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CAS Annual Seminar on Reinsurance

A View from Wall Street



RESEARCH

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Bank of America-Merrill Lynch

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Refer to important disclosures on page 21-22.

Product ID

Role of an analyst

- Convey investment recommendations to clients
- Provide industry-level insight
- Use public information to form views of companies/sector

How insurance stocks are valued

Price/Earnings

- Expected earnings growth
- Earnings stability
- Discount to market
- Price/Book - preferred method
 - Cyclical business
 - Relatively volatile earnings
 - Flexibility of management in reporting EPS

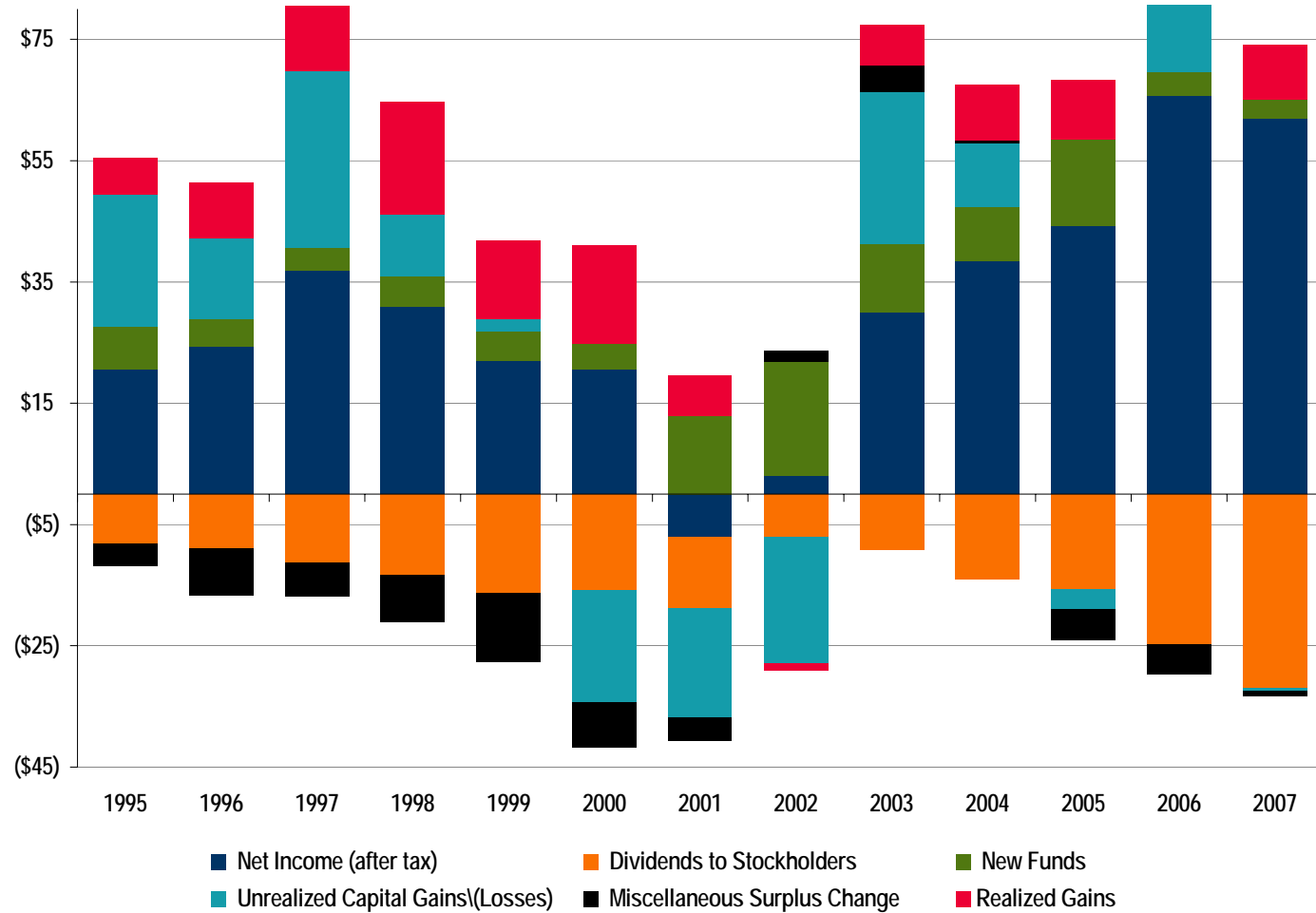
Price/Book Ratio

- Which book value to use
 - Reported book value
 - Book value excluding unrealized gains/losses
 - Tangible book value
- Historical range of valuations
- Indication of franchise value
- Driven by expected growth in book value

Growth in book value

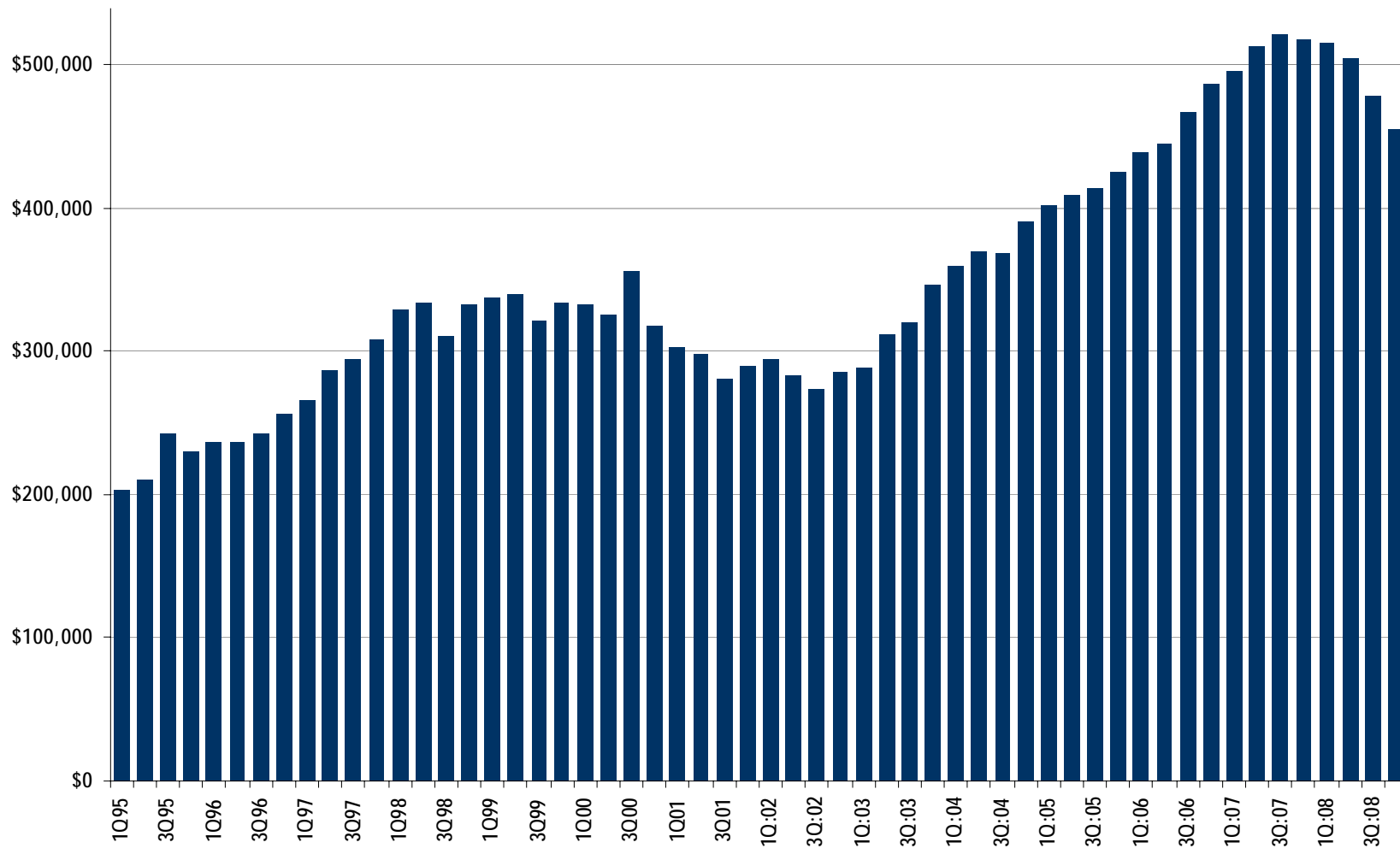
- Operating earnings (ROE)
- Realized gains/losses
- Unrealized gains/losses
- Dividends
- Share repurchase/issuance

Source of surplus growth



Source: Insurance Services Office

U.S. Statutory surplus



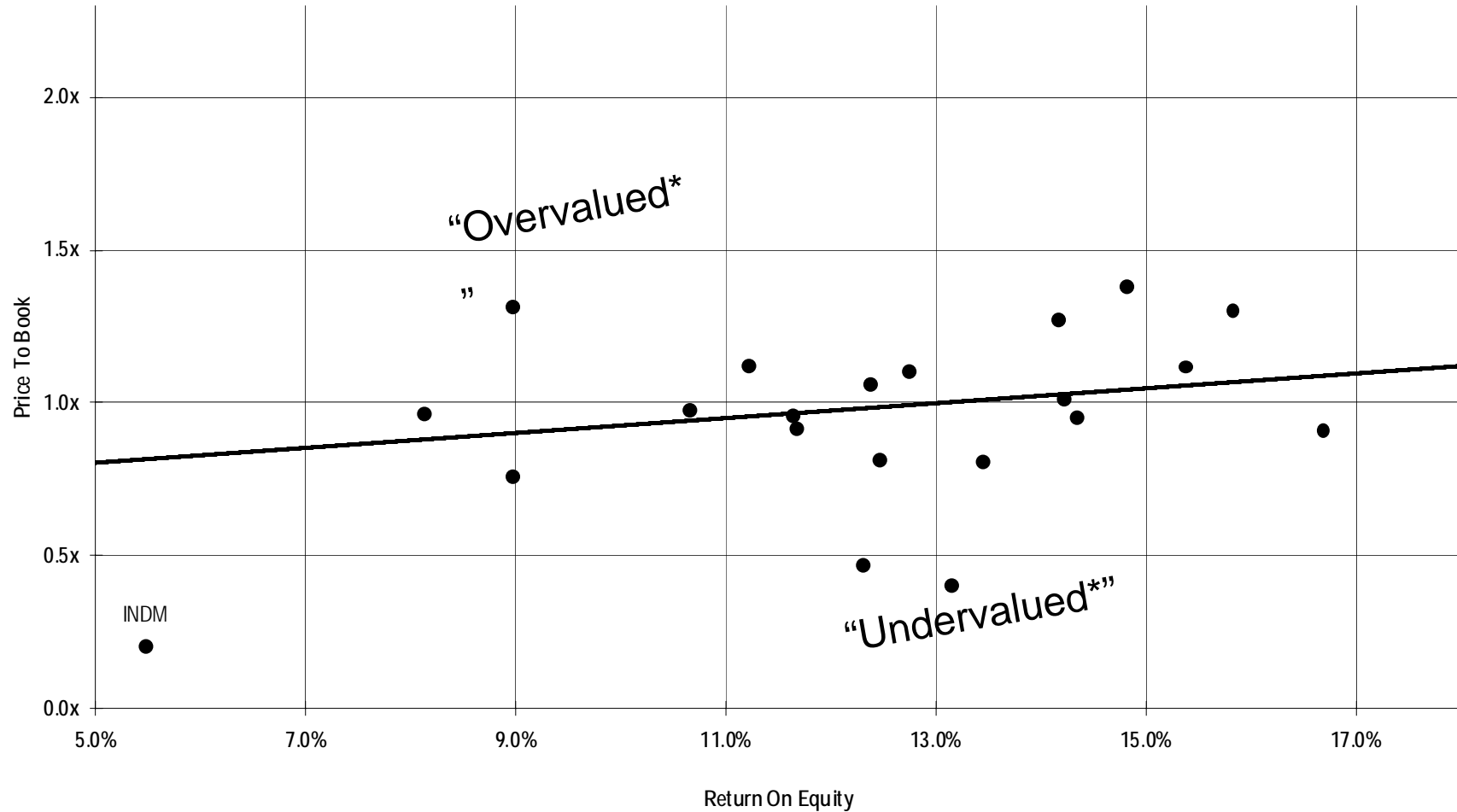
Source: Insurance Services Office

Components of ROE

- Premiums/Equity
 - Business mix
 - Reinsurance strategy
- Combined Ratio
 - Loss ratio
 - Expense ratio
- Assets/Equity
- Yield on investments
- Financial Leverage

Price/Book vs. ROE

$$y = 8.8344x + 0.0726$$



Source: Bank of America-Merrill Lynch

* All else being equal

Price/Book considerations

- Volatility of returns
- Sustainability of returns
- Quality of book value
 - Loss reserves
 - Asset quality
- Quality of earnings
- Leverage
 - Helps returns, adds to risk
- Excess capital
- Make-up of investment portfolio
- Cost of capital
- Correlation of risk

Debating a cycle turn

Arguments for a turn	Arguments against a turn
<ol style="list-style-type: none">1. Declining capital2. Higher cost of capital3. Increased reinsurance demand4. AIG5. Fear6. Expect less capital markets capacity	<ol style="list-style-type: none">1. Its about claims not capital2. Not enough fear3. Insurers look at normalized investment returns4. Long term cost of capital5. Statutory vs Gaap equity

Investor concerns about reinsurers

- Earnings volatility
- How to sustain competitive advantage
- Ease of capital flow into business
- Removed from underwriting decisions
- Growing vs. shrinking

Contending with a recession

- Impact on premiums
- Impact on claims
- Limited historic conclusive data

Table 1: Premium growth in past economic downturns

Downturn period	Change in real NPW	Comments
1980	-7.4%	Commercial prices declining. Nominal premiums rose.
1982	-1.5%	Commercial prices were still falling. Nominal premiums rose.
1991	-1.8%	Commercial lines prices were declining.
2001	5.6%	Price increases offset economic weakness

Source: ILL and Banc of America Securities-Merrill Lynch

Our view of the group

■ Pricing Environment

- Commercial Lines

- Prices still falling in most lines of business, but decreases moderating
- Expect to see increases in large specialty business

- Reinsurance - A combination of increased demand and reduced supply should drive prices higher

- Personal Lines - Prices moving up modestly. Questions over claims trends.

■ Earnings/Book Value Growth

- Underwriting results expected to remain good but worsen in 2009
- Cash flow remains positive for most carriers
- Loss reserves appear adequate and releases should continue
- ROEs should decline but stay reasonably good through 2009. Could stabilize with more stable pricing.

■ Investment Themes

- Positive on group. Multiple compression overdone. Key differences with other financial sectors
- Focus on reinsurers and high quality insurance names.
- We like Aon and Willis among the brokers

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster*
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

* Ratings dispersions may vary from time to time where BAS-ML Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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