2012: A Compelling Outlook for Catastrophe Bonds

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Summary

Catastrophe bond market dynamics are combining with robust structural growth of the industry to create a highly attractive environment for cat bond investors.

The following market factors are particularly significant:

- Strong supply is resulting in net growth of bond issuance, which is creating a larger opportunity set for investors
- Insurance industry losses in 2011 have taken the spreads on offer to investors to all-time highs, and
- A short-term shortage of investor capacity is driving spreads even wider

The structural growth story for cat bonds remains compelling.

The structural growth story for cat bonds remains compelling. Over the last ten years, a number of factors, such as increasing regulatory demands on re/insurers for capital (eg Solvency II), have meant the demand for catastrophe capital has doubled. However, the available catastrophe capital held by reinsurance companies has only grown by about half that amount due in part to a high level of claims and poor investment returns on the assets they hold. Today, this has resulted in an estimated shortfall of USD 100–150bn in reinsurance capital. Even if 10–20% of that were to flow into the cat bond market it could double or even triple its size over the next three years.

More recently, events over the past 12 months have created a set of favourable conditions in the cat bond market, arguably even better than those experienced in 2006/07 when spreads spiked after Hurricane Katrina.

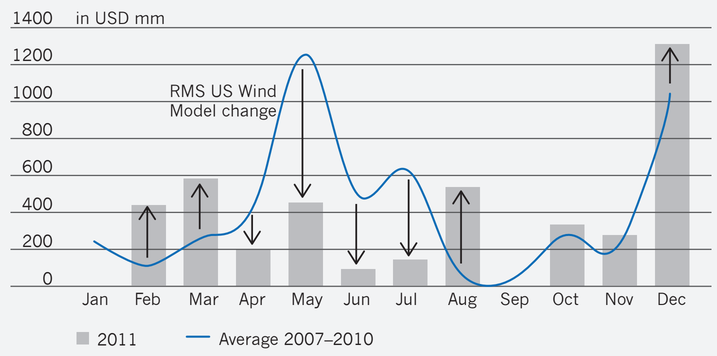
We believe the combination of these factors is now offering attractive opportunities for experienced cat bond investment managers.

Issuance returning to pre-2008 levels, volume of maturing bonds falling

The historical growth rate of the cat bond market since its inception has been approximately 20% per annum and, although interrupted by the global financial crisis of 2008, this growth pattern is now expected to resume.

With approximately USD 4.5bn worth of gross issuance, 2011 was the fourth highest year in the market's history. The first and third quarters of 2011 experienced record issuance whilst the fourth quarter saw near historic highs (see Figure 1).

Figure 1: 2011 issuance vs historical average



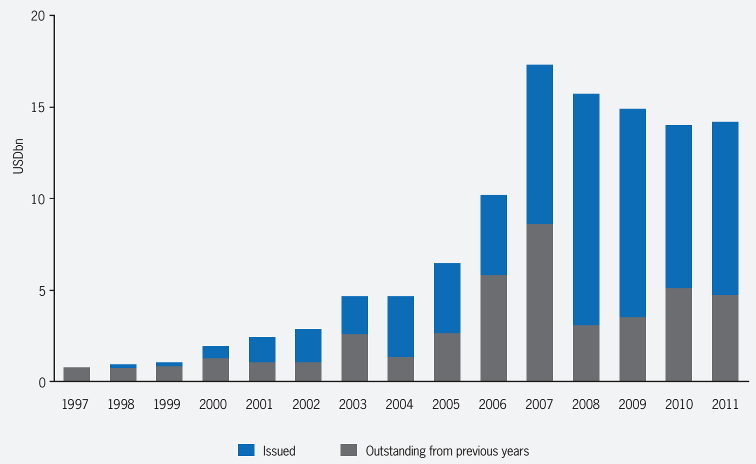
Source: Swiss Re Capital Markets (as of 31 Dec 2011)

By contrast, second quarter issuance was almost a record low. This is explained by both the Japan earthquake in March and a model change from RMS, one of the industry's major catastrophe risk modeling agencies. The new model resulted in material increases in certain estimates of potential US hurricane losses, which in turn led to temporary uncertainties in pricing and risk. An estimated USD 1.5bn of new issuance was put on hold; but this was merely delayed, not cancelled.

Issuance is recovering to pre-GFC levels.

At the start of 2012, the total value of outstanding cat bonds stood at just over USD 14bn across a diverse set of 125 issues (source: Swiss Re Capital Markets). Seven bonds were issued in the first month of 2012 totaling a healthy USD 650m. Overall, there is more than USD 5bn in the pipeline for the first half of the year, approximately USD 2bn more than the market originally anticipated. Issuance is recovering to pre-GFC levels.

Figure 2: Outstanding cat bond volume



Source: Swiss Re Capital Markets, January 2012

Meanwhile, the market is set to experience significantly lower levels of bonds maturing over the next 2–3 years. Just USD 3.7bn is set to mature in 2012, significantly down from recent years (almost USD 10.5bn of bonds matured over 2010/2011). As can be seen from Figure 2, this merely reflects the fall in issuance that followed the global financial crisis in 2008. With that trend now reversing, we should therefore witness robust net market growth over the next three years.

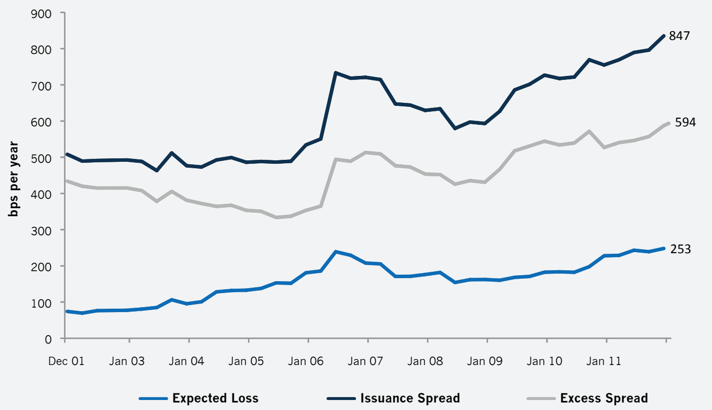
Issuance spreads at all–time highs

Insured losses from natural catastrophes exceeded USD 100bn in 2011. Claims from the Japan and New Zealand earthquakes, floods in Australia and Thailand, tornado events and Hurricane Irene in the US meant 2011 was the second highest year on record for insured losses, and more than double that from 2010.

2011 produced the second highest global aggregate insured loss on record.

These events have caused global property catastrophe insurance rates to rise on average by 9.5% at 1 January 2012 (source: Guy Carpenter & Company LLC). This is good news for the cat bond market as issuance spreads, which are to a large part driven by underlying insurance premiums, continue to widen (see Figure 3).

Figure 3: Average issuance spread and expected loss[1] of the Swiss Re Global Cat Bond Index



Source: Fermat Capital Management, Swiss Red Capital Markets, February 2012

At the start of 2012, average issuance spreads (over a reference rate such as LIBOR) are approximately 15% higher than their post-Hurricane Katrina peak of 2006/07 (when the Swiss Re Global Cat Bond Index returned 29%[2]). Average excess issuance spreads (issuance spread minus expected loss) are wider than at any time in the history of the cat bond market.

As past experience has illustrated, it is often those periods following a catastrophe(s) that offer the greatest opportunities to cat bond investors.

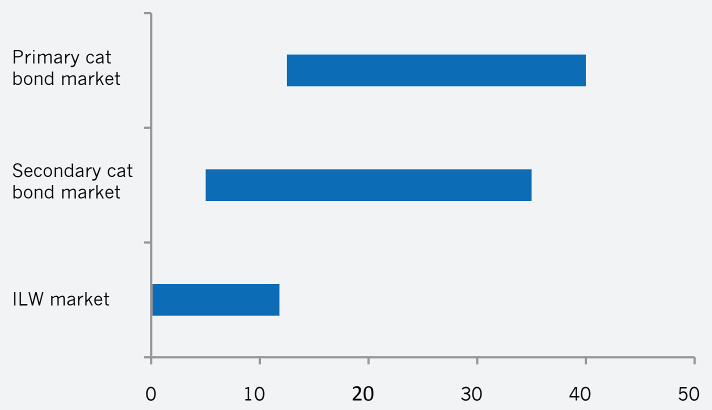
[1] Expected loss is defined as the average annual potential loss to the portfolio as determined by independent, third-party catastrophe models.
[2] Swiss Re Global Cat Bond Performance Index Total Return in USD terms from 1 Jan 2006 to 31 Dec 2007.

Lower than expected investor capacity is also causing spreads to widen

Fermat also believes that lower than expected investor capacity in the cat bond market is contributing to yield spreads widening. A number of specialist managers have positioned against a strong cat bond pipeline in 2012 and instead deployed their capital in the reinsurance market by allocating to securities such as Industry Loss Warranties[3] (ILWs). Their reasoning was that the supply of cat bonds would not keep up with investor demand in 2012, and cause cat bonds to price less attractively versus ILWs.

Fermat's analysis, however, shows that ILWs are not currently trading at wider levels relative to cat bonds (see Figure 4). According to Fermat's estimates, cat bonds in the primary market are currently issuing at around 125 to 400bps higher than estimated levels twelve months ago. In the secondary market they are trading anywhere from 50 to 350bps higher than a year ago. Fermat estimates an increase of only 0 to 125bps for comparable ILWs.

Figure 4: Estimate of improved spreads versus 12 months ago



Source: Fermat Capital Management, February 2012

Although it is important to keep in mind that ILW pricing is highly volatile, the analysis indicates that the ILW market is not experiencing the same surge in supply and shortfall in capital that the cat bond market faces today.

[3] ILWs are over-the-counter insurance linked contracts that pay out on an index of insurance industry losses.

Current Strategy

As one of the most experienced cat bond managers in the world, Fermat's position in the market gives it excellent transparency on the new issuance pipeline. Against this set of market dynamics, the team is positioning its portfolios to take advantage of the current wider spreads and is making selective investments. The team is confident that 2012, barring any major event losses, will be a compelling year for cat bonds. Attractive starting yields and the potential tightening of spreads from their current highs offer the opportunity for attractive returns. With a robust supply story, short-term capacity shortages and issuance yields at historic highs, Fermat believes that current market conditions are very favourable.

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