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Sitting on Top of the World

Red Hot Insurance Hokum

When the playwright George S. Kaufman lost a bundle in the market, he said he felt he deserved it—after all, what did he expect buying stock on a tip from the Marx Brothers? Based on how insurance companies are embracing New Age corporate finance—divesting "bad" businesses, acquiring "good" ones, repurchasing shares at high prices, and "refocusing" on "core competencies"—one might think that they're taking their lead from that unreleased Marx Brothers' film, *A Night at the Investment Banker's*.

Our hypothesis is that insurance companies are suffering from a surfeit of prosperity: 15 fat years in stocks and bonds have muddled their judgment. While we don't prophesize biblical equilibrium—that the fat years will be followed by as many lean—we do know that good times are bewitching. Hoary Wall Streeters who have actually lived through a bear market love to invoke the maxim "Don't confuse a bull market with genius" to new generations of callow gunslingers. The words, however, never sink in, and now insurance executives, flush with stock-option money, are taking on a risk that is, by definition, uninsurable: management advice from 27-year-old mutual-fund managers.

Prudential employees file documents related to insurance-fraud litigation.

Despite insurers' apparent optimism, we think a downturn is on the horizon. When profits (whether from underwriting or investment) bolster the industry's balance sheet, insurance companies scramble for new business by cutting rates. (The good news is that rates can't go below zero.) Rate-cutting generally produces losses. (It hasn't yet in personal auto, which accounts for 40% of industry premiums. Claims have fallen faster than rates.) Losses deplete capital, which drives out the weaker players and sets the stage for an upswing.

Although insurance is a state-by-state, territory-by-territory business, following the flow of money in the industry gives one a sense of where we are in the cycle. By our reckoning that stage can be summed up in a word: late.

In 1981, when the Dow Jones Industrials averaged 933 and 10-year Treasurys yielded 14%, the property/casualty industry's "adjusted" surplus (marking investments to market and factoring in reserve deficiencies) was about $20 billion. Written premiums were $100 billion, or five times surplus. Then, as now, the industry invested three quarters of its assets in bonds. These bonds, which had an average maturity of 14 years (versus nine years today) were worth $30 billion less than their carrying value.

Continued

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Since 1981—which admittedly was a bottom—the industry's adjusted surplus has grown at an 18.5% annual rate, to $260 billion. Written premiums, by comparison, have grown at a 7.1% rate, to $280 billion. In the last two years surplus has grown 35.4%. Premiums have grown 7.3%.

At the Joint Industry Forum three months ago, Chubb's chief honcho, Dean O'Hare, said that "the industry is grossly overcapitalized, even though it is underreserved by $100 billion." Catching the scent of that excess capital, Wall Street is persuading insurance CEOs to do something about it. "These days the pressure for securities' performance is so great that companies can't sit with cash," says Bill Berkley, chairman of W. R. Berkley. "Wall Street's view is that you have to buy back stock. Their argument is that 'you can always raise money when you need it.'"

Berkley, who is one of the industry's more astute managers of capital, knows that's not the case. When his company's stock has been high he has issued *more* stock. When it has been cheap (less than 125% of book value) he has bought back shares.

Savvy specialty underwriter Markel Corporation also knows that nobody loves you when you're down and out. In January it issued $150 million of 8.71% junior subordinated debentures that mature in 2046. Although it had no use for the money, Markel rightly felt that the terms were very attractive. "Somehow it is always easier to raise capital when you don't need it," says Steve Markel, who believes that he will "find a sound use for the funds in the not-too-distant future."

O'Hare, it seems, is not expecting such a find. Although Chubb is an excellent company with top financial ratings, it doesn't want its balance sheet to be *too* good. (Tell that to Berkshire Hathaway.) "We have an obligation," says O'Hare, "to maximize the value of our shareholders' investment. This means ensuring that we are adequately capitalized, not over-adequately capitalized."

In February Chubb put its real-estate business on the block and announced the sale of its life-insurance business, for $875 million. Then, with its stock near 60 (an all-time high and up 50% from last summer) Chubb's board authorized the repurchase of 17.5 million shares, 10% of the total outstanding. Why, at historically high levels—14 times earnings and almost twice book—did Chubb get religion? The company, after all, hadn't repurchased many shares when the price was lower. During the previous three years Chubb bought back 3.7 million shares at an average price of $41.89. However, it "sold" 6 million shares (in the form of employee stock options) at an average price of $44.33.

Does it build shareholder value to buy back stock at a price way above book? We're skeptical. If the industry is overcapitalized, won't margins be pressured and earnings lowered? The demand for insurance, after all, is relatively stable. It's the supply that generally fluctuates.

Supply-and-demand imbalance notwithstanding, dozens of insurers, from ACE to Zurich, have been loading up on their own shares. So, too, has reinsurance broker E.W. Blanch Holdings. In 1994, 17 months after going public at a net price of $17.37 per share, it bought $9.5 million of stock from retiring president Michael Cashman at $19.88 per share. In October 1995 it bought another $7.8 million from him at 17 5/8. Although Blanch's stock chart has been flat for years, the company didn't buy back more shares until this February, when it snagged a block of 750,000 at $19.40 per share. The seller was none other than Edgar W. Blanch, the company's chairman and CEO.

Not all companies repurchase stock to *increase* shareholder value. FBL Financial Group, for example, bought in 965,370 shares last month from its Farm Bureau-member companies. The price paid was $25.73 a share, which was $9.46 higher than the net price received in the company's IPO eight months earlier. Why did FBL pay up? Its answer would delight the Marx Brothers: "To alleviate downward pressure on the stock [if] large blocks [were sold] in the open market."

Although stock buybacks at high prices imply that business is great, word from the field suggests otherwise, especially in the commercial markets. Guy Carpenter, for example, reported that the average rate on line for property catastrophe reinsurance has fallen 17% and is near the pre-Hurricane-Andrew level. As rates have come down, however, capacity has gone up, from $150 million in 1993 to $600 million or so today.

At a recent breakfast meeting, AIG's executive vice president Evan Greenberg told a small group of New York brokers that price cutting was a worldwide trend: rates were off 50% in Hong Kong, 35% in South America, and 50% on certain classes in the UK. Shaking his head in frustration, he commented on insurance companies' inability to earn a decent return on their capital. "If a stock company can't utilize its capital, it should return it to its shareholders." (He didn't say that buying back stock at high prices was the best way to accomplish this.) Noting the inadequate rates charged by his competitors, he said that "many stock companies are behaving like mutuals—they're returning capital to their policyholders."

At the Joint Industry Forum, Greenberg's father, insurance-legend Hank, told property/casualty industry leaders that "globally there are some companies that give earthquake [coverage] away for nothing!" That thought almost made him wince. "No insurance company," he noted tersely, "should take infinite risk with finite capital."

Yet it seems they can't help themselves. Herbert Haag, chairman of PartnerRe, a monoline Bermuda property-catastrophe insurer, said that "market conditions make it imprudent to expand our business." Regarding the takeovers of Cologne Re, National Re, Frankona Re, Aachner Re, American Re, and Mercantile & General Re, he said, "The only real surprise was

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the very high price the acquiring reinsurers were willing to pay...In terms of economics, these transactions can appear to have an accretive effect for shareholders if the 'goodwill' is amortized over a period of 20 to 30 years, or written off immediately against the existing equity. However, for the acquiring reinsurers to achieve a meaningful return on the investments, the acquired companies will have to produce greater annual profits than in the past."

That was way back in November. In March, PartnerRe announced the acquisition of Societé Anonyme Française de Réassurances (SAFR), a multi-line reinsurer. The price, $950 million, was 12 times earnings and $130% of book value. Although PartnerRe had been a staunch proponent of the mono-line catastrophe-reinsurance concept, adverse market conditions and an abundance of capital apparently changed its mind.

In the primary market, the pricing of risk sometimes seems irrational. Granted, the evidence is usually anecdotal. Still, when you hear the same tale from several sources in different parts of the country, there's often something to it. For example, Ralph Hatch of Hatch Agency in Minnetonka told us that Liberty Mutual was writing heavy-duty long-haul truck insurance with a vengeance. In his market (Minnesota) the going price for a $1 million CSL liability policy was $3,200 to $3,800 per truck, which has produced a combined loss ratio somewhere between 98% and 110%. Liberty, Hatch claims, has been writing the same business for prices as low as $1,500 to $1,800 per unit."It defies explanation why they'd leave so much money on the table," he says. "It seems like they don't have a clue as to what the rest of the world is charging for a truck. If you had a gas station on one corner charging $1.50 a gallon, why would the gas station on the other corner charge 75¢? I'm just waiting for the red ink to start running."

Mike Birge, vice president and manager of Redland Insurance Company's transportation division, agrees that Liberty has been wreaking havoc in the market. "We've lost every account over 100 power units, and most over 50."

Redland has made an underwriting profit every year—except last year. "There were six players when we started in 1990. Now there are probably 50." Birge says the stronger economy has produced "a real driver shortage. Trucking companies are hiring less qualified drivers." One need not be an actuary to suspect that might increase risk. "A lot of these standard-lines companies really don't know what they've gotten themselves into, but there's not much we can do about it other than sit back and try not to participate too much. Our strategy is to remain visible and be positioned if the market changes. But I'm starting to get a little pessimistic about when that's going to happen."

Liberty Mutual had no comment on the matter, but Brian Sullivan, editor of *Auto Insurance Report*, one of our favorite insurance publications, pointed out that commercial auto experience has been excellent and companies are making a lot of money. "There have been doomsayers for the last four years," he says, noting that last year he was one of them. "Eventually they'll be right, but so far the losses haven't come to pass."

Wait till next year.

One attraction of financial businesses such as insurance is that the product is money. Paradoxically, it's tough to make a buck in the money business—everyone wants to be in it. Management, therefore, is particularly important. Fortunately, insurance companies have a cutting-edge arsenal of new tools and concepts at their disposal. *InformationWeek* reported that "insurers, saddled with big mainframe legacy systems and an increasingly fast-paced business environment, are taking a hard look at their *core competencies* and finding ways to lop off whole departments full of clerks, administrators, and associated technology. 'This is cutting edge,' says Steve Cook, senior VP of finance at TIG Insurance."

TIG is not the only one pondering its "core competencies." When Lincoln National Reassurance opened an office in Singapore, only 1,500 miles from its nearest office (in Manila), a senior executive admitted that the market was complex, but expressed confidence anyway. "It's our belief that the core competencies of Lincoln National Re can be utilized to add value to the vibrant insurance markets of the region."

Like so many others these days, New York Life's chairman, Seymour Sternberg, prefers to "stick to his knitting." He told Dow Jones that he's wary of "blurring our core competencies" by expanding further into financial services.

When Allstate sold its reinsurance operations and Northbrook Insurance last year, chairman Jerry D. Choate had a good explanation. He said both units were "good businesses, but didn't fit us longer term. Our core competencies are auto, homeowners and life."

Anthem, which fired 35 people after getting out of the workers' comp market in California, also had a good explanation. "We want to concentrate on our core competencies."

Finally, Saul Steinberg, Reliance's chairman and a master at the black art of asset shuffling and wheeling-and-dealing, told shareholders last year that Reliance had "sharpened its operational focus by divesting non-core businesses."

What does all this mean?

Scott McIntyre, chairman of United Fire & Casualty, a fine company in Cedar Rapids, has some words of wisdom. "Companies have fallen all over each other trying to recast themselves as niche players with a 'core competence' in health care, substandard auto, reinsurance, or what have you, apparently forgetting what has been one of the basic justifications for multi-line underwriting and a foundation of the insurance business—spread of risk."

Words to live by. ■

Welcome to *Schiff's*

As you have undoubtedly noticed, *Emerson, Reid's Insurance Observer* has changed its name to *Schiff's Insurance Observer*. This change was made after much serious consideration and many late-night, strategic planning sessions. We think the new moniker will increase value for our shareholders, although our value is so low to begin with that it has no place to go but up, anyway.

During the course of our strategic-planning sessions we also came to a sobering realization: we have no core competencies. As a result, you can rest assured that *Schiff's Insurance Observer* is not "new and improved," (which *Consumer Reports* defines as "more expensive"). We're the same old rag, published by the same old bunch of misfits.

ISO Gets Religion, Then It Converts

Stock Deal Creates Windfall for Employees

On November 18, 1996, Insurance Services Office, Inc., a non-stock, non-profit corporation better known as ISO, announced that 73% of its members (all of which are insurance companies) had voted to approve ISO's conversion to a for-profit stock corporation as of January 1, 1997.

"ISO's conversion puts the company at the threshold of a new era," declared Fred Marcon, chairman, president, and CEO. "We will have the long-term financial flexibility and access to capital needed to develop and support new products in a more technology- and capital-intensive business environment."

Marcon neglected to mention that ISO, an insurance rating and advisory organization, was already awash in cash and had no imminent need for capital. Nor did he mention that the conversion had been opposed by William Berkley of W. R. Berkley, Hank Greenberg of AIG, Carl Lindner III of American Financial, and David Mathis of Kemper. In a memo written three days earlier, these big hitters (who represented a 6.45% interest in ISO) had urged members to vote against the conversion on the grounds that it "did not optimize the value for existing members." To put it another way, the conversion, as proposed, was a windfall for two constituencies: ISO's senior management, who stood to receive stock worth about $25 million, and ISO's Employee Stock Option Plan, which would get about $50 million in stock. This windfall was to come at the expense of ISO's members. Concomitant with the Berkley-Greenberg memo was some behind-the-scenes maneuvering to thwart the conversion plan, followed by some last-minute modifications by ISO's Board to appease the dissidents.

The entire episode—which has not been reported until now—raises troubling questions about ISO's governance. Whose interests were best served by the conversion, and why did insurance companies allow it to happen?

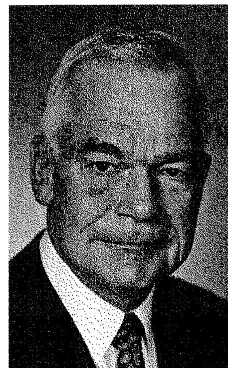
It is true that corporations generally serve many masters (shareholders, customers, employees, community). A weakness inherent in the non-profit structure is the absence of any "owners." As a result, management tends to assume greater power than it might otherwise have, which can leave the members disenfranchised. In ISO's case, the employees were able to carve out a chunk of the company for themselves.

Of course this couldn't have occurred unless two-thirds of ISO's members had voted for the plan. That they did—even though $75 million or so was removed from their pockets—is a testament to the members' neglect and calls into question how often insurance companies truly know what they're doing with their money. Granted, some viewed ISO as small potatoes. But it's not *that* small. Travelers, which apparently voted for the plan, owned a 5.54% stake worth $30 million. Many insurance companies that owned far less didn't read the disclosure statement, relying instead on the directors' recommendation that they vote for the plan. (Eight percent of the eligible votes didn't bother to return their proxies.)

Although ISO has long operated under the not-for-profit cloak, it is, in fact, a moneymaker whose customers include almost every property/casualty insurance company in the U.S. Among the services it provides are prospective loss-cost information, standardized forms, manuals, underwriting rules filed with state regulators, underwriting and rating surveys, and specialized research studies.

ISO, which has 2,086 employees (including 600 in the field who determine specific loss costs for the 2.2 million properties in the company's database), "enjoys a dominant position in the market for its core products," according to the company's disclosure statement.

ISO's 1995 revenues were $216 million; its profits were $24.4 million. (As a "non-profit" it paid no taxes.) Business was even better in 1996. For the six months ending June 30 (the most recent financial information available) revenues increased 5% but operating profits surged 50%, to $14.7 million. The company's balance sheet is more than pristine, with $126.6 million of cash and marketable securities in the till.


ISO's CEO, Fred Marcon

ISO's roots can be traced back to July 1866, when 75 leading stock companies formed the National Board of Fire Underwriters. Their goal: establishing uniform rates, commissions, and policy forms, thereby eliminating the brutal competition that engulfed the industry every few years. The concept was eminently sensible. In practice, however, price fixing—and, put simply, that's what it was (member insurers were obliged to use the Board's rates)—was all but impossible to enforce. Then, as now, insurance companies gained business by lowering prices.

In *Paul v. Virginia*, a landmark 1869 decision, the Supreme Court ruled that insurance was not interstate commerce and, therefore, was not subject to federal regulation. In the age of the steel rail and the iron horse, the Court's dictum was logical. "[Insurance] policies are simple contracts of indemnity," wrote Chief Justice Stephen J. Field. "They are not commodities to be shipped or forwarded from one state to another...They are local transactions governed by local law." The significance of *Paul* was confirmed 21 years later with the passage of federal antitrust legislation—from which the insurance industry was exempted.

Although the National Board of Fire Underwriters never really succeeded in its goal of fixing prices for any prolonged period, it was not for lack of trying. Much of the industry embraced the cartel concept in *theory*, but the forces of the marketplace were such that complete adherence to bureau rates and policy forms was a long-term impossibility.

In the last third of the 19th century, hundreds of regional rating bureaus were established. "To enforce their edicts," writes William H. A. Carr in *Perils Named and Unnamed: The Dramatic Story of the Insurance Company of North America* (McGraw-Hill, 1967) "the controlling bodies were authorized to examine the books of [insurance] companies and agencies. Every policy that was written had to be

submitted to 'stamping offices,' which put their seal of approval on the documents if they conformed to rate and coverage restrictions....The stamping offices later were called 'inspection bureaus,' an innocuous label that concealed their true function."

In 1896 the Bureau of Liability Insurance Statistics was formed. Later known as the Insurance Rating Board, it was a direct predecessor to ISO. (In 1971 it joined with Multi-Line Insurance Rating Bureau, National Insurance Actuarial and Statistical Association, Insurance Data Processing Center, and Fire Insurance Research and Actuarial Association, to form Insurance Services Office.)

Rating bureaus provided the insurance industry with valuable information that was often ignored. An example was the 1906 earthquake in San Francisco, which caused the demise of twenty of the 243 insurance companies writing business there. Although the quake was devastating, most of the $400 million in damage resulted from the ensuing fire, which was exacerbated by broken water mains. All told, 28,188 buildings in 522 city blocks were destroyed in the inferno. San Francisco's vulnerability should have come as no surprise to insurance companies. The congested city was "unmanageable from a fire-fighting standpoint," stated a report issued by the National Board of Fire Underwriters eight months earlier. "San Francisco has violated all underwriting traditions and precedents by not burning up; that it has done so is largely due to the vigilance of the fire department, which cannot be relied upon indefinitely to stave off the inevitable."

In 1942, when the property/casualty industry was enjoying its tenth year in a row of underwriting profits, the Justice Department charged the Southeastern Underwriters Association with antitrust violations. (Southeastern was an Atlanta rating bureau owned by 200 stock fire-insurance companies that, collectively, controlled 90% of the fire insurance in six southern states.) The matter went to the Supreme Court in 1944, which held this time around that insurance was interstate commerce subject to federal antitrust law. Rather than allow the industry to be thrown into disarray, Congress responded by passing the McCarran-Ferguson Act which, in essence, preserved state regulation.

By the late 1940s most of the states had passed "All-Industry laws," which helped entrench the bureaus by requiring prior approval of rates, rules, and forms. This spurred the formation of the National Association of Independent Insurers, which championed the cause—not very successfully—of "open competition" favored by State Farm and Allstate. By the 1960s the trend had reversed, with most states adopting some form of open competition.

When ISO was formed in 1971, its charter specifically *prohibited* any requirement that insurers adhere to its advisory rates or policy language. Furthermore, insurers were allowed to pick and choose among ISO services; they were not required to buy them all. By 1982 ISO's stance had shifted from promulgating "advisory rates" to issuing "advisory prospective loss costs."

In 1988 ISO became the subject of major antitrust litigation that ultimately set the stage for the company's present incarnation. The litigation was settled with insurance companies relinquishing control of ISO's board and transferring complete decision-making authority on all rate-related matters to ISO's staff. By 1994 the insurance companies' official influence was whittled down further, to just three of the eleven seats of ISO's board of directors.

ISO's management, however, saw the need for further change. In December 1995 the Board adopted a new corporate mission and strategic direction. In 1996 it began considering alternative structures such as converting to a for-profit, recapitalizing with private equity or through a public offering, recapitalizing without any outside equity, or making a cash distribution.

The Board set about identifying issues that would be important to members and "prioritizing" these issues on a "high," "medium," or "low" basis. Issues that were considered to be of "high" concern to members were product continuity, customer satisfaction, and attracting and retaining management. Cost efficiency, financial leverage, and influence over ISO were considered to be of "medium" importance. The euphemistic term "value realization," was considered to be of "relatively low importance."

To figure out a plan of action the board spoke with former ISO chairmen and with the company's financial advisor, Lehman Brothers, which was paid $1.5 million for its advice.

Along the way the Board concluded the obvious—that ISO "had no immediate needs for new capital." It also concluded, surprisingly, that "as a non-profit organization ISO has difficulty attracting and retaining key personnel." (Almost every

ISO's Largest Members

Company	Votes	%
Travelers	9,001,854	5.54
CNA	7,119,570	4.38
Hartford	5,976,015	3.68
Allianz/Fireman's	5,315,271	3.27
Zurich	4,596,432	2.83
St. Paul	4,411,683	2.72
AIG	3,892,325	2.40
Royal	3,813,495	2.35
General Accident	3,416,069	2.10
USF+G	3,394,977	2.09
Liberty Mutual	3,286,186	2.02
Cigna	3,245,354	2.00
Nationwide	3,207,441	1.98
Lincoln National	3,189,563	1.96
United Services	3,154,723	1.94
Farmers	3,079,865	1.90
Allstate	3,039,045	1.87
Kemper	2,697,602	1.66
Crum & Forster	2,675,279	1.65
Hanover	2,501,005	1.54
Chubb	2,442,173	1.50
American Financial	2,406,884	1.48
Commercial Union	2,109,372	1.30
Reliance	2,066,774	1.27
Winterthur Swiss	1,986,492	1.22
Ohio Casualty	1,986,406	1.22
Cincinnati	1,952,268	1.20
TIG	1,936,538	1.19
Atlantic Mutual	1,752,007	1.08
Orion	1,573,120	0.97
Safeco	1,517,611	0.93
EMC	1,515,586	0.93
Vik Brothers	1,501,001	0.92
Federated	1,485,194	0.91
W R Berkley	1,477,671	0.91
Motors Insurance	1,466,747	0.90
Tokio Marine	1,428,520	0.88
Old Republic	1,418,605	0.87
Amerisure	1,413,221	0.87
Total		**70.48**

one of ISO's 11 senior executives has spent his entire career there or at one of its predecessors. Fred Marcon, for example, started with the Cook County Inspection Bureau in 1959. Michael Fusco, the chief operating officer, went to work at the Insurance Rating Board in 1970. Carole Banfield, the executive vice president, began with the National Bureau of Casualty Underwriters in 1962. And so on.)

On July 29, 1996, ISO's Board authorized the company's *management*, working with Lehman Brothers and Chadbourne & Parke LLP, to come up with a conversion plan without any outside investors. Since management was given control of the project it should not be surprising that it came up with a plan that was beneficial to itself. After all, it had already been decided that the members weren't too concerned about "value realization."

Under the proposed plan, ISO's insurance-company members were to receive 10,000,000 Class B shares representing an 85% economic interest in the company. These Class B shares would be second-class citizens in the sense that they would elect only three of the eleven directors. (The Class A shares, which would be given to management and employees, would elect seven directors. ISO's chief executive would receive one seat.)

Members of ISO's senior management fared much better. They would receive loans (half of which would be non-recourse) allowing them to buy 147,100 Class A shares at $25 per share. In addition, they would get 441,400 Class A shares pursuant to "restricted stock-award" plan. Thus, senior management would own 588,500 shares representing a 5% interest in the company. In addition, an Employee Stock Ownership Plan (ESOP) would receive 1,176,500 shares, or 10%.

Insurance Services Office: **Big Growth in Earnings**

$000	1993	1994	1995	6 months ending 6/30/95	6 months ending 6/30/96
Participation fees, survey services etc.	$203,770	$206,434	$216,197	$106,898	$112,586
Interest and dividends	1,306	2,387	4,747	2,251	2,504
Other	16,328	14,463	16,191	7,673	7,251
Total Revenues	221,404	223,284	237,135	116,822	122,341
Salaries	141,485	140,303	146,009	74,062	74,385
Rent etc.	30,391	30,829	31,394	14,908	14,184
Other	41,068	35,856	35,336	17,862	19,080
Total Expenses*	212,944	206,988	212,739	106,832	107,649
Profit	$8,460	$16,296	$24,396	$9,990	$14,692

* Excluding restructuring charges

Especially galling to some dissidents was the ridiculously low valuation ($25 per share, or $250 million) accorded to ISO. ISO is a cash cow: it has no inventory, gets paid up-front, and has modest capital-spending requirements. Its pretax operating profit was $24 million and its balance sheet included $35.4 million in cash, $23.4 million in Treasurys, $42 million in stock funds, and $25.7 million in bond funds. ISO could have paid a $100-million dividend and still have had plenty of cash left over. At $25 per share the operating business was being valued at a paltry $150 million—less than ten times after-tax earnings—an unusually low price for an information business that earns a 50% return on equity and enjoys a "dominant position." Assuming that ISO can raise margins slightly, it doesn't seem like a stretch to project after-tax earnings exceeding $20 million. Considering ISO's stable characteristics and attractive economics, a valuation for the business of 20 to 25 times earnings—$400- to $500-million (about three times what Lehman said was "fair") seems possible, especially in a frothy bull market.

The Insurance Broker at Work

ISO's board of directors met on September 19, discussed the plan, and heard Lehman Brothers tell them that $25 per share "was fair to the *company* from a financial point of view." (Lehman Brothers *did not* opine that the plan was fair to, or good for, the *members*.) The board then unanimously approved the conversion. In doing so it set the stage for a $75 million transfer of wealth to Fred Marcon and the employees.

On September 25 a "disclosure statement" was mailed to members in connection with a November 18 special meeting at which members would vote on the plan. The disclosure statement provided information about ISO's financials, its history, and its plans. A copy of the Lehman Brothers fairness opinion was included, as was a copy of the company's by-laws.

The disclosure statement did not, however, disclose many things that one would ordinarily consider material. For example, no mention was made of Fred Marcon's salary (in excess of $1 million) or that of any other employee. Also left undisclosed

In the Money: Insurance Services Office

Assets	$000 June 30, 1996
Cash & Securities	$126,606
Current Assets	13,783
Other	27,368
Total Assets	167,757
Liabilities	
Accounts Payable	27,650
Fees received in advance	39,982
Other	2,371
Total Current Liabilities	70,003
Other Liabilities	24,010
Total Liabilties	94,013
Equity	$73,744

were the number of restricted shares and stock options that would be granted to specific individuals and directors, and what Marcon and senior executives would receive under the ESOP. (Because of the unusually low valuation, these options would be especially valuable.)

There is, of course, nothing wrong with giving Fred Marcon and the officers and directors lots of money, but ISO's members should have been made aware that this was the intent of the plan. There is also nothing wrong with offering employees a chance to participate in a company's future growth. It is quite another thing, however, to structure an "incentive" in such a manner that employees are conferred an immediate windfall because the options were at a price far below market value.

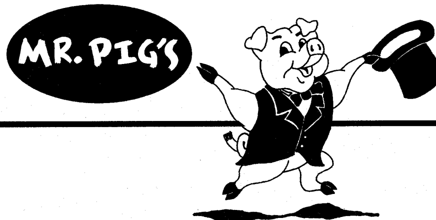
Dave Otswold, ISO's vice president of corporate communications, has a perspective that differs from ours. "I think the board believed that creating employee ownership was in the best interest of this company, or they wouldn't have done it," he told us. "I'm not besmirching the opposition's motives, but there were various reasons why some members opposed the plan." He explained that ISO's members have evolved in differing ways, and so have the services that they would like to receive from ISO. In earlier years, for example, the pricing of ISO's products was based on premiums, but no one wanted to subsidize someone else's product development, so the company switched to a unit pricing scheme where each company paid for what it bought.

"In order to respond to members' concerns," Otswold said, "[the pricing of the options] was sweetened to $40 per share" and the ESOP's price was changed to $29 per share. The number of shares granted to management was also reduced, to 2.5%.

Despite these changes, which were modest, the conversion plan garnered only 73% of members' votes, barely exceeding the $66\frac{2}{3}$% needed for passage.

One person familiar with the voting told us that some of the larger companies that might have opposed the plan were nervous about doing so because they were dependent on ISO's information and didn't want to incur its wrath.

Whatever the case, ISO is now a for-profit corporation. Over time its mission will undoubtedly evolve—from servicing its members to maximizing profit. Don't be surprised to see a public offering in the future. After all, if there wasn't going to be a market for the stock, why become a for-profit stock company? ■



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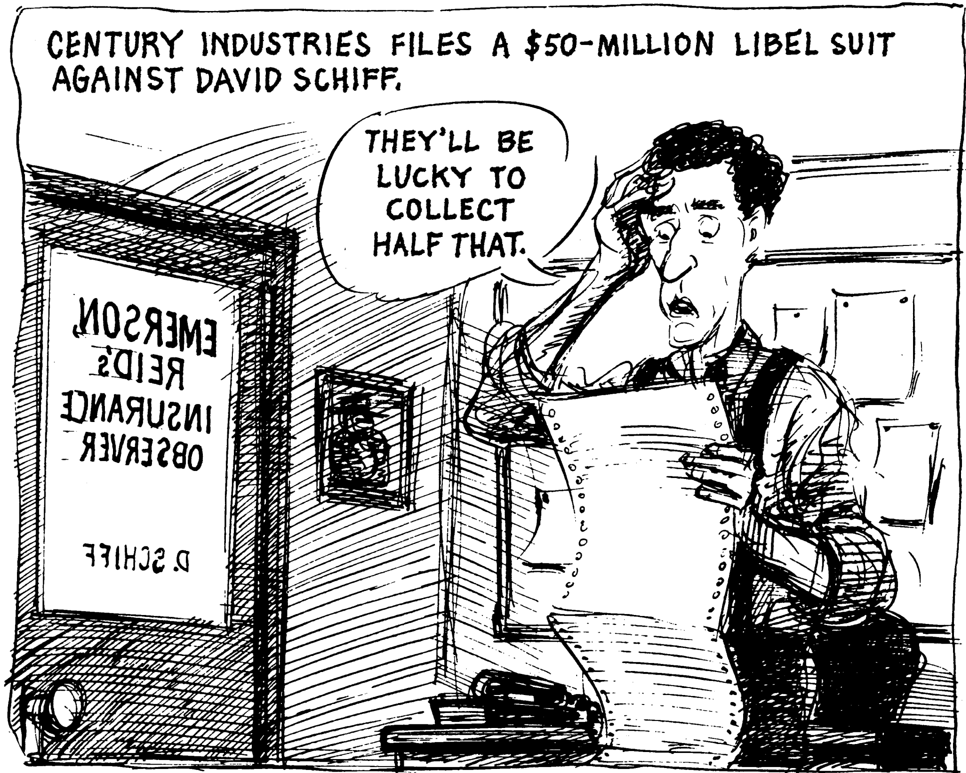
Century Drops Lawsuit Against Muckraker

Libel, Iranian Assassins

by David Schiff



In September 1996 *Emerson, Reid's Insurance Observer* and I became the defendants in an unusual lawsuit filed by Century Industries, a penny-stock company that I had written about ("The Boys in The Back Room," *Emerson, Reid's Insurance Observer*, July 1996). The plaintiffs were: 1) Century Industries, a small public company; 2) U.S. Insurance Brokers, a subsidiary of Century; 3) Century Steel Products, a subsidiary of Century ; 4) Richard Campanaro, Century's chairman; 5) Theodore Schwartzbeck, Century's CEO and largest shareholder; and 6) Robert J. Flynn, Jr., a lawyer who has represented Century. The plaintiffs apparently did not agree with my characterization of their company as being engaged in unusual accounting practices, questionable financial transactions, and dubious projections. Their response: a legal action seeking about $50 million in damages for libel, disparagement, and interference. Fifty million dollars, by the way, is about $50 million more than Century's earnings from operations during 1993-1995. (It's also a tad more than my net worth.)

Far more absurd than the money, however, were Century's statements in their "request for admissions" that—I kid you not—I was an Iranian agent named Iraj Ertefai who had acted as a front for assassins in the employ of Ayatollah Khomeni, that I had written a libelous article "because of a homosexual lovers' quarrel" with a former partner, and that this "partner" had filed "a palimony suit relating to [my] common residence with him at 10 Columbus Circle."

These preposterous propostions—which had no relevance to the article about Century in any event—didn't even make sense. Ten Columbus Circle, for example, is not my residence or anybody else's; it's the 26-story office building where I work. My former associate—who was never my "partner"—is married and has a child. And as for me, well, its hard enough getting a date on Saturday night *without* someone calling me a gay Iranian hit man.

It's an unpleasant fact of the muckraking business that every now and then some peckerhead will sue you for writing the truth. For example, Circle Fine Art, a publicly held chain of art galleries that peddled schlocky limited-editions, sued me *five* times over a *Barron's* article I wrote criticizing its finances and wares. The suits were all dismissed and Circle is now bankrupt and in liquidation.

Others who disliked my writing chose to bypass the legal system entirely. In a harangue laced with expletives, Steven Hoffenberg, the chairman of Towers Financial, recited my home address and told me that I'd better watch out if I knew what was good for me. (Hoffenberg's business, ostensibly, was collecting bad debts.) I wrote the article anyway. Towers was a colossal fraud—several hundred million dollars disappeared—and the crooked Mr. Hoffenberg is now in jail.

Although Century's lawsuit was of the off-the-wall variety, I had to take it seriously. My lawyer, Laura Handman, a partner at Lankenau Kovner Kurtz & Outten, got on top of the situation and quickly put in lots of hours. This was, of course, expensive (no one ever said that free speech is cheap) but Laura did a fine job, as did her associate, Greg Welch. With these two at my side I felt like Muhammad Ali stepping into the ring against Willie Shoemaker. Shortly after we filed a motion in Federal court seeking sanctions against Century et al. for their outrageous conduct, the plaintiffs agreed to drop their lawsuit, and one of them, attorney Robert J. Flynn, Jr., issued a formal apology (see below).

I didn't pay the plaintiffs a cent nor did I retract one word of my article. In fact, I'm still proceeding with my motion for sanctions. I did agree to publish a "letter to the editor" from Century's chairman, Richard Campanaro. That letter, and my response to it, are on the next page.

To the Editor:

I am an attorney and was also a plaintiff in a lawsuit filed against *Emerson, Reid's Insurance Observer* and David Schiff regarding an article entitled "The Boys in the Back Room: U. S. Insurance Brokers' Curious Cast of Characters." During the course of that suit, we made several discovery requests regarding Mr. Schiff that implied facts both unfair and untrue. We regret the sought discovery including, among others, that Mr. Schiff was involved with Iranian terrorists, that he had a homosexual relationship with his former business partner, and that his former business partner had filed a palimony suit against him. I acknowledge that all these implica-

tions are completely false. I apologize to Mr. Schiff for any harm or inconvenience my actions may have caused, and I wish to add that it is my firm belief that Mr. Schiff, after further investigation, would never have had any such involvement as the discovery sought to establish.

ROBERT J. FLYNN JR., ESQ.

To the Editor:

With respect to the claims and allegations of *Emerson, Reid's Insurance Observer*, I hereby state I have never been associated with Underwriters Capital Corporation as an officer, director or in any other capacity, and, in fact, do not even know of their existence. Further, I have never controlled Underwriters Insurance Group, and have no knowledge of their relationship with either Underwriters Financial Group or any Kwajalein guarantees.

I can categorically state that I am Chairman of Century Industries, Inc., which has had a profitable history for 18 years. 1996 combined revenues were upwards of $15,000,000, a substantial increase over 1995 revenues of approximately $3,000,000. These increased revenues have accounted for Century's stock to increase from $.50 to $3.00 during 1996. Century's net worth has concomitantly increased to over $7,000,000 at year end 1996.

I can further categorically state that U.S. Insurance Brokers, Inc., a Century Industries, Inc. subsidiary, has a Marketing Limited Partnership Agreement with the National Lumber & Building Material Dealers Association, and is the Broker of Record for the Association of Metropolitan Sewage Agencies. We are very proud of these arrangements and project substantial premiums to be generated through these arrangements in 1997.

I have been a target of various news releases since my extremely high profile role as CEO of Tandem Financial Group, which sold over $4 billion of fixed annuities through the Merrill Lynch offices in the 1980's. Tandem was owned by Merrill Lynch and the Equitable Assurance Society. Tandem is now Merrill Lynch Insurance Group.

Emerson, Reid's Insurance Observer apparently relies (to my detriment) on documents which I believe are unreliable, and operates much like the often sued *National Enquirer*, as its articles about me are totally unsubstantiated in fact and reality. This is probably due to Schiff's lack of advertising revenue and its operating as a privately published newsletter, where it is unfettered by any regular ethical press truthful reporting considerations.

RICHARD CAMPANARO
Chairman, Century Industries

David Schiff replies:

Although Campanaro claims to have no association with Underwriters Capital Corporation ("UCC"), documents prepared by UCC state that Campanaro helped found the company in 1988, and that UCC "facilitated" Century's merger into Alpha Energy & Gold, a public shell. A "tombstone" ad for that deal shows UCC's address as being the same as the one Century listed in its articles of incorporation.

The Back Room Shuffle:
Century Industries, Inc. & Subsidiaries

Assets	9/30/96	12/31/95
Current Assets	$2,859,323	$511,508
Net Fixed Assets	1,751,224	42,848
Goodwill	5,400,937	547,244
Other	539,268	63,130
Total Assets	$10,550,752	1,164,730
Liabilities		
Current Liabilities	$5,640,461	$797,686
Notes Payable	733,945	—
Minority Interest	2,079,500	—
Stockholders' Equity	$2,096,846	$367,044

Campanaro says that he had "no knowledge" of Underwriters Insurance Group's (UIG) involvement with Underwriters Financial Group (a large insurance brokerage that went bankrupt in 1995) and Kwajalein guarantees. Public documents suggest otherwise. According to Century's 1993 10-K, which is filed with the SEC and *signed by Campanaro as chairman*, Century's largest asset—comprising 65% of its total assets—was its holding in UIG. UIG's principal asset was its stock in Underwriters Financial Group, whose filings with the SEC provide a history of the Kwajalein guarantees.

Campanaro says that Century "has had a profitable history for 18 years." I don't know what he means by that. Since going public in 1993, Century's losses have outstripped its earnings. It showed a loss from operations of $600,059 and $12,693 in 1993 and 1994, respectively. Although it made $7,737 (before debt restructuring) in 1995, for the nine months ending September 30 1996, it lost $664,562.

Regarding U.S. Insurance Brokers' "marketing agreement" and "broker of record," as of September 30, 1996 they have generated less than $3,400 of revenue. Whether they will generate substantial premiums or commissions in the future remains to be seen. I, for one, am not holding my breath.

Finally, as for Campanaro's likening *Emerson, Reid's Insurance Observer* to the *National Enquirer*, all I can say is that Century's financial statements and SEC filings couldn't be stranger if they were the work of aliens and the ghost of Elvis. ■

The Boys in the Back Room
U.S. Insurance Brokers' Curious Cast of Characters

It's no secret that the insurance brokerage business is tough. Premiums are soft, carriers have been cutting commissions, and those nasty but necessary evils—insureds—have been demanding more and offering to pay less. Although most insurance brokers would willingly admit that there's plenty of competition out there, Washington, D.C.-based U.S. Insurance Brokers won't—not even in its filings with the SEC, which state that "there is very little agency competition in association insurance marketing."

Who is U.S. Insurance Brokers and why is it saying such things?

U.S. Insurance Brokers is a subsidiary of Century Industries, a tiny public company with a history of losses and nebulous business transactions. It was formed in 1994 and has little in the way of revenues. It does, however, claim to have agreements to sell insurance to the members of two large national associations. In a 10-K filing with the SEC, U.S. Insurance Brokers "projected" that these two programs would generate $104 million in premiums and $3.12 million in profits. And that's just the beginning. U.S. Insurance Brokers also says it is in "active negotiations" with other associations and is, if one believes the company's press releases, on the verge of hitting it big.

Before taking these claims at face value one might want to consider the players involved. Richard Campanaro, U.S. Insurance Brokers' president, was previously associated with Underwriters Capital Corporation, an amorphous—and now defunct—investment banking firm that operated in the nether world of penny-stock shell corporations. In 1992 it arranged for BRI Coverage, a notorious insurance brokerage in New York with whom it shared office space, to go public by merging with a troubled oil and gas concern named Chippewa Resources. BRI, which subsequently changed its name to Underwriters Financial Group, went bankrupt in 1995 amid allegations of financial irregularities, missing premium trust funds, dubious accounting, and phony premium-finance deals (see "The Worst Insurance Brokerage in America," *Emerson, Reid's Insurance Observer*, August 1995).

Campanaro also controlled Underwriters Insurance Group (UIG), a Dublin-based company that, according to *Business Insurance*, had ties to convicted felon Michael Arthur Strauss. UIG's subsidiary, Mid Atlantic Insurance Brokers, went bankrupt in 1991. In 1992 Campanaro and one of his UIG partners, Andres Romero, introduced BRI/Underwriters Financial to promoters peddling $35 million of questionable "financial guarantees" from Kwajalein Island, a small South Pacific atoll. BRI/Underwriters Financial then began using these guarantees as if they were real money. It made bids for a number of large insurance brokers and put $5 million of the guarantees into its Cayman Islands reinsurance company, International General Insurance. The guarantees, apparently, were no more creditable than Confederate bank notes. UIG's dealings with BRI/Underwriters Financial led to litigation that resulted in UIG receiving 150,000 shares of BRI/Underwriters Financial stock in March 1993.

On December 31, 1993, UIG's Bermuda subsidiary, Covent Insurance Co., entered into a spurious excess-of-loss-reinsurance and portfolio-transfer agreement with International General Insurance that gave BRI/Underwriters Financial the appearance of significantly greater financial strength than it actually had. International General Insurance subsequently defaulted on notes it owed to Reliance Insurance, and Covent was ordered into liquidation in 1995.

Campanaro, who claims to have no knowledge of these transactions, told us that Underwriters Insurance Group is no longer in existence and that he had merely "served them at the request of an [English] gentleman."

In 1993 Campanaro, through Underwriters Capital, arranged for Century Industries, an unprofitable steel fabricating company (which now owns U.S. Insurance Brokers, of which he is president), to go public via a merger with a penny-stock shell corporation. Although Campanaro denied any involvement in this transaction as well, Century's 10-K, *which he signed as chairman*, states that Campanaro was "issued 100,000 shares of stock for services rendered in connection with" the deal.

Once public, the creative accounting techniques that Century employed were available for scrutiny. Although Century's 1992 financial statement showed a net worth of $2.5 million, it included a vaporous $1.5 million "subscription receivable" and a dubious $1.5 million "investment," both of which were subsequently deleted from the balance sheet. The statement also showed a $450,000 profit; the reason: it counted $500,000 of the dubious "investment" as "income."

In 1993 Century beefed up its balance sheet via further legerdemain: it exchanged 5,000 shares of its preferred stock for 100,000 shares of UIG. This transaction was valued as a $1-million addition to paid-in capital. (According to Century's lawyer, Robert Flynn, UIG's primary asset was its shares of BRI/Underwriters Financial. Thus, Century's indirect holdings of BRI/Underwriters Financial became its largest "asset." Century's filings, however, did not disclose this.) Century's investment in UIG was written down to $57,500 the following year.

Although he was chairman of Century during this time, Campanaro denies any knowledge of these transactions, or of those involving Underwriters Capital's cohort, a New York securities firm, Cameron Phillips (now defunct) which—what a coincidence!—used the same obscure Virginia accounting firm, Esquerra & Esquerra, as did Century.

In 1994 Century announced the signing of a letter of intent to purchase Prestige Casualty Insurance Company for $3-to-$4 million (Prestige had been run by convicted insurance con man, John Goepfert). Century then issued a press release projecting $3 million in earnings from the deal, hoping, it would seem, to boost its stock price. Century also announced the sale of 600,000 shares of its preferred stock to UIG for $3 million. Since UIG's primary asset was its shares of BRI/Underwriters Financial, it appears that it was in no position to come up with much of anything, let alone $3 million. Campanaro and Century, as major shareholders of UIG, should have been well aware of this. Century also announced that it had given UIG the option to buy more of its stock in exchange for $2 million in "guaranteed bank notes" (shades of the Kwajalien Island "financial guarantees"). None of these deals actually took place, and several months later Prestige was declared insolvent.

In 1995 Century acquired U.S. Insurance Brokers by issuing 1,000,000 shares of convertible preferred stock to Ted Beck, a director and controlling shareholder of Century. (An Underwriters Capital brochure lists Beck, who is 34 years old and sometimes goes by the name of Schwartzbeck, as one of the firm's "founders," and states that he "has been active in the U.S. and European investment market for many insurance companies for two decades." When queried, Beck said he knew nothing about this.)

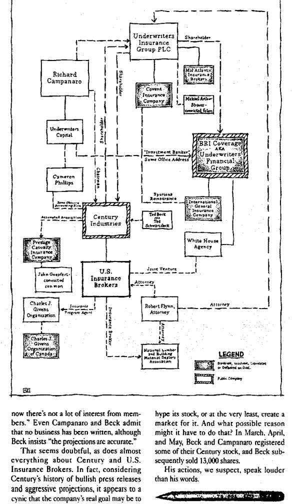
In a 1995 press release, Century stated that U.S. Insurance Brokers was the "national association insurance plan administrator agent for the members of the Charles J. Givens Organization." Givens, the best-selling author of *Wealth Without Risk*, is a financial charlatan whose Canadian organization went bust last year and whose U.S. organization is in shambles as a result of a $14.1 million class-action judgment stemming from his "intentional and negligent misrepresentations" and "violations" of California statutes.

In early 1996 U.S. Insurance Brokers announced "agreements" or "broker of record letters" with the National Lumber and Building Material Dealers Association (NLBMDA) and the Association of Metropolitan Sewerage Agencies (AMSA). U.S. Insurance Brokers also said it was "in active negotiations" with the National Association of Career Colleges, the American Vintners Association, and the National Association of Letter Carriers. U.S. Insurance Brokers' marketing gimmick, if one might call it that, is to give associations a cut of the "profits" from the sale of insurance to association members.

U.S. Insurance Brokers, by the way, has no employees of its own. Instead, it enters into joint-venture arrangements with other agencies and lets them do the work, assuming there is work to do. One such firm is the White House Agency, which, perhaps not coincidentally, is the same name as a subsidiary of bankrupt BRI/Underwriters Financial.

Although U.S. Insurance Brokers claims to be licensed with a number of insurance companies, inquiries to some of these carriers—Fireman's Fund, Golden Rule, and American Medical Security—revealed that they had no record of U.S. Insurance Brokers.

As for the $104 million of premium that U.S. Insurance Brokers projects it will write, that seems to be a matter of opinion. The NLBMDA didn't have any comment, but Ken Kirk, AMSA's director, said that "right



now there's not a lot of interest from members." Even Campanaro and Beck admit that no business has been written, although Beck insists "the projections are accurate."

That seems doubtful, as does almost everything about Century and U.S. Insurance Brokers. In fact, considering Century's history of bullish press releases and aggressive projections, it appears to a cynic that the company's real goal may be to hype its stock, or at the very least, create a market for it. And what possible reason might it have to do that? In March, April, and May, Beck and Campanaro registered some of their Century stock, and Beck subsequently sold 13,000 shares.

His actions, we suspect, speak louder than his words.

EMERSON, REID'S ♦ JULY 1996

The article that prompted Century and U.S. Insurance Brokers to sue Schiff for $50 million.

Eighty Cents on the Dollar

Reinsurance is Capital

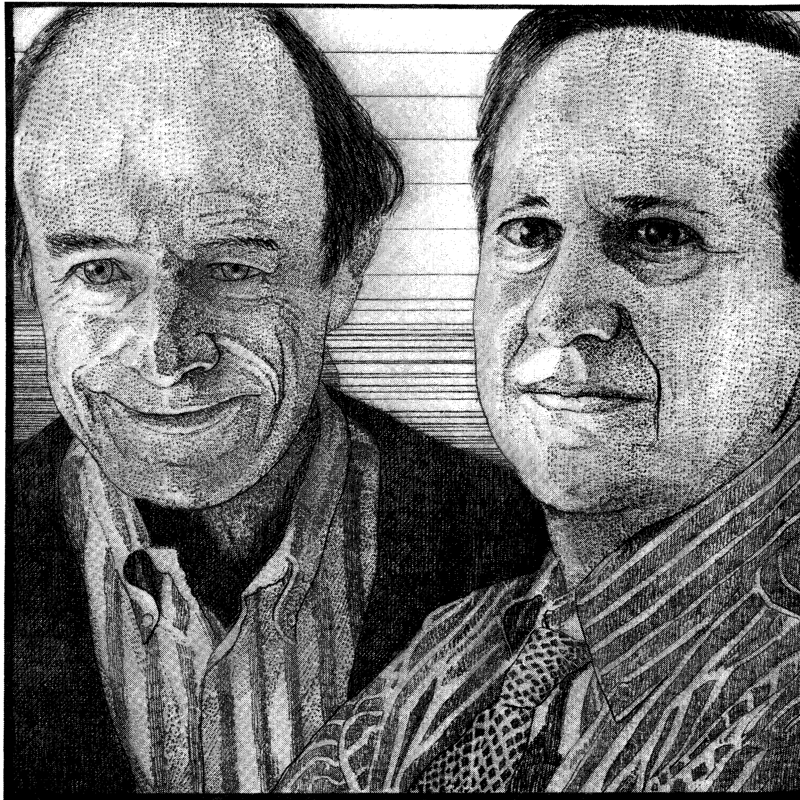
Robert Clements, chairman of Risk Capital Reinsurance Company and former vice chairman of Marsh & McLennan Companies, is worthless. So, too, for that matter, is Mark Mosca, Risk Capital Re's president. In fact, all of Risk Capital Re's employees are worthless—at least in the eyes of investors. Although the company has a book value of $357 million, or $21 per share, its stock is selling for 16⁷/₈, a discount of $70 million from net asset value. In other words, a buyer of Risk Capital Re's shares is getting stocks, bonds, and cash for 80¢ on the dollar. Thrown in for free is an insurance business, Clements, Mosca, and 25 others. (This is a bargain, which is why we've become a shareholder.)

While it's not unheard of for an insurance company to trade below book value, these days it's unusual, and those that do are generally mired in problems. Risk Capital Re, which was formed in 1995, is not. It is clean, run by nice folks, and is a member in good standing of the Marsh & McLennan *zaibatsu*. On the other hand, Risk Capital Re has not yet proved it can make money. The company's annualized premiums are $140 million; reserves are a paltry $21 million. (Insurance companies make money by investing the assets that back the reserves.)

Risk Capital Re was "sponsored" by Marsh & McLennan Risk Capital, an investment and investment-advisory company then run by Clements (and now by Jeffrey Greenberg). Among the successful companies previously created under this aegis were ACE, EXEL, Centre Re, and Mid Ocean. All, however, differed from Risk Capital Re in at least one respect—when they were formed, they filled a void in the marketplace. ACE and EXEL provided liability insurance at a time when there was an industry-wide capacity shortage. Mid Ocean did the same for property catastrophe reinsurance.

Risk Capital Re's raison d'être is fuzzier. Responding to what it sees as the "convergence of reinsurance and other financing- and capital-management techniques," it has set itself up as The Merchant Reinsurer℠. Its slogan, Reinsurance is Capital℠, is apt: the company provides clients with "a choice of reinsurance and/or capital."

In a radical departure from standard operating procedure, Risk Capital Re intends to put the majority of its money into insurance equities. At this moment the portfolio is 60% in short-term fixed income, 30% in insurance stocks (ACE, AIG, E. W. Blanch, EXEL, Gainsco, Insurance Investment Group L.P., Island Heritage, Peregrine Fund, Terra Nova, Trenwick, USF+G, and Vesta Group), and 10% in private equity deals. Why so little in insurance stocks? When we chatted last December, Clements told us he thought they looked pricey.



Risk Capital Re's Robert Clements and Mark Mosca

The concept of the insurance company as investment fund is an appealing one. Investors such as Warren Buffett, Larry Tisch, Henry Singleton, Carl Lindner, and Saul Steinberg have been attracted to—and prospered in—the insurance business, which generates loads of cash. Although insurance companies deploy most of their assets in bonds, there's a case to be made for investing heavily in equities. As every shoeshine boy on Wall Street can tell you, over time stocks have outperformed everything else.

The case against stocks—at least the case we've been making for a while—is equally compelling: valuations are off the charts. Hordes of investors have been buying "growth" stocks and chanting the buy-and-hold mantra. Why weren't they doing the same in, say, 1979, when the cover of *Business Week* proclaimed "The Death of Equities"? It is an irony of the market that the best time to buy stocks is when they are out of favor.

By that standard alone, Risk Capital Re is worth considering. Although its concept is one that could only have been executed in a bull market (an insurance-stock fund that writes insurance) the company's underwriters, Smith Barney and Morgan Stanley, had a tough time placing the offering, even though EXEL, Marsh & McLennan Risk Capital, and The Trident Partnership invested $70 million, $40 million, and $35 million, respectively, at the same $20 per share price that the public paid. (Trident and Marsh & McLennan Risk Capital, however, received warrants to buy additional shares at $20.)

While Risk Capital Re is certifiably cheap, cedants must ask whether it is sound, and even a Graham & Dodd fundamentalist might wonder whether it will be able to compound its capital at an acceptable rate. But its strategy *seems* sensible: running a global business from a single location, writing "traditional" and "finite risk" reinsurance, staying away from facultative reinsurance (the reinsurance of individual policies—too people intensive), pursuing transactions with a minimum premium of $2.5 million, and doing business through intermediaries. (The last is no surprise, since Guy Carpenter, the largest reinsurance broker, is owned by Marsh.)

Befitting its status as a merchant reinsurer, Risk Capital Re's accommodations look more like those of an investment banking boutique than of an insurance company. The setting is spacious and the ambiance is hushed. The offices are equipped with handsome wood

furniture and ergonomic Aeron™ chairs. The aura of success (but not opulence) is accentuated by the employees' casual attire—when you've made it you can wear what you want.

Mark Mosca, 43, is articulate and persuasive. He has worked at General Re and NAC Re and was chief underwriting officer of Zurich Re Centre when Clements recruited him. He is well aware of the risks in the market, yet believes that it's possible for a recently formed reinsurer with $357 million of capital to create value in an environment where there's too much money chasing too little business.

"There are several reasons we're writing attractive business," he says. "Forty percent of premiums comes from 'integrated' transactions where we package reinsurance with investments. By definition, this is less price sensitive.

"We've concentrated on larger deals that require a lot of effort to understand, and we spend a considerable amount of time on deals that have a less than obvious solution. We bring a broader perspective. Others may be great at reinsurance, but they're *only* looking for a reinsurance solution."

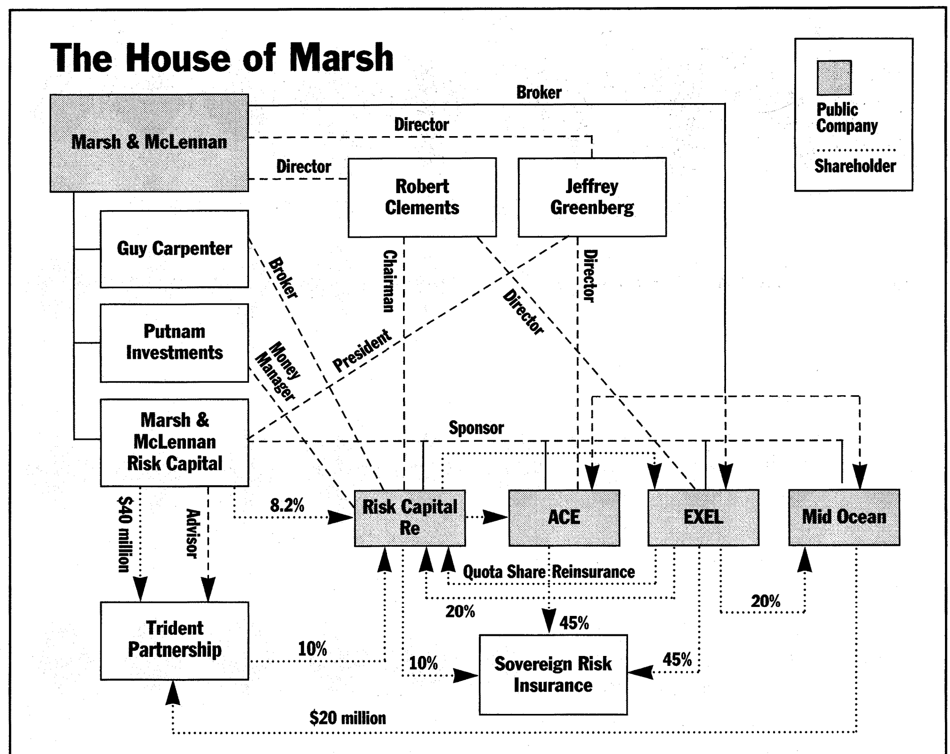
He gave us an example: "An insurance company had a profitable book of urban non-standard auto, but the company's surplus was at a level that prevented it from writing new business. A venture capital firm was planning to infuse capital but wanted the prior years' loss reserves to be guaranteed. Reinsurance solutions didn't work, so we came up with *contingent* financing that kicks in over a certain level of adverse loss development. (We think it's unlikely that our financing will be called upon—they'd have to exhaust reserves and another layer of funding.) Part of the package was a large and attractive quota-share arrangement."

Befitting its name, Risk Capital Re is comfortable risking its capital in non-traditional ways. But is it possible to find good private investments in non-troubled insurance companies when valuations are so rich? And if so, can one find enough of them?

Mosca says yes.

"We have excellent deal flow from Marsh & McLennan Risk Capital. They see an enormous number of opportunities. We've also made a strong effort to turn reinsurance brokers into sources of investment opportunities. Forty-to-fifty percent of the deals we see come from them."

Mosca says Risk Capital Re works in an "inefficient" area, so pricing is attractive. "We're looking at investments that are under $10 million, which is at the very small end of the deal scale. We're a source for companies that don't have many places to go. We're easy to talk to because we know their business, and we can do things for them other than provide capital.



"A lot of the most interesting opportunities are from insurance companies that made bad business decisions in the past, but have a current book we want to reinsure. But just like any venture capital operation, we have to sort through enormous amounts of garbage. We've seen 170 deals in 15 months and have closed on nine."

Risk Capital Re now has 32 clients. Its book is 60% casualty and 40% property, with 30% of premiums coming from outside the U.S. The company is not expecting significant earnings in the next two years because its book of business hasn't grown into its capital base and overhead, and its strategy of investing in equities generates far less investment income than investing in bonds does.

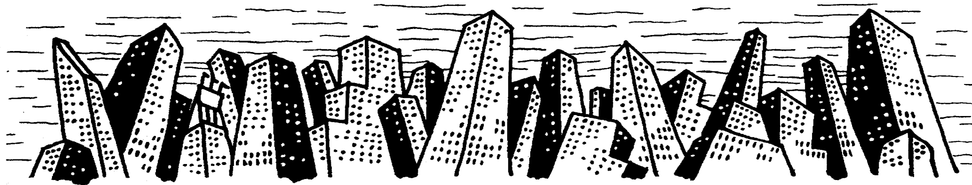
Despite the "inefficient" market, returns on equity investments over the next few years are likely to revert to the mean—that is to say that they will be a lot lower than they have been recently. (The Fidelity Select Insurance Fund, for example, gained 79.5% in the last three years.) Like most insurers, Risk Capital Re will have a difficult time achieving high returns on its equity. Reinsurance may be capital, but capital, alas, is abundant, which holds down returns. Other companies can and will do what Risk Capital Re does, especially if it appears to be profitable.

Still, we think there's a reasonable likelihood that Risk Capital Re can increase its intrinsic value at a 6% rate over the next three years. (That's no great shakes; 3-year Treasurys yield 6.58%.) If it does, it will then be worth $27 per share—60% more than it is currently selling for.

Down the road, Marsh McLennan Risk Capital and The Trident Partnership will probably want to sell their stock. If the market price doesn't reflect fair value, steps will be taken to see that it does, such as an outright sale of the company. Perhaps EXEL, which already owns 20%, might be a buyer. At book value one is getting the "business" for nothing. (Mosca's former employer, Zurich Re Centre, is a good case study. Four years ago, although it was newly formed, through the miracle of modern finance it went public at $35 per share—$15 higher than its intrinsic value. Not surprisingly, the stock subsequently headed south, finally stopping at $24¼. The company, however, grew, and Zurich Insurance recently offered to buy out the public for $36 per share, slightly less than intrinsic value.)

A final observation:

Bob Clements is on the board of Marsh & McLennan and EXEL. During the last three years these two companies have spent $510 million and $672 million, respectively, buying back their shares at prices far above book value. At 80¢ on the dollar, Risk Capital Re looks mighty cheap by comparison.



THE INSURANCE BEAT

Toot Toot Tootsie, Good-bye

OUR DECEMBER ISSUE contained an article about one of Reliance Insurance Company's new ventures—the formation of an "African-American owned" insurance company, of which Reliance was the de facto owner. Accompanying the article was a magnificent cartoon depicting Reliance's chairman Saul Steinberg in blackface, à la Jolson.

Two of our subscribers found the cartoon objectionable.

"Cancel my subscription," wrote one, who had not yet paid for his subscription.

"I want nothing to do with your publication," wrote the other, who toils at Reliance.

Fool's Gold

CALIFORNIA INSURANCE COMMISSIONER Chuck Quackenbush seized Golden Eagle Insurance Company on January 31. This event was an unusual turn in an already strange situation. For the previous five months Golden Eagle, the third largest workers' comp writer in California, had been playing a high-stakes game of chicken with the commissioner, who claimed that Golden Eagle was underreserved by $138.5 million.

Golden Eagle, which is owned by John Mabee—a wealthy real-estate investor, farmer, and breeder of horses—publicly disputed Quackenbush's contention and offered a $100,000 reward to anyone who could prove that the commissioner's actions were politically motivated. Although no one stepped forward with any evidence, last November the company placed a full-page ad in the *Insurance Journal* quoting some of Golden Eagle's 700 agents. The ad, addressed to Quackenbush, criticized him sharply.

"All of us," wrote Blair Belden of Calvert-Belden Insurance in El Centro, "have made the decision that Golden Eagle is a sound company. Your time might be better spent trying to discover the secret of their success so you could help your friends in those big companies cut their expense ratios..."

Dwight Halverson of Halverson Insurance Services in Roseville noted that Golden Eagle was a "competitive market" with excellent service. "Mr. Quackenbush, I don't know who you represent, but it isn't the employers in California or the agents representing Golden Eagle."

Mark Fredricksen, an agent in Hemet told Quackenbush that "the publicity assault by your department on Golden Eagle has adversely affected our business."

Finally, William Delaney of Delaney Insurance in Rancho Cucamonga, blasted Quackenbush for "trying to destroy" Golden Eagle.

When Quakenbush took over Golden Eagle, he said that his court-approved action "was necessary to ensure that policyholder claims will be paid" and noted that he was "particularly concerned about the $66 million in unsecured loans taken by John Mabee."

We recently phoned these outspoken agents to ask what they thought of Golden Eagle now. None returned our call.

Disaster Diary

WHEN YOU PUBLISH A NEWSLETTER about the insurance business all sorts of stuff shows up in the mail: press releases, financial statements, new product announcements, and the occasional outraged letter of cancellation.

One of the better things we received last year was TIG Re's *1997 Disaster Diary.* This pocket-sized book, made by Smythson of Bond Street, captured our fancy. It starts with an irreverent "prologue" that refers to General Re as "throwing money" at National Re. Then it mocks Munich Re's acquisition of American Re: "Consolidation abounds, from sea to shining panacea. Aren't there certain to be acquisitions that end in disaster? This diary may save you from an actuary's bullet or an agent's bull____. Or at least from repeating the disasters of others."

The date entries in the diary are noted by disasters over the ages, a reminder of the precarious nature of things. For example:

March 10, 1939: 7½-pound hailstones kill 2,000 cattle and 1,000 sheep in India.
March 25, 1913: Ohio River floods, nearly wiping out the city of Dayton.
June 8, 1783: Volcano erupts and poisonous gases cover Iceland.
June 30, 1908: Siberian fireball levels 25 square miles of remote forest.
August 1, 1874: Locust swarms attack Kansas.
November 15, 1985: Insurance market hardens.
November 16, 1985: Insurance market softens.

And so on... Have a nice day.

No Annuities. Please!

THE PIANO BUSINESS isn't so hot these days, at least that's the word coming from the 135-year-old Baldwin Piano & Organ Company, which recently hired Lehman Brothers to advise it how to "increase shareholder value."

Like the Return to Core Competencies movement, the phrase "increasing shareholder value" is sweeping the nation. But wait a moment: doesn't it go without saying that management's job is to increase shareholder value?

We wonder what course Baldwin will take. Those who have been around awhile will remember that several decades ago, in a previous incarnation, Baldwin Piano attempted to increase shareholder value by expanding into the insurance and annuity businesses. Under the direction of Morley Thompson, an asset-shuffling wheeler-dealer, it became Baldwin United, and was, for a spell, a high flier.

The good times ended in 1983 when the company went under, and 165,000 policy-holders with $3.4 billion in annuities were left stranded.

A Bet on Biotech

SAY WHAT YOU WANT about Saul Steinberg, chairman of Reliance Group, but one thing is certain: he's a clever fellow. Steinberg, who recently startled the entire world by forming an "African-American owned" insurance company, is bullish on science.

"Biotechnology, we believe, will be extremely important and profitable in the first decade of the next century," he writes in his annual letter to shareholders.

Reliance has invested $197 million in the biotechnology industry. Half of that is in one stock, Human Genome Sciences. For the record, the shareholders' equity of Reliance Insurance Company and of Reliance Group (the holding company) are $1.2 billion and $678 million, respectively.