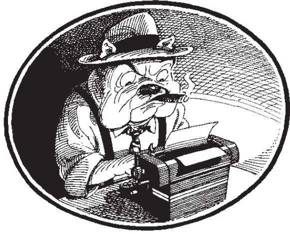

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Can the Hard Market End Before it Starts?

A Tidal Wave of Capital

The capital markets are efficient—in an irrational way. Capital flows towards opportunities that offer superior returns. Paradoxically, those superior returns can fail to materialize if too much capital flows into the "opportunities."

Investors, aided by investment bankers and brokers, can take a logical investment thesis and carry it to the point of madness. In recent years we've witnessed spectacular debacles in internet stocks, telecommunications stocks, go-go mutual funds, and high-flying "blue-chip" glamour stocks. That bubbles burst is not new; similar bubbles have burst in electronics, conglomerates, restaurants, computers, land, railroads, automobiles, utilities, natural resources, and virtually every other sector over the years.

A key component of any investment is value. The price that one pays for something bears some relationship to the future returns from that investment. During booms, however, investors tend to forget about value and focus instead on growth, the theory being that there's no price too high to pay for that.

Right now, capital is flowing into the insurance industry based on the theory that it's poised for a big cyclical upswing. Depending upon how you count it, about $15 billion of new capital has been invested or committed (in equity and debt) since September 11. The stocks of the stronger reinsurers and specialty underwriters have rallied sharply. The market is anticipating boom times ahead. But is that sensible?

In our August 1999 we noted that we'd been buying stock "in a number of reasonably capitalized, out-of-favor property-casualty companies selling below book value…When buying a bargain, one doesn't need everything to go right. When securities are priced for the worst, one merely needs the worst not to happen to make money."

"…and then insurance companies raised $30 billion and lived happily ever after."

We then asked a rhetorical question: Why weren't the investors who were paying 28 times earnings and 430% of book value to buy AIG taking a flyer on W. R. Berkley and Loews, both of which were then selling below book value?

"The answer, we must assume, lies in the nature of markets," we wrote. "There's no way to tell when, if ever, AIG will go out of style, or when, if ever, Berkley and Loews will come into style. For our money, however, we feel more comfortable with what's currently cheap and unfashionable."

Since then the market has changed its opinion of the three companies. Berkley and Loews are up 120% and 51%, respectively, while AIG is up 28%.

The fact that these "value" stocks outperformed in this short period is ultimately neither here nor there, but it's worth considering. Berkley has been a sensational investment not because the company did well in 2000 or 2001 (it didn't), but because its stock was priced far too cheaply based on its intrinsic value and cyclical earnings power. Now, however, at 200% of book value, Berkley is being valued based on its bright prospects for 2003. We like Bill Berkley and admire him, but believe that his company's shares are priced for the best (or close to it), and that the margin of safety one wants in an investment is no longer there. The insurance business is cyclical, and, although analysts confidently predict that Berkley will earn $5 or $6 per share in 2003 (figures that seem plausible to us), no one—we repeat, *no one*—has any idea what the company will earn

in 2006. (We wouldn't be surprised if that year's earnings are well below those of 2003.)

Fidelity, which is in the business of selling and managing mutual funds, has a vested interest in making investors complacent. After September 11, the company began running full pages ads written by Peter Lynch. The purpose was to convince people that investing in the stock market was the smart thing to do. Lynch, who's a legitimate genius at managing money, said that recessions come and go, and that "the next 10,000, 20,000 and 40,000 points" in the market "will be up." Since the Dow Jones Industrial Average was below 10,000, his banal comment couldn't help but be correct.

Lynch noted that recessions have always been followed by recoveries, and focused on the past in the most convenient way. He said that downturns in the U.S. don't get out of control for a number of factors, among them, "The price of the average house has not fallen over the last 30 years. In fact, the value of the average house has increased 5-6% over the last three years."

That's true—in America. In Japan, by way of contrast, land prices have declined for 10 years in a row, and residential land prices have fallen 19.8% since their 1991 peak. Our point: yes, things are cyclical, but cycles aren't really predictable. The past tends to repeat itself, but not in precisely the same way.

Which brings us to comments published last week in *IBNR Weekly*, the indispensable research report put out by Hartford-based Dowling & Partners, an independent institutional securities firm that specializes in property-casualty stocks. We've learned more about the property-casualty business from V. J. Dowling, the firm's proprietor, than from anyone else. *His thoughts, published below, are concise, timely, and, as always, worth considering*:

When looking at the capital raising for the property-casualty reinsurance-and-insurance industries, investors should look at two distinct pieces: 1) venture-capital driven new startups—the $5 billion to $10 billion likely to be raised in Bermuda, and 2) secondary offerings by existing public reinsurers and insurers—another $5 billion to $10 billion of new money.

Market conditions are likely to be the best in 15 years, and with few attractive opportunities elsewhere in the economy, everyone wants to participate. Private equity is being raised easily, and secondary offerings of property-casualty reinsurers and insurers are now "hot" deals. The fact that we are hearing from people for the first time in years is another sign of the focus on the "group" by investors. While not yet significant in terms of a September 11 industry loss of $30 billion to $50 billion *pre-tax* (don't forget, the key figure is the after-tax loss of $20 billion to $40 billion), the amount of money being raised *is* material to the ultimate length of the "hard" market. We think looking at absolute dollars raised is less meaningful than looking at where the money is going. While we like the validation of our investment thesis (Bermuda/reinsurers are best positioned), we are uncomfortable with the implications that 80% of the money raised (from startups and existing companies) will, in fact, go to Bermuda and to reinsurers.

Startups

With the approach of the January 1 renewal season, the feeding frenzy for investment bankers, private equity, and "sponsors" is quickly coming to an end. Not "being there" on January 1 will make attainment of stated goals for premium and return on equity difficult, if not impossible, to attain. It's not easy to earn a 15% to 25% ROE on $1 billion of common equity in a low single-digit interest rate environment—even with the tax advantages of Bermuda. It's even more difficult to earn those 15% to 25% venture-like compounded returns on $5 to $10 billion of "fresh" capital. (Let's not forget that the "exit strategy" calls for selling the shares at a premium to book value to public investors in an IPO and subsequent secondary offerings.)

Unfortunately, given the economic incentives for "sponsors," we see before us the classic prisoner's dilemma where what is good for one (each startup) is bad for the group/industry. While each excel spreadsheet (with projections of premiums written and loss ratio as the key variables) looks rational on its own merits, the sum of all the planned spreadsheets may not be so rational.

The reinsurance intermediaries—unindicted co-conspirators in the soft-market debacle of 1997-2000 (yet to play out fully in reported results)—will likely be responsible for organizing the majority of the startup capital created. We suspect that $3 billion to $5 billion will be raised for reinsurers effectively created by Aon, Marsh Mac Capital, Benfield, and other "intermediaries." From a macro perspective, reinsurers that blew up from poorly underwritten/priced business (i.e. Australia) in the soft market are replaced by fresh capital as we enter the hard market. Disciplined reinsurers—unfortunately an oxymoron last cycle based upon RAA data—will soon compete with fresh capital raised by the bro-

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kers (who gain economically if the startups do well).

All three officially announced $1 billion+ Bermuda reinsurance deals (Marsh, Arch, White Mountains) are being "led" by "underwriters" who have *not* actively underwritten for at least five years. (We think of them as player/managers rather than players.) Thus, while the "name" will help to raise capital, and hopefully "sell" the IPO, there exists the need to recruit a strong team of day-today underwriters—quickly. Every solid reinsurance executive we know has been offered a job(s) in Bermuda (some with Net Jet trips weekly so the family can stay in the states). Talent remains a serious issue, and we believe the startups will not have equal success in attracting talent and/or "good" January 1 business.

Publicly Traded (Re)Insurers

The (re)insurance stocks have been advancing up the "wall of worry" concerning valuation and the sustainability of pricing trends (both very real concerns). For the diversified public market investor (mutual fund, hedge fund), however, the logic for the solid stock performance is simple: when investors look at corporate America there are few, if any, industries that have pricing power and will generate improving reported results for at least two years. Insurance is one such sector. Meanwhile, within financial services, the weak economy is having the expected impact on income statement and balance sheets of lending institutions, hence a rotation into insurance. Add to these macro investing factors our thesis of a secular (as well as cyclical) change in the industry's ability to earn a higher return, and we still believe that select property-casualty stocks remain attractive.

Unfortunately, as we have pointed out before, the liquidity of the (re)insurance sector is terrible, and the number of large cap "names" for investors to "play" is limited. Investors have to be in early and out early. Thus, with secondary offerings, even after strong advances since September 11, there is a liquidity event for big investors to purchase the shares. So far, completed secondary common stock offerings have raised $2.75 billion in the U.S. and $340 million in Australia. The offerings create demand for the shares in general as the "story" for positive future property-casualty (re)insurance results is articulated by senior managements against a backdrop of advancing stock prices. New investors, many drawn simply by the strong stock performance, want in—even though their knowledge of the insurance industry is basic, at best. *The momentum money is now back in the stocks and long-term investors must keep that in mind*. The movement of momentum investors in and out of the (re)insurance stocks is an important issue to understand, and one we have always had trouble calling when the trend will shift.

Looking ahead, we expect a very strong January 1 renewal season for reinsurance, and an improving pricing environment for commercial lines. Information will become known in very late December and early January as to the trends and magnitude. *Then, when results are reported for the fourth quarter, we expect earnings to be terrible*: 2001 has been lost and the fourth quarter will be a "kitchen sink" quarter for many (re)insurers. Not only will WTC losses move upward (oops sorry, we were wrong) but we expect other reserve shortages and reinsurance collectible issues to be addressed. Expect special charges. Any CEO of a publicly traded (re)insurer that doesn't "clean up" the balance sheet (to the extent possible given rating agency and investor constraints), is crazy. The industry will not fix the A&E problem or the shortfalls of 1997-2000 in the fourth quarter, but (re)insurers should make a down payment. We've entered the "restoration phase," and the fourth quarter should reflect that fact. Longer-term investors—assuming the premium trends are strong and the commentary on January renewals favorable—will look beyond the poor 2001 results to the 2002 and 2003 figures. (We have no idea how the momentum investor will react to a "miss" in the fourth quarter while top line is strong.)

We still believe that 2002 will be better than "consensus" for most of our "Buy"-rated stocks (the one exception has been Chubb, where we had the lowest estimate published for 2002, due to "payback" issues, and that has proved correct this week), *but the key to stock performance from here is 2003+*. The stocks are fully valued or overvalued on 2002 prospects, but 2003 should be a significant improvement. Beyond that—which is beyond our "investable horizon"—we have no opinion currently.

By next summer, after the second quarter results are released, investors should have a good feel for 2003 trends and earning power. If, as we suspect, the stocks have then discounted 2003 numbers (with talk of a big 2004), it will then be time to review one's holdings. The time to sell will likely be when everything is great—earnings are rising and the IPOs of the private equity Class of 2001 are beginning to come to market. Reported earnings will be meaningless (the "self-graded exam") in our decision about an exit point. *We still believe that simply looking at price-to-book (after adjustments, of course) will be the best approach as to when to sell*. Until then, we remain bullish on the group despite the solid performance of late and our discomfort with the amount of capital being raised. ■

The publication of the final part of our series "Reflections on Insurance Companies' Annual Reports," has been delayed until next week.