HollAnd Advisors

Holland Views

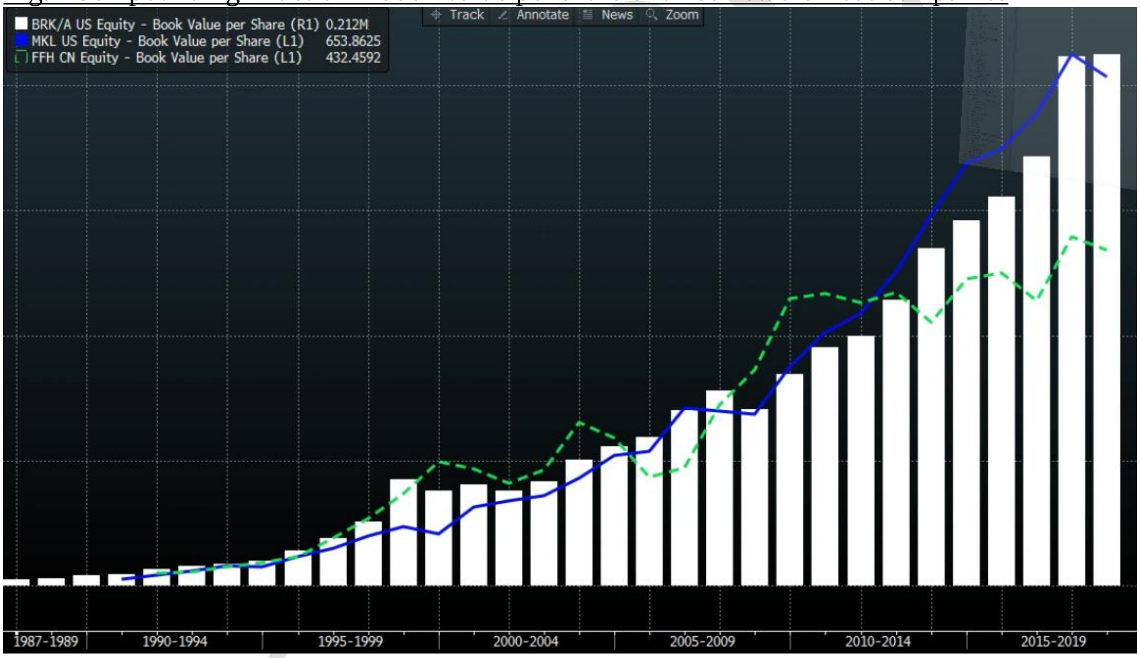
BRKA US $305k – HOLD; FFH CN: $611 – BUY; EXO IM $57 – BUY; MRL US $1,060 – HOLD

Rare birds, that float

What is a float company? At its core, it is simply a well-run insurance business that judiciously uses its insurance income as a source of permanent capital for investing. The best float businesses thus enjoy both excellent underwriting and capital allocation track records – that's why they are so rare to find. Done well, float businesses can offer excellent, geared returns for equity holders. Insurance businesses are common, but successful float businesses amongst them are extremely rare.

Over the last month we have spent a considerable amount of time attending shareholder meetings and studying what we consider to be the world's best 'float' companies, namely; Berkshire Hathaway, Fairfax Financial, Markel and Exor.

Fig.1 Compounding in action – book value per share of three notable float companies



Source: Holland Advisors

In this note, we review our stance on these four businesses. Whilst the beauty of the float model lies in its simplicity, in truth, much complexity lies beneath. Simplicity in all things is good, but some of the owner-managers of these businesses (*including* Messrs Buffett and Munger) continue to over-simplify the story. We also acknowledge that a zero/low interest rate world has become a real headwind for these businesses' returns. A prudent purchase price however brings a margin of safety. We are thus drawn to either low-valued float businesses with good track records (Fairfax) or those with diversified income streams and NAV discounts (Exor).

In this note, we:

1. Recap on the traits and attractions of a 'float' business model
2. Consider the imbalance that exists in shareholder disclosure for all these businesses
3. Update company valuations and give context on capital and interest rate cycles

Float Businesses for Dummies (a guide for the rest of us)

Float businesses are simple on paper but, like most financial businesses, far more complex and gritty in real life. "Simple, but not easy", as the saying goes. Below we discuss a number of generic factors that we think are relevant in assessing these businesses. Without wanting to dumb things down too much, and with apologies to those already well versed, please allow us to recap with a Dummy's Guide to Float Businesses!

There are two key aspects to float businesses: insurance underwriting and investing.

1. **Underwriting:** Float businesses – above all else – need to write insurance premia profitably (or generate a 'combined ratio' below 100%). However, doing so on a regular and sustainable basis is much harder in reality not least due the intense competition in insurance markets. In an effort to differentiate, the best companies often seek-out specialist or niche areas in the insurance or reinsurance markets that gives them slightly greater pricing power and ideally, scale. Such market power can also derive from being the lowest-cost operator with Berkshire's GEICO being the best example of this. Combining a stream of uncorrelated insurance premia has been a key part of Berkshire Hathaway's phenomenally consistent insurance operation profits (having the genius that is Ajit Jain at the helm helps too!). Other companies such as Fairfax are now achieving consistent underwriting profits also.

   > *"it is important to recognize that underwriting is more than risk selection and pricing. It requires a comprehensive set of capabilities across hard and soft skills, qualitative judgments about future industry performance, and rigorous portfolio management to avoid markets where even great underwriting cannot compensate for unfavorable conditions. Underwriting performance is also influenced by exogenous factors, such as the business development activities with distribution partners to generate consistent and attractive submission flow."* – **McKinsey review of P&C insurers, 2019**[1]

2. **Investing:** The second part of the float business model is the profitable investment of the resulting insurance float (along with the company's own equity capital). The beauty of this, usually growing, pool of capital is that it is akin to permanent capital and can be managed like a closed-end fund.

   It's not a free lunch though – crucially this capital must be invested within the guidelines of local insurance regulators in terms of the chosen investment's asset duration and its liquidity etc. (credit ratings agencies also bring significant influence to bear here too). Each insurance business will have its own restrictions depending on its local regulatory regime, the type of insurance liabilities it has assumed and magnitude of its capital base. In other word's one float company's allowable investment mandate cannot necessarily be directly compared to another.

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