13 of the world's top 40 reinsurers, according to Standard & Poor's Global Reinsurance Highlights Report of 2005.

And it is home to Nephila Capital, a hedge fund pioneer specialising in the creative packaging of risk solutions that has been standing between reinsurance companies and investors since 1997. Nephila specialises in such products as catastrophe (Cat) bonds, weather derivatives, and principal-to-principal transactions that transfer risk wherever big losses might occur.

Frank Majors, a principal and co-owner of Nephila, may appear to be an anomaly among hedge fund managers, having begun his career as a reinsurance broker in New York.

But his work in the early 1990s structuring some of the first catastrophe bonds and options has led him to a business that is offering investors two extremely rare things in today's financial markets: uncorrelated movements with other assets and the opportunity for outsized returns.

"In the beginning our value proposition was in the low correlations we offered," says Mr Majors. "And these correlations were certainly tested early on with events such as LTCM [Long Term Capital Management] and 9-11."

What he means is that in times of extreme market stress, such as the Russia crisis of 1998, assets

that are not typically correlated can become so rather quickly.

In the last few years, however, investors everywhere in the world have been struggling to find returns in what have been less than generous markets across many asset classes. This has forced some to take on increased risk and explore more widely for noncorrelated exposures. And Nephila has been ready to provide that exposure. “When we first launched we were considered exotic beta, whereas now we are focused on alpha generation,” says Mr Majors.

He explains that Nephila's professionals – whose principals are the original founding members, Mr Majors and Greg Hagood, along with Barney Schauble – are accustomed to taking on risk and that lumpy returns are just part of their model. Expertise among the firm's 16 people includes seismic engineering and reinsurance modelling, as well as consulting arrangements with several meteorologists.

Nephila was one of the original investors in catastrophe bonds, or debt instruments that state that the issuer's (usually an insurance company) obligation to pay interest or principal can be deferred or forgiven should the issuer have liabilities related to some catastrophe, say a hurricane.

Within a few years, however, says Mr Majors, demand for these types of instruments quickly outstripped supply and Nephila began to undertake principal-to-principal transactions under similar investment objectives.

Insurance companies that are exposed to large, concentrated payouts can hedge themselves against counterparty risk in the reinsurance market, and speculators can gain access to those “fat tail” events, or events of very low probability that carry very high returns should they occur.

For example, a insurer might cover damage losses on houses in a particular area, say Florida. They might buy protection from reinsurers if they lose more than a certain amount, say a $1bn deductible, on one particular storm. But they then have counterparty risk with the reinsurers, hoping that they will ultimately be able to provide the protection promised.

Nephila can come in and create a vehicle that in turn issues a contract to the insurer, who receives a trust account with its name on it and gets funded from an issued bond or pledged capital from Nephila. If no event occurs, the vehicle is retired, whereas if an event occurs, the insurer can draw down on the funds.

Although for competitive reasons the firm is reluctant to release figures on asset size or business mix, it estimates that $150-200bn of catastrophe coverage was purchased worldwide, about $2bn of which was in the form of Cat bonds (issued in that year – it estimates that about $5bn of Cat bonds were outstanding at end of year).

Nephila also deals in weather derivatives, or instruments that allow companies, such as construction or agricultural concerns, to hedge against weather-related losses. And competitors have been eager to try to come into this market.

According to Mr Majors, other investors including multi-strategy hedge funds have been thinking about how to play in this market. But he does not seem overly concerned.

“We've built considerable in-house expertise, and information is difficult to come by in this market. You cannot go to a Bloomberg to get prices on catastrophe products,” he says.

Further, Nephila has an in-house transformer, which in insurance parlance means a reinsurance company to transform reinsurance contracts into securities.

“An important part of our mindset is to be in the reinsurance business but not be a reinsurer,” notes Mr Majors.

For one thing, the reinsurance market is governed by completely different regulations from securities markets. In addition, the Nephila philosophy as a speculator and provider of risk capital is to remain outside the industry for maximum flexibility.

But while being an insider in this rather opaque business might today translate into a competitive advantage, opacity cannot last forever. Ten years ago the broad hedge fund business was considered opaque, and yet today robust information exists across various strategies, down to levels of individual funds and even position level, pioneered by firms such as Hedge Fund Research and others.

Until such a time, however, Nephila would seem to be well-placed to offer a unique value proposition.

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