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# Insurance-Linked Securities: Catastrophe Risk as a Diversifying Return Stream

## A Return Driver Largely Independent of the Economic Cycle

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## EXECUTIVE SUMMARY:

The diversifying leg of the traditional portfolio depends on stocks and bonds moving in opposite directions — an assumption that has broken down in periods when inflation is elevated and correlations turn positive. Catastrophe bonds offer a return stream whose principal driver is a natural-catastrophe loss event, a factor with limited structural connection to the credit or equity cycle. Over the roughly two decades since the Swiss Re index began, the exposure has historically delivered equity-like returns with materially lower volatility, including three consecutive years of double-digit performance through 2025 as the reinsurance market repriced.

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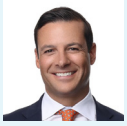

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## INTRODUCTION:

Our work on stock–bond correlation established that the diversification benefit of a 60/40 portfolio is regime-dependent: in sustained inflation above 4%, equities and bonds tend to decline together as correlation turns positive, weakening the hedge when it was most needed. That paper pointed toward exposures whose returns hedge this risk. Insurance-linked securities (ILS) are among the clearer available examples. A catastrophe bond pays a coupon for as long as a defined natural-catastrophe event — a specified hurricane or qualifying loss event, an earthquake of a given magnitude, an industry loss above a threshold — does not occur. Whether a hurricane makes landfall in Florida bears little direct relationship to earnings multiples, credit spreads, or the path of policy rates. That fundamental independence is the basis for the asset's historically low correlation to traditional markets, though realized correlation is not fixed and can behave differently under stress.

## HOW CATASTROPHE BONDS WORK:

A sponsor — an insurer, reinsurer, or public entity — transfers a defined slice of catastrophe risk to capital markets through a special-purpose vehicle. Investors buy floating-rate, principal-at-risk notes; proceeds sit in a collateral account (typically money-market instruments), which substantially reduces conventional sponsor counterparty risk, while leaving investors exposed to collateral, structural and operational risks as well as the insured peril. Because coupons generally comprise a floating money-market reference rate plus a catastrophe-risk spread, income typically resets upward as short rates rise, with limited conventional duration exposure — the opposite of a fixed-coupon bond in a tightening cycle.

Each bond carries an attachment point (the loss level at which the investor begins to lose principal) and an exhaustion point (the level at which principal is fully consumed); impairment is often partial rather than binary. Trigger design determines how closely the bond's payout matches the sponsor's actual losses. Indemnity triggers generally produce the lowest basis risk for the sponsor but settle more slowly; industry-loss and parametric triggers are more transparent and can settle faster, but may leave a larger mismatch between the sponsor's losses and the bond payout. Deals typically run one to five years, most commonly three to four, in sizes from roughly USD 50 million to USD 500 million. The market grew from USD 35.5 billion outstanding at year-end 2022 to USD 43.1 billion at year-end 2023, with record primary issuance of USD 17.7 billion in 2024 taking the outstanding market close to USD 50 billion.

## THE DIVERSIFICATION CASE:

Historical performance supports the diversification case, but the record remains short. The Swiss Re Global Cat Bond Total Return Index — the sector's most widely used benchmark, whose return history extends to 2002 — has recorded only one negative calendar year, 2022, the year Hurricane Ian drove roughly USD 65 billion of insured Florida losses. A record this short, over a period that has not included a sustained clustering of severe insured-loss years, may understate the frequency and depth of drawdowns that a full loss cycle could produce.

| Year | Swiss Re Global Cat Bond TR Index | Context |
|---|---|---|
| 2023 | **+19.69%** | Record annual return; highest since 2002 (prior record 15.43%, 2007) |
| 2024 | **+17.29%** | Second-highest on record; post-Ian price recovery plus elevated spreads |
| 2025 | **+11.40%** | Third consecutive year above 10% — a first in market history; January wildfire drag, benign US hurricane season |
| 2002–2024 | **~6.7% annualized** | ~5% annualized volatility; Sharpe ≈ 1.16 vs. ≈ 0.49 for the S&P 500 over the same window |

*Sources: Swiss Re Cat Bond Performance Indices (annual figures via Swiss Re / Artemis, Jan 2024–Jan 2026); long-run statistics as presented by Morningstar from the Swiss Re Global Cat Bond Total Return Index (Jun 2024). The index is non-investable; realized fund returns have generally been lower.*

Two properties have historically distinguished the exposure. First, realized correlation to equities and credit has been low, because the loss driver is a physical event rather than an economic one — although that correlation can rise when ILS positions are sold to meet redemptions in a broad market drawdown, so the diversification is most reliable outside, not within, acute liquidity events. Second, the floating coupon means income has risen with short rates rather than falling, so the exposure did not suffer the duration damage that hit both stocks and bonds in the 2021–2022 tightening. In combination, a modest ILS sleeve has historically improved portfolio Sharpe ratios at the total-portfolio level; whether it continues to do so depends on pricing, loss experience, and correlations that may not repeat.

## THE TAIL:

The premium is compensation for a genuinely unpleasant risk shape, and understating it would misrepresent the asset. Returns are negatively skewed: the upside in any year is capped at the collateral yield plus the risk spread, while the downside on an individual bond extends to a total loss of principal. Reported Sharpe ratios may be flattering the exposure, because the left tail is fat and under-sampled — two decades is a short record against which to judge a low-frequency, high-severity risk, and the realized period has been comparatively benign.

The loss experience is also concentrated. US wind is the single largest peril in the market because US hurricane and earthquake exposure is the largest risk on the insurance industry's balance sheet, which means a broadly held cat bond portfolio is, in practice, a large bet on Atlantic hurricane and a smaller one on California earthquake. The 2022 mark illustrates the mechanics: on the Friday after Hurricane Ian, the broad index fell about 10% and the US-wind sub-index roughly 32% (Swiss Re Capital Markets, via Artemis, Oct 2022). More recent seasons show the range — Hurricane Milton moved the broad index only about 1.34% in 2024, while Hurricane Melissa triggered a full payout on Jamaica's World Bank-supported parametric catastrophe bond in October 2025, and California wildfires produced a negative January. Layered on top is model risk: expected-loss figures depend on catastrophe models whose calibration to a changing climate and to rising exposure values in coastal, high-population areas is an assumption rather than a measurement and may understate the tail. An allocation sized as though the low-loss years are the base case, rather than as premium collected for underwriting the bad one, would be mis-sized.

## CONCLUSION:

When the correlation between stocks and bonds turns positive, the portfolio needs return streams that answer to something other than the economic cycle. Catastrophe risk may be one such stream: its driver is weather and geology, its coupon floats with rates, and its long-run record has paired equity-like returns with materially lower volatility. The same features that make it potentially diversifying — a return earned by underwriting rare, severe events — also make it negatively skewed and peak-peril concentrated, and its short history may flatter both its return and its apparent stability. Held in that spirit, as a deliberately bounded allocation whose premium is understood as payment for a real and imperfectly measured tail, ILS may be one of the more credible candidates for diversification when the traditional stock-bond relationship becomes less reliable.


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