KBW Insurance Conference

Company Participants

- Jay Bullock, EVP & CFO

Other Participants

- Unidentified Participant, Analyst

Presentation

Unidentified Participant

Good morning, everyone. For this fireside chat we have CFO, Jay Bullock, from Argo joining us. So thank you, Jay, for coming.

Jay Bullock {BIO 3644311 <GO>}

Happy to be here. Thank you.

Unidentified Participant

Okay. Great. So I guess will just start off at an overall level. Argo has been shifting its portfolio in both the US and then international segments. So how should we think about this increasing proportion of casualty business, as well as your expense ratio improvements on accident year level underwriting results?

Jay Bullock {BIO 3644311 <GO>}

Yes. So when you talk about the shift in the portfolio towards casualty, I think what you may be referring to is in 2018, for example, in our property business we are employing a greater amount of third-party capital, which means by definition we've got less property than we had before. That is number one.

Number two, we have been talking a lot about investments in technology and investments in workflow. And those have largely been related to some of our better casualty businesses. Which means then, all other things being equal, we are seeing not growth in the casualty business.

Then let's translate that into what we saw in the first six months of the year, which was an improving expense ratio and what I would say is -- there's nothing behind that improvement in expense ratio that needs to be explained away. It is simply we are getting more leverage out of the same infrastructure. And a lot of that is being enabled by the investments that we've made in technology and so forth.

What does that mean for the future? It means that areas that we think -- where we see the greatest opportunity for growth we still see those opportunities. We think we can achieve much of that growth without meaningfully adding to the workforce. And that means that has a positive longer-term effect on expense ratio as a number.

Unidentified Participant

Right. And so, what are you thinking just in terms of your expense ratio target as these shifts are occurring? Less property, more casualty. So you expect your expense ratios to move on that. Plus you are getting the benefits of you had mentioned the technology investment. So that should help drive more premium growth and more expense synergies. So how does that translate to an overall expense ratio for us that have to model it?

Jay Bullock {BIO 3644311 <GO>}

Yes, right . You are not going to get a number out of me. I'm going to (multiple speakers).

Unidentified Participant

(Multiple speakers). So the expense ratio and then how does that shifting mix towards more casualty which provides higher loss ratios, how does that translate into a combined ratio too?

Jay Bullock {BIO 3644311 <GO>}

Yes. The businesses that we are growing from -- on the casualty side, even with that growth, should not dramatically change the ratio loss ratio. So if you roll things forward for three years and that business mix was the only factor that was impacting it, that might have a 100 basis points impact on the loss ratio.

I was just joking with you for a minute, because I wanted to take a step back and reiterate something that we talk about with our underwriting teams all the time. And that is the objective for the underwriting teams is dollars of underwriting profit.

And so, we are, at the start of analyzing any business, agnostic as to what the launch ratio and expense ratio is. We need to know what the long-term sustainable loss and expense ratio in combination are and how to do those generate underwriting profit.

So that is to say when we have a business like the surety business and we're able to see good growth in the surety business, that's going to make our expense ratio worse because the acquisition cost in the surety business can run up to 50%. Are we going to stop writing surety because that ratio gets worse? No. So that's number one.

But having said that, when the dust settles we then step back and we say how can we improve the expense ratio? We do focus on that. So I don't want to give you the impression that we're not focused on it. And our objective is to continue sequential improvement and we see the ability to improve that 100 basis points a year.

So if last year was 38 and change; now you have to normalize some things in last year's numbers, it was a complicated year. We made an acquisition, we bought some additional reinsurance, there were losses in the year. So it was a complicated year so you have to normalize that year.

But last year was 38 and change. This year we are looking for 37 and change and we'd like to continue to drive that 100 basis points a year. That is not an incident path obviously. But I think by the time you get to a 35, 36 we are in a pretty good state for us, especially if we can maintain loss ratios in the high 50.

Unidentified Participant

Got it.

Jay Bullock {BIO 3644311 <GO>}

I almost gave you some numbers, didn't I?

Unidentified Participant

Yep, very much appreciate those numbers. Any questions from the audience? Okay. So just kind of diving in, what trends are you seeing in commission rates? Just in terms of -- I'm trying to get an idea of competitive landscape, how that translates -- because we hear all the time about excess capital in the industry and think excess capital. That should have downward pressure on commission rates which would obviously benefit Argo.

Jay Bullock {BIO 3644311 <GO>}

Well there has been excess capital in the industry, all things being equal. And I don't mean losses by this. There's been -- with the consolidation that has gone on there's been a meaningful amount of capital that's been taken out of the industry recently. At the same time there's probably as much or more alternative capital has come in on the margin to support the market.

But back to commission rates. Let me address it this way. We are very active in working with our distribution partners. What do I mean by that? We meet with them on a quarterly basis, we talked about -- first off, we talk about what we are interested in, what's our risk appetite, what type of business are we looking for, what do we expect.

But then we also give them regular feedback about how they are doing with us, what commitments we made to each other the last time we met, how they perform relative to the other people that we work with. We do that on a no names basis. We are not trying to put anybody in a tight spot. But the feedback that we get is that some of that is really good information, they're not getting it from all the other parties.

So that means that there's a really good balance and a really good tension between the quality of results and what we are going to pay to acquire that business. So there's been a lot of tension in the market broadly on commissions over the last several years. We have been vocal about it, we've talked about the London market.

And at one point Mark pointed out that the amount of profit being taken out of the equation by distribution was going to render that market unviable. And I think what you see -- and I'm speaking very specifically now of the Lloyd's market -- what you see in the Lloyd's market right now is a lot of pushback on growth and a lot of pushback on that very issue, that the parties that are underwriting there have to make a good return.

So I think that there is -- I think there are countervailing forces is what I'm suggesting that are -- sorry, two things. One, on a micro level we are really active with our distribution and I think that gives us an advantage because we are able to point out, hey, this is what we need from you and this is what we are getting from you.

Then on a macro basis there are countervailing forces that are providing some positive influences where they are most needed. And I think of things like the London market.

And the final thing that I will say is we've talked a lot about our employment of technology in our business and the digitization of the insurance business. I see the other parties that are really active there are many of our distribution partners. They are thinking about how to do that more intelligently.

And the more we can align ourselves with good outcomes for us and good outcomes for them with the employment of technology we can achieve better underwriting results in what is otherwise a slightly improving or flat rate environment.

Unidentified Participant

Great, very helpful. Then just taking a high level question, the latest news and everything, is that obviously we had a recent announcement where The Hartford purchased Navigator, another specialty platform, not dissimilar to Argo. And got a pretty good multiple. So how does Argo think about -- process that type of news just in terms of -- and kind of what feedback and (multiple speakers)?

Jay Bullock {BIO 3644311 <GO>}

We think first off it's a great opportunity for us. Every time there is a transaction similar to that in the market it creates opportunity. It creates opportunity because another -- a competitor is probably going to take their eye off the ball, a competitor is going to be consolidated, assimilated into another platform.

And I'm not close to what The Hartford's plans are with Navigator. But I believe they said they are going to let it run on a standalone basis. So that may be the case. Nevertheless, there is always some level of assimilation that creates opportunity.

Then what we also find is that -- and this is not specific to a Navigator situation. But people that have enjoyed working in a smaller environment maybe that is more entrepreneurial may not want to work in a very large environment. So that is number one, it creates opportunity for us.

I guess the other thing, how do I process in looking at it was -- the price that they achieve for that is the price that specialty platforms trade at. And I say that -- it sounds like kind of a statement of the obvious. But I say that in the sense that we can all scratch our head about math and returns and so forth. But it happens again and again and again.

And so, it leads me to the conclusion that our platform continues to be undervalued and it's a great investment opportunity because I think there's meaningful upside in our stock.

Unidentified Participant

I agree. Any questions? Okay, we have one from the gentleman there. Let's see if we can get you a microphone.

Questions And Answers

Q - Unidentified Participant

Thank you. I'm curious about the earlier comment on capacity where you said acquisitions take capacity out of the market. At least that's what I heard. Then just thinking about the example, we are talking about Hartford/Navigators. Navigators is no longer public. But they're not going away; they are still writing business and they in fact write more business with a bigger balance sheet.

Aspen got taken out by private equity; presumably they want to write business and make a return on their investment. So could you just comment on that? And how does capacity come out when there are acquisitions? Thank you.

A - Jay Bullock {BIO 3644311 <GO>}

I guess there's been other transactions in the market as well. So again, I'm not going to speak to specifics because I don't know about what the strategy is for some of these things. But AmTrust is involved in a go-private transaction, right? Maiden, which was an important part of the -- I think an important part of the AmTrust structure -- at least it was an important trading partner of theirs -- is effectively out of the market.

And so, I guess what I'm suggesting is that in situations like that. And in situations like -- even in situations like Aspen, there's a reason that they chose to go down that path because the strategy wasn't playing out the way they wanted it to. I suspect that under new ownership the strategy will be rationalized.

So that by itself doesn't take capital out of the market. But the end result is if you rationalize that strategy in how you shrink the business, then you've got excess capital and you're going to do something with that.

I would also point to a buyer like Apollo who had a pretty effective off-the-shelf strategy that they had deployed with (Brit) when they bought Brit. They will be active -- they will actively, I would think, want to get capital out of that business. So that is what I'm thinking.

Q - Unidentified Participant

Any other questions? Well we'll ask one more M&A question and we will kind of move on. So the insurance insider had reported that Argo was potentially interested in Aspen. And I think I asked Mark something about this on the last earnings call. But just how do you think about that?

I mean, because Argo did do the (PF3), which I'd say was a slightly transformational type of transaction. How do you think about that type of large transformational acquisition versus more I guess value opportunity like you picked up in Ariscom?

A - Jay Bullock {BIO 3644311 <GO>}

Well I think we start with the same thing -- I think we look at it the same way we look at something -- a tent our size and that is what's the strategic benefit of doing this? How does it enable, how does it advance our business strategy? So that's number one.

Number two, we think very immediately about math, how do we generate -- so first off how do we make this an accretive transaction for our existing shareholders of which all of the management are meaningful shareholders? How do we make this an accretive transaction for our existing shareholders? And how to we get a good return on that investment?

So I don't think we would think about the small or the large from either one of those two things any differently. And those are the two really most important things we think about. That said, a small transaction or a large transaction might bring with it other benefits that might -- whether it is scale in a particular business where scale would be helpful or otherwise that might help us to advance our strategy somewhere else.

So I think that's the only difference that we would apply based on the size of a given opportunity, what might that do that something smaller might not do. Conversely, what might something small do that something larger might not do? We might be willing to take on maybe a -- more of a project, if you will, if it's really small as opposed to something that's really large.

Q - Unidentified Participant

That makes sense. Back to the regular operations. And so you had spoken a little bit about surety. And we noticed some specialty competitors have noticed about the -- that just -- that product line becoming more competitive. Can you give us color what you are seeing in the surety line? Then how does Argo feel comfortable growing that?

A - Jay Bullock {BIO 3644311 <GO>}

Sure. Well it's interesting for me. My background -- before being at Argo I was a banker. So I started my career in credit, surety credit. It's a banking product, if you will, that is enabled through the insurance business. So I have always been really interested in it and -- but that leads me to look at what's happened in the broader credit markets.

How stable have the broad credit markets been since 2009? Pretty stable, right? And so, that is number one. And number two, it's a very non-correlated risk to a lot of other things that people do. So if you factor those two things in I can understand why people wanted to get into that business.

The other thing that I would say, much like credit businesses outside of insurance, is you really need to have people that know what they are doing, that really have good, solid, sound underwriting fundamentals; in this particular instance, sound credit underwriting fundamentals. So that's number one. We have a great team that started sound underwriting fundamentals.

The second thing is, much like everything else that we do at Argo, we've been very focused on how can we specialize in the surety market. So for example, we have -- I think this is correct -- we have two petroleum engineers and one mining engineer on staff in our surety business because we are active in both of those markets, in the oil and gas market and in the mining market.

That gives us an advantage because we are able to go in and underwrite the assets, if you will, that might ultimately underlie one of those bonds. So we've created specialties within surety and those specialties have helped us grow that business. So when you have how we get comfortable with it, just making sure we stay on top of the fundamentals is probably number one.

Q - Unidentified Participant

So just moving on to Argo Pro, can you just give us some overall color in terms of just the underlying construction of that portfolio? How much is primary; how much is excess? And what are you seeing in terms of rates, loss cost trends?

A - Jay Bullock {BIO 3644311 <GO>}

I'm not going to give you all of that, just because that's what we think is some of our competitive advantage, sort of knowing where to be in that portfolio or not. That said, that's another area where we are able to deploy and are actively deploying technology to enable both the underwriting process to be more efficient and knowing where to participate.

So that's the point that I was being a little cheeky about. And that is we think we've got and are developing some tools that help us think more intelligently and get the underwriters more focused about which parts of the market we want to be in. Which layers we want to play on, where the pricing is on the layers.

When you think about it as a primary and an excess market, an awful lot of professional liability markets, especially when you get to the public company and even private company, is sold in layers. So the majority of it therefore would be an excess market technically defined, because it's not in that very first layer. And you'll generally find us operating above that very first layer.

The other thing that I would say in professional liability is it's a very broad definition. There's a whole lot of things inside of professional liability. So everything from writing public company D&O which we do -- we do some of that, to things that we've done, for example, in Brazil.

You've heard us talk before about our Protector product, which was a small product designed to write very small premium professional liability in the Brazilian market. We have been able to take tools like that and export them out of Brazil and use them in other parts of our platform.

So we would be -- so, back to the non-answer on your question about construction of the portfolio. We have everything from the large company risk to small standalone -- very small premium business that we write in professional liability.

Q - Unidentified Participant

Got it. And any change -- I mean, has there been any shift in your attachment rates, like where you are playing at within layers?

A - Jay Bullock {BIO 3644311 <GO>}

Yes, over the last five years. But we've got a great individual that runs our professional business. His name is Craig Landi. And he joined us three years ago, probably maybe four. And so he's led a modest shift in how we approach that business. That's the main reason for the shift that we just think is -- we hired him for a reason because we think he's a really smart guy. And we think that he's got some great ideas about where to have that portfolio. But if I told you all of them then you would have all the secrets.

Q - Unidentified Participant

I'm assuming the attachment rates are going upward.

A - Jay Bullock {BIO 3644311 <GO>}

Yes.

Q - Unidentified Participant

Okay, good. So Argo exited the E&S commercial auto book a while ago before the current market headwinds. But we've just seen so much rate going into that book. Does that get attractive to Argo at some point in the future? And if so, like how much do rates have to move for you to get interested in that again?

A - Jay Bullock {BIO 3644311 <GO>}

It should be, shouldn't it, right? I am always at a loss why there's not -- it is such a large part of the market -- why people are not able, companies are not able to make more money in commercial auto. But throughout my career -- before coming to Argo, throughout my career of 10 years plus now at Argo, I've just never seen anybody make money in commercial auto.

Now, if you turn on the football games in Texas on a Saturday every other commercial is the plaintiff's bar suggesting if you are injured in an accident with an 18 wheeler please call us. So it doesn't surprise me that the results have been bad. But I can't think of a sector of the market that is better positioned to deploy technology, know when people should and shouldn't be on the road and so forth. And rates have gone up substantially.

But it would be a lot, is my technical answer to how much rates would have to go up, a lot, for us to get really excited about being in the commercial auto business. I mean we tried, trust me. Our exit from the transportation and E&S I think was very well timed. But it happened after the fourth iteration of trying to fix it.

Now it wasn't a big problem for us, right. So it wasn't something you would have been reading about every quarter like when are they going to fix that. It was not a big issue. But we kept trying to figure out how are we going to get the right sort of return. The last time we looked at it and for the fourth iteration I think the answer was four years from now they will have an acceptable outcome.

That's not acceptable in and of itself. And we made the decision to get out of it. And it was well-timed because that was before some of the other things happened in the market. But I continue to scratch my head about why that's not a better opportunity because it sure should be.

Q - Unidentified Participant

Any audience questions? Okay. So shifting gears to Lloyd's, how are you focusing on that market? I mean, obviously you added Ariel, which gives you another syndicate or two. How are you thinking about that participation in the market? And just how does that look as Lloyd's starts weeding out some of the weaker competitors? Does it give Ariel an opportunity to get in there to price some business.

A - Jay Bullock {BIO 3644311 <GO>}

Yes, I was going to go with the answer exactly where you went, which is I really see this is the time of year when everybody is submitting their plans to the Lloyd's market and so forth. And growth is being rejected across business plans. And that's a really healthy thing I think for the market. And so, that's number one. Number two, the organization of Lloyd's is being very active in managing -- the managing agents to exit lines of business where the results have just been really poor.

And so, I think for those of us that are on the scale of large to small, at the larger end of the market I do think that creates opportunities and will create an overall better result for the market. But also creates opportunities for us to drive rate where we can and just get an overall better result out of that market. So I am really positive about the changes that I see going on there right now.

Q - Unidentified Participant

Got it. And when you talk about competitors exiting the market, is that more (technical difficulty) the opportunity? Is that more for like an organic, you can pick it up with the existing syndicates? Or could there be an opportunity to purchase and -- it's a smaller turnaround situation to access to a good book that's just been --?

A - Jay Bullock {BIO 3644311 <GO>}

Right. Despite -- there are a number of platforms that I guess are for sale right now; some of them I guess have been formally announced in that process. And despite the recent results, it's still a scarce asset, meaning Lloyd's -- there's not -- you can't just start one; you have to go through a pretty rigorous process to start one. So buying one might save you a lot of time.

That means that, all things being equal, the largest one I think that's for sale right now that I've heard of is Chaucer. And I think there was some rumor about who might be buying that last week. I still think they'll get a premium for that.

So if you are already in the Lloyd's market and you already have a pretty good amount of scale, buying another Lloyd's platform doesn't make a lot of sense to pay that -- why pay another premium? And when we bought Ariel we paid a pretty modest premium, much lower than what had been paid in other parts of the Lloyd's market.

So would we be interested in -- and I go back to my earlier comment, we look at a lot and we look at most everything and reject a lot of it -- it's out of hand pretty quickly because it's not strategic. But if we saw something -- an opportunity to do something that might be like a fixer-upper or something like that that might give us something in that market, yes, we would be interested in that. We definitely would take a look at it.

Q - Unidentified Participant

You feel like the Ariel Re integration is complete and then you would have the bandwidth to do that internally?

A - Jay Bullock {BIO 3644311 <GO>}

Yes, I do, I do. I think that integration has gone well. We wasted no time in combining teams -- integrations are all about people, right? And so, we wasted no time combining teams. And I think that was a good decision because it feels much more like one team today than the old guys and the new guys.

Q - Unidentified Participant

Great. So just kind of switching gears to capital management a little bit. As interest rates rise Argo's cost of capital is probably also rising. So how does this translate into your underwriting hurdles like your combined ratios? Then divisional ROE targets? Then, just what's a reasonable near-term -- I'm thinking like the next 18 months to like maybe five-year ROE for Argo to achieve?

A - Jay Bullock {BIO 3644311 <GO>}

Risk-free rate plus 700 basis points. I answered that real out of hand because we've been pretty regular and vocal about -- I think that's the right metric for a business like ours to be thinking about in this environment -- in any environment. That's the right sort of thing. So that's 9.8% today, it's 10%. And that's what we think about from a target standpoint.

When we talk to our underwriting teams and we talk to our business units, again, the first point of connection is let's talk about what's an acceptable margin in that business -- dollars of underwriting, combined ratio, however you want to put it.

And we also help connect people to the fact that they are part of a larger organization and that large organization brings -- it may bring challenges for them but it brings benefits as well. It brings capital, it brings centralized management, it brings centralized resources and so forth.

And so, the hurdles that we set for those underwriting units from a returns standpoint are greater than and often not directly connected to. They would be sufficient to achieve it but not directly connected to that risk-free rate plus.

So we want people to be thinking about their business model over a long period of time, somewhat agnostic to where interest rates are -- because we don't want to create an environment that enables cash flow underwriting. If interest rates -- if the 10-year went back to 6% or 7% would people say, hey, I can write at 104 now because I'm still making money. No. We don't want that.

And frankly I don't think that the other constituents that have now lived through the last 10 years and sort of gotten used to the fact that this is what the environment is, whether it is rating agencies or regulators or otherwise, I think about having that conversation today.

Let's say that the math would support -- interest rates went up so much that the math on a particular line of business would support 104, if your only objective was what is your return on capital. I think about taking that conversation into a rating agency or a regulator today and it would not be a good conversation.

And I don't necessarily see that changing because you said to the regulator or rating agency, well, I know; don't worry we are losing money on the underwriting side, we're making a return on capital because interest rates are so high.

So they haven't been tested yet. But my instinct tells me that the underlying conversation has changed a lot in the last 10 years. And I just see people -- at least in the specialty markets, I can't speak for the standard commercial markets, I can't speak for personal lines which I think is a whole different kettle of fish. But at least in the specialty markets I think that the conversation and the requirements to define success in that market are different today.

Q - Unidentified Participant

Now, if 9.8 is the target; Argo is a little bit beneath that today. So what needs to change to kind of get to that glide path to get back to risk-free 700 (multiple speakers)?

A - Jay Bullock {BIO 3644311 <GO>}

Well I think the sequential improvement in the expense ratio is the most tangible and visible thing that will reflect that.

Q - Unidentified Participant

So more underwriting leverage? Talk about --.

A - Jay Bullock {BIO 3644311 <GO>}

More underwriting leverage or cost reduction. But more likely to be underwriting leverage. I do think that the shape of the yield curve has worked to our detriment from a book value standpoint in the first half of this year. But it's worked to our benefit from the standpoint that we have -- our duration is relatively short.

So when we were getting really low yields on short-term money -- there is a difference between getting 4 basis points on $0.5 billion of short-term cash and now getting 40 basis points. I mean, it really does make a difference.

And so -- sorry. So the flattening of that curve, because it has been the short end, has impacted our portfolio -- not materially. But our book value growth was underwhelming in the first half of the year -- disappointing I would call it from my vantage point. But it's also had a benefit on investment income which we see increasing.

So I'm trying to answer your question as to what are the things that are going to affect that glide path. One is probably increased scale and improvement in that expense ratio. The second is I think that the move in interest rates, all things being equal, is helpful to us.

We still have -- as you saw at the end of the Second Quarter, we still have kept the portfolio relatively short. We just don't see -- haven't seen and don't see the risk/reward of extending that duration. There's just not enough return two or three years out from where we sit today.

Q - Unidentified Participant

Okay. So basically there's upside from the underwriting -- I am just decomposing the operating ROE into the underwriting and investment. So you basically can see upside from either -- from both sides of that, expense ratio improvement on the underwriting side which should drive the combined ratio lower. Now anymore leverage that you (multiple speakers)?

A - Jay Bullock {BIO 3644311 <GO>}

Financial leverage you mean? Or operating leverage?

Q - Unidentified Participant

Underwriting -- yes, operating leverage.

A - Jay Bullock {BIO 3644311 <GO>}

We have room for growth, right? And I think that the biggest industry-wide constraint right now is on various rating agency models and how they model out diversification. Some of them give relatively low credit for diversification. Most other people that have sophisticated capital models, as do we, think that there's a lot more diversification.

So that means from where we sit we have material room for growth in some of the lines where we have good opportunities for growth. We are not constrained from a capital standpoint by the rating agencies. But we certainly have to pay attention to it because there's just not a lot of diversification credit. So I think that we will continue to see some growth and some leverage from that standpoint.

I want to go back to one thing that you said though. If you just look at the math and you just look at the model, companies like ours are very positively levered to a changing interest rate environment. But I don't count on that anymore. I stopped that about five years ago.

Q - Unidentified Participant

Got it. Okay, well, great. It's lunchtime. So I'll go ahead and let everybody go. But thank you, Jay, for joining us. We really appreciate it.

A - Jay Bullock {BIO 3644311 <GO>}

Thank you.