EMERSON, REID'S

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Drowning on Dry Land

Interest rates and environmental liabilities

One of the ironies of the insurance market—perhaps all markets, for that matter—is that bad news generally comes from where it's least expected. This makes sense, because only something that isn't expected has the capacity to surprise. For example, although it has been acknowledged for years that commercial property/casualty rates are woefully inadequate, it was the homeowners' market that was thrown into some disarray after insurance companies were blindsided by catastrophes. And it was the unexpected catastrophe, a hurricane (Andrew) rather than an earthquake, that caused underwriters to reevaluate their Probable Maximum Loss projections.

It would be wrong, however, to say that bad news always comes out of the blue. The warning signs are usually there, but people, optimists by nature, have a way of ignoring them.

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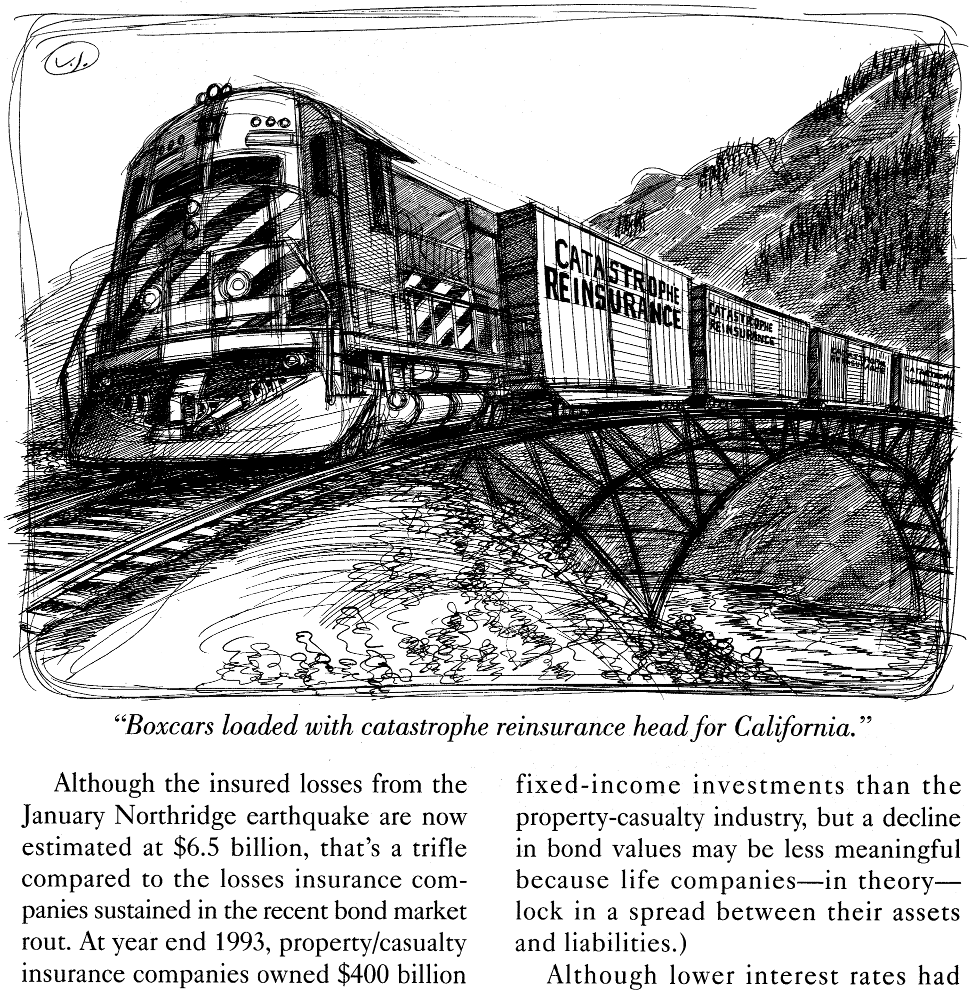

"Boxcars loaded with catastrophe reinsurance head for California."

Although the insured losses from the January Northridge earthquake are now estimated at $6.5 billion, that's a trifle compared to the losses insurance companies sustained in the recent bond market rout. At year end 1993, property/casualty insurance companies owned $400 billion of bonds, with an average maturity of nine years. According to Ryan Labs, a New York-based asset manager, the value of ten-year bonds declined 7.06% in the first quarter of 1994, as yields rose from 5.80% to 6.76%. That translates into a loss of about $28 billion for the property/casualty industry, or about 15% of the industry's $181 billion of surplus. Although this loss, for the most part, is unrealized, it's a loss of value just the same. (The life insurance industry owns far more fixed-income investments than the property-casualty industry, but a decline in bond values may be less meaningful because life companies—in theory—lock in a spread between their assets and liabilities.)

Although lower interest rates had bolstered insurance-company balance sheets in recent years, they had their downside as well: insurance companies earned less on the "float"—their reserves for incurred-but-not-yet-paid claims. "As interest rates have fallen, the value of float has declined substantially," notes Warren Buffet in Berkshire Hathaway's 1993 annual report. "A company writing at the same combined ratio now as in the 1980s has a far less attractive business than it did then."

continued

Sean Mooney, the senior vice president and chief economist of the Insurance Information Institute, filled in some specifics for us: in 1984 the General Liability combined ratio was 150; in 1993 it was 136. Why the improvement? "Interest rates," he says. Companies couldn't afford to write business at such a high ratio once they came down. (In 1984 long-term rates were about 10%. Now they're around 7.33%.)

"If you go through a discounted cash flow model," explains Mooney, "you can figure out that the 150 and 136 combined ratios are about the same—actually 136 is a bit worse... In other words, casualty is still being underpriced. We should be having a liability crisis."

Mooney did try to point out the silver lining to the recent upswing in rates, but his words lacked conviction. "Higher long-term interest rates could offset the underpricing."

Higher interest rates, as the chart on this page shows, could also make a good chunk of the property/casualty industry's surplus disappear. Such an occurrence would not be unprecedented. In 1981, CNA (for example) had a reported net worth of $1.14 billion. But had its stock and bond portfolios been marked to market, its net worth would have been $51 million.

Similar situations occurred during the Great Depression. The Home, America's largest fire insurance company, would have been insolvent at year-end 1932 if it had marked its investments to market. (The problem then was credit quality, not interest rates.) Most other insurers were in a similar predicament, but the National Association of Insurance Commissioners came to their rescue by approving a resolution that allowed insurance companies to value their securities at June 30, 1931 prices, which were significantly higher. (There were precedents for this move: similar actions had been taken in 1907 and 1917.)

Environmental/asbestos liabilities may make many of the largest insurance companies unacceptable credit risks.

Declines in a company's bond portfolio will have less of an effect on financially strong companies that are capable of holding their bonds to maturity. Many insurers' financial strength, however, may be less than meets the eye. According to a recent report prepared by A. M. Best, the property/casualty industry is facing a "black hole" of environmental/asbestos liability exposures. Best says that these claims have a net present value of $132 billion, or 72% of the industry's surplus. Unfortunately, just forty-seven insurance companies accounted for 81% of the industry's Other Liability and Products Liability premium in 1992, and their $65 billion in surplus "appears inadequate relative to...required reserve additions," notes Best without a trace of emotion.

When we checked in with Jack Snyder, Best's senior vice president and one of the authors of the report, he stressed that these figures assumed that there would be no meaningful Superfund reform. "However," he noted, "there will be reform, but how much and how meaningful remains to be seen."

Which insurance companies will be most affected by environmental/asbestos liabilities will largely depend upon the numbers of pre-1986 Comprehensive General Liability policies written for any one of the more than 26,000 "Potentially Responsible Parties." (In 1986, the absolute pollution exclusion was added to CGL policies.)

Best says that some insurers could become "financially impaired" or "insolvent," and adds that "several insurers' environmental/asbestos liabilities are already hampering their ability to compete." The report doesn't name names, but one can make an educated guess as to which companies might have significant exposures by examining market-share data for the periods prior to 1985. For example, the leading writers of Other Liability and Products Liability in 1967 were Travelers, with a 6.7% market share, followed by Aetna with 6.2%, and Hartford with 4.9%. In 1975 these three companies were still the largest writers, with a 15.9% combined market share. (Today they only have 8.7% of the market.)

If Best's $132 billion environmental/asbestos reserve-shortfall estimate is reasonably accurate, it's plausible that these three insurers might be responsible for anywhere from $21 billion to $24 billion of claims, or about $8 billion per company.

Although Best stresses that "caution must be exercised" in extrapolating individual companies' exposure from market-share data, it seems likely that a company's market share would bear some correlation to its ultimate exposure.

The question we pose, therefore, is: could these three companies each add $8 billion of reserves to their balance sheets tomorrow and still remain viable? The answer is "no."

On the other hand, not everyone views that question, and its answer, as relevant. The Travelers, Aetna, and Hartford don't think their potential environmental/asbestos exposures are a life-threatening problem. (Other large carriers that would

Now you see it, now you don't: The effect of higher interest rates on the property-casualty industry's surplus.

Rise in interest rates (basis points)	Decline in surplus[1]	Decline as % of surplus[1]
+100	$29 billion	16%
+200	58 billion	32
+300	87 billion	48

1. Pre-tax

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appear to have significant exposures include Cigna, CNA, Continental, Crum & Forster, and USF&G.)

In its annual report, Aetna says that although it "is unable to make a reasonable estimate as to the ultimate amount of losses" for its asbestos and environmental-related claims and litigation expenses, future results "are expected to be affected adversely." Aetna's management, however, says that it "is unable to determine whether such effect will be material to future results, liquidity and/or capital resources." To date, Aetna has posted $456 million of environmental/asbestos reserves. Its property/casualty company's statutory surplus is $4.3 billion.

Hartford (which is a subsidiary of ITT) and Travelers have a more sanguine outlook. ITT says that it "believes the ultimate resolution of all its claims, including reinsurance effects, will not have a material adverse effect on its overall financial condition." And Travelers says that even though it can't "quantify the ultimate exposure...it is not likely these claims will have a material adverse effect on The Travelers Insurance Group's financial condition." Travelers' surplus is $4.1 billion and ITT's net worth is $7.6 billion.

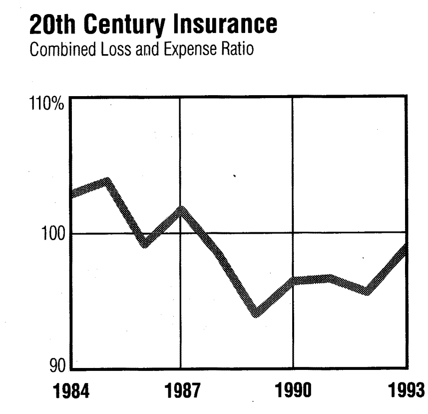
While one can't prove that these companies are wrong, anymore than one could prove that Best's $132 billion is correct, environmental/asbestos liabilities may take their toll in a different way. Perhaps in the not-too-distant future, corporate insurance buyers will suddenly decide that these liabilities make many of America's largest insurance companies unacceptable credit risks. What might prompt such opinion and spur a flight to quality? Perhaps it will be a series of front-page stories in *The Wall Street Journal,* perhaps the insolvency of some other carrier, or of a Lloyds syndicate. Who knows? But it seems clear that buyers of commercial insurance aren't presently paying attention to financial strength, much less paying a premium for it.

We ran some of our ideas by one of our savviest subscribers, a big-time Wall Street analyst who prefers not to see his name bandied about in the context of negative sentiments such as ours. Regarding the environmental/asbestos liability question, he said simply, "It's just one more reason to hate these companies." ■

Shaken, Not Stirred

20th Century's Insurance Company's $500,000,000 miscalculation

Gus D'Amato, the late fight trainer, used to say that one of the objects of boxing is not to get hit. The same can be said of the insurance business. Insurance companies are in the business of taking calculated risks where the odds are in their favor. One of the tenets of insurance underwriting is to limit one's exposure to any single occurrence. Property insurers do this by making sure their Probable Maximum Loss is not too large relative to their surplus. But, as 20th Century Insurance Company's experience from the January Northridge earthquake has proved, the science of projecting PMLs is not always sweet, and even the best of companies can make horrifying mistakes.



20th Century Insurance has been one of the insurance industry's great success stories. It started out as a reciprocal thirty-six years ago, with two employees in a small office in downtown Los Angeles. Back then the company was writing auto insurance for members of the National Hot Rod Association, but it soon changed tack and has grown rapidly and profitably by adhering to a simple strategy: marketing auto insurance directly to good drivers. (Auto insurance accounts for 92% of premiums.) 20th Century eschews agents and brokers: it deals with customers over the phone and through the mail. As a result, its expense ratio is about 10%—the lowest in the business. (The industry average is 22.7%.)

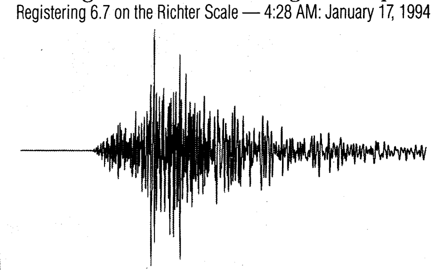
20th Century's efficiency has enabled it to achieve a seeming contradiction: the lowest rates and the highest profits. Since 1983, earned premiums have grown from $194 million to $908 million, the combined ratio has averaged 98.7%, and return on equity has averaged 23%. Ninety-two percent of policyholders renew their policies each year, 70% of new auto policies come from customer referrals, and annual unit growth has been in excess of 10%. With just 6.1% of the auto insurance market in California—the only state in which it operates—20th Century's advantage as the low-cost producer gives it plenty of room for growth. (That's why we bought stock several years ago, paying about $10½ per share.)

Brian Sullivan, editor of the first-rate *Auto Insurance Report,* raves about the company: "They have such an obvious advantage. And it's especially impressive that they have achieved such efficiencies despite being a smaller company without the economies of scale. They do that by being smarter than a lot of people."

In recent years 20th Century has faced two potentially serious pitfalls. The first, Proposition 103—which calls for a rate rollback and limits an insurance company's return on surplus to 10%—seems unconstitutional as well as illogical. 20th Century has appealled Proposition 103. Why, after all, should it be penalized for efficiency? We expect that reason will ultimately prevail, even in California.

As for the second pitfall, 20th Century appeared to be on top of it: "The Company believes its major catastrophe exposure is to loss from an unusually large earthquake," the 1992 annual report blandly stated. "The Company

Seismogram of the Northridge Earthquake
Registering 6.7 on the Richter Scale — 4:28 AM: January 17, 1994



reduces its net exposure to such an event by the purchase of reinsurance in amounts which are based on global reinsurance market conditions and the Company's estimates of its exposure. The Company reviews its estimates of exposure each calendar quarter."

Most of 20th Century's earthquake exposure is attributable to homeowners' insurance, and given that this $81 million book of business has been, at best, only marginally profitable, one would assume that the company's exposure would be kept proportionately small. But that wasn't the strategy. The company's 1992 Earthquake Liability Questionnaire, filed with the California Department of Insurance, projected a Probable Maximum Loss of $166 million before reinsurance and $91 million after. A loss of that magnitude, estimated as a once-in-every-fifty-year occurrence, seemed large but manageable, relative to the company's $582 million of statutory surplus. 20th Century's management may have felt comfortable with this exposure because earthquake insurance had been quite profitable: in 1992 the company took in $21 million in premiums ($12 million net of reinsurance); losses were just $750,000.

Since management knew that there was only one thing that could really hurt them—a big earthquake—all they had to do was heed Cus D'Amato's words, which in their case meant avoiding an over-concentration of exposure and buying enough reinsurance. Neither seemed difficult to do.

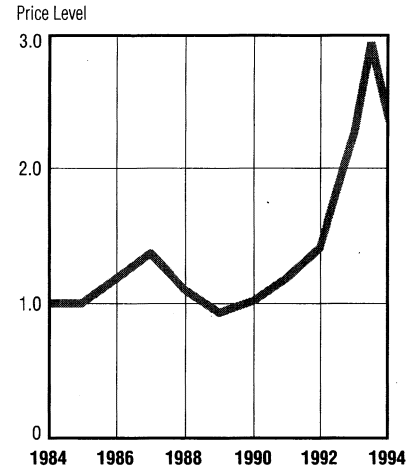
Perhaps that's why 20th Century's failure to do either is so shocking. Several weeks after the January 17 Northridge earthquake, the company estimated that its losses were $160 million ($85 million after reinsurance)—right in line with the Probable Maximum Loss projection. In March, however, it upped its loss estimate to $325 million ($250 million after reinsurance). And then, on May10, it revised its estimate again, this time to a staggering $600 million ($525 million after reinsurance, $340 million after taxes, and $6.82 per share), almost six times what it originally thought its net exposure was. As a result, its statutory surplus has declined from $564 million to $220 million and its stock has fallen more that forty percent since year end, to about $15.

Although 20th Century has purchased another $75 million of reinsurance (a good portion of which was placed in Bermuda) bringing its total to $150 million, that's not nearly enough. On July 1, when its current reinsurance policies expire, it "expects to substantially increase its coverage." Although it previously had indications that about $325 million of coverage was available, whether that much will still be available on July 1 remains to be seen. We can, however, be certain of one thing: the cost will be high. The company has already spent the equivalent of $25 million for $150 million of reinsurance. (See chart on page six.) At those prices we'd rather be a seller than a buyer of reinsurance, but 20th Century has little choice.

The foregoing raises two questions: should 20th Century even be in the homeowners business, and how could people who are so smart be so dumb?

That last question is especially difficult, but we suspect the answer has something to do with success breeding carelessness. 20th Century got into the homeowners business in 1982, and, as a company, hadn't lived through an earthquake. But more importantly, it placed too much faith in its projections. By relying on the false precision of its catastrophe-loss models and simulations, it neglected to maintain an adequate margin of safety. It never asked the question: "What if losses are two or three times our projections?" It simply assumed that was impossible.

The Price of Disaster
Catastrophe Reinsurance Price Index



Source: Paragon Reinsurance Risk Management Services, Inc.

Most of 20th Century's homeowners policies are in earthquake-prone southern California, especially the San Fernando Valley and the San Gabriel Valley. To put its exposure in perspective, 20th Century had about thirteen times more exposure per dollar of surplus than does industry-leader State Farm.

Despite 20th Century's stupidity, we think its stock is now a good investment (even though we expect the dividend to be suspended), and in fact, have tripled our position. It should be able to rebuild its surplus and reduce its exposure to reasonable levels in two or three years. Its main business, automobile insurance, is unaffected by the earthquake and remains extremely profitable and low risk. (Auto claims from the earthquake are under $20 million.) Auto insurance should account for about $100 million ($2 per share) in net profit this year, and that figure could very well double over the next five years. In addition, 20th Century has filed for a 9.2% rate increase, its first increase since 1988. Even if it gets only half that, it would boost premiums by $42 million.

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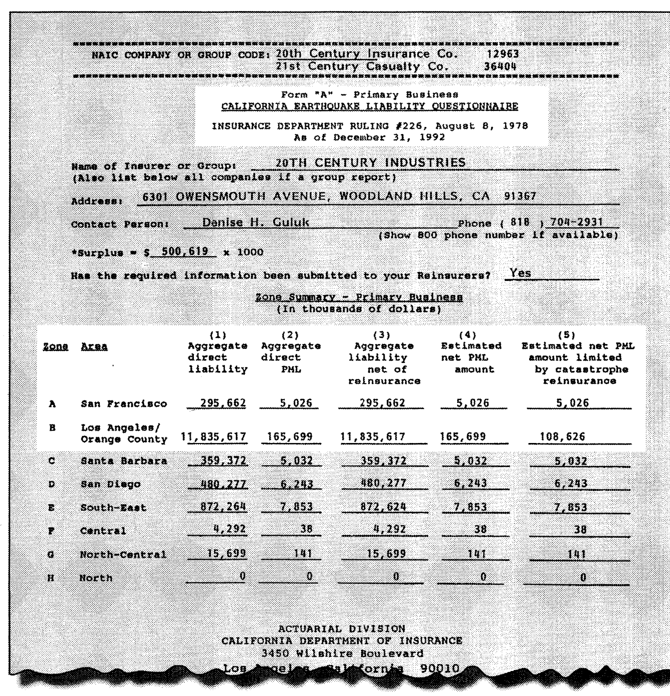


NAIC COMPANY OR GROUP CODE: 20th Century Insurance Co. 12963
21st Century Casualty Co. 36404

Form "A" - Primary Business
CALIFORNIA EARTHQUAKE LIABILITY QUESTIONNAIRE

INSURANCE DEPARTMENT RULING #226, August 8, 1978
As of December 31, 1992

Name of Insurer or Group: 20TH CENTURY INDUSTRIES
(Also list below all companies if a group report)

Address: 6301 OWENSMOUTH AVENUE, WOODLAND HILLS, CA 91367

Contact Person: Denise H. Guluk Phone (818) 704-2931
(Show 800 phone number if available)

*Surplus = $ 500,619 x 1000

Has the required information been submitted to your Reinsurers? Yes

Zone Summary - Primary Business
(In thousands of dollars)

Zone	Area	(1) Aggregate direct liability	(2) Aggregate direct PML	(3) Aggregate liability net of reinsurance	(4) Estimated net PML amount	(5) Estimated net PML amount limited by catastrophe reinsurance
A	San Francisco	295,662	5,026	295,662	5,026	5,026
B	Los Angeles/ Orange County	11,835,617	165,699	11,835,617	165,699	108,626
C	Santa Barbara	359,372	5,032	359,372	5,032	5,032
D	San Diego	480,277	6,243	480,277	6,243	6,243
E	South-East	872,264	7,853	872,624	7,853	7,853
F	Central	4,292	38	4,292	38	38
G	North-Central	15,699	141	15,699	141	141
H	North	0	0	0	0	0

ACTUARIAL DIVISION
CALIFORNIA DEPARTMENT OF INSURANCE
3450 Wilshire Boulevard
Los Angeles, California 90010

20th Century's PML estimate was $435 million too low.

20th Century

20th Century's homeowners line (which is only 8% of total premiums) has been a disaster. The company suffered $600 million in claims as a result of the Northridge earthquake and has recently filed for a 272% increase in earthquake insurance rates.

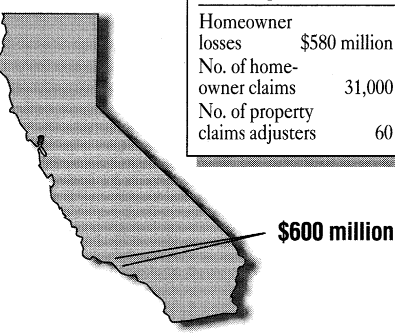
20th Century's Largest Reinsurers[1]

Company	Domicile
Lloyds	London
General Reinsurance	Delaware
AXA Reassurance	France
Mid Ocean	Bermuda
Renaissance Reinsurance	Bermuda

1. Based upon premiums ceded. 1993.

20th Century's Probable Maximum Loss

Homeowner Policies In Force	
1990	167,293
1991	196,241
1992	218,725
1993	233,346



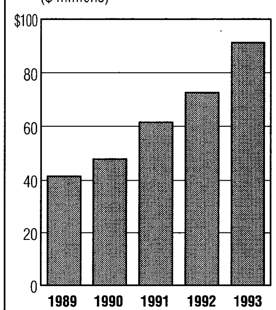
Northridge Earthquake Results	
Homeowner losses	$580 million
No. of homeowner claims	31,000
No. of property claims adjusters	60

20th Century Insurance

($000)	3/31/94	12/31/93
Assets		
Investments	$1,381,000	1,386,000
Other	247,000	147,000
Total Assets	1,628,000	1,534,000
Liabilities		
Losses & Loss exp.	948,000	589,000
Other	460,000	381,000
Total Liabilities	1,324,000	970,000
Policyholders' Surplus	220,000	564,000

1993 Premiums	$989,000,000
1993 Net Income	$108,000,000

Homeowner Premium[1]
($ millions)



1. Includes other lines

Ratings	Pre-/Post-earthquake
Best	A+/A–
Standard & Poor's	AA/BBB+

20th Century's Reinsurance: Not enough, and very expensive

20th Century's Probable Maximum Loss is at least $600 million. In 1993 the company took in $21 million in earthquake premiums. As this chart shows, the cost for just $150 million of reinsurance is $25 million.

Catastrophe Loss Layer	Company Retention	Reinsurance Amount	Cost
first $ 10,000,000	$10,000,000	0	0
next $100,000,000	$25,000,000	$75,000,000	$13,000,000
next $100,000,000	$25,000,000	$75,000,000	$12,000,000[1]

1. On an annual basis. Policy is effective from April 1, 1994 to June 30, 1994.

The homeowners business, however, is problematic, to say the least. It hasn't been especially profitable in the past, and it's not essential to the company's operations. Other than selling this book of business (who would want it?), there are only two ways to manage earthquake exposure: reduce the number of policies or buy adequate reinsurance. Reducing policy count is the only practical long-term solution because adequate reinsurance is not always available. 20th Century would have to non-renew about 50,000 of its 233,000 homeowners' policies to lower its Probable Maximum Loss to $165–200 million.

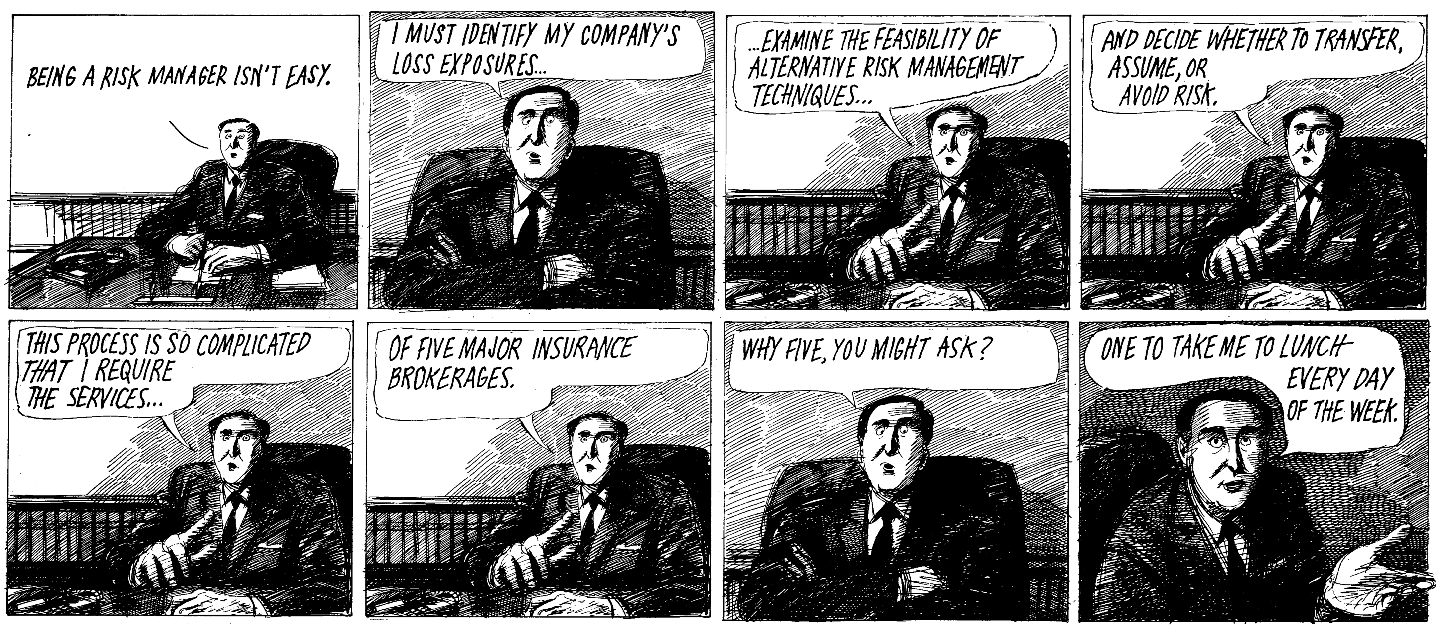
The biggest short-term risk, of course, is another earthquake. And if it were a big one, it could threaten the company. Bob Kilcup, a research structural engineer and earthquake analyst with Applied Insurance Research in Boston, says that, statistically speaking, such an occurrence in the next three to five years is quite unlikely—about 5% to 10%.

Although the odds are in 20th Century's favor, it's a dangerous game. "Obviously we're terribly concerned about earthquake exposure," said James Curley, 20th Century's president, "and we certainly don't see the advantage of building up more exposure in the future. We think that we can manage our way out of this, but it's not going to be business as usual."

Because of various regulations, 20th Century won't be able to cancel or non-renew 50,000 policies immediately. It will probably have to reduce its exposure through a combination of higher rates and attrition. (Prior to the earthquake, it had filed for a 21.8% increase in its homeowners line.)

20th Century is a great company that has done many things right over the years. It's ironic that a foolish blunder in one of its ancillary businesses could jeopardize the entire company. But that's the nature of things, and that why Cus D'Amato reminded his fighters again and again that they had to hit and *not get hit.*

We're pretty sure that next time around 20th Century won't forget to duck. ■



Grandfather Knows Best

A "genetic disposition" to insurance stocks

Chris Davis, a New York money manager who specializes in insurance stocks, is sitting in his grandfather's office eating lunch—a turkey sandwich, potato chips, iced tea—and telling us why he loves the insurance business. "Everybody's a customer, the products don't become obsolete, and there's no pollution, patents, or foreign competition to worry about. And," he says, looking comfortably casual in a tweed suit, "financial stocks tend to sell at discounts."

If the ability to invest successfully in insurance stocks is a genetic trait, then Christopher Cullom Davis, a smart and affable twenty-nine year old who has run the New York marathon in three hours and fifty minutes, is a thoroughbred. His father, Shelby Davis, manages the New York Venture Fund, which also invests in insurance stocks and is among the top-performing mutual funds of the last twenty-five years, and his grandfather, Shelby Cullom Davis, now retired, may be the most successful insurance investor of all time. "Following him on Wall Street isn't easy," says Chris.

Shelby Cullom Davis was born in Peoria in 1909 to a family whose roots trace back to the Jamestown colony and the Mayflower. He was named for his grandfather, Shelby K. Cullom, a U.S. senator and the first governor of Illinois, whose autobiography was called *Fifty Years of Public Service.*

After his graduation from Princeton in 1930, Davis moved to Geneva, where he wrote a book on the French military, was a special correspondent for the Columbia Broadcasting System, and got a doctorate in international economics. In 1934 he returned to America and entered the investment trust business. He subsequently became a member of the New York Stock Exchange, and, in 1939, an economic advisor to New York governor and presidential candidate Thomas Dewey, who named him deputy superintendent of insurance in 1944.

In 1947, after leaving the insurance department, Davis formed Shelby Cullom Davis & Co. with an investment of $100,000, and set up offices at 110 William Street. An announcement stated the firm's mission: "to conduct a general investment business and specialize in the shares of American insurance companies and their markets."

Chris Davis

Davis soon made a fortune. His investment strategy, which he called "the Davis double play," was to uncover outstanding growth stocks before they were generally recognized as such. "The trick," he later said, "is to identify those emerging growth companies whose records of earnings growth are similar to those better-known growth companies commanding far superior price/earnings ratios." In other words, he bought stock in companies that were growing rapidly yet selling at bargain-basement prices. That's where the "double-play" effect came in: he would be doubly rewarded when the increased earnings were eventually recognized by the market and the stock accorded a higher price/earnings multiple. If a company's earnings quadrupled over a period of years, for example, and its price/earnings ratio doubled, he would make eight times his investment, twice what the actual earnings growth had been.

Davis' first coup came in the early 1950s when he scooped up shares of life insurance companies when they were little known and selling at just three or four times earnings. In 1962, after a trip to the Far East, he scored again by buying Japanese fire/casualty companies at equally cheap valuations.

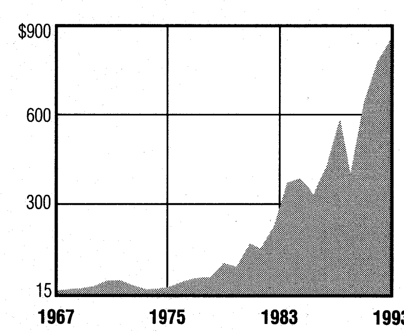
Davis based his investment opinions on his understanding of the market, but also on his understanding of people. "You have to be able to spot the bluffers from the doers," he told his grandson Chris, who worked for him in the summers. "The first lesson of investing is to ask as many questions as you can and listen carefully to the answers. The key is to learn as much as possible about the companies in whose stocks you have invested." But understanding a company's products and financial statements wasn't enough for him. He felt that one also had to evaluate the vision, character, and goals of a company's management because that was the way to gain conviction—and only with conviction could one buy when others were panicking and selling. "It is the long view rather than the short view," Davis once said. "It is the waves that count rather than the ripples; the tides in man's affairs rather than the waves."

Focusing on the distant horizon worked well for Davis. Over the years his initial $100,000 investment in Shelby Cullom Davis & Co. grew more than 8,500-fold. As of year-end 1993 the firm's net worth stood at $854 million.

Despite a capital base that ranks it among the largest Wall Street firms, Shelby Cullom Davis & Co., which has only thirty-five employees, is an unassuming place tucked away on the forty-third floor of 70 Pine Street; its offices are indistinguishable from those of any of the scores of little brokerages that ply their trade in old buildings in Manhattan's financial district. According to Chris, the stock brokerage arm of the firm has never been much of a money-maker. "My grandfather never considered himself a good businessman, just a good investor."

Chris, who grew up in Manhattan, didn't plan to go into the investment

Shelby Cullon Davis & Co.
Growth in net worth ($ millions)



Since its inception in 1947, Shelby Cullom Davis & Co.'s net worth has grown at a 21.75% compounded annual rate; since 1967 the rate has been 16.67%. These figures far outstrip the broader market.

business; he wanted to be an Episcopal priest, and attended the University of St. Andrews in Scotland where he got his Masters in philosophy and theology. (His grandfather later told him that this was the perfect background because, "in the investment business you need your philosophy and then you've got to pray like hell.") Chris' political leanings at the time—he was a "diligent and committed Marxist"—no doubt exasperated his Establishment grandfather, whose office walls are lined with signed photos and letters from Herbert Hoover, Thomas Dewey, Richard Nixon, John Mitchell, Henry Kissinger, Gerald Ford, Ronald Reagan, and George Bush.

After a stint as a seminarian at the American Cathedral in Paris, during which Chris realized that this life wasn't for him, he moved to Boston and got a job with State Street Bank and Trust. He went to school at night and studied accounting and securities analysis. He then did his "basic training" with a small money management firm in New York.

One morning, at a Chubb breakfast meeting for securities analysts, he ran into his father and grandfather—none had known that the others would be there. Since they were all following the insurance business, they decided that it made sense to work together. Chris now works at his father's firm, Venture Advisors, where he manages the Global Value Fund, of which Shelby Cullom Davis & Co. is the largest investor. Since its inception almost three years ago, the Global Value Fund has earned a load-adjusted compounded annual return of 19.68%.

Shelby Cullom Davis & Co.'s Investment Portfolio

Top holdings[1] as of April 8, 1994

American International Group
New York Venture Fund
American General Corp.
Selected American Growth, Inc.
Tokyo Marine & Fire Insurance
Berkshire Hathaway Inc.
Conseco Inc.
Torchmark Corp.
Aon Corp.
Chubb Corp.
Progressive Corp.
Federal National Mortgage Assoc.
Sumitomo Marine & Fire Insurance
Capital Holding Corp.
The Travelers Inc.
Mitsui Marine & Fire Inc.
NWNL Co., Inc.
Cincinnati Financial Corp.
RPF Global Value Fund
Allmerica Property & Casualty

1. Shelby Cullom Davis & Co. maintains positions in about 500 securities. The top ten holdings represent 30% to 40% of the portfolio.

Heeding his grandfather's advice, Chris is constantly questioning and listening. Conversations with him reveal a depth of knowledge about the insurance business as well as a healthy dose of skepticism. He approaches his work with a sense of exuberance that's refreshing; clearly he enjoys what he's doing even though insurance stocks have been in a rather sharp downtrend for the last six months. While the decline doesn't please him, his approach to it is philosophical. "You make most of your money in bear markets—you just don't realize it at the time," he says. "That's because you're given a chance to buy first-class properties at distressed prices. Over time, as the value of these properties becomes clear, the prices move up accordingly."

Chris favors companies with solid earnings prospects, focused growth strategies, and, not surprisingly, outstanding management. His favorites include American International Group: "A first-class, global leader. A growth company selling at a cyclical multiple. Our favorite—and lowest risk—vehicle for participating in the dynamic growth of China and Southeast Asia"; W.R. Berkley: "Owner-operators with a proven winner at the helm. Spring-loaded for growth in an improved pricing environment"; Chubb: "Investors won't often have a chance to buy this kind of quality growth at such a discount"; The Equitable: "Positioned to be a leader in all aspects of the fast growing savings and investment industry. Selling below its liquidating value"; General Re: "A blue-chip industry leader selling at only 6½ times 1998 earnings"; and NAC Re: "Selling below its 'drop-dead value.' You get the franchise and growth for nothing."

How is it that Chris is comfortable looking out to 1998, to a turn in the cycle, to a time when the growth he foresees for his companies materializes?

Perhaps his comfort has something to do with a "lesson" he learned from his grandfather: "I remember when I spent a summer working with him in New York," said Chris. "We were walking down the street and I asked him if I could have a dollar to buy a hot dog. 'Well,' he said, 'do you realize that if you invest that dollar wisely it will double every five years?'

"I said, 'I didn't.'

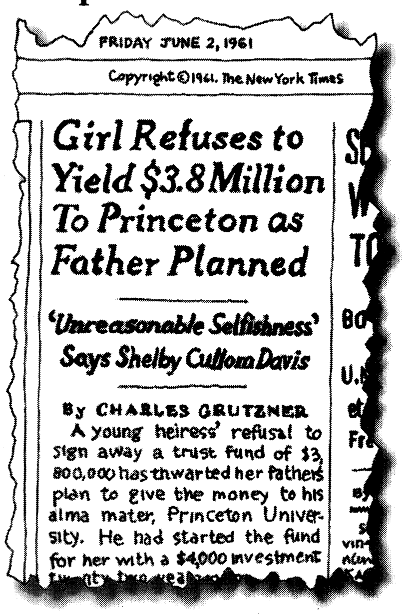
"'Do you realize that by the time you're my age—in fifty years—that dollar will be worth $1,024?'

"I said 'I didn't.'

"He then asked, 'Is that hot dog really worth over $1,000?'

"I said 'I guess not.' So, in one fell swoop, he taught me three lessons: the value of a dollar, the value of compound interest, and the importance of always carrying my own money." ■

Father, Can You Spare a Dime?


FRIDAY JUNE 2, 1961

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Girl Refuses to Yield $3.8 Million To Princeton as Father Planned

'Unreasonable Selfishness' Says Shelby Cullom Davis

By CHARLES GRUTZNER

A young heiress' refusal to sign away a trust fund of $3,800,000 has thwarted her father's plan to give the money to his alma mater, Princeton University. He had started the fund for her with a $4,000 investment

AN INDICATION OF Shelby Cullom Davis' investment success, philanthropy, and family angst can be gleaned from the article above, which hit the front page of *The New York Times* in 1961.

The article said that twenty-two years earlier Davis had established a $4,000 trust for his baby daughter, Diana. (A similar trust was also set up for his son.) Now that the trust had grown to $3.8 million he intended to donate the money to his alma mater. Diana, however, who had been introduced to society at the Westchester Cotillion, the Debutante Cotillion, and a dance at her parents' home, refused to sign over the trust.

Shelby Cullom Davis, who was described as a "slight, gray-haired, courtly man prominent in the world of society as well as finance," attributed his daughter's "unreasonable selfishness" to "the unrealistic materialism prevalent among American youth."

Diana told the *Times* that she was distressed that her father was "so bitter" as to criticize her in a public statement.

She never signed over the trust.

Doing Business Person-to-Person

Cincinnati Financial makes money the old-fashioned way

The first thing you notice about Cincinnati Financial's home office ("home office" is something of a misnomer since there are no branch offices) is how neat and quiet it is. The facilities are neither grand nor Spartan, but they are pleasant in a slightly bland middle American way. Although the company has been growing rapidly and says it's running out of space, you wouldn't know it from looking around. Most of the "associates" (that's what the 1,975 employees are called) work in spacious modular workstations, and there's a reasonable amount of open space.

Waiting in the building's Hyattesque atrium lobby or walking through its hallways, you wouldn't perceive anything especially noteworthy about Cincinnati Financial. Yet, by almost every quantifiable criterion it's one of the best insurance companies in America: it has top-notch financial-strength ratings, consistently makes an underwriting profit, ranks at or near the top in surveys of customer satisfaction, invests its assets well, and has provided shareholders with solid returns (a $1,000 investment in 1950 is now worth $756,000).

You might expect results like these to be attributable to some complex business strategy, but that's not the case. "Some competitors who learned about Cincinnati's unique expense structure sent delegates to our headquarters this year," writes Robert Morgan, the president and CEO. "They studied the controls that keep our costs low and allow us to pay fair commissions. We were honored by all this attention from our respected peers but don't think they learned anything surprising. Quite simply, there is a real Cincinnati difference: we dedicate the Cincinnati Companies to making it easier for local agents to do business. And when properly supported, they bring us the invaluable advantages of personal relationships with their clients, friends, neighbors, and businesses in their communities."

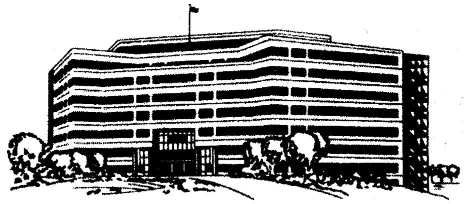
Although this sounds like typical insurance-company twaddle, it isn't. Cincinnati really is different. It was formed by insurance agents forty-four years ago and is still run by them. The chairman of the board, Jack Schiff, Jr. (no relation to David Schiff, the *Insurance Observer's* editor), also serves as president of the John J. & Thomas R. Schiff Insurance Agency. Six of Cincinnati's other sixteen directors are also insurance agents, and many of the company's 965 agents are shareholders.

Of course, having a bunch of insurance agents around is no guarantee of success (in fact, it could easily lead to failure). So what is it that makes Cincinnati so special? Hard work is part of the equation, as is attention to detail. Most of the associates work on Saturdays and there's a 10 o'clock staff meeting every morning where *all* new policies are reviewed. Each Monday all officers meet for lunch.

At Cincinnati Insurance the employees do everything they can to make it easier for agents to do business. They even work on Saturdays.

But is that what really makes the difference? Surely, we thought, there had to be something a bit more complicated. So we went to Cincinnati to talk to some of the company's associates and divine the answer.

Our first meeting was with Larry Plum, president of Cincinnati Casualty and senior vice president in charge of personal lines. Larry, who had been in the military and whose son is a cadet at The Citadel, was wearing a gray suit, white button-down shirt, and loafers. He had been running Hummel & Plum, a Circleville, Ohio agency founded by his grandfather, when in 1987 he got a call from Jack Schiff asking, "How'd you like to be president of Cincinnati Life?" He took the job.



Cincinnati Financial

Larry did his best to explain Cincinnati's success. "There's really no secret," he said. "It just gets back to working harder and having quality people. Our office hours are seven-thirty to five, and we operate with about half staff on Saturday. I love working here. It's the people; we don't have a dud. We attract employees with a good work ethic—working on Saturdays weeds out a lot of job applicants.

"My main function is finding out what's going on in the field. Three days a month I'm out of the office visiting agents. We're very sales oriented. Bob Morgan and Jack Schiff travel throughout our territories and run twenty-five sales meetings a year. They meet with all our agents.

"We're responsive to our agents. Our field marketing reps, who work out of their homes, have complete authority. We need to give the agents something unique, and we do. We're the only company offering a three-year, guaranteed-rate homeowners policy. And our agency contract is more lucrative than others'.

"Although we like to think that we have the best underwriting staff, we look at the agencies as our front-line underwriters. Our agents *turn down* business. We expect them to know the customer and have face-to-face meetings.

"Our average agency does $1.2 million of premium with us, and $2–3 million in total volume. They're mostly in the suburbs, rural areas, and small towns. We don't do business with the alphabet brokers. We don't want our agencies selling out to them, because then we'll lose the business.

"People talk about the market being soft. Well, this *is* the market. I think it will stay soft. A lot of people say that independent agencies are at a disadvantage, but I don't think that's true. Our major competitors include State Farm, Westfield, Pekin, and American Family. Our prices are competitive with State Farm—they have to be. But most of our agencies tell us, 'Get me within 10% of State Farm and I'll sell the account.'"

We met with Tom Joseph next. He's been with Cincinnati for seventeen years, working as a claims adjuster, underwriter, and field marketing rep. He is now vice president and manager of commercial lines. A lot of his time is spent making sure that work flows are efficient. "We've made a lot of changes to improve service," he says. "If you ever start thinking you're too good, you get into trouble. Our agents deserve better than that.

"The market is competitive, but the key to our making an underwriting profit is the personal knowledge of our senior people. We have a better-quality agent, and a large number of them are shareholders. Our fifty-one marketing reps know their areas. Each rep has twenty-five to twenty-eight agents. We want our reps in the agents' offices every three weeks.

"Loyalty is important. You know, we still buy all our company cars from an auto dealer that Jack Schiff wrote in the 1950s. We have a generous profit-sharing and stock-option program. My net worth is in my home and in Cincinnati Financial stock."

Bob Nieberding, vice president and manager of information systems, loves to play golf, but because of the Saturday work schedule he doesn't get out on the course as much as he'd like. "I think one of the keys to our success is the way people are motivated," he says. "They're encouraged to own stock. We've also done a few things from an automation standpoint that others haven't done: our system allows the agent to enter information, rate the forms, and issue policies. We have E-mail with most of our agents and with the field reps."

Cincinnati Financial

($000)	12/31/93	12/31/92
Assets		
Fixed maturities	$1,759,655	1,635,947
Equity securities	2,318,803	1,972,293
Other	523,830	490,473
Total Assets	4,602,288	4,098,713
Liabilities		
Insurance Reserves	1,748,484	1,552,281
Other	748,400	685,704
Debt	158,066	146,952
Total Liabilities	2,654,950	2,384,937
Shareholders' Equity	1,947,338	1,713,776

J.B. Skockey, assistant secretary, sales and marketing, has the neatest office in the world. There's nothing on his desk but a telephone and two pieces of paper. "We're successful because of the agencies we've selected," he told us. "We trust them and try to give them some exclusivity. We bend over backwards for them, and they're loyal to us. They really value the Cincinnati contract.

"Fast response to an agent is what makes you successful. Our field reps give prices and answers on the spot. Our plan is to get to $2 billion in premiums in the year 2000, with 1,100 agents."

Cincinnati's long-term plan seems reasonable. The company has attracted a dedicated cadre of first-rate agents who value their franchise, and there are many more good agencies that would love to do business with Cincinnati, if it will have them.

Perhaps the secret to Cincinnati's success lies in its consistency. Restructuring, re-engineering, and corporate shuffling are the norm at many carriers; that isn't the way Cincinnati does business.

As Larry Plum told us when we were leaving, "We appeal to agents because we haven't changed much." ■

Cincinnati Financial: Outstanding results

	1993	1992	1991	1990	1989	1988	1987	1986	1985	1984
Premiums[1]	$1,140	1,038	947	871	813	754	747	666	513	412
Combined ratio	100.1	101.8	101.4	99.0	101.6	96.0	99.7	96.6	102.6	102.0
Shareholders' equity[1]	$1,947	1,713	1,441	1,006	1,020	815	633	580	470	370
Equity per share	$38.85	34.30	29.07	20.44	20.88	16.80	13.26	12.38	10.11	8.18

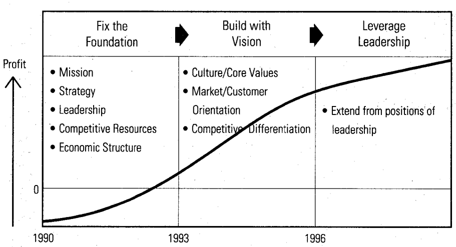
1. In $ millions.

The Insurance Beat

No Comment

FROM THE USF+G 1993 annual report:

"USF+G's new logo, an open door with light shining through it, represents the energy that is USF+G today and the clarity, openness, and customer orientation that we bring to the insurance process....As a totally revitalized and refocused insurance enterprise, it is appropriate for USF+G and its people to now be seen in a different "light."...As illustrated in the chart below, the restructuring and rebuilding of our company involves a three-phase process..."



USF&G is now entering the "Build with Vision" phase of its restructuring and rebuilding process.

Free Enterprise Strikes Again

SAUL STEINBERG, the chairman of Reliance Group and recipient of the Insurance Federation of New York's 1993 Free Enterprise Award, recently proved why he's worth his $6,000,000 salary.

Based on traditional yardsticks such as book value and share price (both of which had declined at Reliance over the last seven years) Mr. Steinberg's performance looked anything but award winning. Traditional yardsticks, however, don't always tell the whole story.

Time and again Steinberg's adept maneuvers have demonstrated how the "invisible hand" of free enterprise works (or fails to work, if you aren't Saul Steinberg). In Steinberg's case, it seems that the invisible hand dips into shareholders' pockets and deftly transfers their wealth to his pocket.

For three decades now, Steinberg has been on the cutting edge of capitalism, whether it was crafting clever accounting ploys that beautified his financial statements, swapping overvalued Leasco securities for undervalued Reliance securities (the deal where he made his fortune), issuing junk bonds and then buying them back at a discount, or simply issuing new shares to suckers with short memories.

In 1986, for example, Reliance Group issued fifteen million shares of stock at $10. A year and a half later the stock tumbled about fifty percent and hovered in that range for the next six years as Reliance reported poor results. One not versed in the vagaries of the free market might have surmised that investors had had their fill with the avaricious Mr. Steinberg, but he proved the skeptics wrong when Reliance Group issued twenty-five million shares of stock at $8 apiece last November.

Since then, the stock has made a beeline for the South Pole, sinking 25% to a recent price of $6. By selling stock in November rather than at today's prices, Steinberg garnered an extra $50 million for his company.

Assuming he doesn't get a raise, that should just about cover his salary for the next eight years.

Behind the Green Door

ALTHOUGH THE CALIFORNIA workers' compensation manual contains no classification entitled "Ecdysiasts, not otherwise employed," that hasn't prevented two ecdysiasts who work at the venerable Mitchell Brothers' O'Farrell Theatre in San Francisco from filing a class action lawsuit against the theater. The ecdysiasts claim that because they've been classified as independent contractors rather than employees they've been denied their right to workers' compensation coverage.

For those not well versed in etymology, "ecdysiast" is derived from the Greek *ekdysis*, which is the act of getting out. An ecdysiast, therefore, is a practitioner of the art of stripteasing.

Stripteasing, however, is far too narrow a term to describe the form of exotic dance practiced at the Mitchell Brothers' Theatre. (The Mitchell brothers are regarded by many as the D.W. Griffiths of adult cinema, having directed the Ivory Snow girl in *Behind the Green Door.*) When we visited the O'Farrell Theatre last fall, we observed several "independent contractors" performing jobs that we defy any workers' compensation underwriter to classify, much less rate.

Beth Ross, an attorney representing the exotic dancers, told *Business Insurance* that the dancers' jobs—which might include strutting across a stage in nothing but spike high heels—are "dangerous."

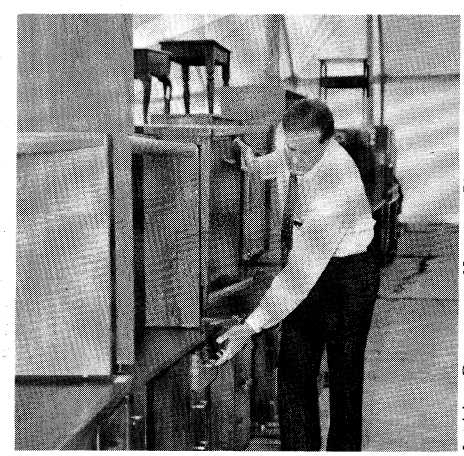
Perhaps that's why the theater has employed the basic risk management technique of transferring risk rather than retaining it or insuring it. Whether that's against the law, however, is the issue addressed by the lawsuit. And whether the ecydiasts at the Mitchell Brothers theater are a good risk or bad is ultimately a decision that can only be made by an underwriter.

One thing seems certain: if the underwriter is your typical guy, he will be only too glad to inspect this risk before writing it.

Sotheby's It's Not

JIM BROWN, who's been Commissioner of Insurance in Louisiana for a couple of years, works on Saturdays. On March 19, in a large tent in Baton Rouge, he performed the dirty job of inspecting used furniture that had been seized from insolvent insurance companies.

A short while later, the used furniture, along with used computers, used copying machines, and other used office equipment, was sold in an auction that brought in $65,000. To date, six auctions of stuff that belonged to busted insurance companies have brought in $1,047,000.



Louisiana Department of Insurance Photo

Photo opportunity for Louisiana Commissioner of Insurance Jim Brown