GRANT'S
INTEREST RATE OBSERVER®
Vol. 36, No.19c Two Wall Street, New York, New York 10005 • www.grantspub.com OCTOBER 5, 2018

Insurance runs

Hear the words "property and casualty insurance" and you don't think first of Silicon Valley. Still, what the P&C business lacks in glitter, it sometimes compensates for in opportunity. Now in progress is a look back at *Grant's* pick-to-click W.R. Berkley Corp. (WRB on the New York Stock Exchange), a look ahead at CNA Financial Corp. (CNA, also on the Big Board) and a short overview of the world in which the two companies operate. In preview, we're trying to be bullish.

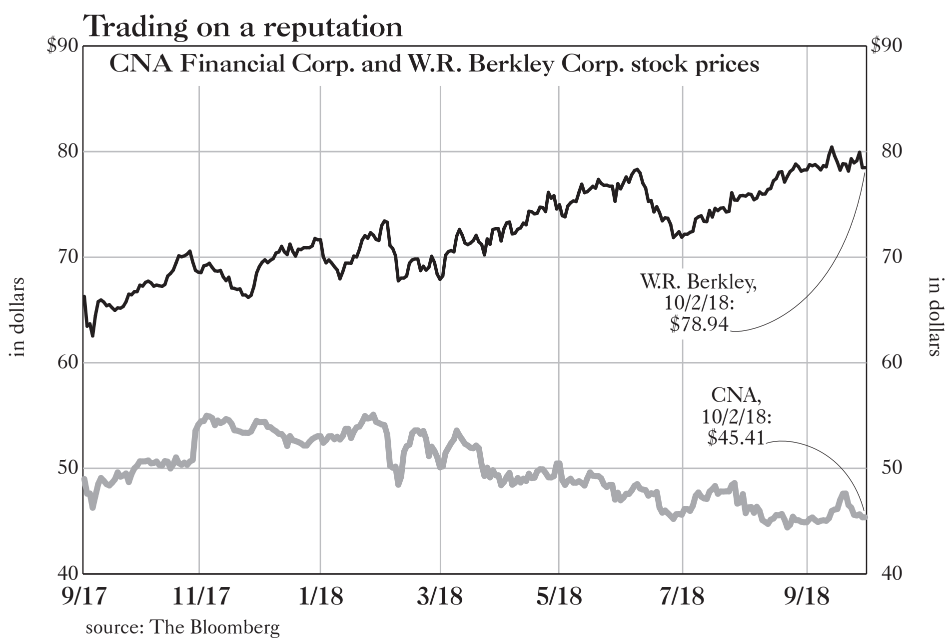
Actuarial science is daunting. So, too, is the specialized vocabulary of even the non-actuarial branches of the insurance trade. So it's nice to know that the forces of supply and demand, and the movement of interest rates, exert their (almost) intuitive effects on insurance just as they do in ordinary fields.

For instance, weak returns in catastrophe insurance have driven some undernourished carriers to branch out, others to consolidate. You've seen it in the headlines, e.g., Hartford Financial Services Group, Inc.'s acquisition of marine-focused insurer Navigators Group, Inc. for $2.1 billion, or 1.8 times book value; American International Group, Inc.'s purchase of Validus Holdings, Ltd. for $5.6 billion (1.5 times book); Kemper Corp.'s acquisition of Infinity Property and Casualty Corp. for $1.4 billion (2 times book); and Axa Group's scooping up of XL Group Ltd. for $15.3 billion (1.5 times book).

When interest rates stood tall, underwriting losses were the norm. Indeed, according to the Insurance Information Institute, industry-wide underwriting profit was literally nil for a quarter-century. From 1979 to 2003, the carriers made money by clipping the coupons in their high-grade bond portfolios, not by performing their supposed day job of insuring against fire, storm and slipping-and-falling. Insurance adepts measure underwriting profitability by the "combined ratio," dividing underwriting costs (net claims, commissions, expenses) by net earned premium. A combined ratio of less than 100% is good, one above 100% is not good. In those dry 25 years, the industry's combined ratio was unfailingly not good.

But tiny interest rates have changed things. Actuaries, lacking the interest income with which to absorb underwriting losses, have sharpened their pencils. Steven Shapiro, chief investment officer at Chicago-based New Vernon Wealth Management, goes so far as to assert that "low interest rates have been good for the insurance industry." They've certainly been good for underwriting discipline. In 2003, two years after the Fed slashed the federal-funds rate to less than 2%, the industry was again making money before investment income. Six years of underwriting profits duly followed, with the three-year period ended Dec. 31, 2015 proving the most profitable since 1979–1981.

Interlopers have noticed. Pension and sovereign funds entered the market, not themselves writing insurance but rather buying insurance-linked securities, better known as cat bonds (as in "catastrophe"). Seeking returns uncorrelated to stocks and conven-



Grant's authorizes use by CLAYTON ISOM only. © 2025 Grant's Financial Publishing, Inc. Reproduction or distribution without written permission is prohibited.

Grant's authorizes use by CLAYTON ISOM only. © 2025 Grant's Financial Publishing, Inc. Reproduction or distribution without written permission is prohibited.

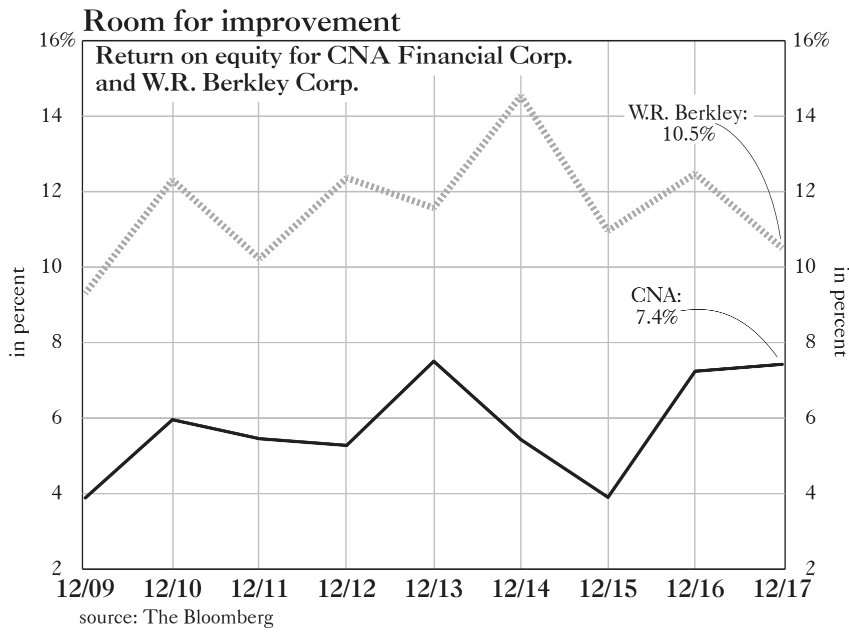
tional bonds, they have bet on a certain incidence of property-related disasters (*Grant's*, May 5, 2017). Losses above that threshold could spell catastrophe—for their investments.

This year's $9.7 billion in cat-bond issuance trails only last year's record $11.5 billion, bringing the amount outstanding to $30 billion, another record, according to Dowling & Partners Securities, LLC. On Aug. 31, insurer Markel Corp. said it was acquiring Nephila Holdings Ltd., the most prominent manager of ILS in the market, for an undisclosed sum rumored to be near $1 billion. "It remains to be seen," observes colleague Fabiano Santin, "whether this type of volatility-selling will prove to be a winning bet."

Anyway, the proliferation of such securities has pushed catastrophe premiums lower and legacy carriers and reinsurers into alternative fields, e.g., medical malpractice, workers compensation, commercial auto, general liability insurance.

Not that the new lines guarantee disruption-free prosperity, either. "Social inflation," i.e., rising awards by angry juries, presents one potential risk. Large damages to plaintiffs related to talcum powder (supposedly causing ovarian cancer) against Johnson & Johnson and to glyphosate herbicide (a.k.a. Roundup, supposedly causing non-Hodgkin lymphoma) against Bayer A.G.'s Monsanto division are among the fluttering red flags.

Perhaps consolidation will lead to more rational pricing. Diversificiation across insurance markets may also bolster bottom lines. "There is something to be said for having a portfolio of different lines of insurance because not all lines of insurance are going to be doing well at the same time," Steve Virgili, Shapiro's partner and portfolio manager of the New Vernon Insurance Fund, tells Santin. "Workers' compensation [insurance] is suffering from falling premium rates, although it had done well for a number of years. Insurance is cyclical, and the different lines of insurance have their own idiosyncratic supply- and demand-driven cycles. And so [the lines] are not all experiencing rising prices and profitability at the same time. Hence, why having a portfolio of different lines of insurances is beneficial. Now the management team needs to be good at managing those different cycles and allocating capital to the right lines of business at the right times."



Which brings us to W.R. Berkley. Since their Feb. 23 appearance in these pages, the shares have appreciated by 16.5% vs. 7.7% for the S&P 500 and 5.5% for the FAANGS, reinvested dividends included. Berkley sells specialty insurance lines focused on mid-size businesses, a segment deemed not so commoditized as others. The company generated net income of $346.5 million in the six months ended June 30, 49% higher than the $232.4 million in the first half of 2017. Underwriting improved a bit with the combined ratio dropping to 94.8% vs. 95.4% in the comparable period last year.

The bond portfolio delivered the goods. Investment income came in at $328 million, up from $284 million in the first six months of 2017, with the average yield rising to 3.7%, from 3.3% in 2017. On the second-quarter earnings call, founder and chairman William Berkley credited a decision to bump up the allocation to floating-rate securities as the chief source of improvement. As of June 30, 71% of the $18.5 billion investment portfolio was apportioned to debt securities with an average rating of double-A-minus and an average duration of 2.9 years.

Following this pleasant run-up, Berkley trades at 21 times the $3.83 share that the Street expects the company to earn in 2019, i.e., nearly flat with 2018. Perhaps the Street is overly conservative.

"We think," as Santin relates, "that earnings could exceed $5.80 a share, which would reduce the prospective multiple to 13.6 times. Berkley has averaged a pre-tax return on equity of 13% for the past five years. It has an investments-to-equity ratio of 3.4:1. If it could boost its investment yield by an additional percentage point—say, with a little help from rising rates—it would generate 16.4% in pre-tax ROE and 13% after tax. Apply that to the $44.58 in book value to get $5.80 in earnings per share.

"The stock yields 2.6% and commands a price to book value of 1.7 times," Santin goes on. "It deserves to trade at a premium given its historical track record of above-average returns and management's demonstrated ability to allocate capital. Berkley's book value has grown by an average of 17.1% since 1974. Assuming a continued 13% ROE, paying 1.7 times book value is similar to accepting a return on equity of 7.6% (13%/1.7)—before tax, that is. The return is equivalent to a 10.4% yield from junk-rated bonds for a New York City resident who pays tax rates of 36.5% on qualified dividends and long-term capital gains and 53.5% on corporate interest income in the highest brackets; the iShares iBoxx $ High-Yield Corporate Bond ETF (HYG on NYSE Arca) delivers 6.2% and the Bloomberg Barclays triple-C-rated index 9.3%."

Maybe the Berkley executives have their doubts that rates will rise much more, if at all. Or perhaps they suspect now is not the time to build a bullish investment case on even well-founded conjecture. (They don't doubt that a 15% ROE is possible, because W. Rob-

Grant's authorizes use by CLAYTON ISOM only. © 2025 Grant's Financial Publishing, Inc. Reproduction or distribution without written permission is prohibited.

Grant's authorizes use by CLAYTON ISOM only. © 2025 Grant's Financial Publishing, Inc. Reproduction or distribution without written permission is prohibited.

ert Berkley Jr., CEO and president and son of the chairman, told Santin that, in his opinion, it is certainly possible.) In any case, the only two insider transactions of the past 12 months were a pair of sales, each in June, by the executive vice president of investments, James G. Shiel, who unloaded $1.6 million worth of stock while leaving himself with more than $19 million worth.

No insurance aristocrat, now, is CNA, as its lofty dividend yield—7% including specials—and droopy share price attest. Founded in 1897, CNA is the eighth-largest commercial property-and-casualty insurance company in America. Loews Corp. owns 89% of the stock (representing 70% of Loews's $15.8 billion market cap), having brilliantly purchased majority control in 1974, not far from that year's stygian stock-market lows. The public owns a minority interest worth $1.4 billion.

CNA's top divisions are the specialty and commercial units, which, through the first six months, collected 84% of net written premiums and brought in nearly all operating income. Specialty premiums stem from insurance coverage for professional malpractice, directors-and-officers liability, surety bonds for contractors and warranties for vehicles and cellphones. It's a profitable business; over the past three years, the two segments have posted a combined ratio of 87%. Compare and contrast that with the P&C industry's long-term, average combined ratio of plus or minus 100.

The commercial segment sells standard and excess property, marine and boiler and machinery coverage, as well as workers' compensation, general and product liability, commercial auto and umbrella insurance. There's not much to shout about here: The units show a combined ratio of 104% over the past three years. The international and life and health divisions break even.

Berkley trades on a sterling kind of reputation. CNA trades on another, its volatile underwriting results plagued by asbestos claims, medical-malpractice liabilities and immense losses from the World Trade Center's destruction and Hurricane Katrina. Mediocre cost control and the occasional investment slip-up complete the legacy reputational picture. Over the past five years, ROE has averaged 6.3%, less than half WRB's. The shares have long traded at a discount to book value, and not without reason.

It's our conviction that better things lie ahead. Certainly, operations have taken a positive turn. CNA's long-term care business, an incorrigible problem child, is in run-off mode. Dino Robusto, who became CEO in November 2016, is earning high marks in all phases of the business, including cost control. By the first half of 2018, the expense ratio on written premiums had fallen to 33.5% from 35.1% in 2016. As the average ratio for other commercial insurance companies is around 32%, there is evidently room for further improvement; removing an additional percentage point would add about $55 million, or 5%, to the bottom line.

Net earned premiums climbed to $3.6 billion, or 7%, measured year-over-year, in the first six months. Net income rose to $561 million, or 5%, year-over-year. The consolidated combined ratio stood at a more-than-respectable 93.5%, down from 95.3% a year earlier.

"They need to drive their expenses lower, and what that's going to do over time is that they'll be more competitive on pricing and they'll be able to attract more business," Virgili says. "The longer you are writing insurance for particular businesses, the more time you have to gather data and information on how the claims from those businesses perform over time. As you become more comfortable and get a better understanding of the dynamics of a particular insured, you're able to add value by figuring out ways to drive down those claims costs."

Today the stock trades at $45.41, representing 1.1 times book value, or 10.6 times 2019 expected earnings. The $45.2 billion investment portfolio features $39.8 billion of single-A-quality bonds with an average 5.9-year duration; rising interest rates would help the reinvestment rate. Bloomberg analysts forecast 2019 earnings of $4.29 a share, marginally higher than 2018's expected net income.

The aforementioned 7% dividend yield comprises a regular quarterly payout of 30 cents a share (representing a 2.6% yield) plus $2 a share in annual special dividend (representing a 4.4% yield). The directors have paid the $2 special in each of the past four years. "Finding itself in a capital-flooded industry," Santin observes, "the board has wisely decided to pay out large dividends to shareholders rather than unwisely deploy the money in wasteful investment."

Robusto owns 142,277 shares worth $6.5 million, but he acquired most of them as a grant from the company. In May, he sold 2,036 shares for proceeds of not quite $100,000. Memo to the new broom: Writing a check to buy shares in one's own company is the most bullish kind of forward guidance.

•

Grant's® and Grant's Interest Rate Observer® are registered trademarks of Grant's Financial Publishing, Inc.
PLEASE do not post this on any website, forward it to anyone else, or make copies (print or electronic) for anyone else.
Copyright ©2018 Grant's Financial Publishing Inc. All rights reserved.

Grant's authorizes use by CLAYTON ISOM only. © 2025 Grant's Financial Publishing, Inc. Reproduction or distribution without written permission is prohibited.