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Whistling Past the Graveyard

Waiting for the Man

Despite a 17-year run in which property-casualty insurance companies' adjusted net worth has grown 1,100%, the people who run these companies have professed a good deal of optimism this year. Many have told analysts—who else listens so intently?—that rates will go up, or at least stop going down. (You'd think that grown insurance executives would know better than to try to predict the future. Many can't even predict the past: their loss reserves.)

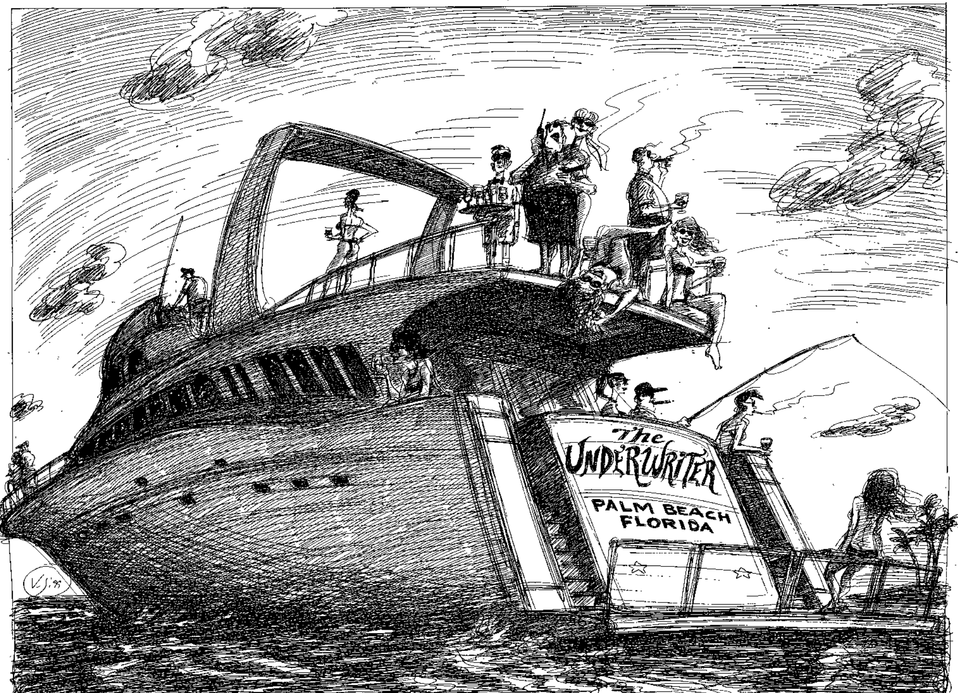
Hank Greenberg, AIG's chairman and the greatest man in the insurance business, went on record not long ago, saying "the worst is over." It was big news for a moment.

Two other comments by Greenberg are also of note, although they haven't even been mentioned by any member of the media: 1) Last year "saw the first signs of a more sensible industry approach to underwriting;" and 2) "There were signs during the year...that an upturn [in insurance pricing] was close at hand." We cite these two comments because Greenberg made them to AIG's shareholders—in 1990 and 1991.

Back then, many thought that the property-casualty cycle was *obliged* to adhere to a three-year schedule. Greenberg's inability to predict a turn in pricing hasn't hurt AIG's results, just as Warren Buffett's inability (and unwillingness) to predict the direction of the stock market hasn't hurt Berkshire Hathaway's results. The best insurance companies tend to do well in hard markets and make it through soft markets relatively unscathed.

Despite the property-casualty industry's $330 billion of capital, many Wall Street analysts predict that insurance companies will achieve higher earnings next year. Certainly there are troubling signs: written premiums and paid claims have grown faster than loss reserves, which raises issues about the quality of earnings. If things are bad, the analysts figure, that will force the market to harden, which is good for everyone—except those who buy insurance.

While sectors of the market will firm (some sooner, some later), a hard market won't be greeted by cheers all around, because a hard market is a reaction to pain. Money must be lost, and insurance companies must feel fear, before excess profitability materializes. We don't say this out of any cold-shower, Calvinistic



"Damn it, Johnson! If you don't cut claims, we'll have to cut expenses."

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Weltanschauung. We say it because that's the way the law of supply and demand works: when there's a lot of supply, prices tend to stay down.

So there will be pockets of opportunity in the industry, but companies that are properly capitalized will be in the best position to avail themselves of these opportunities. (We are intrigued by the workers' comp market simply because it has been so bad, and have spanned the alphabetical gamut by making modest investments in Argonaut and Zenith National, at prices below book value.)

One doesn't have to be an optimist to find opportunities in the insurance business. In fact, optimists can be dangerous—they tend to *imagine* opportunity where none exists. Although we've been bearish on the industry for what seems like ages—and particularly wary of personal auto (see *Schiff's*, May 1998, page 1)—our bearishness hasn't prevented us from owning and buying insurance-company stocks. In our January 1995 issue, for example, we noted that we'd purchased shares in eleven insurance businesses. (This turned out to be a cyclical bottom for insurance stocks.) Lately, we've been buying stock in a number of reasonably capitalized out-of-favor property-casualty companies selling below book value. Despite our purchases, we don't feel optimistic. On the other hand, when buying a bargain, one doesn't need *everything* to go right. When securities are priced for the worst, one merely needs the worst *not* to happen to make money.

Over the years we've tried to approach the insurance industry as a realists, and have espoused plenty of opinions contrary to the prevailing wisdom. A recent reading of a decade's worth of articles confirms (to us, anyway) that our cautious contrarianism has served our readers well. Since 1999 marks our tenth anniversary, we'll take this opportunity to recommend that newer readers buy "The Complete *Schiff's Insurance Observer*" a/k/a "David Schiff's Lost Decade," from Mr. Pig's House of Insurance. (See page 28.)

At one end of the insurance-stock universe there are a reasonable number of "cheap" stocks in companies with decent balance sheets and pretty good market positions. Light years away, at the other end of the universe, is AIG, whose stock trades at 28 times earnings and 430% of book value. It is priced for perfection, or something close to that. (We noted this last October, too, when the stock was not only at a lower multiple of earnings and book value, but at a lower price.) If AIG is worth 430% of book value, why, one wonders, don't the people who are buying it at that valuation take a flyer on W. R. Berkley and Loews, both of which are selling below book value (and both of which we've bought below book value)? The answer, we must assume, lies in the nature of markets. There is no way to tell when, if ever, AIG will go out of style, or when, if ever, Berkley and Loews will come into style. For our money, however, we feel more comfortable with what's currently cheap and unfashionable.

Our comments shouldn't be interpreted as any negative feeling on our part about Hank Greenberg, or AIG. We just see a disconnect between the value of his company and the value of its stock. (The same could be said of Coca-Cola, General Electric, and others.)

On January 13, Greenberg spoke at the Joint Industry Forum, and three of his comments caught our ear. They are worth repeating. Speaking about the high prices being paid for many insurance companies, he quipped, "there ought to be an acquisition discount," rather than an acquisition premium. We'll bet that there will be a number of acquisition discounts in the next year.

Greenberg, a man not known for his easy-going manner, doesn't mince words: "If anyone thinks workers' comp reserves are profitable, they're in dreamland," he said sharply. But even Hank Greenberg can't talk sense into an overcapitalized market. Markets are bigger than people, governments, and even AIG.

Finally, he asked a rhetorical question: "When are the auditors going to stop" signing off on the financial statements of companies that are underreserved?

We think we know the answer. They'll stop signing off when they usually do: after it's too late.

The insurance business, as we have noted before, is the investment business. Insurance companies take in money and invest it. The best insurance companies get their money at no cost (by underwriting profitably), and then invest it skillfully, earning above average returns with below average risk. They then repeat the process.

The concept of taking in premiums and investing them is so appealing that people who fancy themselves good investors want to get into the insurance business. (As Warren Buffett has pointed out, "float"—the funds that offset reserves—is a wonderful thing. And as Martin Frankel knows, life insurance companies have a lot more float than property-casualty companies.)

Although the insurance business looks appealing, it is a difficult one in

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which to earn superior returns over prolonged periods. An insurance company is often a Rube Goldberg contraption: a money-losing machine. It works like this: 1) Underwriter issues underpriced insurance policies; 2) premiums from underpriced insurance policies are invested in overpriced assets; 3) actuaries, struggling to achieve corporate objective, use complex computer models to predict that underpriced policies are profitable; 4) actuaries use different computer models to predict that overpriced investment assets will have above average returns; 5) insurance company acts upon the belief that steps 1-4 make sense; and 6) hires more people to repeat process.

Sometimes things go awry. Despite having underpriced its policies or made bad investments, an insurance company may avoid being hit with significant losses for quite some time.

The money-losing contraption may also fail to work if the insurance company makes the acquaintance of a reinsurance company that has its own money-losing machine. Since a reinsurance company, in its most pristine form, is just a pile of capital, an underwriter, and a money manager, it can be a purer form of money-losing machine. A reinsurance company may well believe that it can take pieces of underpriced primary policies but make up the difference by investing well. Or it may only believe that it can find a greater fool on whom it can lay off its risk. (This isn't so silly—the reinsurance market knows no borders, and the world is filled with fools.)

In January, when the 30-year Treasury was 100 basis points lower than it is now, one small insurer that was invested in Treasurys told *Insurance Finance & Investment (IFI)* that it planned to outsource its money management because it wanted more credit risk—"something that will earn some decent interest," an executive at the company said. (If this company had only gone *short* Treasurys...)

The same issue of *IFI* quoted a knowledgeable fellow discussing the life-insurance opportunities in Eastern Europe. He was advising companies not to enter the Czech Republic (it was too crowded), and suggested, instead, that they expand into Poland—despite the fact that 30 Western insurance and finance companies had *already* applied for licenses there.

Around the same time, one of the world's largest securities firms published a detailed report on Skandia, the "leading non-life insurer in the Nordic area." The firm's analysts concluded that a "reasonably generous" valuation for the company was 104 krona per share. "On valuation grounds [What other grounds are there?] the price is full," the analysts wrote—a reasonable conclusion given that the stock was at 127 krona, 23 krona more than "full" value). What didn't seem reasonable, however, was the firm's opinion of the stock. For the short term it was "neutral"; for the "long term" it was "accumulate." (Why is it good for long-term investors to pay more than full value?)

We didn't ask any analysts for their opinions of InsWeb, the Internet insurance marketplace, which went public on July 23 at $17 per share and shot up to $44, giving it a market cap of $1.5 billion. The stock has now sunk back to its offering price, and sports a more modest market cap of $600 million, not bad for an insurance business that had $8 million of revenues and $23 million of expenses for the first six months of 1999. (In our March issue we called "Internet-stock mania" a "good example of a current speculative bubble.")

Although it doesn't have earnings, InsWeb has a good website, and you can probably save some money on your auto insurance by spending 20 minutes there. More memorable than the website, however, is the prospectus for InsWeb's IPO. It lists 41 "risk factors" (8,477 words in all)—a world record, we believe, for a company in the insurance business.

Rather than invest in Polish life insurers, overvalued Swedish non-life insurers, or risk-laden Internet insurance businesses, there is an alternative: short-term Treasurys. Another alternative can be found at www.BHLN.com, which, to our knowledge, offers the best single-premium-deferred-annuity (for those who want a long-term guaranteed rate). The website belongs to Berkshire Hathaway, and the annuities are sold directly by Berkshire Hathaway Life and carry no commission. The rate you will receive will be equal to the yield of a U.S. Treasury strip with a comparable term. (On the day we took a look, the interest rate was 6.22%, and it was *guaranteed* for up to 70 years. You choose the term.)

This is a brilliant product for Berkshire to sell. Essentially, the company is borrowing money at the same rate as the U.S. Treasury—plus whatever expenses are associated with issuing the annuity, which has a $40,000 minimum.

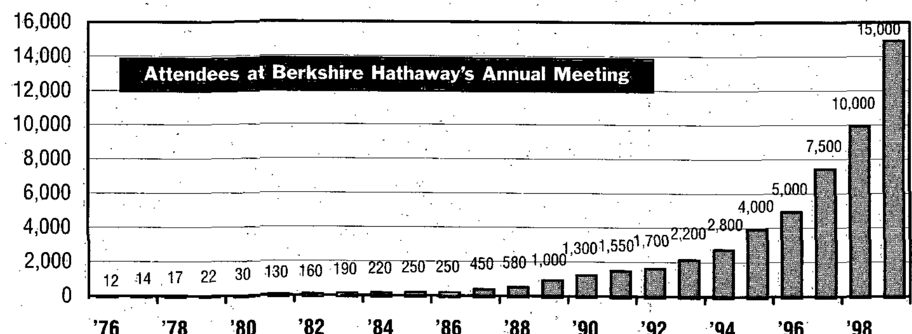
It's worth noting that while others are setting up shop in Poland and the Czech Republic, Berkshire is selling a prosaic product here in America. It's doing in annuities what GEICO has done in auto insurance.

The window of opportunity for annuities probably won't stay open for too long, however. Other companies will become aggressive and offer yields that are too high, driving profit from that line, at least temporarily.

By that time, however, Berkshire will have accumulated assets cheaply and, more importantly, while the going was good. ■

A Bull Market in Attendance: Berkshire Hathaway's Annual Meeting

For those who don't feel like schlepping to Omaha every Spring, edited (but still long and wonderful) transcripts of Berkshire Hathaway's annual meeting are available from *Outstanding Investor Digest*, 295 Greenwich St., PMB 282, New York, NY 10007. Phone: (212) 925-3885.



Sources: Berkshire Hathaway, *Omaha World-Herald*. Figures for 1977-79 and 1982-84 are estimates made by *Schiff's Insurance Observer*.