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Insurance Equities: 21 April 2021

The Great Global Insurance Catch-up Trade

Executive summary:

- Global Insurance Equities have lagged the broader market since the onset of the Covid-19 pandemic resulting in attractive relative valuations for the group since the 2008/2009 Global Financial Crisis
- Receding tail risks, an improving earnings outlook, and leverage to global reflation provide catalysts for a broad-based catch-up trade in Insurance Equities in Twelve's view
- Further, an active M&A environment provides both evidence of a large gap between private and public market valuations and a catalyst to close this gap should under-valuations persist
- The Twelve Capital-managed equity strategies and multi asset best ideas strategies are well positioned to take advantage of this catch-up trade

Introduction

Global Insurance Equities have materially lagged the broader market from the pre-Covid peak. As the uncertainties and tail risks associated with Covid-19, financial market turbulence, and uncertain regulatory intervention recede, Twelve Capital sees the resultant once-in-a-decade level of undervaluation as an attractive opportunity for equity investors to rotate meaningfully into insurance industry exposures.

This historic level of under-valuation persists even as capital positions have remained robust, dividend credentials largely intact, and the forward-looking earnings outlook continues to improve.

The (re)insurance market represents an economically significant and important industry characterised by steady revenues, a cyclical product demand, strong dividend yields, and high barriers to entry. These have all remained true throughout the Covid-19 pandemic.

Moreover, it is increasingly clear that the global (re)insurance industry is entering a period of particularly strong fundamental tailwinds as 2021 progresses.

Twelve Capital's equity and multi asset strategies are positioned to take advantage of the coming catch-up trade in Insurance Equities, and particularly tilted to benefit from the triple tailwinds of strong insurance pricing, high relative dividend yields, and leverage to the ongoing global reflation trade.

Insurance Equity Catch-up Trade: current discounts are unwarranted

	P/E ratio relative to broader market		
	2011-2019 average	Current	Discount to 2011-2019 avg
Global [A]	77%	61%	(21)%
Europe [B]	77%	66%	(14)%
U.S. [C]	72%	59%	(17)%

	Index dividend yields			
	Insurance	Broader market	Current excess dividend yield	Excess yield 2011-2019 avg
Global [A]	3.3%	1.9%	140bps	70bps
Europe [B]	4.9%	2.9%	200bps	110bps
U.S. [C]	2.4%	1.4%	100bps	(10)bps

[A] MSCI World Insurance[1] vs MSCI All World[2]
[B] STOXX Europe 600 Insurance vs STOXX Europe 600[3]
[C] S&P 500 Insurance[4] vs S&P 500[5]
Source: Bloomberg, Twelve Capital. As at 13 April 2021.

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[1] The MSCI World Insurance Index is an Index focused at measuring the equity performance of the c.80 largest listed global insurance companies weighted by free-float of market capitalisation.
[2] The MSCI World is a market cap weighted stock market index of 1'585 companies throughout the world.
[3] The STOXX Europe 600 has a fixed number of 600 components representing large, mid and small capitalisation companies among 17 European countries, covering approximately 90% of the free-float market capitalisation of the European stock market (not limited to the Eurozone).
[4] The S&P 500 Insurance Index is designed to measure constituents from the Insurance sub-industry of the S&P 500 Index.
[5] The S&P 500 is a market capitalisation weighted index of the largest 500 stocks in the US.

Checking the rear view mirror: Covid-19 insured losses

About one year ago, as the Covid-19 pandemic was accelerating around the globe, commentary from insurance industry participants raised serious concerns about the potential scale of losses that would ultimately be borne by (re)insurers.

Brian Duperreault, then CEO of American International Group, one of the largest commercial property/casualty insurers in the US, predicted that Covid-19 would be "the single largest cat [catastrophe] loss the industry has ever seen" on the company's first quarter earnings call in May 2020[6].

John Neal, CEO of Lloyd's of London, the large specialty insurance marketplace, forecast in May 2020 that Covid-19 related losses would be "of a magnitude that none of us have seen in our lifetime," including total insured losses of over USD 100bn with another nearly USD 100bn in lost asset values for (re)insurers[7].

Over the coming months, industry estimates coalesced around a forecast of total ultimate industry losses in the range of USD 30-100bn. Now, roughly a year on, the top end of this range looks increasingly unlikely. At YE'2020, around USD 35bn of losses have been booked by publicly traded insurance companies[8]. Twelve estimates another USD 5-10bn have likely been booked by privately held insurance companies and mutuals.

Significant sources of realised losses so far have been in event cancellation coverage, travel insurance, and life insurance. These first two categories have largely been addressed via reserving and re-underwriting as policies renew while the on-going vaccine roll-out continues to reduce the impact of the third.

While Covid-related losses are likely to continue to emerge over the coming quarters and years, Twelve believes the most significant areas of uncertainty are largely passed. Business interruption insurance, for example, has been a major source of uncertainty, with important legal disputes around coverage terms in key markets. The courts have largely resolved these questions in the UK and Australia. In the US, where the greatest uncertainty remains, litigation continues. To date, federal courts have ruled in favour of insurers on over 80% of cases where initial rulings have occurred[9].

Indeed, while uncertainty undeniably continues to percolate, the (re)insurance industry has already provisioned for materially more claims than have been made by policyholders. At year-end 2020, more than 50% of reserves set aside by the industry so far, relate to IBNR[10]. This implies ample room for additional claims to be made without further negative earnings or balance sheet impacts for the (re)insurer.

At this point, it is becoming increasingly clear that potentially exposed insurance policies have largely been lapsed, re-written to specifically exclude Covid-19 related exposures, or are well reserved against potential claims.

Further, balance sheets across the industry have been supported by the rebound in financial markets from 2020 lows.

As the global vaccine rollout continues, Twelve sees Covid-19 and related balance sheet concerns as increasingly a rear view mirror issue for the (re)insurance industry.

Nonetheless, while the uncertainty and resultant market anxieties recede, the stocks of (re)reinsurance companies have yet to fully revalue.

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[6] Source: AIG Q1 2020 Earnings Call Transcript.
[7] Source: https://www.ft.com/content/51d32286-5264-4c93-80c3-3d0b0fd4558a
[8] Source: Barclays Research.
[9] As at 13 April 2021. Source: Covid Coverage Litigation Tracker, University of Pennsylvania.
[10] IBNR: Incurred But Not Reported claims, meaning reserves set aside for losses assumed to have occurred, but for which the (re)insurance company has not received any notice.

Looking ahead: (re)insurers are now undervalued

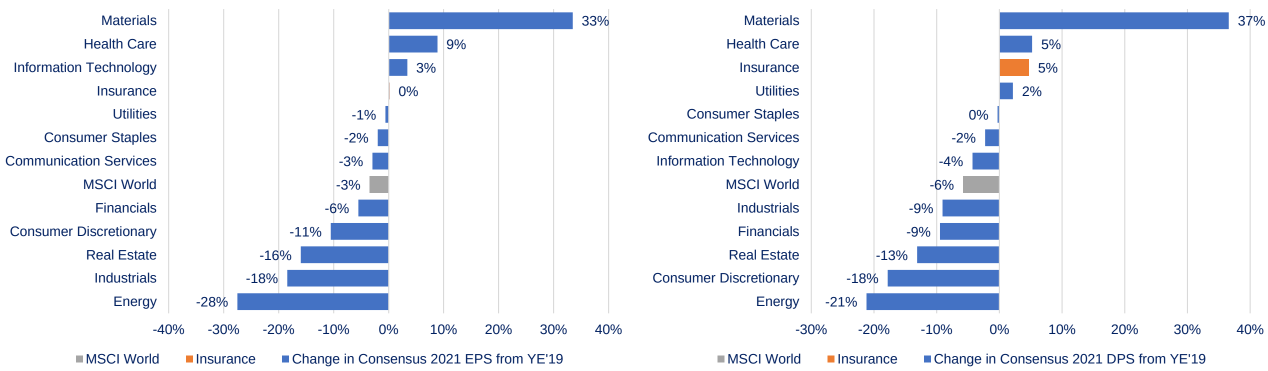
Though showing some recovery from relative lows since October 2020, Insurance Equities globally have posted a total return of just +10% from YE'2019 compared to the broader MSCI World Index of +27%, an underperformance of 17%. This marks the largest relative drawdown for the insurance industry since emerging from the global financial crisis about ten years ago.

Figure 1: Relative total returns – short- and long-term

Source: Bloomberg, Twelve Capital. As at 13 April 2021.

Despite this material underperformance, the insurance industry has been the model of fundamental resilience. Over the same time period, consensus estimates for 2021 EPS for the insurance sector have remained unchanged, compared to a (3)% decrease for the broader market index while dividend per share estimates for the insurance industry are +5% on average, compared to a (6)% decrease for the overall market.

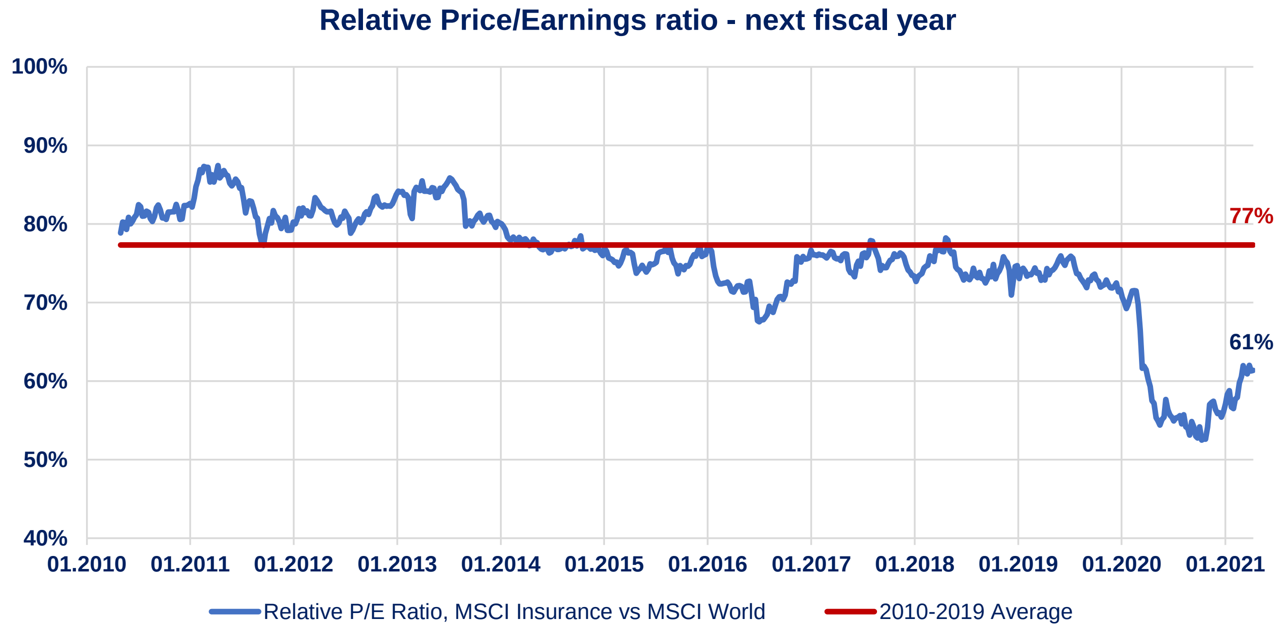
Figure 2: Changes in consensus 2021 EPS and DPS since YE'2019 by sector



Source: Bloomberg, Twelve Capital. As at 13 April 2021.

This sharp underperformance coupled with greater earnings resilience has driven the relative valuation for the insurance industry versus the broader market to lows not seen since the financial crisis. For example, the relative price/earnings ratio on a next fiscal year basis, the sector trades at just 61% of the P/E of the broader MSCI World index compared to average of 77% from 2010 through 2019.

Figure 3: Historical relative valuations



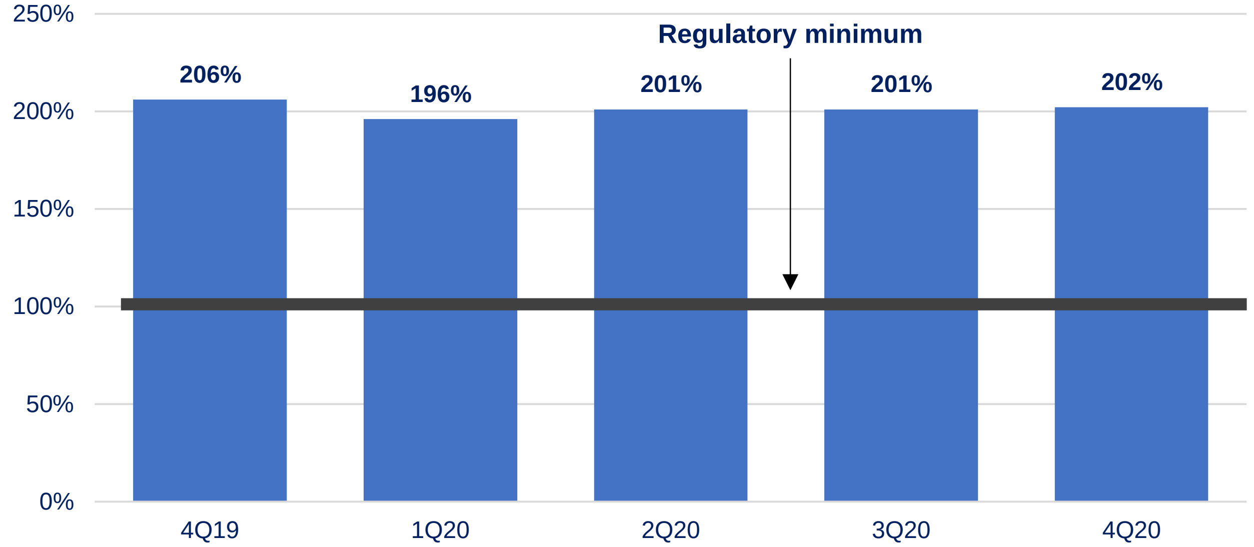
Source: Bloomberg, Twelve Capital. MSCI Insurance P/E relative to MSCI World P/E. As at 13 April 2021.

Dividend credentials: largely intact

As the Covid-19 pandemic evolved, insurance regulators, primarily in the European Union and the UK began to voice caution about insurance company dividend distributions in the face of the evolving global health crisis. With high and stable dividend payouts a key attraction of Insurance Equities, particularly in the single market, this rhetoric only contributed to the pressure on valuations of affected stocks.

Ultimately, the industry has emerged with dividend credentials largely intact and re-affirmed. EU (re)insurers paid out EUR 20bn of the originally declared EUR 24bn in FY2019 dividends. This performance reflected the robust capital positions and risk management of the industry. For example, EU sector-wide solvency ratios declined, as expected, but dropped only 10 percentage points to a still strong 196% of required levels at the low of Q1 2020.

Figure 4: European sector Solvency ratios



Source: Willis Re.

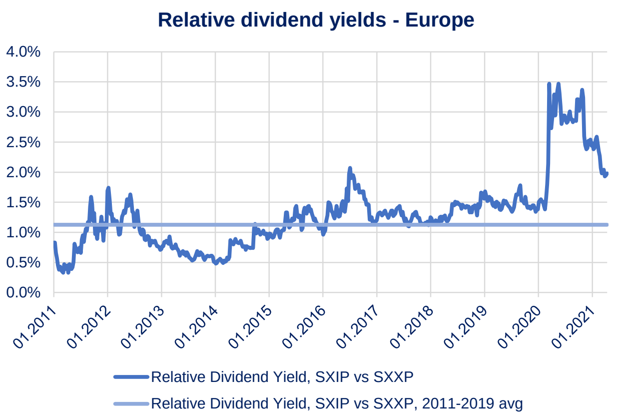
Looking forward, the dividend story for the industry becomes even more compelling in Twelve's view. As noted above, consensus estimates for 2021 dividend per share payouts have actually risen by 5% from YE'2019, compared to a (6)% decline for the broad MSCI index.

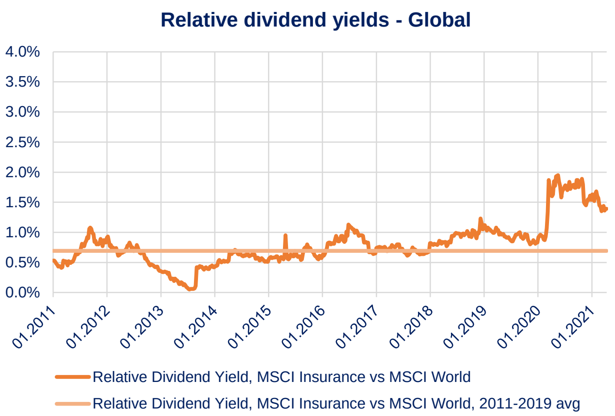
Coupled with relative stock underperformance over the same time frame, this has pushed relative dividend yields among (re)insurance equities to unusually rich levels. Even after partially re-tracing since last autumn, these still sit at post-financial crisis highs.

The current MSCI World Insurance Index dividend yield of 3.3% is 140bps wider than the MSCI World Index compared to an average spread of 70bps from 2011 through 2019. Even more compelling, the 4.9% dividend yield of the STOXX Europe 600 Insurance index is 200bps wider than the STOXX Europe 600 yield, compared to a 110bps historical average.

Viewed another way, in order to narrow the relative dividend yield to historically average levels, the global insurance index would need to rise 27% from current levels.

Figure 5: Relative dividend yields





Source: Bloomberg, Twelve Capital. As at 13 April 2021.

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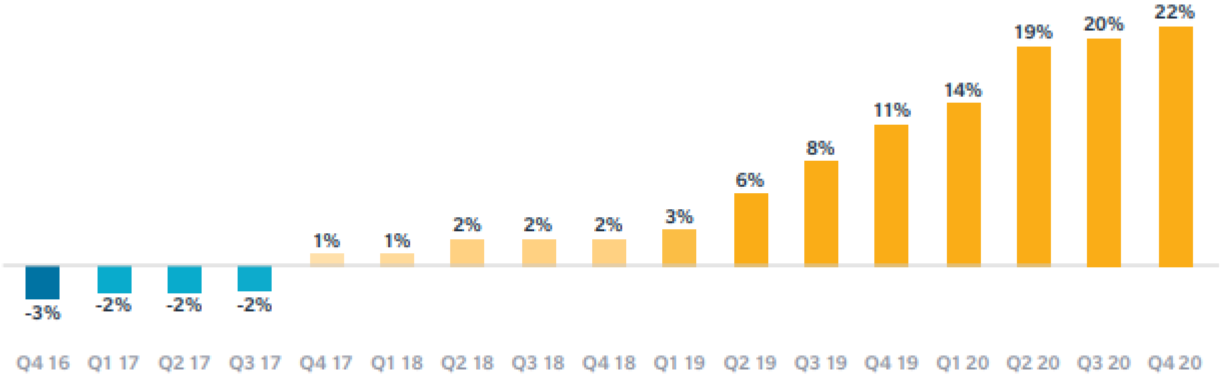
Insurance pricing: improving margins ahead

Pricing in insurance tends to follow broad cycles of soft and hard markets. After several years of a soft pricing environment, pricing began to pick up for commercial lines of insurance around mid-2019 and continued to accelerate through 2020, as seen in Figure 6. Many companies now report seeing the sharpest rate increases since the 2001/2002 hard market.

Figure 6: Global commercial insurance composite price changes



Source: Marsh & McLennan Companies.

There are multiple drivers of this trend, which suggest an extended positive pricing cycle for the industry. These include the need to catch up from years of under-pricing, a heightened risk aversion across companies, recognition of rising natural catastrophe frequencies, and acknowledgement of high claims severity trends (e.g. social inflation).

These rising prices emerge only gradually into (re)insurance company earnings, as higher prices on newly written or renewed policies are only reflected in revenues over the resulting life of the policy. Thus, as the pricing on new and renewed policies written in 2020 begin to earn in over the course of 2021, this should create a meaningful tailwind for earnings. For many commercially focused underwriters, a single point of loss ratio[11] improvement can be worth 5-10% of consolidated earnings, all else being equal, and some companies are likely to observe multiple points of loss ratio improvement over the next several years.

This positive outlook is reflected in commentary from company managers in recent earnings calls and conference presentations, as highlighted in Figure 7.

[11] Loss Ratio is the ratio of claims incurred to premium earned, a fundamental measure of (re)insurance company profitability.

Figure 7: Recent company commentary

"[We] anticipate continued margin expansion into 2021 resulting from the favourable global market conditions."
- Mark Lyons, AIG CFO, 4Q20 Earnings Call

"Commercial P&C rate increases in the quarter, which averaged 16.5% in North America Insurance and 18.5% in Overseas General Insurance, exceeded loss cost trends by 11.5 percentage points and 15.5 percentage points, respectively."
- Chubb 4Q20 Earnings Press Release

"Our average renewal rate increases are the highest we've achieved in over 15 years... allowing us to achieve attractive renewal rate increases in excess of loss cost."
- Carl H. Lindner, American Financial Group Co-CEO, 4Q20 Earnings Call

"Rate is exceeding social and economic inflation by a substantial margin… we see 2021 and 2022 as extraordinary years and maybe even a little past there."
- William R. Berkley, W.R. Berkely Executive Chairman, RBC Investor Conference

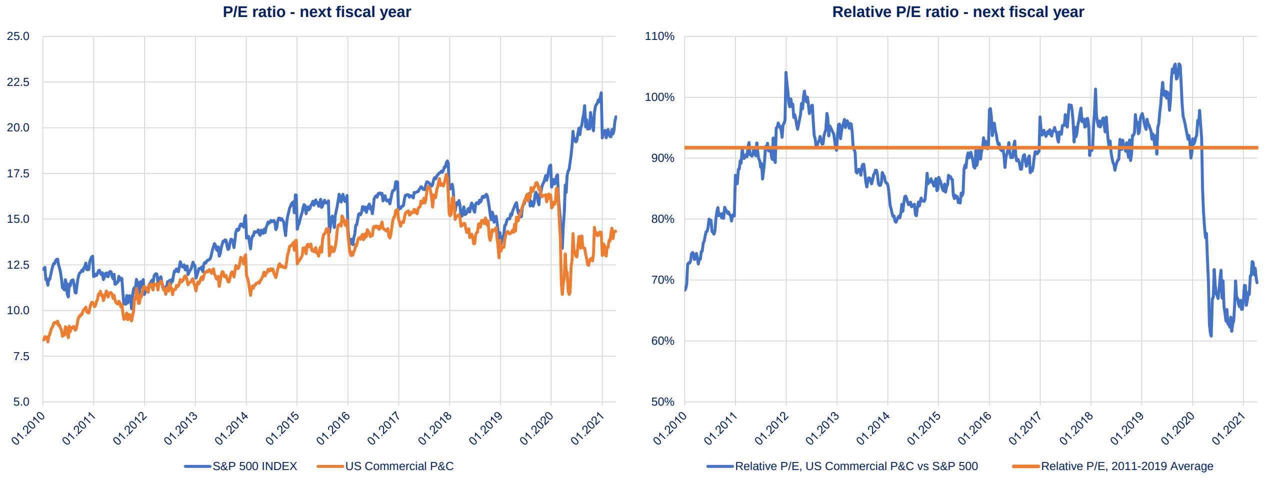
"We anticipate sustained improvement in prices and conditions in both the insurance and reinsurance markets, and Hannover Re is very well positioned to benefit from these market dynamics."
- Jean-Jacques Henchoz, Hannover Re Chairman, FY20 Earnings Call

"Combined with the current price trends, which are expected to continue through this year, I'm really confident that our property and casualty business is well positioned to deliver further strong profitable growth"
- Mario Greco, Zurich Insurance Group CEO, FY20 Earnings Call

"At January 1, we saw opportunities for profitable growth in both of our segments and across our platforms, resulting in the full deployment into our underwriting portfolio of the $1.1 billion raised last June."
- Kevin O'Donnell, RennaisanceRe President and CEO, 4Q20 Earnings Call

Despite this improving outlook, an index of US commercial lines insurers[12] is trading at a (12)% discount to its YE'2019 valuation and a 24% discount to the 2011-2019 average relative valuation versus the S&P 500.

Figure 8: Absolute and relative P/E – US Commercial Lines Insurance



Source: Bloomberg, Twelve Capital. As at 13 April 2021.

[12] The US commercial lines index is a Twelve Capital calculation using a market-cap weighted average of: Chubb Ltd (CB), Travelers Cos Inc (TRV), The Hartford Financial Services Gr (HIG), Cincinnati Financial Corp (CINF), Argo Group International Holdings (ARGO), Markel Corp (MKL), W R Berkley Corp (WRB), Selective Insurance Group Inc (SIGI), and CNA Financial Corp (CNA).

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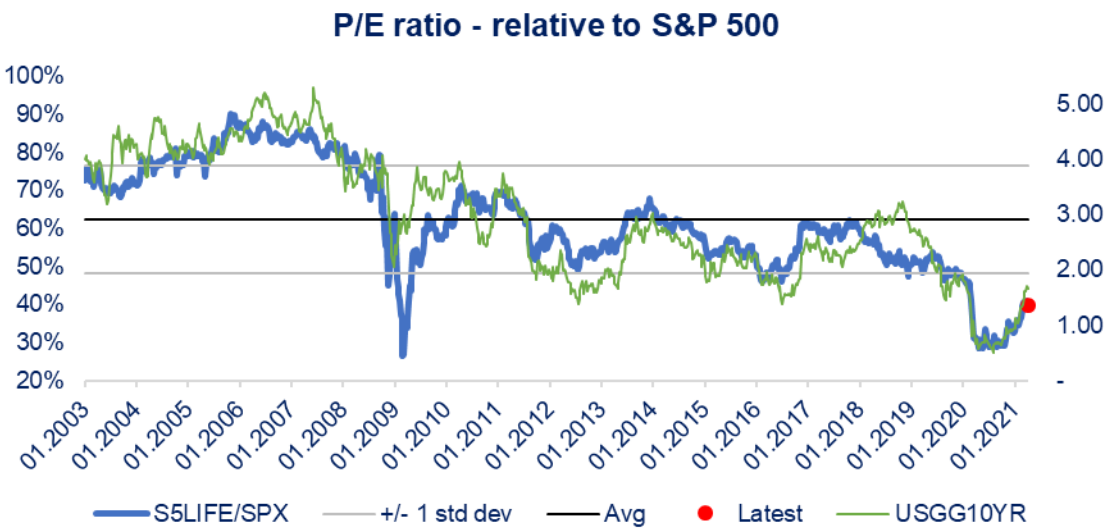
Pockets of reflation leverage

As highlighted in the recent Twelve Capital Spotlight, Riding the Global Reflation Trade, the broad insurance industry in aggregate is generally positively levered to the global reflation trade. Specifically, within the insurance industry, life insurers particularly benefit from rising long-term interest rates.

This can be seen by comparing the US 10yr treasury yield to the P/E ratio of the life insurance sector relative to the overall S&P 500 over time, as in Figure 9.

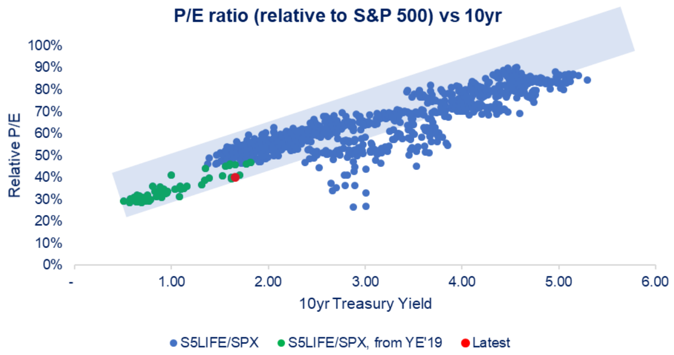
Figure 9: Relative P/E ratio between S&P 500 Life Insurance and S&P 500 vs 10 year US Treasury Yield

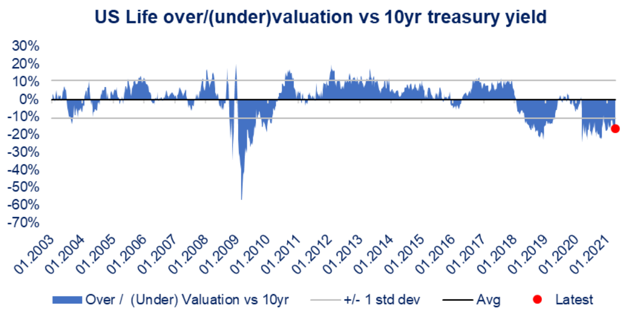


Source: Bloomberg, Twelve Capital. As at 13 April 2021.

Thus, if rates continue to climb higher, Twelve would expect relative valuations on US life insurers to continue to rise from their lows. Moreover, these higher price/earnings ratios would come on top of rising earnings estimates. Finally, as a further point of positive leverage, there remains additional valuation catch-up even within this dynamic, as the life insurance sector is trading at a 16% discount to their historical price/earnings level relative to current interest rate levels, as seen below in Figure 10.

Figure 10: Relative P/Es compared to US 10yr treasury yields





Source: Bloomberg, Twelve Capital. As at 13 April 2021.

Public vs. private valuations: evidence and a catalyst

As insurance valuations have lagged in the face of resilient and improving fundamentals, the industry has seen a pick-up in mergers & acquisition activity in all forms: business line dispositions/acquisitions, private capital acquiring public companies or subsidiaries, and growing public company merger activity.

As one example, American Financial Group's sale of its annuity business to MassMutual, announced in January 2021, is highlighted, which valued the business line at about 12-13x earnings compared to 5-7x P/E ratios that other publicly traded annuity companies trade at currently.

Other notable M&A activity in the insurance space includes Allstate's acquisition of National General Holdings Corporation for USD 4bn (announced July 2020), Equitable's landmark transaction to reinsure a block of legacy variable annuities to Venerable valued at USD 1.2bn (announced October 2020), Zurich/Farmer's acquisition of MetLife's P&C business for USD 4bn (announced December 2020), and Chubb's recent offer to acquire The Hartford for USD 23bn (The Hartford has declined the offer, with industry analysts widely commenting that the proposed price undervalued the business).

Outside of the U.S., insurance M&A has been equally active, highlighted by the November 2020 announcement by UK-insurer RSA that it had agreed to sell itself to a coalition of Canadian insurer Intact Financial and Scandinavia-based Tryg for GBP 7bn.

Beyond whole-company M&A, restructuring and divestures are a growing theme to unlock or realise value at group level. UK-based Aviva has been active with eight announced divestitures since August 2020. Prudential PLC is nearing completion to separate its U.S.-based annuity business to focus on its higher growth Asian life insurance platform. And AIG has been working since October 2020 to separate its life & retirement business from its property & casualty operations, with plans to execute either a sale or IPO of a 19.9% stake sometime in 2021.

This activity highlights the wide gap between valuations placed on insurance businesses by public markets and the value placed on these assets by private capital or industry buyers. Twelve expects continued active M&A and restructuring activity within the global insurance industry to unlock or reveal value for shareholders.

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