Government Actuary's Department

INVESTMENT NEWS

MONTHLY NEWS BULLETIN
FROM THE INVESTMENT AND RISK TEAM

01

3 March 2014

MONTHLY UPDATE

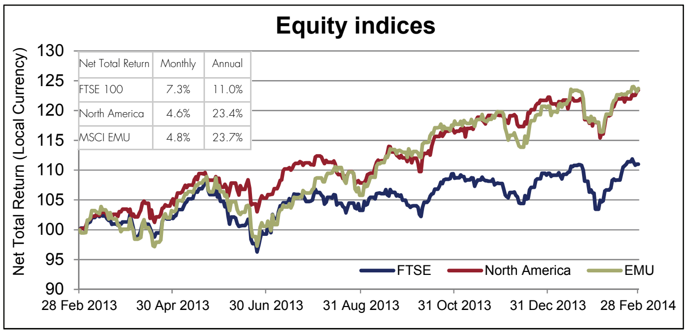
Overview

UK CPI inflation fell to 1.9% year-on-year for January, the first time it has been below the BoE's 2.0% target since November 2009. Many commentators suggest they expect inflation to remain low for several months, meaning the MPC is under little pressure to raise interest rates in the short term. Further to this the MPC clarified their forward guidance on interest rates to state they will consider several other indicators of slack in the economy alongside the 7.0% unemployment level (which many expect to be breached in the near future) when considering interest rate decisions. In addition the MPC believe that, even when the economy has recovered, interest rates are likely to remain below the 5% average level seen before the financial crisis.

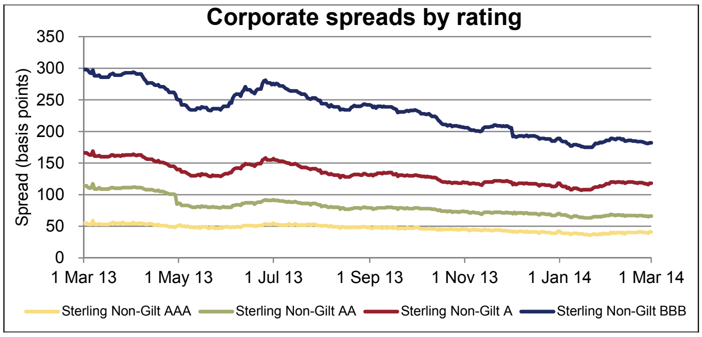
In the US, employment figures showed a lower than expected 113,000 jobs were added in January and the unemployment rate fell from 6.7% to 6.6%. In the face of slower than expected figures, the Federal Reserve resisted calls to end their tapering programme. Minutes also showed that, similarly to the UK central bank, they are preparing to change their forward guidance as unemployment nears the threshold.

Despite mixed global economic news, equities recovered strongly from the falls experienced at the end of January/beginning of February, with the S&P 500 reaching a new high and the FTSE 100 reaching its highest level since 1999.

Equity markets recovered through the month



Credit spreads were largely unchanged over the month

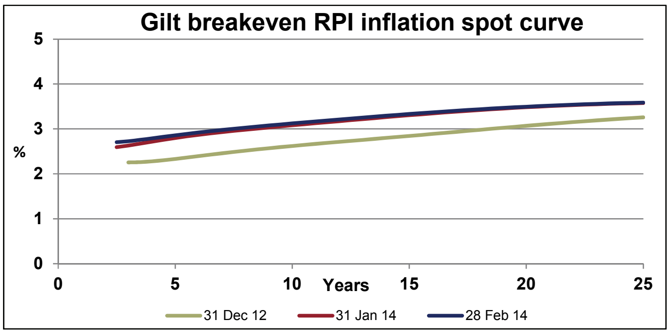


LATEST ECONOMIC NUMBERS

Current base rate	0.5%
Quantitative easing level	£375bn
CPI increase January (%y/y)	1.9%
Halifax house prices Jan (%m/m)	1.1%
IPD TR property index Jan (%m/m)	1.1%
PPF 7800 funding ratio	97.6%
VIX (volatility) index	14.0
$/£ exchange rate	1.68

Numbers as at the end of month unless stated

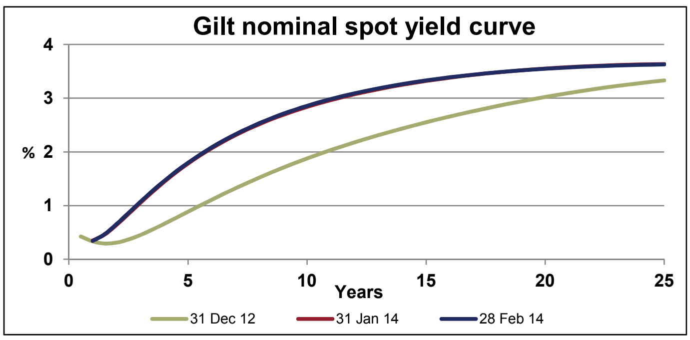
Breakeven inflation was largely unchanged this month



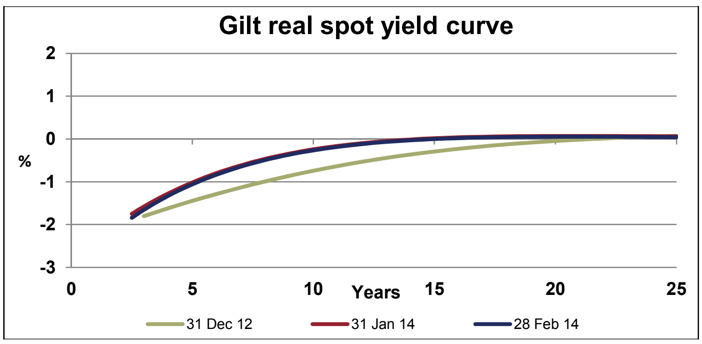
CALENDAR OF EVENTS AND DATA RELEASES

MPC interest rate announcement	6th Mar
UK trade Jan 2014	12th Mar
BoE Quarterly Bulletin	14th Mar
Labour Market Statistics	19th Mar
Minutes of MPC meeting	19th Mar
UK GDP (Q3 Third estimate)	21st Mar
Public Sector Finances Nov	21st Mar
RPI / CPI	25th Mar

Nominal yields are largely unchanged this month



Real yields are largely unchanged this month



All chart data sourced to Bank of England, Merrill Lynch, Financial Times, MSCI & Standard and Poor.

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Insurance Linked Securities

This month we look at the use of Insurance Linked Securities (ILS), and in particular catastrophe bonds, as an investment for pension funds and other institutional investors. Insurance Linked Securities (ILS) are instruments whose returns are linked to insurance events. ILS are attractive to insurers, as an alternative to traditional reinsurance, as they allow insurers to transfer risks to the capital markets. For investors they provide an alternative asset class that can add diversification to help improve their risk/reward profile. As the returns on ILS depend on the occurrence of insurance events, rather than economic factors, they normally have a low correlation to traditional asset classes.

What are catastrophe bonds?

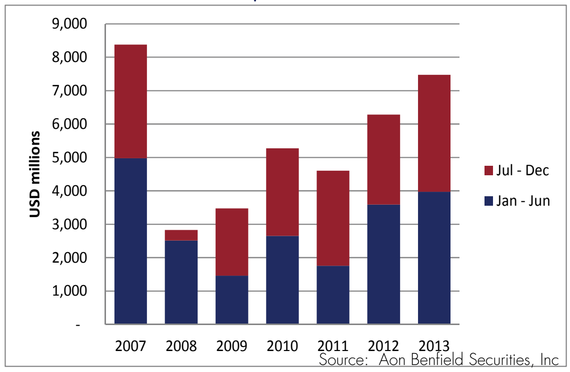
Catastrophe bonds are one of the most common forms of ILS currently available. In the absence of a triggering catastrophe occurring, the buyer of a cat bond receives a coupon payment from the insurer and the return of their principal upon maturity. However, in the event that a specified catastrophe occurs then the principal will be lost. Cat bonds have been issued to cover natural disasters such as hurricanes, floods or earthquakes as well as pandemics and medical insurance claims.

There may be one or more loss triggers for cat bonds, which can be based on an insurer's actual or modelled losses from an event or can be linked to industry losses or a measurable parameter, such as, wind speed or earthquake magnitude. Each of these provide a different level of basis risk to the issuer and transparency to investors.

Why do insurers issue catastrophe bonds?

A catastrophic event, such as a large hurricane or severe earthquake, could cause upwards of $100bn in losses to the insurance industry. Whilst traditional reinsurance could be used to cover these losses, it results in a small number of reinsurance firms exposed to low frequency, high loss events. By offering catastrophe bonds the risks are spread to the larger number of participants in the capital markets and, as the catastrophic events usually occur independently of stock market fluctuations, more favourable pricing can be provided.

Box 1 — Catastrophe Bond Issuance



Source: Aon Benfield Securities, Inc

The chart shows the total issuance of cat bonds from 2007 to 2013. The outstanding issuance is now at a record high of over $20bn. Commentators suggest the decrease in issuance in late 2008 and early 2009 was caused by increased caution about counterparty risk following the financial crisis, whereas the 2011 dip was caused by an updated hurricane model predicting higher expected losses for investors.

From an investor's perspective

In return for accepting the 'tail risk' of insurers, investors receive coupon payments. The majority of cat bonds are issued with expected losses in the range of 1 to 3.5 percent. Traditionally yields have compensated for these expected losses and exceeded yields on other bonds of similar credit quality, with spreads of around 5 to 15 percent above LIBOR. Cat bonds are also attractive as they have historically shown very low correlations with traditional asset classes. This diversification occurs because cat bonds are structured so that the risk is limited to the risk of an extreme event occurring, rather than the probability of the issuer defaulting, as with traditional bonds. This low correlation remained during the financial crisis which saw many other alternative assets perform poorly. Returns on cat bonds have been favourable with total returns of 11 percent in 2013. However, part of this return was the result of a narrowing of spreads, suggesting that those investing now will achieve lower returns than previous investors.

Cat bonds are rated by agencies such as Standard and Poor's, based on the probability of an event triggering a loss of capital, as opposed to the probability of the issuer defaulting. Typically cat bonds are rated below investment grade in B or BB categories. Some bonds have been rated above investment grade, but these tend to involve multiple triggers that are considered more unlikely than single trigger events.

The small size of the market (estimated to be around $20bn in the US at the end of 2013) and specialised nature of cat bonds means that they are usually only considered by larger pension funds (and even then only as a small percentage of investments). Pension funds and other institutional investors tend to invest in cat bonds indirectly through specialist funds and other vehicles such as hedge funds. This allows them to diversify their holdings within the cat bond market, and reduce their exposure to any one event. However, the majority of cat bonds contain US hurricane risk and hence there is a limit to the extent of the diversification within a portfolio of cat bonds (for example there are likely to be minimal losses from the storms in Europe this winter).

Other Insurance Linked Securities

There are a number of other ILS available to investors, but the market is generally smaller, more specialised and less liquid. These cover an even wider variety of risks and are often exposed to more likely loss events. Worthy of note are ILS linked to longevity risk, whether through mortality swaps or life settlement instruments which can have a high correlation to pension schemes liabilities (whether positive or negative).

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