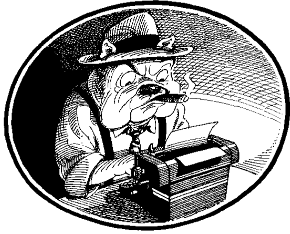
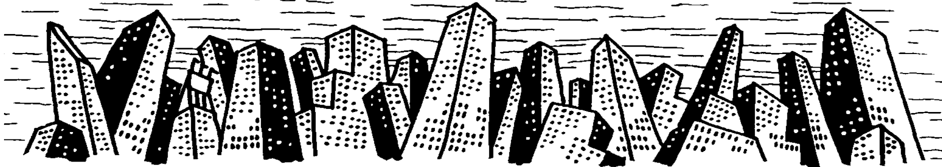


The world's most dangerous insurance publication℠

# SCHIFF'S

June 4, 2002
Volume 14 • Number 8

INSURANCE OBSERVER



## THE INSURANCE BEAT

### Buffettology

MERRILL LYNCH RECENTLY agreed to pay a $100-million fine after New York attorney general, Elliot Spitzer, investigated the firm and was shocked to discover that its analysts had, allegedly, defrauded investors by recommending stocks of dubious value in order to generate investment banking fees.

Merrill's behavior is pretty much the standard operating procedure on Wall Street. It is not the standard operating procedure on Sixth Street (in Sioux City, Iowa), where the securities firm Pecaut & Company is located.

We met Dan Pecaut and Corey Wrenn about a decade ago, and we're glad we did because, over the years, they've written insightful material that we've enjoyed reading.

In 1998, after Berkshire Hathaway announced that it would acquire General Re for stock, Pecaut and Wren published the definitive commentary on the deal. By issuing 18% of Berkshire stock to General Re shareholders, they explained, Warren Buffett was, in fact, "selling."

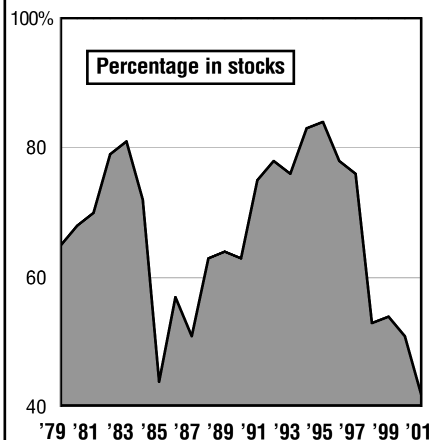
"Issuance of shares is a sacred issued at Berkshire," Pecaut and Wren wrote. "Buffett has long said he would never issue stock unless he received more than fair value in return. In the 1997 annual report, Buffett even issues a 'confession' stating that 'when I've issued stock, I've cost you money,' and concludes 'you can be sure Charlie and I will be very reluctant to issue shares in the future.' Berkshire/General Re is an all-stock deal. Either Berkshire is ridiculously overvalued or this is an exceptional deal. Or both."

When Pecaut and Wren wrote those words Berkshire was trading at $76,800. It is now $74,000.

As these analysts saw it, by issuing shares for General Re, Buffett could reduce the percentage of his assets in stocks without selling any shares. "With a 36% capital gains tax rate and over $30 billion in unrealized capital gains, Berkshire would pay a heavy price to sell," they wrote. "To a large degree, Buffett is trapped into holding on."

**Berkshire's Investment Portfolio**

The following chart shows the percentage of Berkshire Hathaway's investment portfolio in stocks since 1979. The percentage has declined since the acquisition of General Re in 1998. (1985 was an aberration: 38% of Berkshire's investment portfolio was in cash due, in large part, to Phillip Morris' acquisition of General Foods, in which Berkshire had a large investment.)




Note: Convertible preferred stocks are not included.
Source: Pecaut & Company

Prior to the General Re transaction, Berkshire had $50 billion of investment assets, $40 billion of which was in stocks. General Re had $24 billion of investment assets, $5 billion of which was in stocks. (Buffett sold General Re's stock portfolio.) Merging with General Re would thus reduce Berkshire's stock holdings from 80% of assets to 53%. "In effect," wrote Pecaut and Wren, "Berkshire is trading away 18% of its holdings in Coca Cola, American Express, Gillette, etc., but doing so in a way that Berkshire pays no taxes."

Pecaut & Company's May 2002 newsletter includes a table of Berkshire Hathaway's asset allocation between stocks and fixed income since 1979. The percentage of Berkshire's assets in stocks is now the lowest that it has been since the early 1970s. Considering Buffett's less than bullish outlook on stocks, this isn't surprising. (Because of the growth in Berkshire's insurance business, it's unlikely that the company will ever be as heavily invested in stocks as it was in the early 1990s.)

Pecaut and Wren's opinion of Berkshire's stock is not exactly "buy," "hold," or "sell." Berkshire is "soundly positioned for steady growth," they write, and is "selling at roughly a 15% premium to our adjusted book value calculation of $65,000 per share." It is "reasonably valued."

### The Efficient Market

RIGHT NOW, THE MARKET for insurance stocks is far too efficient for our taste. Most companies seem reasonably valued or overvalued. (In early 2000, when we were last bullish on insurance stocks, most decent insurance companies were unreasonably valued: pessimism was so

great that many were selling below book value and for far less than what they were worth.)

Although we haven't bought an insurance stock for some time, we did make a significant purchase of insurance securities last year. In our December 31, 2001 issue, we explained why we'd bought CNA Financial's 6.45s of '08. (The price was 82, which provided a yield to maturity of 10.6%—about 600 basis points more than Treasurys.)

Our analysis was fairly simple. CNA's stock, which was trading at 29, had a market capitalization of $6.5 billion. Its bonds, on the other hand, were selling at distressed levels that implied a significant chance of default. One thing was certain: one of the securities was priced incorrectly. If the stock was worth *anything*, then the bonds were worth par. Furthermore, simple math demonstrated that if the stock turned out to be a good investment—or even a fairly bad investment—then the bonds would still be a good investment. Under most circumstances, the bonds (actually, they're "senior notes"), were a safer security that were almost certain to yield better returns.

Why the market failed to see the appeal of the low-risk, high-reward bonds (versus the stock) is one of those mysteries of life. (Perhaps stock investors are conditioned to buy stocks even when they're likely to yield less than similar bonds.) Buyers of CNA's stock should have been buying the bonds instead, since they offered almost as much upside with much less downside.

The CNA bonds are now 94.25—a price that yields 7.73% to maturity—not enough to make us continue to hold them. We have sold our position. Our total gain in five months was 17.9% (a 43% annualized return). During the same period, CNA's stock declined 9.1%.

Just as stock buyers often pay little attention to bond prices and credit ratings, property-casualty insurance buyers, for the most part, pay too little attention to insurance-company financial-strength ratings. Insurance is about transferring risk. Risk that is transferred to a weaker company may turn out to be risk that is not transferred at all.

Insurance buyers concentrate their credit risk and therefore cannot take as much risk as bond buyers, who can spread their risk by diversifying their holdings. They only risk their investment, whereas insurance buyers risk a sum far greater than the premium paid.

Commercial insurance buyers should place greater emphasis on an insurance company's financial strength before doing business with it. (Many insurance buyers are satisfied if a company is rated "A-" or higher by Best.) All things being equal, it's well worth it to pay a higher premium for greater financial strength.

While a company's *ability* to pay a claim is important, so is its *willingness*. In "The Loss of the Certainty Effect," (*Risk Management and Insurance Review*, 2001, Vol. 4, No. 2, pages 29-49), Richard and Barbara Stewart of Stewart Economics, write that recent changes in the commercial property-casualty business have made it unlikely that large claims will be paid promptly and willingly. If they are correct, these changes may have significant ramifications for the insurance industry.

"What does asymmetric information theory say about insurance?" the authors ask. "It says that as buyers became aware of the tightened claims practices of insurers, insurance would move from being an item with assured quality to one whose quality was better known to the seller than to the buyer. As with used cars, buyers would assume the worst, and prices would gravitate towards the price of the least reliable insurance...Unreliable insurance would tend to drive reliable insurance out of the market."

Writing about "the certainty effect," the Stewarts ask: "What is the value to you of a deal with someone whose handshake is 100% solid and dependable? Now, what is the value of the same handshake from someone who performs most of the time, but not always?"

They note that "buyers attach great importance to closing off the smallest chance of nonperformance. One leading study found that 'people demand about a 30% reduction in the premium to compensate them for a 1% chance that their claim will not be paid.' If this finding is true, then if insurance were ever perceived as less than reliable and certain—for reasons of insolvency or claims practices—the willingness of buyers to pay for it would drop by an amount far greater than expected-utility theory would predict and insurance professionals would expect."

So far, most insurance buyers have not placed as much emphasis on insurance companies' financial strength and willingness to pay as one might expect. At some point, that will change.

## The Devil Made Them Do It

WE DON'T CARE WHAT ANYONE SAYS—it was wrong of Martin Frankel to loot several life-insurance companies. Frankel, who liberated about $200 million from the Franklin Protective, Family Guaranty, and First National, has now pled guilty to securities fraud, mail fraud, wire fraud, conspiracy, racketeering, and


The world's most dangerous insurance publication℠

# SCHIFF'S
INSURANCE OBSERVER

**Editor and Writer** ....... David Schiff
**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: (434) 977-5877
Fax: (434) 984-8020
E-mail: Subscriptions@InsuranceObserver.com

For questions regarding subscriptions please call (434) 977-5877.



© 2002, Insurance Communications Co., LLC. All rights reserved.

**Copyright Notice and Warning**
It is a violation of federal copyright law to reproduce all or part of this publication. You are not allowed to e-mail, photocopy, fax, scan, distribute, or duplicate by any other means the contents of this publication. Violations of copyright law can lead to damages of up to $100,000 per infringement.



**Reprints and additional issues are available from our publishing headquarters.**

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

racketeering conspiracy. Federal and state prosecutors are still looking into matters, and may bring more charges against the ex-fugitive. The Securities and Exchange Commission, which is also right on top of things, has filed a civil suit against Frankel.

While we don't condone Frankel's larcenous behavior, we think the press has been a tad hard on the fellow. Articles (and a book) have detailed his scams, thievery, extravagant lifestyle, and penchant for sadomasochistic sex. To the best of our knowledge, however, no one—we repeat: no one—has pointed out that Frankel never took stock options with exercise prices below book value or intrinsic value.

The same cannot be said of many well-known insurance-company CEOs.

On May 22, 2001 we published "The Insurance Company Stock-Option Bazaar," which listed a dozen companies that had issued their CEOs stock options at or below book value. (Our list was not intended to be comprehensive; it was simply the result of reading numerous proxy statements.) The options were issued at prices so cheap that they could not, by any stretch of the imagination, be called "incentives."

The accompanying table, which we've updated from last year, shows the percentage gain for each company's option issuance. The smallest gain is 31%; the largest is 277%. Virtually all of these gains have nothing to do with any CEO's performance; they are the result of options that were granted during a time—early 2000 in most cases—when the insurance companies were selling for a fraction of what they were really worth.

Having a board of directors that's accommodating enough to give a CEO free money in the form of bargain-basement options is not securities fraud, mail fraud, wire fraud, conspiracy, racketeering, or racketeering conspiracy. It is capitalism.

Viva free enterprise!

**Free Money: Insurance-Company CEOs Clean Up on Cheap Stock Options**

During 2000, the CEOs of these companies received stock options at bargain-basement prices—below book value in all but two instances. This chart shows the exercise price of the options granted, the book value at the time of the grant, today's stock price, and the CEOs' profit per share (to date) from the options grant. Since the options were issued for 10 years, most CEOs will reap greater profits over time.

In 2001, all of the honchos of the companies listed below (except for Investors Title) received options. (St. Paul, which hired a new CEO, is a different situation.) In our opinion, the most flagrant options grants took place at AmerUs, Berkley, and PXRE.

We routinely vote against stock-option plans and advise you to do the same (unless you're the CEO of an insurance company, or expect to become one. In that case, bring in the compensation consultants and get your options now, before it's too late.)

| Company | Book Value | Option Price | Current Stock Price | CEO's Profit Per Share | % Gain |
|---|---|---|---|---|---|
| American Financial Group | $26.37 | $19.84 | $26.06 | $6.22 | 31% |
| AmerUs | $25.36 | $20.00 | $35.35 | $15.35 | 77% |
| W. R. Berkley | $23.00 | $15.50 | $58.42 | $42.92 | 277% |
| Cincinnati Financial | $31.18 | $29.72 | $44.54 | $14.82 | 50% |
| Harleysville Group | $18.29 | $16.48 | $26.70 | $10.22 | 62% |
| Investors Title | $14.20 | $12.44 | $20.03 | $7.59 | 61% |
| IPC Holdings | $19.42 | $15.38 | $31.05 | $15.68 | 102% |
| Loews (CNA) | $47.75 | $30.14 | $56.39 | $26.25 | 87% |
| Midland (American Modern) | $27.11 | $22.75 | $47.37 | $24.62 | 108% |
| PXRE | $22.54 | $12.50 | $24.10 | $11.60 | 93% |
| RLI | $29.68 | $31.90 | $53.46 | $21.56 | 68% |
| St. Paul | $28.68 | $29.31 | $41.62 | $12.31 | 42% |