The world's most dangerous insurance publication℠

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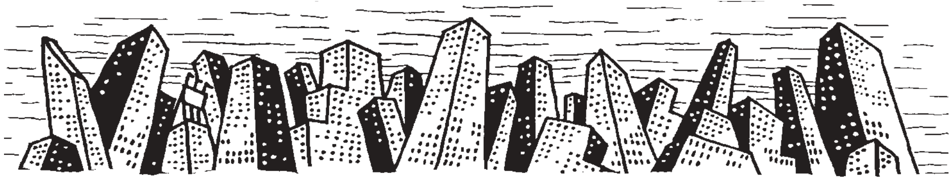

THE INSURANCE BEAT

Call of the Year

ALMOST A YEAR AGO, on January 13, 2004, J. P. Morgan Securities put out a prescient six-page research report on the subject of insurance brokers' contingent commissions. The report was written by Hugh Warns, David Sheusi, Meyer Shields, and Theresa Tremel. (Warns and Shields are now at Legg Mason.)

"We expect increased scrutiny to result in greater disclosure" of contingent commission agreements, they wrote, which could "negatively affect brokers' earnings." They discussed undisclosed conflicts of interest, writing that when "viewed in the worst possible light, the 'unbiased' professional advice for which insureds are paying brokers to assist in obtaining the best insurance solution may in fact be influenced by the economics of contingent commissions."

The report also discussed Marsh & McLennan's Placement Service Agreements (PSAs) and noted that the company had more to lose than other brokers that derived less of their revenues from contingents.

The report concluded by opining that Willis, which didn't make as much from contingent commissions, "offers a compelling alternative to Marsh & McLennan."

Since those words were written, Willis's stock is up twenty-one percent and Marsh's is down thirty-one percent.

Marsh & McBuyback

INSURANCE BROKERAGES, investment-management businesses, and consulting firms generate a significant amount of free cash flow when they're run well. They require no capital, no inventory, and negligible capital expenditures. They earn their money in cash. Marsh & McLennan, which is in all three businesses, has had extremely attractive economic characteristics. By that we mean that it has generally made piles of cash. How well it has spent its cash is a subject for discussion.

Companies that generate a lot of cash are confronted with a challenge: what to do with it. Common uses include paying dividends, making acquisitions, and repurchasing stock. It is not common for companies to accumulate cash and *wait patiently* for a great opportunity to surface. Indeed, most companies treat cash as a hot potato, and look to get rid of it as quickly as possible.

We have nothing against dividends—especially now that the maximum federal tax on them is fifteen percent, the same as on capital gains. (Prior to 2003, dividends were taxed as ordinary income and therefore weren't a particularly attractive use of corporate funds.)

Acquisitions *can* be a good use of funds, but often aren't. It's not so easy to buy companies. Often the price is too high and the business isn't as good as the purchaser thinks it is. Studies have shown that a majority of mergers and acquisitions don't work out especially well.

There are good reasons why a company might want to repurchase its own shares. First, a company *should* understand its own business better than it understands other businesses, so, at the very least, it should know what it's buying. If a company's stock is undervalued, a share repurchase will increase that company's per-share value. Also, share repurchases often increase earnings per share (by lowering the denominator in the calculation) and return on equity (by diminishing the amount of capital employed in the business).

Repurchasing shares has potential negatives. It increases a company's leverage, weakens its balance sheet, and often reduces financial flexibility. These trade-offs may be worthwhile if the buybacks create enough value.

The math of share repurchases is simple. For the most part there's one big criterion that must be met for a buyback to work out well: the shares must be bought for less than their intrinsic value. (If a company overpays it *decreases* its per-share value.)

Since 2001, Marsh & McLennan has spent $3.6 billion to repurchase 78.8 million shares at an average price of $46.34 per share. Marsh's stock is now $32.51. (The company's market cap is about $17 billion.) To put Marsh's buybacks into perspective, consider these facts: 1) in the last four years Marsh overpaid for its stock by about $1.1 billion, based on the current market price, and 2) about three-quarters of the money Marsh earned during the past four years was spent overpaying for its stock.

One rationale for the buybacks was that they would offset the *supposedly* dilutive effect of the 53.9 million stock options that Marsh granted from 2000 to 2003. (The average strike price of the options is $48.31 per share.) Marsh has been a prodigious issuer of stock options; it has eighty-nine million outstanding. That comes to almost seventeen percent of the total number of shares outstanding.

Marsh's credit ratings are now "Baa2" from Moody's and "BBB" from S&P and Fitch. All raters have a negative outlook. Marsh's total debt is about equal to the $3.6 billion it spent buying back its stock since 2001.

If Marsh hadn't spent so much money repurchasing its stock, it would have had a clean balance sheet today, and would be in a much better position to deal with its problems (bid-rigging, contingent commissions, regulatory scrutiny, etc.). Marsh's long-term shareholders would be much better off if, instead of buying back shares, Marsh had paid out the $3.6 billion as dividends.

That would come to about $6 per share.

PIA, E&O, and Reliance

WE WROTE THE BRIEF PIECE BELOW *several years ago, well before Reliance Insurance Company became insolvent. For reasons we no longer recall, we never got around to publishing it. Still, it can serve as a cautionary reminder of the risks of choosing a low premium over a conservative balance sheet.*

The National Association of Professional Insurance Agents (PIA), has, for the second year in a row, endorsed Reliance National Insurance as the provider of choice for Errors & Omissions coverage for its members.

Log on to the PIA's website and you'll see a banner ad for its co-branded E&O policy. Click on the banner and you'll see the following: "In a world of look-alikes, The CHOICE is obvious."

The text continues: "Now there's The CHOICE from Reliance National and PIA. The CHOICE offers all of the advantages of any standard, high quality E&O policy, but it also provides protections for unique coverage you should not do without in today's constantly changing business environment. Take a moment to compare your E&O policy to The CHOICE."

The PIA represents more than 180,000 insurance professionals throughout the United States. "Through membership in PIA, agents have access to *top quality insurance products* [emphasis added] they need for themselves, their families and their employees," states the PIA's website.

Should the PIA be recommending an E&O program underwritten by a weakened company that's on "credit watch" for a downgrade? Ask your local professional insurance agent for the answer.

Formerly Cheap

FIVE YEARS AGO WE WERE BULLISH on many insurance stocks. Today, we're not bullish on any. Our bullishness had nothing to do with our short-term outlook for the business. We thought it was lousy. That said, we were still able to find plenty of good-quality insurance companies selling at nice discounts to their book values, making them—in our opinion—bargains.

In an article entitled "Whistling Past the Graveyard," we wrote the following:

> At one end of the insurance-stock universe there are a reasonable number of "cheap" stocks in companies with decent balance sheets and pretty good market positions. Light years away, at the other end of the universe, is AIG, whose stock trades at twenty-eight times earnings and 430% of book value. It is priced for perfection, or something close to that…
>
> If AIG is worth 430% of book value, why one wonders, don't the people who are buying it at that valuation take a flyer on W. R. Berkley and Loews, both of which are selling below book value (and both of which we've bought below book value)?
>
> The answer, we must assume, lies in the nature of markets. There is 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.

It may interest readers to know that the unfashionable stocks have outperformed by a mile. Since we wrote the article, the total return from AIG's stock has been 7.42% versus 404% and 90.89% for Berkley and Loews, respectively. The SNL Insurance Index is up 62.63% during the same period. (For the record, we sold our Berkley shares for considerably less than what they're going for now.)

Berkley now sells for 200% of book value, and AIG goes for 216%. These valuations diminish the odds that investors will earn exceptional returns by purchasing either stock at the current price.

The Spitzer Effect?

ELIOT SPITZER'S INVESTIGATION into the insurance business is the biggest thing to hit the industry since…well, since forever. Never before has the industry been scrutinized so closely by the general-interest media.

Do the insurance industry's shenanigans deserve so much attention? Yes. Is the stuff that Spitzer is known to be investigating the sleaziest stuff that's ever gone on in the insurance business? No.

From 1997 through 2000, *Schiff's* devoted much of its coverage to the issues of mutual-insurance-holding companies and abusive demutualizations. At that time much of the mutual insurance industry was pursuing a path that would enable the mutuals to demutualize in a manner in which they could rip off about one-hundred billion dollars that belonged to policyholders. (In the end, the avaricious mutuals were defeated—for the most part.)

The press coverage of the demutualization issue was okay; major business

A Waste of Money: Marsh & McLennan's Stock Repurchases

Since 1998, Marsh & McLennan has spent about $4 billion to repurchase it shares at prices considerably higher than the current price ($32.51). As a result of the repurchases, Marsh is now in somewhat strained financial condition, and has limited financial flexibility.

In addition to being a big purchaser of its own stock, Marsh has been a prodigious grantor of stock options to its employees. Most of these options are now underwater, a situation that, obviously, is not good for employee relations and morale. Will Marsh have to reprice some of these options to keep employees happy? Or, going forward, will employees want more cash compensation and fewer options? Neither situation is good for shareholders.

	1998	1999	2000	2001	2002	2003	2004	TOTAL
Shares Repurchased	8,675	381	838	15,275	25,095	27,443	11,000	88,707
Amount Spent ($)	242,000	13,000	49,000	763,000	1,184,000	1,195,000	510,000	3,956,000
Average Price/Share ($)	27.89	34.16	58.50	49.95	47.18	43.55	51.00	44.60
Stock Options Granted	12,230	15,985	14,368	15,734	21,007	17,119		96,443
Average Price/Option ($)	30.10	37.93	45.67	46.42	55.78	43.11		44.28

All figures except stock prices are in thousands.

publications devoted some space to it. But it never got the play it deserved. Perhaps that's because the story was inherently dull: hundreds of mutual insurance companies no one had ever heard of pushing for obscure legislation that would allow them to do complex corporate reorganizations that, in a variety of subtle ways, would secretly screw the policyholders *in the future*. To pull off this scam, many of the mutuals' staid, bland, plain-spoken executives colluded, schemed, and lied. Why would anyone want to read about that?

We conducted a Factiva news search using the keywords "demutualization" and insurance" and found 7,261 articles in the last ten years that mentioned both words. A search using "Spitzer" and "insurance" turned up 8,908 articles in the past *year*.

We can't help but feel that when it comes to the subject of demutualization the press has shortchanged the public. But don't blame Eliot Spitzer. According to Factiva, Paris Hilton was mentioned in 14,137 articles last year.

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