Buffett's Berkshire Hathaway Buoyed by Insurance 'Float'

By Serena Ng And Erik Holm

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[Warren Buffett](http://topics.wsj.com/person/b/warren-buffett/641)'s [Berkshire Hathaway](http://quotes.wsj.com/BRK.B) Inc. [BRKB +0.06%](http://quotes.wsj.com/BRK.B) [**BRKB**](http://quotes.wsj.com/BRK.B) **in** Your Value Your Change Short position has spent tens of billions of dollars on railroads, machine tools and utility companies in recent years. But Mr. Buffett's 2010 annual letter, to be released Saturday, is likely to emphasize just how much Berkshire's core insurance business is still driving its growth.

Berkshire, where Mr. Buffett serves as chairman and chief executive, is likely to report improved fourth-quarter earnings and an increase in book value, a performance yardstick Mr. Buffett uses to measure the company's growth.

Results will be buoyed by rising stock markets that helped Berkshire's large stock portfolio and its derivatives contracts. The company's manufacturing and retail operations, and its February 2010 acquisition of railroad Burlington Northern Santa Fe, likely boosted net income, as did insurance underwriting. Berkshire's net earnings through the first nine months of 2010 totaled $8.6 billion, already exceeding reported net income for the whole of 2009.

Of importance, Berkshire's pool of funds from insurance—something known as "float"—could have swelled to roughly $67 billion at the end of 2010 from $63 billion a year earlier. It is poised to rise further in 2011 despite challenging insurance-market conditions amid the slow economy, analysts say.

This float is money Berkshire holds to pay insurance claims in the future, but in the meantime can be put to work in stocks and long-term investments that earn returns for Berkshire's own benefit. Effectively borrowed funds at little or no cost, Berkshire's float enables the company to acquire businesses and assets beyond what its equity capital alone would permit, Mr. Buffett has previously said.

Last year's growth in float occurred even though Berkshire Hathaway Reinsurance Group, the giant reinsurer run by Ajit Jain, wrote its lowest level of property insurance to protect against hurricanes and other disasters in nearly a decade, as of Sept 30. As the broader market for commercial insurance extended a multiyear pricing slump, Berkshire limited the amount of catastrophe and individual risks it took because it didn't find premiums attractive enough.

Instead, the reinsurer acquired large books of long-term business from other insurers to bring in billions of dollars that Mr. Buffett and Berkshire's new investment manager Todd Combs can invest for many years—if not decades—before payouts have to be made.

For example, Berkshire collected $2 billion in premiums last summer from a single asbestos and environmental-liabilities deal with insurer [CNA Financial](http://quotes.wsj.com/CNA) Corp.[**CNA**](http://quotes.wsj.com/CNA) **in** Your Value Your Change Short position , whose earnings had been hurt by liabilities from policies sold many years ago.

"Insurance companies that want to clean up parts of their balance sheet from historical woes often look to transact deals with Berkshire," said Bryon Ehrhart, chairman of reinsurance broker [Aon](http://quotes.wsj.com/AON) [AON +0.29%](http://quotes.wsj.com/AON) [**AON**](http://quotes.wsj.com/AON) **in** Your Value Your Change Short position Benfield's analytics division.

Berkshire Hathaway Reinsurance Group also grew significantly in the business of life reinsurance, by taking over coverage on the lives of thousands of Americans. A contract with [Swiss Reinsurance](http://online.wsj.com/public/quotes/main.html?type=djn&symbol=RUKN.VX) Co. that closed in early 2010 gave Berkshire a block of individual term-life reinsurance business. This likely brought in over $2 billion in life and annuity premiums for Berkshire last year, estimates Jay Gelb, an analyst at Barclays Capital.

More premiums will come in this year from a recent acquisition of the life-reinsurance business of Toronto-based [Sun Life Financial](http://quotes.wsj.com/SLF) Inc., [SLF +0.20%](http://quotes.wsj.com/SLF) [**SLF**](http://quotes.wsj.com/SLF) **in** Your Value Your Change Short position which was one of the largest players in this space.

The life-reinsurance deals will enable Berkshire to collect potentially tens of billions of dollars in premiums over the next few decades, money that Messrs. Buffett and Combs will put to work.

Berkshire will have to make payouts if individual policyholders die during the covered periods, but that won't happen immediately.

"These are all float creation deals," said Paul Howard, director of research at Solstice Investment Research. The expectation is that above-average investment returns generated by Berkshire over the long term will ultimately outrun its insurance liabilities, he adds.

Investment returns, however, have fallen across many asset classes since the financial crisis, when Berkshire was able to use money from its insurance operations to scoop up high-yielding securities in such companies as [Goldman Sachs Group](http://quotes.wsj.com/GS) Inc. [GS +0.71%](http://quotes.wsj.com/GS) [**GS**](http://quotes.wsj.com/GS) **in** Your Value Your Change Short position and [General Electric](http://quotes.wsj.com/GE) Co. [GE -0.07%](http://quotes.wsj.com/GE). [**GE**](http://quotes.wsj.com/GE) **in** Your Value Your Change Short position Those aid packages have earned Berkshire double-digit annual returns, but much of the money is expected to be repaid by the companies this year.

In his widely followed annual letter this Saturday, Mr. Buffett may repeat an earlier warning he has given Berkshire investors: The outsize returns he made on those crisis-era investments are unlikely to be repeated.

Berkshire's insurance businesses, which also include auto insurer Geico Corp. and reinsurer General Re Corp., likely generated underwriting profits last year, meaning they made money from the insurance they sold before factoring in investment income.

As long as the insurance is profitable, any money made by Messrs. Buffett and Combs on the float from these businesses belongs entirely to Berkshire. Mr. Buffett has previously described this as investing using other people's money without having to pay interest on the borrowed funds. The recent reinsurance deals, however, aren't without risk.

The deal with CNA Financial transferred $1.6 billion in asbestos and environment-pollution net liabilities to Berkshire along with $2 billion in premiums. Called "retroactive reinsurance" because it covers losses that have already occurred but whose final costs aren't known, Berkshire will be on the hook for up to $4 billion in insurance payouts. But if this limit is hit, it will likely be years in the future, by which time Berkshire could have multiplied the money it collected, say analysts.

Berkshire reached a similar retroactive reinsurance deal in 2006 with Equitas, a company formed by underwriters at Lloyd's of London. Berkshire agreed to pay up to $13.9 billion in asbestos and environmental claims and expenses at Equitas in the years ahead in exchange for $7.1 billion in cash and securities up front.

Mr. Buffett told shareholders in 2007 that there was no guarantee the Equitas deal would earn Berkshire money in the long term. But, he wrote, "Ajit and I think the odds are in our favor. And should we be wrong, Berkshire can handle it."

The retroactive reinsurance deals typically require Berkshire to record accounting losses over a period of time. Unlike most public companies, Berkshire "is willing to take business that depresses reported profits" if it expects to generate large economic profits over the long run, says Tom Russo, a partner at Gardner Russo & Gardner, an asset manager that holds Berkshire stock.

Mr. Gelb of Barclays Capital says it will "take a fair amount of time for the profits to emerge, but [the deals] will enable Berkshire to build up a tremendous amount of wealth over time."

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