also served as president of Marsh & McLennan and then chairman and CEO of MMC Capital.

In 1995, Clements became chairman of newly-formed Risk Capital Reinsurance (backed by Marsh & McLennan, MMC Capital, and J. P. Morgan). Risk Capital billed itself as a "merchant reinsurer"—it would provide its clients with "a choice of reinsurance and/or capital." Unlike traditional insurance companies, Risk Capital planned to invest heavily in insurance equities. In short, it would be a closed-end insurance-stock fund that wrote reinsurance. While this has a certain appeal, as we noted back in 1997, it's a concept that could be executed only in a bull market—precisely the time one doesn't want to buy stocks.

Risk Capital did not distinguish itself as an underwriter or investor. The company eventually redomesticated to Bermuda, sold its insurance operations to White Mountains, changed its name to Arch Capital, and began looking for something to do with its money. (It had gone public in 1995 at $20 per share, and book value is still around that level.)

On, November 20, Arch announced that it closed on $763 million in private-equity funding led by Warburg Pincus and Hellman & Friedman, bringing its capital to approximately $1 billion. Arch has hired several big hitters and plans to take another shot at the reinsurance business. In anticipation of the profits that it will achieve in the coming years, its stock has gone from $17 on October 22 to $25.75 today.

In connection with the $763 million transaction, Clements was granted 1,689,629 restricted shares. At $25.75 per share, the grant is worth $43.5 million.

Buy the Bonds, Not the Stock

BEFORE BUYING STOCK in a company, one should always check to see if that company has a fixed-income security that's a more attractive investment. Markets are inefficient, and equity is sometimes valued richly, while fixed-income securities—which provide greater protection—are not.

A case in point is CNA Financial. At $29 per share, the company has a market capitalization of $6.5 billion. CNA is a giant multi-line insurer and a perpetual turnaround story. Investors who buy the stock are probably doing so on the theory that CNA is "cheap" (75% of book value), that the worst is over, and that it really *can* be turned around.

If CNA's stock is a good investment—or even a somewhat bad investment—then its fixed-income securities should be an excellent investment. CNA Financial's 6.45% senior notes due January 15, 2008 are trading at 82, which provides a yield to maturity of 10.6%—about 600 basis points more than Treasurys, and 300 basis points more than similarly rated notes. (CNA's notes are rated BBB- by Standard & Poor's and Baa2 by Moody's.)

There is a disconnect between CNA's $6.5 billion equity market capitalization and the discounted prices for the company's $2 billion of debt. As students of Corporate Finance 101 know, if a company's debt isn't money good, then its equity is worthless. Thus, CNA's notes provide considerable downside protection compared to the stock under most circumstances. (If CNA becomes insolvent, then both the notes and the stock will probably be worthless, although an investor in the notes will, at least, have received interest payments.)

Suppose, however, that CNA's stock is undervalued, and three years from now is trading at $43.50. In that case, a shareholder would make 50% on his investment.

How would a noteholder fare in that scenario? We'll assume that the notes would trade around 96 (the theory being that the company's solvency is not in question). In addition, a noteholder would have received three years of interest payments. The total return, therefore, would be 40%—almost as much as the stock, but with much lower risk.

To recap: if the stock stays the same or goes down, the notes are a much better investment (and should earn a 10.6% yield to maturity). If the stock goes up 50%, the notes are almost as good an investment. Thus, it seems that the only circumstance under which an investor might prefer the stock to the notes would be if he thought the stock was going *way* up. (An investor with such confidence could always buy the notes on margin, however.)

When we bought the notes recently, our broker told us that Merrill Lynch's credit analyst had a negative opinion on them. At that same time, Merrill's stock analyst rated CNA as a "buy" for the "long term."

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