RISK MANAGEMENT news

Markel Cambridge Alliance

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For Investment Advisors

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Insurance Concepts

Aggregate Depletion

The annual aggregate limit may be quite high for a broker-dealer or group policy, but remember that all insureds under the policy share it. The Markel aggregate also applies to all insureds under the policy, but it covers only your practice. Systemic market risk is a common exposure within financial services, so take this into consideration when you are comparing limits, premium, and coverage. The greater the number of insureds under the same policy, the greater the risk that the annual aggregate limit can be depleted, thus leaving no coverage for any further claims reported during that annual policy period. This is also the reason that group coverage often costs less than a limit dedicated to your practice.

Investment Selection

Alternative Investment Exposure

Two drawbacks of alternative investments are the lack of transparency on unregistered investment securities as well as their lack of liquidity. In a claim situation regarding alternative investments, these inherent weaknesses can put an advisor in an extremely defensive position. It is not difficult to convince an arbitrator or jury that the client didn't fully understand the risks they were taking through alternatives. We recommend that advisors who wish to gain alternative exposure for their clients use mutual funds that incorporate alternative investments. As mutual funds, they are registered securities subject to regulatory oversight and allow daily liquidity. These mutual funds give advisors access to alternative investments through a vehicle that is covered under their Markel policy.

Avoid a Common Claim

Concentrated Positions

We recommend that you pay particular attention to a client who has a large position in a given security and refuses to diversify the position. Often this can be an inherited stock to which the client has sentimental attachment or company stock built up over years of employment. Whatever the reason, clients who do not wish to diversify from a concentrated position often blame their advisor for not convincing them to diversify in the event of a decline in value.

There is a range of steps you can take to protect your practice from circumstances like these.

- At a minimum, thoroughly document each conversation with the client. Contact a compliance attorney and draft a letter for the client's signature stating that you have recommended diversification, but the client instructed you not to diversify and understood the risk associated with their decision.
- A stronger response would be to take the entire position, place it in a separate account, and do not charge any management fee on this asset. This reinforces that the advisor has no responsibility for management of this position.
- Strongly consider whether you wish to continue with this client.

Tom's Take

Municipal Bond Diversification

Tom Gayner is President and Chief Investment Officer of Markel Corporation (NYSE: MKL). Mr. Gayner oversees the Markel investment portfolio, which was in excess of $8 billion as of 12/31/2010. Below is a clip from Markel's Q4 2010 earnings conference call.

Analyst: Tom, there's a lot of controversy surrounding the municipal bond market. Are you going to de-emphasize muni bonds due to the concerns about the credit quality?

Tom Gayner: I am going to walk you through how we think about the municipal bond portfolio. In rough order of magnitude, we expect to have about half of the fixed portfolio in munis. So in rough, rough terms that is $3 billion. And that's roughly the same as the shareholders' equity account. The first thing we do is to have the highest quality and be at the top of the food chain in terms of what is in that portfolio. Those are general obligation (GO) bonds and essential products and services, such as water and sewer. That's step number one.

Step number two is we have a 10% rule that we will not have any more than 10% in any one state. So for instance, California or Illinois or New York or whichever story you want to talk about, remember there would be a 10% limit of that $3 billion—or $300 million—that would be exposed to any one of those states.

Within each of those states, we don't buy one bond for $300 million that says "California" on it. We buy some bonds that say "LA Airport" and some that say "City of Los Angeles." Some that say "City of San Francisco" and some that say "GO of the State of California." This further disperses and spreads the risk. It is the prudent way of managing things.

The last and final point—if you want to imagine nightmare scenarios. My personal belief is that if there was a severe problem in one of those entities, you would not be looking at a zero; you would be looking at a restructure. If it was a 5% bond that was due in 10 years, my guess is that the bond would be restructured and become a bond with a lower coupon and longer maturity.

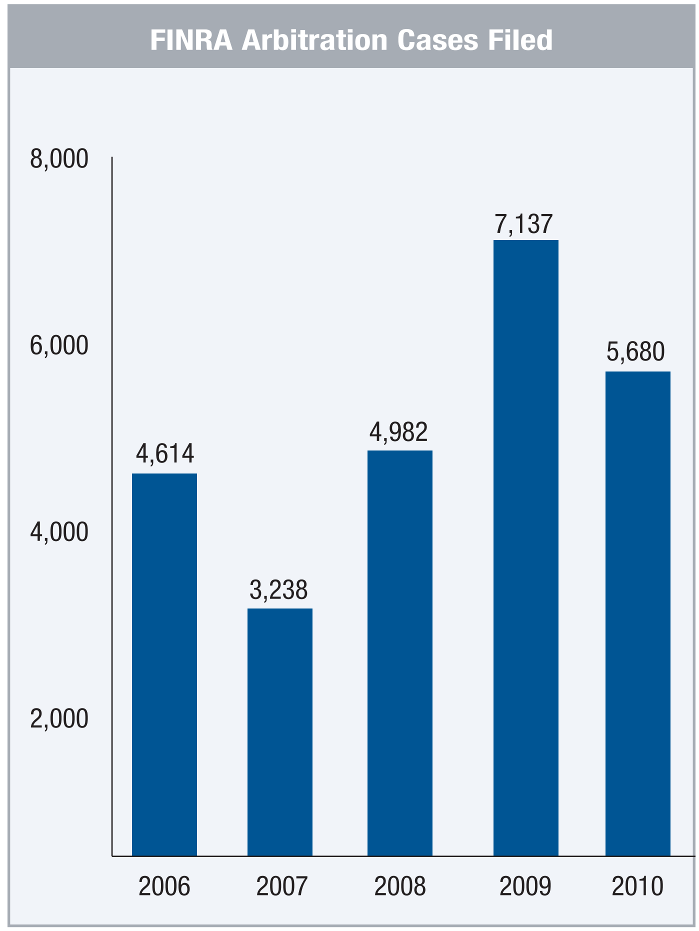
So it's a very high degree of dollar recovery, even with a hit of the mark to market. I think municipalities and states all face the crisis that you read about in the headlines. But also there is growing sense of reality within the world of government, and they are beginning to realize that they have to live within the means that they have in the credit market.

Between those factors and the specific, concrete risk management steps that we have in place, I am comfortable with our exposure.

Loss Environment

2010 Statistics

FINRA arbitration claims against registered representatives were down 20% from the highs in 2009 but remained well ahead of the previous 3 years. The most common allegations in these claims are breach of fiduciary duty, misrepresentation, and negligence.



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Do you have a question for our team?

Please contact your insurance professional or contact us directly at 800-691-1515