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Insurance-Linked Investments: Herding cats… and other insurance-linked risks

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It is not always easy to tell what someone means when they talk about 'insurance-linked investments' – but distinctions are imperative because the various components of this complex market present very different risk and return profiles.

Let us take the most commonly-used term – 'insurance-linked securities'. Often shortened to 'ILS', this is what most investors are sold by the industry involved in insurance-linked investment. But the term tends to be used to cover two very different markets: catastrophe bonds (or 'cat' bonds for short); and traded life settlements. We cover both markets in this report, looking at supply-and-demand dynamics in the former and controversies over pricing of risk in the latter. Any reader will soon pick up that one involves taking non-life insurance risks (receiving premiums in exchange for occasional, fairly predictable large losses); and the other involves buying life insurance risk (paying premiums in exchange for a one-off, fairly unpredictable return).

Arguably, only the catastrophe risk represents a genuine insurance risk premium, and its risk profile has more in common with options-based financial market 'insurance' strategies than with traded life settlements – an idea that we pursue further in this report.

But even if we dig further into the catastrophe market itself, the differences are complex. The insurance-linked securities tend to be focused on 'peak perils', with their own very specific risk-return characteristics determined largely by the nature of the insurance industry; but most of the capacity is in non-securitised reinsurance, which offers a different risk-return potential again. Which should investors favour – one, the other, or both?

The answer depends largely upon what that investor wants to do with insurance-linked investments in the context of its broader portfolio and strategy. The traditional, straightforward answer – 'diversification' – fails to address the problem properly. Is it there to diversify income, or equity-like risk, or to generate leverage? These possibilities, and the importance of considering them, are covered in our lead article and in our interview with AQR Re and its commentary on the way Berkshire Hathaway deploys its insurance float.

By the end of the report, we hope that we'll have helped readers to move beyond the sector's catch-all, and sometimes misleading, labels.