

September 2013 - Market Outlook

PhiloSmith was up 5.9% in the third quarter of 2013, in line with 5.2% gain of the S&P TR. Our performance was the result of above-average returns by many of the core holdings, and was widespread across the sectors in which we invest. The top five holdings, which accounted for a significant proportion of the total performance, each represent a different industry sector.

PhiloSmith's results in the first three quarters of 2013 reflected continued strength in asset managers as well as specialty companies, property casualty, and insurance brokerage stocks. Asset managers were up 47% on average, reflecting financial market gains and strong sales leading to growth in assets under management. Insurance brokerage stocks, up 26% on average, performed well largely as a reflection of strong internal growth. Over time, both Brown & Brown and Arthur J. Gallagher have been successful acquirers, but growth this year is largely internal. Exposure unit growth from economic expansion is having a measurable impact on revenues. Primary property casualty stocks played a meaningful role in performance. Property casualty revenues now reflect slow but steady economic growth as well as the compounding effect of year over year rises in premium rates. At the same time, low inflation is putting downward pressure on claims costs. Even low investment returns haven't halted the expansion of both profit margins and return on equity. For the most part, PhiloSmith's holdings have not been impacted by capital in the form of alternative capacity structures that is flowing rapidly into both the property insurance and the reinsurance marketplace, which has led to reductions in premium. Casualty rates continue to rise. In a low investment yield environment the management teams of well-run property casualty companies are pressing hard for underwriting profits. At the same time, active capital management strategies, particularly stock buybacks and, in some cases, special dividends, have increased the ROE of many holdings.

The Portfolio

Specialty property casualty insurers account for 34% of PhiloSmith's holdings. The performance of specialty stocks had the greatest impact on overall performance. The top performing holdings, Hiscox and RLI, continue to benefit from excellent underwriting results. Primary property casualty stocks, accounting for 22% of the portfolio, also reported strong gains. Horace Mann continues to gain market share in its core business. The Hanover Group, up 42.8% in the first nine months of 2013, is reaping the benefits of a more focused strategy as well as operational improvements.

Asset managers Ameriprise Financial and Waddell & Reed's above-average performance was supported by the strong financial markets. At the same time, both company's strategies have led to market share gains.

Annuity writer American Equity Investment Life was up 74% in the first nine months of 2013. With American Equity's growth and gain in market share the stock now trades in line with the market, up from a deep discount. The other life insurance holdings performed well.

Outlook and Strategy

PhiloSmith' holdings trade at reasonable valuations and are expected to generate above-average growth. In addition, the return on equity of holdings is projected to improve materially. PhiloSmith is well diversified and continues to hold high quality companies with real competitive advantage. Our expectation is that the superior attributes of these companies will translate into above-average growth and profitability. Today, the narrow focus on underwriting earnings will allow portfolio companies to continue to show improving financial results. PhiloSmith's property casualty holdings are seeing the benefits of premium rates gains, but still trade at discounts to book value. Specialty property casualty holdings trade at a small premium to book value, but still trade at material discounts to long-term average valuations, which gives us continued optimism.

Performance through September, 2013

