CREDO WEALTH

Managing risk

You don't get paid for taking risk, you get paid for creating value. Risk doesn't disappear, but it can be managed. It can be avoided, accepted, reduced, or transferred. Commodity risks such as those in car, home and life insurance are well understood. These follow the "Law of Large Numbers" where something that isn't at all predictable on an individual basis, becomes very predictable for large groups. In contrast, the risks involved in speciality insurance against events such as art theft and cyber-attacks are more esoteric.

If you are selling cans of Coke, it is very easy to know what you have sold, and what profit you have made. Insurance is different. You are covering an unknown event in the future for a fixed premium now. In 'normal' businesses, competition may drive the profit down but because the cost is known upfront, you know how low you can go before you are making a loss. With insurance, high levels of skill in understanding risk are required in order to realise profits by taking that risk on, whilst the magnitude of the costs are not known.

Arch Capital Group ('Arch') is a Bermuda-based insurance and reinsurance company with a strong track record. Part of Arch's successful strategy has included "managing the cycle" by actively deploying capital into those areas where the best returns can be made. For example, in the most recent cycle, as prices have fallen, the company has cut its exposure to commoditised business segments and instead focussed on speciality lines. This is the segment of the insurance industry where the more difficult and unusual risks are covered.

Over the past 18 years, management's track record of compounding shareholder value has been amongst the best performers, tested in both difficult and easier periods. Foremost, the team are underwriters and have been together a long time. Ex-CEO, Constantine Iordanou, started with the company in 2001, and took over as CEO in 2003. Before Arch, Iordanou served at Zurich and Berkshire Hathaway. He was praised by Warren Buffett in his 1990 annual letter as being amongst his "cadre of stars". Current CEO, Marc Grandisson, worked alongside Iordanou at the same companies for 30 years, also joining Arch in 2001. He previously served as Chief Underwriting Officer and Actuary. Similarly, both CEOs of the 2 largest divisions (insurance and reinsurance) come from underwriting backgrounds and also joined Arch in 2001.

2017 was an expensive year for reinsurers as a result of an elevated number of natural disasters, including hurricanes and the Californian wildfires. This resulted in significant negative sentiment surrounding the Bermuda and US, property and casualty insurance (P&C), and reinsurance companies. Share prices suffered. These factors resulted in Arch trading at an attractive valuation, both relative to the market and to its own history, allowing us to purchase the shares in early 2018. Arch's exposure to catastrophe losses was well below Bermuda and Lloyds peers and as a result its balance sheet would be amongst the least impacted. This would put Arch in a strong position if pricing for reinsurance increased, which is often the case after a year where excessive losses deplete capital in the sector. Absent a recovery in pricing, Arch's balance sheet would still have excess capital which they could deploy, for example into share buybacks, at attractive valuations.

Headline catastrophes created an attractive entry point for investors into the company. The company's strategy differentiates it from the Bermuda reinsurance sector with which it is often grouped. We gladly bought Arch, believing in its ability to continue to generate attractive returns for shareholders.

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Important notice