

Insurance

Insurance Sector Presents Near-Term Opportunity, but Not Without Risk

On the surface, the insurers have little cyclical and present a good defensive option, although there are number of underlying risks to monitor should the market meltdown continue. The brokers have a degree of cyclical, but most of the potential downside is already reflected in the stocks. From a pure safety perspective (i.e., if the meltdown continues), the brokers are the better choice because of their lack of balance sheet risk. On balance, we would cautiously wade into the insurers to take advantage of short-term values and use the opportunity to buy into a broker or two at historically low valuation levels.

Commercial Insurers: We have been neutral to negative on the sector based on the potential for declining returns over the next 12 to 18 months. However, the recent correction is providing some short-term opportunities. Commercial insurers have several risks to consider if the current instability continues. A higher level of D&O claims would be likely. The other potential risk is the declining value of their fixed portfolios—in particular, municipal bond portfolios.

- **Travelers Companies, Inc. (TRV \$50.31; Market Perform):** With the stock currently trading at only 0.82 times book value, it has good relative value compared with the sector. It was trading at 0.98 times book at the end of June. We continue to rate the stock Market Perform, as returns should decline moderately over the next two years, but we believe there could be a good near-term trading opportunity.
- **Tower Group, Inc. (TWGP \$22.36; Market Perform):** Tower Group's trading multiple has fallen 9% from June 30 and is also down materially from March 2009. The market-to-book multiple is 0.83 times and the price-to-cash-flow multiple is 4.2 times. We still have some concerns about long-term earnings growth, but near-term fundamentals appear to more stable. We continue to rate the stock Market Perform, but believe there could be a good near-term trading opportunity.
- **The Chubb Corporation (CB \$58.48; Underperform):** We still have a bearish view of Chubb (reflected in our Underperform rating) and with the stock not declining as much as the sector, we believe it is a good time to sell and pick up better values in the sector, such as Travelers. Recent data points suggest favorable reserve development related to directors' and officers' (D&O) insurance may decline in the future.

Financial Services | Insurance
Brokers

August 11, 2011

Adam Klauber, CFA
+1 312 364 8232
aklauber@williamblair.com

John Thomas
+1 312 364 8430
jthomas@williamblair.com

Chris Leikhim
+1 312 364 8943
cleikhim@williamblair.com

Brokers: The brokers have a degree of exposure to the economy, although our recent report showed that earnings downside should be limited to the 10% range.

- **Brown & Brown, Inc. (BRO \$18.91; Market Perform):** We still have a somewhat bearish long-term stance on Brown & Brown given its lackluster organic results over the last several quarters. However, the stock has sold off meaningfully since it reported second-quarter earnings and is more than 27% lower than at the beginning of July. While we have not altered our long-term investment perspective, Brown & Brown has an attractive risk-reward profile for a short-term trade.
- **Aon Corporation (AON \$44.34; Outperform):** Aon has fallen more than 16% during the third quarter, as the brokers have sold off with the overall market. However, we still maintain an Outperform rating on the stock and view it as one of the best investment opportunities within the public brokers.

Commercial Insurers

Property-and-casualty stocks have low cyclicity. The investment portfolios has exposure if credit quality weakens or spreads widen materially; however, this tends to have only modest impact on earnings. We have been negative on the sector based on the potential for declining returns over the next 12 to 18 months. However, the recent correction is providing some short-term opportunities:

Valuations:

- **The Travelers Companies, Inc. (TRV):** The recent pullback has made Travelers attractive, with the stock falling 16% compared with Chubb declining only 10%. With the stock currently trading at only 0.82 times book, it has good relative value compared with the sector. It was trading at 0.98 times book at the end of June. On a price-to-cash-flow basis, the stock has declined to 6.6 times from 7.9 times and is one of the only stocks trading below its five-year median. On a P/E basis using 2012 earnings, Travelers at the end of June was trading at 9.6 times earnings per share, compared with the current multiple of 8.0 times. We continue to rate the stock Market Perform, as returns should decline moderately over the next two years, but we believe there could be a good near-term trading opportunity.
- **HCC Insurance Holdings, Inc. (HCC \$26.38; Underperform):** HCC's stock price has dropped the most of our insurance universe; however, we have this stock rated Underperform and we still believe it will underperform the sector going forward. The price-to-book multiple is 0.87 times compared with 1.06 times at the end of June, and 0.83 times at the beginning of March 2009. The current 2012 P/E multiple is 9.2 times compared with 11.3 times at the end of June, and 7.3 times at March 2009 (2010 earnings).
- **Tower Group, Inc. (TWGP):** Tower Group's trading multiple has fallen 9% from June 30 and is also down materially from March 2009. The market-to-book multiple is 0.83 times and price-to-cash-flow multiple is 4.2 times. We still have some concerns about long-term earnings growth, but near-term fundamentals appear to more stable. We continue to rate the stock Market Perform, but believe there could be a good near-term trading opportunity.
- **The Chubb Corporation (CB):** We still have a bearish view of Chubb (rated Underperform) and with the stock not declining as much as the sector, we believe it is a good time to sell and pick up better values in the sector, such as Travelers. The price-to-book multiple is 1.02 times compared with 1.13 times at the end of June and 0.83 times at the depths of the recession in March 2009. The 2012 P/E multiple is 10.4 times compared with 11.5 times at end of June and 0.83 times at March 2009. Recent data points suggest favorable reserve development related to D&O may decline in the future.

**Property and Casualty Insurers
Stock Valuation**

Ticker	Rating	Current Price	GAAP Forward P/E		
			6/30/2011	Current	% Difference
HCC	U	25.66	11.3x	9.2x	-19%
TRV	M	49.04	9.6x	8.0x	-16%
CB	U	56.51	11.5x	10.4x	-10%
TWGP	M	21.63	7.7x	7.0x	-9%
AFSI	O	20.74	7.6x	6.9x	-9%
RLI	M	58.18	12.3x	11.6x	-6%
NATL	M	22.00	11.0x	10.6x	-4%

Ticker	Rating	Current Price	GAAP Forward P/E		
			3/1/2009	Current	% Difference
TWGP	M	21.63	8.0x	7.0x	-13%
NATL	M	22.00	10.5x	10.6x	1%
HCC	U	25.66	7.3x	9.2x	26%
RLI	M	58.18	9.3x	11.6x	25%
TRV	M	49.04	5.8x	8.0x	39%
CB	U	56.51	6.6x	10.4x	57%
AFSI	O	20.74	3.7x	6.9x	86%

Ticker	Rating	Current Price	Price to Book		
			6/30/2011	Current	% Difference
HCC	U	25.66	1.06x	0.87x	-19%
TRV	M	49.04	0.98x	0.82x	-16%
CB	U	56.51	1.13x	1.02x	-10%
TWGP	M	21.63	0.92x	0.83x	-9%
AFSI	O	20.74	1.65x	1.51x	-9%
RLI	M	58.18	1.51x	1.42x	-6%
NATL	M	22.00	1.34x	1.29x	-4%

Ticker	Rating	Current Price	Price to Book		
			3/1/2009	Current	% Difference
TWGP	M	21.63	0.90x	0.83x	-7%
HCC	U	25.66	0.83x	0.87x	5%
NATL	M	22.00	1.18x	1.29x	9%
RLI	M	58.18	1.25x	1.42x	13%
TRV	M	49.04	0.69x	0.82x	20%
CB	U	56.51	0.83x	1.02x	23%
AFSI	O	20.74	0.87x	1.51x	72%

Ticker	Rating	Current Price	Price to Cash Flow		
			6/30/2011	Current	% Difference
HCC	U	25.66	8.6x	7.0x	-19%
TRV	M	49.04	7.9x	6.6x	-16%
TWGP	M	21.63	4.7x	4.2x	-10%
CB	U	56.51	9.1x	8.2x	-10%
AFSI	O	20.74	7.2x	6.6x	-9%
RLI	M	58.18	10.9x	10.2x	-6%
NATL	M	22.00	5.0x	4.8x	-4%

Ticker	Rating	Current Price	Price to Cash Flow		
			3/1/2009	Current	% Difference
TWGP	M	21.63	4.8x	4.2x	-12%
TRV	M	49.04	5.7x	6.6x	15%
NATL	M	22.00	4.1x	4.8x	16%
RLI	M	58.18	8.2x	10.2x	25%
HCC	U	25.66	5.2x	7.0x	34%
CB	U	56.51	5.7x	8.2x	45%
AFSI	O	20.74	4.1x	6.6x	60%

Source: Company reports and William Blair & Company, L.L.C. estimates

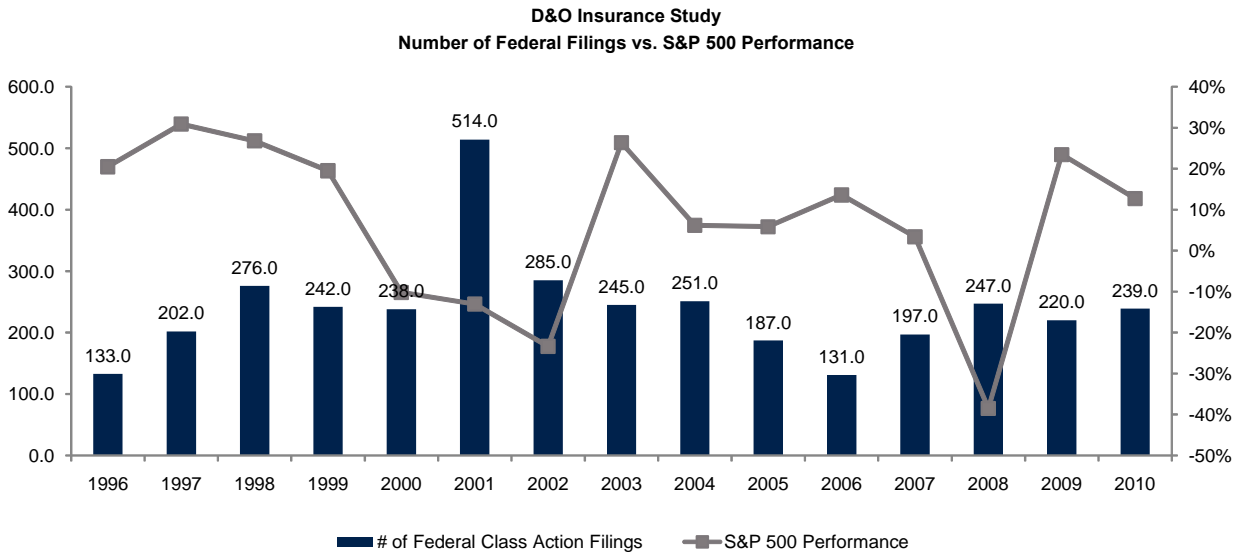
Commercial Insurance Risks

Commercial insurers have several risks to consider if the current instability continues and potentially widens. A higher level of D&O claims would be likely. D&O claims tend to spike during times of economic stress and material downturns in the equity—in the dot.com bubble and recent financial crisis, D&O claims increased by 50% to 10% and the size of the settlements/awards also were materially higher. The other potential risk is a decline in the value of the fixed portfolio—in particular, the municipal bond portfolio. Most insurers have municipal bond portfolios that are equal or greater to the size of the shareholder equity base. To date, the municipal market has held firm, but continued financial contagion could be a negative for these bonds.

Directors’ and Officers’ Insurance

Frequency and severity of claims tied to stock market performance. The chart shows that claims tend to increase when the stock market experiences material declines. The 2000 and 2001 market decline resulted in a significant spike in claims. D&O was particularly hard hit during this period by dot-com lawsuits, followed soon after by the accounting scandals at Enron, Tyco, WorldCom, and others. As premiums began to slide in 2007, claim activity began to pick up for the first time in over five years because of the financial crisis and ensuing recession.

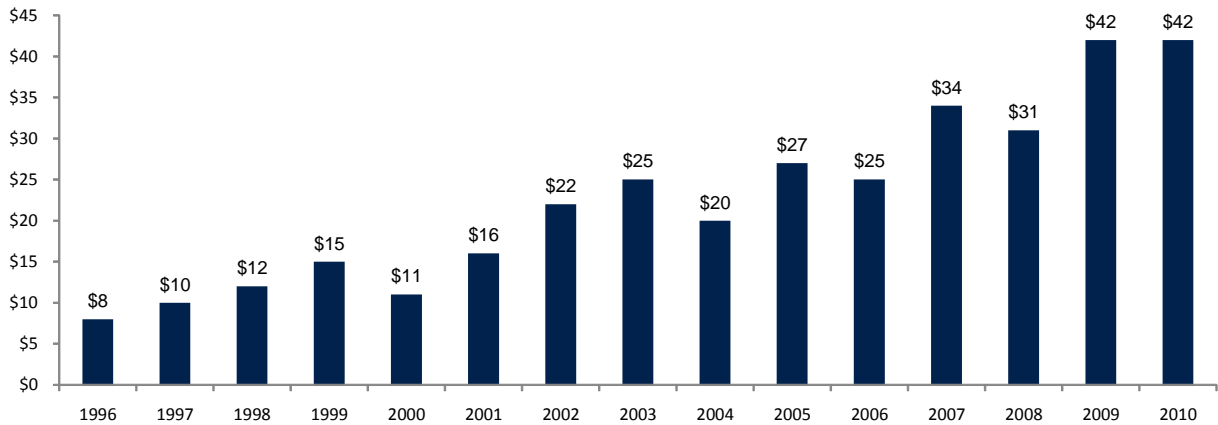
More recently, heightened M&A and IPO activity over the last two years has the potential to spur claim frequency, specifically in regard to shareholder litigation suits. Considering the decline in rates, the uptick in frequency could pose severe threats to accident-year loss ratios for 2010 and 2011. In addition, the recent heavy losses experienced by the markets could lead to additional D&O cases over the next 6 to 12 months, particularly in industries that are getting hit the hardest, like financials.



Source: NERA 2010 Trends in Security Class Action Filings

Not only is frequency increasing, but average settlement values have been on the rise for security class action lawsuits since 1996. Much of this increase can be explained by the sheer amount investors are losing in the market, especially with two particularly harsh bear markets over the last decade. This will make any subsequent claims on the D&O policies even worse for the insurers to bear.

D&O Insurance Study
Average Security Class Action Settlement Value* (\$MM)

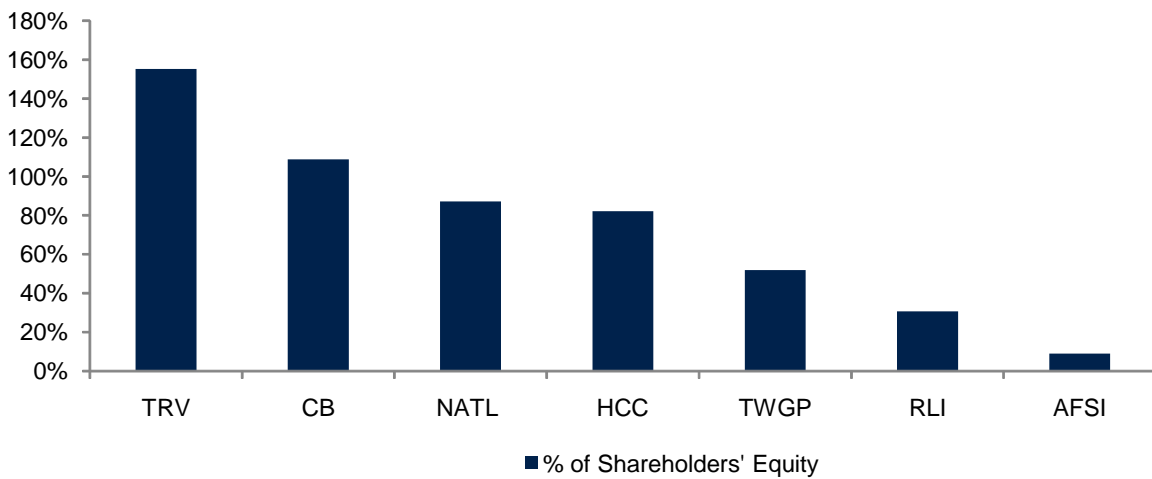


Note*: Excludes Settlements over \$1 BN and IPO Litigation
 Source: NERA 2010 Trends in Security Class Action Filings

Municipal Bond Exposure

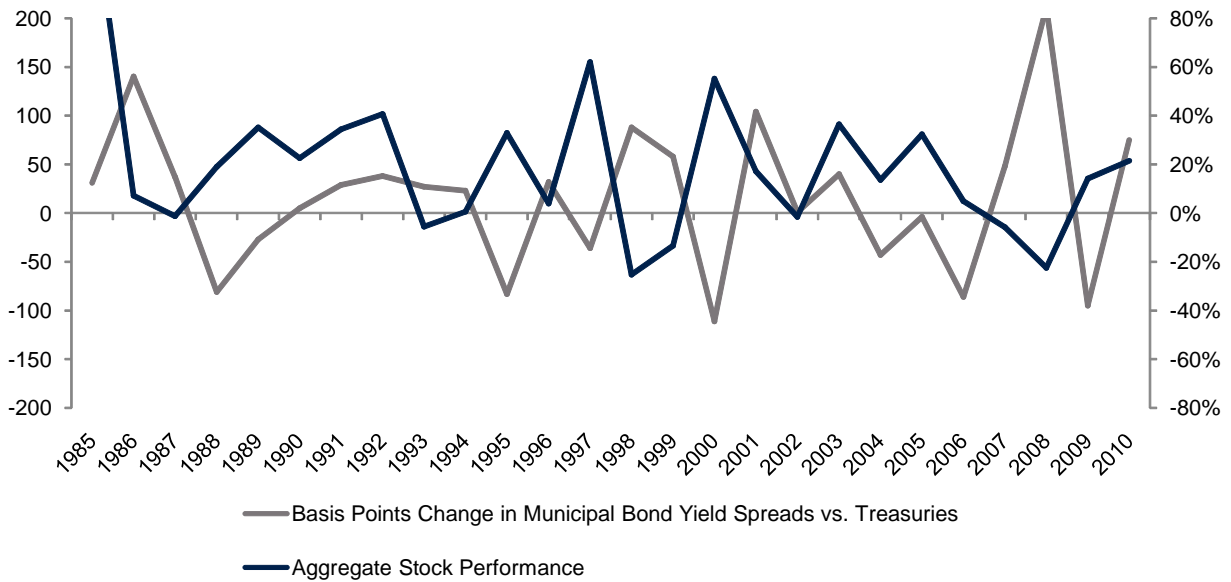
Municipal bonds have potential downside if the instability begins to spill over to other markets. Similar to other bond markets, municipal yields and spreads over treasuries are at very low levels, as investors have used them as safe havens. However, the sector has downside potential from less support from the federal government, the threat of further decline in tax revenues, and increased pension deficits (i.e., lower equity values). Municipal-rated debt with ratings linked to federal support—including some public finance credits, and state and local governments that are heavily dependent on federal aid—is worth watching. To date, Moody’s has identified five states (Maryland, Virginia, South Carolina, Tennessee, and New Mexico) that are heavily dependent and their Aaa-rated debt could be downgraded. S&P has downgraded debt related to the federal government, including at Fannie Mae and Freddie Mac. Moody’s has also identified 180 Aaa-rated public finance credits that could be downgraded.

State and Municipal Bond Investments as a % of Shareholders' Equity



Sources: SNL and William Blair & Company, L.L.C.

Municipal Bond Credit Spread vs. Insurance Stock Performance

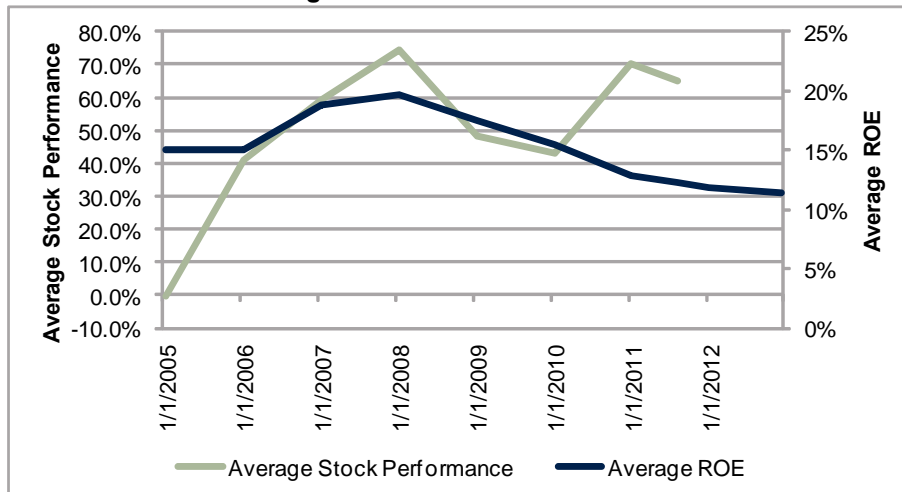


Note: Aggregate stock performance for CB, CINP, WRB
 Source: Thomson, Federal Reserve, William Blair & Company LLC

Declining Returns on Equity

One major difference between now and when the stocks declined during the financial crisis is that return on equity has contracted materially. The exhibit below shows the average annual stock performance and ROE for the seven commercial insurers William Blair has under coverage (AmTrust Financial Services [AFSI \$20.95; Outperform], Chubb, HCC, National Interstate [NATL \$22.33; Market Perform], RLI [RLI \$59.74; Market Perform], Travelers, Tower Group). The index had strong stock performance in 2005 through 2008 as returns on equity were increasing. This trend reversed in 2008 when returns started to decline and the stock performance since has not been strong. We project for the group that the returns will continue to decline, which somewhat negates the attractiveness of current insurer valuation levels.

**Insurance Industry
 7 Commercial Insurers Under William Blair Coverage
 Average Stock Performance and ROE**



Source: Company reports and William Blair & Company, L.L.C. estimates

Insurance Brokers

We examined the potential downside for the public brokers given concerns over the economic recovery and the potential for a double-dip recession. Potential recessionary conditions should affect earnings estimates on two key fronts: lower organic growth levels and declining margins. Our bearish scenario analysis suggests that sector stocks have the potential to decline by roughly another 10%. The analysis clearly shows that the brokers have economic risk. However, given already depressed trading levels, we believe the brokers as a whole represent a fairly conservative investment alternative. Aon and Willis Group (WSH \$35.40; Outperform) continue to represent attractive investments, especially given that the majority of their near-term earnings growth is tied to expanding margin leverage.

2012 Broker Downside Projections

Ticker	Rating	Current Price	Current 2012 EPS	Depressed 2012 P/E Multiples	Downside EPS Target	Downside Price Projection With Depressed Multiple	% Downside
AON	O	\$43.39	\$3.97	12.0x	\$3.61	\$43.32	0%
AJG	M	\$25.34	\$1.68	15.5x	\$1.54	\$23.87	-6%
BRO	M	\$18.63	\$1.18	17.0x	\$1.05	\$17.85	-4%
MMC	M	\$26.90	\$2.24	14.0x	\$1.97	\$27.58	3%
WSH	O	\$34.68	\$3.55	11.0x	\$3.11	\$34.21	-1%

Sources: Company reports, Thomson One, and William Blair & Company L.L.C.

Additionally, we would expect any economic weakness to continue propagating the divergence between the global brokers (Aon, Willis Group, Marsh & McLennan [MMC \$27.67; Market Perform]) and the mainly U.S. middle-market brokers (Brown & Brown, A.J. Gallagher [AJG \$25.90; Market Perform]). A number of factors should disproportionately help the global brokers, including strong international growth, better reinsurance brokerage conditions, and some revenue diversification with the consulting businesses. At the bottom of the last recession (2009), the global brokers averaged 1% organic growth compared with -4% for the middle-market brokers (Brown & Brown's growth was the lowest).

Short-Term Trading Opportunities

The brokers are down on average 17% since the beginning of the third quarter. As we mentioned in a previous piece on the potential downside for the brokers, we believe that the high correlation between economic conditions and the brokerage organic growth will have a negative impact on their stock prices, and there is the potential that 2012 estimates could come down as we see how the economy progresses over the last five months of 2012. Assuming that economic conditions remain somewhat stable over the near term, we do not expect more than 5% to 10% of downside for 2012 estimates or expect much deterioration in trading multiples. Thus, we believe the recent sell-off in the brokers is somewhat overdone. In particular, Brown, Aon, and Willis could be strong short-term trading opportunities, as there is the possibility of a rebound from the current oversold levels.

- Brown & Brown, Inc. (BRO):** We still have a somewhat bearish long-term stance on Brown & Brown given its lackluster organic results over the last several quarters. However, the stock has sold off meaningfully since it reported second-quarter earnings and is more than 27% lower than at the beginning of July. In addition, the stock is only 10% above its trough forward P/E multiple from the financial crisis, so we do not believe the stock will go much lower than current levels. While we have not altered our long-term investment perspective, Brown & Brown does have an attractive risk-reward profile for a short-term trade.
- Aon Corporation (AON):** Aon has fallen more than 16% during the third quarter, as the brokers have sold off with the overall market. However, we still maintain an Outperform on the stock and view it as one of the best investment opportunities within the public brokers. The stock is trading more than 10% below its trough multiple during the recent financial crisis, and thus we view the current price as an attractive long-term entry point.

Brokers Valuation % Change From End of Q2

Ticker	Rating	Current Price	GAAP Forward P/E		
			6/30/2011	Current	% Change
BRO	M	\$18.63	21.8x	15.8x	-27%
AON	O	\$43.39	12.9x	10.9x	-16%
WSH	O	\$34.68	11.6x	9.8x	-15%
MMC	M	\$26.90	13.9x	12.0x	-14%
AJG	M	\$25.34	17.0x	15.1x	-11%

Broker Average			15.5x	12.7x	-17%
----------------	--	--	-------	-------	------

Sources: Company reports, Thomson One, and William Blair & Company L.L.C.

Long-Term Valuation Perspective

However, should economic conditions worsen substantially, there could be additional downside for some of the stocks that are still trading at a premium to their trough multiple levels. Over a longer-term horizon, we compared current broker valuation levels against their recent cyclical lows during the financial crisis. The brokers are on average still 20% above the trough multiples observed in early March 2009. However, Aon stands out as being exceptionally attractive on a long-term basis. It is trading at its lowest forward P/E multiple over the last several years, and we believe there is great potential for it to beat Street earnings expectations in 2012. We continue to favor Aon and Willis Group as the best plays in the public insurance brokers' space, and believe that current levels are attractive as entry points or for continued accumulation of shares.

Brokers Valuation Difference From 2009 Low

Ticker	Rating	Current Price	GAAP Forward P/E		
			2/28/2009	Current	% Difference
AON	O	\$43.39	12.1x	10.9x	-10%
BRO	M	\$18.63	14.4x	15.8x	10%
MMC	M	\$26.90	9.9x	12.0x	21%
WSH	O	\$34.68	7.5x	9.8x	31%
AJG	M	\$25.34	10.2x	15.1x	47%

Broker Average			10.8x	12.7x	20%
----------------	--	--	-------	-------	-----

Sources: Company reports, Thomson One, and William Blair & Company L.L.C.

Additional information is available upon request.

Current Rating Distribution (as of 07/31/11)			
Coverage Universe	Percent	Inv. Banking Relationships*	Percent
Outperform (Buy)	59	Outperform (Buy)	8
Market Perform (Hold)	31	Market Perform (Hold)	1
Underperform (Sell)	1	Underperform (Sell)	0

*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.

Adam Klauber attests that 1) all of the views expressed in this research report accurately reflect his/her personal views about any and all of the securities and companies covered by this report, and 2) no part of his/her compensation was, is, or will be related, directly or indirectly, to the specific recommendations or views expressed by him/her in this report. We seek to update our research as appropriate, but various regulations may prohibit us from doing so. Other than certain periodical industry reports, the majority of reports are published at irregular intervals as deemed appropriate by the analyst.

Stock ratings, price targets, and valuation methodologies: William Blair & Company, L.L.C. uses a three-point system to rate stocks. Individual ratings and price targets (where used) reflect the expected performance of the stock relative to the broader market (generally the S&P 500, unless otherwise indicated) over the next 12 months. The assessment of expected performance is a function of near-, intermediate-, and long-term company fundamentals, industry outlook, confidence in earnings estimates, valuation (and our valuation methodology), and other factors. Outperform (O) – stock expected to outperform the broader market over the next 12 months; Market Perform (M) – stock expected to perform approximately in line with the broader market over the next 12 months; Underperform (U) – stock expected to underperform the broader market over the next 12 months; not rated (NR) – the stock is not currently rated. The valuation methodologies used to determine price targets (where used) include (but are not limited to) price-to-earnings multiple (P/E), relative P/E (compared with the relevant market), P/E-to-growth-rate (PEG) ratio, market capitalization/revenue multiple, enterprise value/EBITDA ratio, discounted cash flow, and others.

Company Profile: The William Blair research philosophy is focused on quality growth companies. Growth companies by their nature tend to be more volatile than the overall stock market. Company profile is a fundamental assessment, over a longer-term horizon, of the business risk of the company relative to the broader William Blair universe. Factors assessed include: 1) durability and strength of franchise (management strength and track record, market leadership, distinctive capabilities); 2) financial profile (earnings growth rate/consistency, cash flow generation, return on investment, balance sheet, accounting); 3) other factors such as sector or industry conditions, economic environment, confidence in long-term growth prospects, etc. Established Growth (E) – Fundamental risk is lower relative to the broader William Blair universe; Core Growth (C) – Fundamental risk is approximately in line with the broader William Blair universe; Aggressive Growth (A) – Fundamental risk is higher relative to the broader William Blair universe.

The ratings, price targets (where used), valuation methodologies, and company profile assessments reflect the opinion of the individual analyst and are subject to change at any time.

The compensation of the research analyst is based on a variety of factors, including performance of his or her stock recommendations; contributions to all of the firm's departments, including asset management, corporate finance, institutional sales, and retail brokerage; firm profitability; and competitive factors.

Our salespeople, traders, and other professionals may provide oral or written market commentary or trading strategies—to our clients and our trading desks—that are contrary to opinions expressed in this research. Our asset management and trading desks may make investment decisions that are inconsistent with recommendations or views expressed in this report. We will from time to time have long or short positions in, act as principal in, and buy or sell the securities referred to in this report. Our research is disseminated primarily electronically, and in some instances in printed form. Electronic research is simultaneously available to all clients. This research is for our clients only. No part of this material may be copied or duplicated in any form by any means or redistributed without the prior written consent of William Blair & Company, L.L.C.

THIS IS NOT IN ANY SENSE A SOLICITATION OR OFFER OF THE PURCHASE OR SALE OF SECURITIES. THE FACTUAL STATEMENTS HEREIN HAVE BEEN TAKEN FROM SOURCES WE BELIEVE TO BE RELIABLE, BUT SUCH STATEMENTS ARE MADE WITHOUT ANY REPRESENTATION AS TO ACCURACY OR COMPLETENESS OR OTHERWISE. OPINIONS EXPRESSED ARE OUR OWN UNLESS OTHERWISE STATED. PRICES SHOWN ARE APPROXIMATE.

THIS MATERIAL HAS BEEN APPROVED FOR DISTRIBUTION IN THE UNITED KINGDOM BY WILLIAM BLAIR INTERNATIONAL, LIMITED, REGULATED BY THE FINANCIAL SERVICES AUTHORITY (FSA), AND IS DIRECTED

ONLY AT, AND IS ONLY MADE AVAILABLE TO, PERSONS FALLING WITHIN COB 3.5 AND 3.6 OF THE FSA HANDBOOK (BEING "ELIGIBLE COUNTERPARTIES" AND "PROFESSIONAL CLIENTS"). THIS DOCUMENT IS NOT TO BE DISTRIBUTED OR PASSED ON TO ANY "RETAIL CLIENTS." NO PERSONS OTHER THAN PERSONS TO WHOM THIS DOCUMENT IS DIRECTED SHOULD RELY ON IT OR ITS CONTENTS OR USE IT AS THE BASIS TO MAKE AN INVESTMENT DECISION.

"WILLIAM BLAIR & COMPANY" AND "WILLIAM BLAIR & COMPANY (SCRIPT)" ARE REGISTERED TRADEMARKS OF WILLIAM BLAIR & COMPANY, L.L.C. Copyright 2011, William Blair & Company, L.L.C.