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Cycle unto itself

Evan Lorenz writes:

Flagging growth, rising interest rates and percolating inflation spelled trouble enough even before Vladimir Putin decided to attack Ukraine and, simultaneously, the S&P 500. Still, the cyclically adjusted price-earnings ratio for the blue-chip index stands at 35.3 times, a level bested, if that's the word, only by the peak valuations of the dot-com boom.

The prudent investor will therefore look for protection, but where, and from what? Fearing inflation, many will reflexively turn to Treasury Inflation-Protected Securities, but 10-year TIPS are priced to deliver a return no better than the Consumer Price Index minus 1%. Better, we think, is the insurance afforded by the insurance industry itself, in particular by the common shares of W.R. Berkley Corp. (WRB on the New York Stock Exchange).

Deprived of last year's fiscal palooza and, perhaps, any day now, of zero-percent funding costs, GDP growth may decelerate. The Atlanta Fed's GDPNow model projects flatlining first-quarter growth, a far cry from the 5.7% surge of 2021, while consumer expectations, according to the Conference Board, slumped to 87.5 in February from 108.4 in July.

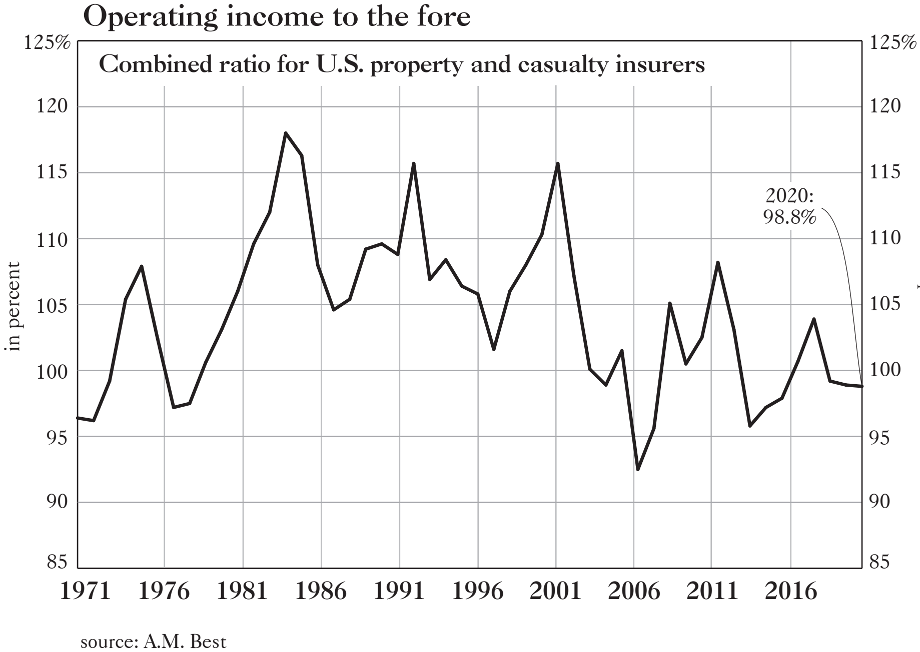
For the full 12 months of 2022, component companies of the S&P 500 are expected to report growth in earnings per share of just 8.5%, barely above the 7.5% rise in the CPI in January and nothing like the gaudy 47.6% leap in calendar 2021. Yet even those expectations may be too high, as company-issued guidance in the first quarter is the least upbeat since 2009.

While insurance is a cyclical industry, its cycles are largely its own. Margins expand and contract based on exogenous events (e.g., the Sept. 11, 2001 attacks), the ebb and flow of capital into insurance underwriting and trends in the cost of claims settlement. According to the Marsh & McLennan Cos. global commercial insurance index, insurance prices have now been rising for 17 consecutive quarters, with rates up 14% in the United States in the December quarter compared with the year-ago period.

Sympathetic juries have done their bit to help. Last August, a Florida jury awarded $1 billion to the parents of a teenage motorist who was killed in an accident involving a pair of allegedly negligent truck drivers (one of whom admitted to gazing at his cell phone at the moment of impact). "Social inflation" is the insurance industry's name for such nuclear settlements. And besides social inflation, there's the other kind that balloons the cost of repairing damaged cars, homes and other covered properties.

"Combined ratio" is a rule of thumb for measuring profitability in the insurance business: It's defined as operating expenses plus settlement costs divided by premiums earned. Over the two decades ended 2017, U.S. property and casualty (P&C) insurers posted an average combined ratio of 102.5%, according to A.M. Best, the insurance-focused credit-rating agency. Operat-

Operating income to the fore



source: A.M. Best

W.R. Berkley Corp. at a glance

all figures in USD millions except per share data

	2021	2020	2019	2018	2017
sales	$8,106.0	$6,930.8	$6,633.3	$6,371.5	$6,260.5
operating income	1,282.9	704.8	852.9	812.1	772.8
net income	1,022.5	530.7	681.9	640.7	549.1
earnings per share	5.48	2.81	3.52	3.33	2.84
book value per share	35.75	33.51	31.62	28.48	28.17
shares	186.5	188.8	193.5	192.4	193.5
combined ratio	89.6	94.9	93.8	95.3	96.7
reserves	15,390.9	13,784.4	12,583.2	11,966.4	11,670.4
debt	3,267.1	2,725.3	2,626.3	2,789.5	2,497.3
equity	6,667.7	6,325.8	6,118.3	5,479.8	5,451.2
total assets	32,086.4	28,606.9	26,643.4	24,896.0	24,299.9

source: company reports

ing at a slight loss, the underwriters kept the lights on with investment income, such as it was.

Given the paucity of that income, managements redoubled their focus on underwriting profits. And in view of the rising costs of claim settlements, those same managements pushed for price increases. Such efforts succeeded to the extent that the combined ratio for American P&C insurers fell to 99.2% in 2018, 98.9% in 2019 and 98.8% in 2020, from 103.9% in 2017.

As might be imagined, the new prosperity was not evenly distributed across insurance product lines. Excess and surplus (E&S) coverage delivered better results than the heavily regulated standard, or "admitted," kind did. E&S lines cover unique risks or risks that standard carriers want no part of. "E&S is the 'safety valve,'" Steve Virgili, a portfolio manager at Highland Park, Ill.–based New Vernon Wealth Management, LLC, which holds a position in WRB, advises by email. "They can alter forms, terms and conditions, pricing, etc. to more closely match their view of the risk."

The more popular an insurance category, the greater the competition, the heavier the regulation and the lower the profit. Homeowners' and auto lines illustrate the point. In December, elevated claims due to wildfires led American International Group, Inc. to announce its exit from standard homeowners' insurance. And at the Feb. 15 Bank of America Securities Insurance Conference, Allstate Corp. CEO Tom Wilson served notice about coming rate hikes in auto insurance. "We're not waiting for annual cycles," he vowed.

No rising tide lifts every insurance boat, and the good ship Lemonade, Inc. has been taking on water. Common shares of the online upstart (it sells renters', pet and auto coverage for less than the cost of settling claims) have fallen by 70% since a bearish analysis appeared in the Aug. 6, 2021 issue of *Grant's*.

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Which brings us to W.R. Berkley, the specialty insurer with a $15.6 billion market cap that got its start in 1967 with the $2,500 that its founder, eponym and current chairman, William R. Berkley, was able to scrape together. Since going public in 1973, Berkley has compounded book value per share at an annual rate of 15.1%. In 2015, the founder's son, W. Robert Berkley, Jr., assumed the CEO role.

Last year, 56 WRB business units earned $8.1 billion in net premiums, consisting of $7.1 billion in direct insurance and $1 billion in net reinsurance premiums. So-called short-tail lines (including multi-peril, inland marine and accident and health) made up 22.2% of primary-insurance net premiums, followed by professional liability (17.7%), commercial auto (12.5%), worker's compensation (12.4%) and other liabilities (35.2%). Approximately one-third of the direct premiums written are E&S. Within reinsurance, casualty risks contributed 61.8% of net premiums, followed by property (19.2%) and monoline excess, mostly worker's compensation (19%).

Risks incurred by small and medium businesses are Berkley's stock in trade, and management has little tolerance for outsize claims exposure (90% of policies are capped at payouts of $2 million or less). While active in more than 60 countries worldwide, Berkley derives the vast majority of its earned premiums from the 50 states.

It's the Berkley way to hire entrepreneurial underwriters and turn them loose when risk-adjusted returns are fat. As the hard-pricing market has made new business more attractive, Berkley's net premium earned jumped by 21.5% year over year in the fourth quarter, with about a third of the gain driven by price and the rest by volume. Between 2017 and 2021, Berkley's combined ratio declined to 89.6% from 96.7% and returns on equity surged to 16.2% from 10.9%.

Unfortunately, at least some of that good news is already priced into shares that change hands at 2.3 times book value and 16.1 times trailing earnings. For comparison, the 22 insurers in the S&P 500 trade at an average of 1.5 times book and 14.5 times earnings.

Some worry that the best of the upcycle may be in the rearview mirror, that the clock is ticking in the fourth year of a strong pricing market and that the pace of margin improvement is not what it could be. "Only 89.4%?" the disappointed bulls demanded in the wake of the disclosure of Berkley's fourth-quarter 2021 combined ratio.

Nine of the 14 analysts covering WRB rate the shares a buy versus one lone seller, and 1% of the float is sold short. In the past 12 months, insiders sold a net 24,991 shares for proceeds of $2 million.

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Of course, Berkley has rarely been cheap on trailing numbers: "We curb our enthusiasm because the stock is only relatively attractive," we sniffed in the issue of *Grant's* dated Feb. 23, 2018, concerning a trailing price-earnings ratio of 18. Since then, Berkley has generated a 109% return versus a 68% gain in the S&P 500, reinvested dividends included.

While we don't know when the hard

market in insurance may soften, the time is evidently not now. "[T]here is a lot of momentum," Robert Berkley told investors on the Jan. 27 earnings call. "As we look at January, we're looking at [applications for coverage]…. [T]here is nothing that leads us to believe that the environment is not stable or, perhaps, improving, and we're very encouraged by that."

And despite an elevated trailing multiple, Berkley's high growth and strong margins make the stock cheap on a forward basis—assuming, of course, that the balance sheet harbors no nasty surprises. Analysts pencil in earnings growth of 13.1% this year and 12.2% in 2023, valuing shares at 14.2 times 2022 projected earnings and 12.7 times next year's guesstimate.

"I think Berkley has legitimately been the most conservative [insurer]," Ryan Tunis, who rates WRB a buy for Autonomous Research, tells me. "I think that this is a company in which consensus estimates are 30% too low." If you peruse the footnotes to its 10-K reports, you can see WRB's cautious approach to underwriting. Thus, from 2018 through 2021, Berkley added $2.9 billion more in reserves than it paid out to settle claims.

On average at Berkley, the elapsed time between setting aside funds for a loss and paying out a claim is four years. I asked Robert Berkley how the team approaches the art of creating a buffer against future losses.

"During the Covid period there was a reduction in the frequency of loss," the CEO replied. "People were sheltering in place, cars and trucks were off the roads and people weren't going into work. As a result, frequency trend for loss activity came down considerably.

"It's hard to know whether that is a permanent benefit or whether there is a delay in the court system," Berkley continued. "We've been very reluctant to recognize that benefit prematurely. When we think of the loss picks [i.e., expected losses] we choose today, we also don't want to recognize that benefit on frequency. So, what we've done is [go] back to the 2019 year and then waterfall off of that on our assumptions for cost trends as well as our rate increases."

In other words, built into Berkley's earnings are higher losses than the company is actually bearing. If those losses do not increase, management will have the pleasant task of reversing excess reserves into earnings. Otherwise, the capital to cover the claims has already been set aside.

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As for the optically underwhelming insider activity in Berkley shares, there is the mitigating fact that CEO Berkley and Chairman Berkley must each hold shares equal to 10 times his base salary while other named executive officers are required to hold stock worth three times their annual pay. All in all, officers and directors own 22.4% of the company they manage.

With debt summing to 32.9% of capital employed as of Dec. 31, Berkley is a model of conservative financial practice, as A.M. Best attests. The agency gauges Berkley's financial strength rating at single-A-plus (on a scale that tops out at single-A-double-plus) and declared, in a May 27, 2021 update, that WRB "has the strongest level of risk-adjusted capitalization as measured by Best's Capital Adequacy Ratio."

That W.R. Berkley stands to gain from rising interest rates is another point in its favor. As of Dec. 31, bonds dominated its $23.7 billion investment portfolio (70% of the total), followed by real estate (7.8%), cash and equivalents (6.5%), investment funds (6.2%), an arbitrage trading account (5%), stocks (2.9%) and miscellaneous (1.6%).

The bond portfolio is highly rated (double-A-minus on average) and relatively short-duration (2.4 years, down from 2.8 years at year-end 2018 and 3.3 years in 2015). The decision to reduce duration has cost Berkley some interest income in the short run but positions the company to gain from rising reinvestment rates in the long run. All things being equal, a 1% increase in yields would add $166 million in interest income. Last year, pretax profit weighed in at $1.3 billion.

"Historically, insurers have had a low correlation with the overall market and have had betas below one," Steven Shapiro, CIO of New Vernon Wealth Management, tells me. "For whatever reason, in 2020 insurance stock betas went above one and started to trade with interest rates. Now, we are starting to see betas revert back to their historical sub-one range. It's not surprising. When the dust settles after the pandemic and the market starts to discern among sectors and stocks, this is an industry with a cycle all its own. It's not particularly economically sensitive.

"It's poised to do well regardless of what happens to the economy over the next couple of years," Shapiro continues. "It's not going to get hurt by rising rates, and, in fact, it may be a beneficiary. It kind of feels like these stocks have maybe regained some appreciation for what they have to offer, which is an uncorrelated return profile."

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