

An Amazing Ten Years for Insurance Stocks

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Disclaimers

- What is presented here is akin to what I do at my website alephblog.com – my employer, Finacorp Securities considers this an “outside business activity,” and so they bear no liability for anything written here, or spoken in my talk.
- I am an investment professional, and like every investment professional, I make mistakes. I encourage you to do your own independent "due diligence" on any idea that I talk about, because I could be wrong. Nothing written here, or in my writings at RealMoney or Alephblog.com is an invitation to buy or sell any particular security; at most, I am handing out educated guesses as to what the markets may do. I am fond of saying, "The markets always find a new way to make a fool out of you," and so I encourage caution in investing. Risk control wins the game in the long run, not bold moves.
- You can find a [list of my stockholdings here](#). Since I am talking about insurance stocks today, here is a list of my insurance holdings as of 11/20/2009: Allstate, Assurant, Chubb, National Western Life, Reinsurance Group of America, PartnerRe, and Safety Insurance.

Overview

- How I ended up in such an unusual job for an actuary
- What has happened to the financial markets, particularly for insurance equities?
- Credit, Equity, and Liquidity
- Are things better now?
- What does the future hold for insurers?

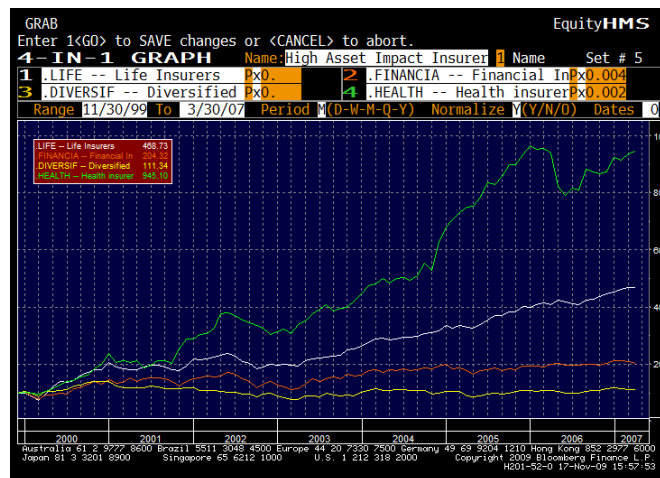
What's a Nice Actuary Like You, Doing in a Place Like This?

- My career has been very generalist, broad but not deep
- Pacific Standard – Generalist Actuarial Trainee
- AIG Life – Annuity Actuary
- Provident Mutual – Investment Actuary
- Mt. Washington – ALM Actuary and Mortgage Bond Manager
- Dwight Asset Management – Corporate Bond Manager
- Hovde Capital – Equity Analyst / Portfolio Manager
- Finacorp Securities – Chief Economist and Director of Research

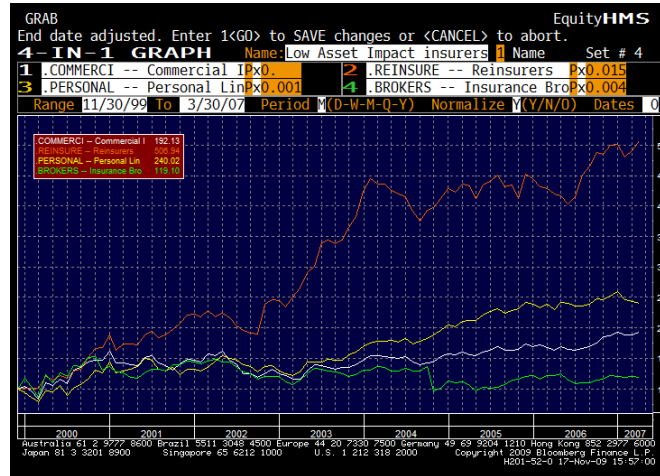
Lessons from the Journey

- Take Prudent Risks
- Build up Knowledge about the Target Profession
- Spend Time with People in the Target Profession
- Learn some of the Language of the Target Profession
- Get Additional Credentials
- Be a Lifelong Learner
- Write

The Boom -- Nice While It Lasted



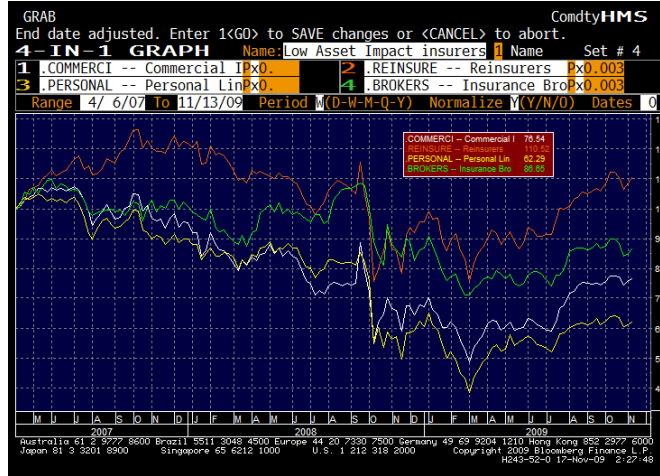
The Boom -- Nice While It Lasted (2)



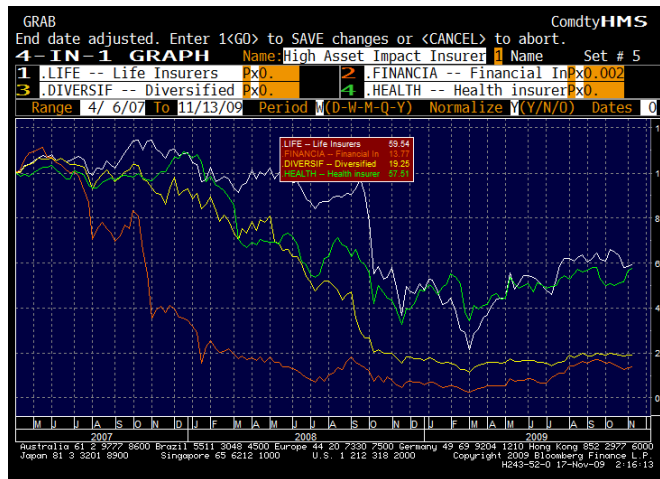
The Boom -- Nice While It Lasted (3)

- During this same period, 11/30/99 – 3/31/07, the S&P 500 (w/divs) returned 15%, or 2%/year.
- It went from being a technology-heavy index to a financials-heavy index.
- Every insurance subindustry did better than that, once dividends are included. (the graphs are price return only)
- Banks and non-bank lenders did better still
- Who needs slack capital? Buybacks were the rage – optimizing the capital structure was job #1 for CFOs.
- ROAs kept falling, ROEs required more leverage.

The Bust – Bad for Some



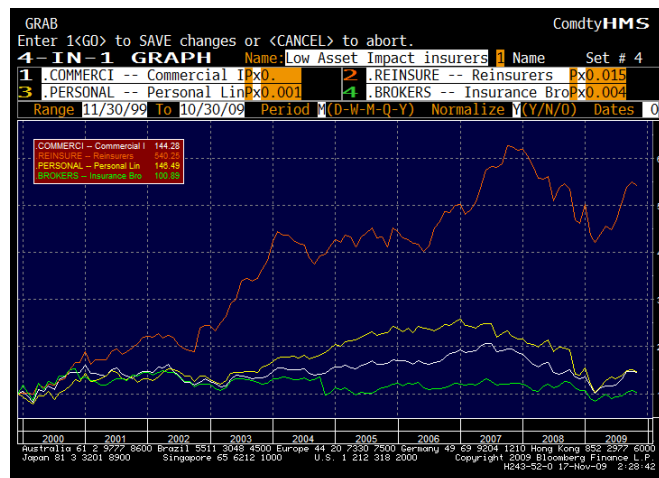
The Bust – Worse for Others



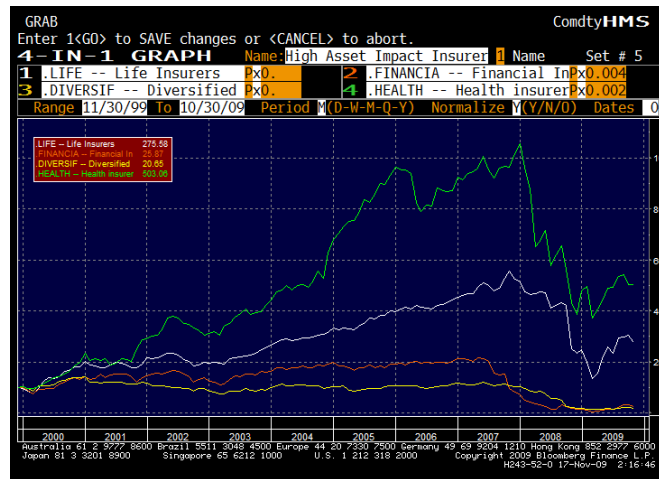
The Bust -- Analysis

- The cleaner and higher quality the assets, the better subindustries and companies did.
- Only Reinsurers , Commercial Insurers, and Brokers did better than the S&P 500 during the bust.
- Avoiding mortgage risks was wise.
- Avoiding complexity in investments generally helped.
- Lower leverage helped.
- A focus on underwriting helped.
- Life Companies varied. Those that wrote a lot of variable products did worse.

The Decade (Not so Bad)



The Decade – What an End!



A Word on Equity, Credit, and Liquidity

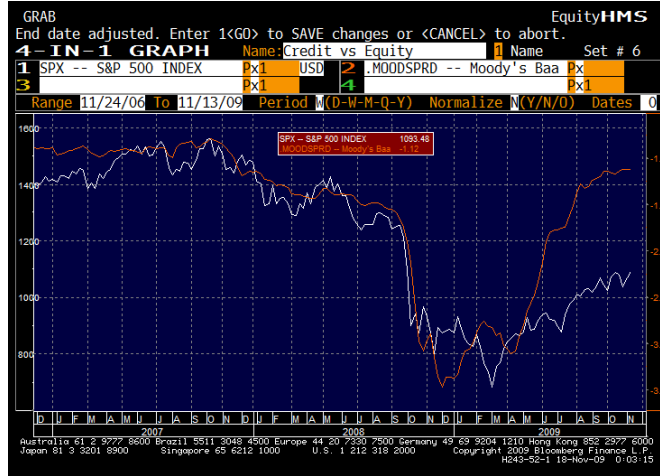
Risks

- Liquidity
- Duration
- Convexity/optionality
- Foreign Exchange
- Credit/equity
- Complexity/structure
- Inflation/Commodities

Effects

- Credit and equity returns are closely correlated in bear markets.
- Illiquidity events become more common when equity prices are falling, and credit spreads rising.
- Complexity and structure raise illiquidity during crises.
- Bonds with negative credit optionality underperform in a crisis.

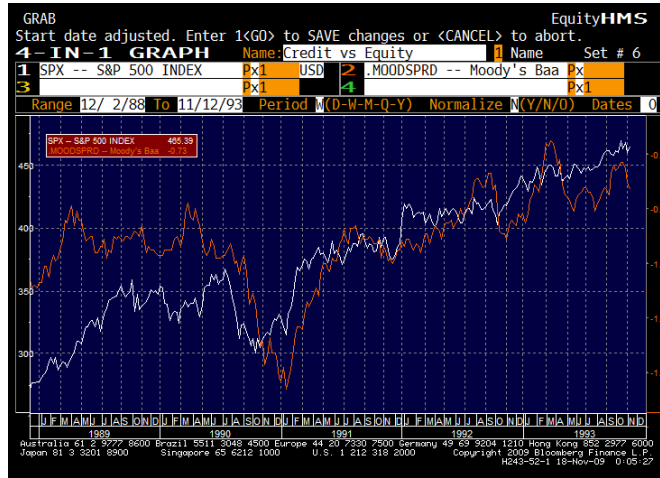
Credit and Equity 2007-2009



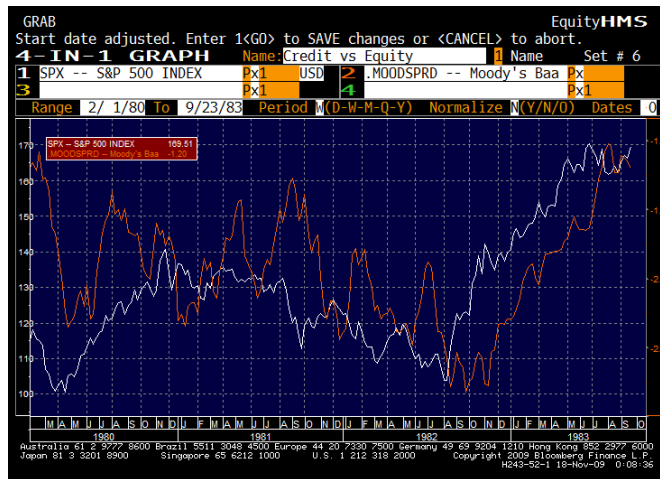
Credit and Equity 1999-2004



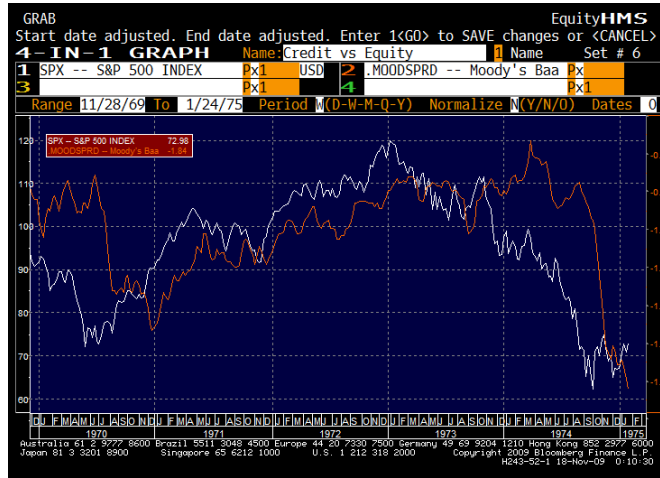
Credit and Equity 1989-1993



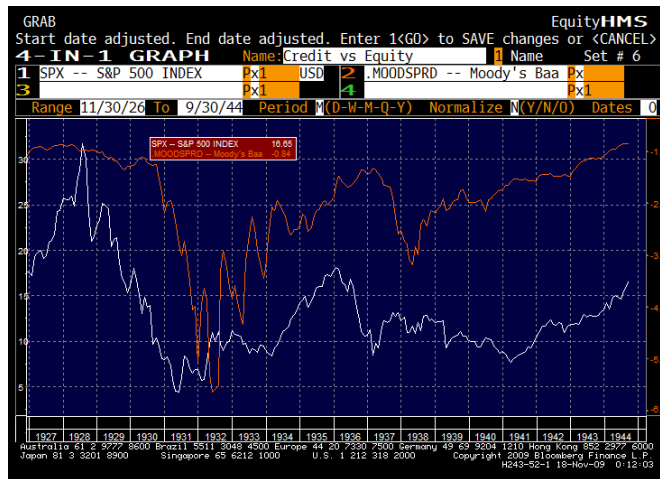
Credit and Equity 1980-1983



Credit and Equity 1969-1975



Credit and Equity 1927-1944



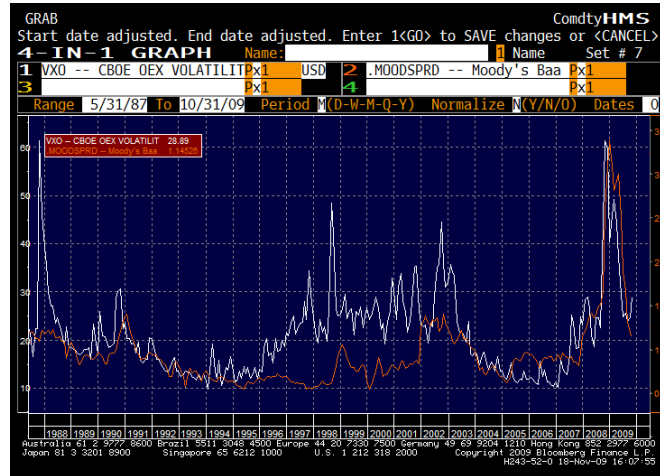
Equity, Credit, and Liquidity, Redux

- Credit booms are different – equities rise, while credit spreads stay low and stable.
- There are sometimes exceptions when selloffs are sharp, like 1987 or 1998.
- Ignore what the government says. It is impossible to eliminate the boom-bust cycle. The best a good businessman can do is try to understand where he is in the cycle, and be prepared.
- Building liquidity looks dumb after credit spreads have been tight for a few years, but can save a lot of performance. The same is true of an “up in credit trade.”

Equity, Credit, and Liquidity, Redux (2)

- During the bust phase, illiquid companies and investments get whacked. It is often good to “leg into” such investments during the panic. This is when credit analysis really pays off, because during the panic, everything gets hit.
- Equity risk shows up in Surety, D&O, E&O, Mortgage, Financial, etc.
- If you have equity risk in your liabilities, reduce credit risk in your assets. Same is true if you need to regularly buy equity options. When implied option volatility rises, credit spreads tend to rise as well.

Implied Volatility and Credit Spreads



Lessons?

- Credit risks are usually underpriced. When they are overpriced, most are scared to death to take them.
- Having slack capital is wise. Goosing short-term EPS is dumb, whether through buybacks, or reaching for yield in a bull market.
- Illiquidity has a cost. Don't take it on unless you are getting fair compensation, and your balance sheet can handle it.
- Avoid taking risks with assets and liabilities simultaneously.

Why did Most Insurers do better than Most Other Financials?

- Asset exposure wasn't perfect, but was a lot better than during the last two crises:
 - Less junk and CDOs than 1999-2002
 - Less commercial mortgage and real estate exposure than 1989-1992.
- Not many liquid liabilities, or collateral calls.
- Not much subprime exposure, aside from AIG.
- Most insurers stopped buying Jumbo and Alt-A RMBS in 2004 or 2005, or, stuck to the AAA tranches.
- With a few exceptions, insurers were similarly conservative with CMBS and ABS.
- Insurers do ALM better than commercial banks, and investment banks.

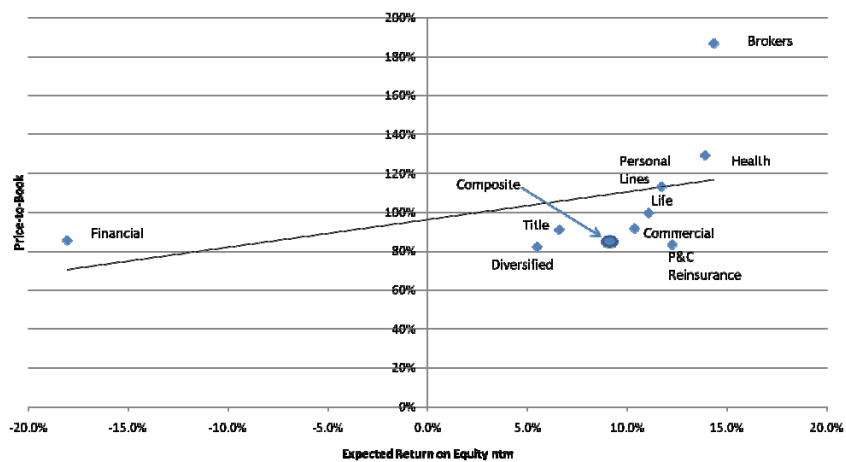
Where are We Now?

| Sub-industry | P/E ttm | Earnings Yield ttm | P/E ntm | Earnings Yield ntm | P/Book | Div Yield | ROE ntm | Oddities |
|--------------|-----------|--------------------|---------|--------------------|--------|-----------|---------|------------------------|
| Broker | 21.1 | 4.7% | 13.0 | 7.7% | 1.87 | 2.7% | 14.3% | |
| Commercial | 13.2 | 7.6% | 8.8 | 11.3% | 0.92 | 2.2% | 10.4% | |
| Diversified | (3.8) | -26.2% | 15.0 | 6.7% | 0.82 | 0.4% | 5.5% | AIG, BRK |
| Financial | (1.6) | -63.7% | (4.7) | -21.1% | 0.86 | 0.3% | -18.1% | ABK neg NW, ROE |
| Health | 10.2 | 9.8% | 9.3 | 10.8% | 1.29 | 0.1% | 13.9% | Don't pay dividends |
| Life | (1,029.2) | -0.1% | 9.0 | 11.1% | 1.00 | 3.4% | 11.1% | |
| Personal P&C | 76.2 | 1.3% | 9.7 | 10.3% | 1.13 | 3.2% | 11.7% | |
| Reinsurance | 6.4 | 15.7% | 6.8 | 14.7% | 0.83 | 2.2% | 12.3% | |
| Title | (578.0) | -0.2% | 13.8 | 7.2% | 0.91 | 3.3% | 6.6% | LFG |
| Grand Total | (19.6) | -5.1% | 10.7 | 9.4% | 0.97 | 1.8% | 9.1% | |

Where are We Now? (Notes)

- Note that AIG and Berkshire Hathaway skew the diversified subindustry.
- Title Insurance – one of the big 4, LandAmerica failed.
- Ambac, with negative net worth and an expected loss next year, has a positive ROE.
- Most subindustries are in a “Back to Normal” mode, but with considerably lower valuations than early 2007.
- I can appreciate high quality insurers with single digit P/Es and trading near book value.
- Health insurers didn’t have the asset issues to the same degree as other insurers, but the election of Obama has knocked the stocks down.

Subindustries P/B-ROE



What am I Looking for Now?

- Conservative Management
- Competent Management
- Pricing and Loss Trends
- Cheap Valuation
- Ideally, I like to own cheap, misunderstood, well-run, well-capitalized companies in sectors that have increasing pricing power
- Low Asset Risks

Broad Themes

- Larger companies.
- Companies with a niche.
- Low Asset Risks
- Prudent Underwriting
- Slack capital is a plus.
- I like Reinsurers, Life Insurers, and selected Personal Lines and Commercial Insurers.
- Avoid equity-sensitivity for now

Caveat Emptor

- Financial Insurers are not out of the woods yet. Most of them will die.
- AIG will die.
- Changes to accounting rules will lower valuations of financials. (There is no free lunch.)
- Health Insurers are a wild card.

For Further Reference

- [How Wall Street Looks at Insurance Companies](#)
- Residential Real estate pieces – [Tops](#) and [Bottoms](#)
- Equity Market pieces – [Tops](#) and [Bottoms](#)
- [Subprime piece](#) (before the crash)
- [Buy High Yield piece](#)
- [AIG piece](#)
- [Loss Severity Leverage](#) – on an unnamed mutual insurer.
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