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Buffett Warning Unheeded as Catastrophe Bond Sales Climb.

Bond buyers are betting more than ever on the mercy of Mother Nature as they seek to boost yields being suppressed by central banks.

Demand for notes linked to insurance against hurricanes and other natural disasters is prompting investors to accept the lowest relative yields in almost a decade for this time of the year, when the Atlantic storm season gets underway. Buyers are speculating that the $22 billion market can continue its streak without an annual loss even as Warren Buffett said last week that Berkshire Hathaway Inc. is avoiding writing hurricane insurance in Florida because premiums have been pushed too low.

Investors who have snapped up $5.76 billion of new catastrophe bonds this year, the fastest pace of issuance ever as measured by data provider Artemis, are being emboldened by weather forecasts and average annual returns of 8.5 percent since 2002. Offerings this year include a record $1.5 billion transaction linked to potential hurricane damage in Florida.

"Wind season looks to be slightly below average in terms of the hurricane outlook and that's attractive," John Brynjolfsson, chief investment officer at Irvine, California-based hedge fund Armored Wolf LLC, which oversees about $700 million including the disaster-linked notes, referred to as cat bonds. "Although cat bonds are relatively tight, on a comparative basis they look attractive to capital markets investors."

Spreads Narrow

Cat bond yields have dropped to about 4.7 percentage points more than benchmark interest rates, the lowest second-quarter level since 2005 and down from 6.57 percentage points a year ago, according to John Seo, managing principal at Fermat Capital Management LLC. The Westport, Connecticut-based firm oversees $4.5 billion, more than 90 percent of which is invested in cat bonds.

"The hurricane does not know the rate that was charged for the hurricane policy, so it's not going to respond to how much you charge," Buffett said at the Edison Electric Institute's annual convention in Las Vegas on June 9. "And if you charge an inadequate premium, you will get creamed over time."

The National Oceanic and Atmospheric Administration predicts only one to two storms will escalate to major hurricanes during this year's season, which lasts from June through November, compared to a historic average of three major storms. A measure of loss probabilities for cat bonds issued this year averages 1.32 percent, down from an average 1.95 percent for securities sold in 2013, according to Steve Evans, Artemis's founder.

Reinforcing Models

Catastrophe bonds in the U.S. have returned 22 percent the past two years, about the same gains delivered by junk-rated corporate notes, during a period that included the damage caused by superstorm Sandy that tore through the northeastern U.S. in October 2012.

“Some of the events that kind of captured headlines, such as superstorm Sandy, as devastating and headline-grabbing as they were, did not trigger any losses of note,” Brynjolfsson said. That has helped to “reinforce the integrity of the modeling firms,” he said.

Insurance companies and reinsurers typically sell cat bonds to help cover their most extreme risks, with the proceeds of the issues set aside and paid out in the event of a qualifying disaster. Buyers get a relatively high interest margin for holding the notes and risk forfeiting their entire investment if the securities are triggered before they mature.

Japan Losses

Catastrophe-bond investors haven’t experience major losses on bonds since 2011, when damage caused by the earthquake in Japan that March caused $300 million of losses for securities issued by Muteki Ltd. that helped cover earthquake risks taken on by German reinsurer Munich Re.

The market’s track record through the 2008 financial crisis and natural disasters of recent years is “especially important for the key investors in the sector, which are pension funds, endowments and sovereign wealth funds,” said Michael Millette, global head of structure finance at New York-based Goldman Sachs Group Inc.

Demand has “grown steadily over the past four years,” with most funds typically allocating less than 1 percent of their assets to cat bonds, he said in a telephone interview.

Investors are willing to accept lower yields because they provide returns that aren’t correlated with other asset classes such as equities.

Florida Bonds

“When you factor in that you can’t find anything else that is non-correlating with a decent return, it’s easy to see that cat bonds are still very attractive,” Artemis’s Evans said in a telephone interview from London.

In Florida, where state-run Citizens Property Insurance Corp. issued a record $1.5 billion sale in April, Chief Risk Officer John Rollins said the insurer is seeing an increasingly diverse pool of investors.

The three year floating-rate notes, with a spread of 750 basis points more than borrowing benchmarks was originally marketed for $400 million, and attracted investors including “a pension fund for Scottish miners, a mutual fund backed by Japanese middle class savers, a fund dedicated to managing royal assets,” Rollins said in a telephone interview from Tallahassee.

‘More Mainstream’

Rollins said he saw no indication of “limited demand” even as new issuers are debuting on the market.

The Texas Windstorm Insurance Association announced an offering this month after contemplating the securities for three years, according to General Manager John Polak.

Three years ago, “the terms and conditions associated with cat bonds weren’t quite as attractive and competitive as they are today,” he said in a telephone interview from Austin. Now, cat bonds are “more mainstream” and “most importantly, pricing is at a point where it’s a realistic consideration” for the association.

The offering is expected to grow from the initially marketed $300 million to $400 million, according to Polak.

Italian insurer Assicurazioni Generali SpA (G), based in Trieste, also issued its first cat bond this year, 190 million euros ($256 million) in floating rate notes at a spread of 225 basis point more than the London interbank offered rate, Bloomberg data show. The notes, which mature in 2017, cover damages from European windstorms.

“I think there’s kind a tipping point that has been passed,” Citizens’ Rollins said. “If we have significant weather activity, if we have some bond get triggered, I think there will be recalibration mostly in the area of price, but not in the unwinding of structures. I don’t anticipate that a test of these structures will not be passed.”

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