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How to . . . make money from the weather

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The ravaging of the east coast of the US by Hurricane Sandy last month highlighted the devastating impact of weather-related disasters. In addition to leaving more than 100 people dead, the storm is expected to rank among the eight costliest in the US, with estimated costs to insurers of between $10bn-$20bn. The total economic damage is expected to be as much as $50bn.

Sandy follows a string of natural disasters in 2011. which saw Thailand and Australia hit by heavy flooding and Japan devastated by a tsunami and an earthquake. For Lloyd's of London, the international insurance market, 2011 was the costliest year for natural disasters in its 324-year history, with total catastrophe claims running to £4.61bn.

That sounds like a financial disaster, too. But not necessarily. For those involved in insuring against weather-related catastrophes, such disaster-strewn years are only really a big problem if there are several of them in succession, which is very rare.

The weather is, of course, highly unpredictable, and that's part of the attraction. Products related to weather and catastrophe cover tend to be uncorrelated with mainstream asset classes such as shares and bonds, so offer useful diversification for a portfolio. Reflecting the risk of a heavy hit to capital, the returns also tend to be quite high.

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Invest in a catastrophe bond

So-called catastrophe bonds are catching the eyes of wealth managers and private investors searching for uncorrelated assets to diversify investment portfolios.

These specialist bonds are issued by insurance and reinsurance companies and transfer some of the risk of natural catastrophes, such as a hurricane or an earthquake, to investors.

Each “cat bond” is linked to the occurrence of a specified natural disaster, such as a certain strength of earthquake or a specific region that might be hit. Payout of some or all of the cash to the insurer only occurs if all of the specific conditions are met.

The benefits of these products are that they pay investors a high regular income. Cat bond funds can yield as much as 8 per cent per annum after charges. The risks are that you might lose some or all of your initial investment.

Private investors can gain exposure to cat bonds through two specialist reinsurance funds listed on the London Stock Exchange: CatCo Reinsurance Opportunities and DCG Iris, which is managed by Credit Suisse. Yields are about 5 per cent.

Thomas Becket, chief investment officer at Psigma Investment Management, also likes the GAM FCM Catastrophe Bond fund, run by Fermat Capital.

“Catastrophe bonds are one of the most attractive risk/reward opportunities that we can currently find in financial markets. We like the fact that this investment effectively has no exposure to credit risk and low exposure to both interest rate risk and financial market risk,” says Becket.

For more information go to: www.catcoim.com/ and www.dexioncapital.com/, or www.ft.com/markets.

Trade weather derivatives

Weather derivatives were introduced on the Chicago Mercantile Exchange (CME) in 1999 and are typically used by utilities and agribusinesses to hedge against unexpected and adverse weather conditions.

The benchmark products are “heating degree days” and “cooling

Become a Lloyd’s name

Being a “name” at the Lloyd’s of London insurance market essentially entails providing money to underwrite insurance risks. In the early 1990s, there were about 34,000 names, but this has fallen to about 2,500 today after many were driven out by losses from asbestos claims.

A change in the regulatory structure in the mid-1990s means investing in Lloyd’s has become less risky. The introduction of limited liability partnership and company structures limits investors’ total potential losses to the amount of their initial investment.

But this investment is only an option for the wealthy. Investors need at least £500,000 to put up as collateral, and shouldhavee total assets of at least £5m for it to be an “appropriate risk” within a diversified investment portfoli..

There are several benefits to being a Lloyd’s name. The money “invested” is in fact only collateral, so it can effectively be used twice. Investors could put up a buy-to-letpropertyy or a share portfolio as collateral.

There are also potential tax

advantages. Assets used as collateral in this way are exempt from inheritance tax after two years.

"The main draw for investors these days is that Lloyd's underwriting is uncorrelated with your other investments. It is one of the rare investments where performance is driven mainly by natural disasters," says James Mackay of Argenta Private Capital, a members' agency that deals with private investors who want to invest in Lloyd's.

Personal underwriting remains a high-risk investment; investors can potentially lose all their money. But returns over the long-term can be very profitable. According to Mackay, the average annual return from a standard managed portfolio at Lloyd's over the past nine years is 27.4 per cent.

Investors interested in becoming a Name can contact Argenta Private Capital: http://www.argentaplc.com

degree days", which essentially measure deviations in temperature over a calendar month from a base level of 18 degrees Celsius. They are available for US, Canadian and European cities, including London (where the temperature is measured at Heathrow airport).

Weather futures are mainly an institutional product. They are high risk, very specialised and the minimum contract sizes are high. See CME for more information: www.cmegroup.com/trading/weather

However, some platforms have seen individuals use OTC weather options to bet on the weather as losses are limited.

These allow individuals and companies to bet on whether there will be an above average rainfall during a specified period, for example. CelsiusPro is one platform that allows investors to make such betsamongst other weather-based trading. http://www.celsiuspro.com/

Clean-up stocks

In the immediate aftermath of a weather-related disaster, there's generally substantial demand for heavy lifting anearthmovingng equipment, and in some cases temporary power supplies. Companies that rent out this kind of equipment can generate substantial short-term revenue on the back of a natural disaster. Plant hire group Ashtead and temporary power group Aggreko are both listed on the London Stock Exchange but have substantial businesses in the US. However, the majority of their business comes from the construction industry.

Insurance and reinsurance

The immediate consequences of weather-related disasters are indeed very costly. An insurer's share of the payouts is usually funded from the company's reserves, which are generally held in cash and very safe government and corporate bonds.

But in the aftermath of a major disaster, insurers will raise their premium rates in order to rebuild those reserves, in just the same way as a car insurer raises premiums for drives who've made claims. Provided there are no more unusually large claims, the losses are quickly made good and the "combined ratio" of claims to premiums moves back into the black (lower is better, and anything below 100 per cent indicates the company is making underwriting profits).

Major insurance companies manage their risks very carefully to avoid overexposure to one geographical area or business line. Typically, they'll lay off risk either through syndicates at the Lloyd's of London insurance market, or through big reinsurance companies. There are no reinsurers quoted on the UK stock market, but in Europe, Munich Re and Swiss Re are big players.

Capacity at Lloyd's is owned either by syndicates of individuals, known as Names or by companies. These include Brit Insurance, Lancashire Holdings.

Insurance is hardly exciting, but it is profitable. Much of the cash that has built up in Berkshire Hathaway, the investment company controlled by billionaire investor Warren Buffett, was generated by its insurance subsidiaries such as Geico and General Reinsurance.

Like catastrophe bonds, shares in insurance and reinsurance companies are only loosely correlated with the wider stock market because their returns are dictated more by the incidence of natural disasters, rather than wider economic cycles.