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Speculate at Your Own Risk

E-Madness, Insurance Stocks, and Capital

SINCE WE BEGAN *Schiff's Insurance Observer* twelve years ago, we've generally maintained an attitude of skepticism. However, not wanting to be a stopped clock that's right twice a day, we've tried not to let our skepticism turn into cynicism, tainting our views so that we're skeptical of *everything*.

In business—especially the insurance business—it's not a bad idea to be wary of things that sound too good to be true: can't-lose reinsurance schemes, coverage that's too cheap, guarantees of underwriting profits, and so forth. Like investing, insurance involves risk. A prudent insurance company spreads its risks properly and avoids situations that can imperil it.

Security Analysis, written by Benjamin Graham and David Dodd in 1934, attempted to define the difference between investment and speculation: "An investment operation is one which, upon thorough analysis, promises safety of principal and an adequate return. Operations not meeting these requirements are speculative."

Graham and Dodd, writing during the Depression, when many believed that *everything* other than Treasurys was speculative, were proponents of investing in common stocks. Just as a bad insurance risk can be profitable for an underwriter if the premium is high enough, a poorly performing company can be a good investment if priced cheaply enough.

One of Graham's central concepts is "margin of safety." Put simply, an investor should buy securities that are selling at a comfortable discount to a conservative estimate of their intrinsic value. (In *The Intelligent Investor*, Graham suggests several investment rules, including adequate diversification and investing in companies that are conservatively financed.)

Variations of these themes apply to the insurance business. A good insurance company should avoid an excessive concentration of risk and have a strong balance sheet. This seems ridiculously obvious, yet most insurance-company debacles can be traced to a failure to follow these rules. (Executive Life, for example, overconcentrated its assets in junk bonds. The Home and Reliance—in addition to underwriting poorly and having weak balance sheets—had excessive exposure to ratings-sensitive business. Superior National was overleveraged and wrote only one line of business—workers' compensation in California.) In each of these cases, the company's management demonstrated hubris, lack of discipline, and unwarranted optimism.

A *New Yorker* profile of Alan Greenberg, head of Bear Stearns, contains an anecdote about Greenberg's good sense in avoiding outsized risks. In 1981, Seagram, Mobil, and DuPont were trying to take over Conoco. The head of Bear Stearns' risk arbitrage department had figured out a "can't lose" investment strategy. The catch, however, was that the firm had already reached its buying limit in these stocks. The trader went to Greenberg to say that the firm could make much more money if it ignored the buying limit. Greenberg replied: "Why do you think we have these limits? To keep people from buying too much of things they *don't* really like?"

As an observer of the insurance industry, we've tried to tune out the folly of excessive optimism as well as excessive pessimism. We've tried to divine what the crowd was up to, and then—acting on the theory that the crowd is often wrong—raised the idea of doing the opposite.

In a cyclical industry like insurance, the average insurance company (which has no competitive advantage) can still do all right by *not* getting wrapped up in manias. When business conditions have been good for a while, it's wise to be cautious. When they've been bad for a while, that should be viewed as a time of opportunity. In the June 1994 issue of *Schiff's Insurance Observer*, money manager Chris Davis noted, "You make most of your money in bear markets—you just don't realize it at the time. You're given a chance to buy first-class properties at distressed prices. Over time, as the value of these properties becomes clear, the prices move up accordingly."

Since the insurance business is the money business, and since "capacity" is, to a large extent, a function of the strength or weakness of insurers' balance sheets, from time to time we like to comment on insurance stocks and financial markets in general.

For several years, *Schiff's* has been bearish on the insurance *business*. Despite our feeling that overcapacity would restrain profitability,

E-Madness: Internet vs. Insurance—An Update

Market caps of various companies, in billions of dollars.

Internet	12/10/99	01/14/00	10/13/00
America Online	$205	$141	$123
Yahoo	93	93	33
Amazon	36	22	10
CMGI	23	30	5
eBay	21	17	15
E*Trade	9	7	4
InsWeb	1	0.7	0.06
Quotesmith	0.2	0.2	0.03
Insurance	**12/10/99**	**01/14/00**	**10/13/00**
AIG	$172	$177	$214
Marsh & McLennan	24	28	32
Allstate	22	19	24
Cigna	15	15	18
Hartford	10	10	16
Chubb	9	10	13
Progressive	6	5	5
W. R. Berkley	0.6	0.5	0.8

we began to get modestly positive on insurance *stocks* in 1999. As the prices of insurance stocks declined, our opinions—which appeared in *Schiff's Insurance Observer* and, on occasion, *Insurance Investor* (published by our partner, SNL Securities)—became more positive. Despite the mania that was occurring in the stock market in general and Internet, tech, and telecommunications stocks in particular, insurance stocks were in a bear market.

In December 1999 we wrote that "some [insurance] stocks are so cheap relative to book value that it seems as if the situation cannot endure for many years." Something, we felt, *had* to happen. "When independent insurance companies trade at huge discounts to conservative estimates of their liquidating values, they stand a good chance of being taken over."

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At that time we contrasted the insurance industry, which was having trouble earning money, with an industry that made no money whatsoever: the Internet industry. We noted that although AIG earned seven times as much as AOL, AOL's market cap was greater than AIG's. Yahoo's market cap was equal to that of Allstate, Chubb, Cigna, Hartford, Marsh & McLennan, Progressive, and St. Paul *combined*. And InsWeb, which lost $11 million on $7 million of revenues, had a market cap twice that of Brown & Brown, which earned $25 million.

The overvaluation of dot-com stocks was irrational, and so was the undervaluation of many insurance stocks. We suggested that the highly valued dot-commers use their inflated stock to take over insurance companies. (None did.)

On January 18 we wrote a piece entitled, "The Insurance Business Stinks, but Insurance Stocks Are Cheap." We said that we were "bullish" on cheap insurance stocks with decent balance sheets, and noted that many seemed to be "bargains" and "good buys." (We didn't like *all* insurance stocks. We labeled the following as "dicey": Conseco, Fremont, Frontier, Paula, Reliance, and Superior National. Each of these has subsequently collapsed or taken a terrible beating. As a group, these stocks are down 77%.)

In March, in *Insurance Investor*, we reprinted a quote from the chief NASDAQ trader at a big Wall Street firm who was bullish on the New Economy and a believer in the *new paradigm*, which he defined as, "the promise of tomorrow and the belief that [we're in] a technological revolution that will change the world economy." Our advice, in a somewhat mocking tone, was "Buy the 'old' paradigm," which included "dozens of insurance businesses trading at significant discounts to their liquidating values."

We didn't profess to know when cheap insurance stocks would go up. We only knew that when things get too cheap, they're a good buy.

Since March, a massive revaluation has taken place. Internet and tech stocks have plunged, and good insurance companies have rallied sharply. (A couple of examples: Priceline has gone from 64 to 6; W. R. Berkley has gone from 15 to 33.) We've updated our "E-Madness" chart (see page 1). It's interesting to note that since the chart was originally published, the market cap of each Internet stock has declined precipitously. The market cap of all but one insurance company has increased.

The big rally in insurance stocks has dampened our enthusiasm for insurance stocks. (In recent months we've sold all of our stock in American Country, Berkshire Hathaway, Chubb, LaSalle Re, and St. Paul, and some of our stock in Allstate, Berkley, Cincinnati Financial, and PXRE.) Yes, business conditions are improving in commercial lines; a cyclical upswing seems to be underway. That's one of the reasons insurance stocks have rallied. But conditions won't *always* be good.

We still own shares in many insurance companies, and there are still some good, cheap insurance stocks selling below liquidating value. But the industry is no longer in the bargain basement. Ironically, one can now purchase some Internet stocks for less than the value of their cash.

In fact, we have.