Absolute Return Magazine

November 28, 2006

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Main feature

Reinsurance redux

The roll of the dice paid off this year, but it's still a big gamble

As this year's U.S. hurricane season quietly winds down, hedge funds that took on windstorm exposure for Florida and the Gulf of Mexico are breathing a sigh of relief - and celebrating a pretty posh payday. Not one of this year's five Atlantic tropical depressions reached landfall, leaving the multistrategy firms that reinsured hurricane losses along the U.S. coast with returns estimated between 20% and 40%.

With such bountiful results - and such paltry returns in many strategies elsewhere - it's no surprise that some of the biggest hedge fund names have been attracted to property catastrophe reinsurance this past year. Citadel Investment Group, Magnetar Capital, Eton Park Capital Management, Farallon Capital Management, Highfields Capital Management and Och-Ziff Capital Management have all recently increased their reinsurance exposure. Other major multistrats are understood to be carefully considering the strategy, including the $23.2 billion D. E. Shaw.

But were this year's outsize results sheer luck, a fortunate turn of the roulette wheel, or have hedge funds found a more permanent source of alpha? Standard&Poor's estimates that the reinsurance industry's average 10-year rate of return is a mere 5.2% - not exactly up to hedge fund standards. The answer, then, depends on which of the many ways a hedge fund firm chooses to play the markets, how big the exposure is relative to the rest of a firm's portfolio and, ultimately, how prickly Mother Nature proves to be.

A hedge fund can invest in reinsurance in any number of ways, from catastrophe bonds and sidecars to more involved techniques such as fronting risk through derivatives contracts to actually setting itself up as a reinsurer. While these various strategies can produce a range of returns, "hedge funds have shown great comfort thus far in assuming the most volatile business from the reinsurance industry," according to Greg Hendrick, president and chief underwriting officer of Bermuda's XL Re.

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Typically, hedge funds target returns of 15% to 20% for their reinsurance investments. In an industry with such low average profitability, funds can achieve these targets only by writing a narrower subset of riskier policies focused on the most capacity-constrained areas, such as retrocessional reinsurance - reinsurance for reinsurers. Meanwhile, some hedge fund-backed reinsurers are looking for higher returns on the asset side of their balance sheets, by investing capital more aggressively - in, say, long/short equity strategies as opposed to safer investment-grade bonds.

that is cheaper than capitalizing and setting up their own reinsurer" Christopher McGhee

But that's a big gamble. Even though the offshore nature of reinsurance means there are few regulations and no mandated capital cushion, hedge funds don't have extra capital to throw around. Hedge fund-backed reinsurers that take on higher risk on both sides of the balance sheet could be writing a recipe for big losses.

Some funds dabbling in reinsurance have already been singed. D. E. Shaw and Eton Park, for example, were big holders of the stock of Bermuda reinsurer PXRE Group, which suffered sizable losses from the 2005 hurricane season.

Hedge funds are not new to reinsurance. After all, John Meriwether's Long-Term Capital Man-agement was a big investor in catastrophe bonds in the 1990s, as was Nephila Capital, a Bermuda-based hedge fund firm. Moore Capital Management set up a reinsurance company, Max Re Capital, in 1999.

What has changed, however, is the magnitude of hedge fund interest. "Hedge funds want new sources of return to replace other sources of hedge fund return that have been competed away. Further, the fact that returns to reinsurance risks are orthogonal to strategies that seek risk premiums from traditional capital market sources makes reinsurance even more attractive," says Andy Sterge, who is responsible for reinsurance risk investments for Magnetar, a $3 billion multistrategy hedge fund firm in Evanston, Ill.

The shape and success of the reinsurance industry run in cycles, tracking the pattern of losses and claims. Years that bring costly disasters, such as 1992's Hurricane Andrew, 2001's terrorist attacks on the World Trade Center and 2005's Hurricane Katrina, are typically followed by a reduction of reinsurance capacity as reinsurers pull back on their risk exposure. As capacity shrinks, prices rise in what is dubbed a hard market, and new companies form to take advantage of higher premiums.

Underscored by Hurricane Katrina and its estimated $80 billion to $90 billion in insured losses, 2005 turned out to be the busiest and costliest hurricane season on record. In the aftermath of mammoth losses, premium prices rose by as much as 70% to 100% in the most exposed zones, according to Steve Ader, a director in S&P's insurance ratings group. Now, more than a year later, S&P says the industry is still experiencing substantially improved pricing, particularly in catastrophe businesses such as property, marine and energy. New reinsurance companies are also continuing to form.

Hedge funds don't need to be reinsurance companies to get reinsurance exposure. One of the simplest and purest ways to take on insurance risk is to purchase catastrophe bonds, a market that is estimated to have doubled in size to about $4 billion over the past year. Cat bonds, risk-linked securities issued by an insurer such as Swiss Re or AXA, began appearing after Hurricane Andrew in the mid-1990s. Generally structured to mature in two or three years, cat bonds pay out a floating-rate coupon in return for the catastrophe risk transferred to investors. That risk is simply this: If certain conditions are met regarding insured industry losses, the investor forfeits the bond's principal to cover claims.

Yield-hungry hedge funds like cat bonds because their risk premiums, of up to 15%, are generous relative to double-B-rated corporates, a cat bond's most analogous counterpart. Hedge funds also like the fact that cat bond returns emanate from a class of risk, such as Tokyo earthquake or Florida hurricane, that is independent of the capital markets.

Another technique for taking on shorter term insurance risk, and one that has received a lot of attention this year, is the so-called sidecar. A sidecar, structured as a special-purpose entity, allows a hedge fund to take on a pro-rata share of a specific part of a reinsurer's business for a fixed period of time, say one or two years. Late last year, for example, XL Re formed a sidecar with the $8.4 billion Highfields. Capitalized at

$535 million for a period of two years, Cyrus Re covers the catastrophe excess-of-loss portfolio of XL Re for certain lines of property catastrophe reinsurance as well as its retrocessional business.

"Setting up a reinsurer allows you access into the marketplace, because that is where there are the most buyers of protection" Barney Schauble

Sidecars are popular in a market where capacity is shrinking because "insurance companies get to write more business, and hedge funds get a chance to access the insurance business in a way that is cheaper than capitalizing and setting up their own reinsurer," explains Christopher McGhee, managing director in charge of the investment banking and capital markets business for Guy Carpenter & Co.

Hedge funds typically look for a 20% return on sidecars, at least for the equity tranches, which have recently run in size from $60 million up to as much as $1 billion. Like cat bonds, sidecars are not brand new. Renaissance Re set up two joint ventures - Top Layer Re, in 1999, and DaVinci Re, in 2001 - that could be viewed as models for today's sidecars. Unlike Top Layer Re and DaVinci Re, however, today's sidecars are not rated and do not do business on their own behalf. But they do allow reinsurers to offset some risk from their own balance sheets.

Following Katrina, interest in side cars has picked up dramatically as the market for reinsurance tightened. This year, some $5.24 billion in sidecars have been funded, according to the Rein-surance Association of America. Hedge funds have poured an estimated $3 billion into such vehicles.

But cat bonds and side cars are limited in that they typically carry very heavy exposure to property catastrophe. The cat bond market is also relatively small, representing a mere 2% to 3% of the risks transacted in the reinsurance market. A more involved investment technique that involves working with a reinsurer to "front" or "transform" risks from reinsurance form to capital-markets form has evolved to allow hedge funds to participate in a broader range of risks than are currently available in cat bond form. This lets them invest more heavily in insurance risks, says McGhee of Guy Carpenter.

To get more flexibility and control over their reinsurance exposure, as well as access to much deeper markets, hedge funds may choose to set up their own reinsurer. In the past year, Citadel, Magnetar, Eton Park and the management team of West End Capital Management all established and capitalized their own reinsurers. Eton Park, through its private equity portfolio, also participated in such a transaction in partnership with other private equity funds. Ritchie Capital Management, meanwhile, set up Ritchie Risk-Linked Strategies in Bermuda in the spring of 2005.

"Setting up a reinsurer allows you access into the marketplace, because that is where there are the most buyers of protection," says Barney Schauble, a principal at Nephila Capital, which manages insurance- and reinsurance-related hedge fund assets. Nephila formed its own reinsurer, Poseidon Re, in 2003.

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Establishing a reinsurer may sound like a costly and time-consuming proposition. But in truth, the barriers to entry - at least in the lightly regulated reinsurance capital of the world, Bermuda - are relatively low. All a hedge fund really needs is enough capital to satisfy its clients - the insurance companies seeking to offset some liabilities - and a team of experienced reinsurance executives.

For hedge funds, capital is the easy part. The $12.1 billion Citadel set up New Castle Re late last year with $500 million. The $4 billion Greenlight Capital capitalized Greenlight Re with $220 million. Flagstone Reinsurance Holdings, which was sponsored by the management team of West End Capital Management, a Bermuda hedge fund, Lehman Brothers Merchant Banking and Lightyear Capital, a New York private equity firm, was initially capitalized with $715 million.

Getting industry expertise is critical, and for most hedge funds that means looking outside for help. "People want to know 'Who is running the company, and does the market think they are credible?'" says one investment banker with long years of reinsurance experience.

Magnetar, founded by Citadel alum Alec Litowitz, brought in Sterge and his team this year to help establish its reinsurer, Pulsar Re. Sterge once served as chairman and chief executive of Cooper Neff and created Cooper's Risk-Linked Assets Fund, one of the earlier hedge funds dedicated to reinsurance. More recently, Sterge managed his own firm, AJ Sterge Investment Strategies, which managed investments in insurance risk as well as other segments of the equity and fixed-income markets. AJ Sterge is now a division of Magnetar.

Similarly, when David Einhorn's Greenlight Capital set out to launch Greenlight Re in the Cayman Islands, the hedge fund firm hired Len Goldberg from Alea North America Insurance and Bart Hedges from Platinum Underwriters Bermuda. Citadel, meanwhile, tapped Chris McKeown, former chief executive of Ace Tempest Re, when it formed its first reinsurer, CIG Re, in 2004. McKeown now also runs New Castle Re, which Citadel formed after Hurricane Katrina.

The staffing needs of a reinsurance company depend on its lines of business and the breadth of risk types taken. But it doesn't require loads of people. "A Bermuda reinsurer is a way to participate in the market as an insider. It allows one to be more flexible," explains Magnetar's Sterge. In large part that's because of the role reinsurance brokers play. "The reinsurance business is one in which you don't need a massive distribution arm," says McGhee of Guy Carpenter. "You can hire a relatively small number of people to write a relatively small number of policies."

Most of the attention to hedge fund investment in reinsurance has focused on short-term property catastrophe plays in the Atlantic, Caribbean and Gulf Coast. Reinsurance is obviously a much broader business than that. The big multistrategy hedge fund firms typically take risks in the four biggest territory perils: Japan earthquake, California earthquake, U.S. hurricane and European windstorm. Hedge fund-backed reinsurers have also delved in to the life settlement, or viaticals, business.

Catastrophe is attractive to hedge funds in part because the risks can be more easily modeled. "If you are going into more difficult insurance products, such as directors and officers coverage for a large and diversified company, then you would need to keep an eye on the company's whole business operation. If you're a hedge fund, catastrophe risk is something that is easier to model. The risk is binary: either the contract is triggered, or it isn't," explains S&P's Ader.

Through a reinsurance arm, hedge funds can participate in a range of reinsurance transactions. One popular strategy is to purchase contracts of indemnity called industry loss warranties. These warranties are triggered when two conditions are met. The ceding company must have experienced a loss at a specified level, and the insurance industry as a whole must have suffered a loss at a specified level as measured, at least in the United States, by Property Claims Services.

Industry loss warranties may be the easiest type of reinsurance contracts to understand. "They require expertise, but they are not esoteric like indemnity reinsurance contracts, where a firm is indemnifying a ceding company on a piece of business," Sterge explains. "ILWs are something that capital-market derivatives guys can understand because they are instruments with a probability of payoff. You can't get it off Bloomberg, but you can hire a guy to run the probabilities and obtain a price."

Citadel set up two reinsurers to take advantage of different segments of the reinsurance market. CIG Re, established in 2004, writes collateralized, customized property catastrophe business. New Castle Re, which carries an A- rating from A.M. Best and thus doesn't have to tie up its capital in collateral, is more likely to participate in broadly syndicated risk offerings over a range of perils beyond property catastrophe, such as aviation and workers compensation.

Hedge funds do hold a few advantages over their traditional reinsurance peers. First and foremost, their primary business is investing - oftentimes aggressively - which could boost returns on their investment portfolio. Max Re, for example, originally set out to put its entire investment portfolio in hedge fund strategies. Cayman Islands-based Greenlight Re, which carries an A- rating from A.M. Best, invests most of its assets in the same types of equities that Greenlight's hedge fund buys. That's probably good news for

Greenlight Re this year. Greenlight Capital offshore netted 20.53% through October, according to investors. Investment risk, Greenlight reasons, is mitigated by the liquid nature of the stock holdings and relatively low leverage.

What's more, "hedge funds have capital and good access to prime broker leverage," notes Sterge. That access to leverage allows hedge fund-backed reinsurers that write collateralized policies to lever their asset base fairly easily by collateralizing their insurance plays with money borrowed from their hedge fund strategies.

Not everybody is convinced that hedge funds will stay the course in reinsurance. And not everyone is convinced the strategy will prove profitable. Over the past 18 years, starting in 1988, when S&P began compiling data, global reinsurers posted double-digit rates of return in only two years — 11% in 2003 and 10.3% in 1997 - both of which had abnormally low levels of catastrophe losses.

"The two main threats to hedge fund participation in my mind are more attractive equity and bond markets or a large catastrophe not anticipated by hedge fund participants" Greg Hendrick

As has been widely noted, one reason hedge funds like reinsurance risk is because it is uncorrelated to other risks in their portfolios. "But just because [reinsurance] is not correlated to the stock market doesn't mean it's a good bet," says one industry insider, who likens short-term reinsurance plays to "buying a lotto ticket." In 2004, for example, four hurricanes hit landfall, a scenario that was classified as a 1-in-250-year event. Yet the following year brought on Hurricane Katrina, a category 5 storm that itself was classified in a 1-in-100-year event. "Hedge fund guys who take a one-or two-year bet are taking a big gamble," this insider says.

What's more, pricing catastrophe risk is anything but a sure process because the probabilities are always in flux. "The track record in terms of weather studies is relatively short," says S&P's Ader. "So if you think about a 1-in-250-year event, how much information do you really have? Is there really any comprehensive data about Atlantic hurricanes at the time of Christopher Columbus's crossing? And then you have terrorism. Who knows what the frequency of that will be?"

Hedge fund-backed reinsurers could also get clobbered on their investment portfolios if they take on undue risk. Max Re has slowly pared back the hedge fund investments in its investment portfolio, and having suffered a $31 million loss from such investments in this year's third quarter, has said it would further reduce its alternatives target allocation to between 15% and 20%. In February, following unimpressive performance, PXRE submitted redemption notices for its entire hedge fund portfolio. The reinsurer's hedge funds lost 1.4% in this year's second quarter.

Then, of course, the opportunistic nature of hedge funds could mean that a number may not actually intend to stick with reinsurance for the long haul. In October, less than one year after it was formed, Flagstone Re filed for an initial public offering, in which it hopes to raise a minimum of $175 million. Greenlight Re, meanwhile, is said to be planning an IPO.

Says XL Re's Hendrick: "The two main threats to hedge fund participation in my mind are more attractive equity and bond markets or a large catastrophe not anticipated by hedge fund participants." Did we forget to mention global warming?