CREDO WEALTH

An improved outlook for insurers

After multiple years of a “soft” pricing environment, Covid-19 has been the catalyst for a change in the insurance cycle. Over the last few quarters pricing has substantially improved, signalling the start of a somewhat “harder” market. As such, we believe that the outlook is rosy for holdings such as Chubb, Arch Capital and Beazley.

The prolonged soft market had been caused by an excess of supply. As adequate returns became harder to find in the equity and bond markets, an abundance of capital flowed into the insurance market from investors, putting pressure on pricing.

Insurance companies must hold sufficient reserves to ensure that they are able to pay out in the event of a claim. In most years, only a small proportion of customers will claim on their insurance policy and therefore liabilities are limited. However, every so often a completely unexpected major event happens, which results in significantly higher claims than were ever expected or provided for in the reserves. In addition, the market also becomes much less attractive to the “hot money” investors who had been chasing returns with little attention paid to the risks. The result is that capital across the industry becomes depleted, necessitating higher future pricing and profitability to replenish balance sheets and reserve levels. In addition, the unforeseen event for which there had been no previous loss estimates is now quantifiable and pricing can be adjusted such that a premium for covering the risk of reoccurrence is included. Alternatively, the risk can be explicitly excluded in the policy terms. The result is that the industry enters a “hard” market with stronger price inflation and underwriting margins.

One example of such an event was 9/11. In the aftermath, many insurers had insufficient reserves to pay out on such an unimaginable event. In the subsequent hard market, some of the smartest underwriters started new firms, including Arch Capital. Arch was founded on the philosophy that the company should focus on maximising returns over the long term. Sometimes, this means holding back and not chasing growth in policies or, alternatively, buying reinsurance to hedge the risks when the returns from underwriting don’t stack up. Instead, management focus on disciplined underwriting and only allocating capital to areas where they can achieve satisfactory long-term risk-adjusted returns. Chubb and Beazley are both also run with a similar mindset. The outcome of this management style is that when the market does harden, companies have capital to deploy and will be able to grow volumes and market share.

As the global pandemic forced entire countries into lockdown, the market became concerned about the impact of Business Interruption insurance and the pay-outs that might be claimed as businesses tried to recoup some of their lost income. Ultimately, this did not materialise as a major loss event for our holdings. However, significant pay outs have been made for event cancellations and cyber insurance. Insurers of events or conferences must now factor into their pricing the possibility of events being cancelled or without crowds due to Covid outbreaks. As people shifted to working from home, the risk regarding cyber-attacks has changed materially and did result in an increased number of cyber-attacks. The result of this more uncertain world is that insurance pricing has substantially increased over recent quarters. A previously unconsidered global pandemic is now being priced into premiums since it is now possible to foresee and assess the damage. Management of Chubb have described the current market environment as the best conditions for 15 years. ▶▶

One last aspect of the current environment that gives us cause for optimism is the current interest rate environment. Insurers generate a portion of their income through investments, which has been negatively impacted by the rapid drop in interest rates. Moreover, excessively low rates in the aftermath of the global financial crisis precipitated the soft market, as financial investors sought yield in non-traditional markets. Whilst we do not bank on a recovery in interest rates in the near term, a return to more normal levels over the medium term would provide a tailwind.

We increased our overall positions in Arch and Chubb in the Global Equity Fund in May 2020, and subsequently purchased Beazley in November of that year. We continue to hold all 3 companies in the Global Equity Fund, Chubb in both BIP and DGP and Arch in BIP. ■

Important notice