US Commercial Insurance Pricing Continues to Accelerate

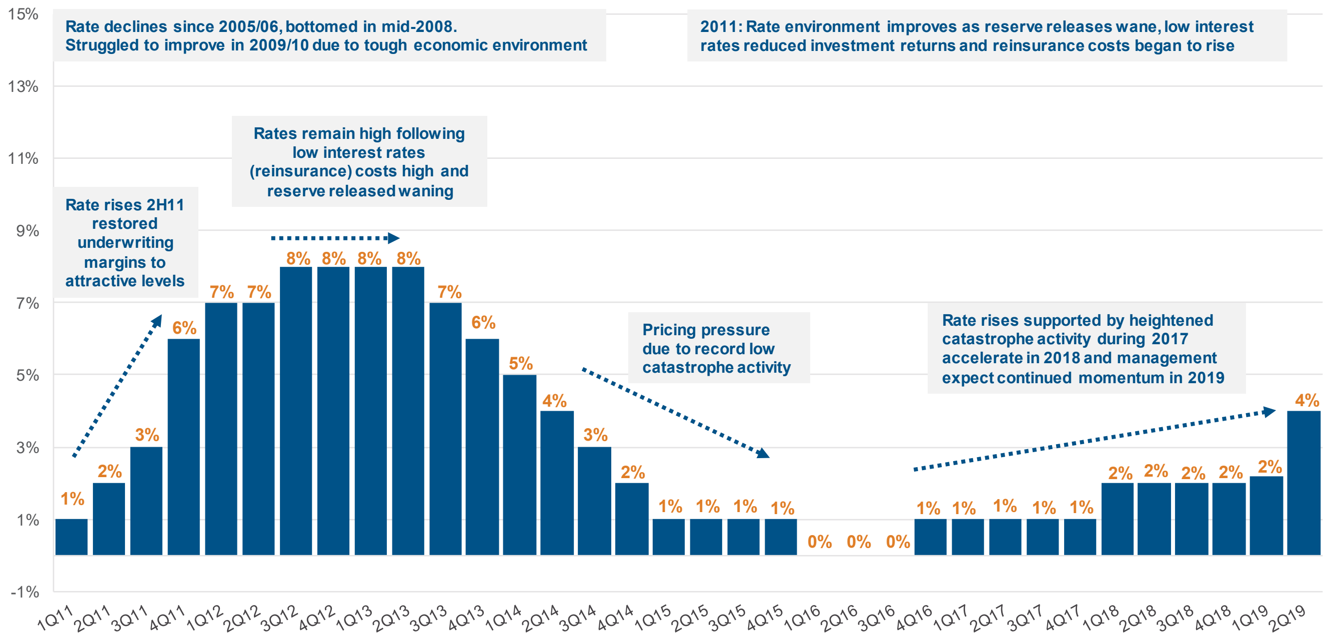
We are in the middle of Q2 earnings season and, given the incrementally more favourable comments we are hearing from the company management teams, it is a good time to update our investors on the continued improvement we are seeing in the US (re)insurance market.

Book value growth for our companies was again strong in Q2 which, when added to what was achieved in Q1, we believe sets us up for what will most likely be a very good year. However, the main focus of the earnings calls has been on the accelerating momentum in US insurance pricing which we view as very encouraging.

We have commented in recent fact sheets that we were seeing evidence growing that rates were starting to respond to the large losses and catastrophe events of the past few years. In recent months, this trend has become far more apparent and it was obvious during several calls this quarter that management teams have become more confident on the direction of travel, building on the more guarded optimism shown on the first quarter calls. For example, the CEO of WR Berkley noted in their Q2 call that "the pace of change [in rates] seems to be accelerating" and RLI admitted to being cautious on their commentary about the level of change they were seeing in Q1 with a much more positive tone in Q2. Evan Greenberg, CEO of Chubb, commented that "positive pricing and underwriting continued to improve through the quarter and spread to more classes of business".

As anticipated, property rates responded quickest to the events of recent years with the continually elevated loss cost environment due to storms and flooding in the US Midwest, combined with rising concerns over wildfire risk, adding further momentum to pricing in 2019. However, US primary casualty rates (excluding workers comp) are beginning to show much more positive rating trends. This is best illustrated by bellwether US primary insurer Travelers whose rates for its business insurance segment (largely SME) "stepped up" during the quarter, as shown in the chart below.

Renewal premium charges for Travelers' business insurance



Source: Travelers Q2 2019 results presentation.

While these trends in smaller and mid-sized commercial business are positive for many companies in the Fund, the increase in rating on larger account business, which have seen much of the pressure in recent years, was in many cases far in excess of these levels. US large accounts at Chubb saw an average rate increase of 8.5%, led by property at 18.5%, with increased momentum in casualty classes, particularly excess casualty up 10%, and public D&O, where we have heard that some accounts were quoting up as much as 50%. Growing momentum in rates at the larger end of the market has been further accelerated by significant underwriting actions at some large US companies as well as the much publicised Decile 10 initiative at Lloyd's of London, intended to improve underwriting returns in that market.

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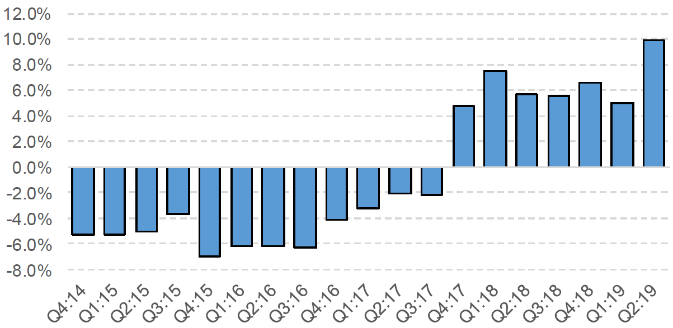
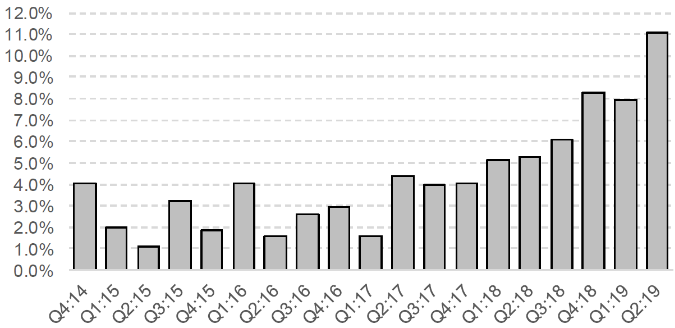
It is acknowledged among market participants that these initiatives have begun to bear fruit with Beazley (not owned) commenting in their results that “the past nine months have seen a material change in sentiment in our market as heavy claims in numerous lines of business have driven prices higher[1]”. The E&S market (excess and surplus lines), continues to be one of the greatest beneficiaries of the tightening of terms and conditions in the US primary markets. There has been a material increase in E&S submissions as more risks are deemed “too hairy” for standard market insurers and therefore need to seek out capacity in markets such as Lloyd’s of London. The withdrawal of capacity discussed above, due to underwriter exits and job losses from lines such as construction to aviation, particularly at Lloyd’s of London, has been combined with certain large companies significantly reducing their underwriting appetite which means the increase in demand is happening at the same time as more limited market capacity.

We can see this trend clearly in AmWINS recent *State of the Market* report. AmWINS is one of the largest wholesale brokers that specialises in the E&S market and trends in the charts below help to provide further evidence to the commentary of the spike in pricing seen during Q2. Lancashire’s results also drew attention to the much improved pricing in Q2 compared to Q1. AmWINS noted that the “property market continues to harden, with changes in pricing, deductibles, covers and/or capacity noticeable from quarter to quarter”. However, most significantly, casualty is also seeing hardening conditions, with AmWINS noting “it’s getting more and more difficult to place accounts. Capacity continues to dry up in areas of casualty particularly in the tougher areas of transportation and habitational”. Brokers further acknowledge that “there’s no automatic renewal anymore either – every policy is being re-underwritten”.

AmWINS E&S Property Pricing History



AmWINS E&S Casualty Pricing History



Source: AmWINS; Dowlings & Partners Analysis, July 2019.

In summary, we believe our companies are well positioned to benefit from the favourable trends discussed above. As submission levels continue to increase, they are seeing opportunities to grow in areas such as London wholesale accounts for the first time in many years. We focus on investing in companies with strong balance sheets and conservative reserving strategies that balance their portfolios in relation to the underwriting opportunities they face. As a consequence, in recent years the Fund has had a more limited exposure to large accounts due to weak pricing and elevated loss conditions.

We are increasingly seeing our companies identify opportunities to expand again as market conditions improve further, as shown by the solid top line growth in Q2 at a number of companies. We recently met with the management team of Arch Capital, our largest holding, who noted that growth prospects are improving. The increased submission activity noted by brokers such as AmWINS is a lead indicator of increased premium volume which ultimately should support positive analyst earnings revisions for the sector as the year progresses.

The Fund has performed well in 2019 although much of this performance is reflective of the very strong book value growth seen year to date. US industry valuations which meaningfully declined in 2018 have recovered to c150% price to book which is where they started 2018 and is only modestly above 30 year averages. It is very clear that we are in a substantially better underwriting market today than back then supporting attractive double-digit book value growth prospects.

Nick Martin and Dominic Evans

31 July 2019

[1]Beazley plc results for period ending 30 June 2019.

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