GOING TO EXTREMES

GETTY IMAGES

By *Yaldaz Sadakova*

In the quest for yield, some pension funds are buying riskier insurance products

Dan Bergman doesn't spend his days praying to avoid a U.S. hurricane, although the pension fund he helps manage—the Third Swedish National Pension Fund, also called AP3—holds insurance-linked securities (ILS). Such products help insurers offload various risks, so when disasters strike and claims pile up, investors help foot the bill.

Bergman, who heads investment research and ILS at AP3, doesn't see insurance-linked products as opportunistic, although that's how these high-yield instruments are often described. He considers them a great diversifier because their returns aren't tied to financial markets. During the 2008 meltdown, for example, insurance-linked products were largely unaffected.

"We want to replace part of our equity exposure with this insurance-related exposure [and] diversify our total portfolio. That's the opposite of opportunistic," Bergman says. "If you're going to replace equities with something else, you might want to have returns that are at least comparable to equities."

Other pension funds in Europe and the U.S. have also entered the growing ILS market. But these complex securities, typically treated as alternatives, are less popular among Canadian pension funds.

Roll With the Returns

AP3 started buying insurance-linked products in 2007, managing most of those investments internally. Since then, major natural catastrophes have occurred worldwide, and some investors have lost money. Bergman wouldn't reveal if AP3 has sustained any losses. "The sum of our ILS investments during this period, when you had these serious events, has been very satisfactory," he says.

As with any investment, some years are better than others. "Most of the time, you're going to make money, and once in a while—just like any insurance company—you'll have to pay up," explains Leo de Bever, senior fellow at the C.D. Howe Institute.

The payments can amount to millions of dollars. "So you have to have a tolerance for that uneven pattern of gains and losses," adds de Bever, who recently retired from his position as CEO of the Alberta Investment Management Corporation (AIMCo), which invests the assets of public pension plans in Alberta. "It only works for pension funds that are willing to take a truly long-term view of these vehicles."

Bergman can't say what percentage of AP3's assets is dedicated to ILS. But, says Martha Tredgett, an independent Toronto-based alternatives specialist, European pension funds investing in ILS generally allocate about 2% to 5%. AP3's diverse ILS investments include two common insurance types pension funds hold: catastrophe (cat) bonds and collateralized reinsurance contracts, both of which are property and casualty products.

WHAT DO ILS COST?

ILS generally come with an annual management fee of about 1.5%, depending on the size and complexity of the mandate, says Martha Tredgett, a Toronto-based alternatives specialist. Some managers charge performance fees, too. But, she says, these fees make less sense with ILS. "The performance, or the return, comes at the beginning of the contract when you receive the premium. Once the contract is negotiated, it's up to the weather and different events."

How ILS Work

With cat bonds, investors get a risk premium upfront, and if certain events (or triggers) happen, they help cover the claims. One popular trigger is the indemnity type, which is tied to the amount of claims the insurer gets when a specified event happens. Once claims exceed a certain threshold, the investor starts to lose money.

Say a U.S. insurer buys a hurricane "cover" that is triggered at a loss of $2 billion. If the insurer's losses exceed $2 billion, the investor starts losing money, notes Michael Stahel, a Switzerland-based partner at LGT Capital Partners. For example, he says, if the investor puts in $200 million, then at a loss of $2.1 billion, the investor loses half of the investment. At a loss of $2.2 billion or more, the investor loses the full amount.

With cat bonds and all other types of insurance-linked products, investors don't assume the risk of the insurance company going bankrupt—just the risk of a trigger occurring. So even if the insurer goes bust, investors' money is safe as long as no trigger has occurred (see " What's a Special Purpose Vehicle?" page 38).

Cat bonds are liquid and tradeable, generally with maturities of about three years. The market's global value is estimated at around US$26 billion.

About 70% of the world's cat bonds are currently geared toward U.S. catastrophe risk, due to the country's susceptibility to extreme weather and its

TOP 5 | FASTEST GROWING (%) - LESS THAN $1.0 BILLION

CPA = CANADIAN PENSION ASSETS / ASSETS (MILLIONS) AS OF DEC. 31, 2014

	Company	2014 CPA	2013 CPA	% Variance
1	Unigestion SA	$886.4	$417.0	↑112.6%
2	Janus Capital Group	$763.1	$405.3	↑88.3%
3	Acorn Global Investments Inc.	$4.0	$2.6	↑57.0%
4	Morneau Shepell Asset & Risk Management Ltd.	$611.0	$451.1	↑35.4%
5	HSBC Global Asset Management (Canada) Ltd.	$172.9	$128.3	↑34.8%

TOP 5 | FASTEST GROWING (%) - $1.0 BILLION TO $10.0 BILLION

CPA = CANADIAN PENSION ASSETS / ASSETS (MILLIONS) AS OF DEC. 31, 2014

	Company	2014 CPA	2013 CPA	% Variance
1	Neuberger Berman LLC *	$2,291.0	$1,204.0	↑90.3%
2	QV Investors Inc.	$2,959.9	$1,951.4	↑51.7%
3	CGOV Asset Management	$1,235.6	$849.6	↑45.4%
4	Innocap Investment Management Inc.	$1,696.9	$1,221.9	↑38.9%
5	Investec Asset Management Ltd.	$1,006.6	$743.2	↑35.4%

Note: *Restated Dec. 31, 2013 figure

TOP 5 | FASTEST GROWING (%) - GREATER THAN $10.0 BILLION

CPA = CANADIAN PENSION ASSETS / ASSETS (MILLIONS) AS OF DEC. 31, 2014

	Company	2014 CPA	2013 CPA	% Variance
1	PIMCO Canada Corp.	$12,389.0	$10,221.0	↑21.2%
2	J.P. Morgan Asset Management (Canada) Inc.	$23,495.7	$19,889.0	↑18.1%
3	Connor, Clark & Lunn Financial Group	$26,527.3	$22,598.2	↑17.4%
4	BlackRock Asset Management Canada Ltd.	$77,513.6	$66,337.1	↑16.8%
5	Phillips, Hager & North Investment Management (RBC Global Asset Management)	$54,034.3	$47,196.3	↑14.5%

Figures in this report are based on responses provided by the survey participants. Benefits Canada assumes no responsibility for the accuracy of the data provided. All totals are subject to a +/- variance due to rounding.

Source: Firms participating in the Canadian Institutional Investment Network's spring 2015 *Top 40 Money Managers Survey*

high levels of insurance penetration, industry experts say. As a result, U.S. risks have historically paid the best, adds Sandro Kriesch, a Switzerland-based partner at Twelve Capital, an asset manager.

Europe, in contrast, has high insurance penetration but less extreme weather, explains Jens Hagendorff, a professor of finance and investment at the University of Edinburgh. And, he adds, while many developing countries experience extreme weather, they have much lower insurance penetration, so insurers don't take as much of a hit when catastrophes occur there.

For example, Typhoon Haiyan struck the Philippines in 2013, causing billions of dollars in damage—but only 10% of the losses were insured, notes Kriesch. This will change, of course, as emerging economies develop further, and more people and businesses there buy insurance, Hagendorff explains.

Diversification Options

To diversify away from cat bonds and access broader property and casualty reinsurance markets, pension funds also invest in collateralized reinsurance contracts. Globally, the size of that market is estimated at about US$38 billion.

While similar in structure to cat bonds, collateralized reinsurance contracts are illiquid, non-tradeable and usually for one year. Investors get their premium upfront and post a monetary collateral at the beginning of the contract. If the trigger event doesn't happen by the contract's end, that collateral goes back to the investor.

Both cat bonds and collateralized reinsurance have brought handsome returns. Data covering the period from

TOP 40 MONEY MANAGERS

CANADIAN ASSETS (MILLIONS) UNDER MANAGEMENT AS OF DEC. 31, 2014
CPA = CANADIAN PENSION ASSETS
↑↓ Indicates an increase or decrease in variance from 2013 to 2014

Rank	Firm	Rank 2013	Variance	2014 CPA	2013 CPA	Total Assets 2014
1	TD Asset Management	1	↑13.5%	$79,995.0	$70,452.0	$236,911.8
2	BlackRock Asset Management Canada Ltd.	2	↑16.8%	$77,513.6	$66,337.1	$151,561.2
3	Phillips, Hager & North Investment Management (RBC Global Asset Management)	3	↑14.5%	$54,034.3	$47,196.3	$246,527.1
4	Manulife Asset Management *[1]	n/a	↑17.9%	$35,263.1	$29,911.9	$83,736.1
5	Beutel, Goodman & Company Ltd.	4	↑5.9%	$35,211.0	$33,262.0	$42,018.0
6	State Street Global Advisors, Ltd.	5	↓5.3%	$26,871.1	$28,383.8	$42,847.1
7	Fiera Capital Corp.	6	↑8.8%	$26,723.4	$24,554.7	$74,262.5
8	Connor, Clark & Lunn Financial Group	7	↑17.4%	$26,527.3	$22,598.2	$54,312.8
9	J.P. Morgan Asset Management (Canada) Inc.	9	↑18.1%	$23,495.7	$19,889.0	$28,138.5
10	CIBC Asset Management Inc.	11	↑14.3%	$20,841.8	$18,226.9	$119,149.6
11	Greystone Managed Investments Inc.	8	↓1.2%	$20,631.0	$20,884.6	$32,558.0
12	MFS Investment Management Canada Ltd.	12	↑2.8%	$17,678.6	$17,193.2	$25,336.3
13	Letko, Brosseau & Associates Inc.	13	↑3.5%	$17,433.6	$16,839.0	$28,266.5
14	Pyramis Global Advisors (A Fidelity Investments Company)	14	↑13.7%	$17,208.8	$15,139.0	$96,958.1
15	Brookfield Asset Management	15	↑7.7%	$16,302.0	$15,136.0	$45,050.0
16	GLC Asset Management Group Ltd.	19	↑8.5%	$15,258.8	$14,063.3	$38,000.9
17	Franklin Templeton Institutional	18	↑5.6%	$14,902.3	$14,111.0	$47,732.8
18	Jarislowsky, Fraser Ltd.	16	↓5.0%	$14,080.0	$14,815.0	$32,930.0
19	Bentall Kennedy (Canada) LP	21	↑5.6%	$13,828.0	$13,099.0	$22,869.0
20	Wellington Management Group LLP	20	↑2.8%	$13,813.0	$13,436.0	$17,961.0
21	BNY/Mellon Asset Management Ltd.	17	↓7.2%	$13,704.9	$14,767.9	$17,803.7
22	Leith Wheeler Investment Counsel Ltd.	23	↑7.2%	$12,733.1	$11,878.4	$17,030.6
23	PIMCO Canada Corp.	25	↑21.2%	$12,389.0	$10,221.0	$24,072.0
24	Morguard Investments Ltd.	24	↓2.9%	$10,491.1	$10,809.6	$14,242.0
25	Addenda Capital Inc.	27	↑13.1%	$10,302.2	$9,106.6	$24,996.5
26	Aberdeen Asset Management PLC	28	↑9.6%	$9,884.1	$9,016.8	$15,257.3
27	Sprucegrove Investment Management Ltd.	26	↓1.7%	$9,502.3	$9,664.4	$13,821.1
28	Baillie Gifford Overseas Ltd.	29	↑11.4%	$8,160.0	$7,325.0	$10,963.0
29	Sun Life Global Investments	33	↑23.3%	$7,610.9	$6,174.3	$9,526.0
30	Mercer Global Investments Canada Ltd.	36	↑33.5%	$7,082.0	$5,305.9	$7,197.5
31	Guardian Capital LP	30	↑6.2%	$6,949.8	$6,545.3	$22,199.5
32	Burgundy Asset Management Ltd.	37	↑30.6%	$6,905.2	$5,287.7	$17,481.0
33	Industrial Alliance Group	34	↑12.4%	$6,886.6	$6,125.0	$76,755.1
34	Mawer Investment Management Ltd.	35	↑18.9%	$6,815.4	$5,733.3	$27,707.2
35	Hexavest Inc.	31	↑5.1%	$6,707.2	$6,382.6	$7,816.9
36	Foyston, Gordon & Payne Inc.	32	↓8.1%	$5,733.0	$6,235.0	$13,157.0
37	Invesco	38	↑10.8%	$5,357.1	$4,833.8	$33,650.8
38	Canso Investment Counsel, Ltd.	n/a	↑11.9%	$4,784.8	$4,275.9	$15,204.6
39	Acadian Asset Management LLC	n/a	↑9.7%	$4,536.6	$4,134.9	$5,247.0
40	SEI Investments Canada	40	↑1.6%	$4,528.3	$4,458.6	$10,157.5

2014 Top 40 Total	$728,676.0
2013 Top 40 Total	$663,810.0
% Variance	↑9.8%

"Most of the time, you're going to make money, and once in a while—just like any insurance company—you'll have to pay up" — Leo de Bever, C.D. Howe Institute

Notes: *Restated Dec. 31, 2013, figure

1. The assets reported as at Dec. 31, 2013, and Dec. 31, 2014, include the assets associated with the Canadian operations of Standard Life Investments acquired by Manulife on Jan. 30, 2015, and now reported under Manulife Asset Management.

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March 2003 to January 2015 show property and casualty ILS delivered an annual average return of 8.4%, with 3% volatility. During the same period, equities (per the MSCI World Index) produced an annual average return of 9.7%, with about 15% volatility.

Life insurance also presents investment opportunities. But, says Kriesch, longevity products can be a bad idea for pension funds because they require investors to assume longevity risk for certain populations—and pension funds are already exposed to this risk on the liability side of their balance sheets because people are living longer.

Still, pension funds can buy longevity instruments with short durations (eight years or fewer), such as U.S. life settlements, says de Bever. That short-duration risk wouldn't correlate with the pension plan's longevity risk, which has a much longer duration.

"It's very different from taking on a new pension member in a DB plan and having a 40-year investment horizon," de Bever explains. "Most of the time, you are buying the policies of people who, for a variety of reasons, have a shorter life expectancy."

These people sell their life insurance policies rather than taking smaller cash surrender values from the insurer—or getting nothing, if they can't afford the premiums and let their policies lapse. For them, the one-time cash payment makes sense; the investor then takes over the premiums and eventually reaps the death benefits.

AIMCo holds life settlement policies, which make up nearly all of its ILS allocations, says de Bever. They're large U.S. policies, some of which were originally bought as part of tax planning strategies, he adds.

Insurance-linked products make up only about 1% of AIMCo's total portfolio because of their unusual nature, says de Bever. "You want to make sure you don't get out of the comfort zone of [AIMCo's] clients. That may not be a good reason in an abstract sense, but in practice, it's a fact of life." AIMCo declined to confirm this ILS information.

WHAT'S A SPECIAL PURPOSE VEHICLE?

To issue debt, insurers need to establish special purpose vehicles (SPVs). These legal entities transform a reinsurance contract into a capital markets product investors can buy. It's the SPV that technically issues insurance-linked products, so the contract is always between the investor and the SPV.

SPVs are companies typically based in Bermuda, the Cayman Islands, Guernsey or Ireland because these offshore jurisdictions have lighter insurance regulations, such as limited regulatory reporting requirements, says Michael Stahel, a Switzerland-based partner at LGT Capital Partners.

It's because of SPVs that investors don't assume any credit risk when they buy ILS, the way they do with traditional bonds. The legal status of an SPV allows the investor's money to remain safe no matter what happens to the insurer, as long as no trigger has occurred.

Don't Want to Look Stupid

AIMCo is one of the few Canadian pension investors currently allocating to ILS. Others include the Ontario Teachers' Pension Plan and the Canada Pension Plan. Both declined to comment for this story.

"Most of the big funds have probably looked at them at one time or another," says de Bever, adding some may already be investing in these products indirectly through hedge funds or other vehicles.

And a few smaller pension funds in Canada have also expressed interest in ILS. One $3-billion plan initially invested $25 million in ILS and is considering investing another $25 million later this year, says Tredgett.

"It's at the nascent stages of growth in the Canadian market," she adds, explaining ILS allocations by the largest pension plans in Canada typically range from about 1% to 2%.

By contrast, in Europe, off-the-shelf ILS funds—a common way to invest in the asset class—are available even to retail investors, says Tredgett.

Complexity is a major barrier to adoption here. "It's much harder for people to understand, so I wouldn't expect there to be a stampede in Canada," says Janet Rabovksy, a director at Towers Watson. "But certainly among the more sophisticated clients, I can't see why they wouldn't look at them. I have one client in Canada that has actually made an investment, but it's not common."

Another barrier for Canadian pension funds is what Kriesch calls "career risk." "If they stick their heads out to another asset class, and they take a hit and others don't, they may look stupid," he says. "As a manager, as a pension fund, you don't want to look stupid when everybody else is shining."

However, Tredgett adds, ILS allocations in Canada and elsewhere will likely increase as EU insurance companies adopt the Solvency II Directive, which encourages them to issue more ILS. This means Canadian investors would have more insurance-linked offerings to choose from.

Issued by the European Commission to address the amount of capital EU insurers must hold to ward off bankruptcy, the directive takes effect in 2016. "By buying a hedge against extreme events, insurers are allowed to reduce their on-balance-sheet capital, thereby improving their return on equity," says Stahel.

As for Bergman, he plans to remain Zen about AP3's insurance-linked investments, despite the losses they'll inevitably bring. "We expect the good years to more than compensate us for the bad years," he says. "And when a disaster happens, it's our obligation to pay for that. That's why we earn money during the other years."

This approach makes sense to de Bever. Insurance-linked investments make up a small percentage of pension fund allocations—so, in the grand scheme of things, the losses they cause aren't that big, he explains.

"It's really a rounding error for those large [pension] funds. But a rounding error of $200 billion is still, in terms of absolute dollars, a large number. It's all a matter of perception." BC

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