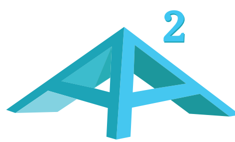

INSURANCE

Nephila Capital

What are some of the more recent developments in the field of insurance related investing?

• In the context of new issuance

Issuance of catastrophe bonds is slightly down for 2008 at just under USD3bn year to date (relative to the record highs of 2007 at roughly USD8bn for a full year, but there are a range of other instruments - such as industry loss warranty contracts, exchange-traded futures and direct reinsurance policies, in which managers can invest.

We continue to see new cedants and new sponsors of cat bond issues, primary insurers and reinsurers that have not previously issued bonds. We also see new structures come to market - new underlying risks, new triggers and tranching.

However, as in most risk management markets, the vast majority of transactions are executed on an over-the-counter, principal-to-principal basis and are not distributed as bonds - thus, are harder for general market investors to access.

• New risks being considered for securitisation

• The scope and palette of non-life insurances that lend themselves to securitisation

We also manage a fund dedicated to weather risk, which is a much smaller market than cat but we believe holds growth potential.
We recently saw the second motor (auto) risk securitisation by AXA (EUR710mm) and there will certainly be more.
Life risk management tools are a popular topic, and many transactions in that market also take place on an OTC basis.

The (re)insurance industry is gradually moving to more of an "originate-and-distribute" model - which is the rule rather than the exception in credit markets. This will result in broader opportunities for investors to choose specific underlying risks and profiles for their portfolios. Each of the risks mentioned above have not only different physical characteristics but also vary by typical risk/return profile - for example, life and motor transactions have been more remote in risk/credit rating and lower yielding (usually investment grade), with cat risk at higher risk/return and weather as the most high-yielding.

Some players in the industry are also exploring the potential securitisation of casualty risks - specific classes of liability exposure. Clearly this is a large segment of the insurance market, but it may be more difficult from an investor allocation perspective as it is more likely to correlate with the overall financial markets - liability of a company may not be unrelated to its financial/stock performance.

Broadly though, the central appeal of securitised insurance risk remains its zero correlation to all other market sectors, especially in times of extreme financial market drama - as experienced over the past twelve months.

> **"The (re)insurance industry is gradually moving to more of an "originate-and-distribute" model - which is the rule rather than the exception in credit markets. This will result in broader opportunities for investors to choose specific underlying risks and profiles for their portfolios."**

Barney Schauble

Agriculture - insurance led securitisation - the implications of:

• As governments start withdrawing subsidies

• In the context of risks/catastrophes where governments extend no coverage

• In the context of a steady rise in the occurrence and magnitude of catastrophes triggered by pronounced changes in weather patterns.

For crop, catastrophe and weather risk we are seeing more examples where even subsidising governments (Florida and India, among others) are seeking to hedge their aggregated exposures in private risk transfer markets. Forms of coverage range from pure indemnification (payment for any damage to a crop, which can be tricky to price) to more specific compensation based on rain, temperature, wind, etc. which allow for more transparent pricing and swifter payment.

Unfortunately there remain many situations where price controls in the primary insurance markets lead to a warping of risk/return, encouraging primary risk takers (home owners and farmers) to take on more risk than would be logical under a more honest representation of exposures. However, rising exposures - more property in high hazard areas, higher crop prices, etc. - mean the aggregation of risk is becoming more of a problem for the existing holders and they need to seek an outlet where they can transfer the peak risk to a broader market. We believe that this will continue to develop over time, especially as the perception and impact of climate variability continues to grow.

Scope of returns going forward.

INSURANCE

Nephila Capital

- **Impact on spreads – compression?**

The market for insurance risk behaves like every other market. Following an extreme dislocation (such as 2005 in cat) spreads widen out dramatically, and over time those spreads settle to more normal trading levels. We have certainly seen some compression in spreads over the past two to three years, but in peak areas in particular spreads relative to risk remain extremely attractive when compared to a longer history (the past 20 years) and even more so when compared to average spreads for similarly risky credit instruments over that time.

- **LIBOR (as ILS instruments behave as floaters on short term LIBOR) and mark-to-market related issues**

Most investors in this space focus on managing spreads (premiums paid as return) in light of the underlying risk, assuming that the risk-free rate will be generated by the underlying collateral (varying from short-term US Treasury rates to some sub-LIBOR return) on a short-term, resetting basis. Absolute returns will therefore vary as the risk-free rate moves, but investors prefer to know that they are not taking any interest rate risk given the floating nature of the underlying. Mark-to-market of these instruments is driven first by fundamental risk elements (real exposure, seasonality, value relative to other instruments, any concerns about underlying collateral) and then by technical issues (supply and demand).

- **Pricing and advances in modelling efforts**

As in most markets, there is a broad range of approaches, and many investors rely upon the outside modelling firms, rating agencies, and/or market-based syndicated pricing. More sophisticated investors' license third-party models and some even, build their own proprietary models.

Geographic split - non life, of the current issuance -:

- **In the context of origination - catastrophes and insurance providers - scope for securitisation**
- **Why does it remain US centric; developments in Europe and in Asia - scope and constraints**

Companies seeking to hedge their insurance risk are obviously focused on areas of peak exposure, where there is an intersection of hazard and value. Re/insurers are motivated by rating agencies and shareholders to have an evenly-weighted diverse portfolio of risks, and as is the case in other markets are willing to pay the most to hedge out peak risks result in an imbalanced portfolio. Some investors in these markets are also seeking a broadly diversified portfolio, and express disappointment in the somewhat limited array of risks making their way into capital markets. We are more of the view that since these risks are diversifying within a broader investment portfolio, diversity within insurance is less important than focusing on real value. Prices for risk in Europe and Asia have been lower than in the US, for some time now. This reflects the fact that there is less pressure arising from that exposure in the overall re/insurance industry.

Your reaction to: "``That party is over,'' Buffett wrote in his annual letter to shareholders in February.
``It is a certainty that insurance industry profit margins, including ours, will fall significantly in 2008.''

Profitability of the overall insurance industry - a huge market - has historically been fairly low taken as a whole. Specific re/insurance risks have been transferred to capital markets because they present more marginal risk than the industry can bear, and therefore is more highly priced to reflect that concern. Catastrophe risk in particular has very different characteristics than "insurance industry profits", and as Berkshire makes clear in their annual report every year, they are the single largest player in pure catastrophe risk space (this has been a profit driver for them over time). As a matter of fact Berkshire recently entered into a quota share contract with Swiss Re where they assume 20% of all reinsurance risk and receive 20% of all reinsurance premiums over the next few years, which would imply that they expect some meaningful profit from that overall transaction. Swiss Re is the largest reinsurer in the world by premium volume, so they are hardly a specific sub-segment of the reinsurance market. Actions speak louder than words.

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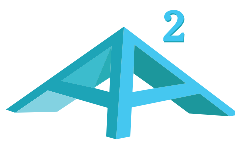


CARBON CREDITS

Aeolus Fund II

Focus

• Identify research, screen and construct a portfolio that capitalises on:
Project based global greenhouse gas ("GHG") emissions: reduction offsets (renewable energy markets) inefficiencies (generally 40% - 60% of the portfolio)
- Originate and potentially syndicate environmental asset transactions
- Purchase and manage delivery of GHG compliance instruments that participants can use to comply with emission targets
- Deploy capital to develop portfolio environmental and renewable energy assets
- Invest in a pool of commodities*, equities, debt instruments

Strengths

• Fund's manager (Natsource Asset Management LLC) together with its affiliates offers an established, integrated business platform
- Origination / transaction services (one of the largest buyers of carbon compliance instruments created by projects)
- Advisory and research
- Environmental compliance, international emissions trading, project technology expertise

• Fund's capacity - currently targeted at USD1bn, scalable to USD3 - 4bn

Weaknesses

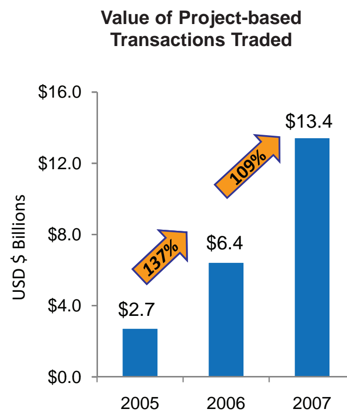
• Non-completion, delays, set-backs of carbon emission compensation linked projects the fund has allocated to
- Project Carbon Performance Risk
- Associated with the project's likelihood to achieve successful registration, e.g., a CDM project must be successfully registered by the CDM Executive Board

• Partially invests in illiquid assets that may not have a secondary market, difficult to price

Opportunities

Carbon Market Growth and Development

Market growth in the trade of allowances and project-based assets has been significant



Source: Natsource

Data derived from the World Bank's 2006 , 2007, and 2008 "State of the Carbon Market" reports.

In the context of the global greenhouse gas markets (mainly the EU and Japan):

• Estimated demand: approx. 2.9bn tonnes emission shortfall in 2008 -12 (including Canada)

• Supply: Approx. 2.2 bn tonnes of CERs (Certificate Emission Reduction) and EUA (European Union Allowance) est. to be created by projects

Proposed regulation in the US (which is lenient than that in the EU) has a cumulative shortfall over the same time period (2008-12) which is 5 x greater than the EU market

Threats

• The introduction of unforeseen, not conducive to policy development and regulatory process measures

• Increasing competition

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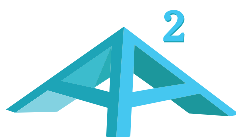


CARBON CREDITS

Aeolus Fund II

Strategy Analysis

- Sourcing offset deals: access to manager's integrated business platform
- Securing capacity: network (Natsource manages over USD1.4 bn in AuM)
  - Natsource currently has a pipeline of new projects greater than USD1 billion
- Pricing/ valuation: independent valuation agent - ICF International
- Project risk & regulatory analysis: each project is running through a proprietary Delivery Risk Model (DRM) that assigns confidence intervals for each project's delivery versus the project design document (PDD) and other project documents
- Counterparty risk: hedged
- Currency risk: not their expertise, hence are not attempting to mitigate it [current beta (as of 30 June'08) currency risk=0.3]

Portfolio Management

- Portfolio construction:

  Diversification sought

  - Geographical allocations to projects, technologies and asset types:

    opportunistic (varies over time with changes introduced to current regulation and the addition of future policy)
  - Invest in a pool of commodities* including:

    Environmental commodities including Certified Emission Reductions ("CERs"), European Allowances ("EUAs") and related futures, options and derivatives (generally up to 25% of the portfolio)

    Traditional energy related commodities where the price of carbon is driven or drives performance (i.e. oil, natural gas, power, etc.) (generally up to 15% of the portfolio)
  - Invest in equities and debt instruments - where the value added proposition is driven by carbon (generally up to 15% of the portfolio)

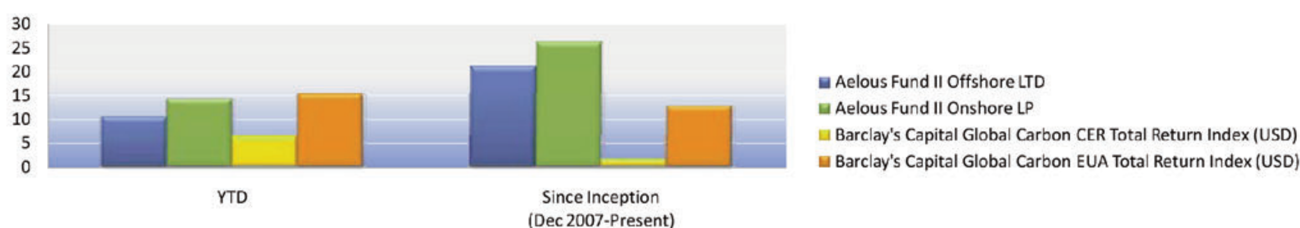
- Asset and liability management: managed via redemption clause/gates
  - Projects in the portfolio are self-liquidating assets - with most contracts engaged in, ending in 2012 (some go beyond)

    Leverage: do not use financial or repo leverage

    Pari-passu allocating: executed based on investment guidelines

    Hedging practices: proprietary,
    - A portion of CER yield is hedged (by using various environmental commodities) to reduce exposure to future price volatility
- Threat posed by competition: This is a very physical business and the barriers to entry are high
- Key man risk: No provision

Relative Performance vs. Benchmarks



Source: Natsource, May2008

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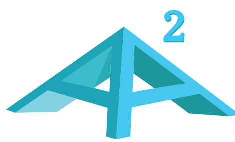

ASSET BASED INVESTING (ABI)

Belmont Asset Based Lending (USD class E)

Focus

Portfolio of pure asset-based lending and insurance linked hedge funds

• Fund's underlying managers invest in a broadly diversified portfolio of loans secured by underlying assets/ collateral, with a focus on first lien debt

• Assets used as collateral include:

: •Physical assets (real estate, inventories) •Financial assets •Intellectual Property (payment, royalties, trademarks, etc.)

Strategy	Tenor of Loans	Average LTV	Average Yield (pa)
Corporate Lending	12 - 36 months	50 - 60%	11 - 15%
Real Estate	6 - 18 months	20 - 75%*	10 - 15%
Factoring / Inventory	3 - 6 months	70 - 75%	14 - 18%
Insurance / Life settlement	24 months	50%	12 - 18%
Agriculture	10 months	50 - 80%**	10 - 15%
Leases	48 months	25%	16 - 18%
Consumer	Usually short term	Pool of loans	15 - 50%

* Depending on type of property ** Based on lifecycle

• The more liquid the collateral is - the higher the LTV (the mean ranges from 40% -60%)

• Expectations of defaults range between 5 -15% of the portfolio depending on the asset class

Strengths

• Ability to identify and secure capacity with managers

• Benefits from the firm's research, risk management, resource pool

Weaknesses

• Individual funds are not cocooned from idiosyncratic risk, contagion related risk

• At the individual fund level - capacity constraints

Opportunities

More than 99% of US businesses are defined as “small businesses” and generate half of GDP - but have limited sources of financing

- Traditional commercial lending for SMEs accounts for only of 30% of lending
- Government programmes are channelled through banks, are expensive and have strict criteria: max loan size of USD2 mn

In contrast to traditional lender ABL funds can offer borrowers:

- Ability to act quickly, discreetly as well as have the flexibility due to lack of regulatory constraints
- Expertise on evaluating collateral
- Innovative financing solutions

Threats

• ABL: liquidation value of collateral < loan

• ABI: cash flow producing assets, fail to do so - challenging the achievement of capital gains eventually triggering a forced exit

Strategy Analysis

Main risk at portfolio level: idiosyncratic risk

Main risks of the strategy include:

- Liquidity risk
- Legal risk
- Fraud
- Valuation
- Credit risk

Mitigated at portfolio level by:

- Conducting a labour intensive due diligence on each underlying ABL hedge fund
- Securing background and track record of manager / reference from external parties
- Monitoring for consistency of the underlying hedge fund's investment strategy over time

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ASSET BASED INVESTING (ABI)

Belmont Asset Based Lending (USD class E)

- Analysed for deal flow origination and scalability of strategy
- Matching liquidity of fund vs. liquidity of assets in the portfolio
- Negotiate full transparency in the context of type of deal, industry and geographic concentration
- Ascertaining the underlying hedge fund's collateral evaluation process -
  - Careful screening of borrowers
  - Seniority in capital structure
  - Appropriate LTV to the type of asset
  - Focus on cash returns
  - Ability to repossess collateral and reliability of legal system
  - Third party evaluation of collateral at inception and on an on-going basis
  - On-site visits by manager to verify condition of collateral

Cash reconciliation and valuation process: is performed by the administrator and other third parties

Leverage: none at fund of fund level

- max. of 10% strategic level on a single fund level

Currency risk: Hedged

Key man risk: Team managed

Performance

- No. of positions in the portfolio: current 14 - targeted 20
- Geographic allocations as of: 1July 2008: US/Canada: 59%, Europe: 4.5%., Asia: 2.4%, Lt Am: 14%, Cash: 20%
- Tenor of underlying loans in the portfolio: range across portfolio is between 3 and 36 months
- Targeted volatility: < 2.5%
- Returns driver: interest payments (“clipping coupon”)

Outlook

- Inception date: 1, May 2008
- Targeted returns: CHF Libor + 250 bps.
- Barriers to entry: subject to increasing competition - however, securing capacity, expertise in strategy and structuring, laborious - intensive monitoring required

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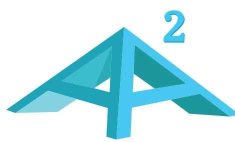

Opalesque Research Issue 68, 17.07.2008

LITIGATION LED INVESTING

Juridica Capital Management

"Juridica offers access to a wide range of deal structures that enable firms to strategically manage risk and monetise contingent or speculative returns. Juridica has developed a new paradigm for law firm capital that enables law firms to spread risk, smooth cash flows."

Could you elaborate in the context of the above extract and explain how this is achievable?

Juridica operates in an investment bank tradition - brings thoughtful, value-added capital to law markets, rather than mere capital.
For example, we might be asked by a law firm, or plaintiff, to absorb some of the risk the firm has taken in a contingent fee case. So the firm earns compensation hourly or a fixed current fee income, and some on a contingent basis. This sort of arrangement often better aligns the interests of the client and the law firm, and some times creates better incentives to optimise settlement and case strategy. This is particularly useful in the law market place, but it is increasingly apposite in the UK, where firms want access to financial arrangements that can allow them to offer more financing options to their clients.

Is there a growing demand for such services, why? Potential and prospects.

We are overwhelmed by the market place response to Juridica even in the short time we have been in operation.
Throughout history, the legal community has been perceived as inflexible and unresponsive to market demands.
Since we have introduced workable, ethical alternatives to the traditionally unilateral approach to case finance (that is, the client pays for legal services and awaits the outcome of his case in a process that he neither understands nor controls) - lawyers and clients, including major companies, have recognised that case outcomes are often assets that can be monetised, freeing up cash reserves to pursue other business objectives.
Based on this response, we are squarely on target to meet our objective of deploying our first round of fund raising by the end of next year.

Could you elaborate on your firm's presence in the intellectual property litigation/management space?

Our goal is to build a diversified portfolio of first-rate investments, and intellectual property is an important part of that diversification model. We have invested in patent enforcement activities and are examining opportunities in the trademark copyright and trade secret areas as well. We have a target figure for intellectual property as a percentage of Juridica's overall portfolio - it is relatively small.

• Do you believe this is a growing niche? Why?

A number of major investment banks and hedge funds are involved in this market.
Certainly, the interest in financing patent enforcement activities, at least in the US, is growing and validates our overall business proposition.
Our view is that most of the other entrants in the space are investing on an ad hoc basis without a master plan or strategy and without the benefit of an in-house trained team of analysts – which could have repercussions in the long term.

> **"Since we have introduced workable, ethical alternatives to the traditionally unilateral approach to case finance - (that is, the client pays for legal services and awaits the outcome of his case in a process that he neither understands nor controls) - lawyers and clients, including major companies, have recognised that case outcomes are often assets that can be monetised, freeing up cash reserves to pursue other business objectives."**

Richard W. Fields

• How does one proceed with the challenging task of valuations in the context of "intellectual property (IP) rights"?

This may seem over simplistic, but we believe IP enforcement investment can be measured and valued like most other claim investments. On balance, they are more risky, but often result in greater returns on invested capital.
A distinguishing characteristic of our business model is our methodology and underwriting system for claim valuation - a core trade secret!

• From a legal perspective - managing patents is very challenging given that they are specific geographic validations?

This is true, but we rely on experts in enforcement and licensing to advice us where necessary.

• Can this really be profitable in the context of protecting patents globally?

Patent enforcement is undertaken on a country-by-country basis given limitations on cross border patent enforcement and national grants of patent rights. Certain fields are easier to predict and manage, such as internet and telephony patents, most of which have emanated from the US in the past twenty years.

• How do you help your clients steer around this and such loopholes?

We are involved in the finance side, and leave the overall enforcement systems to expert lawyers and technical advisors.

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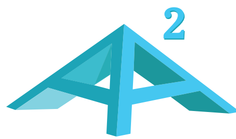

LITIGATION LED INVESTING

Juridica Capital Management

What would you say are some of the other constraints and challenges of operating in the litigation led investing space?

One of the challenges is that the legal profession is, by definition, conservative and slow to change.

In the UK, for instance, change has been led by consumer-oriented legislation and regulation. In other places, like the US, the market place itself is demanding change.

Another challenge is "perception" - both of the legal profession and the consuming public. To be clear, there are legal professional and regulatory prohibitions on certain kinds of claim financing in certain places, but they are not as draconian as people believe. On a daily basis we encounter managing partners of major law firms and general counsels of major companies that are fascinated by what we do and how we do it.

I should hasten to add that having a flow of case opportunities fortunately has not been a problem. We examine on average 8-10 claim opportunities for every investment we make. Adverse selection in this environment could be a problem - but we have been careful to develop underwriting systems that allow us to quickly and efficiently reject opportunities that do not meet our guidelines.

And what do you believe is the annual average profitability of investing in firms such as Juridica.

We obviously have to be careful about predictions for regulatory reasons and to manage the expectations of our investors. But we hope for and expect returns that are at par with or in excess of well managed hedge funds. Our investments are uncorrelated to any particular market, and there is evidence that they, by nature, maybe somewhat recession proof.

Have you identified other "high growth potential niches"- such as that of intellectual property rights?

Our goal is to build a diversified portfolio of investments. We have seen increasing interest in certain sectors, such as those involving sovereign claims and debt. But we are sticking to our original diversification models and are trying not to be lured into any particular niche.

What is the scope and capacity of investing in third party litigation led investing over the next 3-5 years: in the US, Europe, Australia?

We believe the market capacity is sizeable and virtually untapped. Depending on which statistics you believe - the marketplace for claims and professional fees is in the tens, even hundreds of billions of dollars. More companies are going to enter the market.

The US is the largest and most innovative market, but New South Wales in Australia, and the UK are the most forward looking, at least in terms of governmental support. Continental Europe, with the exception of Germany, is far behind in terms of market and regulatory attention. Over the next five years, we believe investment in claims will become relatively commonplace.

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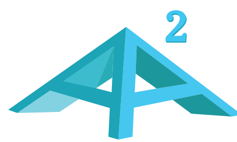

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