SCHIFF'S
INSURANCE OBSERVER
Evening Telegraph Edition
January 18, 2000 *Volume 12e • Number 1*

The Insurance Business Stinks

But Insurance Stocks Are Cheap

A Visit to Graham & Doddsville

IN THE DECEMBER ISSUE of *Schiff's Insurance Observer* we commented on the relative valuations of Internet stocks and insurance stocks. Although AIG earns seven times as much as AOL, its market cap was then 15% lower than AOL's. Time (or, more specifically, Time Warner) has lowered AOL's market cap 30% since we went to press last month. That decline notwithstanding, Internet stocks are still priced at levels that bear no known relationship to sales, earnings, and assets, or to book value.

"Somewhere in the world of high finance there's an arbitrage waiting to happen," we wrote. "Companies with rich valuations will realize it makes sense to use their stock as currency to buy insurance companies." We noted that AOL could take over Progressive for *three times* what Progressive was then trading for, and that doing so would be a drop in the bucket for AOL.

But AOL didn't want "cheap" insurance stocks. For that matter, hardly anyone does—for the moment.

"Cheap," of course, is subjective. Although Amazon.com loses about 40¢ for every dollar of goods it sells, some believe that in the future it will make money, and that once it starts doing so it will compound those earnings at a monumental pace for a long time—maybe even forever.

The insurance industry, on the other hand, is so loaded with capital that it can't possibly earn a satisfactory return on its assets now. While the laws of supply and demand tend to rule in industries that deal in commodity products (like insurance), when the industry was posting good numbers, many were willing to make the leap of faith that the laws of supply and demand had been repealed and that *this time it would be different*.

As we survey the insurance landscape right now, it is hard to feel positive. In private-passenger auto—the largest single line—the bloodbath is only just beginning. Margins will be under pressure for years as the Internet wreaks havoc by making prices transparent.

The only good news about workers compensation is that it has been so bad, it can't get much worse. Losses will stop growing rapidly (at least for the next couple of accident years), but profits may be elusive. That said, we've bought stock in two workers' comp companies with good balance sheets.

Life insurance and annuities have benefited from the tailwind of an unprecedented economic boom. But someday that boom will end. In any event, ease of entry, abundance of capital, and financial deregulation augur ill for increased profitability.

As for "niche" property-casualty businesses, they *would* be good if there weren't two dozen competitors in each niche.

Although bigger has been considered better, size doesn't really matter. In fact, it kind of hurts. Ask Safeco, which blew its money on American States, or St. Paul, which did the same with USF&G. Nationwide paid top dollar (at the top of the market) for Allied and CalFarm. Although Allstate and Chubb didn't go wild on acquisitions, they did waste billions buying back their own shares at inflated prices.

On the other hand, State Farm is thought of by many (but not by us) as a sleepy giant. Yet it has proven to be shrewd and fair. Its market share in private-passenger auto has been declining since 1997 (right about the time the business was turning sour), and it is heavily invested in equities, which have done quite well. Furthermore, in 1997 and 1998 it paid giant dividends to its mutual policyholders.

According to many securities analysts, insurance stocks aren't attractive for three reasons: 1) a lack of earnings' momentum, 2) a low return on equity, and 3) an inability to accurately forecast earnings. The conclusion: insurance stocks aren't going up, ergo, they shouldn't be bought.

Although we agree with items 1, 2, and 3, we arrive at a different conclusion: some insurance stocks are so cheap that, despite their dismal *current* fundamentals, they are good buys.

For what it's worth, 96 stocks in the SNL insurance universe are trading below book value. While many of these companies are dicey (Conseco, Fremont, Frontier, Paula, Reliance, and Superior National, to name a bunch), others seem like bargains.

While we're bearish on the insurance industry, we're bullish on cheap stocks with decent balance sheets, and have been a buyer of many over the last few quarters. The following is a partial list of insurance stocks we've bought, and their current prices relative to third-quarter reported

E-Madness: Internet vs. Insurance

Market caps of various companies, in billions of dollars.

Internet	12/10/99	01/14/00
America Online	$205	$141
Yahoo	93	93
Amazon	36	22
CMGI	23	30
eBay	21	17
E*Trade	9	7
InsWeb	1	0.7
Quotesmith	0.2	0.2
Insurance	**12/10/99**	**01/14/00**
AIG	$172	$177
Marsh & McLennan	24	28
Allstate	22	19
Cigna	15	15
Hartford	10	10
Chubb	9	10
Progressive	6	5
W. R. Berkley	0.6	0.5

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book values: American Country (65%), Argonaut (64%), Capitol Transamerica (84%), Cincinnati Financial (99%), EMC Insurance (75%), LaSalle Re (78%), Loews (65%), NYMAGIC (58%), PXRE (48%), Risk Capital (70%), W. R. Berkley (75%), and Zenith National (98%).

(A note of caution: depending upon prices and a variety of other factors, we may be buying *or* selling at any given moment.)

Other stocks worth examining—not necessarily because they are good companies, but because they are quantitatively cheap—are Independence Holding (73%), MONY (80%), Baldwin & Lyons (93%), Donegal (52%), Harleysville (75%), Midland (77%), and Old Guard (62%). One can also buy a LaSalle Re preferred that yields 11%, and Reliance bonds with a 17% yield to maturity.

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Although many of the above companies could, in all likelihood, be taken over for considerably more than last Friday's prices, we don't know which, if any, *will* be taken over. But when piles of securities are selling for substantial discounts to their liquidating values, something tends to happen. We expect to see more hostile takeovers in the insurance business (there haven't been many in recent years), and we expect to see shareholders rising up against managements and demanding that *something* happen. (Since managements can't make profits happen, they may have to resort to selling their companies.)

In short, why buy InsWeb and Quotesmith (which have negligible revenues and a combined market cap of $900 million), when, for the same combined market cap, one can buy W.R. Berkley, PXRE, and United Fire & Casualty? ■

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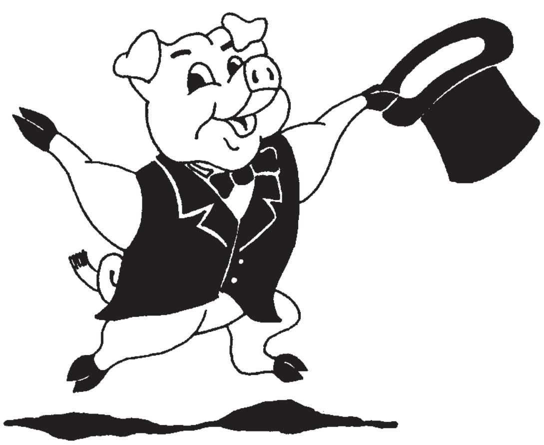

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