The world's most dangerous insurance publication℠

SCHIFF'S INSURANCE OBSERVER

November 9, 2001
Volume 13 • Number 21

Reflections on Insurance Companies' Annual Reports

Between the Lines, Part 3

As Warren Buffett was gaining renown and hostile raiders were taking over undervalued, mismanaged companies, the people running big companies woke up and realized that they might be held accountable for their poor management.

Soon, insurance companies began talking about "shareholder value," "core competencies," and "returning capital to shareholders." In 1992, Rand Araskog, chairman, CEO, and president of ITT (which owned The Hartford), proclaimed that "creating value is the top financial priority of the 1990s for ITT." (What, one wonders, was the top financial priority before that? Destroying value?)

Traditionally low-profile companies began behaving differently, too. The contrasts between Chubb's 1986 and 1996 annual reports, for example, are illuminating. The 1986 annual report was plain; it was printed on uncoated paper and had no pictures. The letter to shareholders, dated March 6, 1987, was signed by chairman Henry Harder, vice chairman Percy Chubb III, and president Dean O'Hare. They noted that Chubb had achieved record earnings in 1986 because the company had been well positioned to take advantage of "a period of cyclical [property-casualty] recovery."

Chubb, however, wasn't about to get carried away by the good times:

> *Our experience in the market cycle of one business teaches us lessons of broader applicability. The recent cycle in property and casualty insurance, for example, has reinforced our determination to use restraint in excessively competitive markets. That experience has also affected the way we manage our financial assets…*
>
> *It would be naive not to expect imbalance to return and, flush with capacity, markets to be more competitive. As underwriting profits reveal the adequacy of prices, competitors will again seek to increase market share. Again there will be new entrants, convinced that they can engage in our business more successfully than we who have paid dearly for the scar tissue of experience.*

Befitting a company with scar tissue, Chubb's investment strategy in 1986 was designed to ensure strength: "Our objective is to manage our invested assets in a manner that provides maximum support for our insurance businesses."

Ten years later, Chubb's annual report had a somewhat different look and feel. It was kind of elegant, and contained color photographs. The cover had once merely stated the company's name, logo, and date; now it stated the following in large letters: "We took definitive action to enhance shareholder value…"

The 1996 letter to shareholders was no longer written by a triumvirate; it was written by O'Hare, who had become chairman and CEO. Of the 14 directors (not counting O'Hare) who were on the board in 1986, only five remained. Two years later only three were left.

O'Hare, whose photograph accompanied the 1996 letter to shareholders, wrote the following: "We clarified our strategic direction for the future and acted decisively to enhance the value of your investment in both the *near term* and longer term." [Emphasis added.]

O'Hare was acutely aware of Wall Street's short-term focus—and embraced it. He said Chubb was selling its life insurance business because building it "would require a level of capital commitment that is demonstratably not in our shareholders' *near-term* interests." Chubb planned to put the proceeds from the sale of the life-insurance business "to work in ways that *immediately* enhance shareholder value and improve our return on equity." [Emphasis added.]

Chubb's plan was one that young money managers applauded: a stock buyback. Over the next two years Chubb spent more than $1.5 billion to buy in its shares, often at all-time high prices.

Although Chubb had once paid dearly for the scar tissue of experience—it had been forced to issue shares at book value in 1984—that seemed like a dim memory by 1997. Maintaining financial strength, wrote O'Hare, "is a critical component of the insurance promise we make to our customer. At the same time, however, we have an obligation—one I feel most strongly—to maximize the value of our shareholders' investment. This means ensuring that we are adequately, not over-adequately, capitalized." (On March 7, 2000, Moody's lowered the ratings of Chubb's insurance companies from AAA to Aa1, and its senior debt from Aa2 to Aa3. On November 7, 2001, S&P lowered Chubb's rating from AAA to AA+.)

"Additional share repurchases at current prices [$80.19] represent a good value," O'Hare wrote on March 6, 1998. (Chubb's stock is now $68.60.) O'Hare—and CEOs at many other large insurance companies—had gotten swept up with the good feelings that were then prevalent. As we noted in our May 1998 issue, "It's easy to forget that an abundance of capital is to the insurance business what a 16-ounce prime steak is to a patient in the cardiac-care ward…Optimism—an emotion rarely seen in times of stress—abounds; it virtually oozes off the pages of insurance-company annual reports."

If Chubb's stock was such a good buy at $80, why hadn't the company been buying it by the bucket load when it was $40? In 1998 and 1999, O'Hare would refer to Chubb's stock repurchases as *returning money directly to shareholders*. Repurchasing stock at prices above intrinsic value destroys shareholders' value. Repurchasing stock at intrinsic value is neutral to shareholders' value. Repurchasing stock at prices below intrinsic value is accretive to shareholders' value, but even then a company must consider whether better investment opportunities exist. Only time will tell whether Chubb's repurchases eventually work out, but it's clear that the company missed out on better investment opportunities in the meantime.

Chubb is a fine company, and provides excellent products. (For the record, we've been a policyholder for 25 years.) Nonetheless, Chubb's financial results over the last three decades are less than what one would have expected from such a high-quality company. Chubb's book value, for example, has grown from $3.25 per share in 1972 to $39.23 at September 30, 2001—a compounded annual rate of 8.73%. (Including dividends would bring the rate to 12%-13%.) While 12%-13% is certainly respectable, one must bear in mind that during the same period the yield on top-rated corporate bonds averaged 9%.

Why is it that Chubb didn't achieve better results over a long period? The answer is that it's extremely difficult to do so. The insurance business offers countless opportunities to make mistakes, and Chubb has zigged when it should have zagged often enough. It issued shares when insurance stocks (including its own) were depressed, paid too much for a life insurance company at the wrong time, and repurchased shares when it would have been better off issuing new ones.

In its 2000 annual report, Chubb's "objectives" included growing revenues by 15% a year and achieving a 15% return on equity. These objectives are shared by many companies, are highly unlikely to be realized over time, and aren't necessarily sensible, anyway.

Chubb would be better off focusing on increasing intrinsic value per share—however one chooses to measure that—over the long term.

The final part of this series will be published next week.

The world's most dangerous insurance publication℠

SCHIFF'S
INSURANCE OBSERVER

Editor and Writer .... David Schiff
Copy Editor .... John Cauman
Editorial Associate ...... Isaac Schwartz
Production Editor .... Bill Lauck

Publisher .... Alan Zimmerman
Subscription Manager....... Pat LaBua
Advertising Manager ..... Mark Outlaw

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.

Reprints and additional issues are available from our publishing headquarters.

Insurance Communications Co. (ICC) is controlled by Schiff Publishing. SNL Securities LC is a research and publishing company that focuses on banks, thrifts, real estate investment companies, insurance companies, and specialized financial-services companies. SNL is a nonvoting stockholder in ICC and provides publishing services to it.