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SCHIFF'S

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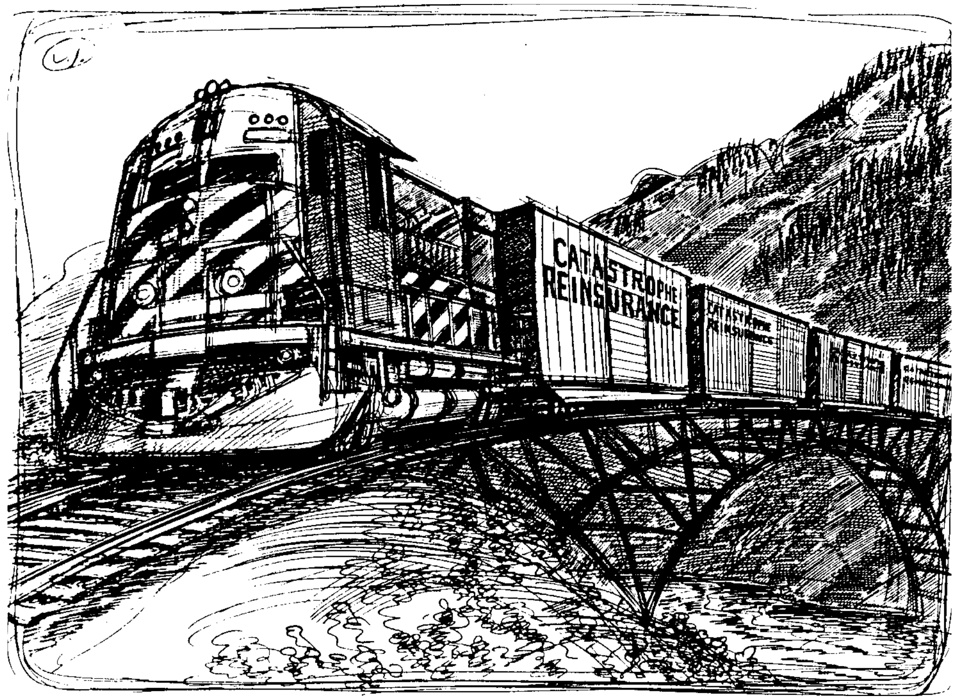
INSURANCE OBSERVER

Reflections on Insurance Companies' Annual Reports

Between the Lines, Part 1

Insurance companies' annual reports have generally differed from those of companies in other industries. Insurance companies like to appear conservative. They tend to convey an image of stability, maturity, financial strength, and concern for policyholders. Because insurance is a highly regulated industry, insurance companies are often careful about boasting of high profit margins (not that there's usually too much to boast about). When an insurance company mentions its higher profits or growing margins, it usually attributes these to efficiency, good investments, or the notion that it has done well by providing valuable products and services to its clients during times of need.



New capacity heads for the marketplace.

Someone who didn't know better might assume that insurance companies' annual reports would be marked by cautious statements made by prudent men with a keen appreciation of risk, seasoned by the exposure to numerous underwriting cycles and knowledge of financial history. That, however, is often not the case.

Insurance CEOs, like most CEOs, want to give people good news. (Too much bad news could get them fired.) Many insurance CEOs have an innate financial myopia that keeps them permanently out of synch: when business is too good they *should* be cautious; instead, they are emboldened and want to expand. When business is bad they *should* be preparing to be more aggressive; instead, they're often too scared to do so.

Many of the guys (and it is mostly guys) who run insurance companies fill their annual letters to shareholders with buzzwords, euphemisms, and self-serving comments. A general rule we follow when reading annual reports is that the greater the hype, the more dangerous the company.

One has to look hard to find an insurance company that *hasn't* told shareholders that its plan calls for double-digit growth in revenues and a 15% return on equity—if not this year, then over a cycle. But the insurance industry isn't one that can grow 12% annually or achieve a 15% ROE. It's a cyclical business in which companies sell products that, for the most part, are commodities, or quasi-commodities. Most insurance buyers don't give a hoot what company they get their insurance from as long as that company meets whatever criteria the insured deems important (price, financial strength, policy terms, etc.). Agents and brokers aren't particularly brand conscious, either, when it comes to insurance companies.

Insurance is a tough business, and companies have plenty of opportunities to make mistakes: underwriting, investing, claims handling, reserving, marketing, acquisitions, and internal growth. It's the rare company that, over time, doesn't make a serious mistake in one of these areas.

Despite the many risks insurance companies face, and the obstacles they must overcome to achieve profitable long-term growth, the pressure for *consistent* growth is embedded in corporate bureaucracies. (It is, of course, easy to grow, but not easy to grow profitably.) CEOs promise their boards growth. They pass this message on to executive vice presidents, who pass it on to senior vice presidents, who spread the word to vice presidents, who pass the gospel along to regional managers, who put pressure on sales reps, who then induce agents to produce more business, perhaps offering a greater commission if production goals are met. Agents, however, don't have much control over how much business they can produce in any given year. To a good extent that will be dictated by the market.

Since property-casualty premiums have, historically, grown slightly faster than the rate of inflation, it's impossible for all companies to achieve even 10% domestic growth absent inflation, and the mathematics of the insurance industry make it all but impossible for the industry to achieve a 15% return on equity. (If the industry were *that* profitable, new capital would come in and drive down returns.) But that doesn't stop insurance companies from making bold projections, especially during good times.

"While Reliance [Group] has accomplished much in the past several years," chairman and CEO Saul Steinberg wrote to shareholders in early 1997, "we have set high goals for the future: 1) Continued profitable growth in our core business, 2) Consistent growth in earnings per share, 3) A return on equity of at least 15%." As subsequent events would prove, Steinberg was only right about one thing: the goals were "high." (*Schiff's* questioned Reliance's shaky finances back in 1991, and followed up with another score of articles on the subject over the years. Reliance Group is now in Chapter 11, and Reliance Insurance Company is insolvent and in liquidation.)

In Allstate's 1998 annual report, chairman, CEO, and president Edward Liddy, in his first letter to shareholders, implied that Allstate could "achieve sustainable, profitable growth *year-in and year out*." [Emphasis added.] Allstate is a good company with many strengths—including one of the best insurance-industry brands—but its business has always been cyclical. Why would anyone think that it wouldn't be cyclical in the future? Not long after Liddy's letter went to shareholders, Allstate's results began deteriorating. Operating earnings per share were down 16% in 1999, 13% in 2000, and should be down about 10% this year.

For the last 95 years or so, the primary cause of cyclicity in the insurance business has been human behavior. (Prior to that, catastrophes—fires and earthquakes—played a greater role in cyclicity.) People—and even underwriters fall into that category—tend to feel optimistic when things are good and pessimistic when they're bad.

Although securities analysts read annual reports carefully, they often get as swept up by extreme bullishness or bearishness as do those who lead normal lives. Many shareholders, investors, agents, and brokers don't even bother to read annual reports, and if they do, they tend to make the mistake of believing what they read.

Over the years we've noticed that a company's financials—the stuff at the back of the annual report—often bear little resemblance to the comments made by the company's chairman and CEO (too often the same person), at the front of the report.

Continental's 1990 annual report, for example, was a handsome-looking piece, and chairman John Mascotte informed shareholders of good news: "We've been able to earn our shareholder dividend over the last two years despite being in a soft market." Mascotte neglected to mention the method that Continental employed to "earn" its dividend: taking capital gains during a period when the overall value of the company's portfolio actually declined.

Although Continental *reported* earnings per share of $2.53 in 1990, seventy-five percent of this was due to nonrecurring gains. (Despite the so-called earnings, Continental's shareholders' equity decreased by almost $4 per share during 1990).

One *could* have read Continental's annual report carefully and figured out what had really taken place, but a shareholder shouldn't have had to do that. Shareholders should be able to rely on a company's chairman to *tell* them the truth. (*Schiff's Insurance Observer* had read Continental's annual reports fairly carefully, and had written the following in June 1991: "As a holding company, Continental Corp. is dependant upon dividends or advances from its insurance units, and these are subject to regulatory restrictions that limit the amount of money that can be upstreamed. It has been our experience that companies that are unable to earn their dividends over time generally cut their dividends.")

In the fourth quarter of the following year, Continental cut its quarterly dividend from 65¢ to 25¢ per share.

In Continental's 1992 annual report (sent to shareholders in early 1993), Mascotte's letter to shareholders kept up the facade. "Income from continuing operations—before hurricane charges and realized capital gains—increased to $1.32 per share from 40¢ per share the year before."

Mascotte cited the "hardship" felt by policyholders due to Hurricanes Andrew and Iniki (and by shareholders, whose dividends, he implied, were cut as a

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result). He wrote that "financial strength is paramount," and cited Continental's "strong balance sheet."

The 62% dividend cut was *not* the direct result of catastrophe losses, and Continental's balance sheet was not particularly strong. During 1992, Best, S&P, and Moody's had lowered their ratings to A-, AA-, and A2, respectively. Mascotte didn't mention the downgrades in his letter to shareholders, nor were they mentioned anywhere in the glossy—and most widely read—part of the annual report. The downgrades were discreetly relegated to the fine print at the back, under a section entitled "Other Developments."

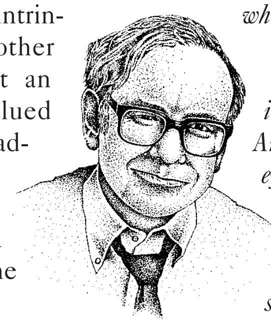
Most large public companies are in the "earnings management" game, and perhaps it's unrealistic to think that insurance-company CEOs will come clean about their company's dim prospects or lack of financial strength. Although to do so would be honest, it would shatter the carefully crafted image—or illusion—that companies strive to create. If an insurance company is perceived as weak it will have trouble competing. Even publicly traded insurance *holding* companies don't want to be perceived as weak, because that would be a sign that more dividends might have to be paid by the insurance company to the holding company, thereby weakening the insurance company. Nevertheless, public companies are obligated to disclose material information, and to give an honest portrayal of their company.

For our money, the standard by which all annual reports should be judged is that of Berkshire Hathaway. When we first read the company's annual report in the early 1980s, we were struck by how different it was from those put out by other large companies. Warren Buffett didn't bother with fancy paper, pictures, or graphs.

The annual report didn't even contain a reproduction of his signature. It didn't need to. Buffett explained his philosophy and businesses clearly, with refreshing wit. (Buffett's sophisticated albeit homespun-sounding commentary has often been misleadingly characterized as simple, and his investment concepts have been misinterpreted as buy-and-hold.)

In many ways, Buffett's letters to shareholders are to annual reports what *The New Yorker* is to magazines. They are well written and eschew hype and sensationalism. While the humor may be disarming, it isn't gratuitous: Buffett uses it to make his point. Berkshire's annual report requires *reading*, but then, it's a pleasure to read. (To read Berkshire's 1977 to 2000 annual reports, go to www.BerkshireHathaway.com.)

One of Buffett's goals has been to attract long-term investors who understand what he is doing and who care about value. By writing his messages carefully, he hoped that Berkshire Hathaway would trade at a price that was reasonable in relation to its intrinsic value. Unlike many other CEOs, Buffett didn't want an overvalued or an undervalued stock; he wanted one that traded as little as possible, but at a rational price. In Berkshire Hathaway's 1983 annual report, Buffett addressed the issue of stock splits:



We often are asked why Berkshire does not split its stock. The assumption behind this question usually appears to be that a split would be a pro-shareholder action. We disagree. Let me tell you why.

One of our goals is to have Berkshire Hathaway stock sell at a price rationally related to its intrinsic business value. (But note "rationally related", not "identical": if well-regarded companies are generally selling in the market at large discounts from value, Berkshire might well be priced similarly.) The key to a rational stock price is rational shareholders, both current and prospective.

If the holders of a company's stock and/or the prospective buyers attracted to it are prone to make irrational or emotion-based decisions, some pretty silly stock prices are going to appear periodically. Manic-depressive personalities produce manic-depressive valuations. Such aberrations may help us in buying and selling the stocks of other companies. But we think it is in both your interest and ours to minimize their occurrence in the market for Berkshire.

To obtain only high quality shareholders is no cinch. Mrs. Astor could select her 400, but anyone can buy any stock. Entering members of a shareholder "club" cannot be screened for intellectual capacity, emotional stability, moral sensitivity or acceptable dress. Shareholder eugenics, therefore, might appear to be a hopeless undertaking.

In large part, however, we feel that high quality ownership can be attracted and maintained if we consistently communicate our business and ownership philosophy—along with no other conflicting messages—and then let self selection follow its course. For example, self selection will draw a far different crowd to a musical event advertised as an opera than one advertised as a rock concert even though anyone can buy a ticket to either.

Through our policies and communications—our "advertisements"—we try to attract investors who will understand our operations, attitudes and expectations. (And, fully as important, we try to dissuade those who won't.) We want those who think of themselves as business owners and invest in companies with the intention of staying a long time. And, we want those who keep their eyes focused on business results, not market prices….

Were we to split the stock or take other actions focusing on stock price rather than business value, we would attract an entering class of buyers inferior to the exiting class of sellers. At $1300 [the stock is now about $72,500] *there are very few investors who can't afford a Berkshire share. Would a potential one-share purchaser be better off if we split 100-for-1 so he could buy 100 shares? Those who think so and who would buy the stock because of the split or in anticipation of one would definitely downgrade the quality of our present shareholder group. (Could we really improve our shareholder group by trading some of our present clear-thinking members for impressionable new ones who, preferring paper to value, feel wealthier with nine $10 bills than with one $100 bill?) People who buy for non-value reasons are likely to sell for non-value reasons. Their presence in the picture will accentuate erratic price swings unrelated to underlying business developments.*

We will try to avoid policies that attract buyers with a short-term focus on our stock price and try to follow policies that attract informed long-term investors focusing on business values.

Why is it that all CEOs don't have such sensible things to say?

Part 2 of this series will be published on Friday.