UK pensions allocate $300m to Bermudan catastrophe risk hedge fund

UK - Eleven UK pension funds allocated a total of $340m (€373m) to a $2.6bn catastrophe reinsurance strategy run by Bermuda-based Nephila Capital in the second half of 2009. The investments mark a spike in interest from institutions in these cashflow assets, prized for their high yields and lack of correlation with financial markets.

Nephila Capital was founded in 1998 as part of insurance broker Willis Ltd and as a specialist in insurance-linked securities, looking in particular at reinsurance against catastrophic risks such as hurricances and earthquakes. It is now 25%-owned by London's Man Group.

"Insurance-linked securities are clearly gaining broader acceptance from institutional investors and consultants," said Paul Dackombe, head of UK institutional sales at Man. "After the recent financial market turmoil, institutional investors are actively seeking return streams that are independent from the capital markets and catastrophe reinsurance certainly provides that portfolio benefit."

The fact that losses in catastrophe reinsurance are linked to natural, rather than financial, market events is the basis for their diversification benefits in a traditional asset portfolio. Nonetheless, reinsurance securities such as catastrophe bonds are financial assets and in times of stress they have shown some correlation with credit markets.

In the past, bond investments have been structured using total return swaps collateralised with AA-rated credit – effectively creating a long-duration product with counterparty credit exposure: some bonds for which Lehman Brothers managed collateral experienced losses in 2008. Forced selling by leveraged multistrategy hedge funds to meet redemptions also resulted in some financial market correlation during 2008, although mark-to-market losses were nowhere near as large as in traditional credit markets.

Financial market stress can also affect primary issuance: whereas 2006 saw nearly $5bn of issuance and 2007 saw more than $7bn, issuance dried up in H2 2008 and H1 2009 as the market was unable to compete with yields in the dislocated credit markets.

A spokesperson for Man Group said "over the last few years, the correlation has been negligible" and argued "Nephila investors have benefited from the fact that it also invests in reinsurance directly".

As well as in securitised reinsurance like catastrophe bonds, the fund also writes underlying direct reinsurance, retrocession and industry loss warranties, all of which "dwarfs the cat bond market" and further reduces financial market correlation.

Still, the financial crisis has created good conditions for new investors to make their entry. Man's spokesperson said "insurance balance sheets are still impaired, meaning that capital is fairly scarce and catastrophe premiums are still well above pre-Katrina levels".

Nephila's co-founder, Greg Hagood, added: "Insurance payouts for damages caused by hurricanes Gustav and Ike and the heavy investment losses and liquidity constraints brought about by the financial crisis have led to a major market shakeout. Remaining participants, such as Nephila, have therefore been able to capitalise on this opportunity and charge higher catastrophe premiums."

Man's spokesperson said: "Double digit returns against very manageable volatility is very attractive [for pension funds]."

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