January 2023

Insurance Linked Securities – Review of 2022 and Outlook 2023

The highest inflation figures in decades in Western countries led to a sobering and highly volatile 2022 for investors in many asset classes. Overview tables show a deep red in almost all areas.

The initial hesitation of many central banks to take action, followed by their late but significant reversal, the ongoing war in the Ukraine, and the confusing Covid situation in China created an environment of great geopolitical and macroeconomic uncertainty that plagued all markets. Increasing interest rate put pressure on every bond portfolio, regardless of whether government bonds, corporates or high yield positions were held.

The perhaps even positive cause of these developments was a general re-pricing of risk, which was observed in almost every investment market. However, the significantly increased yield potential came at the expense of very sharp price declines. In this environment, Insurance Linked Securities performed relatively well, as was impressively demonstrated in the first eight months of the year.

Nevertheless, the new level of return expectations affected the cat bond market as well. The Swiss Re Global Cat Bond Price Index lost 3.64% over the first seven months of the year, and most ILS funds lagged behind initial return expectations. Still, compared to what was going on in other sectors, ILS proved their value as a stabilizing diversifier in a broader portfolio, as evidenced by the still positive performance until mid of September. ILS, being a form of 'market-neutral high-yield fixed income' investment, are generally interesting in an environment of elevated inflation, as they do not devaluate with increasing interest rates due to their short duration, but pass the enhanced money market interest rates on to the investor.

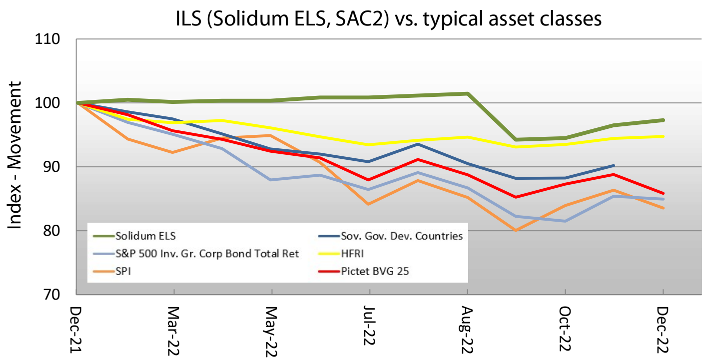


Figure 1: Insurance Linked Securities, as exemplified by the Solidum Event Linked Securities Fund, SAC Fund 2, performed with a high degree of independence during the turmoil of the markets in 2022.

In the midst of this difficult market situation, Hurricane Ian hit Florida on the last days of September, which strongly influenced the previously stable development of ILS investments in 2022. The coincidence of this insurance event with a period of general stress in the markets was certainly very unfortunate, as it obscured the fundamental independence of the ILS asset class. Ultimately, however, an event like Hurricane Ian is a manifestation of the raison d'Être of the ILS market and as such it is fully independent of the general market. The interesting aspect for existing and potential ILS investors, on the positive side, is Ian's reinforcement of the already evident re-pricing dynamics in the reinsurance market, which makes the situation for ILS investors more attractive today than it has been for over a decade.

In the following, we shall take a closer look at the factors that influenced the price development of ILS and which are responsible for the significantly increased return expectation of the asset class today.

Re-Pricing of Risk

Figure 2 shows the development of the yield potential of the ILS market on the example of its Cat Bond sub-segment, for which regular price information is available. The graph depicts the issue-weighted yield to maturity (in excess of the money market (MM) base) since 2017. After a temporary contraction of risk spreads in 2021, by mid-year 2022 the market's return leved had risen to a level not seen since the end of the credit crisis. As attractive as this sounds, the ILS market still stood in competition with other asset classes, of which the return expectations went up as well. It should be emphasised, though, that the ILS market achieved such yield increases without i) the massive devaluations seen on other assets and ii) the enhanced risks that hide in the unstable geopolitical situation and the general uncertainty of the economic environment which both have the potential of severely crashing the party in other asset classes.

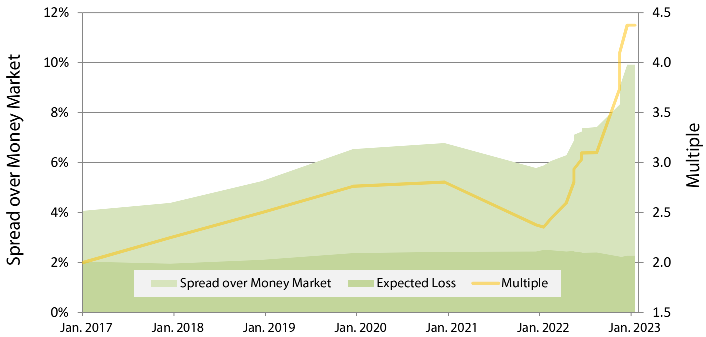


Figure 2: Spread of the cat bond market: Based on mid-spreads over MM-rate, various pricing sources, issue weighted, exclusion of «pathological» cases and short maturities (<1y, seasonality effects)

Hurricane Ian changed the picture again. The reinsurance market rapidly hardened further in the expectation of a significant undersuply of capacity. Bonds exposed to risk in Japan or Europe, completely unaffected by Ian, nearly doubled their yield, and a parallel movement was observed for US risks. As a consequence, the average yield of the cat bond universe over MM increased further, as can be seen in the final spike in Figure 2. Through this effect, Cat Bonds were able to further improve

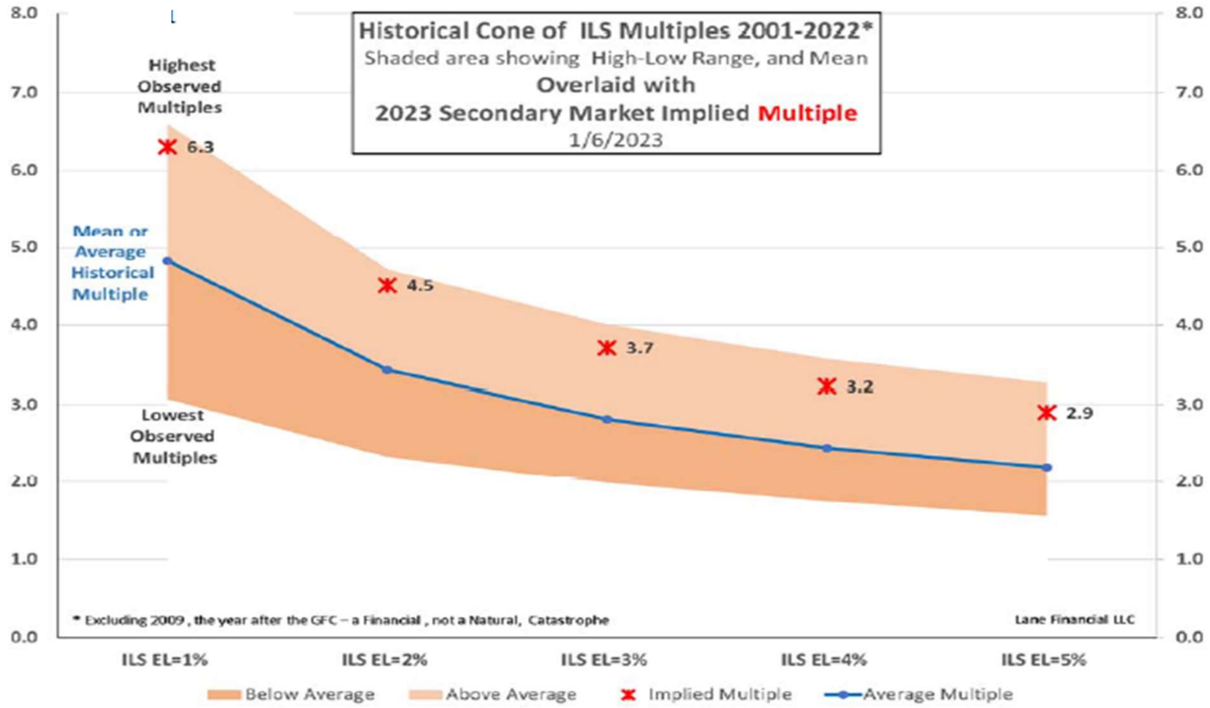


Figure 3: Prospective multiple of the Cat Bond Market excluding bonds with avlaue below 80c (impaired) at different expected Loss levels Source: Morton Lane / Roger Beckwith: "Hard Times – ILS Risk and Return in 2023"; Lane Financial L.L.C.;16.01.2023

their relative attractiveness versus other asset classes. The multiple of the market, a simple measure of its attractiveness defined as the ratio of running yield to expected loss, rose further from 3.1 to 4.4 because of Hurricane Ian. According to a research article by ILS analysis firm Lane Financial, these figures raise the attractiveness of the Cat Bond market to a level last seen in the aftermath of Hurricane Katrina in 2005.

The Solidum Funds in 2022

As described above, the year 2022 was characterized by two distinct phases of spread expansion in the ILS market. Both phases also had an impact on the Solidum portfolios.

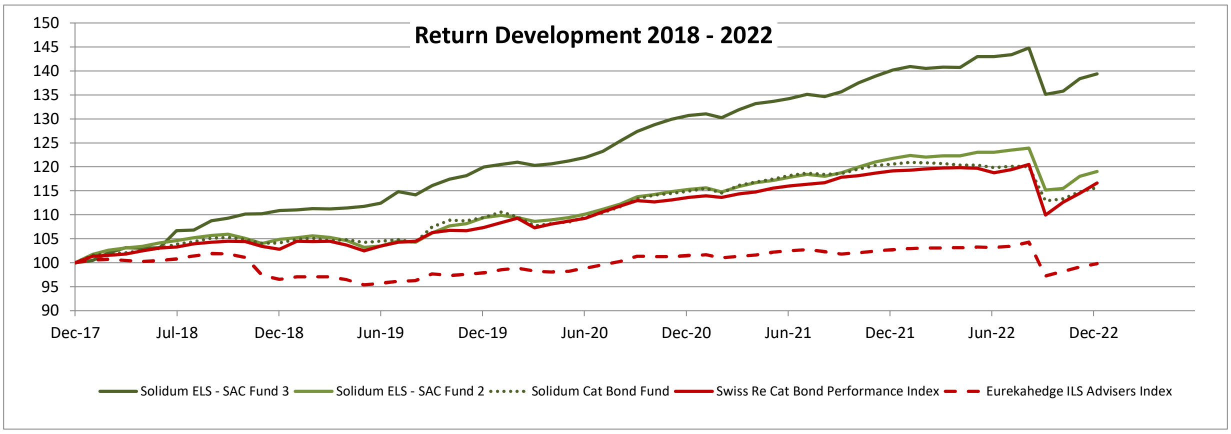
During the first half of the year, the general re-pricing of risk in all market segments put pressure on the valuations of ILS securities. The average price level in the Cat Bond market, as measured by the Swiss Re Global Cat Bond Price Index, declined by 3.64% to August. These price declines affected performance and acted against coupon earnings and amortized reinsurance premiums. In this environment, the portfolios of the Solidum Event Linked Securities Fund, with their higher proportion of direct business (reinsurance and retrocession contracts), performed better than the Solidum Cat Bond Fund, as the price dynamics of spread expansion is less influential in the former due to the annual nature of these contracts.

Hurricane Ian, the costliest storm for the insurance industry since Hurricane Katrina, affected all portfolios to a similar extent. Because, unlike most other Cat Bond funds, the Solidum portfolios are valued using a conservative average bid principle (as opposed to the more widespread best bid methodology, which has been proved to be too optimistic under stress scenarios in semi-liquid markets such as Cat Bonds), the price reductions have become more pronounced.

Based on information available as at the turn of the year, however, none of the Solidum portfolios expect Ian-induced defaults of Cat Bonds or private transformed contracts. Thus, only valuation volatility, caused by market-to-market depreciations, is the driver for the negative performance. As soon as the currently still observed fluctuations in the price indications of the brokers will normalise, a strong recovery of the portfolios is hence expected.

	2022	2021	2020	2019	2018
Solidum Cat Bond Fund (USD R)	-4.07%	4.91%	5.02%	5.10%	4.13%
Solidum ELS SAC 2 (USD A-1)	-2.73%	5.10%	4.83%	3.84%	4.31%
Solidum ELS SAC 2 (USD I-1)	-2.24%	5.62%	5.36%	4.36%	4.83%
Solidum ELS SAC 3 (USD I-1)	-0.56%	7.27%	8.92%	8.22%	10.88%
Eurekahedge ILS Advisers Index	-2.79% *)	0.82%	3.69%	1.43%	-3.49%
Swiss Re Cat Bond Performance Index **)	-2.15%	4.92%	5.81%	4.43%	2.81%

*) non-final December; **) without fees and costs, non-investable



However, the new spread level provides the best conditions for above-average earnings over the next 24 months absent the occurrence of new events.

Concluding Remarks

In 2022 a re-pricing of risk has taken place in most asset classes, and similarly so in the ILS market. As a consequence, future earnings expectations rose globally. Contrary to other asset classes however, in which an increased level of risk can be perceived that is linked to the global situation of the economy, in the ILS market the underlying risks did not change, and the expansion of yields is not achieved on the expense of running a higher uncertainty in the portfolio.

The occurrence of hurricane Ian provided an additional boost to this situation and increased the attractiveness of ILS further, beyond the level offered in other markets. The 2023 reinsurance renewals affirmed the picture of a very hard reinsurance market. This development makes the ILS market more attractive than it has been for over a decade.

The management team is always at your disposal for in-depth discussions about the asset class or for further information about the Solidum Funds. We look forward to continuing our dialogue with you about Cat Bonds and Insurance Linked Securities.

With kind regards

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