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Building up to an Awful Letdown

Good News Is Bad News, Sort of

In a front-page headline last December, we set forth the proposition that "bad news is good news, sort of." The accompanying article posited that the insurance industry's cyclicity was not a thing of the past; that despite the industry's many problems there might be a flight to quality that would benefit the stronger players and, that quite a number of insurance stocks were attractively priced. The stocks mentioned (AIG, Allstate, Arista, Chubb, Cincinnati Financial, H.W. Kaufman, Loews, Merchants Group, Reliable Life, SCOR U.S., and St. Paul) have aptly demonstrated that insurance stocks don't necessarily march to the beat of the same drummer as insurance rates, chalking up total returns this past year in the neighborhood of 40%. That, of course, is a fancy neighborhood, and not one where these companies will reside in the coming year.

The year 1995 has brought forth a plethora of things worth considering: reserve strengthening by Aetna, CIGNA, and Fireman's Fund, a turnaround in workers compensation, increased scrutiny by the rating agencies (especially A.M. Best), the good bank/bad bank approach to insurance-company liabilities, and the absence of a mega-catastrophe. The most important insurance development, however, has taken place in the financial markets. There is, apparently, no such thing as a bad insurance company: underreserved companies are takeover and restructuring candidates; recently-formed companies are unencumbered by the baggage of prior years; big companies are the beneficiaries of a flight to quality; small companies—God bless 'em—know how to exploit overlooked niches in the marketplace; companies with long track records of full-blown mediocrity will get religion and cut their expenses; and good companies will become even better. Even teetering concerns with toxic balance sheets will somehow rejigger their liabilities and tap Wall Street's money tree. Capital, created out of the ether of the stock market's inexorable ascent, is abundant and looking for a new home.

When one factors in the now-widely-accepted notions that inflation is dead and that the stock market is always a buy on the dips, there is but one conclusion: this is the best of all possible worlds. The financial markets, it seems, are taking their cue not from Warren Buffet, who seeks a "margin of safety," but from pitcher Satchel Paige,

"I'll trade you two Sandy Weills for a mint Hank Greenberg."

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whose maxim was "Don't look back, something might be gaining on you."

The insurance business, however—if history means anything—is not about to enter the realm of perpetual prosperity implied by the stock market. While one might look at the semiconductor or software business and see only the vast potential of cyberspace, it is hard to make the same case for the insurance industry, where the limits to growth are more obvious.

One thing seems painfully clear: all the cost cutting, layoffs, restructuring and reengineering in the world will not, on average, increase the insurance industry's profits in the long run; the savings will be passed along to the customer. For the average insurance company, cost cutting simply allows it to continue to play the game.

The financial markets' euphoria is certainly disconnected from the mood in the insurance trenches. Writing in the annual report of NYMAGIC (the parent company of New York Marine & General) earlier this year, John and Mark Blackmun, brothers who are, respectively, chairman and president, remarked that "As far as the casualty market (the great abyss) goes, it appears that the inmates are now clearly in control of the asylum. Rates remain inadequate in spite of chronic bad results."

Perhaps because the brothers Blackmun have their own money on the line—their family owns 51% of the company—they have been reluctant to go where others have no fear of treading, and haven't chased volume, pulling back sharply in lines such as Other Liability.

The question worth pondering then, is this: does the insurance marketplace, which has a history of mediocre underwriting and deficient reserves, know more than, for lack of a better example, NYMAGIC, which has a history of underwriting profits and redundant reserves?

Also worth pondering is the pile of capital seeking strategic deployment into the insurance biz. There's a slew of investment-banker types and LBO mavens who want to buy or start insurance companies, not to mention the insurance companies that want to buy other insurance companies. And why not? It's a bull market. Prudential, for example, which a couple of years ago was unable to sell Prudential Reinsurance in either a private sale or a public offering, discovered this time round that its refiled public offering was vastly oversubscribed (the stock, which was priced at $16.75 on October 2, quickly traded up to $20).

Far more ambitious was American Life Group, an "A–" rated annuity peddler that filed a preliminary prospectus on September 20. Those with *long* memories (we're using the official Wall Street definition of "long," which is "that which takes place after six months," as in, "I've bought these Micron Technology May 80 call options for the *long* term") will recall that American Life went by the name of Statesman Group until it was acquired by Conseco Capital Partners II in an LBO ($406 million of debt and $46 million of equity) in September 1994. Conseco, which paid $5 for each of its American Life shares, planned to sell 80% of its ten million shares to the public for $18 per share—a mark-up of 355%—but the offering was withdrawn on October 19 due to, as Dow Jones put it, "unfavorable market conditions." Unfavorable, that is, in the sense that there are *some* limits to the public's appetite for overpriced insurance paper. Conseco's chairman, Stephen Hilbert, a smooth-talking salesman with a knack for twisting generally accepted accounting principles to his advantage, said with a straight face that the deal could have been done at a lower price, "but we were just not going to give this fabulous company away."

Hilbert, without knowing it, hit upon one of the ironies of a bull market. Investors love momentum and want to own securities whose prices have been rising. Since insurance companies have most of their assets in stocks and bonds, when the markets rise, so too does the net worth of insurance companies. This rising net worth is then justification for higher insurance-stock prices. The average insurance stock is up about 30% this year, which means that insurance executives who have stock and stock options are considerably richer than they used to be. The problem, however, is that if the average insurance executive is 30% richer he probably feels 130% smarter, and that may be a dangerous thing. As the old Wall Street adage goes, "Don't confuse a bull market with genius."

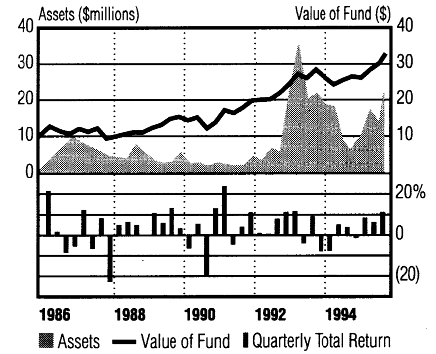
One proxy for insurance stocks is the Fidelity Select Insurance Fund (see graph). Late last year, Chris Davis, who runs the Davis New York Venture Fund and is in insurance stocks for the long haul, noted that with a measly $6 million in assets, Fidelity Select Insurance, the smallest of Fidelity's "select" funds, was a good "contrary indicator." In other words, the fact that it was so out of favor was a sign that insurance stocks were beaten down too far. This year the Select Insurance Fund has outperformed the market, but more significantly, it assets have almost quadrupled. The last time the fund saw such an inflow of new money was in late 1992 and early 1993, right about the time insurance stocks were reaching a top.

Ironically, high insurance-stock prices tend to coincide with a flood of new capital for the industry, which has the effect of increasing competition, which leads to lower insurance rates, which leads to lower insurance-company profits, which leads to lower insurance-stock prices.

Although the insurance industry's capital isn't spread about evenly—some companies

Fidelity Select Insurance Fund

This fund is a microcosm of the insurance business. Note that during "good" times — when the fund has achieved good returns — money pours in. In bad times — when the fund has declined — money leaves.



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have plenty, some don't have enough—there doesn't appear to be an industry-wide capital shortage. On the other hand, many companies have less capital than meets the eye. One potentially misleading trend is the long-term decline in the property/casualty industry's premium-to-surplus ratio, from 2.75 in 1974 to 1.31 in 1994. On the surface, this indicates that insurance companies are writing at more conservative ratios and have untapped capacity. In fact, premium-to-surplus ratios have been skewed by the trends towards greater exposures, higher limits, and high deductible programs. Take, for example, Mr. Pig's Fire & Casualty Insurance Company of the Turks and Caicos Islands, which has $100,000 of surplus. Mr. Pig's only client is *Emerson, Reid's Insurance Observer*, which has a first-dollar casualty program generating an annual premium of $125,000 per year. *Emerson, Reid's Insurance Observer's* annual losses come to about $100,000 (mostly slip-and-falls on the mess in the editor's office). Mr. Pig's, therefore, is writing at a 1.25-to-1 premium-to-surplus ratio. Now suppose that *Emerson, Reid's Insurance Observer* retains the first $100,000 of risk and pays a premium of $25,000 for the excess. It might appear that Mr. Pig's has become very conservative; its premium-to-surplus ratio is just .25-to-1. Its real exposure, however, hasn't changed much. If Mr. Pig's writes five more programs just like the one with a $100,000 retention, it's back to a 1.25-to-1 premium-to-surplus ratio yet is taking five times as much risk as it was originally. If Mr. Pig's pricing is adequate, profits will increase markedly, but suppose that each policy is underpriced by $10,000. In the first instance, Mr. Pig's would have broken even for the year, when factoring in investment income. In the second, with the same premium-to-surplus ratio and the same sort of clientele, Mr. Pig's will lose 40% of its surplus.

Although life insurance company balance sheets also look nicer than they did last year, looks can be misleading. Life insurers, for example, have reduced their holdings in commercial mortgages and real estate from 23% of assets in 1991 to 19% at the present. However, "the industry began this process by selling and securitizing the better-performing properties," noted Moody's recently, "while retaining the weaker real-estate investments." There's the rub: having a higher percentage of your assets in mortgages isn't bad, but having a higher percentage of bad mortgages in your assets is. (As Mae West used to say, "It's not the men in my life, it's the life in my men.")

Although the life insurance industry was once about selling life insurance, these days it is about something else—accumulating assets. A number of life insurers are hawking something known as "leveraged life insurance," which allows investors to use their mutual funds as collateral to borrow money from a life insurance company to—get this!—buy life insurance with no money down. The transaction has something for everyone: the life insurance company gets a new policyholder and charges prime plus three percent on the loan, the agent who sells the policy gets a big commission, and the investor who buys into this gets...well, that's hard to say.

That the life insurance industry pushes too hard every now and then seems to be a recurring theme. Whether it's Primerica's "buy term and invest the difference" hucksters or MetLife representatives marketing something as a Nurses' Guaranteed Retirement Savings Plan (when, in fact, it is really a life-insurance policy) the industry has a tendency to play it close to the edge, perhaps because the life-insurance business has become the investment business. Prudential Securities ("rock solid, market wise"), a division of Prudential Insurance, has shelled out $853 million to recompense investors who were snookered into bum limited-partnership investments sold by the firm. (For more on this, read Kurt Eichenwald's recently published *Serpent on the Rock*. For an earlier Prudential *cause célèbre*, see the box below.)

The life-insurance industry, of course, has always had its idiosyncrasies. In the 1920s it was common practice for the mighty J.P. Morgan & Company to allocate shares of hot stock offerings to certain titans of industry on a virtually risk-free basis. One such titan was Metropolitan Life president Frederick H. Ecker, whose sure-thing-J.P.Morgan stock deals for his own account stood in stark contrast to his misplaced prudence about buying stocks for his company. In 1941, with Metropolitan chastened by the depression, Ecker testified at a New York State Insurance Department hearing that equities had no place in life-insurance company portfolios. "If the stock is sound, the [debt] of that company is more sound." At that time stocks yielded well over 6%, versus 2½% for corporate bonds.

Ecker, of course, was not alone in his fear of the market. Most people felt the way then. But in investing—and insurance underwriting—following the crowd is risky. True, life-insurance companies shouldn't load their portfolios with stocks, but neither should they load up on long-term bonds paying 2½%.

Today, the yield on the Standard & Poor's 500 is a shade over 2%; the yield on SNL Securities' insurance index is a mere 1.06%. Insurance stocks, and the insurance industry, have had a good run since 1990, and that has brought in plenty of money and bred a certain complacency. The softness in casualty rates has been more than offset by the strength of the stock and bond markets.

The insurance industry still faces the same problems it always has: competition, environmental liabilities, interest-rate risk, catastrophes, hostile regulation, and so on. The big difference now is that with the stock market running wild and capital in abundance, these things *seem* less important.

This too shall pass. ■

Pru Scandal Circa 1960

IN 1960, CARROLL SHANKS, who, as Prudential Insurance Company's president, had shaken up and revitalized the business, was forced to resign after the *Wall Street Journal* reported that he'd been involved in a tax shelter that raised troubling questions. Owen Cheatham, Georgia-Pacific's founder and a director of Prudential, had arranged for Shanks, who served on Georgia-Pacific's board, to buy 13,000 acres of timberland for $8.4 million, financed by a one-day loan from the Bank of America (of which Cheatham was also a director). Shanks then turned around and sold the land to Georgia-Pacific for cash and a stream of timber production payments, the net effect of which was that Shanks, without taking any risk, was able to save $400,000 in taxes. This cozy transaction raised conflict-of-interest issues, especially because Georgia-Pacific owed Prudential $65 million at the time.

After leaving Prudential, Shanks became president of Universal Controls, which made tote boards for race tracks. (Journalist Leslie Gould wrote that the difference between Prudential, where Shanks had been for 28 years, and Universal, "was the same as that between a church bingo game and Las Vegas.") One of Universal's large shareholders, as well as former chairman, was Louis "Uncle Lou" Chesler, a 300-pound Canadian wheeler-dealer who'd been active in the formation of General Development, a speculative Florida real-estate developer which was a Prudential borrower. Chesler, who had ties with Meyer Lansky, then partnered up with Wallace Groves, a convicted stock swindler, and got involved in Grand Bahamas Development, which owned a casino and hotel.

A Lesson in Corporate Democracy

Stick it to the Shareholders

by David Schiff

In *Wall Street*, Michael Douglas gave an Academy-Award-winning performance as Gordon Gekko, an odious corporate raider. The film's climactic scene takes place at the annual meeting of a company that he has put in "play." Addressing the shareholders to win their votes, Gekko declares that "greed is good."

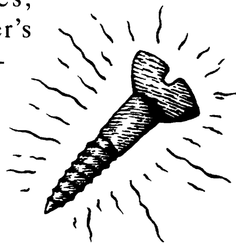
If that's true, then Bernie Kooper, the chairman of Arista Investors Corp.,which owns Arista Insurance Company, is a good man, indeed. (For more on Arista, see "Other People's Money" in our October 1994 issue.)

Although Arista is a small company with only $26 million in premiums and a few hundred thousand dollars of profit in a good year, Kooper, whose "B" shares allow him to elect a majority of the board of directors, runs it as if its prime reason for being is to enrich the Kooper family. Not surprisingly, Arista's shareholders aren't too happy about this. (For the record, I own about 2½% of the company.)

It is often said that if you don't like the way a company is run you can vote with your feet—that is, sell your shares. In a small, publicly held company such as Arista, where the shares tend to trade by appointment, that's not always an option. Despite Arista's sad record—it went public in 1987 at $4 per share and now sells for $2¼ (I bought a bunch of my stock at $1⅜)—and despite the fact that earnings have gone downhill and turned into losses, the company is not without value: it has a solid block of New York State Disability business that a larger company could easily run at a profit. In fact, Arista has had many suitors in recent years, and twice has announced deals to sell the company for about $3.75 a share. The deals fell through for vague reasons, not the least being the $1.54 million contract and golden parachute that Arista recently gave Kooper. (The whole company is worth only $7 million.)

Over the years I've written about the abuses heaped upon shareholders by greedy managements. Because I tend to believe what I write, it struck me that what Arista needed on its board was an outsider who wasn't beholden to Kooper. (The board has included Kooper, his son, his son-in-law, and his insurance-agency partner.) That outsider, I decided, was me.

On October 12, determined to get myself elected to the board, I went to Arista's "annual meeting." (The term is a misnomer, since Arista failed to hold an annual meeting in 1994, and failed to file a proxy statement, as well.) The board of directors sat at a long table at the front of the room. About fifteen shareholders were in the audience. The company's executive vice-president, Stanley Mandel, recited the usual boilerplate, waived the reading of the minutes, went over the ground rules, announced Kooper's hand-picked nominees for the board, and then, rhetorically, asked whether there were any other nominations.



I stood up and nominated myself. Another shareholder seconded me. The directors seemed taken aback, and the company's lawyer, Michael Reiner, asked if I was a shareholder.

"Yes," I replied.

"May I see your proxy?" he requested.

I handed it to him. Reiner and another lawyer left the room and returned a few minutes later. It was then announced that the election of the directors would continue. I asked Reiner to return my proxy, which I had yet to complete.

"You've already handed it in," he informed me.

I walked to the front of the room and explained that I had merely let him look at it, as he had requested.

"We're not giving it back to you," he said. "Please sit down."

"I'm not moving until I get my proxy."

"You've already cast your vote."

"No I haven't."

"It's not a valid proxy, anyway," he said, incorrectly.

"Fine. I don't care *what* it is. It's my piece of paper, not yours. You asked to take a look at it. I gave it to you. Now I want it back."

This inane conversation went on for a couple of minutes, and soon shareholders began shouting for the company to return my proxy.

Reiner stood firm. "This isn't your proxy. It's our proxy, because I have it," he explained, waving my proxy around in front of me.

Possession, apparently, being nine-tenths of the law, I reached down and grabbed a bunch of Reiner's legal folders that were stuffed with documents. "I suppose these are mine now, because I have them."

After a little more arguing, we swapped hostages and I took my seat, wondering if other insurance companies' annual meetings were anything like this. Soon it was my turn to make a speech soliciting shareholders' votes. Reiner warned me that I had two minutes.

I touched on the main issues: Kooper's bleeding of the company, the compliant board that allowed this to happen, the company's poor results, and my own qualifications. (In my spare time I oversee a wholesale insurance brokerage specializing in Arista's main line of business.)

Next came question-and-answer time. Stanley Mandel, Arista's executive vice-president, reviewed the company's miserable record. Then, as politely as possible, I directed questions to Kooper, whose main function at the company consists, to the best of my knowledge, of rolling over certificates of deposit: Why did he get a bonus when the company is losing money? Why does he get $230,000 a year when his contract only calls for 120 days of work? What exactly is it that he does? What do his son and son-in-law do? Why did the board grant a 71-year-old man who does nothing a seven-year contract? What's the outlook for the business? And so on.

Kooper refused to utter a word. Mandel, however, sheepishly told the audience that the board felt that Kooper's compensation was "appropriate."

Finally the election results were announced. Although at least 50% of the votes had been cast in my favor, they were counted for Kooper's slate because they weren't on the proper proxy form. There being no further business, the meeting was adjourned.

Afterwards, Kooper—short, corpulent, an unlit cigar in his mouth—came over to me with an apoplectic look on his face and, in a coarse, gravelly voice finally provided the answer to my questions. "You're a liar and you're full of shit!" he said. "You can print that." ■

Warren Buffett on Insurance
The Maestro in His Own Words

WARREN BUFFET has commented extensively on business, finance, investments, markets, economics, and insurance. His words are invariably described as folksy and homespun, and while it's true that he has an uncanny ability to reduce complex thoughts to their essence, he isn't merely a cracker-barrel Will Rogers of finance or a fortune-telling "Oracle of Omaha."

Buffet's comments are astute, incisive, prescient, and highly entertaining. His wisdom and good sense, conveyed with wit and clarity, form a brilliant philosophy. Most people have read much more *about* Buffet than *by* him. But, in our view, Buffett's writings—when read in their entirety—are more valuable than a business-school education and are certainly more fun. Berkshire Hathaway's 1977-1994 annual reports are available at no charge from the company at 3555 Farnam Street, Suite 1440, Omaha, Nebraska 68131, (402) 346-1400.

The annual reports, however, give only part of the picture. At Berkshire's annual meeting, Buffet and his partner Charlie Munger spend four or five hours answering questions posed by shareholders. Since 1988, *Outstanding Investor Digest* has been publishing edited transcripts of these meetings, as well as volumes of other exciting material. These transcripts are, in a word, enlightening. *Outstanding Investor Digest* can be reached at 500 Greenwich Street, New York, N.Y. 10013, (212) 777-3330.

Examples of Buffet's thoughts about the insurance industry, which follow, are culled primarily from his comments at Berkshire Hathaway's annual shareholders' meetings in Omaha, and secondarily from Berkshire Hathaway's annual reports. Most of these words appeared, in somewhat different form, in *Outstanding Investor Digest,* which has been kind enough to allow us to use some of that material.

1979

It is not easy to buy a good insurance business, but our experience has been that it is easier to buy one than to create one. However, we will continue to try both approaches, since the rewards for success in this field can be exceptional.

1980

You can get a lot of surprises in insurance. Nevertheless, we believe that insurance can be a very good business. It tends to magnify, to an unusual degree, human managerial talent—or the lack of it. We have a number of managers whose talent is both proven and growing. (And, in addition, we have a very large indirect interest in two truly outstanding management groups through our investments in Safeco and GEICO.) Thus we expect to do well in insurance over a period of years. However, the business has the potential for really terrible results in a single specific year.

1981

Our largest non-controlled holding is a 33% interest in GEICO. We purchased our GEICO stock pursuant to special orders of the District of Columbia and New York Insurance Departments, which required that the right to vote the stock be placed with an independent party.

GEICO represents the best of all investment worlds—the coupling of a very important and very hard to duplicate business advantage with an extraordinary management whose skills in operation are matched by skills in capital allocation. [*Editor's note: GEICO is a direct writer of auto insurance for good drivers and has one of the lowest expense ratios in the business.*]

We have written about the disappointments that usually result from purchase and operation of "turnaround" business. Our conclusion is that, with few exceptions, when a management with a reputation for brilliance tackles a business with a reputation for poor fundamental economics, it is the reputation of the business that remains intact.

GEICO may appear to be an exception, having been turned around from the very edge of bankruptcy in 1976. It was certainly true that managerial brilliance was needed for its resuscitation, but it is also true that the fundamental business advantage that GEICO had enjoyed—an advantage that previously had produced staggering success—was still intact.

The GEICO situation—an extraordinary business franchise with a localized excisable cancer (needing, to be sure, a skilled surgeon), should be distinguished from the true "turnaround situation."

The reinsurance industry continues to reflect the excesses and problems of the primary writers. Worse yet, it has the potential for magnifying such excesses. Reinsurance is characterized by extreme ease of entry, large premium payments in advance, and much delayed loss reports and loss payments. Initially, the morning mail brings lots of cash and few claims. This state of affairs can produce a blissful, almost euphoric feeling, akin to that experienced by an innocent upon receipt of his first credit card.

1983

There are indications that several large insurers opted in 1982 for obscure accounting and reserving maneuvers that masked significant deterioration in the underlying businesses. In insurance, as elsewhere, the reaction of weak managements to weak operations is often weak accounting.

1984

We have become recently active—and hope to become much more so—in reinsurance transactions where the buyers' overriding concern should be the seller's long-term creditworthiness. In such transaction our premier financial strength should make us the number one choice of both claimants and insurers who must rely on the reinsurers promises for a great many years to come.

1985

In most businesses, insolvent companies run out of cash. Insurance is different: you can be broke but flush. Since cash comes in at the inception of an insurance policy and losses are paid

much later, insolvent insurers don't run out of cash until long after they have run out of net worth. In fact, these "walking dead" often redouble their efforts to write business, accepting almost any price risk, simply to keep the cash flowing in. These companies hope that somehow they can get lucky on the next batch of business and thereby cover up earlier shortfalls.

Even if they don't get lucky, the penalty to managers is usually no greater for a $100 million shortfall than for one of $10 million; in the meantime, while the losses mount, the managers keep their jobs and perquisites.

At GEICO, as usual, the news is mostly good. In its core business—low-cost auto and homeowners insurance—GEICO has a major sustainable competitive advantage. This is a rare asset in business generally, and it's almost nonexistent in the field of financial services.

1986

We correctly foresaw a flight to quality by many large buyers of insurance and reinsurance who belatedly recognized that a policy is an IOU—and who, in 1985, could not collect on many of their IOUs. These buyers today are attracted to Berkshire because of its strong capital position. But, in a development we did not foresee, we also are finding buyers drawn to us because our ability to insure substantial risks sets us apart from the crowd.

1987

Pricing behavior in the insurance industry continues to be exactly what can be expected in a commodity-type business. Only under shortage conditions are high profits achieved, and such conditions don't last long. When the profit sun begins to shine, long-established insurers shower investors with new shares in order to build capital. In addition, newly-formed insurers rush to sell shares at the advantageous prices available in the new-issue market (prices advantageous, that is, to the insiders promoting the company, but rarely to the new shareholders). These moves guarantee future trouble: capacity soars, competitive juices flow, and prices fade.

When insurance executives belatedly establish proper reserves, they often speak of "reserve strengthening," a term that has a noble ring to it. They almost make it sound as if they are adding extra layers of strength to an already-solid balance sheet. That's not the case: instead the term is a euphemism for what should more properly be called "correction of previous untruths" (albeit non-intentional ones). [*Editor's note: This is especially timely in light of recent "reserve strengthening" by Aetna, Cigna and Firemen's Fund.*]

It's expensive to make mistakes in reserving. We know we'll have some surprises; I've made some mistakes in the past.

[*Editor's note: A shareholder asked Buffet to comment on his "reserving techniques."*] That dignifies it, as if there are some new Greek symbols that I didn't understand in the past. In the insurance business the hangover lasts longer than the party.

The most important ingredient in GEICO's success is rock-bottom operating costs. The difference between GEICO's cost and those of its competitors is a kind of moat that protects a valuable and much-sought-after business castle.

1988

At Berkshire, we work to escape the industry's commodity economics in two ways. First, we differentiate our product by our financial strength, which exceeds that of all others in the industry. Our second method of differentiating ourselves is a total indifference to the volume that we maintain. In 1989, we will be perfectly willing to write five times as much business as we write in 1988—or only one-fifth as much. We hope, of course, that conditions allow us large volume. But we cannot control market prices. If they are unsatisfactory, we will simply do very little business. No other insurer acts with equal restraint.

Three conditions that prevail in insurance, but not in most businesses, allow us our flexibility. First, market share is not an important determinant of profitability. In this business, in contrast to the newspaper or grocery businesses, the economic rule is not survival of the fattest. Second, in many sectors of insurance, including most in which we operate, distribution channels are not proprietary and can be easily entered. Small volume this year does not preclude huge volume next year. Third, idle capacity—which in this industry means people—does not result in intolerable costs. In a way that industries such as printing or steel cannot, we can operate at quarter-speed much of the time and still enjoy long-term prosperity.

GEICO has a wonderful insurance business—much better than ours. They have a low-cost method of distribution, a low-risk book and a very high renewal rate. I'd love to run Berkshire's insurance operations to earn an underwriting profit. We just don't have the franchise that GEICO does. That's one of the main reasons why we decided to buy them. I love to buy businesses that I can't compete with.

I was very fortunate many years ago that GEICO's Lorimar Davidson, who didn't know me at the time, spent four to five hours with me one Saturday afternoon explaining GEICO's advantages. [*Editor's note: Davidson later became GEICO's CEO.*]

Many companies have advantages that are temporary. For example, Berkshire had an advantage when the supply was tight and we had excess capacity. However, GEICO has a permanent marketing and risk selection advantage. Those are the sorts of advantages you want to have—not the temporary ones.

1989

I think it's very difficult to improve the public image of the insurance industry. Explaining the logic of something doesn't necessarily make it very popular.

The present insurance distribution system is not necessarily the most efficient one. The distribution and other frictional expenses under the present system cost nearly 50% of total insurance cost. In other words, they roughly match the amounts actually received by claimants. With $200 billion spent on insurance each year, that's real money.

Frictional costs are the same with newspapers and candy, but people buy these products because they want to rather than because they are forced to. I'm not sure that even if people completely understood the economics and the logic of the insurance situation, that they wouldn't still choose to vote themselves a benefit.

Many insurance managements underestimate their costs for many years. It's not a good thing to have competitors continually underestimating their costs.

Our insurance volume over the next few years is likely to run very low, since business with a reasonable potential for profit will almost certainly be scarce. So be it. At Berkshire, we simply will not write policies at rates that carry the expectation of economic loss: we encounter enough troubles when we expect a gain.

There's nothing magical about a combined ratio of 120, but once you start getting north of 120 it will cause people writing insurance to change their behavior dramatically—sometimes they won't write insurance at any price. And that's often when they should be writing it. But they never quit gradually.

1990

The insurance industry will say it needs higher prices to achieve profitability matching that of the average American business. Of course it does. So does the steel business. But needs and desires have nothing to do with the long-term profitability of industries. Instead, economic fundamentals determine the outcome. Insurance profitability will improve only when virtually all insurers are turning away business *despite* higher prices.

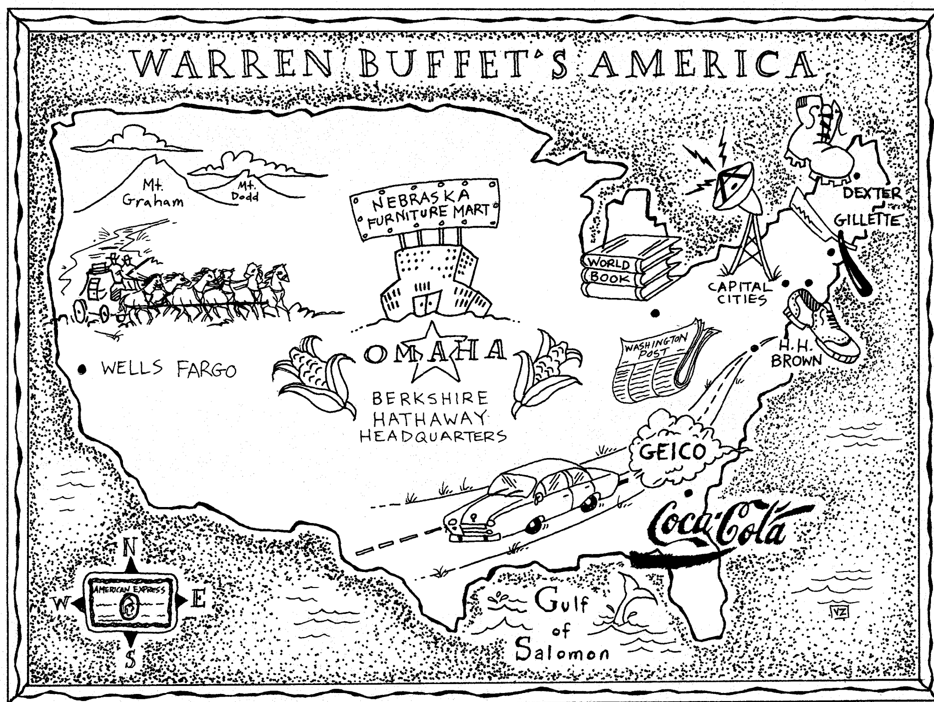
The 1989 disasters created an immediate shortage of much-needed catastrophe coverage. Prices instantly became attractive. Just as instantly, Berkshire Hathaway offered to write up to $250 million of catastrophe coverage.

Our willingness to put such a huge sum on the line for a loss that could occur tomorrow sets us apart from any reinsurer in the world. There are, of course, companies that can sometimes write $250 million or even far more of catastrophe coverage. But they do so only when they can, in turn, reinsure a large percentage of the business. When they can't lay off in size, they disappear from the market.

Berkshire's policy, conversely, is to retain the business we write rather than lay it off. When rates carry an expectation of profit, we want to assume as much risk as is prudent. In our case that's a lot.

We will accept more reinsurance risk for our own account because of two factors (1) we have a net worth of about $6 billion, and (2) we simply don't care what earnings we report quarterly, or even annually, just so long as the decisions leading to those earnings (or losses) are reached intelligently.

This posture is one few insurance managements will assume. Typically, they are willing to write scads of business on terms that almost guarantee them mediocre returns on equity. But they don't want to expose themselves to an embarrassing single quarter loss, even if the managerial strategy that causes the loss promises, over time, to produce superior results. I can understand that thinking: what is best for their owners is not necessarily best for the managers. Fortunately, Charlie [*Charles Munger, Berkshire's Vice-Chairman*] and I have both total job security and financial interests that are identical with those of our shareholders. We are willing to *look* foolish as long as we don't feel we have *acted* foolishly.



1991

The source of the intrinsic value of our insurance business is its ability to generate funds at a low cost.

We think there is significant potential in it. In terms of dollars, we think that it's bigger than that of our other directly owned businesses. We also think it's the hardest one to figure out. It's much easier for us to sit down and make guesses about the next five or ten years for our candy business than it is for our insurance business.

There's no question that the present system for monitoring the solvency of insurance companies has a great many defects. And you'd think that a better system could be designed. Whether it comes about through state or federal regulation, I don't care. The present system really doesn't catch companies until so much damage has been done that you get a very, very bad result. Of course, the insurance business generally has solvency funds so that the policyholder doesn't get hurt, but all the solvent companies contribute to make up the cost of the insolvency. That's particularly true in property/casualty—a little more so than in life insurance.

Periodically, Charlie and I have seen major companies where, if they had a 20-foot neon sign flashing "Fraud!" it couldn't have been any clearer. And the regulators don't do much about it. And sometimes the investment bankers cooperate in raising more money for them.

Insurance is susceptible to both fraud and megalomania. You literally hand somebody a piece of paper and he hands you a lot of money. And that has a certain appeal. So something better is needed. So far, the rating agencies have not been particularly alert watchdogs. *Continued*

Results will improve only when most insurance managements become so fearful that they run from business, even though it can be written at much higher prices than now exist. At some point these managements will indeed get the message.

The most important thing to do when you find yourself in a hole is to stop digging. But so far that point hasn't gotten across. Insurance managers continue to dig—sullenly but vigorously.

The picture would change quickly if a major physical or financial catastrophe were to occur. Absent such a shock, one to two years will likely pass before underwriting losses become large enough to raise management fear to a level that would spur major price increases.

When that moment arrives, Berkshire will be ready, both financially and psychologically, to write huge amounts of business. In the meantime, our insurance volume continues to be small but satisfactory.

Because the need for these buyers to collect on such a policy will only arise at times of extreme stress—perhaps even chaos—they seek financially strong sellers. And here we have a major competitive advantage. In the industry, our strength is unmatched.

Note that we are not spreading risk as insurers typically do—we are concentrating it. Therefore, our yearly combined ratio on our catastrophe reinsurance business will almost never fall in the industry range of 100 to 120, but will instead be close to either zero or 300.

Most insurers are financially unable to tolerate such swings. And if they have the ability to do so, they often lack the desire. They may back away, for example, because they write gobs of primary property insurance that would deliver them dismal results at the very time they would be experiencing major losses on super-cat reinsurance. In addition, most corporate managements believe that their shareholders dislike volatility in results.

We can take a different tack: Our business in primary property insurance is small and we believe that Berkshire's shareholders, if properly informed, can handle unusual volatility in profits so long as the swings carry with them the prospect of superior long-term results. (Charlie and I always have preferred a lumpy 15% return to a smooth 12%.)

"Float" is the funds of others that insurers, in the conduct of their business, temporarily hold. Because these funds are available to be invested, the typical property-casualty insurer can absorb losses and expenses that exceed premiums by 7% to 11% and still be able to break even on its business. Again this calculation excludes the earnings the insurer realizes on net worth—that is, on the funds provided by shareholders.

However, many exceptions to this 7% to 11% range exist. For example, insurance covering losses to crops from hail damage produces virtually no float at all. Premiums on this kind of business are paid to the insurer just prior to the time hailstorms are a threat, and if a farmer sustains a loss he will be paid almost immediately. Thus, a combined ratio of 100 for crop hail insurance produces no profit for the insurer.

At the other extreme, malpractice insurance covering the potential liabilities of doctors, lawyers and accountants produces a very high amount of float compared to annual premium volume. The float materializes because claims are often brought long after the alleged wrongdoing takes place and because their payment may be still further delayed by lengthy litigation.

In long-tail situations a combined ratio of 115 (or even more) can prove profitable, since earnings produced by the float will exceed the 15% by which claims and expenses overrun premiums. The catch, though, is that "long-tail" means exactly that. Liability business written in a given year and presumed at first to have produced a combined ratio of 115 may eventually smack the insurer with 200, 300 or worse when the years have rolled by and all claims have finally been settled.

The pitfalls of this business mandate an operating principle that too often is ignored: though certain long-tail lines may prove profitable at combined ratios of 110 or 115, insurers will invariably find it unprofitable to price using those ratios as targets.

Instead, prices must provide a healthy margin of safety against the societal trends that are forever springing expensive surprises on the insurance industry. Setting a target of 100 can itself result in heavy losses. Aiming for 110 to 115 is business suicide.

All of that said, what should the measure of an insurer's profitability be? Analysts and managers customarily look to the combined ratio—and it's true that this yardstick usually is a good indicator of where a company ranks in profitability. We believe a better measure, however, to be a comparison of underwriting loss to float developed.

This loss/float ratio, like any statistic used in evaluating insurance results, is meaningless over short time periods. Quarterly underwriting figures and even annual ones are too heavily based on estimates to be much good. But when the ratio takes in a period of years, it gives a rough indication of the cost of funds generated by insurance operations. A low cost of funds signifies a good business; a high cost translates into a poor business.

During 1990 we held about $1.6 billion of float slated eventually to find its way into the hands of others. The underwriting loss we sustained during the year was $27 million. Thus our insur-

The Value of 'Float'

Float = (Loss and loss-adjustment expense reserves + Unearned premium reserves) – (Agents' balances + Prepaid acquisition costs + Deferred charges applicable to assumed reinsurance)

Year	Underwriting Loss*	Average Float*	Cost of Funds	Yield on Long-Term Treasurys
1967	profit	$17.3	<0%	5.50%
1968	profit	19.9	<0	5.90
1969	profit	23.4	<0	6.79
1970	$.037	32.4	1.14	6.25
1971	profit	52.5	<0	5.81
1972	profit	69.5	<0	5.82
1973	profit	73.3	<0	7.27
1974	7.36	79.1	9.30	8.13
1975	11.35	87.6	12.96	8.03
1976	profit	102.6	<0	7.30
1977	profit	139.0	<0	7.97
1978	profit	190.4	<0	8.93
1979	profit	227.3	<0	10.08
1980	profit	237.0	<0	11.94
1981	profit	228.4	<0	13.61
1982	21.56	220.6	9.77	10.64
1983	33.87	231.3	14.64	11.84
1984	48.06	253.2	18.98	11.58
1985	44.23	390.2	11.34	9.34
1986	55.84	797.5	7.00	7.60
1987	55.43	1,266.7	4.38	8.95
1988	11.08	1,497.7	0.74	9.00
1989	24.40	1,541.3	1.58	7.97
1990	26.65	1,615.9	1.65	8.24
1991	119.59	1,895.0	6.31	7.40
1992	108.96	2,290.4	4.76	7.39
1993	profit	2,624.7	<0	6.35
1994	profit	3,056.6	<0	7.88

* In millions. <0=less than zero.

ance operation produced funds for us at a cost of about 1.6%.

As the table [*on page 8*] shows, we managed, in some years, to underwrite at a profit, and in those instances our cost of funds was less than zero. In other years, such as 1984, we paid a very high price for float. In 19 years out of the 24 we have been in insurance, though, we have developed funds at a cost below that paid by the government. [*Editor's note: The record is now 23 out of 28 years.*]

There are two important qualifications to this calculation. First, the fat lady has yet to gargle, let alone sing, and we won't know our true 1967-1990 cost of funds until all losses from this period have been settled many decades from now.

Second, the value of the float to shareholders is somewhat undercut by the fact that they must put up their own funds to support the insurance operation and are subject to double taxation on the investment income these funds earn. Direct investments would be more tax efficient.

Figuring a cost of funds for an insurance business allows anyone analyzing it to determine whether the operation has a positive or negative value for shareholders. If this cost (including the tax penalty) is higher than that applying to alternative sources of funds, the value is negative. If the cost is lower, the value is positive—and if the cost is significantly lower, the insurance business qualifies as a very valuable asset.

So far Berkshire has fallen into the significantly lower camp. Even more dramatic are the numbers at GEICO, in which our ownership interest is now 48% and which customarily operates at an underwriting profit. GEICO's growth has generated an ever-larger amount of funds for investment that have an effective cost of considerably less than zero.

Essentially, GEICO's policyholders, in aggregate, pay the company interest on the float rather than the other way around. (But handsome is as handsome does: GEICO's unusual profitability results from its extraordinary operating efficiency and its careful classification of risks, a package that in turn allows rock-bottom prices for policyholders.)

Many well-known insurance companies, on the other hand, incur an underwriting loss/float cost that, combined with the tax penalty, produces negative results for owners. In addition, these companies, like all others in the industry, are vulnerable to catastrophic losses that could exceed their reinsurance protection and take their cost of float right off the chart.

Unless these companies can materially improve their underwriting performance—and history indicates that is an almost impossible task—their shareholders will experience results similar to those borne by the owners of a bank that pays a higher rate of interest on deposits than it receives on loans.

"In the insurance business there is no statute of limitations on stupidity."

All in all, the insurance business has treated us very well. We have expanded our float at a cost that on the average is reasonable, and we have further prospered because we have earned good returns on these low-cost funds.

A particularly encouraging point about our record is that it was achieved despite some colossal mistakes made by me prior to Mike Goldberg's arrival. [*Editor's note: Goldberg runs Berkshire's insurance operations.*] Insurance offers a host of opportunities for error, and when opportunity knocked, too often I answered. Many years later, the bills keep arriving. In the insurance business, there is no statute of limitations on stupidity.

1992

Berkshire continues to be a very large writer—perhaps the largest in the world—of "super-cat" insurance. [*Editor's note: "Super-cats" are huge catastrophes.*] We price this business expecting to pay out, over the long term, about 90% of the premiums we receive. In any given year, however, we are likely to appear either enormously profitable or enormously unprofitable. That is true in part because GAAP accounting does not allow us to set up reserves in the catastrophe-free years for losses that are certain to be experienced in other years. In effect, a one-year accounting cycle is ill suited to the nature of this business—and that is a reality you should be aware of when you assess our annual results.

Berkshire writes an unusually low volume of insurance business compared to the net worth of the insurance companies. Companies often write at a 2-to-1 ratio of premium volume relative to surplus and it's thought that they can go up to 3-to-1, depending on the lines of business.

Berkshire, as you know, writes at a tiny fraction of that. [*Editor's note: In 1994, Berkshire's premium-to-surplus ratio was .075-to-1.*] In large part, that's because we have not been able to grow the insurance business at a rate that's proportional to the gain in net worth.

I would doubt, starting from where we are, that we will be able to do so, although we'd love to. We have loads of capacity to write a lot of business, and we will use it in the next hard market when prices are better. [*Editor's note: Buffet's partner, Charlie Munger, pointed out that this excess capacity can be thought of as "untapped earning power," but that it may also be "untapped losing power."*]

Between now and then, we don't care how much insurance business we write in a year. We have no volume goals, because volume goals in insurance can and will be met if discipline in pricing is ignored. Our Insurance Group could write $1 billion or $3 billion dollars' worth of insurance this year. All we have to do is quote silly prices. It's a terrible mistake, in our view, to set any sort of premium goals.

Nevertheless, there will come a time when our volume will jump dramatically. Still, we will never get to a premium-to-net-worth relationship that is normal for the industry. That's because of the kind of net worth that we employ in the business.

Our unique net-worth position lets us do some kinds of business right now that other companies wouldn't want to take—for example, our super-catastrophe business, which is protection against huge catastrophes. Very few companies in the world would be prepared to write that business on the scale that we do. We can do it because of our really huge net worth.

In theory, any business we can do where there are only a couple of competitors in the world is likely to be more profitable.

Will our insurance business ever get to a point in the future where it's profitable simply from an underwriting standpoint excluding the contribution from the investment income? I doubt it. I think it's very unlikely because we now have, and

are likely to continue to have, a significant portion of our business generated from contracts where the calculated investment income is a very important part of the product. Other than for our investment related products, I think we'll see periods of pure underwriting profit.

But I don't make a great distinction in my own mind about how we make the money. If we generate funds for investment appreciably below the cost of borrowing that the U.S. Treasury incurs, that's as good a way to make money as any. We have no preference for making it by pure underwriting profit. We would much rather write business that generates a lot of float for us at 102 (which means a 2% underwriting loss) than write business at 98 (which means a 2% underwriting profit) that generates no investment income.

If our insurance business were constituted as it was 10 to 15 years ago, when virtually all of the business came from what you might call "relatively normal" insurance sources, then I would say we would have periods of pure underwriting profit from time to time. But with our present mix and the direction it's been going—tilting the mix of business very substantially toward products which generate a lot of funds—it's unlikely.

Float is, in effect, the net money that we are holding that eventually will go to other people, but of which we have temporary possession. We had a float business, for example, in our trading stamp business—people buy trading stamps ahead of the time that they cash them in. In our insurance business—in recent years particularly—we've emphasized products that generate unusual amounts of float. We probably have as large an amount of float compared to our premium volume as virtually any property and casualty company that there is—and that's intentional.

So, growth in float can be viewed as a plus—subject always to the reservation that if we do something dumb enough, in either underwriting or investing, we can negate the value of float for us. In effect, increasing float acts as a substitute for borrowed money, to some degree. We crank it into our heads in terms of determining how much leverage we want to have. But we have no plans at all to issue any public debt at present. We now think it's more attractive to generate the same money through float. It's our desire to build float significantly. I think you'll see float up significantly this year.

If you could see our float for the next 20 years and you could make an estimate as to the amount and the cost of it, and you took the difference between its cost and the returns available on government bonds, you could discount it back to a net present value. It's not an easy calculation to make. And it's not something you could do precisely.

Insurance float has certain characteristics of debt, but not the worst ones. (But even counting debt and float, we have an awful lot of capital.) It's a way of using other people's money—as is debt. It probably poses less risk in most respects. When it's accurately stated, it poses very little risk. What you have to worry about is miscalculating how much you owe at any given time.

If you look at the record of the property/casualty insurance industry and recast their liabilities as they've found them to be in retrospect, a significant number of the major insurance companies in the U.S. would have been insolvent at one year-end or another in the last 20 years. That's not because they were intentionally misreporting. It's just that nobody understood the extent of the environmental and asbestos problems. And they probably don't yet.

We regard our float as a very significant asset. We've always said that about our insurance business. In the last five years, the potential of the insurance business, even though we're in a lousy period generally, is better than ever.

In the super-cat business, which we're very active in, we're one of the largest in the world. (Much of our business in big lines is now done outside the U.S.) There's no question that conditions—particularly violent conditions—can change in some ways. And conditions relating to technology and all aspects of human behavior can make the future a lot different than the past.

We think about those things. We try to price with a margin of safety. But we can't be sure. And that, of course, is part of the reason why people buy insurance from us. It's a business that is not subject to

looking up in some table how many people aged 80 to 89 died in a particular year. It's not actuarial.

The variety of things that could cause your guess to be off is wider than either my imagination or Charlie's. And therefore, you have to crank in a fair amount for events that have not previously occurred. It's just the nature of the business.

We think it's a decent business when prices are right. And if prices change—and they probably will if we get a couple of catastrophes—we want to be there.

The insurance business is a fiduciary business. You get access to other people's money under conditions where in many cases the other people have very little knowledge or control of where the money's going. So you need a cop.

We basically believe in the cop being very alert and quite tough—because businesses that generate investable float money from other people tend to attract both foolish optimists and crooks.

1993

Hurricane Andrew awakened some larger insurance companies to the fact that their reinsurance protection against catastrophes was far from adequate.

Currently, Berkshire is second in the U.S. property/casualty industry in net worth (the leader being State Farm, which neither buys nor sells reinsurance). Therefore, we have the capacity to assume risk on a scale that interests virtually no other company. We have the appetite as well: As Berkshire's net worth and earnings grow, our willingness to write business increases also. But, let me add, that means good business. We will stay a major factor in the super-cat business so long as prices are appropriate.

What constitutes an appropriate price, of course, is difficult to determine. Catastrophe insurers can't simply extrapolate the past.

When you start talking about a $50 billion or $60 billion catastrophe—and major companies in this business only have a couple of billion dollars of net worth—Berkshire has a significant advantage in being able to sustain significant losses. We should be able to get the appropriate premium. And we're more likely to get it the fewer competitors that we have.

I'm not sure what Lloyd's total capital is, but I don't think that they have as much capital in aggregate as we do—and most of theirs is psychological, whereas ours is real. I don't see any great response they have that will make them far more competitive with Berkshire over time. The world is groping for a new reinsurance concept now. There are a number of companies that have written business where if they get some bad luck—and it has to be really bad luck, but that can happen—they won't be around anymore. They need reinsurance to take care of that. And they need it on a scale that's hard to find.

"There will continue to be a lot of irrational capacity in this business."

Of course, most people who go into the reinsurance business end up doing some very dumb things with their money. Just because you stick the word "reinsurance" in your name, all that guarantees you is that you'll get a lot of dumb propositions offered to you—dumb for you. It does nothing else for you at all. There's been a lot of irrational capacity in this business over the years and there will continue to be.

It should be a good business for us over time. The problem is that you don't know for ten years—because events are so infrequent. If you're insuring automobiles and you reserve accurately, you know within a relatively short time if you're charging the right premium or not. In our business—where in most years we'll be profitable, but occasionally we'll lose very large amounts of money—it's hard to know until ten or twenty years go by whether you're charging the right rates.

Our super-cat business is certainly a high volatility business. We think that we're charging rates that will prove to be remunerative if we stay in it over the long term, but there's no book you can look it up in to be sure. It is really a question of judgment—whatever that word means. And with something that is highly volatile and very infrequent, there is no way even at the end of ten years to know for sure whether you were charging the right price. So you'd better have a huge surplus relative to what you're writing.

What's been interesting so far is how little change has taken place in some elements of the reinsurance market. The reaction so far to Hurricane Andrew—everybody wishes he had less coastal business or close-to-coastal business from Florida to possibly as far north as Long Island—but there's really been no significant change in the overall insurance business. Everybody still feels as if he has plenty of capital, and wants to keep writing business. You won't get a major change until people flee the business. And so far, that's not happening.

We write a lot of super long-tail business. The structured settlement business is probably the longest-tail business that you can find. We like float at the right price, and we've designed our business to reflect that preference. There are certainly some opportunities in the structured settlement business. Some of those payments may go on for 50 or 60 years. And some of them step up over the years to compensate for inflation. We don't tie them to an inflation index, but we may write them so that they step up 3% a year. We won't take the chance of trying to guess the inflation rate.

But when you think about these contracts, you're talking about the wherewithal for medical care and income for somebody who one way or another has been impaired— sometimes very severely—for the rest of life. Often minors are involved. So the company buying the policy, as well as the person representing the injured person, should be terribly interested in selecting an insurer whose financial condition is absolutely unquestioned now and will be unquestioned for decades to come. And we are a particularly logical insurer for that sort of business.

A few years back, there were some really second-rate companies in the business. That business has become much more rational now because people do insist on quality insurers. We've written that business in a property/casualty company, but some people wish to have it written in a life insurance company. Therefore we're setting up a life insurance company that will write the business. It may write other kinds of business, too. But that will be the primary focus initially.

Continued

1994

Only by making an analysis that incorporates both underwriting results and the current risk-free earnings obtainable from float can one evaluate the true economics of the business that a property/casualty insurer writes. The table showing our cost of float and the trend in the amount of our float over the years would tend to point you in the direction of concluding that our insurance business does have a very significant excess of intrinsic value over its carrying value.

For example, last year, when we actually had an underwriting profit, the value of that float was something over $200 million. Last year was unusually favorable. But that's a very significant stream of earnings. And it's one that we feel has very favorable prospects. So we feel very good about the insurance business.

We could pay out $600 or $700 million in a worst case super-cat. Our total premiums this year might be $250 million—or something in that area. So one super-cat in the wrong place—and there could be more than one—could produce a $400 million or thereabouts underwriting loss in that business.

A Class 5 hurricane on Long Island would leave a lot of very big insurance companies in significant trouble. We confine our losses. For example, $700 million sounds like a lot of money. And it is. But we have limits on our policies. That isn't true of people writing basic homeowners or business policies. Their losses could go off the chart.

It's a business we like to write because there are very few companies who can afford to write it at the level that the underlying companies who require reinsurance need it. We're in a position, if the rates are right, to do significant business. Normally, our policies don't kick in now until an event gets up to at least $5 billion or so of insured damage. (One indication of our premier strength is that each of the four largest reinsurance companies in the world buys very significant reinsurance coverage from Berkshire.)

The difference between our reinsurance business and many other outfits, although not all, is essentially the difference that may exist between our operations in securities and those of others. We will offer reinsurance at any time in very large quantities at prices that we think make sense, but we won't do business if we don't think they make sense. Similarly, we'll buy securities to the extent of the cash we have available if we think they make sense, but we have no interest in being in the stock market *per se* just to be in it.

I think most managements, if the only business they're in is the reinsurance business, may like it better when prices make sense. But I think they'll be prone to do quite a bit of business when prices don't make sense, as well, because there's no alternative except to give the money back to the owners. And that's not something most managements do somersaults over.

"You don't find out who's been swimming naked until the tide goes out."

So I think we are in a favored position: essentially having the flexibility of capital allocation that lets us take the lack of business with a certain equanimity that most managements probably can't because they have a sole focus on the business.

Rates will get silly, in all likelihood, after a period when nothing much happens—when insurers have had a couple years of good experience. But we price to what we think is exposure. We don't price to experience. And the fact that there was no big hurricane last year has nothing to do with rates next year.

Everyone says they price to exposure, but the market tends to price and respond to experience—generally to recent experience. That's why so many retrocessional operations in London went bust. I'd argue, they priced to experience rather than to exposure. It's very hard to be there year after year with business coming by, and not do that. But we'll never knowingly do it any more than we will accept stock market norms as the proper way for us to invest money in equities. Basically, when you lay out money or accept insurance risks, you really do have to think for yourself. You cannot let the market think for you.

Bermuda is simply a new competitor. Actually, they're not all that new. There have been companies in Bermuda before. But in the last 15 to 18 months there's been maybe $4+ billion raised.

Essentially there's no great difference between that type of competition and other reinsurer competition except for the fact that that capacity is new and the money has just been raised, so there may be some greater pressure on the managers of those businesses to go out and write business promptly than there is on somebody who's been around for 50 years.

It's no plus for us when capacity enters *any* business we're in. And that certainly goes for reinsurance. The reinsurance business, by its nature, will be a business in which some very stupid things are done *en masse* periodically. You can be doing dumb things and not know it in reinsurance and all of a sudden wake up and find that the money is gone. You don't find out who's been swimming naked until the tide goes out. Essentially, that's what happens in reinsurance. You don't find out who's been swimming naked until the wind blows.

1995

Berkshire has a special advantage in the super-cat business. Because of our towering financial strength we can write policies for amounts that no one else would even consider. At Berkshire, we will quote prices for coverage as great as $500 million on the same day we are asked to bid.

By writing coverages in large lumps, we obviously expose Berkshire to lumpy financial results. That's totally acceptable to us: too often, insurers (as well as other businesses) follow sub-optimum strategies in order to "smooth" their reported earnings. By accepting the prospect of volatility, we expect to earn higher long-term returns than we would by pursuing predictability.

Given the risks we accept, we constantly focus on our worst case. It is now about $600 million after tax, an amount that would slightly exceed Berkshire's annual earnings from other sources. If you are not comfortable with this level of exposure, the time to sell your Berkshire stock is now, not after the inevitable mega-catastrophe.

There is an ease of entry into the catastrophe business. And it's been really

attractive for promoters—because if you start an insurance company to write earthquake insurance in California and you raise a few hundred million dollars, you'll either have essentially no losses or, if you write enough of it, you'll go broke. And most years, you'll have no losses.

So if your intention is to sell your stock publicly in a year or two, the odds are very good that you will have a beautiful record for a couple of years—and you can sell. Maybe one time out of ten, you'll go broke. Nine times out of ten, you'll sell to someone else who'll eventually go broke.

The only thing that may restrict the ease of entry is if the buyer is sophisticated enough to question the viability of that company under really extreme conditions—which is the only condition that counts when you're buying catastrophic insurance.

The second thing, of course, is that none of the people who started up can offer anywhere near the amount of coverage we can. Berkshire is really one of a kind in terms of its capital strength in the business. No one in Bermuda that I can remember has even a billion dollars of net worth.

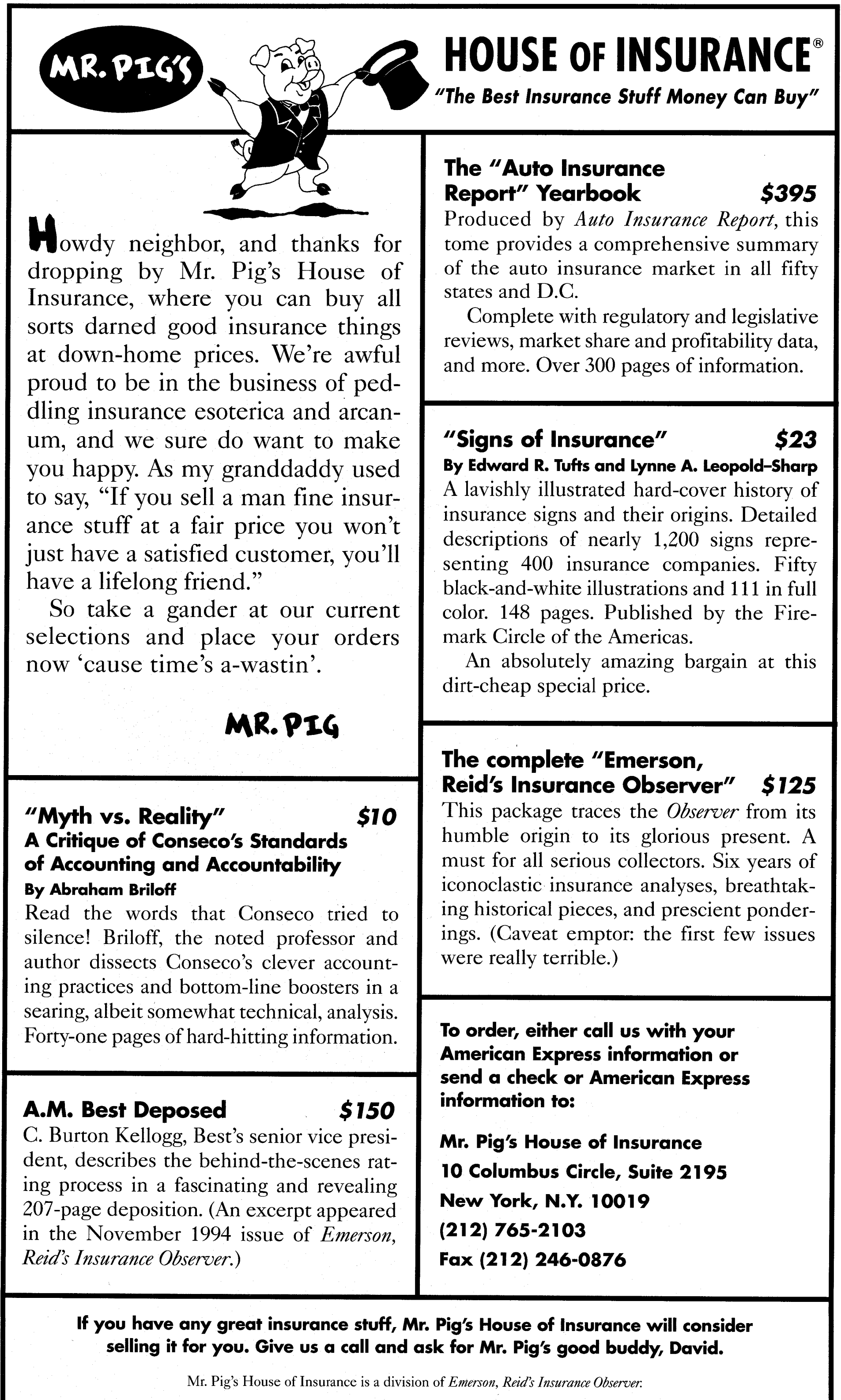
We have very close to $13 billion of net worth and considerably more of value. So we can sustain shocks—and will sustain shocks—that others can't. And we try to get paid appropriately for that.

But when we say we can take a billion-dollar loss, we can. And we will have a billion-dollar loss at some point. And anyone buying insurance should know we can take it, or something greater. And they should know that very few of our competitors can.

There are certain companies that are exposing themselves to losses that would wipe them out, but they prefer not to buy reinsurance because it's "expensive." But what they're really doing is betting that something that won't happen very often will not happen at all.

If you take a huge hurricane on Long Island or a major earthquake out in California, there are a number of companies that have not positioned themselves to withstand those losses. If you're a 63-year old CEO and you figure that you're going to retire in a couple years, the odds are pretty good that it won't happen on your watch. But it will happen on somebody's watch.

How much flexibility do we have investing that float? The answer is that we have a lot of flexibility. We're not disadvantaged by that money being in float as opposed to equity really in any significant way. If we had a very limited amount of equity and a very large amount of float, we'd impose a lot of restrictions on ourselves because we'd want to be sure we're in a position to distribute it, in effect, to policyholders or claimants or whomever it might be at the time it was appropriate. However, we have so much net worth that, in effect, float is just about as useful to us as equity—and that means quite useful. It's a big asset. ■



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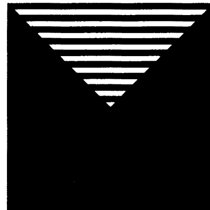

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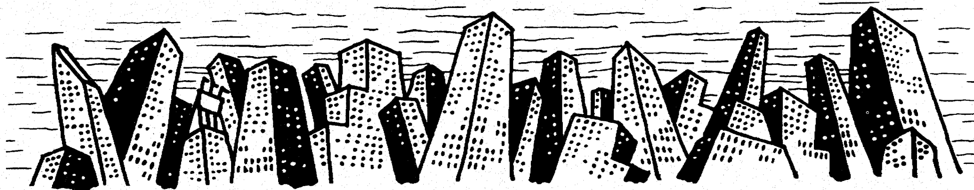

The Soft Sell

SAVAGE ON SELLING: Secrets From an Insurance Great, by the late John Savage, a life member of the Million Dollar Round Table, advocates a low-key approach to salesmanship. Savage, apparently, was not one for the cold call; referrals were his game. At a first meeting with a prospect, Savage had two rules: "be a good listener" and "never press for a sale." When asked what he did for a living, Savage would say, "I help people manage their money."

Of course, there's no law that says a life-insurance salesman can't call himself a "money manager," just as there's no law preventing a garbageman from calling himself a "sanitation engineer" or a stockbroker from calling himself a "financial planner."

Call us old-fashioned, but selling insurance by pretending that you're doing something else just doesn't seem right.

The Hard Sell

THOMAS A. SKIFF, the president of AMEX Insurance Company, a subsidiary of American Express, is not a practitioner of John Savage's sales methods. We recently received a mass-mailed letter from Mr. Skiff that seems intended to scare us into buying his company's Long Term Care Plan to "help protect [our] retirement assets from ruin." The letter read:

> I think you have a right to be concerned by what I am about to tell you. An estimated 40% of all elderly will spend some time in a nursing home. The cost is high...Yet our great nation has no system to provide for the skyrocketing cost of nursing home or in-home care...And Medicaid won't pay a cent until virtually all your finances have been wiped out. In fact, about *50% of all couples are impoverished* just one year after a spouse is admitted to a nursing home.
>
> Fortunately, this doesn't have to happen to you. We've made a commitment to solve this crisis with a valuable insurance plan...This flexibility will help *you stay in your own home* as long as possible...
>
> *Alzheimer's disease is covered...*
>
> Complete details about the benefits, costs, limitations and exclusions of this valuable Insurance Plan will be provided to you by an AMEX representative. There is *absolutely no cost or obligation* for this service.
>
> P.S. Don't let the overwhelming costs of long-term care destroy your retirement assets, your freedom, and your dignity...

Although AMEX's doomsday approach to selling long-term care insurance isn't exactly a breath of fresh air, at least it's straightforward. On the other hand, for a salesman who has to spend his life hawking insurance, this gloomy, depressing sales technique is something of a bummer.

It's not surprising that many prefer the cheery "I help people manage their money" approach.

'Career of a Lifetime'

WHILE WE'RE NOT ASHAMED to admit that some of our best friends are insurance agents, we would be remiss if we didn't also say that these agents are given to a fair amount of grumbling about the insurance market, insurance companies, insurance regulators, insurance buyers, and the vicissitudes of the insurance-agency business.

This has not prevented the National Alliance for Insurance Education & Research from putting out a leaflet extolling the virtues of being an independent insurance agent, going so far as calling it "the career of a lifetime."

According to the National Alliance, "perhaps no other business plays a more vital role in underpinning the national economy than the insurance business." Not only do agents gain "financial security," but their job is more "challenging" and "rewarding" than that of the underwriter, actuary, claims person, or adjuster.

Independent agents also have great freedom in the decision-making process, notes the leaflet. They are "unencumbered" by boards of directors and the "counterproductive efforts of corporate bureaucracy."

"Forget the unfortunate stereotype of the hard-sell solicitor who shows up on an unsuspecting person's doorstep at dinner time," says the National Alliance, working itself up into a froth in before venturing into fantasyland. "The successful independent insurance agent maintains a level of business sophistication as great as that of any major company CEO."

The leaflet observes that "without insurance, the nation's extensive commercial and consumer credit system would surely collapse, and millions of American home, auto, and business owners would be left at risk of financial devastation." While there is truth to those words, it is also true that without farmers we would starve, without plumbers we would soon find our homes uninhabitable, and without bus drivers we would spend most of our day walking to and from work.

If it sounds as if we're being a tad hard on the National Alliance, we apologize. After all, at least it never claimed that insurance agents help people manage their money.

The Annals of Bureaucracy

ON APRIL 28, 1995, the New York Insurance Department issued a bold pronouncement: "Department to review insurance company catastrophe modeling: models are being used to drop homeowners customers in shoreline communities." The press release went on to say that the superintendent of Insurance, Edward J. Muhl (who, by the way, is appointed rather than elected) had undertaken an "intensive review," to be completed in 30 to 60 days, of catastrophe-related computer models and their underlying technology.

It seems that Muhl was "skeptical" about the "methodology" used. Implied in Muhl's statements was that the insurance industry is up to no good with its models.

One need not be a superintendent of insurance to know that there are generally two reasons why an insurance company would cancel or non-renew blocks of business: either rates are too low or the exposure is too great. If insurance companies' models are inaccurate, it is not because the companies *want* them to be, but that catastrophe modeling is inherently imprecise.

Mr. Muhl, as befits an insurance regulator, is filled with concerns, among them "the wide disparity in the computer models currently being used by insurance companies." On the other hand, if all insurance companies were using the same model, wouldn't that also be cause for concern?

When we called the insurance department on October 9 to find out how its review was coming along, we were told that it wouldn't be finished for a while. Said a spokesman, "It's more complicated than originally thought to be."

Perhaps what he meant to say was that the insurance department is making it more complicated than it is.

David Schiff, the editor and writer of "Emerson, Reid's Insurance Observer," ponders the insurance scene.

Instead of doing something productive, like selling waxed fruit, David Schiff, the curmudgeonly editor and writer of *Emerson, Reid's Insurance Observer*, has chosen to wile away his time chronicling the madness of the insurance crowd.

Why insurance, you ask? To that same question Haverhill replied (in what was to become known as "Haverhill's reply"), "Why not insurance?"

Insurance, you see, is just like any other business—only worse. It combines the tedious drudgery of banking with the mindless travail of the assembly line. If it were possible to get repetitive-stress syndrome of the cerebrum, one would, undoubtedly, get it from the insurance profession.

It is against this dismal background that Schiff, a spirited iconoclast with plenty of time on his hands, has chosen to ply his trade at a scrappy little newsletter that hopes someday to turn a profit.

Of course, *Emerson, Reid's Insurance Observer* isn't for everyone. Those who don't have the time for cutting-edge analyses, the stomach for groundbreaking exposés, the guts for hard-hitting commentary, or the sense of humor for seething irreverence, are better off not subscribing.

All others should send in their money.

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