

THE BIG SECRET ON WALL STREET

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# THE WORLD'S GREATEST INVESTMENT

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Guide to Property & Casualty  
Insurance Investing

FROM THE DESK OF PORTER STANSBERRY

SPECIAL REPORT

## Guide to Property & Casualty Insurance Investing

### The Ultimate Safety Play

Warren Buffett has been with the love of his life for 56 years.

That's longer than his – according to the finance gossip press – “unconventional” 52-year marriage to Susie, who passed away in 2004. And certainly longer than his widely-publicized affair with Katharine, or his 17-year (and counting) second marriage, to Astrid.

You see, Warren's true love is the insurance business. They'll be together until death parts them.

In 1967, Buffett's company, Berkshire Hathaway, made its first major insurance purchases – National Indemnity and another, smaller company – for \$8.6 million. They've been together ever since – in good times and in bad... but mostly good...

Today, the core of Berkshire remains insurance – Berkshire Hathaway Reinsurance, Geico, and General Re, plus a collection of smaller companies. This growing tribe of insurance companies provided Buffett with the fuel that powered the compounding machine of Berkshire Hathaway – a source of permanent “free capital”, which he has used to invest in a wide range of other businesses.

This “free capital” gives Berkshire the ultimate advantage over banks, hedge funds, and other money managers, all of which must pay to borrow capital for making investments. And it's the secret sauce that paved the way for Berkshire Hathaway to become the eighth-largest company in the S&P 500, with a \$660 billion market cap.

Starting in 1970, Berkshire's insurance operations provided Buffett with \$39 million in “free capital.” He invested this free capital into a collection of world-class companies, providing more profits to buy more insurance companies, which in turn, provided more “free capital” in a virtuous compounding cycle.

Over the last five decades, Berkshire has snowballed its way into an incredible \$164 billion in “free capital.”

In Buffett's own words, if he hadn't made that first, fateful insurance buy back in the '60s, “Berkshire would be lucky to be worth half of what it is today.”

Warren flirted with insurance long before they got together, though.

In 1951, he made a small purchase of Geico, for around \$10,000. He sold a year later, for around \$15,000.

## The World's Greatest Investment

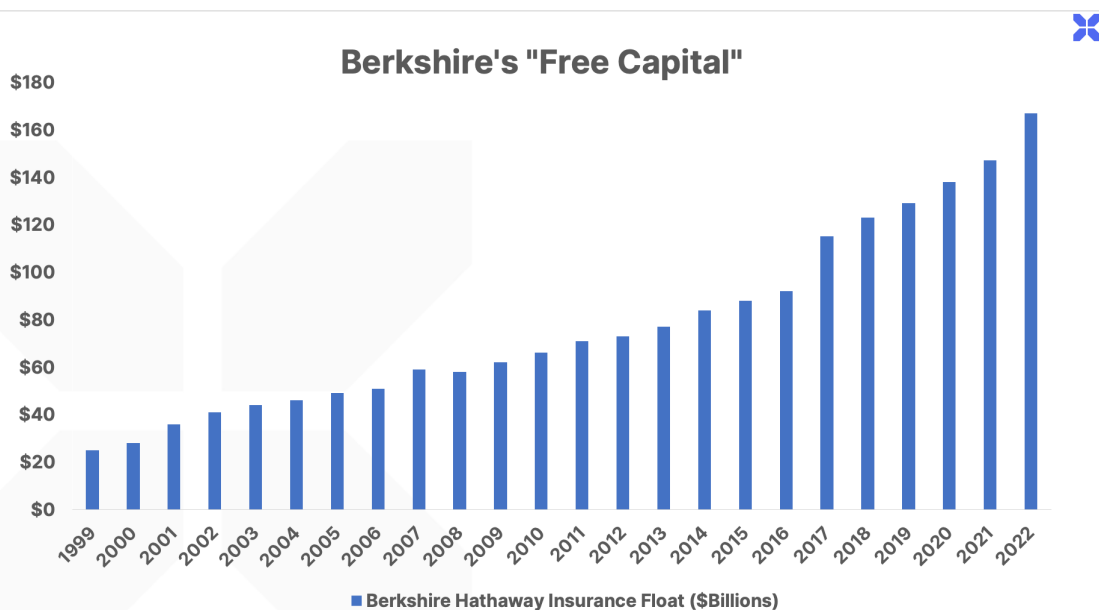
He didn't buy back in until the 1970s. Waiting so long – and selling in the first place – was a mistake.

If he'd held his original stake during that 20-year period, he'd have walked away with \$1.3 million. The episode "taught me a lesson about the inadvisability of selling a stake in an identifiably wonderful company," he said later.

But starting again in the 1970s hasn't turned out so badly.

Today, Geico – now fully owned by Berkshire Hathaway – is worth approximately \$27 billion, and has made Buffett \$25 billion, for a return of around 1,050%, since then. But far more importantly, the original \$2.35 billion acquisition of Geico now provides Berkshire with over \$30 billion in "free capital" each year.

And Geico is just *one* of Buffett's insurance businesses (though, he's admitted it's his favorite). Since he first bought into the industry, Berkshire's "free capital" base has exploded from \$39 million in 1970 to \$164 billion as of year-end 2022:



It's not hard to see why Warren's in love with insurance. But why do these companies turn everything they touch to gold?

It's a fascinating story – and one that may very well end up as a passionate (investment) love affair for you, too.

And, like many great stories, it starts with catastrophe.

## We All Need Insurance – Whether We Want It Or Not

Insurance, at its core, is the **sharing or pooling of risks**. When the chances of a financial loss – as catastrophic as a hurricane that wipes away your house or as minor as a fender bender in a parking lot – are spread among many members of a group, the loss to any one member is substantially less than had the risk not been pooled.

Without this risk-mitigating tool, the economy would be a fraction of its size... Global trade would collapse, businesses would be reluctant to produce, and innovation would be crippled. People would live shorter, sicker lives. It's no exaggeration to say that without insurance, you wouldn't own a home, drive a car, go on vacation, have healthcare, or enjoy any of the luxuries of modern life.

In the words of the International Association of Insurance Supervisors (IAIS),

*"The absence of insurance would make progress and growth impossible."*

And for investors property and casualty (P&C) insurance offers a way to compound money, year after year, with unyielding efficiency. And, when applied correctly, with very little risk.

P&C insurance enjoys a unique financial benefit like no other business: it has a positive "cost" of capital.

That is, rather than having to pay for capital – like when a bank pays interest on deposits – well-run P&C businesses receive zero-cost upfront capital in the form of insurance premiums. If the company charges more for the premiums than what it ultimately pays out, it pockets the difference.

And because P&C claims typically aren't made for a number of years (or, in the best case scenario, are never paid at all if a claim fails to arise), insurance companies can invest that capital – earning returns beyond the profits from their insurance underwriting.

Because insurance is a cost of living and of doing business – you have to have insurance in order to buy a car or home; businesses are required to have insurance in order to operate – overall growth of the industry is tied to the health of the economy.

But despite its close marriage with the economy, P&C is a business with a mind of its own.

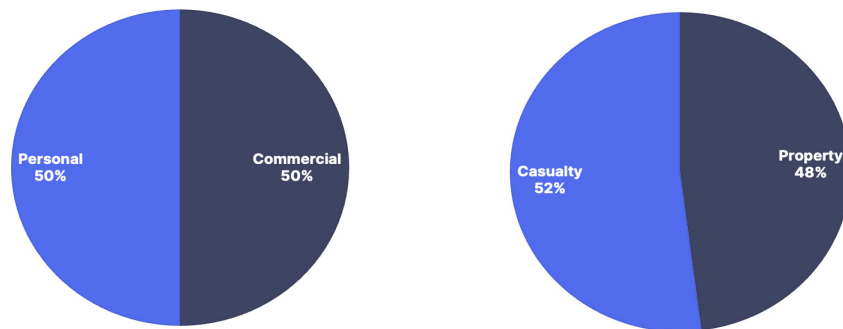
And today, we'll walk through exactly what makes it special... why it's one of the safest defensive investments of all time... and how to find the top-performing companies in the sector.

## How the P&C Business Works

The P&C business (not to be confused with Porter & Co.!) writes about \$700 billion total of annual premium. There are two main ways to split up this premium: **property vs. casualty** (each about 50% of the total premium) and **personal vs. commercial** (also, each about 50% of premium).



### U.S. P&C Industry: ~\$722B Annual Premium Market



Source: Bloomberg

- **Property** lines of insurance are “first party” lines: that is, they pay for actual physical damage to the insurance buyer’s (first party’s) owned property. Examples would be damage to your car from a hailstorm, or damage to the insurance buyer’s warehouse from a heavy wind storm.
- **Casualty** lines are “third party” lines that pay for damage that the insurance buyer caused to a third party’s – someone else’s – property. Liability is the determining factor of the insurance claim here: the insurance buyer is at fault for the damage, and the insurance premium pays for the loss as well as for legal defense, if necessary.

Property lines are typically settled and paid quickly, since there is no liability in dispute – and doctors and lawyers are not involved. Casualty lines, in contrast, can take years to settle because of complicated medical bills, liability disputes, and attorney involvement. It’s not unheard of for casualty claims to take more than a decade to reach full resolution, making the pricing for such insurance products incredibly complex.

Both property and casualty insurance can also include **personal** (insurance purchased by an individual) or **commercial** (insurance purchased by an institution) lines.

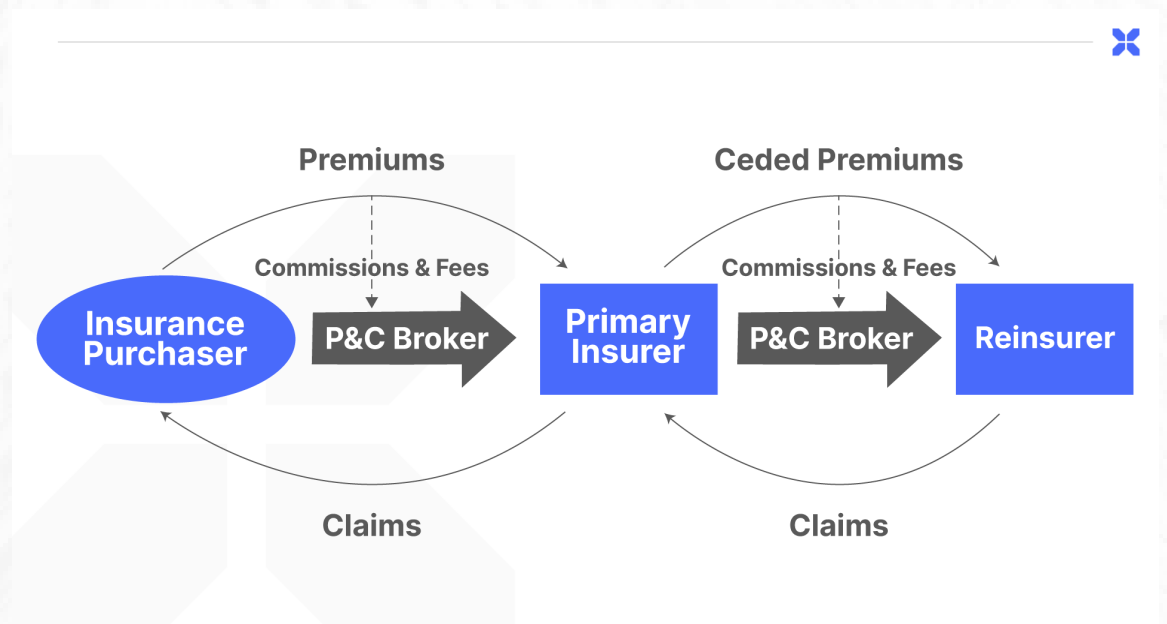
Insurance for large corporations is far more complex than personal home or auto



insurance, so companies that excel over the long run in commercial lines stand out with an unyielding focus on quality **underwriting** at the account level.

Underwriting is the process where an insurance company evaluates risks and decides which to take. Losses that are incurred and paid by an insurance company are known as **claims**.

The chart below diagrams the industry supply chain, showing the flow of payment (premiums – what you pay for insurance) from the insurance buyer to the primary insurance company:



In return for premiums, the insurance company agrees to pay claims if a qualifying future loss event – like the car accident that damaged your vehicle or the hurricane that hit your Florida beachfront home – occurs. Most insurance business is placed via a broker (agent), who collects a commission or fee – but assumes none of the underlying risk. Insurance companies also buy insurance from “reinsurers” in order to further spread the risk of large losses to more insurers.

Insurers earn money on their underwriting expertise (underwriting income) and on earnings from investments that they make with premiums (more on this later).

Underwriting profitability is measured by the “combined ratio,” which is the sum of losses paid for insured claims and expenses associated with these losses, divided by the premium collected. For example, on one individual risk, if the insurance company collected \$1,500 from you for your auto policy, and you had one claim to repair a bumper that cost \$1,000... the combined ratio on this one risk would be  $\$1,000 / \$1,500$  or 67%.

Of course, such ratios only make sense when evaluated on an insurer's entire book of business and not just one individual auto policy. Note that from this definition, a combined ratio below 100% equates to an underwriting profit, while one above 100% is an underwriting loss. A combined ratio of exactly 100% is breakeven. While the industry is in the business of underwriting and pricing insurance risk, most years it has an underwriting loss.

But that loss is usually more than made up for by gains from investments it has made from investing the insurance **float** (stay tuned, more on this topic below).

### **P&C Insurance Protects Investors, Too**

While there are certainly growth periods for the P&C insurance industry, investing in these stocks is generally more of a defensive investment strategy.

A defensive strategy aims to reduce risk exposures and provide a more conservative approach to weathering market volatility while preserving capital. The primary focus of defensive investing is capital preservation rather than maximizing returns. The goal is to protect the value of investments and limit potential losses.

**One of the more overlooked aspects of investing is to preserve capital (minimize losses) when markets are in turmoil.**

It's important to note that while the P&C insurance sector is generally considered defensive, it can still be influenced by factors such as catastrophic events, regulatory changes, and shifts in underwriting conditions. Additionally, individual companies within the sector may have different risk profiles and financial performance.

**Here are some of the reasons why the P&C sector is considered "defensive":**

- **Steady Demand:** The need for insurance coverage persists regardless of the economic climate. People and businesses require protection against property damage, liability claims, and other non-life risks, regardless of economic downturns. This consistent demand for insurance products provides a level of stability for P&C insurers.
- **Non-Cyclical Nature:** The P&C insurance has a more micro-oriented cyclicity because it's less influenced by broader economic cycles compared to other sectors. While economic downturns can affect premium growth and investment income, insurance claims tend to correlate less with overall economic conditions. This non-cyclical nature provides a defensive characteristic, as the sector is less susceptible to significant volatility caused by economic fluctuations.
- **Long-Term Orientation:** P&C insurers operate with a long-term perspective, focusing on risk management, underwriting discipline, and maintaining sufficient reserves to meet policyholder obligations. This conservative

approach helps P&C insurers weather short-term market volatility and uncertainties.

- **Predictable Cash Flows:** P&C insurance companies often have a reliable and predictable stream of cash flows. Premium payments are typically collected upfront, providing insurers with a consistent inflow of funds. Additionally, claims payments are spread over time, allowing insurers to manage their cash flow and liquidity.
- **Risk Diversification:** P&C insurers diversify their risk exposure across various policies, geographic regions, and lines of business. This diversification helps mitigate the impact of localized events or specific risks on the overall financial performance of the insurer.
- **Conservative Investment Practices:** P&C insurers generally adopt conservative investment strategies, focusing on low-risk assets such as high-quality bonds and cash equivalents. This approach aims to protect the insurer's capital and ensure liquidity, minimizing the impact of market volatility on investment returns.
- **Regulatory Oversight:** P&C insurers operate within a regulated framework, subject to capital requirements, reserve obligations, and strict oversight by regulatory authorities. This oversight helps maintain stability and financial strength within the sector.

For these reasons, the P&C sector tends to be considered a “safer” investment asset class than many others such as technology, communications, or consumer cyclicals. This is because unlike many other industries, the demand for insurance remains relatively stable during all phases of the economic cycle and the industry has a recurring revenue model that provides more predictable cash flows.

At the same time, the regulatory oversight of the industry helps ensure that P&C companies maintain strong capital levels.

### Why P&C Stocks Are Exceptionally Low-Risk

Remember, the industry is highly regulated, and the primary concern of regulators is to protect consumers. Protect how? Given that insurance policies are essentially a contract by the insurance company to honor their ability to pay claims that occur at some point in the future, regulators want to make sure that consumers are not left high-and-dry when that future time comes... that is, regulators want to be sure of insurers' claim-paying abilities.

This philosophy is at the heart of why insurers' investment portfolios very conservatively run. The investment portfolio is an insurance company's largest asset, and a typical investment portfolio is approximately 80% invested in fixed-income securities with a duration of two to four years, and more than 85% invested in AA-rated or higher bonds.



The year 2023 is a good example of what tends to happen to P&C stocks when interest rates are rising – often, the stocks will initially underperform the market. However, there is a fundamental dichotomy at play in the analysis of the effect of interest rates on the sector. Here are some examples of that.

- 1. Book Value Effect As interest rates rise, the value of fixed income securities (bonds) fall.** Since most of an insurer's invested assets are in fixed-income securities, their asset values fall. Hence, book value growth either stalls or falls. Book value is the difference between the assets of an insurer and the estimated liabilities, or the equity of the insurer. When interest rates rise, the value of the invested assets fall (65% of all invested assets are in fixed-income securities) but the estimated future liabilities stay the same. Hence the equity, or book value, contracts. And since most analysts and investors value P&C stocks based on a Price / Book Value (P/BV) method – a measure of the price of the company relative to the value of all its assets – some investors immediately assume that rising interest rates must have a deleterious effect on the fundamentals of the P&C stocks.
- 2. Investment Effect** The investment portfolio is the largest asset of a P&C company, with a typical investment portfolio 75% invested in fixed-income securities with a two-to-four-year duration. Most P&Cs carry 2x-4x investment leverage (invested assets/equity), so a 100-basis-point rise in interest rates lowers book value by 2%-14% after tax. With P&C stocks trading on a P/BV basis it is easy to see why historical P&C stock returns have lagged when rates are rising.
- 3. Earnings Effect** What is shortsighted in the above thinking is the fact that the assets are marked-to-market, which simply means that the value of the invested assets are immediately adversely affected as interest rates rise by accounting gimmicks. However, recall that we mentioned that roughly 75% to 80% of a P&C insurer's earnings come from investment income. Hence, the longer-term effect of rising interest rates is that it boosts the future earnings power of the company and drives higher returns on equity ("ROE"), which, in turn, boosts valuations. Simply put, with an average duration of about three years on the portfolio it means that one-third of the current, lower-yielding assets will mature and get re-invested in the current year at a higher interest rate. The same for the next year and the third year. Hence, each year, the yield on those assets is growing and thus, investment income is growing.

In short, the regulation of the industry ensures that its massive investment portfolio is high quality (again, more than 80% in AA-rated corporate bonds), and high customer retention (mid-80%) means that most of the underwritten business is renewed, equating to more steady revenue flows over time.

All of this leads to an industry with low risk and volatility, which typically means poorer performing. Yet, remarkably, the P&C sector tends to outperform from a stock perspective.

## P&C Stocks Beat the Market... Even with Low Beta

The P&C sector (including reinsurance) represents about 8% of the financial sector, which itself is 12% of the S&P 500. This means P&C stocks make up roughly 1% of the S&P.

But even though they're a tiny slice of the S&P 500, P&C stocks have proven to be a longer-term outperformer relative to the market. Moreover, the industry achieves this feat even with a lower "**beta**" than the market.

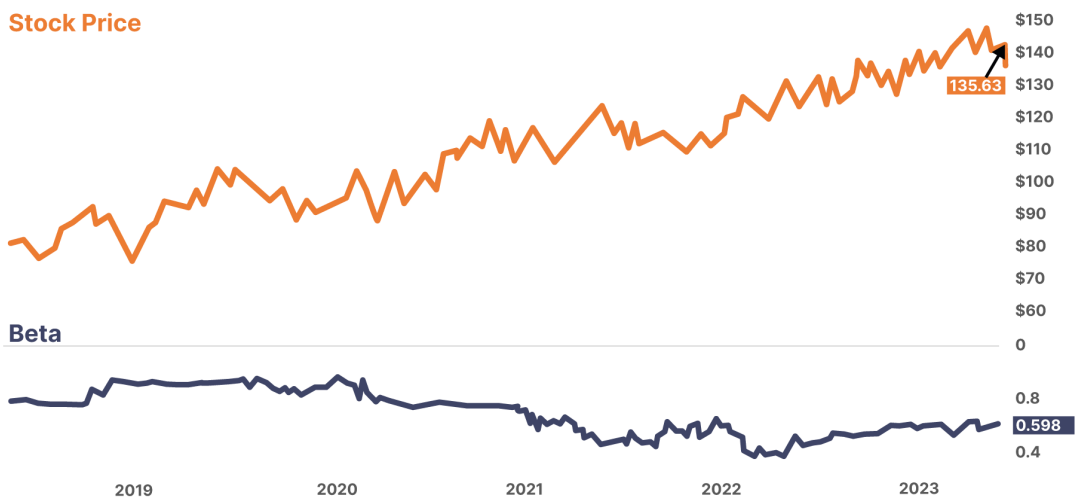
**Beta** is a term that describes, and quantifies, the risk of an investment in an industry or a stock. It measures the potential volatility, or how much a stock fluctuates up or down relative to its longer-term average price. More specifically, volatility refers to both the frequency with which a security changes in price and the degree to which it changes its price. It is an indicator of the inherent fear or uncertainty in a stock or index.

The beta indicates how volatile a stock's price is relative to the overall market. For example, a beta of 1.0 would indicate that an investment's risk is the same as the risk of the overall market. In theory, if the broader market is up 10% then the stock's performance with a 1.0 beta would also be up 10%. A beta greater than 1.0 indicates that the stock's price swings more wildly (i.e., is more volatile) than the overall market, while a beta less than 1.0 indicates the stock's price is less volatile than the overall market.

For example, in the chart below of Progressive Insurance (PGR), we notice that even as the stock price performance began to rise in 2020, the beta declined significantly. Of course, this was due to the fact that COVID-19 had wreaked havoc in the markets and despite the rise of the broader markets beginning in 2020, there was significant volatility (or risk) in the market. PGR stock's beta fell from 0.90 to 0.60 during the pandemic (represented by the blue trend line).



### Beta Tracking Progressive Insurance (PGR)

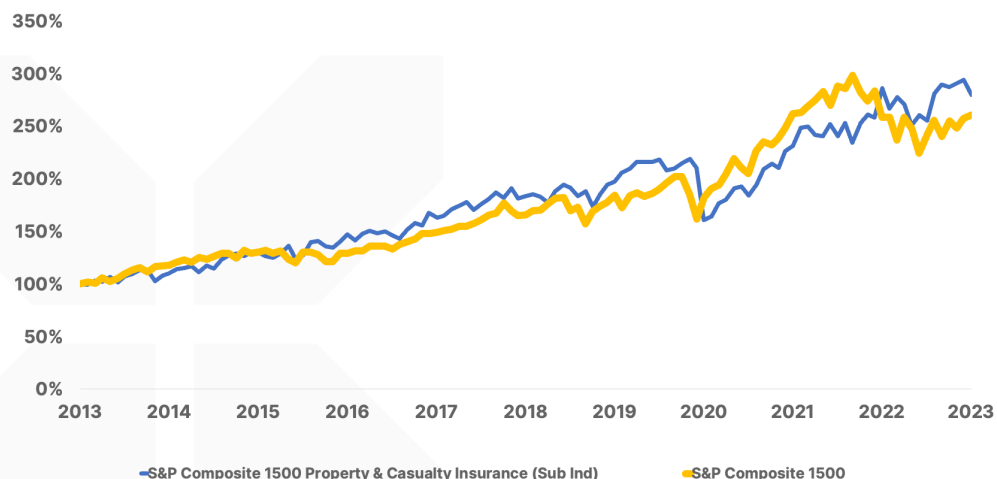


Source: Profitspi.com

The 10-year historical **beta** for the property/casualty index of stocks has been about 0.75, or 25% less risky than investing in the S&P 500 Index. Hence, the outperformance shown in the chart below is all the more impressive given the fact that the P&C sector is significantly less volatile than the overall market itself.

In fact, for the 10-year period from 2012 to 2022, the P&C sector's stock performance was over 100 basis points (12.75% vs. 11.50%) better than the broader market performance. Moreover, the P&C sector maintains a very steady dividend yield in the range of 2.6% versus about 1.6% for the S&P 500. Hence, the total returns are even more impressive for P&C stocks relative to the S&P 500. And this outperformance comes with 25% less risk.

### S&P P&C Composite Index 10-Year Outperformance



The 10-year outperformance has been relatively steady and consistent, at least up until the pandemic. The sector did decline at about the same pace as the overall market, but the broader market had a slight outperformance on the rebound during the uncertainty of the COVID timeframe. However, in 2022, the P&C sector resumed its historical outperformance as investors embraced “value” strategies and rewarded insurers’ pricing power.

As we said before, the P&C sector (including reinsurance) represents about 8% of the financial sector, which itself is 12% of the S&P 500. This translates into property/casualty representation of the S&P 500 of roughly 1%.

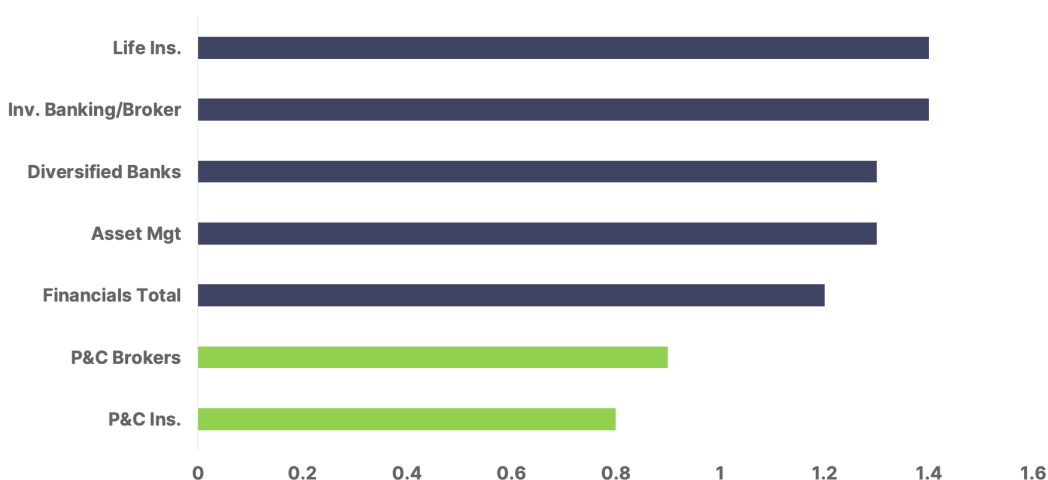
The main drawback to the S&P 500 is that the index gives higher weights to companies with more market capitalization. The stock prices for Apple and Microsoft have a much greater influence on the index than a company with a lower market cap. In fact, with almost 30% weight toward technology, the S&P 500 has almost become a de-facto tech-induced index. So it inherently has more volatility than all of the financial services subsectors.

The P&C insurance sector is, as a derivative of financials, considered a value (or defensive) play while the broader market index is much more heavily influenced as a growth play. This is, in part, why P&Cs (and financials in general) tend to outperform over the long term. In times of broad market declines, the defensive, or value, plays usually outperform significantly.

As we mentioned before, P&C stocks have a very low beta, meaning there is inherently less risk involved in the sector. In fact, even among all financials, a sector considered “defensive” has the lowest risk factor.



### Average Beta Across Financials



Defensive stocks tend to get a lot of attention and money flow when there is a great deal of uncertainty in the market or in the overall economy. They tend to be a safe haven in times of greater market volatility as a result of exogenous events, such as a recession or other global economic turmoil created by pandemics and/or war, etc. **In fact, P&C stocks have outperformed in four of the last six recessions, exceeding the market by seven points on average.**

And, remarkably, the sector also outperforms even during “micro-recessions” in its own industry...

### P&C Outperforms During Both “Hard” and “Soft” Cycles

Usually, costs associated with a business – whether it’s making toilet paper, providing consulting services, or flying airplanes – are easy to calculate. And, for the most part, they’re fairly similar from one year to the next – variables like inflation or recession or a product falling out of favor can of course affect this, but otherwise, costs are pretty predictable.

But it’s different with insurers. First, the costs (to an insurer) of its goods sold are the claim payments it makes to the insurance buyers once a qualifying loss event (whether it’s a car crash, a house burning down, or a lawsuit against a corporation) occurs. If no loss event occurs during the period that the insurance policy was in force, then no claim payment is made by the insurer.

So, what is different about this? Remember, the insurance premium is paid upfront, at the beginning of the policy period... thus, the insurance company charges



a premium for the coming policy period (typically one year), without knowing whether a loss event will occur – meaning, its costs of goods sold are completely unknown when it charges the insurance buyer for premium payment at the outset of the policy period. And this has implications for P&C stock prices.

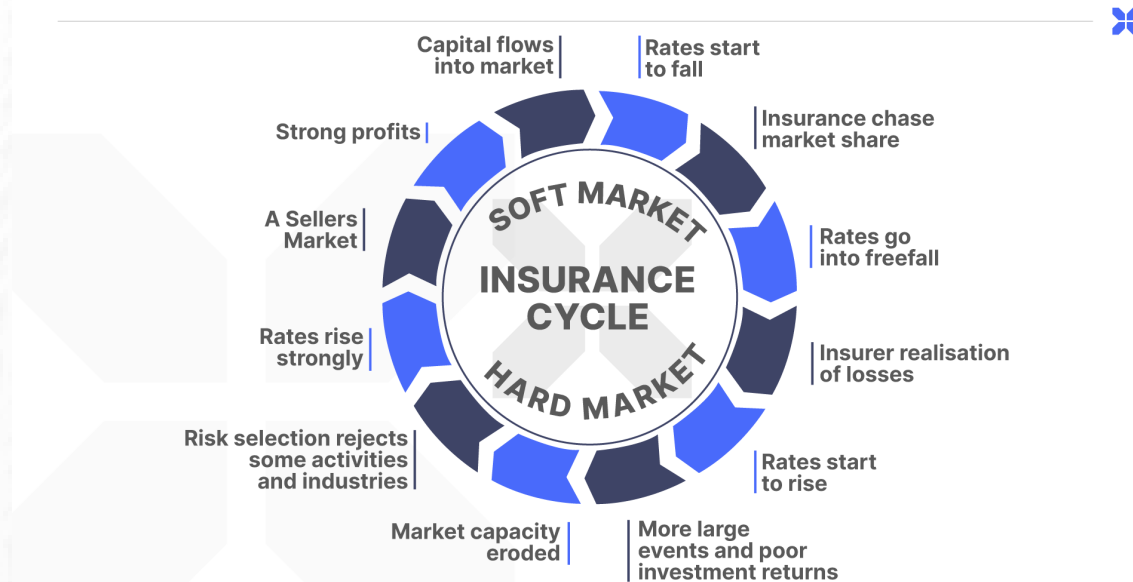
Because true loss costs are not known until years after the premium is paid, insurers looking to grow can keep their prices low for long periods of time in order to gain market share. In fact, we see this when looking at a long-term view ...

The P&C industry has one of the more unusual business cycles in the economy. Long periods of price declines lasting five to 10 years are punctuated by sharp spikes in pricing power lasting two to four years. While all P&C “lines of business” (such as personal auto, homeowners, renters’ insurance, etc.) move differently, the broader industry swings are driven more by inflections in the combined ratio of longer duration commercial lines than personal lines.

Periods of concentrated pricing power are referred to as “hard” markets, as it is during these dislocated periods that insurance capacity is difficult to obtain for insurance buyers. A hard insurance market is characterized by a **high demand for insurance coverage and a reduced supply**. Insurers impose strict underwriting standards and issue a limited number of policies. Premiums are high and insurers are disinclined to negotiate terms. This is considered a seller’s market.

Periods where pricing is declining are referred to as a “soft” market. A soft insurance market is characterized by **low rates, high limits, flexible contracts, and high availability of coverage**. During a soft market, insurance organizations are often trying to expand their market share and will often try to offer the cheapest deal to win the business. This is why a soft market is considered a buyer’s market.

Here's a diagram of how the cycles work:



Source: Embark Group "Cycle Management" Report

As we mentioned earlier, demand for insurance remains relatively stable compared to other industries. Consumers must have insurance for financed homes and automobiles. In addition, businesses are required to carry certain insurance such as workers' compensation and medical malpractice insurance. Hence the underwriting cycles tend to be driven more by the entrance and exit of supply.

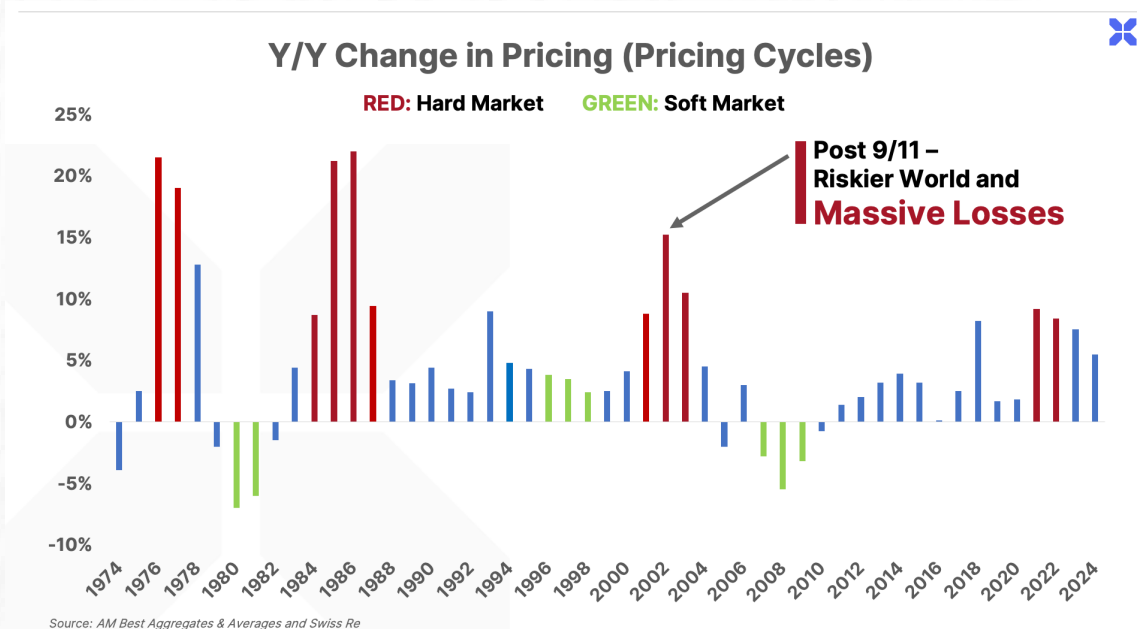
For an insurance company, the supply is equal to capital. During periods when profitability is high (due to a lack of loss claims or because pricing is very high) new capital – from private equity, venture capital firms, or other investment vehicles – enters into the market to try and take advantage of the high profits. The new entrants look to gain share in the market, usually by offering lower pricing. As that occurs, prices and profitability fall.

Hence, the new capital, or insurance supply, creates a change in the underwriting cycle until profits fall below acceptable ranges and then capital exits the market (supply falls).

Steady demand for insurance also creates competition in the form of supply of capital. This supply-demand dynamic does create cyclical periods of pricing and/or earnings power. The property/casualty insurance industry is cyclical, continually fluctuating between a hard and soft market. These fluctuations affect the availability and price of business insurance, so it is helpful to understand why they occur, especially because it is the single most important focus of Wall Street analysts and institutional investors when determining when to invest in the sector.

That said, it tends to be a fool's game because the **P&C stocks have historically performed well in both hard and soft cycles**. Hence, investors should not look to "time" the cycles.

The following chart shows P&C outperformance during both hard and soft cycles over the past century:

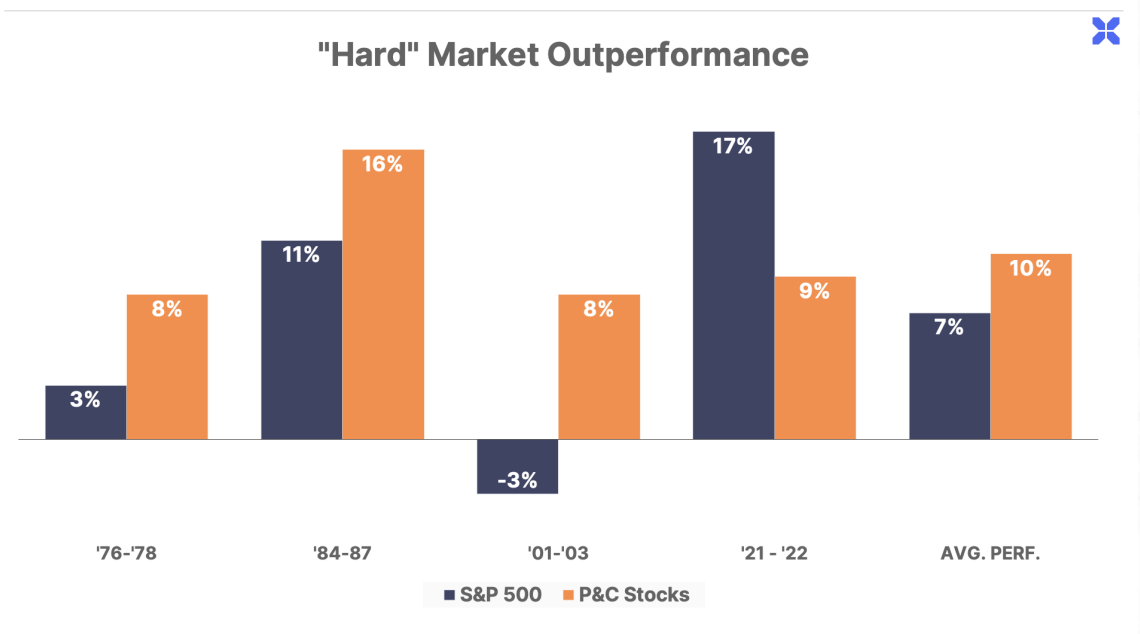
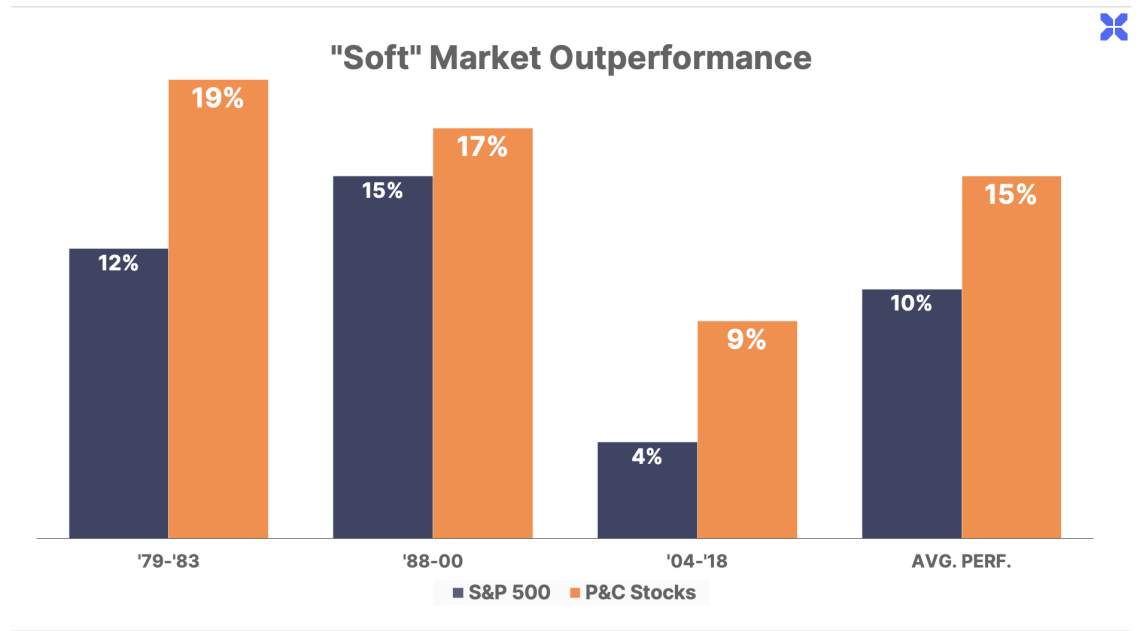


But from an investment perspective, it really does not make a difference where we are in the cycle. Over time the P&C insurance sector proves much more resilient than most industries. That's why we do not recommend "timing" these stocks.

What could be better from an investment perspective over time than to invest in a sector where the stocks tend to outperform when the fundamentals are strong and often when they are not strong? **P&C stocks tend to also outperform many times during the "softer" cycle periods as well as in the "hard" markets.**

It is obvious why the stocks would outperform in a "hard" market environment – the industry is growing at a much faster pace than it usually does and higher profits always follow the "hard" markets. What is not as obvious, perhaps, is why would the sector outperform during soft cycles.

Soft cycles tend to be longer in duration than hard cycles. As such, there is usually a bear market sentiment in the broader markets during that time. For example, in the 2004-2018 time period, there were four years when the broader markets were bearish with negative returns. Because of the defensive nature of the P&C stocks, there was significant relative outperformance during those four years.



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- Average annual return in the “good” times is 10% compound annual growth rate (“CAGR”), which is 300 basis points better than the broader S&P 500 return.
- Excluding the anomaly of COVID years’ fall and rebound, the P&C stocks would have been more than double the return of the broader market during the hard market years.
- However, what fewer investors seem to realize is how well the P&C stocks do during the “soft” markets, beating the S&P 500 by 500 basis points in those years.
- P&C stocks are not growth stocks. They are not “fad” stocks like artificial intelligence, cannabis, or “meme” stocks. They are defensive stocks by nature. Some might call them value plays.

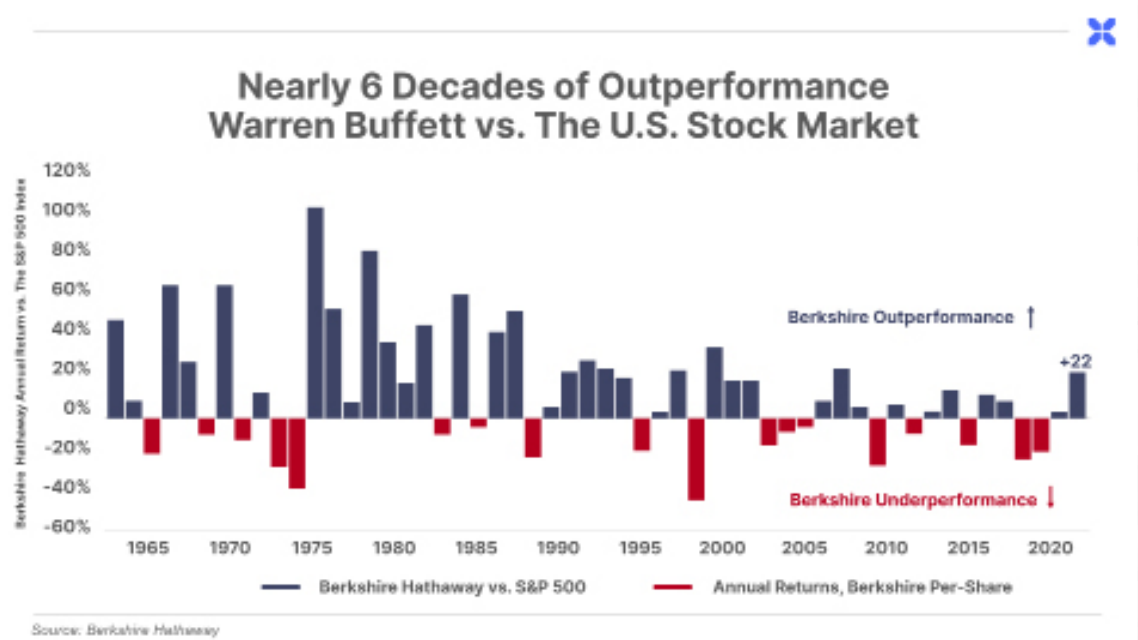
It’s not surprising that these safe outperformers are a centerpiece of Warren Buffett’s legendary portfolio. And in fact, they offer one more very special characteristic that he describes as “cost-free” money.

It’s what is called the “float”.

### Warren Buffett’s Secret Weapon: Float

Warren Buffett is one of the greatest generators of wealth in history – and as we mentioned earlier, his love affair with insurance companies is a great source of that wealth. And what he loves most is a special characteristic of the property/casualty industry – **the float**.

Insurance float has been the main reason why Berkshire Hathaway’s book value and market value have grown at an average of 20% per year over the past six decades, compared to just under 10% per year for the S&P 500.

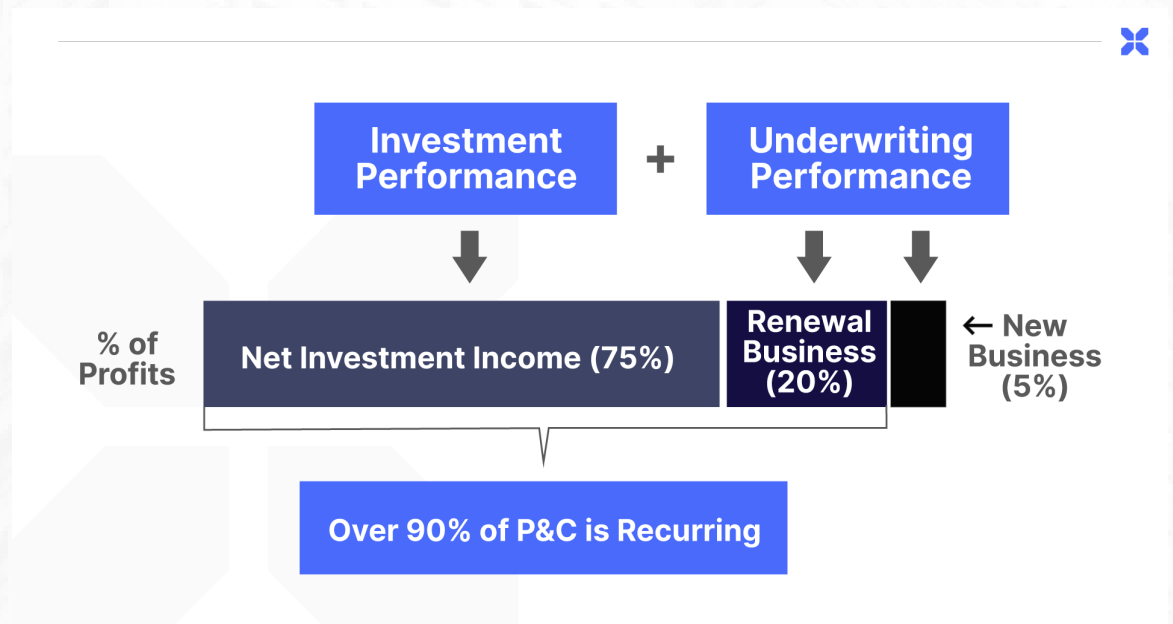




Float is the difference between the **premium** an insurer brings in and the **claim** that is eventually paid out. The insurance business is, perhaps, the only business that does not know its cost of goods sold until much later – because the “cost” (what the insurer pays out) doesn’t happen until well after the premium is collected.

It is also comfortable (in many cases) with making almost no money from the product it manufactures (the underlying policy). That is because the name of the game in the P&C industry is “make money on the float.”

The investment income earned on this float – that is, the return on investment of premiums collected by insurance companies before, or if, they’re paid out – is the source of the bulk of the industry’s operating profits. In fact, investment income represents about 75% of the industry’s profits:



When combined with the fact that retention of insurance buyers is high (about 80%), we get an industry with high recurring earnings. Of course, the level of interest rates affects returns – as it does with anyone investing capital – and the longer-term growth rate of overall earnings, but investment income is a predictable and highly recurring line item within the P&C industry.

Insurers don’t pay out all the money they collect – that is, the premium – right away. Rather, an insurance company will collect money in the form of premiums, invest that money, and then pay out claims as needed at some future date. The difference between premiums collected and claims paid out is the insurance float.

Insurance float has been a huge contributor to Warren Buffett’s success with Berkshire Hathaway. Because premiums received are essentially like loans from

policyholders – with the key caveat that these “loans” only need to be paid back if a claim is made sometime in the future – Buffett has been able to use insurance float when investing in stocks and private companies. That’s how Berkshire Hathaway has been a market-beating business for decades.

The insurance float represents the available reserve, or the funds available for investment once the insurer has collected premiums but is not yet obligated to pay out in claims.

Underwriting gains or losses are the “cost of the float.”

The float is money the insurer holds but does not own. In an insurance operation, float arises because premiums are received before losses are paid, an interval of time that sometimes extends over many years. During that time, the insurer invests the money.

This activity carries with it a downside: the premiums that an insurer takes in usually do not cover the losses and expenses it eventually must pay.

Consider the medical-malpractice insurance business. A service provider, such as a doctor, will pay, for example, \$5,000 in medical-malpractice premiums each year. Several years may lapse before a claim is made against that doctor’s policy. But typically, enough claims are filed in the aggregate that the insurance company will pay out more to its insureds than it collected in premiums. But that does not mean the insurer loses money. This is because medical malpractice claims take five years on average to run through the legal system, and it can take as many years before the insurance company must actually pay the claim.

So the insurer will have invested that money for years, thus earning a profit on that capital. That leaves it running an “underwriting loss,” which is the cost of float. An insurance business has value if its cost of float, over time, is less than the cost the company would otherwise incur to obtain funds.

So to summarize, insurance float is the difference between premiums received today over claims that must be paid many years in the future. During that time, the insurer invests the money. Insurance float is so valuable that insurance companies often operate at an **underwriting loss** – that is, the premiums received are not enough to cover the eventual losses (hurricanes, car accidents, lawsuit liabilities, etc.) that must be paid and the expenses required to resolve those claims, operate the business, etc.

A quality P&C insurer will therefore receive capital without having to pay for it.

Why would an insurer operate at a loss? Because the insurer can invest the insurance float and make even more money. In this sense, insurance float is like a loan and the underwriting loss is like the interest rate on that loan (i.e., cost of capital). **This is why it is important to recognize the high-quality underwriters when investing in the P&C sector.**

## The World's Greatest Investment

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Those that consistently make an underwriting profit – that is, collect more in premium than they pay out in insured losses – essentially have a negative cost of capital, or are “paid to take other people’s money.” That is a great model for building longer-term wealth!

To see how we value P&C companies – and find high-quality businesses that aren’t too expensive – [see our detailed Valuation Report here.](#)