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In 1992, Hurricane Andrew made landfall in Florida and the Gulf Coast, causing 65 fatalities and inflicting \$27.3 billion in damages.¹ This tragedy led to the failure of eight insurance companies, and pushed others to the brink of insolvency, threatening the survival of the regional insurance industry.² Less than two years later, the Northridge Earthquake tragically caused the deaths of fifty-seven people, injured more than 9,000, and caused estimated property damages of \$35 billion.³ As a result of this devastating events, companies and academics came together to develop a new type of investment vehicle that would transfer the risks presented by catastrophe and natural disasters from insurers to investors which have deeper and more liquid pools of capital. In 1997, the first catastrophe bond was issued, and what started as a \$1-2 billion dollar market in the 2000s has grown to become a \$56 billion dollar industry.⁴ In this paper, we will explore the catastrophe (CAT) bond market, their unique features of this asset class, the role these investments can play in a portfolio, and address common questions about the space.

What are Catastrophe Bonds?

Catastrophe bonds are fixed income securities that will pay the insurer if a predefined disaster occurs. Examples of such disasters could be a hurricane causing \$250 million in insured losses in a particular region or an earthquake occurring with a magnitude of 7.5 or higher. To mitigate counterparty risk and ensure that the only risk being taken on by investors is insurance risk, the bonds are placed in a special purpose vehicle which separates any payments from directly flowing between the investor and the insurer. If no disaster occurs over the life of the bond, the principal is repaid at the maturity of the bond. In addition to principal repayment, floating rate coupon payments are made by the insurance company over the life of the bond for taking on the insurance risk.

Why this appeals to insurers?

There are four major reasons why cat bonds are attractive to insurers:

- Catastrophe bonds help keep insurance companies solvent when severe storms hit areas that they insure.
- Catastrophe bonds are 100% collateralized and eliminate counterparty risk with their structure.
- Catastrophe bonds are typically issued with maturities of 3-5 years, which offers a more longer time frame for the insurer to lock in prices, increasing business stability.⁵
- The prevalence and growth of catastrophe bonds has lowered the cost of accessing reinsurance, leading to more efficient markets overall.

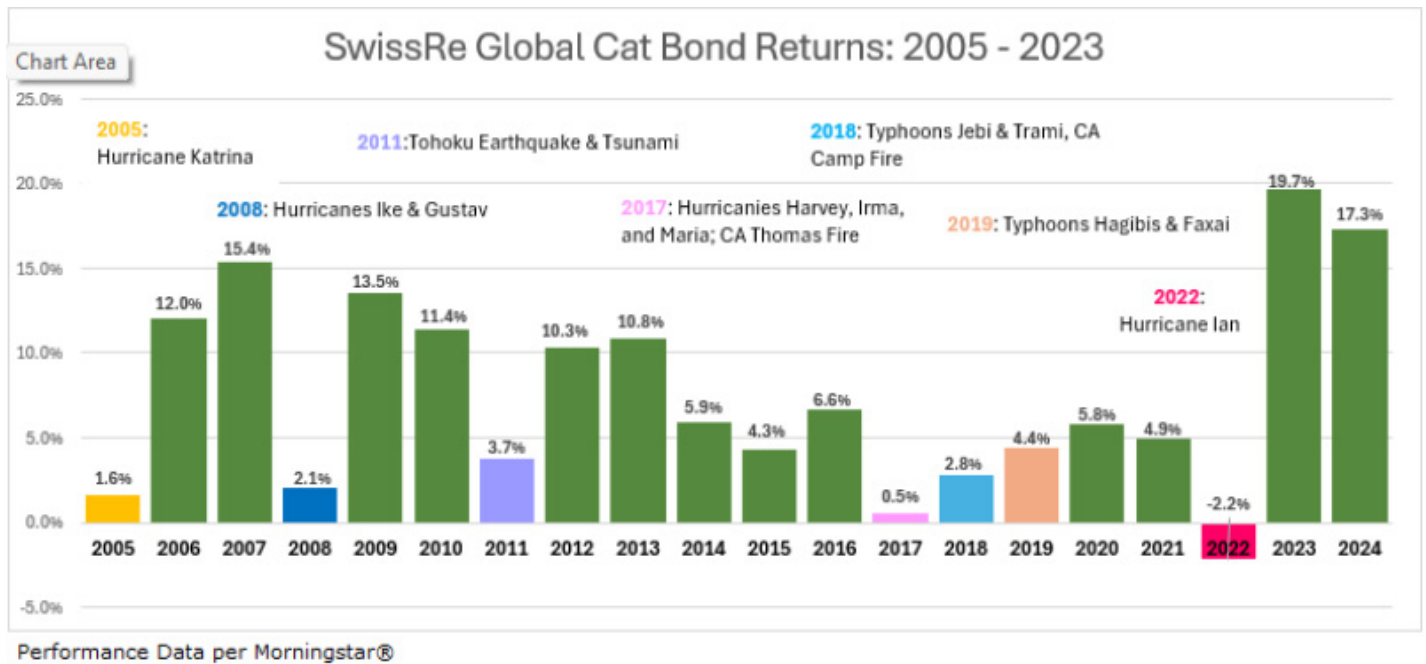
Why this appeals to investors?

1) Portfolio diversification

One of the core building blocks of portfolio management is asset diversification. By investing in different securities classes such as real estate and alternatives, investors can increase portfolio returns, reduce portfolio volatility, or a combination of both. Reinsurance neatly fits into the alternatives category, with the returns of the asset being upon the occurrence of earthquakes, hurricanes, or other natural disasters, and not on the economic cycle, interest rates, or asset valuations. Shown by the table on the left, reinsurance has historically shown minimal correlation to equities, commodities, investment grade, and high yield fixed income assets, making it an excellent diversification asset for portfolios.⁶

Historic Correlations: July 2004 - May 2025					
	US Equities	US Agg I.G. Bonds	US HY Corp Bonds	Commodities	Cat Bonds
US Equities	1.00				
US Agg I.G. Bonds	0.22	1.00			
US HY Corp Bonds	0.74	0.36	1.00		
Commodities	0.44	-0.01	0.49	1.00	
Cat Bonds	0.23	0.23	0.29	0.17	1.00

Performance Data per Morningstar®



2) Attractive return opportunity

Shown by the table to the right, catastrophe bonds have historically had positive returns, with the SwissRe Global Catastrophe Bond index being positive in 22 of the last 23 years. This is in spite of the world suffering through multiple disasters such as Hurricane Katrina, the Tohoku Tsunami, and Hurricanes Harvey and Irma in the same year.⁷ The lower volatility in the returns of this asset class can make it an attractive risk / reward proposition for investors which can endure periods of uncertainty.

Common Questions About Reinsurance

Q: If an area is hit by a natural disaster, does 100% of the money go to the insurance company?

No – catastrophe bonds utilize triggers, such as a hurricane causing \$250 million in insured losses, that must be met for a bond to begin accumulating losses. After all claims are made against a security on a bond that is triggered, any remaining principal is returned to the bondholder.

Q: What types of natural disasters are typically insured?

There are five common storm types in which reinsurance markets are active: U.S. hurricane, U.S. earthquake, Japanese earthquake, Japanese Typhoon, and European winter storms. While the largest markets for reinsurance tend to be for the U.S. hurricane and earthquake, the three other major markets are growing in both size and liquidity. In addition, new areas such as cyber and pandemic threats are seen as future areas of opportunity for the reinsurance market to expand in coming years.

Q: What is the typical credit rating for catastrophe bonds?

Typical credit ratings for catastrophe bonds range from BB to B, with some select credits obtaining BBB ratings from rating agencies such as Moody's, S&P, or Fitch.

Q: How can active managers add value in the catastrophe bond space?

Active managers have multiple ways to drive performance to the catastrophe bond markets, including having strong relationships with reinsurance issuers, higher quality analytics in modeling storms using historic data or simulating future storms using forward-looking data, accessing third party data to supplement models, and by implementing sound portfolio and risk management practices into the operation of strategies.

References:

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- 6: Data Per Morningstar Direct
- 6: Data Per Morningstar Direct

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