WCMA Interview: Luca Albertini

Luca Albertini is the Chief Executive Officer of Leadenhall Capital Partners LLP.

First of all, congratulations on your recent Investor of the Year Award at the Trading Risk awards. You have grown your fund from $100 million fund to $1.4 billion within the last three years, what do you put this success down to?

Thank you. First of all we believe we have a very strong pool of talent in the company with experience in both reinsurance and capital markets. In addition we have a strong partnership with a leading reinsurer. Working with Amlin provides us with a vast pool of underwriting skills; it allows us to share our thoughts, technical expertise and ultimately transactions with a traditional reinsurer. It is quite unique, for example, for an ILS fund manager to be able to discuss, underwriting and claims paying track record or contract wordings with traditional underwriters, constantly exposed to a vast range of opportunities across layers. We have always believed that in order to invest in indemnity risk, we need to be able to offer to investors access to a “know how” comparable with that of a reinsurance company. Also, our investors endorse the quality of our approach pointing to our performance in some testing years for insurance losses. We do not know everyone else’s performance, but our investors normally do. Finally, our broad product offering ranging from non-life to life insurance-linked strategies has supported our growth as it targets different investor needs.

In 2012, you launched a fund entirely dedicated to the life mortality space. How important has your life offering been to your business?

Yes, it has been key. We have invested in the life side of our business since inception, and that has allowed us to grow in a diversified way, which our investors like as it stabilizes the sources of income of our management company. The dedicated fund is a natural extension of this and is one of the three Leadenhall strategies active in the life space. The investor base in our life strategies is mainly pension funds. In our mortality investments, they see an uncorrelated source of income with a directional risk profile, which is opposed to the risk profile of pension fund liabilities. Leadenhall’s three life strategies today represent almost 50% of Leadenhall AUM.

Just how durable is capital we are seeing entering ILS?

Many investors demand alternative investments that are non-correlated to credit and / or equities, and so there is scope to continue growing. Currently insurance risks are not only a diversifier in an investment portfolio but are also considered as yielding a premium over non-diversifiers. Whilst the premium is justified for “novelty” products, as insurance is becoming more and more mainstream, it is no longer necessary and so I believe that the bulk of the investors will maintain their allocations even when non-diversifiers will rebound and offer equal or better yields. In addition, whilst before 2008 hedge funds were an important source of capital, now the majority of investors seem to be pension funds, which is a more stable capital base as it makes strategic allocation decisions as opposed to opportunistic ones. I am hearing less and less, the classic chime of investors who want to deploy just after the big event, and then exit the space a year or two later. However, it is crucial that the capital is well invested. We need to think how quickly the money came in, and realise that it can leave just as quickly if big mistakes are made. The moment that capital markets’ capital is viewed as the cheap capital to the insurance world, then it’s the stability may be called into question. It is up to the entire ILS community to ensure that capital markets investors are treated with professionalism and respect. Reports that capital markets investors are taking terms which a professional reinsurer would not take, or pricing which is below what a professional reinsurer would accept based on its risk assessment (rather than just its ROE requirements) could lead to instability to this important capital base for the industry.

With some ILS fund closures recently, set against the continuing inflows of pension fund capital into ILS, do you believe that the industry has large enough risk pool to match the demand for products?

The capital markets are still operating in a very small percentage of the world non-life industry. If global ILS capital funds are $50 billion now, it means we still have well over $250 billion to go until we are saturated. At present ILS certainly does have constraints, and often these are structural and based on the criteria we are given by our investors. If an investor wants to generate a 10% return today they will need a somewhat different risk profile today relative to a year ago.

Note: Luca Albertini is the CEO of Leadenhall Capital Partners LLP and is not affiliated with Willis Capital Markets & Advisory or its affiliates. The views expressed herein by Mr. Albertini are his personally and do not reflect the views of Leadenhall or Willis Capital Markets & Advisory or its affiliates.

WCMA Interview (Continued)

That said, you can still grow by matching the risk and return expectations of investors and protection buyers. In Q1 this year we have seen transactions with spreads below 3.00%, which I wouldn't have seen as possible two years ago. However the capital markets found a way to meet the pricing of the traditional markets in diversifying perils and, sure enough, $400 million was invested in a sub-3.00% issuance. A more general point here is that the insurance markets need to keep challenging vast pots of uninsured risk. Outside of U.S. risks, there is a clearly large scope for a greater pool of risks to be tapped by the capital markets. The biggest constraints to growth here has been the very low pricing offered by traditional reinsurance players, the fact that some protection buyers are used to facing traditional reinsurers and do not see the advantage to learn a new way of trading risks, and the reliance on modeling by some capital markets players. This reliance clashes with the amount of risk modeled to capital markets standards outside of the U.S. With that said, every year we see innovation and expansion. New risks are coming to the market, new issuers and protection buyers are making the steps necessary to have a direct dialogue with capital markets players, and the variety of risk layers and regional scope in the ILS transaction pool has expanded. This is all is very promising for further capital markets growth.

How do you think about the relative attractiveness of collateralized re and bonds?

As a fund we are agnostic to the form of our transactions. We can invest in both, and will favor the deal which gives the higher yield. Some market participants will take lower yield for increased liquidity. However, our funds do not have monthly liquidity and, as such, we don't have to pay for it. However, if the risk and return profiles are comparable, we do favor the liquidity and transparency offered by bonds.

Today 25.00% of our book is in cat bonds. That percentage was higher in 2009, when we had almost 100% cat bonds, but that was because bond yields were so favorable due to a market dislocation post-Lehman. The collateralized market has also allowed us to build a more diversified book away from U.S. wind and quake, and has also allowed us to regionalize our peak peril exposure.

How do you see the different ways that reinsurers are operating in the ILS space?

Clearly reinsurers have operated in the capital markets in a number of different ways in recent years; they have bought protection, they have sold protection and they have lent their expertise to third parties in exchange for fee income. The latter is an increasing trend, as the industry has accepted that this capital is here to stay and has sought an active role in its deployment. In seeking out fee income, some reinsurers have involved themselves in arranging trades, other have shared their books via the sidecar structure, while the third fee model is to be involved in open-ended insurance linked funds. Some reinsurers do all and some do one or two.

A distinguishing feature of reinsurer involvement in insurance linked funds, is around the level of interaction when making decisions. Is the asset manager a standalone investment on behalf of the reinsurer, or can he call on the expertise of the reinsurer when making decisions? I do believe that being able to have a dialogue on individual investments has suited the growth in business coming to the market in indemnity form.

Recent WCMA research has shown that a 0.50% asset allocation of global pension fund assets to ILS, would see the estimated $35 to $50 billion market grow to $150 billion. Do you see this level of penetration as realistic?

Yes, that is possible. Above all, ILS must continue to innovate and produce products so that capital can structure itself around pricing and risk profiles which are palatable to the protection buyers. On one side the capital markets should continue to look at products that tap the vast amount of uninsured risks or the retention of primary carriers. On the other hand the ILS market needs to keep on converging its offering to the need of the protection buyers.

One of the clear advances made by capital markets investors has been their availability to absorb a larger proportion of indemnity triggers, so that new protection buyers approaching the capital markets do not need to take basis risk into account. Also some risk of the new capital reaching the market has been available to cover very remote risks at a low rate on line, which up to a few years (or even months) ago were deemed to be below the minimum spread acceptable to capital markets players.

Diversifying non-life perils have been placed at a spread below 3.00% and some very remote Florida risk has been placed with the capital markets just above 4.00%. This shows that some of the capital markets capital has come to market with risk and return profiles which are in line with the one demanded by traditional protection buyers.

In summary, with the investors requirements meeting the protection buyer needs, and with investors and capital markets players being innovative in creating extra protection products which complement the traditional markets, we may well be one day 2-3 times the current size. There are two main threats to this growth: 1) surprises (i.e. losses which are not in line with what the marketing effort showed being in the range of the possibilities) and 2) the investor community not maintaining pricing discipline and being recognised as the cheap source of capacity which is arbitraged by the reinsurance community.