

# Pensions: Insure your pension

---

Pension funds are increasingly understanding the value of cat bonds and other insurance linked securities in their investment portfolios. BRAVE Partners believes that it is time for the underlying risk exposures covered by cat bonds to be expanded.

July 30, 2011

BRAVE Partners has often commented on the pensions buy out market (see "Bye buy"). This commentary, however, is different.

## The pension double down

One issue that seems to dog pension funds is the fact that many of the risks that they face are highly related. In good times, the assets perform well and deficits, if any are lower. If there is a deficit then the sponsor is stronger with more access to cash to replenish the fund. In bad times, when the assets are performing badly and the deficits widen, then the sponsors are also short of cash and financially weak in the bad economic conditions.

Pension trusts need not just Alternative Investments, but Alternative Alternative investments. These are truly disconnected with general market conditions.

## Alternative alternatives

Inflation is a key factor for pension funds and their investments. BRAVE Partners has commented on this issue frequently (see "When debt balloons - inflate", "Is now a time to have an inflated expectation of your pension fund?").

However, pension trusts do need to invest in some truly diversified, high yielding assets. These are what the investment management is calling "Alternative Alternatives". Most hedge funds are called alternative investments because the return is driven by a factor other than direct long only exposure to an asset class. However, most hedge fund returns are still driven by standard market risks. An alternative alternative investment is one that is not driven by standard market risks in one way or another.

Insurance risks fall exactly into this category.

## Gathering momentum

The Insurance Insider reported this week that the BBC has invested in one of the leading insurance risk funds, Nephila. Leadenhall Capital has also announced \$100m of inflows during June. Overall it appears that insurance risk funds are reaching acceptance with pension money.

## Picking your investment

Whilst insurance risks are a potentially good investment for a pension trust, picking how to invest is a crucial element.

## My name is bond

One option is simply to invest directly in listed catastrophe (or “cat”) bonds. Whilst this is the cheapest in terms of fees – it is potentially expensive in terms of losses for the inexperienced. There are a number of nuances in insurance risks that can make a significant difference between two seemingly equal propositions. Moreover, the listed cat bond market does not cover a particularly diverse set of risks. It is therefore a useful source for those that want to trade in and out of small positions – but this is hardly the domain of pension investing.

## Insurance risk funds

For pension money, BRAVE Partners would recommend the specialized insurance risk funds. These funds invest in a broader range of risks than just those that are available in the cat bond market. The cash in the fund is used as collateral that backs reinsurance contracts. The reinsurance is written by a specialised company, often located in Bermuda. This allows the fund to access a range of risks that are not necessarily available in the cat bond market. Whilst the strategy is not announced yet, this is likely to be the play for a new \$250m fund recently announced by the hedge fund AQR with Andy Sterge at the helm.

As BRAVE Partners recommends, never trust any reinsurance risk where the reinsurance brokers says helpfully: “we have modeled it all out for you...”

Furthermore, most insurance risk funds are run by experienced underwriters who know the nuances and intricacies of the risks and are able to differentiate between a good risk and a bad one. As BRAVE Partners recommends, never trust any reinsurance risk where the reinsurance brokers says helpfully: “we have modeled it all out for you...”

## Keeping your powder dry

As the other piece of commentary this week (“Stormbringer”) states, August is the height of the US hurricane season. It is thus not the time for a first time investment in insurance risks. However, the impact on pricing of a large storm this year is likely to be more acute than usual. August 2011 is therefore the time to begin reviewing and understanding investments in insurance risks and picking the right entry point. The next few weeks could provide an opportune moment to invest.

## The end of the world for financial markets

The power of diversifying into insurance risks will become particularly apparent if the USA does default on its debt. The impact might be reasonably short term, but BRAVE Partners believes that this will see financial markets fall by 600+ points as in the height of the stress in 2008. This fall will be across the board, apart from gold. Once again financial assets will be shown to be highly correlated in stress scenarios. However, a diversified pool of insurance risks will still hold up in value.

## Expanding the risk pool

The listed cat bond market is too narrow in terms of the risks. This market does not allow an investor to create a diversified investment. Some insurance risk funds are considerably better. Good friends of BRAVE Partners run a diversified insurance risk fund and have had up to forty different exposures in the fund. Whilst this is excellent and gave the fund an attractive downside profile, there is still more to be done.

## Arrested development

A cat bond to transfer earthquake and hurricane risk was an innovative development in the capital markets. However this is now done. The catastrophe models helped to drive that process and there is now a standard approach based on the three main cat models.

## Avalon Pray

There have been some attempts at extending the cat bond market. The Avalon Re issue sought to transfer third party liability risk to the capital markets. As BRAVE Partners commented (see "Avalon Pray") this was not that successful.

## Moving on

One area that the BRAVE Partners have considered for development in cat bonds is the liability risk from major oil spills. UK pension funds took the brunt of the loss caused by the BP Macondo well spill. Perhaps it makes sense for them to also get paid for that risk.

## BRAVE Partners' services

BRAVE Partners can advise pension funds seeking to diversify their investments into insurance risks. The firm has considerable experience in structuring and placing insurance risks into capital markets and extensive connections in the insurance risk fund community.

The firm is also constantly seeking to develop new products and solid transfer mechanisms for new risks.

## Interaction

If you enjoyed this commentary and would like to receive a weekly update by E-Mail, then please contact BRAVE Partners on [commentary@bravepartners.com](mailto:commentary@bravepartners.com)

If you would like to comment on the content of this piece, then please send an E-Mail to [discussions@bravepartners.com](mailto:discussions@bravepartners.com)

- In periods of extreme stress most financial investments all decline dramatically in value.
- Investors need some true alternative alternative investments.
- Insurance risk funds offer true diversification in a portfolio of long term, yield seeking investments.
- BRAVE Partners LLP has extensive experience in structuring insurance risk investments.
- The firm has broad connections to all of the major insurance risk funds.
- BRAVE Partners can advise pension trusts and their investment advisors on the insurance risk market and solid sustainable business opportunities within it.

[enquiries@bravepartners.com](mailto:enquiries@bravepartners.com)

[www.bravepartners.com](http://www.bravepartners.com)

OFFICE: +44 844 997 0271