Twelve Capital Perspectives 2H Outlook

Executive Summary

Twelve Capital continues to see attractive investment opportunities from across the insurance sector coming to the fore during the second half of this year:

- The search for yield has drawn investors to revisit Insurance Bonds as an asset class, given its spread differential in comparison to other sectors.

- Twelve Capital has a strong pipeline of attractive Insurance Private Debt transactions that are likely to come to fruition over the second half of the year, offering investors the ability to generate illiquidity premiums in this area of the market.

- The attractiveness of Insurance-Linked Securities (ILS) as a diversifying asset class continues to be underlined by the growing size and broadening investor base of the market, encouraging innovation within the space.

- Insurance Equities are supported by three themes that investors are likely to focus on during the second half of the year: rising interest rates, attractive dividend yields and M&A.

- Twelve Capital's Best Ideas strategies have gained further appeal as these portfolios offer similar returns to pure Insurance Bond or Cat Bond portfolios whilst typically having lower levels of risk and volatility.

Fundamental Overview

On a fundamental basis, it has been a less eventful first half of the year for the insurance sector than had been expected at the time of writing the last Twelve Capital Perspectives in January 2017. Fresh detailed Solvency II disclosure has not changed investor sentiment towards individual insurance groups, whilst a less certain outcome to the UK's snap general election contrasted with voters going to the polls in both France and the Netherlands, where results have been broadly supportive for markets.

As a result, continued industry balance sheet resilience, combined with a benign macro backdrop, has supported strong returns for insurance focused investors over the period. We discuss the development of each individual asset class in more detail later in this note.

However, the same cannot be said for the European banking sector, which continues to generate negative surprises for investors. The roll call of problem names is long, most recently having Spain's Banco Popular, Italy's Banca Monte dei Paschi di Siena, Banca Popolare di Vicenza and Veneto Banca and the UK's Co-operative Bank added to the list. In our view, there is clear potential here for the number of names to increase over the remainder of 2017.

By contrast, the insurance market continues to reward investors, with the sector only having experienced one lost coupon from Europe's insurers over the past ten years (a period that notably included both the global financial crisis and European peripheral sovereign crisis).

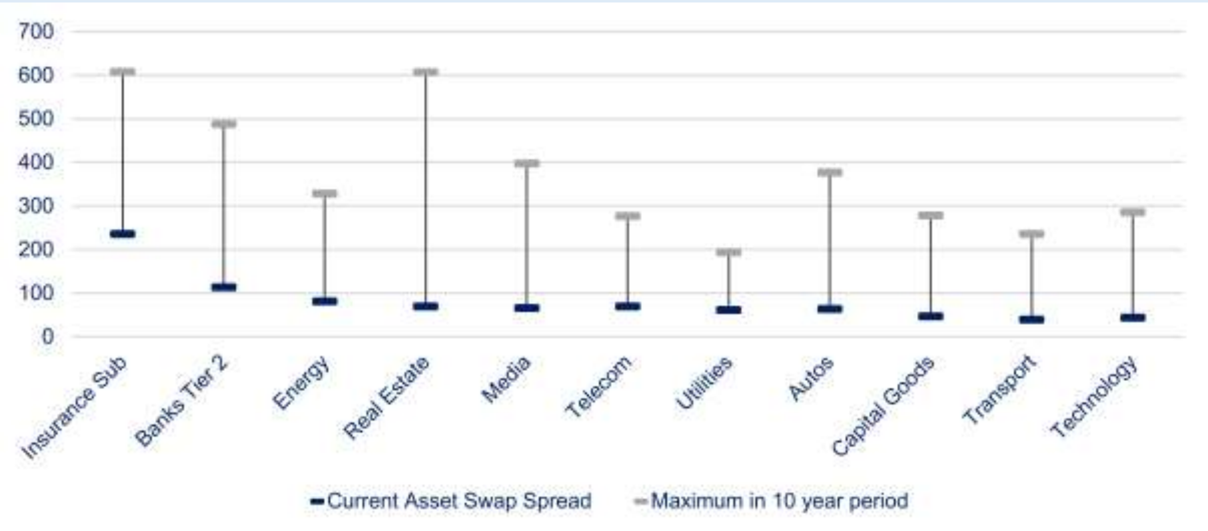
Yet despite such compelling empirical evidence, the insurance sector continues to trade at a material discount to the wider market, across both equity and credit asset classes.

As the following graphs illustrate, in equity the global insurance sector trades at around a 25% P/E ratio discount to the broader market (Figure 1) whilst in credit, despite spreads generally compressing materially over the past ten years, insurance sector spreads remain at relatively elevated levels (Figure 2).

Figure 1: MSCI World Insurance P/E absolute (x) and relative to MSCI (RHS)

Source: Bloomberg. As at 30 June 2017. The MSCI World Insurance Index is an Index focused on measuring the equity performance of the c.80 largest listed global insurance companies weighted by free-float of market capitalisation.

Figure 2: Sector asset swap spreads in bps over 10 years



Source: Bloomberg, Bank of America Merrill Lynch. As at 30 June 2017.

Twelve Capital is often asked by investors to explain this discount and it firmly believes it is not rooted in sector fundamentals. Indeed, within a recent Twelve Capital Research Spotlight report, marking ten years since the start of the global financial crisis, ten reasons were listed in order to demonstrate why insurance companies could now be viewed as being more robust and investible entities than they were a decade earlier. A summary of this list can be found overleaf, although a more detailed explanation is available in the report itself, which can be downloaded here.

As a result, Twelve Capital believes the insurance sector continues to offer strong relative value for investors where, in our view, the discount to the broader market continues to reflect a 'complexity premium' required by those not so well versed in the space. Securely harvesting this premium for investors remains Twelve Capital's key goal.

Looking ahead to the remainder of 2017, we see five key fundamental issues to monitor for insurance investors over the second half of the year, namely:

- **The direction of interest rates.** Economically, the insurance sector is positively geared to a rising interest rate environment. For example, higher rates lower the cost of options and guarantees embedded within life insurance liabilities. Whilst interest rates have rebounded from their summer 2016 lows (there is divergence globally in this respect), they still remain depressed by historical standards and market debate continues as to their direction of travel over the coming months. As a result, a material gap is expected to persist over the foreseeable future between the yield generated by existing insurer investment assets and the new money reinvestment rate achievable for most life insurance companies. It is imperative therefore that insurers considered as core investments can demonstrate an ability to withstand low interest rates for even longer if necessary;

- **The outcome of the 2017 North Atlantic hurricane season.** At the time of writing, there have been no major loss events in the early parts of this year's North Atlantic hurricane season. Nonetheless, third party forecasts point to an above average year for named storm formation. It remains to be seen how these forecasts translate into actual landfall events;

- **The potential for non-life (re)insurers to lose their perceived defensive valuation premium.** Pricing of insurance risk in most non-life (re)insurance markets remains very competitive, in part due to the continuing oversupply of capital. Furthermore, insurance investors should continue to closely monitor the adequacy of technical reserve strength, noting the impact of events earlier in the year relating to UK motor bodily injury reserving;

- **Industry consolidation.** Over the next twelve months, conditions are likely to remain conducive towards ongoing insurance sector consolidation in our view, although the focus is likely to switch between industry sub-segments. M&A is a key element of Twelve Capital's insurance equity proposition and is discussed in more detail later in this report;

- **Sector capital management.** At around a 5% dividend yield, this remains a key attraction of the sector for equity investors compared to the wider market. Indeed, such yields are expected to remain, supported by strong Solvency II ratios and with neither management teams nor regulators likely to allow capital management to reach a point where concerns build sector wide around issues such as sustainability of regular dividends.

10 reasons why insurers are more investible now than they were 10 years ago in our view:

1. Lower risk investment portfolios;
2. Higher quality earnings;
3. Improved disclosure;
4. Strong Solvency II ratios;
5. Lower debt leverage;
6. Stronger capital management;
7. Improved earnings resilience;
8. Cash flow transparency;
9. Improved quality of management teams;
10. Stronger corporate governance.

Insurance Bonds

Insurance Bonds have delivered strong returns over the first half of the year and yet subordinated insurance debt still remains the most attractive asset class on a relative yield basis within the European iBoxx IG index, as illustrated in Figure 3. On average, subordinated bonds are estimated to have tightened in spread by approximately 93bps over the first six months of the year and currently offer an average yield to expected buy back of 3.07%[1].

Looking ahead to the second half of 2017, there has been no change in our view around the relative attractiveness of insurance bonds, where this sector continues to remain the widest relative to all other asset classes within the European iBoxx IG index.

[1] Figures in EUR, adjusted for FX.

Figure 3: Average sector spreads

Spread (June 2017)	
iBoxx EUR IG	64
Insurance Subordinated	254
Bank Subordinated	150
Metals & Mining	90
Chemicals	65
Telecoms	63
Media	61
Services	54
Insurance Senior	54
Utilities	51
Healthcare	43
Autos	41
Retail	40
Building Materials	39
Transport	39
Capital Goods	38
Bank Senior	35
Technology	28

Source: J.P. Morgan, Markit, Bloomberg.

As outlined above, subordinated insurance bonds remain relatively cheap, even factoring in recent spread tightening in the space. The search for yield as a result of low underlying interest rates has drawn investors to revisit and invest in this asset class, given its spread differential compared to other sectors. Indeed, this increased level of interest is likely to be a significant driver for continued spread compression over the second half of the year in our view.

Since the start of 2017, the sector has also seen continued activity on the primary market, with approximately EUR 12.9bn of new issuance year to date across multiple currencies.

Furthermore, over the last few months it has become clear that a number of investors are increasingly recognising and appreciating the insurance industry's robust fundamentals, most notably in contrast to recent negative headlines generated across the banking sector for instance.

Over the second half of the year, and given the low yield environment, insurance bonds are likely to continue to benefit from a variety of exogenous factors in our view. Whilst the spread differential between insurance and other sectors persists (driven by a complexity premium rather than any underlying fundamental concerns), the strategy is expected to continue exploiting market inefficiencies and offering ongoing positive yields on a relative basis versus other sectors.

Private Debt

The first half of 2017 saw attractive returns generated for insurance Private Debt investors, with both appetite for insurance bonds leading to price increases in the more liquid segment of the market and coupon P&L also contributing to performance. Two new transactions, with a total volume of USD 62m, were able to be bound during the first half of the year and the average coupon of these investments was 3m USD Libor + 7.7%.

Having said this, not all transactions materialised in the first half of the year and although there were a number of opportunities which did not meet Twelve's stringent investment criteria, several others were declined due to price expectations (a clear indication that this area of the market is also being impacted by spread tightening).

The main motivation of issuers to transact with Twelve Capital remains the increasing demand for solvency capital both in Europe and the US. This capital is most frequently used to finance future growth, although insurers may also be driven by a desire to replace expensive reinsurer quota share programmes with debt capital or to improve their credit rating. For investors, insurance Private Debt generally provides welcome diversification to corporate credits with elevated return levels and moderate duration.

Looking ahead, there is a healthy pipeline of potential transactions within the insurance Private Debt space which are likely to come to fruition over the second half of the year.

Insurance-Linked Securities

Catastrophe Bonds

The Catastrophe Bond market reached a new milestone in the first half of the year, with record issuance levels of USD 10bn bringing the market size to an all-time high of USD 29bn. This development underlines the importance of the ILS asset class as both an efficient risk transfer vehicle for the (re-)insurance industry as well as an attractive investment opportunity for those looking to achieve uncorrelated returns structured with floating rate coupons.

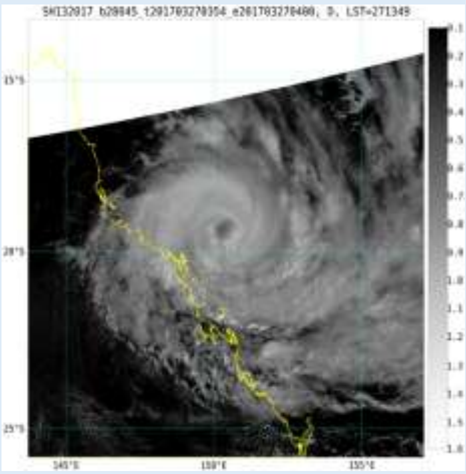
The broadening of the ILS investor base has also encouraged innovation within the space, as demonstrated by the recent pandemic-linked cat bonds sponsored by the International Bank for Reconstruction and Development (IBRD) and the World Health Organization (WHO). These bonds are intended to provide an insurance solution for fast access to funding in the early stages of a spreading pandemic, such as during the Ebola crisis in 2014. The favourable reception and support from investors, including Twelve Capital, which these issuances received underscores the positive socio-economic impact on developing and emerging economies which can be achieved using capital markets based insurance solutions.

At this time, yield levels in the cat bond space remain attractive on a relative basis in our view, as spreads stabilise and increasing interest rates provide support, whilst average expected losses have improved slightly from the previous year. Recent market growth trends are expected to continue in the second half of the year, albeit at a slower pace as issuance activity typically lowers during the hurricane season.

Private ILS

In the Private ILS market, Twelve Capital looks to source business in the reinsurance and retrocession arenas where most investments can offer positive levels of diversification potential. The majority of capacity in this market is renewed at or around the 01 January period. Renewals over the last 6 months have shown some resilience in terms of pricing levels.

Figure 4: Cyclone Debbie

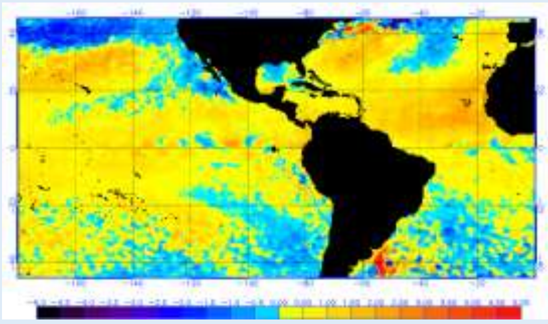


Source: http://rammb.cira.colostate.edu, 27 March 2017.

In terms of claims developments, 2017 has already seen some significant damage globally, with cyclone Debbie in Australia being one of the most significant. Debbie, which made landfall in March, is estimated to have caused around AUD 1.4bn in insured losses, mostly as a result of heavy rainfall. Figure 4 illustrates the infrared satellite image of the system on 27 March 2017 at 0400 UTC.

In the US, strong tornado and hail activity has caused losses during the first half of 2017 and, although most of these losses were absorbed through insured retention levels, some Private ILS transactions have been affected. Having said this, these events did not have a significant impact on the cat bond market.

Figure 5: Sea Surface Temperature Anomaly



Source: NOAA, July 2017.

During the second half of the year, a number of third party forecasters have pointed to a North Atlantic hurricane season with an above average level of named storm formation for 2017 partially attributable to a weak El Niño as outlined in Figure 5. One aspect of the forecast is the level of sea surface temperatures or, rather, the anomalies of temperature compared to a longer term average. Although this is the most relevant meteorological driver for the ILS market, it remains to be seen whether these forecasts translate into actual landfall events.

Insurance Equity

Global Insurance Equities made a strong start to the year, with the MSCI World Insurance Equity Index[2] appreciating by +11% in 1H17 and outperforming the MSCI World Equity Index[3] by 2ppts.

However, this strength has not been universal, with Asia ex-Japan based insurance companies

[2] The MSCI World Insurance Equity Index is an Index focused on measuring the equity performance of the c.80 largest listed global insurance companies weighted by free-float of market capitalisation.

[3] The MSCI World Equity Index is a broad global equity benchmark that represents large and mid-cap equity performance across 23 developed markets countries. It covers approximately 85% of the free float-adjusted market capitalisation in each country and does not offer exposure to emerging markets.

delivering the strongest returns of more than 20% year to date. In contrast, European and US Life insurers have delivered performance of just 2-4% on average, as low interest rates continued to weigh on returns over the majority of the period.

During the first half of 2017, the insurance market had been anticipating two changes that were likely to be announced over the period. The first of these was related to the UK discount rate for long term injury claims (the so-called Ogden Rate), with implications for UK motor insurers and their reinsurers. The discount rate used was lowered from 2.5% to -0.75%, far more than many had anticipated, and following this announcement there were material equity price moves for many of the affected names. Those insurers whose balance sheets were negatively impacted by the change in discount rate saw some sharp share price declines, while those less affected took advantage by increasing market share.

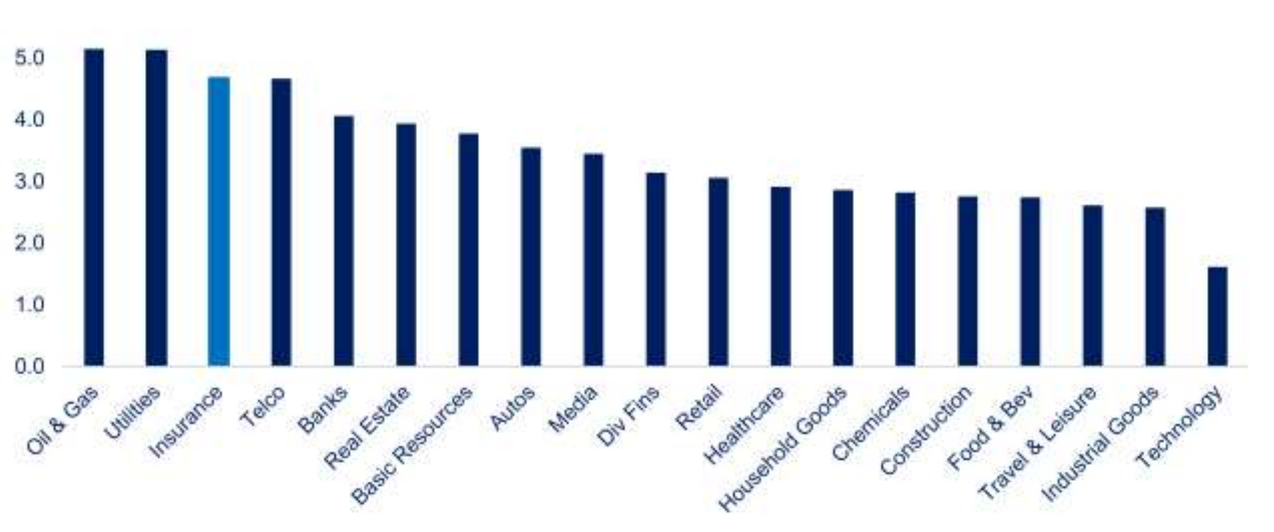
The second anticipated change during 1H17 was the release of additional Solvency II disclosures (the so-called Solvency and Financial Condition Reports or SFCR), although the announcement caused few concerns for equity market investors who appeared to have digested the additional levels of improved capital transparency well. As a result, it seems that insurers have continued to transition to the new Solvency II world relatively smoothly, with minimal levels of volatility experienced by the vast majority of stocks.

Looking forward, it seems that much can change in twelve months. Last year, this Twelve Capital Perspectives report referred to the theme of 'even lower, for even longer' when it came to interest rates, in a note that was published shortly after the UK's Brexit referendum. In recent weeks, yields have picked up and the environment seems more favourable for insurers positively geared to rising rates. Indeed, this is one of three themes that equity investors are expected to focus on over the coming months, alongside the sector's attractive dividend yield levels and industry M&A, as discussed in greater detail below.

The economics for many life insurers typically improve during times of rising interest rates. Life insurers' longer term earnings expectations should increase and market perceptions of risk are likely to reduce, particularly relative to wider market risks. Indeed, life insurer earnings should increase given that they are better positioned to generate higher spreads on investments versus the returns guaranteed to policyholders. There may also be second order benefits in terms of new business sales as well. In addition, perceived levels of risk reduces as concerns around insurers not being able to meet minimum guarantee levels recede.

Also during the second half of the year, high dividend yielding stocks, together with those that can positively surprise, are likely to continue to be viewed as relative safe havens by investors, particularly those in Europe. This is exaggerated by a number of names being increasingly seen as bond proxies. Indeed, insurance carries the third highest yield across all sectors, at 4.7%, compared to the market at 3.4% (see Figure 6). Oil & Gas and Utilities are the only sectors carrying a yield in excess of insurance. In our view, investors can be confident around the insurance sector's dividend yield, given the robust balance sheets and relatively stable earnings expectations for the majority of names in the space. In fact, as in more recent years, there is the potential for upside here, in the sense that special dividends and/or share buybacks could be announced in the months ahead.

Figure 6: Euro Stoxx 600 Dividend yield by sector (%)



Source: Bloomberg. As at 30 June 2017.

The plethora of M&A in the insurance sector in recent years is expected to continue over the coming months. Conditions that remain supportive for further consolidation include; i). Subdued organic growth opportunities; ii). The increasing importance of scale; and, iii). Cheap financing availability. Typical M&A premiums for the sector have been in the 25-40% range.

However, the attractions of the insurance sector do not come without risk. One that continues to unfold is the more recent development of some relatively minor reserving issues for the space, most notably amongst US P&C names. While some appear to have been company specific issues, there are a number of lines of business that appear to be under increasing pressure on an industry basis. Reserve releases have heavily supported reported earnings across many companies in recent years and any material slowdown or emergence of shortfalls is likely to lead to a spike in cost of equity assumptions and sharp share price falls. Our investment strategy, focused on the most robust balance sheets, should help to alleviate this risk.

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About Twelve Capital

Twelve Capital is an independent investment manager specialising in insurance investments for institutional clients. Its investment expertise covers the entire balance sheet, including Insurance Bonds, Insurance Private Debt, Catastrophe Bonds, Private Insurance-Linked Securities and Insurance Equity. Twelve Capital also composes portfolios of its Best Ideas. The firm's capital solutions aim to draw the world of insurance and reinsurance into a closer, more productive relationship with capital markets. Twelve Capital was founded in October 2010 and is majority-owned by its employees. The firm has offices in Zurich, London and New York.