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Expect the Unexpected

A Brief Look at Extremes

InsWeb and Quotesmith Revisited

THE LEGEND GOES LIKE THIS: a man asked the omniscient J. P. Morgan what was in store for the stock market. "It will fluctuate," was Morgan's self-evident, but wise, answer.

This leads us to the question: what's in store for the insurance market?

It wasn't all that long ago that many pundits predicted a permanent soft market brought on by never-ending competition and permanent excess capital. *Schiff's*, which matriculated at the school of thought that believes in cyclicity, never subscribed to that theory. Indeed, over the years we've chimed in regularly with the same opinion—that the pendulum of change would continue to swing, and that the distance it would swing would vary and was not predictable. (Markets almost always go to extremes greater than one expects.)

In the past we've commented on the extremes in the insurance market and in insurance stocks. Although we don't profess an ability to identify the precise dates of tops or bottoms, we do profess an ability to tune out a lot of nonsense, and are proud that our comments have been accurate, for the most part.

On January 3 we published a piece about InsWeb and Quotesmith, two Internet insurance marketplaces. What struck us about these two companies was how far the pendulum of investment opinion had swung against them. Although InsWeb had $40 million (95¢ per share) of net *cash* after subtracting *all* liabilities, we'd been able to buy its shares for 69¢ apiece, a price that valued the entire company—including the $40 million of cash—at $29 million.

Since January 3, Mr. Market has reconsidered his opinion of InsWeb. At Tuesday's close InsWeb was changing hands at $1.69 per share, giving it a market cap of $71 million. While the company may prove to be worth more than that—or nothing at all—the manic-depressive Mr. Market now values InsWeb's *business*, adjusted for its cash, at $31 million. Our only important opinion about InsWeb is that it's no longer in the statistical bargain basement, and, as a result, we've sold our shares.

Quotesmith, on the other hand, hasn't caught Mr. Market's eye (perhaps with good reason), even though its attributes are easy to see: $1.39 of net cash and receivables per share versus a stock price of 88¢. Its negatives are equally obvious: the company has never made money and will lose about 45¢ per share this year. At that rate it will run out of money in three years. On the other hand, when buying Quotesmith at 63¢ on the dollar, one has some margin for error. If something goes right—say the company makes money…or liquidates—an investor should do all right.

We're fascinated by these Internet companies because they benefited from an extreme (the boom in Internet stocks and the belief that selling insurance via the Internet was almost as good as minting money). When investors lost faith in those beliefs, however, InsWeb and Quotesmith became part of the bust that follows the boom: investors accorded *no value whatsoever* to the companies' businesses, and discounted the value of the companies' cash on hand.

Whereas the boom-and-bust cycle experienced by InsWeb and Quotesmith was compressed into a 15-month period, it might be prudent to use these two companies to remember that insurance companies, and the insurance industry, will have wide fluctuations over much longer periods of time.

When the property-casualty industry experiences terrible results, one should consider that, at some point, the terrible results shall pass. And when conditions become prosperous, it's perhaps even more important to remember that the good times can't last forever. The laws of supply and demand will see to that.

During the 1975-to-1999 period, the property-casualty industry's net written premiums grew 87%, adjusted for inflation. In four of those years, however, written premiums grew at a double-digit rate. In eight years premiums shrank, taking inflation into account.

Although pricing in many lines has firmed, we aren't especially optimistic. While the industry has plenty of capital, we're not sure that we'd go as far as Best and Standard & Poor's and label a good

Editor and Writer .... David Schiff
Production Editor .... Bill Lauck

Publisher .... Alan Zimmerman
Subscription Manager....... Pat LaBua

Editorial Office
Schiff's Insurance Observer
300 Central Park West, Suite 4H
New York, NY 10024
Phone: (212) 724-2000
Fax: (212) 712-1999
E-mail: David@InsuranceObserver.com

Publishing Headquarters
Schiff's Insurance Observer
SNL c/o Insurance Communications Co.
321 East Main Street
P.O. Box 2056
Charlottesville, VA 22902
Phone: (804) 977-5877
Fax: (804) 984-8020
E-mail: Subscriptions@InsuranceObserver.com

For questions regarding subscriptions please call (804) 977-5877.

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chunk of it as "excess." Indeed, in the insurance industry, it's hard to have too much capital.

The prices of insurance stocks have gone from severely undervalued a year ago to reasonably valued now (and severely overvalued in some cases). Higher stock prices permit companies to raise equity on attractive terms. Although equity is good for individual companies, it isn't good for the industry as far as pricing goes. A hard market is the result of fear, which generally is the result of a shortage of surplus; a soft market is typified by an abundance of surplus.

On Monday, Markel Corp. announced a $200-million stock offering. On Tuesday, Hartford announced a $600-million equity offering.

We wouldn't be surprised to see other companies, trading at significant premiums to their book values, hop on the bandwagon. That would be the sensible thing to do.