



# SCHIFF'S

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## Enron-o-Mania and the Insurance Industry

### Berkshire Hathaway and AIG

**T**his is our third article titled "Enron-o-Mania and the Insurance Industry." What is "Enron-o-Mania?" We define it as 1) The hoopla over Enron itself; 2) The new interest in financial reporting, financial manipulation, accounting, corporate governance, executive compensation, and the integrity of corporate numbers and corporate executives; 3) The scrutiny of the foregoing by legislators and the media; 4) Increased skepticism of financial complexity and lack of "transparency;" 5) Increased skepticism about the accounting and legal professions; and 6) A heightened sensitivity to risk.

These topics are relevant to the insurance industry. Many insurance companies are run by people whose integrity and competence are no greater than those who ran Enron and served on its board of directors. Insurance is highly political and insurance companies' accounting is inherently more complex and less precise than that of many other industries.

The following article focuses on Berkshire Hathaway, and, to a lesser extent, AIG. (We'll write more about AIG soon.) Although both companies are affected by Enron-o-Mania in one way or another, we're turning our attention to them because of their superb long-term results and financial strength—not because either resembles a house of cards. Berkshire and AIG are complex companies (AIG is much more complex) that have been molded in the image of their virtuoso CEOs. Although both companies are similar in that they have been particularly successful, their styles, methods, businesses, and CEOs are quite different.

**B**erkshire Hathaway's annual report, written by Warren Buffett, is the world's best annual report. Anyone who takes the time to read 25 years worth of Buffett's letters to shareholders ([www.BerkshireHathaway.com](http://www.BerkshireHathaway.com)) will come



AIG's Hank Greenberg and Berkshire Hathaway's Warren Buffett discuss which company has greater financial strength.

away with a good education and an excellent understanding of Buffett's thought process, as well as a pretty good overview of many of Berkshire's businesses. Most annual reports are worthless even when they're new, but Buffett's seem to improve with age. (We've reread them many times.) They're entertaining, as well.

Berkshire has grown increasingly complex over the years—particularly after its acquisition of General Re. As a result, it's more difficult to have a reasonable understanding of the company's fundamentals and to form an accurate opinion about the company's value.

AIG, due to its size, international scope, and complex mix of financial businesses, is even harder to understand.

Although it has more than a three-decade track record of exceptional growth, AIG is, to many, a "black box." (Webster's defines this as "anything that has mysterious or unknown internal functions or mechanisms".)

A January 23 *Wall Street Journal* article, "Deciphering the Black Box," focused on five companies with complex, impenetra-

### Conference Update

Although our April 9th conference is sold out, spaces sometimes open up due to cancellations, and we may be able to accommodate people on the waiting list. If you're interested in attending next Tuesday, please call (434) 977-5877 immediately.

ble, or dubious accounting: General Electric, AIG, Williams, IBM, and Coca-Cola. (Berkshire Hathaway owns \$10 billion of Coca-Cola stock.)

One can make a strong case that General Electric, IBM, and Coca-Cola have engaged in accounting or business contrivances that have improved their financials. Although many analysts suspect that AIG “smoothes” its earnings, *proving* this is virtually impossible.

On the subject of AIG’s inscrutability, the *Journal* quoted the editor of the world’s most dangerous insurance publication: “It’s not obfuscation,” he said, “it’s sheer complexity.” The editor noted that loss reserves are estimates that are *likely* to be proven wrong, even if they’re made with the best of intentions.

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In the post-Enron society, many investors are wary of black-box companies and complex companies, even if these companies have a long history of making money. Although we’ve written several articles expressing skepticism about AIG’s stock price in recent years, our skepticism was due to AIG’s high price-earnings and price-to-book ratios. One cannot deny, however, that AIG (and Berkshire Hathaway), with their triple-A ratings, will *benefit* from an Enron-induced flight to quality. At the margin, those seeking financial strength are more likely to do business with these two companies now than before.

It’s hard to imagine that Hank Greenberg likes to see AIG referred to as a “black box,” or considers it to be one. “Hank knows his business as well as I know my business,” says Bill Berkley, chairman and CEO of W. R. Berkley, “and his is 50 times larger.”

Greenberg’s intense involvement in AIG’s businesses is notable. In addition to being on the boards of dozens of AIG’s insurance companies, and serving as chairman of 60%-owned Transatlantic Holdings and recently-acquired American General, he’s well known for grilling employees, scrutinizing budgets, and traversing the world.

Greenberg inspires fear, reverence, and admiration. Although stories about his temper are legendary, he’s a man of considerable charm and humor. Many Wall Street analysts are afraid of him, however, and avoid making critical comments about AIG. (Greenberg’s greatness and achievements are beyond question; his company’s future success and stock price are not.) As for reverence, make of this what you will: AIG’s 2000 annual report contains a photo of 14 of the company’s top executives (including Greenberg) sitting at a conference table. A caption identifies each executive—five of whom are on the company’s board—by first and last name. Greenberg, however, is identified as “Mr.” Greenberg.

Lately, Greenberg, who is almost 77 (but seems *much* younger), has been pestered about naming a successor. His response is that AIG’s board will deal with this issue and that there is a succession plan. AIG has also been criticized for having too few “independent” directors. (The company is making some

nominal changes to address this.)

Although Berkshire Hathaway only has two “independent” directors, we don’t recall much criticism of that. (At most companies, “independent” directors aren’t particularly independent, anyway.) Nor is Buffett, who is 70, criticized for failing to name a successor. (Buffett doesn’t plan to retire, but has said that there’s a succession plan in place.)

Unlike Greenberg, Buffett prefers to be a *hands-off* manager. (He’s not on the boards of General Re or GEICO, for example.) Berkshire owns an array of great or good businesses, most of which generate excess cash, and, absent an extraordinary problem, the managers run these businesses and Buffett allocates the cash. (Of course, saying that Buffett “allocates cash” is an understatement akin to saying that Toscanini merely waved a baton.)

Berkshire is not usually referred to as a “black box,” and yet, as a result of its acquisition of General Re and other companies, and the growth of its own insurance businesses, it has become increasingly difficult to analyze.

Although the big losses at General Re last year surprised many, Buffett was aware that Berkshire’s results could become more volatile when he bought General Re in 1998, and beginning that year changed the way he presented data to shareholders. (Over the years Buffett has taken great care to make his financial reports reasonably transparent. Also, he has not hyped his stock, and has gone so far as to warn that it was not undervalued and that he wouldn’t purchase it.)

In Berkshire’s 1990 annual report, Buffett included a table showing the “cost of float” for the company’s insurance operations. Here’s his explanation of “float” and the significance of its “cost”:

Float is money we hold but don’t own. In an insurance operation, float arises because premiums are received before losses are paid—an interval that sometimes extends over many years. During that time, the insurer invests the money. Typically, this pleasant activity carries with it a downside: the premiums that an insurer takes in usually do not cover the losses and expenses it eventually must pay. That leaves it running an “underwriting loss,” which is the cost of float. An insurance business has value if its cost of float over time is less than the cost the company would otherwise incur to obtain funds. But the business is a lemon if its cost of float is higher than market rates for money. *continued*

Buffett has said that the cost-of-float ratio “is meaningless” over the short term. “Quarterly underwriting figures and even annual ones are too heavily based on estimates to be much good,” he wrote. “But when the ratio takes in a period of years, it gives a *rough indication* [emphasis added] of the cost of funds generated by insurance operations.”

Buffett’s cost-of-float table showed Berkshire’s annual underwriting loss (or profit) since 1967, the average of amount of float for each year, and the approximate cost of float for each year. (The cost of float is the quotient of the annual underwriting loss divided by that year’s average float. In other words, the underwriting loss is the numerator and the average float is the denominator.) In 1990, for example, Berkshire recorded a \$26.65 million underwriting loss and had \$1.637 billion of float. Thus, its cost of float was 1.63%.

Buffett’s table also compared the cost of float (1.63% in 1990) to the year-end yield on long-term government bonds (8.24% in 1990).

Looking at the table, one could see that in many years Berkshire earned an underwriting profit, and thus its cost of float was less than zero. (Viewed another way, Berkshire was *getting paid* to hold money it didn’t own.) In all but five years, Berkshire’s cost of float was less than the yield on long-term government bonds.

When introducing the cost-of-float table, Buffett provided a caveat: “There are two important qualifications to this calculation. First, the fat lady has yet to gargle, let alone sing, and we won’t know our true 1967-1990 cost of funds until all losses from this period have been settled many decades from now.”

Buffett last published the cost-of-float table in the 1997 annual report. In 1998, Berkshire acquired General Re, whose float far exceeded Berkshire’s. In his 1998 letter to shareholders, Buffett provided the *year-end* float rather than the *average* float. Also, he didn’t tell shareholders the cost of float. Why?

At first we thought that given the uncertainties of General Re’s business, Buffett might have felt that calculating an annual cost of float was an exercise in false precision. In fact, when discussing the Berkshire’s float, he wrote the following:

A caution is appropriate here: because loss costs must be estimated, insurers have enormous latitude in figuring their underwriting results, and that makes it very difficult for investors to calculate a company’s true cost of float. Errors of estimation, usually innocent but sometimes not, can be huge. The consequences of these miscalculations flow directly into earnings.

An experienced observer can usually detect large-scale errors in reserving, but

the general public can typically do no more than accept what’s presented, and at times I have been amazed by the numbers that big-name auditors have implicitly blessed.

As for Berkshire, Charlie [Munger] and I attempt to be conservative in presenting its underwriting results to you, because we have found that virtually all surprises in insurance are unpleasant ones. *continued*

### Berkshire Hathaway’s Cost of Float: 1967 to 2001

From 1990 to 1997, Warren Buffett published the following table in his letter to shareholders. He discontinued the table in 1998. Since then he has provided shareholders with a figure for “year-end float” (rather than “average float”) and, except for 1998, has provided a figure for “cost of float.”

We’ve updated the table through 2001 using the cost of float and underwriting earnings provided by Buffett in his letters to shareholders. Although we’ve tried to present our numbers in a manner consistent with the 1967-to-1997 numbers, bear in mind that Buffett hasn’t updated the chart himself.

	(1) Underwriting Loss <i>(\$ Millions)</i>	(2) Average Float <i>(\$Millions)</i>	Approximate Cost of Funds <i>(Ratio of 1 to 2)</i>	Year-end Yield on Long-Term Govt. Bonds
1967	profit	17.3	less than zero	5.50%
1968	profit	19.9	less than zero	5.90%
1969	profit	23.4	less than zero	6.79%
1970	0.37	32.4	1.14%	6.25%
1971	profit	52.5	less than zero	5.81%
1972	profit	69.5	less than zero	5.82%
1973	profit	73.3	less than zero	7.27%
1974	7.36	79.1	9.30%	8.13%
1975	11.35	87.6	12.96%	8.03%
1976	profit	102.6	less than zero	7.30%
1977	profit	139.0	less than zero	8.93%
1979	profit	227.3	less than zero	10.08%
1980	profit	237.0	less than zero	11.94%
1981	profit	228.4	less than zero	13.61%
1982	21.56	220.6	9.77%	10.64%
1983	33.87	231.3	14.64%	11.84%
1984	48.06	253.2	18.98%	11.58%
1985	44.23	390.2	11.34%	9.34%
1986	55.84	797.5	7.00%	7.60%
1987	55.43	1,266.7	4.38%	8.95%
1988	11.08	1,497.7	0.74%	9.00%
1989	24.40	1,541.3	1.58%	7.97%
1990	26.65	1,637.3	1.63%	8.24%
1991	119.59	1,895.0	6.31%	7.40%
1992	108.96	2,290.4	4.76%	7.39%
1993	profit	2,624.7	less than zero	6.35%
1994	profit	3,056.6	less than zero	7.88%
1995	profit	3,607.2	less than zero	5.95%
1996	profit	6,702.0	less than zero	6.64%
1997	profit	7,093.1	less than zero	5.92%
1998*	profit	22,762**	less than zero	5.08%
1999	1,394	24,034	5.8%	6.48%
2000	1,585	26,417	6.0%	5.46%
2001	4,067	31,773	12.8%	5.48%

\*General Re was acquired in 1998.

\*\*The figure provided is for year-end float rather than average float.

Our initial thought about Buffett's reason for not disclosing the cost of float in 1998 was dispelled by the 1999 annual report, in which Buffett mentioned that the cost of float was 5.8% that year. The following year he said its cost was 6%, and for 2001 year he said it was 12.8% (the worst it has ever been compared to Berkshire's investment results).

We've provided an updated table showing Berkshire's cost of float from 1967 to the present. (See *Berkshire Hathaway's Cost of Float* on the previous page.) The figures are derived from Berkshire's annual reports and financial statements. We've also provided a table with two different sets of cost-of-float figures for 1999 through 2001. (See *Berkshire Hathaway's Pro-forma Cost of Float: 1999 to 2001* on the next page.)

Our pro-forma figures indicate that Berkshire's cost of float was unsatisfactory in 1999 and 2000, and that 2001 was not as bad as it appeared. To arrive at these conclusions we made a number of adjustments to Berkshire's results: 1) We charged 2001's adverse loss development to 1999 and 2000; 2) We either eliminated the \$2.4 billion September 11 loss or amortized it over the three years ending with 2001; 3) We eliminated accounting charges for retroactive insurance policies and losses resulting from aggregate excess policies. (These charges and losses are different than traditional underwriting losses.)

When viewed through the pro-forma lens, Berkshire's cost of float for 1999 to 2001 doesn't look good. Considering the soft market and September 11, this isn't surprising. Although three years is too short a period from which to draw conclusions, the restated figures may be useful when considering how to place a value on Berkshire's float. (Float, of course, is offset by liabilities, primarily reserves. If an insurance company can increase its float at a low cost, or no cost, then the float is especially valuable: essentially, it's a loan on which the company pays little or no interest. However, if the cost of float isn't low relative to other sources of capital and investment returns, then the float has no special value—it's merely the consolation prize a company gets from being in a money-losing business.)

Over the years, the "value" of Berkshire's float has become an increasingly important component of Berkshire's total value. Depending upon the assumptions one makes, the value of Berkshire's float will vary tremendously. Assume, for example, that Berkshire's float will remain flat, that the investment returns on the float will be 7.5%, and that the cost of float will be 4%. Under that scenario Berkshire will make a 3.5% pretax annual spread—\$1.25 billion per year—on its \$35.5 billion of 2001 year-end float.

If we assume that Berkshire's investment returns will be 12% and its cost of float will be zero, then the company would make \$4.3 billion per year (pretax) on its float. If we assume that Berkshire's float will grow 6% per year—with the same investment returns and cost of float—then the float becomes increasingly valuable.

Although we've seen estimates that show Berkshire earning double-digit returns on increasing float, we view those numbers with skepticism. Most insurance companies tend to invest their assets in fixed income. Berkshire, which has always had exceptional financial strength, is more concerned about achieving good long-term returns than smooth short-term returns, and has historically been a big investor in common stocks. In the past, however, Berkshire's float was much smaller compared to its shareholders' equity. (Berkshire's float is now about the same as its tangible equity.) As a result, we'd be surprised if Berkshire invested a large amount of its float in equities. (Remember, as Buffett said, Berkshire doesn't "own" the float.) Therefore, it seems likely that Berkshire will earn something closer to fixed-income returns on its float, rather than the exceptional equity returns it has earned on its own capital.

What will Berkshire's long-term cost of float be? Your guess is as good as ours. We do think, however, that the cost is likely to bear some correlation to interest rates. (Higher interest rates will result in a higher cost of float; lower interest rates will result in a lower cost of float.) ■

*Please go to the next page to see "Berkshire Hathaway's Pro-forma Cost of Float: 1999 to 2001," and the accompanying text.*

## A Reminder from Berkshire Hathaway

In its 2001 financial statement, Berkshire made a small, but interesting, change in footnote 1b ("Significant accounting policies and practices—use of estimates in preparation of financial statements"). Here's the footnote. The new language is in italics:

"The preparation of the Consolidated Financial Statements in conformity with generally accepted accounting principles ('GAAP') requires management to make estimates and assumptions that affect the reported amount of assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses during the period. *In particular, estimates of unpaid losses and loss adjustment expenses for property and casualty insurance are subject to considerable estimation error due to the inherent uncertainty in projecting ultimate claim amounts that will be reported and settled over a period of many years.* Actual results may differ from the estimates and assumptions used in preparing the Consolidated Financial Statements."

## Berkshire Hathaway's Pro-forma Cost of Float: 1999 to 2001

In Table 2 and Table 3 we've made adjustments to Berkshire's cost-of-float table. Although the figures in Table 1 are reproduced from the previous *Cost of Float* table and were prepared in a manner consistent with what Buffett had presented, Berkshire's mix of business has not remained consistent. Berkshire acquired General Re in 1998. It also became a large writer of *retroactive reinsurance* and of *aggregate excess contracts* (based on time-value-of-money concepts) in which Berkshire assumes past or current losses that are greater than the premiums it receives. Berkshire records underwriting losses from these transactions, but gains float, from which, eventually, it should more than make up the underwriting losses.

Although the concepts behind these two types of reinsurance are similar, their GAAP accounting treatments are different. The underwriting losses from retroactive reinsurance policies are deferred, and charged against income over many years. (In 2001, these charges appear in footnote 10 of the financial statement—"Unpaid Loss and Loss-Adjustment Expenses"—as "incurred losses recorded" for "prior accident years"). Thus, when assessing Berkshire's loss-reserve development, it makes sense to make an adjustment for the charges relating to retroactive reinsurance.

In 2001, for example, Berkshire reported \$1.165 billion of adverse loss development, of which \$328 million was attributable to charges for retroactive reinsurance. Eliminating the charge for retroactive reinsurance reduces Berkshire's adverse loss development in calendar year 2001 to \$837 million. (In his 2001 annual report, Buffett expressed disdain for the phrase "loss development," noting that adverse loss development and "reserve strengthening" simply mean "that management made an error in estimation that in turn produced an error in the earnings previously reported. The losses didn't 'develop'—they were there all along. What developed was management's understanding of the losses.")

The aggregate excess contracts based on time value of money have a different GAAP treatment: *all* the losses are recognized in the first policy year. Berkshire, however, will have the float attributable to these policies for many years. In 1999 and

2000, Berkshire had underwriting losses of \$400 million and \$482 million, respectively, from this type of reinsurance. As a result, Berkshire's underwriting losses were larger than they would have been otherwise, and its "cost of float" was higher. In the future, because there won't be charges derived from these policies (unless Berkshire writes more of this type of business), the company's "cost of float" will be reduced somewhat.

In Table 1 we've reproduced figures from the previous *Cost of Float* table. In Table 2 and Table 3, we've adjusted Berkshire's "underwriting loss" as follows:

- 1) The \$837 million *adverse* loss development for 2001 has been charged to 2000 and 1999 (based on our understanding that it was primarily attributable to these accident years).
- 2) The \$66 million of *adverse* loss development (after adjustment for \$145 million of retroactive reinsurance charges) for calendar year 2000 has been eliminated.
- 3) The \$251 million of *positive* loss development (after adjustment for \$59 million of retroactive reinsurance charges) has been *added* back to the 1999 underwriting loss.
- 4) The \$400 million and \$428 million losses recorded in 1999 and 2000 resulting from aggregate excess policies have simply been

eliminated. (Since we don't know the precise amount of float attributable to these policies—it is, perhaps, \$500 million—we haven't made any reduction in the "average float" column. As a result, the cost-of-float figures are slightly lower than they would otherwise be.)

5) The \$2.4 billion loss for the terrorist attack on September 11, 2001 has been eliminated or spread over the three years ending 2001. Although *eliminating* the loss allows one to compare cost-of-float figures absent an extraordinary item for which no premium had been charged, the loss was obviously quite real, and had a severe impact on Berkshire's cost of float. On the other hand, when analyzing an insurer as an ongoing operation, it doesn't necessarily make a lot of sense to allocate the cost of an extraordinary mega-catastrophe to one year. There is no "correct" period to allocate the September 11 loss to. Our decision to use three years was somewhat arbitrary; we could have used five, seven, or ten years. If we had used longer periods, it would have reduced Berkshire's cost of float.

The purpose of making these changes is to view Berkshire's cost of float in a different light. Bear in mind, the numbers in the following tables are not the "right" numbers—there's no such thing. There are other adjustments one might choose to make. Or, one might choose *not* to make some of the adjustments we've made. Finally, three years is too short a period from which to draw long-term conclusions.

**Table 1: Cost of Float, 1999 to 2001**

	(1) Underwriting Loss	(2) Average Float	Approximate Cost of Funds	Year-end Yield on Long-Term Govt. Bonds
	(\$ Millions)	(\$Millions)	(Ratio of 1 to 2)	
1999	1,394	24,034	5.8%	6.48%
2000	1,585	26,417	6.0%	5.46%
2001	4,067	31,773	12.8%	5.48%

**Table 2: Pro-forma Cost of Float Excluding September 11 Loss, 1999 to 2001**

	(1) Underwriting Loss	(2) Average Float	Approximate Cost of Funds	Year-end Yield on Long-Term Govt. Bonds
	(\$ Millions)	(\$Millions)	(Ratio of 1 to 2)	
1999	1,663	24,034	6.9%	6.48%
2000	1,509	26,417	5.7%	5.46%
2001	830	31,773	2.6%	5.48%

**Table 3: Pro-forma Cost of Float if September 11 Loss is Spread Over 1999 to 2001**

	(1) Underwriting Loss	(2) Average Float	Approximate Cost of Funds	Year-end Yield on Long-Term Govt. Bonds
	(\$ Millions)	(\$Millions)	(Ratio of 1 to 2)	
1999	2,463	24,034	10.2%	6.48%
2000	2,309	26,417	8.7%	5.46%
2001	1,630	31,773	5.1%	5.48%