

Cashing in on crises

Esoteric investments like catastrophe bonds are coming into their own for investors with very deep pockets. As the hurricane season approaches, it's make or break time for any number of institutional investors.



This asset class, based as it is around severe but low frequency event risks, can represent a lucrative source of income from an institutional investor's standpoint. The trick is to work out how and where to hedge some very big bets.

Insurance linked strategies, at a fundamental level involve a reversal of the roles of insurer and investors. "Here we are reversing that role, in that it is like collateralised re-insurance - we are providing the re-insurer with collateral and if events occur we are able to provide them with a level of cover - in return for a fee of course," says Kate Wilkie, vice president of alternative investments at Credit Suisse.

"The bankruptcy of Lehman meant that there was increased focus on the credit quality of the collateral trust assets to catastrophe bonds," she says. "So, one of the significant developments in

the market is that the newer cat bonds address the credit quality concern. From an investor's standpoint, this should be uncorrelated to the rest of the bond markets, but by virtue of it being a securitised issue you are getting some exposure to whatever is happening inside the financial markets."

Wilkie says prudent institutional investors should be combining both cat bonds and the non-securitised transactions - that is, dealing directly with an insurance company to provide cover. "And what we do is limit the risk that exists in any one asset class when you look at it from a portfolio standpoint," she says. "We're seeking to combine different classes of peril like aviation, US hurricane risk, Japanese earthquake risk- into a portfolio. If you participate in a single cat bond issue, or in just one class of peril then it's not possible to diversify the risk."

This diversification, combined with a rare window of opportunity to extract higher than average premiums from insurance companies, desperate for funds after several large events and a financial crisis, makes catastrophe bonds particularly attractive, says Wilkie.

In this view, Wilkie is strongly backed by AMP Capital Investors, which recently awarded a US\$35 million mandate to catastrophe bond fund manager Nephila Capital, part-owned, by hedge fund Man Investments. Sean Henaghan, investment director, international and future directions funds at AMP Capital Investors says: "We are impressed with the non-correlation of the returns in the insurance-linked securities market. The current environment is particularly attractive since capital in the insurance industry is scarce and premiums are at levels not seen in a long time."

Wilkie adds: "The financial crisis has really resulted an unprecedented situation. We see it as a strategic asset allocation in an investor's portfolio but having said that, if you were an institution looking purely to capitalise on the situation, on the returns that are available now, and for at least for next 6 to 12 months, we expect that these types of premium levels will be in the market."

"So when we're rolling contracts now, we're rolling them over at between 25-60 per cent levels greater than at the same time in Europe and the US a year ago."