

HCC INSURANCE HOLDINGS

Founded in 1974, Houston-based HCC Insurance Holdings, Inc. is a leading specialty insurer with offices across the United States as well as in Spain, Bermuda, Ireland and the United Kingdom. By narrowing its focus to very specific areas of insurance underwriting, HCC has gained unique insight into evaluating and pricing risk in a variety of niche markets. It has combined this insight with disciplined underwriting and a conservative approach to financing and investing operations, resulting in exciting performance in an otherwise less-than-exciting business.

Normally, we think of insurance as a commodity business—customers buy insurance based mostly on price and the insurer’s perceived ability to pay claims. The specialty insurance business, however, is very different. For example, what’s a fair price for insuring the aviation operations for Peru’s law enforcement or for insuring the aircraft supporting drilling operations in Alaska? How much should be charged to insure a business against fraud by members of its own senior management? Can you make money by augmenting traditional medical insurance with coverage for catastrophic medical care? These are some of the problems faced by specialty insurers, and knowing how to price these risks provides HCC with a solid competitive advantage. HCC does insure some plain vanilla risks, such as basic property and casualty coverage, but its focus on niche insurance markets—where there are fewer competitors and better pricing—is where its experience really pays off.

HCC has posted excellent operating results over the years, growing its book value by over 14% per year on average since 1998. In 2008, it collected nearly \$2.5 billion in gross premiums and posted an underwriting profit of 14.4%. Basically, this means that after paying both administrative expenses and incurred losses, HCC kept 14.4 cents for every dollar of insurance it wrote—very good results on a key metric of performance in the insurance industry. Keep in mind that 2008 was not the best year for insurers, as overall weak insurance prices limited premium increases, and low interest rates dampened investment returns. There were also catastrophe claims for hurricanes Gustav and Ike. While pricing weakness may continue for a while, we’re comfortable with HCC’s disciplined approach to writing only what they believe to be profitable policies, rather than simply lowering premiums to keep business.

Successful insurance companies must invest premium cash flows and loss reserves wisely, and while 2008 was unkind to the investment portfolios of many well-known insurers, HCC appears to have avoided most of their pitfalls. Outsourcing its investment function to Berkshire Hathaway subsidiary General Re, HCC emphasizes quality and conservatism in its portfolio. While it does own some

asset-backed and mortgage securities, nearly all of its limited exposure to hedge fund investments has been removed from its investment portfolio. Also, HCC avoided more exotic investments altogether, like highly opaque structured-debt investments. As investors, we appreciate both the risks HCC has taken and those it avoided in its \$4.8 billion investment portfolio.

As mentioned earlier, the financial soundness to pay claims can be an important source of competitive strength for an insurer. Here, HCC stands out. In a business where many players are highly leveraged, debt makes up only 13% of HCC's capital, and the ratio of shareholder equity to policies written is well above industry standards. Further, HCC recently bolstered its reserve pool. Appropriately, HCC uses reinsurers to help offset the risk of high claims payouts. While reinsurance helps protect an insurer from large losses, it also makes insurers somewhat dependent on reinsurers' ability and willingness to pay claims. We're comfortable with HCC's strategy and reinsurance partners. Overall, ratings agencies agree with our assessment of HCC's financial strength, with Standard & Poor's and Fitch rating the company AA and A.M. Best rating it A+ (Superior).

HCC features a talented management team with a proven record of success. In addition to an impressive history of underwriting and investment profitability, revenue growth and strategic capital allocation, the company has generated above-average returns for shareholders. Selecting profitable new markets and assembling the right mix of capabilities in them is a difficult task, yet HCC appears to excel in these areas. For example, while HCC did no business in the professional liability sector in 2000, after the Enron scandal HCC sensed an opportunity to take advantage of the increased demand for insuring officer and director conduct. HCC built this business to more than \$700 million in professional liability premiums in 2008. The company's acquisition strategy continued in 2008, with over \$200 million in annual premiums added by purchasing smaller specialty insurers. It's always possible to overpay for an acquisition, and HCC must be careful about assuming the liabilities of companies it acquires. Nevertheless, its track record shows it usually gets things right. We appreciate a company with a shareholder focus, and HCC has a history of rewarding owners with regular dividend increases and buying back stock when it trades below book value. We were disappointed, though, when a 2005 internal investigation of a 1995 stock option grant led to the resignation of founder Stephen Way. We believe appropriate actions were taken to address this incident and that it does not reflect on the integrity of current leadership.

We believe HCC is a good example of one type of investment we favor—a talented management team focused on using its unique core competencies to excel in very specific market niches. This type of opportunity is often overlooked by investors, since the businesses it involves are well off the beaten path and rarely

household names. We feel HCC's conservative financing and underwriting will outlast more aggressive insurers, and it will continue to expand its impressive base of specialty premiums via acquisition. We also believe shareholders are likely to benefit from today's attractive valuation and by continuing growth in earnings and dividends.

November 10, 2009

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