EMERSON, REID'S

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It Ain't the Meat, It's the Motion

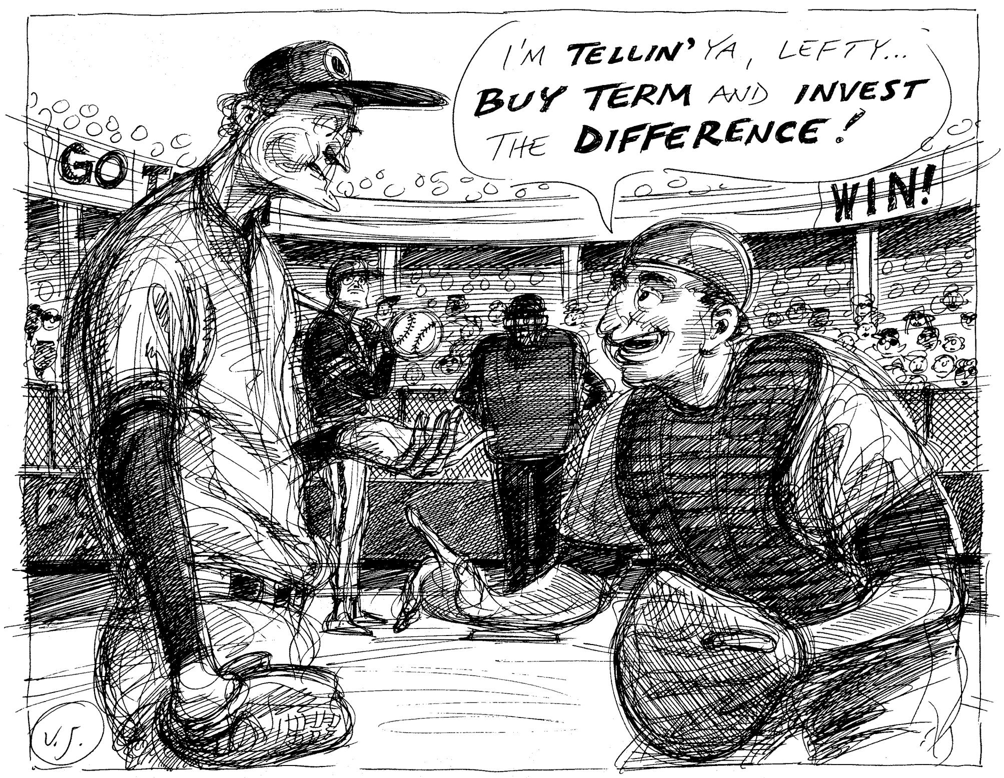
Life insurance, solvency, deception, and ratings

Robert Tedoldi, president of the National Association of Life Underwriters, was speaking to some 4,500 life insurance professionals at the annual meeting of the Million Dollar Round Table.

"I believe in this miracle called life insurance and its unique ability to protect dreams," he said with a straight face. "It's important that we keep alive this last bastion of free enterprise and preserve it for my children and yours so that they can bring the promise of its benefits to countless future generations."

Although we get where Tedoldi was coming from, to the average person the thought of thousands of life insurance salesmen in one room is more horrifying than anything Stephen King has ever imagined.

While there's nothing terribly wrong with trying to add a touch of glory to the lives of insurance salesmen, it would be a shame if the folks at the gathering actually believed Tedoldi's jive. They are, after all, supposed to be the most sophisticated people in the life insurance business.



Inspirational pap, however, has always been a staple of the life insurance business. It's the kind of stuff that "the Coach," Arthur L. Williams, dished out to hundreds of thousands of rubes—the part-time "term-ites" who hawked his high-priced products by repeating his simplistic mantra, "Buy term and invest the difference."

The A. L. Williams organization, now known as Primerica Financial Services (PFS), was once the cornerstone of Sandy Weill's Primerica, now known as Travelers. In Travelers' 1993 annual report, vice chairman Frank Zarb, who in recent years has had the overall responsibility for PFS, described Travelers as a company that "manufactures and delivers financial products," and referred to PFS's part-time horde of hayseeds as "an incredible sales force that believes in those products."

One could go a step further and say that in PFS's case it's not all that important whether the products are good; what's important is that the sales force and the customer *believe* that the products are good. In any event, Zarb's nuts-and-bolts bottom-line comments strip away the bullshit from the holy jihad of the life insurance business and get down to what it's all about: selling something at a profit.

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Zarb has since left Travelers and is now the boss at Alexander & Alexander, the foundering international insurance brokerage that recently received a $200-million cash infusion from AIG. Hank Greenberg, AIG's chairman, has indicated that he wants to see A&A remain an independent insurance brokerage. (This will protect AIG's huge book of business with A&A.) Whether Greenberg has something up his sleeve remains to be seen; and whether the AIG deal is really the best for A&A shareholders also remains to be seen. The company's 205-page proxy statement discloses that although other companies approached A&A about acquiring it outright, it spurned those approaches. As a result, eight years down the road, AIG, with a potential of 29% of A&A's stock, may wind up with de facto control.

We gleaned another interesting tidbit from A&A's proxy: if the deal hadn't closed before October 31, Frank Zarb could have quit his job and collected $12 million in cash and $4 million in stock from A&A.

That's not bad for manufacturing and delivering financial products.

'Highly confident'

At AIG's annual shareholders' meeting on May 16, Hank Greenberg told shareholders that he has wanted to develop a U.S. life insurance business for many years, but that the time hasn't been right—"life companies were giving product away at terms and prices that made no sense." Although that may be true, no one informed Conseco, which in the last few years has spent over a billion dollars—most of it borrowed—on life insurance companies, and has recently made a $2.68 billion offer for Kemper Corp. (life insurance, mutual funds, securities brokerage). As in the past, Conseco has no intention of shelling out its own cash to land Kemper—nor does it have such cash. Instead, it will rely heavily on other people's money. Citibank plans to lend $1.22 billion and, in a move reminiscent of the 1980s, Morgan Stanley has stated it is "highly confident" that it can raise $750 million for Conseco through the sale of junk bonds.

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Equitable's hokum is not just shameless puffery; it is deceptive.

Back at AIG, Hank Greenberg told his shareholders that many life insurance companies have had their ratings lowered in recent years (Kemper is just one such company), and noted that customers "want to do business with strong, financially sound companies, because life insurance is a long-term business." While he's correct—in theory—in the real world customers have some difficulty getting a grasp on financial strength. For example, isn't the ability to borrow scads of money from prestigious bankers a sign of creditworthiness? Isn't a well-known name a sign of security?

It's not surprising that there's confusion among consumers: most life insurance companies have "secure" ratings from A.M. Best, and virtually every company professes to be in great shape. A case in point is The Equitable. "Few In The Industry Have Stronger Capital-To-Liabilities Ratios," it recently proclaimed in a two-page ad that appeared in a variety of publications. "Equitable Life, with its record high ratio of statutory capital to liabilities, now ranks in the forefront among all major insurers in this key measure of financial strength," the ad continued, in smaller type.

Equitable's hokum is not just shameless puffery; it is deceptive. In the July issue of our favorite life insurance publication, the *Insurance Forum* (P.O. Box 245, Elletsville, IN 47429, $60 per year), editor Joseph Belth explained why. For starters, it's false to say that "few in the industry have stronger capital-to-liabilities (C/L) ratios." In fact, 82% of all companies had higher C/L ratios than Equitable. (If Equitable was referring *only* to the largest companies, there is some truth to its statement.)

Second, the C/L ratio is hardly a "key measure of financial strength." It's just one of 120 financial tests that A.M. Best, for example, uses to evaluate financial leverage, profitability, and liquidity.

Belth asked Equitable why it chose to advertise its C/L ratio "in view of the company's efforts to suppress distribution of risk-based capital ratios." (Equitable provided the language for the NAIC gag rule forbidding insurance companies or agents from disseminating risk-based capital data.) Equitable didn't answer that question, but the answer is obvious: although Equitable's C/L ratio is higher than that of many other large companies, its risk-based capital ratio, and, more importantly, its financial ratings, are among the lowest of the major companies. Of the fifty-six life insurers with general account assets greater than $5 billion, only four have Standard & Poor's ratings as low as Equitable's A+ (Good): Aetna Life, Mutual of New York, Travelers, and Western National (part of Conseco). None has a lower rating.

Of the fifty-three companies rated by Moody's, only three—Kemper Investors (which may soon be part of Conseco), Mutual of New York, and Western National—have ratings as low as Equitable's A3 (Good).

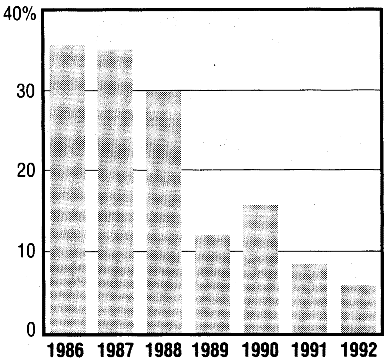
Of the fifty-five companies with Best's ratings, only three were rated as low as Equitable's A–: Kemper Investors, Mutual of New York, and Travelers.

What price risk?

Consumers of insurance aren't the only ones not paying enough attention to insurance companies' financial strength. In a study published in the *CPCU Journal,* two insurance professors, Steven M. Cassidy, Ph.D., CLU, and Reinhold P. Lamb, Ph.D., surveyed independent agents and found that the majority of respondents classified their agencies as willing to take little risk. The survey also

The Junkman Goeth

Percentage of premiums written by property/casualty insurance companies with more than 10% of assets in lower-grade bonds, real estate, and mortgage loans



Source: Insurance Services Office

indicated that the "portfolio" of insurance companies each agency represented was actually considerably riskier than that agency's stated tolerance for risk. (Although we disagree with the way Cassidy and Lamb measured the riskiness of an insurance company—they used combined ratios and premium-to-surplus ratios, we would have used Standard & Poor's and Best's ratings—their conclusions are in line with our observations of the industry.)

Agents, like most buyers of insurance, have been guilty of complacency. As long as an insurance company met their minimum standards—generally an A– rating from Best—they were happy not to give it too much thought. We have a feeling, however, that complacency will prove to be an unhealthy habit going forward. In the long run, companies with weaker financials won't be effective competitors, and as a result, won't be the best markets for agents and brokers, not to mention *purchasers* of insurance.

Insurance companies face an array of difficulties: asbestos and environmental liabilities, shrinking investment returns, diminished cash flow, catastrophes, the detrimental effect of interest rates on their balance sheets, and overregulation. And if none of those things knock out a few of the weaker players then perhaps it will just be the competition that grinds them down. This litany of problems doesn't tell us much, however. *Every* industry—and every company—faces a list of potential pitfalls. It is a given that for most people, things tend to look the worst at the bottom. Still, we don't think the property-casualty market will improve significantly until some of the players are forced to throw in the towel. We think the turn, whenever it happens—and it will—is going to be accompanied by extreme financial pain and a concomitant flight to quality.

AIG's Hank Greenberg told his shareholders that it's "hard to see how the industry can continue on this death spiral much longer." (AIG, by the way, is in excellent financial shape.) Of course, trying to pinpoint the upturn in the cycle is as futile as making a long-term weather forecast. Still, we're willing to wager that the strongest companies will gain market share and profitability when the turn comes. The same can not necessarily be said of some of the weaker companies. For starters, their clients may be afraid to do business with them. In its prospectus last year, Reliance Group stated that "a downgrade in [its] Best rating below A– could adversely affect the competitive position of the Reliance Property and Casualty Companies." That admission may not sound like much, but it hadn't appeared in Reliance's previous 10Ks. And, as we've pointed out many times in the past, an A– Best rating isn't necessarily a resounding seal of approval. In fact, only 21% of companies receiving a letter rating from Best are rated lower than A–.

Does Continental deserve a B+ rating instead of an A–?

The Continental Insurance Companies, which also carry an A– rating, were recently placed under review by Best "with developing implications pending further evaluations of the group's capital preservation efforts, restructuring actions, and future business plans." Best said this rating action follows the company's "poor first-quarter 1994 financial results and depleted surplus position that has left it with weakened capitalization and diminished financial flexibility over the near term." Best expects to reevaluate Continental in the fourth quarter of 1994, the implication being that if Continental doesn't sell a couple of autonomous divisions, redeploy some of its capital, arrange a large quota-share reinsurance program for its personal lines book, slow its premium growth, and, we assume, make some money, that it may just find itself with a B+ rating. In the meantime, we're wondering what we always wonder in these sort of situations: does Continental *at this moment* really deserve an A– (Excellent) rating? Shouldn't one who wants to err on the side of conservatism consider it to be B+ (Very Good)?

This is a touchy subject for Best. (It hasn't downgraded any major company below A–.) We chatted with Dolson Smith, the analyst who follows Continental, and he said that Best "does its best to see companies through a difficult period. Continental knows it's on notice, and we have reason to believe they can accomplish what they set out to do."

In the meantime, where does that leave the cautious insurance buyer? Suppose Continental can't achieve its goals?

To these and similar questions, we reply: caveat emptor. ■

All Shook Up

Dwight Dodson, vice president of property underwriting for the Tennessee Farmers Mutual Insurance Company, which writes most of its business smack dab on the New Madrid fault in western Tennessee, testified before the Senate Committee on Commerce, Science and Transportation that his company would be caught short and could be wiped out by an earthquake of the same magnitude as the 1811-12 New Madrid earthquake.

That's a surprising admission from a company with an A++ Best rating, a BBBq Standard & Poor's rating, and a five-year combined ratio of 89.9%. Indeed, the Tennessee Farmers appears to be the model of conservatism. But looks, at least according to Dodson, are deceiving. That's why he testified in favor of S.1350, the Natural Disaster Protection Act, that calls for catastrophe reinsurance from the Federal government. The bill provides reinsurance for insurance companies whose catastrophe losses exceed 20% of consolidated surplus.

Whether S.1350 will become law remains to be seen, but in the meantime we've got a simple piece of advice for Mr. Dodson: cut back your quake exposure.

Disaster Re Company

Paulson, Dowling's modest proposal

Paulson, Dowling Securities, a small Hartford-based property/casualty research boutique and broker-dealer, produces a wonderfully quirky and incisive report called *IBNR Insurance Weekly*. It's edited by thirty-four year old V.J. Dowling, Jr. (one of the firm's founders), and written by Dowling and analysts Alice D. Schroeder and Brenna Sullivan.

IBNR is filled with a compelling blend of information and insights. It's faxed on Sunday nights and is definitely worth reading first thing Monday morning. But don't bother calling for a subscription, because you can't get one. The report is only for the firm's clients, and these happen to be institutional investors. Although we're loath to admit it, some of our best friends happen to be institutional investors, and they've been kind enough to pass along copies of *IBNR*.

In the June 23 issue, V.J. Dowling discussed the proposed Natural Disaster Protection Act and took keen note of the provisions that call for Federal reinsurance for domestic and international insurers (and reinsurers) for 95% of their catastrophe losses up to 200% of surplus, after 20% of surplus has been lost.

The thought of this Federal largesse prompted Dowling to put forth a modest proposal: upon passage of the Natural Disaster Protection Act, Paulson, Dowling will become a catastrophe reinsurance company called Disaster Re. The company is already seeking investors and figures that $100 million will do the trick.

Disaster Re will write business in four overlapping U.S. zones, with an aggregate limit of 230% of surplus per zone, or $230 million. Since Dowling freely admits he doesn't know a damn thing about underwriting, he's decided to save the money and not bother with it. "We will simply write industry loss covers like Berkshire Hathaway (but cheaper) that will provide protection for industry losses somewhere north of $5 billion," he writes.

Assuming a rate on line of 20% (which is lower than current levels), that works out to $46 million of premium per zone. Dowling's conservative projections call for actual written premium of $100 million. Expenses should be 25%, which includes a 10% brokerage commission as well as Dowling's bills in Bermuda. That leaves 75%—or $75 million—for profit (or to pay claims if absolutely necessary, which it won't be. Read on.)

Since the company isn't taking any risk on the insurance side (the federal government is) it can afford to invest its assets in a diversified portfolio (long and short) of insurance stocks.

There are no taxes in Bermuda, so capital should build up quickly. In years when there aren't large natural disasters, profits will be in the $75 million to $85 million range.

Obviously, if insurance companies never had to pay claims, insurance would be one hell of a business. But that's not realistic. So let's examine what happens when there's a total loss of $230 million, the company's aggregate limit.

Disaster Re	
Policyholders' Surplus	$100,000,000
Premiums Written	100,000,000
Gross Loss	$230,000,000
Initial Retention (equal to 20% of surplus)	–20,000,000
Loss subject to Federal reinsurance	210,000,000
Federal Reinsurance Collected (95% of losses after 20% retention, and less than 200% of surplus)	–199,500,000
Additional unreinsured loss	10,500,000
Disaster Re's net loss (Initial retention + add'l unreinsured loss)	$30,500,000

Even in this worst possible case, Disaster Re's combined loss-and-expense ratio is just 55%, thanks to the Natural Disaster Protection Act. And even if there are two total losses ($230 million twice, or $460 million) Dowling has that covered:

> We have an agreement with Backup Re to pay a $10 million retrocessional premium for a "second-event cover" of $230 million. Backup Re's only property cat contract is their retrocessional contract with Disaster Re. Yes, the government will provide the same deal discussed above to Backup Re...The financial exposure to Backup Re is $20.5 million ($30.5 million loss minus $10 million premium received from Disaster Re).

Dowling's scheme, while wonderful for those who choose to invest in his company (we're signing up for $10-20 million worth of stock), illustrates why the Natural Disaster Protection Act is no bonanza for the U.S. government. Under the worst-case scenario outlined above, Disaster Re will make $45 million while the government will lose $400 million.

To paraphrase an old line: $400 million here and $400 million there—after a while it adds up to real money. ■

If you feel like it, this announcement may be considered an offer to buy these securities.
A deal this good does not require a Prospectus.

5,000,000 Shares

DisasterRe

Price $20 Per Share

DisasterRe is a to-be-formed Bermuda-based catastrophe reinsurer that is guaranteed to make a profit by taking advantage of provisions in the proposed Natural Disaster Protection Act. The issuance of these securities involves significant and unquantifiable risks to the U.S. Treasury, and there can be no assurance that the federal government will not lose its shirt on this Act.

The Authority on Property Insurance

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Property Insurance Report

The Authority on Insuring Homes and Commercial Property

Vol. 1 #1 **July 4, 1994**

Inside

Higher deductibles and restrictions on replacement cost coverages are being implemented by property insurers struggling to reduce their exposures, particularly in catastophe-prone areas. **Page 2**

California is struggling to find a solution to a property insurance crisis, but the options are few and no one likes any of them. **Page 7**

The Grapevine

ISO Building Code Plan Is A Good Start

Many insurers have rejected the notion that they are responsible for enforcing building codes or even leading the way in development of building standards. But the poor performance of much of the nation's housing stock in heavy storms has driven the industry to reconsider.

The recent announcement by **Insurance Services Office** that it would be reviewing building codes nationally is a good first step. Others in the industry are beginning to talk about the need for insurers to attack building codes the way they push for highway safety. Property and casualty insurers have long felt it was worth the money invested in testing cars

Please see GRAPEVINE on Page 10

Mortgage Markets Threaten To Bring California Insurance Crisis To Head

The secondary mortgage markets may force the hand of **California** regulators, legislators, insurers, and consumer groups who are struggling to solve the state's property insurance crisis.

Currently, earthquake insurance is not required by the mortgage markets, which has long demanded that homes carry traditional homeowners coverage. But sources report that officials at the two quasi-governmental organizations managing the secondary mortgage markets - Fannie Mae and Freddie Mac - are seriously considering such a requirement.

And before market officials act, traders may make the debate a moot point, as the value of California mortgages falls to compensate investors for the higher risk of default that comes with properties uninsured against earth-

Please see CALIFORNIA on Page 5

Computer Model Gains Acceptance

Insurers Win Small Victory In North Carolina Rate Case

A year after the initial filing, the property insurance industry and **North Carolina** Insurance Commissioner **Jim Long** finally came to terms on a homeowners rate increase last week. And with insurers gaining an increase of only $11 million rather than the $73 million they sought, it was hard for them to find a silver lining.

But insurers, who file a single rate through the **North Carolina Rate Bureau**, had been working all year to convince the commissioner that he should accept their new method of using a long-term computer model to calculate rates, rather than recent loss experience, and on this point it seems they made progress.

Though Long took the dollar amounts the computer

Please see NORTH CAROLINA on Page 3

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It Ain't Necessarily So

Chubb tells a tall tale

Perhaps the most obvious sign of the complacency prevalent among corporate insurance buyers is that they are generally unwilling to pay a premium price to buy insurance from a company with top-notch financial ratings (e.g. AAA, AA from Standard & Poor's; A++ from A. M. Best). There's a widespread feeling in the marketplace that as long as a company has an A– Best rating, it's okay. (Of the 1,735 property/casualty companies that received a letter rating from Best in 1993, 79% were rated A– or higher.) Although everyone agrees that insurance companies should have unquestioned financial strength, we haven't heard many stories of buyers who are actually willing to pay much more for solvency and quality—until recently, that is.

At Chubb's annual managers' meeting in April, Bob Crawford, the company's president, regaled his audience with a wonderful story about how Chubb—which has a reputation as the Rolls Royce of the insurance business—was able to get a premium price for its services. Said Crawford, "Gregory & Appel, hands-down our best agent in Indianapolis, presented this opportunity: would Chubb be interested in writing property coverage for the city of Indianapolis? Well, we weren't so sure. Municipalities typically bid their account and tend to go for the low bid. Not really our kind of thing. But this was our best agent so we went along and quoted $320,000.

"According to the city's risk manager," Crawford continued, "that was about $80,000 higher than the competition. Holding firm on our price, Parker Rush [a Chubb vice-president] suggested that the risk manager might want to talk to his counterpart in Des Moines, Iowa. Apparently we'd done a pretty good job for them at the height of last summer's floods.

"The risk manager in Des Moines said this: 'We were enduring the worst case imaginable: the city was a disaster area as a result of the floods. But Chubb was there for us, demonstrating expertise throughout the claim settlement and helping the city back to its feet in a matter of days.'"

Crawford went on: "Story told, price was no longer the issue. We won the account on our terms and have a customer to thank for sealing the deal. It's an example of Chubb at its best. On one hand, it is what we're famous for. On the other, this isolated incident is no longer enough..."

We can only surmise that the Chubb managers in attendance had intense and unabashed feelings of corporate pride by the time Crawford finished. We, too, were impressed when we read his words in a pamphlet put out by Chubb. After all, this sort of thing doesn't happen every day. There is only one thing wrong with Crawford's wonderful story: it isn't true. At least that's what Cindy Avery, Indianapolis' risk manager, told us. According to her, Chubb came in $189,000 lower than Hartford's renewal quote and $3,000 lower than CNA's quote. Avery told us that although Chubb had an excellent contract and she appreciated the company's reputation for service, she didn't know whether she would have paid a higher price to go with Chubb. In fact, there were actually certain "special considerations" that weighed in Chubb's favor during the bidding process, namely that the Federal Insurance Company (the Chubb subsidiary that issued the policy) happens to be domiciled in Indiana. That, according to Avery, was an important factor in the decision.

Although Chubb—because of the quality of its products and the integrity of its balance sheet—undoubtedly *deserves* a premium price for its policies, in this instance it wasn't able to get it. Chubb seems to have got the Indianapolis account for much the same reason that WalMart gets business: everyday low prices.

We don't expect that always to be the case, however. Financial strength is an important consideration for buyers of corporate insurance, and at some point corporate buyers may simply refuse to buy insurance from the shakier carriers.

When that happens, the story about the risk manager who pays a higher price to buy insurance from Chubb will become true. ■

The Banality of Greatness

State Farm is there

The flat, level Central Illinois prairie stretches in all directions, broken only by a small network of roads and the occasional town. Aging barns and farmhouses dot the landscape and the coal-black Corn Belt soil—thick and fertile—yields an abundant harvest. On a winter's day a certain bleakness blankets the terrain; in the summer, under the hot August sun, cornstalks form an endless pale yellow cover.

Situated in the heart of this region, forty miles east of Peoria and almost equidistant between Chicago and St. Louis, at the intersection of the Amtrak rail lines and Interstates 55 and 74, is Bloomington, a bland Midwestern town of 52,000. A mile or so from the decaying downtown area, along what was once Route 66 but is now a multilane highway that rings the city, stands a low rectangular office complex almost as large as the Empire State Building. This is the corporate headquarters of the State Farm Insurance Companies.

Although one imagines that people in this part of the country leave their front doors unlocked, security at the building's entrance is tight. Six uniformed officers are on guard in a command center with at least forty closed-circuit TV monitors, and the glass front doors are electrically controlled. It's not clear why security is such a concern, but some years back an irate group of consumer advocates stormed the president's office in search of, one imagines, lower insurance rates. But then, State Farm is a magnet for this sort of thing. During the week we visited, union officials representing striking workers at Archer Daniels Midland, a giant agricultural processing company of which State Farm owns 7.4%, called for a boycott of the Good Neighbor company.

Almost everything about State Farm is on a grand scale. It is far and away the largest insurance company in America, with about 22% of the auto and homeowners markets. It has 65,000,000 policies in force, 67,000 employees (including 400 in-house attorneys), and 18,000 agents. Its $22 billion in surplus and $20 billion in property/casualty claim-benefits paid last year dwarf that of any other insurance group.

State Farm has twenty-eight regional offices, each with about 1,200 employees. There are 900 claims offices across the country. In all, the company occupies 22,599,431 square feet of space—enough to fill 753 football fields. Not far from its Bloomington headquarters, a new 2,000,000 square-foot office complex on 217 acres is under construction. This $180-million project, which includes two power plants and one grounds-maintenance facility, will house 5,200 people, the majority of them in computer operations.

State Farm is one the largest users of first-class postage in the country, sending out 298,000,000 pieces of mail last year at a cost of $113 million. Its agents mailed 12,000,000 credit-card-sized State Farm calendars, 1,279,000 Norman Rockwell wall calendars, and a similar number of State Farm road atlases.

State Farm shipped 188,000,000 pounds of freight last year, or 2.89 pounds for each policy. It recycled 8,398 tons of material (51% of its total waste). Its 14,000 passenger-car fleet is the largest in the country.

Size, of course, doesn't explain the company's success—it merely measures it. State Farm's acheivements are the result of its unique corporate culture: it is a "mutual" insurance company in the very best sense. Everything revolves around its single-minded dedication to its customers—the "owners" of the business.

"Our goal is to serve our customers—period," says Bill Sirola, the company spokesman. "Not growth or price, just service. We write homeowners, auto, and life. We don't do credit cards, mutual funds, or financial services. We concentrate on what we know, and that's the American market. People want service. We're an efficient company with a well-priced product."

State Farm *is* efficient. Its expense ratio, although not the lowest in the industry, is five to six points below the average, a significant competitive advantage. Although State Farm is commonly referred to as a "direct writer," the term is a misnomer. State Farm writes business through its 18,000 *exclusive agents*. These agents, independent contractors who run their own businesses, sell only insurance—not real estate or "financial services." Commissions are reasonable: 10% for auto insurance and 15% for property. State Farm agents make a good living.

Despite its stature as a national financial powerhouse, State Farm's roots are, not surprisingly, on the farm. The company embodies the rugged individualism of the American spirit, and its story is very much that of its founder, George Mecherle. In fact, his biography, *The Farmer From Merna* by Karl Schriftgiesser (Random House, 1955), is

State Farm: A good idea catches on

	Earned Premium	Policyholders' Surplus	No. of auto policies
1922	$12,768	$7,758	1,339
1927	685,922	223,153	
1932	5,795,110	1,233,385	335,952
1937	10,448,251	3,377,955	
1942	24,033,121	8,994,982	840,149
1947	69,951,025	15,978,049	
1952	128,477,169	70,342,659	2,447,380
1957	314,493,729	117,636,494	
1962	544,080,101	274,418,045	7,517,769
1967	1,054,339,745	383,634,938	
1972	2,007,403,168	1,100,847,940	13,548,047
1977	3,825,941,534	2,652,819,153	
1982	6,648,542,012	6,820,838,365	23,456,475
1987	13,053,522,194	13,985,982,488	
1993	21,924,001,917	21,269,733,369	36,252,796

subtitled "A History of the State Farm Insurance Companies."

Mecherle was born in 1877 in Merna, a tiny crossroads community nine miles east of Bloomington. The Mecherle family was thrifty, conservative, and hard working. "By neighborhood standards they were even rich," writes Schriftgiesser. "Neither poverty nor insecurity ever threatened them. The banks owned no part of their land. Frugal but never mean, they had an abiding love for their land and no fear of the hard work that its care required."

George Mecherle never completed high school (the local school was shut down during his first year there). Instead, he went to work on his uncle's farm, eventually saving enough money to acquire it outright. He was more than just a good farmer: he was a good businessman and a believer in efficiency. "He understood how to restore tired, worn-out soil through the use of phosphates and limestone," says Schriftgiesser. An early believer in the theory of crop rotation, he was, in the words of one neighbor, "a scientific farmer without a scientific education."

Despite his success (his farm was worth a quarter of a million dollars by 1917), Mecherle was a provincial man whose travels had rarely taken him beyond the immediate area. Observes Schriftgiesser, "Up to the age of forty he was just another McLean County farmer—prosperous, progressive, and seemingly with no ambition to move far from his home, his family, or his rustic way of life." Unfortunately, his wife suffered from severe arthritis, so he sold his equipment, rented his farmland, and moved his family to Florida. But the warm climate didn't help her, so the Mecherles returned to Bloomington and George began looking for some new endeavor to keep him busy. He ended up selling insurance policies for the Union Automobile Indemnity Association of Bloomington, a small reciprocal insurance exchange.

A short while later, in 1922; he formed State Farm with the radical premise of selling auto insurance at reduced rates to farmers under the theory that rural areas were less hazardous than cities, and that farmers were better-than-average risks. The policies were sold by part-timers—mostly farmers who belonged to farm bureaus and farm mutuals. (The company switched over to the career-agency system in the early 1950s.) State Farm billed and collected the premiums directly (a novel idea) and issued six-month rather than one-year policies, thereby keeping the initial premium payment even lower. A nonrefundable initial membership fee was also charged.

By 1931, State Farm had 366 employees, 70,045 policies in force, and offices in every state west of the Mississippi. "Its growth has been phenomenal," reported the Alfred M. Best Company.

Insuring the preferred risk had always been one of the important tenets of State Farm's operations. Ironically, the preferred risk just happened to be, in the words of the company's assistant secretary T.F. Campbell, "the average citizen of normal habits."

By 1942, twenty years after it had been founded, State Farm was the largest automobile insurance company in America.

In many respects State Farm is something of a conundrum. It is a fierce advocate of free markets, but, as a result of its mutual ownership, it is actually a collective. Although there are no large shareholders to demand profitability, it has been recording excellent results, delivering a good product, and providing exceptional financial stability for generations. All this while "in the clutches of nepotists," as *Fortune's* Carol Loomis noted with irony. Since its inception, the company has been dominated by two families. George Mecherle, the founder, was succeeded by his son Ramond, who was followed by Adlai Rust (George Mecherle's right-hand

man) and then his son Edward, who ran the company until his sudden death in 1985. This unexpected occurrence caught State Farm off guard, and the board of directors, chaired by Roland Marston, searched for a successor, ultimately settling on Edward Rust Jr., who also happened to be Marston's nephew. By all accounts, the company has been run well run under Ed Jr., as he is often called.

True to its roots, State Farm is a conservative skinflint that never forgets that each dollar belongs to its policyholders. When we asked for a copy of the company's Schedule D (the list of investments filed with state insurance departments), for example, John Killian, the controller, told us that he could only *lend* us one since the company hadn't spent the money to get extras printed.

When it comes to its investments, State Farm is also refreshingly out of synch. It is a buy-and-hold investor with a conservative portfolio managed for the long haul rather than for the next quarter. Because of the strength of its balance sheet, it can afford to invest a significant portion of its capital in equities. (This strategy is also employed by other well-capitalized insurers such as Berkshire Hathaway and Cincinnati Financial.) In fact, a complaint leveled against State Farm by consumer advocates has been that it has too much capital—that it doesn't really need $20 billion in surplus. Longtime readers of Emerson, Reid's Insurance Observer will know that we scoff at such mindless notions. State Farm's capital, top financial ratings, and debt-free balance sheet are significant competitive advantages that provide great comfort to the company's policyholders, agents, and employees. Furthermore, it's conceivable that State Farm could face $10 billion to $15 billion in losses if a Class 5 hurricane hit a heavily populated area along the east coast. (When we asked State Farm why it doesn't reduce its exposure in this area, we were met with a surprised look and a straightforward answer: "We do not like abandoning customers. It's not our tradition.")

In fact, it's difficult to find any rational, informed person who has anything but praise for State Farm. We checked in with our pal Brian Sullivan, the savvy and erudite editor of *Auto Insurance Report* (and now *Property Insurance Report*) to hear his thoughts.

An early logo

"All I can do is gush about those guys," he sighed, a trace of regret in his voice for not providing us with some juicy exposé. "I speak with everyone in the industry, and State Farm's competitors say that they don't really compete with State Farm—they let them do their thing and fight for the rest.

"It's generally accepted that if State Farm wants market share it can take it. The irony is that they've gotten to this point of power by not really wanting to be at this point of power. It sounds so hokey to say that it has grown out of their dedication to service, but it's true, and no one can tell me otherwise.

"Allstate agents, for example, will freely criticize their company, but State Farm agents, even in states where they're cutting back, remain pleasant and upbeat about the company. The agents even echo the company when they say that want to grow in life insurance. Its unusual for agents to toe the company line so consistently, but they do, and it's because they mean it. The agents are singing out of the same hymnbook as the company, and that's unusual."

To get a better handle on just what it is that makes State Farm so special, we sat down with John Killian, the vice president and controller. Like everyone else, he attributes State Farm's success to its customer orientation. "Business is conducted with absolute integrity. The numbers are a *result*, but what causes them is customer satisfaction.

"Historically, we've viewed our role as fiduciaries. Our advantage comes because State Farm is *not always* the cheapest. The combination of price and service equals value. And the most important aspect of value is the personal insurance agent in the neighborhood, who has a personal relationship with the customer.

"We don't have any sophisticated strategy. We're not bumpkins, but we're really not all that sophisticated. I don't want to be simplistic, but it's not all that complicated. We're unswerving in our dedication to personal lines."

We then spent some time with Vincent Trosino, the fifty-three-year-old chief operating officer. Trosino grew up in Philadelphia and got a degree in psychology from Villanova. Upon graduating, he was advised by an employment agency to apply to State Farm. He'd never heard of the company and thought the employment agency was recommending a job at the state prison.

Trosino went through State Farm's training program, worked in regional offices, then served as director of personnel at the headquarters. He got a masters in human resources management and worked in line management in the southern California auto division before returning to Bloomington.

"We serve our customers first," he started off. "Outsiders don't always believe that's really our goal, but it is. We want to stay with what we do well. Selling more life insurance, for example, is one of our major goals. State Farm Life has excellent twenty-year records, but we only sell 16% to 18% of the life insurance bought by our customers. If we want to retain the long-term policyholder it's better to have the life insurance."

Although he is on top of the changes that the industry is undergoing, especially competition from financial-services companies and banks, Trosino, unlike many others in the industry, isn't looking for government protection. "As long as there's a level playing field I think its healthy to have competition. If we want to keep the government out of our hair, competition is good. Our strategy is to compete vigorously for the customers we want. I still think that when people look at their car and their home insurance they want personal attention."

Far out, man! An ad from the Sixties.

State Farm

($ millions)	December 31, 1993
Assets	
Cash and short term investments	$772
Bonds	22,865
Common & Preferred stock	11,637
Equity in insurance subsidiaries	6,373
Other	5,890
Total Assets	47,537
Liabilities	
Claims and claims expenses	15,158
Unearned premiums	6,536
Other	4,573
Total Liabilities	26,267
Policyholders' Surplus	$21,270

He has no plans for State Farm to enter the financial services business. "Our business is not the investment business," he says emphatically. "*We're in the insurance business*, and—oh, by the way—we produce capital that must be invested."

"How do you spend your days?" we asked.

"What do I do? Expense management. Strategy. We ask the question, 'Where is this thing going?' A lot of my time is taken up by politics, regulation, and legislation. We're in a proactive mode. As Wayne Gretzky said, 'Skate to where the puck *will be*, not where it is.'

"How do we keep our culture with 67,000 employees? That's crucial. Our rank and file get competitive wages based on the region, and our executive-level salaries are benchmarked to the industry. We pay reasonably, although far from excessive. We don't try to compete with the top salary-payers. No one's enormously wealthy around here. People need to save. They respect State Farm when they retire. We have very low employee turnover. It's a cultural thing."

That holds true for the company's agents, as well. More than 86% of new State Farm appointees are still with the company after four years, versus 20% to 40% for the rest of the industry. Perhaps that's partly because it's not easy to become a State Farm agent. New agents must go through a two-year training period and then come up with the money to start their businesses.

Given State Farm's size, complexity, and financial wherewithal, the company's top executives aren't well paid compared to their competitors at stock companies. Always curious to understand what makes people tick, we asked Trosino whether he was interested in money.

"I'm not here to judge," he said plainly. "That's for others. Once you meet your needs, compensation means different things. How many cars, suits, and shirts can I own? There's that subjective other-person comparison, but from my point of view, if I'm competitively paid with the other employees here, that's okay with me. I have accepted the State Farm Mutual nature. If I ever regret that, then I'm out of here. I've been headhunted and offered much more, but it's not about that. I guess you have to be here and be part of the culture to understand that. It's almost a religious thing."

As we were getting ready to leave, the conversation veered to politics and social issues. "I believe I have an obligation to support my fellow man," Trosino said, "but I'm against socialism and government intervention."

His sentiments echo those of George Mecherle, who, despite being a product of the late nineteenth-century prairie, wasn't influenced in the least by any of the progressive political movements of his generation. According to *The Farmer From Merna*, Mecherle was, "by instinct and upbringing, by environment and ex-perience, a dyed-in-the-wool Republican who honestly believed that his and his fellow citizens' interests were best served by the Republican Party, which had come into being in the very region where he was raised. He was, in so many ways, a rugged individualist—and his rise from an inexperienced farmer to the chairmanship of a multi-million-dollar business had been so rapid, and accomplished so consistently along the lines of an old-fashioned success story, that he could countenance no political philosophy which seemed to place any barrier in the way of private initiative. He looked with dismay upon what he felt was the 'trend toward socialism' in the New Deal."

The spirit of George Mecherle lives on in Bloomington, Illinois. ■

The Insurance Beat

Oracle at Delphi

ROBERT ROSENKRANZ, the president, chairman, and controlling shareholder of Delphi Financial Group, which acquired Reliance Standard Life Insurance Company in 1987 via a leveraged buyout, is a smart, shrewd, successful guy, and he is not bashful about saying so.

Rosenkranz's 1993 letter to shareholders is overflowing with rip-roaring, hyperbolic bullishness and self-praise. While it is true that Delphi's results over the last few years have been excellent, it's worth noting that they have been achieved through—or at least significantly augmented by—the use of leverage, and that Delphi has since deleveraged its balance sheet.

Here are Rosenkranz's words:

> Delphi's 1993 performance is almost a textbook example of how [managing for both the short term and the long haul] blend together to speed shareholder value forward. Our financial results were nothing short of spectacular—premium fuel and plenty of it...[Delphi is] in every way a much more powerful, fuel-efficient and better handling vehicle that it was when 1993 began. Look at the high-octane results first...Equally remarkable is the growth in fully diluted book value per share... This bodes especially well for the future of Delphi shares, since not only do we have a rapidly and consistently growing book value, but also, Delphi stock sells at a below average multiple...Delphi's stock made a whopping 71% in 1993...Recognizing our growing financial might along with our hard-to-ignore operating performance, two rating agencies have given our senior debt and investment grade seal of approval...We are now poised with tremendous financial power growling under the hood to zoom ahead in whatever direction we judge to be astute. Possibilities we could only dream of a year ago are now within reach. [We have] the power to accelerate on the straight-aways of corporate opportunity.

Delphi's first quarter earnings were down 60%, and its stock is down 33% from its recent high.

Cursed Table

IN OUR MARCH 1993 ISSUE we told the story of Towers Financial, a crooked collection agency that had some unsavory dealings in the insurance business. Towers—which was run by Steven Hoffenberg, a slimy thug who tried to intimidate us with the threat of physical harm on several occasions—defrauded investors out of hundreds of millions of dollars. Hoffenberg, the mastermind of the scheme, now faces a well-deserved jail sentence.

At the recent bankruptcy auction held in Towers' New York headquarters, one item, a magnificent six-foot-by-twenty-four-foot conference table, stood out among the rest. A friend told us that the auctioneer informed buyers that this lovely piece of furniture had a lustrous provenance—its prior owner was none other than defunct junk-bond dealer Drexel Burnham.

According to our friend, the table went cheap.

The Methuselah Factor

IN OUR JUNE ISSUE we wrote about 20th Century Insurance, the California direct marketer of auto insurance that was almost knocked out of business by the January Northridge earthquake. How, we wondered, could such an otherwise fine company so completely underestimate its earthquake exposure? (20th Century thought it could lose $85 million in a quake. In fact, it lost $610 million.)

Perhaps the answer can be found in the company's proxy statement, which says—although not in these words—that the board of directors is composed primarily of old-timers, senior citizens, and retirees. For example, the chairman, vice chairman, and chief executive officer are eighty-one, seventy-five, and seventy-one years old, respectively. All told, five of the company's eleven directors are septuagenarians, and two are octogenarians.

While it would be unseemly—and therefore something we would never do—to criticize insurance executives for being gray-bearded, mossbacked geriatrics who might, at any given moment, fall and not be able to get up, it is fair to say that 20th Century's golden-agers, some of whom came to maturity when Herbert Hoover was in the White House, were certainly out of touch with the realities of their company's earthquake exposure.

Of course, as one ages, family generally becomes more important than business matters. Perhaps that why it's so touching that chairman Louis Foster and vice chairman John B. DeNault get together with their sons at least six times a year. We're privy to this piece of information because their sons, John B. DeNault III, a forty-six-year-old investor, and R. Scott Foster, a fifty-three-year-old ophthalmologist, are also on 20th Century's board of directors.

The board is aware, however, of the importance of bringing in some fresh blood, and, in August 1993, formed a Management Succession Committee to locate a new chief executive officer.

Unfortunately, the Committee has never held a meeting.

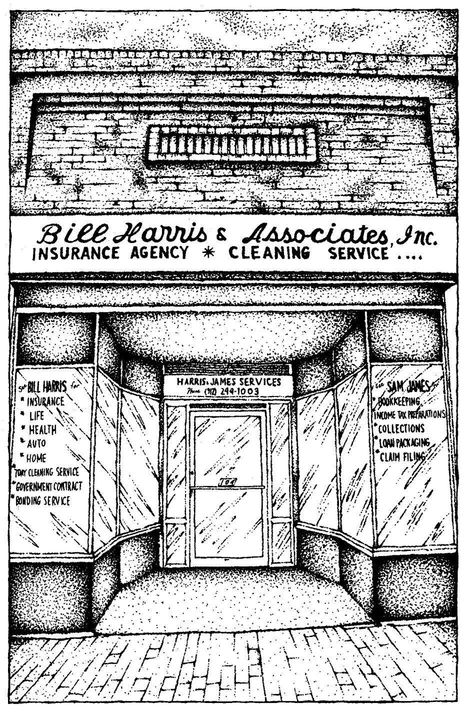
David Schiff, the thirty-eight-year-old editor of Emerson, Reid's Insurance Observer, is already well on the way towards becoming a cranky old geezer.

Real Clean

IT'S ONE THING for an agent to deliver a policy to an insured's home. It's quite another, however, for him to enter the house and clean it. Yet that, it seems, is how business is conducted at an insurance agency we passed in southern Georgia.

Who knows? Perhaps they're on to something.

Marsh & McLennan, take note.



An insurance agency in Georgia

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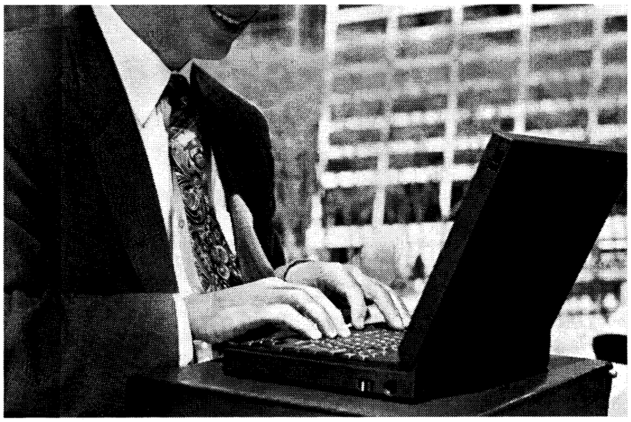

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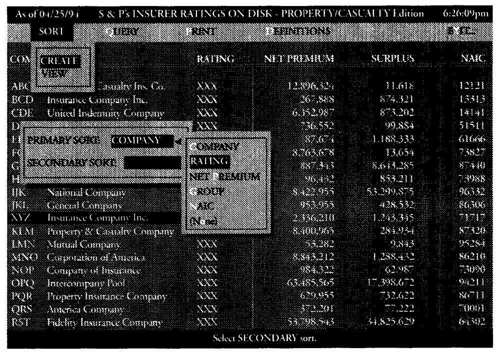

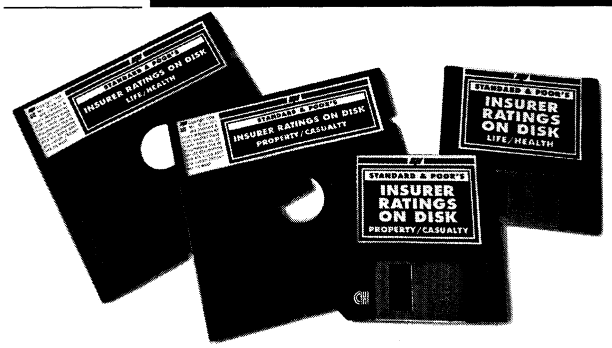

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