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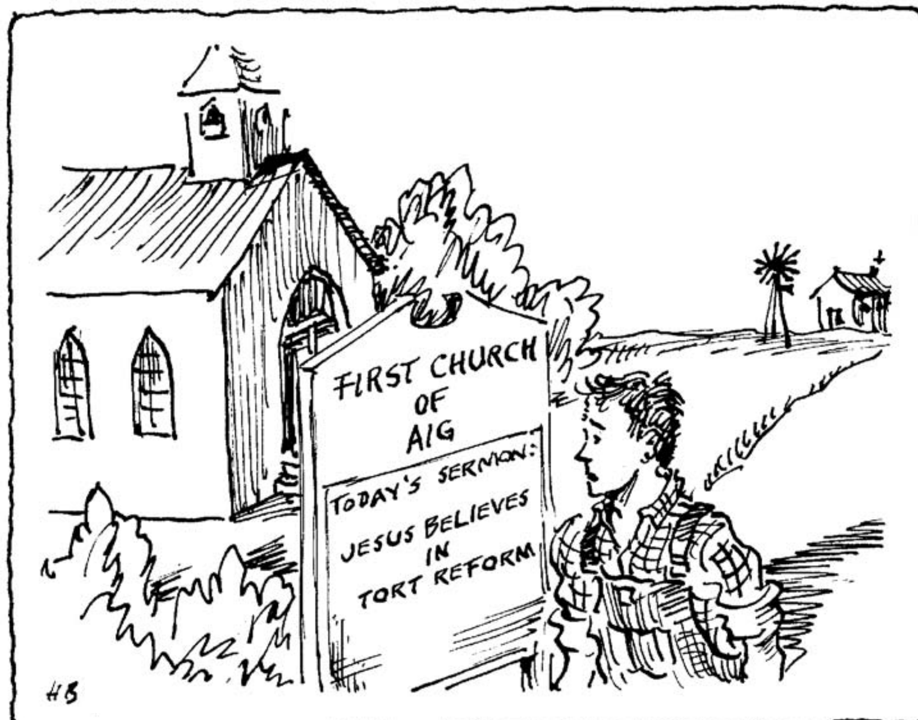
'Death of the Sure Thing'—Thoughts on AIG

Play it Again, Hank



At 8:23 p.m on February 3, when AIG announced that it would take a $2.8 billion pretax charge ($1.8 billion after tax) to boost loss reserves, investors' perception of the company was radically altered. AIG had been venerated for its rapidly growing, *predictable* earnings. When it turned out that AIG had been underreserved for 1997 to 2001, it was a blow to the company's perceived invincibility, and a confirmation that investors' almost unlimited esteem for AIG had been unwarranted. As Jim Grant, editor of *Grant's Interest Rate Observer*, said to us, the charge marked "the death of the sure thing."

Although Hank Greenberg, chairman and CEO, tried to minimize the importance of the charge on a conference call the following day, the damage was done: AIG had (by mistake) overstated its earnings in the previous five years and hadn't achieved the earnings growth that investors thought it had.

Blaming AIG's losses on a "liability bubble," as Greenberg attempted to do, did not assuage investors. Yes, liability claims have increased sharply, but insurance companies are in the business of assuming complex risks. No one forced AIG to write underpriced business.

Greenberg's performance on the conference call was not his finest hour. He was strident and sharp (as always), and he was even sharper the following week. But his attitude wasn't reassuring. AIG had made underwriting and reserving mistakes, yet Greenberg didn't want to admit that. *We priced the business accurately, but the tort system exploded in our face*, he said. *No one could have foreseen the corporate governance issues that would lead to such massive D&O claims*, he asserted. *The venue-hunting by trial lawyers is shameful; it really degrades our legal system*.

AIG is a great company, but it isn't as great a company—or underwriter—as many people thought it was, and its earnings and growth are not as predictable as was widely believed.

AIG and Hank Greenberg are always colorful topics of conversation in the insurance business. The company is watched closely (even though no one *really* knows what he's seeing), and virtually every Wall Street analyst had a "buy" rating on AIG for ages. Now, four analysts rate it a "hold," and one heretic rates it a "sell." (*Schiff's* official opinion is that AIG's stock is somewhere in the range of "fair value." We wouldn't buy it, however, just because it's fairly valued. We'd only buy if we thought it was considerably undervalued.)

AIG's $2.8 billion charge provided considerable fodder for discussion. Just for the hell of it, we read several thousand postings on *Yahoo! Finance*'s bulletin board about AIG. Below, in edited form, are a smattering of the postings from February 3 to February 24:

02/03/03 10:34 pm
Re: $1.8B charge for increase in reserve
by: CitiKid

I remember many years when AIG socked away additional reserves. It was a smart thing to do.

The $2.8-billion charge will place a high degree of scrutiny on P&C companies' financials. The rating agencies will not want to look like idiots by finding out that a company is going under and they haven't changed their rating.

I'd be amazed if AIG's credit rating

doesn't get a much higher degree of scrutiny. They have a lot of debt, and it will make at least one rating agency nervous.

02/04/03 10:27 am
AIG's Arrogance...
by: philip_in_san_francisco (36/M/Bay Area)
...now it doesn't look so smart.

02/04/03 10:30 am
Real Money
by: CitiKid
Peter Eavis [of *The Street.com*] just wrote the following:

"AIG's surprise reserve increase should be taken very seriously. The insurer's multiple rested on great trust built up over many years. That will now have evaporated.

"The skeptics always wondered how AIG came up with impressive earnings increases quarter after quarter. Part of it now appears to be under-reserving. 'How many more increases will it take to bring reserves up to a safe level?' is now the question people are asking."

The rating agencies don't like the smell of this.

02/04/03 10:39 am
Re: $1.8B charge for increase in reserve
by: Elmo_V
The size of this hit means that 1) the socked-way money wasn't enough, 2) recent business has been much worse than expected, 3) management mistook the market reaction; they figured they could slip in bad news along with everyone else.

Another alternative is that management is playing a political tort-reform card. I'd like to think that was true, but I don't buy it.

02/04/03 10:45 am
AIG goes from leader to laggard
by: punchtheclock35
Long-Term Sentiment: Strong Sell
Only last Tuesday M.R. said "it's not a problem for us" while discussing reserves. Today, AIG is putting up $3.5 billion [of gross reserves]. What changed from last Tuesday to today?

02/04/03 10:51 am
Re: AIG goes from leader to laggard
by: garhighway
M.R. was referring to asbestos. This increase has nothing to do with asbestos.

02/04/03 10:59 am
Re: AIG goes from leader to laggard
by: punchtheclock35
Long-Term Sentiment: Strong Sell
M.R. was, ultimately, referring to reserves.

So I guess he didn't know $3.5 billion in reserves was going up when he spoke last Tuesday and was quoted all over the media?

02/04/03 11:07 am
Re: Too clever by half
by: GreyLag35
Time for Hank to go. As a shareholder, I'm getting more than my share of "pain and suffering," and it's not from litigation!

02/04/03 12:01 pm
Re: AIG goes from leader to laggard
by: stevekoozer2001
Long-Term Sentiment: Buy
AIG is still the leader and will absorb this charge easily. The real problem is for the rest of the industry. AIG is the best-reserved company with the deepest pockets. What's going to happen to its competitors who don't have the financial wherewithal to absorb these kind of hits? Very bad things, is the answer.

02/04/03 12:43 pm
F@ckin p/e ratio is still too high
by: investor_1947
Long-Term Sentiment: Sell
That's what my analysis indicates.

02/04/03 12:53 pm
Re: reply to jack_1688
by: punchtheclock35
Long-Term Sentiment: Strong Sell
You have to respect Greenberg.

02/04/03 03:28 pm
CEO & CFO certification - Huh!
by: trustedadviser
Long-Term Sentiment: Strong Sell
What about the previous quarterly certification? The events leading to this large adjustment did not happen in the fourth quarter.

02/04/03 03:28 pm
Needs a 4% dividend now!
by: RAMSTOCKS
Where do they get off paying a 0.33% dividend? That won't attract buyers now that they can't count on steady earnings.

02/04/03 03:52 pm
The other shoe
by: Elmo_V
Food for thought: AIG pre-releases this earnings bomb today. All the First Call analysts reduce their earnings estimates accordingly. AIG tweaks some numbers next week and "beats" the revised analysts' expectations.

02/04/03 09:37 pm
Re: Mr. Dowopguy
by: mrdowopguy
Long-Term Sentiment: Buy
AIG is a quality 10-year holding. The reserve hit was $1.8 billion. The company has 2.5 billion shares outstanding. That's less than $1 per share.

AIG will continue to be in a position to raise rates. Earnings show every sign of continuing to grow. A final kicker: there's no U.S. financial company with a stronger position in China, which will be the single strongest growth region in the first half of the 21st Century.

02/04/03 10:57 pm
Surprised or simply shrewd?
by: kiltartanscross
Is it possible that MRG was surprised by these reserves?

continued

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There's no way his iron grip on the company has loosened. I'd call the reserves shrewd. Take your pick: 1) it justifies further rate increases, 2) lesser companies will be pummeled with skepticism from Wall Street and ratings agencies, and 3) he just put money away for another 10 years of smoothed earnings.

AIG may be a black box, but MRG isn't a fraud. I've never worked at AIG—only competed with it—and it's sheer size and brass balls never cease to amaze me.

02/06/03 11:30 am
Re: Why
by: thirdandshort2

I don't presume Hank or his chief actuary just woke up and realized they were underreserved.

The business of setting reserves is highly speculative. Chief actuaries and CFOs make careful decisions as to the timing of any reserve changes. Many times, they'll take part of the change this year and wait to take the remainder next year. Next year comes around and soft markets reveal further deterioration, so they fall further in the hole, hoping that the following year is better so they can offset the prior years' deterioration.

Actuarial science doesn't provide certainty about future results—just confidence levels around ranges of estimates, subject to changing conditions.

02/06/03 02:12 pm
Re: Economist article
by: kiltartanscross
Long-Term Sentiment: Hold

Do you remember the negative article questioning AIG's performance published about a year ago in *The Economist*? If I recall correctly, a perturbed MRG pulled all advertising from *The Economist*. [Editor's note: AIG says that it didn't pull advertising. *The Economist*, however, says that although it doesn't have contracts with its advertisers, it and its affiliate *CFO* were expecting advertising from AIG. After the article, AIG didn't advertise in either publication.]

02/06/03 06:14 pm
Conference call
by: pickanameus

I remember listening to Greenberg on a conference call one time. He was irritated by a question about the stock price dropping. At the time the price was around $80—about $30 higher than now—and he

continued on next page

was asked to explain the drop. He gave a short reply, then said he wasn’t worried about the stock price because “people don’t stay stupid forever.”

02/07/03 08:07 am
Have a little faith!
by: lokinixon
Maybe we should have a little faith in AIG’s ability. The company has consistently outperformed. AIG/MRG is always thinking many steps ahead.

02/07/03 10:25 am
AIG: Survivor
by: freesaladbar (43/M/mid-TN)
Long-Term Sentiment: Strong Buy
It is amazing how the naysayers come out after a big fall. AIG is the largest, most successful company in its field. It got that way by being good. It didn’t stop being good last week. Premiums are rising and the market is returning to normal after years of underpricing.

02/07/03 11:39 am
AIG/MRG support
by: hipoppyed3 (65/M/Florida)
Long-Term Sentiment: Strong Buy
I was privileged to work closely with Hank in the financial reporting area for many years. He is a man of great, great integrity, who demands loyalty and honesty among his people. Over the years he has rewarded investors. He is a great visionary and very conservative. He has surrounded himself with a cadre of brilliant managers. His chief actuary and financial officer are no exception—there are none better. In light of a tort system out of control, strengthening reserves is a powerful and prudent move.

Regarding succession, Hank is an absolute physical specimen who will continue to lead AIG to greatness for many, many years. AIG and Hank deserve our thanks and support.

02/07/03 01:07 pm
Re: AIG/MRG support
by: go70pine2000
Long-Term Sentiment: Strong Sell
Axel, is that you? Or Corrine? [Editor’s note: Axel Freudmann is the Human Resources director at AIG. Corrine is Hank Greenberg’s wife.]

02/07/03 04:16 pm
AIG and TYCO
by: philip_in_san_francisco (36/M/Bay Area)
Long-Term Sentiment: Sell
Both expanded rapidly. Both felt no need for transparency. Both were arrogant. Both lost credibility. And with that goes the P/E.

02/09/03 02:43 am
General
by: axecleaver
Long-Term Sentiment: Hold
Anyone who posts negative comments does not know anything about AIG. The problems we are all facing today show the difficulty in doing business around the world. AIG is a complex company with great talent. In due course, it will be a favorite again. AIG builds bridges before anyone, and creates new products and innovates before anyone.

02/10/03 06:22 pm
Re: speaking of options
by: surely_you_must_be_joking
Long-Term Sentiment: Strong Sell
Once the “old man” goes, the skeletons will come pouring out of the closet. Just like Welch and GE.

02/12/03 01:11 pm
Appointment of new chairman
by: maxeyco
Long-Term Sentiment: Strong Buy
When Hank Greenberg announces his replacement, how could that affect the value of AIG stock?

02/12/03 02:25 pm
Re: Appointment of new chairman
by: wipnumber
What replacement? Greenberg is 77, and may decide to go until he drops. Did you

listen to him scold that one questioner during the post-speech Q&A? It reminds me of some scoldings I heard when I was with the firm. Incredibly intolerant at times. This drop in the stock has got to cut close, and it must anger him that he cannot just "will" the price to go up on command.

02/13/03 02:28 pm
Re: Massive pump & dump operation
by: adhrf_2000
AIG is still a superior company to its peers and deserves a price premium. The degree of the premium is the only debate.

02/13/03 02:30 pm
Re: Pre-market bid $48.60 - Sorry shorts
by: mdcen
MRG's credibility is certainly part of the equation. But, I believe his comments. He has built the largest insurance company in the world, and owns enough of it that he hurts when it goes down. Hank's credibility should not come into question.

02/13/03 04:29 pm
RegFD
by: dcpapa2003 (32/M/Alexandria, VA)
If I'm not mistaken, Hank could not have disclosed the charge at the Merrill conference. All material disclosure would fall under Reg. FD and would have to be disclosed to the public under a different format.

Hank answered the asbestos issue accurately. I don't understand why this is an issue.

02/13/03 04:43 pm
Re: Reg FD
by: CitiKid
I'm surprised no one has asked why he released the news when he did. The timing right before earnings would leave a person wondering if he didn't have a choice.

The fact that he dismissed the write-off as a small thing in the conference call today shows his stance. I agree that it is a small amount relative to total capital. But then again, how often has this happened before, and would most shareholders consider this to be a "material change?"

02/13/03 06:57 pm
Re: Massive pump & dump operation
by: CitiKid
AIG's stock was inflated; a lot of stocks were. The issue of succession has been bungled. Hank has cost shareholders money by refusing to address the issue in open manner. He bristles when asked questions. Analysts chuckle at Hank's demeanor.

02/14/03 01:42 pm
Reserve increase
by: klineshubby
If Hank was forced to put up reserves, he's going to make damned sure not do it piecemeal. Hank understands that if you increase reserves in a step-ladder fashion, you seriously undermine the credibility of a company's dedication to maintaining adequate reserves.

AIG may not trade at its historical multiple to the insurance industry, but it will still get a higher multiple than the industry.

02/24/03 09:30 am
AIG Chairman M. R. Greenberg...
by: bull_inv (42/M/USA)
AIG chairman M. R. Greenberg to participate in Sanford C. Bernstein & Co. client conference call.

02/24/03 08:37 pm
Re: AIG Chairman M. R. Greenberg...
by: all_in_long
Long-Term Sentiment: Strong Sell
AIG lost some credibility with the Street on that reserve increase. Now they try to put on a dog and pony show. Standard operating procedure.

It's actually a bit embarrassing to see MRG leading pep rallies at this stage in his impressive career.