

21 April 2009

As Lloyd's Insurance Market Recovers, HNW Investors Can Earn Solid Returns



Tom Burroughes Editor in London

Back in the 1980s and 1990s, the Lloyd's of London insurance market was in a poor state, as the unlimited liability investors in the syndicates composing the market discovered to their horror that unlimited liabilities were indeed unlimited. The market was hit by events such as the Piper Alpha disaster in the North Sea and huge claims connected to asbestos and hurricane damage in the US. As far as high net worth investors were concerned, this market looked very unappealing.

But Lloyd's has recovered; new investors can not have unlimited liability due to rule changes – there are a few of the other type of investor still around – and a period of reform and overhaul has meant that the syndicates are making money again. While other parts of the financial industry, such as once-strutting investment banks or hedge funds, have taken a beating, Lloyd's has at least so far been able to ride out the storm.

For high net worth investors able to put up the sums involved, the long-term payoffs to investing in this market are worth considering so long as they take a long view and understand the risks, Alistair Wood, head of research at Hampden Agencies, a firm that advises individuals investing in syndicates, told WealthBriefing recently.

Data on returns take several years to come through – and data for 2006 shows that there was a record average profit for HAL members of 26.3 per cent on capacity, representing an average return on funds invested at Lloyd's of 65.8 per cent. Projections for 2007 and 2008 are relatively bullish.

"We are quite excited by the prospects for next year. The combined effect of the financial crisis for 2008, and some hurricane damage, we think means that premiums will have to go up," Mr Wood said, saying that if premiums rise and payouts are steady, it will boost profits for 2010, Mr Wood said.

Investing in this market is good for diversifying risk, Mr Wood said, because returns are relatively lowly correlated to other asset classes. Lloyd's will also typically invest premium income in low-risk assets such as government bonds.

The investment process

Typically, an investor puts up a sum equal to about 40 per cent of premium income – say £400,000 (\$581,559) on £1 million of income underwritten by syndicates. There are 87 syndicates in Lloyd's, focusing on different insurance risk areas, ranging from cargo ships to industrial buildings. In 2008, premium income across the whole of the Lloyd's market amounted to about £14 billion.

The profit paid out to investors is the unused premium income, minus claims and other costs. In a year when premiums have risen but payouts are low, such as due to mild weather, then the profit an investor earns can be high.

The money an investor puts up does not have to be given straight away to the syndicate; the investor can keep the money in a trust within Lloyd's and earn a return on that, so he gets two opportunities to earn money.

"You get a double use of your assets and that is a key attraction for investors," said Mr Wood.

"When investing in Lloyds, you take a risk as an underwriter but on the asset side, they tend to be more conservative," he said.

Investors are high net worth individuals, mostly from the UK, but also continental Europe and some English-speaking nations such as South Africa and Australia. The minimum investment is £350,000 for Hampden clients; once the purchase cost of buying access to syndicates has been taken into account, the total commitment is around £600,000.

"It [insurance investing] should make up about 5 per cent of your overall wealth. This should be a portion of your investment in alternatives."

The time horizon of such investment is usually in the region of about 7 to 10 years and is akin to private equity. Investors are locked in to the extent that if they commit to underwriting risks in a particular year, they cannot suddenly pull out from a commitment. If an investor commits to underwriting risks in 2010, for example, they do not see a full payout of any profits until 2013.

However, if investors want more flexibility, they can set up a company into which their committed money has been put and these companies can be bought and sold. There is a developing secondary market in such investment commitments, Mr Wood said.

Hampden will charge a fee made up of a fixed and variable element, as well as a profit commission.

The insurance market at Lloyd's has been through a number of storms, both literal and metaphorical. It would be reckless to assume that tough times might not return to this part of the investment arena, but insurance is not a market that HNW investors should ignore. If Mr Wood's predictions are correct, it could prove to be one of the few good news stories in the financial markets.