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Known Unknowns

We are currently in the Atlantic hurricane season which runs from June to November each year. In late September 2022, Hurricane Ian struck the US state of Florida and the narrative in the media became somewhat hysterical as a result. President Biden, facing mid-term elections in November, warned that it may be Florida's deadliest storm ever. Coincidentally, the state is governed by one of the most popular Republican (potential) nominees for the 2024 presidential election, Ron DeSantis. Biden assures us though, "this is not about …. anything having to do with our disagreements politically. This is about saving people's lives, homes and businesses."

Climate experts have warned that similar catastrophic events could become more frequent and severe as a result of global warming. Some investors ask what that means for Property & Casualty (P&C) insurance companies. Often when one reduces a question to the absurd, the answer becomes clearer. In a world with no hurricanes, there would obviously be no need for catastrophe cover. Therefore, increased frequency and severity of events act as a long-term growth driver for the sector. We believe that industry profitability will mean revert, as we see with other insurance capital cycles.

This view is backed by empirical evidence over the last 30 years. In 1992, Hurricane Andrew directly struck Miami, Florida and was the most destructive on record at the time (as measured by insured losses). Andrew was a "Category 5" storm, which is the point where the Saffir-Simpson Hurricane Wind Scale stops counting how strong it is. Since records began, only four Category 5 storms have ever hit the United States – in the years 1935, 1969, 1993 and 2018. Moreover, the metropolitan complex from Miami in the south, to West Palm beach in the north, is one of the largest coastal population centres in the US exposed to hurricanes. It includes affluent cities such as Fort Lauderdale and Boca Raton. Put simply, Andrew was as severe a storm as we've had in the past century, hitting one of the largest US coastal populations head-on.

In the aftermath of Andrew, the cost of hurricane reinsurance, as measured by the World Property Catastrophe Index, skyrocketed a year later and has never since reached those highs in the past 30 years. The reason for this is that the "hard" market attracted more sophisticated underwriters such as Lloyds, who employed catastrophe models to more efficiently price risk and transfer excess risk off their balance sheet by utilising syndicates, reinsurance and securitisation (issuing catastrophe bonds and insurance linked securities). Altogether, we now have a much deeper, more efficient market for hurricane risk.

Catastrophe insurers now stress test using "realistic disaster scenarios" (RDS) as 1 in 250-year or 1 in 100-year events. Over the past 30 years, insurers have built up a trove of empirical data and they can provide a reasonable estimate of what a hurricane of a specific size hitting a specific location might cost. By way of example, Hurricane Andrew today would cause insured losses estimated in the range of $80-90bn. Lloyds currently estimate a RDS for a Florida windstorm hitting Miami-Dade at $130bn, which would be roughly 50% more damaging than Andrew and which there is no precedent for. In their annual reports, many of our holdings actually disclose exposure to such RDS.

Size is not everything when it comes to hurricanes. Andrew was not unusually big, but it was as severe as it gets in terms of wind speed, which is what caused the damage. By contrast, Hurricane Katrina (2005), which is the most damaging storm to impact the US to date, was a very large, Category 3 storm. Katrina's damage was mainly inflicted by flooding (not wind) as a result of the unprecedented storm surge which breached New Orleans's levees.

Reinsurance pricing spiked in the aftermath of Katrina, though it never reached the peaks after Andrew. Frequency matters too. 2017 was the costliest catastrophe year on record due to 3 mid-size hurricanes hitting the US mainland. By that time, however, the insurance industry's risk management had evolved to the extent that the 2017 losses were mostly an "earnings event", which could be absorbed by the balance sheet and not a "capital event".

In the world of insurance, it is the unprecedented which has not been priced for which concerns us most, not the precedented which is already understood. A recent example of an unprecedented event is the wave of "business interruption insurance" cases in the wake of the Covid-19 pandemic. Business interruption insurance is written to provide property cover where damage causes temporary interruption – for example a burst pipe flooding a restaurant. However, some businesses tried to claim for government-imposed Covid-related shutdowns where there was no damage to a property. The issue became politicised and there have been different legal opinions by courts in different countries based on similar contract terms. As history shows, there is no free lunch. The cost of future cover has adjusted, and business interruption is today much more expensive as a result.

Ex-US Secretary of Defence Donald Rumsfeld once opined *"as we know, there are known knowns; there are things we know we know. We also know there are known unknowns; that is to say we know there are some things we do not know. But there are also unknown unknowns - the ones we don't know we don't know. And if one looks throughout the history of our country and other free countries, it is the latter category that tends to be the difficult ones*".

If you don't believe us, nor Mr Rumsfeld, then believe Mr Market, which is unconcerned. None of our five P&C insurance holdings, which have exposure to Florida, have underperformed over the past three months. ■

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