Bloomberg.com

Hedge Funds, Betting on Hurricanes, Wade in to Fund Insurers

July 12 (Bloomberg) -- Karsten Bromann won't take a vacation this summer. He'll be tracking hurricanes for his hedge fund.

Bromann, a hedge-fund manager at Zurich-based ISPartners Investment Solutions AG, plans to profit from forecasts of more violent storms. He's snapping up ``catastrophe bonds,'' as insurers sell more of the securities to protect themselves from increasingly unstable weather triggered by global warming.

Companies such as Swiss Reinsurance Co. and Munich Re, which provide insurance for insurers, are seeking new sources of funding after disasters such as Hurricane Katrina produced record claims of more than $90 billion last year. Hedge funds are embracing that risk, lured by yields of as much as 40 percentage points more than investment-grade debt. Investors forecast sales of catastrophe bonds may triple to $4 billion this year.

``The reinsurance industry is currently in a state of massive dislocation,'' says Bromann, 40. ``Our expert models tell us last year's estimates of hurricane risk need to be raised by 50 percent. That outlook is a great opportunity.''

Catastrophe bonds, a type of insurance-linked security, pay higher yields because investors may lose their entire stake in the event of a disaster. The chances of such a loss are limited to narrowly defined events such as a strong hurricane that devastates Miami or an intense earthquake that levels San Francisco. If the scenario becomes reality, the cash goes to the seller to cover claims.

Investor Losses

Investors have lost their money on catastrophe bonds only once. Swiss Re in July 2005 sold bonds tied to policies written by Zurich Financial Services AG, Switzerland's largest insurer. Buyers bet Zurich wouldn't suffer claims of more than $1 billion on any hurricane or earthquake in the U.S. in the 28 months to December 2007. Zurich's claims from hurricanes alone amounted to $1.2 billion last year, triggering the loss of all funds put up by investors.

While politicians and scientists argue over the extent to which global warming is changing the planet, the insurance industry has concluded the phenomenon is real.

``Global warming is leading to higher sea surface temperatures in the Atlantic, which is the most important factor for the rising intensity of hurricanes,'' says Eberhard Faust, head of climate risk research at Munich Re's Geo Risk Research department. The unit employs some 25 people, including scientists who analyze the likelihood of earthquakes, hurricanes and floods.

Lloyd's of London, the world's largest insurance market, estimates there may be as much as $100 billion in insured hurricane damage on the U.S. Gulf Coast this year.

`Indisputable Fact'

``It's an indisputable fact that global warming is having an impact,'' Lloyd's Chairman Peter Levene said July 5 at a conference in London. ``We need to better plan and prepare for catastrophe loss.''

Invented after Hurricane Andrew devastated the Florida coast in 1992, triggering then-record losses of $20 billion, catastrophe bonds remained a minor tool for spreading insurance risk for the next decade.

That changed after Katrina rampaged through Louisiana, Florida and Mississippi last August, says Barney Schauble, a partner at Bermuda-based hedge fund Nephila Capital Ltd. The once-obscure niche is becoming crowded by hedge funds that quickly shift investment focus to chase returns, he says.

``There is a huge crunch,'' says Schauble, 33, who wrote his senior thesis on catastrophe bonds while a student at Harvard College. ``Last year it was energy, this year it's insurance.''

Capital Needs

Following last year's losses, reinsurers also face higher capital requirements. Standard & Poor's changed the models it uses to rate insurers because more frequent storms may increase claims.

``Reinsurers now, on average, need about 10 to 15 percent more capital to underwrite the same risks as before the changes took effect,'' says Grace Osborne, a New York-based insurance analyst at S&P.

Larger insurers such as New York-based American International Group Inc. are boosting premiums to profit from concerns about hurricanes as rivals curtail coverage.

AIG, the world's No. 1 insurer, raised prices at its biggest U.S. commercial property unit by an average of 50 percent after last year's storms.

Berkshire Hathaway Inc., with $95.3 billion in shareholders equity, is expanding property and casualty sales. Omaha, Nebraska-based Berkshire gets about half its profit from insurance and reinsurance units, including Geico Corp., General Re Corp. and National Indemnity Co.

Willing to Lose

``We will do more than anybody else if the price is right,'' Berkshire Chairman and Chief Executive Officer Warren Buffett, 75, said in a May 7 interview with Bloomberg News. ``We are certainly willing to lose $6 billion on a single event. I hope we don't.''

Hedge funds, loosely regulated investment pools for those with $1 million or more to invest, are also embracing insurance risk as cash inflows slow. Investors put $46.9 billion into hedge funds last year, down from $73.6 billion in 2004, according to Chicago-based Hedge Fund Research Inc.

Swiss Re, the world's No. 1 reinsurer, moved to meet that demand when it sold $950 million of catastrophe bonds in June, the biggest offering ever. About $467 million of the total will protect against hurricane claims, and the bonds contain options that can expand the issue to $16 billion over the next three years.

Hedge funds bought the highest-risk bonds, which paid more than 39 percentage points over the London interbank offered rate, or Libor, says Martin Bisping, the Zurich-based head of risk- sharing at Swiss Re. Those securities carry the highest reward because they cover multiple perils: North Atlantic hurricanes, European windstorms and earthquakes in California and Japan.

BB Rating

S&P rates most catastrophe bonds at or below BB, one step lower than investment grade status. Catastrophe bonds typically carry interest rates of about 7 percentage points over the three- month Libor, according to Niklaus Hilti, who manages about $1 billion of insurance-linked bonds at Zurich-based Bank Leu AG.

``Relatively juicy spreads have awakened the interest of investors that weren't even aware of the existence of insurance- related securities,'' says Tibor Winkler, 37, a director at Risk Management Solutions in London. The Newark, California-based company provides continuously updated projections of damage and potential losses in various disaster scenarios.

Risk Management Solutions opened an office in London in 2004 as hedge funds, mutual funds and pension funds began demanding their services. The office, which had 45 employees before Katrina, has almost doubled its staff of scientists and risk assessors in the past 12 months.

`A Boom'

Insurers sold about $1.3 billion of catastrophe bonds in May alone, almost equal to last year's total, says John DeCaro, a Chicago-based hedge fund manager at Stark Investments who manages more than $100 million in insurance-linked securities.

``There absolutely is a boom,'' DeCaro says. ``The pipeline for the remainder of the year looks strong.'' He expects $3 billion to $4 billion of the bonds to be issued this year.

One reason catastrophe bonds have grown in popularity is because their returns aren't tied to the performance of other securities. Investors call them ``non-correlated'' holdings that are shielded from shifts in the stock and bond markets.

``Negative outcomes are not triggered by weak economic conditions, turbulent markets, or business mismanagement,'' says John Brynjolfsson, managing director of Newport Beach, California-based Pacific Investment Management Co. He oversees $50 billion in assets, including about $1 billion in catastrophe bonds at Pimco.

The hurricane season that started last month is expected to produce 13 to 16 named storms, almost double the 1990s average, according to the U.S. National Oceanic and Atmospheric Administration. Alberto, the first tropical storm of the season, approached hurricane strength in June as it neared Florida.

Record Season

A record 28 named storms hit the U.S. last year, with Katrina causing the largest insured loss in history, eclipsing Hurricane Andrew in 1992 and the Sept. 11 terror strikes in 2001.

Katrina drove down investor appetite for reinsurance shares. Zurich-based Swiss Re's shares are down 10 percent this year, while Munich Re's stock has dropped 7 percent. Shares of Hannover Re, the world's No. 4 reinsurer, have fallen 11 percent this year after the company last year cut its profit goal twice and canceled a dividend payout. Those declines compare with a 3 percent drop in the 30-member Bloomberg Europe Insurance Index.

Some hedge funds are reluctant to discuss details of their catastrophe bond holdings. Chicago-based Citadel Investment Group LLC, which has more than $12 billion in assets, said it participates mainly through investments in reinsurance companies. Ritchie Capital Management, a Chicago-based firm that mentions ``risk-linked'' strategies on its Web site, didn't return several phone calls requesting comment.

`Relatively New Field'

Soros Fund Management LLC, the New York-based private investment firm founded by billionaire George Soros, last year teamed up with HBK Investment Management LLC to invest $300 million in a reinsurance start-up. The company also declined to discuss details of its strategy for catastrophe bonds.

``This is a relatively new field that people just may not be comfortable talking about in public,'' says **Joseph Calandro Jr., a University of Connecticut finance professor** who specializes in catastrophe bonds. ``When an investment area is lucrative, all the funds tend to rush into it. There's some element of protecting one's investment turf.''

Bad Weather Models

Now reinsurers are building assumptions of permanently bad weather into their business models.

Hannover Re, for example, more than doubled its rates in storm-affected areas and sold $414 million in insurance-linked securities earlier this year. The combination of higher rates and hurricane risk reduction means that a Katrina-type disaster would trigger losses equivalent to 40 percent of what they were in 2005, says Wilhelm Zeller, Hannover Re's chief executive officer.

Bromann of ISPartners, who has a Ph.D. in physics from the Swiss Federal Institute of Technology in Lausanne, spent seven years analyzing risk for Zurich Insurance Co. He shifted to investment management in 2005 to make money for himself from increasingly violent weather patterns.

Last year, when some scientific models were playing down the threat posed by Katrina, Bromann's analysis indicated the possibility of serious damage, leading him to back away from some short-term contracts. Others couldn't be canceled and resulted in losses for investors in Bromann's fund and others in the segment.

``In retrospect, it was unlucky to start an event-linked securities fund in that very year when the insurance industry suffered its biggest loss of all time,'' Bromann says.

Last year's experience hasn't prevented him from targeting annual returns of as much as 17 percent for investors. ``Do we do this again?'' he asks. ``Sure, we do it again.''

To contact the reporters on this story:
Mike Anderson in London at Manderson34@bloomberg.net
Oliver Suess in Munich at osuess@bloomberg.net.

Last Updated: July 11, 2006 19:10 EDT