NEWS LETTER

Invest

Vol. 13 No. 3 **November 2013**

Argo Group International Holdings, Ltd.

Ticker Symbols: **AGII [common stock]**
AGIIL [preferred stock]

Should I Buy the Stock or Bonds of an Individual Company?

Greetings from LFS

Dear Clients and Friends:

Invest is a quarterly newsletter created and distributed by LFS. The purposes are to offer:

- An investment idea that will perform regardless of market conditions.
- Insight into an industry including trends, opportunity and challenges.

I welcome any questions, comments or suggestions.

Sincerely,

Doug Ruth

Douglas Ruth, Broker

Invest
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The question in the title is an interesting one that financial advisors discuss from time to time. To answer this question, we must respond, “It depends.” We must look at each situation carefully and consider all of the different factors that contribute to a logical answer.

Argo Group International Holdings, Ltd. (AGII or AGIIL), is an insurance company that has been in business since 1986. Investors who have owned the company’s bonds and bond equivalents (i.e., preferred stock) have done well. However, those investors who owned the company’s common stock have achieved poor results. (Please note that when we refer to the company, Argo International Holdings, Ltd., we use ticker symbol AGII; however, we refer to the preferred stock as ticker symbol AGIIL to differentiate between the two.)

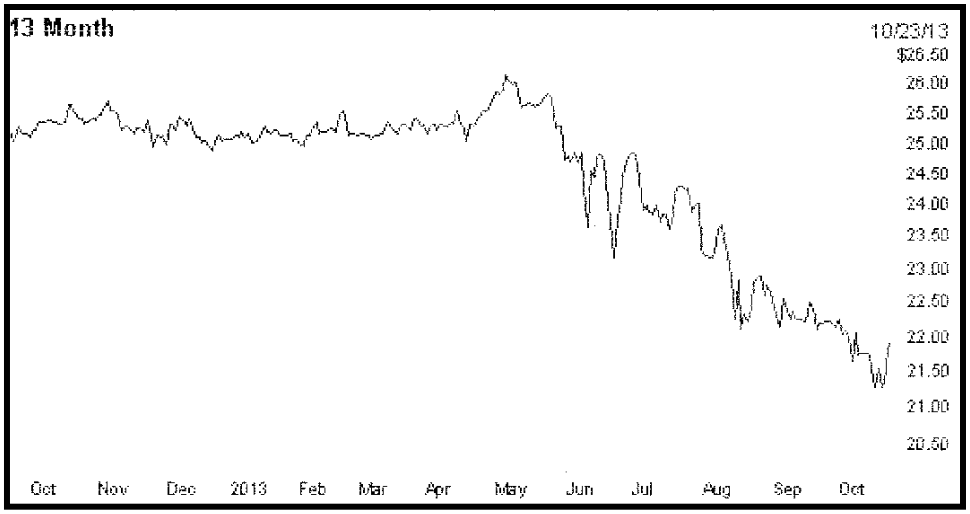
Recently, AGII bonds and bond equivalents have performed poorly. LFS believes that this creates an opportunity for investors to receive both:

- High current income; and
- Possible modest appreciation potential.

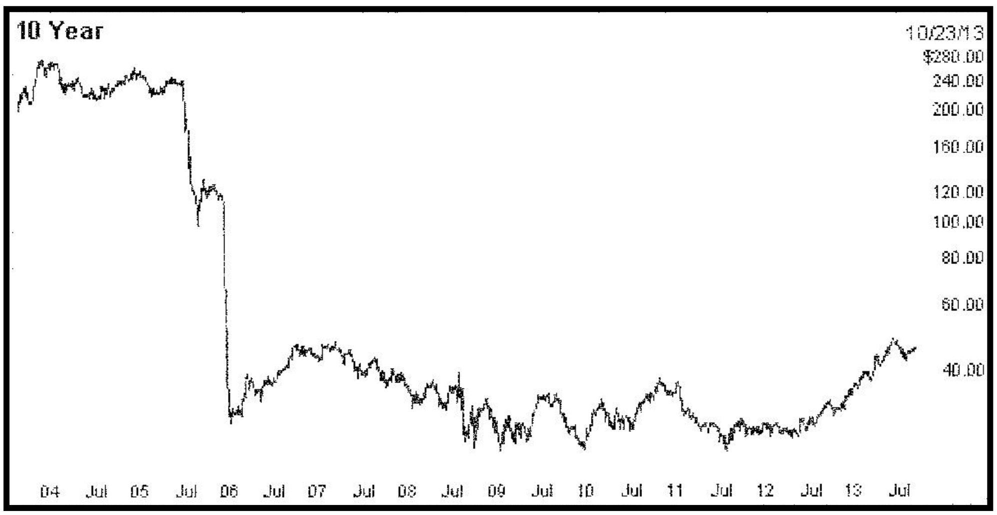
We believe that investors should consider buying Argo preferred stock, ticker symbol AGIIL.

The preferred stock was issued in September 2012 at $25.00 per share. Refer to the graph on the next page to see the preferred stock’s performance.

AGIIL 13-Month Preferred Stock Performance



AGII 10-Year Common Stock Performance



Profits:

Argo has been profitable six out of the last seven years.

Profits (Loss)
(In $Millions)

2006	2007	2008	2009	2010	2011	2012
$106.0	$143.8	$58.3	$115.2	$86.7	($81.9)	$52.3

The company is financially strong.

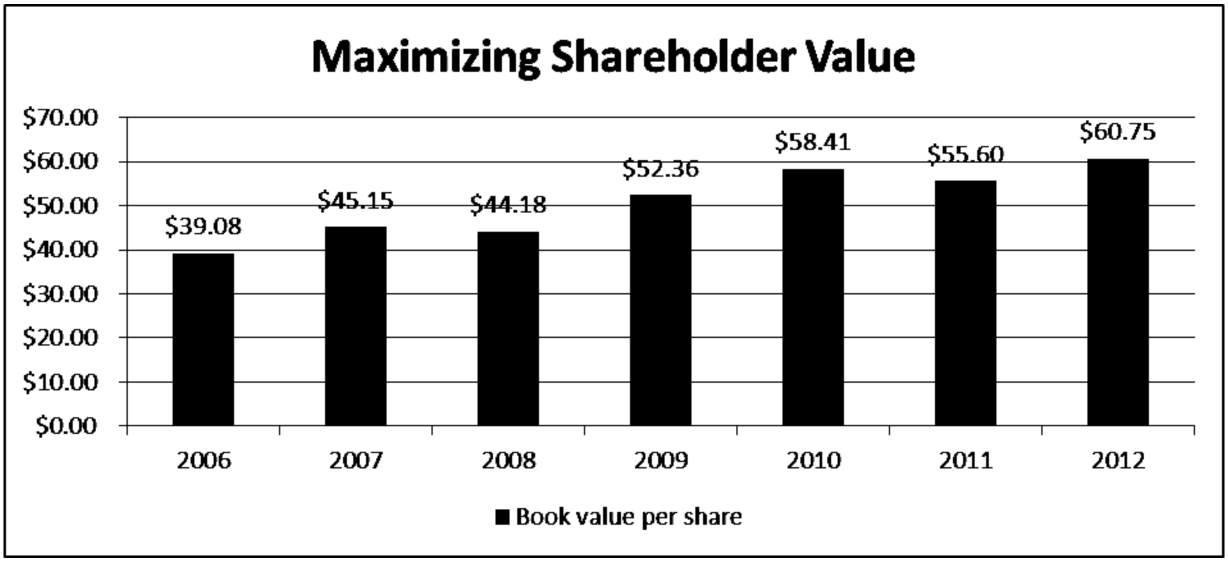
The company believes that growth in book value per share is:

- The most comprehensive measure of financial strength and the ability to create shareholder value; and
- Achieved through a combination of earnings, appreciation in the value of invested assets, accretive acquisitions and, in recent years, through opportunistic stock repurchases.

The compound annual growth rate in book value presents a compelling record.

- The following graph shows that since 2006, the company's book value per share has grown at an above-average rate.

- In the company's view, book value is the most relevant measurement because it represents the point after which current management actions are most clearly reflected in its financial results.



- The company has an A.M. Best rating of A. This is the third-highest rating assigned by Best and meets LFS' requirements. (A financial strength rating reflects the rating agency's assessment of an insurer's ability to meet its financial obligation to policy holders.)
  - The company's debt is rated separately.
- Standard and Poor's has also rated the company's debt, which includes the senior unsecured notes, as investment grade BBB- (with a stable outlook).

The Opportunity:

In September 2012, Argo issued new senior unsecured notes, which traded on the NASDAQ stock market. The notes were originally offered at $25 per share and paid a dividend of $1.63. Argo had an investment grade rating on its debt. Recently, the stock price of the debt declined below $22 per share.

LFS believes the Argo notes:

- Drifted lower with the market; however, fundamentally the company remains strong.
- Are an attractive investment for people who desire high income to supplement their retirement incomes.

Summary: Argo Unsecured Notes

Offer price:	$25.00
Coupon:	6.5%
Current price (10/08/13):	$21.50
Dividend (paid quarterly)	$1.63
Size of offering	$144 million
Rating:	BBB-[1]

Minimum purchase:	400 shares
Cost of minimum purchase:	$8,800

Dates of Interest Payments	**Amount**
March 15:	$0.4075
June 15	$0.4075
September 15	$0.4075
December 15	$0.4075

[1] Investment grade.

What is Important?

A company's ability to pay its bills is the most important factor when an investor owns either a preferred stock or a bond. In this case, the "bill" is the required interest payment.

The following table shows that AGII has historically been able to pay its bills and generate profits.

Abbreviated Financial Statement
(In $Millions)

	2008	2009	2010	2011	2012
Total revenue	$1,249.4	$1,544.8	$1,384.5	$1,258.4	$1,336.3
Expenses:					
Interest expense	31.5	25.9	22.5	22.8	26.5
Total expenses	$1,163.0	$1,402.4	$1,262.6	$1,320.3	$1,269.6
Net income	$58.3	$115.2	$86.7	($81.9)	$52.3

Interest Paid
(In $Millions)

	2008	2009	2010	2011	2012
Senior unsecured fixed rate notes	$0	$0	$0	$0	$2.1
Other indebtedness	4.7	3.9	3.1	3.5	3.1
Junior subordinated debentures	24.9	21.3	19.3	18.3	21.3
Revolving credit facility	1.9	0.7	0.1	0	0
Total interest paid	$31.5	$25.9	$22.5	$21.8	$26.5

The year 2011 was a difficult one for AGII. The company's insurance operation lost money. When extreme weather occurs, insurance companies incur losses because they must pay policyholders' claims.

Insurance Company Profits:

Property and casualty companies should be consistently profitable. Profits are the summation of three separate activities, including:

1. Selling insurance and earning (or losing) money based on the claims filed and administrative expense incurred;
2. Generating income from bonds and sometimes dividend-paying stocks from the capital that is set aside to pay claims; and
3. Generating capital gains (or losses) from selling stocks or bonds from the capital that has been set aside to pay claims.

At times, some companies generate losses from selling insurance. Other times, they are successful because they earn enough income from bonds, dividend-paying stocks, and capital gains to offset the losses from their insurance operations. This is the case for investors who own AGII preferred stock.

Activity 1 – Selling Insurance and Earning a Profit:

Companies that can sell insurance and earn underwriting profits are highly desirable. The amount of profits can be measured by looking at the combined ratio. Underwriting profit is produced when the combined ratio is below 100 percent. The lower the combined ratio, the higher the profit.

When a person has a claim, there are two different costs to the insurance company:

- **Administrative costs:** The insurance company spends time and money processing the claim. A large portion of administrative costs can be spent verifying that the claim is legitimate.
- **Paying the claim:** Money is spent to repair or replace the damaged property. However, insurance companies should be able to generate underwriting profits.

Between 2008 and 2012, AGII earned an underwriting profit only once, in 2009.

Combined Ratio

2008	2009	2010	2011	2012
101.0%	97.1%	102.7%	119.8%	104.6%

Activity 2 – Generating Income from Stocks and Bonds:

The company has been able to generate income from its stock and bond portfolio. The following table shows the net investment income and realized gains.

Net Investment Income and Realized Gains (Losses)
(In $Millions)

	2008	2009	2010	2011	2012
Investment income:	$132.7	$133.6	$130.7	$121.4	$105.9
Interest and dividends on fixed maturities	8.0	7.9	8.7	9.6	15.2
Dividends on equity securities	16.7	5.7	2.6	4.7	7.3
Interest on short-term and other investments	2.3	7.7	(0.1)	(0.5)	(0.4)
Other	159.7	154.9	141.9	135.2	128.0
Investment expenses	($9.5)	($9.4)	($8.3)	($9.4)	($9.2)
Net investment income	$150.2	$145.5	$133.6	$125.8	$118.8

Activity 3 – Generating Capital Gains from Stocks and Bonds:

AGII has generated some profits from capital gains.

Gross Realized Investment and Other Gains (Losses)

(In $Millions)	2008	2009[1]	2010	2011	2012
Realized gains					
Fixed maturities	$4.6	$35.6	$31.5	$30.5	$27.2
Equity securities	14.2	9.1	6.3	26.6	0.4
Other investments	0.2	2.7	8.9	16.1	21.5
Short-term investments	0.0	0.0	0.2	1.0	0.5
Gain on sale of affiliate	3.1	0.0	0.0	0.0	4.8
Gain on sale of real estate	0.0	0.0	0.4	0.0	0.0
Gross realized investment and other gains	$22.1	$47.4	$47.3	$74.2	$54.4
Realized losses					
Fixed maturities	($5.3)	($17.2)	($8.2)	($11.6)	($9.1)
Equity securities	(0.3)	(0.9)	(1.1)	(0.7)	(0.5)
Short-term investments and other Investments[1]	(0.3)	0.0	0.0	0.0	0.0
Other investments	0.0	(0.7)	(0.3)	(10.5)	(15.1)
Short –term investments	0.0	(0.3)	(0.1)	(1.0)	(0.3)
Other-than-temporary impairment losses on fixed maturities	(21.3)	(6.9)	(0.8)	(0.1)	(1.5)
Other-than-temporary impairment losses on equity securities	(30.0)	(20.3)	0.0	(1.1)	(2.2)
Other-than-temporary impairment losses on funds at Lloyd's foreign currency exchange	0.0	(17.8)	0.0	0.0	0.0
Gross realized investment and other losses	(57.2)	(64.1)	(10.5)	(25.0)	(28.7)
Net realized investment and other gains	($35.1)	($16.7)	$36.8	$49.2	$25.7

1. Presentation changed.

Selling Insurance and Earning an Operating Profit:

Argo Group markets and distributes insurance through four different segments:

1. Excess and Surplus Lines (E&S);
2. Commercial Specialty;
3. International Specialty; and
4. Syndicate 1200.

Additionally, AGII manages a segment that is entitled "Run-off," which represents a book of business that is no longer active. These policies were issued in the past but are no longer available.

Segment 1 – Excess and Surplus (E&S):

AGII's excess and surplus lines segment has been consistently profitable. The excess and surplus line represents the majority of the segment's income.

E&S Income (Loss) before Taxes
(In $Millions)

	2007	2008	2009	2010	2011	2012
E&S income before taxes	$112.7	$98.3	$64.7	$64.6	$65.9[1]	$74.1
Total insurance segment income	$175.2	$168.7	$191.3	$103.5	($80.9)	$87.8
E&S income as a percentage of total insurance segment income	64.5%	58.3%	33.8%	62.4%	181.5%	84.3%

1. The company's E&S segment generated an operating profit. However, the organization's other insurance operations incurred losses in excess of the E&S gains. $65.9 (E&S operating profits) – 146.8 (other segment losses) = ($80.9) net loss.

AGII's other segments have been "consistently inconsistent," alternating between generating operating income gains and operating losses. LFS believes that investors can own AGII preferred stock based on the strength of the E&S lines.

More about E&S:

The profits have been increasing in the E&S lines segment. The table that follows shows the results of operations.

Results of Operations – E&S
(In $Millions except Percentages)

	2010	2011	2012
Gross written premiums	$522.9	$478.9	$513.5
Earned premiums	$489.7	$405.3	$399.3
Losses and loss adjustment expenses	311.1	247.1	223.3
Underwriting, acquisition and insurance expenses	166.2	139.8	143.9
Underwriting (loss) income	**$12.4**	**$18.4**	**$32.1**
Net investment income	58.6	56.0	51.1
Interest expense	(6.4)	(8.5)	(9.1)
Income before income taxes	$64.6	$65.9	$74.1
Loss ratio	63.5%	61.0%	55.9%
Expense ratio	33.9%	34.5%	36.0%
Combined ratio	97.4%	95.5%	91.9%
Loss reserves on December 31	$1,338.0	$1,271.8	$1,209.0

Excess and surplus line carriers focus on risks that the standard (admitted) market is unwilling or unable to underwrite. The standard market's limited appetite for such coverage is often driven by the:

- Insured's unique risk characteristics;
- Perils involved;
- Nature of the business; and/or the
- Insured's loss experience.

E&S surplus line carriers are able to underwrite these risks with more flexible policy terms at unregulated premium rates on a nonadmitted basis.

Nonadmitted and Admitted Carriers:

- Nonadmitted carriers, while approved, are not licensed in the states where they underwrite and, therefore, are not subject to the regulation of the states' departments of insurance.
- By contrast, admitted carriers are licensed by states and are subject to all of the regulations and requirements of these states.

In 2011 and 2012, the E&S business segment consisted of two operating platforms:

- Colony Specialty; and
- Argo Pro.

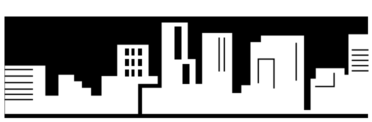
While focused primarily on nonadmitted business, each of these operations may also underwrite certain classes of business on an admitted basis for risks that otherwise meet Argo's underwriting standards.

Two Operating Platforms:

Operating Platform 1 – Colony Specialty:

Colony Specialty underwrites coverage for hard-to-place risks and/or distressed businesses that typically fall outside of the standard insurance market's risk appetite. The following are covered:

- Property;
- Primary and excess casualty; and



- Automobile and professional liability.

This business is written through six business units.

Colony Specialty Premium Volume

	2011	2012
1. Casualty	36%	34%
2. Transportation	22%	19%
3. Specialty Property	9%	10%
4. Contract	29%	26%
5. Environmental	4%	5%
6. Allied Medical[1]	0%	6%
Total	100%	100%

1. Allied Medical was part of Agro Pro but was moved to Colony Specialty in 2012.

Commercial Enterprises Covered by Colony Specialty

	2011	2012
Contractors	X	X
Manufacturers	X	X
Distributors	-	X
Property owners	-	X
Retailers	-	X
Restaurants	X	X
Environmental consultants and contractors	X	X
Smaller medical facilities within social services	-	X
Miscellaneous healthcare and long-term care	-	X
Day care centers	X	-
Apartment complexes	X	-
Condominium associations	X	-

Operating Platform 2 –Agro Pro:

Argo Pro is the company's combined professional lines platform. This platform provides:

- Ease of access to a broad portfolio of Errors & Omissions and Management Liability products for the company's wholesale and retail distribution partners; and
- Customized coverage for small- to medium-sized risks on both an admitted and nonadmitted basis.

Argo Pro is comprised of three divisions:

Division 1 – Management Liability: Targets commercial and select financial institution risks in the middle market and upper middle market segments.

Divisions 2 and 3 – Errors & Omissions and Insight: Focuses on small- to medium-sized risks on both an admitted and nonadmitted basis. (The

Errors & Omissions division and the Insight division have some overlap in the customers they serve.)

Premium Volume – Argo Pro Divisions

Division	2011	2012
Management Liability		25%
Errors & Omissions		24%
Insight		51%
Total		100%

Commercial Enterprises Covered by Divisions 2 and 3 of Agro Pro

	2011	2012
Accountants	X[1]	X
Architects and engineers	X[1]	X
Information technology products and services providers	-	X
Lawyers	X[2]	X
Miscellaneous professions	X[2]	X
Employment practices	X[2]	X
Real estate-related accounts	X[2]	X
Insurance agents	X[1, 2]	-

1. Insight.
2. Errors & Omissions.

E&S Marketing and Distribution:

Colony Specialty distributes its products through a network of appointed wholesale agents and brokers specializing in excess and surplus lines and certain targeted admitted lines.

Premium Volume – E&S, Colony Specialty

	2011	2012
Wholesale brokers[1]	51%	60%
Limited group of wholesale agents	49%	40%
Total	100%	100%

1. These agents are granted authority to underwrite, quote, bind and issue policies in accordance with predetermined underwriting guidelines and procedures prescribed by Colony Specialty

Argo Pro distributes its products through both wholesale and retail partners.

Preferred Stocks:

Preferred stocks are considered to be a hybrid security. They are not as well understood by investors as common stocks and bonds are. This lack of understanding often creates opportunity. This is why.

When a preferred stock is issued, the security is initially promoted by brokers and brokerage firms. The promotion is based on a combination of elements.

There is:

- A new investment story to tell; and
- An opportunity for clients, brokerage firms and brokers to prosper.

Argo has a history of offering new preferred stock from time to time. These are the details. This most recent issue was listed on the stock exchange in 2012. The offering was valued at $143.9 million:

5,755,000 shares at $25 per share = $143,876,000

After the securities have been marketed and distributed, the level of interest can decline. Considerably fewer people follow the issue as time goes by. It is common for the security to simply drift both up and down with the market. This drifting creates the opportunity. Argo's preferred stock often trades at a discount to its carrying value.

The company's preferred stock, both AGIIL and previous issues, have been offered to the investment community and listed on the stock exchange.

The carrying value in this case is $25 per share. The $25 is multiplied by the numbers of shares issued. If AGIIL were on Argo's balance sheet, this is how it would appear:

Argo Proforma Balance Sheet
(In $M except Percentages)

Carrying value	$143.9
Fair value	$125.2
Percentage of fair value	87.0%

By looking at the table below, you can see that the outstanding preferred stock between 2009 and 2012 traded at a discount to its carrying value.

Argo Preferred Stock Carry Values

(In $Millions)	2009	2010	2011	2012
Carrying value	$311.4	$311.5	$311.5	$193.3
Fair value	$190.9	$238.6	$250.8	$151.8
% of fair value	61.3%	76.6%	80.5%	78.5%

We believe that at the present price, now is a good time to start to build a position in AGIIL preferred stock.

This is our logic:

Investors purchased $143.9 million of the company's preferred stock and originally received 6.25 percent interest in September 2012.

Per share information		
Dividend:	$1.5625	X 100 =
Price in 09/13:	$25.00	6.25%

In early November 2013, investors are buying the same security but the yield is higher because the price is lower.

Per share information		
Dividend:	$1.5625	X 100 = 7.1%
Current price as of 11//04/13:	$21.75	

Reasons for Purchasing Argo's Preferred Stock:

Some of the reasons an investor might consider buying AGIIL include:

1. The insurance industry is considered to be a "necessity-of-life" need;
2. The company has a history extending more than 25 years;
3. The issued preferred stock has an investment grade rating from Standard & Poor's;
4. The dividend yield is an attractive 7.1%; and
5. The stock may experience modest appreciation.

I would like information on the following:

- ☐ **ADDvantage Group Holdings (AEY)**
- ☐ **Argo Group International Holdings (AGIIL)**
- ☐ **Bassett Industries, Inc. (BSET)**
- ☐ **Delphax Technologies, Inc. (DLPX)**
- ☐ **Deswell Industries Incorporated (DSWL)**
- ☐ **Federated National Holding Company (FNHC)**
- ☐ **International Ship Holding (ISHPRA)**
- ☐ **Jinpan International, Ltd. (JST)**
- ☐ **Lakeland Industries, Inc. (LAKE)**
- ☐ **Star Gas Partners, L.P. (SGU)**
- ☐ **21st Century Holdings (TCHC)**

Insurance:

- ☐ **Term**
- ☐ **Whole Life**
- ☐ **Fixed Annuities**
- ☐ **Disability Income**
- ☐ **Universal Life**
- ☐ **Individual Health**
- ☐ **Group Health**

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