Adviser Soapbox

Playing Hurricane Chicken

Lauren Keyson 08.08.07, 3:00 PM ET

It's that time of year again, when the potential for hurricanes looms largest and investors in insurance stocks start to get nervous.

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"The take on it right now is that investors are pricing companies with hurricane exposure quite cheaply," said Eric Fitzwater, associate research director at SNL Financial. "The storm season has been benign to this point, which suggests that maybe hurricane-exposed companies as a whole are undervalued."

So how intense is hurricane season going to be this season, which officially ends Nov. 30, 2007? WSI, a Massachusetts-based weather-consulting firm, last month revised its forecast downward from 15 to 14 named storms in the Atlantic this year, citing cooler-than-expected water temperatures. WSI predicts that six of these storms will become hurricanes, and three will become major hurricanes.

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In April, noted hurricane experts Philip Klotzbach and William Gray at Colorado State University forecast a very active hurricane season, with 17 named storms, nine hurricanes and five major hurricanes.

Even though there have been no major storms yet, there is still a risk that the second half of the season could still spawn some big storms. So how are the stocks reacting?

Since Gulf Coast hurricanes have historically been the most devastating for insurance company earnings (there are notable exceptions such as Hugo, which struck South Carolina in 1989), it may be most helpful to focus on the companies with the highest exposure in six states: Florida, Alabama, Louisiana, Mississippi, Texas and Georgia. The companies are ranked by the amount of business they do in those states.

Public property and casualty insurers with highest concentration of business in FL, TX, LA, AL, MS, GA

Company	Ticker	P/E	Gulf Coast business %
21st Century Holding	TCHC	9.2	99.70
Gainsco	GAN	12.9	82.60
First Acceptance	FAC	22.7	70.57
National Security Group	NSEC	7.6	64.34
North Pointe Holdings	NPTE	23.7	61.10
Source: SNL Financial			

"Twenty-First Century trades for just above nine times trailing earnings, which is a fairly low number," said Fitzwater. "If anything less than a worst-case scenario happens, it looks like it could be a great deal," he says, also mentioning National Security Group, which trades at 8.2 times the past 12 months of earnings.

These smaller companies have a lot of relative exposure, while larger companies like Berkshire Hathaway, Allstate and Progressive have higher absolute exposure but plenty of diversification to dampen the financial impact of a severe storm season.

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Berkshire Chairman Warren Buffett set the stage for hurricane season when he wrote that natural catastrophes are the biggest unknown in determining the direction of 2007 insurance results after the company benefited from "a large dose of luck" with the weather front in 2006.

"Were the terrible hurricane seasons of 2004-05 aberrations? Or were they our planet's first warning that the climate of the 21st century will differ materially from what we've seen in the past?" wrote Buffett to Berkshire shareholders. "If the answer to the second question is yes, 2006 will soon be perceived as a misleading period of calm preceding a series of devastating storms. These could rock the insurance industry. It's naive to think of Katrina as anything close to a worst-case event."

Some of the biggest casualties in 2005 were reinsurance companies. "They got hit hard with the 2005 Katrina-Wilma-Rita punch," says John McCune, research director for SNL Financial. "They are poised to do very well if the hurricanes don't show up. If they do show up, then we'll get to see how much the companies have improved their risk modeling and forecasting. This could get ugly, but likely not as bad as 2005."

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So which are the better buys, the large insurance companies that have absolute exposure to hurricanes or the small insurance companies that have relative exposure to hurricanes because they are focused in the Gulf Region?

"I think it depends on how much volatility you are willing to accept," says Mark Dwelle, senior vice president and equity analyst at Ferris, Baker, Watts. "If somebody wants a pure hurricane bet, they can get the most bang for their buck on reinsurers like RenaissanceRe, Montpelier Re and IPC Holdings.

"Indeed," says Dwelle, "those are three of the companies that had the largest amount of losses relative to their size, when the Katrina-Wilma-Rita storms came through two years ago. These would be good to invest in if there were no hurricanes."

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