# How Wall Street Looks at Insurance Companies

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# Overview

- How I ended up in such an unusual job for an actuary
- How does Wall Street evaluate insurers?
- The deficiencies of the Wall Street model
- My alternative model

# 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

# 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

# The “Wall Street Model”

- There really isn’t a single formal model
- But there are factors common to most:
  - Estimation of “run rate” earnings
  - Common valuation metrics used for companies in a “peer group.”
    - Price to “run rate” earnings
    - Price to Book, or Tangible Book
  - Higher multiples awarded to companies that grow “run rate” earnings faster

# “Run Rate” Earnings

- Usually defined as GAAP earnings, adjusted for “one time” events, such as:
  - Accounting changes
  - Realized capital gains and losses
  - Adjustments due to M&A
  - Unusual losses or expenses
- In practice heavily reliant on formal guidance from management

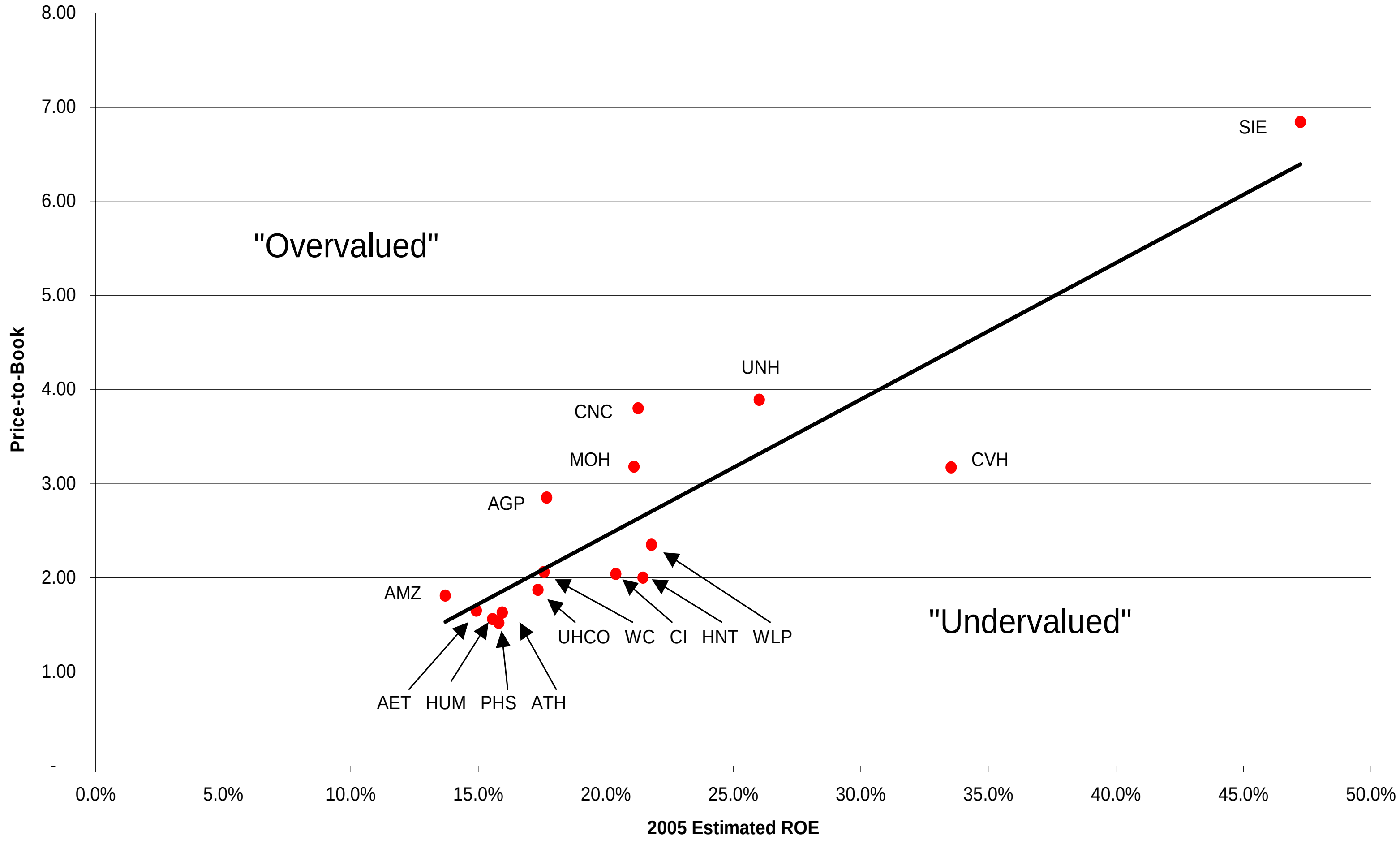
# Valuation Metrics

- Metrics for the industry on the whole are typically historic
  - Industry earnings multiple relative to the market on the whole
  - Historical price-to-book or tangible book
  - Often does not account for secular shifts in the economy, i.e., changes in interest rates, fiscal policy shifts, regulatory changes, etc.

# Valuation Metrics (2)

- Metrics within an industry vary off of growth expectations
- Often expressed through return on equity [ROE], since growth is viewed to be proportional to growth in capital and surplus
- One common method is to graph price-to-book versus ROE

# Health Insurance Sector Example



# Problems with the “Model”

- Encourages maximization of ROE in the short run, rather than the long run
  - Stock buybacks encouraged
  - No such thing as bad premium growth, only bad loss trends
  - If a deal is accretive to “run rate” earnings, it is viewed as good, so long as nothing breaks as a result (CPA ratings, etc.)
- Revenue growth is often equated with earnings growth
  - Premiums
  - Agents
  - No concept of a bad sale

# Problems with the "Model" (2)

- "Run rate" is adjusted GAAP, versus distributable earnings
  - Capital slack or tightness usually not considered, until growth slows below targets
  - Many analysts are lost in the details of calculating "run rate" earnings
  - Many analysts overanalyze quarterly results
  - Continued negative "one time adjustments" in the same direction indicates that management is possibly liberal in earnings recognition
- Implicit assumption of constant earnings growth, required return, and dividend policy in the Price to Book versus ROE metric
- ROA is more critical than ROE; it's harder to achieve

# My Alternative

- I would rather be approximately right, than precisely wrong
- I view insurers as a businessman would, and analyze attractiveness relative to current pricing.
- I “don’t do earnings estimates”
  - But I do analyze the biases of the sell-side analyst community; they have a lot of influence on short-term price movements, but no influence on the long term
  - When are they unduly pessimistic or optimistic?

# What I Look For

- 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

# Conservative Management

- Willing to grow more slowly when conditions are bad
- Profits before growth
- Focus on growth in book value, excluding SFAS 115, and adding back dividends
- On net, positive nonrecurring adjustments
- Makes money during bad periods
- Disciplined in reserving
- Ethical about claim payments

# Competent Management

- Risks get managed on the front end – disciplined in pricing and underwriting
- Careful in choosing lines of business
- Disciplined in mergers and acquisitions
  - "Small is Beautiful" – can gain competencies, synergies, new markets, distribution methods
  - Large acquisitions have large integration risks
  - Track record matters
- Use of excess capital is a strategic question
- Capital structure is also a strategic question

# Identifying Trends

- Trends in pricing, losses, expenses
  - All mature industries are inherently cyclical – where are we in the cycle?
  - What is in short supply, or oversupply, at current pricing levels?
- Examples: Group and individual disability, and life reinsurance seem to be in short supply; annuity writers and certain areas of casualty insurance seem to be in oversupply

**My Insurance Industry Sectors**

- Life and Life Reinsurance
- Health
- Title
- Mortgage and Financial Guaranty
- Personal Lines
- Commercial Lines
- P&C Reinsurance
- Brokers
- Conglomerates

# Identifying Anomalies

- Who is growing rapidly in a poor business?
- Accounting looks funny
- Where is change occurring?
  - Tax
  - Regulatory
  - Cultural
- Demutualizations, spinouts, complex companies
- Example: many title insurers are misunderstood; they are becoming more comparable to transaction processors.

# Trading

- Skepticism – Things are rarely as good or bad as feared
- Buy panic, sell ecstasy, but be humble
- There are exceptions – many downside moves self-sustain because market players underestimate the true effect of changes in the underlying profitability of companies
- Understand the other players in the sandbox – not everyone shares your motivation to buy or sell

# An Alternative View on Valuation

- How risky is the equity of a company relative to its bonds?
- What would you pay for a BB bond with a coupon of 11%? A single B bond?
- If an equity has a PE of 9 with no growth, and has reasonably protected margins, good management, conservative leverage, then how does it differ from a zero coupon bond?
- It depends on what management does with free cash flow.

# Summary

- It is possible to enter a different career as an actuary.  I was 38 when I got my first real job in investing.
- The “Wall Street Model” largely depends on “run rate” earnings, and appropriate multiple to capitalize those earnings
- That model does not capture the richness of the economic environment that insurance companies live in.
- By viewing insurance companies as a businessman might, better decisions can be made.

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