Buy P&C Insurance Firms

Property & Casualty Underwriters Face Low Interest Rates & Rising Claims

Bottom Line:

The insurance industry was hit hard by the one-two punch combination of low interest rates and COVID-19 claims. Low interest rates decrease investment income. COVID-19 could lead to a surge in policyholder claims, which would increase claims expense. The combination of wide-scale payouts and investment impairments are causing investors to flee the insurance industry.

Within the insurance industry, commercial property and casualty insurers are most negatively impacted. Government mandated business closures disproportionately hurt commercial clients. Policyholders are already filing business interruption and revenue loss claims. Insurance companies are promptly denying the claims, stating COVID-19 losses are not covered. State legislatures are passing bills to retroactively cover COVID-19 losses. In our view, the insurance industry chaos offers an attractive tactical investment opportunity.

Main Points:

► **Interest Rates Sit at Historic Lows; COVID-19 Leads to Claims Surge**

● The Federal Reserve cut interest rates three separate times during 2H19. COVID-19 caused the Federal Reserve to cut interest to near 0% in 2020.

● Policyholders filed COVID-19 business closures and revenue loss claims.

► **Commercial Rate Pricing Improving; COVID-19 Supports Rate Increases**

● Commercial rate growth positive since 4Q17 after weakness since 2007.

● Insurance companies' pricing power improves after major catastrophes. COVID-19 claims surge provides further support to raise rates.

► **Focus on Property & Casualty Underwriters; ETF & Stock Tickers**

● Business closures and loss of revenue impact commercial insurers much more than personal property and life insurers. Two ETFs offer broad insurance industry exposure, but we prefer a concentrated P&C basket.

► **Legislative Changes & Declining Investment Income Represent Key Risks**

● Politicians introduce legislation stating COVID-19 losses should be retroactively covered. Industry vows to fight the rule changes.

● The insurance business model relies on investment income to supplement earned premiums. Low interest rates lead to lower total revenue.

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Trade Details

Trade Type
U.S. Equities / Insurance Stocks

Trade ID
USEQ.2020-07

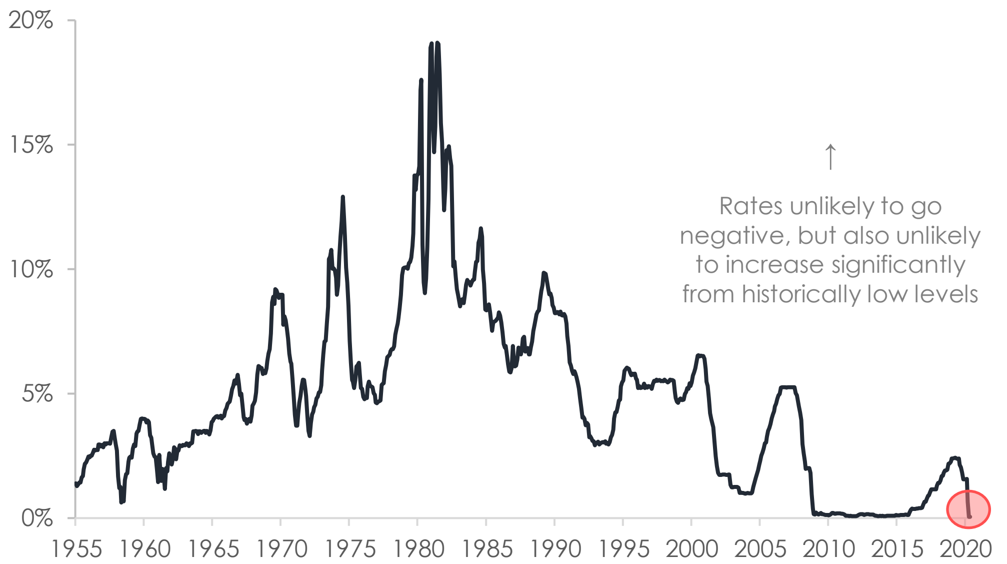
Ticker(s)
ETFs: IAK, KIE

Stocks: AFG, CB, JRVR, SIGI, THG, WRB, Y, HIG, TRV

Benchmark
VTI (Russell 3000 Index)

Interest Rate Cuts & Rising Claims

Figure 1: Effective Federal Funds Rate (1955-2020)



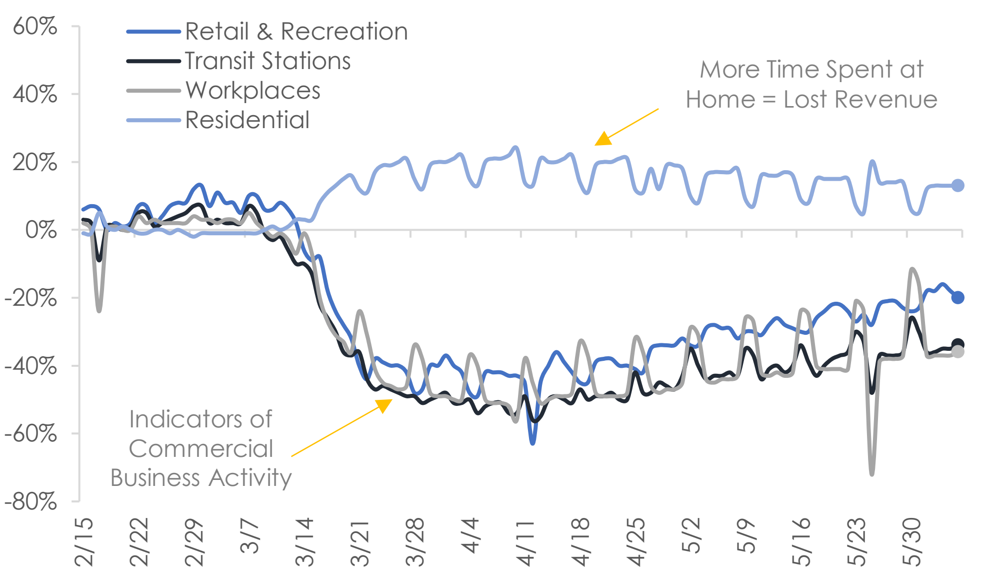
Source: MarketDesk Research, St. Louis Federal Reserve

Federal Reserve Cuts Interest Rates to Near Zero…

● Figure 1 charts the effective federal funds rate over the past 7 decades. The federal funds rate is the interest rate at which depository institutions trade federal funds (balances held at Federal Reserve Banks) with each other overnight. It is the central interest rate in the U.S. financial market and influences other interest rates.

● Insurance companies are negatively impacted by low interest rates. Insurance providers invest the premiums they receive to generate additional income. Low interest rates decrease investment income, which in turn decrease earnings and operating margins.

Figure 2: Real Time Data Shows Extent of Economic Shutdown



Source: MarketDesk Research, Google Mobility Report

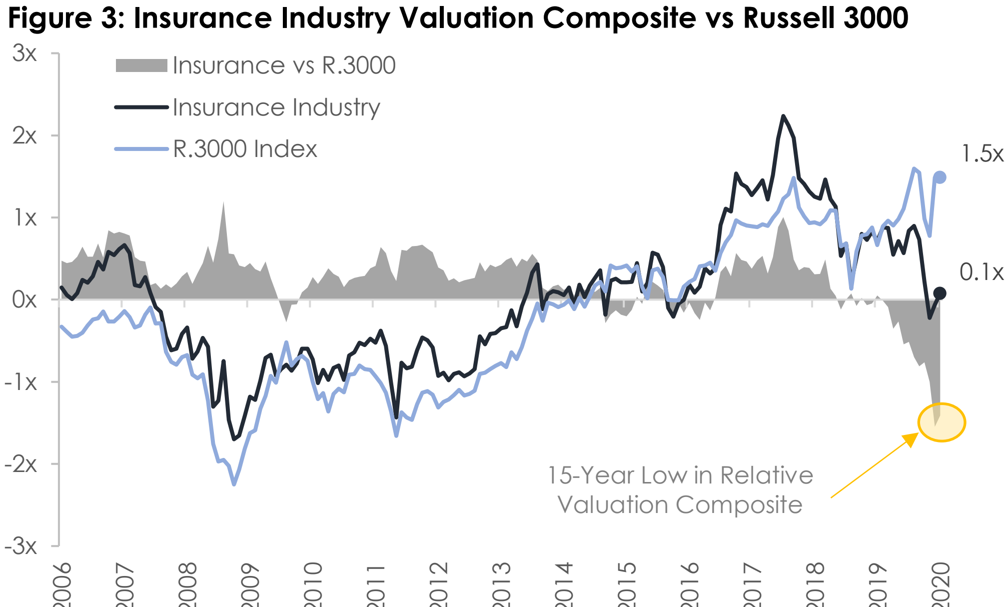
COVID-19 Leads to Business Closures and Expected Surge in Policyholder Claims…

● Figure 2 charts Google's COVID-19 community mobility reports across four key areas: retail & recreation, transit stations, workplaces, and residential.

● Positive numbers indicate more time spent at the referenced locations, while negative means less time spent at the location. COVID-19 shutdown orders led to a dramatic drop in commercial business activity.

● Commercial businesses expect their insurance policies to cover business interruptions and revenue loss. Businesses are already filing claims.

Figure 3: Insurance Industry Valuation Composite vs Russell 3000



Source: MarketDesk Research. ***Note:*** *Insurance industry is represented by IAK ETF.*

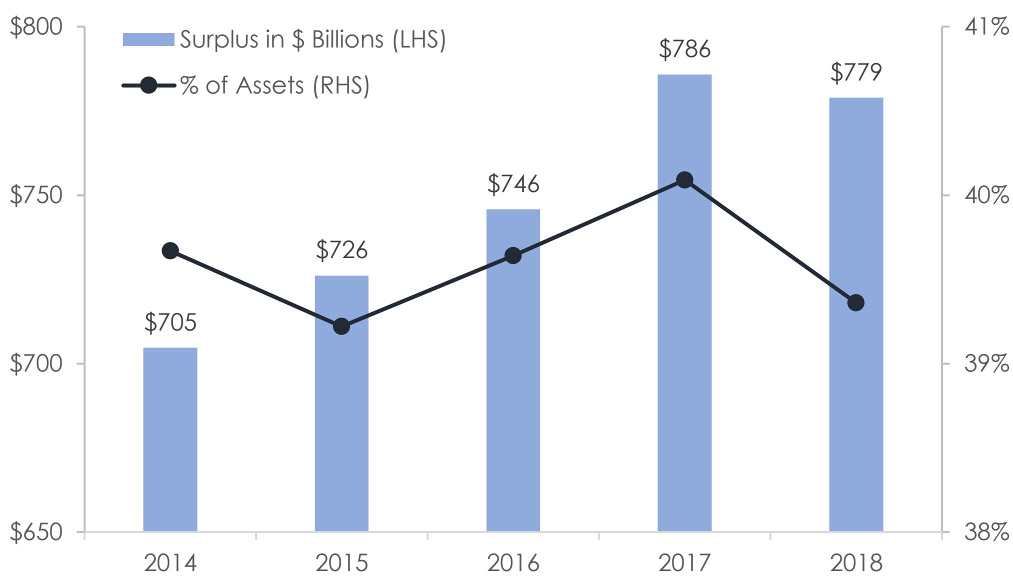
Insurance Industry Valuations Attractive vs Russell 3000 Index…

● Figure 3 graphs the insurance industry's valuation composite relative to the Russell 3000 Index (e.g. total market) over the last 15 years.

● The valuation composite flipped negative during the second half of 2019 as the Federal Reserve cut interest rates three times. The valuation gap widened in 2020 as the Federal Reserve continued to cut interest rates and COVID-19 raised fears of surging policyholder claims.

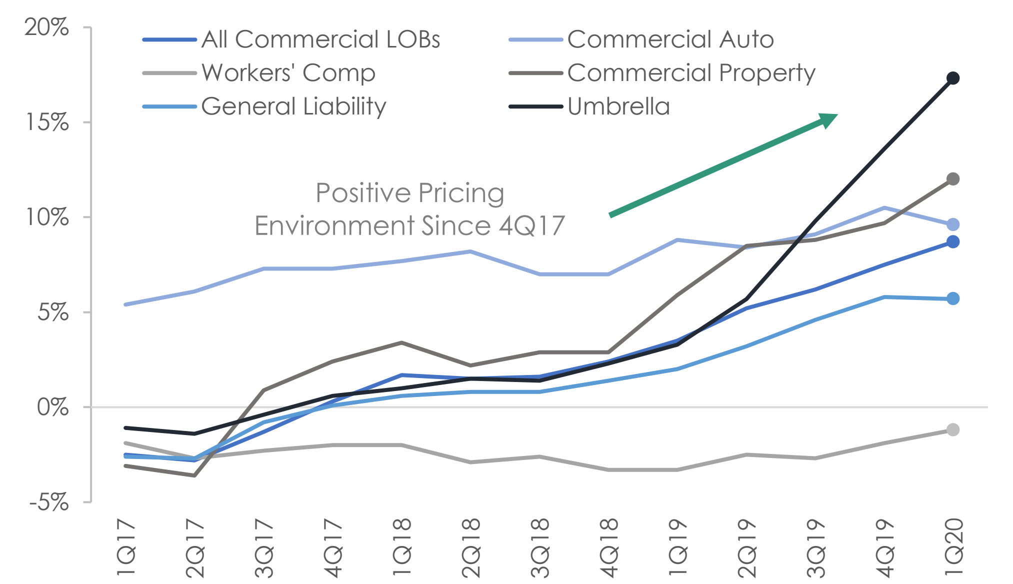
Premium Rate Increases & Attractive Valuations

Figure 4: Property & Casualty Industry Surplus Position



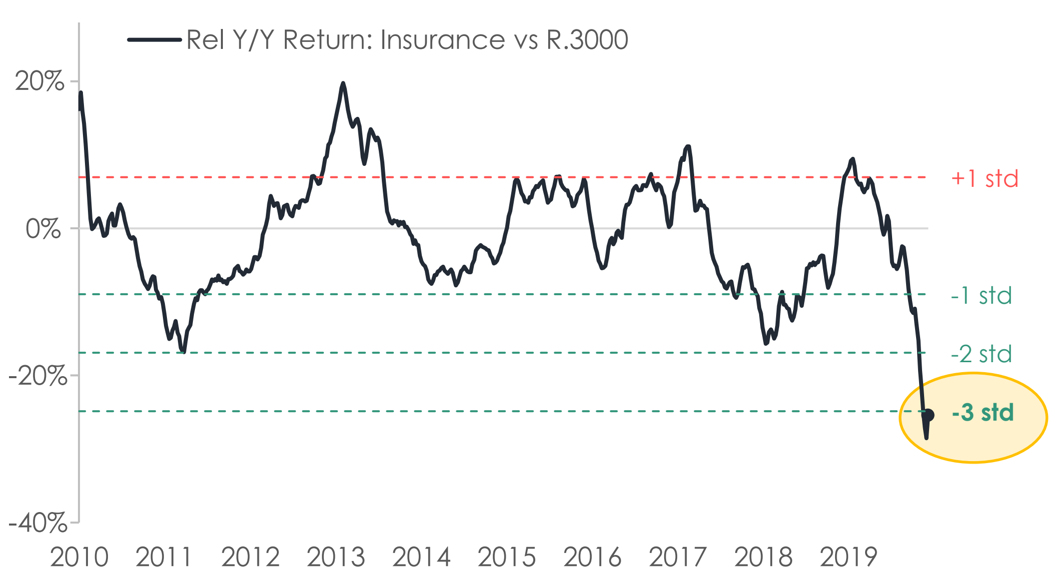
Source: MarketDesk Research, NAIC

Figure 5: Commerical Premium Rate Increases by Line of Business



Source: MarketDesk Research, NAIC, Council of Insurance Agents & Brokers

Figure 6: Insurance Industry's Rolling Y/Y Relative Return vs R.3000



Source: MarketDesk Research. ***Note:*** *Calculations use 10-years of weekly data.*

Property and Casualty Insurance Industry Surplus Position Strong…

- Figure 4 graphs total surplus and the corresponding percentage of assets based on annual statement filings across the property and casualty insurance industry.
- Willis Towers Watson calculated four COVID-19 loss scenarios for U.S. & UK insurers. Loss estimates range from $11Bn in an "Optimistic" scenario to $140Bn in a "Limited Success" scenario.
- The wide estimate range highlights the unprecedented nature of the COVID-19 pandemic. Claims losses and investment impairments could stress balance sheets. However, we view wide-scale payouts as a low probability event.

Commercial Premium Pricing Remains Strong During 1Q20…

- Figure 5 tracks commercial premium rate increases / decreases across major commercial insurance lines by quarter starting in 2017.
- The commercial pricing environment turned positive during 4Q17. It improved again during 1Q20. With the exception of workers' comp, all commercial lines have experienced 10 straight quarters of premium increases.
- Insurance companies' pricing power improves after major catastrophes, such as hurricanes, tornados, and other high loss events. The expected surge of claims due to the COVID-19 pandemic may provide P&C insurers an opportunity to increase commercial rates.

Insurance Industry Y/Y Performance Hits -3std Level…

- Figure 6 charts the insurance industry's y/y rolling return vs the Russell 3000 Index.
- For an approximately normal data set, ~99.7% of the values should fall within 3std of the average. Statistically speaking, the Insurance industry's y/y rolling return vs the Russell 3000 had a < 1% probability of reaching current levels. There are reasons for the underperformance (e.g. low interest rates and COVID-19 policyholder claims), but we think investors overpriced those events.
- For reference, we calculated the energy sector's y/y rolling return. Energy only breached the -2std twice, once in 2015 and again in 2020.

Legislative Changes & P&C Underwriters

Key Risks: Legislative Changes & Declining Investment Income

There are two primary risks to the property and casualty insurance investment thesis. Insurance is a unique industry that is highly influenced by unknown variables, such as loss frequency and severity, natural disasters, and now health pandemics.

#1 Legislative Changes & Adverse Court Rulings: The COVID-19 pandemic and related shutdown orders resulted in significant business interruption and revenue loss. A battle over policyholder claims related to "business interruption" coverage has taken shape as the country opens back up. Policyholders are filing insurance claims under their commercial insurance coverages. The claims request reimbursement for the business interruption and revenue loss created by government mandated shutdowns. Commercial insurance providers are denying the claims on grounds that most commercial coverages exclude pandemic related business interruptions.

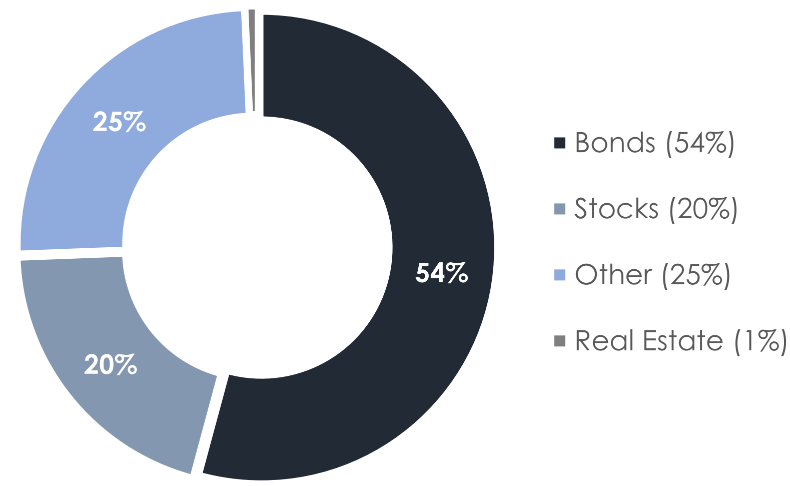
COVID-19 business interruption claims are grabbing significant attention both within the industry and government chambers. Politicians are taking up the cause. Eight states already introduced legislation stating COVID-19 losses should retroactively be covered, which would essentially shift losses from the retail, hospitality, etc. industries to the insurance industry. The industry has vowed to fight back, which means the issue will likely be settled in the courts.

In our view, the risk of large business interruption claim payouts is low. First, most business interruption claims are triggered by physical property damage. Second, most policies were modified after the 2003 SARS outbreak to specifically exclude bacteria and virus-related losses from non-life products such as business interruption and travel insurance. Finally, and most importantly, legislative changes to retroactively cover COVID-19 losses have a low probability of being implemented. Insurers did not include or price that type of risk coverage. The precedent of altering contracts will ultimately do more good than bad.

#2 Declining Investment Income: Falling interest rates represent a significant threat to the insurance industry's business model. This is because insurance companies invest policyholder premiums into bonds, equities, and other asset classes to generate additional revenue via investment income. Policyholder claims are paid out using a combination of received insurance premiums and earned investment income.

Figure 7 breaks down the combined property and casualty industry's portfolio by asset class as of 2018. Bonds made up 53%, while stocks made up 20%. Since the data was published, interest rates have moved down to 0%. This represents an existential risk for insurance companies. While insurance companies benefitted from rising bond

Figure 7: Combined P&C Insurance Investment Portfolio (2018)



Source: MarketDesk Research, NAIC

prices as yields fell, lower absolute yields are a significant headwind. This is because the investment principal deployed by insurance companies is originally received as policyholder premiums. Insurance companies are more focused on the steady yield from bonds than the capital appreciation, because they want to sync claim expense payouts with investment cash flows. With interest rates at historic lows, investment cash flows will shrink. The risk is that investment income does not cover claims expense if claims are in excess of premiums received. In that scenario, the underwriter would need to dip into its capital to bridge the gap.

Trade Implementation: Focus on Property & Casualty Insurance Companies

Property and casualty insurance companies are at the center of the COVID-19 insurance debate. Business closures and loss of revenue impact commercial insurers much more than personal property and life insurers. Underwriters focused on commercial auto and property, workers compensation, and general liability insurance policies. However, there are two potentially big commercial sub-segments to watch within the non-life insurance segment. The first is trade credit insurance, where underwriters cover businesses against debts that cannot be paid by suppliers or customers. The second is workers' compensation, which could see claims spike from workers that say they were not adequately protected from the virus by their employers.

There are two insurance industry ETFs. iShares's IAK and State Street's KIE both offer exposure to the insurance industry. Both ETFs contain ~50% exposure to the property and casualty sub-industry, with the remaining split across life, multi-line, and insurance brokers. While both ETFs provide broad insurance industry, investors that want targeted exposure to the property and casualty industry should build their own mini-basket. For example, Allstate, where commercial makes up ~2.5% of total premiums, is ~6% of IAK. Progressive, where commercial makes up ~11% of total premiums, is ~8.6% of IAK. Refer to page 5 for our preferred property and casualty companies.

Impacted Companies / ETFs

Figure 8: Impacted Companies

Ticker	Company	YTD Return	Notes / Rationale
Insurance ETFs			
IAK	iShares U.S. Insurance ETF	-24.3%	Broad insurance industry exposure; ~52% P&C, ~26% Life, ~12% Multi-Line
KIE	SPDR S&P Insurance ETF	-23.6%	Broad insurance industry exposure; ~47% P&C, ~24% Life, ~13% Insurance Brokers
Property & Casualty Insurance			
AFG	American Financial	-45.0%	Combined ratio steady in mid-70s; Workers comp exposure to healthcare ~6.5%
CB	Chubb Limited	-22.0%	Combined ratio low 90s; ~57% combined commercial exposure; Trades at 1x P/Book
JRVR	James River Group	-4.5%	Focused on small/medium commercial core E&S (63%); Less property exposure
SIGI	Selective Insurance	-22.9%	Combined ratio in low 80s; ~80% commercial; Trades at 1.5x P/Book vs 1.8x 5yr avg.
THG	Hanover Insurance	-26.3%	59% exposure to core & specialty commercial lines; Combined ratio near 100
WRB	W. R. Berkley Corporation	-18.9%	Conservative underwriter, but combined ratio rising; 21% worker's comp
Y	Alleghany Corporation	-37.8%	Mini-Berkshire Hathaway; Significant focus on commercial reinsurance
Multi-Line Insurance			
HIG	Hartford Financial	-35.7%	Improving combined ratio; 40% commercial exposure; Trades slightly below 1x P/B
TRV	Travelers	-19.3%	Combined ratio high 90s; 56% commercial (24% worker's comp, 23% multi-peril)

Source: MarketDesk Research.

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