# EMERSON, REID'S INSURANCE OBSERVER

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# Reading, Writing, and Risk Management

## *10,000 CPCUs Can't Be Wrong, Can They?*

According to a survey of 803 college students conducted by the Connecticut Chapter of the Society of CPCU, "college students do not hold the insurance industry in the highest regard." Although that's not surprising, the surveyors were dismayed that students didn't consider insurance "a desirable career option;" that they preferred teaching, law and medicine.

The students' negative view of our industry raises a good question: If a bunch of kids who've spent the last four years drinking beer, listening to loud music, and depriving their bodies of sleep are smart enough to know the insurance industry stinks, how come the CPCUs aren't?

The CPCU Society thinks "broadly directed image-building and educational efforts" are what's needed to rectify the situation, including "many more educational interventions at the college, high school and even earlier levels."

Although the CPCUs' report didn't spell out a new curriculum, we believe their modest proposal includes replacing Geography, English Literature, and European History with Risk Management 101, Automobile Rating, and Introduction to Claims Adjusting.

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Students aren't the only ones with a negative opinion of the insurance industry. In the wake of Allstate's retreat from the Florida homeowners market, Florida's Insurance Commissioner, Tom Gallagher, explained why he thought the resulting shortage of insurance would be short-lived. "I have faith that the greed of the insurance industry will bring companies back," he said. Although he may well be a believer in Adam Smith's "invisible hand," that hasn't prevented him from investigating insurance companies that are planning to reduce their exposure to catastrophic storm losses.

While we're certain the Sunshine State's Insurance Commissioner would never begrudge a man the healthy glow obtained from spending time outdoors, the same can not be said of Salvatore R. Curiale, New York's Superintendent of Insurance. He recently blasted the lavish corporate lifestyle of Albert Cardone, the boss of beleaguered Empire Blue Cross and

*The Risk Manager at Work*

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Blue Shield. Although it's a fact that Cardone takes home $600,000 a year, knocks about in a chauffeur-driven limo, and has a vacation home in Florida, what really irks the Superintendent is that Cardone looks too good. "Al Cardone is his own worst enemy," said the pale Curiale, who, when we last saw him, looked like he hadn't been outside in years. "It drives me crazy when he comes to a rate hearing with people who are desperate for insurance—whose premiums are going up—and he comes in with a beautiful tan."

Cardone, who sometimes rents a helicopter to shuttle up to Albany, justifies his posh offices—replete with Tiffany glassware—by explaining that Empire must compete with big insurance companies for influence and employees. Left unsaid is the fine example he's setting for America's college students. If these callow beer-guzzlers could only understand that top insurance executives make loads of money for doing very little—that most of their time is spent playing golf and drinking martinis—then surely they'd consider insurance to be a more desirable career option and the CPCU Society could abandon its ambitious educational program; assuming, of course, that the CPCUs can hush up the shocking development that recently took place at Sedgwick Group. In the wake of poor financial results and a cut in the dividend, the chairman and executive directors have all taken a ten percent pay cut.

It's people like that who give insurance a bad name. ■


EMERSON, REID'S
INSURANCE OBSERVER

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# Smoking TNT and Drinking Dynamite

## *It's Business As Usual in the Insurance Industry*

Every year, in an ongoing attempt to make some sense of the insurance industry, we read stacks of insurance-company annual reports. After reading this year's crop, it's easy to see why college students have such a low opinion of the insurance business. Insurance—like pork bellies, coffee beans, or lumber—is a commodity. (Since December, insurance catastrophe futures have been bought and sold on the Chicago Board of Trade.) Like other commodities, insurance is ruled by the laws of supply and demand. When there's a shortage—as there is in Florida, and in the catastrophe reinsurance market—prices rise. When there's a bumper crop of insurance-company surplus, as there *appears* to have been for the last few years, prices fall.

Despite these vagaries, certain insurance companies tend to turn in respectable results no matter what. GEICO, 20th Century, Progressive, Hartford Steam Boiler, AIG, Chubb, and General Reinsurance are prominent examples. Most companies, however, muddle along as usual. That's not surprising. The insurance business is tough, and will probably get tougher over the next generation.

Right now, virtually everyone agrees that competition has gotten out of hand; the market is too soft; prices are too low; and companies are underreserved. Yet no one is forcing companies to write insurance at these prices; they are doing it of their own free will.

Underwriting, in a sense, is a psychological game. As long as an underwriter *thinks* he has the necessary surplus, and *thinks* he's making money—or at least breaking even—he will generally write business at the prevailing rates. But how does an underwriter really know if he's making money? Accurate loss reserves aren't easy to set, and the process of doing so is imprecise. More than sixty percent of Chubb's reserves, for example, are for claims that have been incurred but not reported and for future development on reported claims. CNA recently increased its asbestos-related bodily injury claim reserves by an astounding $1.5 billion. Lest you think this resulted from aggressive underwriting, think again. All the claims are from a policy with a $1,000,000 limit that was in force for twenty-two months in the late 1950s.

Although insurance companies don't try to lose money underwriting, it just seems to happen. That doesn't mean insurers will always be receptacles for money-losing risks. "The market could turn in an instant," Richard "Rocky" Shaw, Chairman of Lowndes Lambert, told us in the vast expanse of his penthouse office in London. "At 4:30 one afternoon an underwriter says 'no.'" Although he didn't predict when this might happen, he noted that insurance markets have hardened everywhere but the United States.

### A "New Era"

The possibility that the U. S. market will soon turn has Wall Street licking its chops and viewing bad news as good. Earthquakes, hailstorms, explosions, blizzards, tornadoes, and tropical storms are considered augurs of better times to come. The losses caused by these catastrophes will supposedly beget a shortage of capital which will beget higher prices which will beget greater profits. The stock market, which supposedly is somewhat efficient, has embraced this scenario and insurance stocks have soared. As a result, insurance companies are eagerly tapping the equity market. There's just one hitch: If insurance companies can replenish their capital by issuing stock and taking capital gains on their fixed-income portfolios, they won't be so short of capital. If they're not short of capital, why should rates rise? If rates don't rise, why should profits increase? And if profits don't go up, won't insurance stocks go down?

On the other hand, many believe we're in a "new era"—that investors are in it for the long haul this time. Since historical studies have shown that stocks outperform bonds, it has become accepted wisdom to view every decline as a buying opportunity. Not surprisingly, we're skeptical. It wasn't long ago that Wall Street's hucksters were hauling out professors who could *prove* that junk bonds outperformed investment grade bonds, that the *real* risk was in buying high-grade bonds since they had no place to go but down.

One of the year's more telling remarks was buried in the "Management's Discussion and Analysis of Financial Condition" section of Continental Corporation's annual report. After explaining that its Best's rating was lowered to A– (which, in relative terms, isn't especially good) and that its Standard & Poor's and Moody's ratings were also lowered, Continental said it "does not expect these rating changes to have a material impact on its competitive position within the insurance industry," but "expect[s] that they will increase its borrowing costs." In other words, although lenders will now demand a higher rate of interest on Continental's debt, policyholders *(because they're too dumb?)* will not demand lower premiums or more coverage for the same price.

Is Continental's matter-of-fact observation—that ratings don't matter—accurate? Is there really little value to superior financial strength? It seems that way, at least for the moment. A study undertaken last year by the Independent Insurance Agents of America found that thirty-two percent of agents considered "price" the most important factor in the placement of a commercial risk, whereas just eleven percent thought "financial strength" was the most important.

On the other hand, A– rated Reliance Group, which has pared down its exposure to junk bonds and garnered $1.768 billion from selling (or agreeing to sell) its stakes in General Casualty, Frank B. Hall, Commonwealth Mortgage, and United Pacific Life, is not so sanguine. "A downgrade below A– could adversely affect the Reliance Property and Casualty operations," the company's 10K reads. That warning is positively cheerful compared to what follows: "[Reliance's] ability to maintain these ratings depends on a number of different factors, not reasonably within its control. There is

*continued on page 4*

**Just Do It: CEO Compensation 1990-1992**

| Name | Company | Total Compensation |
|---|---|---|
| Sanford Weill | Primerica | $86,944,000 |
| R.K. Richey | Torchmark | 32,844,000 |
| Rand Araskog | ITT (Hartford) | 16,807,000 |
| A.J.C. Smith | Marsh & McLennan | 12,193,000 |
| Maurice Greenberg | AIG | 8,160,000 |
| Dean O'Hare | Chubb | 7,328,000 |
| R.B. Morgan | Cincinnati Financial | 2,340,000 |
| Warren Buffet | Berkshire Hathaway | 300,000 |

Source: *Business Week*

no assurance that the Company will be able to maintain these ratings."

We called Brian Martin, Reliance's vice president for communications, to ask why such language wasn't included in prior financial statements, when the company was, arguably, in weaker financial condition. He didn't return our call.

Norman Blake, chairman, president, and CEO of USF&G doesn't mention his company's A– rating, although he writes that "a strong balance sheet is essential to being competitive in the insurance business," the implication being that his company has a strong balance sheet. Unlike Reliance's 10K, USF&G's makes no mention of financial strength as an important competitive factor. Competition is based on price, says USF&G, and it distinguishes itself on the basis of service, consistency, and underwriting practices. (And so does everybody else.)

At the Loews annual meeting (Loews is the parent company of CNA), Chairman Laurence Tisch said he was surprised that financial strength didn't give a company pricing power. "Even sophisticated insurance buyers have been willing to accept long-term policies from companies with lesser financial strength. We thought there would be a pricing differential at some point."

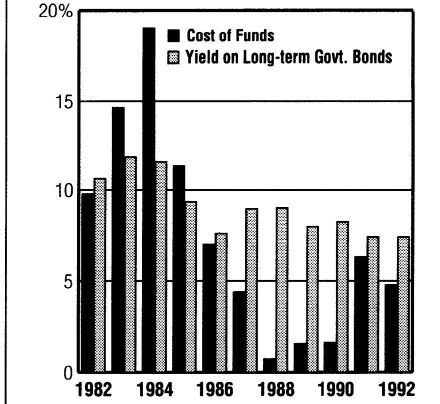
It's likely that at some point—probably after the failure of a major property-casualty company—there will be a pricing differential. But a higher rating doesn't guarantee safety, as the recent failure of the Casualty Indemnity Exchange demonstrates. (It had an "A" Best's rating and the highest qualified solvency rating from Standard & Poor's.)

W. R. Berkley, Chairman and CEO of the well-run company that bears his name, has other concerns. "The industry has not yet responded to a problem that could prove to be much more severe than the catastrophic losses of 1992—the decline of investment yields," he writes. Casualty companies tend to make their profits on the "float"—the money they hold onto until claims are paid. Berkley figures the 300 basis-point decline in intermediate-term bond yields "will convert historically profitable business into very unprofitable business."

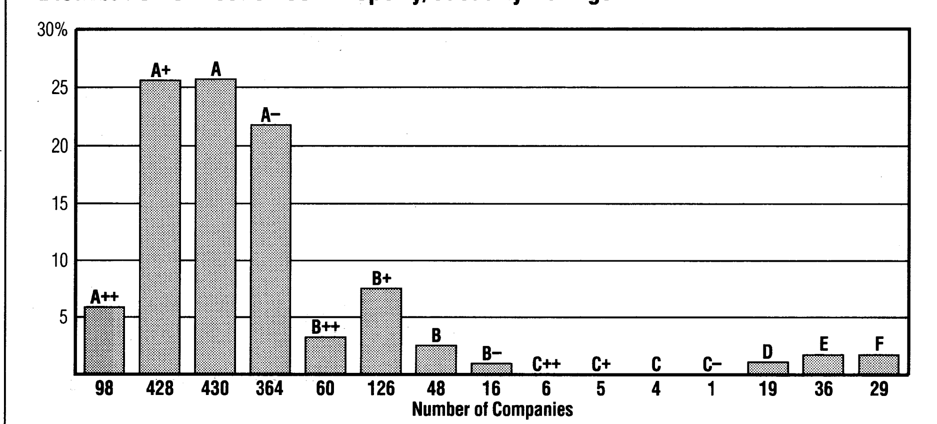
Laurence Tisch is well aware of this but has decided not to stretch for yield by going out longer term or buying lower-rated bonds. He is bearish on bonds and believes interest rates are headed higher—and has structured CNA's portfolio accordingly. "We're interested in capital preservation," he explained. As a result, earnings are being penalized, for now.

The value of float is illustrated in Berkshire Hathaway's annual report. (In a sense, float is borrowed money that must be repaid in the future in the form of claims. The underwriting loss is the cost of borrowing the money. If over time, an insurance company cannot generate float at a cost less than it can borrow money—and at a rate less than it can make on its investments—it's in trouble.)

Berkshire's 1992 float was $2.29 billion, and its underwriting loss was $109 million. Therefore, its cost of funds was 4.76%. Berkshire's underwriting results have improved as the company has grown (see chart), and its insurance operations had a net worth of $8.5 billion at year end 1992, second only to State Farm, and more than double that of General Re.




**Cheap Funds**
Cost of "float" for Berkshire Hathaway's reinsurance business




**Distribution of Best's 1992 Property/Casualty Ratings***

*Includes all companies receiving a letter rating

Source: *Best's* 1992

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When a company has done poorly it usually glosses over the bad results and speaks of the rosy future that lies ahead. Aetna Life and Casualty, however, has been an underperformer for so long that this tactic no longer works. Earnings have declined every year since 1987, and last year they evaporated entirely. Perhaps that's why the 1992 financial statement is a somber affair designed to give the feeling of austerity. Gone are the glossy pages and beautiful photos. Ronald Compton, Aetna's Chairman, takes the humble and honest approach (which, we're sure, is a calculated public relations tactic). He says 1992's financial results were "completely unsatisfactory," and that although "it would be easy to blame our anemic results" on environmental reserves, storms, bad investments, staff reductions or a host of other things, he won't do that. "We offer no excuses," he writes. "The fact is that Aetna's 1992 financial performance reflects continued problems in our core businesses as well as the necessary costs of repositioning Aetna for the future."

In other words, the problem certainly isn't the management—*it's the core business.*

It's amazing what happens when your job is threatened. Take Sears, a perennial underperformer. Last year, chairman, president, and CEO Edward Brennan said he was dead set against divesting the company's financial services division, which includes Allstate (which lost $2.5 billion after reinsurance from

Hurricane Andrew), Dean Witter, and Coldwell Banker. But when shareholders revolted, Brennan began to sing a different tune.

Sears is spinning off Dean Witter, selling part of Allstate to the public, and engaging in "divestitures, spin-offs, exits and downsizings." And Brennan? Now he embraces these decisions, calling them "far-reaching actions taken by your board to enhance shareholder value."

Ray Dirks (who is profiled on page eight) thinks the huge Allstate stock offering is very bullish. "It's going to get people and institutions to focus on insurance stocks," he says.

We shall see.

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In the insurance business, small and medium-sized companies often have the most spectacular results. A case in point is Capitol Transamerica, in Madison, Wisconsin. It was brought to our attention by one of our subscribers, Stephen Wallman of Wallman Investment Counsel, also in Madison.

Capitol, which has an A+ Best's rating, writes property-casualty (restaurants, taverns, day care centers) and fidelity and surety bonds. Over the last five years its combined loss ratio has averaged 71.8%. We're not aware of any company that's done as well, so we asked George Fait, the founder and president, to tell us his secret.

"You have to find niches if you're a small company," he said. "We've stayed in the Midwest. We're in smaller communities. You've got a fighting chance in courts there. The jury awards, in general, are one-third to one-half of big cities."

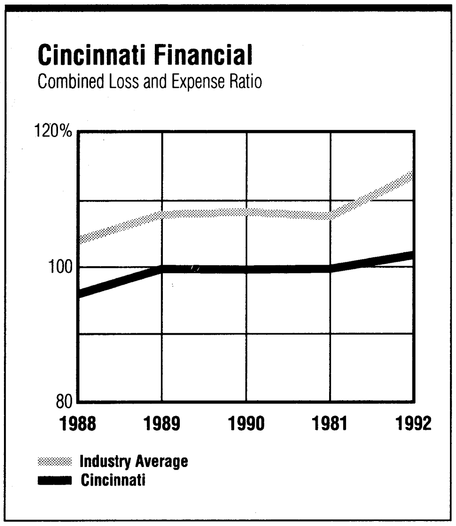
Although Capitol's return on equity has been extremely high (last year it was a mere 21.4%), Fait explains that it gets "tougher and tougher" to make such returns. "We're overcapitalized. We have $70 million of surplus but only write $50 million in premiums."

Fait knows his territory: he named a few places where you could make money writing motorcycle insurance; told us Butte, Montana is a difficult market because of its liberal juries; and explained why his company looks at a restaurant's financial statement before quoting it: "When they're not making money there's a much greater risk of arson."

Because Capitol is small and nimble it can pick up pieces of business larger carriers ignore. But it isn't easy. "Since 1987 the major companies have been very competitive, trying to gain market share," Fait says with a hint of annoyance in his voice, as if those interlopers have no right doing business in his backyard.

Cincinnati Financial, another fine company, has done nicely over the years, mainly by providing excellent service, stability, and competitive products. (USF&G has also provided service, stability, and competitive products, yet *hasn't* done well. It makes you think.) Cincinnati was started by insurance agents, and is still dedicated to working closely with them.

Although it does over $1 billion in premiums a year, it keeps things simple by dealing with only 959 agencies. (That's over $1,000,000 in premiums per agency.) It has no claims or marketing branch offices; regional marketing, claims and loss control reps work out of their homes. As a result of its no-frills approach, expenses are kept to ten percent of premiums, which leaves twenty percent for agents' commissions and bonuses. The strategy works. *Consumer*




*Reports* reported a ninety-three percent satisfaction level among policyholders and the fewest complaints about automobile claim service.

Like many other insurance companies that make underwriting profits and have impeccable balance sheets, Cincinnati has been a big investor in equities. Almost half its assets—$1.972 billion—are in stocks. As a result, the reported earnings understate the company's true earning power, since the annual appreciation of the stock portfolio is only a balance sheet item. If one were to add back the approximately $200 million in capital appreciation in 1992, earnings would have doubled.

Investing, of course, is not a one-way street. Last year, The St. Paul Companies wrote off $365 million of "goodwill" incurred from its 1988 acquisition of Minet. However, its $11 million investment in The John Nuveen Company, made in 1974, has fared much better. St. Paul has received $229 million in dividends over the years, and last year sold part of its holding, realizing a $98 million capital gain. Its remaining shares, carried on the year-end balance sheet at $157 million, are worth $975 million at current market prices.

The St. Paul is the largest writer of medical liability insurance in the United States, and over the last three years this line has generated virtually all of the company's profits. The combined loss ratio on this book—which represents twenty-three percent of the company's total premiums—has hovered around seventy-eight percent, generating underwriting profits of $537.7 million. St. Paul's underwriting loss from all other classes of business was $1.389 billion. Since medical liability claims are paid out over a prolonged period, the float is significant, making this business all the more profitable.

The St. Paul expects to make money on medical liability in 1993, but not as much as in the past. (Favorable development of prior years' loss reserves was the reason for the profits. That can only go on for so long.)

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For the third year in a row we want to mention 20th Century Industries, which for our money (literally, since we've been a shareholder for a while) is one of the finest companies around. 20th Century is a direct writer of automobile insurance for drivers with good records, and its main market is southern California. Even though premiums are approaching the billion dollar mark, 20th Century has only a 6.5% share of the California auto insurance market, but that could easily double as the company expands in northern California.

20th Century has been able to grow rapidly without sacrificing profitability because it's *the* low cost producer of auto insurance. Its expense ratio is just 10.2%, which allows it to have the lowest rates, incur an eighty-five percent loss ratio, and still be immensely profitable. Over the last decade its return on equity has averaged 24.16%.

20th Century has operated under the cloud of Proposition 103 for the last four and a half years, although its recent victory in California's Superior Court—which ruled, in a nutshell, that the Insurance Commissioner's rate rollback was invalid—has lifted some of that cloud.

Earnings should grow at a ten to fifteen percent clip over the longer term—barring some further weirdness in California, although, knowing California, a bit of weirdness is to be expected. The stock, at a recent price of $28⅛, is selling at thirteen times earnings, which, while not cheap, is not unreasonable given the high-quality balance sheet, the exceptional return on equity, and the favorable positioning in the market. ■

# Beating the Taxman

ACE LIMITED is truly the big boy in the high limits insurance market. It provides excess liability up to $200 million per occurrence, and directors and officers liability up to $50 million. The average attachment point for its policies is $141 million, and the average policy limit is $135 million.

ACE, which insures about 470 companies, including more than half the top 250 companies as ranked by *Fortune,* was formed eight years ago by Marsh & McLennan (which still owns a 5.51% share worth $81 million) and J. P. Morgan. In late March, the company completed a public offering of stock, raising $511 million. Shareholders' equity is now in the neighborhood of $1.2 billion.

Although ACE has been primarily owned by U.S. companies, it is a Cayman Islands corporation that operates out of Bermuda. Consequently it has never paid U.S. corporate income taxes. It is exempt from Bermuda taxes until 2016.

U.S. tax laws being what they are, ACE is quite careful to avoid American soil. It's not registered or licensed as an insurance company in the United States, nor does it have offices, solicit business, or advertise here. In fact, according to its prospectus, it "must rely exclusively on non-U.S. insurance brokers to originate business with U.S. companies." ACE's business is obtained from thirty-nine foreign brokers, three of which were responsible for sixty-seven percent of premiums placed.

And who are these "foreign" brokers? They are Bowring (Bermuda) Limited, a subsidiary of Marsh & McLennan; J & H Intermediaries Limited, a subsidiary of Johnson & Higgins; and Alexander International Insurance Services Limited, a subsidiary of Alexander & Alexander.

Since ACE doesn't want to endanger its tax status, its thirty-nine employees don't visit insureds in the United States or inspect their operations. However, the company does let on that "a substantial number of policyholders" do come to Bermuda each year to discuss their insurance coverage.

We'll bet they do.

# Ray Dirks, Securities Analyst

## *Profile of a Maverick*


*Ray Dirks, Insurance Maven*

Ray Dirks, the irrepressible insurance-stock impresario, was feeling bullish, as usual. "I think these stocks will double this year," he told an audience of 500 securities analysts, money managers, and stockbrokers, at his annual Insurance Day Conference in New York. His thirteen picks from the year before had performed wonderfully—their average gain was fifty-one percent—and his favorite stock, Conseco, has soared 700% in the last few years, much to the consternation of Wall Street's shortsellers.

In the buttoned-down world of Wall Street, Ray Dirks, a carelessly attired securities analyst with a Humpty-Dumpty physique, is a maverick. His investment ideas are often more Nick the Greek's cup of tea than Warren Buffet's. "Over the years I've had several stocks that have gone up a hundred times," he says. He admits to his share of big losers, too.

Although Ray is one of the most famous stockbrokers in America, you wouldn't know it from looking at him. He's small. His shirttails are untucked, his tie is too short, and his soft, bulbous belly tumbles over his belt, which only barely holds up his low slung pants. His gentle, friendly eyes peer through glasses with thick lenses. Although he's fifty-eight years old, his huge roly-poly face is unlined.

Ray's first brush with fame came in 1973, when, as an investigative insurance-stock analyst he exposed the Equity Funding fraud. This earned him the respect of many, but the enmity of the SEC, which censured him. (Ray took the case all the way to the Supreme Court and eventually won.) "He was very courageous," says well known venture capitalist Alan Patricof, a friend from the early Sixties. "Ray's on his own wavelength. I like him. I think he's smart."

Ray's description of himself in his 1974 book about Equity Funding, *The Great Wall Street Scandal*, is straightforward: "I am thirty-nine, stubby, and indifferent about my appearance. Although the financial world that yields me my living operates on unwritten rules as formalized as those of a private club, I try to live as I choose....I believe in people and distrust institutions."

Although he was a pariah on Wall Street, Ray resurfaced at John Muir & Company in the late 1970s and transformed the sleepy, old-line brokerage into the wildest shop in town. He hired a rag-tag assortment of financial neophytes, including former Yippie Jerry Rubin, and turned them loose with little supervision. Muir's specialty became low-priced new issues, and its deals were a screwy grab-bag of unseasoned, overvalued companies. Not surprisingly, Muir went bust.

Cayman Islands Reinsurance was probably the firm's worst deal. According to the SEC, the prospectus didn't disclose that the company's chairman had previously been convicted of stock fraud or that Cayman Re invested the proceeds from its IPO (Initial Public Offering) in the stock of other John Muir IPOs.

For much of the next decade, Ray operated on the outskirts of the securities business, lured by the siren song of high-flying over-the-counter stocks. The results were not always pretty, but there was plenty of action. He worked long hours and his office overflowed with people. Eventually he returned to what he knows best: insurance companies.

For the last year and a half, he and his group have been ensconced at RAS Securities in New York. "I've changed the complexion of the firm a little," Ray says in his typically understated manner. Before his arrival RAS had sixteen employees. Now it has about seventy-five.

Although he picks up the tab for a lot of the expenses in return for a piece of the gross, Ray doesn't manage RAS. "It's not my thing," he says sheepishly. "I don't pretend to have administrative skills. I like to have a lot of people around. I'm not the kind of guy to run my own firm."

Ray does run the Shortbuster Club, which puts out research and touts selected stocks with a heavy short interest.

Ray's critics claim he's just another cynical stock peddler, but that tag misses the point. He is drawn to visionaries and high fliers, often whether they are right or wrong, but he puts his money where his mouth is—in the highly volatile stocks he recommends. An action junkie, Ray "invests" by purchasing "down-and-out" call options—the equivalent of buying on eighty percent margin. It's a dangerous game, but he can't resist. "I tend to be attracted to stocks that can go up many times," he mumbles. "That's not to say that everyone should buy those type of stocks."

Ray has been involved in hundreds of IPOs, and over the years has raised more than $500 million for smaller companies. Why do so many promoters, companies, and dealmakers come to him? "Because I'm usually receptive," he says. "I'm doing the same thing I've been doing for a long time."

Certain facts about Ray are noteworthy: He's a Hoosier. He was a conscientious objector. His driver's license lapsed twenty-five years ago, and he's lived in the same rented, shabby-but-charming Barrow Street carriage house since 1963. He last voted in 1956, for Adlai Stevenson.

He works on the weekends and doesn't take vacations. ("My lifestyle is easy. I enjoy working," he says.) His graying hair is on the long side. ("A barber comes around the office every now and then. I don't pay attention to little things.")

Ray has written several books, been on the advisory board of *The Partisan Review*, and tried his hand at playwriting. A gambler by nature, he once wrote, "Rather than saying something is so preposterous that I don't want to bother, I would say this is something worth looking at precisely because it's so preposterous."

He hired Jerry Rubin because he "admired him and thought he'd done something constructive."

His long running battle with the SEC didn't dampen his good spirits. ("The last time I was called for jury duty there was a grand jury investigation going on

# Go Long Young Man

## *Ray Dirks Loves Annuity Stocks*

RAY DIRKS is bullish on annuities and the publicly-traded companies that sell them. He believes the annuity industry has been overlooked and underappreciated by Wall Street; that, in fact, a revolution has taken place, albeit one that's been ignored by the old-line life insurance companies that "don't yet get it."

Given the demographic trends—the growth of the senior citizen population and a shift from consumer spending to consumer savings—it seems he's onto something.

In a January 1993 report, Ray trotted out some telling statistics; 1) only seven percent of households earning more than $50,000 own annuities; 2) since 1986—the year annual annuity premiums exceeded life insurance premiums—life insurance premiums have been flat while annuity premiums have grown twenty percent annually; 3) a Gallup poll found that fifty-one percent of baby boomers believe their greatest retirement concern is how to finance their retirement.

Even though the annuity market is, according to Ray, still in its early stages of growth, seventy percent of the life insurance industry's reserves are already the result of annuity products. He writes, "What's strange is that this kind of growth involving hundreds of billions of dollars has occurred without the fanfare of national media marketing efforts. If the behemoths of the industry... had blitzed the consumer with major TV campaigns, we'd all realize the significant benefits of annuities. Who, after all, ever heard of many of the annuity industry's leaders: Great Northern Annuity, Western National, Keyport Life, Pacific Fidelity, USG Life, and Anchor Life?"

Ray points out that these smaller companies have seized a disproportionate share of the industry—they now control tens of billions of dollars—and are poised for greater expansion.

In a sense, the annuity business is simple. The insurance company receives a premium, promises to pay out a specified amount in the future, and pays its salesman a commission. The insurance company profits from the spread—the difference between what it makes on its investments and what it credits the annuity holder. The spread is generally in the neighborhood of two hundred basis points, and is achieved (these days) by buying longer-term fixed-income securities yielding around eight percent, while crediting six percent.

### High Growth, But at What Cost?

Annuities are risky, however, and profitability varies widely depending upon how long they remain in force and how the investments perform. Higher interest rates, for example, can wreak havoc on an insurer's bond portfolio while at the same time causing annuitants to engage in disintermediation—cashing in annuities in order to take advantage of the higher yields available.

Perhaps it's no coincidence that leading annuity writers (and issuers of other interest-sensitive policies) such as Baldwin United, Charter Financial, First Executive, and First Capital have gone down the tubes.

Ray thinks the tax advantages of annuities are so significant the industry will roll along, despite the periodic crises or panics that occur: "Through it all, annuity companies with sound investment policies emerged as clear winners, partly because consumers have determined that annuities as savings and retirement vehicles offer significant advantages," he writes.

Ray sees huge growth coming from banks and thrifts, which have only recently been selling these products in any volume. (The annuities are issued by insurance companies, however.) One study he cites says that although only half the banks and thrifts currently sell annuities, virtually all will do so by 1995, and that sales from this source will rise from $12 billion this year to $40 billion. And, if banks really start to push these products..."There are almost twice as many dollars invested in mutual funds as in annuity products," Ray writes. "That's one indicator of what modern marketing efforts can do for a product. We believe that annuity products should be one of the new darlings of Madison Avenue.... We expect total annuity premium to expand so rapidly that the constraint on the annuity companies won't be demand, but rather capital to finance the growth."

We agree with Ray that the annuity industry will continue to boom (as long as it retains its tax advantages). And we agree that many of the leading players have cleaned up their balance sheets and improved their asset quality. And we agree that some will continue to be highly successful. We also know that in financial services big risks accompany rapid growth, and profit margins tend to narrow—or disappear— as capital chases high returns.

In his report, Ray listed twelve insurance companies whose earnings are primarily influenced by annuities: AmVestors Financial, American Annuity Group, Broad, CCP Insurance, Conseco, Equitable of Iowa, First Colony, John Alden Financial, National Western Life, Presidential Life, and Statesman Group. According to his projections, these companies have relatively low price/earnings multiples and high growth.

So what's his recommendation?

"Buy the group."

of me.") He says he's not really interested in money but loves "the idea of getting rich quick."

Although not a conspicuous consumer, he wears a fur coat. (It belonged to his wife.) His house is cluttered, he doesn't own a car, and much of his net worth could disappear quickly, depending upon the market.

Ray has made and lost millions many times. "I haven't kept an awful lot of the money, particularly for a man my age," he says. "I don't plan very well."

So why not settle down and play it safe?

"People don't change much," he explains. "I'm not going to change much. I should, but I'm not going to. The only question is 'Am I going to go down again?'" He paused a moment. "I have a one-year old baby. The shorts have attacked me. I've got to be more conservative."

It seems fair to say that Ray has something of an Icarus Complex. But what is it that often draws him too close to the sun? "I enjoy the ups and the downs of the market," he says. "I always have this vision of building this thing, but I always spend a lot of money getting there."

Is there any lesson he's learned from the past?

"Boy, there's nothing worse than a bad deal." ■



# On The Road

## *Kansas: A Trip Through the Heartland*

The fastest way to get to Santa Fe from New York is by flying to Albuquerque then driving an hour north. The whole trip takes six or seven hours door-to-door. On our last trip out west we took a longer route: the Santa Fe Trail.

We flew to Wichita, Kansas, a city of 304,000 that springs up out of nowhere from miles of fields, and headed west on US 54. Given the late hour—3:00 in the afternoon—it wasn't easy finding a place still serving lunch. We passed through Garden Plains and Waterloo without any luck. Just before Kingman we crossed the 98th meridian, which is the unofficial dividing line between the fertile Midwest and the semiarid Great Plains. All across the southwest Plains, fields are irrigated by powerful center-pivot pumps that suck up water from the ancient Ogallala Aquifer, which is being depleted at an alarming pace.

After a total of fifty miles we came to Cunningham, which is little more than a small grocery store, a school, and a few old buildings. Like every other town in the area, it has several monolithic grain elevators that rise from the plains and loom in the distance. Miles before one reaches a town, its grain elevators can be seen.

We entered The Hi-Way Cafe and took a seat, feeling conspicuously out of place among the grizzled farmers wearing narrow jeans, boots, and baseball-style caps. The food was basic fare befitting the heartland: rib eye steak, baked potato, bread and butter. We drank iced tea.

At the table nearest us, three older men with cropped hair and long sideburns sat and talked in their terse, plainspoken way. It appeared they'd known each other all their lives, but when one fellow left, one of the remaining men said to the other in his flat prairie twang, "What's he do, besides nothing?"

There isn't much to do in Cunningham, and from what we could tell, people were doing it. The two streets were empty, although occasionally a car passed by on US 54, the two-lane main road. Our waitress said if we wanted excitement, we'd have to go to Pratt, the county seat.

Half an hour later we drove through Pratt (population 6,700), which has a Radio Shack and a J. C. Penney. Pratt is also home to the Kansas State Fish Hatchery.

We were still full from lunch when we passed Lorenzo's Barbecue a while later. Having sampled barbecue from Brunswick, Georgia to Kilgore, Texas, there was no way we could pass up the opportunity here, so we made a U-turn and pulled into the parking lot. The chopped, barbecued pork, served on a hamburger bun, made our effort worthwhile. Lorenzo, the only black person we saw in Kansas, cooks his barbecue in a old smoker out back, and he's so proud of his profession that his license plate reads Barbecue 1.

Further along our route, next to the Cotton Belt railroad tracks in Mullinville, equidistant from Greensburg and Bucklin, is the Equity Exchange, a grain cooperative owned by 350 nearby farmers. Like other grain coops, the Equity Exchange buys grain from farmers, stores it in grain elevators, and resells it, often to regional cooperatives.

There are several hundred grain cooperatives in Kansas. "Almost every small town has one," said Ron Freeman, who has managed the Equity Exchange and its five full-time employees for the last eleven years. Although the Equity Exchange celebrated its eightieth year recently, the going has been rough. The wheat crop—which is Kansas' main agricultural product—has failed three of the last four years. "Normally it grows very well here," said Freeman.

A more severe blow to local farmers occurred in 1986, when the government got out of what Freeman called "the grain storage business"—the buying and stockpiling of wheat. "Farmers live and die based on the government programs," he said.

Freeman likes living in Mullinville. "The best thing here is we don't have much crime. We don't even lock things up." But the population is dwindling as younger people, eager for work, an easier life, or excitement, move away. "A small town is a thing of the past," he said matter-of-factly.

As we drove along, it was easy to see what Freeman was talking about. Empty stores, boarded-up shops, and abandoned buildings are the norm on Main Street in rural Kansas. Although there's a vast supply of vacant buildings, we came across a number of recently built red brick post offices—undoubtedly the results of Federal largesse.

Before we reached Dodge City we saw cattle feedlots and slaughterhouses. A large sign on top of a grain elevator read "Eat Beef – Keep Slim." Dodge City, once one of the wildest frontier towns, is now a hellish tourist trap filled with fast food joints. There's a replica of Front Street as it appeared in the 1870s, replete with Boot Hill and a saloon. We left immediately.

Nine miles further west, alongside US 50, we finally came across the actual Santa Fe Trail. We parked and followed the Trail about a quarter mile until we came to a fence. Wagon wheel ruts more than a century old were still visible.

At one time, the Atchison, Topeka and Santa Fe ran its *Superchief* along this part of the Santa Fe Trail. These days, Amtrak's *Southwest Chief* makes the 2,246 mile trip from Chicago, to Kansas City, to Albuquerque to Los Angeles in thirty-seven hours. The railroad still follows the route of the Santa Fe Trail, and, like the Trail itself, doesn't actually go through Santa Fe.

We spent the night in Garden City at the Wheat Lands Motor Inn, which, it turned out, was where Truman Capote stayed thirty-two years earlier when he was researching *In Cold Blood*, his account of a mass murder in nearby Holcomb. There's a photograph of him on the wall.

Had we arrived in Garden City a few days later we could have attended the annual 3–I (Industry, Irrigation, and Implement) show. Had we hung around another two months we could have enjoyed Beef Empire Days, a five-day celebration of the beef industry. Instead, we left the next morning after driving through Garden City's mostly deserted downtown. We then drove across southwestern Kansas and southeastern Colorado, the New Mexican desert plains, and the Sangre de Cristo Mountains. We arrived in Santa Fe in the late afternoon. ■



# LETTERS TO THE EDITOR

YOUR NEWSLETTER is very thought provoking and insightful. I'm looking forward to the next issue.

Kenneth J. Sciara
Executive Vice President
Rollins Hudig Hall
New York, New York

I'VE BEEN RECEIVING the *Insurance Observer* since its inception, I believe, and find it the most interesting publication on the street. No kidding.

You pack more information and common sense into fewer words than one could hope to expect from the verbose, vacuous media we readers must plow through in order to dig out useful information, let alone interesting commentary. Please keep up the good work. Often your newsletter makes my day.

Herbert Rubin
New York, New York

I WANT TO TAKE this opportunity to thank you for sharing a copy of your *Insurance Observer*. It is without a doubt the most enjoyable reading I have done in years. The writing is professional, witty and informative. Great job.

James R. Eisenman
Managing Director
Seabury & Smith
New York, New York

IT WASN'T TOO LONG AGO that the *Observer* was one of the better kept secrets. In fact, since I was perhaps only one of a scant handful to receive it in this locale, I was able to offer many of your observations, ideas and conclusions as my own and, in so doing, was beginning to garner some reputation as to my keen insights.

Your success has, of course, changed all that. Since big shots from all over are now fawning over the *Observer* like so many eager hand-licking puppies, I will have to be very careful how I use these tidbits in the future.

I think my new tact will be to say "I read it in the *Observer*." Not quite the same, but it will at least put me into a very select and elite group.

J. Patrick Carroll
Assistant Vice-President
A. T. Armstrong Co.
Syracuse, New York

*We welcome your comments, criticism, and suggestions, so please call or write. Letters should be addressed to David Schiff, Emerson, Reid & Company, Inc., 10 Columbus Circle, New York, NY 10019.*

*We are also interested in publishing articles by our readers, so let us know if you've got a good idea.*