Insurance-linked securities: Unlocking niche opportunities to enhance portfolio resilience

Key takeaways

- For investors aiming to bolster their portfolios against market downturns, insurance-linked securities (ILS) offer the potential to provide valuable diversification alongside appealing risk-adjusted returns.
- Investing in ILS offers a unique structural opportunity: a risk, return and liquidity source that is structurally uncorrelated to the capital markets. This characteristic may provide investors with solid diversification benefits and blunt the impact of market volatility, helping to improve the risk/return profile for investors.
- ILS may present an attractive option for investors seeking alternative fixed income solutions to support their financial goals, increase yield and enhance portfolio resilience.

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Introduction

The genesis of insurance-linked securities traces back to 1992, when Hurricane Andrew, alongside other devastating natural disasters, severely tested the insurance industry's capacity to bear risk. Since 1992, the risk landscape has metamorphosed into a volatile terrain where the pendulum swung from global cataclysms to localized natural disasters, underscoring the imperative of adaptable strategies and the need for ILS in navigating these tumultuous waters. As such, investors continuously seek innovative strategies that complement risk/return characteristics in the quest for risk mitigation and portfolio diversification. This intersection of risk and reward is where reinsurance and capital markets converge, offering investors the possibility of attractive returns with low volatility. The potential of ILS is clear, and the following paper will explore various topics related to the ILS market.

A focus for today's market: Flexibility and opportunistic allocations

A convergence of market risks, including those related to interest rates, credit, liquidity and macroeconomic challenges, can create a tempestuous headwind for fixed income managers, underscoring the unpredictable nature of financial markets.

Amid market uncertainties, the importance of tactical flexibility within a broad investment universe cannot be overstated. We explore the benefits of possessing both tactical allocation expertise and access to low return correlated assets in the following case study of insurance-linked securities, an asset class that offers both return correlation benefits and total return potential to opportunistic fixed income strategies.

As we experienced during the global financial crisis of 2007-2009, the onset of COVID-19, and again during the significant interest rate hikes in 2022, fixed income markets are not immune to price volatility. Economic cycles, geopolitical events and regulatory changes constantly reshape investment market dynamics, presenting both opportunities and risks. A tactical investment management approach allows portfolio managers to adapt swiftly to these changes, seizing opportunities for excess return generation and mitigating risks effectively. While the ability to shift portfolio weightings is great, the capability isn't effective in practice unless the strategy affords the flexibility to select among a broad universe of sectors and subsectors. In this publication we'll discuss insurance-linked securities, a high-yielding type of investment not found in broad U.S. fixed income indexes. Catastrophe (CAT) bonds are the most prevalent type of insurance-linked securities and first became of interest to the Nationwide Amundi Strategic Income Fund in late 2022 after yield premiums for such securities increased significantly.

What are insurance-linked securities?

Insurance-linked securities (ILS) are financial instruments whose performance depends upon insurance risk rather than traditional financial risk. The most widely accepted forms of insurance-linked securities are those related to catastrophe risk or the risk of primarily natural disasters (perils). The major types of perils covered in the catastrophe risk market include U.S. hurricanes, U.S. earthquakes, European windstorms, Japanese earthquakes and Japanese typhoons.

Major types of perils covered in the catastrophe risk market:

- U.S. hurricanes
- U.S. earthquakes
- European windstorms
- Japanese earthquakes
- Japanese typhoons

4 primary types of ILS are issued to cover catastrophic risk:

Investment	Definition	Features
Catastrophic bonds (commonly referred to as "CAT bonds)	Issued for a precise level of protection above a certain threshold (trigger), covering losses from a particular low-frequency, high-severity event (peril) in a specified geographic area	• Relatively liquid • Limited secondary market • Multiyear contract
Industry-loss warranties (ILWs)	Insurance contracts whose loss calculation is determined by industrywide catastrophic losses rather than from a specified event	• Contracts typically 1 year or shorter • Not tradable on the secondary market • Quick loss determination and resolution
Quota share instruments (also known as reinsurance sidecars)	Allow investors to purchase a portion of an insurance book of business from an insurance company to share in the profits and risks	• Typically illiquid and less transparent • Generally a 1- to 2-year contract • Broadly diversified
Collateralized reinsurance	Like CAT bonds in terms of insurance risk but created via private contract rather than tradable security	• Much less liquid than CAT bonds • Customizable exposures across regions, perils and risk layers • 1-year contract • No secondary market

For fixed income investors, the most familiar of these types of ILS are CAT bonds, whose return of principal depends on the non-occurrence of a predefined catastrophic event during a specific risk period — usually 1 to 4 years in duration. For insurance companies, CAT bonds are a means of reinsurance that can also provide valuable capital relief. For investors, the securities represent an opportunity to add diversification at yields and spreads that may be attractive relative to those of similarly rated corporate credit securities.

The first traded 144A CAT bond was issued in 1997 to protect against the risk of a major hurricane — a step taken by the financial industry after Hurricane Andrew caused $15.5 billion in insured losses, as well as a shortage of reinsurance capacity, in 1992. Over the past 10 years, approximately $86 billion of CAT bonds have been issued, providing protection to numerous reinsurers, governments and corporations for a multitude of risks.[1]

Why has demand for ILS increased?

The ILS market has seen significant growth, particularly in recent years as the breadth of investment vehicles has increased. As of March 31, 2024, the overall outstanding ILS market (primarily represented by CAT bonds) was approximately $48 billion, nearly 20% larger than at the same point during 2013. The increased market size has improved liquidity, allowing the securities to be more heavily considered for daily liquid vehicles. Traditional fixed income instruments such as government bonds and corporate debt form the foundation of many investor portfolios, but given their sensitivity to interest rates, global growth trends and issuer credit fundamentals (debt/leverage), they may not provide adequate diversification in times of market stress. The gain in ILS's popularity probably stems from its independently unique sources of returns, which are tied to nonfinancial risks — primarily natural catastrophic events such as earthquakes and hurricanes, but also other insurable events such as longevity/life insurance or event cancellation. All are risks that do not correlate to the stock or bond markets (a correlation table is shown below).

Correlation 1/1/2002 through 9/30/2024	CAT bonds	U.S. equities	Commodities	U.S. Agg Inv. Grade Bonds	U.S. HY Corporate Bonds
ILS CAT bonds[2]	1.00				
U.S. equities[3]	0.01	1.00			
Commodities[4]	0.03	0.28	1.00		
U.S. Agg Inv. Grade Bonds[5]	0.01	-0.17	-0.08	1.00	
U.S. HY Corporate Bonds[6]	0.02	0.37	0.27	0.16	1.00

[1] Swiss Re statistic as of 12/31/23.

[2] CAT bonds (ILS) are represented by the Swiss Re Global CAT Bond Total Return Index, which tracks the aggregate performance of all USD, EUR and JPY denominated CAT bonds, capturing all ratings, perils and triggers. The index seeks to hedge out the EUR and JPY currency risk at the inception of the bonds. However, the index does not reflect the full ILS market because it does not include private market securities (e.g., quota shares, collateralized reinsurance, and ILW). Furthermore, the index also has a higher concentration to peak zone risks (U.S. hurricane/earthquakes) than what might typically be included in an Amundi US ILS portfolio.

[3] US equities are represented by the S&P 500 Index.

[4] Commodities are represented by Bloomberg Commodity Total Return Index.

[5] US Aggregate Investment Grade Bonds are represented by the Bloomberg US Aggregate Index.

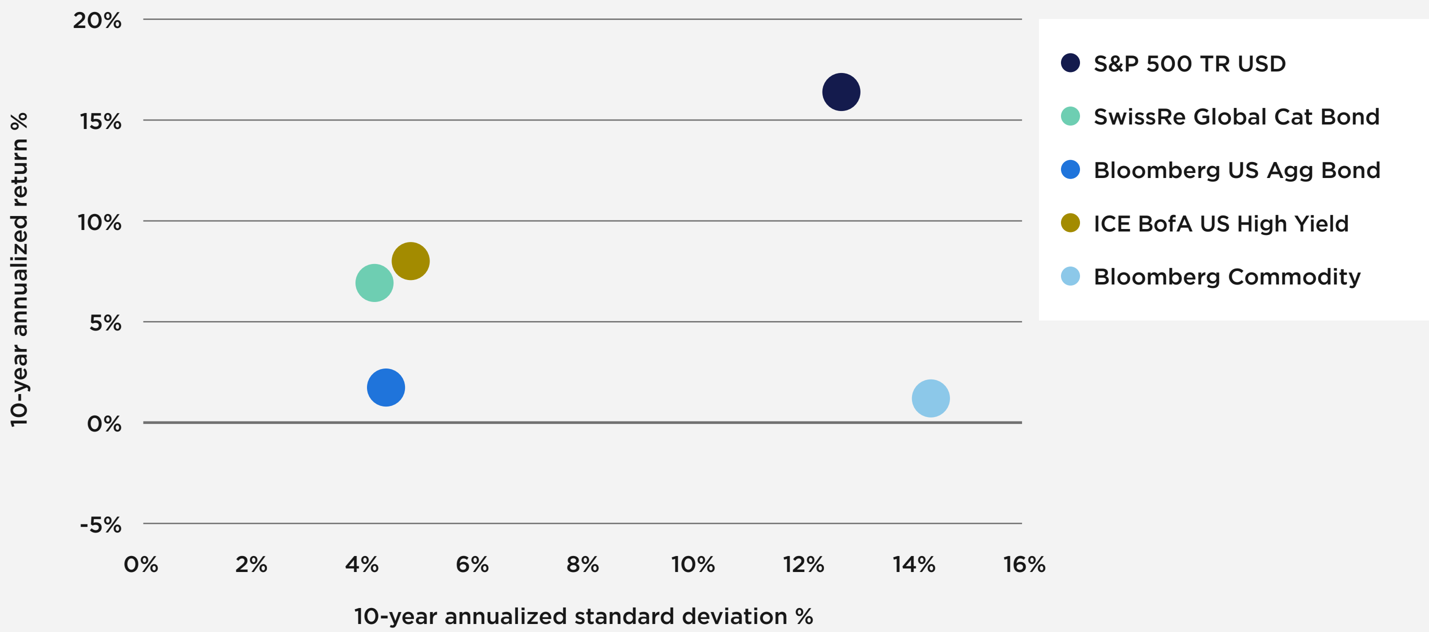
[6] US High Yield Corporate Bonds are represented, by the ICE BofA US High Yield Index. Indices are unmanaged and their returns assume reinvestment of dividends and do not reflect any fees or expenses. It is not possible to invest directly in an index. Data is based on past performance, which does not predict future results.

Source: Morningstar. Dates from January 1, 2002, to September 30, 2024. Note: Correlations for Swiss Re Global CAT Bond Index reflect Swiss Re return calculations for the 5-years prior to the January 2007 inception of the index.

Attractive return potential with lower volatility

Over the 10-year period ended September 30, 2024, CAT bonds offered higher returns with lower realized risk than many other asset classes.

10-year risk/reward ended September 30, 2024



Source: Morningstar as of 9/30/2024. Data is based on past performance, which does not guarantee future results. Data is not meant to represent the performance of any Amundi US portfolio. Commodities are represented by the Bloomberg Commodity Total Return Index. CAT bonds are represented by the Swiss Re Global CAT Bond Total Return Index, which tracks the aggregate performance of all USD, EUR and JPY denominated CAT bonds, capturing all ratings, perils and triggers. The index seeks to hedge out the EUR and JPY currency risk at the inception of the bonds. However, the index does not reflect the full ILS market. U.S. equities are represented by the S&P 500 Index, a commonly used measure of the U.S. Stock Market. U.S. Aggregate Bonds are represented by the Bloomberg U.S. Aggregate Bond Index. High Yield Corporate Bonds rare represented by the ICE BofA U.S. High Yield Index. Indices are unmanaged, and their returns assume reinvestment of dividends and do not reflect any fees or expenses. It is not possible to invest directly in an index.

Since its inception, the Nationwide Amundi Strategic Income Fund has maintained the ability to access a diverse array of securities across global markets, spanning different market sectors, credit qualities and maturities. Insurance-linked securities are a subset of this large opportunity set and serve as one example of how the Fund's portfolio management team positions around a tactical opportunity when reward relative to risk appears particularly favorable. The Fund's allocation to ILS, particularly CAT bonds, was built from 0% to approximately 10% of market value during 2023. After repositioning following strong performance, ILS exposure now sits at roughly 7% as of September 30, 2024. The Fund maintains an allocation in ILS with close attention to total yield and spread levels to ensure appropriate compensation for holding such securities. By embracing niche opportunities and employing a tactical mindset, the Nationwide Amundi Strategic Income Fund strives to confidently navigate market uncertainties, unlocking value for investors and setting the stage for long-term success.

To speak with a Nationwide investment specialist, please call 1-877-877-5083 or look up the best contact for your location.

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Call 1-800-848-0920 to request a summary prospectus and/or a prospectus, or download prospectuses at nationwide.com/mutual-funds-prospectuses.jsp. These prospectuses outline investment objectives, risks, fees, charges and expenses, and other information that should be read and carefully considered before investing.

The Fund is subject to the risks of investing in fixed-income securities, including high-yield bonds (which are more volatile). These risks include default risk and interest rate risk (if interest rates go up, bond prices go down, and if interest rates go down, bond prices go up). The Fund may invest in corporate loans (which have speculative characteristics and are high risk) and sovereign debt (a governmental entity may delay or refuse to pay interest or repay principal). The Fund also is subject to the risks of investing in foreign securities (currency fluctuations, political risks, differences in accounting and limited availability of information, all of which are magnified in emerging markets). The Fund may concentrate on specific sectors or countries, subjecting it to greater volatility than that of other mutual funds. The Fund may invest in more-aggressive investments such as derivatives (many of which create investment leverage and illiquidity and are highly volatile). The Fund's holdings may subject the Fund to liquidity risk, making it more volatile than other mutual funds. Please refer to the most recent prospectus for a more detailed explanation of the Fund's principal risks.

Investing involves risk, including the possible loss of principal. Share price, principal value and return will vary, and you may have a gain or a loss when you sell your shares.

The Swiss Re Global Cat Bond Index: An Index that tracks the aggregate performance of all USD, EUR and JPY denominated CAT bonds, capturing all ratings, perils and triggers. The Index seeks to hedge out the EUR and JPY currency risk at the inception of the bonds.

Bloomberg Commodity Total Return Index: A rolling Index that reflects the returns of a fully collateralized investment in the Bloomberg Commodity Index (BCOM), which combines the returns of the BCOM with the returns on cash collateral invested in 13-week U.S. Treasury bills. The Index also reflects the rate of interest that could be earned on cash collateral invested in specified Treasury bills. The Index is rebalanced annually.

Bloomberg U.S. Aggregate Bond Index: An unmanaged, market value-weighted index of U.S. dollar-denominated, investment-grade, fixed-rate, taxable debt issues, which includes Treasurys, government-related and corporate securities, mortgage-backed securities (agency fixed-rate and hybrid adjustable-rate mortgage pass-throughs), asset-backed securities and commercial mortgage-backed securities (agency and non-agency).

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ICE BofA U.S. High Yield Index: The Index tracks the performance of U.S. dollar-denominated below investment grade corporate debt publicly issued in the U.S. domestic market.

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