Last updated: April 28, 2014 5:48 pm

Investors place bet on insurers' catastrophe bonds

By Tracy Alloway in New York

Yield-starved investors are gambling that mother nature will be kind this year as they flock to a risky type of insurance-linked debt known as catastrophe bonds.

Sales of "cat bonds" have hit a record level in the first four months of 2014 as insurance companies take advantage of investor appetite for a type of debt that offers higher yields as well as returns that are uncorrelated to other types of securities.

The bonds allow insurers to transfer some of the risk that they will have to pay out billions of dollars in the event of a natural disaster taking place. While the debt offers juicy returns, investors are at risk of losing their principal if catastrophes such as earthquakes or hurricanes do occur.

"The spreads on these bonds have been incredible and so that has attracted a number of investors," said Jeff Mohrenweiser, senior director at Fitch Ratings. "There's been greater demand, and insurance companies are now meeting that demand with increased supply."

A new deal offered last week by Allstate, the biggest publicly traded home and car insurer in the US, helped push year-to-date issuance of cat bonds to $4.75bn, according to figures from Artemis.bm, which collects data on insurance-linked markets.

That is the highest amount sold in the first four months of the year since at least 1996, and takes the amount of cat bonds sold over the past 12 months to $8.4bn – not far from the $8.5bn 12-month record recorded in late 2006 and early 2007.

The Allstate sale followed a $1.5bn offering by Citizens Property Insurance, in what will probably be the largest cat bond sale on record, according to Artemis.bm. The bonds cover citizens' losses in the event of a hurricane in Florida.

"The market has a lot of potential right now, definitely helped by the continued low pricing," said Steve Evans, owner and editor of Artemis.bm.

Allstate said last week that it would offer at least $600m worth of catastrophe bonds – more than twice the $250m the company sold last year.

The new bonds, issued as part of Allstate's Sanders Re shelf programme, cover lage storms in most of the US, as well as earthquakes in a handful of states.

Losses on cat bonds have so far been relatively rare but can occur even if natural disasters do not materialise. A $250m cat bond sold by Allstate back in 2007 defaulted because of a derivatives agreement struck with Lehman Brothers, the failed investment bank, for instance.

While cat bonds remain a small portion of the overall amount of net premiums written by the insurance industry, transferring some risk to investors through the debt has clear benefits for insurers, according to Mr Mohrenweiser at Fitch.

"Typically insurance companies are going to get catastrophe coverage from the large reinsurers," he says. "Cat bonds provide a little bit of a diversification benefit. They also help keep people honest because there are competing forces on pricing."

tracy.alloway@ft.com

Twitter: @tracyalloway