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THE BIG SECRET ON WALL STREET

The P&C Giant With "Universal" Market Share

- *A Best-in-Class Diversified Insurance Powerhouse*
- *Long-Term, Overachieving Underwriting*

FROM THE DESK OF PORTER STANSBERRY

SPECIAL REPORT

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The P&C Giant With "Universal" Market Share

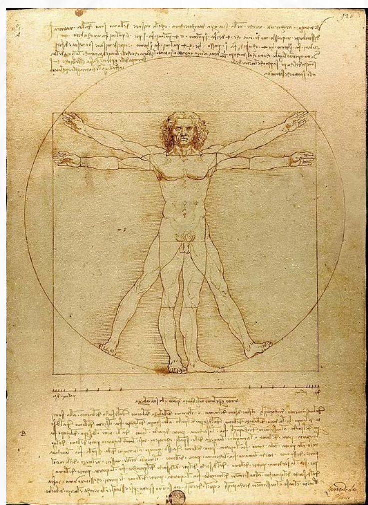
A Best-in-Class Diversified Insurance Powerhouse

Long-term, Overachieving Underwriting

Leonardo da Vinci was good at *everything*. Well, nearly everything.

We know very little about the personal life of the bearded painter of the *Mona Lisa*, who died in 1520. But his extraordinary notebooks – in which the left-handed polymath wrote everything backwards – reveal exactly how brilliant he was.

Leonardo’s artistic genius gave us *Mona Lisa*, the *Last Supper*, and the iconic sketch of the Vitruvian Man… and that was just the beginning.



He dissected cadavers against the will of the Church to create detailed medical diagrams… solved abstruse mathematical and scientific equations… composed and played complex music for the lute… envisioned the airplane, the helicopter, and the tank more than four hundred years ahead of their time… and, in lighter moments, doodled things like a “human slingshot” and a tiny dragon frolicking among kittens.

The proper term for people like Leonardo – people who are good at everything – is **Universal Man**, or **Uomo Universale** in Italian. It was coined by another 1400s genius, Leon Battista Alberti, who believed – in keeping with the blossoming ideals of Renaissance humanism – that “*a man can do all things if he will*.”

(The phrase “Renaissance man” didn’t crop up until much later, in the 1800s.)

Leonardo’s “Universal Man” status served him well…

Whenever one career didn’t pan out for him – for whatever reason – he just hopped disciplines and moved to a new field entirely.

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For instance, up until 1499 Leonardo was happily ensconced as artist-on-call for a wealthy patron, Ludovico Sforza, the Duke of Milan. (It was during this period that he painted the Virgin of the Rocks and sketched Vitruvian Man.)

The next year, disaster struck during the Battle of Novara, when the French government attacked Milan and captured Sforza. Leonardo escaped to Venice... and immediately launched a new career as a military engineer and architect, where he designed strategies to protect the city from seaborne attackers.

After a few years as an engineer, he returned to Milan – this time as an acclaimed court sculptor.

And he spent his twilight years living on a generous allowance, working on passion projects like an improved paint varnish, a life-sized lion robot, and a live lizard coated in quicksilver.

Being a Universal Man, in other words, means you have options. Not all of your professional eggs are in the same basket... vulnerable to being knocked over by war, the inventor’s equivalent of writer’s block, pestilence, or a shifting economy.

It’s analogous to the business strategy of “diversification” – being active in a wide variety of markets or products, so the company spreads out its risk and won’t be in deep trouble if one segment underperforms.

Today, we’ll look at a broadly diversified insurance company that avoids concentration risk in just this way... a true “Renaissance company,” or perhaps better, “**Compagnia Universale**.”

A Best-In-Class Insurance Growth Story

Chubb Limited (NYSE: CB) is a global insurance company with a strong reputation and track record in the property and casualty (P&C) insurance industry. Chubb outperforms in three crucial areas:

- A broadly diversified portfolio across markets and products
- Disciplined underwriting, leading to underwriting outperformance
- Strong investment income growth

With operations in 54 countries, Chubb provides commercial and consumer P&C insurance, Accident & Health (A&H), reinsurance, and life insurance to a diverse group of clients. In its **business insurance (commercial lines)** it provides specialized insurance products, ranging from Directors & Officers (D&O) liability and financial lines (which covers, for example, possible financial loss to a company – employment practices liability, kidnap, ransom, and extortion, crime/fidelity)... to various lines to niche areas such as aviation and energy.

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In its **personal (consumer) lines business** it offers homeowners, automobile, valuables, umbrella liability, and recreational marine products, mainly to affluent and high-net-worth individuals with substantial assets to protect. Several of these lines of business are experiencing significant growth as a result of newly defined, or newly enforced, risks. A good example is in the Employment Practice Liability business, where more lawsuits, and higher settlements, is causing premium rates to surge.

The two largest lines of commercial business for Chubb are its D&O and Financial Lines businesses (22% of North American P&C business), while its High Net Worth personal lines coverage, which is ranked #1 in the U.S., makes up about 19% of total North American P&C premiums.

Chubb is the product of a number of acquisitions. In 2015, ACE Ltd, a Bermuda-based commercial insurer, paid $28 billion to acquire Chubb, Inc., an American company founded in 1882. At the time, the deal was the largest acquisition in the industry. Today, the combined companies write $43 billion in premiums.

Most of ACE’s management stayed on while the combined entity kept the name “Chubb” thanks to its strong brand recognition. Current CEO Evan Greenberg was an ACE executive who took over the combined company during the acquisition, and is well-known for his unique capital efficient management strategy.

Most insurance company managements use excess capital to implement huge share buyback programs. But Evan Greenberg historically has differentiated himself – oftentimes to Wall Street analysts’ scorn – by not instituting an aggressive share repurchase campaign. He wants to have the capital available to increase the book value of the business through acquisitions – not shrink it through returning capital to shareholders. In his own words, “You are never going to shrink your way to greatness.”

The result of Chubb’s book value growth, thanks to its growth-through-acquisition strategy and profitable organic growth, has been enormous market cap growth, and has made Chubb the largest pure-play publicly traded P&C company in the world.

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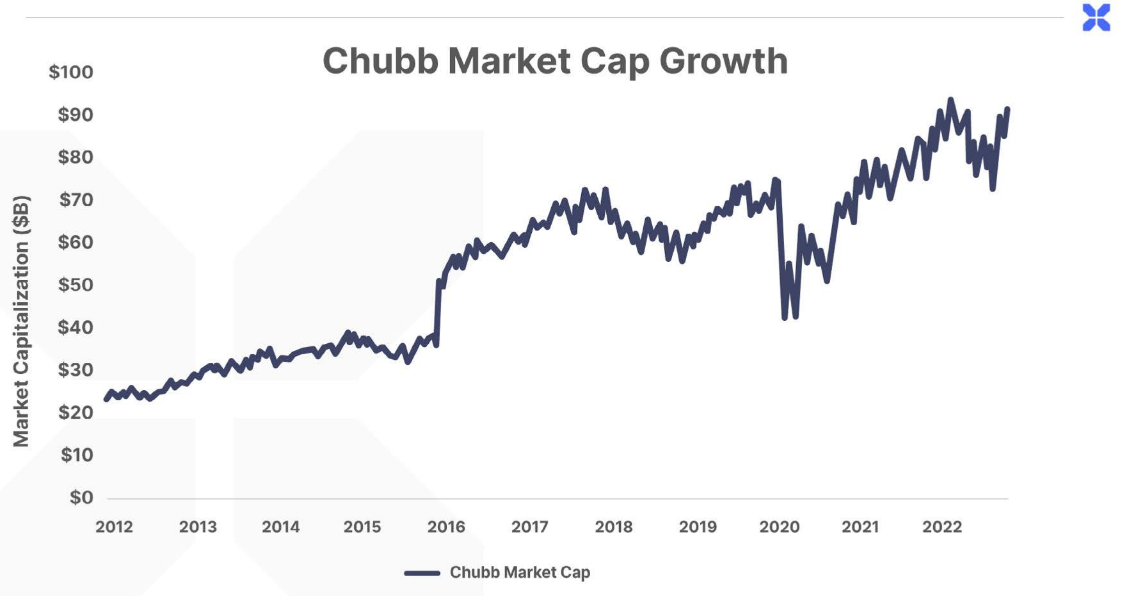
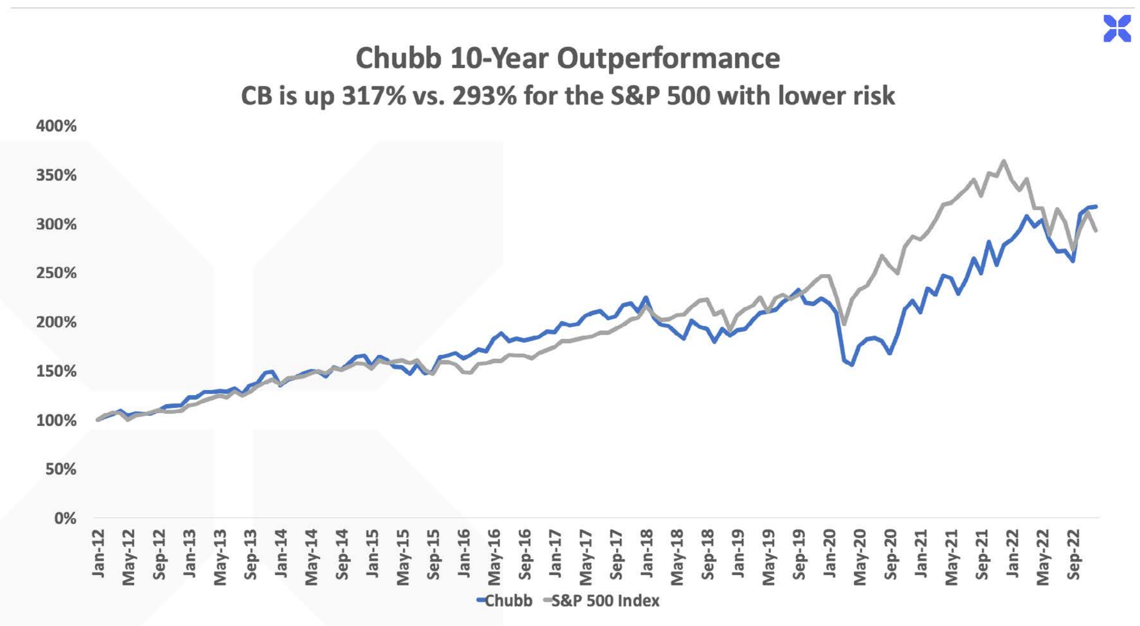


Over the past decade, Chubb has also consistently outperformed the S&P 500 index (except during the Covid period, when tech shares boomed and the S&P temporarily outstripped CB).



Now, we'll dive into the first of CB's three key competitive advantages... and why we're adding it to the portfolio of *The Big Secret*.

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A Broadly Diversified Portfolio

Insurers that focus too heavily on a single line of business or market segment are vulnerable to “concentration risk”: they may be very heavily, and disproportionately, affected by adverse developments within that sector, such as economic downturns, regulatory changes, or a wave of unfavorable claims.

Hurricane Ian in Florida, in September 2022, is an example of how concentration risk can wreak havoc…

Ian, and the massive claims it left in its wake, caused six Florida insurance companies to go bust. United Property & Casualty Company (UPC), the largest subsidiary of publicly-traded United Insurance Holdings, mainly covered homeowners and commercial property policies in South Florida. Its assets were not sufficient to cover the fallout from Ian, and the company was eventually taken over by the Florida Department of Insurance.

Similarly, Lumbermen’s Mutual, a U.S.-based property and casualty insurer, became insolvent in 2012. The company faced significant financial difficulties primarily because of its concentration in the surety bond market (insurance that guarantees a project is completed, and finished on time) and its exposure to the construction industry. Adverse developments in the construction industry in 2013 and related claims eventually bankrupted Lumbermen’s.

Chubb, however, limits concentration risk. It sells insurance in 54 countries around the world, giving it a global footprint larger than most insurers. Its geographic diversification allows the company to access different markets, spread risks, and capture growth opportunities worldwide, as different economies of the world thrive and struggle at different times.

The following two charts show the breakdown of the different regions around the world where Chubb collects premiums from writing insurance policies, as well as the growth rates in these different regions.

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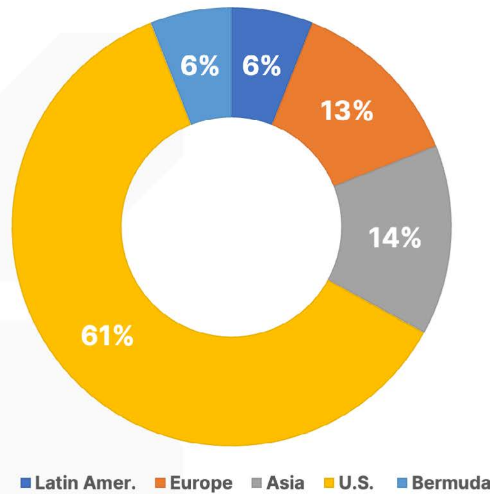

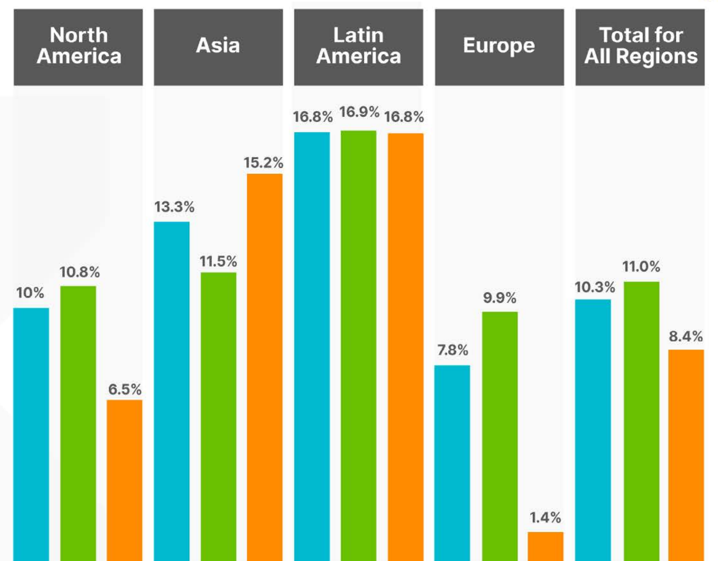

In addition to geographic diversification, Chubb offers a diverse portfolio of products, including property, casualty, specialty lines, and accident and health insurance (see below). This mitigates risks associated with any particular line of business or sector – similar to the way a diversified portfolio helps protect stock investors.

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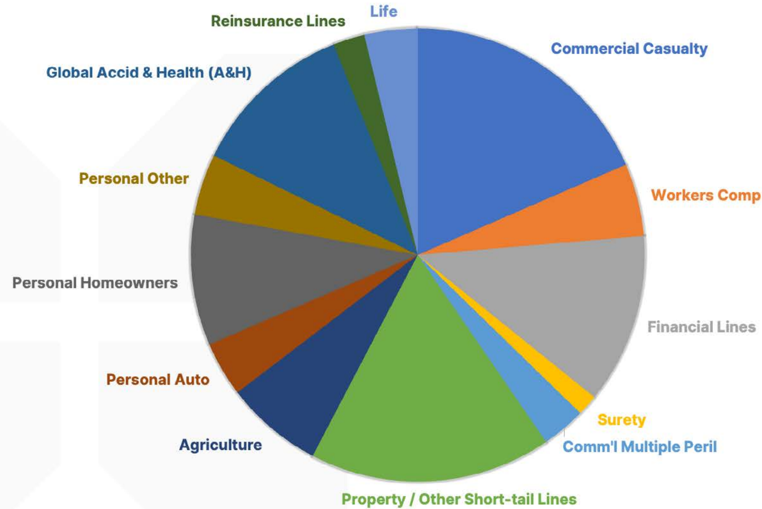

Here are just a few ways that this broad diversification across products and markets benefits Chubb:

Risk mitigation: Chubb (like all insurance companies) is, at its core, in the risk mitigation business. By offering a diverse range of insurance products across multiple lines of business, Chubb can spread its risk exposure and reduce the financial impact to the company if one sector underperforms.

Revenue stability: Multiple income streams from multiple lines of business help Chubb weather economic uncertainties.

Cross-selling: Customers – particularly large businesses that need multiple types of insurance – often prefer to work with a single insurance provider that can address multiple aspects of their insurance requirements. Chubb can be that "one-stop shop," which helps it retain customers.

Adaptation to market trends: Diversification enables Chubb to adapt to evolving market trends and changing customer needs. A good example of this is the expansion of its accident & health (A&H) business in the Asian markets, where products like business travel accident insurance, international travel insurance, and out-of-country medical insurance are in much higher demand than in the U.S.

Capital utilization: Instead of concentrating its capital in a single line of business, Chubb can allocate capital across various products based on their risk-return profiles. This efficient capital deployment helps improve Chubb's overall financial performance and ROI.

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Chubb's other major advantages lie in its skilled financial management.

P&C insurers make money in two main ways: *investment income* and *underwriting profits*. Investment income is the income generated by investing the premium dollars over time (the insurance float). Underwriting income means earnings from the policies the company sells.

We'll look first at Chubb's skilled underwriting – courtesy of extremely disciplined management.

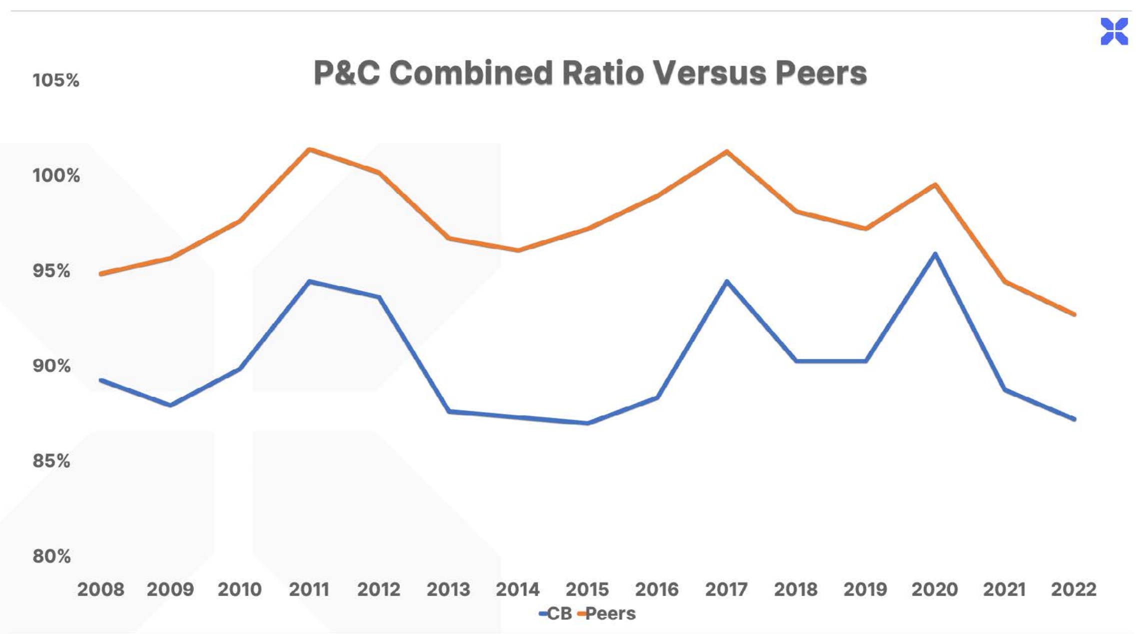
Underwriting Outperformance

Chubb consistently outperforms the industry in terms of the ability to generate underwriting profits, meaning it collects more in premiums versus what it pays out in claims.

Here's how underwriting profits (and losses) work...

If costs and expenses associated with loss are less than the premium taken in, there is an underwriting profit, represented by the combined ratio. A combined ratio (loss ratio + expense ratio) of 100% is breakeven. Below 100% is the profit margin on the policy sold (95% combined ratio indicates that the policy sold generates about 5% profit margin). Above 100% is a loss on underwritten policies.

Chubb is always well below 100% on its combined ratio, meaning it is very profitable on its underwriting. Its cost of float is negative, meaning it is getting paid to invest the money it brings in.



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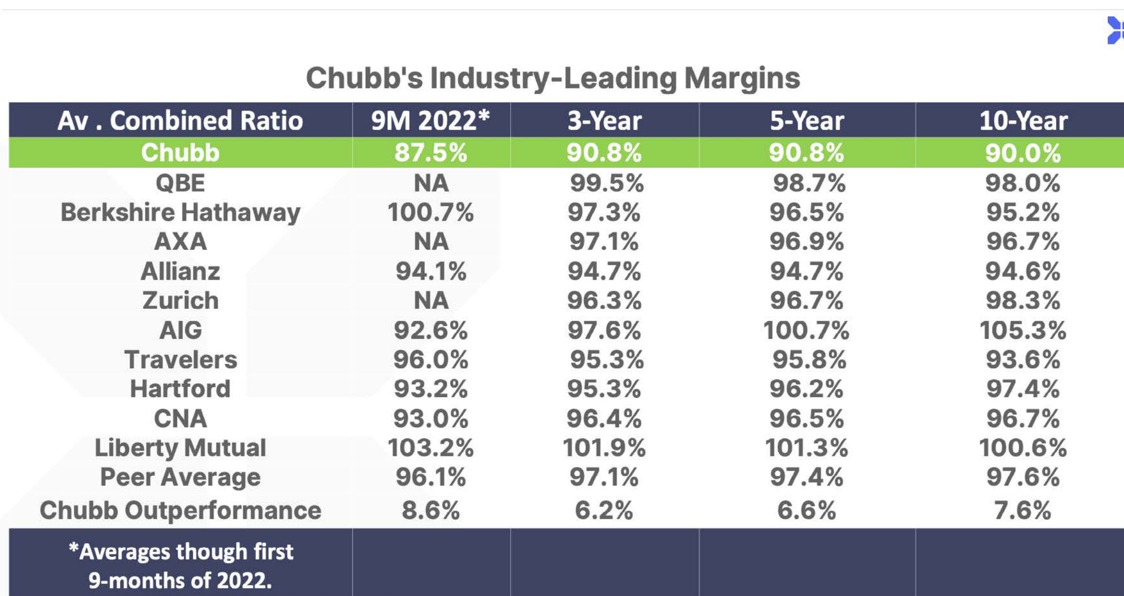
Chubb is known for its disciplined underwriting practices and risk assessment capabilities. The company's long-term success lies in the ability to not bend when the market turns to a competitive market with falling prices. When pricing falls to levels that profitability is difficult to obtain through the float and/or underwriting, too many insurers continue to do so in an attempt to maintain market share. That leads to combined ratios well in excess of 100%, or negative profit margins.

That has rarely ever been the case for Chubb. It consistently outperforms its peers when it comes to underwriting discipline and expertise, as reflected in the combined ratio – as the chart below demonstrates.



Chubb's Industry-Leading Margins

Av . Combined Ratio	9M 2022*	3-Year	5-Year	10-Year
Chubb	87.5%	90.8%	90.8%	90.0%
QBE	NA	99.5%	98.7%	98.0%
Berkshire Hathaway	100.7%	97.3%	96.5%	95.2%
AXA	NA	97.1%	96.9%	96.7%
Allianz	94.1%	94.7%	94.7%	94.6%
Zurich	NA	96.3%	96.7%	98.3%
AIG	92.6%	97.6%	100.7%	105.3%
Travelers	96.0%	95.3%	95.8%	93.6%
Hartford	93.2%	95.3%	96.2%	97.4%
CNA	93.0%	96.4%	96.5%	96.7%
Liberty Mutual	103.2%	101.9%	101.3%	100.6%
Peer Average	96.1%	97.1%	97.4%	97.6%
Chubb Outperformance	8.6%	6.2%	6.6%	7.6%
*Averages though first 9-months of 2022.				

The P&C graveyard is full of insurance companies that refused to pull back on writing insurance policies when pricing became challenged. They inevitably failed to collect enough premiums to pay out future claims, resulting in substantial underwriting losses in the future, when those claims were paid out. Underwriting proficiency is still key to longer-term profitability and book value growth. Moreover, Chubb's expertise in risk management helps navigate uncertainties and potential losses.

That brings us to Chubb's investment income growth and asset quality – the other half of its financial business...

Strong Investment Income Growth

Chubb's solid underlying performance, buoyed by underwriting profits, produced strong operating cash flow in 2022 and Q1 2023. This has been the case for many years (even during those of very high catastrophic activity), and we expect it to

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continue to be strong in the future.

Chubb's strong liquidity makes it largely immune to "shock loss" scenarios, like Hurricane Ian – the largest disaster in Florida's history and second-largest ever, behind Hurricane Katrina. Chubb lost about $750 million during Ian, but its strong cash and short-term holdings were more than enough to cover that, and any other future shock losses.

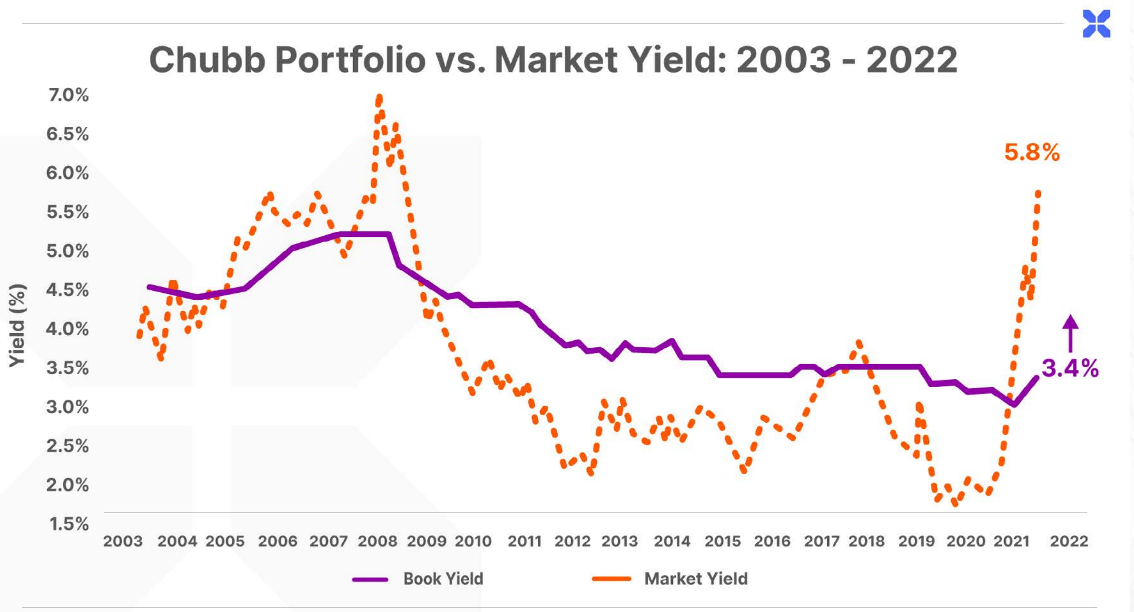
As of March 31, 2023, Chubb had $68 billion in total capital. It holds cash and short-term investments worth $2.3 billion as of March 31, 2023.

In addition to that strong cash flow, rising interest rates, a four-year portfolio duration and widening spreads will all continue to drive strong investment income growth.

With $113.4 billion in invested assets (as of the end of 2022) at an average of 3% yield and an average duration of those assets of 4 years, $28 billion of invested assets will mature in 2023 and be reinvested at much higher interest rates. This will increase the overall yield on the portfolio and, thus, grow investment income.

Chubb should continue to accelerate the turnover of its portfolio in a targeted way – put cash to work more quickly at higher yields.

The chart below shows the current reinvestment rate 5.8% (up from 2.3% Q4 2021) vs. portfolio yield of 3.4% (Q3 2022).



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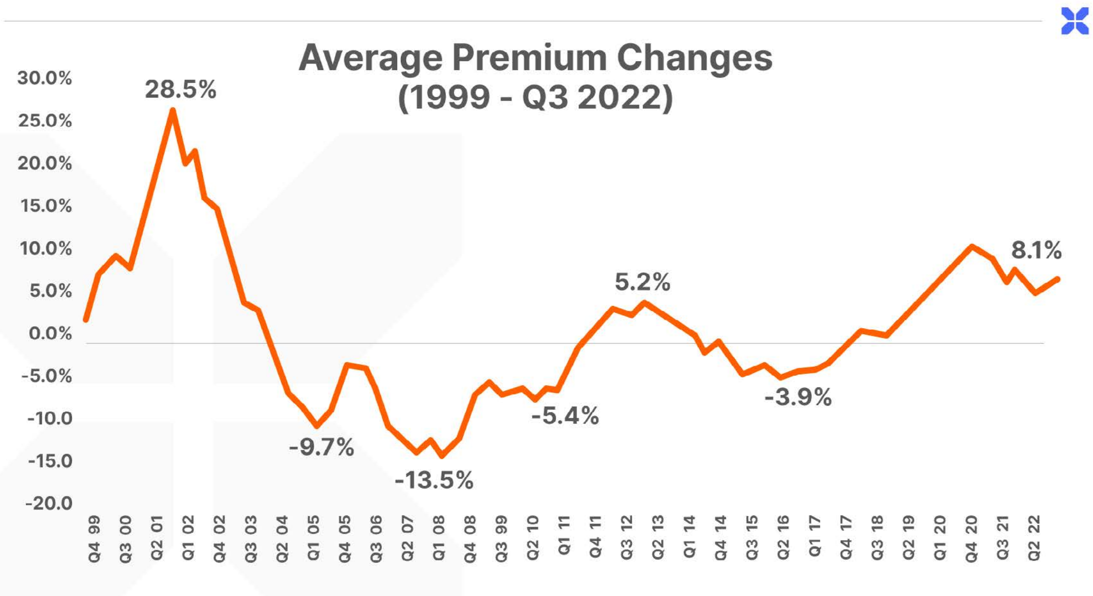
We expect the portfolio yield to increase to about 4.4% by year-end 2023, a 100 basis point (that's one percentage point) increase from the end of 2022. Every 100-basis point increase in investment yield generates approximately $1.1 billion in pre-tax net investment income.

Next, we'll examine a few reasons Chubb is poised to handle upcoming market challenges better than its peers.

Chubb Has Been Beating Inflation for a Long Time

As one of the largest writers of commercial lines insurance, Chubb has benefited from a hardening market – one where pricing is rising significantly, like has been the case for over the past five years. In 2022, pricing was up on average 8.5% and according to Swiss Re, pricing power should remain in the mid-to-high single digits. As the chart below shows, pricing has been rising since 2018. It has been as high as 14% year-over-year in 2020 and has steadied at roughly 9% in Q1 2023. This cumulative effect of rate increases for Chubb has resulted in significant underwriting profitability.



Source: The Council of Insurance Agents & Brokers

The fundamentals of the pricing cycle should continue to be favorable in commercial property and personal lines business. But some challenges remain in 2023 that should separate the more disciplined companies from the pack.

Chubb has always anticipated inflation factors before its peers. Rather than lagging and getting caught by rising loss cost trends associated with inflation, Chubb has been through inflation cycles many times and has almost always anticipated

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correctly. The evidence is in its long-term underwriting outperformance. In fact, beginning in 2021 Chubb began raising prices for those areas most affected by rising inflationary loss costs.

Overall inflationary trends are in the mid-single digits while property and liability pricing is in the high single digits in 2023. That bodes well for Chubb’s continued underwriting profitability.

Value creators, like Chubb, will likely ride out this cycle better than the rest of the group, as they have in the past. One of the fundamental differentiators for value creators is their ability to take the long view on market conditions.

The inflationary responses of Chubb are far better than the rest of the industry. Rising inflation means that the costs to insurers are going to also run higher in the near future. For example, there has been a surge in the cost of building materials and labor costs associated with repairing hurricane-damaged homes and businesses. Even technology innovation has caused a rise in loss costs related to things such as the higher price of automobiles.

With all the new technology, repair costs have risen. The value creators in the insurance industry are the ones that have proactively addressed the financial inflationary issues – either by raising their prices accordingly (like Chubb has done) or lowering limits on policies to stem the rising costs of claims.

As the costs of replacement rise, so will the prices paid by insurance customers. One of the unique things about the P&C industry is its ability to react swiftly to rising prices. In many cases policies may only be 6 month policies (car insurance). In other instances, the policy stipulates that in the event of a loss the insurer has the right to cancel or postpone the policy or charge a renewal rate commensurate with the new risk.

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Chubb also has a thriving reinsurance business, which is another effective way to limit overall losses. While this may seem logical (as costs rise, raise prices!), many insurers are afraid of losing market share and will not re-price their products.

And, historically, these businesses suffer. AIG is a classic example. Even after the financial crisis bailout of AIG, its property/casualty business was on the brink of failure due to too many years of inadequate pricing and a lack of underwriting discipline.

As a final tailwind for Chubb, its executives are paid for underwriting acumen, not market share growth. Unlike AIG, a company that was notorious for chasing market share at any cost because its executives were compensated on market share gains, underwriting discipline is at the heart of Chubb's operating philosophy.

And it's no wonder. The executives are all paid according to matrices that emphasize underwriting profits, not market share. In fact, 94% of the CEO's direct compensation and 87% of the Named Executive Officers' (NEO) direct compensation is variable or "at risk", with underwriting profitability the main factor in achieving the "at risk" compensation.

Now, a note on valuation.

How We Value Chubb

Chubb is a large commercial lines company that has a longer tail liability – that is, it may owe money well after the premium was collected – than a smaller personal

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lines carrier like Progressive. That means that its liabilities are larger than a short-tail liability company like an auto company. In other words, an auto insurer has a very finite liability, typically of six months or one year. If you have a six month policy and get into no accidents and the policy expires, then all potential liability is over. On the other hand, commercial lines liability companies (like Chubb) can have to pay out even after the policy expires.

As an example, let's assume a doctor takes out a medical malpractice insurance policy. For the insurer, a strong balance sheet is vital to protect the policy against malpractice of “failure to diagnose”. The doctor could have failed to diagnose a disease in 2010 that is later discovered in 2023. There is a lawsuit for failure to diagnose in 2010. The insurer of record in 2010 is on the hook for paying that medical malpractice claim – not the insurer of record in 2023 (assuming it was a different insurer).

As such, a strong balance sheet is vitally important to companies like Chubb. They have much longer-tailed liabilities than auto or homeowners insurers. That is one reason why book value is a main valuation technique. Price-to-book-value (P/BV) indicates the strength of the valuation of the balance sheet, not strength in current earnings, which can be volatile given the shock losses inherent in the business like hurricanes or other natural disasters.

Book value growth has been mostly steady and very good for Chubb. Of course, in 2008, the financial crisis and corresponding recession wreaked havoc on its book value growth. But 2022 is a good example of how P/BV can be somewhat distorted due to exogenous events.

As we have mentioned, Chubb’s asset base is made up primarily of fixed income securities. The value of those assets is inversely related to the direction of interest rates. As we see in the chart below, there was a significant drop in book value due to the rapid spike in 2022.

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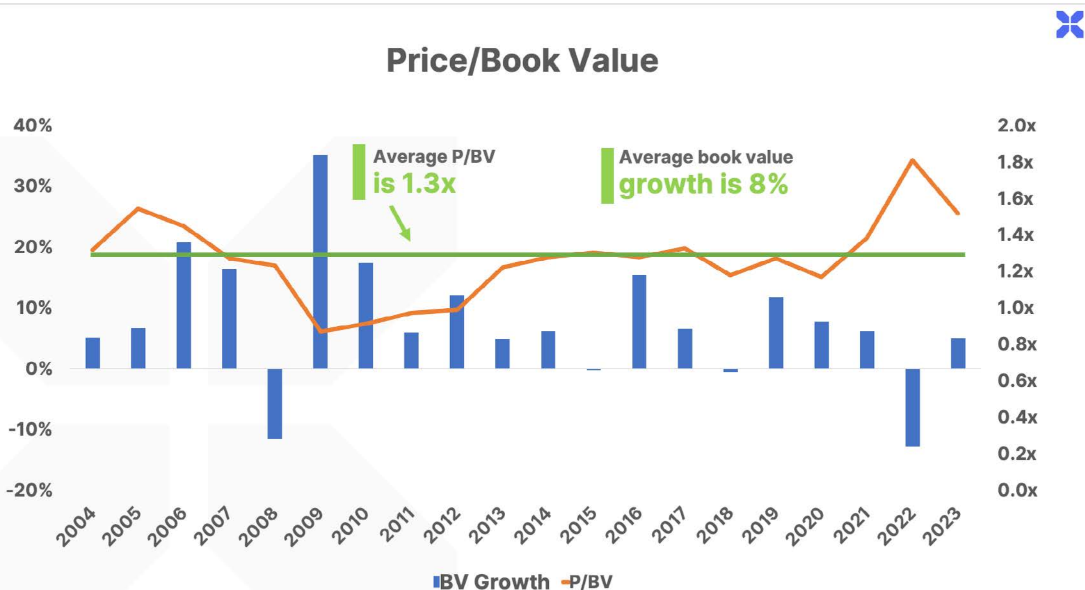

At the same time, the stock was rising as investors' sentiment changed during the year to a more defensive mentality. The result was an anomaly in the valuation of Chubb stock in that the numerator was rising while the denominator was declining (something that also happened during the unusual market conditions of 2008).

Of course, as the rapid rise of inflation-induced interest rates has abated, we see a correction of the 2022 phenomenon. Book value is growing while the P/BV is correcting downward as the stock has lagged in the first quarter due to profit-taking from the gains in 2022.

We expect book value growth to accelerate as interest rates steady and/or fall and reach historical averages of 8%. This bodes well for the stock in that typically as book value grows, so does an expansion of its multiple.

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Action to Take

Being the world's largest pure-play publicly traded property and casualty insurer, Chubb continues to witness robust premium revenue growth globally. We expect the momentum to continue, driven by its commercial businesses, double-digit commercial P&C rate increases and expanding underwriting margins, new business and strong renewal retention.

Moreover, we expect an acceleration of earnings contribution from investment income as the overall yield increases as the short duration portfolio is turned over and re-invested at higher yields. This alone should accelerate earnings as we expect investment income to grow about 20% in 2023.

In this period of economic uncertainty and financial market volatility, Chubb's business model, capabilities, and ability to deliver provide both a safe haven and long-term growth opportunity for shareholders.

Action to Take: For the latest updates on our open positions, please visit our live portfolio **here.**

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