Lane: ILS returns a 'hands-down victory' for diversification

6 July 2017

The ILS asset class has achieved a "hands-down return victory" over the past 15 years when compared with risk-adjusted returns from corporate bonds and yields from US stocks, according to analysis from Lane Financial.

The firm compared returns since 2002 for its ILS all-cat index against those from high-yield US corporate bonds, investment grade corporate bonds, the S&P 500 (assuming full reinvestment of dividends), and a baseline of one-month US Treasury securities.

Compound annual returns over the period came to 8.40 percent for high-yield debt, 7.86 percent for ILS, 7.1 percent for the S&P 500, 4.66 percent for investment grade bonds and 1.19 percent for the US Treasury securities.

Taking the US Treasury returns as a risk-free rate, returns from the ILS sector have shown a Sharpe ratio of 2.76 - compared to less than 1 for the other asset classes.

"In other words, ILS investments have returned 2.76 units per unit of risk taken (when the risk measure is standard deviation)," the firm explained.

"We anticipate the same comparative result going forward, albeit at lower levels."

However, Lane noted that there is a debate over whether Sharpe ratios are an appropriate tool for considering asset classes such as ILS or high-yield bonds, where returns are expected to show a fat-tailed distribution - in other words, a highly skewed return profile at remote return events.

But it also added that looking at month-to-month returns, high-yield debt and the S&P 500 had big peak-to-trough fluctuations, whereas the line showing the "ILS 'heartbeat' is very quiet when overlaid against stocks".

Moreover, ILS correlation to the performance of other asset classes is also low.

When investors sought to cash up assets during the financial crisis, ILS correlations rose from 20 percent to 50 percent, but have since dropped back to the range of 20 percent and lower.

In the past couple of years, ILS returns have actually shown a negative correlation to the performance of stocks and high-yield bonds.

The firm noted that it is not possible to compare ILS yields net of expected losses with the same data for corporate bonds, as there is no publicly available information on the probability of default used to rate corporate debt.

But on an absolute basis, ILS yields in the past 15 years have typically hovered between those of investment grade bonds and high-yield bonds.

Lane said this trend reinforced the sense that "bond buyers now consider ILS as legitimate additions to the menu of alternatives available in the universe of corporate bonds".

Meanwhile, Lane's rate-on-line index showed a 5 percent increase in ILS rates in the second quarter, reflecting the seasonal increase in cat bond prices ahead of hurricane season.

Average yields reached 5.42 percent, slightly up from the 5.22 percent gross average yield at the end of Q1 2017.

However, net of expected losses, yields had dropped to 2.42 percent, from 3.21 percent in the prior quarter.

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