CATCo Reinsurance Opportunities Fund

Differentiated strategy provides attractive risk/return profile

CATCo provides exposure to a portfolio of collateralised retrocessional reinsurance contracts written to provide reinsurers with protection against low frequency/high severity insured loss events such as hurricanes and earthquakes. CATCo is far less complex and more transparent than conventional reinsurance companies. In relation to other catastrophe insurance-linked strategies (ILS), including other London listed reinsurance funds, CATCo offers a higher potential return and far greater diversification of risks.

- **Attractive risk-adjusted returns**: CATCo’s objective is to deliver Libor plus 12-15% pa in US$ over a five year period. However, attractive retro rates mean that the projected net return from its 2013 portfolio is Libor +28%, assuming no claims (equivalent to projected NAV growth of 24% allowing for uninvested assets and expenses). Asset risk is negligible as the collateral is held solely in cash and cash equivalents.

- **Diversified portfolio limits downside**: CATCo’s 2013 portfolio is invested across 42 non-correlated risk pillars on a global basis. This diversification means that the fund may be less likely to be claim-free in any single year than a typical ILS. However, most ILWs and Cat bonds are heavily exposed to potential losses from a major single catastrophe in the US. In contrast, the maximum impact of any single event (US Wind) would result in a negative net portfolio return over the year for CATCo of just 2%.

- **Performance to date**: Since CATCo’s launch, there has been an extraordinary series of events around the world, with 2011 being the highest year for insured losses on record ($120bn), including the earthquakes in Japan and NZ. This was followed by $80bn of insured losses in 2012, including Superstorm Sandy. Nevertheless, CATCo has delivered positive NAV total returns of 7.4% pa for investors at IPO and 15.8% pa from the C share in May 2011.

- **Outlook for returns**: The high prospective return from catastrophe reinsurance has attracted significant investor capital into ILS this year, driving mid-year pricing down by as much as 25-35% for some reinsurance products. However, assuming there are no major events before the end of this year, therefore, we expect to see some pressure on retro pricing for 2014. However, the pricing impact on CATCo’s multi-pillar UNL retro reinsurance is expected to be far less than for standardised products such as Cat bonds and ILWs. Indeed, preliminary negotiations with reinsurers suggest that CATCo’s premiums for 2014 are likely to be broadly unchanged.

- **Attractively valued**: CATCo’s share price of $1.092 is in-line with our current NAV estimate. We believe that there is a strong argument for the fund to trade at a premium given its attractive return profile and lack of correlation with financial markets. By comparison, the listed reinsurers, which have a similar return target but far less transparency, are currently trading at 1.4x net assets. CATCo pays a yield of 5% of year-end NAV, but is considering making an enhanced distribution in early 2014.

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The Investment Opportunity

What is Retro Reinsurance?

Retrocessional (“retro”) reinsurance involves reinsurers purchasing reinsurance themselves to provide protection against peak losses or catastrophic events. This is the final element of the insurance risk transfer model, as illustrated in the chart below.

**Figure 1. Insurance – Transfer of Risk**

At the first stage of the process, primary insurers provide insurance for individuals and corporate entities against numerous types of risk in exchange for an insurance premium. These insurers are often local or regional players, and they are vulnerable to large claims from specific events. As a result, they look to offset some of their risk by entering into reinsurance contracts with other insurers or reinsurers. This reinsurance reduces claims volatility in order to smooth income over the cycle, and results in lower capital requirements to cover substantial claims, which frees up capital to write further business. The primary insurers earn annual premiums of c.$2trn globally in relation to Property and Catastrophe insurance, and the major insurers include RSA, Zurich, AIG and Lloyds.

There are three major global reinsurance centres: London, Zurich and Bermuda. The major reinsurers are Lloyd’s, Munich Re, Swiss Re and Bermudan reinsurance companies. According to estimates from Guy Carpenter, a leading reinsurance broker, the reinsurers provided cover of $312bn in relation to property catastrophe cover on a global basis at the start of 2013 and received reinsurance premiums of $24.4bn, equivalent to a “Rate on Line” of 7.8%. By exposure, the risks are spread 50% to the Americas; 30% Europe; and 20% Japan/Australasia, although premiums tend to be higher in the US (11.2%) than in Europe (5.6%), reflecting the greater likelihood of natural disasters in densely populated areas.

A reinsurer takes on the risk from the insurer and will manage its overall risk exposure by diversifying its portfolio both by geography and type of risk. However, catastrophes, such as earthquakes or hurricanes, are peak events that are hard to model and can lead to severe financial losses. In order to meet capital requirements and protect credit ratings (typically they need at least an A- rating), reinsurers look to pass-on some of their own “tail-end” risks. The demand for third party capital has risen in recent years as insurers/reinsurers have been faced with higher capital requirements under a more rigorous regulatory environment (e.g. Solvency II) and stricter accounting rules.
Alternative Reinsurance Products

In order to increase capacity to take advantage of higher reinsurance rates after one or more major event, insurers/reinsurers must either raise new equity capital from shareholders or find ways to pass on more of their tail risks to third parties. They can achieve this in a number of ways:

- **Catastrophe (“Cat”) Bonds**: These are securitised products, typically issued by insurers/reinsurers via an investment bank. They usually have a 1-3 year maturity and offer returns of Libor plus an insurance premium (often in the range 3-8% pa). They typically have a very low loss expectancy, but have substantial downside if a claim is triggered by a major event due to the lack of diversification. The total Cat bond market worldwide has an estimated value of $15bn, according to estimates from Guy Carpenter, and the majority of Cat bonds have exposure to US events. This market is dominated by reinsurance funds and asset managers seeking direct exposure to the reinsurance market.

- **Industry Loss Warranties (“ILWs”)**: These are OTC products, typically with a one-year term, issued by reinsurers (or insurers) in relation to a specific industry event (e.g. a hurricane in Florida). The trigger point for losses is determined by an index of industry losses, rather than an insurer’s own losses. Various ILW options can be purchased providing different risk/return characteristics. The market is dominated by reinsurance funds, with participation from a few traditional reinsurers.

- **Collateralised Reinsurance**: This is traditional reinsurance written in collateralised form. The trigger point for losses is based on an insurer’s own amount of loss. The participants in this market may represent asset management subsidiaries of the reinsurers (e.g. Blue Water for Montpelier Re) or “side-car” vehicles (e.g. Lancashire) established to provide cover for a specific portfolio of catastrophe risks. However, during 2013, there was a significant increase in the amount of collateralised reinsurance written by reinsurance funds, focused heavily on US wind events. With the influx of reinsurance fund capital for 2013 and a limited increase in the amount of CAT bond or ILW demand, collateralised reinsurance appears to be the new focus for several large reinsurance funds (excluding CATCo).

- **Collateralised Retro Reinsurance**: This involves the reinsurers purchasing reinsurance for tail risks that relate directly to the company’s portfolio losses from collateralised investment vehicles (including CATCo).

Traditional reinsurance (provided by rated reinsurers) still accounts for the vast majority of the global property catastrophe reinsurance market. However, the ongoing convergence of the reinsurance and financial markets means that an increasing proportion of capacity is being provided through alternative sources (currently 14% from 8% in 2008). This trend is expected to continue.

**Size of the Retro Market**

The overall size of the catastrophe retro reinsurance market is estimated to be $20bn, with 50% represented by UNL retro (where claims are based on the actual losses suffered by insurers), and 50% by Cat bonds/ILWs (claims are typically based on industry loss metrics). Of the UNL retro, $8bn is represented by collateralised vehicles, including CATCo’s assets of $2bn. It should be noted, however, that these figures exclude Berkshire Hathaway, believed to be the largest single provider of capital for retro reinsurance, due to the difficulty in estimating its total exposure to the market.
How Common are Catastrophic Events?

The chart below shows insured losses by calendar year, adjusted for inflation. These are not the same as economic losses due to differing levels of insurance cover by country, and often bear little relationship to the number of fatalities. In an average year, there are 257 separate catastrophic events, and economic losses have averaged $187bn over the past ten years, with insured losses averaging $53bn. The biggest events tend to occur in the US due to the high level of insurance penetration. For instance, the peak year for insured claims was in 2005, primarily as a result of Hurricane Katrina.

2011 was the highest year on record for insured losses, but was unusual in that the largest events occurred in the Asia-Pacific region due to earthquakes in Japan and New Zealand and severe floods in Thailand. During 2012, Superstorm Sandy and a drought in the US accounted for two-thirds of losses, with other key events being earthquakes in Italy, flooding in the UK and China, as well as the sinking of Costa Concordia, the Italian cruise liner. In total there were 295 separate events during 2012, causing insured losses of nearly $80bn. Importantly for reinsurers, there were four events during 2011/2012 that resulted in insured losses of more than $15bn.

Following two years of above-average catastrophe loss activity, 2013’s global insured losses to-date are well below the ten-year average. In H1 2013, catastrophe events resulted in $13bn of insured losses, according to Munich Re, compared to a half-year average of $22.8bn over the prior ten years. During the period, the most notable catastrophic events were the South Eastern European floods ($4bn insured loss), the Oklahoma tornados in the US ($2bn) and flooding in Canada ($2bn).
Table 1. Biggest Insured Losses from Historic Catastrophes

<table>
<thead>
<tr>
<th>Event</th>
<th>Year</th>
<th>Insured Loss ($bn)</th>
<th>Location</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Hurricane Katrina</td>
<td>2005</td>
<td>76.3</td>
<td>US, Caribbean</td>
</tr>
<tr>
<td>2. Earthquake, Tsunami</td>
<td>2011</td>
<td>36.7</td>
<td>Japan</td>
</tr>
<tr>
<td>7. Superstorm Sandy, floods</td>
<td>2012</td>
<td>18.8</td>
<td>north east US</td>
</tr>
<tr>
<td>8. Hurricane Ivan</td>
<td>2004</td>
<td>15.7</td>
<td>US, Caribbean</td>
</tr>
<tr>
<td>9. Flooding</td>
<td>2011</td>
<td>15.3</td>
<td>Thailand</td>
</tr>
<tr>
<td>10. Christchurch Earthquakes</td>
<td>2011</td>
<td>15.3</td>
<td>New Zealand</td>
</tr>
<tr>
<td>12. Hurricane Rita</td>
<td>2005</td>
<td>11.9</td>
<td>US, Caribbean</td>
</tr>
<tr>
<td>13. Drought</td>
<td>2012</td>
<td>11.0</td>
<td>mid-US</td>
</tr>
<tr>
<td>15. Typhoon Mireille</td>
<td>1991</td>
<td>9.6</td>
<td>Japan</td>
</tr>
<tr>
<td>16. Hurricane Hugo</td>
<td>1989</td>
<td>8.5</td>
<td>US, Caribbean</td>
</tr>
<tr>
<td>17. Earthquake, Tsunami</td>
<td>2010</td>
<td>8.4</td>
<td>Chile</td>
</tr>
<tr>
<td>18. Winter Storm Daria</td>
<td>1990</td>
<td>8.2</td>
<td>Europe</td>
</tr>
<tr>
<td>19. Winter Storm Lothar</td>
<td>1999</td>
<td>8.0</td>
<td>Europe</td>
</tr>
<tr>
<td>20. Mid-West Tornados</td>
<td>2011</td>
<td>7.5</td>
<td>Alabama, US</td>
</tr>
</tbody>
</table>

Note: Insured Losses are indexed to 2012 values, but do not allow for changes in population density.
Source: Swiss Re

When Does an Event Trigger Losses?

As reinsurance is designed to cover peak events, only a small proportion of catastrophes will trigger losses for ILS investors. Different reinsurance products will have different attachment points (e.g. a contract may have a 1% or a 5% modelled risk probability). Reinsurance protection is typically provided for a particular ‘layer’ of losses. However, a claim may be binary and payable in full once a specific level of insured loss is reached, or it may rise gradually between specified attachment and exhaustion points.

ILS investments can have several types of trigger:

- **Indemnity**: Based on the actual losses suffered by the insurer/reinsurer, also known as ultimate net loss (UNL). This is the standard most for reinsurance or retro reinsurance contracts.

- **Industry**: Relates to insured losses across the industry as a whole. For US events, the loss estimate is typically based on data from Property Claims Services (PCS) via surveys with the insurers. Events outside the US often rely on estimates from SIGMA (a division of Swiss Re) or NatCAT (Munich Re).

- **Parametric**: The pay-out is linked to measurable factors such as earthquake magnitudes or wind speeds. This reduces exposure to un-modelled risks such as second order consequences of the catastrophe event, such as flooding.

An advantage of industry and parametric triggers over indemnity-based triggers is that the contracts are more standardised and the pay-out is typically determined more quickly. However, the pricing may be less favourable since money flowing into the sector via ILWs and Cat bonds will typically be focused on standardised industry triggers. In contrast, insurers/reinsurers prefer to acquire cover against their actual incurred losses.
Why Invest in Catastrophe Reinsurance?

The key reasons for investors to consider catastrophe reinsurance as an asset class are:

a) **Attractive absolute returns**: the Swiss Re Cat Bond Index has delivered annualised returns of 8.6% since inception in 2002, versus 6.1% for the MSCI World (total return in US$).

b) **Low volatility of returns**: the volatility of the Swiss Re Cat Bond Index since inception has been just 2.8% pa, versus 18.7% pa for the MSCI World.

c) **Low correlation of returns**: The asset class offers low correlation with financial markets. For instance, the Swiss Re Cat Bond Index has a historic correlation of 0.12 to equity markets and 0.15 to corporate bonds.

d) **Nature of event risk**: Catastrophe risks are typically unrelated to each other (e.g. floods in Europe are not linked to the probability of earthquakes occurring in the US). This means that an investor’s downside risk can by reduced through diversified exposure to a range of catastrophic events.

Two questions that investors in reinsurance funds may ask:

**Do models based on historic data underestimate the likelihood of natural perils?**

Despite fears over global warming, there appears to be no evidence that hurricanes are more frequent or more severe today than in the past. Inevitably, however, it is difficult to predict precisely when a 1 in 20 or 1 in 100 year event will occur. This suggests that investors need to take a multi-year approach to the asset class and also focus on the downside risk if a “black swan” event does happen.

**Are trended historic losses an accurate reflection of potential future liabilities?**

The answer is likely to be no, if the losses are simply adjusted for inflation. For instance, Hurricane Andrew was a $26bn event trended for inflation, but could be in the region of $50bn allowing for changes in population density and insurance penetration. However, these factors are taken into account in Cat models (including those used by CATCo to determine its attachment levels). Costs may be higher as a result of environmental pressures or government action (as with Costa Concordia). However, we see no reason to assume that the Cat models do not provide a reasonable guide to potential liabilities.
Is Now a Good Time to Invest in Reinsurance?

The left-hand chart below shows an index of reinsurance rates since 1990. Reinsurance rates typically fall by 5-10% following years with no claims. In contrast, they have risen at least 25% following major industry claims such as Andrew, Katrina and the WTC attacks. Capital became scarcer in the aftermath of the Financial Crisis. However, low interest rates and attractive reinsurance rates have led to a rapid influx of new capital from a variety of sources.

An Influx of Capital During 2013

A report from a leading reinsurance broker suggests that there was c.$9bn of fresh capital raised by new and existing reinsurance funds for deployment during 2103. However, buyer demand for ILWs was flat, while Cat bond issuance was up c.$1bn during the year. This suggests that most of the new capital was targeted at writing fully collateralised reinsurance for US wind events, competing directly with traditional reinsurers.

Retro Pricing has Been Stronger

Unsurprisingly, perhaps, there is often some confusion over retro reinsurance rates and reinsurance rates. The two markets are inevitably linked, but the retro market is smaller with far fewer participants. It is not easy for providers of capital, such as hedge funds, to take advantage of higher UNL retro rates without specialist knowledge of the reinsurance sector and existing industry contacts.

A Retro Rate Index is available from 2002, based on estimates from a leading reinsurance broker. This shows that retro rates rose 40% post-Katrina and have remained at high levels ever since. Retro reinsurance rates increased significantly in mid-2011 following the earthquakes in Japan and New Zealand, as there was a shortage of risk capital, combined with significant demand from reinsurers for retro protection ahead of the hurricane season. Rates stayed high at the end of 2012, largely due to Superstorm Sandy. However, losses from this event were not as bad as some had feared, and the final PCS estimate for insured losses of $18.75bn was just below the key trigger of $20bn that would have resulted in losses for many ILW contracts.
## Significant Pricing Pressure for Commoditised Products

Due to the amount of capital entering the asset class since the start of 2013, there has been significant pricing pressure on reinsurance rates for mid-year renewals. For instance, pricing for Cat bonds and ILWs is down 35% and 25%, respectively, while traditional US Wind UNL reinsurance rates are down 15%. The impact on traditional UNL retro rates is harder to assess until the year-end renewal season. However, a leading reinsurance broker suggests a less significant fall of c.10% as most of the new entrants are focused on the traditional reinsurance market, rather than the more specialist retro market. Furthermore, due to CATCo’s unique offering via a multi-pillared approach, it believes that its premiums are unlikely to fall by more than 5%.

## How is CATCo Differentiated?

CATCo IM has been a huge success since its inception, building a 20% share of the retro reinsurance market (and 25% of the collateralised retro market) within less than three years. CATCo’s timing was fortuitous, as it was able to exploit the significant demand for retro reinsurance in mid-2011 after reinsurers found that their cover had been exhausted by the earthquakes in NZ/Japan before the hurricane season had even started. However, its growth also reflects the fact that it offers a unique product that appeals to the major buyers of retro reinsurance protection (Lloyds of London Syndicates and traditional reinsurers). It also results in an attractive risk/return profile for financial investors in CATCo’s funds, most of which would not have the expertise to invest directly in the reinsurance market.

### Key Attraction to Reinsurers

#### Fully Collateralised

Collateralised insurance involves pledging capital as security, rather than conventional reinsurance that is based on a promise to pay. Offering 100% collateral avoids the need for a credit rating and removes counterparty risk. This makes CATCo particularly attractive to reinsurers, enabling it to achieve premium pricing. In recent years, there has been far more emphasis on counter party risk as a result of delayed settlement of reinsurance claims following large events. Tony Belisle, CATCo’s CEO, was a pioneer in developing collateralised reinsurance investments back in 2001.

#### UNL Offering

The vast majority of CATCo’s contracts are Ultimate Net Loss, i.e. based on the insurers’ actual losses rather than an industry index. This is favoured by the reinsurers and means that CATCo is able to gain premium pricing in relation to commoditised products, such as Cat bonds or ILWs. Typically, UNL retro will earn a premium of 20-30% over ILWs, but it requires far greater industry knowledge and modelling expertise. Around 95% of CATCo’s contracts are UNL.

#### Multi-Pillar Approach

Typically reinsurers buy UNL retro protection via single contracts providing cover against all perils in US or on a Worldwide basis (sometimes they may provide cover for two events). This can leave them without cover ahead of the US hurricane season if one or more major catastrophes occur in the first half of the year (as was the case in 2011). In contrast, CATCo only writes multi-pillar contracts, whereby the reinsurers buy protection across 8-9 events. For each reinsurer, these will include the peak risks of the US, Europe and Japan, but also a range of more specialist risks such as China, Mexico or Australia. As a result, CATCo only focuses on the top 30-40 global reinsurers who have a broad enough product range to buy diversified global protection.
CATCo’s attachment points are determined individually for each type of event (rather than a catch-all single contract attachment point). This enables reinsurers to buy protection at customised attachment points for specified countries or types of peril. The types of exposure, trigger levels and size of liability are individually negotiated for each contract.

The multi-pillar approach is the key to CATCo’s return profile. Each pillar is non-correlated, with no more than one claim possible as a result of a single catastrophe (with the same counterparty). CATCo may reduce its exposure to peak events by buying ILW protection e.g. 2-3% of the 2012 premiums were spent on protection. The only exception where CATCo has moved away from the multi-pillar approach is for specialty lines such as marine, energy, terrorism and aviation. CATCo wrote significantly more marine and energy protections at the start of 2013 (representing 7% of the overall portfolio) as a result of attractive pricing following recent loss events (notably, the BP oil spill and Costa Concordia).

Lack of Conflict
CATCo has no conflict of interest with traditional reinsurers, unlike a collateralised fund managed by another reinsurer. Such funds (e.g. Montpellier Re’s Blue Capital) target traditional reinsurance rather than the retro market.

Scale
CATCo has substantial firepower, with assets of over $2bn. This enables it to write large contracts with the major reinsurers, but still maintain diversification. Other major players in the UNL retro reinsurance market include D.E. Shaw and Aeolus. However, their product offering is not directly competitive with CATCo’s multi-pillar approach.

Long Term Commitment
Continuity is important within the insurance industry and the reinsurers now have a relationship with CATCo and appreciate the nature of the product offered. Furthermore, they see CATCo as an ongoing provider of capital: more than half of CATCo’s assets are invested in the listed fund or the share class of the Master Fund with a three year lock-in (the remainder is annual). This contrasts with more opportunistic providers of retro reinsurance, such as Berkshire Hathaway or hedge funds, who cannot be relied on to provide capacity each year.

Key Attraction to Investors
In relation to other reinsurance funds, CAT Bonds, and listed reinsurers, CATCo offers higher returns and/or far greater transparency:

Higher Potential Returns
CATCo seeks to return Libor plus 12-15% pa, and the NAV return in 2013 is expected to be 24.1%, assuming no losses. The gross return from the 2013 portfolio is 33% and the net return at the Master Fund level is 28% (after fees and protection). However, the projected NAV return for CATCo, assuming no losses, is 24% due to dilution from holding some cash and the operating expenses of the listed fund (management fees are charged at the Master Fund level). This is far higher than the expected return from CAT bonds, other listed funds or listed reinsurers.

CATCo’s unique multi-pillar approach enables it to achieve premium pricing. In addition, it has considerable flexibility to exploit market conditions. For instance, rather than writing the same contracts each year, CATCo seeks to actively manage the portfolio to allow for pricing movements and to optimise the risk/return profile. For instance, at the start of 2013 CATCo took advantage of higher rates for Offshore Marine (following Costa Concordia) by increasing exposure to this risk pillar.
CATCo does not use borrowings for investment purposes and the potential losses have limited liability that does not exceed CATCo’s net assets. However, returns are enhanced by using the annual reinsurance premium as part of the collateral to cover a claim. Assuming that the premium is 25%, this would mean that CATCo would invest $75m to provide $100m of retro reinsurance cover. CATCo has also reduced the amount of collateral required by limiting its exposure to multiple events by negotiating restrictions on the number of risk pillars that can be claimed under any policy. For instance, it may cover eight risk pillars with a single insurer, but would be contracted to pay out on a maximum of four, thereby reducing the amount of capital that needs to be held.

CATCo’s current portfolio has c.1.5x exposure for each individual pillar, and this internal gearing helps to enhance the fund’s potential returns. The consequence is that CATCo’s exposure to losses on specific events is higher than its simple exposure based on the portfolio breakdown. However, this is taken into account in the calculation of the potential maximum liability for each event.

**Diversified Portfolio**

Many reinsurance products are heavily exposed to a handful of risks, typically in the US. In contrast, CATCo’s portfolio is broadly diversified with 42 fully non-correlated risk pillars in 2013. This level of diversification has increased significantly since 2011 when there were 19 pillars.

The majority of CATCo’s capital is exposed to residential and commercial property losses from natural disasters such hurricanes or earthquakes, although it also writes contracts relating to Marine, Energy, Terrorism and Aviation risks.

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**Figure 9. 2013 Portfolio by Geography**

![Figure 9](image1)

**Figure 10. 2013 Portfolio by Type of Peril**

![Figure 10](image2)

* Backup protection provides additional coverage for the other risk pillars at the same contract triggers and in the same proportion.  
  Source: CATCo

* Backup protection provides additional coverage for the other risk pillars at the same contract triggers and in the same proportion.  
  Source: Numis Securities Investment Companies Research
Limited Downside to Individual Events

The key benefit of diversification is that the downside risk to any event, however large, is limited. In contrast, many reinsurance products, including Cat bonds, are heavily exposed to a major hurricane or earthquake in the US.

CATCo’s 2013 portfolio would suffer only a modest NAV decline over the year (-2%) even under the worst single event scenario (US wind). Indeed, the prospectus dictates that the maximum loss from any single event should not reduce the calendar year NAV return below -5%. This is achieved primarily through diversification of risks, although the managers may also seek to hedge exposure to some pillars by buying protection through ILWs.

CATCo – Worst Case Single Event Net Returns in 2013

The chart above shows the maximum impact on net portfolio return from a single event during 2013. However, it should be noted that there is the possibility of more than one event happening (discussed in more detail below). In addition, the recognition of a loss event may reduce the NAV at the time (by up to 30% for a US Wind event), even if this loss is materially offset by premiums accrued over the year.

Over the past 20 years, key catastrophic events for the insurance industry have included Andrew in 2002, Katrina in 2005, and the Northridge California Quake in 1994. A recurrence of such events would be likely to result in substantial losses for less diversified ILS vehicles such as Cat bonds. However, CATCo’s diversification means that its exposure would be limited. The chart below illustrates that the 2013 portfolio would achieve positive net returns based on trended losses from these historical events (e.g. it is estimated that a repeat of Hurricane Andrew would reduce net returns by 25%, resulting in a return for the year of 3%, assuming no other losses). According to back-tested data, CATCo estimates that historical average returns from its investment strategy would exceed 18% pa (ex Libor) over the long term, based on the 2013 portfolio.

Source: CATCo
Transparent Return Profile

CATCo provides a clear breakdown of its portfolio by risk peril and by geography. It also shows the maximum downside for any single risk event and projected growth in monthly NAV, assuming no losses. The portfolio characteristics are largely determined at the start of each year, but an update is provided in the Monthly Factsheet, together with a summary of recent catastrophe events and the expected impact on CATCo’s returns, if any. Since launch, we believe that the quality of information provided by CATCo has improved, and returns/downside are now shown on a net rather than gross basis.

CATCo publishes a monthly historic NAV, but also provides projections for growth over the year assuming no losses. Due to the seasonality of hurricanes, only a third of the annual premiums are earned in the first six months of the calendar year. This is reflected in CATCo’s projected NAV (assuming no claims), which rises more sharply from August-October as the hurricane season passes.

Losses are recognised in the published NAV once it is possible to assess the potential level of claims from an event. How soon this will be depends on the size and complexity of the catastrophe: the first PCS estimate for US hurricanes is published within four weeks of an event, and tends to settle at a final estimate within 12 months after the event, whereas earthquake damage is likely to take longer to finalise. As CATCo writes mostly indemnity-triggered contracts, the settlement time should be assumed to be 2-3 years, depending on the severity and type of peril.
No Asset Risk

Listed reinsurance companies typically invest their capital in a variety of asset classes, with the objective of delivering enhanced returns over cash. In contrast, the premium paid by the reinsurer and the collateral from CATCo required to meet any potential claim are both deposited directly into a trust account held at The Bank of New York Mellon (BoNYM) and invested solely in AAA-rated money market funds or short term US Treasury bills.

Management and Resources

CATCo has an extremely experienced underwriting team with decades of experience within the retro reinsurance market. In addition, Tony Belisle, CATCo IM’s CEO, has considerable financial and reinsurance expertise, having been involved in launching one of the first collateralised vehicles in 2001.

The managers assess risks, and determine the trigger levels for each type of catastrophe risk, using the standard vendor property risk models widely used throughout the industry. For specialty classes, CATCo has developed proprietary actuarial models. They also have access to the knowledge and models of Guy Carpenter, a leading reinsurance broker.

CATCo will only offer cover to reinsurers that provide full model information on the underlying risk portfolio. In addition, it only provides cover for events that it can model (e.g. it did not cover the floods in Thailand in 2011 which was a $15bn+ event, primarily due to business disruption). In contrast, most reinsurance funds only access exposure at an industry loss level and cannot evaluate specific information related to underlying risk (which is why they tend to focus on ILWs and Cat bonds). If full portfolio information is not available, CATCo may consider offering ILW protection on a multi-pillar basis (although this only represents c.5% of its current portfolio).

How Often are Losses Expected?

Current reinsurance premium rates on CATCo’s target portfolio represent a multiple of the expected average event risk per pillar of c.5-6% based on models that adjust for inflation, as well as other factors such as population density and insurance penetration. In addition, CATCo’s contract triggers are set at levels that would not have occurred more than twice in the past 40 years on a trended loss basis.

The contract triggers apply to each event separately (i.e. two separate mid-sized hurricanes do not add up to a big one). However, it is possible that some events, such as earthquakes on the same fault-line, may be treated as being linked. In the case of tornados, these are treated as a single event if they form part of the same storm system.

No more than one claim can be made under each risk pillar (with the same counterparty), although CATCo has also written a 2nd Event Risk pillar (also termed “backup protection”) that provides additional coverage for a second event at the same contract triggers and in the same proportions as the first event.

Given that CATCo has over 40 risk pillars, there is a much higher probability of some losses occurring in any year than if it covered just a single risk. However, the impact on returns depends on what event occurs. For all but 10 of CATCo’s pillars, a full loss from the pillar would still result in a net return for the 2013 portfolio of over 10% (assuming no other losses). In effect, the premiums paid under the multi-pillar approach cover the first event loss, however large.
Impact of Multiple Events

Of course, there is the possibility that more than one loss may be triggered in a calendar year, as happened in both 2011 and 2012. Again, though, shareholder returns may still be positive over the year (e.g. the adjusted NAV return in 2012 was 7% despite a full provision for Costa Concordia and a partial provision for Superstorm Sandy). If there were two major US Wind events in a calendar year, it is possible that CATCo’s NAV could fall by up to 30% over the year (based on the 2013 portfolio). Under this scenario, however, it would be likely to significantly outperform other less diversified reinsurance vehicles. In addition, retro rates would be expected to rise sharply, giving the opportunity for CATCo to exploit premium pricing in the following year. This helps to smooth the impact of losses for CATCo investors that are willing to take a multi-year view. For instance, the projected net portfolio return of 28% in 2013, is far higher than the equivalent net portfolio return of 18% in 2011, if no losses had occurred.

Working out the precise probability of losses is not easy. It is simple maths that the probability of a 5% loss (1 in 20) occurring twice is 0.25% (1 in 400), assuming the events are uncorrelated. However, several of CATCo’s pillars are written at 1-2% probability and others at 6-7%. There is also the impact of internal gearing to consider, and the possibility of multiple events. Nevertheless, CATCo’s managers believe that they should deliver or exceed the return target of Libor plus 12-15% over a five year period. Indeed, for the current portfolio they believe that there is an 85% probability that investor returns will be positive over a year, and a probability of almost 70% that they will deliver positive returns in excess of 12%.

Back-tested data for the 2013 portfolio suggest that there would have been 15 “clean” years out of the past 20 years, with 2011 being the only year when the losses were not covered by premiums received (although this may be reversed if, as expected, a provision for the Japan earthquake is partially released). This would have resulted in hypothetical returns of c.20% pa over the 20 year period (excluding Libor), or c.18% pa over a 10 year period, both of which are well in excess of the target of 12-15% pa. It should be recognised, however, that the target return is based on historic premium rates and it cannot be assumed that the current high level of premiums are sustainable.

Diversification is the Key to Limiting Risk

The managers emphasise that models should be treated as a guide to risk and feel that the key is to be diversified. They believe that investors in reinsurance should not “fear losses”, as this creates an opportunity to generate higher returns in future so long as they still have sufficient capital to exploit the subsequent period of expected higher rates. They point out that many “low risk” reinsurance products/funds could be wiped out if a Cat 5 hurricane hit Miami or New York (potentially a $150bn event), whereas CATCo may still protect shareholders’ capital.
How has CATCo Performed?

Events Since Launch

Since CATCo’s launch, there have been an extraordinary series of events around the world, with 2011 being the costliest year for insured losses on record ($120bn), followed by $80bn of insured losses in 2012 (making this the most costly two year period on record). Despite this, CATCo has delivered positive returns for shareholders, and very healthy returns for C share investors (who represented 75% of the capital raised by the listed fund).

CATCo had no exposure to the vast majority of catastrophes that have occurred since its launch, including Australian flooding (2011), Thailand flooding (2011), Hurricane Issac (2012), European floods (2013). However, it has made provisions for four significant events, as summarised in the chart below.

A brief summary of these events is provided below:

- **NZ Quake** (Feb-2011): A magnitude 6.3 earthquake in Christchurch led to substantial damage and deaths, with insured losses of more than $15bn. This was the second quake in six months on a fault line that had been dormant for thousands of years. This event has been fully settled at an amount representing 6% of NAV.

- **Tohoku Quake** (Mar-2011): A magnitude 9.0 earthquake off the coast of eastern Japan triggered a massive tsunami. This led to huge damage to property and loss of life, as well as a radiation leak from the Fukushima nuclear power station. Although insurance penetration was relatively low, insured losses are estimated to be close to $40bn (CATCo’s exposure did not include radiation). This event has been reserved at 18% of NAV, but only 6% has been settled. CATCO’s managers expect that some recovery of value will occur in early 2014.

- **Costa Concordia** (Jan-2012): This Italian cruise liner hit a reef off the Tuscany coast due to human error, with the loss of 32 lives. CATCo’s attachment point was $1.25bn, and it was originally estimated that the total claim would be below this figure. However, the Italian government’s protracted recovery of the vessel has increased salvage costs considerably and it now seems likely that the total insured loss will be in the region of $1.5bn. CATCo has settled a claim with one counterparty, equivalent to 1.5% of net assets, and has made a provision for a further 2.5%. Although this has not yet settled, CATCO’s managers do not expect any recovery in value.

- **Superstorm Sandy** (Oct-2012): This is expected to be the second costliest wind event on record, although the losses were primarily a result of flooding (it was downgraded from a hurricane to a storm). The final PCS industry insured loss estimate was $18.75bn, which was reduced by the fact that the US government provides residential flood cover. CATCo had potential exposure of 24% of NAV to Sandy, both through UNL and ILW contracts. 7.5% was released at the end of the year as the attachment levels ($30-40bn) were well above the potential losses. A further 4.5% was not available for reinvestment at the start of the year, but has since been released by the counterparties. Of the remainder, 5% has already been paid, with the remaining 7% fully provided for in the NAV and held in a side pocket of the Master Fund.

Given that these are UNL contracts (based on actual losses of the insured counterparties), it remains hard to predict how much the final liability will be, nor how long settlement will take. CATCo’s managers are hopeful that there will be some recovery of value from this side-pocket, but capital appears unlikely to be released until after the 2014 renewal season. As at 30 June, the side-pocket for Superstorm Sandy (valued at nil) was equivalent to 7.34% of shareholders’ funds.
Performance Since Launch

Despite these provisions, CATCo has delivered positive NAV total returns for shareholders:

- 7.4% pa for investors at IPO in December 2010;
- 15.8% pa from the $124m C share in May 2011; and
- 14.3% pa from the $125m secondary issue in December 2011.

Assessing CATCo’s performance record is not as straightforward as it might appear. For instance, it might appear that performance has been disappointing given that the share price is up just under 10% since launch. However, the raw data on historic NAV performance needs to be adjusted for:

- **Timing of Capital Raised**: Since CATCo’s inception the Company has completed three significant fund raisings leading to NAV total return calculations for differing share classes. Investors in the original IPO had exposure to the earthquakes in Japan and New Zealand, whereas investors in the C share did not.

- **C Share Conversion**: The bulk of the fund’s capital raised (75%) was via the two C share issues in 2011. These shares converted into Ordinary shares in August 2012 at a rate of 1.156 Ordinary shares per C share (giving an effective entry price of $0.865 per C share). As a result, their price today is effectively $1.26, based on the Ordinary share price of $1.09.

- **Dividend Payments**: The fund paid dividends of $0.051 and $0.05006 in relation to 2011 and 2012, respectively, reflecting the policy to distribute Libor plus 5% of the year end NAV.

- **NAV Lag**: The NAV is published monthly, but the historic NAV will underestimate the true NAV (assuming that there have been no loss events), particularly in the period from July to September when premiums are accrued at a higher rate during the hurricane season.
2011 Ordinary share returns complicated by provisions for Tohoku

Strong returns for C shares in 2011

7% return in 2012 could be higher if part of Sandy provision is recovered

Performance by Year

2011 Ordinary Share Returns: The provision for the Christchurch earthquake, made at the end of 2011, reduced net returns for the year by 6% (this is now a crystallised loss). However, assessing performance in 2011 is complicated by the fact that most of the provision (70%) for the Tohoku earthquake was made in mid-2012. Had the 100% loss reserve been put in place at 31 December 2011, the NAV per Ordinary Share would have been reduced to $0.895 from the previous figure of $0.999 (excluding a dividend of $0.051 that was paid in March 2012 to holders on the register at 30 November 2011). Furthermore, it is now expected that some of this provision will be recovered and a contingent distribution of c.5% of the net return for 2011 may be returned to Ordinary shareholders on the register in August 2012 (prior to the C share conversion).

2011 C Share Returns: The C shares raised in May 2011 delivered NAV growth of 11% over the remainder of the year as they had no exposure to the NZ/Japan earthquakes.

2012 Returns: Stripping out the additional Japan provision made in mid-2012, the NAV return for Ordinary shareholders over the year was 7.06% (the actual return for C share investors). This included a 4% provision for Costa Concordia and a 12% provision for Sandy (some portion of which could still be recovered).

2013 Returns: The projected increase in NAV is 24.1% if there are no loss events in Q4.

Source: CATCo IM, Numis Securities Investment Companies Research
Robustness of Structure Tested

At launch, CATCo represented a new concept within the reinsurance market due to its multi-pillar approach. Investors needed to have faith that the management could invest the capital on terms that would deliver the projected returns. As highlighted earlier, the number of catastrophic events was exceptional in 2011-12, as well as the high level of insured losses. As a result, CATCo’s business model and structure have been thoroughly tested. We believe that the fund’s returns have met investor expectations given the market environment, particularly for C share investors that did not have exposure to the events in New Zealand or Japan in early 2011.

However, some complications have arisen for the listed fund:

How to Value NAVs when there is a Potential Claim?

Investors dislike uncertainty. Unsurprisingly, they want to know what impact a catastrophe will have on CATCo’s projected returns as soon as possible. This is easy for a small event where insured losses are clearly below CATCo’s attachment points (e.g. the Oklahoma tornados this year) or for very large events whereby early estimates indicate a full loss in relation to the risk pillar.

The maximum impact of the four events that have impacted CATCo’s returns since launch was always made clear. However, three of the key events to which CATCo has been exposed (NZ, Japan and Costa Concordia) were not provided for in the NAV until several months after the catastrophe occurred. This was because after initial discussions with its reinsurance counterparties, CATCo’s management believe that insured losses for these events were well below the fund’s trigger points.

For instance, the earthquake in Christchurch, New Zealand happened in February 2011, but a full provision was not made by CATCo until January 2012. Similarly, the Tohoku earthquake occurred in March 2011, and CATCo made a 30% provision in January 2012, followed by a full provision in July 2012. Furthermore, CATCo did not make a full provision (4% of NAV) for Costa Concordia until the end of 2012, even though the ship ran aground in January.

In each case, there were specific reasons why the level of claims rose far more than had been expected:

a) **NZ Quake**: Christchurch suffered three significant earthquakes over a nine month period (September 2010, February and June 2011). This presented the insurance industry with a unique challenge in determining where the allocation of loss really occurred. Ultimately, most of the losses were allocated to the February 2011 event. In addition, soft soils in the Christchurch area resulted in ground failures (landslides, liquefaction), making it difficult to repair buildings/utilities in some locations.
b) **Tohoku earthquake:** CATCo had two reinsurance counterparties with potential exposure. It took a full provision for one counter party, representing 30% of the Japanese exposure, in January 2012. At that time, the larger counterparty indicated that it had ILW protections that were expected to shield CATCo from any losses, but subsequently increased its loss reserves as the costs of the earthquake/tsunami continued to escalate. In July 2013, CATCo provided an update, stating that the reinsurance counterparty had reduced its loss reserves by c.35% over the previous 11 months and this stood at c.65% of CATCo’s Japan exposure. CATCo will continue to hold reserves equal to 100% of the Japan exposure until it is fully commuted, but the current information suggests that there is potential for a contingent distribution at some stage. As highlighted above, this would be distributed to Ordinary shareholders on the register as at 10 August 2012.

c) **Costa Concordia:** CATCo’s attachment point for this Offshore Marine event was $1.25bn and initial estimates were below this trigger. However, the cost of salvaging the vessel proved far more costly than expected. With hindsight, it is easy to question whether CATCo could have been more conservative in guiding the market about the possibility of insured losses rising. Under accounting rules, it is difficult to make a general provision to the NAV if the evidence from reinsurance counterparties suggests that losses should be below the contract trigger point. Furthermore, the managers are wary of being overly conservative as this could mislead the market. In our view, however, there is potential for the Board to announce an “adjusted NAV” to the market, allowing for a probability adjusted NAV where an event has occurred but estimated insured losses are still below the trigger. In the case of Superstorm Sandy, CATCo announced the estimated impact on the NAV of a $20bn event. Furthermore, the management/Board took a view that original PCS estimate of $11bn was likely to be an under-estimate of the final figure as some claims were delayed by the power outages and the damage to infrastructure took time to assess. CATCo continues to base its estimate of losses on $20bn, even though the final PCS estimate was $18.75m.

The timeframe to recognise losses is usually shorter for wind claims than for earthquakes. As a result, it is difficult to directly compare Sandy with the other three events. Nevertheless, we believe that CATCo has taken a conservative stance by writing its remaining exposure (7% of assets) down to zero, and the managers remain hopeful that there will be some recovery of value.

### Impact of Side Pocket Investments

CATCo’s capital will not be released by a reinsurer at the end of the year if there remains a realistic possibility of a claim being made. In this situation, the capital is moved to a side-pocket of CATCo’s Master Fund that earns interest but cannot be reinvested into new contracts. For the Master Fund, new investors have no exposure to this side-pocket. For the listed fund, however, the ability to trade daily means that new investors have exposure to changes in the valuation of the side-pocket (which may be negative or positive). In addition, any uninvested cash included in the NAV creates a drag on returns for the following year. For instance, at the start of 2013, the side-pocket for Superstorm Sandy that had not been fully provided for represented c.4.5% of shareholders’ funds (this has since been released).
There are a number of options for CATCo Reinsurance Opportunities (the listed fund) in relation to side pockets:

a) Retain them as potential asset/liability within the fund, as with Superstorm Sandy (the residual exposure of c.7% is fully provided for).

b) Create a separate share class for the side-pocket: this would only be viable if the side pocket were substantial. Otherwise the costs to create the share class would be prohibitive. In any case, trading liquidity for the side-pocket share class would probably be poor.

c) Declare a continent distribution on any recovery (as was the case with Tohoku). This is perhaps the cleanest solution when a side-pocket is fully provided for, but there is the chance of a meaningful recovery.

Complications over potential losses following a catastrophe are an inevitable consequence of investing in the asset class. One disadvantage of Ultimate Net Loss (UNL) contracts is that losses are based on actual insured losses rather than industry wide losses, and these will typically take longer to assess. However, we believe that this is more than compensated for by the higher potential returns that can be generated.

Valuation and Outlook

In our view, CATCo offers an extremely attractive risk/return profile that is likely to have little correlation to other asset classes. The problem with many listed funds investing in alternative assets such as property or private equity is that the share prices are closely correlated to financial assets. For CATCo, however, both the NAV and share price have shown negligible correlation.

The key with any insurance investment is to understand the nature of the risk/return profile. Both the likelihood of losses and the size of potential losses need to be considered, and a product that appears to be a low risk investment may not necessarily be so. For instance, a Cat bond may have a 1% loss probability. However, investors could stand to lose all of their investment if a major catastrophe occurred.

In our view, CATCo provides a high degree of transparency on its portfolio for investors. The return profile and maximum impact of individual events is clear. However, the risk of multiple events happening is inevitably harder to assess. As the managers point out, historic modelling should be only treated as a guide. Nevertheless, it is encouraging that returns were positive during 2011/2012 despite this being the highest two year period on record for catastrophe insurance claims.
Potential for Enhanced Distribution

Looking forward to 2014, a potential concern for investors is that CATCo will not be able to invest its capital on such attractive terms as for 2013. As highlighted earlier, substantial inflows have hit pricing for ILWs and Cat bonds, but there has been little additional capital coming into the UNL retro market. At the recent Monte Carlo insurance gathering, CATCo’s preliminary negotiations with reinsurers suggest that its premiums for 2014 are likely to be broadly unchanged.

Investors in the Master Fund have the option to receive a distribution equivalent to the annual net return, but the current indications are that the vast majority are looking to rollover gains. Adding the annual premiums of $438m to the invested capital of $2.1bn would result in total assets of over $2.5bn for the 2014 renewal season. CATCo’s managers believe that the capacity for their strategy is up to $3bn. However, they have indicated that they may consider returning capital to investors at the end of 2013 if they cannot invest all the capital on attractive terms. For the listed fund, this could mean returning a substantial part of the NAV return for 2013, potentially giving investors the choice of a capital or income distribution. The company is currently consulting shareholders on this subject. In any case, the Master Fund is now soft closed and the managers will not look to raise further capital at the end of 2013.

Valuation and Trading Liquidity

CATCo’s share price tends to follow the NAV, albeit that it has typically ranged between a 5% discount and a 5% premium. The share price has risen 9% over the past few weeks to $1.092 per share following a period of marketing by the management team, which is broadly in line with our current estimated NAV (based on the last published NAV of $1.0769 at the end of September).

At launch, CATCo’s shareholder base was dominated by a number of institutional/multi-asset investors, and secondary market liquidity was relatively low. The shareholder base was broadened significantly through the C share issues and although the average daily trading value is around $350,000, it frequently trades in larger size on a matched basis via the broker.
Peer Group Comparisons

Comparison with Listed Reinsurance Funds

The universe of London-listed reinsurance funds is small, with three funds launched since the end of 2010: CATCo Reinsurance Opportunities, DCG IRIS and Blue Capital Global Reinsurance. These currently have a combined market cap of £419m ($674m), of which CATCo represents 60%. However, we believe that there is potential for the asset class to grow over time, reflecting the attractive risk/return characteristics. Key features of the three listed funds are compared in the table below, while more detailed summaries are provided in the Appendix.

### Table 2. Key Features of London Listed Reinsurance Funds

<table>
<thead>
<tr>
<th>Feature</th>
<th>Blue Capital Global Reinsurance</th>
<th>CATCo Reinsurance Opportunities</th>
<th>DCG Iris</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Ticker</strong></td>
<td>BCGR</td>
<td>CAT</td>
<td>DCG IRIS</td>
</tr>
<tr>
<td><strong>IPO Date</strong></td>
<td>06-Dec-12</td>
<td>20-Dec-10</td>
<td>27-Jun-12</td>
</tr>
<tr>
<td><strong>Listing</strong></td>
<td>London SE (SFM), Bermuda SE</td>
<td>London SE (SFM), Bermuda SE</td>
<td>London SE (main market)</td>
</tr>
<tr>
<td><strong>Domicile</strong></td>
<td>Bermuda</td>
<td>Bermuda</td>
<td>Guernsey</td>
</tr>
<tr>
<td><strong>Currency</strong></td>
<td>US$</td>
<td>US$</td>
<td>GBP</td>
</tr>
<tr>
<td><strong>Market Cap</strong></td>
<td>$167m/n</td>
<td>$404m</td>
<td>£61m</td>
</tr>
<tr>
<td><strong>Management</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fund Manager</td>
<td>Blue Capital Mgmt (Montpelier Re)</td>
<td>CATCo IM</td>
<td>Credit Suisse</td>
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<tr>
<td>Master Fund</td>
<td>Blue Water Master Fund</td>
<td>CATCo Diversified Fund</td>
<td>CS IRIS Low Volatility Plus Fund</td>
</tr>
<tr>
<td>Master Fund Liquidity</td>
<td>Monthly</td>
<td>Annual</td>
<td>Quarterly</td>
</tr>
<tr>
<td>Custodian</td>
<td>Bank of New York Mellon</td>
<td>Bank of New York Mellon</td>
<td>Zurich Kantonalbank</td>
</tr>
<tr>
<td><strong>Strategy</strong></td>
<td></td>
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<tr>
<td>Mandate</td>
<td>Reinsurance</td>
<td>Retro Reinsurance</td>
<td>Insurance linked strategies</td>
</tr>
<tr>
<td>Investments</td>
<td>Direct contracts with primary insurers</td>
<td>Direct contracts with reinsurers</td>
<td>Cat bonds and IL swaps</td>
</tr>
<tr>
<td>Main Trigger Type</td>
<td>UNL (actual losses)</td>
<td>UNL (actual losses)</td>
<td>Synthetic (index or parametric)</td>
</tr>
<tr>
<td>Type of contracts</td>
<td>Single event</td>
<td>Multi-pillar</td>
<td>Single event</td>
</tr>
<tr>
<td>Geography</td>
<td>Global (c.90% US)</td>
<td>Global (c.40% US)</td>
<td>Global (c.73% US)</td>
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<tr>
<td><strong>Target Return / Risk</strong></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Target Return</td>
<td>Libor +10%</td>
<td>Libor +12-15%</td>
<td>Libor +5-7%</td>
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<tr>
<td>Probability of meeting target return</td>
<td>68%</td>
<td>67%</td>
<td>n/a</td>
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<tr>
<td>Probability of positive returns</td>
<td>87%</td>
<td>85%</td>
<td>n/a</td>
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<tr>
<td>Max capital exposed to Single Event (impact on Annual Returns)</td>
<td>25%</td>
<td>5%</td>
<td>40%</td>
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<tr>
<td><strong>Yield</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Prospective Yield %</td>
<td>Libor plus 6%</td>
<td>Libor plus 5%</td>
<td>5%</td>
</tr>
<tr>
<td>Dividends Paid</td>
<td>Semi-annual</td>
<td>Annual</td>
<td>Quarterly</td>
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<tr>
<td><strong>Valuation</strong></td>
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<td></td>
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</tr>
<tr>
<td>Share Price</td>
<td>$1.1025</td>
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<td>99.5p</td>
</tr>
<tr>
<td>Last NAV</td>
<td>$1.0541 (30-Sep)</td>
<td>1.0789 (30-Sep)</td>
<td>98.92p (11-Oct)</td>
</tr>
<tr>
<td>Premium(+) / Discount(-)</td>
<td>4.6%</td>
<td>1.4%</td>
<td>0.6%</td>
</tr>
<tr>
<td>NAV Frequency</td>
<td>Monthly</td>
<td>Monthly</td>
<td>Monthly (&amp; weekly est)</td>
</tr>
<tr>
<td><strong>Fees</strong></td>
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<td></td>
</tr>
<tr>
<td>Base Fee</td>
<td>1.5% net assets (1.25%-$300m)</td>
<td>1.5% net assets</td>
<td>1.25% net assets</td>
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<tr>
<td>Performance Fee</td>
<td>15% NAV returns &gt;Libor +3% hurdle</td>
<td>10% NAV returns</td>
<td>None</td>
</tr>
<tr>
<td></td>
<td>subject to HWM &amp; Libor +10% trigger</td>
<td>subject to HWM &amp; Libor +7.5% trigger</td>
<td></td>
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<tr>
<td><strong>Website</strong></td>
<td><a href="#">www.bluecapital.bm</a></td>
<td><a href="#">www.catcoreoppsfund.com</a></td>
<td><a href="#">www.dexioncapital.com/dcg-iris</a></td>
</tr>
</tbody>
</table>

Source: Numis Securities Investment Companies Research
Some factors to consider when comparing the funds include:

- **Strategy:** IRIS employs a different strategy to both CATCo and BCGR in that it invests primarily in Cat bonds and insurance-linked swaps. Both CATCo and BCGR both have the ability to invest in these types of security, but their core focus is offering direct UNL exposure to collateralised reinsurance underwriting. The key difference between them is that BCGR provides reinsurance coverage for primary insurers, whereas CATCo provides reinsurance coverage for other reinsurers (retrocessional protection).

- **Target Return:** CATCo offers the highest target return of Libor plus 12-15% pa over a rolling five year period. In contrast, IRIS offers a much lower return target of Libor plus 5-7% pa. The Libor element of the return represents the interest on cash held as collateral, albeit that this is currently small.

- **Risk Profile:** To some degree, the risk of these vehicles reflects their return targets i.e. IRIS typically invests in ILS products with higher attachment points than CATCo or BCGR, suggesting that losses are less likely to be triggered (e.g. its exposure to Sandy was modest). Its expected losses from the portfolio are “in the region of 2-4% pa”. However, IRIS may be more susceptible to a mega event than CATCo or BCGR. While the probability of a major loss for IRIS may be small, this would be little consolation for investors if it happened, particularly if they classify it as a low risk investment.

- **Each fund provides data on the downside exposure to a major event, but these figures are not always easy to compare.** In summary:
  - **BCGR:** maximum loss of 25% of NAV based on a 1 in 100 year event (1 in 250 for earthquakes). 68% probability that returns exceed Libor +10%; 13% probability of a negative return; and 0.5% probability of a loss exceeding 25%.
  - **CATCo:** Maximum downside of 5% over a calendar year from any single event (2% for 2013 portfolio). For the current portfolio, the managers estimate a 85% probability that investor returns will be positive over a year and an 67% probability that they will deliver positive returns in excess of 12%.
  - **IRIS:** The prospectus states that the maximum impact of a single event will not exceed 40% of net assets. According to the company’s factsheet, the annual VaR is -9.0% at the 95% percentile and -28.9% at the 99% percentile.

- **Diversification:** In terms of the number of investments, IRIS is highly diversified. However, the majority of its investments (73%) have exposure to US Wind or Quake events. BCGR is also heavily focused on US Wind events (albeit broken down on a regional basis), whereas CATCo’s portfolio is globally diversified across 42 different risk pillars, with exposure to the US of around 40% (including second-event backup protection). It should be recognised that the exposures will differ each year, but we believe that CATCo’s multi-pillar approach means that it will remain the most diversified by geography.

- **Structure:** All three listed funds are feeders into a Master Fund. IRIS is listed on the main market of the London SE, while CATCo and BCGR are traded on the SFM. However, CATCo and BCGR both have secondary listings on the Bermuda SE which make them eligible for ISAs/SIPPs.
Currency: CATCo and BCGR are US$ denominated vehicles, which may introduce currency volatility for UK investors. In contrast, IRIS is Sterling traded and its investment returns are hedged into Sterling.

Cash Drag: IRIS and BCGR are both seeking to raise additional capital through regular placing programmes which may result in cash drag. For instance, cash represents 14% of IRIS’ portfolio and 12% for BCGR, according to their latest factsheets. CATCo’s portfolio is fully invested at the start of the year (subject to any side-pocket reserves), and neither the listed fund nor the Master Fund is currently looking to raise capital.

Asset Valuation: The valuation methodology used by all three funds is essentially the same, with premiums of direct investments recognised as they are “earned” based on the seasonality of risk exposure. A reserve is provided for through a side pocket in the Master Fund once there appears to be the potential for a claim (the reserve is released once the claim is finalised or commuted). IRIS values its Cat bond exposure based on average bid prices from brokers.

Management Expertise: Both CATCo and BCGR benefit from experienced underwriters with access to detailed Cat modelling. Both managers look for detailed information on the underlying portfolio to determine pricing and attachment points. Credit Suisse has a team of 11 investment professionals managing assets of $5.3bn in ILS.

Fees: IRIS has the lowest fee at 1.25% of net assets with no performance fee. However, this would be expected given its lower return profile and investment policy (buying Cat bonds and commoditised ILS products). CATCo and BCGR have the same base fee of 1.5% pa, and both charge performance fees based on annual NAV gains subject to a high water mark and trigger (with fees charged at the Master Fund level). CATCo charges 10% of gains subject to a trigger of Libor plus 7.5%, while BCGR charges 15% over Libor plus 3% subject to a trigger of Libor plus 10%. Assuming a 15% annual return, CATCo’s performance fee would be lower than BCGR whilst Libor remains below 2% pa. As a larger vehicle, the expenses of CATCo’s listed vehicle are spread over a broader asset base.

Performance: Comparing performance is difficult given the short track records, particularly for IRIS and BCGR. The charts below show performance since the IPOs of IRIS (mid-2012) and BCGR (start of 2013).

Figure 23. Performance since June 2012

<table>
<thead>
<tr>
<th></th>
<th>% Total Return</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>CATCo</td>
<td>16.3%</td>
<td>17.3%</td>
</tr>
<tr>
<td>IRIS</td>
<td>5.8%</td>
<td>6.9%</td>
</tr>
</tbody>
</table>

Note: % total return in local currency (US$ for CATCo, Gbp for IRIS), Source: Numis Securities Investment Companies Research

Figure 24. Performance in 2013 YtD

<table>
<thead>
<tr>
<th></th>
<th>% Total Return</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>BCGR</td>
<td>11.1%</td>
<td>9.6%</td>
</tr>
<tr>
<td>CATCo</td>
<td>18.7%</td>
<td></td>
</tr>
<tr>
<td>IRIS</td>
<td>5.1%</td>
<td>4.8%</td>
</tr>
</tbody>
</table>

Note: % total return in local currency (US$ for CATCo & BCGR, Gbp for IRIS), Source: Numis Securities Investment Companies Research
Fortunately, there are some vehicles that can be used as a proxy for historic performance. The Master Fund for IRIS, the CS IRIS Low Volatility Plus Fund, dates back to the start of 2012, but the CS Low Volatility Fund has a track record dating back to August 2007 (this has a similar mandate, but with monthly liquidity and a higher weighting in Cat bonds).

In its prospectus, BCGR provided a track record for a carve out of contracts written by Montpelier Re that meet its investment policy for the ten years from 2002-2011. The average annual return based on this data is 10.5% (excluding Libor), but there were three years of negative performance (-6.3% in 2004, -4.7% in 2005 and -1.4% in 2008). Interestingly, the strategy delivered strong returns in 2011 of 11.2%; we believe that this reflected the heavy focus on US risks during a year when the three largest events happened in the Far East/NZ.

**Figure 25. Historic Performance of Related Investments for BCGR and IRIS**

<table>
<thead>
<tr>
<th>Year</th>
<th>Montpelier</th>
<th>CS IRIS</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>13.7</td>
<td></td>
</tr>
<tr>
<td>2003</td>
<td>12.2</td>
<td></td>
</tr>
<tr>
<td>2004</td>
<td>-6.3</td>
<td></td>
</tr>
<tr>
<td>2005</td>
<td>4.7</td>
<td></td>
</tr>
<tr>
<td>2006</td>
<td>25.3</td>
<td></td>
</tr>
<tr>
<td>2007</td>
<td>17.8</td>
<td></td>
</tr>
<tr>
<td>2008</td>
<td>-1.4</td>
<td></td>
</tr>
<tr>
<td>2009</td>
<td>6.7</td>
<td></td>
</tr>
<tr>
<td>2010</td>
<td>18.3</td>
<td></td>
</tr>
<tr>
<td>2011</td>
<td>19.2</td>
<td></td>
</tr>
<tr>
<td>2012</td>
<td>11.2</td>
<td></td>
</tr>
</tbody>
</table>

Note: CS IRIS is from Aug-07, Returns of CS IRIS Low Volatility Fund. Montpelier Re data available to end-2011.
Source: Company prospectus

CATCo provides back-tested data for its current portfolio (as discussed earlier) showing returns of c.18% pa over a historic 10 year period. The fund’s NAV returns were negative in 2011 (-4%), although this may be reversed if, as expected, a provision for the Japan earthquake is partially released. In any case, the actual NAV returns since launch have been decent for the Ordinary shareholders since IPO (7.4% pa) and impressive for original investors in the C share (15.9% pa).

**Yield:** All of the funds generate a yield by redeeming shares of the Master Fund (or by utilising existing cash resources) as the portfolios do not typically generate regular income. Although this could be regarded as a “manufactured yield”, we believe that the nature of the reinsurance premium equates to a regular yield. Significantly, the funds look to pay out a predetermined yield regardless of NAV returns during the year, providing certainty for investors (although, as stated earlier, CATCo is considering an enhanced distribution at the end of 2013).

**Time to Resolve Claims:** IRIS focuses on synthetic triggers which means that it is likely to be much quicker to resolve potential claims than CATCo or BCGR which are dependent on the (re)insurers actual losses via UNL contracts. This was illustrated by Superstorm Sandy: IRIS has now closed its reserve whereas CATCo’s provision appears unlikely to be resolved until 2014 (albeit that there is now only potential upside to the NAV).
CATCo has a performance trigger, as well as a discount trigger

**Life/Discount Controls:** None of the funds has commitments to protect a specific discount. However, each has some form of tender/redemption triggered if the discount exceeds 5% over a defined period. In addition, CATCo has a performance related continuation vote if the trailing three year annualised gross return is below Libor +7.5%.

**Table 3. Listed Reinsurance Funds – Discount Controls**

<table>
<thead>
<tr>
<th></th>
<th>Blue Capital Global Reinsurance</th>
<th>CATCo Reinsurance Opportunities</th>
<th>DCG Iris</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Buyback Authority</strong></td>
<td>14.99%</td>
<td>14.99%</td>
<td>14.99%</td>
</tr>
<tr>
<td><strong>Tender/Redemption</strong></td>
<td>25% tender at NAV less costs if discount &gt;5% in 3 mths to 31 Aug each year</td>
<td>25% tender at NAV less 2% if discount &gt;5% in 3 mths to 31 Aug each year</td>
<td>Board considers 25% redemptions at NAV less costs if discount &gt;5% in 3 mths to end-Feb and 31 Aug each year</td>
</tr>
<tr>
<td><strong>Continuation Vote</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Size Triggered</strong></td>
<td>If NAV &lt;$150m at 30-Jun-14</td>
<td>Passed</td>
<td>Failed (but vote passed)</td>
</tr>
<tr>
<td><strong>Fixed Date</strong></td>
<td>None</td>
<td>Every 5 years from launch</td>
<td>None</td>
</tr>
<tr>
<td><strong>Performance Triggered</strong></td>
<td>None</td>
<td>If 3 yr trailing IRR &lt;Libor +7.5% from 2014</td>
<td>None</td>
</tr>
</tbody>
</table>

**Exposure to Pricing Pressure:** The Cat bond/ILW market has seen considerable pricing pressure during 2013 and we believe that this is likely to have a significant impact on the returns of IRIS. BCGR’s returns are also likely to be impacted by the increase in reinsurance capital, even though the fund seeks to target smaller insurers where margins may be higher. In contrast, there is far less pricing pressure in the UNL retro market, and CATCo’s unique multi-pillar approach has already established a market leading position.

**Pros & Cons of Peer Group**

All three of the London listed reinsurance funds are trading at modest premiums to NAV and so there is no compelling short term valuation argument to differentiate between them, in our view. CATCo is the largest and has the greater secondary market trading liquidity (although the other funds are currently raising capital which provides liquidity for buyers). We believe that CATCo’s combination of high potential returns, diversified portfolio and limited exposure to even the largest catastrophe makes it the most attractive vehicle for investors on a medium term basis.

BCGR has a very similar structure to CATCo, perhaps unsurprising given that the former Chairman of CATCo was also non-executive Chairman of Montpelier Re. In summary, we regard BCGR as a similar vehicle to CATCo, with a lower return profile, but with similar or potentially higher risks. CATCo has a similar probability of generating positive returns as Blue Capital (BCGR), yet this is achieved with much less exposure to both US risks and to a single loss event. Furthermore, in a typical year of modest losses (such as 2013 YtD) CATCo’s returns are likely to be far higher than BCGR’s.

BCGR is heavily exposed to US Wind Events (including >38% Florida Wind). In contrast, CATCo has a far more diversified portfolio and its returns are enhanced by the multi pillar approach through which the risk of multiple events in a single year are passed back to the reinsurer (by covering only the first four of 8/9 risk pillars). In addition, BCGR targets primary insurers where there is greater pricing pressure from capital entering the asset class. The UNL retro market would probably be difficult for Montpelier Re to access as it would be viewed as a competitor by other reinsurers.
On the face of it, IRIS looks attractive as a low risk exposure to the reinsurance market. It can be expected to deliver low-mid single digit positive NAV returns most years due to high attachment points within its reinsurance contracts. Furthermore, its portfolio is relatively liquid, enabling the manager to exploit relative value opportunities over the year. In addition, claims are likely to be resolved relatively quickly due to the use of industry/parametric triggers, reducing the likelihood of side pockets. The Sterling hedged currency quote is also likely to be favoured by UK investors. On the other hand, the expected return is modest relative to CATCo and BCGR, but the downside to a mega event is perhaps greater. Furthermore, IRIS invests in commoditised ILS products that are likely facing considerable pricing pressure, bringing questions over the attractiveness of the risk/return profile in the near term.

### Table 4. Pro and Cons of London Listed Reinsurance Funds

<table>
<thead>
<tr>
<th>Fund</th>
<th>Pros</th>
<th>Cons</th>
</tr>
</thead>
<tbody>
<tr>
<td>Blue Capital Global Reinsurance</td>
<td>Attractive target return</td>
<td>Lack of diversification - heavy US focus</td>
</tr>
<tr>
<td></td>
<td>Backing of large reinsurer</td>
<td>Up to 25% downside from major event</td>
</tr>
<tr>
<td>CATCo Reinsurance Opps</td>
<td>Attractive target return</td>
<td>Diversification increases likelihood of some losses in a year</td>
</tr>
<tr>
<td></td>
<td>Limited downside (5%) even from mega event</td>
<td>UNL contracts may take time to settle</td>
</tr>
<tr>
<td></td>
<td>Experienced management</td>
<td>Pricing pressure in traditional cat reinsurance market</td>
</tr>
<tr>
<td>DCG ISIS</td>
<td>Low probability of significant loss</td>
<td>Relatively low expected return</td>
</tr>
<tr>
<td></td>
<td>Steady return profile</td>
<td>Large potential loss (up to 40%) from mega event</td>
</tr>
<tr>
<td></td>
<td>Quick settlement of losses due to synthetic triggers</td>
<td>Lack of pricing power</td>
</tr>
<tr>
<td></td>
<td>No performance fee</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Sterling hedged</td>
<td></td>
</tr>
</tbody>
</table>

Source: Numis Securities Investment Companies Research

### Comparison with UK Listed (Re) Insurers

The UK listed reinsurance stocks have delivered compound net asset value growth of around 15% pa over the long term. However, share price returns have often been weaker due to dilution from equity issues. In addition, there is often a poor correlation between NAV performance and share price returns in any year as the sector ratings are influenced by anticipated earnings, equity market sentiment and sector rotation. For instance, 2005 saw a net asset return of +4% versus a share price return of +48%, while in 2009, the net asset return was +30%, but the return to shareholders was -2%. In contrast, CATCo’s share price tends to move closely in line with NAV. In our view, this primarily reflects differences in the buyers of the two vehicles.

Somewhat perversely, the share prices of the listed reinsurers may perform strongly following a major catastrophe as investors anticipate a period of higher reinsurance rates. In contrast, investors in CATCo are likely to focus solely on the expected NAV impact of the event.
Table 5. Comparison to listed (re)insurance companies

<table>
<thead>
<tr>
<th>Reinsurance Company</th>
<th>CATCo</th>
</tr>
</thead>
<tbody>
<tr>
<td>Target ROE</td>
<td>Typically 15%</td>
</tr>
<tr>
<td>Risk appetite</td>
<td>Not clearly defined</td>
</tr>
<tr>
<td>Underwriting portfolio</td>
<td>Diverse</td>
</tr>
<tr>
<td>Exposure</td>
<td>Low transparency</td>
</tr>
<tr>
<td>Investment Portfolio</td>
<td>Generally low risk assets</td>
</tr>
<tr>
<td>Premium revenue</td>
<td>50-300% net assets</td>
</tr>
<tr>
<td>Capital</td>
<td>Risk of regulatory / rating agency shortfall</td>
</tr>
<tr>
<td>Strategy</td>
<td>Subject to change (eg M&amp;A risk)</td>
</tr>
<tr>
<td>Yield</td>
<td>7.2% (range 3.9%-17.5%)</td>
</tr>
<tr>
<td>Valuation</td>
<td>c.1.4x net assets</td>
</tr>
</tbody>
</table>

Current UK-listed (re)insurers include Amlin, Beazley, Catlin, Hiscox, Lancashire, Novae. Source: Numis Securities Investment Companies Research

Furthermore, there can be a wide range of returns each year between the best and worst performers, as illustrated in the chart below for 2011. The two worst performers in the year (Omega and Hardy) were subsequently taken over.

At present, we believe that CATCo looks attractively valued in relation to the listed reinsurers which are trading at an average of 1.4x of net assets, compared to a historic range of 0.7x to 1.8x. CATCo has a similar return profile for net asset value growth (potentially higher in 2013 assuming no losses), but the nature of its returns are far more transparent. In addition, its yield is secure, whereas the dividend of reinsurers is subject to earnings and capital constraints.
Appendix I – CATCo: Background and Structure

Capital History
CATCo started trading on 20 December 2010 on the Specialist Fund Market of the London Stock Exchange. At launch, CATCo raised gross proceeds of $80.4m at $1.00 per share, including $25m from the Qatar IC. It has held two further significant fund raisings: $124.4m for the issue of C shares in May 2011 at $1.00 per share and $125m for a secondary issue of C shares in December 2011 at $1.052 per C share. The C shares converted into Ordinary shares in August 2012 at a rate of 1.156 Ordinary shares per C share (giving an effective entry price of $0.865 per C share). The company now has a single share class, with 369.849m Ordinary shares in issue.

Figure 28. CATCo – Growth in Net Assets

Structure
The company is domiciled in Bermuda and is structured as a feeder fund into an unquoted Master Fund, the CATCo Diversified Fund. The Master Fund writes its reinsurance contracts through CATCo-Re, a Bermuda licensed Class 3 reinsurance company.

Following IPO, the listed fund represented the bulk of assets within the Master Fund. However, we understand that the Master Fund now has assets of c.$2bn, of which the listed fund represents c.20%. There are two unlisted share classes, one with a three year lock-up (similar fees to CATCo) and one with a 12 month lock-up (and higher fees).

CATCo (via the Master Fund) sets up segregated accounts with reinsurers. The premium paid by the reinsurer and the collateral from CATCo required to meet any potential claim are both deposited directly into a trust account held at The Bank of New York Mellon (BoNYM) and invested solely in AAA rated money market funds or short term US Treasury bills. If there are no claims during the period of the contract (typically 12 months), then BoNYM will pay CATCo the premium, collateral and interest earned. In contrast, if conditions are met for a claim, then this will be paid directly to the reinsurer by BoNYM, with any excess returned to CATCo at the end of the period. No claim can be for more than is held in the account.

Return Target and Yield
CATCo seeks to deliver a target total return of Libor plus 12-15% pa, net of fees and expenses. Its policy is to make a distribution to shareholders of Libor plus 5% of NAV at the end of the calendar year, regardless of the level of returns in the previous year. As discussed above, however, the Board has indicated that it may consider an enhanced distribution at the end of 2013.
Contingent Distribution for Tohoku: The merger of the Ordinary and C share classes was facilitated by a contingent distribution declared to Ordinary shareholders in respect of any recovery from the reinsurance contracts linked to the New Zealand earthquake of February 2011 and the Japanese earthquake/tsunami in March 2011. A full provision had already been made in respect of these events, but if there is any recovery of value a distribution would be made by 31 December 2014 to Ordinary shareholders on the register on 10 August 2012. The NZ loss has now been fully crystallised, but CATCo’s managers are hopeful that a portion of the 12% reserve of Tohoku (potentially 5-6%) will be released in Q1 or Q2 2014.

Management Team

The investment manager, CATCo Investment Management, is backed by the Qatar Insurance Company, the largest insurer in the State of Qatar. The key individuals responsible for the fund and its investments are:

- **Tony Belisle, CEO:** An actuary with 30 years’ (re)insurance and investment experience with Goldman Sachs, Citadel Investment Group, Deutsche Bank, Fidelity Investments, Sun Life of Canada and Oxygen Insurance Brokers.

- **Jason Bibb, COO/CFO:** CFA and AICSA with over 18 years of investment management experience for alternative investment vehicles. Previous roles included COO of Citigroup’s Alternative Investments division and North American product head. Jason also spent 10 years with Martin Currie IM in active equity and alternative management.

- **Graham Wood, Chief Underwriting Officer:** Over 20 years of reinsurance experience with Lloyd’s syndicates and global reinsurance broking houses, including Benfield, Gallagher Re and Oxygen Re.

- **Ron Collins, Director of Underwriting:** 30 years of reinsurance underwriting and broking experience with Aon Benfield, Benfield Group, Willis Re, and Reliance National Company.

- **Sam Niles, Chief Actuary:** Over 25 years’ insurance and investment experience, focused on developing risk/financial projection models. Previous experience includes First Marblehead, American Financial Systems, Sun Life of Canada and Paul Revere Insurance Group. Sam is both an accredited actuary and a software engineer.

- **Judith Wynne, Group Counsel & Company Secretary:** Qualified solicitor and chartered company secretary (ACIS) with more than 20 years’ experience in corporate governance, M&A, investments and legal and compliance. Previously worked at Aberdeen AM, Martin Currie IM, National Australia Group and Scottish & Southern Energy.

- **Michael Toyer, Head of Investment Operations:** Over 10 years of accounting experience, including in reinsurance, hedge funds and financial services having held a number of senior accounting roles at Ernst & Young and Prime Management where he focused on Insurance Linked Securities based portfolios.

- **Mark Way, Corporate Communications Director:** 17 years’ experience of financial communications. Managed over $10bn of corporate transactions and IPOs in the UK, Australia and the US with specialist knowledge of the financial services sector. Previously, Managing Partner of City of London investor relations consultancy.
Corporate Governance

CATCo has a fully independent Board with considerable (re)insurance experience: Nigel Barton (Chairman), James Keyes, Margaret Gadow and Alastair Barbour. The fund is a member of the Association of Investment Companies (AIC) and its reports follow the principles and recommendations of the AIC Code which “translates the UK Corporate Governance Code into a framework suitable for the industry’s unique structure”.

Management Fees

CATCo charges a basic management fee of 1.5% pa of net assets, and there is an annual performance fee of 10% of total return, subject to a trigger of Libor +7.5% and a high watermark. In the last financial year, the day-to-day operational expenses of the company, including directors’ fees, administration and professional fees were $830,000 pa and CATCo’s share of the expenses of the Master Fund is around $265,000 pa (there is no double charging of management fees by the Master Fund). Together, these expenses represent c.0.27% of net assets.

Discount Controls

The company has the authority to repurchase 14.99% of its share capital. However, the annual liquidity of the portfolio makes it difficult to buy back shares on a regular basis without holding excess cash or using gearing. As a result, there is also a commitment to offer a tender offer for up to 30% of the share capital if the volume weighted average discount to NAV exceeds 5% in the three months to 31 August each year. The tender would be held post the calendar year-end at NAV less the costs of the tender and an exit charge of 2%. If more than 50% of the share capital elects to tender, the company would hold a continuation vote at its next AGM. Most of the portfolio is expected to be highly liquid at the end of each calendar year due to the nature of the retro reinsurance contracts.

At launch, there were provisions for tenders if the company’s net assets were below $150m at the end of 2011 or below $200m at the end of 2012. However, these “size tests” were achieved, and so no tenders were triggered.

CATCo does not have a fixed life, but there is a continuation vote every five years and, from the third year, a vote will also be held if the trailing three-year IRR based on the gross portfolio return is less than Libor plus 7.5%. There is also a key-man clause relating to Tony Belisle, and his departure prior to the start of 2014 would also trigger a continuation vote.
Appendix II – Other Listed Reinsurance Funds

DCG IRIS

Capital history: DCG IRIS raised £40.1m at IPO on 27 June 2012. In November 2012, IRIS published a prospectus for a placing of new shares, but this was delayed by uncertainty over the impact of Sandy. Subsequently, it issued 11.025m C shares on 20 December 2012 which converted into Ordinary shares in February 2013 at a rate of 0.9956. In May 2013, a further 9.174m shares were issued through the placing programme at 101.12p, and the fund is currently seeking to make another secondary placing: this closes on 21 October, with the new shares due to start trading on 25 October. IRIS currently has 61.469m shares in issue, equivalent to net assets of £62m.

Mandate: IRIS is a London-listed feeder into the Credit Suisse IRIS Low Volatility Plus fund, which offers exposure to a diversified portfolio of catastrophe risks. IRIS invests primarily through Cat bonds and insurance-linked swaps. However, the Master Fund has “maximum flexibility” to invest in a wide range of listed and OTC financial instruments providing insurance exposure, with up to 30% in IL funds managed by Credit Suisse. The portfolio is actively managed, using a relative value analysis, and targets “the lowest expected losses and should only be impacted by mega or very large events”. The manager favours synthetic triggers, which “reduce complexity and provide transparency to quickly assess losses”.

The Master Fund was launched in January 2012 and had $619m in assets as at 31 May 2013. The Credit Suisse Insurance Linked Strategies team is based in Zurich and had 11 investment professionals as at 30 June 2013, managing $5.3bn in insurance-linked strategies.

Target Return: IRIS targets a net return of LIBOR plus 5-7% pa and annual volatility of 2-4%. Expected losses from the portfolio are “in the region of 2-4% pa”.

Portfolio: As at 31 July, 74% of assets were invested via direct IL swaps and 12% in Cat bonds, with 14% in cash. The weighting in Cat bonds is currently low relative to a typical target of 30%, reflecting unattractive pricing at present. The portfolio exposure by risk type is shown in the chart below. This adds to 148% as some contracts are exposed to more than one risk (but the portfolio is ungeared).

<table>
<thead>
<tr>
<th>Exposure</th>
<th>US Wind</th>
<th>US Quake</th>
<th>Japan Quake</th>
<th>Japan Wind</th>
<th>Europe All</th>
<th>Aus/NZ Wind</th>
<th>Aus/NZ Quake</th>
<th>L America All</th>
<th>Canada All</th>
<th>E Europe/M East</th>
<th>Marine/Energy</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>39%</td>
<td>34%</td>
<td>14%</td>
<td>14%</td>
<td>19%</td>
<td>5%</td>
<td>5%</td>
<td>7%</td>
<td>5%</td>
<td>3%</td>
<td>2%</td>
<td>1%</td>
<td></td>
</tr>
</tbody>
</table>

Note: Total exposure adds to 148% as some investments cover more than one region/peril.

Source: Company Factsheet

Source: Factsheet as at 31 Jul 2013
There were 137 positions in the portfolio as at 31 July, through 65 counterparties, including 20 Cat bonds. The largest position represented 3.1% of net assets.

**Currency:** IRIS is listed in Sterling and its returns are hedged into Sterling. This contrasts with CATCo and Blue Capital which are US$ denominated vehicles.

**Distributions:** The fund targets a quarterly dividend of 1.25p, equivalent to a yield of 5% pa.

**Fees:** The base management fee is now 1.25% pa of net assets, with no performance related fee (prior to 1 April 2013 it was 1.1% of net assets, with a performance fee of 10% of returns in excess of Libor, subject to a high water mark). Operating expenses are estimated to be £275,000, equivalent to 0.44% of current net assets.

**Discount Controls:** IRIS has the authority to buy back up to 14.99% pa of its share capital. In addition, the Board will consider a redemption for 25% of the share capital at NAV less costs if the discount exceeds 5% during the three month period to end-February and end-August each year. The redemptions would be held at 30 June and 31 December, respectively, and would include a mix and match facility. A continuation vote and redemption offer were triggered by the company’s net assets being below £150m at 30 June 2013. However, no redemption requests were triggered and the continuation vote was passed at an EGM on 5 September 2013.

**Performance:** Since launch in mid-2012, IRIS has delivered an NAV and share price total return of 5.8% and 6.4% respectively (equivalent to 4.6% and 5.0%, respectively, on an annualised basis). The fund’s first six months saw two events have a negative impact on performance:

- 0.79% of NAV due to the US crop drought in mid-2012
- 0.24% of NAV due to Superstorm Sandy. In Q4, 4.9% of the NAV (via 12 investments) was transferred into a side pocket, reflecting uncertainty over the size of the claim. The side pocket was reduced to c.1% of NAV in January 2013 and released in September 2013 following the publication of the final PCS insured loss estimate.

**Downside risk:** The prospectus states that the maximum impact of a single event will not exceed 40% of net assets. According to the company’s July factsheet, the expected annual loss from the portfolio is 2.03% (versus the expected pre-loss return of Libor plus 6.89%). The annual VaR at the -9.0% at the 95% percentile and -28.9% at the 99% percentile. Based on modelling by Credit Suisse, the negative impact of historic events would be 23.1% for Hurricane Andrew, 12.1% for Katrina, 5.4% for Tohoku Quake, 3.6% for the Northridge Quake and 3.3% for the Kobe Quake.

**Blue Capital Global Reinsurance**

**Capital history:** BCGR was listed on the Specialist Fund Market of the London SE in December 2012, having raised $100.1m, including an investment of $50m from the parent group, Montpelier Re (which is locked-in for 12 months). BCGR raised a further $52.275m through a secondary placing in May 2013. As a result, the fund now has 151.4m shares in issue. It is looking to raise further capital this month as part of a regular placing programme. This will be at a price of $1.09 which represents a 3.4% premium to the September NAV (the placing closes on 22 October and the new shares are due to start trading on 28 October).

**Target Return:** BCGR seeks to deliver an NAV return of Libor +10% pa “over the longer term”. The factsheet also states an expected median return target of Libor +13% pa.
Management: The Master Fund invests via Blue Water Re, a Bermudan reinsurer wholly owned by Blue Capital Management. In turn, Blue Capital is an asset management subsidiary of Montpelier Re, a US listed ($1.3bn market cap), Bermuda based reinsurer focused on the property catastrophe market. It was established in 2001 and now has over $3.5bn of assets. Adam Szakmary, the portfolio manager for the strategy, joined the Montpelier Group in 2004.

Mandate: BCGR invests primarily in a portfolio of collateralised reinsurance-linked contracts with primary insurers, although it also has the ability to invest in other ILS such as ILWs and Cat bonds. Its investment strategy “is to actively invest in a more diversified range of reinsurance instruments than is typically accessed by most reinsurance funds”.

Montpelier Re has a proprietary risk management system, called CATM, to analyse and manage its reinsurance exposures. As part of Blue Capital’s pricing and underwriting process it assesses property construction type, location, value and geographic risks, as well as the historical loss data of the insurer as well as its claims mitigation history.

Investment restrictions: BCGR’s Master Fund has adopted a number of restrictions which apply at the time of investment:

- the maximum aggregate exposure (i.e. the sum of all contractual limits) in any one zone (each zone being defined by a combination of geography, peril and occurrence) will not exceed 35% of net asset value;
- the probable maximum loss from any one catastrophe loss event at the 1 in 100 year return period (1 in 250 years for earthquakes) will not exceed 25% of the Master Fund’s NAV;
- no more than 20% of the Master Fund’s NAV will be invested in any one catastrophe-linked contract or security; and
- the Master Fund will not invest in contracts or securities with a premium of less than 5% of the limit exposed to a single event

Portfolio: The key renewal season is at the start of the calendar year, and BCGR’s portfolio still held cash of 12% at 31 August as a result of its fund raising in May. Around 90% of the current portfolio is exposed to US events, with a substantial exposure to Florida Wind (39% of assets plus additional exposure through nationwide/global contracts). The interim report at 30 June stated that the Master Fund had invested $136m across 83 different positions and 36 different clients, generating $28m of net premium written (equivalent to 20.6% RoL).

Figure 31. BCGR - Portfolio by Asset Type

Figure 32. BCGR - Portfolio by Geographic Region
Distributions: The fund targets a yield of Libor plus 6% pa, paid semi-annually in August and March. Its first dividend of $0.19 per share was paid in August 2013, and a dividend of $0.44 is expected in March. The dividends will be funded by redemptions from the Master Fund or from existing cash resources.

Fees: Fees are charged at the Master Fund level. The base management fee is 1.5% pa of net assets (1.25% on assets over $300m). There is a performance fee of 15% of NAV total return over a hurdle of Libor plus 3%, subject to a high watermark and a trigger of Libor plus 10%.

Discount Controls: BCGR has the authority to repurchase 14.99% pa of its share capital. In addition, it will hold a 25% tender at NAV less costs if the discount exceeds 5% in the three month period to 31 August each year.

Life: The company has an indefinite life. A continuation vote will be proposed within four months if the NAV as at 30 June 2014 is less than $150m (although this appears unlikely).

Performance: It is still early days, as there have been few significant catastrophes since the start of 2013 when the fund started trading. However, the fund included a reserve provision of $0.8m (0.5%) in May for estimated losses from the Oklahoma tornadoes. For the first nine months of the year, the NAV total return was 9.6%. The NAV at 30 September was $1.0541, up from $0.98 at launch. The historic track record of a carve out of Montpelier Re’s reinsurance portfolio was highlighted earlier in the report.

Downside risk: BCGR’s latest factsheet states that there is a: 68% probability that returns exceed the mean target return; a 87% probability of a positive return; and a 0.5% probability of a loss exceeding 25%. It models the maximum probable loss as a proportion of NAV for various events as follows: Florida hurricane 23.7%; US NE hurricane 15.8%; US Gulf hurricane 15.1%; Japan quake 9.7% and US Mid-Atlantic hurricane 6.9%.
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16 October 2013

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