Building up an ILS portfolio over time

alecta

Agenda

- Background on Alecta
- Benefits of Alternative Assets
- Overview of the ILS market
- ILS in an institutional portfolio
- The St Petersburg Paradox: Finding the right risk level
- Summary
- Q&A

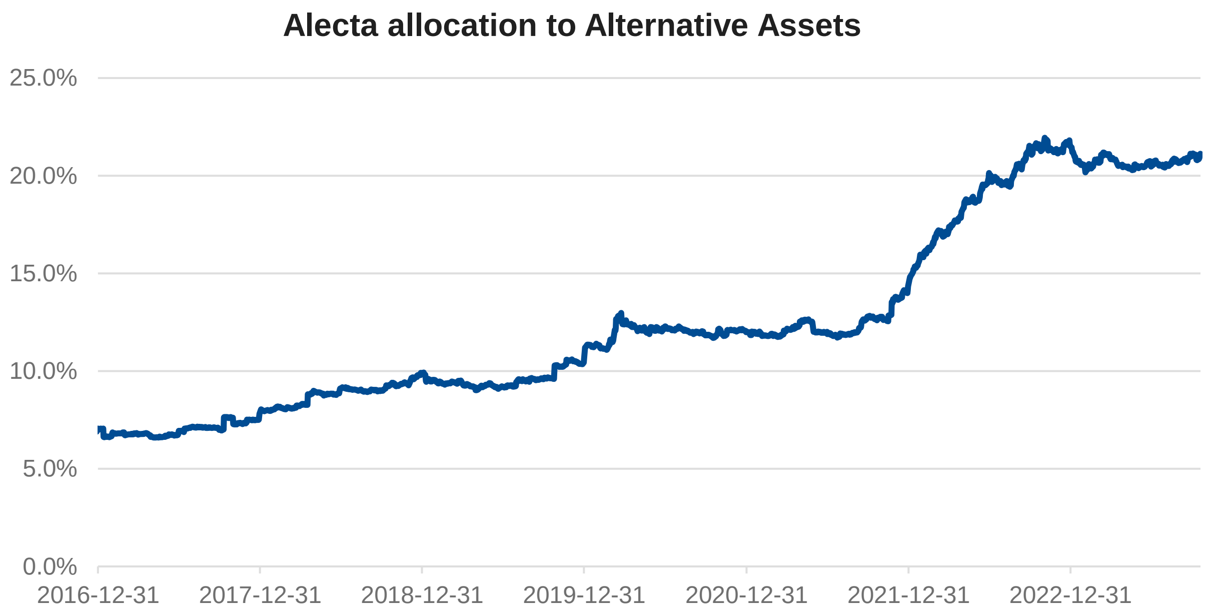
Background on Alecta

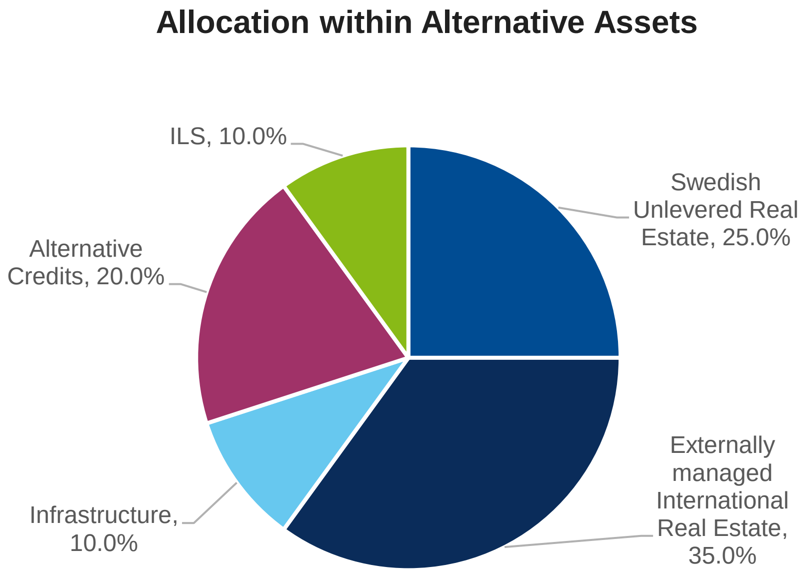
- 5th largest pension fund in Europe, 100+ years old, 120 bn Euro under management. 80% defined benefit, 20% defined contribution.
- Primarily default provider for collectively agreed occupational pension in Sweden, mutually owned by 2,6 mln workers and 35 thousand corporations.
- As the default provider we currently get around 2-3bn euros in inflows annually.
- *”Probably the world’s cheapest pension fund”,* 90% of assets managed internally keeps total costs at roughly 2 bps.

Benefits of alternative assets

- Historically high risk concentration in listed equity: 45% of assets but 90% of volatility.
- This creates uncertainties in the prognosticated pension and potential conflicts of interest between different age groups.
- Focus on reducing equity volatility in the portfolio and finding assets with lower risk, diversifying capabilities and where prices were not distorted by the central banks.
- Alecta started to look more into ILS after 2020. Today ILS makes up 1,5% of the total portfolio.

Allocation Alternative Assets



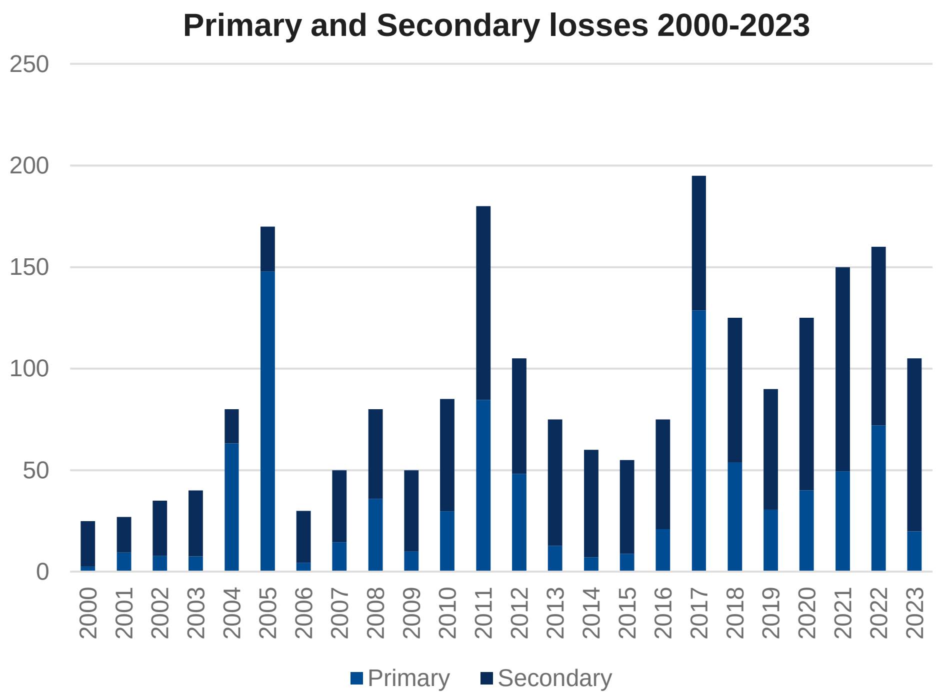


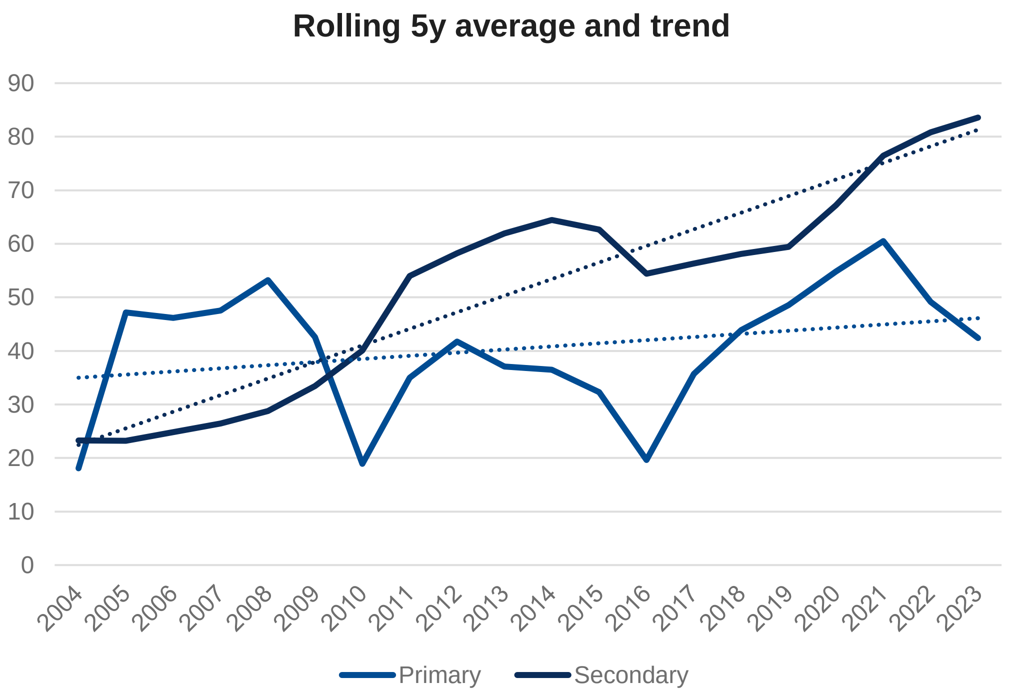
→From 5 bn Euros in swedish Real estate in 2016 to 20 bn today across five broad buckets.

Overview of the ILS market

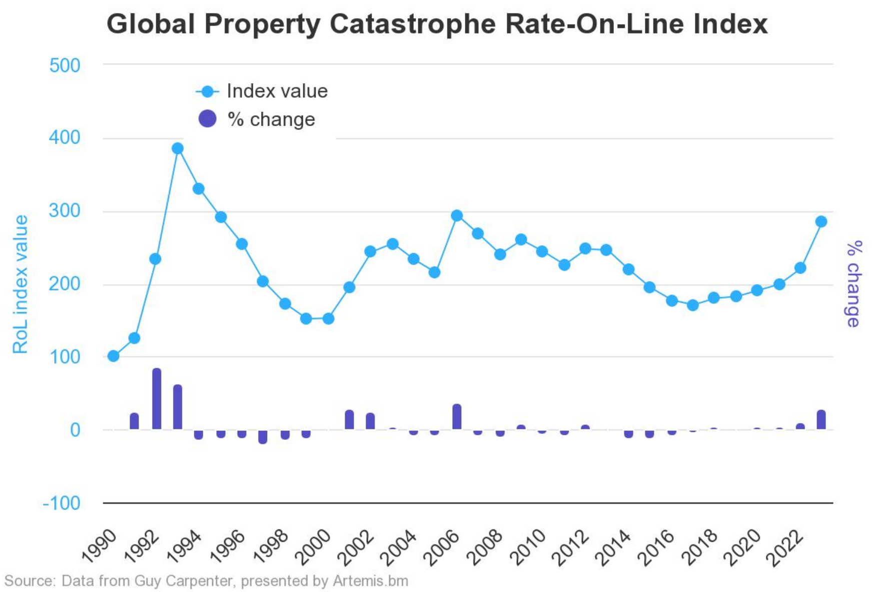
Source: Aon Reinsurance Market Dynamics (June 2023) ($bn)

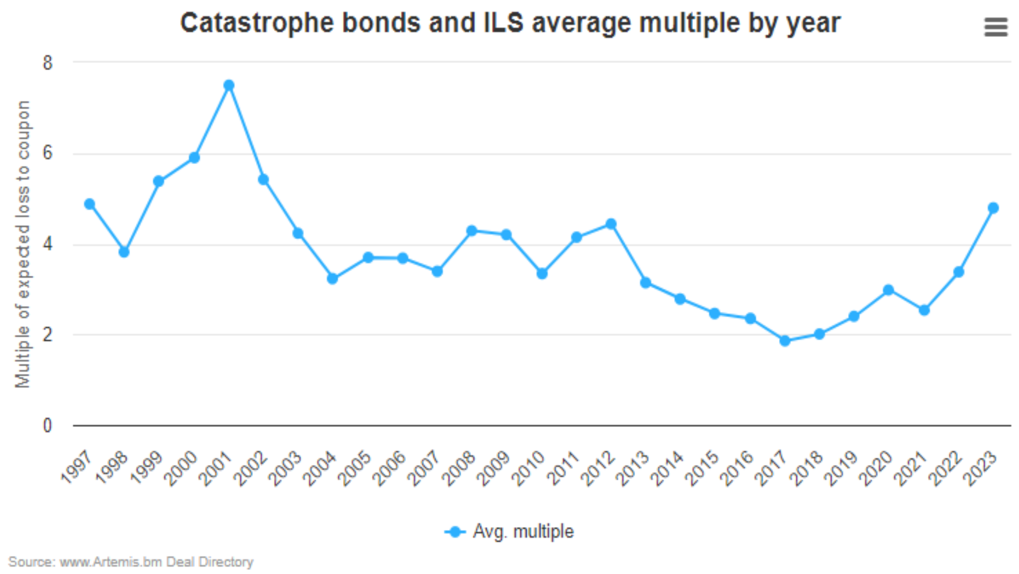
Realised losses: Primary vs Secondary





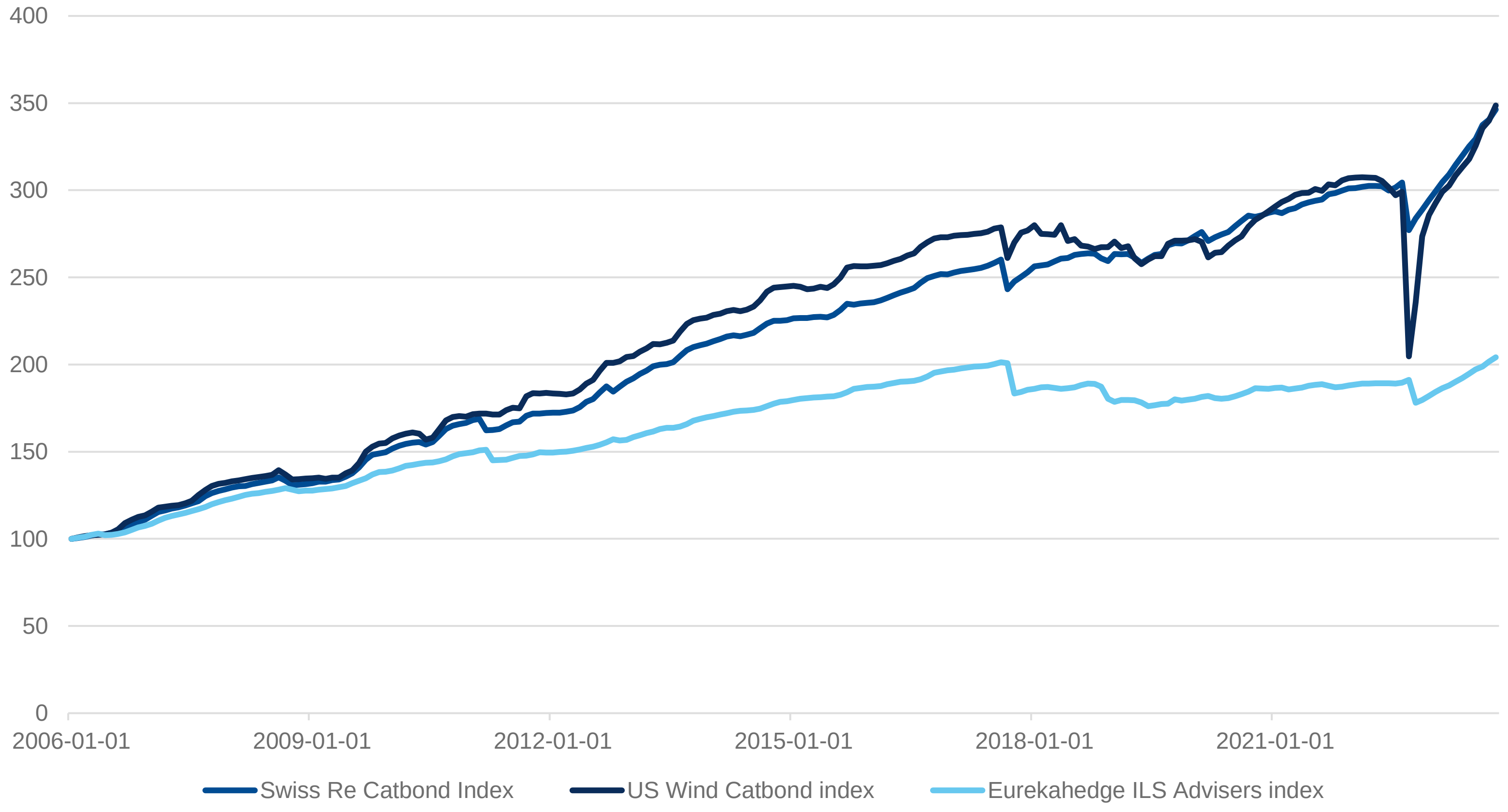
ILS pricing trends





- Heavy inflows into ILS in combination with low losses led to price pressure and a soft market.

Historical returns 2006-2023



ILS in an institutional portfolio

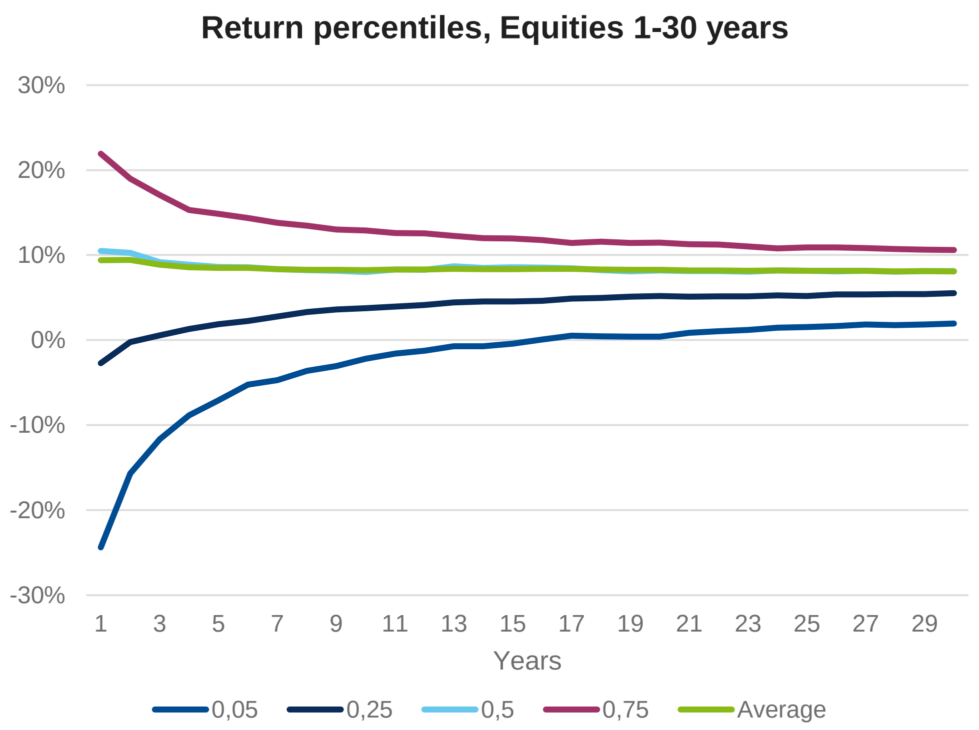
- Obvious benefits: positive and uncorrelated expected return, theoretically it’s the perfect asset… But how much risk can you take?
- First you have to decide on the maximum loss your institution can take.
  - For **Swiss Re** that’s a fairly high number, but they’re also the experts.
  - For **Alecta** the number is a lot lower. We ”know” that equities has a positive long term return and therefore have a high risk tolerance in our organization. But for unknown asset classes the risk tolerance will be lower.
  - Finding the right threshold is crucial: take too much risk and you will be stopped out after a series of poor years. Too little and the diversification benefit will be minimal.

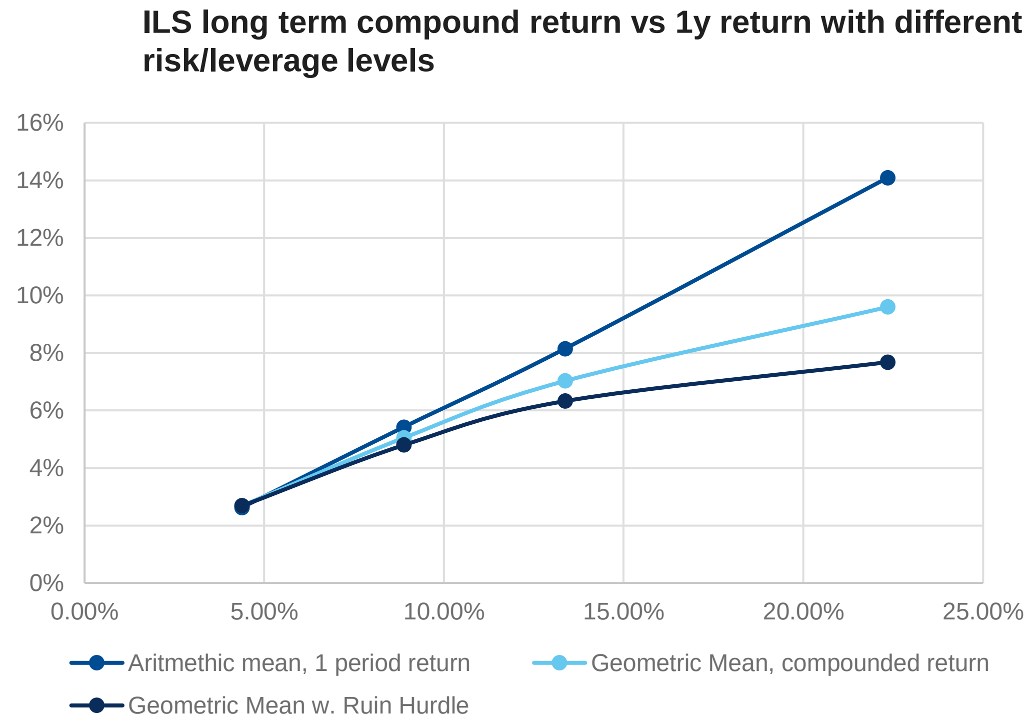
“Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally.”

Finding the optimal allocation: the St Petersburg paradox of ILS

- Given that we have no ILS the optimal solution would be to have a small concentrated position in the best paying risk (~Florida)
- There is no point (?) to diversify a tiny 1% allocation.
- BUT it’s a big difference between 1 period arithmetic expected returns and long term realized compounded geometric returns, especially if you consider the cost of trapped collateral or if you are stopped out after loss years.

Different long term distributions for Equities and ILS





- Equities get cheaper after losses, and therefore have a negative autocorrelation that reduces long term risk.
- Single risk ILS is also repricing after losses but not to the same extent. There is a significant drag on the long term mean from ruin risk and trapped collateral if you take more risk than you can rebalance.

alecta

Alectas approach to ILS

- We started with adding exposure in late 2021. By partnering with Swiss Re and SCOR we get a broad exposure to the syndicated reinsurance market.
- During 2022 we added an index mandate in Catbonds.
- Going forward we would like to increase our allocation and we will look more closely at private reinsurance and retrocession.
- We have focused mainly on adverse selection risks, market depth, modelling capabilities and capital efficiency. Skin in the game through high retention rates gives us increased comfort.

Summary

- Collaborate with reputable counterparties with significant skin in the game.
- Find repeatable business/business partners to reduce Prisoners dilemma risks.
- Solving the St Petersburg paradox: find the right risk profile for *your* organization.
- Increase staying power by understanding the risk, requires education and full transparency to set reasonable expectations internally.