Practical Ways to Understand Financial Stocks Better

(and a little more)

AAII – Baltimore
5/13/2017

By David J. Merkel, CFA
Principal, Aleph Investments, LLC

Where to find this Presentation

- http://alephblog.com/?p=9204

Disclaimer

David Merkel is an investment professional, and like every investment professional, he makes mistakes. David encourages you to do your own independent "due diligence" on any idea that he talks about, because he could be wrong. Nothing written here, at RealMoney, or anywhere else David may write is an invitation to buy or sell any particular security; at most, David is handing out educated guesses as to what the markets may do. David is fond of saying, "The markets always find a new way to make a fool out of you," and so he encourages caution in investing. Risk control wins the game in the long run, not bold moves. Even the best strategies of the past fail, sometimes spectacularly, when you least expect it. David is not immune to that, so please understand that any past success of his will be probably be followed by failures.

Also, though David runs Aleph Investments, LLC, this is not intended as advertisement for Aleph Investments; David is not soliciting business through it. When David, or a client of David's has an interest in a security mentioned, full disclosure will be given, as has been past practice for all that David does on the web. Disclosure is the breakfast of champions.

Additionally, David may occasionally write about accounting, actuarial, insurance, and tax topics, but nothing written here, at Aleph Blog, or anywhere else is meant to be formal "advice" in those areas. Consult a reputable professional in those areas to get personal, tailored advice that meets the specialized needs that David can have no knowledge of.

All images in this article are public domain, to the best of my knowledge.

Quick History

- Actuary – Pacific Standard Life, AIG, Provident Mutual Life
- Bond Manager – St. Paul, Dwight Asset Management
- Investment Analyst – Hovde Capital, Finacorp Securities
- Writer – RealMoney.com, Alephblog.com
- Value Investor – Aleph Investments

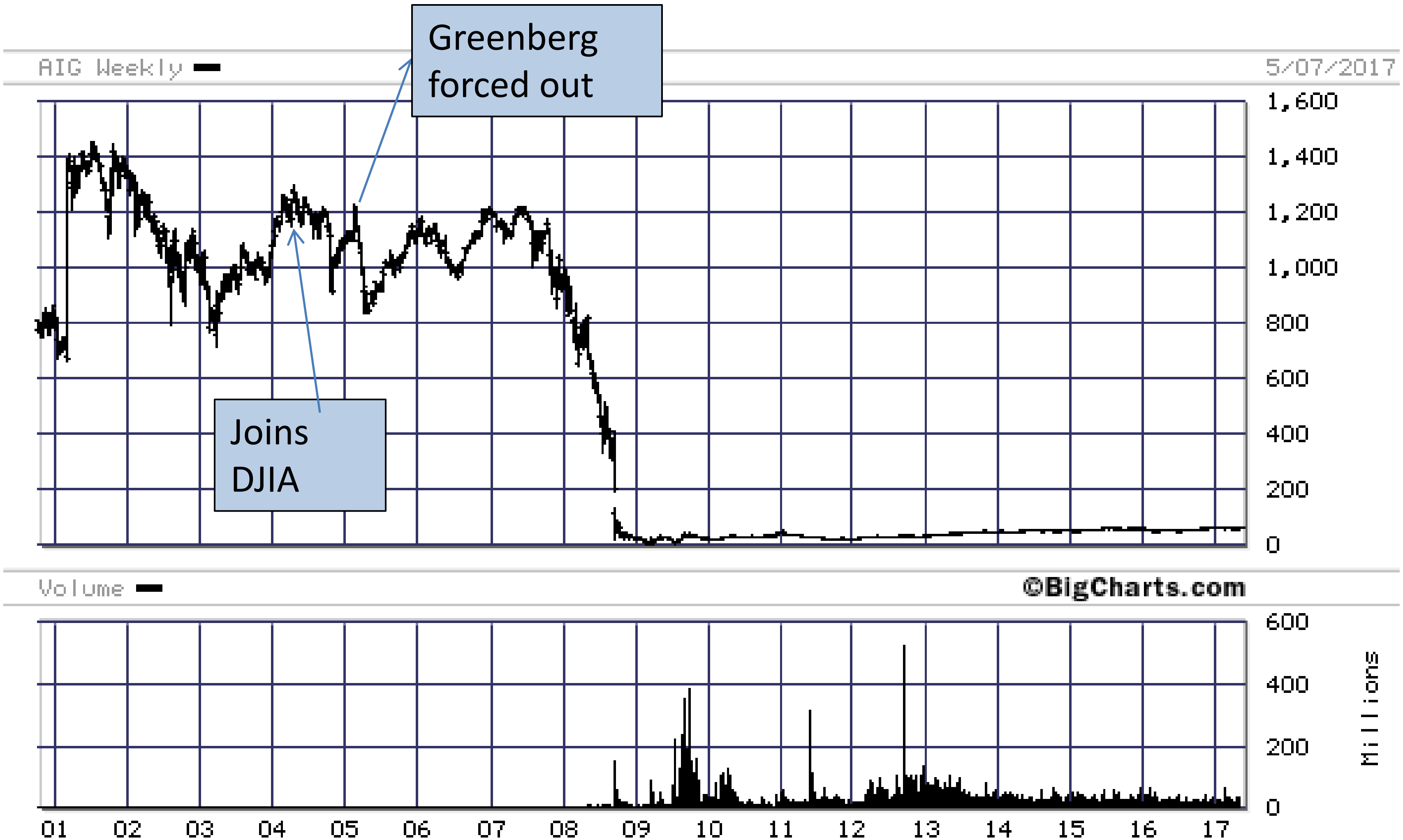
What I Learned From Experience

- Ethics matters most
- Competence matters
- Conservatism matters
- Regulated Financials are more similar than different
- Reputation Matters A LOT
- But not entirely

"Genworth is the One That Always Does It Right"

Expert Comment made here

AIG without Hank Greenberg



What is Different About Financials?

- Accrual Entries Dominate Accounting
- Capital is the Limiting Factor, not Tangible Assets
- Regulators Play a Large Role
- The Assets are the “liabilities,” and the Liabilities are the “assets”
- Quality is Paramount – Management, Accounting
- The Triangle – Growth, Quality, and Price

What Do I Look For?

- Conservative Management
- Competent Management
- Pricing and Loss Trends
- Cheap Valuation
- Ideally, I like to own cheap, misunderstood, well-run, well-capitalized companies in sectors that have increasing pricing power
- Low Asset Risks

Conservative Management

- Willing to grow more slowly when conditions are bad
- Profits before growth
- Focus on growth in book value, excluding SFAS 115, and adding back dividends
- On net, positive nonrecurring adjustments
- Makes money during bad periods
- Disciplined in reserving/credit
- Ethical about claim payments / market conduct
- “We are losing business to these five companies. Why can’t the investment department make money like they do!?”

Competent Management

- Risks get managed on the front end – disciplined in pricing and underwriting
- Careful in choosing lines of business
- Disciplined in mergers and acquisitions
  - "Small is Beautiful" – can gain competencies, synergies, new markets, distribution methods
  - Large acquisitions have large integration risks
  - Track record matters
- Use of excess capital is a strategic question
- Capital structure is also a strategic question
- Do they act like owners maximizing long-term profits, or as workers aiming to maximize their pay packets?

Choose Lines of Business Wisely

"When a management with a reputation for brilliance tackles a business with a reputation for bad economics, it is the reputation of the business that remains intact."

-- Warren Buffett

The Bust -- Analysis

- The cleaner and higher quality the assets, the better subindustries and companies did.
- Only Reinsurers , Commercial Insurers, and Brokers did better than the S&P 500 during the bust.
- Avoiding mortgage risks was wise.
- Avoiding complexity in investments generally helped.
- Lower leverage helped.
- A focus on underwriting helped.
- Life Companies varied. Those that wrote a lot of variable products did worse.

"How Are You Going to Grow the Top Line?"

- Common Question to Management
- But what constitutes revenue?
  - Is a deposit in a bank revenue?
  - How about the sale of a life insurance policy?
- Is it good to expand business?
- The Triangle: Quantity, Quality, Price
- Gain on sale accounting -- We don't know the cost of goods sold at the time of sale

Capital/Surplus

- Two types – Required and Free
- Assets, Liabilities, and their interaction affect capital levels
- Statutory accounting basis
- Companies decide on what types of business to write by looking at the return on marginal capital required
- Free surplus can be used for strategic uses

Free Cash Flow

- What proportion of your earnings are available for buybacks, dividends & investment in organic growth?
- FCF = Regulatory Earnings Available to the Holding Company - Change in required Capital
- Nature of holding companies w/regulated subsidiaries – dividending complicates FCF

Ways to back into FCF

- Ask questions on leverage policy.
- Ask the company how they decide what the maximium amount of business they could write next year is.
- Premiums-to-surplus?
- Look at the income and dividend capabilities of subsidiaries (lotta work)
- How much more could you borrow at the holding company at your current rating?

Using Free Cash

- Dividends
- M&A – Small is beautiful
- Buybacks that grow Fair Market Value

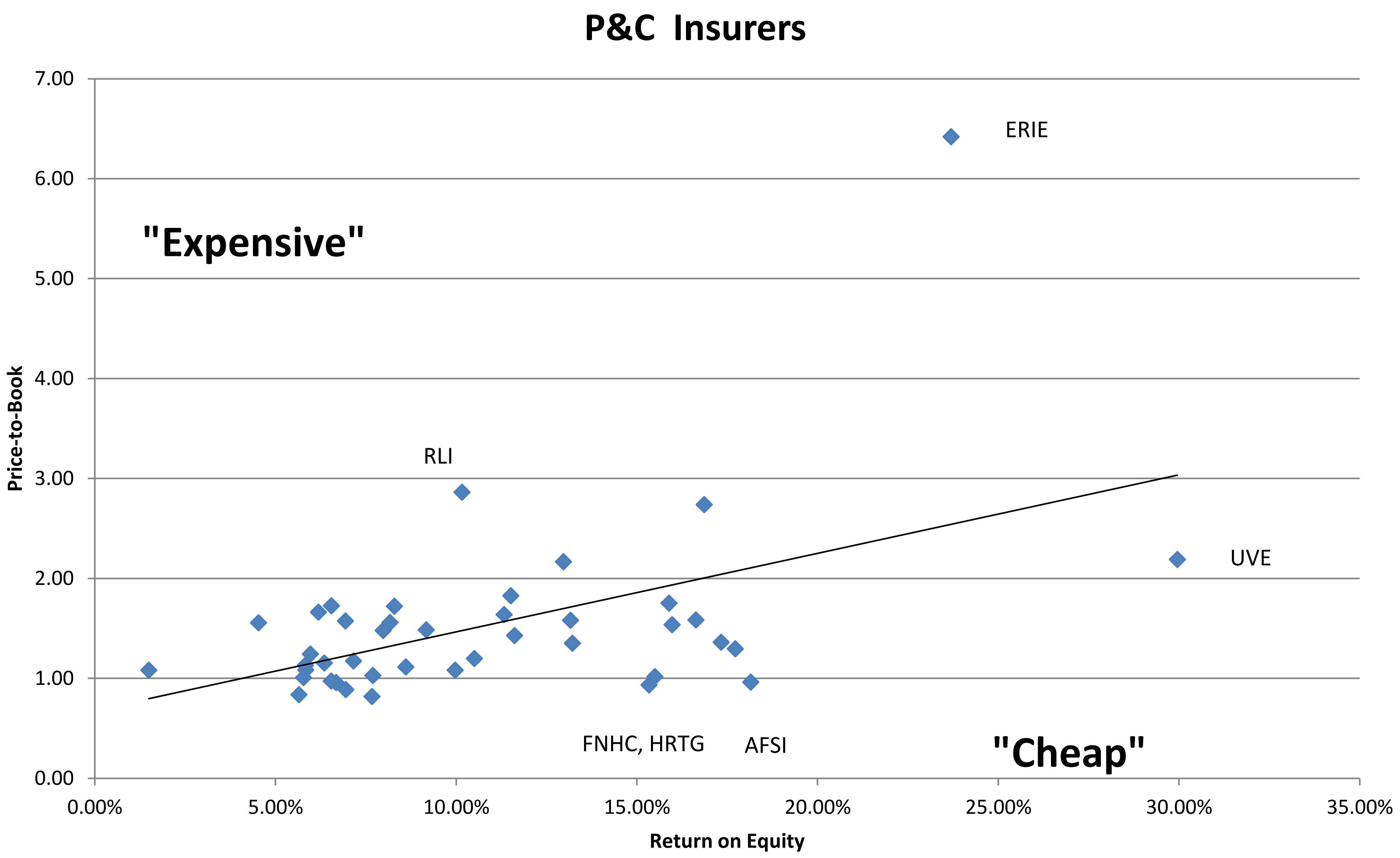
Asset Quality

- Risk – ALM, Credit, Opacity
- Yield-seeking
  - Can always add yield
- New asset classes – ratings not useful
- Credit Cycle – feast/famine
- The Assets are the “liabilities,” and the Liabilities are the “assets” (e.g., deposit franchise vs brokered CDs)

Risk Management

- Wrong risk models – VAR, WOW
- Leverage and risk transfer to the least well-regulated
  - Who took the risk for subprime mortgages?
  - CDOs?
  - Foreign Reinsurers – Cayman Islands, Ireland
  - Shadow Banks
- Can always add leverage and mismatch risk
- Complexity is not rewarded, generally – AIG, GNW, SCT – Opacity
- Products: Financial/Mortgage insurers, LTC, Living benefits

PB-ROE Analysis of P&C Insurers



Problems with PB-ROE

1. Encourages maximization of ROE in the short run, rather than the long run
2. Revenue growth is often equated with earnings growth in practice
3. “Run rate earnings” is adjusted (operating) GAAP earnings, versus distributable earnings (free cash flow)
4. **Implicit assumption of constant earnings growth, required return, and dividend policy in the Price to Book versus ROE metric**
5. **The model assumes that capital is the scarce resource needed to produce more earnings.**
6. ROA is more critical than ROE; it’s harder to achieve. In bull markets, anyone can add leverage.

More on PB-ROE

- It’s the start of analysis, not the end
- Adjust for:
  - Quality
  - Capital Needs
  - Size
  - Business Type – Unique Risks
- Might decide that some companies don’t belong.

P&C Insurance Reserving

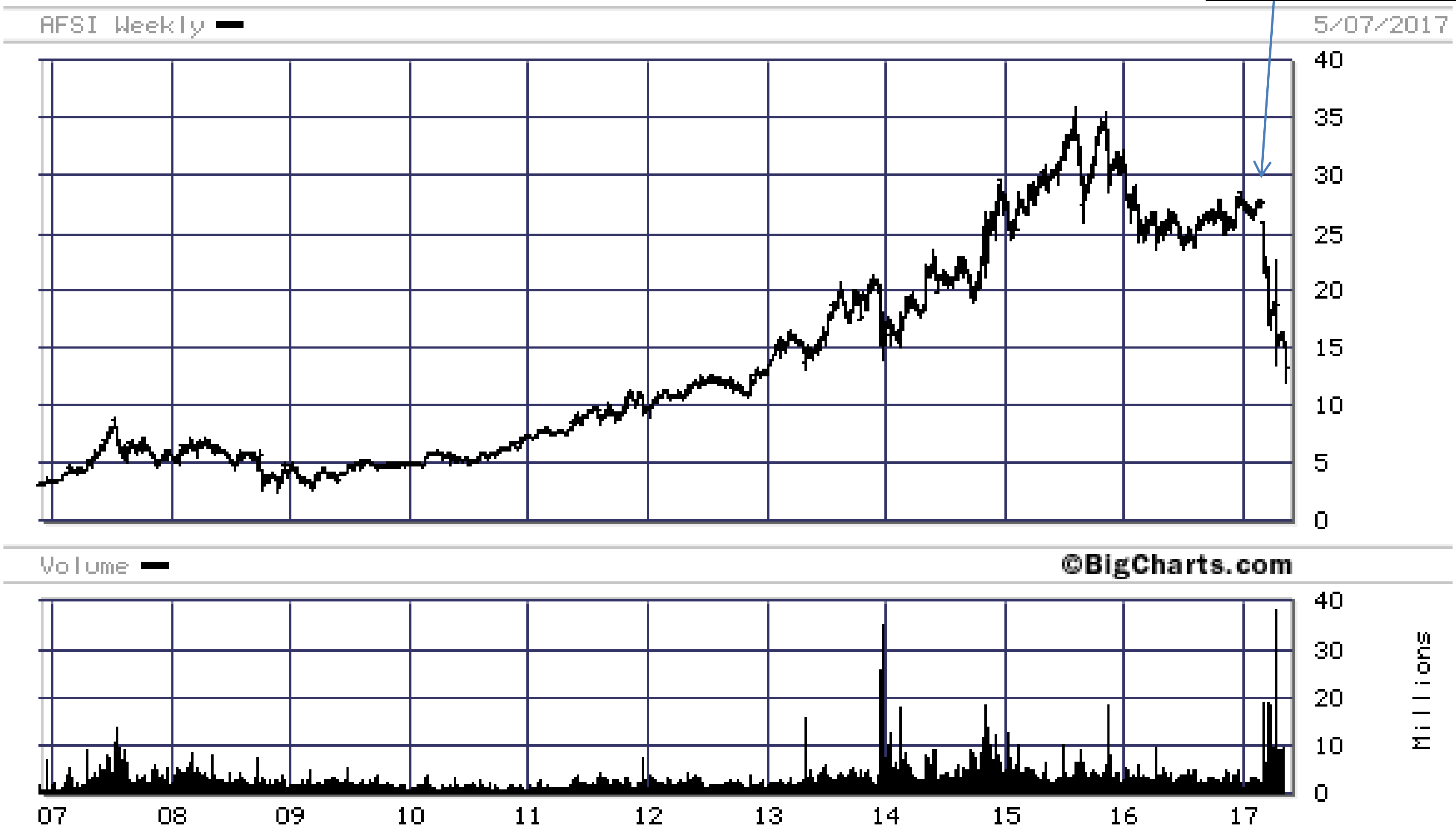
	2016	2015	2014
Unpaid losses and loss adjustment expenses—beginning of year:			
Gross liabilities	73,144	71,477	64,866
Reinsurance recoverable and deferred charges	-10,994	-10,888	-7,414
Net balance	62,150	60,589	57,452
Incurred losses and loss adjustment expenses recorded during the year:			
Current accident year events	30,636	27,829	24,335
Prior accident years events	-1,512	-2,014	-2,280
Retroactive reinsurance and discount accretion	1,782	712	4,351
Total incurred losses and loss adjustment expenses	30,906	26,527	26,406
Paid losses and loss adjustment expenses during the year with respect to:			
Current accident year events	-14,898	-13,070	-11,291
Prior accident years events	-10,958	-10,268	-10,297
Retroactive reinsurance	-1,130	-1,151	-1,082
Total payments	-26,986	-24,489	-22,670
Foreign currency translation adjustment	-537	-545	-666
Business acquisitions	0	68	67
Unpaid losses and loss adjustment expenses—end of year:			
Net balance	65,533	62,150	60,589
Reinsurance recoverable and deferred charges	11,385	10,994	10,888
Gross liabilities	76,918	73,144	71,477

P&C Insurance Reserving (2)

(Amounts in Thousands)	2016	2015	2014
		As restated	
Loss and LAE, gross of related reinsurance recoverables at beginning of year	7,208,367	5,664,205	4,368,234
Less: Reinsurance recoverables at beginning of year	2,665,187	2,149,444	1,739,689
Net balance, beginning of year	4,543,180	3,514,761	2,628,545
Incurred related to:			
Current year	2,884,392	2,654,187	2,312,768
Prior year	257,887	33,931	18,557
Total incurred during the year	3,142,279	2,688,118	2,331,325
Paid related to:			
Current year	-1,060,771	-847,357	-875,430
Prior year	-1,484,638	-1,018,931	-554,495
Total paid during the year	-2,545,409	-1,866,288	-1,429,925
Commuted loss reserves	--	129,377	--
Loss Portfolio Transfers	312,049	--	--
Acquired outstanding loss and loss adjustment reserves	783,066	116,044	71,755
Effect of foreign exchange rates	31,765	-38,832	-86,939
Net balance, end of year	6,266,930	4,543,180	3,514,761
Plus reinsurance recoverables at end of year	3,873,786	2,665,187	2,149,444
Loss and LAE, gross of related reinsurance recoverables at end of year	10,140,716	7,208,367	5,664,205

AmTrust Financial

Reserving Irregularities Hinted



Hall of Shame (2014)

- AIG – Announced big restatement, fired CEO – up 11%
- The Hartford – up 36%
- AmTrust Financial Services – down 40%
- Mercury General – up 7%
- National General Holdings – up 20%
- Average – up 7% vs S&P up 20%
- http://alephblog.com/2014/08/20/ranking-pc-reserving-conservatism/
- There are other methods that are more work

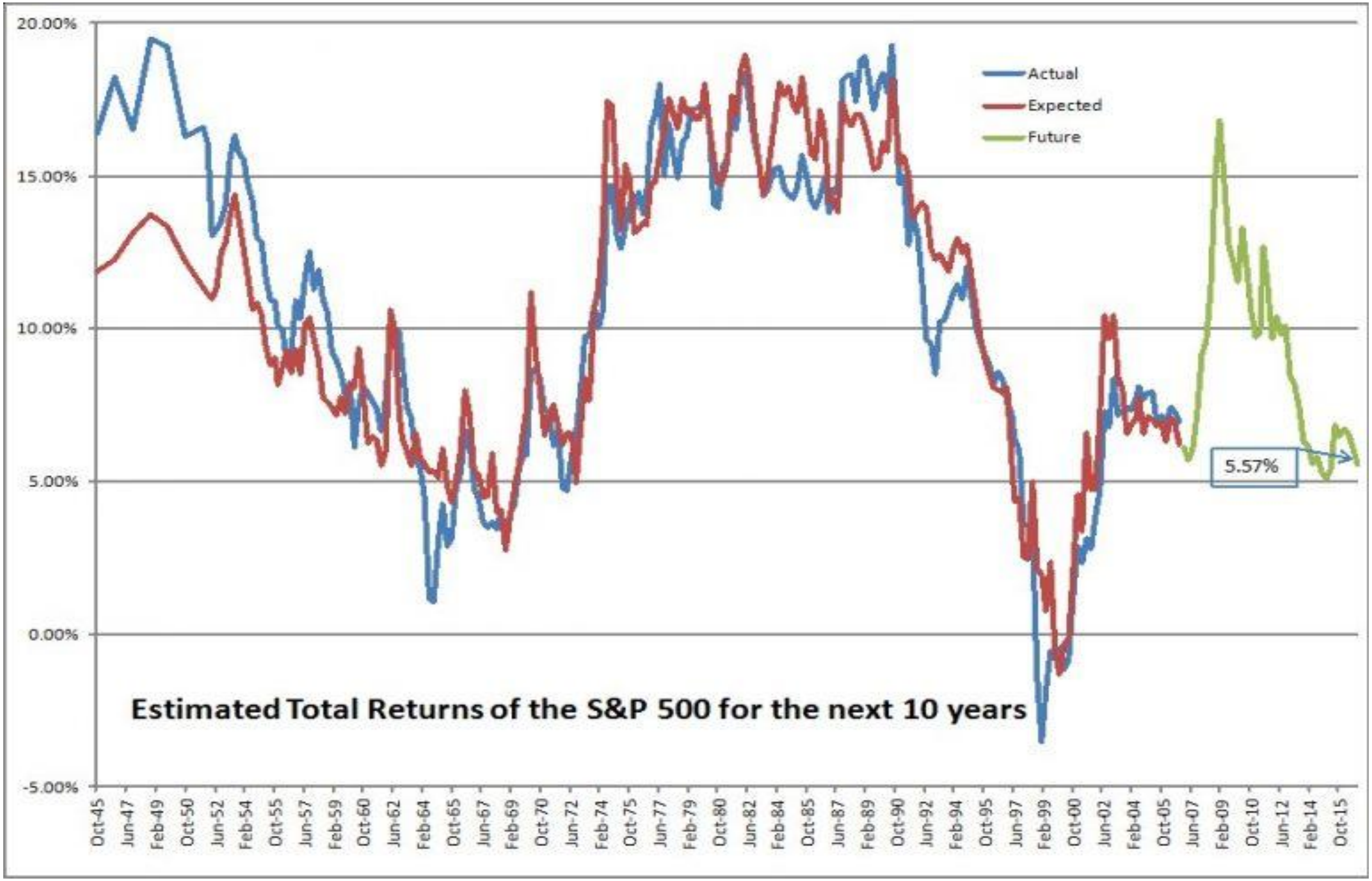
Other Notes

- Medium-sized companies do best
- Beware the company that has found a “hole in the system”
- Momentum
- A company, industry or sector can get too big – Housing/Financials in 2007
- Data sources – Call reports, NAIC, Rating Agencies
- FAS 115 – must adjust book value

Summary

- What are the risks that the company faces?
  - Leverage
  - Credit
  - Borrowing short to lend long
- How ethical, conservative and competent is management?
- How saturated is the area they play in?
- Is it safe? (neglected question)
- Is it cheap?

Estimating Future Stock Returns



How does this model work?

- Assumes that overall returns on assets are fixed, as are the returns on assets other than stocks.
- What varies is the proportion of assets invested in stocks, and the expected return on them.
- When the proportion of assets invested in stocks is small, future returns are high, and vice versa.
- Average return has been 9.5% or so.
- Current estimate is 4.9%/year for the next ten years.

That's All!

- Website: The Aleph Blog
- Contact me at david.merkel@gmail.com
- http://alephblog.com/?s=Insurance+investing&submit=Search