Risky Business: How to Pick Winning Property & Casualty Insurer Stocks

By John Deysher

It's no secret that many great fortunes have been built by smart insurance operators.

A good example is Berkshire Hathaway, which has interests in several insurers and reinsurers covering a variety of property and casualty (P&C) risks including vehicles, medical malpractice, workers compensation, marine vessels and others.

What is it about the unglamorous business of underwriting personal and commercial P&C risks that attracts the best minds in the investment business?

Profit potential, that's what!

At its heart, the P&C insurance business is one of shared risk. Insurers (or carriers) collect premiums from customers (insureds) and in return agree to pay any covered claims that may occur during the policy year.

Before a policy is proffered, the customer typically undergoes an "underwriting process" to assess their level of risk. Once determined, the policy is priced and, if acceptable to the customer, signed. Generally speaking, the higher the risk, the higher the premium (price).

As a wise person once said of P&C insurance, "There's no such thing as a bad risk, only bad rates."

The Business: How It Works

Insurance companies can be mutual companies owned by policyholders (for example, State Farm) or stock companies owned by shareholders (for example, Allstate).

Regardless of their ownership structure, insurance firms generally make money three ways:

- ***Underwriting Profits:*** By underwriting (assessing risk) and pricing a policy properly, the carrier is betting that the premium collected will more than offset any claims and operating expenses incurred during the policy year. If this occurs, the carrier is said to make an underwriting profit; if not, it has an underwriting loss.
- ***Fees:*** Renewal fees, late fees and other special charges have minimal costs or risks attached and flow directly to pretax profits.
- ***Float:*** This is money that doesn't belong to the carrier, but which it temporarily holds. Float usually occurs because premiums are paid up front but the insurance protection is delivered over a specified period, usually a year. There's also a lag—loss events that occur today don't always result in the immediate payment of claims by the carrier since it sometimes takes time for losses to be reported and settled. An automobile or homeowner claim may be settled fairly quickly, while a medical malpractice or environmental claim may take years. During this time, the carrier is free to invest the funds as it sees fit, so long as there is enough to pay claims that ultimately occur. Any resulting interest, dividends, capital gains and losses accrue to the owners of the insurance company, NOT the policyholders.

Lots of float can be good, if the cost of the float is not too high. The cost is the underwriting results: Do the premiums collected cover the losses and expenses ultimately paid?

When an underwriting profit is achieved, the carrier is actually "paid" to hold other people's money. When there is an underwriting loss, the carrier is "paying" to hold other people's money. This can still be acceptable if the return on the float (dividends, interest, net capital gains) exceeds the

Property and Casualty Insurers: What to Look for

P&C Winning Characteristics

1) Strong Balance Sheets

One basic measure is the capital ratio (common equity divided by total assets), which should be at least 20% or better.

- If convertible preferreds or debt have been issued, count each toward equity if the conversion/strike price is less than the stock price.
- For margin of safety, exclude goodwill and other intangibles when evaluating capital ratio.
- Capital also affects the amount of insurance a carrier can write, so the larger the capital base, the greater the underwriting capacity.

2) High Financial Ratings

A high financial strength rating from a third-party rating agency such as Standard & Poor's, A.M. Best.

- Aside from providing confirmation of financial strength, a high rating also allows a firm to charge higher prices for the same coverage, or provide lower coverage for the same price.

3) Disciplined Underwriting

- No exposures at prices that don't properly reflect loss probabilities.
- Stay within their area of expertise and accept only risks they are qualified to evaluate.
- Price their coverage for profitability; willing to lose to competitors that offer insufficient rates or policy conditions.
- Limit exposures to single event (flood, fire, earthquake, explosion, windstorm, etc.).
- Always want to understand possible correlations among seemingly unrelated risks.

4) Astute Expense Management and Operating Efficiency

- Operating expenses, including selling, general, administrative, litigation and actuarial costs, are kept low.

5) Adequate Reserves

The black box of the insurance business. The best operators are both consistent and conservative in their reserving.

- You can gain a better understanding of whether a firm is under- or over-reserved by examining the firm's loss development chart (if available), which is included in many P&C insurers' Form 10-Ks on file with the SEC. This chart shows the development of losses for a given policy year and how reserves have tracked those losses.

6) Reputable Reinsurers

Instead of selling thousands of small policies to drivers and homeowners, a reinsurer sells a few big policies to other insurers, thus assuming a portion of the risks that its customers have underwritten. It is essential for reinsurers to be well-capitalized, so that when losses hit their primary insurance customers they can meet their obligations. Most reinsurers today are large, international, well-capitalized publicly traded players. But make sure to check which reinsurers a primary insurer has relationships with.

- Reinsurers also can be considered as potential investments. The analysis mirrors that of primary insurers.

7) Adequate Liquidity

Regardless of an insurer's book of business, asset maturities should always match liabilities.

- Many observers are predicting inflation. Higher inflation is usually accompanied by higher interest rates, which destroy bond portfolios—the bedrock of many P&C insurers. If you're expecting inflation, make sure the bond portfolios of insurers you are interested in have short duration.

8) Stable, Consistent "Operating Earnings"

Focus on core operating earnings.

- To assess how the core business is fairing, exclude capital gains and losses from your analysis.

9) Insider Ownership and Insider Buying

Investors are well-served when insiders have large positions that align their interests with shareholders' interests.

- Insider buying on the open market is usually a sign of bullish prospects.

Key Ratios

Return on Assets: 4% or higher is strong

Return on Equity: 12% or higher is strong

Combined Ratio (the loss ratio plus the expense ratio): The lower the number, the better. The industry ratio is usually above 100%; combined ratios above 120% are unsustainable.

Capital Ratio (common equity divided by total assets): Should be 20% or greater amount of the underwriting loss.

Business Profit Structure

Property and casualty insurance can be a good business for several reasons.

First, profits can be generated multiple ways, as we have seen.

Second, capital requirements are usually minimal, with no major outlays required for fixed assets or working capital such as inventory.

However, the business is highly dependent on human capital: Capable underwriters, claims handlers, and marketing, sales and investing personnel are essential. While a portion of this can be automated, the human touch is still required to control risk, enhance returns and maintain a high level of customer service.

Finally, most insurance businesses are highly scalable once the infrastructure is built, allowing existing people and technology to handle a multiple of premiums, transactions and claims with little or no increase in costs. This is known as operating leverage: Revenues rise faster than expenses, causing margin expansion.

Business Challenges

Insurance can be a challenging business.

For one thing, the key assets walk out the door every night. Properly structured incentive compensation is essential to retaining good talent.

In addition, the product itself is a commodity available from many firms via fairly standard policy forms—anyone can copy another's product. There are no proprietary assets—like manufacturing know-how, entrenched distribution, patents or critical supply relationships—to protect one's competitive position.

Another challenge is that competitors are often mutual companies with minimal or no profit requirements. The result is often low prices that make it difficult for public companies to earn adequate returns for their shareholders.

Finally brand recognition is minimal and price competition is often high. Consequently, most P&C companies experience underwriting losses, not profits, over the long term.

P&C Winning Characteristics

Here's a brief description of the winning characteristics that the best P&C insurers exhibit.

Balance Sheet Strength

As regulated entities, insurers must meet certain net worth requirements to allow them to absorb the impact of claims (expected and unexpected) that inevitably occur.

As a basic means of assessing balance sheet strength, we look at common equity divided by total assets, which should be at least 20% or better.

If the capital structure includes convertible preferreds or debt, count each towards equity if the conversion/strike price is less than the stock price. For an extra margin of safety, many analysts exclude goodwill and other intangibles in making this calculation.

Capital also affects the amount of insurance a carrier can write. State insurance regulators usually limit the amount of premiums a carrier can write to twice (2×) its capital.

The larger the capital base, the greater the underwriting capacity.

High Ratings

Virtually all insurers have ratings attesting to financial strength assigned to them by third parties like Standard & Poor's and A.M. Best.

A high rating is critical to maintaining policy renewal rates and keeping pricing firm. A rating of AAA conveys greater financial strength than a single-A rating, allowing a firm with the former to charge higher prices for the same coverage or provide lower coverage for the same price.

Disciplined Underwriting

The best carriers are unwilling to take on even small exposures at prices that don't properly reflect loss probabilities. They stay within their area of expertise and accept only risks they are qualified to evaluate.

The best carriers price for profitability and are willing to lose customers and business to competitors that offer insufficient rates or policy conditions. They will also limit exposures so their solvency is not threatened by the aggregation of losses from a single event (flood, fire, earthquake, explosion, windstorm, etc.). They always want to understand possible correlations among seemingly unrelated risks.

Astute Expense Management and Operating Efficiency

After losses or claims, the next largest expense for most insurers is operating expenses including selling, general, administrative, litigation and actuarial costs.

When selling a commodity product, it's essential to be a low-cost operator.

Adequate Reserves

This is the black box of the insurance business.

A reserve is a liability that must be established to cover losses that have been incurred and reported (but not yet paid), as well as losses that have been incurred but not reported (IBNR).

Estimating reserves and maintaining reserve adequacy is one of the trickiest parts of the insurance business. Being too optimistic (not reserving enough) overstates earnings, which can continue for years until the day of reckoning when the shortfall becomes evident.

Conversely, a carrier is said to have excess reserves when the money set aside years ago to pay claims is more than enough because the claims weren't as costly as expected.

Ultimately, excess reserves are recaptured into earnings, which can provide the illusion that current earnings are better than they actually are.

The best operators are both consistent and conservative in their reserving.

The 10-K (the report of the company's performance that must be submitted annually to the SEC) of many property and casualty insurers includes a loss development chart showing the development of losses for a given policy

Table 1. High-Quality P&C Insurers

Institution	Mkt Cap ($ Mil)	5Yr Avg (2004–2008) Return on Avg Assets (%)	Return on Equity (%)	Combined Ratio* (%)	Equity/ Assets (%)	Current Price/ Earnings (X)	Current Price/ Book (X)	Yield (%)	Market
Amer. Phys. Cap. (ACAP)	330	4.3	16.0	92	38	9	1.4	1.1	Med Mal
Baldwin & Lyons (BWINB)	290	3.6	8.6	95	42	13	0.9	5.1	Trucking
CNA Surety (SUR)	600	5.3	12.6	84	42	8	0.8	0.0	Surety
Donegal Group (DGICA)	360	4.3	11.4	92	38	15	1.0	2.8	General
Hallmark Financial (HALL)	150	4.9	13.6	87	36	6	0.8	0.0	Specialty
Infinity P&C (IPCC)	500	4.1	13.2	92	31	10	1.0	1.3	Auto
Investors Title (ITIC)	70	7.1	11.0	100	65	12	0.8	1.0	Title
Montpelier Re (MRH)	1,100	11.1	26.4	98	42	7	0.8	2.2	Reinsurer
ProAssurance (PRA)	1,500	3.3	13.0	90	25	11	1.0	0.0	Med Mal
State Auto (STFC)	60	4.2	12.3	95	35	16	0.9	3.6	Auto
Zenith National (ZNT)	790	7.4	23.2	77	32	14	0.8	9.5	Wkrs Comp
Averages		**5.4**	**14.7**	**91**	**39**	**11**	**0.9**	**2.4**	

**The combined ratio is the loss ratio (losses and loss adjustment expenses divided by earned premiums) plus the expense ratio (sales, actuarial, litigation, general & administrative expenses divided by earned premiums).*
Data as of June 25, 2009.

year and how reserves have tracked those losses. From this chart, one can gain a better understanding of whether a firm is under- or over-reserved.

Reputable Reinsurers

Instead of selling thousands of small policies to drivers and homeowners, a reinsurer sells a few big policies to other insurers, thus assuming a portion of the risks that its customers have underwritten.

It is essential for reinsurers to be well-capitalized, so that when losses hit their primary insurance customers they can meet their obligations.

In the early 1980s, many reinsurers were not well-capitalized, leading many to go bankrupt and saddling the primary insurers with unrecoverable reinsurance to cover their losses. Eventually the absence of capacity caused prices to rise, at which point profitability rose and capacity returned to the marketplace.

Most reinsurers today are large, international, well-capitalized publicly traded players, but make sure you know which reinsurers a primary insurer has relationships with.

Reinsurers can also be considered potential investments. The analysis mirrors that of primary insurers.

Adequate Liquidity

Most property and casualty claims are settled in a short amount of time. These are known as "short tail" liabilities, since the time between the loss event and the claim settlement is relatively short. This requires that most of the investments be fairly liquid.

Claims that are settled over a longer time period are known as "long tail" liabilities, and allow the carrier to make longer-term investments.

Regardless of an insurer's book of business, asset maturities should always match liabilities.

Many observers are predicting inflation given the tremendous fiscal and monetary stimulus we've seen. Higher inflation is usually accompanied by higher interest rates, which destroy bond portfolios—the bedrock of many P&C insurers. So if you're expecting inflation, make sure the bond portfolios of insurers you are interested in have short duration.

Stable, Consistent "Operating Earnings"

To assess how the core business is fairing, many analysts exclude capital gains and losses from their analysis, as these are highly unpredictable and often non-recurring.

Insider Ownership and Insider Buying

As with other industries, we're encouraged when insiders have large positions that align their interests with ours.

Insider buying on the open market is usually a sign of bullish prospects.

Key Ratios

These are the key financial ratios that you should spend a considerable amount of time analyzing when evaluating these firms:

1: Return on Assets (ROA)

Assets are to financial firms what sales are to non-financial firms. The amount of income those assets generate is a primary indicator of an insurer's profitability.

Generally, ROAs of 4% or higher are considered strong.

2: Return on Equity (ROE)

Return on equity—net income as

a percentage of average shareholder equity—is an important indicator of financial profitability.

ROEs of 12% or higher are strong.

3: Combined Ratio

The combined ratio is calculated by adding two factors:

- Loss ratio: Losses and loss adjustment expenses divided by earned premiums. This can soar during periods of heavy losses such as those occurring after 9/11 or Hurricane Katrina; and
- Expense ratio: Sales, actuarial, litigation, general and administrative expenses divided by earned premiums. This measures how effectively an insurer controls non-loss-related expenses.

A combined ratio of 100% or less indicates an underwriting profit, while over 100% indicates an underwriting loss.

The lower the number, the better. The industry ratio is usually above 100% because of the competitive nature of the business.

Combined ratios above 120% are unsustainable, and usually result in the cessation of underwriting and a subsequent hardening (rising) of rates that enhances profitability.

4: Capital Ratio

The capital ratio is simply common equity divided by total assets.

This number should be 20% or greater.

Conclusion

The current P&C insurance market may merit a closer look. Many of the stocks of these firms are well off their highs. Investment losses for many were significant in 2008, eroding net worths.

Despite two significant hurricanes in 2008 (Ivan and Gustav), pricing remains soft.

Low interest rates continue to reduce the returns on fixed-income portfolios.

Finally, many stocks are trading at discounts to book value, making it difficult for them to raise additional equity without diluting existing shareholders.

All of this may set the stage for an increase in rates that could result in higher earnings per share and rising share prices.

Stay with insurers that have high ratings and a history of rock-solid balance sheets, low combined ratios, above-average returns on equity and assets, and large insider ownership.

Table 1 provides the current characteristics of a number of high-quality property and casualty insurers.

Start your search now using the metrics we discussed above. Long-term followers of the P&C industry know the stocks always move ahead of the underwriting cycle.

You can't wait to see the whites of their eyes before investing. Be ready. ▲

John Deysher is president and portfolio manager of the Pinnacle Value Fund, a diversified, SEC-registered mutual fund specializing in the securities of small and micro-cap firms. He is a CFA charterholder and has managed equity portfolios for over 25 years. He lives and works in New York City and may be reached at deysher@pinnaclevaluefund.com.