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The Return of Irrational Exuberance

The Thrill is Gone: Part 2

Printing new stock certificates for insurance companies to issue in public offerings.

One of our subscribers, a fellow who runs a large insurance company but doesn't like to be quoted, reeled off a list of risks the other day. "There's so much money out there looking for things. People have reached for yield. The biggest risk is in the asset-backed stuff—U.S. housing asset-backed securities. Also credit-default swaps. Banking has moved its risk to the insurance business. My general view [of the insurance business] is that the biggest risk is on the asset side of the balance sheet. The liability side is fully recognized. You have to worry about what others aren't thinking about."

Insurance companies, which are allegedly in the business of taking calculated risks in which the odds are in their favor, often seem to be in the business of taking risks and hoping to earn enough on their investments to make up for underwriting miscalculations. Most insurance executives simply can't contain their desire to grow their businesses by 10% to 15% per year, all the while promising a 15% return on equity. Absent a high rate of inflation, the insurance industry's ROE can't be anywhere near 15%—the barriers to entry are low enough to assure that new capital will keep a damper on long-term returns.

Indeed, capital in search of yields higher than those offered by T-bills pours into the industry. Worthy of note is China Life Insurance Company, which has 45% of the market in the People's Republic. It raised $3.46 billion in an IPO last week and its stock is trading at well over twice book value. (By comparison, Principal, MetLife, and Independence Holding trade at 142%, 120%, and 111% of book value, respectively.)

So great an investment opportunity was China Life perceived to be that Hong Kong investors lined up outside banks hoping to get some of the shares allocated to individual investors. According to FinanceAsia.com, retail investors subscribed for 168 times as many shares as they were allocated. In total, investors placed $80 billion of orders for $3.46 billion of shares. This oversubscription is all the more interesting considering that three months earlier China's Ministry of Finance was unable to complete the sale of twenty-four billion "renminbi" (the Chinese currency) of ten-year notes and had to cancel an auction of three-year notes.

The allure of China Life is semi-obvious: it's a leader in a potentially huge market and it has the potential for hypergrowth. Citizens of the People's Republic spend only 2.2% of GDP on life insurance right now, versus 4.4% in the United States and 8.9% in Japan. According to the *CIA Fact Book*, China's "purchasing power GDP" was $4,700 per capita in 2002. (Based on the "official" renminbi-dollar exchange rate, China's per capita GDP is about $1,000.) If China's economy grows rapidly and the country's 1.3 billion people eventually have a car in every garage, it stands to reason that they'll be spending hundreds of times more on life insurance products than they spend now.

Some of the risks of investing in China Life—aside from its rich valuation—can be found in the 186,456 words which comprise its prospectus. The company's assets and operations are in China, and the renminbi is not a freely convertible currency. As *Grant's Interest Rate Observer* recently noted, the Chinese monetary authorities "continue to fix the price of the renminbi," pegging its exchange rate with the dollar at 8.28:1 and capping three- and six-month bill rates at 2.46% and 2.6%, respectively. "Both the exchange rate and the bill rates are clearly below the rates the market would set for itself," *Grant's* writes. "In consequence, the supply of renminbi continues to boom," a sign of inflationary pressure.

Life insurance is a "spread" business. The goal is to take in money at one rate and invest it at a higher rate, hedging interest-rate risk in the process. But China Life is unable to do a good job matching its assets to its liabilities. "Because of the general lack of long-term fixed income securities in the Chinese capital markets and the restrictions on the types of investments we may make," states the company's prospectus, "we are unable to match closely the duration of our assets and liabilities, which increases our exposure to interest rate risk."

CHINA LIFE INSURANCE COMPANY LIMITED
中國人壽保險股份有限公司

An investor in China Life also assumes considerable credit risk. Most of the company's investment assets are in Chinese government bonds and Chinese bank deposits. (For the record, dollar-denominated Chinese sovereign bonds are rated A2 by Moody's.)

There are legal risks as well. "The Chinese legal system is based on written statutes," notes the prospectus. "Prior court decisions may be cited for reference but are not binding on subsequent cases and have limited precedential value...The laws in China differ from the laws in the United States and may afford less protection to our minority shareholders." Chinese law makes no provisions for shareholders to sue the directors, supervisors, officers or other shareholders on behalf of the company, and class-action lawsuits apparently do not yet exist in China. Also, China doesn't have treaties with the United States and many other countries that provide for the reciprocal recognition and enforcement of court judgments.

Investors may also recall that China Life's majority shareholder, the People's Republic of China, affords less protection to its citizens (in terms of civil liberties and human rights) than Western countries do.

Investing in good companies at significant discounts to their net asset values—a practice taught by Benjamin Graham—is an intelligent, low-risk way to earn respectable returns. Despite its obvious logic, this sort of value investing is not especially popular. Perhaps it's too dispassionate, too dependant upon the compounding of money over the long term. Or perhaps it's too dull: it won't generate anywhere near the excitement that investing in high-flyers will.

Historically, when plenty of good insurance companies are selling for discounts to book value, it says more about the mood of investors than the returns that can be made from the investments. Bargain-basement stock prices are usually the result of investors' fear or despair, often in the aftermath of the bursting of an investment bubble. Bad news, underwriting losses, poor investment results, and losses can fill investors with such fear that buying dollar bills for 65¢ seems too risky to them.

Benjamin Graham's investments were not unscathed by the Depression. The fund he managed declined 70% between 1929 and 1932, due in large part to his use of margin. According to Janet Lowe's *Benjamin Graham on Value Investing*, Graham had to give up his posh duplex on 81st and Central Park West overlooking the park as a result of his losses, and move nine blocks uptown into what she describes as a "smaller and darker flat at a less impressive address. (Graham's new apartment was in The Eldorado and it wasn't as bad as she makes it sound. The 32-story Art Deco building has a grand lobby, spacious apartments, and was declared a landmark in the 1980s. In fact, the editor of "the world's most dangerous insurance publication" has lived in the building for the last twenty-one years.)

In June 1932, Graham wrote the first of a series of articles in *Forbes*. Stocks were severely undervalued, he declared. More than thirty percent of industrial stocks were *net-nets*—that is, they were selling for less than their net current assets per share minus all liabilities. Scores of common stocks were selling for less than their net cash per share. From an investment perspective, these companies were "worth more dead than alive." (In theory, investors could liquidate them and earn a significant profit.) Graham suggested that companies "return to their stockholders the surplus cash holdings not needed for the normal conduct of their business. His preferred method for returning cash was a tender offer above the market price.

The vast sale on the floor of the NYSE and elsewhere was also noted by Frank L. Brokaw, who specialized in insurance stocks. The August 5, 1932 issue of the *American Agency Bulletin* carried an ad by F. L. Brokaw & Co., which read, in part, "Insurance stock prices [have] been forced down so far below anything justified by the condition of the companies that it appears certain the upward movement in sound issues will be correspondingly swift when it comes." The Bank Holiday and the depths of the Depression were still in the future, and it would be almost fifteen years before a period a great prosperity returned. Nonetheless, about a month earlier the Dow Jones Industrial Average (DJIA) had hit its low of 41.22.

Two weeks after Brokaw's ad ran, the *American Agency Bulletin* contained an article, "Investment Appeal of Insurance Stock," by E. C. Wilkinson, a Brokaw employee. "Stocks of many of the strongest American fire insurance companies are selling for about fifty cents on the dollar of liquidating value, based on prevailing market prices of their investment portfolios," he wrote. Since insurance companies' investment portfolios were *also* selling at big discounts to their liquidating values, insurance stocks were even cheaper than they appeared.

The Depression had a salutary effect on underwriting results. The fire and casualty industry's combined ratio was below 100% every year from 1933 to 1945. The flip side of this, however, was that investment income as a percentage of premiums declined each year until

1948. (When you can't make any money investing, you damn well better make some money from underwriting.)

Although Brokaw's bullishness on insurance stocks was correct, it's not clear that things worked out well for him, as we shall see later. Insurance stocks—and most stocks—rose sharply from their lows, but the securities business languished. Wall Street was a depressed, chastened environment in the 1930s and 1940s, and fear prevailed. The total number of shares traded on the NYSE in 1935 was 381,600,000, about one-third of 1929's volume (and 0.1% of 2003's volume). Stocks came to be viewed as inherently speculative even though, in absolute terms, their cheap prices made them good long-term investments. The DJIA's average dividend yield was higher than the yield on Moody's Aaa bonds every year from 1935 to 1958. During the 1940s, for example, the dividend yield on the DJIA averaged 5.32% versus a 2.7% yield for Aaa bonds.

Railroads, public utilities, and industrial companies were the blue chips of the day. Insurance stocks were obscure, and most traded over the counter. In *Security Analysis*, published in 1934, Benjamin Graham wrote that "the investment counselor should do his best to discourage the purchase of stocks of banking and insurance institutions by the ordinary small investor." (In the 1962 edition of his book, Graham espoused a different view. He wrote that "industries which do not show large profit declines in periods of recession" have the "qualities of stability and predictability which make them ideal for formal appraisal." These industries included utilities, *insurance companies*, pharmaceuticals, and tobacco.)

The effects the capital markets have on the insurance business haven't changed much over the years. "It is also true," wrote Graham in 1934, "that rampant speculation (called 'investment') in bank and insurance company stocks leads to the ill-advised launching of new enterprises, to the unwise expansion of old ones, and to a general relaxation of established standards of conservatism and even of probity."

Insurance cycles aren't the result of physical laws; they're the result of human behavior. Insurance leaders have been jabbering away about underwriting discipline for at least 130 years, and many were doing so again at the 15th Annual Executive Conference for the Property-Casualty Industry, held a few weeks ago. (We cannot recall any instance—even during hard markets—when insurance CEOs said that insurance companies were charging rates that were too high.)

By 1944, when Shelby Cullom Davis was appointed as New York's commissioner of insurance, insurance companies had grown so risk averse that they eschewed common stocks, which were cheap, loading up on long-term bonds, instead. (They were especially fond of long-term Treasurys, even though they yielded a mere 2.5%.) As John Rothchild writes in *The Davis Dynasty*, Davis was an "anti-bond maverick." He considered bonds to be "certificates of confiscation" and railed against their purchase, urging life-insurance companies to invest some of their funds in common stocks instead. His ideas were considered heresy, and ignored. But the ensuing years would show that buying long-term bonds in 1946 was a worse investment than buying stocks in 1929. (In early 1981, Treasury yields peaked above 15%.)

In 1946 and 1947, Benjamin Graham gave a series of lectures at the New York Institute of Finance. He discussed a variety of subjects, including insurance and insurance stocks. Using North River Insurance Company as an example, he pointed out that "from the standpoint of good results for the stockholders, [it seems] to have much too much capital per dollar of business done in 1945." At that time North River had $25 million of equity and wrote $9 million in premiums. In 1927 it had written more premiums with half as much capital.

Graham threw out a concept:

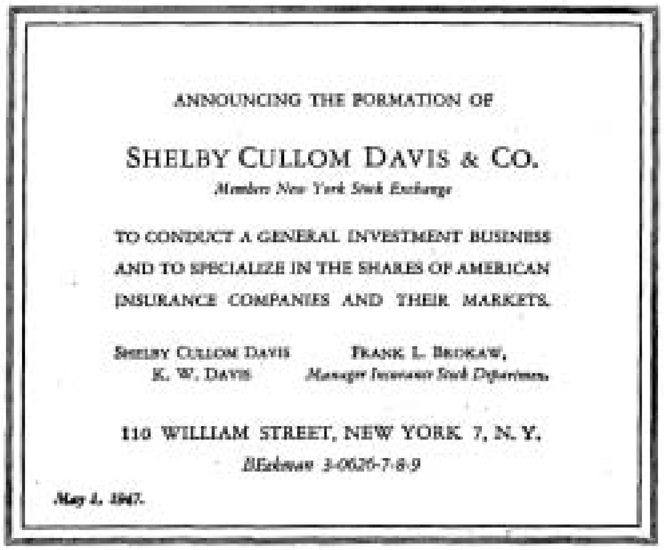
> Now, I might suggest that somebody should raise the question, "What can the stockholders do to get a decent return on their investment on the North River Insurance Company?" Let us assume it was a matter for the stockholders to decide, which would be a very extraordinary suggestion for anyone to make—elementary as it sounds in theory.
>
> Here is a possible answer: Suppose you reestablished the relationship between capital and premiums that existed in 1927, when things were quite satisfactory, by simply returning to the stockholders the excess capital in relation to the business done.
>
> If you did that, you would be able to get the earnings of about 6% on your capital and to pay the 4% dividend on your capital, which I suggested might be a definition of a reasonable return to the stockholder.
>
> That could happen because, when you take out $15 a share from the present $31—and you have left only $16 to earn money on for the stockholder—you are reducing your earnings only by the net investment income on the $15 withdrawn, which is on the order of, say, 40 cents at the most. Thus you would earn about 85¢ on the remaining investment of $16, and you would get reasonably close to the 6% which you need.

Graham's idea made sense: give the excess capital—which was earning about 2.7%—back to the shareholders. Of course the executives running the insurance companies were not about to part with their capital willingly, and Graham knew this. He remarked that his idea "will not recommend itself to insurance company managements."

By 1947, Frank Brokaw's small firm was in poor shape. Brokers make their money from executing trades, and very little trading was being done. NYSE daily share volume was only sixty percent of what it had been in 1935. Total volume for all of 1947 was 253.6 million shares.

On May 1, 1947 Shelby Cullom Davis, who had left the insurance department, bought a controlling interest in F. L. Brokaw & Co., which owned a seat on the NYSE, and changed the firm's name to Shelby Cullom Davis & Co. An advertisement in *The Weekly Underwriter* noted the formation of the new company and listed three employees: Shelby Cullom Davis, K. W. Davis (his wife Kathryn, who bankrolled him), and Brokaw, who was listed as "Manager Insurance Stock Department." (Brokaw committed suicide several months later.)

Over the next forty-seven years Davis would become the greatest insurance investor of all time. Frugality was part of his essence, and he didn't like to pay much for his investments. He bought stocks of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May 1, 1947.

insurance companies—especially life-insurance companies—at dirt cheap prices and realized tremendous capital appreciation over time as those stocks' prices increased to reflect their true value, and to reflect the growth of the underlying businesses. Davis, who was a perpetual bull, owned hundreds of insurance stocks and always invested on margin. When he died in 1994, his initial $100,000 of capital had grown to almost $1 billion. Most of his estate went to charity. (For more on Davis, see *Schiff's*, June 1994.)

On September 18, 1952, Davis gave a speech to the Insurance Accountants Association, "Finance Looks at Insurance." He predicted a wave of mergers and acquisitions of smaller independent insurance companies, similar to what had happened with smaller banks. More importantly, he called the audience's attention to a great buying opportunity: insurance stocks were selling at discounts of 40% to 50% of net asset value or liquidating value. So cheap were insurance stocks, Davis observed, that not only did the market accord a 50% haircut to the value for insurance companies' tangible assets, it accorded no value for intangibles such as agency plant or goodwill.

Davis had the good fortune to be in the right place at the right time, and he had the foresight to do the right thing. Regarding his contempt for "certificates of confiscation," investors may do well to ask whether the return on "high-yield" bonds (currently about 7%), is worth the risk. For that matter, they may also question whether the return on high-quality bonds is worth the risk.

Insurance companies prospered during the post-war years and their balance sheets grew flush. Over time the fear of investing in stocks subsided, and insurance companies' balance sheets were enriched by the rising market. In August 1967, when Ed Netter, a 34-year-old analyst at Carter, Berlind & Weill, wrote a report entitled "The Financial Services Holding Company," insurance stocks were in another one of their cyclical bargain periods, however.

Netter's report, probably the most influential piece of insurance-stock research ever published, outlined "The New Economics." A fire & casualty company making a 6.5% return on equity could, by "operating as a diversified and leveraged holding company," earn a 9% after-tax return on equity, he wrote. The idea was so sensible. A little asset shuffling and—poof!—higher returns.

The concept worked because, as Netter calculated, many prominent insurance companies had a "capital redundancy" (aka "surplus surplus").

Netter's thesis was the logical extension of Benjamin Graham's writing and speeches, as well as thoughts put forth by Brokaw and Davis. Graham had noted that insurance companies had more capital than they needed to run their businesses and had suggested that they return that capital to their shareholders. Brokaw and Davis had, years earlier, said that many insurance companies were trading at prices well below their liquidating values.

Netter's "new economics" added a twist to the old economics. He stated, for example, that Great American's book value was $98 per share, its stock price was

$57.50, and its capital redundancy was $55 per share. Reading Netter's report it was quite clear—at least in theory—that one could take over Great American for $57.50 and immediately recoup $55 from its excess capital. Thus, for a net investment of $2.50 per share one could own a large insurance company that had a $43-per-share book value.

Other major insurers with similar mathematics included Continental Insurance, The Hartford, The Home, INA, and Reliance. Many would be acquired by conglomerates or holding companies within several years of Netter's report. Two early ones to go were Great American and Reliance, bought by National General and Leasco Data Processing Equipment Corp., respectively. (Netter's employer, Cogan, Berlind, Weill & Levitt, served as consultant to National General and Leasco.)

Reliance's takeover by Leasco in 1968 was noteworthy. Leasco, run by its 29-year-old founder, a wheeler-dealer named Saul Steinberg, had negligible earnings and only $75 million of assets. Yet it managed to acquire the 151-year-old Reliance Insurance Company, which had $750 in assets and a net worth of $250 million. How could such a thing happen? These were, in the words of John Brooks, "The Go-Go Years," and Leasco didn't use cash to buy Reliance; it used its own securities—which many called "funny money" or "Chinese paper." (Buyers of China Life should take note.) Each Reliance share received Leasco convertible preferred stock and one-half a Leasco warrant. Leasco was able to accomplish this preposterous swap because the marketplace, in its foolishness, placed a high value on its shares and a low value on Reliance's.

In 1969, Senator Philip Hart's Senate Subcommittee on Antitrust and Monopoly held hearings on the subject of takeovers, conglomerates, and insurance. The senators were stunned and concerned about the new economics. Future SEC chairman Arthur Levitt—then president of Cogan, Berlind, Weill & Levitt—testified about the Reliance takeover, as did Ed Netter. (Levitt expressed an exceptionally high opinion of his client, Saul Steinberg: "I would say that the management of Leasco Data Processing Equipment Corp., in our judgment, represents some of the most astute business minds in the United States today.")

We talked with Ed Netter about those times fairly recently. "We didn't create the research report to get investment banking business," he said. "I wrote the report because the stocks were cheap. The investment banking business followed." In Netter's view, insurance stocks had been so cheap because "most of the companies owned common stocks with low dividends yields." These stock portfolios were, for the most part, non-income-producing assets, and the market accorded little value to them at that time.

By 1971, many big insurance companies had been taken over or were on the verge of being taken over. "That whole era got me thinking about not being a broker anymore," Netter told us. "I wanted to be a principal. I got interested in the reinsurance business, which was relatively unknown. I researched it and concluded that it was a great business."

Netter left what was then called CBWL-Hayden Stone and went into reinsurance. Six or seven years later he sold his business, First International Reinsurance Company.

Since then, Ed has been extremely successful. He's run numerous businesses and currently controls, among other things, Independence Holding, which owns a number of life-insurance companies. (The editor of *Schiff's* is a shareholder of Independence.) We asked Ed why he got out of the reinsurance business.

"A lot of people got into the reinsurance business and forgot about underwriting profits," he said. "They were writing for cash, and it went nuts. I decided that I liked the life-insurance business better."

Part 3 of this article will probably be published before the end of the year.

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