Equity Spotlight
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CREDO

Benefiting from the insurance cycle

Death and taxes are life’s only certainties according to Benjamin Franklin. Car insurance might as well be added to that list. If you drive a car in America, you are legally required to have insurance in 49 out of 50 States. New Hampshire, the only exception, has a population representing only about 0.4% of the country. In the European Union, third-party car insurance is mandatory in all countries.

Car insurance is, by and large, a commoditised product. Few of us care which company we ultimately select, so long as it is the cheapest quote. Insurers offer similar ranges of deductibles and levels of cover. Some try differentiating with add-ons (courtesy cars, vouchers, etc.) but with little success. Ultimately, price is what matters to customers.

Whereas traditionally car insurance was peddled by agents (on generous commissions), over the past few decades, the direct-to-consumer channel has flourished. At first, direct policies were sold over the telephone, later over the internet and more recently through mobile phone apps.

In the UK, price comparison websites have facilitated apples to apples comparisons and accelerated direct penetration. These websites are slowly gaining traction in Europe. However, they have not taken off in the US, despite repeated attempts, because each of the 52 states has their own regulations.

Whereas the industry is extremely competitive where pricing power is non-existent, auto insurers’ respective profitability profiles are anything but uniform. Profitability, by which we mean “return on equity” (ROE), is comprised of three components: (1) profit margins (2) asset turnover and (3) financial leverage. The first two of these provide a sustained competitive advantage for companies such as Progressive and GEICO.

Profit margins are measured by the appropriately named “combine ratio”, which is comprised of two components: firstly, “loss ratio” which measures underwriting expertise; secondly “expense ratio” which measures operational efficiency. Ajit Jain’s comments in Berkshire Hathaway’s 2019 shareholder meeting explain these concepts, “*GEICO has a significant advantage over Progressive when it comes to the expense ratio to the extent of around seven points or so. On the loss side, Progressive does a much better job than GEICO does. They have, I think, about a 12-point advantage over GEICO. So net-net, Progressive is ahead by about five points*”.

Operational efficiency is company specific. The expense ratio of a scaled, national operator would be lower than a regional competitor. Direct sales would have a lower expense ratio by cutting out the agents. Since GEICO exclusively sells direct, whereas Progressive operates in both channels - its superior expense ratio is unsurprising. Overall, Progressive still generates superior combine ratios though - taking into account both operational efficiency and underwriting prowess.

Superior underwriting is also company specific – involving different internal risk models, data inputs such as telematics, credit scores, demographics, addresses and qualifications. When asked to compare Progressive versus GEICO (controlled by Berkshire Hathaway), Warren Buffett commented at a recent AGM, “*Progressive has had the best operation in recent years in terms of matching rate to risk. I mean, that's what insurance is all about, among other things.*” ▶▶

His deputy Ajit Jain commented further, “*There's no question Progressive is a machine. They're very good at what they do, but it's underwriting…GEICO had clearly missed the bus and were late in terms of appreciating the value of telematics. They have woken up to the fact that telematics plays a big role in matching rate to risk. They have a number of initiatives and, hopefully, they will see the light of day before not too long and that'll allow them to catch up with their competitors…but when it comes to branding, GEICO I think is miles ahead of Progressive and in terms of managing expenses, well, I think GEICO does a much better job than anyone else in the industry*.”

Asset turnover, the second component of ROE, measures how efficiently an insurer uses its asset base to generate revenue. The late Jack Cohen (founder of Tesco) had a motto, “pile it high and sell it cheap”. Supermarkets, like insurers, have little pricing power, hence Cohen sought to generate superior returns through higher volumes, which more than made up for the sacrificed margin. As the direct channel has lower cost structures and is more asset light (distributed online, through telesales teams), it is inherently more scalable than the agency channel. Direct operators typically offer the lowest prices and focus on growing volume through catchy national advertising campaigns. GEICO has the Gecko and Progressive has the fictional character Flo, who has become an iconic national mascot.

Progressive’s industry leading ROE has allowed it to consistently take market share over the past three decades. Ample runways remain for this trend to continue (the company only has mid-teens % market share today). Mr Buffett concurred at Berkshire’s FY’21 AGM, “*State Farm is still the largest auto insurer. I will predict that five years from now, it's very likely that the top two will be GEICO and Progressive and in which order, we'll see. But both companies are going to do very well in my opinion*.”

The insurance industry follows a cycle, such that underwriting margins and ROE tend to overshoot both to the up and downside, but always mean revert. By way of explanation, during the lockdown, insurers’ profit increased due to fewer accidents. The high profit margins attracted more capital, resulting in a “softening market” (lower pricing). In turn, lower pricing reduced margins – however underwriters never know by how much since they must price today what will only be known in a year’s time. Who could have predicted Covid 12 months prior!

The reactive nature of underwriting guarantees that pricing will ultimately overshoot both to the up and downside. Fast forward to 2022 and that is exactly what has happened. Today underwriting margins have collapsed due to normalising accident frequency and cost inflation. Now capital is retreating and giving birth to a “hardening market” (rising prices).

Covid has amplified the insurance cycle creating a longer-term entry point in our opinion. We added Progressive to the Credo Best Ideas Portfolio at the start of 2022 and increased its weight in the Credo Global Equity fund (CGEF). In just the last month, we have added Admiral to the CGEF and Dividend Growth Portfolios, which we believe is the long-term auto insurance winner in the UK market. ■

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