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Graham & Dodd Meet the New Economy

Quotesmith.com at 36¢ on the Dollar

On April 24 a meeting took place in Insuranceville, at the corner of Graham and Dodd. Quotesmith.com, the online quoting service and insurance agency, was coming face-to-face with Mr. Market.

In August 1999, during the New Economy's heyday, Quotesmith had raised $58 million in an IPO at $33 per share. At its peak, it had a stock-market valuation of $220 million—even though its annual revenues were $8 million and it was losing money. (See *Schiff's Insurance Observer*, January 18, 2000.) Quotesmith's shares have since declined 98% from peak to trough. Unlike many Internet companies, Quotesmith is a real business.

Mr. Market, on the other hand, is not a real person; he's the anthropomorphic representation of the stock market, thought up by Benjamin Graham. As described by Graham, Mr. Market is your partner in a company. He's a volatile character given to bouts of euphoria and depression, especially regarding your company's prospects. Every day Mr. Market will name a price at which he'll buy your share of the company or sell you his. Some days he'll make a very high bid; other days he'll offer to sell at a very cheap price. When it suits you, you might accept his bids and offers, but you need not make him a bid or offer. Most of the time, Mr. Market's bids and offers aren't of interest to you. It's important, however, not to let Mr. Market's erratic behavior affect your judgement.

Until about a year ago, Mr. Market had been enthusiastic about New Economy stocks. When these stocks stopped going up and began going down, Mr. Market started to sour on them. Although he'd loved them *because* they were going up, he hated them because they were going down. The more they went down, the more he hated them.

As Mr. Market was getting depressed about New Economy stocks, a rally began in Old Economy stocks—which Mr. Market *had* hated. In March 2000, insurance-company stocks reached a bottom. Small pieces (aka "shares") of good insurance companies were trading well below book value, and many fine companies were selling for much less than their private-market value. Furthermore, the cyclical downturn seemed to be abating. As investors dumped sinking New Economy stocks, money poured into the stocks of companies that had recognizable value.

An interesting example of market psychology and momentum can be found in the Fidelity Select Insurance Fund, which invests solely in insurance stocks. The fund has been around since 1986, but, for the most part, has been an insignificant member of Fidelity's extensive family of mutual funds. Small amounts of money flowed into Fidelity Select Insurance when insurance stocks did well and flowed out when they did poorly. As recently as 1999, the fund's total assets were $46 million. But then a strange thing happened: last year insurance stocks soared and the broad market indices declined. Fidelity Select Insurance turned in its best performance ever—up 55%. Since the S&P 500 was down 7%, Fidelity Select Insurance's performance was all that much better when measured on a relative basis.

A Case Study in Momentum

Fidelity Select Insurance Fund

Year	Assets *(millions)*
1986	$ 9.6
1987	4.4
1988	5.3
1989	5.3
1990	2.6
1991	4.4
1992	22.2
1993	18.9
1994	10.1
1995	32.8
1996	35.0
1997	111.0
1998	101.1
1999	46.2
2000	210.7
3/31/01	1,619.0

The fund did so well not because its managers are brilliant or because insurance stocks are always great investments, but because it had done poorly before, and because insurance stocks had become so cheap that they were ready to ignite.

By December 31, 2000, Fidelity Select Insurance Fund's assets had grown 400%, to $210 million. By March 31, assets had exploded to $1.6 billion. Mr. Market had suddenly discovered the new new thing—insurance stocks.

Seven years ago, Chris Davis, the savvy money manager who runs Davis New York Venture Fund, pointed out to us that the flow of funds in and out of Fidelity Select Insurance is an intriguing "contrary indicator." That is, when investors redeemed their shares, insurance stocks were often a good buy; when money poured in, they tended to be near a top.

Right now, with Fidelity Select Insurance Fund's assets up 40-fold in 15 months, the contrary-indicator warning signal is flashing. Insurance stocks look pricey. Certainly, the kind of bargains that were in abundance last year no longer exist. (If something isn't a bargain, why buy it?) As for New Economy stocks, despite their huge decline, few fit our definition of a bargain.

There is at least one exception, however, and it's Quotesmith, the New Economy insurance stock that, for reasons best explained by Mr. Market, trades at 36% of its net cash minus all liabilities. Statistically speaking, this is probably the cheapest stock we've ever owned. (We first purchased it late last year for $2.62 per share—adjusted for a one-for-three reverse split [see *Schiff's Insurance Observer*, January 3 and January 31]. We recently bought more stock at prices ranging from 85¢ to $1.20 per share. Quotesmith is currently $1.70 bid.)

People like to say that markets are efficient, and much academic thought has gone into the subject. The efficient market theory is taught in business schools, and even a curmudgeonly "insurance observer" will admit that markets are reasonably efficient over the long term. (We don't know how long "the long term" is, but it's probably decades.)

If "efficiency," however, means that markets allocate capital perfectly, then markets are inefficient. Folks like Mr. Market tend to get swept up in the moment. During good times they envision more good times; during bad times, they think that good times will never return.

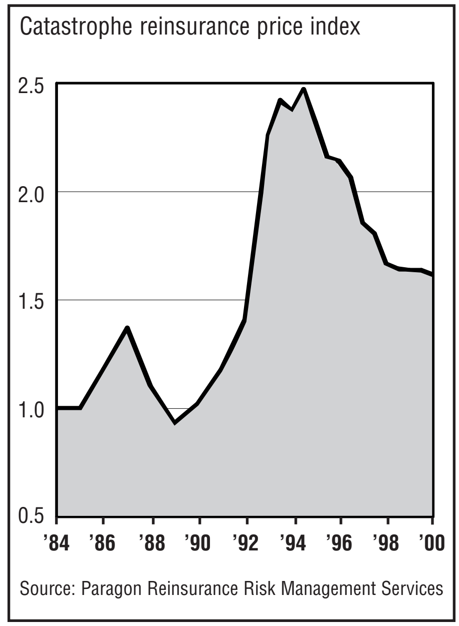
Markets are bigger than institutions, governments, and even Alan Greenspan. Markets aren't efficient enough to prevent booms and busts, surpluses and deficits, abundance and shortage. Even the New Economy, which operated in the virtual, just-in-time mode, couldn't provide a long-term solution to the short-term problem of supply-and-demand.

The April 13 issue of *Grant's Interest Rate Observer* noted that the New Economy techno-bust has created a new asset class: "previously owned," "de-installed" multiplexers, routers, file servers, and PCs that belonged to dot-com, telco, and technology companies that no longer need the equipment. One can purchase used Cisco AS5396 dial-in modems for $13,500 on the second-hand market. That, of course, makes it more difficult for Cisco to sell new AS5396s at the regular price of $44,000. The glut of high-tech equipment has been estimated at $50 billion to $100 billion.

New Economy companies and insurance companies are similar in at least one respect: both are affected by supply and demand. The availability of lower-priced coverage makes it difficult to sell higher-priced coverage. A surfeit of capital or a shortage of fear tends to have the same effect on insurance prices that previously-owned high-tech equipment has on the new equipment market.

Paragon Reinsurance Risk Management Services' *Catastrophe Price Index* provides a glimpse of a market in action. From January 1, 1991 to June 30, 1993 the index more than doubled due to a shortage of capacity. As capacity expanded to meet the demand, prices began a steady decline that lasted at least until January 1, 2000.

The Price of Risk



All of which brings us back to Quotesmith and its April 24 meeting with Mr. Market. On that day, Quotesmith's shares hit 81¢, a remarkable price that valued the entire company at $4.5 million—less than 20% of its cash on hand. Although Quotesmith's shares have doubled since then, they still appear to be a compelling value. The company has $26 million of cash and equivalents ($4.72 per share) *after subtracting all liabilities*. At $1.70 per share, Quotesmith is valued at a mere $9.4 million—36% of its net cash. In short, Mr. Market is saying that 64¢ of every dollar bill on Quotesmith's balance sheet is worth nothing; that the $35 million of losses Quotesmith has incurred to date have been for naught; that Quotesmith's $10 million of annual revenues has no value; and that Quotesmith's operations are worth nothing to anyone.

Mr. Market, we believe, is ridiculously pessimistic. The price of Quotesmith's stock is utterly irrational (although probably no more irrational than when the company sported a $220-million market cap).

Term life has been Quotesmith's main line of business, but the company also offers auto insurance, homeowners insurance, health insurance, and annu-

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ities. The Internet insurance market is still in its nascent stage, but there's little doubt that it will be a huge market. The question is: when?

"We still believe that someday auto-insurance pricing will be easy to obtain on the Internet," writes the indispensable *Auto Insurance Report*. "Someday, all companies will make their rates known to everyone. But that day certainly isn't today, and it most certainly isn't tomorrow. It is unlikely to happen in 2002, and if it happens in 2003 it is because something happens that is not apparent today."

Based on its first-quarter loss of $2.4 million, Quotesmith can make it to the end of 2003 before it runs out of money or ceases losing money. The company, however, believes it can do much better than its current burn rate. Its net loss declined by 73% in the first quarter. Perhaps more important, marketing expenses (which accounted for two-thirds of expenses last year) declined 72%, while new policy sales declined only 33%. In theory, Quotesmith could discontinue most of its operations tomorrow, pay out a $4.50 dividend, and still have a stream of revenue from commissions and new business.

Robert Bland, 47, is Quotesmith's founder, CEO, and owner of 2,381,444 shares (43.6% of the company). He—and his seven children under the age of nine—will be those most affected if Quotesmith achieves a state of worthlessness.

For the record, Bland is bullish about his business. Although most dot-coms are hoarding their remaining cash, Quotesmith recently repurchased 14% of its outstanding shares at a steep discount to book value. "I'm saying that my business plan is going to turn the corner or I wouldn't be using cash to buy back stock," says Bland, who is no longer in the growth-at-all-costs mode. "There's no reward for top-line growth without earnings.

Dollar Bills for 36¢

Quotesmith's balance sheet: March, 31, 2001

Assets	*($000)*
Cash and equivalents	$ 4,015
Investments	20,836
Commissions receivable	1,213
Other assets	446
Total current assets	26,510
Total assets	28,861
Liabilities	2,345
Stockholders' Equity	**$26,516**

[Cash + equivalents] – [liabilities]	$26,064
Shares outstanding	5,517,779
Net-net* per share	$4.72
Stock Price	$1.70
Stock price as a % of net-net* per share	36%

*Current assets minus all liabilities

"We're a 'B to C' play—I hate that term. I think a lot of dot-com companies accepted huge amounts of capital without a sound business plan. We darn near broke even in 1998, but when you accelerate marketing expenses to become the leader, you're going to lose money.

"At this point we're viewing survival as more important than leadership. We're bringing out a superb long-term care engine. We let people choose their plan. The idea of a good content experience is extremely important. Our site is for a serious insurance buyer. If you believe that there's a place for a self-directed insurance buyer who doesn't need consultative service, then we're it. Our heads-down focus is on that self-directed buyer.

"We're not changing our business model," Bland says. "Consumers want *quotes*. We're quoting nearly 400 companies and are about to bring out the mother of all auto-insurance quoting engines.

"The sale of personal-lines insurance—auto, homeowners, life and health—is set to explode on the Internet. We sold 33,000 term-life policies out of the 3.8 million sold in the U.S. last year. Almost one of every 100 term-life policies in the U.S. was sold through us."

That's an impressive figure, but Quotesmith still has a problem. It completed 4,099,000 policy quotes last year, but sold 37,520 policies—a closing rate of 0.92%. The trouble is that it's still difficult for a consumer to purchase a policy; one can't just click and buy. Many consumers use Quotesmith for comparison shopping and then buy a policy through an agent.

The marketplace is changing, however, and some insurance companies are simplifying the process of buying insurance online. As insurance companies develop the ability to "click and bind," online insurance sales should increase, and Quotesmith's closing rate should improve.

In the meantime, Quotesmith is offering a wide array of companies and quotes. "I'm out to make insurance fast and simple and give the buyers perfect market knowledge on a pre-purchase basis," says Bland. "That's radical enough."

Quotesmith may not become a great success and it may never again be worth $220 million. But shareholders—especially Bland—don't need that to happen to come out all right. If the company can get to breakeven in 18 months, it should have about $3.00 of cash per share, plus a reasonable footing in a business with good growth prospects.

What would such a company be worth? We don't know, but it's much more than $1.70 per share.

Suppose Quotesmith can't stanch the losses after 18 months? It should still have more than $2.00 of cash per share plus a business that ought to be worth *something* to someone.

Right now, at 36¢ on the dollar, the odds of making money on Quotesmith's stock look good to us.