Deutsche Bank Global Financial Services Conference

Company Participants

- Mark Lyons, CFO, EVP and Treasurer

Other Participants

- Josh Shanker, Analyst
- Unidentified Participant, Analyst

Presentation

Josh Shanker {BIO 5292022 <GO>}

Thanks for coming to the Arch Capital presentation, if everyone could come on in. We're really pleased we have Mark Lyons here, who is the CFO of Arch Capital. He is one of the founding people at the Company. He's been a lifer from Berkshire Hathaway, AIG; a virtual encyclopedic knowledge of the industry. And so I think that's where I want to start. I managed to throw away my questions; luckily I found them on my BlackBerry. It all works out pretty well.

Looking at the market right now, if we think about 2016 to 2018, what is the ROE of the industry? How -- people talk about outperforming the risk-free rate by a certain amount. Can a company like Arch outperform the risk-free rate by its targeted amount during this period of time? And how much better can Arch do than the industry in the dry spell, I guess?

Mark Lyons {BIO 6494178 <GO>}

Great question. I'd say the industry -- that comes down somewhat to mix. But if you have an average cat mix, it's probably 10 at best. My guess would be. So in terms of out-selecting or your approach to it, some companies try to deal with the cycle and the bad pockets by having massive diversification around the world. (Asa) I think is a great example. Others, you might try to do some out-selection. I think you got to be careful to not fool yourself to the degree by which you can out-select. But from the beginning we always said we wanted to be the best, not the biggest. The bigger you are the more you converge to any index or any industry average. So we kind of like continue to be nimble. So we think between our pockets, with growing mortgage insurance as a greater percentage of total. With I'll call it the even keel on insurance and more difficult views of reinsurance. That's what we do. We manage mix. So we manage the cycles pretty effectively.

Josh Shanker {BIO 5292022 <GO>}

So I think part of the secret sauce. And you can push back if you want, is incentives. And people at Arch from the beginning, you designed an incentive model early on that for the (casual) res there was really a 10-year payout if they do a good job and whatnot. Obviously the 2003 to 2007 vintages in the past for those years were wonderful for Arch underwriters. Can you retain the talent in the dry spell to the same extent that you can the good times? How does an incentive system maintain a core cadre of underwriters as things are less opportunistic?

Mark Lyons {BIO 6494178 <GO>}

Well one thing is the messaging internally is very, very consistent. You cut through all the mechanics of it, it's effectively a quota share of -- between the Company and the eligible employees on the after-tax profits that emerge, firstly. Secondly, since it's in underwriting year basis, which you kind of alluded to, there is an initial payout, then you have to earn the rest. It gets rid of all the arguments of IBNR, the actuaries overdoing or underdoing it. Eventually over 10 years you're totally or predominantly paid. And everything is self-evident. So you get incremental payments over the period of time, as justified. It always balances into the balance sheet reserve. So we are not construction guys; we don't have three sets of books. There's one set of books. But the core of your question is, in this difficult market place. And it is, you can still make that all work. Because for the 2016 year you are still getting payouts back from 2006. In some cases, we kept the years open. So it might be 2005, 2004. Still producing payouts in calendar 2016.

Josh Shanker {BIO 5292022 <GO>}

So the employees who wrote that business favorably are quote-unquote locked in to get their maximum payout? They're still getting paid for the old business?

Mark Lyons {BIO 6494178 <GO>}

If they are thinking rationally, yes.

Josh Shanker {BIO 5292022 <GO>}

Makes sense. I think I'm always sort of nickel and diming you a little bit on share repurchases, trying to figure out how much you paid. Generally the firm said can we get paid, are we buying back our stock at a discount to book value three years compounded out.

Mark Lyons {BIO 6494178 <GO>}

Rule of thumb.

Josh Shanker {BIO 5292022 <GO>}

Rule of thumb. I think I would argue you might've gone over that in the most recent publicly disclosed basis share repurchase. Maybe it's a rounding error you've decided that you went for it. First of all, to what extent are you confined by that system? But two, if you are pushing the limits on what is an acceptable share repurchase, what does it say about (inaudible)? Are you confident the single best thing you can do with capital right now, versus growing mortgage insurance, making an acquisition -- I know you don't love dividends. How confident are we that a share repurchase maybe 3 1/2 years of compounded book out might be a better use of capital than something else?

Mark Lyons {BIO 6494178 <GO>}

A lot of questions here, Josh.

Josh Shanker {BIO 5292022 <GO>}

I'm making it tough. You earn it.

Mark Lyons {BIO 6494178 <GO>}

So your first point I disagree with. We bought back at about 135% of average book value for the quarter. We've been talking about 10% to 12% depending upon our mix on a forward look. And that would be 10.5%. So it's sneaked over in there, into that territory. Doesn't mean it can't be increasingly tough. But it does mean we have a rich man's problem. But what we view, because we are in the mortgage space in a lot of different ways -- we are in the US primary MI, as you know; we are in it on a reinsurance context. We are not just in US, we are international. And we are innovators and highly participative in the GSE structured credit transactions that are dominated. But not exclusively, 60 to 80 LTV.

So it's increasingly capital consumptive. And some of the capital associated with those are still partially unknown from some of the rating agencies, especially on the GSE transaction side. We keep some of that in abeyance. So our major ROE growth engine is consumptive. And to some extent there's volatility around how much that needs. So we are maintaining that. And now on the second part of capital management, would be a dividend or a special dividend. We've never had a dividend on the stock.

Josh Shanker {BIO 5292022 <GO>}

Or M&A, or redeployment I guess. There's a lot of other --.

Mark Lyons {BIO 6494178 <GO>}

Well as you know, the second there's going to be signals of a PC hardening, we press our foot on the accelerator probably harder and faster than most. And we also back off, coast. And apply brakes differently. Part of being successful isn't just maximizing good times, it's minimizing bad times and playing defense and giving cultural awards inside for Golden Glove awards, not just high batting averages, which is what we do. But on the special dividend side, if I could for a minute, the difficulty with that is we have a lot of long-term investors, meaning decade or more, with very low cost basis.

And the last thing a lot of them want is to have a not forecastable taxable event jammed down their throat. When it's share repurchases, they choose when to the extent of participations. Special dividends, a little different story. That doesn't drive our decisions. But it's a component.

Josh Shanker {BIO 5292022 <GO>}

Okay. Let's shift to Watford a little bit. As some of you know, Watford is a business that Arch founded in 2012 or 2013?

Mark Lyons {BIO 6494178 <GO>}

It was really 2014 that it really started to (multiple speakers).

Josh Shanker {BIO 5292022 <GO>}

2014. And the assets are alternative assets that allow the Company a little more leeway in terms of the underwriting margin. Has Watford performed in line, outperformed, underperformed expectations? And obviously I don't think you knew what the 2016 market would look like. That might be market-driven to some extent, or is this a great business given the climate today?

Mark Lyons {BIO 6494178 <GO>}

Let me give you a couple views on that. And there will be a definitive answer.

Josh Shanker {BIO 5292022 <GO>}

Okay, I'll take it.

It's not just obfuscation. I'm not running for office. So we invest $100 million into the common. So there's an investor perspective. But we are also a service provider by providing the underwriting and sourcing services. There's a little different views. On the service provider side, I think it's done exceedingly well. It's basically a run rate of $0.5 billion of premium. And the sourcing has gotten broader and the market acceptance has gotten deeper. So compared to 1 1/2 to two years ago, there's more sources and different types of business coming in. It's a softening market. So it's tougher. But you're getting a broader net. But there are more submissions to come in that Watford will want to write. So it's increasingly difficult for them as it would be on a normal PC insurer or reinsurer.

From an investor point of view, I would say the jury is still out. Not I'd say on Watford. But on the models, the aggregate model. Because of when -- I'll call it reinsurer, too, or hedge reinsurers, too -- started to come out is when the market started to really go South. So it was kind of timing. From every index I have seen of the performance of the sectors on the asset side that Highbridge is doing, they've outperformed the indexes. That's a relative comment. That's like saying you lost money at a slower rate than others on the investment side. But overall, I think we are satisfied. We are happy with the underwriting side of it and the investment side has yet to be proven.

So I was talking to some of you and I both know who is a (inaudible) some might call a competitor of Watford. And he said look, we were talking a recent deal that was done by two very large -- a primary and a reinsurer. Said look, I don't really care, he said, what they say. The going rate for a lot of reinsurance right now all-in is about 105% combined ratio, excluding catastrophes. And one of the problems as we have an alternative strategy; we were willing to write at 105% before. But now we are finding at this point in time there are a lot of traditional reinsurance models that are also willing to write at 105%.

And we are finding it harder and harder to find good business because we were finding more competition from people in the past who weren't competing with us for that same level of margin. So you've broadened out the Watford distribution; is it harder or easier for Watford to find that sweet spot margin to date than it was a couple of years ago?

Mark Lyons {BIO 6494178 <GO>}

Well I would say it's not easier. I think people are earning their salary a lot more. But there's more choice now, just because of broadening of -- because the way we started, being so recent. The jumpstart, though, compared to some of the other analogous firms like you talked about is they had to hire people and reestablish distribution from scratch, whereas with us they piggybacked on 14 years of relationships and risk appetites and things like that and they could hit the ground running. That's one of the reasons they got to $500 million so quickly. But let's be serious. In this environment, if you're targeting 105% it will be 108%, to begin with. And the returns will not satisfy you. Any company who is thinking as their business model that they're going to write 105% is not going to have a good result.

Josh Shanker {BIO 5292022 <GO>}

I have more questions about the mortgage insurance business, about investments. But I want to make sure that people have a chance to ask questions. So can I -- in the back.

Questions And Answers

Q - Unidentified Participant

Just a quick one in terms of June 1 renewals, which I assume closed today. But just if you could give us a quick update in terms of what you saw for pricing and just terms and conditions.

A - Mark Lyons {BIO 6494178 <GO>}

In general or are you talking cat in particular?

Q - Unidentified Participant

For property cat.

A - Mark Lyons {BIO 6494178 <GO>}

Property cat averaged about, I think -- or averaging, it's still in process -- about 5 down I believe. So a softer landing than it's been on some of the prior. I think we have to be close to hitting bottom. I don't think we are going to have a negative return interest rate environment for us. So I was a little bit pleased by that, actually, that it was only to that extent of a drop. More challenging elsewhere. But it is -- for example, the property business -- here's one thing to differentiate, if we take a minute. Everybody talks about property cat. Property cat, I'm going to use the word loosely, is a derivative product on the insurance companies that they are reinsuring. Early on, when property cat rates were plummeting, there was strength still, or least stability, in the underlying business.

Now the property cat seems to stabilizing more but there is deterioration in the underlying business. So whether you're sitting on top as a pro risk or a cat XOL or you a quota share participant taking severity in traditional losses, your economics are changing even if you're flat on renewal on reinsurance terms. So both things have to be taken into account. The underlying primary and how you're risk managing it. And then secondly reinsurance on top of it. On other lines of business it's tougher. Shorter tail businesses are under I think more competition. You still are seeing minor fall off in some of the third-party lines. I think D&O is an exception. I think D&O continues to fall off a little faster than it should, especially in the high-capacity lines.

Virtually any high-capacity line is under pressure. By that I mean you're putting up $25 million in limits, gross limits, something like that. The capacity has to be built through reinsurance purchases. So it's becoming overly commoditized. That high-capacity business is tougher risks, on average. It's extremely well broked and they generally have risk managers. So it's very hard to make money in a difficult market like that in those lines, which is why we have cut it back dramatically. And to the level that we still retain it, we have reinsured it more. I got a little off track there.

Q - Unidentified Participant

The way you account for your mortgage insurance business, there's been a lot of upfront costs. Then the business earns out over five or six or seven or eight years. Just wondering what the pattern looks like in terms of -- is it going to be -- is it going to take a while for the earnings to start kicking in? And when they're going to start kicking in sooner than later. And how is the slope going to be?

A - Mark Lyons {BIO 6494178 <GO>}

Good question. It's a -- earning, certainly. But I would even say it's steeper on writing recognition, on written premium, not just -- when you're writing a bunch of singles, you get writing recognition. And then you get earnings over time. When you're on the monthly business, which dominates the industry, written and earned come in simultaneously. So you don't front end load it and have massive persistency assumptions and front-end load it. It's as it comes in. So where we are, at least in the US MI piece of the overall mortgage business, that's still in incline mode. That's still growing I think fairly steeply. I wouldn't expect steady-state for a few years, if that's the kind of question you're asking.

Q - Unidentified Participant

(inaudible; microphone inaccessible)

A - Mark Lyons {BIO 6494178 <GO>}

Earnings recognition, first, you got to recognize that, again, the US MI model, accounting model, which I view as broken. It overestimates profits early and underestimates them later. You're only allowed to put reserves up on loans that actually have a notice of default. You cannot project an IBNR, if you will, for PC parlance, for currently performing loans that will become unperforming loans, which is insane from a property casualty perspective. So we are cognizant of that. Now, on our reinsurance business there is not -- that restriction is a little more lax in that regard.

So to make a long story short, keeping combined ratios, I got to be careful what I say, because every time we talk combined I always talk duration at the same time, or combined ratios mean nothing. But assuming the combined ratios don't change too materially, you're going to see a pretty big increase in the dollar underwriting profits, because it's just proportional to the recognition of the earning curve as it comes in.

Q - Unidentified Participant

Just following on on the mortgage business, with a soft rate environment here in the US, what's the appetite to keep building that offshore mortgage business?

A - Mark Lyons {BIO 6494178 <GO>}

We still believe its returns are north of our PC operations at this point. There's different cycles. Mortgage business is cat business at the end of the day. The (inverting) years are auto-correlated. You go through a bunch of attritionals and then you get an explosion. So your market cycle management is key on that. And your risk management and your acception of tolerance is measured it and managing it is pretty critical. We still like the returns. The returns differ on primary versus international versus reinsurance deals. People set the terms differently. And there are still fewer participants in the reinsurance market. So you can -- your terms are a little bit and the GSE transactions, we still feel, although thinning, are still profitable. So we still have appetite. But our appetite is likely to be -- our marketplace approach is likely to be driven by our internal risk tolerance more than it is market forces.

Q - Josh Shanker {BIO 5292022 <GO>}

That's interesting describing MI as a cat business. Given underwriting standards at the mortgage origination level today, is it possible that you could have a huge spike in losses suddenly? Right now it's just -- I don't want to be too -- say something and spoil it for everyone. It seems like you're printing money a little bit at this point in time given how strong and hard it is to get a mortgage right now.

A - Mark Lyons {BIO 6494178 <GO>}

Well here's how you have to look at it. It's a good analogy would be workers comp. Workers comp has -- there's lot of medical components, like 60% medical now. But when they make big indemnity changes, whether there's a big law amendment change, it cuts across all underwriting years. It's imposed on a calendar year basis and prior and current underwriting years are affected -- varying degrees, depending upon the age. The older it is, the less impacted it is and so forth. So now obviously in mortgage, it is, we believe, highly profitable now. But I think the risks of a meltdown in the foreseeable future are very, very low.

But if it's, let's say six or seven years from today, that's going to cut across the board. Just like in surety business, let's put it that way too. In surety business, when a contractor goes down it affects the entire credit exposure you have with that contractor. So it's not just bonds that you recently wrote; its bonds that are still outstanding and written over many, many, many years and therefore it cuts across the underwriting years. So you're exposed -- that's what I really mean by a cat business, because it's not isolated to an underwriting year. It cuts across underwriting years.

Q - Josh Shanker {BIO 5292022 <GO>}

So when we talk about -- and maybe it would be worthwhile -- and I feel like early on this is 15% to 20% ROE business, was sort of how I think it was described to me. Does that include the meltdown year or is that a modal type return?

A - Mark Lyons {BIO 6494178 <GO>}

That was more of a return that we felt was for business being put on the books then, which was probably our 2015.

Q - Josh Shanker {BIO 5292022 <GO>}

And given one of your competitors allegedly has put pricing pressure on that business over the past year, what is new business today? If there's sort of a loose range at what you think the level ROE is for new business to be put on today?

A - Mark Lyons {BIO 6494178 <GO>}

Well given the increasing capital commitment, I think it's south of that. I think it also depends on what your mix of monthlies and singles are. And whether it's borrower or lender paid. And how it's done in bulk versus not. So I think it's more challenging. I believe. And I hope not incorrectly, that the introduction of our risk-based pricing -- I mean, UGC has it and we have it, where -- think of it as a big -- for any stat guys out there, a big discriminant function that takes many, many variables into account to isolate characteristics unique to identifying risk and matching risk with price.

Or the marketing side having it exceed price and possibly pricing yourself out of certain areas because you have a much better zeroed in view of relative risk versus market price and what you can achieve. So we really think that, for those companies -- so it's more of a first mover advantage. I think others will catch up to it ultimately. But in the short term it allows you to isolate the better risk/reward trade-offs. So I think that what could help in the out-selection point of view. But I think it's transitory.

Q - Josh Shanker {BIO 5292022 <GO>}

So I think the rates are -- I think it was about five quarters ago I think that it sort of became the topic du jour that everyone was really wondering. And your competitors, if they so chose, I assume could've caught up or could've started. And most of them haven't. Most of them are still saying the customer doesn't want this product. To what extent do you find that that objection is true? The receptivity? Or here one year later are people saying okay, we'll do this?

A - Mark Lyons {BIO 6494178 <GO>}

It's really not the year. We've been talking about it for a year. But the traction is probably closer to half a year of real introduction. I think it was December that we really got some introduction. We've been very happy with the receptivity. And I think even Dinos mentioned in the last call that it was roughly 50%, 55% of new -- I'll call it submission flow or applicant flow, coming through RateStar. But in the last month of the quarter was closer to two-thirds. That trend has continued. So we don't see -- now, I don't see broad disapproval of that. There are pockets of a bank here or there that might get -- not complete acceptance yet. But I think eventually that will fall, too.

Q - Josh Shanker {BIO 5292022 <GO>}

I'll just give a chance for there being questions. I think we are good. Okay, can we talk a little about a 0% interest rate environment? And interest-bearing investments versus non-interest-bearing investments? And what three-year plan how the investment portfolio might need to change or if it changes at all?

A - Mark Lyons {BIO 6494178 <GO>}

Well If I'm like you, I don't even open my retail bank statements at home anymore. Because the CA pays more than the interest I've gained. As you know, we're a total return shop. And the -- it's not just because of the lower interest rate environment. We've been talking about that for quite a while. But it's increasingly hard to know where to place your money. We have allotments, equities and alternatives, as you know. And we are kind of adhering to that. We have about $1 billion in the ground of investments on the alternative side. And we have roughly, I think, $1 billion of committed but not yet funded.

Now, I don't think we will ever really have $2 billion at the same time, because you get return on capital that floats through. But -- so there's some. And some of those are unique investment opportunities. And some of those are just a combination of mixtures of other more standard assets, perhaps done in a different way. So the one thing we will not do, back to your interest-bearing and so forth, we will not have our fixed income go further out on the curve and exceed what we think the duration of the liabilities are. That's first and foremost.

So it's really the assets supporting shareholders' equity, where we take the more risky investments, alternatives and so forth. We are not going to have a four-year duration of outflow and do six years on our investments. And have that open risk in cases of spike. And it's just right. So you can get hit proportionately more than the average of our peer set. I don't know if I've addressed all of your questions.

Q - Josh Shanker {BIO 5292022 <GO>}

There's a lot in there. I think one thing -- I guess I start doing this in 2002 and over the course of various times in the last 14 years, there's been duration shortening exercises as people were anticipating interest rates going up.

A - Mark Lyons {BIO 6494178 <GO>}

We've been consistently wrong.

Q - Josh Shanker {BIO 5292022 <GO>}

This is par for the course, whatever. But to the extent to which the idea of being obviously there's a liquidity -- there's no liquidity risk of being shorter than liability duration, whereas one might present itself as being a little longer. But I guess there are some commits where you're willing to go a little bit longer on the asset duration and liability (inaudible); you got a little bit more yield. In terms of past cycles, is there evidence that that is a very real risk that somebody could have a liquidity moment by doing so?

A - Mark Lyons {BIO 6494178 <GO>}

Based on past cycles, probably not. There's been different reasons, underlying cycles. You go back to the 1980s with that idiotic cash flow underwriting, when everybody thought 14% interest rates were going to continue forever. And hence matching zeros they go forever out there, get it to match their investments. So I don't think there's been a lot of empirical evidence on it. I think there's common sense that that happens. But back to your point, we've had an opportunity loss effectively by purposely having a lot of the assets associated with shareholders' equity being under a year. I remember a couple points in the last few years, we were at, like, 4/10 of a year as our duration on those assets. In anticipation of being hurt less, that it's not symmetric and that at some point they have to go the other way and we didn't want to get caught if it was violent. So we sacrificed net investment income associated with that. We are still happy with it. We note it, we acknowledge it, we talk about it. But we wouldn't have done it differently.

Q - Josh Shanker {BIO 5292022 <GO>}

And given -- is there a house view right now? Are you particularly short right now? It doesn't feel like you're making one of those (multiple speakers).

A - Mark Lyons {BIO 6494178 <GO>}

No. We are still under a year on that shareholder assets supporting it. But our duration on the outflow, as cat has lightened, we still think that's the right decision. Others can grow and gobble it up and God bless them. And when a couple events occur and we see whether the new capacity has any stomach, then we'll see what happens. But I'm happy to let them gobble that up in the meantime. So even if we were nothing else and didn't increase our claims we made in the current base businesses, our duration would increase as the cat side is falling away.

Q - Josh Shanker {BIO 5292022 <GO>}

You've made a conscious effort to radically shrink your exposure in cat, more so than most anybody in the industry. But you still have finger in the wind. This is going to be a reasonably sized cat quarter, I guess, between Texas, Ecuador, Japan and Canada.

A - Mark Lyons {BIO 6494178 <GO>}

It's a cornucopia.

Q - Josh Shanker {BIO 5292022 <GO>}

All over. But there is still some debate on whether or not these are reinsurance events. Do you have any market intelligence on any of these various events at this point?

A - Mark Lyons {BIO 6494178 <GO>}

Well if you want my guess, we are still going through it ourselves. Although we just -- the quarter is not over. You just had Bonnie, which is on the lower-end scale of things. But others could emerge. It varies by event. I think it's less so an event probably in Canada on -- no, it's all over the map. Some have pretty low attachments in Canada. And some are gobbling a lot of net. So I think it depends on which of the companies we are talking about. See, we selfishly, when these events occur -- I mean, these are -- none of these, other than the Canadian event, are overly large from our perspective. And that's what risk management is about. You understand the trade-off, you take the actions, they're demonstrative actions. And when events like this occur, you should have no worse than an average hit, if you've done it right. And I mean at the upper end. We view that as just that active part of cycle management.

Q - Josh Shanker {BIO 5292022 <GO>}

And at this point in time, (inaudible) for Arch. But the Canadian event -- there's a great deal of debate on whether it's going to be a reinsurance event or not still. I guess maybe even today is the first day they allowed --.

A - Mark Lyons {BIO 6494178 <GO>}

I know it's been difficult to get in (multiple speakers).

Q - Josh Shanker {BIO 5292022 <GO>}

Claims management, to take a look. All right. And there's time for one more question.

Q - Unidentified Participant

(inaudible; microphone inaccessible)

A - Mark Lyons {BIO 6494178 <GO>}

I'm not going to have any directed comments. But if we are cutting back dramatically, I think the conclusion of someone towards someone who is growing, well, you probably wouldn't agree with them. But there's a lot of variability and volatility in the business. And it's not always as evident as you think. We can take Reinsurer A, Reinsurer B. Look at the books, assume they are on identical programs. They are on the same cedents. And you can have radically different loss ratio results based on where they play and what they retro out.

So on the surface they may be growing. But you don't know the extent -- there's some complicated retros out there. And it's possible that that growth is ameliorated by the triggers involved in getting retro protection. It would be pretty naive of me to be too generalized. But I'll leave it at that.

Q - Josh Shanker {BIO 5292022 <GO>}

Thank you, everyone, for attending and have a great day the rest of the conference. And thank you to you.

A - Mark Lyons {BIO 6494178 <GO>}

Thank you, Josh, Appreciate it.