EMERSON, REID'S

INSURANCE OBSERVER

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Does The Insurance Cycle Still Exist?

We're not so sure anymore. There was a time when the insurance industry operated with a cyclical consistency, like the tides. These days it acts with a different type of consistency—it is consistently bad. One thing we feel pretty strongly about is that there won't be any dramatic changes in underwriting until the industry perceives—rightly or wrongly—that it is undercapitalized and in trouble. We think it will take a certain amount of pain before that occurs.

We are not alone in our thoughts. Warren Buffet, John Byrne and others have voiced this opinion in the past. Indeed, in the new Fund American (the old Fireman's Fund) annual, Byrne comments on the difficulty of setting accurate loss reserves, pointing out that he has been very wrong about estimating reserves for five years in a row. He says: "With a prediction record this good, I hereby retire from the field of predicting the strength of our balance sheet ... As the noted Midwestern philosopher [Buffet] said, 'Setting casualty reserves is much like burying Dad in a rented suit.'"

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Hard Times

1989 was a sorry year in the insurance industry. Natural catastrophes and a soft pricing environment made it no fun to be an underwriter and less fun to be a broker. The price firming many had hoped for did not materialize. About the best that could be said for the insurance industry was that things didn't get much worse.

Since we're the curious sort, we decided to find out what all the big boys had to say about the situation. So we got a stack of insurance company annual reports and began reading. Not surprisingly, much of the text of the annuals is garbage, fluff, and hype (more about that later). But there are some gems.

Our favorite, and always one of the most illuminating annual reports, is Berkshire Hathaway's. You may not be aware of this, but Berkshire's statutory net worth is about $6 billion, making it the second largest insurance company in the country in those terms. Speaking of the so-called "underwriting cycle", Chairman Warren Buffet says: "If that term is used to connote rhythmic qualities, it is in our view a misnomer that leads to faulty thinking about the industry's fundamental economics." He explains that in the past the industry and regulators worked together "to conduct the business in a cartel fashion", shielding insurance companies from significant price competition. But now "the industry has hundreds of participants selling a commodity-like product at independently established prices. Such a configuration—whether the product being sold is steel or insurance policies—is certain to cause subnormal profitability in all circumstances but one: a shortage of usable capacity."

AIG's Hank Greenberg and Berkshire Hathaway's Warren Buffet discuss the finer points of the insurance marketplace while top insurance industry executives look on.

Unlike most industries, where capacity has to do with physical constraints, the insurance industry's capacity deals with financial constraints as well as insurance companies' willingness to write business. Their willingness to write business depends on their current appetite for risk as well as their perceptions about all sorts of other things. Buffet opines that "capacity at any particular moment primarily depends on the mental state of insurance managers." As a friend of ours remarked: "Having known a few insurance company men in my day, that's not a very reassuring thought."

Buffet's outlook for insurance companies is realistic, but negative:

> "Good profits will be realized only when there is a shortage of capacity. Shortages will occur only when insurers are frightened. That happens rarely—and most assuredly is not happening now. (March 2, 1990)
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> "The industry will meantime say it needs higher prices to achieve profitability matching that of the average American business. Of course it does. So does the steel business. But needs and desires have nothing to do with the long-term profitability of industries. Instead, economic fundamentals determine the outcome."

Many of the other annual reports went on at length about bland things like their mission statements, reducing costs, earning a good return on equity, providing quality service and stuff like that.

For that matter though, we've never run across an insurance company that *didn't* claim to provide quality service.

AIG's savvy Chairman Hank Greenberg predicts that the 1990's are likely to be "a highly competitive decade, on both a regional and global basis. In this environment, only the fittest [insurance] companies will prosper." Interestingly, he thinks that "1989 saw the first signs of a more sensible industry approach to underwriting... Overall, we believe pricing will be firmer than it was in 1989."

Many other CEO's of large insurance groups also predict a more favorable

environment in 1990 and 1991. Indeed, George Scharffenberger, Chairman, President and CEO (a veritable triple threat) of the beleaguered AmBase (parent company of The Home) is one of the most specific. He writes "It is expected that property/casualty insurance rates will start to increase in the second half of 1990, or in 1991 ..." Of course there are those who take Scharffenberger's words with a large dose of salt. AmBase's $2 billion of debt is almost twice its net worth, and some $440 million—about ten percent of its investment portfolio—is in junk bonds. They also have the dubious distinction of being Drexel Burnham's second largest creditor, and an unsecured one at that. Some might say Scharffenberger is *praying* for premiums to rise.

Oh yes. There's one more reason why he might have an incentive to talk up the outlook for the industry. The Home has a "for sale" sign on it. Since we all know that the real estate market has been weak, it'll be interesting to see whether The Home market is any better.

The bosses of The Chubb Corporation, (which reported its fourth straight year of record earnings), don't share Scharffenberger's convenient optimism. They warn that although there were some signs of price improvement last year, "unless that firming movement persists and spreads to the standard, commodity-like coverages, the industry may face an even more severe downturn than the last one."

William Snyder, Chairman of GEICO, concurs. "The near-term outlook is not bright for the personal lines property and casualty industry."

As we read through all these reports, we were struck by another thing. It seems that the insurance companies with the best records and soundest financial positions were the most cautious in their comments about the future, while the companies that have underperformed for ages and are more leveraged often portray the rosiest scenarios. It makes one wonder.

General Re, for example, a paragon of underwriting restraint, profitability, and conservatism, stresses that the latter part of the 1980's demonstrated that financial integrity can't be taken for granted. We agree with that and are of the opinion that insurance companies' financial strength will become a very important issue in the not-too-distant future. General Re reported that "Market conditions for reinsurance remained comparatively stable in 1989. That is to say, competition among reinsurers remained strong."

Cincinnati Financial, another pillar of solid underwriting practices and liquidity, has a long-term record that must make many other insurers green with envy. Although their book value increased more than 23% in 1989 and their combined loss ratio was 99.7% (compared to 110.4% for the industry), Chairman John Schiff (no relation to your editor) humbly reported that "1989 was not a very good year", and only begrudgingly admitted that all things considered, profitability was "satisfactory".

We're always interested in people who've managed to achieve outstanding results in the insurance business while employing little or no leverage. How do they do it? To discover Cincinnati Financial's secret we gave senior vice president Ted Elchynski a call. He pointed out that the company was formed by agents in 1950 and is still heavily owned by agents. (By the way, Cincinnati Financial is no pipsqueak. Shareholder's equity exceeds $1 billion.) Indeed, six out of the seventeen members of the Board of Directors are insurance agents.

The company is also unusual in that it doesn't have any branch offices or local claims offices. People deal with the home office, and claims adjusters work out of their homes. That helps keep the expense ratio down.

But there must be something else sort of special that you do, we said. "Well," Elchynski remarked "We do have a pretty good work ethic." He wasn't kidding. It seems that the home office is open on Saturdays and most of the people are expected to come in. That's quite a contrast to your average insurance company where there's a stampede to leave the office on Friday afternoons.

As for the insurance market, Elchynski admitted that it was still very difficult, especially personal lines and homeowners. Nonetheless, barring any catastrophes, Cincinnati's combined ratio should come in under 100.

That's mighty impressive.

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On The High Seas With USF&G

Sometimes, you can read something over and over again and still feel you don't know what the author is saying. Back in high school we used to have a word for that sort of thing. With that in mind, let's examine USF&G's (USF&G is corporate daddy of United States Fidelity & Guaranty) 1989 annual report, which seems to rely heavily on a seafaring metaphor. Although the four-page Chairman's Letter neglects to mention that earnings declined dramatically during the past four years and have been in the doghouse for the better part of the past decade, it concedes that 1989 was a "difficult year".

It went on: "1989 severely tested our corporate ship of state ...but... with the steady hand of experience... We have [a] vision to keep our bow headed at our corporate targets ... "

Although the combined loss ratio deteriorated to 109.3%, apparently the shareholders can be thankful that: "Once again, experience and forethought brought us through some very rough seas..."

USF&G claims to have begun raising its commercial lines rates in the fourth quarter, and their personal lines posture is euphemistically referred to as "aggressively [pursuing] rate adequacy". We assume that means the same thing as jacking up prices. We also assume that the term "rate adequacy" doesn't fool consumer advocates or policyholders.

Even though underwriting losses totaled $265 million, and the company's "optimistic expectations" for its financial services division didn't pan out, the Chairman still has confidence. As he opines: "I believe that we have set the right course... The horizons we set forth in last year's annual report have closed in with great speed... Our flagship insurance operations face great challenges and opportunities across the country. Our new fleet of financial services looks across a globe..."

Although book value per share has declined over the past decade, the company is getting ready for the 1990's, according to the Chairman's Letter: "No longer are we going to be simply the sum of our parts." So what exactly is their strategy? "*In essence, we have broadened our reach but narrowed our focus.* We know we can't sail on all seas."

A perusal of the financials shows that USF&G has stretched for yield, a bit, in its investments. About 16% of the portfolio was in non-investment grade—junk—bonds. The Chairman is convinced, though, that the company can take

advantage of opportunities "as they appear on the horizon". Naturally, he can't do it alone. "At the helm, I rely heavily on our management," he writes.

"We have prospered because we backed trust with service. This is what has kept our employees, agents, customers and investors with us over the long voyage. And this remains our pledge as we plot our bearing into the next century."

Run that by us again?

They Said It

Speaking before a House of Representatives Subcommittee investigating insurance company insolvencies, Michael Mulholland, former chief financial officer of Mission Insurance Group, testified that insurance reserve estimates are not "real money".

—Mission Insurance's insolvency cost the public $1.6 billion.

Get Your Kicks on

Call us old fashioned, but we like traveling by car. Seeing the USA in our Chevrolet is preferable to flying the friendly skies of United. Every time we set out down the lonesome highway heading west we have nostalgic visions of a simpler America; an America made up of open spaces, hokey roadfood joints and cornball tourist traps, highways dotted with motels shaped like wigwams and hot dog stands shaped liked pigs. We liked things better before the big chains turned much of America's roadsides into a giant stretch of golden arches and whoppers.

Until the mid-teens there was no real cross-country route. Roads ended somewhere in Nebraska. The first paved route across America was the so-called Lincoln Highway, completed in 1923, but it was Route 66, immortalized in song, *The Grapes of Wrath,* and a TV show that became "America's Main Street" and achieved mythic status. This highway, which follows an old Osage Indian trail, was the most famous route west. (Of course it ran both ways, it just *felt* like everyone was heading west.)

It seems there's something about the American spirit that forces us west. Although the frontier has been conquered and paved over with a thousand malls, there's a restlessness to the American psyche that keeps us moving, searching for open space and freedom. De Toqueville observed this in the 1830's, and it's still true today.

The frontier has been officially pronounced dead many times: with the advent of the transcontinental railroad, when the Oklahoma territory was put up for grabs, and with the coming of the interstates. The American frontier—which in this century has certainly been more conceptual than geographical—had shrunk so by 1969 that the film *Easy Rider's* ad campaign read "A man went looking for America ... and couldn't find it anywhere."

Better late than never, we figured, so in mid-April we decided to travel for a spell and see what we would find. We started our journey in Oklahoma City because that conjured up visions of the Joad family in *The Grapes of Wrath* as they set out in their Model T, heading towards the land of plenty.

Somewhere west of El Reno, Oklahoma we spotted a road sign that was, for us, the true gateway to the West. It read: "Last McDonald's for 150 miles." From there on it was open land, albeit fenced-in open land.

It's worth remembering that except for an occasional missionary and some greedy Spanish explorers, the West remained pretty much unchanged until the various trails were opened up in the early nineteenth century. Unfortunately, by 1850, travelers along the Sante Fe Trail reported seeing abandoned covered wagons and various other pieces of civilization scattered along the route.

In the 1950's, an eccentric Texas millionaire named Stanley Marsh 3 (that's how he spells it) commissioned a work of art called *Cadillac Ranch,* which consisted of ten Cadillacs buried halfway into the ground nose first along the road just a couple miles outside of Amarillo. Perhaps more than he realized, this was a fitting—and bittersweet—tribute to what the west had become and the force that had brought about change—the automobile. Everywhere we went, in fields, backyards, dumps, roadsides, deserted gas stations, defunct burger joints, and closed motels, we saw the shells of vintage Cadillacs, Chevys, Ford trucks, and Plymouths, broken down and stripped, but looking surprisingly fit.

Route 66 was decommissioned some years back and replaced by I-40. As a result, many of the towns along that famous highway are now crumbling, dying places—just wide streets, empty store fronts and grain elevators looming in the distance—seemingly well on the way to becoming twentieth century Angkor Wats. In Erick, Oklahoma we stopped in for an early dinner at Cal's Country Cooking. Your editor had a large salty helping of ham hocks and beans with sliced onions, homemade bread, and several glasses of iced tea. Unable to make a choice, he ordered cherry pie and a giant sweet, sticky cinnamon roll for dessert. The tab for this abundance of delights was in the $5 range.

To visit the town of Texola, in western Oklahoma is an intense experience for a New Yorker. Located at a desolate sun-baked crossroads on the old Route 66, Texola doesn't really exist anymore. It is dead, but frozen in time, somewhere in the late 1940's. It's unlikely that more than a handful of people live there. The gas station, diner, and other buildings are deserted or abandoned. We contrasted this vision with a that of 1946 guidebook that describes Texola as a small town with "an old section of stores which truly savors of pioneer days... Old-timers still lounge on the corners."

The terrain became dry and barren in the Texas panhandle. We noticed deep washes—dry river beds—cut into the ground. Often we'd get out of the car and stand in the middle of the road for several minutes, our eyes following the broken white line until it disappeared into the wide horizon.

The roadsides are still filled with coming attractions for what's up ahead. For hundreds of miles before Amarillo there are billboards for The Big Texan, home of the free 72-ounce steak. Free, only if you can eat the whole damned thing, including a potato, in less than an hour.

Along an open stretch of western New Mexico a sign said "Continental Divide, 1 mile." A mile ahead, in terrain indistinguishable from everything else, is the only evidence of the great backbone of America—The Continental Divide Gift Shop and Trading Post. In western Arizona a billboard invites us to "eat upstairs at the 60-foot high teepee".

At a little roadhouse joint in Vega, Texas, called the Hickory Inn, our breakfast consisted of buttermilk hotcakes and homemade biscuits smothered in a thick white gravy flecked with sausage. This fueled us well into New Mexico, across the desert, through the mountains and high plains and onto the final leg of the Santa Fe Trail.

New Mexico is a beautiful, sparsely populated state whose food is so hot it brought tears to our eyes. At the famous M&J Sanitary Tortilla Factory in Albuquerque we couldn't finish our *menudo*, a soup that is a staggering

concoction of *chiles* and cows' stomachs. We washed it down with *sopapillas*, a soft, fried pastry or bread shell onto which one pours honey. Fortunately, sopapillas are ubiquitous in New Mexican cuisine, and we ate many of them.

We drove into the mountains and past fertile valleys along the Rio Grande. We visited the impoverished Taos Indian pueblo, a depressing and overwhelmingly sad place. The Acoma pueblo, built on the top of a plateau in the middle of nowhere is better, but still sad.

The towns became fewer and farther apart in Arizona. The Painted Desert and the Petrified Forest were stunning sights, and we had them to ourselves. This was not the case when we popped in to visit the Grand Canyon, about fifty miles north of Route 66. Four million visitors go there each year, and even though the thing is three hundred miles long they all go to the same spot. It was great, but we much preferred the grandeur of the open road or the solitude of the snow-capped Sangre de Cristo mountains in New Mexico. So it was back onto the highway, heading towards the Mojave desert.

In Kingman, near the California border, we made a twenty-mile detour into the gambling town of Laughlin, Nevada. It was a sobering experience. Laughlin is a nightmareland of blue-haired, double-knitted, beer-bellied, True Detective-reading tourists traveling in recreational vehicles. This torn-up strip of desert is the ugliest place we've ever seen in America. Inside one of the slot machine-filled casinos we witnessed an unforgettable sight—a symbol of what America is in danger of becoming—a man at the blackjack table hooked up to a portable oxygen tank, chain-smoking Marlboros.

Back on the road. About twenty miles outside Needles, California we bid goodbye to Route 66 and headed off into a lonely hundred-mile stretch of desert. After fifty miles or so, we came upon Amboy, which consisted of a bunch of empty buildings and shacks, a two-pump gas station and a closed diner. No people. As we approached, we saw a sign that read "Town For Sale. You can be the mayor."

Our trip finally ended in Los Angeles. After eight days on the road in some of the most sparsely populated parts of America, we felt shocked by the congestion, the air, and the traffic.

Why, you may ask, would folks want to get into a car and drive 2,100 miles during their vacation? Perhaps the answer lies in a country and western song we heard on the radio in Texas:

"I'm a prisoner of the highway, imprisoned by the freedom of the road."

Perhaps we still believe that you must lose yourself in America to find yourself.

We assure you, you can still get your kicks on Route 66, but it's worth doing a little reading first.

Whether you're a true roadologist or just an armchair traveler, we can highly recommend Michael Wallis' new book Route 66: The Mother Road *(St. Martin's Press), a loving tribute to the glories of the road and a history of a way of life that is, sadly, fading into the past. This picture-laden 240-page extravaganza is the best book we've seen on Route 66, and indispensible if you're planning to make the trip. (We wish we had had it.)*

Also, we loved Phil Patton's excellent Open Road—A Celebration of the American Highway.

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The Insurance Forum

It would probably be fair to describe Joseph Belth, editor of the first-rate, four-page monthly Insurance Forum, as something of a gadfly. He's a muckraker who digs deep into insurance department documents, SEC filings, and all sorts of other things to come up with some very interesting information about questionable insurance industry practices.

The curmudgeonly Belth has a nitpicker's eye for detail and is a dogged investigator, letter writer, fact finder and truth seeker. In fact, this former life insurance salesman who became an insurance professor at Indiana University, has been called the "Ralph Nader of the insurance business" by the New York Times.

Belth has been particularly critical of First Executive and A.L. Williams, as well as many of the financial and accounting shenanigans employed by the industry, such as surplus relief insurance, letters of credit, non-admitted reinsurance, and junk bond holdings.

Clearly, this newsletter is not for for the casual observer of the industry. But if you want to read fascinating material that's on the cutting edge, we think a subscription, at a mere forty bucks, is a bargain.

Subscriptions are available from Insurance Forum, Inc., P.O. Box 245, Elletsville, IN 47429. The price is $40 per year.

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You're Kidding, You Haven't Heard About Emerson, Reid's DBL Rate Stabilization Program?

This is an interesting approach to take for larger insureds (over $25,000) who have had reasonable experience. Give us a call and we'll tell you more about it.

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New Jersey TDB—Kiss the State Fund Goodbye

Unlike New York, where most of the DBL is written with private insurance carriers, most of the TDB (Temporary Disability Benefits Law) in New Jersey is written through the State Fund, which (obviously) doesn't pay any commissions. That's crazy! Emerson, Reid has a number of very competitive markets that are actively seeking TDB.

In case you need a refresher in TDB, here it is: The law requires employers in New Jersey to provide Short Term Disability benefits to their eligible employees who are unable to work because of an off-the-job injury or sickness.

The benefit is $66^{2}/_{3}$% of the average weekly wage to a maximum of $261 per week. Rates are a percentage of the first $13,900 of annual wages per person.

Benefits begin on the eighth day of disability and there is a twenty-six week duration. If an employee is disabled for three consecutive weeks following the waiting period benefits are retroactive to the first day of disability.

A significant lead time is generally needed to write TDB because there's a decent amount of paperwork involved. Since TDB policies are generally effective January 1, it's important to get started on this as soon as possible.

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Long Term Disability for Small Groups—Finally

Emerson, Reid now has an excellent LTD program available for groups with two to nine employees. Give Mark Wintjen a call right away to learn more about this.

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