Capacity Shmapacity

Why 'one good hurricane' won't harden the market.

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Conventional Wisdom, Example 1

"In the insurance industry so far this year, we have witnessed a significant and rapid destruction of capital. We began the year with ***an over-capitalized industry feeding a soft market***. Since then, natural catastrophes and financial market losses ***have destroyed a great deal of this excess capital***. Additionally, downgrades and government ownership are impairing the ability of a number of companies to operate in the same manner as they have in the past, and this adds to industry capital pressures. Moreover, the cost of debt and equity capital has soared for all industries globally, including insurance, and this will be true for some time to come. While all this is going on, insurance company margins are under greater pressure as underwriting experience deteriorates due to increased cats, soft market pricing, and declining returns on investment portfolios.

In sum, the end of the soft market in insurance has arrived."

Evan G. Greenberg, Chairman and CEO, ACE Limited, October 29, 2008

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Conventional Wisdom, Example 2

"The mid-year renewals, from what we've seen so far, will behave very to what happened in Q1. ***Rates are still off***; we saw that as we looked into Q2. ***Capacity is still plentiful***; while there have been an inordinate amount of catastrophes that have occurred over the last three months, none of them are going to really drive pricing in the reinsurance segment, and we can expect to see the headwinds continue throughout the year, absent any large catastrophes."

Peter Zaffino, President and CEO, Guy Carpenter, May 4, 2010

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Conventional Wisdom, Example 3

"The recent cycle of major natural catastrophes is not expected to materially alter the levels of capital available in the market. Consequently, the general rating environment remains competitive."

Interim Management Statement, Jardine Lloyd Thomson Group plc, April 28, 2011

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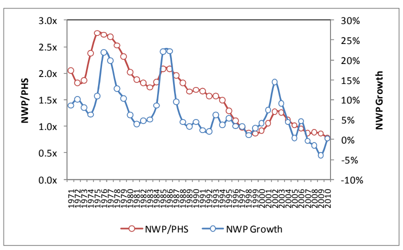
Which Raises the Obvious Question:



Source: A.M. Best, SNL, and Stifel Nicolaus format

If excess capacity (≈ more surplus, ≈ lower NWP/PHS ratios) prevents hard markets, shouldn't peak NWP/PHS ratios correspond to trough NWP growth rates?

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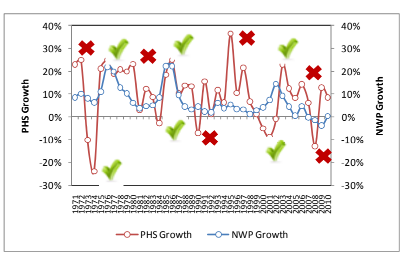
Surplus Growth Isn't a Consistent Indicator



Source: A.M. Best, SNL, and Stifel Nicolaus format

Sometimes, surplus declines precede hard markets, and sometimes they don't; e.g., the 2008 surplus decline was the second-biggest drop in 40 years, and nothing.

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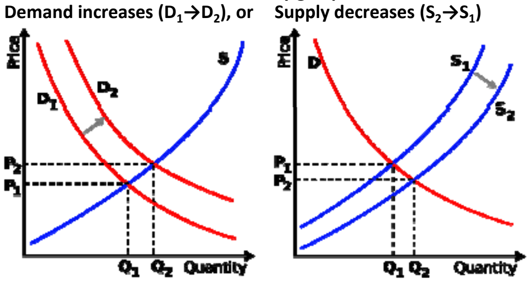
Economics Pre-101

Prices can only go up if

Demand increases ($D_1 \rightarrow D_2$), or Supply decreases ($S_2 \rightarrow S_1$)



Source: Wikipedia

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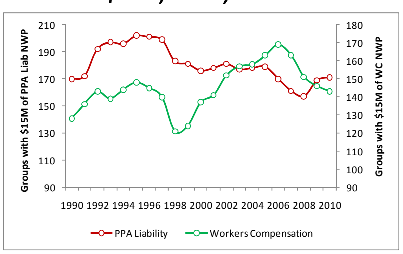
The $15,000,000 Men



Source: A.M. Best, SNL, and Stifel Nicolaus format

Looking past the natural upward drift, PPA Liability seems to show a long-term downward trend, while WC looks more cyclical.

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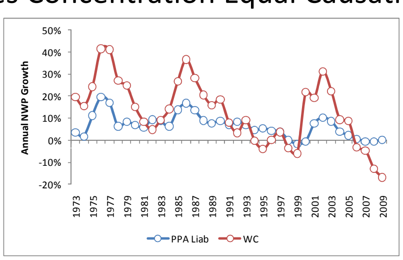
Does Concentration Equal Causation?



Source: A.M. Best, SNL, and Stifel Nicolaus format

PPA Liability annual NWP growth volatility has been declining. WC, not so much.

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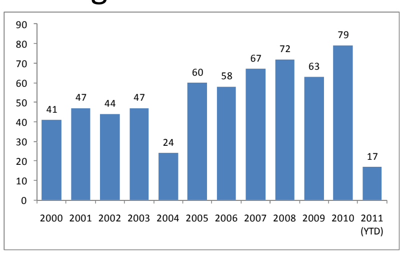
Unconventional Wisdom

"Markets don't change because of capital. I've been pounding the table about this for a long time, but the only thing I have that's in my favor are the facts. No one seems to want to believe the facts, but you can go back to 1974 and the facts have always said that there's always been plenty of capital; what's changed is people's state of mind, and that is the fear that the capital will erode, the losses are unexplainable, unfathomable, and when that starts to happen, people start to behave in a different way."

William R. Berkley, Chairman and CEO, W.R. Berkley Corporation, April 26, 2011

Knowing When to Call it a Day



Source: SNL

The longer the soft market lasts, the more M&A activity there is.

Two Press Releases Dated Oct. 28, 2010

1) First Mercury Financial Corporation (NYSE: FMR) ("First Mercury" or the "Company") today announced results for the third quarter ended September 30, 2010…During the three and nine months ended September 30, 2010, there ***was $11.4 million of unfavorable development*** of prior years' net loss and loss adjustment expense reserves due to adverse claims development principally in the Company's primary general liability and professional liability lines of business.
2) Fairfax Financial Holdings Limited (TSX: FFH and FFH.U) and First Mercury Financial Corporation (NYSE: FMR) today announced that Fairfax and First Mercury have entered into a merger agreement pursuant to which ***Fairfax will acquire all of the outstanding shares of First Mercury*** common stock.

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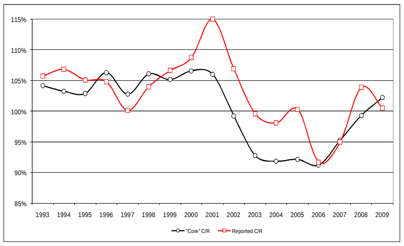
Watch What They Say, Not What They Do



Source: A.M. Best, SNL, ISO, and Stifel Nicolaus format

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BUY -For U.S. securities we expect the stock to outperform the S&P 500 by more than 10% over the next 12 months. For Canadian securities we expect the stock to outperform the S&P/TSX Composite Index by more than 10% over the next 12 months. For other non-U.S. securities we expect the stock to outperform the MSCI World Index by more than 10% over the next 12 months. For yield-sensitive securities, we expect a total return in excess of 12% over the next 12 months for U.S. securities as compared to the S&P 500, for Canadian securities as compared to the S&P/TSX Composite Index, and for other non-U.S. securities as compared to the MSCI World Index.

HOLD -For U.S. securities we expect the stock to perform within 10% (plus or minus) of the S&P 500 over the next 12 months. For Canadian securities we expect the stock to perform within 10% (plus or minus) of the S&P/TSX Composite Index. For other non-U.S. securities we expect the stock to perform within 10% (plus or minus) of the MSCI World Index. A Hold rating is also used for yield-sensitive securities where we are comfortable with the safety of the dividend, but believe that upside in the share price is limited.

SELL -For U.S. securities we expect the stock to underperform the S&P 500 by more than 10% over the next 12 months and believe the stock could decline in value. For Canadian securities we expect the stock to underperform the S&P/TSX Composite Index by more than 10% over the next 12 months and believe the stock could decline in value. For other non-U.S. securities we expect the stock to underperform the MSCI World Index by more than 10% over the next 12 months and believe the stock could decline in value.

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