# CATASTROPHE BONDS ARE
# A DECORRELATED ASSET CLASS

## How cat bonds weather economic crises

### Cat bonds are insensitive by nature to economic crises

Catastrophe bonds, or "cat bonds", are bonds that protect companies, insurers and reinsurers against natural catastrophes such as hurricanes, earthquakes, floods and pandemics.

This asset class is decorrelated by nature from other financial markets and has demonstrated this in the past.

### They were decorrelated during the 2008 crisis

On September 15, 2008, Lehman Brothers failed, triggering a domino effect and bringing all other financial markets down with it.

Until then, certain asset classes, such as real estate, hedge funds and commodities were thought to have little correlation with equity and credit markets, but they also suffered record-breaking losses.

During that crisis, equity markets were down 57% at their lowest, whereas cat bonds lost only 4% (see Exhibit 1).

This decline was due mostly to the default of four cat bonds whose collateral was backed by financial instrument issued by Lehman Brothers. This practice has since been banned.

During the 2008 crisis, the cat bond market also had to absorb a wave of sell orders which depressed valuations in the secondary market.

This was because assets such as cat bonds, which had resisted the crisis and continued to hold up well, were the first to be sold when investors sought liquidity.

### The cat bond market is immunized against Covid 19 contagion

Might the Covid 19 pandemic, which has caused the world economy to grind to a halt, bring the cat bond market into closer correlation with other risk assets?

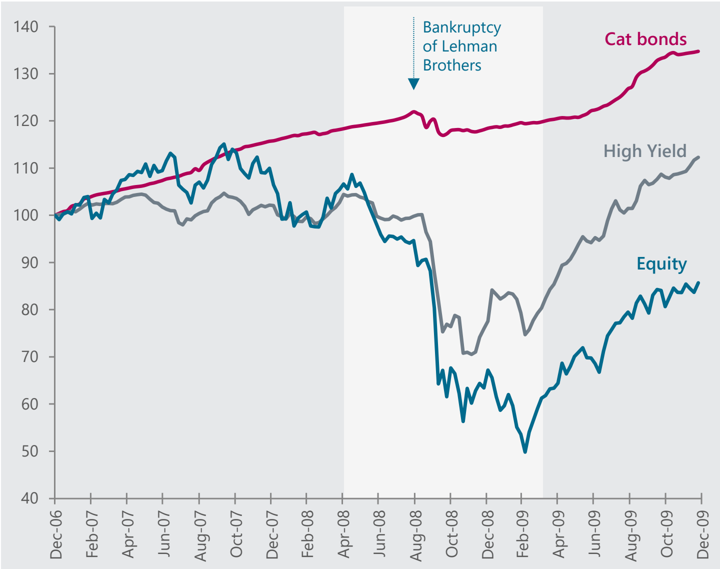
The cat bond market posted a decline of only 1.90% between March 6 and March 31, 2020, then fully recovered, whereas equity markets fell by 32% (see Exhibit 2).

Only one issue was directly affected: the pandemic bonds issued by the World Bank on behalf of the WHO. A total of 132.5 million dollars was paid out as part of the effort to combat and prevent the pandemic.

There was an indirect impact on the valuation of cat bonds, as there was in 2008.

Once again, multi-strategy fund managers took advantage of the

**Exhibit 1** Equity, High Yield and Cat bonds during the 2008 financial crisis




| | Max Drawdown |
|---|---|
| Cat bonds | -4.09% |
| High Yield | -32.63% |
| Equity | -56.71% |

*Source: Bloomberg, based on weekly data. Cat bonds = Swiss Re Catastrophe Bond Total Return Index, Global High Yield =iBoxx $ Liquid High Yield Index, Global Equity = MSCI Daily TR Gross World USD*

*Past performance is not a reliable indicator of future performance.*



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cat bond market's resistance to generate cash that could be used to seize opportunities on more depressed markets.

A wave of 500 million dollars in sell orders poured into the market (compared to a total market size of around 35 billion dollars). This amount, a record since the market was created in the 1990s, was absorbed at the expense of a decrease in valuations, but without any liquidity problems.

In the wake of this valuation decline, the cat bond market now offers yields in the region of 7-8% on average for an unchanged level of risk.

Furthermore, although the primary market dried up in March 2020, it was particularly active in May 2020, when transactions amounting to 1.75 billion dollars were placed, bringing the total since the beginning of the year to 8.8 billion dollars.

## Conclusion: decorrelation has proven itself again

**The cat bond market has seen steady, robust growth since it was created in the 1990s.**

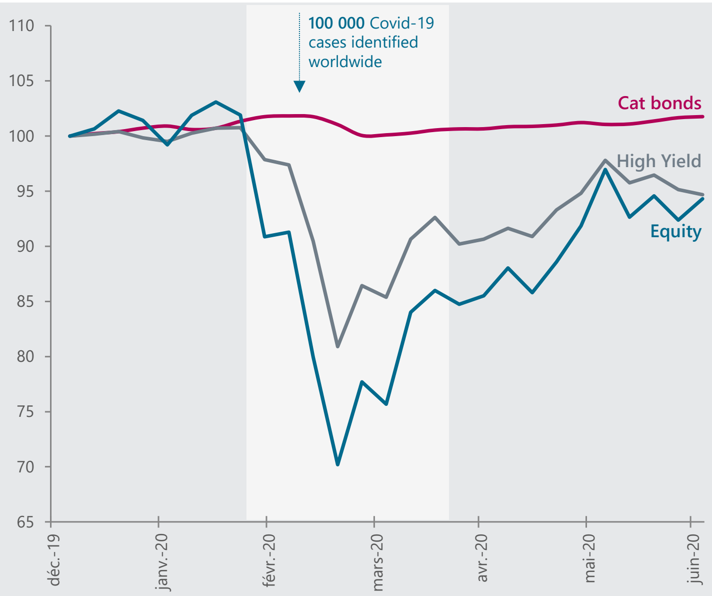
**Insurers' and reinsurers' needs for coverage have been met by investors' needs for yield and diversification.**

**Through major crises, the cat bond market has proven to be decorrelated and resilient, continuing to offer liquidity under difficult market conditions.**

**This correlation can even turn out to be negative in times of stress and increased volatility on the financial markets, like during the Chinese market crash of 2015 or the Argentinian crisis of 2018.**

**In the current environment, with traditional assets having bounced back, even though economic uncertainty remains, the cat bond market presents an attractive risk/return profile for investors seeking to preserve their capital in the event of severe economic downturn.**

**Exhibit 2** **Equity, High Yield and Cat bonds in year 2020 (as at July 03, 2020)**




| | Max Drawdown |
|---|---|
| Cat bonds | -1.74% |
| High Yield | -19.70% |
| Equity | -31.91% |

*Source: Bloomberg, based on weekly data as at 03/07/2020. Cat bonds = Swiss Re Catastrophe Bond Total Return Index, Global High Yield =iBoxx $ Liquid High Yield Index, Global Equity = MSCI Daily TR Gross World USD*

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