

ACE Limited

Exposure to Variable Annuity Guarantees Not Positive, But Should Be Manageable

--Highlights

- Clarifying exposure to variable annuity guarantees.** After the close on November 19, ACE issued a press release clarifying its total exposure to potential losses for its guarantees on variable annuity policies. In the company's third quarter 10-Q filing, it stated that its net amount at risk (NAR) as of September 30 for variable annuity guaranteed minimum death benefit (GMDB) reinsurance was \$6.5 billion, given the significant drop in equity markets year-to-date (stopped writing this business in 1997). However, this level should be meaningfully higher currently given the 31% drop in the S&P 500 quarter to date. The net amount at risk represents the amount of the guaranteed contract value that exceeds current account values of the policies reinsured by the company. This value is a measure of the maximum exposure and assumes the impossible scenario under which all policyholders die immediately. The actual loss in any year may be a few percentage points of the total exposure, although more capital has to be allocated to this risk exposure as it grows. The company also has exposure to guaranteed minimum income benefits (GMIB), although the exposure appears to be smaller (\$539 million) and will take longer to clarify.
- Exposure eats up capital and poses a modest risk to earnings, but should be manageable if disclosure is accurate.** As of September 30, 2008, the capital requirement related to ACE's variable annuity guaranty business was approximately \$400 million, and the company estimated that if the S&P 500 were to drop to a level of 900 (a 23% drop from the September 30 level compared to the current 31% drop), an additional \$250 million of capital would be required, a level that is manageable for ACE at this time. Of course if the market sells off dramatically further we would need to revisit this assumption. Importantly, as of September 30, 2008, the company estimated that actual claims from this business over the next 12 months, given current mortality assumptions, would total \$110 million, compared with \$106 million of expected premiums. Management further stated that as of the end September it expected the business to generate between \$150 million and \$200 million of operating income (\$0.45 to \$0.60 per share and nearly 50% of our life reinsurance earnings estimate) and at current levels the business would earn "reasonable operating income." If equity markets did not recover meaningfully from current levels over the next few months, we would need to cut our 2009 EPS estimate modestly, everything else equal.

Financial | Insurance

November 20, 2008

Stock Rating: **Outperform**
 Company Profile: **Core Growth**

Symbol: ACE (NYSE)
 Price: \$40.45 (52-Wk.: \$35-\$68)
 Market Value (mil.): \$17,316
 Fiscal Year End: December
 Long-Term EPS Growth Rate: 14%
 Dividend/Yield: \$1.08/2.7%

	2007A	2008E	2009E
Estimates			
EPS Q1	\$1.98	A\$2.16	NA
Q2	\$1.98	A\$2.18	NA
Q3	\$2.06	A\$1.51	NA
Q4	\$2.05	\$1.96	NA
FY	\$8.07	\$7.81	\$7.50
CY		\$7.81	\$7.50
Valuation			
FY P/E	5.0x	5.2x	5.4x
CY P/E		5.2x	5.4x

Trading Data (Thomson Financial)

Shares Outstanding (mil.)	334
Float (mil.)	NA
Average Daily Volume	4,086,294

Financial Data (Thomson Financial)

Long-Term Debt/Total Capital (MRQ)	NA
Book Value Per Share (MRQ)	NA
Enterprise Value (mil.)	NA
EBITDA (TTM)	NA
Enterprise Value/EBITDA (TTM)	NA
Return on Equity (TTM)	NA

Two-Year Price Performance Chart



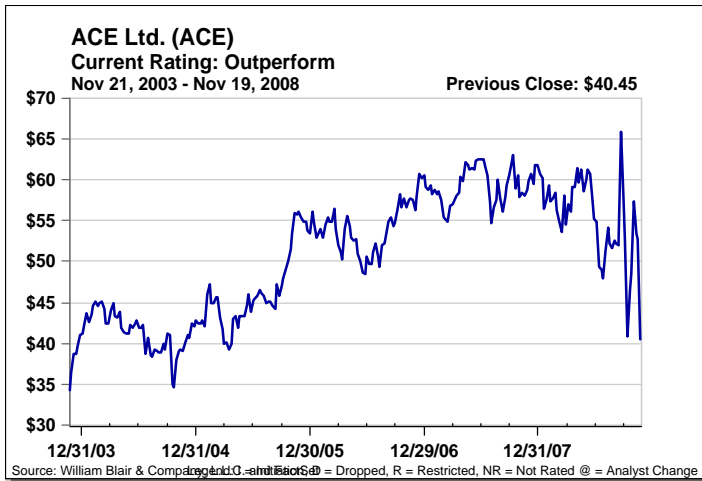
Source: Thomson Financial, William Blair & Company estimates

Mark Lane
 (312) 364-8686
 mlane@williamblair.com

- **View as core, valuation now more reasonable with sell-off.** The shares trade at a 12% discount to diluted book value per share and an 18% discount to diluted book value per share excluding accumulated other comprehensive income as of September 30, 2008. These levels are down nearly 30% from recent highs after optimism regarding the potential for price increases within the commercial property-casualty insurance industry, due to capital pressures from the implosion in equity markets and deteriorating credit markets. Fundamentally we continue to remain cautious on the property-casualty underwriting space given underlying deterioration in profitability, which we expect to worsen into 2009, thus driving earnings disappointment next year. We are skeptical regarding the potential for any meaningful price changes in 2009, and we believe investors underestimate the resistance to higher prices created by the rapidly weakening global economy. That said, any real signs of pricing stability are positive for valuation, and we believe the group in general is oversold on an absolute basis with many underwriters trading below book value. We believe ACE should be core within the space given its franchise, diversification, financial flexibility, and strong execution over the past several years, and we believe the company will be a prime beneficiary of what we see as the imminent competitive degradation of AIG. The shares also are more defensive than other more-credit-sensitive financial names, in our opinion, providing valuation support at current levels and at least market matching returns on the upside.

William Blair & Company, L.L.C. is a market maker in the security of ACE Limited and may have a long or short position.

Additional information is available upon request.



Current Rating Distribution (as of 10/31/08)

Coverage Universe	Percent	Inv. Banking Relationships*	Percent
Outperform (Buy)	58	Outperform (Buy)	4
Market Perform (Hold)	41	Market Perform (Hold)	2
Underperform (Sell)	1	Underperform (Sell)	1

*Percentage of companies in each rating category that are investment banking clients, defined as companies for which William Blair has received compensation for investment banking services within the past 12 months.

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William Blair & Company, L.L.C. 222 West Adams Street Chicago, Illinois 60606 312.236.1600 www.williamblair.com

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