January 2016

Twelve Capital Perspectives — 1H Outlook

Executive Summary

- Extensive post financial crisis and pre-Solvency II balance sheet strengthening indicates insurers are fundamentally well placed to navigate current volatile markets. We see most large to medium sized insurers confirming a comfortable transition into Solvency II, the key fundamental event in 2016 for European based names, with numerous factors suggesting they will manage their capital bases sensibly throughout the year in order to deliver sustainable, attractive returns across both credit and equity asset classes.

- Across Liquid Debt, the macro driven pullback has revealed some compelling investment opportunities. In our view, when combined with strong sector fundamentals, yields available often in excess of 5% mean the sector trades inexpensively versus the broader investment grade credit universe. Technicals are also moving in the sector's favour, as investors increasingly overweight their exposure to insurance.

- In European Private Debt, the launch of Solvency II has confirmed the need for smaller insurers to improve their capital positions. In US Private Debt, other factors such as M&A activity are seen as being important drivers for new investment opportunities. Looking at Private Debt as a whole, we believe the general repricing of risk within liquid markets is increasing the attractiveness of our investment pipeline.

- The attractiveness of ILS as a diversifying asset class is being reinforced by current macro volatility. Recent first signs of some risk adjusted pricing stabilisation are also welcome. There appears to be ongoing potential for new categories of risk to be transferred to the capital markets, a trend we can capture via both our Cat Bond and Private ILS offerings. After a benign 2015, more active Atlantic hurricane activity is anticipated this year.

- Multiple catalysts remain for Insurance Equity outperformance in 2016, including an attractive and reliable dividend yield of c. 5% (in the context of sector balance sheet strength), 'self-help' action to improve earnings (led in Europe by Solvency II optimisation) and a continuation of heightened M&A activity (driven by a confluence of factors). Stock selection will remain key however, given factors diverging performance including the low yield environment and reserving strength.

Fundamental Overview

The start of 2016 has brought with it significant investment market volatility. Trade and exchange rate, commodity price, inflation and monetary policy expectations plus general market confidence have all been impacted. Nonetheless, we believe the insurers within our investible universe are well placed to navigate this difficult start to the year given extensive post financial crisis and pre-Solvency II balance sheet strengthening.

The prospect of 'lower for (even) longer' interest rates flowing from macro led market weakness is the most relevant ripple effect for Twelve Capital. Even before recent market volatility, the impact of low yields on insurers was anticipated to be a key debate for 2016, given the level of regulatory focus the subject is likely to get throughout the year.

Europe's insurers will have to navigate two 'low yield' related regulatory events over the next twelve months. The first is an EU-wide insurer stress test, the scope of which will focus on the prolonged low yield environment plus a 'double hit' scenario (i.e. a risk premia increase whilst risk free rates remain low). The output of the stress test is designed to provide insight to regulators in relation to appropriate mitigation measures and possible areas for further investigation.

The second event is a planned consultation on the 'Ultimate Forward Rate', a key component of the discount curve used to value technical liabilities under Solvency II.

Overall, given its track record, we have confidence in the insurance sector's ability to actively manage and mitigate the impact of low yields, for example through adjustments to products sold, asset duration and prudent investment re-risking.

Away from these macro considerations, in our view the major event for the start of 2016 has been the launch of Solvency II, the sector's new EU-wide regulatory regime. Twelve Capital believes that Solvency II provides investors with a more attractive investment opportunity, i.e. a sector that is capitalised to a higher standard and one that has a much stronger understanding of and manages better the risks it faces.

In the coming months we expect to see an increasing number of insurance groups providing investors with clarity over their Solvency II capital position. Given their extensive preparatory work over several years, including balance sheet optimisation and conservative capital management, it is believed that the vast majority of large to medium sized insurers will comfortably manage the transition to Solvency II by demonstrating robust capital ratios.

Nonetheless, some will have to work harder at improving their capital positions. It is also quite possible that Solvency II transitions and associated reporting may alter market perceptions around the relative financial strength between individual groups, with implications for bond and equity relative value and pricing.

Solvency II's launch is not perceived as the end point of the sector's capital optimisation journey. As a result, further related 2016 newsflow around transitions between standard formula and internal model approaches, plus ongoing asset and underwriting portfolio adjustments is expected. Solvency II remains a key driver behind an anticipated continuation of the current active phase of sector M&A, a topic discussed in greater detail later on in this report.

Market volatility, low yields, upcoming stress tests, the need to bed down a new regulatory regime and a possible EU membership referendum in the UK all point towards a sector acting sensibly in relation to capital management. In our view, this bodes well for insurance credit and equity investors given that they are likely to be able to rely on the delivery of sustainable, attractive returns from both asset classes in the year ahead.

Lastly, and looking ahead to the 2016 hurricane season, we are currently experiencing the strongest El Niño for several decades. This can partly explain the weak Atlantic and strong (both east and west) Pacific hurricane activity seen during 2015. As a strong El Niño is usually not immediately followed by another, it is likely that the 2016 Atlantic hurricane season will be more active. However, we would highlight that higher forecasts of hurricane formation do not necessarily correlate with the number of hurricanes making landfall or the quantum of insured losses experienced. By way of example, it is interesting to note that in 2010 no hurricane made landfall in the US, despite above average activity in the Atlantic.

Other impacts of El Niño are reduced rainfall in Australasia (so higher drought risk) and increased rainfall along the US and South American west coast (so increased flood risk in California and parts of western South America). These are both events that produce economic losses but are unlikely to cause losses to Cat Bonds or reinsurance programs. As the El Niño weakens, we would expect these impacts to reduce later in 2016.

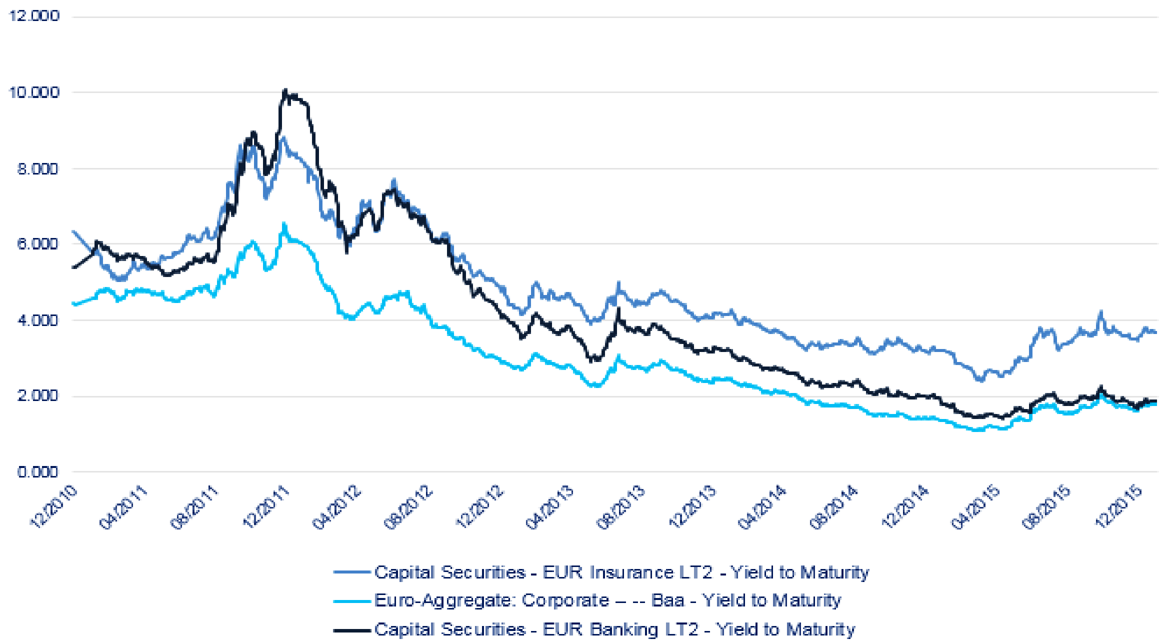
Insurance Bonds

The last twelve months have been volatile for financial markets, with headwinds ranging from volatility in rates and a potential Greek exit from the Euro, to uncertainty around China and commodity price fluctuations. As 2016 begins, volatility across markets remains heightened, with China's macroeconomic travails and price declines in the commodities space continuing to be of concern. Key risks identified during the year include the forthcoming US elections in November, a UK referendum around its European Union membership and geopolitical risk from across the Middle East. Having said this, we believe our investment process is well positioned to navigate such volatility and aims to exploit any windows of opportunity that appear throughout the year.

In our opinion, Insurance Bonds are one of the most attractive sectors within the overall credit universe and both fundamentals and technicals are likely to be supportive throughout 2016. The sector offers potential yields in excess of 5%, trading inexpensively relative to other equivalently rated BBB securities within the credit universe. In our view, this makes the asset class compelling to those investors who are seeking a yield enhancing and capital appreciating strategy to add to their overall portfolio mix. In addition, the discount of insurance names compared to bank debt ranges from between 120 to 130bps (see Figure 1), and it is likely that this gap will continue to compress as more investors allocate to the sector.

Technicals also remain supportive for the sector. Firstly, we believe that investors have increased, or plan to increase, their overweight allocations to insurance post the implementation of the new Solvency II regulatory regime in Europe, and this is

Figure 1: European Insurance Bonds offer superior yields to bank and corporate bonds



Source: Barclays Live. As at Q1 2016.

likely to be a positive step in order to further improve the credit quality of the sector over the long term. Secondly, as experienced throughout 2015, insurance M&A is picking up and we see this trend continuing in the near future, another positive factor at play for the Insurance Bonds investment universe.

Total new issuance in the insurance space for 2015 stood at EUR 21.9bn, of which EUR 17.6bn was subordinated debt and EUR 4.3bn was senior insurance debt. This level of new issuance seems likely to continue into 2016, most notably with Solvency II style Tier 2 bonds continuing to be issued, as they are still viewed as a favourable structure for insurers' capital requirements. In addition, as in 2015, we anticipate further new insurance entities to launch inaugural deals coming to the market at a significant discount.

Private Debt

As previously mentioned, during 2015 there was a total volume of EUR 17.6bn of subordinated debt issued by European insurers. Most of that volume stemmed from larger insurers preparing their capital base for the advent of Solvency II on 01 January 2016. Despite this significant deal flow in the liquid debt arena, transaction volume on the insurance Private Debt side was below expectations throughout the year.

The Twelve Insurance Private Debt Fund was re-opened at the beginning of 2015, but closed soon after, as inflows were unable to be matched with a sufficient volume of attractive transactions. There were various reasons for such a paucity of deal flow. The most important centered around uncertainties concerning the operational implementation of Solvency II, which caused smaller insurers to remain unaware of their final Solvency Capital Ratio (SCR) until Q3 of last year. Many insurers were hesitant to commit to a first time debt placement for the next 10 years before speaking to their regulators. In turn, regulators were themselves focusing efforts on the larger insurers that required approval for their more complex internal capital adequacy models.

Spread widening in the liquid debt space during Q2 and Q3 impacted performance for the Private Debt Fund in both June and August, causing YTD performance of the fund to be below target. However, this spread widening had a positive effect on the pricing of new Private Debt transactions, which will ultimately result in better performance for the years ahead.

Looking forward, we expect Solvency II to remain a catalyst for insurance Private Debt in Europe. Furthermore, M&A activity, organic growth and strategic investments or divestments are likely to result in deal flow from insurers in both the US as well as Europe. A reputation in the market for being able to transact quickly has helped to attract deal flow during 2015 however we continue to remain disciplined, following our investment process and ensuring that only the most attractive transactions are bound.

Figure 2: Private Debt transactions closed in 2015

Q	Country / Segment	Spread	Closing Date	Maturity	Size
Q1	Bermudian Reinsurer	7% Fix	02/2015	10 years	USD 115m
Q3	Italian Composite Insurer	6% Fix	07/2015	10 years bullet	EUR 60m
	US Property Insurer	10% + 3 Months Libor	07/2015	7 years amo.	USD 10m
	Dutch Composite Insurer	7.25% Fix	09/2015	10 years bullet	EUR 50m
	UK Motor Insurer	>6.75% Fix (trade price was 95.5 leading to a 7.42% yield	08/2015	9 years	GBP 125m
Q4	US Property Insurer	8% + 3 Months Libor	10/2015	10 years bullet	USD 8.5m
	Italian Life Insurer	6% Fix	12/2015	10 years	EUR 40.0m
	Italian Credit Insurer	5.7% Fix	12/2015	10 years	EUR 14.5m

Source: Twelve Capital. As at Q1 2016.

Catastrophe Bonds

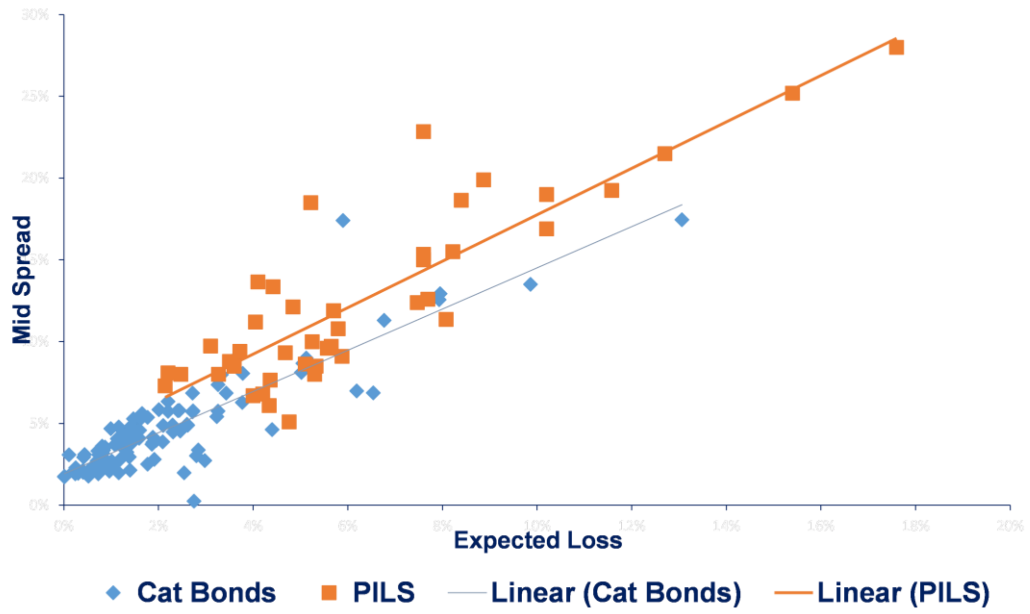
During the latter half of 2015, Catastrophe Bonds once again demonstrated their efficiency as an asset class in mitigating mainstream financial risks whilst also offering attractive risk premiums to investors. Specifically, the high levels of volatility which characterised the broader financial markets throughout the year had very little impact on the performance of the Cat Bond space.

Furthermore, August and September, a very volatile period for the majority of conventional asset classes, were actually some of the most profitable months for Twelve Capital's Cat Bond products, given the usual levels of seasonal cyclicality experienced during this time. In terms of impairments during the second half of the year, we avoided buying MultiCat C, a bond which is likely to trigger due to hurricane Patricia making landfall on the Pacific coast of Mexico in October. The bond is currently priced at c. 25 cents on the dollar. The firm's zero Cat Bond Lite transaction Dodeka V also successfully matured during December.

Intensive discussions with the market suggest that the first half of 2016 is likely to continue to be an active period for new Cat Bond issuances. A large portion of outstanding Cat Bonds consists of issuances that are maturing over the coming months, and it is envisaged that this maturing volume will be offset by renewals and sponsorship of Cat Bonds by new cedants. The introduction of additional perils and trigger frameworks to the Cat Bond space observed during 2015, is likely to continue and become more pronounced over the next six months, resulting in innovative new structures benefitting both cedants' risk-transfer requirements and investors alike in our view. As well as this, the sub-class of Private Cat Bonds is anticipated to continue growing, with many cedants feeling comfortable transferring risk via these structures and investors receiving improved levels of diversification and enhanced returns from previously inaccessible risks.

In terms of pricing development, it appears that prices stabilised during the course of 2015 compared to the previous two years, and we believe that no material change will take place during the first half of 2016. More precisely, we forecast that spreads at issuance for diversifying perils and remotely attaching Cat Bonds with a yield range of 2.0-3.5% have reached their lows from a risk-adjusted pricing perspective and that spreads are likely to improve for new issuances in 2016. For bonds offering a coupon at issuance in the mid-single digits, pricing is likely to be closer to current trends. High yielders may experience certain pricing pressures due to demand considerations. For bonds exposed to US hurricane risks, it is anticipated that the standard spread widening paradigm will take place once we approach the Atlantic hurricane season.

Figure 3: Yield comparison Private ILS versus Cat Bonds



Source: Twelve Capital. As at Q4 2015.

Private ILS

The ILS sector, as the securitised part of the much larger traditional reinsurance industry, is known for its cyclicality around risk adjusted returns. Within the alternative investment universe, the ILS asset class has experienced a strong degree of interest over the last few years, particularly due to its intrinsic diversification potential compared to other asset classes. This investment demand has remained but shown some signs of stagnation, whilst supply levels continue to be strong.

The recent, and important, 01 January renewals are testament to this fact, as less premium pressure was observed than the market had perhaps anticipated (in line with views expressed in last July's Twelve Perspectives 2H15 Outlook). The wider market, on the one hand, reports price reductions in the low- to mid-single digits whilst Twelve Capital's portfolios, on the other hand, actually show a slight improvement of premium compared with positions that are maturing in Q1 and Q2 2016. As a result of this, we believe that there is a turnaround in the cycle at this time.

The firm's portfolios continue to show attractive risk adjusted returns, supported by firmer conditions in property and catastrophe lines compared to mid-year 2015 contracts. Although it does remain more difficult to source transactions in the aviation and crop space, the firm is positioned with broadly diversified books, reflected by various lines of business, a high number of positions and both long and short layers.

For many institutional investors, the underlying illiquidity of 12 month risk periods is not a concern when they are compensated by the collection of attractive premiums during this relatively short timeframe. At the time of the January 2016 renewals, Twelve Capital's investors generated an illiquidity premium of around 1.2% compared to the total universe of Catastrophe Bonds, as per figure 3 above.

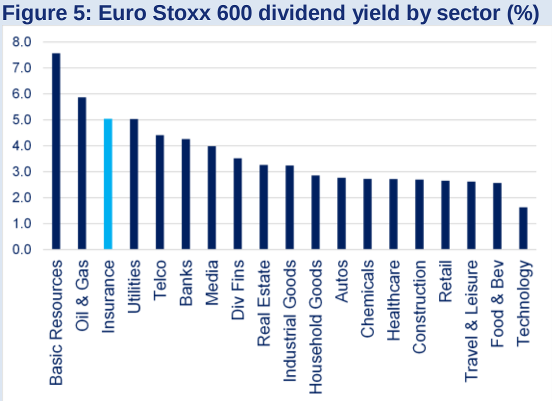
Insurance Equity

During 2015, the Global insurance sector outperformed the wider market index for the third time in the last four years, taking the level of outperformance over the period to close to 30% (see Figure 4). It was another year of volatility, the MSCI World Insurance Equity Index managed to tick marginally up YoY (+1%) vs. the MSCI World Equity Index depreciating by 2.5%, with the majority of outperformance occurring in the final quarter. The seasonal nature of a sizeable segment of the market was a major contributor to this late outperformance in our view, as another benign year for catastrophe and weather events boosted expectations for earnings and the potential for further capital returns to shareholders. From a regional perspective, Europe led the way for insurance, appreciating by 15% during the year. While macro trends exacerbated the volatility, Solvency II transitioning, M&A and management changes also influenced individual share price performance.

The key themes that we expect to drive equity performance in 2016 include; i). Continued low interest rates in Europe focusing investor attention on insurance names with attractive dividends and those with ‘self-help’ stories; ii). US interest rates picking-up, potentially leading to outperformance of insurers based in the region; iii). M&A proliferation continuing; and, iv). Reserving concerns potentially distending.

Figure 4: Insurance sector has materially outperformed

Figure 5: Euro Stoxx 600 dividend yield by sector (%)



Source: Bloomberg & Twelve Capital.

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 being increasingly seen as bond proxies. The sector carries one of the highest yields across all sectors at c. 5.0%, compared to the market at 3.6% (see Figure 5). Some of those sectors that carry higher yields than insurance are heavily exposed to commodity prices. As a result, these names have experienced material price declines in recent months, thus reducing the robustness and validity of their respective yields in our view. 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 was a plethora of M&A in the insurance sector in 2015 which is expected to continue. Conditions that remain supportive for further consolidation include; i). Subdued organic growth opportunities; ii). Increasing importance of scale; and, iii). Cheap financing. Typical M&A premiums have been in the 25-40% range.

In 2015 there was also 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. 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.

Investment Conclusions

Balance sheet strength, reflecting extensive post financial crisis and pre-Solvency II action, provides comfort over the insurance sector’s ability to withstand the current bout of macro uncertainty and market volatility.

In liquid debt, yields often above 5% mean, for us, that the sector clearly trades inexpensively versus the broader investment grade credit universe. Widening in liquid debt is expected to filter through to the private space, improving the return potential of the investment opportunities there.

Current macro volatility is only reinforcing the attractiveness of ILS as a diversifying asset class, first signs of some risk adjusted pricing stabilisation being also welcome.

Stock selection will remain crucial for insurance equity outperformance, with the winners in 2016 likely to include insurers demonstrating reliable and attractive dividends, delivering on self-help to improve earnings, plus insurers caught up in sector consolidation.

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