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Reflections on Insurance Companies' Annual Reports

Between the Lines, Part 2

In America, the roots of the modern annual report can be traced to the Securities Exchange Act of 1934, which required publicly traded companies to provide their shareholders with a financial report once a year. At first, annual reports were rudimentary. "Many contained only skeletal information—a letter to shareholders signed by the chief executive officer, a balance sheet, and auditor's statement—and were four pages in length, including front and back cover," wrote Delphine Hirasuna in *A Historical Review of Annual Report Design*, which accompanied a 1988 exhibition of annual reports at the Cooper-Hewitt Museum. "By the mid-'40s, however, corporations had improved their financial reporting and were even beginning to recognize this yearly document as a keystone for their entire public relations program."

The Cooper-Hewitt exhibit focused on ways in which companies used graphic design in their annual reports to convey their messages more effectively: "Compelling images could pull readers into the text, interpret intangible ideas, and engage the reader's attention on both an intellectual and subliminal level."

Litton Industries' 1959 annual report is often cited as the first "modern" annual report. Hirasuna refers to it as "seminal." Litton, an early conglomerate, was one of the highest-flying stocks in the Sixties. It was run by Tex Thornton, who historian Robert Sobel called "a positive genius at the creation of illusions." Litton started in the defense electronics business, but soon branched out into unrelated areas.

Sobel described Litton's annual report:

Each spring, shareholders would receive a thick annual report, printed on highly polished paper, containing elegant photos and art reproductions, and a commentary that might be described as breathlessly optimistic…

This is not to suggest that [Litton's annual report] lacked any of the necessary facts and figures. They were all there, along with graphs and charts, and made for pleasant reading. Litton had a clean balance sheet, and per share earnings climbed steadily. And if the returns on equity and sales were somewhat low, and a good deal of the profit increases were due to takeovers rather than ongoing operations, this was either lost on or ignored by a majority of stockholders. In the back of the "book" were lengthy footnotes, written in the usually careful jargon employed by lawyers and accountants.

Through promotion and ingenious accounting, Litton turned itself into a *concept* stock. The company spoke of its "free-form management" style. Its subsidiaries didn't manufacture machines; they produced "delivery systems." When Litton acquired Stouffer Food, the frozen-food company became the cornerstone of Litton's "food systems group." American Book, a second-rate textbook publisher, became Litton's "educational group."

Analysts and investors were bedazzled by Litton, and rationalized paying an exorbitant prices for its shares. (The company's p/e multiple was as high as 60.) As a result, Litton was able to use its richly valued stock to make loads of acquisitions. Along the way it bought many mundane (and sometimes bad) low-p/e companies. This strategy (using high p/e shares to purchase low p/e businesses) would prove to be accretive to earnings per share in the short run, but not necessarily the long.

Before its string of earnings' increases ended and turned into losses, Litton's stock had soared to 90. By 1974 it bottomed out at $2.40. (Several Litton executives who left in the Sixties ended up owning insurance companies. The most distinguished was Henry Singleton, the founder of Teledyne. (Unitrin, an insurance-holding company spun-off from Teledyne, eventually wound up owning 28% of Litton.)

"Used effectively, design can be a powerful tool for supporting the corporation's stance in a variety of ways," writes Hirasuna. "For instance, a company may seek to project itself as

Written Premiums Exceed Surplus

The current year will mark the first since 1996 that written premiums will exceed surplus. The industry's surplus has been declining for several years, while premiums have been growing. The higher premium-to-surplus ratio is the result of poor underwriting results, and the necessity for higher premiums due to lower interest rates.

$millions Year	Premiums Written	Surplus
1989	208	134
1990	218	138
1991	223	159
1992	228	163
1993	242	182
1994	251	193
1995	260	230
1996	269	256
1997	276	310
1998	282	333
1999	287	334
2000	302	319
2001	330	290

Source: A. M. Best for 1989-2000.
Figures for 2001 are estimates.

conservative or at the cutting edge. In a down year, it may want to present an image of austerity, without alarming investors or drawing more attention to its problems."

So true.

In 1993, after Aetna's earnings had declined for five years in a row and then disappeared entirely, the company got rid of the glossy photographs and fancy pictures. Chairman Ronald Compton adopted the Straight-Talking Approach, declaring that Aetna's miserable results were "completely unsatisfactory."

But he didn't stop there. He said that *although* "it would be easy to blame our anemic results" on environmental reserves, storms, bad investments, staff reductions, and a host of other things, *he would refrain from doing so.*

"We offer no excuses," he wrote. Then he offered an excuse: "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." [Emphasis added.]

Four years earlier, Compton and chairman James Lynn had outlined the company's bland mission: "To achieve superior, sustained profitability as an underwriter and provider of high-quality, cost-effective insurance and financial products that meet our customers' needs." (Is there any company that seeks to achieve the opposite: inferior profitability by providing low-quality, high-priced insurance that doesn't meet customers' needs?)

Aetna had "identified" four factors that it deemed critical to its mission: 1) "To have the right products and services," 2) "To select, price, and manage risks effectively," 3) To have the right distribution systems," and 4) "To manage resources competently…" (What company *tries* to have the wrong products, and manage its risks ineffectively and its resources incompetently?)

In its 1997 annual report, Reinsurance Group of America (RGA), which was then 64% owned by General American Life Insurance Company, told shareholders that "its strategic plan for the years 1998 through 2000… targets continued *annual growth in revenue and profits at between 15% and 20%*." [Emphasis added.] The letter was signed by RGA's chairman, Richard Liddy, who was also CEO and president of General American (which was seized by Missouri regulators after its speculations in the funding-agreement business blew up in August 1999).

The theme of RGA's 1998 annual report (published in early 1999) was "reinventing reinsurance." Liddy said that 1998 had been "a year of milestones." He cited the company's 25th anniversary, its fifth year as a public company, its 1,000,000th facultative application, and its establishment of a not-for-profit foundation. More importantly, he stated that "income from continuing operations increased 24% over 1997."

RGA's financial statement, however, revealed that *per share* income from continuing operations had grown just 10%. RGA hadn't achieved its goals of earnings-per-share growth, but Liddy, in his letter to shareholders, implied that it had. (For more on General American's misleading behavior, see *Schiff's Insurance Observer*, December 1999, pp. 6-11.) Shareholders either believed in Liddy or chose to ignore numbers and valuation. RGA's stock was then trading in the 40s—about 20 times earnings and 250% of book value.

RGA didn't come close to meeting its projections for 1999. It had been a reinsurer for 25% of General American's disastrous funding-agreement business, and experienced significant losses when that business imploded. Earnings per share from continuing operations declined from $2.11 in 1998 to $1.16 in 1999. They rebounded to $2.14 in 2000, and will be down somewhat in 2001. RGA's stock is now $32.08. ■

Part 3 of this series will be published next week.

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