CREDO WEALTH

Profitable pricing

During the recent COVID-19 induced market sell-off, the insurance components of the S&P 500 fell approximately 45% from their February highs. As businesses were forced to close, events cancelled and earnings lost, investors grew fearful that insurance companies would be forced to pay out on policies never priced to cover this kind of risk.

Insurance in its earliest form is reported to have existed as early as 4000-3000 BC, with Chinese and Babylonian traders looking to reduce the level of risk they were exposed to when sailing the rivers and seas. In the medieval era, more formalised contracts for insurance began to be developed in fields such as marine and property, particularly after the Great Fire of London.

Essentially, insurance involves the transfer of risk from one entity to another: the first party agrees to pay a fixed amount in exchange for the second to cover costs should the insured incident occur. In order to price the policy profitably, the insurer must be able to accurately estimate both the amount of the loss as well as the likelihood of it occurring. Therefore, whether it be the sinking of a ship and the loss of its cargo or the closure of a business due to flood or fire damage, insurance is generally designed to cover events which are finite in time and geography.

The main concern for investors in the wake of COVID-19 has centred around Business Interruption Insurance. Many businesses have been submitting claims in order to try to recuperate some of the lost income due to the pandemic. The concern was that, due to the vast geographic spread of the virus and the unknown time over which earnings will be impacted, should insurance companies be required to pay out, the cost could be astronomical. Policies written to cover more normal reasons for business closure have never been priced to cover this magnitude of pay-out.

In the United States, insurance coverage is more uniform than in other parts of the world, with many of the policies taken out by small and medium sized businesses based on standardised language called ISO forms. This means that if it is ruled that COVID-19 is covered by one of these policies, it will be covered for anyone who has taken out such a policy. The result is that the United States insurance industry stands much more united than in other parts of the world in defending themselves against such claims.

The main challenge for policyholders trying to make a claim is that the ISO forms typically require the property to be damaged to trigger a pay-out. It is extremely debatable whether COVID-19 would constitute property damage. In addition, in order to even claim property damage, policyholders would need to prove that the virus was on the premises at the time of the closure, something which the vast majority of businesses will probably not be able to do. To make things even more difficult, these policies generally have clauses which exclude virus outbreaks.

Without doubt there will be cases where insurers are required to pay out, for example event cancellations as well as policies where notifiable diseases are explicitly covered. Moreover, some of these will be for significant amounts.

Event cancellations are, however, finite, with the potential earnings losses upon cancellation easily estimated in advance. Policies with specific virus coverage are typically designed to cover outbreaks such as Norovirus. These are usually limited as far as both geography and time are concerned, and pay-outs are also normally limited to an overall dollar amount. In the case of both event cancellation as well as specific virus coverage, potential losses are thus known up front, allowing for inclusion in the price of the insurance.

One final risk that investors have been worrying about relates to political action which may force insurers to pay out. However, we believe it is unlikely that retrospective action by a political entity to alter an agreement between two private parties will ultimately be upheld within the US court system. Early cases in states where political action has been attempted have been decided in favour of the insurance companies.

In general, after periods of catastrophic losses, industry pricing tends to increase. Events for which companies were previously estimating total losses are now quantifiable. In addition, the likelihood of such an event, once unimaginable, can now be more effectively reflected in the price. As pricing improves, so does profitability which often makes it an attractive time to own insurance companies.

Whilst it is impossible to tell for sure what the industry losses will ultimately be as a result of COVID-19, we can compare the amount that has been wiped off the share prices of insurers to the magnitude of the likely pay-out.

As a result of our research, taking into account the above points as well as company guidance, we judged that the risk versus reward equation as a result of the sell-off was in our favour, and so we increased our position sizes in both Chubb and Arch Capital in the Credo Global Equity Fund.