Twelve Capital Perspectives 2H Outlook

Executive Summary

As a result of the “lower for longer” interest rate environment and high levels of market volatility, Twelve Capital sees a number of attractive investment opportunities in the insurance sector for the second half of the year:

- After a significant period of spread widening over the last 18 months, Insurance Bonds currently offer an attractive yield of between 5% and 6% at the time of writing. In our view, this is an attractive proposition given that the vast majority of government bonds yield less than or close to zero, whilst the ECB’s bond buying programme should result in some considerable price support for credit markets in general.

- Twelve Capital has a strong pipeline of attractive Insurance Private Debt transactions offering investors an interesting illiquidity premium in this area of the market.

- The attractiveness of Insurance Linked Securities (ILS) as a diversifying asset class is being reinforced by the significant levels of volatility currently being experienced across global markets.

- Insurance Equities are supported by high dividend yields, whilst conditions remain supportive for further consolidation in the industry. Increasing exposures to insurers that are potential take-over targets could enable investors to capture premiums in the range of 25-40% in our view.

- Twelve Capital’s Best Ideas strategies have gained further appeal as these portfolios offer similar returns to pure Insurance Bond or Cat Bond portfolios whilst having significantly lower levels of risk and volatility.

Fundamental Overview

Low interest rates and increased volatility have been the major themes in global financial markets during the first half of 2016. The outcome of the UK referendum has been a further catalyst in this regard, with interest rates now expected to remain lower for longer and nervous markets expected to remain volatile at least over the short term. In terms of direct implications for the insurance sector as a result of the UK referendum, we expect these to be manageable for directly exposed names going forward. To illustrate, we do not see revenues at ‘Pure Play’ UK insurers being impacted given that we do not believe market access for these corporates will be disrupted. Furthermore, claims experience for these names are not expected to deteriorate simply because the UK withdraws from the EU.

Twelve Capital also notes that only a relatively small number of UK insurers have material operational exposure to the European Union. For most of these names, ongoing trading is unlikely to be materially affected given that, in the main, they do not rely on freedoms provided by EU directives to passport services from the UK into the single market. Rather, these organisations generally operate separate legal entities established within the EU that are subject to local supervision. As a result, the ability of these entities to undertake business is not expected to be compromised.

Given insurers’ role as major investors in capital markets, the more significant impact on sector

Pure Play UK: Direct Line, Esure, Legal & General, Liverpool Victoria, Pensions Insurance Corporation, Royal London, Rothsay

Mainly UK based, trading in EU without passporting: Admiral, Aviva, RSA

Mainly UK based, trading in EU with passporting: Society of Lloyd’s, Beazley, Catlin, Hiscox, Novae, Standard Life

Mainly EU based, trading in UK without passporting: Aegon, Ageas, Allianz, Axa

UK based, mainly trading ex-Europe: Old Mutual, Prudential PLC fundamentals from the UK's decision to leave the EU relates to market risk generated by rates, FX, credit spreads, equity moves, wider market volatility and the potential for rating migration in the medium term, in our view.

Despite this somewhat uncertain macroeconomic backdrop, we continue to believe that insurance sector fundamentals are generally robust. Insurer balance sheets are strong in our view, having benefited from substantial post financial crisis and pre-Solvency II strengthening. Indeed, notable prior action taken by insurers has included conservative policyholder and shareholder distributions, financial debt deleveraging, disposal of non-core operations and an ongoing cautious approach to investment. We would not rule out further balance sheet consolidation in the coming months if investment markets remain volatile.

In addition, we would also highlight:

- The insurance sector has a demonstrable track record of navigating more extreme periods of market volatility than that currently being experienced (including the financial, peripheral European sovereign crises). Furthermore, at the time of writing, the tools available to central banks today that were not in place during previous crises appear to have somewhat helped calm markets.

- Insurance company assets remain mainly invested in diverse fixed income portfolios (which make up approximately 80% of invested assets, compared to equities at only c. 5%).

- Fixed income portfolios remain focused on investment grade securities (only c. 3% of assets are explicitly invested in sub investment grade securities, with c. 4% in unrated assets). Furthermore, regulatory regimes such as Solvency II reinforce this.

- The sector actively seeks to mitigate market risk, for example through substantial hedging activities.

- Some insurers are expecting a tailwind to reported earnings given recent FX moves, especially the weakening of sterling against the US dollar.

In our view, market moves witnessed in recent weeks are likely to reveal themselves in solvency ratios announced as part of the 2Q16 reporting season later in the year. However, an analysis of 20 large European insurers indicates to us that whilst headline ratios are likely to be impacted, predominantly by negative moves in rates and equity markets, the decline should be manageable. Indeed, this is a direct result of strong starting Solvency II positions for the majority of these corporates (with ratios of c. 185% on average), the use of market risk management tools and mitigation measures embedded within the Solvency II regime itself.

We expect the median decline of headline Solvency II ratios during 2Q16 to be c. 10 points across our sample of European insurers. In our view, this would be a decent performance, supporting our belief that the sector is robustly capitalised and still offers attractive investment opportunities.

Looking ahead to the second half of the year, the three key fundamental drivers we are closely monitoring in relation to portfolio positioning are as follows:

First, the need for insurers to be able to demonstrate that they can withstand even lower interest rates for even longer. As mentioned above, the shift lower of swap curves in recent weeks will, in our view, be a major driver for the reporting of reduced Solvency II ratios across the sector in the coming months. We expect low interest rate resilience to remain a key area of investor debate for the sector during the remainder of 2016 and beyond, supported by the ongoing consultation around the 'Ultimate Forward Rate' ('UFR'; a key component in the valuation of technical liabilities within the Solvency II framework), plus the forthcoming EIOPA European insurer stress test.

Second, heightened investor interest in the 'quality', not just 'quantity', of Solvency II ratios. Twelve Capital believes there is a wide divergence around how the Solvency II regime is being applied in different member states, with implications for the robustness of insurer Solvency II positions. This is reflected, for example, in higher reliance on transitional arrangements to bolster ratios at some insurers but not others. Quality of ratios also shows itself in the degree to which stated solvency positions rely upon the benefit provided by smoothing mechanisms embedded within the regime, such as the UFR, especially given the current interest rate environment.

Third, the implications for the risk premium attached to other asset classes in the wake of the UK referendum, with implications for insurers as institutional investors. As an example here, we would highlight the heightened levels of volatility in peripheral European banks, plus commercial property in recent weeks.

Insurance Bonds

The start of 2016 was dominated by significant market volatility. This was primarily driven by concerns over global growth, manifesting itself in steep commodity price falls and worries over the financial condition of energy and mining corporates as well as banks, which caused a significant sell-off across global markets. Insurance Bonds were not immune to this negative sentiment and prices gapped as they were marked-to-market at that time.

Such market dislocation provided an opportunity to buy Insurance Bonds at good entry levels, given that concerns about the health of the sector were misplaced in our view. The sell-off was short lived and the sector performed well alongside the broader market rally, driven in part by the ECB's announcement in March that it planned to undertake a series of measures in an attempt to counter lacklustre Eurozone growth. Most notably within this announcement, the ECB highlighted that it planned to expand the organisation's bond buying programme to include corporate bonds and senior Insurance Bonds (more specifically, investment grade Euro-denominated bonds issued by non-bank corporations).

The insurance sector remains one of the most compelling sectors from a spread perspective within the European iBoxx IG index. Indeed, the spread differential between Insurance Subordinated and Bank Subordinated, for instance, is approximately 165bps (as illustrated in Table 1), which translates into an average yield of between 4.5% and 6%. In addition, the sector has, in our view, successfully transitioned into the new Solvency II regulatory regime at the start of 2016, demonstrating highly robust capital ratios and, more importantly, supporting our long term view that insurance companies are well capitalised with strong balance sheets and strong underlying fundamentals. We believe that the sell off at the start of 2016 illustrated how detached spread levels had become from fundamentals and therefore offered investors a significant risk return premia.

The challenge of market volatility and low yields, together with the successful transition into a new regulatory regime in Europe, all point towards a sector that is well versed in the need for good capital management. In our view, this bodes well for investors in the insurance sector, given that they are likely to be able to rely on the delivery of sustainable, attractive returns in the second half of the year. In addition, year to date issuance for the sector stands at just under EUR 14bn, across both senior and subordinated debt.

Table 1: Sector spreads

Spread (June 2016)	
iBoxx EUR IG	104.0
Autos	103.7
Bank Senior	69.7
Bank Subordinated	205.7
Building Materials	65.6
Capital Goods	45.8
Chemicals	99.5
Consumer Products	69.0
General Industrials	83.1
Healthcare	57.4
Insurance Senior	73.7
Insurance Subordinated	370.7
Media	113.5
Metals & Mining	192.2
Oil & Gas	115.7
Retail	64.6
Services	97.6
Technology	52.0
Telecoms	107.3
Transport	67.2
Utilities	106.3

Source: J.P. Morgan, Markit, Bloomberg.

Elsewhere, and as expected, European insurers' strong track record of redeeming bonds at the first call date continued into 2016, with all institutionally placed bonds being called as anticipated (see Table 2).

For Insurance Bonds, we believe both technicals and fundamentals remain highly supportive for the second half of the year. Firstly, the insatiable 'hunt for yield' has only been amplified since the news of the UK's decision to leave the EU, with the vast majority of government debt yielding less than or close to zero. However, it is highly probable that central banks will keep rates lower for longer and, in the case of the UK, the Bank of England is already indicating a strong possibility of an interest rate cut in 2016. In the US, the Fed is unlikely to move rates this year. Secondly, with the ECB's bond buying programme in full swing, this clearly results in a significant amount of price support for credit markets for the remainder of the year.

Table 2: Called bonds of European Insurers

Issuer	Bond	Market Placed	First Call Date	Called
Wuerttembergische	€5.375% 26NC16	Institutional	06.01.2016	Yes
VHV	€5.375% PNC16	Institutional	09.02.2016	Yes
Kommunal Lands.	€5.25% PNC16	Institutional	11.04.2016	Yes
Phoenix Group	£6.5864% PNC16	Institutional	25.04.2016	Yes
Swiss Re	€5.252% PNC16	Institutional	25.05.2016	Yes
Swiss Re	$6.854% PNC16	Institutional	25.05.2016	Yes
Zurich Insurance	CHF 4.25% PNC16	Institutional	26.05.2016	Yes
Ass. Generali	£6.214% PNC16	Institutional	16.06.2016	Yes
Ass. Generali	€5.317% PNC16	Institutional	16.06.2016	Yes
Prudential Plc	$7.75% PNC16	Retail	23.06.2016	No
AXA	€5.777% PNC16	Institutional	06.07.2016	Yes
AXA	£6.6666% PNC16	Institutional	06.07.2016	Yes
SCOR	€6.154% PNC16	Institutional	28.07.2016	Yes

Source: Bloomberg.

Private Debt

Despite the inception of Solvency II on 01 January, deal flow during the first half of the year for insurance Private Debt has been muted, most likely a result of the aforementioned volatility across financial markets.

Having said this, Twelve Capital was able to source and close two transactions in 1H16, the first of which was with Adriatic Slovenica, the third largest Slovenian insurer with Gross Written Premium of EUR 298m in 2015. With a market share of 16.8%, the firm has a large and defendable position in a mature and healthy European insurance market. The EUR 50m Tier 2 subordinated debt instrument was issued to improve the firm’s solvency position. The transaction is a 10 year bullet structure, with a first call option after 5 years, and the coupon pays 7.8% on a floating basis. The second transaction was with a US based company underwriting workers’ compensation and general liability insurance for SMEs in the country.

Both of these transactions are a testament to Twelve Capital’s ability to source, analyse and execute attractive transactions for portfolios managed by the firm. Performance generated by Private Debt during the first half of the year was solid.

While insurance companies are clearly exposed to financial markets, the balance sheets of these corporates are built to withstand much worse periods of market dislocation than the current UK referendum-induced volatility being observed at this time.

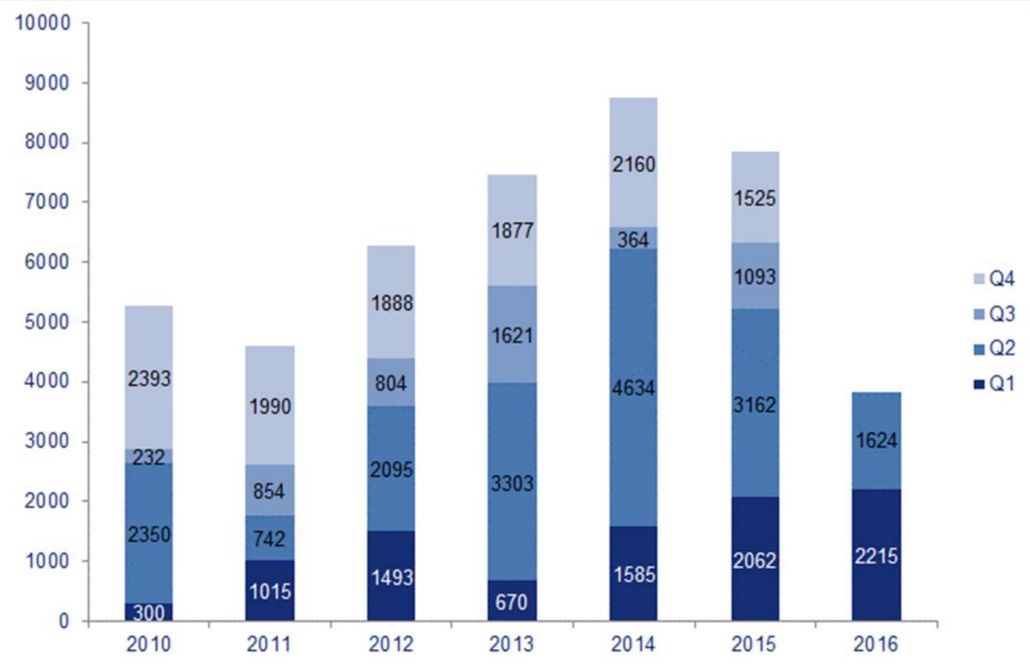
Looking ahead to the second half of the year, our pipeline for insurance Private Debt transactions looks healthy and the case for supporting smaller balance sheets of insurance companies with this type of financing is differentiated in our view. Capital management is high on the agenda for many of these corporates and Twelve Capital is well placed to assist small to medium sized insurance companies as they look to move forward with such transactions.

Catastrophe Bonds

During the first half of 2016, Cat Bonds continued to demonstrate their credentials as providing genuine diversification benefits to investor portfolios as well as strong return potential on a risk-adjusted basis. While conventional financial markets experienced high levels of volatility and, in some instances, negative performance, the overall Catastrophe Bond space continued to perform positively, even with the occurrence of a number of natural catastrophes over the period.

Two Cat Bonds were impaired during the first six months of 2016, the first of which was MultiCat C. The default of this Cat Bond came to a conclusion in February, with the Mexican government receiving USD 50m out of a possible USD 100m available as a result of hurricane Patricia in October 2015 (i.e. a 50 cent on the dollar loss to investors). Furthermore, significant losses were experienced by the (re)insurance industry in the US due to severe convective storms during the first half of the year, amounting to c. USD 11bn according to Aon Benfield. Cat Bond Gator became distressed as a result and is now priced at 80 cents on the dollar. Twelve Capital avoided investing in

Figure 1: Cat Bonds and ILS Issuance



Source: Twelve Capital, Aon Benfield Securities, Inc., Artemis (Q2 2016 Catastrophe Bond & ILS Market Report).

both aforementioned securities due to proprietary analytical considerations.

In terms of growth and issuance activity, the first quarter of the year showed record levels of primary market activity, whereas the second quarter offered a more muted pipeline of Cat Bond transactions (see Figure 1). Having said this, several new sponsors came to the market (including Floridian P&C insurance carriers) whilst the Cat Bond opportunity set continued to broaden with respect to geographical scope and peril categories (including Japanese typhoons, European winter-storms and US hurricanes). Moreover, the sub-asset class of Private Catastrophe Bonds continued to expand, with Twelve Capital launching two of its own “Dodeka” Private Cat Bonds, one of which features a second event mechanism, a trigger unavailable in the open Cat Bond market.

Historically, spreads in the Cat Bond market have widened around this time of the year, given the inception of the hurricane season in the Atlantic basin. Similarly, issuance activity in Q3 is likely to be limited, as is normally the case for Cat Bonds, most likely picking up again in the last quarter of the year. Despite some pressure on margins caused by high levels of investor demand, Cat Bond pricing dynamics should continue to be relatively stable in the near term, provided no shocks, such as natural catastrophes, impact the market.

Private ILS

Private ILS continues to gain acceptance as an asset class from both an investor and protection buyer perspective. As a result, penetration into the traditional reinsurance space has been accelerating for some time now and, in our view, ILS can be regarded as the new incumbent.

At the time of writing, the mid-year renewal season is still ongoing, with large volumes of US capacity being deployed in the market. During the 01 January renewals, a few market participants referred to reduced premium erosion. However, at the mid-year point, there were more voices confirming this trend. From Twelve Capital’s point of view, a more detailed analysis has revealed that retrocession contracts (offering worldwide exposure) have remained broadly at the risk adjusted levels observed about half a year ago. We see less buyer dominance in the market and note that our (higher) quotes are considered, and often picked up, to close a deal.

With regard to potential premium erosion, declines are generally focused on natural perils, mostly in US lines and mainly due to the inherent modelling quality in this area of the market versus other lines of business. Ultimately, this means that diversifiers continue to offer attractive risk adjusted yields, and these transactions make up a notable part of many of our Private ILS mandates.

Although financial markets are focused at this time on the UK's decision to leave the European Union, the Private ILS market is unlikely to be significantly affected by the vote, except in the sense that investors are likely to continue to focus on the asset class as providing attractive uncorrelated returns at this point in the cycle.

The ILS space continues to develop and over the second half of the year we would expect investors to continue to become ever closer to the risks being underwritten. This may be achieved through direct participation in syndicate balance sheets or through special purpose arrangements with underwriting syndicates. We also believe investors will seek access to longer tailed lines of business. Indeed, these trends are testament to the will and need of the industry to continue to innovate, and we believe investors will benefit from such innovation.

During the second quarter of 2016, there have been some losses in the market, particularly due to the earthquake in Kumamoto/Japan, wildfires in Canada and the hailstorms in Texas. All of these events have caused Cat Bond funds to outperform ILS funds with private content. However, Twelve Capital's commingled portfolios have only been marginally affected by these events.

Looking beyond 2016, we anticipate that the London market could become more active in the ILS space going forward, offering its financial halo as a hub for collateralised reinsurance businesses. Additional competition can only be good for investors in our view.

Insurance Equity

Global Insurance Equities had a tough start to 2016, underperforming the wider market and partially eroding some of the material outperformance the asset class had seen over the past four years. Again, macroeconomic issues have been the dominant factors driving markets and have resulted in elevated levels of volatility throughout the first half of the year.

The period commenced with the initial implementation of Solvency II, before concern around growth rates in China and commodity price declines then became key areas of focus for investors. The first half of the year concluded, as previously mentioned, with the UK's referendum on EU membership.

Over this period, the MSCI World Insurance Equity Index[1] was one of the weaker performing sectors, depreciating by 8.7% vs. the MSCI World Equity Index[2], which finished the period almost flat. From a regional perspective, Europe has been the significant laggard, with higher beta names the underperformers.

During this period of volatility our funds were well positioned given i). sizeable cash balances available for investment at lower prices in the immediate aftermath of the UK referendum result; ii). a greater exposure to defensive names, i.e. greater exposure to non-life vs. life insurers, defensive asset exposures, etc.; iii). a large proportion of UK/European exposed names that have either material foreign exchange benefits (given sizeable assets/earnings held/generated in non-European countries), or are in fact pure play UK domestic businesses that are not impacted by potentially changing legal arrangements with the EU.

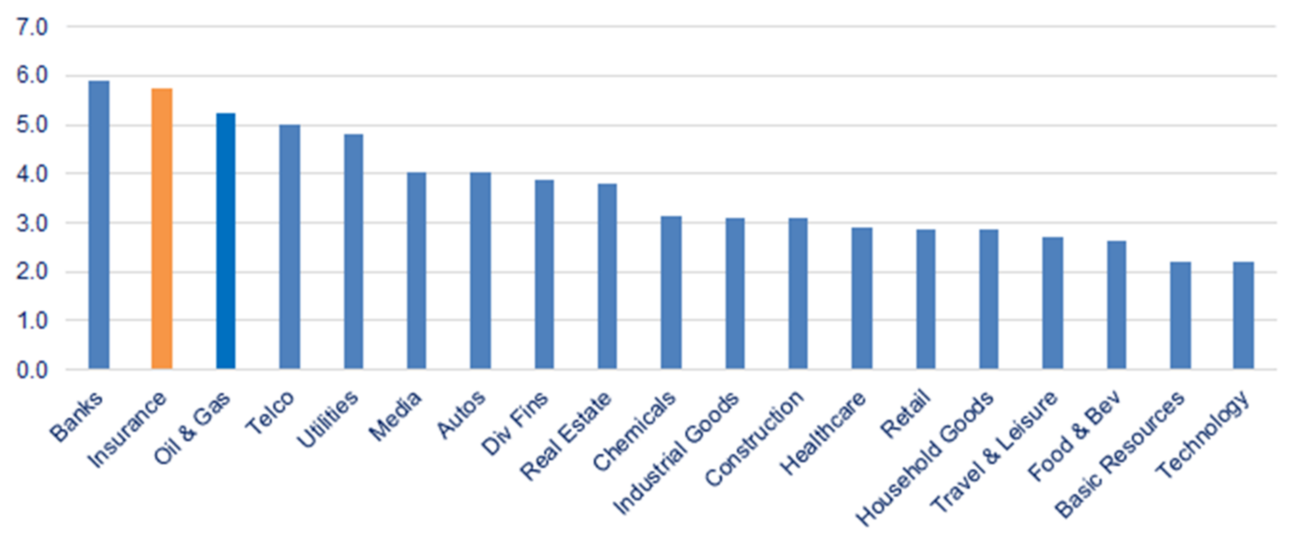
Insurers transitioned to the new Solvency II regulatory regime relatively smoothly, with minimal impact observed for the vast majority of insurance stocks. However, there were notable exceptions where share prices materially underperformed, due to either lower than expected Solvency II ratios being published (leading to questions over dividend sustainability), or greater sensitivities being disclosed.

In contrast, the outcome of the UK referendum has had major reverberations across global markets. The most significant of which, for insurers, is that interest rates are now not just likely to be 'lower for longer' but, rather, 'even lower, for even longer'. The initial read-through for insurers is on capital positions, together with sustainability of business models. However, once the dust has settled, we expect European investor focus to switch back to those names that have attractive dividend yields and 'self-help' stories. Another theme we expect to continue is M&A proliferation, exacerbated by recent foreign exchange moves that make UK assets, in particular, cheaper and therefore more attractive to overseas acquirers.

It is expected that high dividend yielding stocks, together with those that can positively surprise, will continue to be viewed as relative safe havens by investors in Europe. This is exaggerated by a number of names increasingly being seen as bond proxies. At the time of writing, the space carries the

[1] The MSCI World Insurance Equity Index is an Index focused at measuring the equity performance of the c.80 largest listed global insurance companies weighted by free-float of market capitalisation.
[2] The MSCI World Equity Index is a broad global equity benchmark that represents large and mid-cap equity performance across 23 developed markets countries. It covers approximately 85% of the free float-adjusted market capitalization in each country and does not offer exposure to emerging markets.

Figure 2: Euro Stoxx 600 Dividend yield by sector (%)



Source: Bloomberg as at 30 June 2016.

second highest yield across all sectors, at 5.75%, compared to the market at 3.5% (see Figure 2). Only the Bank sector carries a yield in excess of Insurance, and we would argue that there are greater risks associated with Bank dividends than those of Insurers, especially in light of recent macroeconomic events. We are confident around the dividend yield of the insurance sector, given robust balance sheets and relatively stable earnings expectations for the majority of names in the space.

There has been a plethora of M&A in the insurance sector in recent years which is expected to continue. Conditions that remain supportive for further consolidation include; i). subdued organic growth opportunities; ii). the increasing importance of scale; and, iii). availability of cheap financing. As noted, recent foreign exchange moves may also act as a further catalyst for this trend. Typical M&A premiums for the insurance sector have historically been in the 25-40% range.

More recently, there has been the emergence of some relatively minor reserving concerns for the sector. While some appear to have been company specific issues, there are a number of lines of business that appear to be under increasing pressure on an industry basis and we will continue to monitor this over the second half of the year. Reserve releases have heavily supported reported earnings across many companies in recent years. Any material slowdown/emergence of shortfalls will likely lead to a spike in cost of equity assumptions leading to a sharp share price fall. An investment strategy focused on the most robust balance sheets should help to alleviate this risk.

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About Twelve Capital

Twelve Capital is an independent investment manager specialising in insurance investments for institutional clients. Its investment expertise covers the entire balance sheet, including Insurance Bonds, Insurance Private Debt, Catastrophe Bonds, Private Insurance-Linked Securities and Insurance Equity. It also composes portfolios of its Best Ideas. Its capital solutions are drawing the world of insurance and reinsurance into a closer, more productive relationship with capital markets. It was founded in October 2010 as a partnership and is majority-owned by its employees. It has offices in Zurich and London.