CUSP sells Allstate to purchase Aon

By Daniel Ralls & Cole Goeltl

The CUSP Fund managers replaced Allstate with Aon in March 2023. In November 2022, the class voted unanimously to sell Allstate, but the transaction was tabled until a suitable replacement was identified. In March 2023, the CUSP Fund managers determined Aon was an appropriate replacement for Allstate. The core drivers of this decision were greater confidence in the future of insurance brokers than primary insurers, Allstate's poor performance relative to its peers and Aon's superior performance relative to its peers.

We believe that insurance brokers, such as Aon, have a brighter outlook than primary insurers, like Allstate, due to insurance brokers having less underwriting exposure, less reliance on investment income and a more favorable basis of competition.

First, we believe that it will be increasingly challenging for primary insurers to profitably underwrite insurance policies given mounting claim severity and volatility. For example, we are particularly worried about primary insurers' ability to profitably underwrite in the face of climate change, monetary inflation, social inflation, global decoupling between the U.S. and Asia, auto manufacturers offering their own insurance policies and increasing customer concentration as fewer people transition from owning their own cars to usage-based models, like ridesharing apps.

Second, we believe that fixed-income investment returns will provide a major headwind for primary insurers, with rising interest rates generating considerable unrealized losses. Notably, although the current instability of financial institutions is largely driven by unrealized losses due to rising interest rates, additional interest rate increases will likely occur to combat inflation. In other words, regulators must balance financial instability with rising inflation, but solving one by changing interest rates would likely make the other worse. Therefore, it seems likely that primary insurers will continue experiencing either increased claim severity due to continued inflation or increased unrealized losses due to continued interest rate hikes – if not both.

Third, we believe that insurance brokers have a brighter outlook than primary insurers due to the former having a more favorable basis of competition than the latter. More specifically, whereas primary insurers have increasingly become commoditized goods that compete on price, insurance brokers compete based on service and relationships across diverse but complementary product offerings. As a result, we believe that insurance brokers can sustain and expand their margins due to their favorable competitive landscape and value proposition and that primary insurers will struggle to maintain their already thin margins as they compete on price in the face of challenging headwinds from underwriting and investments.

We decided to sell Allstate rather than the Fund's other insurance holdings because Allstate had the highest percentage of revenue from auto and home policies of the three companies (88%), and we believe that those product lines face the most challenging underwriting prospects. Additionally, we do not believe that Allstate is well positioned to overcome these challenging underwriting prospects in the future given that the firm already has a loss ratio of 89% and a combined ratio of 112% compared to its competitors' average loss ratio of 70% and combined ratio of 97%. Finally, we do not believe that Allstate's stock price adequately reflects the firm's poor performance and outlook given that the firm had a P/B of 2.3 compared to its competitors average of 1.5.

Conversely, we believe that Aon is the most attractive investment among insurance brokers considering its profitability, growth, shareholder returns and valuation. For example, relative to its peer group average, Aon's profit margin is 43% higher, its FCFF/Assets is 65% higher, its FCFF/Assets 3-year CAGR is 657% higher and its combined buyback-dividend yield is 142% higher. Despite Aon's superior financials, its P/E is only 2% above its peers, and its P/FCFF is 19% below its peers. Thus, AON was added to the CUSP Fund in March 2023.