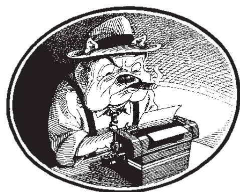

SCHIFF'S
INSURANCE OBSERVER

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Revolution at Standard Life Assurance Company

U.K.'s Largest Mutual Faces Insurgent Demutualization Plan

CAN AN OBSCURE, UNDERFUNDED individual force the largest mutual life insurer in the United Kingdom to demutualize?

Perhaps.

On February 9, the Standard Life Members' Action Group, formed by Fred Woollard, announced that it had obtained the requisite 50 signatures needed to call a special meeting of Standard Life's policyholders. The purpose of the meeting is to vote on Woollard's resolution calling for Standard Life to demutualize and distribute shares to its 2.3 million participating policyholders.

Edinburgh-based Standard Life, which is celebrating its 175th anniversary, has 11,000 employees and more than $110 billion in assets under management. It is in no mood to demutualize. "When a company demutualizes," Standard Life stated last year, there is "a potential transfer of value from the company's *future* policyholders to its *existing* policyholders…*The duty of the directors of the mutual is, however, to its future policyholders* as well as to its existing policyholders." [Emphasis added.]

Woollard disagrees. "It does seem odd that the board feels they owe a duty to a group of people whose identities are unknown—who may not even be born yet—when that 'duty' causes them knowingly to act against the interests of their existing members. Existing members are the very people who (theoretically at least) appointed them, and in whose interest they are obliged by law to act."

According to Woollard's calculations, Standard Life is worth between $19 billion and $24 billion, which, in a demutualization, would average $8,260 to $10,430 per policyholder. Under his proposal, even the smallest policyholder would receive at least $810.

His proposal shrewdly provides for Standard Life employees to receive 1.5% of the shares (about $29,000 per employee). One percent of the shares—about $200 million—would be set aside for charity, as well.

"The great attraction of this proposal," says Woollard, "is that there are many winners and no losers. It is rare to see a transaction that provides such large benefits to so many people, with almost no offsetting costs."

Who is Fred Woollard?

Woollard is a slight, unassuming, and very sharp 37-year-old investor. He grew up in Australia and now lives in Monaco. As a result of his demutualization proposal for Standard, he will be called a "carpetbagger" by the U.K. press and by Standard Life.

In contrast, we'll refer to him as Fred, mainly because we know and like him.

David Schiff and Fred met in 1998 through a mutual friend with whom they had both done business. The two shared an interest in the Graham and Dodd style of investing and enjoyed discussing obscure, undervalued investments. Mutual insurance was also a passion of theirs, although for very different reasons.

In 1997 and 1998, Schiff, outraged by the abuses taking place at mutuals, attempted to take over Allied Mutual, FCCI Mutual, and Provident Mutual, all of which had snookered their policyholders, or were in the process of doing so. Schiff viewed his actions as a form of public-interest work: he was acting on behalf of disenfranchised policyholders and sought no gain or remuneration.

His long, exhausting battle against Allied—which had engaged in a staggering series of asset shuffles that greatly enriched its managers at the expense of its mutual policyholders—was particularly instructive. Although Schiff was ultimately unable to wrest control from the rapacious reprobates who had entrenched themselves on Allied Mutual's board, his writings and election campaign put the company under justly deserved pressure, ultimately leading to its acquisition (via hostile takeover) by Nationwide. Allied's mutual policyholders received $110 million—about one-tenth of what they deserved. Still, that was $110 million more than they would have received otherwise.

Fred's interest in mutual insurance evolved from his experience in searching for undervalued investments that carried little risk but had the potential for significant gains.

There's a reasonably active secondary market in the United Kingdom for "with-profits endowment assurances" (also known as "endowment policies"). Endowment policies are issued by life insurers and are sold as investments. They combine aspects of fixed annuities, term insurance, and participating whole-life insurance.

An endowment policy is issued for a specific term—20 years, for example—and pays a guaranteed amount upon maturity or upon the death of the insured. In addition, a "bonus" (dividend) accrues annually and is paid upon maturity.

An insured buys an endowment policy by investing a lump sum with an insurance company. He must then make relatively small monthly premium payments until the policy matures.

Endowment policies are long-term contracts, and, for a variety of reasons, a good number of insureds choose not to keep them in force. (They might need the money right away or perhaps can't keep up the premiums.) Rather than surrender their policies, some choose to sell them to investors, who generally pay more than the surrender value offered by the issuing insurance companies.

In the U.K., an investor can purchase a "second-hand" endowment policy from any of a number of firms that make markets in them. According to one market maker's brochure, policies bought in

the secondary market "offer a good low-risk high-yield investment opportunity." (The brochure states that past performance of "traded endowment policies…is not necessarily a guide to future performance," but shows charts and projections implying 10% to 14% yields to maturity.)

An investor can also purchase "second-hand" endowment policies at auctions held by Foster & Cranfield (www.foster-and-cranfield.co.uk). At yesterday's auction, for example, the number of policies for sale as individual lots was 121.

Back in 1998, Fred told us that many private investors were buying policies with the expectation that they would earn the high yields shown in the brochures. He was skeptical, however: "All that can be said with confidence is that the current bonus rates are unsustainably high—unless world bond and equity markets continue rising strongly until the endowment policies mature. Personally, I think this is unlikely and therefore believe that those who buy endowment policies from traders (believing the 'forecast' yields of 10% to 12%) will be disappointed."

Fred's analysis of the second-hand policy market, however, had convinced him that investing in endowment policies offered excellent potential rewards with low risk—but only under certain circumstances. He explained his concept: "I prefer to look at these policies as a form of negative-coupon closed-end investment trusts trading at around net asset value, plus or minus 20%. [The "negative coupon" is the result of the monthly premium payment.] The return on the policy to maturity will approximate the return (after tax and expenses) on the underlying assets."

Fred said he guessed that a person who bought policies judiciously could earn a 5% to 10% annual return. That isn't exciting, but it's not terrible either, since the policies are generally the equivalent of AAA-rated bonds.

But Fred didn't spend his time learning the intricacies of "with-profits endowment policies" to earn a bond-market return. He realized that not all endowment policies are alike. Generally speaking, he eschewed those issued by stock companies in favor of those issued by mutuals. Endowment policies issued by mutuals have a latent intrinsic value due to the potential upside resulting from a demutualization.

Although Fred didn't phrase it this way, it quickly became clear to us that purchasing second-hand endowment policies issued by *mutuals* was similar to buying AAA-rated bonds that came with a free warrant. If you did your homework, you could buy an endowment policy and be fairly certain that your downside was earning a money-market return. Your upside, in the event of a demutualization, was a very high return.

Fred has purchased a good number of endowment policies and stands to reap a handsome profit if his demutualization resolution is approved by Standard Life's policyholders. While there are those who will decry his actions and call him a carpetbagger, we seeing nothing wrong with Fred's activities. Mutuals have sold (and in some cases mis-sold) policies as investment vehicles. The policyholders are *investors*, as are the owners of second-hand policies. In the case of a company like Standard Life, the amount that policyholders will receive from a demutualization is so substantial that it's hard to see why they wouldn't vote overwhelmingly for Fred's resolution. (The resolution was filed in order to ensure that the special meeting can be held on the same day as Standard Life's annual meeting, usually held on the last Tuesday in April.)

Standard must respond to Fred's proposal by March 1. The company has already responded by declaring that it remains "fully committed to mutuality." It will be interesting to see how it tries to convince policyholders to share that commitment and vote against a resolution that will be so profitable for them. Most existing policyholders probably don't share Standard Life's concern for *future* policyholders.

Indeed, why should they?

A lot more information on Fred Woollard's demutualization proposal can be found at www.slmag.co.uk.

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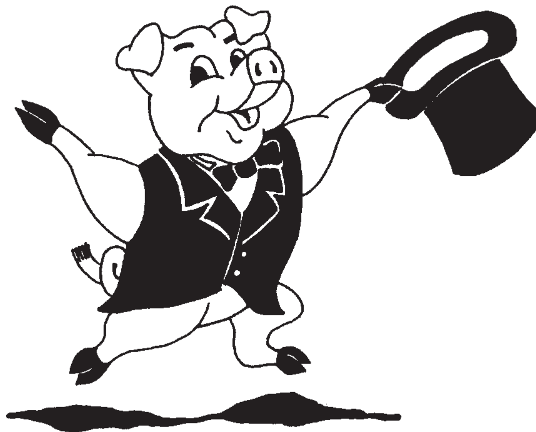

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