EMERSON, REID'S
INSURANCE OBSERVER

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Has Crazy Eddie gone into the insurance business?

Although just about everybody in the property-casualty insurance business is complaining that rates are inadequate at current levels, they keep on writing business. In some ways, the industry's behavior reminds us a bit of that now-defunct, wild and crazy pitchman who claimed he had to be nuts to offer such low prices. Unfortunately, he eventually went bust. While we don't foresee such dire consequences for most insurance companies, there will be some that don't make it through the Nineties.

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Our Dinner With Fred

Fred Carr is the Chairman of First Executive Corp., the embattled life insurance company that owns about $8 billion of junk bonds. Lately Carr has been vilified in the press and on Wall Street for his company's relationship with Drexel Burnham and Mike Milken. As the prices of junk have collapsed in the past several months, so has the price of First Executive stock. Although it changed hands at over $17 last summer, it was recently selling for $2⅝. A major shareholder has called for Carr's resignation and offered his own highly dubious takeover proposal.

Let us preface what we are about to say with the following: we've been wary of the junk bond market since late 1986. For that matter, we've been wary of the stock market since around then too. We were early, but we don't think we were fundamentally wrong. The Eighties—particularly the late Eighties—were a time of rampant speculation. Caution wasn't just thrown to the wind, it jumped off the top of the Empire State Building. Corporate America, LBO firms, bond buyers and fiduciaries all seemed to be operating under the principle that 50,000 investment bankers can't be wrong. Debt was something to be refinanced, not repaid. Debt, in fact, was supposed to be good for business. Nothing could get management working harder than a crushing avalanche of debt. At least that was the prevailing theory. Unfortunately, even if there were 100 hours in a day, Mr. Campeau wouldn't be able to work long enough to repay his creditors. But then again, what were many junk bond *investors* if not Esaus selling their birthright for a coupon promising a high current return? Naturally, this is a simplification of a very complicated issue.

An Insurance Underwriter—1990

Our rates are so low we're practically giving it away!

Anyway, back to Fred Carr. We got to know him while researching an article for a major financial publication last summer. We figured he'd be a slippery fellow who wouldn't return our phone calls, which is why we were so surprised when he called us back promptly.

It turns out that he's a rather soft spoken, sensible sounding, nice guy. Carr pointed out that one must take risk in the life insurance and annuity business. You'd go bankrupt just buying treasuries. (Perhaps that's why we thank our lucky stars each day that we're not in the life insurance business.) Since an insurance company, for regulatory reasons, must generally purchase fixed-income securities, there are two types of risk available. The first is interest rate risk. This is what most companies chose in the past, and it is what almost destroyed the savings and loan industry in the Seventies. Life insurers traditionally purchased loads of long term bonds and mortgages. If interest rates rose these went down in value. If interest rates rose a lot, say three or four hundred basis points, bondholders became seriously depressed. In the Seventies, one pundit defined a bond as "A fixed income security guaranteed to decrease in value." The insurers always said fluctuations in their portfolio didn't really matter much since they were planning to hold the bonds until maturity—about a generation hence. Of course there were no guarantees that an insurance company's policyholders would be equally patient.

An alternative strategy, given that we live in an era of volatile interest rates, was to purchase high yielding junk bonds that had a relatively short duration, say five or six years. That's what First Executive did. The theory was that a well diversified portfolio of high yielding bonds more than compensated one for the increased credit risk. For example, if the total junk portfolio yielded 400 basis points over treasuries, but that one lost 200 basis points because of defaults, the net result would still be a spread 200 basis points over treasuries. There's a good deal of statistical evidence and academic theory validating this concept, but like everything else, timing, staying power and analysis affect the outcome. For example, over the last seventy years the returns on stocks have been far greater than the returns on treasury bills. Had you bought stocks in 1929, 1974, or the summer of 1987—just before large declines in the stock market—you could have taken scant solace from the knowledge that you'd made a wise move *in theory.*

The point is, an insurance company is an inherently leveraged operation even before applying investment leverage. As everyone used to know (but forgot in the 1980's) leverage works both ways.

Carr spoke eloquently about credit, markets and giving value to his policyholders. He pointed out that all the other big insurance companies had copied his products and some of his methods. He correctly pointed out that many of the big mutuals had lots of bad real estate loans that were in fact "junk" and that they also had all sorts of off balance sheet and contingent liabilities that could come home to roost. He mentioned his A+ Best's rating and his triple A rating from Standard & Poor's. (Both were subsequently downgraded.)

In August, Carr treated us to an outstanding Chinese dinner at Chin Chin, during which we debated and laughed. Afterwords, we walked up Madison Avenue. It was a balmy August evening and we were really stuffed from eating too much. Although Carr hadn't convinced us that it was safe to own $8 billion of junk, we were convinced that he was sincere and honest, and we liked him. We also decided that if we had $8 billion we wouldn't spend it on junk bonds. Not right then, anyway.

We know that Carr is facing some difficult times right now. It seems that one way or another he'll probably lose control of the company he's built up over the last fifteen years. Although he's got many critics and skeptics, ourselves included—you know what? We wish him well. Good luck Fred.

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Living Blues

We can assure you that when Woody Guthrie wrote "It takes a worried man to sing a worried song" he didn't have the insurance business in mind. We can also assure you that the insurance industry was far from our minds during our recent travels in Mississippi.

As the rain poured down we crisscrossed the Delta in our rented Ford, blowing through dying towns and villages that saw their heyday several generations ago. Marks, Clarksdale, Tutwiler, Parchmen, Drew, Ruleville, Benoit, Mound Bayou, Hushpuckena. Boarded-up shops and deserted buildings, crumbling shacks, empty roads, pawnshops and poverty. A rural landscape strewn with broken machinery, dead cars, combines and tractors, train tracks and fading churches.

Dying towns without movie theaters, stores or restaurants. In the old days if you wanted to go from Baton Rouge to Memphis you'd head north on Highway 61. You passed by Natchez, Vicksburg, Rolling Fork, Chocktaw, Skene, Alligator, Bobo, Coahoma, Lula, Tunica and many others. Today you can get on U.S. Interstate 55 and make the 391 mile journey in about six hours—perhaps a little longer if you stop at McDonald's. U.S. 55 cuts through the middle of the state, bypassing the small towns it helped make obsolete.

The Illinois Central Railroad still passes through many of these bleak little Mississippi towns, its whistle blowing as it pulls a long string of freight trains. To a casual observer there's a certain romance to this slice of life straight out of Walker Evans and the 1930's. To inhabitants of the region though, life is hard. Let's not forget, the Delta is where The Blues were born. Robert Johnson, Sonny Boy Williamson, Muddy Waters, Son Thomas, James Cotton, Elmore James, Little Milton, Otis Spann and B.B. King. This is where that primal, powerful sound of sorrow and soul comes from.

We visited Living Blues magazine in Oxford, home of Ole Miss. The next day we checked out the Stackhouse/Delta Record Mart in Clarksdale, which doubles as the home of Rooster Blues Records. We crossed the tracks and drove into the rundown black section of town, in search of juke joints and lounges where we could hear the blues. Margaret's Blue Diamond on West Tallahatchie and the House of Blues on Fourth Street were dead that night, and we were disappointed. The Chamber of Commerce had warned us to stay away from these places—they weren't safe. Knife fights, murders, drugs. But when a policemen found out we were from New York he said "You'll be fine, you're used to all that stuff."

In Greenville we found the music we'd been searching for. In a dilapidated, boarded-up one floor storefront building on Nelson Street we heard Booba Barnes at his "Playboy Club". Booba, the king of Nelson street, wears thick gold chains with a Cadillac emblem. He plays raw, rocking, Delta juke joint blues, and he plays all night without stopping. It was the first Saturday of the month and people had just gotten their welfare checks so there was a good crowd.

The long room was lit by two bare bulbs and everyone was staggeringly drunk from knocking down thirty-two ounce bottles of beer. Except for an incredible woman who tended the bar and sang with the band, we were the only whites in the place. We were the only whites in the whole rundown, busted up, violent-looking neighborhood for that matter. As we drank our beers and listened to the blues late into the night, we felt deep feelings. To be there we had to span a chasm of poverty, geography and race. We were just visitors—strangers in a dismal town, viewing the flip side of the *American Dream*. But when Roosevelt "Booba" Barnes was burning up the makeshift stage his music took us into the ether of the night. You should have been there.

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They Said It

"There is no reason for any individual to have a computer in their home."
—Ken Olson, Pres. of Digital Equipment 1977

"With over 50 foreign cars here, the Japanese auto industry isn't likely to carve out a big slice of the U.S. market for itself."
—Business Week
August 2, 1968

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Junk Bond Woes and Ohio Casualty

Does the junk bond market debacle and the Drexel Burnham's bankruptcy spell trouble for insurers? In a word, yes—and no. Yes, if the insurance company in question has stretched it's balance sheet to the hilt. No, if it's in sound shape. As a matter of fact, the junk market breakdown will undoubtedly provide significant opportunities for savvy investors. Well capitalized insurers will be able to take advantage of the

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lack of liquidity and panic selling, though it is hard to say whether these opportunities are in existence now instead of some indeterminate time in the future.

Wall Street, though panicked and upset by the situation, would prefer that the junk bond market be viewed as a glass half full rather than half empty. It just so happens that we have lots of friends and associates on Wall Street, and once did a stretch there ourselves. As a result, we usually try to do just the opposite of what that crowd is doing. That's why we've made a modest investment in Ohio Casualty Corporation's (OCAS) stock. Ohio Casualty is a first-class insurance operation. They've got an A+ Best's rating—not all that common anymore—and in some respects appear to be just the bunch of stodgy, conservative folks one would expect to find living in Hamilton, Ohio. Although they don't quite make an underwriting profit, they consistently outperform the industry and seem to have things under control. There's not a penny of debt on the balance sheet and the dividend has been raised forty-four years in a row.

All this is very nice, but we wouldn't be writing about OCAS if their stock hadn't plunged from 43 to 36 on February 12 and 13, after topping out at 52½ last October. Why the big collapse? The company owns a lot of junk bonds. To be more precise, they owned about $700 million (at cost) of the devils at year end. Still, OCAS had $2.5 billion of invested assets at year end and a net worth around $775 million, or $36.93 a share. They earned over $100 million ($4.74 per share) in 1989 and will probably do the same this year. At $37, the stock yielded 5.7% and was selling below book value and at only 7.7 times earnings.

We thought that seemed pretty cheap, their junk woes notwithstanding, so we called up David Mencer, the company's Controller. He said that at the end of 1989 OCAS still had $100 million of unrealized gains in their portfolio. That was after figuring in the unrealized losses on junk bonds with a then-market value of $655 million. He ventured a guess that the high yield securities might be down another $50-75 million as of February 13. For the record, the company's been buying junk for seven or eight years, and has been a net seller of it for the last two or three years. They own approximately 100 different issues, the largest being $20 million of RJR bonds. Most of their bonds are rated BB and none are currently in default.

Even if some of the bonds do default (and we're sure some will), we can't help feeling that things have been overdone. Even though we think insurance companies are facing some lean years ahead, and even though we think the junk bond market disaster is far from over, we think Ohio Casualty is worth a lot more than $37 a share. We'll keep you posted on the results of our speculation.

As we were going to press, Ohio Casualty stock shot up 15%, and we sold our shares for a quick profit. We're not sure we made the right long term move, but we've always been the nervous type.

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Boffo DBL'ers Bag Biz Biggie

Our apologies to Variety for the above headline, but we were just so thrilled to announce that Steve Austin is joining Emerson, Reid effective March 1, that we didn't know how else to put it. As many of you know, Steve was a DBL and Group Life Underwriter at First Commercial, a subsidiary of Continental Insurance. Not only is Steve a first rate insurance man, but he's a really nice guy. We're glad to have him.

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DBL—An Analysis of Market Conditions "Freudian Effect" Rediscovered

Emerson, Reid & Company is the leading general agency specializing in New York DBL. We do business with close to twenty insurance companies and see and handle more DBL than any other firm in the country. While this is no great shakes in and of itself, it has provided us with a laboratory from which we can analyze one of the more interesting (and according to some, aberrant) forms of human behavior—insurance underwriting.

The DBL market is one of the best to use as a guide to check out what goes on inside an underwriter's head for a variety of reasons. For starters, the coverage and limits are generic—everybody is selling the same thing. Claim frequency and severity can be projected with a reasonable degree of statistical significance. Catastrophic losses don't really exist since the maximum individual claim is only $4,420. There are many companies licensed to write DBL and the market seems to be reasonably competitive. Fairly accurate loss information as well as accurate risk information are readily available.

We decided to go back through our voluminous files and analyze the various insurance company quotes on policies that we placed to see if we could come up with some interesting and useful statistics showing the actual competitiveness of this market. We particularly wanted to examine the difference between the lowest and highest quotes, as well as the mean and average. For example, is there really a statistically significant difference between quotations? Does this difference change depending upon the size of the risk?

Of course, it is impossible to reduce everything to numbers and graphs. The low quote doesn't always win the account. Services offered, stability, financial strength and relationship as well as other factors affect the outcome. In compiling our data, value judgements had to be made by us. How should we factor in "declinations to quote"? Should we use an underwriter's first quote or his quote after he's "sharpened his pencil"? In many cases we didn't even bother to approach markets that we knew would be uncompetitive. Obviously that would skew the results. Still, we had to choose something, so we let our consciences be our guides. The results are fascinating, and as far as we know, a first.

Our studies showed that the average variation between the low quote and the high quote was an impressive 35.7%. The mean variation was 33.4%. On the cases we surveyed, the lowest deviation between high and low quotes was 7.9% and the highest deviation was 130%.

Clearly, our study demonstrates that obscure but very important underwriting phenomena known as the "Freudian Effect". The "Freudian Effect", which was discovered by an old friend of ours many years ago, basically states that you will not be able to figure out what an underwriter is going to do on an individual case no matter how hard you try. We also believe that our study demonstrates the importance of using a general agent such as Emerson, Reid to obtain quotations from a number of markets.

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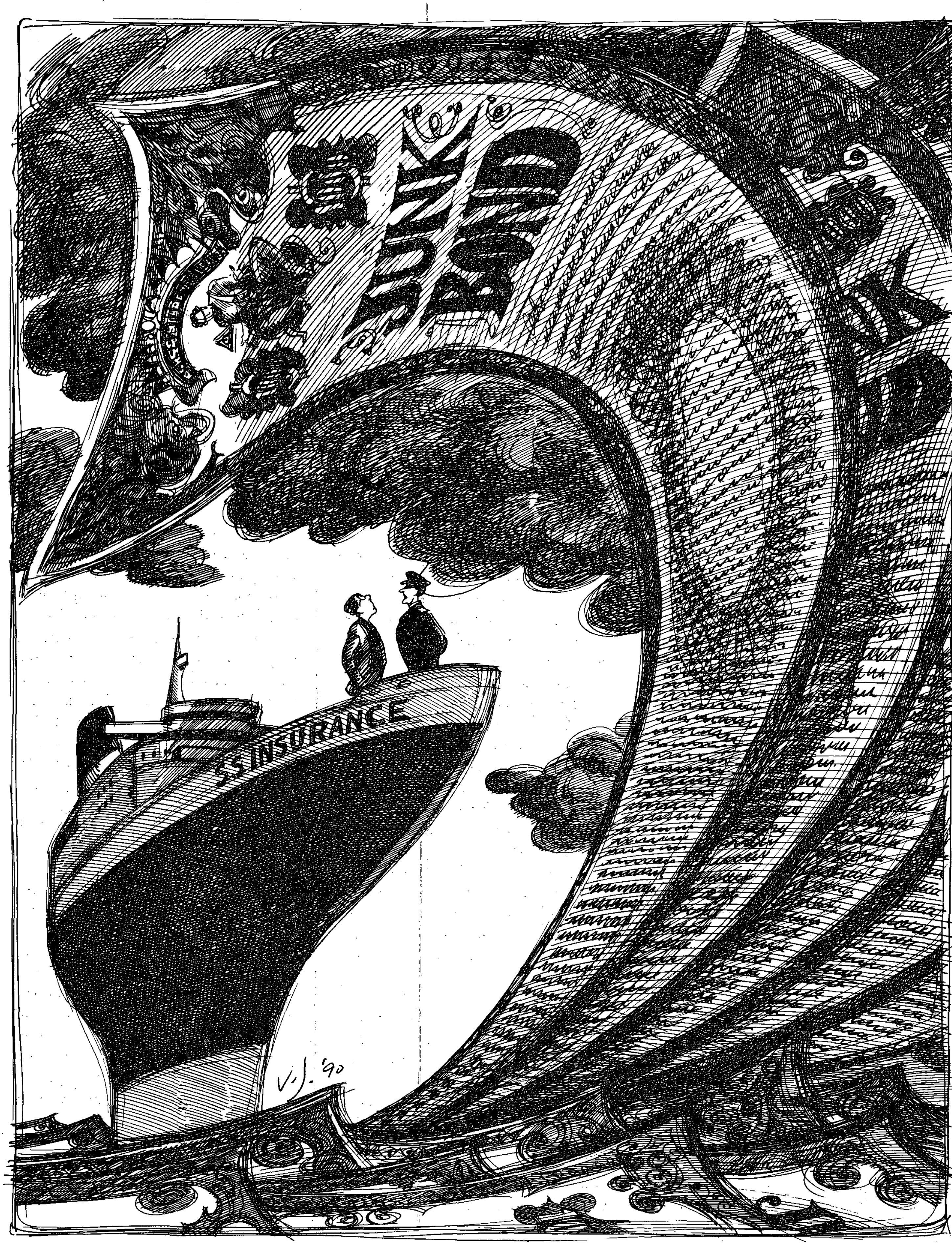

My insurance company? Why do you ask?