Bank of America Merrill Lynch Insurance Conference

Company Participants

- Mark Edmund Watson, President & CEO

Other Participants

- Jay Adam Cohen, Research Analyst
- Unidentified Participant, Analyst

Presentation

Jay Adam Cohen {BIO 3220715 <GO>}

We're getting to the cleanup hitter here, the heavy hitter. Next presenter will be Argo Group. We're pleased to have Mark Watson with us. He's the company's President and CEO. He has been associated with Argo since 1999.

Mark Edmund Watson {BIO 1463509 <GO>}

'98.

Jay Adam Cohen {BIO 3220715 <GO>}

Has not aged a day. '98, excuse me. Has been CEO for 16 years. So really, he is the architect behind what you see today as Argo. And he continues to make changes, to put his imprint on the company with key hires in certain areas, really a forward-looking strategy, looking to the next decade in the insurance industry. So we always look forward to having Mark here. I will turn it over to him now.

Mark Edmund Watson {BIO 1463509 <GO>}

Good afternoon. And Jay, thank you for that very nice introduction. We have changed the company a lot. I first invested in the company in 1998, if you can believe that, having been in another specialty company before called Titan. Joined the board in 1999. And I became CEO in 2000, 17 years ago. And I always like to kind of tell the story of the journey we've been on because I think it says a lot about who we are, where we've been, where we're going and how we're going to get there, which may be a little unconventional sometimes. So I'm told.

But before I kind of get into that story, I'm sure that you guys can all read the fine print here on the slide. By the way, this year, I brought my own slides because I couldn't read the confidence monitor last year. Yes, I can't read it this year. Okay. So here we go.

So let me just tell you a little bit about who we are today. And then I'll talk a little bit about how we got to where we are and where we're going. So we're, we believe, one of the leading specialty underwriters in our market. About half of our business is in the United States, a little more than that. And sorry, I guess, we grew so much this last year in the U.S., that now it's almost 2/3 of our business. And the remainder is primarily underwritten in either London or in Bermuda; and then to a lesser extent, Continental Europe, Dubai, Singapore and Brazil.

We have, I think, a pretty good presence in all the markets where we operate. And I think we have a really good mix of business. Keep in mind that we're primarily an insurance company. About 90% of our business is insurance risk and only 10% is reinsurance. And the majority of that is property cat reinsurance underwritten in Bermuda. When you look at a spread of risk by product category, the largest bit is our casualty portfolio. And our professional lines is probably the fastest-growing part, even though it's only 15% right now.

If I just kind of talk about how we tick and what we think about, it all kind of starts with our balance sheet and how we manage that and how we build value for our shareholders. And that's, over the last decade or 2, been a combination of underwriting margin, total return on invested assets plus capital management. And we'll talk a little bit more about these as I go through our presentation.

When I think about how we can differentiate ourselves or how we do differentiate ourselves from our competition, it really comes down to what we think are our comparative competitive advantages. And we think those are our successful operations in very particular niches or products. And I'll go through those in more detail in a minute; and being in markets where we think we can actually generate a return because we have a positive opportunity with market price; and making sure, perhaps most importantly, that we're a market leader in the things that we do and try very hard to get out of markets that are getting commoditized or where we're just adding additional capacity.

And when I look at our company today versus a few years ago, I think the biggest difference is our ability to innovate over time and the fact that it's ingrained in our company. A lot of our competitors talk about building innovation teams. And that's great. But until you can actually build innovation into your business day to day, it doesn't really stick. And I like to remind my colleagues that innovation is not invention. And it's not this magic thing, right? If you really want to break it down to its core essence, it's just iteration or trial and error, right? You try new things. And if they work, you kind of keep going at it. And we've been doing that for a long time.

We've been able to grow a fair amount over the last couple of years, we've gone from -- I should say, for the last couple of decades. And at the same time, we've been able to improve our loss ratio by about 7 points from 2012 to 2016. And that is important, which I'll show you in just a minute. And along the way. And Jay, I think you said this in your introduction, we've been able to acquire some very talented people. And I was asked a few years ago, with all the consolidation going on in the industry, did we want to be a part of that? And I said, well, maybe, at the right price. I said that with all the M&A going on and all the restructuring going on, I'm willing to bet we can pick up some very good people.

And I'll bet they'll bring some really good business with them. And indeed, that's been the case. And that's in part what's driven a lot of the loss ratio improvement over that period of time.

When you look at the tenure of our team, on average, we've all been together at Argo for about 10 years. And on average, our industry experience is about 26 years. And the last thing I would say about our team is when you look at the alignment of interests -- I think about everything as a shareholder more than I do CEO as one of -- as the largest individual shareholder in the company. But our remuneration for all of our underwriters and management is geared around underwriting profitability over periods of time, not just moments in time. And I think that alignment of interest has also helped improve our loss ratio as much as just portfolio selection.

At the end of the day, what we really care about is those 3 drivers at the beginning: underwriting margin, return on asset, capital management. And that drives book value per share growth, which is a good segue into this slide.

So if you look over time, this is kind of our scorecard. Over the -- since 2002, we've grown our book value per share plus dividend at a 9% compounded rate. And that includes the last two years. Recall that the last two years have had a fair amount of cat activity. And we'll talk about how we fared relative -- this year relative to last year. And of course, there is a fair amount of upheaval in the capital markets this last year. With interest rates going up, you saw bond portfolios coming down in value. Because we're pretty short out the curve, that's now starting to inure to our benefit. And the equity markets were a bit challenged towards the end of the year. The good news for us is that what we lost in the Fourth Quarter in our investment portfolio, we've almost made back in the First Quarter of this year.

So what you'll see on there is a fairly consistent growth. And if you look at the yellow line -- it's hard to see the numbers. But if I can point, we peaked at 1.7x book. And then we made a couple of acquisitions, which I'll get to in a second. And I think some people thought we were going to transform ourselves into a Bermuda reinsurance company. And I hope what you'll take away from today is we're still very much the specialty company that we were back in -- a decade ago. And we're now seeing our multiple come back. And we're presently trading at 1.3x book.

Just one more long slide about time. And this tells a few stories. One, the growth in premium. The dark blue is our U.S. operations. And you'll see that it kind of ebbs and flows. And you'll note that that's pretty consistent with market pricing. Although in the last few years as market pricing in the U.S. has not been that great, you'll see we've been able to grow. And that's again by having really good people and having really good data to underwrite with. And I'll talk more about data in just a minute.

And you'll see that our international operations have grown a fair amount. That has been mainly organic growth. But it's also been a combination of acquisitions as well, both in London and in Bermuda. And I should also say the first part of the growth of our company, from 2002 to 2005, was driven primarily by acquisition. And that was also at a nice period of time when rates were growing quite robustly.

So I think that's important. And I would just make 2 notes about that. One, when we think about acquisition, we think about them as a tool for us to continue driving our strategy. But in the last few years -- really the last decade, our M&A activity has been very limited because we've had so many opportunities to grow organically, mainly by a lot of innovation and hiring really good people.

And so to just put a few numbers around the difference between kind of where we started and where we are today, our premium back in 2002 was a little over $600 million. Today, at the end of 2018, it was just short of $3 billion or a growth of 4.8x. During that period of time, total assets grew from about $2.2 billion to about $9.5 billion. And the investment -- I should say, shareholders' equity went from $328 million to $1.750 billion. And if you kind of add back the investment portfolio movement, we're closer to $1.8 billion. And as you'll see in a minute, during that period of time, we repatriated over $0.5 billion to our shareholders. So we've been able to grow equity faster than the other parts of the balance sheet.

So what's kind of driving the company today? And let me break it down into what is our U.S. business today and what is our international business today. So for years, the flagship of the group has been our E&S business, which was started several decades ago. And it remains pretty constant under our stewardship. We acquired it in 2001. And sometimes, it's better to be lucky than good. We closed on the acquisition in August of 2001. And at the time, the company had a run rate of about $100 million in premium. And over the course of 4 or five years, we were able to grow that to $600 million or $700 million of top line. It's kind of moved up and down a little bit since then. And that's because the market -- as the admitted market's appetite increases for risk, we tend to dial it back. Then when they don't do so well and it comes back to the E&S market, we tend to have more opportunity.

But the other reason that you haven't seen that much growth relative to our whole portfolio is our opportunities that we've had in our retail business, with our professional liability team, our surety team, our public entity team and our mining team, Rockwood. In almost all of these instances, we bring real value to our shareholders -- real value to our policyholders. And I'll talk about that in a minute.

Outside the U.S., we have our Bermuda operation, which is both insurance and reinsurance. For our insurance business, it's mainly large, complex risks where we're insuring businesses that are buying hundreds of millions of dollars or up to $1 billion of coverage that they've got to syndicate out into the global marketplace. So that kind of balances the supply-and-demand scale. And therefore, the right price.

We originate a fair amount of business through one of our syndicates at Lloyd's. But as many of you heard me say recently, we're starting to originate more and more of our risk more locally because it's expensive to trade at Lloyd's today. And if we can find the same risk somewhere else, then we're more prone to do so.

Then we also have, again, our operations in Brazil. The last point I would make is when you look at the growth, which we'll talk about in a minute, a lot of it's coming from many of our digital initiatives.

So let's talk -- let's dive into the U.S. a little bit more. The overwhelming majority of our risk in the U.S. is liability driven. It tends to be shorter tail in nature because most of our -- most of the accounts that we write are smaller. So they have less volatility, they have a shorter tail. And they're more predictable, which means they actually use less capital. It's hard to tell on the slide. But if you look down to the bottom left, you can see the pretax operating income. And more importantly or equally important, the combined ratio. And what you'll see is it's been a pretty steady number in the low 90s to high 80s. And if I went back on this chart another 5 or 10 years, you would see the same thing. You would also see that the number has -- sorry, this is the whole U.S., not just E&S. But the mix between the 2, the combined ratio is about the same. And you'll see that there's been a fair amount of growth over the last five years, from $1 billion in premium to $1.7 billion in premium. And that's been pretty evenly split between our E&S business, our surety business, our professional liability business and then, to a lesser extent, Argo insurance.

If I go on to our international business -- sorry, I should say one other thing about our U.S. business. It's about half and half between retail and wholesale at the moment. If I go into our international operation, the Bermuda business is all through brokers. And if you go to our London business, it's primarily through wholesalers. And you'll see that the combined ratio, again back to the bottom left, is a little bit more volatile here. And that's because most of the cat risk that we have in the company flows through our international business, either through the Bermuda reinsurance company or the syndicate, Lloyd's.

I'd like to say sometimes when I'm talking about -- when people ask me what we do at Lloyd's. And this is less true today than it was before. But if things happen on -- if things happen at night and you see them on TV the next day, chances are we're writing somebody a check. And I'm thinking about airplanes and satellites and cargo ships. And you go back a decade or 2 ago. And there was a lot of margin in that business. But as it's become more and more commoditized, we've gotten out of that and focused more on professional liability, more on surety and more on liability outside of the United States.

You'll see that our premium was pretty flat from 2013 to 2016. Then we started growing again as we've been resetting our portfolios. And a fair amount of work has gone into that again this past year. I think you've heard some of the other speakers today talk about what's going on in the London market. And that's a whole market challenge. And as some of my colleagues were reminding me last week, they said, "We're in the first quartile in London." And I said, "Well okay, that's great. But do we really want to be the best of not a very good pack at the moment?" And so I think you'll see us continuing to pull back more and more of our business there as we reprice it and really think about whether we're really getting a return on the capital that we're allocating.

The good news is that, particularly for our reinsurance business but across the board, we rely on a substantial amount of third-party capital. And I think that's been an interesting opportunity for us. And you'll see that in our financial results in just a minute. When we acquired our second reinsurance business, Ariel Re, two years ago, we were talking about how -- because of the timing, we were ending up with multiple retentions. And you saw that in our financial results in 2017. But for 2018, we were able to combine that together. And we really have kind of gone from risk taker to risk originator as we've been able to reinsure most of the risk back to the capital markets or to other third-party capital providers at Lloyd's.

Let's jump ahead for second. And I was talking a minute ago about loss ratios. And I think this is an important slide. And it really shows, I think, the quality of our portfolio today. If you look at the dark blue numbers, those are our loss ratios over the last seven years. And if you look at the light blue, that's kind of our peer group average. And what you'll see is that in almost every year, the dark blue number is lower. And more importantly, you'll see that it's been pretty consistent. By the way, this also includes cat activity. So last year, even with all the cat activity, we still had a 66.8%. And this year a 60.1% with the cat activity. If you take that out, then we're running in the mid-50s.

If I can go back on that, okay.

So just one other point. I mentioned distribution earlier. We deal with wholesalers, retailers. And you can see that we have a pretty broad product portfolio. And that's led to a pretty broad distribution platform.

So what's kind of driving all this besides hiring good people? It's been innovation and it's also been our digital team or the digital initiatives and the use of technology. And again, this isn't something that started a year ago, although I started talking about it here on this podium a year ago. It's something that really went back about 7 or eight years ago. And 7 or eight years ago, we started building an enterprise-wide software for our -- what we brought -- we built it with a third-party vendor for our U.S. business. And that's because, at the time, technology was really expensive. And we just couldn't afford to go buy something off the shelf like some of our bigger competitors have. Now the good news today, by the way, is the cost of technology has come down considerably. And I'll talk more about that in a minute. But what we've been able to do over the last few years is put teams of people together where we can embed the digital team into our underwriting teams or vice versa. And that's led to a lot of innovation and a lot of premium growth, most recently in our casualty and professional liability lines here in the U.S. But in addition to that, it's allowed us to change how we engage people.

For certain lines of business, where the risks are kind of complicated and they're backed up, take some our E&S business, the turnaround time on some submissions was three days. And we've now got 75% of our submissions down to an hour. And you say, well, why didn't you do that before? Well because there's a lot coming in. And so what we found, not surprisingly, because if it's an E&S quote, you're the last one to get it because the admitted market didn't want it. He who closed first win. And so that's really driven a lot of our growth the last couple of years.

And also what's been important with our use of artificial intelligence is our ability to figure out, by using third-party data, what not to write, because there's some risks that we think -- or some businesses that we think have certain inherent risks that, at any price, we think it's the wrong price. And it's better to just focus on risks where we think we have a better chance of meeting our return-on-capital threshold.

So I can keep going. But I want to leave you with the sense that it really is kind of every part of our business that's being touched, at least in the U.S. And now the opportunity is to take that now -- that know-how and move it into international.

If I can just give a few more examples for a minute. So on a premium base of $3 billion -- roughly $3 billion, in the last few years, we've processed about $1.4 billion through the platforms that I mentioned earlier that we started about seven years ago. We also launched a sensor-based technology called -- that we now call Argo Risk Tech, for our retail business. And I was talking about this actually on our earnings call yesterday. So take a typical grocery store where the biggest risk is slip and fall. And we have these sensors all over the grocery store. And it helps the store owner know if people are actually out kind of policing what's going on. And they also have -- there's a sensor for almost everything now. And this is like Nest for your grocery store. But it's really dropped the incidence of claims a lot. And our loss ratio has gone from the high 90s in this portfolio to the low 50s. So we went from losing money to making money over a few years.

We've also partnered up with a number of insure tech companies. One of them is in the cyberspace. It's called Coalition. I think you have probably heard about that. And the most interesting thing going forward is our ability to collect data and use that data to do a better job of underwriting. And most of that data is coming not just from our own underwriting systems. But from third parties as well.

And I think this is kind of the most exciting thing, right? As the cost of data comes down and the cost of technology comes down, it's more available to all of us. And for a company our size where we're kind of in between, right, we're still small enough to be nimble but big enough to take risk when we want to, with the cost of technology coming down, we can afford to go head to head with all the big companies as long as we know how to efficiently deploy it. And I think we've done a really good job of that.

If you -- just to give you an example. We've been spending millions of dollars a year on our digital operation, not tens of million. But if you just look at one product that we wrote a couple of -- for the last couple of years, the incremental growth, which runs at about an 85 combined ratio, has more than paid for our digital initiative over the last couple of years. And so now the question is how do we leverage that and really get more out of it? And that's our focus going forward.

Let me just move on to our investment portfolio for a minute. So we think we have a pretty balanced portfolio. About $4 billion of it is in investment-grade bonds. And the other $1 billion is in what we refer to as our risk portfolio. As we saw the capital markets getting bid up the last couple of years, we have been lightening the risk portfolio. But as -- it's going to -- literally, for like every $10 million of equities that we reduce, our portfolio would go up another $10 million. And so we've been reallocating that back into our core bond portfolio, our investment-grade portfolio.

To just go on to our investment results for a minute. What a difference a year makes, both for the quarter and for the year. For the quarter last year, we had an underwriting loss of $27 million compared to an operating profit of $2 million in the Fourth Quarter, notwithstanding all the cat activity again this year. Last year at this time, we had -- basically, we broke even for the Fourth Quarter; and this year, we had $23.5 million of operating profit. And on the full year last year, with all that cat activity, our underwriting loss was $113 million; and this year, we had an operating profit of $36 million. And our operating income went from $7 million a year ago to $140 million this year. So if I think about that in terms of margin, our combined ratio went from 107 to a 98. And if you exclude the cats, we're running more around a 95.

So not quite where we'd like to be, which is to get down to the low 90s. But we're moving in the right direction this year. We had improvement both in our loss ratio and in our expense ratio. We dropped our expense ratio 260 basis points year-over-year. So I think we finished the year in a really good place to start for 2019.

And let me just talk about capital management for a minute. So over the last eight years or so, we've grown our equity base from about $1.4 billion to $1.8 billion. And we've given back $646 million to shareholders in the form of cash dividends, stock buybacks, special dividend -- or I should say, stock dividends. And I think that it's been pretty consistent over that period of time. And I think to be able to give that much back and still be able to grow has been really exciting as we've been able to finally leverage our balance sheet and our platform.

And if I go to our return, for the last three years, I'm happy to say we're the one up here. And so that says 65%. I think the last three years, I thought it was not quite that much. But that's not bad for the last three years given the volatility in the marketplace.

So if I could just kind of sum up. I think we're really well positioned to create value in 2019 and beyond because of the investments that we've been making the last few years. We've established ourselves as a leader, particularly as an underwriting leader in many of the markets, if not most of the markets, where we operate. Our loss ratios really are best in class. And they've been consistent over a period of time now. We've consistently grown our top line double digits in the U.S. for the last five years. The digital tools that we've built are things that we started several years ago. And we're able to finally see tangible financial benefits in 2018 and I think we'll see more in 2019. I think we're finally at scale in the U.S. and almost at scale with our international business.

As for our capital, I think we have a very balanced investment strategy. I think we have a very strong balance sheet. Our reserve development for the last 14 years has been positive. I think we are very good at using third-party capital to manage a lot of the volatility on our balance sheet. And I think that we've done a good job over that period of time of really driving all the levers to grow book value per share, from underwriting income, total return on the investment portfolio, capital management. And I think us earning a return on our goal of 700 basis points above the risk-free rate or about 10% right now, we're really close to getting there. And I'm really happy with where we're starting 2019.

So Jay, with that, I'll take some questions.

Questions And Answers

Q - Jay Adam Cohen {BIO 3220715 <GO>}

I had a question back here.

Q - Unidentified Participant

So you said you were taking advantage of third-party capital. Given what's going on at CATCo and others, what does that mean for your business?

A - Mark Edmund Watson {BIO 1463509 <GO>}

Well it means we were the beneficiaries of really good programs. Look, I think that it's interesting to see what the capital markets will do and who they'll support for 2020. We've got all of our reinsurance and retro programs set for 2019. And I think that just to be cautious, we'll probably dial back some of our gross exposure this year. A lot of what we renew that relies upon that third-party capital renews later in the year. And if we can't get the rate, then we'll walk away. I'm pretty comfortable that 80-plus % of our retro will be there no matter what next year because we haven't touched it from a loss perspective. And I think that we'll be just fine next year. But I think our retro program will likely look a little different than it does this year. And I think in part, bringing our gross down will help our net exposure. Most of our third-party capital comes from funds at Lloyd's and, to a lesser extent, our main retro program. The managers that are challenged right now were writing some pretty big sideways cover. And I think we'll be able to absorb that, if we need to, on our own.

Q - Unidentified Participant

I see your goal of 700 bps over the risk-free rate. A lot of the other specialty players who trade at many multiples of book have higher ROEs. Is this like an interim goal? Can that move up higher over time to where some of the other specialty players are? And you would be -- benefit from a higher price to book, hopefully?

A - Mark Edmund Watson {BIO 1463509 <GO>}

Well I'm not sure who you're referring to. But when I look at all the specialty players and add them up, that's kind of about where they're trading as a group. Do I think we can get above that? Well yes, actually, I do. But I'd like to get there first. I mean -- so if -- we're not that far away now. But we need another couple of hundred basis points improvement in margin and a little bit more leverage on the balance sheet. And I think we'll get there.

Q - Jay Adam Cohen {BIO 3220715 <GO>}

Let me just throw one out there. So many companies are investing in digital. But typically they say we're making these big investments in digital. Those investments will tail off. So yes, it's hurting us now. But in a year or 2, those investments come down and that will help the earnings. It sounds like you're doing this on a much more consistent basis. I mean, I assume we should not expect your digital investments to tail off in a year or 2.

A - Mark Edmund Watson {BIO 1463509 <GO>}

Absolutely not. It's an ingrained part of who we are. And we paid for a lot of it by kind of freeing up seats in one part of the company. So that we could hire new people into not just the digital team. But other parts of the company as well. If you go back five years ago, about 1/3 of our employees were underwriters. Today, that's only 1/4. And today, we have many more data scientists than we did before. We have more actuaries than we did before. We have more software programmers than we did before. Probably, half the people that are joining our company today come from outside of the insurance business. And so I think we've kind of gotten over the hump where now it pays for itself. And so now we just need to scale and keep our digital spending commensurate with the benefits that we're getting.

Q - Jay Adam Cohen {BIO 3220715 <GO>}

Got it, makes sense. Out of time, we'll leave it there. Mark, thank you very much. Great presentation.

A - Mark Edmund Watson {BIO 1463509 <GO>}

Thank you.