

## Smack in the Face: Improved ROE, yet Drop in Price/Book Value

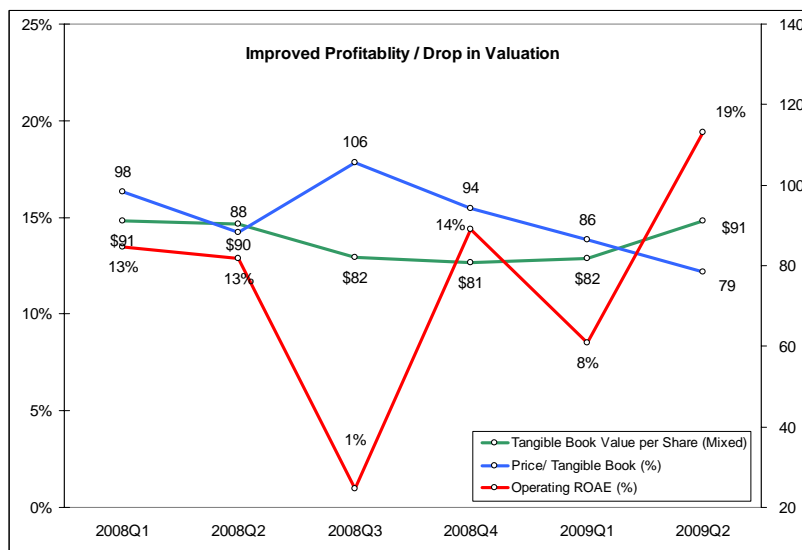
### October 2009- Market Outlook

Over the past several quarters we have seen return on equity (ROE) trends for financial stocks all over the map: some ROEs have remained steady (very simple insurance companies), some ROEs have fallen badly (certain bank stocks), and other companies (reinsurance stocks, for example) have actually had ROEs bounce back to double-digit levels.

**Mismatch:** What's interesting is that valuations in a handful of cases (as measured by price/book), have not increased to reflect recently-improved profitability (as measured by ROE). In the past, these two measurements for insurance stocks have shown a strong correlation as measured by r-squared. However, the last year has seen the correlation fall apart as uncertainty drove fundamentals out of the valuation equation.

**Opportunity:** It may be maddening for the CEOs running these companies that improved profitability has not been matched with a corresponding improvement in valuation, but the mismatch spells opportunity for financial sector investors. Our most recent call has been that once a string of decent earnings results are available to pick through, that fundamentals will regain a proper place in valuation. We are now just two or three quarters into the string, depending on the company. We have said in the past once uncertainty subsides, certain insurance stocks are well positioned for 40% -50% upside without a commensurate improvement in profitability.

**Example:** We are intrigued with opportunities similar to the one depicted in the chart below. Over the last three quarters this particular company has seen its ROE (red line) bounce back to levels similar to those pre-crisis, yet valuation (blue line) steadily declined from about 105% of tangible book to just under 80% of tangible book as of 2Q. For perspective, consider a low teens ROE has historically (15 year average) implied a price/book multiple roughly double the 2Q levels shown in the chart.



Source: SNL Financial and PhiloSmith & Co.

If you have questions regarding the financial services sector, or would like to discuss our investment approach, please contact us at the phone number below, or visit our website.

**E. Stewart Johnson**  
Portfolio Manager

# Performance

Year-over-year through September 30th, 2009

