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Research Spotlight Q1 2020

Insurance investing opportunities compelling after strong 2019

- Repricing of Catastrophe Bonds to levels not seen for five years.
- Insurance Bonds as one of the last sources of attractive positive yield within liquid, investment grade credit.
- In Equity, insurance sector consolidation and restructuring is expected to continue in 2020.

Last year saw strong investment performance across many asset classes globally, illustrated by the global equity markets appreciating by over 25% and global corporate bonds by over 10%[1]. As a result, the question may now arise, do liquid asset classes still have a potential to generate attractive returns at all in 2020?

Twelve Capital believes that insurance sector investing can solve this quandary for investors. It has a bullish 2020 outlook across all major liquid asset classes i.e. Catastrophe Bonds, Insurance Credit and Insurance Equity, each potentially offering around 5% gross dollar returns this year[2].

Catastrophe Bonds: Targeting USD gross returns of 7%+ for 2020

Catastrophe (or 'Cat') Bonds sit at the liquid end of insurance-linked securities (ILS). Such funds generally offer a weekly liquidity in UCITS format and allow capital market participants to invest into insurance event risks, such as tropical cyclones, earthquakes and other catastrophes. Because Cat Bond performance is contingent upon whether or not specified insurance events occur, it is lowly correlated to Equities, Fixed Income and the general business cycle. This diversification is a key attraction for investors concerned about the broader economic outlook.

[1] Source: Bloomberg. As at 31 December 2019.
[2] Source: Twelve Capital.

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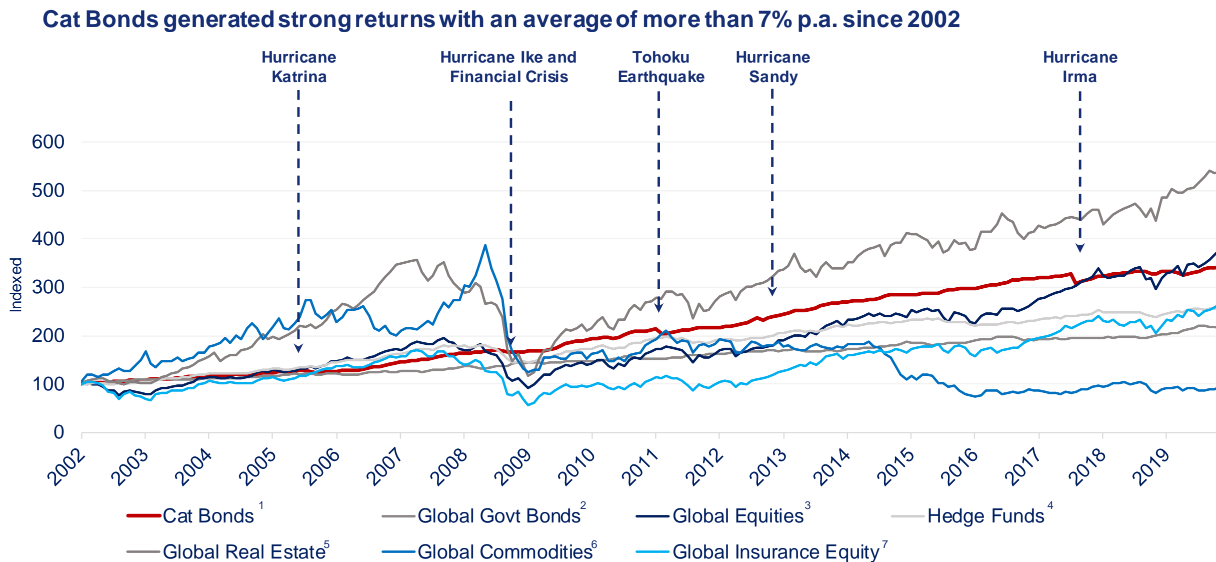
Figure 1: Attractive returns and low correlation to other financial markets



[1] Swiss Re Global Cat Bond Index Total Return, calculated by Swiss Re Capital Markets, is a market value-weighted basket of natural cat bonds tracked by Swiss Re Capital Markets, calculated on a weekly basis. [2] JPMorgan Hedged USD GBI Global. [3] MSCI World USD [4] The Dow Jones Credit Suisse Hedge Fund Index, an asset weighted benchmark that seeks to measure hedge fund performance and provide the most accurate representation of the hedge fund universe. [5] EPRA/NAREIT Dev TR USD. [6] The S&P GSCI serves as a benchmark for investment in the commodity markets and as a measure of commodity performance over time. It is a tradable index that is readily available to market participants of the Chicago Mercantile Exchange. [7] The MSCI World Insurance Index is an Index focused at measuring the equity performance of the c.80 largest listed global insurance companies weighted by free-float of market capitalisation.

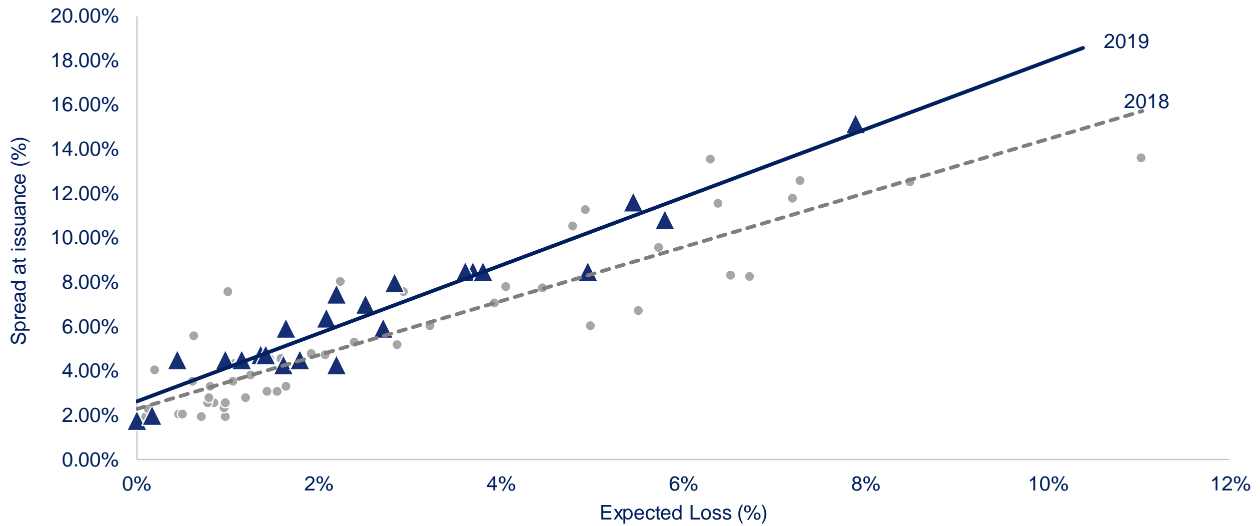
Source: Bloomberg, Twelve Capital. As at 31 December 2019.

Cat Bond spreads reflect prevailing conditions within global (re)insurance markets. Twelve Capital believes these are moving decisively in investors' favour. The reason for this is that the last three years have witnessed an increased frequency of meaningfully sized natural catastrophe events, including North Atlantic hurricanes, typhoons in the Pacific and wildfires in California and Australia. To compensate for these losses, (re)insurance premiums are now rising materially, terms and conditions are tightening, both materially improving the risk adjusted pricing of (re)insurance contracts and by extension catastrophe bond spreads.

This asset class is currently seen at levels which have not been witnessed for the last five years. Twelve Capital estimates that over the past 18 months bond spreads have increased by 100-150bps alone and are expected to improve further. This is in stark contrast to wider Fixed Income markets that have experienced a trend of tightening spreads. As a result, the market is currently priced at USD gross of loss returns in excess of 7% for 2020.

Figure 2: Spreads have increased over the past 18 months

Twelve Capital estimates overall spreads increases of approximately 100-150bps



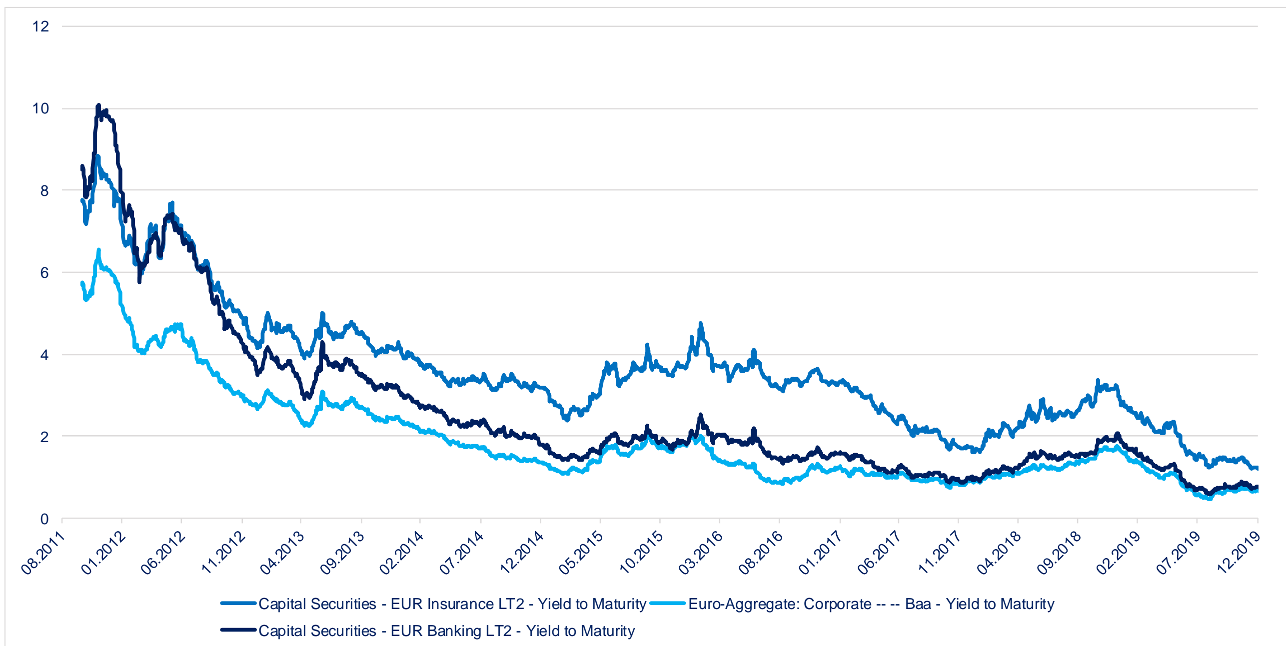
Source: Twelve Capital. As at Q4 2019.

Insurance Credit: Double digit returns potential in a bull case scenario

Twelve Capital has a near 10 year track record of actively managing credit strategies focused solely on exploiting global insurance sector opportunities. At their core, funds are liquid and investment grade (or 'IG') bond dominated.

Since the financial crisis, an 'upgrade' of the global regulatory environment was witnessed, as well as other factors such as the insurance industry's material investment into stronger enterprise risk management capabilities. And, in addition, general balance sheet strengthening, supporting the sector's defensive nature, evidenced by low historical default rates. Yet and despite this, Insurance Bonds are expected to continue to trade wide of broader credit markets.

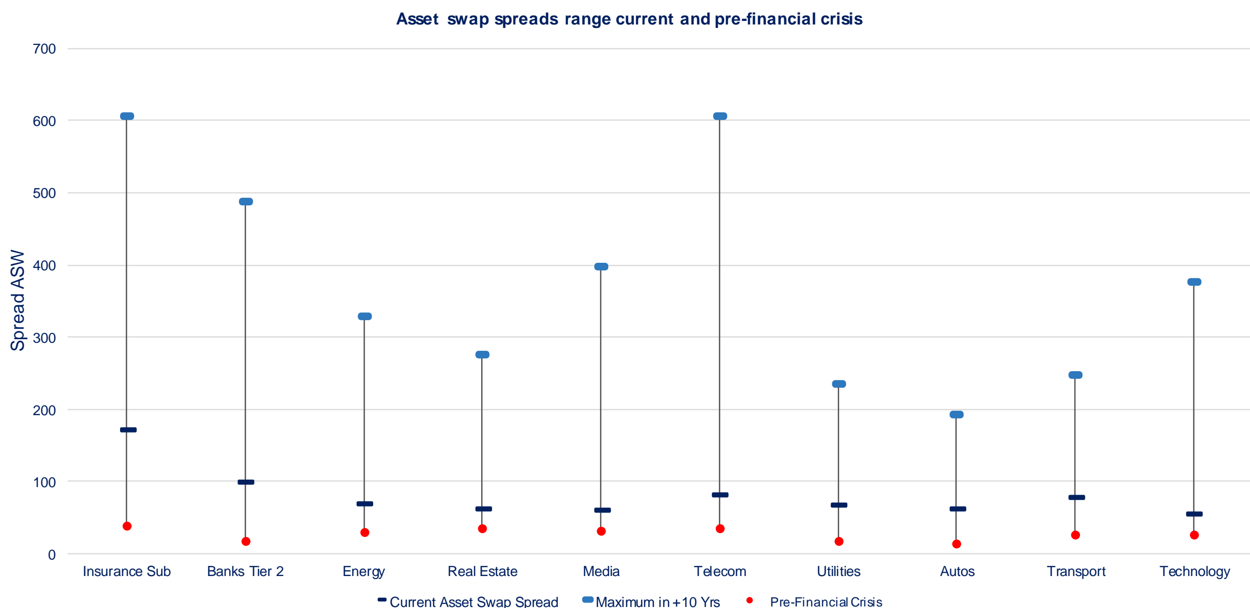
Figure 3: European Insurance Bonds offer favourable yields in comparison to bank and Corporate Bonds



Source: Barclays Live, Twelve Capital. As at 31 December 2019.

Indeed, compared to insurance, most other sectors have made substantially greater progress at returning to their pre-financial crisis tights. Twelve Capital believes the relative wider trading of insurance includes a complexity premium, placed on the sector by those not overly familiar with the strong prevailing insurance credit fundamentals.

Figure 4: Higher yielding sector predominantly IG Bond rated, spread range indicating further compression to come, other sectors having returned close to their pre-crisis levels



Source: Bloomberg, in EUR. As at 31 December 2019.

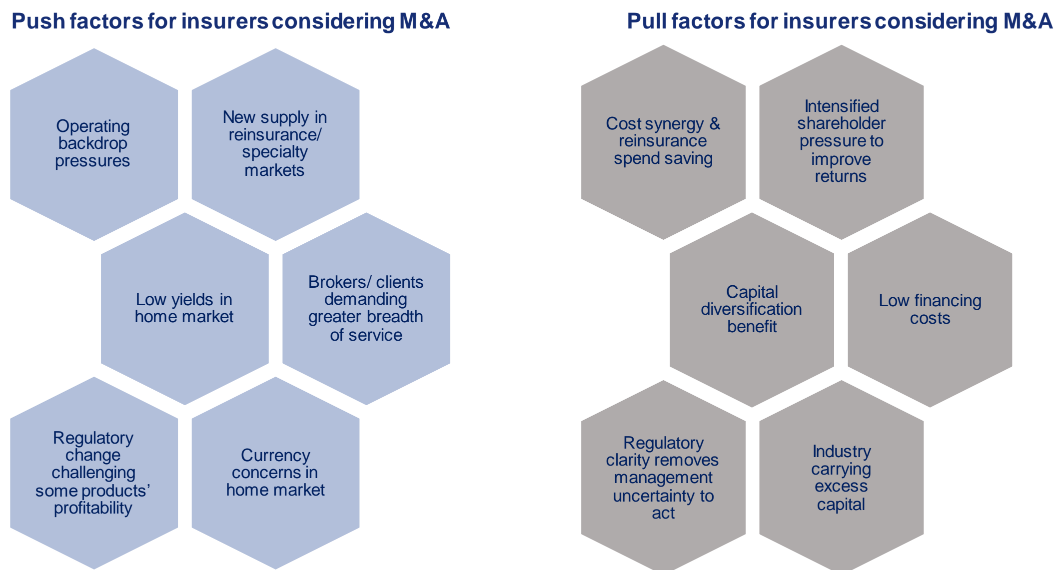
The 2020 investing backdrop for credit investors is one of a very low yield environment, exacerbated by central bank actions. According to Goldman Sachs (Credit Strategy Q4 2019), approximately +53% of the European Corporate Bond market was negative yielding, magnifying the value offered by Insurance Bonds.

Given a relatively sanguine macro backdrop, Twelve Capital sees 2020 for insurance credit performance as likely being in the ranges of gross return in Euros of 5% to 7%, split approximately 60:40, spread:carry contribution. However, a bull case scenario driven by greater central bank actions, could see this year's total gross returns exceed 12%. Driven by significant spread compression, as investors seek return from one of the last remaining sources of meaningful IG yield globally.

Insurance Equity: Targeting USD gross returns of 10%+ for 2020

It is very much not business as usual within the global insurance industry. A confluence of factors is continuing to drive a widespread industry restructuring and consolidation wave.

Figure 5: A sector that is in the midst of ongoing consolidation



Source: Twelve Capital. As at 31 December 2019.

What began approximately five years ago within reinsurance markets, has subsequently spread globally to speciality lines insurance, retail property & casualty insurance and most recently life assurance markets. The rising influence of InsureTech is providing further momentum for this year and beyond.

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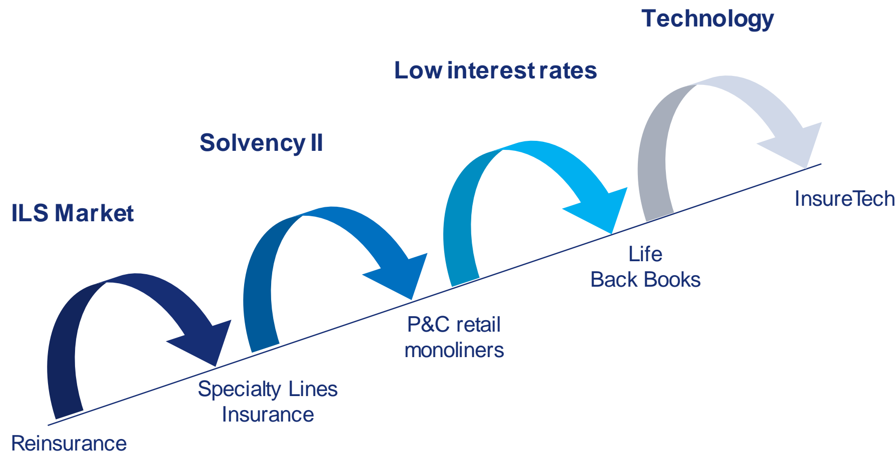
Figure 6: M&A – Twelve Capital believes the story has much further to run



Source: Twelve Capital. As at 31 December 2019.

The insurance industry restructuring and consolidation wave is expected to provide attractive opportunities for equity market investors. First, there is potential for increased gains linked to harvesting merger and acquisition takeover premia. These typically range between 25% and 40% based upon Twelve Capital's experience.

Second, it is not believed that the market has fully priced in the insurance sector's potential to generate sizeable business growth and operating margin expansion as the benefits of restructuring and consolidation take hold. Therefore, EPS growth has the potential to outperform market expectations.

For new investors, Twelve Capital believes the insurance sector is not showing signs of overheated valuation and that the entry point for investment is attractive. Relative P/E and P/BV multiples versus the global equity market remain in line with their historic averages. Further, against the backdrop of a very low yield environment, dividend yields from European insurers in excess of 4.5% are compelling in Twelve Capital's view[3].

[3] Source: Twelve Capital and Bloomberg.

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About Twelve Capital

Twelve Capital is an independent investment manager specialising in insurance investments for institutional clients. Its investment expertise covers the entire balance sheet, including Insurance Bonds, Insurance Private Debt, Catastrophe Bonds, Private Insurance-Linked Securities and Insurance Equity. It also composes portfolios of its Best Ideas. It was founded in October 2010 and is majority-owned by its employees. It has offices in Zurich and London.

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