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SCHIFF'S

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Bullish and Wrong, but Still Okay

RLI Revisited

The insurance business is the investment business. Insurance companies' profits (assuming they actually have any) usually come from investment income rather than from underwriting. Losing money underwriting is the price most insurance companies pay to gain the use of other people's money.

Underwriting profitably has always been harder than it looks. There was a time when the industry had a cycle of several years of underwriting profits followed by several years of underwriting losses. (In modern times, the longest period of underwriting profits occurred from 1933 to 1945. The Depression had sullied insurers' balance sheets, creating extreme fear. Insurers became risk averse; rapid growth was of less concern than preservation of capital.) The industry has not recorded an underwriting profit since 1978.

When insurance companies can do well from their investments—or when they *think* they can do well—underwriting profits become less important. When interest rates are high insurance companies may be able to tolerate underwriting losses. When interest rates are very low—as they are now—insurance companies can hardly expect investment income to bail out poor underwriting.

RLI Corp., of Peoria, Illinois, dates back to 1961, when, as Replacement Lens, Inc., it began insuring contact lenses. Today RLI is a specialty insurer that will write about $700 million in property, casualty, and surety business in 2002.

Although RLI suffered significant losses from the 1994 Northridge earthquake, for the most part it has avoided disaster. The company is an excellent underwriter—it has made an underwriting profit since 1996—and has done much that's right. (We'll discuss where it went wrong shortly.)

On November 7, RLI announced plans to issue 4.8 million shares of its common stock in a public offering. At today's closing price of $25.16 (155% of per-share book value), the offering will raise about $125 million. For RLI, issuing stock now, when pricing is strong and its shares are near their all-time high, is a smart move. During the insurance bull market of 1998, when RLI's shares were in the low 20s, the company was overly optimistic and missed a wonderful opportunity to raise capital on good terms. (The best time to raise capital is usually when you *don't* need it.) Its stock, after sinking to $12.21 in March 2000, traded as high as $29.60 recently (before declining on the news of the offering).

Although RLI's written premiums have more than doubled in the last five years (while the combined ratio has been in the low 90s) shareholders' equity and "comprehensive earnings" (earnings including realized and unrealized investment gains and losses) have lagged far behind, due primarily to management's bull-market belief in the inevitability of stocks' continued rise. Therein lies a lesson about risk, risk versus reward, and the belief that what's worked splendidly in the past will always work splendidly in the future.

Over the years, the primary cause of insurance-company failures has been an overconcentration of risk—in underwriting, investing, or sometimes both. In 1934, for example, USF&G, reeling from poor investments and a disastrous foray into the mortgage-bond guarantee business, had to be bailed out by the Reconstruction Finance Corporation. The Metropolitan Life Insurance Company was saddled with busted farm loans throughout the 1930s. (It foreclosed on so many farms that it became the largest "farmer" in the country.) Many property and casualty companies were hurt by the Crash, and life insurers were wounded by bond defaults. In 1973 and 1974, many insurance companies were, once again, clobbered by a bear market. A generation later First Executive achieved insolvency due to its one-note money-management thesis: placing almost 50% of its investments in non-investment grade bonds. In the summer of 1999 General American became a ward of the state because it let its funding-agreement business get out of control: 34% of its investment assets were derived from funding-agreements that

RLI: Being Bullish Hurts

RLI's large investment in equities has hurt the company in recent years, and caused "comprehensive earnings" (after-tax earnings plus unrealized gains and losses) to turn negative for the first nine months of this year.

(000)	9/30/02	2001	2000	1999	1998
Comprehensive earnings (loss) ($)	(7,336)	11,373	42,042	20,880	51,758
Shareholders' Equity ($)	323,219	335,432	326,654	293,069	293,959
Equity Investments ($)	213,409	277,621	306,194	284,639	296,521
Equities as a % of Shareholders' Equity	66%	83%	94%	97%	101%
Results of Equity Portfolio	-23%	-7%	9.8%	-1%	17.4%

could be (and *were*) "put" to it on seven days' notice.

In May 1998, *Schiff's* took note of the profusion of speculative excesses in an article entitled "Burning in Water, Drowning in Flame," in which we set in type our bearish thoughts on the insurance business, the stock market, mutual funds, consolidation, expansion, and the "money fever" that had spread through the large mutuals. "It seems that the insurance industry is well past the stage of optimism," we wrote. "It has become a true believer in its divine right to compound its net worth at a double-digit return for eternity... Optimism—an emotion rarely seen in times of stress—virtually oozes off the pages of insurance-company annual reports."

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The S&P 500 was then 1,100; it is now 876. RLI was among the companies we discussed. Our words are reprinted below.

RLI Corp. is a successful company that writes specialty property/casualty lines through independent agents. Forty percent of its business is in California and 42% of its investment portfolio is in common stocks. It is the stock portfolio, rather than the risk of earthquakes and crazed regulators, that gives us greater pause. In recent years, Gerald Stephens, RLI's founder and president, has emphasized his company's "comprehensive earnings" to shareholders. (Comprehensive earnings are defined as after-tax earnings plus any changes in *unrealized* investment gains or losses.)

Obviously, good equity investments make a world of difference in a company's book value over time. Berkshire Hathaway, Cincinnati Financial, and Erie Insurance are exemplars of insurers that did well underwriting but made a fortune investing the assets they garnered from underwriting. Because they invested more of their assets in stocks than in bonds (compared to the average insurer), their reported earnings understated their results. That's because unrealized gains show up on the balance sheet, not the income statement, and stocks have generally yielded less than bonds. (We say "generally" because such was not always the case. From 1935 until 1959, the yield on the Dow Jones Industrial Average exceeded the yield on Moody's Aaa bond index. During that period, however, insurance companies evinced the same interest in owning stocks as Joe Namath evinced in broken-field running)

Comprehensive earnings is a valid concept, but an investor must be careful in placing a multiple on such earnings, because capital appreciation is not assured. "A well-managed insurance company, like RLI, is a wonderful institution because we generate three streams of income as reported in comprehensive earnings," writes Stephens, whose company's equity portfolio is run by an outside investment manager. "Together, they give our shareholders reason to expect more from their investment in RLI than they would elsewhere in our industry. It amazes me that many of our competitors do not take advantage of the most potent of these streams: unrealized gains from an equity portfolio."

Jonathan Michael, the company's number two man [he's now CEO], echoes Stephens' sentiments. Indeed, he sounds as if he just returned from a trip to Beardstown. When asked [in the annual report] whether he worries about a "market dip," he responds by saying he would view it as "a buying opportunity," stating that "over any three-, five- or 10-year period, the stock market *will* [emphasis added] have shown improvement, and it *will* [emphasis added, again] have outperformed the bond market by a long shot." Michael did not add the typical mutual-fund disclaimer—that "past performance cannot guarantee future results"—a warning worth pondering with the S&P 500 trading at 28 times earnings and the Nasdaq Composite floating at a lofty 67.5 times earnings.

It is worth noting that RLI has not always been a raging bull. In 1988, when stocks were cheap, equities comprised 15% of its invested assets and 39% of its shareholders' equity. Today, equities make up 42% of its invested assets and 94% of its shareholders' equity.

Schiff's negativity was a bit premature. RLI's equity investments went up 17.4% in 1998; they then comprised 101% of the company's shareholders' equity. But Jonathan Michael's pronouncement that stocks *will* go up over *any* three-year or five-year period—and will outperform bonds—was, of course, wrong. Not only have stocks declined, they have underperformed bonds (which have done quite well). Stocks have also underperformed Treasury bills, gold bullion, real estate in the South Bronx, and cash under the mattress.

RLI's equity portfolio was *down* 1% in 1999, *up* 9.8% in 2000, *down* 7% in 2001, and *down* 23% for the first nine months of 2002. From January 1, 1998 through September 30, 2002, the company's equity investments lost money at a 1.79% annual rate. Despite what RLI said when the going was good, it didn't use the market's "dip" as a buying opportunity.

As of September 30, RLI's equity portfolio comprised 66% of shareholders' equity. Assuming that RLI completes its equity offering, stocks will be 48% of shareholders' equity—far below the 101% level recorded in 1998.

Despite RLI's superior underwriting, the company's "comprehensive" earnings have declined significantly since their peak of $66 million in 1997. For the first nine months ending September 30, 2002, the company reported a comprehensive *loss* of $7.3 million.

RLI's strengths, however, have compensated for its misguided investment strategy. The losses on its large equity portfolio haven't wreaked havoc on the company, but they have turned what would have been stellar results into mediocre results: from January 1, 1998 to September 30, 2002, book value increased at a compounded annual rate of 5.98%. (In addition, RLI has paid an annual dividend that's slightly less than 2% of book value.)

Investing for total return is a sensible strategy for well-capitalized insurance companies. There's nothing wrong with investing heavily in equities or anything else—if a company has the balance sheet to do so. But investing (as opposed to speculating) is like good underwriting—it requires an understanding of value and, on many occasions, great restraint. There are times when the risk in stocks is greater than the reward. The same is true of bonds, real estate, and rapid premium growth. (For the record, we don't see many bargains among large U.S. equities, are wary of bonds, and skeptical of real estate.) On the other hand, there are good opportunities in underwriting, but they won't be permanent. They're the result of short-term imbalances in supply and demand.)

Although Jonathan Michael can't comment while RLI is in registration, we suspect that he'd say that his company has learned a lesson. We also suspect that the lesson will never be forgotten—at least for a while.