2.1 INTERVIEW

Can ILS fit into an absolute return and capital preservation strategy?

Interviewer

David Grana,
Head of North American Media,
Clear Path Analysis

Interviewee

Dr. Floyd Tyler,
President & Chief Investment Officer,
Preserver Partners

SUMMARY

- *Current ILS returns make it difficult to include ILS in an absolute return portfolio*
- *Large amounts of capital in the ILS space makes it difficult to allocate according the return profile*
- *ILS may be at cyclically low rates and could possibly bounce back in the next 1-2 years*
- *It is difficult to say if rising interest rates will mean that reinsurers will offer rates at competitive rates*
- *ILS is not a large enough asset class to be considered mainstream*

David Grana: What are the details around your fund and when did it start?

Dr. Floyd Tyler: Our client base is about 50% institutional and 50% high net worth individuals. We also have some retail clients through a mutual fund that we run. We have a private credit/absolute return fund which is a hybrid structure, which we manage part of internally. The other part we allocate to other credit strategies through specialist firms. The fund started in April of 2010. More recently, in March 2016, we started a liquid alternatives version of that fund, called the Preserver Alternative Opportunities Fund. It has the same investment philosophy, but in a US 40 Act Structure.

David: Is your strategy preserving capital and creating absolute return?

Dr. Tyler: The ultimate goal is positive returns with the least amount of risk. The idea is that we focus on incomegenerating strategies. We do this across asset classes and capital structures. We try to deliver high single digit or low double digit returns with less than bond-like risk. As income-focused investors, we target most of the returns coming from dividends, interest or premium income.

David: Do ILS and cat bonds fit well into the strategy?

Dr. Tyler: They used to be more interesting, when the returns were better. So, conceptually, yes. But more recently, it has been more difficult to reach our return goals without leverage in the space.

David: When they do yield returns, are there any ILS that win over others?

Dr. Tyler: I wouldn't say that to be necessarily true. We tend to invest in a diversified way, because we want exposure to multiple perils and geographies. We have heard rumblings about niche areas, like marine risk, but we haven't participated directly in those spaces.

David: When you do invest are you using an external manager or are you investing directly ILS?

Dr. Tyler: We do the reinsurance through an external manager and also we own publicly traded reinsurance equities.

David: I talk to a lot of institutional investors who have absolute return on their mandate, but not ILS. Why do you think that might be?

Dr. Tyler: It is certainly related to returns. Also, the large amount of capital that is in the space makes it hard to allocate to the return profile that we would like. There is a part of me that feels we should be getting to cyclical lows on renewal rates. So there may be a better opportunity coming in the next 1-2 years. But for now, returns are underwhelming for the amount of risk you undertake.

David: Do you feel that part of the issue is that it has become a bigger asset class and more mainstream so there is a lot of money chasing after it which is driving down the returns?

Dr. Tyler: Yes. There is so much alternative capital in this space and there is a limited amount of supply of reinsurance risk. If you look at the charts of how much alternative capital has come into the space over the last 15 years, it is pretty meaningful. But if you look at the growth in premiums, they have increased, but not nearly as much. If you put those two issues together, it is just a diminished opportunity set until capital leaves the space.

David: There seems to be imbalance between the number of investors that are putting capital towards the asset class and the number of issuers who are willing to take on the risk. If more insurers entered the market to take on more risk would that make it more attractive?

Dr. Tyler: I am not certain, although it would help with the imbalance. However, it is hard to say whether on a second derivative level that would lead to higher prospective returns, since the pricing is still trending lower at almost every renewal period.

David: We have seen interest rates rise in the U.S. Would you say that the prospect of interest rates rising continually throughout this year will have a positive impact on the security or will it be null and void?

Dr. Tyler: The first set of moves probably won't have as much of an impact. If this continues and we get further along in the rate normalization process, we might start to see very competitive rates, particularly in credit. That might siphon off some of the capital being supplied and act as a replacement. The other side of this is that higher rates are very conducive to the balance sheet of insurers. So if their portfolios become more profitable, does that mean that they will write more reinsurance at less competitive rates because now they can afford to? It is hard to say with a great deal of certainty.

David: There were reports that London would become the new ILS central market. Does the establishing a centre like this will have any impact on the market or will it just be another place to go shopping for ILS?

Dr. Tyler: It will be just another place to go shopping. I can't see what the regulatory advantages or disadvantages would be. Maybe there are some U.K.-based or Europe-focused investors who feel comfortable with the close proximity of London, but really I see it just as another place to shop.

David: Do you see ILS becoming more of mainstream asset class or do you feel that it is more of an exotic security in the market and will continue to be so?

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Dr. Tyler: It is still exotic. When you look at issuance in other fixed income like sectors, it is not large enough to be considered mainstream. Its movement to become mainstream is being slowed by returns. You need a resetting of the supply and demand balance and higher, more consistent return experience. The market also needs to simply get bigger. I think it will over time. I see it much like the way REITs were in the U.S. in the 1990s. The REIT sector started out very small but over 15-20 years grew.

David: Thank you for sharing your views on this topic.