

# GRANT'S

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### Let's assume

Interest rates, it says here, bottomed when the yield on the 10-year Treasury plunged to 1.35% in July 2016, from 15.8% in September 1981. It's the house opinion. You, our noble readers, ask, If a new bond bear market is indeed under way, what might an investor do about it? To anticipate, *Grant's* is slightly, contingently, reluctantly, relatively bullish on W.R. Berkley Corp. (WRB on the Big Board), a property and casualty insurer that stands to be a net beneficiary of higher bond yields.

No Wall Street investment banker ever got a bonus for an expression of bullish opinion so lame and wan as this one. We curb our enthusiasm because the stock is only relatively attractive, the market is absolutely rich and interest rates are a wild card. They may not rise soon enough, or high enough, to do our pick much good. They may not rise at all. Berkley, the company, is estimable, strong, well-managed. Its stock is the trouble. What it lacks at Dow 25,000 is what Benjamin Graham called a margin of safety (then, again, so does most every other stock nowadays).

The reign of tiny interest rates has punished the businesses that earn a living by investing their float. Prior to 2009, American P&C companies produced returns on equity in the low- to mid-double digits. Post-crisis, those returns have dwindled to the mid-single digits, or less. According to A.M. Best Co., Inc., the P&C industry earned 3.6% on equity last year, a result not unrelated to the miserable 3% yield on the composite P&C investment portfolio. Higher interest rates would prove a tonic for the companies' investment returns, and thus their bottom lines, other things be-

ing the same (which—we are the first to admit—they are sometimes not).

All P&C insurers collect premiums. The good ones collect more than they pay out. Good, bad or indifferent, the managements of these companies put those premium dollars—that float—to work, pending the arrival of claims arising from hurricanes, earthquakes, wildfires, industrial accidents, slips and falls and other such nuisances.

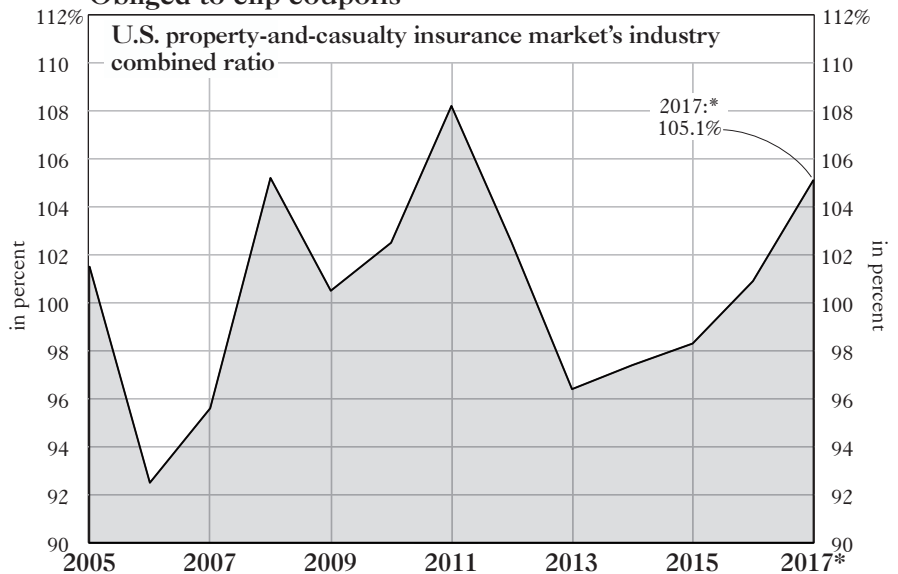
The measure of insurance-underwriting performance is something called the combined ratio: total insurance losses and underwriting expenses divided by premiums earned. A ratio below 100% denotes an underwriting profit. Combined ratios over the past 17 years have averaged 101%, which

means that the P&C business earns its money by clipping coupons.

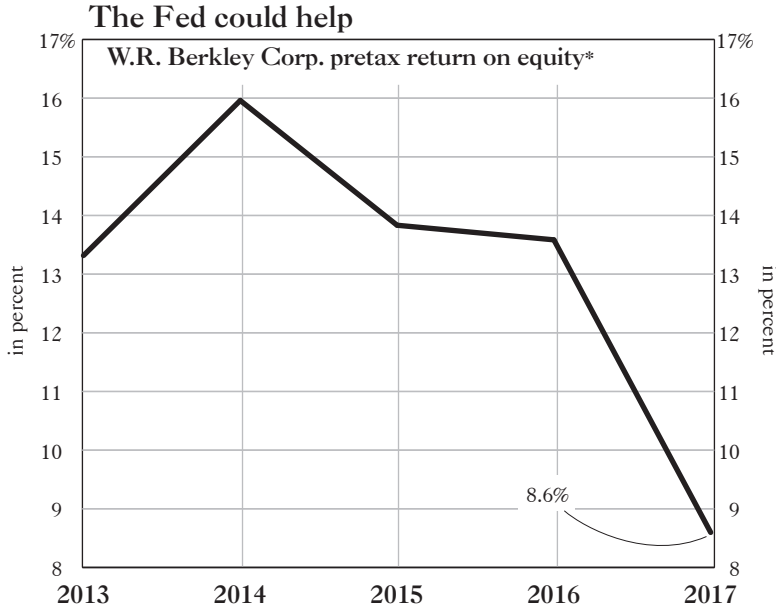
Making the rounds, colleague Fabiano Santin finds that interest rates are not, in fact, the topic of the hour in P&C circles. Tax reform and hurricanes rather take top billing. "I think," says Arash Soleimani, equity research analyst and director of Keefe, Bruyette & Woods, Inc., "that insurance stocks are a bit slower to respond to [higher interest rates] than bank stocks, given it could take another three years or so for the whole portfolio to turn over. It's a more delayed benefit than you'd see at a bank stock."

The P&C business has special reason to cheer the new tax act. U.S. companies have waged a long, uphill struggle against the tax-advantaged offshore

### Obligated to clip coupons



\* Estimated  
source: A.M. Best Co., Inc.



\* Excludes net realized investment gains.  
source: A.M. Best Co., Inc.

competition. The 2017 tax reform is expected to give a boost to U.S. insurers as foreign players absorb a one-time rise in their cost of capital.

How a P&C company invests depends on the risks it underwrites. Take, first, an underwriter of long-tail risks—asbestos liabilities, for instance. As its reserves are long-lived, so will its bonds be long-duration. Now consider an underwriter of high-severity, low-frequency risks—e.g., a standard property insurer. As its reserves must be available at the drop of a barometer, so must its bond portfolio be short-dated and liquid. Such P&C companies don't have the ability to lengthen duration when term premiums become attractive.

"Thus," observes Santin, "the importance of choosing the right horse to benefit from a bond bear market: companies with a track record of good underwriting in low-volatility businesses, supported by high-quality, short-duration portfolios with high gross written premiums to surplus that are able to swiftly recycle the portfolio into higher yields."

Which brings us to W.R. Berkley Corp., founded 51 years ago by the eponym and current chairman, William R. Berkley. Since the company's public-market debut in 1973, WRB's book value per share has grown by a compounded rate of 16% per annum, a respectable runner-up to the 19.5% annual increase in book value per share posted by Berkshire Hathaway, Inc. over the same span. From Chairman

Berkley's initial investment of \$2,500 in 1967 has sprung an \$8.4 billion market-cap enterprise that has distributed more than \$4.2 billion in dividends. In 2015, the founder's son, W. Robert Berkley, Jr., assumed operating leadership from his father. The two hold 21.6% of WRB shares.

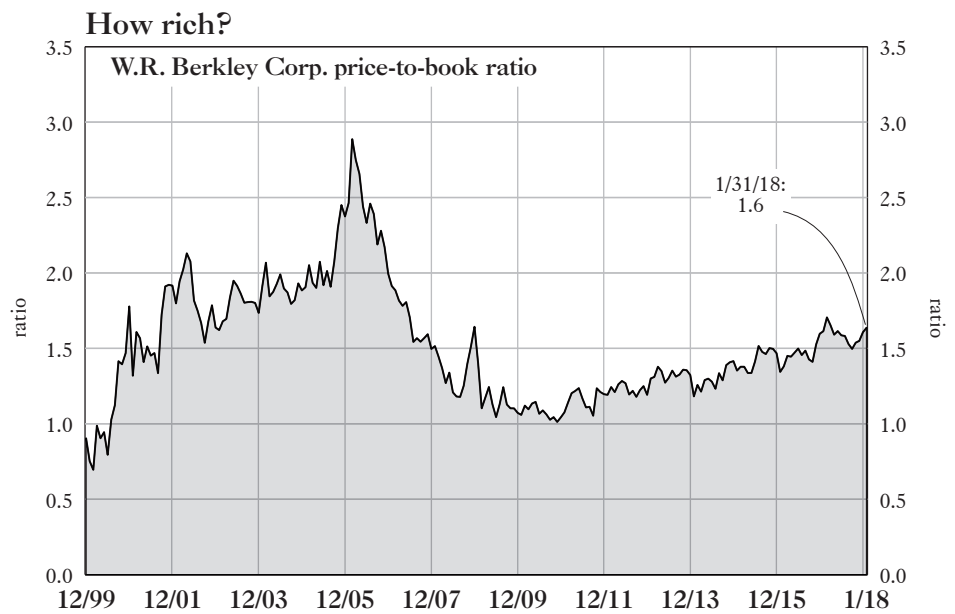
Berkley's M.O. is to run decentralized operating units in niche markets and regions. Fifty-four such subsidiaries generated \$7.47 billion in gross premiums last year (\$6.87 billion in insurance and \$607 million in reinsurance). Of this majestic sum, 80% flowed from the United States, with another 20 other countries

providing the balance. As a specialty underwriter with a focus on mid-sized accounts, Berkley is shielded, to a degree, from commoditized competition. Proof of its underwriting prowess is the average combined ratio of 93% it has managed to deliver for the past 15 years.

Berkley's forte is casualty insurance (68% of 2017 gross premiums) and exposure to property risk that comes mostly from short-tail lines. These include commercial multi-peril non-liability, inland marine, accident and health, fidelity and surety, boiler and machinery as well as commercial auto. Berkley accepts only limited exposure to hurricane-menaced coastal areas, a policy that contributed to an overall combined ratio of 96.7% last year, slightly above the 94.3% in 2016, or the five-year average of 94.7%, but a strong showing nonetheless.

Total 2017 revenues were \$7.68 billion, marginally up from \$7.65 billion in the prior year. Net income fell to \$549 million, from \$602 million in 2016, owing to the aforementioned pop in the combined ratio. Net invested assets footed to \$18.5 billion, matched on the liability side by \$11.6 billion in reserves, \$2.5 billion in debt and \$5.4 billion in equity. Berkley's subsidiaries are rated single-A-plus by A.M. Best, the agency's highest insurance rating.

Berkley holds reserves with an average duration of four years, yet its fixed-income portfolio, combined with cash, has a duration of three. "We have held our breath and short-



source: The Bloomberg

ened up our duration, and quite frankly, given up some fixed income yield,” CEO Berkley said on the fourth-quarter earnings call. “I don’t think you’re going to see that spread [between the duration of the bond portfolio and that of the reserve liabilities] much more, but again, we are pretty well-positioned for a rising interest-rate environment.”

This isn’t the first time that Berkley has taken a stand on rates. It held a similarly short-duration portfolio (3.3 years) when the interest-rate curve was flat in 2007 and no term premium was on offer for the risk one took in extending

(though long-dated Treasuries proved a superb investment in the era of ZIRP and QE). Extending duration a bit to pick up yield is always in the cards as interest rates rise.

“Berkley’s portfolio yielded an average of 3.5% for the past five years and 3.3% in 2017,” Santin observes, and he asks, “What if 100 basis points in additional yield were captured within two years? Not unreasonable, considering the company managed to gain 120 basis points in investment yield in the last Fed hike cycle of 2004 to 2006. At the current ratio of invested assets to equity of 3.4 times, this would translate into 3.4 percentage points

in additional pre-tax ROE, which averaged 13% for the past five years. Assuming stability in the business, the after-tax ROE would be 13% at the new tax rate.”

At 18 times projected 2019 earnings and 1.4 times projected 2019 book value, WRB’s stock is no ocular bargain. Now give effect to the assumptions that led us to the possibility of that 13% ROE, add in an estimate for earnings growth attributable to tax reform, and you are looking at—rather, imagining—a stock valued at, say, 12 times forward earnings. Let it be said that imagination is a poor substitute for a good entry point. Your move, Mr. Market.

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