

Desperately seeking true diversification

Given the increasing frequency of volatility events, Jonathan May believes institutional investors need to seek out strategies that aim to offer consistent diversification and the capability to preserve capital

In recent years, markets have experienced a significant increase in volatility events during which traditionally diversified asset classes have exhibited high levels of correlation. At Pioneer Investments, we believe investors should consider incorporating lowly correlated investments strategies into their portfolios.

Insurance-linked securities

One such strategy is Insurance-Linked Securities (ILS). These are investments whose performance depends upon the occurrence of low-frequency, high-severity natural disasters – such as hurricanes and earthquakes. These events, though statistically unlikely, have historically been expensive to reinsurance companies when they do occur. ILS provides a way for reinsurance companies to transfer a portion of their risk and premiums to the capital markets and in return ILS investors benefit from a periodic coupon payment related to the insurance premiums and principal repayment at the end of the investment term, assuming the triggering events do not occur.

One of the most appealing aspects of ILS is its potential diversification properties. By definition, performance is driven by random meteorological or geophysical events, rather than being determined by economic factors such as GDP growth, interest rates

or corporate profitability. This key distinguishing feature has resulted in very low correlation to other asset classes historically.

Moreover, from a risk-return perspective, ILS can offer higher coupon payments relative to comparably rated corporate bonds. As such, investors may expect relatively high annual returns potentially, although given the randomness and severity of natural disasters, investors should also expect some years of sizeable losses and therefore we believe it is important to maintain a long-term horizon when committing to this asset class.

There are four common types of ILS format – Catastrophe (CAT) Bonds; Industry Loss Warranties (ILWs); Collateralised Reinsurance and Quota Share (also known as reinsurance sidecars). Each of these formats has its distinguishing features, however, so it is important to note that there can also be overlapping characteristics across the formats.

Consider an actively-managed approach

Given the complexity and specialised nature of ILS, we would suggest that institutional investors consider an actively-managed ILS approach. Pioneer Investments has been investing in this asset class since 2007 and has seen the market structure and investor base

evolve significantly over this time. This experience enhances our ability to evaluate and negotiate deal structures, as well as access higher quality investments.

Our actively-managed strategy seeks to reduce adverse security selection through a comprehensive, research-intensive process that can add value over a purely passive, long-term approach. The portfolio construction process seeks to take advantage of the differing characteristics of the various ILS structures by balancing the trade-offs of liquidity, risk layering and diversification.

Our primary risk management focus is to protect investors from permanent impairment of capital and downside risk. However, our approach also attempts to reduce risk by diversifying the types of hazards and the geographic exposures of the portfolio's investments.

Access through multi-asset credit

We believe including ILS within a broader asset allocation can have powerful diversification benefits and total return potential for institutional investors, although it is important to maintain long-term time horizons when committing capital to this asset class. An alternative route to accessing ILS can be achieved through multi-asset credit, where ILS is just one of a wide range of opportunities available within the credit universe. Pioneer Investments' Credit Opportunities and Dynamic Credit strategies are actively managed and the flexible approach is designed with the aim to transform market challenges into investment opportunities.

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