INSURANCE INVESTMENT ADVISORS

SOLIDUM PARTNERS

Solidum ILS - Recent Developments and Current Status of the Cat Bond Market

Solidum Partners - August 2024

For investors in the ILS asset class, the first half of 2024 has been very encouraging. Stable reinsurance premiums in the year-end renewal round and corresponding attractive risk spreads in the Cat Bond market led to a strong performance. Continuously high risk-free interest rates, especially in the USD, supported the earnings development. The exceptional results of the previous year are unlikely to be achieved again in 2024, because they were based on special effects such as price recoveries of bonds that had depreciated excessively after Hurricane Ian. However, an environment of still high spreads provides the potential for a stable performance in the second half of the year.

The Solidum funds generated an attractive return for their investors. Before management fees (but taking into account all operating costs of the funds), the Swiss Re Cat Bond Performance Index, which is calculated without any costs and fees, could be clearly outperformed by all portfolios.

	07 / 2024	2023	2018 – 2022
Solidum Cat Bond Fund	6.68 %	16.08 %	22.57 %
Solidum Event Linked Securities Fund, SAC 2	8.50 %	18.34 %	25.11 %
Solidum Event Linked Securities Fund, SAC 3	8.01 %	20.21 %	46.51 %
Swiss Re Cat Bond Index	6.02 %	19.69 %	16.62 %

Gross returns of the USD share classes of the Solidum funds (before management fee, after all other fund running costs)

Event Activity

The first half of 2024 experiences an average event activity that did not lead to any real surprises. Nevertheless, the level of overall economic losses and the financial burden on the insurance industry is impressive. According to a study by Gallagher Re, natural disasters caused USD 128 billion in damage, of which USD 61 billion were insured.[1] The insured losses are thus 25% higher than the average value of the last ten years.

This may sound alarmist at first glance. However, when one considers that both premium payments and industry capitalization have grown steadily over the past decade, and that inflationary developments of the last two years alone can explain a good part of the increased financial amount of damage, the figure is not overly spectacular. The fact that there were no warnings coming from insurers shows that the industry is well-positioned to handle medium-term trend movements.

However, this observation should not serve as a blanket reassurance formula. Some developments in recent years require close monitoring in order to minimize the potential for negative surprises in the future. An important and recurring trend is that the tornado / hail hazard class continues to significantly contribute to the total claim burden. In the first half of the year, this peril accounted for approximately two thirds of the total claim amount payable by insurers. The significance of individual

[1] Gallagher Re, *Natural Catastrophe and Climate Report: H1 2024*, Juli 2024

events in this class is also continuously increasing. The three most expensive insurance events in H1/2024 were tornado / hail outbreaks, which each on its own came very close to the USD 5 billion mark.

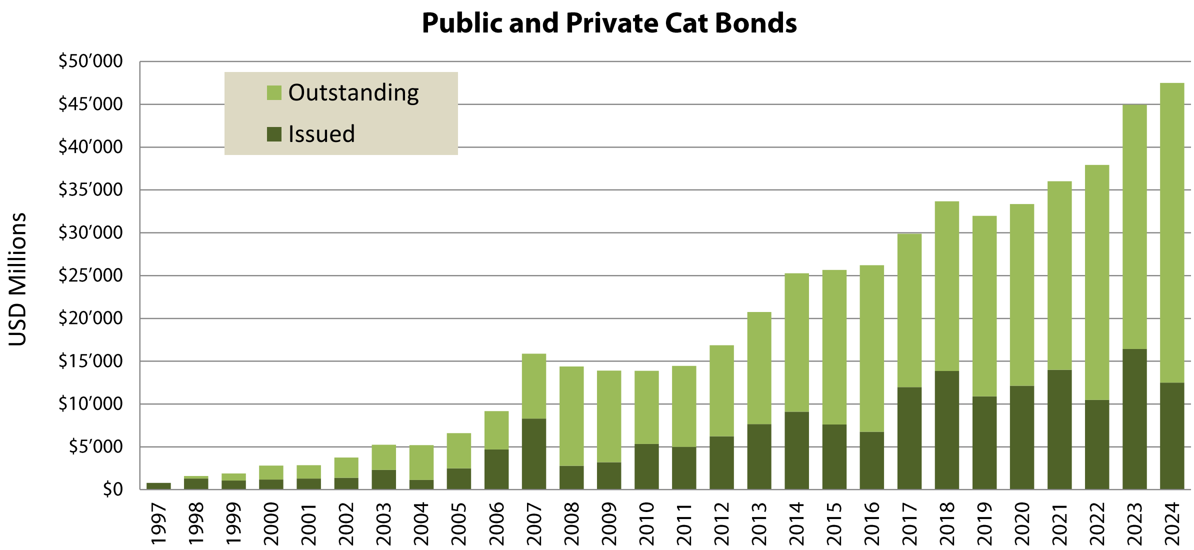
Too late to be included in the half-year statistics, Hurricane Beryl formed in late June and grew into the earliest Category 4 storm ever recorded in the Atlantic. As such, it moved over the Lesser Antilles and caused extensive damage there. After a period of reorganization, Beryl continued to strengthen and develop into both the earliest and strongest Category 5 Atlantic storm ever recorded in June.

As such, it became of interest to the ILS industry as a track just a little further north would have brought it close enough to Jamaica to cause a World Bank Cat Bond to default. However, the management team followed the situation calmly, as the Solidum funds were not invested in this bond. On the one hand, the parametric trigger of this bond features some details that seemed to be not adequately reflected the amount of the bond's coupon. More important to us was the fact that the bond has a lifetime of 2.5 years during which the coupon is paid, but covers 3 full hurricane seasons during this period, which again seemed to provide inadequate compensation for the risk.

The ratio of insured and economic losses mentioned above is about one to two. This alone indicates that a large part of the relevant events concerned developed countries. In the USA, for example, it can be assumed that about 50% of total economic losses due to natural disasters are covered by insurance. In emerging and developing countries, this ratio is much lower, and the closing of this 'insurance gap' is understood by the World Bank as an important step towards increasing the resilience of societies in such countries.

Market Growth

A strong inflow of capital into a market usually leads to an increase in the prices of securities or investments, thus decreasing returns. The ILS market has also seen strong growth recently. In this respect, it is remarkable and pleasing that the yield level of the Cat Bond market has proved to be quite immune to the increased investor interest.



Global brokerage firm Aon estimates that the ILS share of the total capitalization of the reinsurance industry increased by USD 17 billion to USD 110 billion in the five quarters from the beginning of 2023 to Q1 2024.[2] The cat bond segment sums to approximately USD 47 billion (the total amount varies somewhat, depending on where to draw the line to private and club transactions), accounting for a good 40% of the total capitalization. In the first six months of 2024, approximately USD 12.5 billion of cat bond new issues set a record for a first half of a year, significantly surpassing the previous maximum by USD 2.5 billion, achieved only last year. The supply of new cat bonds, driven by the need for expanded reinsurance coverage, attracted the interest of an equally growing investor community of ILS investors, thus keeping the market in balance.

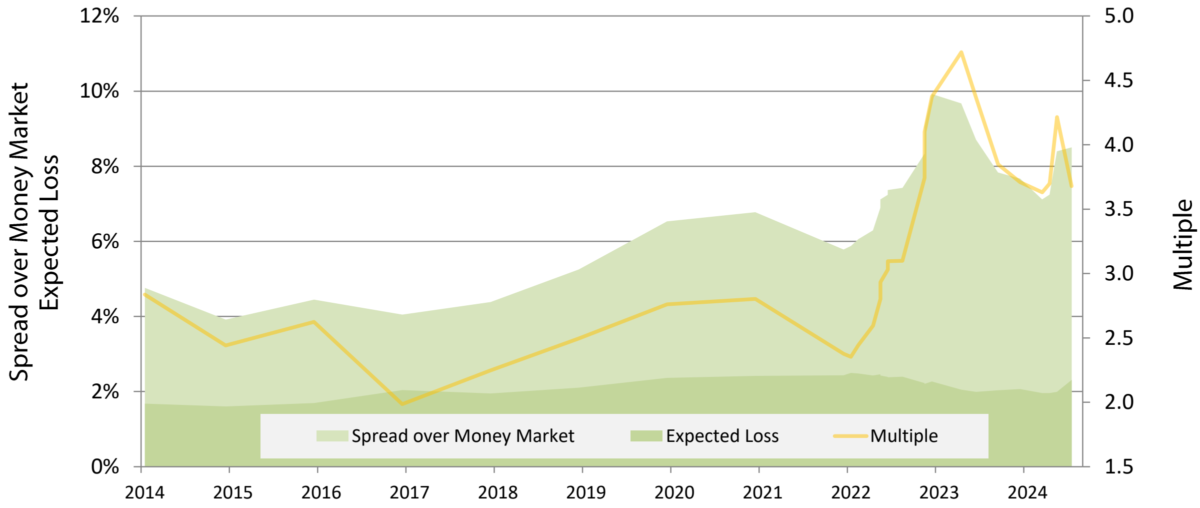
Performance Drivers of the ILS Market in recent Times

The attractive current yield environment of the ILS market is supported by several factors. First, the ending of the period of low or negative interest rates in 2022 not only led to the obvious effect that the base rate component of ILS investments increased. Much more important was the fact that the risk spreads, i.e. the financial compensation that investors demanded for investing in risk-bearing assets, increased in parallel with the ‘price of money’. This effect was observed in almost all asset classes: investments with fixed income characteristics such as corporate bonds or real estate fell in price and thus increased future returns. Equities also declined from previous highs and were traded at more attractive price/earning ratios. And so, after a prolonged period of a ‘soft market’, one saw substantial premium increases again in the reinsurance industry, which were directly reflected in the return potential of ILS investments.

An additional effect then increased the attractiveness of the ILS market beyond the level of other markets: at the end of September 2022, Hurricane Ian made landfall on the Florida Gulf Coast. This event with an insured market loss of just under USD 50 billion did not represent the storm of the century for the reinsurance industry, but was certainly significant enough to act as a game changer after years of moderate returns. Reinsurance premiums and cat bond spreads subsequently widened very significantly and a clear overshooting of technically motivated prices was observed, especially at the turn of the year 22/23. This unnaturally high spread level was certainly not sustainable, and during the course of 2023 a normalization set in, with spreads consolidating at still very attractive levels in 2024.

Finally, the dynamics are supported by another macroeconomic factor: the sharp increase of inflation in recent years means that potential insurance losses are becoming significantly more expensive on a nominal basis. However, such losses have to be compensated by insurance companies with similarly ‘nominal’ amounts of money, which leads to an increased capital requirement of insurers and reinsurers. Generated profits alone have not been sufficient to cover the additional capital requirements of the industry, thus driving an increased demand for additional reinsurance coverage.

[2] AON, *Reinsurance Market Dynamics*, Juli 2024



Spread over money market and expected loss of the cat bond market over time

In 2024, the dynamics of supply and demand led to some movement of spreads in the Cat Bond market. Especially in the first quarter, the secondary market was strongly driven by buyers, which drove prices upwards and depressed yields accordingly. The strong issuance activity in the primary market could not handle the increased demand on its own. In May, a reversal set in and sellers dominated the market. As a result, risk spreads increased again. It should be stressed that all these movements took place at a generally very attractive level and that the market could be rated as attractive even in Q1 2024.

As usual, caution should be exercised when predicting how the spread level will develop over the medium term. Many economic factors influence the market, and the random nature of the occurrence of disaster events can fundamentally change the basis of forecasts very suddenly. If the market is not affected by any special effects, we expect the earnings potential of the entire ILS market and its Cat Bond sub-segment to remain above average over a medium-term horizon..

For further questions or an in-depth discussion, the management team is at your disposal at any time.

With kind regards
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