Welcome to Money for the Rest of Us. This is a personal finance show on money, how it works, how to invest it, and how to live without worrying about it. I'm your host, David Stein. Today is episode 549. It's titled, "Why Catastrophe Bonds Are Yielding 12%, and Should You Invest?"

Recently, LaPriel and I were visiting family in Miami and Naples, Florida. We hadn't been there in eight years. We spent some time staying on Miami Beach, and it rained the first four days we were there, as a front stalled over the Atlantic coast, and moisture just kept coming in.

Now, rain's not unusual in Miami. They get upwards of 60 inches per year. Now, being in Florida, we know there's hurricanes, and I was curious, "Well, how many serious hurricanes has Florida had, that hit landfall over the past 25 years?" And I found a database from NOAA, and it was around 14 storms. Now, Florida is big, and so there has not really been a direct hit to Miami over those 25 years. Miami gets lots of rain, but one thing that has changed is the intensity of the storms, and it's been that way in many places around the world.

## An Increase in Severe Convective Storms

As the planet warms, clouds hold more water, and that leads to what the insurance industry calls severe convective storms. These are non-peak perils, in insurance nomenclature. A peak peril would be something really, really big, like an earthquake. Non-peak peril would be something more localized, like a severe convective storm. And Florida and Miami has been getting more of those.

In 2024, a foot and a half of water fell across South Florida, and this wasn't associated with a hurricane or a tropical storm. It was just a rainstorm. And meteorologists would classify something like that severe as once in a 200-year event. Yet, that was the fourth year in a row there had been that level of massive storm in Florida.

I pulled up an annual report that Aeon does. They're a company that helps businesses manage risk, and they have an insurance arm, a reinsurance arm, and their 2026 Climate and Catastrophe Insight Report stated that extreme weather events are becoming more frequent and unpredictable. It's affecting new geographies and sectors. They point out that there's greater weather volatility and that businesses have to deal with that in order to be resilient and to continue growing.

Last year, it was severe convective storms that had the highest economic and insured losses. Total losses last year due to natural disasters was $260 billion. That was down from previous years. Now, in that report, when Financial Times referred to it, they plotted out, since 2000, so the past 25 years, the type of natural disasters that have been occurring. And the biggest increase in terms of cumulative global economic losses has been tropical cyclones and flooding, but there's also been a big increase in severe convective storms, to the extent that they're just about to overtake earthquakes.

Munich Re, one of the world's largest reinsurers, stated recently with respect to natural disasters in 2025, "It's striking how many extreme events were likely influenced by climate change." This was true of the Los Angeles wildfires, multiple particularly strong hurricanes in the North Atlantic, and many catastrophic floods. Numerous studies have indicated that climate change increases the frequency or severity of weather disasters, if not both.

Munich Re's chief climatologist, Tobias Grimm, said, "A warming world makes extreme weather disasters more likely." Given that 2025 was another very warm year, the past 12 years have been the

warmest on record. The warning signs persist. Indeed, under prevailing circumstances, climate change can worsen further.

And then Thomas Blunck, who's a member of the board of management, said 2025 started off with very high losses caused by the wildfires in Los Angeles, but there weren't really any severe hurricanes that hit the United States in 2025—he says that was sheer luck—but the U.S. is still number one in lost statistics, according to Blunck, owing to the increased trend towards very considerable damage caused by non-peak perils; again, convective storms.

### How Reinsurance Works

Back in 2002, Warren Buffett in the annual letter for Berkshire Hathaway—and Berkshire Hathaway bought General Re in, I believe, the late '90s. They're a reinsurer. A reinsurance company sells insurance to property and casualty insurers. They're the insurance company's insurer. So an insurance company can buy additional coverage for these peak perils, earthquakes, from a reinsurance company.

And Buffett has always liked the insurance business. He liked the idea of float, which he talked about in 2002, that you collect a premium, but you don't have to pay out losses until an event occurs. So you have all this money that can be invested, and he calls that money float. And then with an insurance company or a reinsurer, the idea is that—alright, you collect this premium, you pay out losses, you're investing the money. You want the amount that you earned with the premiums and the investments to be greater than the losses paid, so then you can make a profit.

And one of the things that he likes about this float, Buffett, is the cost of it, or the benefit of it, to be able to use that float to buy businesses, or to invest; that cost of capital is typically less than prevailing interest rates, and so it's a cheap source of capital to make investments, recognizing though that losses need to be covered.

Buffett said that in order for their insurance operations to generate this low-cost float over time, they have to, one, underwrite with unwavering discipline, price the insurance correctly. They have to reserve conservatively in terms of reserving for those losses. And then they have to avoid sort of the compounding of risk, what he refers to as an aggregation of exposures that would somehow lead to an impossible incident that could cause the insurance company to go insolvent. That does happen for insurance companies. There's typically around 20 insurance companies that go insolvent every year around the globe.

Now, in that 2002 annual letter, Buffett said that most of their insurance businesses followed those three rules. They underwrote the insurance with unwavering discipline, they reserved conservatively, and they avoided an aggregation of exposures. Their exception was General Re, the reinsurer that they bought a few years earlier, and they had to take some charges to kind of get that to the level that they expected.

His concern with General Re—and Buffett said, "Cheap reinsurance is a fool's bargain." When an insurer lays out money today in exchange for a reinsurer's promise to pay a decade or two later, it's dangerous and possibly life-threatening for the insurer to deal with any but the strongest reinsurer around. And that's why reinsurers tend to have very high credit ratings, because they're the insurer's insurer.

About a year ago, we looked at reinsurance, and after some major disasters and exposures, losses that reinsurance companies had to absorb in 2017 and 2018, they started massively increasing their premiums. This is something I learned from a hedge fund manager many years ago. He said, "The best time to invest in a reinsurance company is after disaster, because then they have pricing power." And we've seen that as reinsurance companies increase premiums, that flowed through to higher home insurance premiums for consumers over the past few years.

The good news is reinsurance companies have had very strong returns over the past three years; double-digit returns on capital. Their catastrophic losses in 2025 was $121 billion, and that was 18% below the five-year inflation-adjusted average for reinsurers. And that has allowed them to build up their capital base, and then there's more competition, they're not having to raise reinsurance premiums as much, and that will have a positive impact on home insurance premiums. Hopefully, you and me will see a lower increase in our home insurance premiums in 2026.

### How Catastrophe Bonds Work

Now, a property and casualty insurer, one in Florida, or anywhere else, they can buy reinsurance, but more and more property and casualty insurers and reinsurance—they're laying off some of that risk through something called a catastrophe bond. Catastrophe bonds are a type of reinsurance.

But instead of going to an insurance company, they go to the capital markets, to investors, and the investors take on that casualty risk of a severe natural disaster. These are also known as insurance-linked securities. They're not public. Most of them, or historically, they've been private. They've been Rule 144A securities, so they're for qualified institutional buyers.

Richard Penny, who's the chief executive at Aeon Securities, says, "Insurers have no choice but to identify ways to offload increasing risk, and they're doing it in the cat bond market." Cat bond is short for catastrophe bond. I've been aware of the cat bond market—Berkshire Hathaway participates—but it wasn't something that we, as individual investors, could participate in.

Except now we can. There's an ETF that came out last April that invests in cat bonds. And that ETF is yielding just about 12%. That's attractive, but we want to look at "Well, what are the risks here, and is this really an opportunity?" The number of cat bonds that have been issued last year, in 2025, was a record. Annual issuance exceeded $20 billion, and it's been increasing meaningfully the last three or four years. Right now, there's about $50 billion outstanding.

A typical cat bond the maturity is three to five years, so it's a multiple-year bond, and it's been a good performer. There's an index called the Swiss Re Global Cat Bond Performance Index. They have a number of them, but the global index, if we go back to 2002—so 24 years of performance—cat bonds have returned 7.6% annualized, more than double the 3.6% annualized for the Bloomberg U.S. Aggregate Bond Index.

And it's done better than non-investment-grade bonds. U.S. high-yield bonds returned 7.3% annualized. So this is sort of similar to high-yield bonds in terms of overall performance. Volatility has been less. So the Swiss Re Global Cat Bond Index, since 2002, has only had one negative year, negative 2%, and that was in 2022, the same year the Bloomberg U.S. Aggregate had a negative 13% return.

There have been periods where the index hasn't done as well, and we'll look at the structure of these cat bonds here in a minute, and we'll see there's a variable rate component to it. But for the 10 years ending December 31st, 2022, the Swiss Re Global Cat Bond Index returned 4.3% annualized, versus 1.1% for the U.S. Aggregate, and 4% for the U.S. high-yield index.

What's intriguing about cat bond investing is you're not exposed to default risk of corporations, so this is not credit risk, and you're not really exposed to interest rate risk, because these cat bonds are variable rate. You're exposed to natural disaster risk. And so this is a different return driver. And if there is a severe natural disaster, then the insurance company can collect from the cat bond issuer.

Now, these cat bonds—the type of risk that they're protecting against, there's two dimensions. There's the specific peril—is it a windstorm or an earthquake. And that's generally been the majority of the cat bond exposures, earthquake and wind, including the ETF that we'll take a closer look at.

So there's the actual peril, and sometimes it's one peril, sometimes it could be multiple perils. Then there's the territory—what is the geographic region that is being insured? And catastrophe bonds typically are insuring the highest loss layer, so they're the most extreme losses. So there might be a hurricane, but it could be a minor hurricane, and so the property and casualty insurer insures the losses—they don't get severe enough to trigger payouts for the cat bonds.

And the cat bonds—now, these are complicated bonds. That's why they're private bonds, because there's the peril, there's the territory, but then what is the trigger for paying out the losses? Sometimes it could be an indemnity trigger, so if the specific event occurs in a specific region, do the losses exceed some threshold? Losses to that specific insurance company. Or it could be an industry loss trigger. So the insurance industry as a whole suffers these losses, and then it'll pay out.

### Catastrophe Bond Structure

Now, the structure itself for these cat bonds is complicated. It starts with the sponsor establishing a special purpose vehicle, an SPV. And that SPV sits in the middle. You have the investors on one side, and you have the insurance company on the other. And that insurance company has a reinsurance contract with the SPV, that legal entity.

So if there's a specific loss event, the SPV pays the insurance company. At the same time, you have the investors that are investing their principal in the SPV, and the SPV takes that principal and puts it in a trust, and then invests that principal, that collateral, pretty conservatively, in Treasury bills or other very high-quality variable rate securities.

And so the investors are getting variable rate interest on their principal investment, but they're also getting premiums from the insurance company that are passed through the SPV to the investors, because they're insuring against that risk.

If you look at some of these catastrophe bonds, these cat bonds, the yields are 8% to 16%, depending on the level of risk. And the reason why the yields are that high is because of the collaterals being invested, but mostly because of the premium that the insurance company is paying to the SPV to insure against losses.

### Catastrophe Bond Performance

So when we think about it, if a particular portfolio of cat bonds is yielding 12% on average, historically. And if we go back over 25 years and look at the return for the cat bond index, it's returned around 7.3%t, which suggests that over time, the losses have been about 5% per year for a cat bond portfolio.

There has been one fund that I've been aware of, but the minimums were so high, it just wasn't practical for me or most people to invest. It's the Stone Ridge High Yield Reinsurance Risk Premium Fund, the institutional version (SHRIX). The—they call it retail, but the high net worth version is SHRMX; that has a $250,000 minimum. The institutional version it's $25 million. The expense ratio are very high—1.8% for the institutional version, and 1.9% for that high net worth share class.

How has it done? Well, over the past 10 years, it's returned 6.4% annualized. If we compare that to the Swiss Re Global Cat Bond Performance Index, that's returned 6.9% annualized. So gross of fees, this fund would have outperformed the index. Net of fees, it lagged by about 50 basis points. But that kind of, again, gives you an idea historically, over the past 10 years, cat bonds—or even longer, because we went back 25 years for the actual index. Kind of 7% return over long holding periods.

Except we have the issue that the severity of storms is increasing, natural disasters. Not earthquakes, but wind events are, and flood events are. And so the type of exposure— and that's what these managers do, of these cat bond funds and ETFs, they're trying to figure out "Okay, what is the best pricing? What exposure do we want to have? How can we make sure it's diversified, so that we can generate what effectively has been around a 7% annualized return?"

### Catastrophe Bond Investment Vehicles

Now there's actually an ETF that came out last April. It's the Brookmont Catastrophe Bond ETF (ILS). They obviously chose that because it's short for insurance-linked securities. And it's a partnership between two firms: Brookmont Capital Management, which is an expert in ETFs, and King Ridge Capital Advisors. They are insurance-linked security specialists. Their book of business is investing in catastrophe bonds. Their principles— they have decades of experience in reinsurance and capital markets, and they do catastrophe risk modeling and valuation.

So they're coming up with odds of a catastrophe risk, and then they're seeing "Well, how is the deal structured? What are the mechanisms for the various triggers? What is the exposure?" They do climate risk assessment, and they come up with a portfolio. And in this case, it's an ETF that we can invest in. The ticker's ILS. Brand new. Not very big—only about $39 million invested in this ETF. The expense ratio is 1.58%. That's net. It's cheaper than the Stone Ridge offerings, but— these are not cheap, but it's very, very specialized knowledge. Complicated portfolios. They have 71 bonds in the portfolio. So 71 separate cat bonds.

The coupon payment's around 11.5%, and they say the credit rating equivalent—it's like high yield, B+. But the spread over the comparable high-yield bonds is almost 4%. But I like to think of it—it's yielding 11 to 12%, but that's before any payouts as it relates to natural disasters. And historically, cat bonds have offered a higher incremental yield or spread compared to non-investment-grade bonds.

So I took a look at their portfolio. Again, 71 bonds, but we care about what their exposure is. 22% is in windstorms in Florida, a state that over the past 25 years has had 15 to 18 major hurricanes. But

there's also exposure to windstorms in Louisiana, earthquakes in California, and the U.S. has about 10% exposure.

There's also some multi-peril buckets where it could be a multiple of things. There's some Japan earthquake exposure, Texas windstorm, North Carolina windstorm. And as I look through the portfolio, they didn't break it out, but it appears to be mostly windstorm exposure, because my sense is that those generate higher yields. And as you look through the portfolio of insurance-linked securities, they're all listed 144A's. Some yield 8.3%, there's some that have a coupon over 15%. And the average is just about 12%.

Since it was launched last April, the fund has returned 5.9%. So it doesn't even have a one-year return. But if there isn't any disasters, it would return around 11 to 12%. But the reality is, if you hold this ETF, there will be natural disasters, because they are increasing. And particularly wind events and the costs of them. But again, it comes back to what Buffett said—we know there's going to be exposure, but how is the insurance priced? How are these cat bonds priced?

And that, as an investor, we have no idea. We're relying on the manager to determine that, and to build out the portfolio. But we know that there will be disasters, and that can bring the return from 12%, the total return, down to 7%, and potentially, it could be as low as 4% annualized. And there could even be losses. But that's investing. That's the risk. But what's cool about it is this is natural disaster risk, it's not credit risk, because of the structure.

One of my thoughts was "Wel—" Traditionally, these cat bonds—they're private, and pension funds have been investing in them more. You're building out a portfolio. But an ETF is liquid. Do you sell the ETF before hurricane season starts in the U.S.? So you earn this coupon. And I don't know if these cat bonds— how they're structured, if the premium kicks up during hurricane season.

And that's why, you know, this is kind of one of those ETFs that you invest in it, and you kind of just observe how it works, how the returns have been. But here is a public, daily traded wrapper around an illiquid investment, and it has about 13% in Treasury bills right now, so there is some room for liquidity. The premium, the net asset value, has stayed pretty steady.

I find it really intriguing because it's a different return driver. But I also recognize that due to climate change, natural disaster risk is increasing, especially flood risk, wind risk, and storm risk, as hurricanes are getting more severe. But they don't happen every year. And now we have insurance companies, we have capital markets trying to price those risks, and we can invest in them and hopefully earn a 7% annualized return that this type of investment has achieved historically.

What do you think? Is this something you're going to invest in? We'll see. That's episode 549. Thanks for listening.