The Property/Casualty Insurance Industry continues to be ranked in the top half of all sectors under our coverage. The group, in aggregate, has been performing well, thanks to relatively low catastrophe figures (though that item has ticked up in recent months), new business opportunities, along with rate increases in some product lines. These positives have generally outweighed historically low bond reinvestment yields. We will discuss these, along with other factors, in the paragraphs below.

Current Secular Trends

Things have generally remained uneventful over the past three months. Industrywide capacity conditions continue to hover at relatively high levels, which has made rate increases difficult to come by. This is because significant catastrophes, for the most part, have been avoided. Indeed, following Hurricane Katrina, Hurricane Sandy, and the 2001 terrorist attacks, rate increases were more easily attained, as claims payouts related to these occurrences lessened industrywide supply. However, over the past several years, things have been relatively quiet. Most of the sharper rate hikes in recent quarters have come from niche or specialty insurance coverage, or those regions or product lines directly affected by catastrophes.

Less-than-average frequency and severity of catastrophes have been favorable for combined ratios (the sum of the loss and expense ratios) for many insurers under our perusal. Hence, many corporations have an underwriting margin (100% minus the combined ratio), that is solidly in positive territory. This is good news, as it helps to boost profits. Over the past few months, however, there have been some weather-related occurrences that could have an impact on loss ratios. The flooding in Louisiana and hailstorms in Texas are two events that come to mind. Catastrophes such as these are a bit of double-edged sword for insurers. On one hand, profits are reduced as increased claims are paid out. However, it does give insurers the wherewithal to increase prices during policy renewal season, particularly in those segments directly affected.

Insurance companies not only make money on their underwriting operations but also on float. In this instance, float can be defined as premium proceeds received less immediate expenses. However, given the current low interest-rate environment and the fact that most insurers keep a majority of their portfolios in interest-sensitive instruments, this has resulted in waning investment income per share in recent months. While some insurers have gone outside of the box and invested in private equities, limited partnerships, and other instruments, the percentage invested in such vehicles is generally quite low.

Two other variables worth mentioning are policy retentions and policyholder renewals. Policyholder renewals are the percentage of policies that are on the books from one period to the next. Generally, it's advantageous for insurers to keep this ratio higher, since it reduces costs. A caveat could be if a customer's risk profile has changed considerably, or no longer meets the company's objectives.

Retentions are the policies that insurers underwrite themselves rather than sell to a reinsurer. Insurers, often called primary insurers, usually retain a large percentage of policies, particularly when the cost of reinsurance is high. However, there are many times when primary companies cede, or sell, their exposure to secondary insurers. There are many factors that may cause a primary insurer to sell business, but terms & conditions that don't meet its stated goals or policies that have an unacceptable level of risk are the two primary factors, from our perspective.

INDUSTRY TIMELINESS: 38 (of 97)

A Couple Of Timely Choices

Chubb Ltd., fresh off its early-2016 merger with ACE Limited, is a good choice for momentum-based accounts. Underlying fundamentals of this industry giant remain sound, and we look for significant accretion from the ACE merger once the kinks are ironed out.

RLI is another stock we like for the upcoming year. The company sports an above-average combined ratio relative to the industry average, which would enable a nice lift to earnings. A strong balance sheet provides for financial flexibility during both good times and more-difficult periods.

The Importance Of The Balance Sheet

The statement of assets and liabilities is vital in this industry. One sector we want to focus on is reserve additions or releases, which has a direct affect on earnings.

Though there are individual circumstances that dictate how much reserves an insurer should have, we believe a ratio of two-and-a-half-to-one is a solid reserve-to-anticipated loss metric for most companies.

If a company has excess reserves on the ledger, it can release funds, which adds to the bottom line. On the other hand, if an insurer doesn't have enough reserves to cover claims, then it would have to boost funds, which cuts into profits.

Generally speaking, a balance sheet with a modest level of debt is advantageous, and generally the norm in this sector. The degree of leverage needed is generally minimal, particularly when compared to high barrier-to-entry industries such as cruise ship operators.

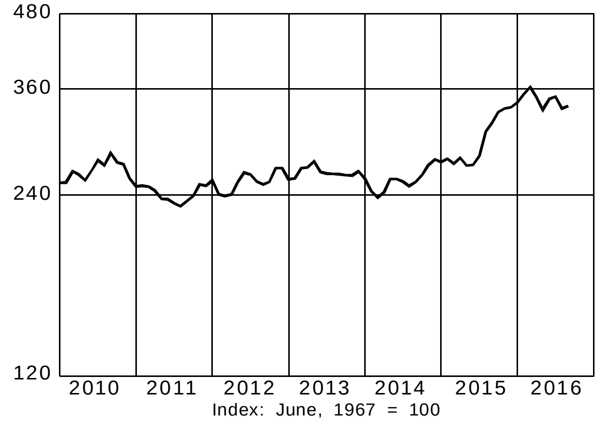
Conclusion

We advise that investors carefully study the individual reports on the following pages to identify those stocks that offer the best risk/reward prospects for their portfolios, both for the year ahead and over the 3- to 5-year pull.

Alan G. House

Insurance (Property/Casualty)

RELATIVE STRENGTH (Ratio of Industry to Value Line Comp.)



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