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Let's Call the Whole Thing Off

Straight No Chaser

We hear it all the time: the quality of the people working in the insurance business is dismal. Unfortunately, it's true; our industry is populated by an assortment of buffoons, jobbernowls, and chuckleheads (except, of course, the folks who read *Emerson, Reid's Insurance Observer*). The graduates of top business schools wouldn't be caught dead in the insurance business—and who can blame them? It has negative prestige, the pay is low, and the job security isn't good anymore.

Walk into any of the plush new cigar "clubs" in Manhattan and you'll see a slew of folks who *don't* work in the insurance business: callow investment bankers, the ink still wet on their MBAs. They are wearing tailored suits and monogrammed shirts and are puffing $20 Cohibas and sipping 12-year-old Macallan single-malt.

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On Wall Street the cultivation of money serves as justification for just about everything. You'd think, for example, that the extravagantly compensated investment bankers at a joint like Salomon Brothers wouldn't be overly impressed by the trappings of wealth, but that's not the case.

Last year, when a 30-year-old "money manager" by the name of Chris Bagdasarian approached Salomon with a harebrained idea—raise him $200 million to capitalize a reinsurance company that would invest most of its money in stocks rather than bonds—they said *rock 'n' roll, man, let's do it.* Young Bagdasarian, who lived in a $6-million California estate and got around in a Gulfstream IIB (both financed with fraudulent loans), fashioned himself as the next Warren Buffett. (In a skeptical article last year, we asked whether his company, Normandy America, was the next Berkshire Hathaway or the next First Executive.) Bagdasarian claimed to manage an $800-million investment portfolio that had grown at a compounded annual rate of 29% over the preceding 10 years. Salomon Brothers believed him even though he wouldn't provide records of the portfolio or identify his clients. (The assets were supposedly held in proprietary accounts that were located—you guessed it!—offshore.)

Although Salomon took Normandy public, the deal was quickly withdrawn because of "adverse market conditions" (in other words, investors didn't want to own this dog), and last month Bagdasarian pled guilty to three things we've always objected to: securities fraud, bank fraud, and perjury. *Continued*

How, you might ask, could Salomon, which is controlled by the real Warren Buffett, have got involved in such a nebulous scheme? It has all sorts of explanations, but the real answer is that it stood to make $10 million in fees from the deal. That's a lot of Cohibas.

Salomon hasn't cornered the market on cockeyed insurance deals. A far worse deal than Normandy (in that it was actually completed) was Riscorp. Back in March, Smith Barney (a subsidiary of Travelers Group), Montgomery Securities, and Piper Jaffray decided that this "managed-care workers-compensation company"—which had $166 million in revenues and shareholders' equity of $13 million—was worth $500 million. Based on that valuation, these august bankers raised $127 million for the company, selling stock at $19 a share. They also allowed Riscorp's founder and chairman William D. Griffin (an owner of the baseball expansion team, the Tampa Bay Devil Rays) to unload $49 million of his own stock.

When an insurance company is priced at 40 times earnings and five times book value, its stock has very little margin of safety: if anything goes wrong, the shares are likely to collapse.

As fate would have it, the last eight months haven't been kind to Riscorp. It is the subject of a class-action lawsuit for securities fraud and a racketeering lawsuit by policyholders of a mutual insurance company it acquired; it has been subpoenaed by a federal grand jury in an investigation of political campaign contributions; it has suffered increasing competition and falling rates in Florida (its main market); and worst of all, it hasn't made much money. Earnings for the first nine months of 1996 were 26¢ per share. Reflecting these developments, the stock has fallen to 3 3/8—a drop of 82%—and the company has announced that it is looking for a buyer.

American Re, whose largest client, representing 7.7% of total premiums, is Riscorp, has fared much better. It has been taken over by Munich Re for a pricey $3.3 billion—$2.5 billion more than its tangible book value. (Viewed another way, Munich Re is paying $2 million in "goodwill" for each of American Re's 1,260 employees. For far less than that, TIG Re raided Munich Re's casualty facultative operations, hiring away six of its branch managers and 12 of its underwriters.)

Although the deal puts Munich Re in the enviable position of number two reinsurer in the U.S., one wonders what the company knows now that it didn't know four years ago, when Aetna sold American Re to Kohlberg Kravis Roberts for a mere $1.4 billion. Had Munich so chosen, it could have bought the company then and saved $1.9 billion.

Certainly, the reinsurance business looks better now, but as we've observed before, one gets a good deal by buying when the future appears cloudy. (Managed-care workers-comp companies, for example, looked anything but cloudy last March.)

Perhaps Munich Re was attracted to the American way of management. Here, insurance companies have "restructured" and "downsized" by eliminating "redundant" employees. That sort of behavior doesn't go over well in Germany. In June, *Deutsche Presse-Agentur* reported that after a series of warning strikes, trade unionists representing 230,000 German insurance-industry employees garnered a 1.9% pay increase for their members. Even if German insurance companies have too many employees, they won't give them the axe. Instead, they'll reduce the work week to 30 hours, thereby preserving jobs.

In a financial world increasingly marked by the concept that stocks must always go straight up, insurance companies, more than ever, are trying to find a balance between safety (plenty of capital) and high returns (more leverage). In July, Standard & Poor's downgraded Zurich Insurance Company (Zurich) from triple-A to double-A+, explaining that "Zurich is becoming increasingly focused on shareholder value, and as a result, prospective capital will not be maintained at levels consistent with a triple-A rating."

Frank Zarb, chairman of Alexander & Alexander, is also focused on shareholder value, or, more precisely, on shareholder *lack* of value. A&A's stock is lower than it was 25 years ago, and lower than it was when Zarb joined the company two years ago. "Our task is to get the stock price up," Zarb told *The Wall Street Journal* recently. (We think his task is to get the earnings up; the stock will then take care of itself.)

Earlier this year A&A's board authorized a 2-million-share buyback ($30 million at current prices). So far only a small amount of these shares have been repurchased, but considering A&A's less-than-stellar balance sheet and avowed strategy of combining with another large brokerage, one has to question the logic of shrinking the capitalization.

But Wall Street is enamored of action. Thus, it is considered a positive development that Travelers was finally able to achieve economies of scale by buying Aetna's property/casualty operations, and that Chubb is selling its life-insurance business (maybe it will use the proceeds to buy back stock). Conversely, it is considered a mildly negative development that Marsh & McLennan isn't "unlocking" the value in its highly profitable Putnam mutual funds operation by selling it or spinning it off.

We bring up Wall Street's perceptions because the pendulum has swung too far, and the muddleheaded milksops running insurance companies are paying too much attention to clever investment bankers. On the other hand, if someone wasn't paying attention to them they'd be leading downsized lifestyles. Instead of frequenting swanky cigar clubs they'd be smoking White Owls and drinking Bud at the corner bar—with the folks who work in the insurance industry. ■

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Up the Insurance Department

The Love Song of Maurice "Hank" Greenberg

It isn't often that an insurance department singles out an insurance executive as a genius, but that's what happened recently. In October, the Delaware Insurance Department issued its long-awaited "Report on Examination" of the Lexington Insurance Company, an AIG subsidiary. The report was of greater than usual interest because of rumors that Delaware had been looking into AIG's transactions with Coral Re, a thinly-capitalized Barbados reinsurer that AIG had formed to reinsure certain classes of its business. Coral was of particular interest, because despite negligible capital—$15 million—it had received $1.6 billion in reinsurance premiums from AIG. (For more on Coral, see the March and July 1996 issues of *Emerson, Reid's Insurance Observer.*)

The Delaware examination report provides a glowing description of Hank Greenberg, AIG's boss. Although it is unusual for an insurance department to heap praise upon an individual, that's what Delaware has done, albeit inadvertently. After reviewing Lexington's business, the examination report goes on:

> Maurice "Hank" Greenberg, AIG's chairman, may, if he so chooses, bend the law to fit his company's needs. Mr. Greenberg is not required to comply with insurance-department requests that he deems irrelevant. It is up to Mr. Greenberg—not the Department—to decide whether a company is controlled by or affiliated with AIG. The Department apologizes to Mr. Greenberg for wasting his time with stupid regulations.

Actually, these words, or words close to these, do not appear. The report is, in fact, as dry and straightforward as the Bonneville Salt Flats. But the sentiment—that Greenberg is the proverbial 900-pound gorilla who sits wherever he wants to sit, is etched in the negative space between each line of text. Although the implication was clear that Coral Re was actually an AIG affiliate and that AIG had accounted for its reinsurance transactions with Coral improperly, AIG was not fined, ordered to restate its financials, suspended, punished, or tarred, feathered, and run out of town on a rail. The Delaware Department merely gave AIG a dirty look and said don't do this again.

The report recounts how AIG helped set up Coral Re, arranged for no-risk nonrecourse loans to Coral's "investors," and ceded $1.6 billion of premiums to Coral on terms that allowed virtually no profit for Coral. The effect of these transactions was to shift liabilities off AIG's balance sheet. In little over a year, AIG had a $1 billion of reinsurance recoverable from Coral.

The Delaware Insurance Department lays out facts to support the contention that AIG "controls" or is "affiliated" with Coral. These facts are set forth in a manner that makes it difficult to believe that AIG's dealings with Coral were on an arm's-length basis. Little doubt is left that Greenberg and AIG pulled the strings.

AIG, however, *denies everything.* Backing up its assertion that Coral is not controlled by or affiliated with AIG, is a letter from the law firm Cahill Gordon & Reindel giving an opinion that AIG "does not control Coral Re within the meaning of the New York Insurance Law." The issue of whether AIG controls Coral Re within the meaning of *Delaware* law is apparently not addressed. Putting the law aside for a moment, consider this: if you and Hank were knocking back a few beers at the Blarney Stone and you looked him in the eye and asked him whether he—wink, wink, nod, nod—controlled Coral Re, we'd bet he couldn't say "no" with a straight face.

But getting Greenberg to admit something to the regulators is as difficult as housebreaking an elephant. Greenberg could probably get a law firm to write an opinion that he isn't affiliated with his wife. A case in point: even though AIG is the largest shareholder of Transatlantic Re, with a 49% interest, and Greenberg is Transatlantic's chairman, AIG claims that Transatlantic is not an affiliate.

It is a testament to Greenberg's savviness and power that the only action Delaware took was to whip AIG with a feather. "In order to alleviate the Department's concerns regarding the close relationship of the AIG companies to Coral Re," says the report, "[AIG] has agreed to stop ceding any business to Coral Re and commute $100 million of the reinsurance credits currently being taken. [AIG] has also agreed to report any reinsurer that has the previously mentioned characteristics as an affiliated reinsurer in future filings with the state insurance regulators." AIG also agreed to run off all of the Coral Re treaties.

That the matter ended with a whimper rather than a bang was no surprise. Greenberg, armed with the best lawyers in the world, is not about to be outfoxed by a bunch of low-paid, understaffed civil servants—even if they're right and he's wrong. You can bet on that.

As for the meaning of the Coral Re affair, Howard Smith, AIG's chief financial officer, termed it "much ado about nothing." But he didn't leave it at that. He rubbed Delaware's nose in the dirt, adding that the only reason AIG wouldn't place business with Coral and would cancel most existing business was *that it suited AIG to do so.*

Hank Greenberg may have dreamed up Coral, arranged for its investors to receive non-recourse loans, seen to it that Coral's board approved of everything he wanted, set the terms on the reinsurance ceded to Coral, arranged for Coral's retrocessions, and done everything else that the owner of the company would normally do. But Hank Greenberg is not now—nor has he ever been—affiliated with Coral Re.

Don't you forget it. ■

Small Change

OVER THE LAST EIGHT YEARS, A.M. Best has tinkered with the definitions of its ratings many times. Sometimes the changes have had the effect of upgrading a rating (making it more positive); other times the effect has been a downgrade. The B+ rating, for example, holds the record for the most permutations; it has been changed four times.

In 1996, Best quietly revised the definition of its B and B- ratings, making this the third year in a row that the definition has changed. Last year, B and B- companies were said to "*generally* have an adequate ability to meet their obligations," this year, the equivocal "*generally*" has been deleted, upgrading the category (which had been downgraded last year). The C++ and C+ rating went through similar changes, as well.

Larry Mayewski, Best's senior v.p. in charge of life/health ratings, told us that the changes were meant to clarify the ratings, and that "the process we went through to place a company in a rating hasn't changed from last year to this year."

Although Best has significantly improved its service in the last few years, and is, in the words of the great V. J. Dowling, "the de facto regulator" of the insurance industry, its ratings are still a bit vague. This can be solved by adopting a rating structure similar to that used by Standard & Poor's, Moody's, and Duff & Phelps (e.g., AAA, AA+, AA, etc.). This would increase clarity by providing Best with a greater range of categories to distinguish insurance companies' financial strength. (The other raters have nine categories of "secure" ratings whereas Best only has six.)

Although Best presently has no plans to do this, we think the odds are strong that it will come around in a few years.

Reliance Group Can't Jump

Paint it Black

What should public utilities and large corporations take into consideration before placing business with an insurance company?

Most would agree that price, policy terms, financial strength, and service are relevant criteria.

One criterion that should be absolutely *irrelevant* is the racial origin of an insurance company's owner. Sable Insurance Company, which was recently formed, disagrees.

Sable is owned by Aaron Richardson, who is an African-American, and by Reliance National, a subsidiary of Reliance Group, which is controlled by wheeler-dealer Saul Steinberg, who is not an African-American. Sable was capitalized with $6 million, virtually all of which was put up by Reliance. Albert J. Marino, chief financial officer of Reliance National as well as a director of Sable, told *The New York Times* that Sable was set up so that it meets the government requirements to qualify as a minority-owned business, one of which is that it be owned by a member of a minority group. Richardson, with a 51% interest, is Sable's majority common shareholder.

It seems unlikely that Saul Steinberg would put $6 million into a startup "minority-owned" company and not demand more than a 49% minority interest. Six million dollars, after all, is a lot of money—it approximates Steinberg's salary in a good year (a good year for him, not necessarily for Reliance). Steinberg's quandary is this: if Reliance owned more than 50% of Sable, Sable's raison d'être—to be minority owned—would disappear.

There's a catch. Reliance has "a preferred stock position" in Sable, admitted Susan Spencer, Sable's executive vice president. She declined to be more specific. There are also contractual arrangements that give Reliance a certain amount of control or protection. In addition, Sable will reinsure most of its business with Reliance, and four of Sable's seven directors have been appointed by Reliance.

According to Sable's press release ("African-American-owned property/casualty insurance company to be formed"), once the company obtains its certificate of authority from the California Department of Insurance, it will offer a "broad range of insurance products and services to public utilities, public entities and Fortune 1000 corporations seeking to do business with a minority-owned insurance company."

Says Reliance National's president, Dennis Busti, a Caucasian, "There is clearly a great opportunity for a minority-owned company with sufficient capacity to participate in the insurance programs of public entities and large corporations."

The opportunity to which Busti is referring was summed up by Richardson: "There are more than 2,600 property/casualty insurance companies in the United States, yet not one of these companies is African-American owned." (Actually, that's not quite right. AAI Syndicate #1, an excess-and-surplus-lines company on the Illinois Insurance Exchange, is owned by an African-American.) According to Sable, many big companies would love to buy insurance from "minority-owned business enterprises" (MBEs), but until now there weren't any.

Sable says it will underwrite "selected lines of insurance where it enjoys a specific market advantage." What sort of "advantage" does this tiny start-up carrier have? The answer appears to be "none," in the traditional sense. In the nontraditional sense, Sable has much to offer. It "gives insureds a practical, straightforward means to substantially increase the level of MBE participation," a press release explains. Furthermore, it "provides the national brokerage firms an opportunity to assist their clients in meeting MBE participation goals *without relinquishing income.*" (Sable, which will only write business through brokers, is referring to instances in which national brokers set up commission-splitting deals with minority-owned brokers.)

Because it has so little capital, Sable will reinsure most of the business it writes with Reliance National. Ordinarily, a lack of capital and the lack of a Best rating (Best usually won't give a rating for five years) are serious impediments to an insurance company seeking to write major accounts. Not for Sable, though. Mr. Marino told *The New York Times* that because Reliance was providing so much reinsurance, A.M. Best was extending Reliance's A– rating to Sable. This was news to Eric Simpson, vice president in charge of Best's property/casualty division. "We can't support Mr. Marino's comments at this point," he said, noting that "Best has not issued a rating." Simpson said that if Sable wanted to obtain Reliance's rating it would probably have to be linked to the Reliance pool through a legal arrangement that provided explicit guarantees.

Considering that Sable is financed and reinsured by Steinberg's Reliance, it is fair to ask whether it's *really* a minority company, or if it's just using a clever marketing gimmick that takes advantage of big companies' desire to tell their shareholders and customers that they're politically correct. By doing business with Sable, are corporations helping the African-American community, or are they simply enriching one African-American who knows a good deal when he sees it?

One wonders whether Nation of Islam leader Louis Farrakhan, who has stirred up some hard feelings with his anti-Semitic and anti-white rhetoric, would consider Sable—which has Steinberg's imprimatur all over it—to be "minority-owned." We raise this issue because we were amused by how *The San Francisco Chronicle* reported Richardson's expression of solidarity with Farrakhan's Million Man March last year: "I'm taking the rest of the afternoon off in support of the march,' [said Richardson] from his car phone while heading home. 'It's a very positive thing.'" Richardson, who is 53, has been in the insurance industry for 29 years. He is president of Aaron Richardson Insurance Services Corporation, a San Francisco-based property/casualty brokerage.

There is certainly nothing wrong with playing the system to one's advantage. It strikes us as a tad unseemly for Reliance to call Sable a minority business, but if Saul Steinberg says that Sable is a great leap forward for America, for African-Americans, and for the insurance community, who are we to disagree?

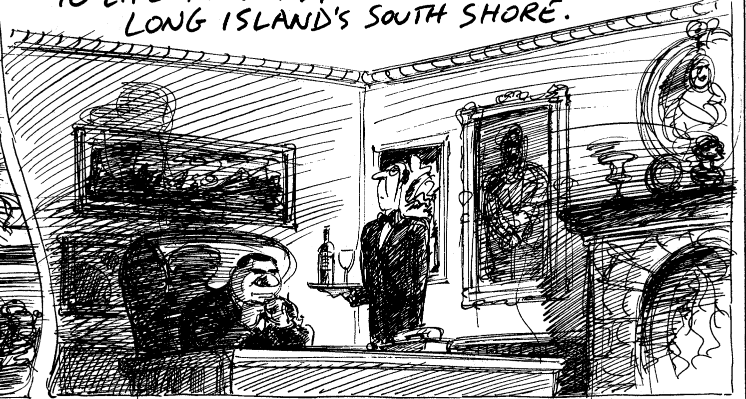
Perhaps the situation is best summed up by Albert Benchimol, vice president and treasurer of Reliance Group: "In this competitive market there are better ways of getting business than underpricing the competition. We are trying to compete on the basis of a broad range of services. I think the client companies will get the services they want." ■

SAUL STEINBERG
INSURANCE LEGEND

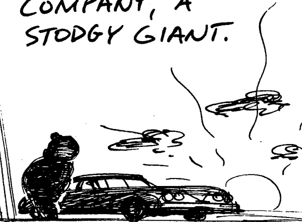
AFTER GRADUATING FROM WHARTON AT THE AGE OF 19 BROOKLYN BORN FINANCE WHIZ SAUL STEINBERG FORMS LEASCO DATA PROCESSING, A COMPUTER LEASING COMPANY.

THE GREAT SIXTIES' BULL MARKET. USING CLEVER ACCOUNTING, LEASCO'S EARNINGS SOAR, AS DOES THE COMPANY'S STOCK.

BUT STEINBERG KNOWS THERE MUST BE MORE TO LIFE THAN A 29-ROOM MANSION ON LONG ISLAND'S SOUTH SHORE.



THE MINNOW SWALLOWS THE WHALE. USING "CHINESE PAPER" - A PACKAGE OF OVERVALUED LEASCO SECURITIES - TINY LEASCO TAKES OVER RELIANCE INSURANCE COMPANY, A STODGY GIANT.



STEINBERG, WHO IS NOT YET 30, THEN SETS HIS SIGHTS ON CHEMICAL BANK, A BASTION OF THE WASP ESTABLISHMENT THAT, QUITE FRANKLY, DOESN'T WANT TO BE ACQUIRED BY ANYONE, MUCH LESS A NOUVEAU RICHE FINANCIER WHO IS... JEWISH.

UNDETERRED BY HIS FAILURE TO BAG CHEMICAL, STEINBERG BECOMES A WHEELER-DEALER EXTRAORDINAIRE.

WITH THE HELP OF JUNK-BOND WHIZ MIKE MILKEN, STEINBERG'S RELIANCE GROUP ISSUES JUNK BONDS, BUYS JUNK BONDS, GOES PRIVATE VIA AN LBO, AND, SUBSEQUENTLY PUBLIC AGAIN. STEINBERG ALSO MAKES A RUN AT DISNEY.

CONT.

BY THE 1980'S STEINBERG HAS IT ALL: THE YOUNGER "TROPHY" WIFE, JOHN D. ROCKEFELLER'S GIANT PARK AVENUE APARTMENT, AND THE HIGHEST SALARY IN THE INSURANCE BUSINESS ($6 MILLION A YEAR).
HANG THE REMBRANDTS IN THE STUDY AND STICK THE CEZANNES IN THE KIDS' ROOM.

IN 1995, STEINBERG, WHO IS ONLY IN HIS MID-50'S, SUFFERS A STROKE. DURING HIS RECOVERY HE PONDERS THE MEANING OF LIFE.
AIG 104 REL 7¼
PSFT 90

GREAT IDEAS SOMETIMES COME AT ODD MOMENTS. STEINBERG DECIDES TO LAUNCH AN INSURANCE COMPANY "OWNED" BY AFRICAN-AMERICANS...

THE AFRICAN-AMERICAN COMPANY IS JUST A "FRONT." RELIANCE WILL PUT UP THE CAPITAL AND REINSURE THE BUSINESS.

AS ALWAYS, THERE ARE BITTER CYNICS WHO QUESTION EVERYTHING.
THIS IS CRAZY!

BUT IN THE END, IT IS STEINBERG WHO HAS THE LAST LAUGH, THIS TIME AS THE "OWNER" OF AMERICA'S ONLY AFRICAN-AMERICAN INSURANCE COMPANY.
RELIANCE INSURANCE presents
THE JAZZ SINGER
STARRING
SAUL STEINBERG
WRITTEN AND DIRECTED BY SAUL STEINBERG

The Road to Riches

Insurance Stocks Meet the Efficient Bull Market

It is a truth universally acknowledged that the stock market always rises over the long term. Historians, however, will recall a time when this truth was somehow obscured, and people were of the mistaken belief that the market would do what J.P. Morgan once said it would do—"fluctuate": that is, go down as well as up.

That this key to wealth was only revealed to the masses during the greatest bull market of all time may strike nonbelievers as more than coincidence. Believers, on the other hand, take comfort in the knowledge that the Magellan Fund, the Beardstown Ladies, and 23,000 investment clubs can't all be wrong—can they?

Since the market always goes up—no matter how high it is—it's widely accepted that investors should buy stocks and hold them forever, or even longer. Unfortunately, most investors can't read a financial statement, which, in theory, makes it difficult for them to separate the good stocks from the bad. But stockpicking, according to theory, isn't necessary for investment success. The "efficient market hypothesis," a staple of business schools, explains that you can't beat the market, especially after taking transaction costs into consideration. But you can beat most investors (and mutual funds) by investing in index funds—funds that invest in, say, the Standard & Poor's 500.

Index funds have several advantages. They're cheap to run and don't require the services of a high-paid fund manager (who usually can't beat the market, either). "Indexing" is especially good for institutional investors. Since their results will always be average, they can't be fired for doing worse than the averages.

There is, of course, a lame argument *against* indexing, and it is that mindless investing is a poor substitute for informed judgment.

Indexing sometimes leads to peculiar behavior. On April 18, for example, shares of Aon Corp. (the parent of Aon Group, formerly known as Rollins Hudig Hall) rose 2¼ to 53⅝ on the exciting news that Aon was replacing Loral in the S&P 500. Thus, index funds—which own all the stocks in an index—had to buy Aon, regardless of its price. Aon has 108 million shares outstanding; therefore the 2¼-point gain translated into a $243 million increase in its market value. To put $243 million into perspective, it's probably about what Aon would make if it got a broker of record letter from every company in the S&P 500.

Although someone who wanted to buy *all* of Aon wouldn't pay $243 million extra just because the company is a card-carrying member of the S&P 500, index funds, which only want to own *pieces* of Aon, have no such qualms.

Despite the market's efficiency, readers of Ibbotson's studies know that the stocks of small companies do better than the stocks of big companies over time (at least if one counts 1926 as the beginning of time). The reason, according to theory, is that since small-company stocks are riskier than big-company stocks, investors require a higher rate of return from them. But if small-company stocks have higher returns, aren't they actually less risky?

Actually, no, because small-company stocks are more likely to do what J.P. Morgan mistakenly believed the market would do—fluctuate. And academicians define "risk" as volatility.

This leads to a perplexing convergence of theory and practice, so pay close attention: small-company stocks have higher returns to compensate investors for the increased risk that their returns will have a greater deviation from the mean. But since their returns are higher, small-company stocks really *are* less risky than big-company stocks (which aren't at all risky because, as everyone knows, the market always goes up). But if the market is efficient, how can small-company stocks (which, as we have just shown, are less risky) have higher returns? Shouldn't it be just the opposite? Conversely, if the market *isn't* efficient, why should anyone buy index funds?

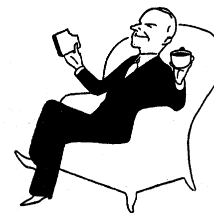
Whatever the case, investors have decided that it's a good idea to own stocks of smaller companies. Unfortunately, there are so many small public companies to choose from that picking the good ones is a devilish task. Fortunately, there are funds that invest in the Russell 3000, an index of the 3,000 companies with the largest market caps. The beauty of the Russell 3000 is that it's purely quantitative—absolutely no thought goes into choosing which stocks are in it. (Standard & Poor's, in contrast, actually *thinks* about which companies it puts into the 500.)

On June 27, shares of Avemco, a profitable direct writer of aviation insurance, plunged 17.5% to 11¾, on the news that the company had been dropped from the Russell 3000. Russell dropped Avemco's stock because it no longer had one of the 3,000 largest market caps. As a result, index funds that aligned their portfolios with the Russell 3000 had to sell their shares, regardless of price.

Although this sounds foolish, theory argues otherwise.

Clearly, it was Markel Corp., which bought Avemco when the index funds were selling, that was acting foolishly (even though Avemco's shares have subsequently risen to 15⅝). Rather than relying on the market's efficiency and a rising tide, Markel chose to take its chances using such discredited tools as judgment and security analysis.

It may work in practice, but it will never work in theory. ■



Lead the Good Life

Write for *Emerson, Reid's Insurance Observer*

AS PART OF OUR BOLD EXPANSION plans, we're thinking about hiring a writer. Not just any writer, but an acerbic iconoclast who likes to have a good time and isn't afraid to get a little dirt on his (or her) hands.

If you know the insurance industry, feel comfortable perusing financial statements, and are tired of working for the man, this may be the job for you. The pay is good and the work is easy.

If you're interested, give me a call, send me an e-mail, or write me a letter. All replies will be kept confidential.

David Schiff
Editor

The Sisyphus Syndrome

The Annals of USF&G

Benjamin Graham's classic investment text, *Security Analysis*, begins with a quote from Horace: "Many shall be restored that now are fallen and many/ Shall fall that now are in honor." While this aptly describes the vicissitudes of the securities markets, it would also make an appropriate motto for USF&G Corporation, the parent of United States Fidelity & Guaranty, which is celebrating its 100th anniversary this year. Because history is littered with the corpses of failed companies, longevity itself is worthy of something. While many great old insurance companies have seen better days (and some, like The Home, are sleeping the big sleep), USF&G, over the course of a century, has fallen and been restored to honor—several times.

USF&G HOME OFFICE, 1906

The company is doing fairly well right now, after having teetered on the edge in the early 1990s. In fact, there are those who would say that USF&G is *prospering*, but we wouldn't go that far. In its 1995 annual report, Norman Blake, chairman, president and CEO, speaks of the "Herculean effort" that went into restoring it. He says that "the management team and the people of our company have accomplished what industry observers claimed was impossible—the turnaround of a property/casualty company."

We agree that USF&G has been turned around—it has gone from bad to okay. Whether it can become superior remains to be seen. What are the hallmarks of a superior company? If it is a stock company, as USF&G is, they are a return on equity well above average, growth that is achieved without a surfeit of risk, and financial strength that is never in danger of being impaired. Furthermore, these must be achieved over a *long* period—ten years at least, and probably more.

If there is any business where results are best viewed over the very long term, it is insurance. Insurance companies are in the business of assuming risk, or as the case may be, assuming too much risk. No reputable company makes a conscious decision to bite off more than it can chew, but it happens nonetheless. Underwriters, one by one, cut rates a bit too far; reserves are set a bit too low; wonderful new lines of business turn out not to be such; and investments sometimes go awry.

Over its 100-year history, USF&G has experienced all of the above, and more. Still, it has survived. Whether this is a testament to the hardiness of big institutions, to the ability of economic cycles to resuscitate the weak, or simply to good fortune, is hard to say. Perhaps Woody Allen was right when he joked that "80% of success is showing up." While management has played an important role in USF&G's current turnaround, one can't ignore the economic environment in which this turnaround has taken place. An insurance company's assets are bonds and stocks, most of which don't really belong to it—they are there as collateral for reserves and will eventually be paid out to insureds. In effect, insurance companies are highly leveraged pools of capital. In 1990, for instance, USF&G's investments (most of which were fixed income) totaled $11.2 billion. Its stockholders equity was a mere $1.2 billion. The company was, in a sense, operating on 90% margin. Had the securities markets gone down rather than up, USF&G—despite the valiant efforts of management—might not be here today.

In 1896, when 45-year-old John Randolph Bland founded United States Fidelity & Guaranty, it wasn't clear that the business of corporate suretyship was a good one. The Panic of 1893 was still fresh in the minds of citizens, 60% of whom lived in farms and small towns. The automobile was, of course, not yet ubiquitous (there were, perhaps, 100 of them in America), and William Jennings Bryan, the Democratic presidential nominee, was preaching against the monetary standard of the day—gold.

The dilemma to which USF&G's birth is attributed sounds equally arcane. Local businessmen had trouble collecting money owed to them by the out-of-state attorneys who acted as collection agents for commercial transactions. Bland, whose job as secretary of the Baltimore Merchant's and Manufacturer's Association included the handling of credit and collection inquiries, had witnessed this firsthand. His solution was to form a company that had two functions: it was a collection agency *and* a surety company. It would publish a nationwide list of attorneys who handled commercial accounts, and it would issue fidelity bonds guaranteeing that these attorneys would remit the funds collected. Bland raised $276,500 from prominent local businessmen, took a $600 pay cut to $3,000 per annum, and, over the course of the ensuing 26 years, built one of the great American insurance organizations.

Bland, a short, stout man with center-parted hair and a walrus mustache, was described, in a biography published by the company he founded, as "absorbingly devoted to business." "Work," he told a 1916 graduating class, "is the greatest blessing God has given to man...[It] has saved thousands of men from sin, from ruin, from the madhouse."

"No conviction was more deeply seated," asserted his biography, "than his belief in the principle of individualism as opposed to socialism." Socialism, in this context, meant taxes or anything else that might substitute "the blighting interference of paternalistic government" for "personal responsibility." (Bland, for example, was opposed to the enactment of state workers compensation laws.)

USF&G grew rapidly and, by 1899, was operating in every state and territory in the union. It soon expanded overseas and, in 1900, into insurance, selling burglary coverage to banks. (Many surety companies actually issued bonds guaranteeing depositors.) By 1903 USF&G had 150 employees.

The early part of this century was a time of particularly fierce competition among surety companies, and many experienced difficulties as a result of the Panic of 1907. Price cutting abated somewhat in 1908 with the formation of the Surety Association of America, which attempted to keep competition in check by formulating bureau rates for various bond classes. Nonetheless, of the 25 surety companies operating when USF&G was founded, all but six were bankrupt by 1921.

By 1909 the company was the largest surety business in America. The following year it entered the casualty-insurance busi-

ness, growing rapidly in auto and, ironically, workers compensation.

The seeds of USF&G's first bout with insolvency were sewn in 1912, when it guaranteed, for a premium, the timely payment of principal and interest on mortgage loans that served as collateral for first-mortgage trust bonds issued by Equitable Mortgage and Trust Company. According to the 1946 history, *Fifty Years of Suretyship and Insurance: The Story of United States Fidelity and Guaranty Company* (by Clarke J. Fitzpatrick and Elliot Buse), Equitable Mortgage and Trust "was formed by Baltimore interests to lend money on real estate." This wasn't as mundane as it sounds. In those days, real estate, which is illiquid and not readily convertible into cash, was anathema to any self-respecting banker. Why Bland chose to enter the financial-guaranty business isn't clear. Perhaps he viewed it as a profitable venture; perhaps he was influenced by the fact that he was also president of Equitable Mortgage and Trust. In any event, USF&G experienced no ill effects from this venture; on the eve of World War I Equitable suspended business, and its mortgage bonds were called and paid in full.

By 1921 USF&G was the largest casualty and surety company in the country. Its premiums were $28 million and its surplus was $5.4 million. In Baltimore alone, it had 1,017 employees, and there were more than that "in the field."

John Bland worked up until the end. When he died in January 1923 he was lauded in numerous editorials as one of Baltimore's—and the insurance industry's—commanding figures. He was succeeded by his son, R. Howard Bland, who had spent 10 years practicing law before "finally yielding to the importunity of his father and enter[ing] the company's service."

Howard Bland took the company into various new areas: product liability, aviation insurance, and credit insurance. An affiliate, Fidelity and Guaranty Fire, was organized in 1928. In the mid-1920s USF&G reentered the business of guaranteeing first mortgages. This must have seemed like a good way to make money. The company's experience with Equitable Mortgage & Trust had been profitable, but perhaps more importantly, the mortgage-bond business was booming. The public seemingly couldn't get enough of these high-yield (for that time) securities; in 1926, approximately $1 billion of new real-estate bonds were sold, three times the figure for 1925.

The mortgages guaranteed by USF&G were relatively conservative. They were on private city residences throughout the country, and were made at 45-to-60% of appraised value. The average principal was $4,600. "Our growth and accumulated experience...convince us that the business is safe," USF&G declared in the January 1926 issue of its agents' publication, the *Bulletin*. Only four years earlier, John R. Bland had told a convention hall full of agents that a "corporate surety's functions were never supposed to cover financial obligations."

Due to losses, USF&G ceased writing new mortgage-guarantees in 1928. (The existing ones, of course, remained in force.) At that time, the company's surplus was $16.9 million. Outstanding mortgage guarantees totaled $56 million.

USF&G did not fare well in the early years of the depression. Earned premiums, of which fidelity and surety business accounted for 27%, peaked at $42 million in 1929. By 1933 they were down to $28.8 million, and significant underwriting losses were incurred. The common-stock dividend, which had been paid for 31 years, was suspended in 1931. By the end of that year the company's net worth had plunged 72% to $4.7 million.

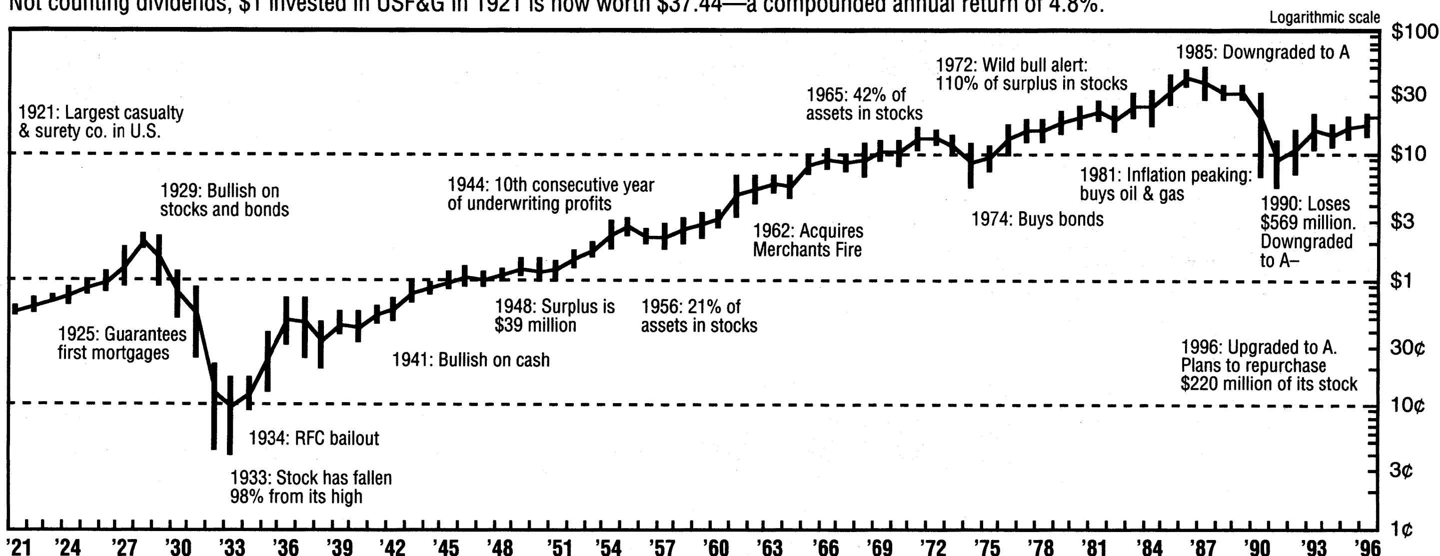
Like many other non-life-insurance companies, USF&G had invested heavily in stocks and bonds. Its 1932 year-end ledger shows bonds carried at $25 million and stocks at $12.3 million. These entries, however, were a fiction that bore little resemblance to market prices. Had USF&G—or many other insurers, for that matter—been forced to mark its investments to market, it might have been insolvent. It was not, however, required to do so. The National Convention of Insurance Commissioners had approved a resolution allowing insurance companies to value their securities at June 30, 1931, prices, which were significantly higher than those a year and a half later. Mortgage guarantees, however, were a far bigger problem. (By the time all the obligations were provided for many years later, the total losses would aggregate a stunning $27.7 million.)

USF&G was in perilous shape. (Its stock, which traded as high as 99 3/8 in

The March of Time: USF&G 1921-1996

Adjusted for stock splits

Although USF&G's surplus is about 460 times greater than it was in 1921, the company's stock hasn't been a big winner. Not counting dividends, $1 invested in USF&G in 1921 is now worth $37.44—a compounded annual return of 4.8%.



1928, touched bottom at $1^3/_4$ in 1933.) Interestingly, the company still carried a respectable Best rating—B, or "very good." Howard Bland, the founder's son, was booted upstairs, although you wouldn't know it from reading *Fifty Years of Suretyship and Insurance*, which noted dryly, "On January 27, 1932, the company's directors held their annual organization meeting. President Bland was elected chairman of the board... E. Asbury Davis was elected president."

Davis had been a director since 1923 but was not an insurance man: he was a prosperous tobacco entrepreneur. Although 60 years old, he would rescue the company and run it for the next 23 years. (Forty-eight years after Davis took over, USF&G would once again be resurrected by an executive from outside the industry.) Davis quickly reduced costs and patched up finances. Salaries were cut 20%—not quite as drastic a measure as it sounds, since prices were falling as a result of the depression. In a show of solidarity with his employees, Davis decided to forgo all but $17,000 of his $100,000 salary. Although 100 home-office employees were let go between 1934 and 1937, mass firings were avoided.

In 1933 the mortgage bonds for which USF&G had provided guarantees were restructured with the help of financing from the Reconstruction Finance Corporation (RFC), a government entity that bailed out railroads, banks, and insurance companies. Davis, a financial whiz with connections in Washington, convinced the RFC to lend USF&G $4.9 million. In April 1934, the RFC provided the company with an additional $4 million by buying newly issued preferred stock. That, coincidentally, marked a turning point. During the last six months of that year USF&G made an underwriting profit. In fact, it made an underwriting profit in each of the next 10 years. USF&G's contract bond business picked up, too, thanks to the New Deal's public-works projects.

Even though USF&G's stock had more than doubled from its 1933 low, it was an ideal time to buy more; it would appreciate 1,145% in the next 15 years. (By way of comparison, Best's Casualty Stock Index appreciated 248.2% and the S&P 90-stock Index grew 77.5%.)

The turnaround in USF&G's fortunes can be attributed to several factors. In the first place, there was nothing inherently wrong with the company. On the contrary, it had a good business but was weighed down by disastrous mortgage guarantees and an overconcentration in stocks, which, in time of need, couldn't be sold for anywhere near their carrying value. Financial restructuring, good management, and an improved economy restored the company to the heights from which it had fallen.

"The go-go years"—By 1972, spurred by the rip-roaring bull market and, apparently, a feeling of invulnerability, USF&G had forsaken caution; common stocks were now half of its assets and 110% of surplus.

In 1936 the preferred stock that was sold to the RFC was redeemed. In May 1942 the Wall Street firm of Huff, Geyer & Hecht noted that USF&G had "rapidly reestablished its preeminent competitive position and earnings power." Although the company's stock had risen sharply from its lows, it was still dirt cheap. At $22^1/_2$, it was priced 20% below book value and at only 4.6 times average adjusted earnings. In addition, its dividend, which had been resumed in 1939 (at half the previous rate), provided a yield of nearly $5^1/_2$%, double that of long-term Treasurys. (It would be another five years before the dividend was restored to honor—that is, to the level of 1930.)

Whereas a decade earlier USF&G had invested heavily in stocks, now it was loaded with "cash," which comprised 22.9% of its invested assets. (The yield on cash was virtually nil: the average interest rate for three-month Treasury bills that year was one-tenth of one percent.) As if that cash was not conservative enough, the company had 33.5% of assets in what Huff, Geyer & Hecht referred to—rightly so—as "low yielding government bonds" paying a scant 2.43%. Another 22.5% of assets was in corporate bonds and preferred stocks. Although the Dow Jones Industrial Average was then yielding a whopping 6.2%, common stocks accounted for just 12.6% of assets. Huff, Geyer & Hecht commented with understatement that USF&G's "income from investments seems susceptible to material increase."

The Dow was then bottoming out at 93 (it is now 6500), and the New York Stock Exchange had more bargains than Macy's basement. But USF&G shunned the high-yielding blue chips and, two years later, had an astonishing 51% of its assets in government bonds, 12.4% in cash, 9.9% in bonds and preferreds, and 12.7% in stocks. Still, earnings were strong, the result of big underwriting profits, and the company's stock almost doubled from its 1941 low.

Like most businesses, USF&G prospered during the postwar years. Fed by its 8,000 agents, premium volume soared from $47.7 million in 1945 to $106.6 million in 1948 (by which time the fidelity and surety businesses accounted for 13.2% of the company's premiums). As the decade came to an end, the company, still chastened by the depression, maintained its Fort Knox balance sheet of Treasurys and cash.

In 1950, USF&G finally discontinued its original business, the Guaranteed Attorneys List, and exited the credit insurance field as well. Insurance companies were now allowed to sell both property and casualty coverages, and USF&G merged with its affiliate, Fidelity & Guaranty Fire, the following year. The result of this combination is described, in all seriousness, in USF&G's 1995 annual report: "The intellectual clout of executives from both companies in the same building quickened the development of package policies, culminating in the introduction of USF&G's original homeowners insurance policy in 1954."

USF&G continued to prosper through the 1950s and 1960s. Growth was rapid, and earnings were strong. Operating highlights include the formation of its life insurance subsidiary in 1959 and the acquisition, for stock, of the Rockefeller-controlled Merchants Fire Assurance in 1962. Between 1948 and 1965, premiums grew from $95 million to $389 million, and surplus soared from $39 million to $406 million.

But the real story was the composition of the company's balance sheet. Burnished by prosperity, USF&G gradually shed its

depression-era mentality. By 1956, 5.8% and 22.8% of assets were still in cash and Treasurys, respectively, but a good-sized chunk, 21.2%, was in stocks. By 1965, common stocks comprised 42.4% of assets and 101% of policyholders' surplus. (It must be remembered that this was a terrific period for the stock market. Furthermore, USF&G's business was steady. In the preceding two decades it lost money from underwriting in only four years and its combined ratio averaged 97.2%.)

By 1972, spurred by the rip-roaring bull market and, apparently, a feeling of invulnerability, USF&G had forsaken caution; common stocks were now half of its assets and 110% of surplus. This was the era, dubbed "the go-go years" by financial writer John Brooks, when institutional investors piled into the Nifty Fifty. Their purchases of these overvalued "one-decision stocks" were justified by the theory that no price was too high to pay for growth. IBM, K Mart, and American Home Products, all of which USF&G owned, traded at price/earnings ratios of 44, 42.5, and 32.9, respectively. When the market finally cracked, falling 40% over the next two years, it took USF&G's stock portfolio with it. Policyholders' surplus declined from $749 million in 1972 to $250 million in 1974. Compounding the situation, underwriting results soured, generating a $37.6-million loss for the 1973-to-1975 period, compared with a profit of $55.5 million profit for the preceding three years. Still, even at the 1974 bottom, USF&G received an A+ Best's rating.

Chastened by the reality that markets go down as well as up, USF&G altered its investment strategy: it sold stocks and invested all new funds in bonds. In terms of investment strategies, it was the wrong time and the wrong way to embrace prudence. Stocks were cheap and would do little but appreciate over the next two decades. Bonds—derisively known as "certificates of confiscation"—would only become cheaper and were exactly what one didn't want to own in an inflationary environment. By the time interest rates peaked in 1981, USF&G had large unrealized losses on its bond portfolio.

Although it was almost as out of synch with the markets as it had been in the 1940s, the company was once again saved by the inherent strength of its business. Between 1974 and 1978, earned premiums surged from $896 million to $1.8 billion and the combined ratio, buoyed by prudent underwriting, dropped from 101 to 89.9. Surplus rebounded to $595 million. By 1978, stocks were down to 19.6% of assets—97% of diminished surplus.

When Jack Moseley became president that year, USF&G had been restored to honor. But that didn't last long. Earnings per share peaked the following year at $4.14, a record that still stands. (Earnings in 1996 will be about $1.38 per share.) The combined ratio turned negative in 1981, and USF&G has yet to return to underwriting profitability.

Moseley, deciding that insurance was too cyclical, diversified into financial services, real-estate enterprises, and travel services. To hedge against inflation, the rate of which was, ironically, then peaking, USF&G invested in timberland, farmland, and oil and gas. As James Grant writes in his must-read new book, *The Trouble With Prosperity*, these proved to be "a hedge against capital gains."

Continued

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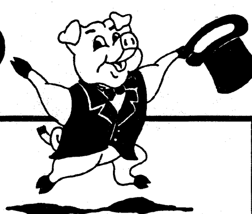

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The company kicked off an expensive national advertising campaign in the 1980s and unveiled an exciting new slogan, "USF&G and the USA," in 1982. In 1986 USF&G became the corporate sponsor of the Sugar Bowl, renamed...the USF&G Sugar Bowl. (There were probably worse ways to spend money.) The sponsorship ended in 1995. Corporate debt, virtually nonexistent in 1980, shot up to $659 million in 1990. USF&G also had $120 million of real-estate debt and $200 million of preferred stock outstanding.

In 1985 Best downgraded the company to A, and in 1990 to A–.

USF&G began to stretch for yield. By 1989, 13% of its $7.25 billion fixed-income portfolio was in junk bonds. As for stocks, the company was once again fighting the last war. Its "equity investment strategy" involved the purchase of high-yielding common stocks and the sale of corresponding call options, which hedged away much of the upside. To protect itself against a serious market decline, the company entered into "an 'umbrella' hedge, [which] is created through the sale of index call options and the purchase of index put options."

Although USF&G was rotting at the core, its dividend was raised each year, from $1.00 in 1978 to $2.89 in 1990. In the company's 1989 annual report, a grim-looking Jack Moseley, who was by this time chairman, president and CEO, rambled on, using seafaring metaphors: "1989 severely tested our corporate ship of state. But we press on with the confidence of strong management—and the steady hand of experience... I believe that we have set the right course... Our flagship insurance operations face great challenges and opportunities across the country. Our new fleet of financial services looks across a globe... In essence, we have broadened our reach but narrowed our focus. We know we can't sail on all seas."

In fact, USF&G was listing badly and taking on water. It was bloated with expenses, underreserved, and heading for the rocks. Yet somehow, investors pretty much ignored this bleak situation. The quarterly dividend was raised from 70¢ to 73¢ in the second quarter of 1990, and the stock—although down from its 1987 peak of 48¾—hovered in the high $20s, giving the company a market cap of more than $2 billion.

And then it all came crashing down.

The preponderance of bad news could no longer be ignored, and in November 1990 Norman Blake, who'd been at GE Credit before turning around Heller International, came in to perform financial triage. USF&G lost $569 million in 1990, and its stock collapsed to 5⅝—the level it had been at 30 years earlier. The dividend was slashed to 20¢ per share. Eighteen of the 54 branch offices were closed, the work force was "downsized," and the non-insurance businesses were put on the block. The company cut back on workers compensation, exited Texas and Louisiana, and reduced personal lines business in nine states.

In 1990 USF&G shored up its sagging balance sheet by blowing out its common stock portfolio. Once again, it was woefully out of synch with the stock market. It may not have made the low tick, but it came close: the Dow was then about 4,000 points lower than it is today.

The life-insurance business, although much smaller than the property/casualty business, suffered too, as policy surrenders increased 386% to $586 million, or 12.5% of life-insurance assets.

Then, in early 1991, A.M. Best did the unthinkable—it told USF&G that it was lowering its rating from A– to B+. Such a downgrade, especially at a time when there were concerns about the insurance industry's solvency, might have knocked out whatever wind was left in the company. Before the rating was made public, Blake went to Oldwick, New Jersey, and convinced Best to hold off for 90 days, giving him time to try to raise capital to retain the A– rating. (For more on this, see box at left.) In June, USF&G raised $320 million through the issuance of high-yield convertible preferred stock and Best held firm at A–. The company reported a $176-million loss in 1991, but the worst was behind it.

When the dust finally settled, USF&G had 6,000 employees, down from a peak of almost 13,000. The agency force had been trimmed from 5,400 to 3,500 and is projected to be 2,000 by 1998. Property/casualty premiums, which had been as high as $3.9 billion in 1987, were $2.6 billion in 1995. Common shareholders' equity has made a round trip, from $1.8 billion to $750 million in 1992 to nearly $2 billion. In January 1996 USF&G's Best rating was restored to A.

Although the company is now on solid ground, it has higher-than-average expenses and a middling return on equity—about 10%. Chastened by its once-weak balance sheet, it has owned virtually no common stocks during the stupendous 1990s bull market. Emboldened by its recent recovery, it is now in the process of buying back

USF&G and A.M. Best

THE ISSUE of whether it was appropriate for Best, in early 1991, to give USF&G time to raise money to retain its rating when it was in weak condition, is debatable. Clearly, USF&G was not the excellent company its A– rating implied it was. Many would argue that Best's action was justified because USF&G successfully replenished its coffers and remained in business.

We disagree. It is not a rating agency's job to protect an insurance company or its policyholders. A rating agency's constituency is its subscribers, and its owes them nothing less than an objective, no-punches-pulled assessment of an insurance company's financial strength. If an insurance company's future is in doubt, that doubt must be reflected in the company's rating. If USF&G needed a capital infusion to remain in business (or to retain its A– rating), and there was a chance that it might not be able to secure financing, then the company should have been downgraded.

It isn't known how often Best, or other raters, have "worked" with insurance companies to "manage" the rating process, but it is known that such an action can backfire. In 1994, for example, Best affirmed the A– rating of $15-billion (in assets) Confederation Life, not because it thought the company was in good shape (it knew it wasn't), but because it thought the company would obtain the significant capital infusion it needed to stay afloat (it didn't). The failure of Confederation, more than that of Executive Life and Mutual Benefit, exposed the folly of "managed" ratings. As a result, Best has reexamined its ratings and has been less willing to bend over backwards to meet the needs of insurance companies.

In 1993 we wrote that Best was "the Will Rogers of insurance rating agencies—it almost never meets an insurance company it doesn't like." Best has changed, and that definition is no longer apropos. But for Best to sharpen its ratings it's going to have to do something that it has been loath to do in its 97-year existence: make some insurance-company enemies.

11 million of its own shares, at a cost of about $220 million. The irony of this is hard to ignore: five years ago, in order to stay afloat, it was forced to issue shares at about half the current price. One wonders whether its quest for growth will lead it to revisit some of its old mistakes.

In its radical restructuring and branch-office consolidation, USF&G undoubtedly lost some good agencies and alienated others. Agents dislike change; they would prefer to deal with companies they can count on to remain the same (assuming that what they're doing is good). Cincinnati Insurance and Erie, to name two shining examples, have built great businesses by having a symbiotic relationship with a cadre of dedicated agents. Norman Blake admires that model, but USF&G can't possibly achieve the same trust—which these companies have built over decades—in a few years.

USF&G has made some smaller strategic acquisitions and is tinkering with distribution. It gave Holmes, Murphy—by far the largest broker in Iowa—exclusive underwriting authority for a new small-business program in that state. The advantages of this "strategic partnership," says Blake, are reduced costs, improved service, and faster turnaround. By lowering commissions and increasing profit sharing, USF&G has provided the broker with a real incentive to write good business. Blake hopes that this program will "serve as a role model for future partnerships" with brokers. Certainly, arrangements like this have great potential and, in theory, make a lot of sense. On the other hand, insurance companies have given the pen to brokers many times before, and when things go wrong, it can be costly.

USF&G is once again at a crossroads. Its turnaround complete, it must balance the rewards associated with high-octane performance versus the risks. Will it settle for safe and stodgy—for that matter, will any of the large stock companies—or will it seek growth, through acquisitions, premium volume, and share buybacks? Undoubtedly, in a quest for superior returns, it will choose the latter strategy.

But it must remember that to show superior results over the long term, an insurance company must do at least two things: 1) post good results in the short term, and 2) avoid getting clobbered every now and then.

As USF&G's history demonstrates, the second isn't as easy as it sounds. ■

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Auto Insurance Report

The Authority on Insuring Personal and Commercial Vehicles

Vol.3#27/123 **April 29, 1996**

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The Grapevine

Louisiana Passes No-Pay, No-Play But With Wild Rate Rollback Twists

The insurance industry wanted the **Louisiana** state legislature to pass a law that would prevent uninsured motorists from suing for pain and suffering damages resulting from an auto accident.

As the old saying goes, beware what you wish for . . .

At the 11th hour, the legislature did indeed pass such a "no-pay, no-play" bill (H196), but at the same time it mandated a 10% rate rollback on bodily injury insurance rates. And if 40% of the market succeeds in arguing that it can't justify the 10% rollback, then insurers will have to rebate 25% of premiums to all drivers

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Growth Clouds Results

Colorado Auto Majestic For Some, But Becoming Rocky For Others

In recent years, **Colorado** has been is a good place for selling auto insurance. On that point most insurers agree. Will it continue? That's where it gets more complicated.

Because the state is growing quickly, it has made room for many new competitors. It has also brought existing companies a book of business that has a high level of new customers mixed in with long-term customers. A number of insurers contacted last week reported that these factors are making it hard to get a firm hold on where the market is headed. Some are certain that tougher times are coming as claims rise and competition holds prices down. Others see a continuation, at least in the near-term, of the current favorable marketplace.

Back in the 1980s, when most state personal auto insurance markets were performing poorly, Colorado was among the weaker states. It didn't help when a giant hail-

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In November, California Ballot Will Again Be Tort Reform Battleground

California voters just rejected three tort reform ballot initiatives in March. But they're going to be faced with another three in November in an ongoing battle between business interests and lawyers with a major impact on insurers. And supporters of a failed no-fault ballot initiative are vowing to try again in 1998.

The March initiatives would have introduced strict no-fault, would have made it more difficult to bring a class action shareholder suit, and sought to curtail the contingent fees lawyers earned on lawsuits that settled quickly.

The state's trial lawyers, through the **Consumer Attorneys of California**, raised millions of dollars to fight the initiatives in March, and simultaneously they were collecting names to put a counter-initiative on the ballot. Depend-

Please see BATTLEGROUND on Page 2

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Thank You for Smoking

WANT TO EARN MORE ON YOUR MONEY? Then ignore investment gurus like Peter Lynch and the Motley Fool and take up the vice of tobacco. Here's the deal: if you're between the ages of 50 and 85 and have smoked at least 10 cigarettes a day for 10 years, you're eligible for State Life Insurance Company's higher-yielding annuities, known as the *Smoker's Advantage*.

The concept is good old-fashioned American ingenuity at its best. Because smokers tend to die at a younger age than do nonsmokers, an insurance company can offer nicotine fiends a higher yield on an annuity, since, in all likelihood, they won't be around as long to collect it. This seems only fair, since smokers are forced to pay higher rates on their life insurance.

It remains to be seen whether State Life will also roll out higher-yielding annuities for alcoholics and crack addicts.

Failure Has Its Rewards

"WHAT DID THEY KNOW and when did they know it?" is the question that has been posed to Electric Mutual Liability Insurance Company (EMLICO), General Electric's longtime liability insurer.

EMLICO's reinsurers have argued that EMLICO was up to no good when it switched its domicile from Massachusetts to Bermuda. What really irked the reinsurers is the fact that shortly after its move to Bermuda, EMLICO was shocked, shocked to discover that it was insolvent by about $500 million, the result of General Electric's environmental claims dating back to the 1950s.

That EMLICO didn't bring bad things to light until it got to Bermuda is nothing more than sheer coincidence, says the company. After all, anyone can make a $500-million reserve miscalculation.

In light of such mistakes, one must question the salary of EMLICO's president, David St. Laurent. According to *Insurance Salary Survey* (Palatine, Illinois, 847-934-6080), St. Laurent's pay increased steadily each year, from $221,276 in 1992 to $667,023 in 1995.

Considering EMLICO's $500 million black hole, we firmly believe that, in fairness to all parties concerned, Mr. St. Laurent should forgo a raise this year.

Truth in Advertising?

STANDARD MANAGEMENT, a small life-insurance-holding company whose stock has tanked from $13, when it went public in 1993, to $5 recently, believes in advertising...its stock.

Despite the company's spotty results, chief honcho Ronald Hunter thinks that Standard's shares are way too cheap and hopes to remedy the situation through advertising. "We are an orphan stock," he told the *Indianapolis Business Journal.* "We have nobody touting us."

So Standard is touting itself. It has placed ads in various midwest publications and even rented a billboard on North Keystone Avenue in Indianapolis.

Has the hype worked? Standard's shares, which were around $4 when the campaign began, are up 25% or so.

Now if only the company can start showing good earnings...

Too Busy to Learn

A CLEAR SIGN OF THE TURMOIL in the insurance industry can be found in the number of CPCU and IIA (Insurance Institute of America) exams administered each year. Between 1987 and 1991 the number of tests taken grew from 112,246 to 135,646. Since then the figure has dropped steadily, to 115,132 in 1995.

Various theories account for this decline, with downsizing, cost cutting and the downfall of some the old property/casualty companies prominent among them. However, a survey of CPCU and IIA dropouts revealed that one of the major reasons for dropping out was "not having enough time."

Norman Baglini, the Institute's president, says that "if employees have no time to acquire in-depth knowledge, and if their professional development is limited to what is available in bits and pieces, the industry's technical expertise will decline, and perspectives will narrow."

Considering the low level the industry is starting from, that's a scary thought.

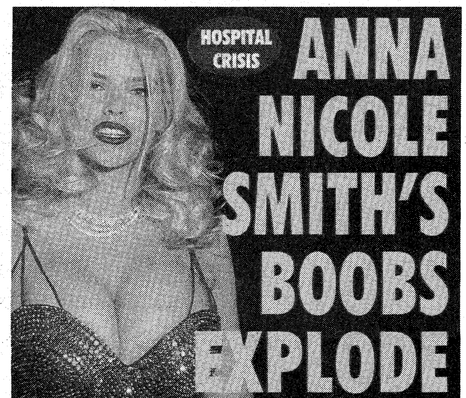
The Hindenburg Syndrome

THE GLOBE, A WEEKLY SCANDAL SHEET sold in supermarkets, recently blew the lid off a story that may have profound implications for the insurance industry. The cover of a recent issue showed a photograph of Anna Nicole Smith, voluptuous Guess model and *Playboy* centerfold, along with this shocking headline: "Anna Nicole Smith's Boobs Explode."

As we went to press, the full extent of the damage from the explosion was unknown. When queried, Hartford Steam Boiler Inspection & Insurance Company—which is reputed to have done a considerable amount of engineering work on this risk—flatly denied that its policies, which provide indemnification for damage to pressure vessels, were intended to cover this sort of equipment failure.

Knowledgeable sources have informed us that although Ms. Smith self-insured the first $100 million of third-party liability, a "significant amount" of excess coverage had been placed in the London and Bermuda markets.

Sir Wesley Mark-Eden, who manages several Lloyd's syndicates, suggested that a disaster of this magnitude "may lead to a hardening of the market."



The Globe's cover story

Revolution for the Hell of It

Bill Clinton and Al Gore wasting time with the editor of an insurance newsletter.

As a youth, David Schiff took a keen interest in the political process: he once attended a demonstration wearing a button that said 'Dick Nixon Before He Dicks You."

Schiff might even have sought elective office, but unlike Bill Clinton, he had inhaled—often and deeply. The result: his brain was so addled that there was only one business in which he could hope to make a living—insurance. (After all, where else do the folks in charge consistently act as if they've had one too many acid trips?)

So it was in the world of insurance that Schiff, a pensive hepcat incapable of holding a real job, found work observing the delusions of the crowd and chronicling them in a far-out newsletter written with verve and panache.

Of course, *Emerson, Reid's Insurance Observer* isn't for everyone. Quite frankly, its bold investigative style may shock you, and its trenchant observations could actually blow your mind. If, however, that's a risk you're prepared to take, we suggest that you tune in, turn on, and subscribe today.

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