Mind the gap - How Mr Market could be overlooking the best underwriting market in a decade

The impact of COVID-19 on insurance companies is driven as much by sentiment as events, with company fundamentals, in our view, significantly stronger than their valuations might outwardly suggest. In their recent webcast, fund manager Nick Martin and analyst Dominic Evans gave their opinions on the impact of COVID-19 on the insurance market as well as, after numerous calls with companies' managements, their latest outlook for their Fund.

Nick Martin
Fund Manager
Nick joined Polar Capital in September 2010 and is fund manager of the Polar Capital Global Insurance Fund (previously the Hiscox Insurance Portfolio Fund).

Dominic Evans
Analyst
Dominic joined Polar Capital in October 2012 from KPMG and is an investment analyst on the Global Insurance Fund.

Nick Martin: This is a fascinating time in the non-life insurance world. We've got a live catastrophe event ongoing in COVID-19; we believe we've got a rapidly improving pricing environment, meaning we're undoubtedly in the best underwriting market we have seen for at least a decade; and we've got valuations that are materially below historical averages, not too much above what we saw during the global financial crisis. There's a huge gap between how the market is currently viewing our sector and the fundamentals, and hopefully by the end of this webcast you'll fully appreciate what a compelling opportunity we have.

The global property and casualty insurance industry is used to dealing with catastrophe events and helping customers and communities in difficult times. Undoubtedly, we're in one of those today. A pandemic is different from the usual hurricanes and earthquakes that we deal with, as it is an ongoing live catastrophe event that increases the scope of potential outcomes.

Another thing to consider is that pandemics, unlike hurricanes or earthquakes, are not limited by geography or time which makes potential losses open-ended and, in the extreme, largely uninsurable. That is why pandemics are routinely excluded in policy wordings as no insurer to speak of, and certainly no insurance regulator, wants to see companies taking on these open-ended and unquantifiable exposures. Remember, the whole principle of insurance is that the premiums of the many, pay for the unfortunate losses of the few and pandemics potentially impact everyone, as we all know, sadly, therefore there's no diversifying risk. This is what makes insuring pandemics so difficult and why these exclusions exist.

That's not to say, of course, there won't be significant losses from COVID-19. Of course there will be. There are some obvious examples, the Olympics being postponed, Wimbledon and other sporting events being cancelled, travel insurance, mortgage insurance as unemployment goes up – what we'd call "known knowns".

The bottom line for us is that COVID-19 will likely become the largest insured loss in history, surpassing the $50bn or so from Hurricane Katrina back in 2005. Now, our base case is for $60-70bn which represents about 2% of global property and casualty capital, so that's very manageable. This excludes any positive claims experience we have in areas such as motor insurance. Another way to look at it is if you take our assumption and add it to the c$85-90bn you would expect from a natural catastrophe event, it would make 2020 a similar catastrophe-type year as 2017. Many of you will remember that was a good year for our companies, despite those heavy catastrophes. Book values grew about 10% that year and we would expect our companies to do just fine in this environment as well. Don't forget, this will bleed into financial results over a period of time, which differs from a hurricane or an earthquake where it impacts a particular quarter.

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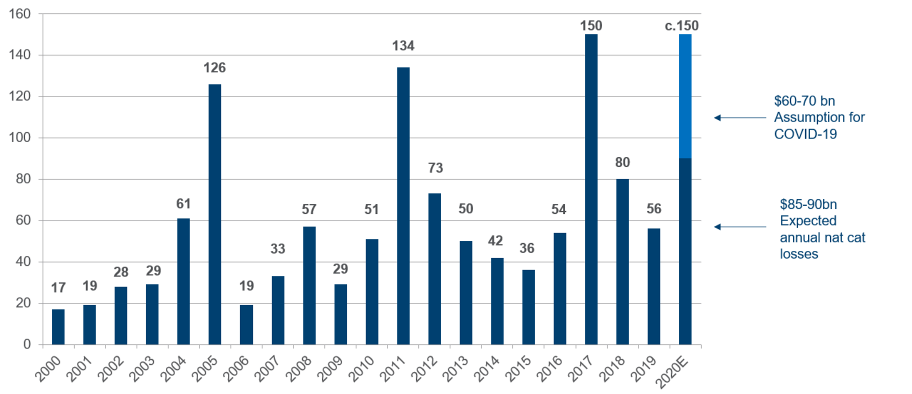
SECTOR SPECIALIST LAST WORD

"We're further encouraged that in some US states which have adopted new business interruption legislation, retroactive action that was talked about has been explicitly ruled out."

Global natural catastrophes - insured losses (current $bn)



Source: Polar Capital, April 2020.

Turning to business interruption, the first question to think about – the only question really – is did the customer explicitly buy business interruption pandemic coverage within their commercial property policy? If you go back to the end of March/early April, whether customers bought a pandemic policy or not was a mute question because there was talk of lawmakers retroactively wanting to change policy wording that would make insurance companies pay out for claims irrespective of whether there was coverage or not. We said at the time that was a very, very remote possibility and what we've seen in recent weeks is that's proving to be the case. That kind of retroactive conversation has since gone quiet, for understandable reasons, as it would fly in the face of contract law in places like the US. It would be deemed unconstitutional so I think we can largely park this to one side now. We're further encouraged that in some US states which have adopted new business interruption legislation, retroactive action that was talked about has been explicitly ruled out.

Some customers did explicitly buy pandemic coverage within their commercial property policy so where an insurer has specifically sold it and priced for that risk, policies will likely pay out. It's important to remember a misunderstood point, that the insured loss is actually the loss profit and not the loss revenue of that insurance buyer. The other thing that's sometimes overlooked as well is that in terms of business interruption losses, they're typically capped at a much smaller proportion of the overall property coverage. Let's say you've bought a policy for fire loss for a $10m commercial building; your business interruption may only pay out or be limited to about $25,000 – that appears to us to be about the average in the US market. Where people have bought business interruption insurance but not explicitly pandemic cover, understandably the insurers are probably going to argue that they should have cover as they haven't provided cover or received a premium to underwrite that risk.

The first line of defence the insurer has is what we call the 'belt', that is basically asking: has there been physical damage to the property? If the answer to that is 'No', there is no insured loss to speak of. A simplistic way of thinking about this is if you were driving your car and had an accident you would have an insurance claim and you would almost certainly make one, but if you went outside one day and your car was a little bit dirty, you wouldn't make an insurance claim. You'd clean your car. That's essentially what we have on that kind of physical damage definition. Of course the lawyers will try and interpret that physical damage definition differently, and would probably argue that a government-imposed lockdown should mean normal business interruption policies pay out so we'll have to wait and see exactly where that ends up in the courts.

It's important to remember some geographies do have a second line of defence, the so-called 'suspenders' – or probably better known as 'braces' in the UK – where there are explicit policy exclusions when it comes to viruses and communicable diseases. They have been commonplace in places like the US since SARS so for almost 20 years it has been fully understood by the insurance buyers, fully understood by regulators and, therefore, there are unlikely to be claims to speak of. At the other end of the spectrum is the UK where you don't have these pandemic exclusions and insurance companies typically use their own wording. It is a much more grey area when it comes to legal challenges, so we'll see how that pans out. With Europe, it's somewhere in the middle, between those two extremes – we've seen cases in France, for example, where some companies have had to pay out on business interruption claims. From our Fund's point of view, it's very important to remember our exposure is largely in the US, which is where we feel very comfortable. We've got a little bit of exposure in the UK and next to nothing in Europe, so from our portfolio point of view, this is very manageable.

"We have a diversified portfolio with only 4% in areas like business interruption where there's the greatest uncertainty. We've got limited exposed areas, like event cancellation and other lines like surety."

The news from an insurance company point of view from some of the early court cases around business interruption in the US so far is very good. A New York judge said in his summary language when looking at a magazine publisher case: "I feel bad for your client. I feel bad for every small business that is having difficulties during this period of time. But New York law is clear that this kind of business interruption needs some damage to the property to prohibit you from going. You get an 'A' for effort, you get a gold star for creativity, but this is just not what's covered under these insurance policies." So, what we've seen so far in the US is that the belt is proving enough and we didn't even need the suspenders, in terms of the exclusion language.

Looking at business interruption as a whole, there's a lot of noise out there but we think you're only going to have losses from the affirmative cover and from particular geographies. If you go back to our $60-70bn base case, around about $25bn of that is actually coming from business interruption itself.

Now I'm going to hand over to Dom who's going to talk you through Chubb, and how COVID might affect that particular company, one of our biggest holdings in the portfolio. The message we're trying to give here is what I said earlier, that COVID-19 is very much a manageable earnings event across our portfolio.

Dominic Evans: We thought it was helpful to put some numbers around the outlook and provide investors with a tangible example with Chubb of our expectations for the Fund's returns against the backdrop of COVID-19 over the next 12 months. The first point is that long-term value creation in insurance is inarguably driven by book value per share growth, with our expectation for book value growth of 9-10%. We updated that in March to reflect the lower investment rate environment we're seeing, the 'lower for longer' environment, and, simply, that number shows the flow-through of lower investment returns expectation for the portfolio as a whole. It has come down from 10%+ to 9-10% which we think is pretty prudent given where we are today.

Around 70% of book value growth is coming from the underwriting side and just 30% from the asset side. So, what's our outlook here? In a typical year we would expect $80-90bn of catastrophe losses across the industry, and you need to think about COVID-19 against our expectation of $60-70bn losses in that kind of context. That number does not include any market benefit from the lockdown in lines such as commercial, auto or lower workplace slips and falls. We have a diversified portfolio with only 4% in areas like business interruption where there's the greatest uncertainty. We've got limited exposed areas, like event cancellation and other lines like surety.

If you look at Chubb, you can see an 11% underwriting margin which is an 89% combined ratio, pretty similar to the portfolio as a whole, which emphasises the focus on companies that really take underwriting incredibly seriously. We also have the amount of leverage that our companies take which is the amount of premiums they can write for every one dollar of capital. Chubb, at 90 cents for every dollar of capital, is slightly higher than the portfolio as a whole and that really reflects the very strong growth we've seen at Chubb in recent quarters, as a result of the improving market with stronger rate rises and more attractive business opportunities.

Their investment yield at 3%, is higher than the portfolio as a whole, demonstrating the prudent approach we've taken in coming to the portfolio numbers as a whole as well as reflecting Chubb's broader global footprint. Their investment yield increased from Q4 into Q1. They took advantage and even capitalised by more than doubling their small equity portfolio in the selloff.

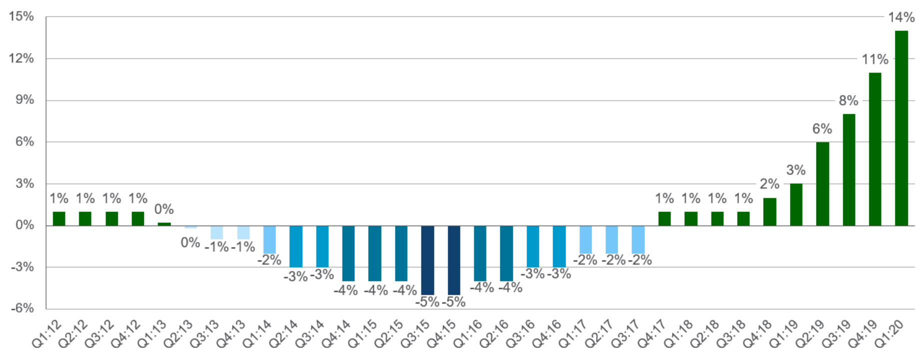
"[Delivering high single-digit book value growth…] demonstrates quite clearly the resilience of the companies in the portfolio to the current backdrop."

On the underwriting side, we see a number of scenarios for Chubb as a result of COVID-19. Our base case starts at a $1.5bn pre-tax loss which, on a $75bn billion events for the industry, is a 2% market loss. We think that looks pretty prudent given some analysts are talking about $600-700m and other large global conglomerates are reporting losses around $1bn. You also have to consider Chubb is a high quality underwriter so should do better as a result, and they're a good buyer of re-insurance.

In that kind of scenario, which we think is cautious, Chubb still delivers double-digit book value returns of 12% for the year which would be a pretty good outcome. What happens if we're wrong? What happens if losses double for the industry to $150bn and Chubb picks up a similar 2% of that market loss? In this scenario, they will still deliver high single-digit book value growth for the year. It's a c10% hit to the combined ratio, and they still deliver a positive underwriting contribution to that book value performance for the year, albeit just 1%. I think that demonstrates quite clearly the resilience of the companies in the portfolio to the current backdrop.

When we talked about the market at the beginning of the year, we were talking about a strong primary commercial market, with retro – the reinsurance that reinsurance companies buy – being very strong, but reinsurance was still slow to react to unprecedented loss activity in 2017, 2018 and 2019. What we see now is that soggy middle bit has been removed so, starting with the primary market which, according to the Marsh Global Insurance Composite Pricing Change, reached 14% in 1Q20, the highest level since the index began.

Marsh Global Insurance Composite pricing charge



Source: Marsh & McLennan 1Q20 earnings call, April 2020. Past performance is not indicative or a guarantee of future returns.

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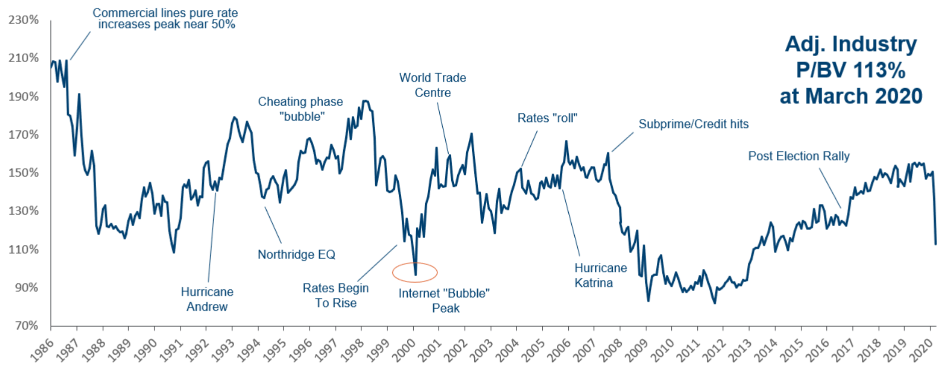
Change is clearly emerging in the reinsurance market. We've been monitoring the Fund's increasing exposure to property and casualty, but it has never been a bet on mother nature and our exposure remains just 5-6%, against the all-time low of 4% a year ago and our cap of 10%. The first indications of price increases came in the April, predominantly Japanese, renewals. Several years of typhoon losses in Japan saw rate increases on loss accounts up 10% to 35%, and those with large losses from the typhoons up 30% to 50%. This disruption really accelerated in the June and July renewals where the Florida accounts typically get written for US hurricane risks. Expectations were initially in the 15-20% range, but this increased rapidly in the second quarter to 20-30%, with brokers talking about a lot of accounts being written at the top end of that range. Significantly, there was a capital crunch in the market, exacerbated by the limited availability of retro and third-party capital, with many programmes facing shortfalls.

During the company's Q1 earnings call, Kevin O'Donnell, CEO of RenaissanceRe, said: "Over the years, I have speculated that market dislocations would look and feel different, with decreased amplitude of rate increases, shorter temperable persistence and more narrow geographic distribution. I am pleased to report that I was wrong. We will now find ourselves in a traditional hard market. Even before March, the price of risk was rapidly rising across most if not all P&C lines. We believe that COVID-19 will accelerate these rising rates."

As a result it was unsurprising to see RenaissanceRe go to the equity market to raise over $1bn of additional equity capital to take advantage of this opportunity. The Lancashire Group in the UK has taken similar action.

Given this market opportunity, where are we in terms of valuations? The Fund finished 2019 at 150% price to book, which we felt reflected the increasing opportunities we were seeing in the underwriting markets.

D&P P/C (re)insurance composite price to stated book value



Source: Dowling & Partners, March 2020. Excluding AIG and Berkshire Hathaway (includes Bermuda). Past performance is not indicative or a guarantee of future returns.

In March it was at 113% price to book, and it's around 115% today, similar to where we were in March. Our Fund's performance reflected a c4-5% hit to book values as a result of investment market volatility, demonstrating the defensive nature of the portfolio. Most of that performance came from price to book value derating, with those book values remaining very much intact. Since then, much of that March investment hit has been reversed – now reflected in the Fund price – but that price to book value number still remains at a similar level to March's, significantly below the 30-year average of 135%.

When we look around the world at other sectors, it is hard to find resilient businesses that can perform well in whatever economic environment we may face post-COVID-19 yet trade at historically low valuations. We feel that valuation discount between the market and the reality we see day in day out is significant.

So, what's the outlook for valuations from here? Well, one scenario is a 9-10% book value growth, and, perhaps over two years, the price to book value goes up to that 30-year average. If you get that kind of rerating over a two-year period, you're looking at returns in the high teens to 20%. Of course, that's just one of a number of possible scenarios that could play out but there's a reasonable chance that we could see a continuation of strong book value growth and, adding to that, some contribution from price to book multiple expansion. The rate story, in our view, is being overlooked and most commentators are expecting that momentum to continue well into 2021, offering a multi-year opportunity.

"We believe the current market opportunity only comes around two or three times in an underwriter's career, and certainly the valuations are not reflecting that. "

NM: As you've heard, we think we are in the best underwriting market we've seen for at least a decade, and there's certainly both pain and opportunity in our industry right now, but not evenly distributed. Many companies were already struggling, reducing their risk appetite. They needed to get their underwriting houses in order, and I think COVID-19 has further added to the problems those companies already had. Looking at the other end of the spectrum – where we're trying to invest – this is where we have quality underwriting companies run by management teams with real skin in the game. A lot of these companies have been sitting on their hands over the past few years and while the momentum was building pre-COVID, it's now accelerating virtually anywhere we care to look.

We've always taken great importance in management ownership and as I'm sure all of you know, Dom and I very much eat our own cooking when it comes to this Fund. I have increased significantly my personal holding in recent months, but I have to say I did feel a little bit humbled last week when one of our CEOs added to his own personal holdings, investing a mere $150m into his company, describing it as "ridiculously cheap".

As we look at the sector today, some of the clouds around the COVID-19 losses, including the business interruption issue I talked through, seem to be lifting and I think the market's pendulum will start to swing back to how great we see the current underwriting market. We believe the current market opportunity only comes around two or three times in an underwriter's career, and certainly the valuations are not reflecting that. As I look around the world, there doesn't seem to be too much value out there, particularly where you've got fundamentals improving the way we have in the non-life insurance sector.

Nick Martin, Fund Manger and Dominic Evans, Analyst

Polar Capital Global Insurance Team

23 June 2020

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