The Property/Casualty Insurance Industry has held its own in our Timeliness Ranking System since our September report, though it continues to reside in the lower-third of all sectors under our review. Many companies under our coverage are on pace to enjoy strong year-over-year earnings gains in 2013. We attribute the strong comparative performance to a relatively low level of catastrophes for the year. However, though share prices of many insurers we follow have appreciated this year, this sector, in aggregate, hasn’t performed as well as some of the more “high-flying” industries, which have markedly benefited from many indices reaching all-time highs. Hence, the industry falls below the middle of the pack for year-ahead relative price action.

A Relatively Light Year For Catastrophes

Through the first 11 months of the year, industrywide catastrophes (individual events that cause damages of $25 million or more) have been low relative to the historical average. The North American hurricane season, which ran from July 1st to November 30th, ended with only 13 named storms and two hurricanes. On the other hand, tornado activity has been quite prevalent over the past several months. Earlier this year, a barrage of tornadoes touched down in parts of Oklahoma, resulting in insured damages in the vicinity of $5 billion. What’s more, in mid-November, tornadoes once again caused significant damage in parts of the Midwest. Most companies haven’t given loss estimates related to the storms, though we believe industrywide damage was in the neighborhood of $1 billion. To put things in perspective, Hurricane Sandy resulted in losses of about $75 billion.

Catastrophes can be a bit of a double-edged sword for insurers. Of course, they could result in significant losses that can cut into bottom lines. However, they may also give insurers greater bargaining power during policy renewal season. We believe companies that have exposure to the aforementioned tornadoes will be able to increase rates in those regions and product segments that were affected.

What’s Our View For 2014?

As noted in our September review, conditions in the insurance industry have strengthened in recent months. We look for this trend to continue, as capacity in the sector should remain at attractive levels. When industrywide supply is manageable, companies generally have the wherewithal to raise prices. On the other hand, when increased capacity comes on the market, this tends to constrain insurers’ ability to raise rates. This was the primary culprit behind the significant industry downturn of the late-1990s into the early 2000s. What resulted was an industrywide shakeout, and many smaller and less financially sound companies went out of business. However, the industry appears to have learned from its mistakes, as many participants have adhered to maintaining a stronger book of business.

Of course, pricing is a key factor behind a P/C insurer’s earnings. However, the combined ratio (the sum of the loss and expense ratios) is also a significant variable. The loss ratio has been favorable thus far in 2013, and though we look for a slight uptick next year (as this year’s level appears unsustainable long term), it should remain quite decent, nevertheless. Though aggregate losses may indeed increase, insurers should benefit from more-stringent underwriting, which includes better terms and conditions. Additionally, tight cost control should lead to a lower expense ratio for the industry next year.

A line item that hasn’t fared as well in recent months is investment income. While increased net premiums earned have helped to push invested assets higher, reinvestment yields on bonds remain at near-record lows. This is due to the easing monetary stance by the Federal Reserve Bank. Looking ahead, we believe that a strengthening economy might well result in a tapering of bond purchases by the government, which would help interest rates inch higher. Thus, we forecast a moderate uptick in net investment income for the broader industry next year.

Good Balance Sheet, Good Earnings?

An insurer’s balance sheet is vital to its overall financial health. We believe that a reserves-to-anticipated-losses ratio of three-to-one is a good cushion to have. This impacts earnings, since an insurer will have to take a reserve strengthening charge if it is underreserved, which cuts into the bottom line. Conversely, if a company feels it is overreserved it can release reserves, which boosts net income. We generally don’t account for such items in our projections, as they are too difficult to forecast.

Another line item to keep an eye on is debt. Normally, insurers don’t take on a lot of leverage and, thus, any figure above 30% of total capital may require a closer look.

What do insurers do with excess capital? Well, during times of strong industry growth, they may take advantage by garnering new business. However, they have to make sure that they are writing policies that are profitable, or, in other words, are priced in accordance with the risk undertaken. Share buybacks, quarterly dividend increases or, in some cases, a special dividend, are other ways that insurers utilize excess capital.

Conclusion

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

Alan G. House