The Henry Fund
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Property & Casualty Insurance

Financial Services – Insurance

Industry Rating **Market-Weight**

Investment Thesis

We recommend a **Market-weight** position for the Property and Casualty insurance industry. Rising interest rates will increase net investment income for the companies, however premium growth has been low in the past few years.

Drivers of Thesis

- P&C industry benchmarks have been improving and we forecast these to continue. Benchmarks such as combined ratio, net premiums written, and net investment income.
- The correlation between Property & Casualty insurance and the state of the economy. The Henry Fund consensus is that GDP growth rate will decrease in the short-term and long-term.
- Underwriting has had a strong turnaround from a $3.7B loss in the first half of 2017 to a $6.7B gain in the first half of 2018. We estimate that companies will be aggressive making up the losses of 2016 and 2017.

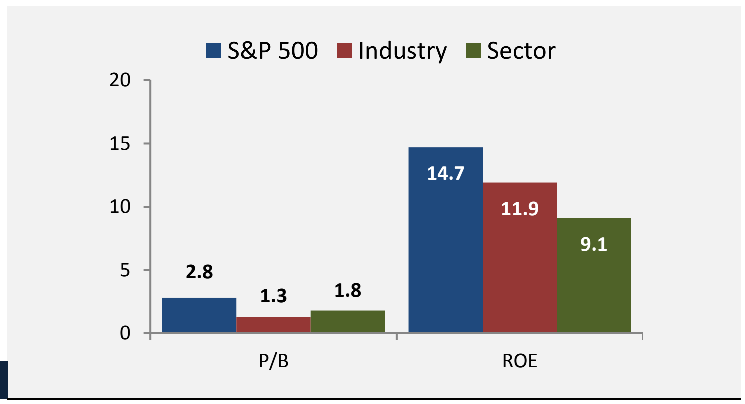
Risks to Thesis

- The trade war between the United States and China could create a new trade deal that fuels a growth in the world economy.
- The recent interest rate hikes will increase net investment income.

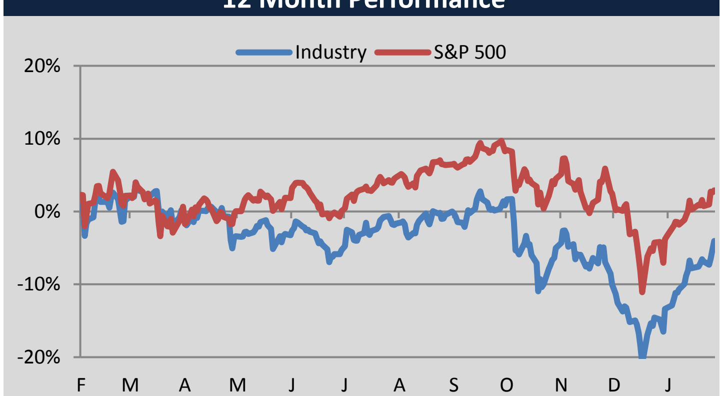
Industry Leaders

U.S. Premiums Written ($mil) 2017	
State Farm	$64,892
Berkshire Hathaway Inc.	$38,408
Liberty Mutual	$33,831
Allstate Corporation	$31,501
Progressive Corp.	$27,862
Travelers Companies Inc.	$24,875
Chubb Ltd.	$21,266
USAA Insurance Group	$20,151
Farmer Insurance Group	$19,855
Nationwide Mutual	$19,218
Total Revenue ($bil) 2017	
Berkshire Hathaway Inc.	$242
People's Insurance China	$71
Zurich Insurance Group	$64
AIG	$49
Tokio Marine Holdings	$48
MS&AD Insurance Group	$47
Liberty Mutual	$42

Key Statistics



12 Month Performance



Industry Description

The property and casualty (P&C) insurance industry offers products that provide financial support if possessions get damaged, thus limiting risk. The industry is dependent on analyzing risk and distributing that risk over all of their clients. The P&C companies take premiums from clients and reinvest those proceeds.

EXECUTIVE SUMMARY

The insurance industry faces a stagnant growth rate in a declining economy or recession. Emerging markets offer the greatest returns through insurance premiums where in China in 2017 were up 15.4%. [1] Property and Casualty insurance premiums are highly correlated with the economy. The Henry Fund has a consensus of a decrease in GDP growth due to the trade wars and government shut down. Thus we are predicting a low growth rate of 0-2 % in 2019.

Technology is changing the industry through blockchain and big data. Insurance companies are protecting their client's data through blockchain. Insurance companies can better understand each client and tailor a personalized policy that will reduce risk.

Net investment income will increase for insurance companies in 2019 due to the four interest hikes in 2018. Insurance company's investment assets are in majority of interest-sensitive assets. Thus will earn a greater return on that invested capital

INDUSTRY DESCRIPTION

The insurance industry is a collection of companies that offer risk management through insurance products.

Insurance company's business models are based around analyzing and diversifying risk. These companies pool together risk from individuals and redistribute that risk across their portfolio. Revenue is earned by charging customers premiums and reinvesting those premiums into low risk interest-generating assets.

Underwriting is the heart of all insurance companies, poor underwriting leads to: high risk exposure, and outpricing customers, If a company has strong underwriting practices then that company should bring in more money in premiums than it spends on payouts. In 2016 insurance carries contributed 2.7 percent of U.S. gross domestic product. [1] Insurance fraud is always a concern for insurance companies, "Property Casualty Insurers Association of America and FICO said that fraud accounts for 5 to 10 percent of their claims costs". [1]

P&C Insurance

U.S. P&C Insurance 2017		
Firm	Premiums Written	Market Share
1. State Farm	$ 64,892,583	10.1%
2. Berkshire Hathaway Inc.	$ 38,408,251	6.0%
3. Liberty Mutual	$ 33,831,726	5.3%
4. Allstate Corp.	$ 31,501,664	4.9%
5. Progressive Corp.	$ 27,862,882	4.3%
Source: Insurance Information Institute		

P&C insurance protects possessions from damage or theft. P&C insurance a wide range of possessions, but the most common are renter's, car, home, and flood insurance. An example of casualty insurance is workers compensation which will provide financial support to an employee insured on the job. We project that the P&C insurance growth rate will be between 0 to 2 percent in 2019, due to the slowing economy and trade war.

P&C Industry Analysis	2016	2017
Net premiums written	$528.30	$552.60
Percent change	2.70%	4.60%
Premiums earned	$523.50	$540.60
Losses incurred	317.9	347.5
Loss adjustment expenses incurred	60.3	62.7
Other underwriting expenses	147.6	151.1
Policyholder dividends	2.3	2.6
Net underwriting gain/loss	-4.7	-23.2
Net investment income	46.6	49
Miscellaneous income/loss	1.1	-5.4
Operating income	43	20.3
Realized capital gain	7.3	15.1
Federal and foreign income tax	7.4	-0.7
Net income after taxes	42.9	36.1
Source: Insurance Information Institute		

The chart above shows that net income for the P&C insurance industry decreased by 16% from 2017 to 2016, even though premiums earned increased by 3%.

Reinsurance

Reinsurance is insurance for insurance companies. Reinsurance is commonly used to transfer risk to other parties, it reduces the net liability on risks for a company. It also allows the company taking on the extra risk to increase their underwriting capabilities

Reinsurance leads to more stable outcomes when outcomes with low probabilities happen, as well as makes insurance companies more liquid. Reinsurance revenue for United States insurance companies grew 2.88% in 2018 from 2017. [7]

Investments

Insurance companies receive premiums for their clients and reinvest those premiums to grow their assets. Insurance companies investing strategy focuses on low-risk and diversification. The main four asset classes that insurance companies invest in are stocks, bonds, mortgage securities, and money markets. Different types of insurance companies will have different asset allocations in their invested portfolio.

In 2016 invested assets for sectors P&C, and Life/Health was a combined $5.48 trillion. 61 percent of P&C assets were invested in bonds, while 74 percent of Life/Health assets were invested in bonds. [1]

INDUSTRY TRENDS

Technology Trends

The millennial factor is what is going to drive the technology trends in the insurance industry. In 2019 millennials will outnumber baby boomers for the first time. Insurance companies that can reach this market in a tech-savvy, and personalized way will set themselves apart from their competition.

Insurance companies have important data on their customers such as medical records. Insurance companies are using blockchain to make their customers data safer by decentralizing their data. The advantages insurance companies will see through using blockchain is improved risk management, reduced time for claim payouts, and enhanced trust from their customers.

Big data is going to help insurance companies create a more personable policy for their clients. Auto insurers can get know in real time what a potential customers driving habits and mileage through vehicle tracking. Life insurers can use biometrics through wearable technology to track a person's health and can offer a lower rate to people who exercise regularly. A personable policy will lower premiums, but the insurance company's risk will be lower because they have more information on their liabilities. [11]

Shifting Demographics

Many baby boomers are still working past 65 and are driving to work. P&C insurers are adjusting to that by increasing premiums due to the decrease in vision and physical abilities. Millennials prefer to rent rather than own a house or apartment. Creating less of a need for homeowners insurance and a greater demand for renters insurance. However, even with these changes only one-third of renters have a renters insurance policies. [1]

Evolving Regulations

Sales of US annuity products. SEC proposed a rule which a broker dealer would be required to act in the best interest of a retail customer. [2] The SEC now requiring raw data instead of summary spreadsheets. This can expose client's private information, but gives the SEC more tools to investigate activities.

MARKETS AND COMPETITION

Porter's 5-Forces

Threat of New Entrants: Is low to small entrepreneurs because of the amount of capital needed to create a diversified portfolio. However, the threat of new entrants is high from other financial service companies such as banks or investment banks. These companies have the capital to disrupt the market, but some countries prohibit banks from entering the market. Access to distribution channels would not be difficult, new companies could sell directly to their customers via the internet. The largest threat of new entrants is from existing insurance companies that create a subsidiary companies to specialize on one area of the market.

Power of Suppliers: The power of suppliers is low for capital, and distribution channel. However, larger companies threaten smaller companies by luring away their human talent in the form of underwriters. The access to more and larger markets could attract the talented underwriters at smaller insurance companies.

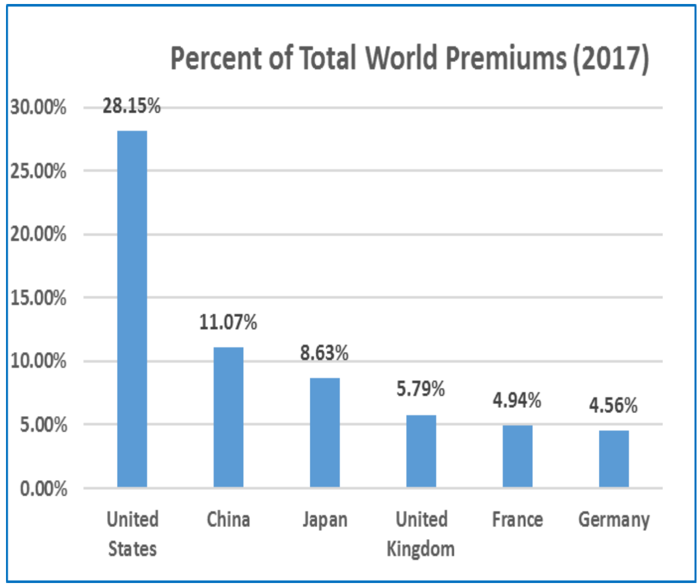
Power of Buyers: Corporate insurance clients have a large amount of buying power due to the amount of people and dollars they represent. On the flip side an individual has low buying power because of the amount of money that individual brings in compared to the industry as a whole.

Threat of Substitutes: There are multiple substitutes available for customers in the most common insurance categories health, life, and P&C. However, in the niche markets of insurance such as seniors and hazardous sports companies can have a competitive advantage.

Competitive Rivalry: Is high due to the amount of insurance companies there are, as well as the accessibility of customers to find other insurance company's quotes. Many large insurance companies offer very similar products, making competition between insurance companies high. What separates these companies is how cost efficient their operations are.

In summary if an existing insurance company sees an area of the market where they could steal market share they will go for it. Underwriting and risk management talent can be the best asset a company can have and to be successful in a mature market a company must have lean operations.

Developed Countries (Europe, Japan, North America)



Source: Insurance Information Institute

Life insurance in North America and Europe are mature markets that are limited for growth. In 2017 developed countries recorded a low growth rate of 1 to 2 percent. [4]

Developing Countries (China, Central America)

Life insurance in developing countries there was a high growth rate in premiums written in 2017. These markets saw growth rates between 12 to 15 percent. [4]

Peer Comparisons

State Farm

State Farm's lines of business includes P&C insurance, life and health insurance, annuities, mutual funds and banking products. The P&C business is where State Farm focuses on, they insure more cars and homes than any other insurer in the U.S.

As of 2017 they had 83.4 million policies, 44.1 million of those were in auto. In terms of assets State Farm is the 101st largest bank in the U.S. with \$16.7 billion in assets.

Float rate = 99.8%, ROE = 15.55%, P/B = 0.90 [2]

Allstate Corporation

Allstate is the largest public personal line insurer in America, serving more than 16 million households worldwide. [9]

Float rate = 99.7%, ROE = 14.79%, P/B = 1.79 [2]

Berkshire Hathaway

Berkshire Hathaway has more than 17 million auto policies while insuring more than 28 million vehicles. Is the fastest growing major auto insurer in the United States.

Auto insurance is what they're known for, Berkshire Hathaway also is the homeowners, life insurance, property insurance, and flood insurance business as well.

Float rate = 99.3%, ROE = 24.54%, P/B = 4.47 [2]

ECONOMIC OUTLOOK

Major economic drivers to the insurance industry is GDP growth and interest rates.

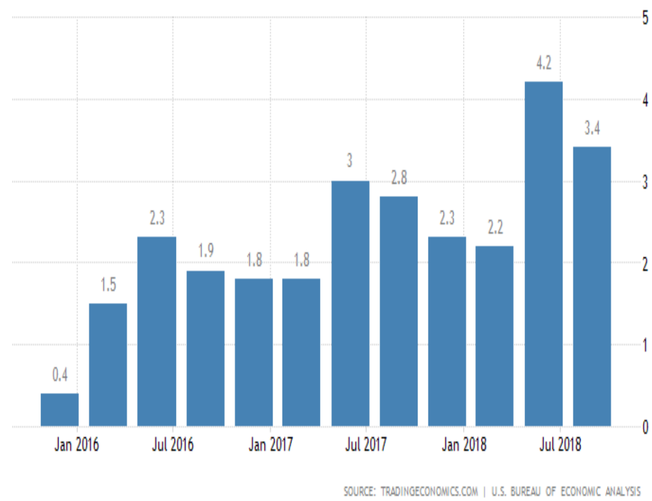
5-yr treasury rate

Source: Macro Trends

The chart above shows that 5-yr treasury rate is close to its 5-yr high. Long-term interest rates are a basis for long-term fixed income returns. The majority of insurance investment portfolios are interest rate sensitive assets this is a major driver of income for insurance companies.

The Henry Fund has a consensus that the 1-yr T-Bill yield will increase from its current rate of 2.58% to 2.80% in 6 months, and to 3.10% in two years. We predict that the fed will increase rates one time in 2019 and one time in 2020. The interest hikes will increase net investment income.

GDP growth rate

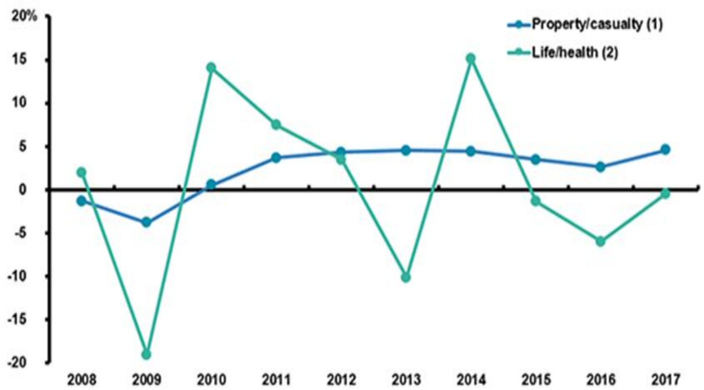


Source: Trading Economics

The chart above shows GDP growth rates. P&C premiums written is heavily correlated with the state of the economy and consumer spending.

The Henry Fund has a consensus that real GDP growth in six months will be 3.00% and in two years will be 2.90%. This is not a strong indicator for the P&C insurance industry in the short and long term.

CATALYSTS FOR GROWTH



Source: Insurance Information Institute

For P&C We can see that in poor economic years, 2008 and 2009, that P&C had a negative growth rate. However in years of strong economic growth P&C had positive growth rates.

Interest rates are a catalysts for growth on the investment side of the insurance industry. Higher interest rates make products like an annuity more attractive to investors. If sales increase then the company will have more money to invest in. The majority of insurance company's portfolios are invested in fixed income, thus if rates increase the companies will earn a higher rate.

INVESTMENT POSITIVES

- Interest Rates – The majority of insurance company's investments are invested in interest sensitive products.
- High Insurance Growth Potential – Emerging Markets (Central America and China)

INVESTMENT NEGATIVES

- Economic Uncertainty – GDP levels decreasing, causing P&C premiums to decrease
- Interest Rates – Higher interest rates lead to a weaker GDP because borrowing becomes more expensive.

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