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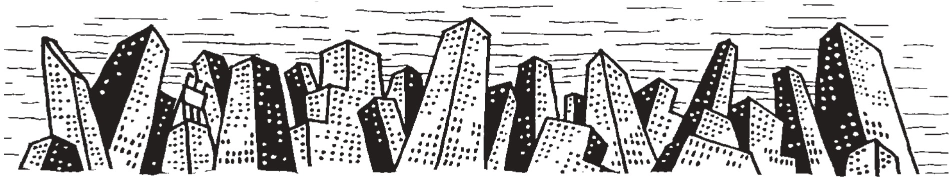

THE INSURANCE BEAT

We Don't Need No Triple-A's

IN RECENT YEARS most of the world's largest reinsurers have had their financial-strength ratings lowered. Companies that at one time had triple-A ratings must now make do with ratings several notches lower. These downgrades have prompted the once-higher-rated companies to say that high ratings aren't really so important. For example, Rick Smith, president of Employers Re, told *Business Insurance* that he didn't see the value of a triple-A rating: "There are better places to deploy [the] capital that triple-A requires, and customers have told us they don't pay more for triple-A's."

That customers aren't willing to pay more for a triple-A rating *right now* is an indication of their lack of foresight rather than an indicator that triple-A ratings have no value. Financial strength is often vastly underrated. One would think that companies whose products liability policies were written by The Mission, whose umbrellas were written by Transit, The Home, and Lumbermens, and whose E&O policies were written by Reliance and Frontier, would have learned by now that even highly-rated companies are not necessarily strong and that so-called financial strength can disappear like a puff of smoke

Business Insurance also spoke with Jack Snyder, chief marketing officer of American Re-Insurance (and former head of the ratings business at A. M. Best, which is owned by his family). Snyder, referring to American Re's decline from "AAA" to "A+" said that the downgrade "had virtually no impact." (We think he's wrong.)

American Re recently ran a full-page ad touting its "experience": "American Re is a company that you can have real confidence in," the ad declared. "We've been paying our claims and standing behind our commitments for over 86 years. And as part of the Munich Re Group, *we're more committed than ever* to continuing this proud legacy of service." [Emphasis added.]

This is, of course, typical insurance-company blather, but it makes one wonder: If American Re is now "more committed than ever" to paying its claims, then it must have been *less committed* to paying its claims and standing behind its commitments in the past.

Chinese Stocks Are Cool

IN OUR DECEMBER 22 ISSUE we noted that the stock of China Life Insurance Company, which raised $3.46 billion in a vastly oversubscribed IPO, was richly valued. Well, it's now twenty percent more richly valued. (The stock is up about eighty percent from its IPO.)

Although the People's Republic of China fixes its exchange rate at a level most believe to be too low and China Life doesn't have a history of making money, China is a big place—a vast financial frontier, if you will. Perhaps that explains why China Life is valued at $20 billion (about three times book value). So rich is China Life's share currency that it might want to consider acquiring John Hancock, which has a mere $11-billion market cap. If China Life can't bust up Hancock's deal with Manulife, it may want to make a run at Principal, which is valued at $10.5 billion. Or perhaps it should just issue several billion dollars of stock at its new, improved valuation.

China Life is a play on the growth and potential profitability of the life-insurance market in China. It is also a play on China's currency (since that's the denomination of China Life's assets), as well as a play on the solvency of China's somewhat troubled banks (since that's where much of China Life's money is).

Henry Luce proclaimed the twentieth century to be "the American century." Many believe that the twenty-first century will be the Chinese century. If so, then China Life may be a chance to get in on the ground floor. At least that's what some investors believe.

Call us old fashioned, but four times tangible book value for a company that hasn't made money just doesn't seem like the ground floor.

A Stock For The Millennium

ONE NEEDN'T GO TO CHINA to find overvalued stocks; there are plenty of them in America. The unweighted S&P 500 index has been hitting all-time highs recently, and the Value Line Index has risen about 60% since the DJIA peaked in 2000.

One of the hottest stocks is Millenium Holding Group, an "early stage financial services company" that recently signed a deal to acquire tiny First Continental Life & Accident Insurance Company, which has 4,000 policyholders, $729,000 of surplus, and was downgraded by Best last year from "C" to "NR-1."

At first glance, Millenium Holding, based in Henderson, Nevada, doesn't look like much. At second glance it still doesn't look like much. As of September 30 it had $64,566 in total assets and a negative net worth of $1.68 million. Revenues for the first nine months of last year were $2,616. Nonetheless, Millenium's stock price has gone from 6¢ a share to $1.61 per share, giving the company a market cap of $22 million. A recent press release spells out Millenium's exciting plans:

> "Acquisitions are a core part of our growth strategy," said Richard Ham, CEO and president of Millenium Holding Group, Inc. "The 42-state licenses and more than 4,000 policyholders in First Continental's portfolio will form the platform for the virtual financial institution Millenium is building. The insurance arm of our company, along with the brokerage and banking businesses, will provide a much more nimble and responsive financial institution that seamlessly meets the needs of law firms, CPAs, financial planners and other constituencies that offer outsourced financial planning assistance."
>
> Millenium is in the process of securing additional funding for complimentary acquisitions, working capital, branding/marketing efforts, management additions and other growth initiatives. Future acquisitions may include a National Bank and/or Broker Dealer.

Perhaps it goes without saying, but you're probably not familiar with any of the accounting firms that have audited Millenium's books in recent years. And we won't bore you with the details of some of the company's prior names or the details of its reverse stock splits. Suffice it to say that widows and orphans may decide that it is more prudent to invest in China Life than in Millenium.

Baldwin & Lyons: Buy & Sell

If markets were rational, people would be willing to pay higher prices for triple-A rated reinsurance and unwilling to pay such high prices for China Life and Millenium Holdings. But markets are not especially rational. An example of a quirky discrepancy can be found in the shares of Baldwin & Lyons (OTC: BWINB, BWINA).

Baldwin & Lyons isn't flashy. It owns the Protective and the Sagamore insurance companies, both of which are rated "A+" by Best. It specializes in writing liability insurance for trucking fleets, and now that rates have improved it's writing a lot more business than it did a few years ago. The company has the kind of balance sheet we like: no debt. It's a cautious investor in high-quality bonds (average maturity is about 3.8 years), and an intelligent value investor in stocks. Shareholders equity is about $320 million and earned premiums were about $140 million or so last year.

Baldwin & Lyons is a good underwriter, has grown its book value at a respectable rate, has repurchased shares when they were cheap, and has paid a decent dividend. The company is controlled by the Shapiro family. Nate Shapiro, the largest shareholder, is a good fellow.

Several years ago *Schiff's* noted that Baldwin & Lyons was selling for less than its book value. The cheap price combined with the conservative balance sheet and the nice folks in charge made Baldwin seem like a low-risk investment with the likelihood of satisfactory returns, so we bought shares. (We bought the "B" shares, which are more liquid than the "A" shares, but have no voting rights. We don't usually buy non-voting or low-vote stock; it's almost like asking to be taken advantage of. But since we trusted Nate and since the stock was so cheap, we made an exception.)

We have now arrived at the part of this article where we can point out the lack of rationality in the market. Baldwin & Lyon's "B" shares (BWINB) closed at $29.25 on Thursday. The company's "A" shares (BWINA) closed at $23.92. The two classes of stock are identical except that the "B" shares have no vote. In theory, the "A" shares have a *greater* intrinsic value than the "B" shares since they control the company. In practice, one would expect the less liquid "A" shares (there are fewer outstanding), to trade around the same price as the "B" shares trade. In fact, this has generally been the case.

On November 21, for example, BWINB closed at $23.70 and BWINA closed at 23.08. (As is often the case, no BWINA shares traded that day.) Since then, the spread between the prices of the two classes of stock has grown so wide—it is now $5.38—that one wonders why any rational person who purchased BWINB recently didn't buy BWINA instead. (For the record, we've sold our "B" shares and bought "A" shares.)

At Thursday's closing price, BWINB is selling for 14.63 times this year's estimated earnings and 130% of book value. Its dividend yield is 1.37%. In contrast, BWINA is selling for 11.96 times this year's estimated earnings and 109% of book value. Its dividend yield is 1.67%.

An arbitrageur might want to short BWINB and buy BWINA. Of course, the prices of the two classes of stock do not *have* to come back into synch with each other; BWINB might trade at $35 and BWINA may trade at $20. We feel fairly certain, however, that over time BWINB will not continue to trade at a 22% higher price than BWINA—that the spread between the two classes of stock will narrow. This should happen because intelligent investors will realize that BWINA is a much better buy than BWINB.

In the short term, people and markets are often irrational. Over the longer term, some semblance of rationality generally emerges. Be patient. Customers that won't pay up for triple-A rated reinsurance today will be willing to pay through the nose for it at some future date.

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