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'Hard' market beckons

Evan Lorenz writes:

With today's macro data, you can write your own narrative. Bullish? Invoke the upbeat August reading of the Institute for Supply Management's services purchasing managers' index, or the boom-like third-quarter guesstimate of the Atlanta Fed's GDPNow model. Bearish? Point to the inverted yield curve, softer labor data or the ISM's manufacturing index, which has languished below the 50 point contraction threshold for 10 consecutive months.

Mr. Market, predictably taking the sunny side of the argument, values the S&P 500 at 17.9 times forward earnings, which earnings are projected to climb by 12%. Possibly—sensibly—you may choose not to take macroeconomic sides but rather devote your energy to the search for value-laden, all-cycle securities. In preview, *Grant's* is bullish on Bermuda-based Arch Capital Group Ltd. (ACGL on the Nasdaq), a high-performance dealer in specialty insurance, reinsurance and mortgage insurance.

Granted, the insurance business will never be mistaken for Nvidia Corp. Even so, it's essential, cheap and well-positioned. The insurance component of the S&P trades at 11.8 times next year's earnings, an unusually wide 6.1 point discount from the blue-chip gauge.

"The insurance industry has only traded at a wider discount to the broader market during times of severe economic and financial stress, i.e., the Global Financial Crisis in 2008 and the Covid-19 pandemic in 2020," insurance-focused New Vernon Wealth Management, LLC advises its limited partners. "Both proved to be exceptionally good times to invest in the insurance industry."

While insurance is a cyclical industry, its cycles are not the same as the economy's. Most people will insure their houses and cars whether the GDP expands or contracts. Work-from-home and declining office-occupancy rates notwithstanding, real estate owners still buy coverage for fire, theft, natural disasters and assorted other risks.

Nowadays, the insurance industry is enjoying what is known in the trade as a hard-pricing market. It's the natural, cyclical reaction to the long-preceding, soft-pricing market.

Years of ultralow interest rates hurt insurers in two ways, first by reducing investment returns and second, by expanding insurance-underwriting capacity. The second effect may require a word of explanation. It came about through the aggressive purchase by yield-famished investors of catastrophe bonds and insurance-linked securities. So buying, the investors added to the industry's capital, therefore to its ability to write business and grow.

The rising prevalence of disaster-induced claims provides another source of pricing support. The annual cost of insured global disasters has averaged $86.4 billion since 2000, but above-average claims have been the rule since 2017. Thus, worldwide losses summed to $120 billion in 2020, $146 billion in 2021 and $132 billion in 2022. Governments keep inflating prices, and juries keep awarding damages.

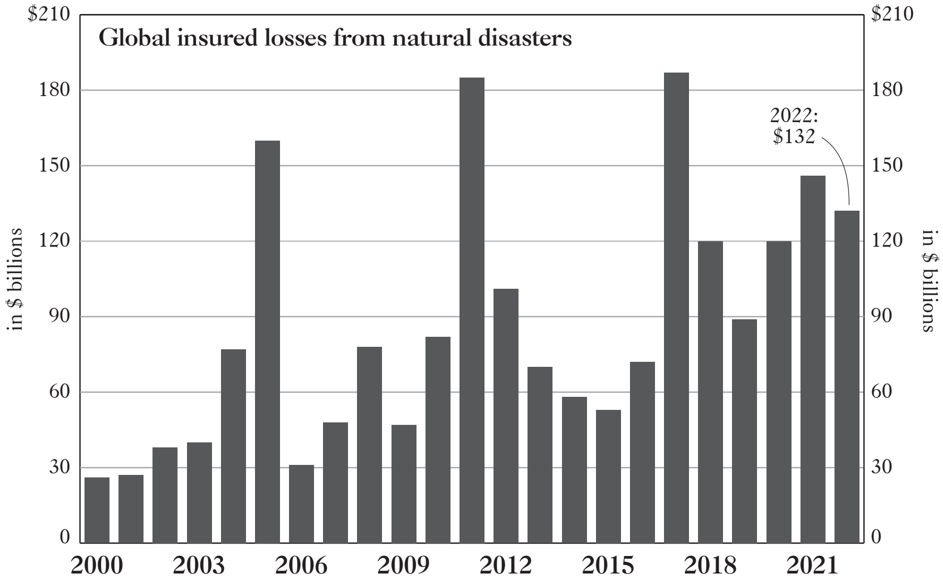
Such trends did not go unnoticed, and the insurance industry began raising prices in advance of claims costs; in 2020, it lifted them by as much as 22%, according to Marsh & McLennan Cos. While the surges have subsided and, in the case of directors and officers (D&O) coverage in the United States, actually reversed, overall pricing remains firm.

Supply and demand go far to explain the strength in reinsurance. According to broker Aon plc, global reinsurance capital totaled $605 billion as of March 31, flat with the level in 2017, while, over the five years through 2022, nominal world GDP in dollar terms vaulted by 23.6%, according to the International Monetary Fund. On the July 27 earnings call, Arch CEO Marc Grandisson estimated that, in relation to demand, the shortfall in reinsurance-underwriting capacity is on the order of $50 billion to $70 billion.

Thus, reinsurance rates are rising—indeed, leaping. They jumped by 30.1% for January renewals and by 35% in July, according to Guy Carpenter & Co., LLC. They're the fastest rate increases since 2005, a year of four category-five hurricanes (Emily, Katrina, Rita and Wilma).

"The dearth of capital injections into the reinsurance market and the resulting supply shortfall has meant that many insurers were unable to fill their request covers from reinsurers except at exorbitant prices during the year," Wai Tang, senior director of insurance-linked securities at rating agency A.M. Best, said last week. In consequence, primary insurers are retaining more risk than they would like or are buying reinsurance that engages at higher levels of loss, e.g., coverage after, say, the first $500 million of claims costs rather than the first $250 million.

Bull market in disaster



source: Aon plc

"That's been a very real challenge here, because weather has been very difficult," Meyer Shields, who rates Arch a buy for Keefe, Bruyette & Woods, Inc., tells me. "By weather, I'm also including things like the Maui fires. The threat of perennial losses is still out there, and I think that precludes any significant loss of discipline. I think the best way to respond to that if you're an insurance company, as opposed to a reinsurance company, is to keep raising prices on property risks. I think that is what we're likely to see."

For heavily regulated lines of business such as standard homeowners' insurance, it takes time to reprice risk—time and a lot of postage, as a rate-seeking management will need approval from regulators in each of the 50 states. Prices on non-standard lines are already bounding higher. Coverage for a mega-mansion on Star Island, a wealthy enclave in Miami, Fla., for instance, jumped to $622,000 from $200,000 in 2022, Bloomberg reported last week.

. . .

Arch was founded in 1995 as Risk Capital Holdings, Inc., a company that set out to invest in insurance companies while simultaneously reinsuring them—bearing risk, so to speak, on both sides of the ball.

It was too much risk, many thought—in 2000, *National Underwriter* magazine shone a light on the oddity of the business model—and Risk Capital rebooted. Under new leadership, it stopped writing new insurance. It sold its legacy book of business and changed its name to Arch Capital. A shell company at the time of 9/11, it raised $763 million from Warburg Pincus and Hellman & Friedman, LLC in the wake of the terrorist attacks and put those funds to work at the higher reinsurance rates that were suddenly in force.

Today, Arch is a large, diversified multiline insurer that, in the 12 months ended June 30, wrote $12.6 billion in net premiums. The corporate M.O. is to diversify risk by business and policy line so that no one disaster can sink a year's results or put the balance sheet in jeopardy.

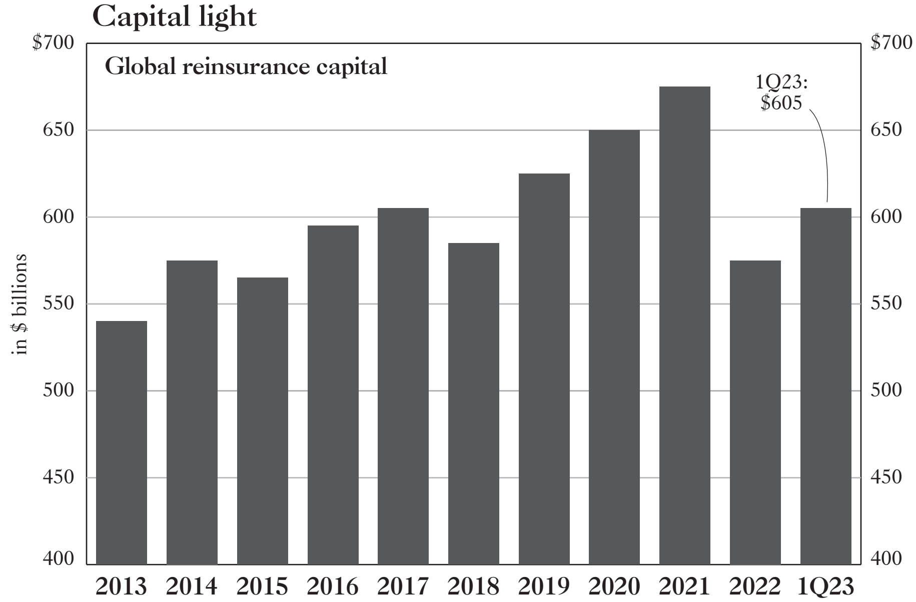
By operating unit, reinsurance accounted for 48% of trailing net premiums, primary insurance 43% and mortgage insurance 9%. The reinsurance division is organized by specialty lines (38%), property (26%), casualty (17%) and property catastrophe (14%).

The insurance division is spread among professional lines (27% of trailing net premiums), property, energy, marine and aviation (19%), program, or niche, lines (12%), construction and national accounts (10%) and travel, accidents and health (9%).

"We like writing small limits, $5 million, sometimes more and sometimes less," Donald Watson, executive vice president of financial services, tells me. "Even in our reinsurance group, where we write larger limits, like $15 million to $25 million, you have to look at how those limits stack up in a catastrophe. We paid almost $600 million in cap losses last year, but we still produced a 12% return on equity. We can do that because we're diversified across a lot of different lines of business."

While Arch is in the business of insuring risk, it specializes in capital allocation. It puts money to work where it earns the highest return, whether reinvesting in its own business, making acquisitions or buying back stock. During

Capital light



source: Aon plc

the fallow underwriting years of 2007 through 2011, it repurchased 39.5% of shares outstanding while allowing net revenues to decline by a cumulative 11.3%.

As returns on equity dipped into the single digits in the soft market of the 2010s, Arch pivoted to mortgage insurance, an industry that still bore the reputational scars of the subprime debacle. However, in the remorseful, post-crisis phase of the cycle, insuring mortgages has reverted to the relatively safe and boring business of enhancing mortgages insured by Fannie Mae and Freddie Mac.

Arch gained market share through a pair of acquisitions, CMG Mortgage Insurance Co., for $300 million in 2014, and United Guaranty Corp. (UCG), for $3.3 billion in 2016. Activists had agitated for American International Group, Inc. (AIG) to sell UCG, though the unit was one of the beleaguered parent's better performers. "Within five years, we made more than $5 billion in earnings on UCG," Watson tells me. "An absolutely stupid thing," he said, referring to the purchase price, "but people don't like mortgage insurance."

From around 2019, when the soft market began to harden, Arch leaned in. From 2018 through the 12 months ended June 30, the company expanded net insurance premiums written to $5.4 billion from $2.2 billion and net reinsurance premiums written to $6.1 billion from $1.3 billion.

Not everyone has navigated the cycles as adroitly as Arch. In the middle of last year, AXIS Capital Holdings Ltd. shuttered its property-reinsurance group. "The decision to close our Property Reinsurance business was not taken lightly and was driven by the significant and increasing effects of climate change and the challenges faced by the catastrophe reinsurance market," AXIS CEO Albert Benchimol explained in a June 7, 2022 press release. Not long after, reinsurance prices exploded to the upside.

But higher rates aren't saving all reinsurers. In May, AIG sold its reinsurance unit, Validus Re, to focus on its insurance operations. According to a July 12 Reuters exclusive, multiline insurer Axa S.A. is mulling a sale of its property-reinsurance business to limit its exposure to natural disasters.

The CEO since 2018, Marc Grandisson, has been with Arch since its 2001 recapitalization, initially as chief actuary of the reinsurance division. Before coming to Arch, Grandisson worked as a vice president and actuary of the reinsurance division of Berkshire Hathaway, Inc. and as a vice president at F&G Re, Inc.

"He's the DNA of that company," Steve Virgili, a portfolio manager at New Vernon, tells me about Grandisson. "He's been there and has been integral to all of these decisions. A lot of the top guys have been there for a long time. Winners tend to attract winners. Arch has been winning, and they have their pick of smart, good people. Their bench is pretty deep and strong."

Arch has crafted incentives to keep its front line and C-suite focused on long-term profitability. "Our underwriters' compensation is aligned with the performance of the underwriting year and the business that they produce," says Watson. "And we pay them out over a 10-year period. So each year, we compensate the underwriters for a portion of what they wrote in previous years. If they've produced returns above our cost of capital, then they have the potential to earn significant bonuses."

Incentive pay for the C-suite is tied to returns on equity and the growth in book value per share. From year-end 2001 through June 30, 2023, the company expanded book value per share to $37.04 from $2.03, or at a 14.5% compound annual rate. This growth in net assets catalyzed a 16.5% annualized return in Arch's stock price over the same span, compared with an 8.5% return for the S&P 500 and a 4.8% return for the insurance component of the S&P (all figures include reinvested dividends).

Arch holds a 29.5% stake in *Grant's* pick-to-click Coface S.A., the French commercial credit insurer (see the issue dated July 14). There would be benefits to folding Coface into Arch. "As part of a larger insurance enterprise, Coface will require less capital because of the bigger base of business and the fact that it's non-correlated with a lot of what we do," Watson tells me.

However, Arch is unlikely to buy the rest of the specialty insurer until the returns on Coface surpass what Arch can earn by reinvesting in its existing book of business. "As rich as the dividend yield from Coface is today," says Watson, referring to the 11.9% payout, "we can generate an even better return by deploying capital into our P&C business." In the second quarter, Arch generated a 19.6% return on equity.

Lightly leveraged Arch is rated Baa1/single-A-minus at the holding-company level and single-A-plus (by A.M. Best) at the insurance-subsidiary level. Outstanding, as of June 30, was $830 million of Arch preferred stock and $2.7 billion of debt against $13.8 billion of common equity, for a ratio of debt (including the preferred) to total capital of 20%.

Another way of looking at leverage in insurers is to compare net premiums to surplus or tangible equity. "Arch's net premium earned to tangible shareholders' equity is 0.98," Virgili tells me. "Axis is 1.3, and Everest is 1.2." In other words, Arch, despite vastly expanding its insurance and reinsurance operations since the start of the 2019 hard market, still has room to grow.

Arch Capital Group Ltd. at a glance
all figures in $ mns except per share data

	TTM*	2022	2021	2020	2019
revenue	$11,788.8	$9,614.8	$9,250.0	$8,508.5	$6,928.2
pretax income	2,338.5	1,488.50	2,103.4	1,560.8	1,849.1
net income	2,222.2	1,436.2	2,093.4	1,363.9	1,594.7
earnings per share	5.90	3.80	5.23	3.32	3.87
shares outstanding	378.4	377.6	400.3	410.3	411.6
debt	2,726.0	2,725.4	2,724.4	3,016.8	2,355.9
equity	14,641.0	12,910.1	13,545.9	13,928.9	12,260.1
total assets	53,856.0	47,990.5	45,100.9	43,282.3	37,885.4

* Twelve months ended June 30, 2023.

source: company reports

The insurer's $30.4 billion investment portfolio is committed 18.8% to equities and equity-method investments (including Coface) with the remainder in bonds. The salient features of the $22.1 billion fixed-income portfolio are short-duration (3.03 years) and investment-grade quality; only 7.1% is allocated to sub-investment-grade claims, while the average security is rated double-A-minus/Aa3. In the second quarter, the portfolio earned an average 3.5%, up from 3% in the prior period and 1.76% in the second quarter of 2022. For each 100 basis-point increase in yield, pretax income stands to increase by $221 million, or $0.59 per share.

The favorable earnings outlook notwithstanding, Arch changes hands at 12.2 times trailing earnings and 10.9 times the 2024 estimate, a discount to the S&P 500 insurance cohort, which trades at an average 12.1 times next year's estimate.

An even dozen of 15 assigned analysts rate Arch a buy, and exactly none says sell. Bears give the shares wide berth, to judge by short interest of 1.4% of the equity float.

Insiders, who presumably know a lot about personal capital allocation as well as the corporate kind, sold 809,617 shares over the past 12 months for proceeds of $53.9 million; there was not a single offsetting purchase. It is not the most heartening set of facts for a public investor to encounter, though, in mitigation, the insiders continue to own 15.1 million shares, or 4.1% of the company, worth $1.17 billion (after giving effect for recent sales to the holdings listed in the latest proxy).

Watson, asked for comment about what just might look like a heavy vote of no confidence, said it is nothing of the kind. He emailed, to start with, that "most" of the senior managers have been with Arch for more than 10 years. "Option grants typically expire in 10 years," he went on, "and many executives wait until maturity, and it isn't surprising that some would choose to exercise those options when the stock has appreciated significantly." In any case, it would stretch credulity to believe that a management group with a continuing $1.17 billion investment has collectively lost interest in its investee.

"They can easily get to $10 per share in earnings by 2025," says Virgili. "Obviously, that depends on a whole lot of things, but they can earn $10 and this can be a $100 stock easily in a year-and-a-half," versus the current share price of $78.80.

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