# GRANT'S

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# Three for the risk

Evan Lorenz writes:

After winning the House, Senate and White House, Republicans are casting an uneasy eye on the federal budget deficit. They call it "The Number," and it's theirs now. Everyone agrees that next year's Republican number will be bigger than the just-ended, Democratic fiscal-year 2024 number, $1.8 trillion. How much bigger is the question.

How much more inflation is another question. A new flareup in the CPI would surely rattle stocks, now quoted near all-time highs with respect to price, value and concentration. Long-dated bond yields and cinched-down credit spreads, too, would likely be at risk. How to navigate these treacherous white waters? Following is a fresh look at W. R. Berkley Corp. (WRB on the New York Stock Exchange), American International Group, Inc. (AIG, also on the Big Board) and Arch Capital Group Ltd. (ACGL on the Nasdaq). Each is an insurance company and a former *Grant's* pick to click. We remain bullish on the lot, especially on the underachiever, AIG.

Among President-elect Donald Trump's most puzzling anti-inflation initiatives is his implied intention to raise consumer prices. Not that he really means to, but higher tariffs are a time-tested formula for higher prices.

For instance, the first Trump administration, in 2018, slapped 20%–50% imposts on imported washing machines. Prices thereupon leapt to the extent of 125% to 225% of the taxes levied (what else is a tariff but a tax?), according to a 2019 study by Federal Reserve economist Aaron Flaaen and a pair of University of Chicago professors.

Foreign dryers escaped tariff-free, but their prices climbed in tandem with the prices of domestic washers. They went up because American shoppers customarily buy a washer and dryer together. Well aware of this proclivity, domestic manufacturers just raised prices.

The incoming administration's signature pledge to close the southern border to trespassers and to deport millions of illegal immigrants may likewise tilt inflation higher. At least, the bargaining power of native-born workers stands to be enhanced. Indeed, hourly wages in October increased by 4%, measured year over year, even with the border jumpers competing for work.

Yet the Fed, since mid-September, has chosen to trim a cumulative 75 basis points from the funds rate. The 10-year Treasury yield, expected to decline in sympathy, has rather gone up, by 77 basis points since the cutting began. A dovish Fed in the context of raging asset prices, snorting animal spirits and a non-recessionary business climate describes no known theory of inflation suppression.

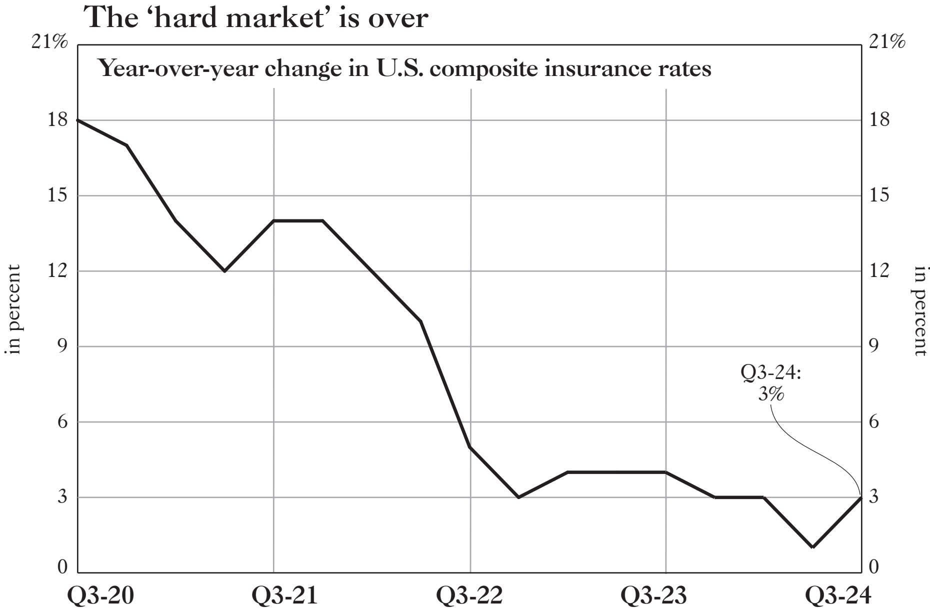
Renewed price pressures and rising interest rates would weigh on the financial markets, all right. However, W. Robert Berkley, Jr., CEO of W. R. Berkley, tells me, "You should expect us to benefit from that. One, I think you'll see us continue to be able to raise our premium rates to comfortably keep up with loss trend. No. 2, I think you will see us simultaneously be able to benefit from higher interest rates and our ability to continue to put new money to work at higher rates."

Besides, in an unreasonable market, insurance stocks are an island of sanity. Insurance component companies of the S&P 500 index are priced at an average of 14.6 times trailing earnings, little changed from the average of the past decade. The blue-chip index itself changes hands at 25.3 times trailing earnings, compared with the 21.3 multiple of the past decade.

Of course, everyday higher prices would increase the cost to settle insurance claims. "It is something they can fix, but it is something they can fix over time," Meyer Shields, who covers the sector for Keefe, Bruyette & Woods, Inc., tells me. The pricing dynamic resembles the familiar setup in the aftermath of a hurricane: Outsize claims in one year lead to rising prices in the following year.

If rising prices boost the cost to settle claims, they also prod prospective claimants to pay up for more extensive coverage. "Nominal GDP goes up," says Steve Virgili, a portfolio manager at New Vernon Wealth Management, LLC. "Assets inflate, and insured asset values go up. Under those scenarios, insurance premiums go up."

Insurers happen to find themselves in a strong position these days. The flattening of bond yields following the 2007–09 recession spurred the carriers to compete on price and resulted in stunted returns on equity during the 2010s. The carriers found relief the hard way. Even as interest income fell, the costs of claim settlement rose. Juries, tending to side with the claimants, awarded them supersized verdicts. Ergo, insurance prices moved higher in 2019 and 2023, well above the measured rate of inflation. A "hard-pricing market" got legs.




source: Marsh & McLennan Cos., Inc.

"I would say overall that rates are accurately priced today, but the biggest differentiator now is just the actual underwriting skill of individual companies because there are a lot of challenges out there," Shields says. "Good underwriters can take advantage of the strength that we've seen in pricing, and that's going to be positive. There will also be examples of companies doing very poorly."

So no more tailwind. Measured year over year in the third quarter, according to broker Marsh & McLennan Cos., Inc., U.S. property-insurance prices fell by 1%, while rates on casualty lines rose by 10%, excluding worker's compensation lines. Averages obscure divergences. In this case, they mask anomalies that adroit underwriters can exploit. Thus, within casualty lines, measured year over year, prices for directors and officers coverage declined by 4% while rates on excess and surplus lines jumped by 21%.

"It used to be that all of these product lines marched in lockstep, so all the boats rose together and all the boats would drop together," Berkley says. "But because we have different product lines at different points in the cycle, our ability, in my opinion, to have ongoing, reasonable and consistent growth is different than what it was in the past." For example, W.R. Berkley is taking a defensive posture on workers' compensation and commercial auto, but the CEO expects pricing in both lines to firm over the next year or two, which would make them attractive once again.

While the hard market may be over, Donald Watson, executive vice president of financial services at Arch, tells me, "I don't think 2024 is our peak earnings." Arch's insurance liabilities run to an average duration of around four years. "The earnings that we're having today...[come from business] written in 2020 and 2021," he explains. If 2024 does, in fact, turn out to be the peak of this insurance cycle, "we're going to earn that over the next three to four years. You're still talking three to five years out before you're at a point where you're going to see these returns be disappointing for some companies."

Our Covid-era insurance ideas have generated respectable—in one or two cases, very much better than that—performance: W.R. Berkley has produced a 59% return (outperforming the market by 16.5 percentage points since March 4, 2022), AIG a 46.8% return (lagging the market by 11.1 percentage points since Sept. 16, 2022) and Arch a 27.4% return (underperforming by 7.8 percentage points since Sept. 15, 2023). Meanwhile, Alleghany Corp., acquired by Berkshire Hathaway, Inc. on Oct. 19, 2022 at a 25% premium to its price on April 16, 2021, the date of a bullish *Grant's* analysis, beat the market by 34.7 percentage points.

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Insurance coverage comes in two basic types: standard policies, sometimes called "admitted," and excess and surplus policies, or E&S. Standard speaks for itself. E&S covers risks that standard underwriters shy away from, for instance, homeowner policies in fire-prone corners of California.

W.R. Berkley derives around 35% of its net premiums from E&S, compared with 8% for AIG and 13% for Arch. Berkley caters, especially, to small and medium-size businesses, and it caps 90% of its payouts at $2 million or less as a risk-control protocol. In the 12 months through Sept. 30, Berkley wrote $11.8 billion in net premiums, consisting of $10.4 billion in primary insurance and $1.3 billion in reinsurance. Within primary insurance, the biggest categories were short-tail lines (23% of the unit's total, including multi-peril, inland marine and accident and health), auto (15%), worker's compensation (12%) and other liabilities (40%). In the third quarter, the strategy produced a combined ratio of 90.9%. This ratio is a basic insurance operating metric that's defined as operating expenses plus claims costs divided by net premiums—lower is better.

Of our three favorites, Berkley is best positioned for a rise in interest rates. At the end of the third quarter, the duration of its bond portfolio averaged 2.4 years, compared with 3.7 years for AIG and 2.7 years for Arch. And Berkley does expect rates to jump and the yield curve to steepen. "We think that is going to create, as we've discussed in the past, an opportunity for us to be nudging our duration out," thus to boost the yield on the bond portfolio, the CEO told his Oct. 21 earnings-call audience.

WRB is priced at 15.2 times trailing earnings (versus a 10-year average of 18.2 times) and 3 times book value (versus an average of 2 over the past decade). I asked the top man to break the valuation tie: the moderate p/e ratio or the expensive p/b ratio? "We do not have much volatility," Berkley replied. "In fact, over years and decades, you can see how stable our results are and how we manage volatility." To his point, the company has generated a double-digit return on equity every year for the past decade except for the plague-marked 2020, when it earned 8.6%. "That should lead someone looking at the stock to view us perhaps more as something that should be valued as a multiple of earnings, as opposed to a multiple of book."

The Sept. 30 W.R. Berkley balance sheet showed a ratio of debt to capital of 25%, which (among other factors) earned it a holding-company rating of single-A-minus from A.M. Best Rating Services. In the third quarter, operating income covered interest expenses by 16 times.

Of the 18 analysts who cover Berkley, 10 say buy and 2 say sell. Just 1.6% of the equity float is sold short. Insiders have neither bought nor sold a share in the past 12 months, but that knowledgeable group collectively owns 23% of stock outstanding.

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AIG's notorious reputation from the Great Recession precedes it even today, 16 years after the panic and slump of 2008 and a lifesaving $182.3 billion government bailout. In the aftermath, the company sold non-core business units and restructured its property- and casualty-insurance business.

Most of that remedial heavy lifting is now over. Between 2008 and 2020, AIG reported only one year of underwriting profits from the core insurance business. However, in the third quarter it produced a combined ratio of 92.6% despite a 6.9 percentage-point loss from hurricanes Beryl and Helene.

In the 12 months through September, AIG wrote $23.5 billion in net premiums split between commercial lines (70% of the total) and personal coverage (30%). It's a well-diversified book of business in terms of both product and geography. The commercial insurance unit specializes in large and complex risks and consists of property lines (24% of net premiums), liability (27%), financial (24%) and specialty business (24%). The personal-insurance division provides coverage to high-net-worth individuals. In the past year, it earned 56% of net premiums outside North America.

In 2022, AIG listed its domestic life business as Corebridge Financial, Inc. and subsequently sold down its holdings in the spinout to 43.8% of shares outstanding. Management said it plans to continue reducing its stake in Corebridge and to earmark the proceeds for share buybacks. Doing exactly that, AIG has shrunk shares outstanding by 16% over the past two years; if it were to deliver on its targets through year-end 2025, the share count would fall by an additional 7.8%.

"The challenge we have today is we have more capital than we need to support our current core general insurance business," CEO Peter Zaffino told a Sept. 4 KBW Insurance Conference. "However, that's going to naturally unwind with our ongoing capital management strategy [i.e., share buyback program] and the realization of our anticipated growth potential. We continue to prioritize prudent risk selection, limit management [i.e., containing maximum loss], appropriate terms and conditions."

AIG's ratio of debt to total capital fell to 17.9% on Sept. 30, 2024 from 31.1% two years prior. Despite this improvement, A.M. Best rates the company as triple-B-plus, or lower investment grade. In the third quarter, operating income covered interest expenses by 6.8 times.

The shares trade at a modest 11.2 times trailing earnings and 1.1 times book value—as if Zaffino & Co. have not made the headway that they have indeed achieved. "I think eventually that AIG's conservative reserving will be more apparent," Shields, who rates the shares a buy, tells me. "There are companies out there—take Arch for example—that are perennial reserve releasers. And I think that as AIG gets closer to entering that pantheon, there's upside to the multiple because that's one component of earnings quality that I think the market really respects." The low starting multiple plus the large buyback and a potential multiple for a rerating could set the stock up for strong future returns.

AIG has won adherents on the Street, with 12 of 20 analysts saying buy and not one saying sell. Short interest sums to 1.3% of the float, though insiders have unloaded 532,327 shares over the past 12 months, raising proceeds of $40.1 million, the fetching valuation notwithstanding.

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Capital allocation has been a particular strength of Arch Capital. In the unproductive insurance years of 2007–11, management allowed profitless lines of business to run off and redirected the proceeds to purchase 39.5% of the Arch shares outstanding. Management opportunistically purchased AIG's mortgage-insurance business in 2016. The company holds a 29.9% stake in trade-insurer Coface S.A., another *Grant's* favorite (see the issue dated Nov. 24, 2023).

In the 12 months ended Sept. 30, Arch wrote $21 billion in premiums, consisting of $11.1 billion in reinsurance, $8.5 billion in property and casualty insurance and $1.4 billion in mortgage insurance. Exposed as it is to a variety of markets, Arch can shift resources from one opportunity to a better one—for instance, to reallocate capital to the mortgage-insurance division should the housing market spring back to life. In the third quarter, Arch reported a combined ratio of 86.6%, driven by very low losses in the mortgage unit.

Long-time CEO Marc Grandisson, 56, announced his resignation on Monday, Oct. 14. It was effective immediately—that very Monday, which happened to be the day of a memorial service for Grandisson's direct predecessor, Constantine "Dinos" Iordanou, who had died in June at the age of 74. The news came out of the blue, and the share price plunged from $114.40 on the Friday before the announcement. It closed at $95.69 on Tuesday.

Nicolas Papadopoulo, president and chief underwriting officer since 2021, was promptly named CEO; he joined the company in 2001. Papadopoulo, says Shields, "has been there for a long time, and we give him credit for both maintaining strong results of the reinsurance segment [which he ran from 2014 to 2017] and actually turning around their insurance segment [which he managed from 2017 to 2020]. Those are two different skill sets, and he's got both of them." Shields calls the stock a buy, as do we.

"Grandisson's resignation was very much a surprise," Virgili tells me. "With respect to Papadopoulo, he is a well-seasoned executive. . . . He's an actuary by training, and he's a lifer at Arch. So, I think Arch is in good hands."

Rated single-A-minus by A.M. Best, Arch showed a ratio of debt to total capital of 15.4% as of the Sept. 30 balance sheet date (adjusting for a special dividend payment). In the most recent quarter, Arch's operating income covered interest expenses by 31 times.

Arch trades at 7.6 times trailing earnings and 1.8 times book value, adjusting for a special $5 per share dividend payable on Dec. 4. Of the 17 analysts on the case, one says sell and 12 say buy. Short interest, at 1.3% of the equity float, is negligible. Nevertheless, insiders have sold 217,149 shares for an aggregate $19.2 million over the past 12 months.

"Looking ahead, we like our position in the market," Papadopoulo told analysts on the Oct. 31 earnings call. "This is true as we enter a responsible growth part of the P&C cycle, where disciplined underwriting and thoughtful risk selection are essential to success."

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