

Catlin Group: International Specialty Property/Casualty Insurer and Reinsurer

Daniel Gladiš presented his in-depth investment thesis on Catlin Group (UK: CGL) at European Investing Summit 2014.

Catlin Group: International specialty property/casualty insurer and reinsurer founded in 1984 and became public in 2004. Managed by Stephen Catlin, who owns 2% of the equity (~\$60 million). Gladiš likes the investment proposition due to the following key factors: 1) relatively simple and understandable business; 2) managed by its founder who is capable and incentivized; 3) clearly defined financial goals with long-term progress measured by growth in book value per share (Catlin's long-term goal is 12-month USD Libor + 10%); 4) strong historical track record, both operationally and in terms of value creation for shareholders (during 2004-13 Catlin delivered an average return on net tangible assets of 16.8%, average ROE of 13.2%, and paid \$1.2 billion in dividends); and 5) the equity is attractively valued at a P/E of 8x, P/tangible book of 1.1x and P/book of 0.9x (dividend yield: 6%). Gladiš thinks the business could pay out \$2.5 billion in dividends over the next 10 years, relative to recent market value of ~\$2.9 billion. Additional positives: low correlation with the economic cycle and leveraged to higher interest rates.

The following transcript has been edited for space and clarity.

MOI Global: It's my pleasure to welcome and introduce Daniel Gladis, CEO of Vltava Fund based in the Czech Republic. Daniel is one of the best value investors in Europe, so we're very excited to have him at this event. Last year, Daniel shared with us his investment case on Irish-listed company, Total Produce, and that stock is up about 25% since then. Two year ago, Daniel presented on London-listed, WHSmith, and that stock is up about 80% since then, so very keen to hear more about Catlin Group, which is Daniel's idea for today.

Before I turn it over, just a few words on Daniel's background. He started the Vltava Fund in 2004 and has amassed a market-beating track record by really sticking to his value approach that is heavy on research and focuses on finding attractively-priced, good companies run by a quality management, which certainly has become more of a feat in today's market environment. Prior to starting his own firm, Daniel was chairman of the Czech-based business of ABM Row Asset Management. I just also want to draw your attention to a video we have available online of a recent conversation with Daniel. For those of you interested to learn more about his investment philosophy. I will stop here now and turn it over to you, Daniel, for your remarks. Go ahead, please.

Daniel Gladis: I always enjoy your conversations as a listener and it's also an honor for me to be a speaker, so thank you very much. The company I will be speaking about today is, again, London-listed and it's called Catlin Group. As a disclosure, I would say that we've owned Catlin since 2008 and we've actually bought more shares every year since then, including this year. The annualized rate of return we've had was about 22% on the stock and the funny thing is it's actually not more expensive than it was, say, four years ago and I think it still offers a good opportunity. The data I'll be using in this presentation are taken mostly from the company's resources, from their annual reports, website and presentations. Let's

get started. Let me summarize first why I like Catlin. I like it because they have a relatively simple and understandable business. I feel actually that they're understanding. It's managed by its founder, Stephen Catlin.

They have very clearly defined financial goals and a strong historical track record as you will see later. They have been creating significant value for shareholders and, of course, it's attractively valued. Otherwise, I wouldn't be speaking about it today. Catlin is an international specialty property/casualty insurer and reinsurer. It was founded in 1984, so 30 years ago and trades in London. The IPO was in 2004. As I said, it's managed by Stephen Catlin, who started the company and he's still running it. He owns now about 2% of the shares outstanding. As you know, every insurance company is trying to make money in two ways - underwriting and in investments. Let's take a look first at the underwriting side of the business. Catlin is doing both insurance and reinsurance, property and casualty. They do no life insurance and, as you can see here, they cover all the major types of risk. There's nothing unusual here. When Catlin started its business 30 years ago as a part of the Lloyd's syndicate, it was doing mostly a business in London, but in 1999, they opened the first international office in Singapore at Kuala Lumpur and since then, they have been growing internationally. Today, they operate in 22 countries and in about 51 offices.

As you can see from this slide, their London business represents less than half of their total business. The other half is done at the other underwriting house. They have six underwriting houses - London, US, Bermuda and then three other, Euro, Asia-Pacific and Canada, which they put together for reporting purposes and they call it international. Catlin's distribution model is very important because this allows them to underwrite a geographic and product-diverse portfolio in different parts of the world. Otherwise, twenty or ten years ago, they would only have to survive on the business that is available in London, but they can now use other opportunities around the world. It also helps them use their capital more productively. As I said, today, they operate in 22 countries and they have six underwriting houses. The prices for business regionally is often not as volatile as London and allows Catlin to form close relationships with clients and brokers worldwide.

The business is sold pretty much exclusively through a number of brokers, of which the top five would probably cover half of their business... The size of its business now is about \$5 billion. Now if you look at the underwriting results here, you will see that the size of the business is growing very nicely, but in this business, this could also be, potentially, a source of risk. Quite often, you find insurance companies trying to grow their business in terms of premiums written aggressively and you only find out years later that they have been doing this while selling insurance contracts at a loss, but by then the management is replaced and the old management that was compensated for big growth is somewhere else. When you look at insurance companies, I think it's important to find one where you don't have the principle aging problem. It means the management should think and behave as owners and I think if you study Catlin's history and also given the fact that it's been run by its founder, Stephen Catlin, you will see that they manage the company as owners. It's simply Stephen Catlin's baby and he treats it very carefully.

Insurance companies are trying to make money in insurance and the best way to judge whether they are successful or not is to look at the combined ratio. You can see here that for the last five years, the combined ratio for Catlin on average was about 91% and only in one of those years, 2011, it was above 100%. Now I'd like to remind you that 2011 was the year of the historically highest natural catastrophe in all the recorded insurance history. The total economic loss from the catastrophe during that year was more than \$400 billion and the insured loss was about \$125 billion. Even in that year, when many insurance companies

struggled, Catlin was only slightly above 100 with combined ratio and the year as a total was profitable because they made more money in investments than they loss in insurance. Just to remind you, 2011 was the year when we had the New Zealand earthquake, actually two New Zealand earthquakes. There was a Japanese earthquake with a huge tsunami, Hurricane Irene, high floods, Danish cloud bursts. Really an exceptional year from the point of view of catastrophe losses, but even in that stressful scenario, stressful environment, Catlin was profitable.

Where I said sometimes it's dangerous when an insurance company is growing too fast, you should also be carefully watching the development of reserves. If you study the loss reserves development triangles that Catlin produces, you would see that their initial estimate of losses was actually usually quite close to the actual results that is also known only years later. That shows they have been reserving realistically and actually on the conservative side because, as you can see, in each of the last ten years they were able to release some of the reserves because they were slightly over-reserved. It's not so important to have releases, but it's important to have consistency in the estimates. The releases are there, but they're not very volatile. I would say the reserving policy is rather prudent.

Every insurance company has to work with a certain capitalization. The company strives to generally maintain a buffer of available capital that's between 10% and 20% of the required economic capital. A required economic capital is a management estimate and it's based on a portfolio view of risk. It takes into account all type of risks and models them at the security equal to a one in one hundred years event. It wants to have economic capital at such high level that it would allow the company to benefit from the improved pricing environment that comes in subsequent years following extreme market losses. These are necessary in raising capital. That's the approach that Catlin is taking to the economic capital and they internally set limits for themselves. They want to operate with a buffer of 10-20% above that. As you can see, at the end of last year, their capital buffer was already at a high level of their internal limits.

Because 2014 is coming to the end and it will probably be a year of very benign catastrophe losses, it's very likely that the capital buffer at the end of this year will be significantly above 20% and Catlin has repeatedly said in the past that they don't want to keep too much capital that they cannot productively use. There's a good chance that there will be a special dividend next year. A special dividend would be somewhere, let's say, between 3% and 7%. If you add this to the 6% regular dividend, it means that you can probably get 10% dividend during next year. This is not unique for Catlin. This is typical for a number of similar companies. Catlin, by the way, is #20 in its size among the global insurers, so it belongs to the Tier II part of the business. The Tier I being companies like Munich Re or Swiss Re or Berkshire, and the Tier II with Catlin would be North Re and Tokio Marine would be these size companies. I think for most of them, especially from London ones, the chance of a special dividend is high for all of them.

Catlin has also put together an interesting problem of third-party capital. During the last several years they put together portfolio participation vehicles and special purpose syndicates that use external capital currently the size of about 300 million that Catlin is managing. This third-part capital arrangement benefits Catlin in several ways. For example, they make money through fees for management expenses and commissions for the underwriting that they do. It provides them with more flexibility to respond quickly to changing market circumstance and it also reduces the total volatility of earnings for their business. I think with all of that, you can see that Catlin is running profitable insurance operations, is reserving realistically and conservatively, is very well capitalized and actually

currently is overcapitalized, has an excess of capital. Just for more information, when I said that they model the economic capital requirement based on catastrophes with a sequence of one in a hundred years, this would be the criteria that I'm using.

For example, working with the Gulf of Mexico windstorm, that would bring an industry loss of \$112 billion. Let me remind you, this is equal pretty much to the historically worst year for the insurance business. That was 2011 where the insurance loss was about \$135 billion. Even that catastrophe of that size, which has never happened in history, but will probably happen at one point, would bring them about 8% loss of available capital. You would have to have, say, two of these events in one year, say, one in a hundred years Florida windstorm and one in a hundred years Gulf of Mexico windstorm in one year that would bring together 22% loss of available capital for Catlin. Catlin, at that time, would still be working with required economic because the buffer that is now at level, 3% would cover that. You can see that Catlin is a very well-capitalized company.

Let's take a look now at the other part of their business and that's investing. You can see here in this table that at the end of last year, Catlin had about \$9.2 billion dollars in total cash and investments. Right away, Catlin is a UK company traded in London, but does all their business in dollars, most of the business in dollars, and does the accounting in dollars. If you want to hedge currency, for example, this is a dollar stock. This is not a sterling stock. They had a total cash and investment last year of \$9.2 billion and stockholders' equity was \$3.7 billion. The investment level is the ratio of total cash and investment and shareholders' equity is about two and a half. For every share, they had more than £13 of investments and the stock trades at £5. Every investment company will accumulate some level of float, which as you know is money that does not belong to the company. It belongs to the holders of the insurance policies.

Eventually, it will be paid out for the insurance plans, but there's a difference between when insurance companies reserve for the losses in the year and the time when the losses are actually paid out. In some cases, it can be not years, but even decades, but for a business like Catlin, their insurance liabilities' duration is about 3.1 years. Basically, they have three years of other people's money that they can use for themselves. Now the investment return on that money belongs to them. You can see investment return in percentage terms has actually been going down for the last five years, which is typical for most insurance companies and it's just because the interest environment is so tough. Last year, they made the historically lowest, about 1.4%. This year will be somewhat higher, many 1.5%, but really, still low. The duration of the investment shorter than the duration of liabilities, insurance liabilities. The fixed income portfolio ratio is about one and a half years. If you combine it with the cash that they hold, then the total duration of the total cash investment is about 1.1 years. Catlin continues to remain short of the liability benchmark given the expectation that interest rates will rise in the future.

If we just consider that they have more than \$9 billion in their investment portfolio, a 1% in rising interest rates basically brings an extra \$19 million in extra return. A 2% rise would basically increase the investment return from \$190 to maybe \$300 million. There is nice optionality here. If interest rates goes higher, Catlin's profitability should also go higher. One thing that is important when looking at insurance companies like this is loss reserves in the balance sheet is not discounted for the time value of money. You have several billion of loss reserves, which are accounted in their nominal value, but you will only pay them out, say, on average, three years later. The discounted economic value is actually smaller, so if the insurance company is running the insurance segment of their business profitably, then I think there's a reasonable argument that it should trade above its book value because the book

value understates the economic value of the business.

If you look at the asset allocation, then you can see they are very conservative and very short-term invested. They have two-thirds of their investment in fixed income investments with very sort durations. As I said, the duration of that segment is one and a half years. A quarter of the portfolio in cash, that makes the duration even shorter and then you have a 7%, small amount in other assets, which will be private equity hedge funds and some equity investments. I think this portfolio is one source of a potential upside, as I said. When interest rates go higher, they will make more money. What I also like very much about Catlin is that they have very clearly defined financial goals. I think the best way to measure long-term progress in companies like Catlin is when you look at gross and book value per share, including dividends, this is exactly the way that Catlin sees itself. Ten years ago when they did their IPO, they declared that their long-term goal is to achieve a growth in book value per share at least equal 12 months' dollar Libor plus 10%. Basically, they want to make 10% real rate of return.

Here's the comparison of their goal and actual result. The lower, green curve shows that cumulative goal, which for the last ten years would be 12.5% annualized and the blue, kinked curve shows the actual result. You can see that the general equity during that period was 13.2% and their return on tangible equity was 16.8%. Of course, the blue line is kinked because some years are worse than others. The insurance business, profitability of the insurance companies are not rated very much to economic cycle of the economy, they are rated through the insurance cycle and the insurance cycle depends pretty much on two things - on the level of catastrophe every year and on the available capital the insurance companies have. For example, in years like 2005, when we had Hurricane Katrina, in year 2008 when we had Hurricane Ike and in year 2011, when we had, as I discussed, the worse year in history, the insurance companies are less profitable because they have to pay out more in insurance claims, but usually in subsequent years, are bonanzas for profitability. Why? Because the insurance sector as a whole has less available capital and the people that want to insure themselves are willing to insure more than before and are willing to pay more. Usually, after every bad catastrophe year, the prices for insurance products go up. Usually, a year or two, half a year is where companies make all the money back. The best way to judge the progress of a company is to look at the book value per share over a longer term or period because everything here by itself could be a mislead.

Catlin also deploys capital nicely. They pay decent dividends, very decent dividends and actually the dividends since the IPO in 2004 roughly are about \$1.2 billion. I estimate the dividends in the next ten years might be about \$2.5 billion. The current market capitalization for Catlin is about \$2.9 billion. If you are a longterm investor, then here's the proposition. If you buy Catlin today and hold it for another ten years, then you'll probably get your purchase price back in dividends. At the end of this period, you will hold a company whose book value will probably be double what it is today and on the top of that, you could reinvest the dividends and because the dividends are large, this is also a substantial amount of money. I think this an interesting proposition because if you look at the current valuation at 515, which was the price from last week when I was preparing the presentation, it means that it still trades at five times earnings, about 90% of book value, somewhat above the price for tangible book and more than 6% of net dividend yield.

As I said, a better measure than PE is price to book because the PE may be somewhat misleading because some years are very good, like this year, so the PE probably shows a more optimistic picture than it should. Some years when the insurance business is tough, it gives you a more pessimistic picture, so I think a better way to look at a company like Catlin

is price to book. I would argue that a company like that should trade above book value because they have shown in their history that they can run the insurance business itself profitably an the book value, as I said, because it doesn't take into account the time value of the liabilities and the value of the insurance flow actually distorts the economic value to business. If their long-term goal is 10% real rate of return, I think that business would deserve more than one times book value, maybe one-quarter or one-third above book value. I see Catlin as a very long-term, good compounder. You have a long-term goal in the book value growth of 10% above Libor, you have an upside due to valuation because I think the price to book should be above one. Then you have high dividends that you can reinvest over time, so I think if you put it altogether, for the next, say, five to seven years, this stock offers 14% annualized rate of return. In today's world, in today's valuation, this is very attractive.

Of course, nothing is black and white and so you might say that there are some arguments that could be made against this case. For example, what is the source of a competitive advantage in Catlin, if there is any? Well, this is a very interesting point because when you look at insurance companies, what they sell is a commodity product. Product differentiation is very difficult. The barriers to entry are very low. Maybe not so much from new entrants, but every insurance company can increase its capacity pretty much overnight. You say this is almost a perfect competition, but if you study different insurance companies and their history, you will see that some are consistently better and some are consistently worse. Why is that? I think you can make a very good parallel with the asset management business. Asset management is also a selling commodity business. The product differentiation is very difficult and the barriers to entry is also low because every asset manager can increase its capacity overnight quite easily, but as we all know, there are some asset managers that are consistently better than others and this is very similar to insurance companies. I think the only explanation to that would be that some people are better than others.

It's clearly a people business and some people have a difference between different asset managers or different insurance underwriters. It must be in the way they do business, it must be their philosophy, their risk management, their patience, their long-term views, things like that. I realize that this explanation requires a certain level of faith or goodwill, but I really believe this explains a lot. The culture is not very often cited as a source of competitive advantage because it's very difficult to pinpoint, difficult to measure. As I said, it requires a certain level of trust, but I think in this people business, if it basically runs money, it would explain a lot. The other point of importance, the alternative capital threat and low investment returns are somewhat connected. We knew that insurance companies would very often come to the situation that there is a lot of alternative capital that has been entering the insurance business.

Investors like pension funds, hedge funds or different other investors that need to reach for yield in this low interest environment are going to the insurance. They're providing their capital, they're buying catastrophe bonds because they are attracted by the rate of returns that these bonds offer. This is nothing new. This alternative capital has been here for a long time and is here to stay. This capital will continue to get access to reinsurance exposure and you have to live with that. The estimate of the amount of this alternative capital in the reinsurance segment varies, probably somewhere between \$50 billion or \$60 billion while the total capital of the industry is about \$600 billion. The alternative capital represents about one-tenth of the total available capital. Now I wonder whether these people know what they are doing because if you buy large catastrophe bonds and a large catastrophe strikes, a lot of the investors might be surprised when they realize they didn't take risk into consideration enough.

We'll see how it works out, but I think it is also connected to the low investment returns environment because if interest rates go higher, the attractiveness of this insurance for the alternative capital goes lower. You have a nice optionality here because if interest rates go higher, there might be less capital available from alternative sources, which should have prices of insurance products and at the same time, companies like Catlin with their current investment portfolio would make more money in a higher interest rates environment. I think that's a very nice potential upside here, very valuable optionality. Right away, even with these points of importance and with this environment, Catlin is certainly profitable, achieving their targets even in this environment, so I think that's very encouraging.

My closing summary would look like this. I think Catlin is a very well-run business and actually quite straightforward. It is a business, which you can understand because it's not very complicated. It has a low correlation with the economic cycle, so it can actually provide some diversification benefits to your portfolio. It is leveraged to higher interest rates, which I like a lot. When I think about the future, I worry about many things. One of them, which is very high on my list, is higher or significantly higher interest rates environment. It doesn't look very likely today because people have the tendency to extrapolate the current environment into the long-term future, but there is a chance that interest rates would go higher in the future and it might actually go higher a lot. If that happens, then most companies would feel pressure on their interest costs and their earnings would go down. Companies like Catlin, you'll probably see their profits go higher and I just want to have something like that in my portfolio. Finally, I think it's cheap. Otherwise, I wouldn't be speaking here about it.

MOI Global: Thank you, John. Actually, before I go to the questions, just perhaps to ask you, Daniel, about that comment about simple and understandable business. We heard yesterday from another instructor about another insurance company in the motor segment. Some would argue that the motor segment is more simple and understandable than property and casualty insurance. Perhaps you could put into context a little bit your way of getting comfortable with insurance businesses in general and then generating this idea relative to other potential insurance businesses out there.

Daniel Gladis: I generally try to avoid life insurance companies because I have difficulties figuring out what they would do if the interest rate environment changed a lot. I just don't know how to figure this out. It's too difficult for me, so I try to focus on the property/casualty. Now there are a lot of companies in that business. Some of them are very large like Munich Re, Swiss Re, Hannover Re. I realize that their competitive advantage comes from their size because companies like Munich Re, Swiss Re or Berkshire Hathaway can write a certain size contract that no one else can, but they seem to be too complex. I like Munich Re, for example, of course. I think it's a very good company and I was tempted to buy it a few times, but still, Catlin seems to me to be simpler. I also like the fact that it is run by the founder because, very often, you find insurance companies, which is doing business and it just looks fine, it just looks fabulous, but really, then you realize some years later that they have been growing the business too fast, selling the insurance contracts at the lowest. They fire the management, different management, it doesn't help you.

I really want to focus only on those companies where you have some sort of probability that they act as an owner and you will find these only in the second or third tier. I generally try to avoid the third tier. The third tier has been losing the business recently, I think. One of the trends I'm seeing here as well is that the reinsurance demands in total is actually shrinking because some of the large, global insurers are retaining more of their business, which means there's tougher competition for the reinsurers. What I think is happening is that the smallest

ones, the ones that, for example, are half the size of Catlin and smaller, are losing market share. The second tier companies, companies like Catlin, Amlin, Score are actually benefitting from that because they are gaining market share on account of the small ones. This, again, makes the universe small for me.

Then there are some special businesses you mentioned that do motor insurance, like Admiral and others. Of course, we all know the shameless history of Geico, which tells that this can be a fabulous business if you can do it well. I like Admiral, but I still was not convinced enough to invest in this sector. Basically, there's a lot of insurance companies. I'm trying to exclude those that I don't like, like life insurance, those that seem too complex to me, like the large ones, those that are not run by the founders and those that are too small. There's only a handful of companies and Catlin is definitely on the top of the list for me.

MOI Global: That's very helpful. Thank you for that explanation. Moving onto the questions, here's one that says, "One big catalyst for realizing value in small insurance companies is being acquired. Do you think management would be willing to entertain an acquisition offer given that they're an owner/operator?" If I'm not mistaken, there has been quite a bit of acquisition activity in the London market. Lloyd's Company is being acquired. How do you see it?

Daniel Gladis: It is a possibility, certainly. Catlin themselves did a decent acquisition in 2006, I believe. They acquired Wellington, which pretty much almost doubled their business overnight. When I do an evaluation or an investment case, I never take this into account because it's too unpredictable. I think that the sector is in a consolidation phase and the think that I described, the shrinking reinsurance demand and the third-party capital, these things lead to concentration of the reinsurance business. The traditional market is going through a shake-out. The smaller insurance are being notched off the larger programs. The Tier I players are maintaining their market share. As I said, the Tier II insurers are winning share as a benefit of the shortening of the list of reinsurance capacity providers and the third tiers are basically losing their market share. M&A is definitely on the table, but I'm not making this part of my valuation at all. I think Catlin is disciplined enough not to overpay for an acquisition if they are on the buying side, but on the other hand, I think they would be an excellent target for someone else. If this doesn't happen, it doesn't matter at all to me. It doesn't change the investment case.

MOI Global: Can you talk about their preference of dividends over buybacks? Given, as you've described, the intrinsic value is greater than where they're trading now, would it make sense to engage in buybacks rather than payout dividends?

Daniel Gladis: It might, yes. I don't remember they've ever done a buyback, but their dividend is very decent, so they don't accumulate the capital and sit on it unproductively. This would be for a larger discussion. I generally am a very big fan of buybacks and I think Catlin could do some, but I don't think it would change the variation that much. It would probably help, but the dividend is big enough already and I have no problem if it stays like that in the future.

MOI Global: There's a related question actually about the share count increasing over the last ten years. Looks like the questioner says it appears to have doubled. If you could talk a bit about what accounts for this increase of acquisition? Could you talk a bit about their record of nonorganic growth and how do you see that?

Daniel Gladis: Well, they only did one acquisition, as I said, of Wellington in 2006 and they

issued some shares for it. Then they issued some shares during the last financial crisis. I think it was in the beginning of 2009. It was not because they needed capital. It was because they saw a lot of opportunities and they wanted to participate. It was a right issue and even if you take into account these two larger issuance of shares, still the underlying way of how to judge the problems of the company is the growth of the book value per share. If you look at the graph that I showed, since they did the IPO in 2004, you wouldn't see that these two share issuances would have a negative effect on price to book. As I said, one was in 2006 and in 2007, there was a large increase in the book value. The other one was in 2009 and, again, in 2009-2010 were very good years. I think, yes, they did issue some shares, but it was not value damaging.

MOI Global: Historically, what is the cheapest price to tangible book or price to book that the company has traded at, if you could perhaps give a range or just roughly give us a sense of the current multiple. How does that compare to the history of the company and talk a bit about that, please?

Daniel Gladis: You've caught me off-guard here because I don't know exactly. I remember the price was really cheap, as you would expect, in 2008-2009. That was the lowest in terms of valuation and then the book value per share in 2008 was about 6.6 in dollar terms, so maybe that time was £4 and you could buy those shares at probably 250 on the bottom valuation, so that would mean a 30% discount of price to book. I think that was the low-end of valuation. Not very far from where it is today. It's about 90% of price to book today.

MOI Global: Daniel, could you talk a bit about the investment approach? There's a question about the lack of equities and you had one slide where you showed what they're investing in, so anything you can share with us in terms of how aggressive they could get and why haven't they shifted more into equities given the low interest rates.

Daniel Gladis: Retrospectively, it looks like a mistake, but the alternative scenario could be that they moved into equities in 2010 and the market would go down by 30%. Then they would lose variable capital. Yes, I know there are companies running totally different portfolios. You have Markel, which for example, has similar float leverage to Catlin, and they have maybe two-thirds of their equity in equities and there are companies like Greenlight Re, they are pretty much hedge funds in disguise. They own a portfolio that is basically longshore equity. I think you can do that, but you have to have really exceptional abilities to run the investments and I think in Markel, they have demonstrated that they have it.

In Greenlight Re, I think they also have it. I don't think that Catlin has it and the good thing is they don't try to aggressively venture into that area. I'm actually quite happy that they run their investments in a conservative way. If I want to get aggressive in equities, I can do it myself. I don't need them to do it for me. I'm actually very happy that their portfolio is very conservative. I think the investment leverage, 2.5, is big enough so that a reasonable fixed income portfolio over time would make decent returns. I firmly believe that the interest rates will rise one day and then the profitability of their investments would multiply from where it is today. Having said that, recently, during the last year or so, they did increase their allocation to equities and hedge funds and private equity. It has done well for them, but they are keeping it at a very small level.

MOI Global: Can you talk more about the underwriting team? You mentioned Stephen Catlin managing the business. Do you know if he has an underwriting background? Is he involved in the underwriting side and how comfortable are you generally in terms of the consistency of the team that's writing the premiums today and in the future, how consistent is that with the

past?

Daniel Gladis: Stephen Catlin does have an underwriting background, but I believe with a company of this size - I think they have about 2,000 - I don't think he personally, himself, can be involved too much in the smaller details of the business. Every insurance company, when you read their materials, presentation, if you speak with them, they claim they have a special knowledge, special data resources, special risk management systems, advantages here or there for the underwriting business, but the only way to judge whether this is true or not, I think is to look at the historical results. I really think this is very similar to asset management. If you are an asset manager who says, "I have such-and-such investment philosophy, investment strategy and this process, etc.," it gives you some confidence that they know what they're doing, but still, you'd probably prefer to see their historical results over a longer term period. That probably tells you more. Unless you really are an insurance specialist and you go through the process and meet with their people in person and maybe they show you in detail what they do, the only way you can judge this is by looking at historical results. If you study the historical results, the loss reserves triangle and the consistency of their attritional rate and combined ratio, I think they do very well.

MOI Global: Here's a question on the releases and I think you had a slide on that subject. If you could tell a layperson how to read the releases, disclosures for an insurance company, so anything you can share with us. What can we do to intelligently look at their release history to make a judgment? Either in this case or just generally, how do you approach that aspect?

Daniel Gladis: At the end of the year, every year, the insurance company makes an estimate of the losses. The estimate at the beginning is just a rough estimate because some of the losses are incurred, but not reported. When an earthquake strikes, you can only make an estimate of what damage it created and how much of it was insured and how much of it will be paid by you, so initially you make estimates. For example, at the end of 2004, the company estimated that they'd have \$2 billion of reserves. Every year after that, they refined their estimate because losses are reported, the claims are calculated and they are being paid. The error in the estimate is going down every year. For example, ten years later, now in 2014, you see that the estimate for losses that incurred in 2004 actually do not change almost at all. In the beginning, they might change by tens of millions from one year to another year, but now they don't change pretty much at all because pretty much they are all figured out and calculated.

When you look at an insurance company, they publish so-called loss triangles where you can see what the estimate was every year, how the estimate was subsequently refined every year after that and you can see in this development where the original estimate was more or less accurate or whether it was too optimistic or too conservative. Now as the estimates are refined over time, if the reserving loss was more conservative, so the company reserved more than the future shows they have been needing, then they are able to release some of the reserves into profit because they don't need all those reserves created before. This is what you see in this slide, that every year they were able to release some reserves. In 2004, their release was equal to 5% of the opening reserves at the beginning of this year. In the subsequent years, it was eight, one, five.

In recent years, it was about 3% every year. It tells you that they have been making the original estimates quite accurate and slightly conservatively. They were actually over-reserving somewhat. You don't want an insurance company to overreserve too much because that would distort the real picture, but of course, even worse is if the insurance company reserves too little because then the reserve releases would have a negative sign.

They would have to refine the original estimates upward and would actually have to make additional reserves every year. That's a worse case because the company would be showing a better picture of themselves than actually is the reality. I think in the case of Catlin, their consistency and the accuracy of estimates is, I think, excellent.

MOI Global: We are, unfortunately, running out of time. I will take one last question and it asks, Daniel, if you can name some other insurance companies that you admire, but are waiting for the price to be right. The questioner mentions if you've looked Lancashire, which seems to have an admirable track record or if you could talk about any CEOs to follow, any books to help us expand our understanding of property/casualty insurance that would be helpful. Thank you.

Daniel Gladis: I don't know about many books off the top of my head, but this is a very large sector or industry and usually there's a large amount of information available from the company themselves, but I think it's very important to study a lot of them at the same time because you have to really be able to make comparisons between them. Now when you ask about what other insurance companies I like, if we stay in Europe, then I think the only one that I like is Munich Re. I might be contradicting myself a little because this is the largest reinsurer in the world and Europe, of course, as well. I said before that I find them a bit too complex, but I think it's an excellently run company, has an advantage that comes from its size because it enables them to run business that not many others can do and it has excellent capital deployment. It's actually one of the few large insurance companies that consistently buys back its own shares. It's very well-run and it's cheap. That would be also be a good place to invest.

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About the instructor:

Daniel, who is based in the Czech Republic, has amassed a market-beating track record since starting VLTAVA Fund in 2004. VLTAVA Fund is a value-oriented, research-driven investment fund focused on investing in good companies run by quality management. Previously, Daniel was Director and Chairman of the Board of Directors of ABN AMRO Asset Management (Czech) from 1999-2004. He was also Director and founder of Atlantik finanční trhy, a.s., a member of the Prague Stock Exchange. Daniel is a graduate of VUT Brno and has authored the best-selling book *Naučte se investovat* (Learn to Invest).