

Chubb's prized Masterpiece homeowners insurance and strong underwriting record make it a standout and a good long-term bet.

## Pulling Away From the Pack

by Andrew Bary

NOT ALL VALUABLE MASTERPIECES ARE HANGING IN MUSEUMS. Venerable **Chubb** has one, too, in the form of one of the property-casualty insurance industry's few distinctive franchises. The company's lucrative high-end Masterpiece homeowners insurance is the leading choice of affluent Americans to protect their houses.

Founded in the late 19th century, the Warren, N.J., insurer also has a conservative underwriting and investment strategy that has enabled it to weather the financial crisis with minimal damage to its balance sheet.

But Wall Street isn't giving Chubb (ticker: CB) much credit for its strengths. The shares, at around 50, trade for less than 1.1 times estimated year-end 2009 book value of \$46.50 a share. That is about as cheap as Chubb has gotten, relative to book value, in two decades. A few years ago, Chubb commanded 1.5 times book.

Chubb looks attractive based on its earnings. The stock trades for eight times estimated 2009 profits of \$5.95 a share and for nine times 2010's estimated \$5.43. Chubb, which has boosted its dividend annually for 27 years, yields 2.8%. And the payout, now \$1.40, could rise as much as 10% in 2010.

Chubb also has repurchased \$5.5 billion of its shares since 2005, including \$564 million in 2009's first nine months. The insurer, whose stock-market value is \$17 billion, is to report fourth-quarter results on Jan. 28.

"It's always good to buy a good company at a good price," says KBW insurance analyst Cliff Gallant, who carries a \$60 price target on Chubb, his favorite among the major property-casualty insurers. He likes its strong balance sheet, high credit rating and ample capital.

Other analysts have good things to say about Chubb lately. Credit Suisse's Vinay Misquith upgraded it to Neutral from Underperform, while Deutsche Bank's Joshua Shanker, formerly at Citigroup, began coverage of Chubb last month with a Buy rating and a \$57 target. "Its unrivaled personal-lines product for the wealthy has acted as a brand-recognition device that also garners it commercial-lines business," Shanker wrote.

Chubb commands a premium to other big property-casualty outfits. Travelers (TRV), at 49, trades below its estimated 2009 year-end book value of 52, while Ace (ACE) fetches 48, versus a projected 2009 year-end book of 57. The Chubb premium reflects its consistently profitable homeowners, auto and other "personal lines" insurance, which together account for a third of its \$11 billion in annual premiums. Chubb

### Winning Strategy

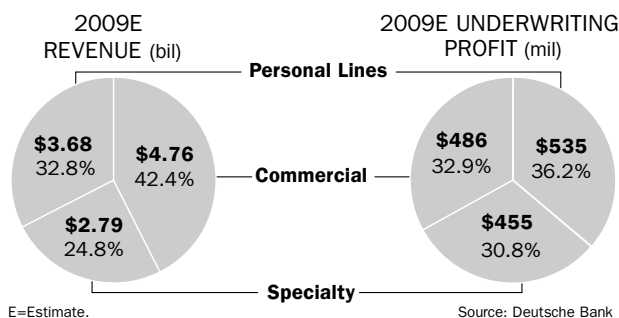
Chubb carries a low valuation, relative to earnings and book value, but gets a slight premium due to its strong homeowners franchise.

Company/Ticker	Recent Price	52-Wk Chg	EPS		P/E '10E	Price/Book*	Div Yld
			'09E	'10E			
<b>Chubb/CB</b>	\$50.08	17.3%	\$5.95	\$5.43	9.2	1.1	2.8%
<b>Ace/ACE</b>	48.73	2.2	8.12	7.50	6.5	0.8	2.5
<b>Travelers/TRV</b>	49.28	23.2	5.69	5.62	8.8	0.9	2.7

\*Based on estimated year-end 2009 book value. E=Estimate. Source: ThomsonReuters

### No Horsing Around

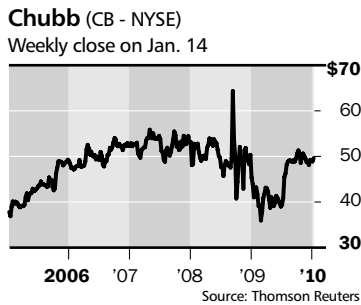
Chubb is believed to have generated ample underwriting profits in all three of its operating divisions last year.



### The Bottom Line

**Chubb has good brands and a conservative strategy. Given its low valuation, the insurer's stock has little downside. It could rise by 10% or more in 2010.**

(over please)



is one of the few insurers that Berkshire Hathaway (BRK-A) CEO Warren Buffett probably would consider buying if it were available.

Homeowners are willing to pay relatively high prices for Chubb insurance because of the company's reputation for fair and generous claims settlements. Chubb's homeowners policies often form the basis of other coverage, for things such as luxury cars, yachts and art, as well as personal liability. The rest of Chubb's business consists of commercial insurance, including worker's compensation, property and marine; and corporate directors and officers, known as D&O insurance.

In one way, the P&C industry has become a victim of its own success. High profitability has led to excess capital, putting downward pressure on commercial-policy pricing. An upturn seems unlikely this year. One reason is that the industry ended 2009 with an ample capital surplus of \$516 billion, 20% above the year-end 2005 level, estimates Shanker.

Ironically, it often takes a major catastrophe, like the World Trade Center's destruction in 2001, to result in better insurance pricing. At one point it seemed as though the 2008 financial crisis, which hammered the bond-heavy investment portfolios of insurers, might be such an event. However, the market rally in

2009—along with a mild hurricane season—produced ample profit.

The knock against P&C insurers is that their earnings and return on equity are apt to be under pressure in 2010 from weak pricing and falling returns from bond portfolios in a low-rate environment.

Chubb and many peers also benefited in 2009 from reserve releases. Insurers estimate losses when they write policies. If the losses turn out to be smaller than expected, they can later release reserves, bolstering earnings. Chubb was helped by \$545 million of releases in 2009's first nine months, boosting profits by around \$1 a share. Reserve releases probably will wane in 2010.

Chubb had a 7% fall in premium revenue in the first nine months of 2009. Its bottom line was boosted by small catastrophe losses in the third quarter, the usual peak period for hurricanes. A more normal year for hurricanes in 2010 would mean higher catastrophe losses and lower earnings.

All this suggests Chubb's 2010 profit will be worse than the \$6 it probably earned last year. Shanker sees \$4.80, while Gallant puts earnings at \$5.60. Even if profit falls to \$5 a share, Chubb would earn about a 10% return on equity, and book value could top \$50 a share.

At its low valuation, Chubb stock probably has little downside and could at least appreciate in line with the growth in 2010 book value. That would mean a 10% total return. If commercial pricing unexpectedly turns up, Chubb has the capital to capitalize on it and its shares—and those of the entire group—probably would rise smartly.

One of the chief investor concerns about Chubb involves exposure for lawsuits against directors and officers of

public and private financial companies, via so-called D&O insurance. Given the many setbacks in the sector in the past two years, Chubb could be on the hook for sizable claims. Chubb and American International Group (AIG) are the leading writers of D&O. Chubb, however, insists its reserves are adequate. Deutsche Bank's Shanker agrees, writing in a recent client note that worries about the business "are overblown." The company has set aside \$7.5 billion in reserves for these policies.

John Finnegan, Chubb's CEO for the past seven years, gets good marks on Wall Street. Probably his smartest move was his decision to shut Chubb's financial-products division, which competed against AIG's. Given that AIG Financial Products' massive derivative losses nearly brought down that giant insurer, his action looks brilliant.

Finnegan and his team still emphasize smart underwriting. "We're looking for every possible way to grow," says Chief Operating Officer John Degnan. "But we have the discipline to walk away from risks that are inadequately priced. We aren't going to take market share by decreasing our rates."

In the first nine months of 2009, Chubb earned an underwriting margin of 13% of premium volume, a great showing for a P&C insurer and one that probably can't be maintained. The industry historically has operated close to break-even on its underwriting, but made money on investments.

Chubb is a defensive financial stock without the sizzle of banks and asset managers. Yet this conservative, well-managed insurer with an attractive valuation and masterpiece of a brand name has rewarded patient investors in the past and may continue to do so. ■



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