The world's most dangerous insurance publication℠

SCHIFF'S

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Walk Softly and Carry a Big Multiple

An Extreme Price for Growth

It is said that markets are efficient. We won't bother to debate that. But even if they're efficient, that doesn't mean they're always rational. Markets are made by people, who are given to feelings such as optimism, fear, exuberance, and depression. Their behavior will now and then drive prices to extreme highs or lows. (Even *Schiff's Insurance Observer's* subscribers aren't always rational; several hundred have failed to sign up for our *Evening Telegraph Edition*, which is delivered by e-mail or fax and included with subscriptions at no additional charge.)

When markets become *too* irrational—when pricing, supply, or demand gets way out of whack—something usually happens. If, for example, gold were selling for $275 in London and $273 in New York, arbitrageurs would short London gold and buy New York gold. These actions would eventually result in a convergence of the London and New York prices.

Insurance can work in a similar fashion. If writing non-standard auto insurance in North Carolina is unusually profitable, the smell of money will cause numerous insurers to flock to that market. The increased competition will then drive profit margins down, or eliminate them entirely. The absence of profits will cause some insurers to exit the market, which will, in turn, reduce competition and, eventually, create an environment in which profits can be made—at least for a while.

"You suffer from the delusion that your casualty reserves are adequate."

In a brief examination, we shall turn our attention to AIG, an example of a great company whose stock trades at an extreme, optimistic, exuberant valuation that leaves little margin for safety.

There is, of course, a certain logic behind AIG's rich valuation. It has a $200-billion market cap and its stock is extremely liquid (which means that institutions can easily buy and sell in size). More importantly, AIG has a long history of steady growth. (Because AIG has never disappointed in the past, many take it on faith that it will never disappoint in the future.) AIG is a core holding of institutions and mutual funds, and, according to Zacks, is rated a "buy" by 21 of the 24 securities analysts that follow it.

Because of its virtues, AIG's shares change hands at 37.4 times earnings and 5.8 times book value—levels that are stratospheric, at least as measured by both basic math and financial history. (At a 37.4 p/e multiple, investors are earning a 2.7% yield on their investment in AIG.) To justify its current valuation, AIG *must* compound its earnings at a breathtaking rate for a long period—a feat that becomes increasingly difficult with size.

The definitive study of AIG, *American International Group: Cultivating Global Growth*, was published in May, when AIG's stock was at 74. (The report's authors,

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Alice Schroeder, Gregory Lapin, and Chris Winans, were then at PaineWebber; they are now at Morgan Stanley Dean Witter.) Their 286-page tome projects that AIG's earnings will grow at a 16% rate through 2005. If AIG does indeed do that, its current stock price, 86, will be 16 times that year's earnings. Viewed another way, if all goes as planned, in 2005 an investor will "earn" a 6.25% return, based upon AIG's current stock price.

Rather than dispute the detailed analysis of Schroeder, et al. (Schroeder, after all, is a friend, subscriber, and featured speaker at our spring conference), we'll stick to the risks of investing in AIG at its current, extreme valuation.

For starters, AIG will not be a big beneficiary of any upturn in the domestic property-casualty market, since its domestic property-casualty income is only 25% of its operating earnings. (Domestic property-casualty is projected to grow at an 8% clip.)

Although long viewed as a property-casualty company, AIG has changed its stripes, and a disproportionate amount of its future growth is expected to come from life insurance, financial services, and asset management. Domestic and foreign life insurance are projected to grow at more than a 17% pace, and earnings from asset management are projected to quadruple by 2005, and comprise 10% of AIG's earnings then (up from 5% now).

Way back in our October 1998 issue, when AIG's stock was 49, we observed that it was selling at a lofty 24 times earnings. The stock is now 86—an even loftier 37.4 times earnings.

Although AIG's earnings have expanded at a 17% annual pace over the last two years, its price-earnings ratio has expanded 60%. If AIG's p/e multiple had remained constant, its stock price would be 66 rather than 86. (If its multiple had shrunk to 20 times earnings, its stock would still be at 49.)

The bottom line: 54% of the gain in AIG's share price over the last two years has been due to the expansion of its p/e multiple, rather than to earnings growth.

Price-earnings multiples cannot expand indefinitely. Indeed, they have been known to contract. This happened to AIG (and many others) during the 1970s (see chart). During the 1990s, however, AIG's p/e multiple regained its lost ground, and then some, as AIG became *the* insurance stock.

According to Value Line, AIG's earnings have grown at a 13.5% rate over the past ten years. During that same period its p/e multiple has expanded from 10.9 times earnings to 37.4 times earnings.

An advantage of having a high p/e multiple is that a company's stock becomes a fine acquisition currency. (Berkshire Hathaway's acquisition of General Re for stock is a case in point.) Interestingly, AIG has *not* benefited much from its high multiple. Although it acquired SunAmerica for stock, SunAmerica had an even higher p/e than AIG; thus the acquisition was not immediately accretive to earnings.

AIG should earn about $5.8 billion in 2000. If it is to grow at the projected 16% next year, it must come up with an additional $900 million in earnings. (By way of comparison, Chubb's *total earnings* for next year are projected to be about $825 million.) One way AIG can grow is by using its high-p/e currency to buy earnings. AIG is acquiring HSB (formerly Hartford Steam Boiler) for $1.2 billion in stock—a price equal to 20 times earnings. Because AIG's p/e ratio is almost double that of HSB, the acquisition will be accretive to AIG's earning per share, and, in fact, should represent about 3% of AIG's earnings-per-share growth next year.

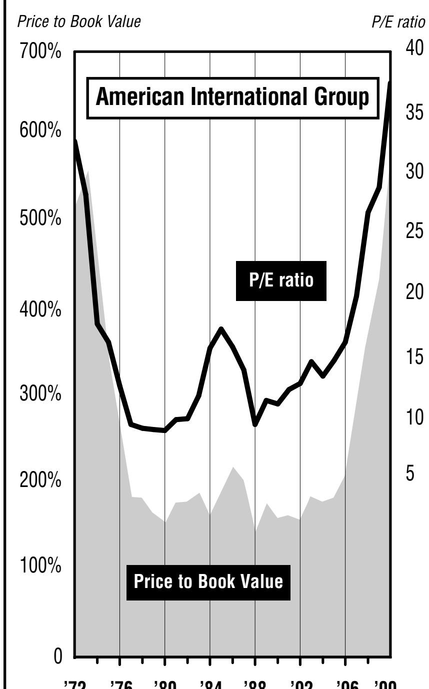
But AIG is so large that it's difficult for it to make acquisitions that, by themselves, materially alter its growth rate. At the margin, however, if it can use its stock to buy lower-multiple companies, then it can eke out incremental growth via an arbitrage of earnings' multiples.

Absent an expansion in its multiple, if AIG grows at a 14% rate forever, an investor could expect no more than a 14% annual return. If AIG's growth rate fails to achieve this difficult hurdle, it's slower growth would likely lead to a much lower multiple. (A much lower multiple could also occur if investors' exuberance subsides.)

From our vantage point, the risk of buying AIG outweighs the reward.

AIG: Does Anyone Remember 1972?

In 1972, AIG's shares traded at 518% of book value and 32.6 times earnings. Between 1972 and 1974, AIG's stock fell 66%, as these inflated multiples shrank, even though AIG's earnings grew. During the last two years, AIG's price-to-book-value ratio and p/e ratio have entered uncharted territory.



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Editor and Writer .... David Schiff
Copy Editor .... John Cauman
Editorial Associate ...... Isaac Schwartz
Production Editor .... Bill Lauck

Publisher.................. Reid Nagle
Subscription Manager....... Pat LaBua
Advertising Manager ..... Mark Outlaw

Editorial Office
Schiff's Insurance Observer
300 Central Park West, Suite 4H
New York, NY 10024
Phone: (212) 724-2000
Fax: (212) 712-1999
E-mail: David@InsuranceObserver.com

Publishing Headquarters
Schiff's Insurance Observer
SNL c/o Insurance Communications Co.
321 East Main Street, P.O. Box 2056
Charlottesville, VA 22902
Phone: (804) 977-5877
Fax: (804) 984-8020
E-mail: Subscriptions@InsuranceObserver.com

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The Catcher in ~~the Rye~~ Reliance

Saul Steinberg's Story

If you really want to hear about it, the first thing you'll probably want to know is what my childhood in Lawrence was like, and how I graduated from Wharton when I was 19 and ended up running Reliance Insurance Company into the ground.

But to tell you the truth, I don't feel like getting into all that David Copperfield kind of crap. In the first place, it's not like I haven't done well or anything. When I was only 22 I started Ideal Leasing on the premises of Ideal Rubber Products, a company owned by my father and uncle.

I later changed Ideal Leasing's name to Leasco and the company became one of the hottest stocks in the Sixties. I used Leasco's securities—which were really full of it—to take over the whole goddam Reliance Insurance Company when I was 29.

Reliance didn't *want* me to take it over. No company *ever* wanted me to take it over. Nobody even wanted me on their goddam board unless they were a charity I gave a lot of dough to. Society is phony as hell. You get in by giving money to things like museums, hospitals, or Carnegie Hall. I donated the Frank Lloyd Wright room in the American Wing at the Metropolitan. It's beautiful and Wright's a genius and all, but his furniture is as comfortable as a toilet seat. People always say that they're *crazy* about old Wright because they know he's a very big deal, but they've probably never sat in one of his chairs for an hour. If they have, their back was probably sore as hell.

To tell you the truth, I made out quite well by donating the Frank Lloyd Wright room. It's *priceless*—now there's a phony word—which means you get a big tax deduction.

I don't want to dwell on the past or anything, but after I bought Reliance, the press made a very big deal about me, like there was something *wrong* with my having a 29-room mansion filled with Picassos and Kandinskys.

The funny thing is that I was a lot more interested in creating a diversified financial-services conglomerate. I really was. And Chemical seemed like a pretty good bank to own. I began buying some of its stock and was planning to take it over and all, but the old boys who *controlled* the company—not the shareholders or anything, but the *directors*—thought this was a goddam tragedy or something. The last thing they wanted was for *their* bank to be taken over by a Jew.

Of course they never *said* they didn't want a Jew taking it over. You'd have to be a real moron to say something like that in public. The truth was they didn't want *anyone* taking over their goddam bank, and they *especially* didn't want a Jew like *me* taking it over. They were prejudiced as hell.

When you think about it, the whole Chemical Bank affair was actually very phony. Chemical got senators, congressmen, and even New York's governor—old Nelson Rockefeller—to propose laws that would prevent *me* from buying it. They really did. At one point, I heard that Chemical's representatives said they'd find a nice "Jewish bank" for me to buy. I was the most successful young businessman in America, for Chrissake, and Chemical's board of directors acted like I was goddam Shylock or something. I'm not kidding.

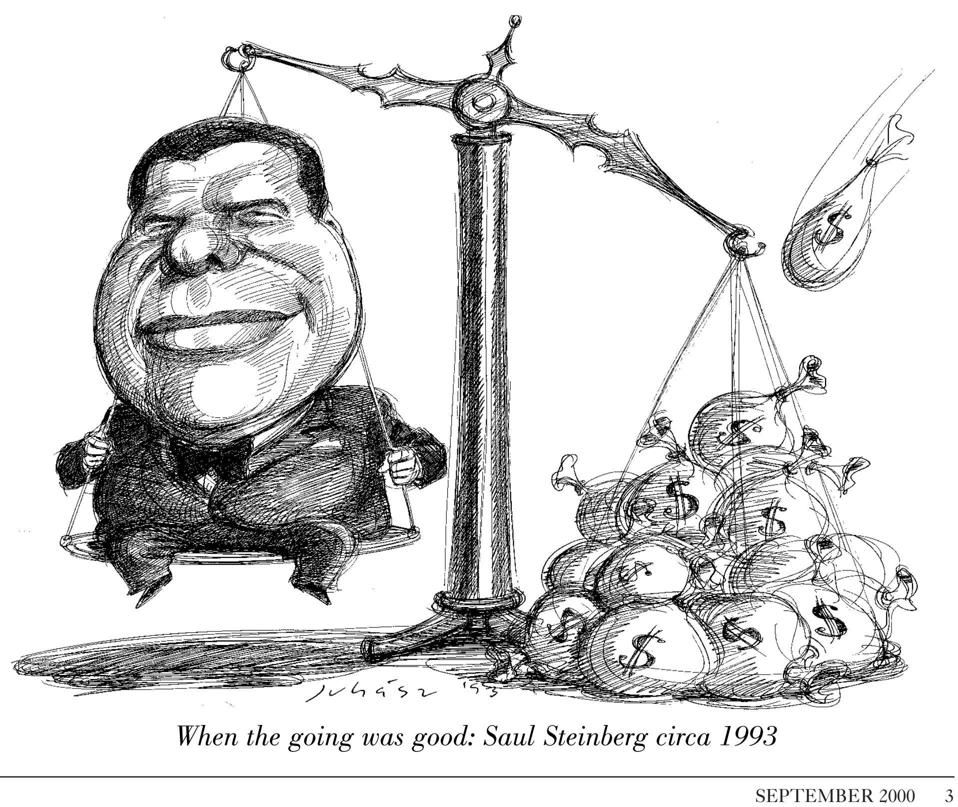
Banks and insurance companies are merging now, and a lot of banks and financial institutions are run by Jews. But when I was trying to take over Chemical, they weren't. When I took over Reliance, Sandy Weill's firm—Carter, Berlind & Weill—was *my* investment banker. Now old Sandy is chairman of Citigroup.

I was 30 years ahead of my time in the financial-services industry, but you don't see the newspapers or magazines pointing *that* out. They always write about my lavish lifestyle, or how much I get paid, or how I'm short and heavy and how my wife is tall and thin and glamorous as hell. Reporters are really full of it.

I'm not saying the experience with Chemical Bank soured me or anything, but later, after I bought old John D. Rockefeller's apartment at 740 Park Avenue, I used to walk down the halls—they're about a mile long—and gaze at my old master paintings. Sometimes I think I'm crazy. I'd imagine I looked like Cary Grant or Douglas Fairbanks Jr.—dignified as hell—and that as I entered Chemical's boardroom the bank's somber WASP directors would nod their heads towards me. Then I'd sit at the head of a grand mahogany table and we'd talk in hushed tones and smoke cigars. When the meeting would end the directors would raise snifters of cognac and say, "Thank you, Chairman Steinberg."

I'm really a madman sometimes. It's the goddam movies. They make you crazy.

I'll tell you a helluva story. Right after I bought Reliance a man from the Anti-



When the going was good: Saul Steinberg circa 1993

Defamation League came in to see me. Back then insurance companies weren't much better than banks when it came to hiring Jews. It was really crummy.

"Mr. Steinberg," the man from the ADL said, "your company doesn't have a diverse workforce."

Diverse workforce. That killed me. Like the ADL had come to see me because blacks or Hispanics weren't getting good jobs at Reliance.

"What do you mean?" I asked.

There was a long pause.

The man from the ADL, who was probably old enough to be my father for Chrissake, finally spoke. "Have you seen *Gentleman's Agreement*?" he said.

It's a pretty good movie. Gregory Peck plays an investigative journalist who poses as a Jew and discovers all forms of anti-Semitism. It was a big deal in its day, and won a bunch of Academy Awards.

Anyway, the guy from the ADL was waiting for my reply, and I was getting tired of horsing around, so I finally said, "The *chosen people* are going to be making a lot of money from the Reliance Insurance Company. Give me a chance—I've only been here three days."

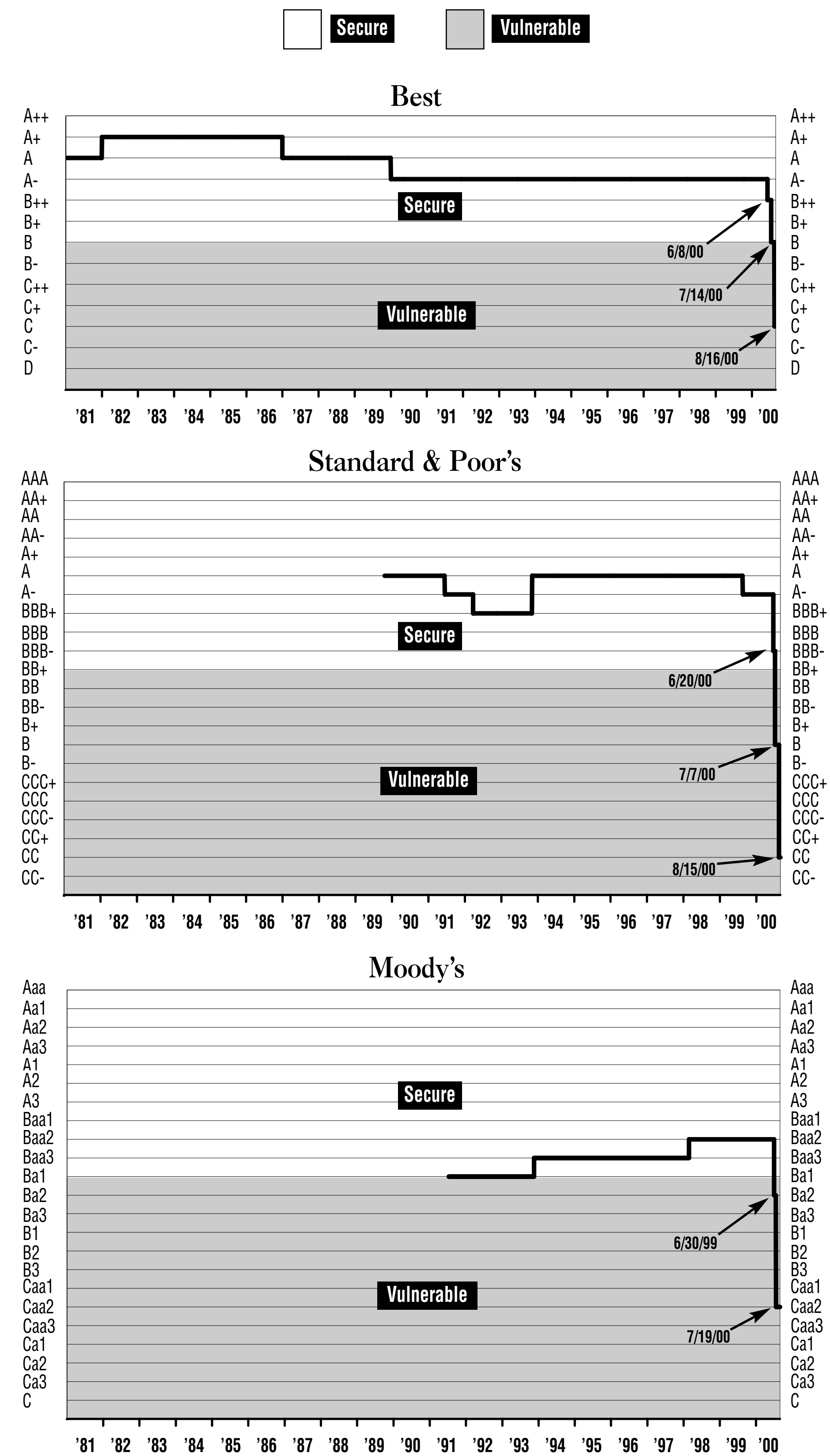
The funny thing is that I turned out to be right, although the *chosen people* turned out to be me, and people related to me. My brother Bobby got paid about $25 million over the last five years.

Anyway, I never bought a big bank or a major financial firm. I mean, it's not like it *mattered* all that much to me anyway, even though everyone thought it did. Everyone always thought I wanted to buy some major company so I could achieve *respect*. That really kills me. People who think that way generally don't have a lot of dough, and they never get tired of saying things like "You can never *buy* respect."

I guess you could say that Chemical marked a turning point for me. My stock went way down in the Seventies—all stocks did. The bad market wasn't good for Reliance's investment portfolio, and business conditions got lousy as hell for a while. Sometimes I had to use some really crappy accounting gimmicks to balance the books. But the old Reliance Insurance Company *was* a pile of dough, which came in handy, even though I wasn't able to take all the dough out for myself on account of the insurance regulators.

Reliance Insurance Company: Comparing the Rating Agencies

A.M. Best and Standard & Poor's consistently gave Reliance Insurance Company higher ratings than Moody's did. Until June 2000, Best and S&P rated Reliance "excellent" and "strong," respectively. Moody's never rated Reliance higher than Baa2 (Adequate).



Source: A.M. Best, Moody's, Standard & Poor's

Insurance regulators, especially commissioners, drive me crazy. They're a bunch of phonies for the most part. They become commissioners so that they can get higher-paying jobs in the private sector peddling the influence they picked up as commissioner. That's how America works. It's what the phonies in Chemical Bank's goddam boardroom call *free enterprise*.

I guess you could say I'm phony as hell, too, since Reliance, like every other company, spent a lot of dough on lobbyists, politically-connected lawyers, and former Insurance Department employees. I guess if you *really* believed in free enterprise you wouldn't hire these people. But that's not how business works. Free enterprise costs quite a lot. It really does.

I remember this one episode back in 1976 when the SEC was giving me the third degree. The whole thing was lousy, because I don't think I've conducted myself a helluva lot different from the tall guys with blond hair who were on Chemical's board—except that I made my money a lot faster than they did. I don't feel like going into all the details, but I was a director of Pulte Homes, and the SEC filed a complaint in Federal District Court saying I tipped off my friends by telling them to *buy* Pulte. According to the SEC, at the same time the people I tipped off were buying Pulte, I was *selling* my Pulte stock. That really sounds like some sort of racket, for God's sake.

The thing is, if I cared so much about what people thought of me, I could've fought the SEC in court. Instead, I signed a consent decree permanently enjoining me from defrauding people, making misleading or untrue statements, or omitting material facts. Big deal. So I'm permanently enjoined from committing securities fraud. It's against the goddam law *anyway*. It would depress the hell out of me if I had to make a living from securities fraud.

I'm only bringing up the consent decree because an insurance newsletter wrote about how I touted a stock, Human Genome Sciences, in Reliance's 1996 annual report. Reliance owned about $100 million of the goddam stock. It was our biggest position, for Chrissake. What was I supposed to say? That people should *sell* Human Genome?

Anyway, the insurance newsletter—*Schiff's Insurance Observer*—wrote about how the company my son Jono runs, *Individual Investor* magazine, which I was the largest shareholder of, was recommending that its readers *buy* Human Genome Sciences. *Schiff's* made a big deal about how Reliance was *selling* Human Genome at about the same time *Individual Investor* was recommending that people *buy*.

I don't want to go on about this because, frankly, it bores me to death, but Arthur Levitt, who's now head of the SEC, was *my* investment banker on the Reliance deal. In 1969 he even testified before Congress about what a *terrific* company Leasco was and how great it was that it took over Reliance. I'd like to see old Schiff publish the transcript of that Congressional hearing one of these days.

You know, the worst thing about the Seventies was that if Reliance *Group* hadn't had so much debt we could have bought a lot more stuff and made a lot more money. I could've cleaned up, just like Carl Lindner, Larry Tisch, and old Warren Buffett. I really could've.

At least Reliance *Insurance Company* had lots of money, but it was a royal pain in the ass to get that dough out of the insurance company and up to the holding company, where the debt was. There are all sorts of clever ways of upstreaming money that aren't strictly prohibited, but still, you can never really get *all* the money out of an insurance company. Not even Mike Milken, who I'll get to later, could figure out a way to do that.

When the stock market recovered a bit in the late Seventies, I, or I should say *Reliance*, began buying 5% or 10% stakes in lots of companies. These companies were worried as hell that we were going to take them over—even though it had been *years* since I'd gone after Chemical Bank, for Chrissake. It seemed that no company wanted a hard-driving Jewish financier to take it over. At least that's how I figured it. Now I wonder if these companies simply didn't want to be taken over by *me*. The Establishment can drive you crazy. It really can. They were talking about me behind my back, which was a lousy thing to do because I had as much right as anyone to buy Chemical. It was a helluva poorly run company, and so were a lot of the other companies that I almost made a run at, and that includes goddam Disney.

I guess this is as good a time as any to bring up old Milken. He arranged the debt for me to take Reliance private in an LBO in 1982, and he underwrote the deal when I took it public at a higher price four years later. His firm, old Drexel Burnham, made a pile in the process. Reliance Insurance Company was one of Milken's biggest clients. We bought junk bonds by the goddam bucketload. We really did.

Old Milken was really something. He was a billionaire, for Chrissake, but he wore a bargain-basement toupee and worked about 20 hours a day. He had this sales pitch about how debt would *empower* America by making people work harder; that debt was an *incentive*, and all that crap. He was kind of a genius, though. He really was.

Old Milken was famous for saying things like "triple-A bonds have no place to go but down." That really killed me. There he was with this corny rug on his head, saying all this banal stuff, and people were behaving like it was *scripture* or something. He kind of acted like he was on a religious crusade, too—like all he cared about was making the world a better place by getting people to buy junk bonds. He nearly cornered the goddam junk-bond market for awhile.

I sometimes think about how my life would be different if I hadn't met old Milken, or hadn't done the LBO, or issued so much junk debt. Without the debt, Reliance wouldn't be in the shape it's in. You can really drive yourself crazy thinking that way.

When you've had a lot of money for awhile, people stop caring how you got it. By the mid-Eighties I'd become part of the goddam Establishment. I really had. It didn't matter that I'd signed a consent decree or was a greenmailer. To tell you the truth, I know plenty of people who signed consent decrees. Most are crying all the way to the bank.

I lived a pretty ostentatious life, but it was *fun* ostentatious. I had the biggest apartment in New York, and threw some of the biggest parties. My florist bill was bigger than most people's salaries, for Chrissake. I gave away a pile of dough, too. I was really quite generous. After giving away a lot of money I was on the boards of museums and universities, and had buildings and wings named after me. It was impressive as hell.

The money *was* rolling in. I pulled down $6 million a year from Reliance, and got another $12 million in annual dividends. The insurance business was a helluva lot better than the leasing business ever was. It's funny, but old Leasco never amounted to much of anything, yet I had used it to buy Reliance, which was worth a fortune until we messed it up.

I never liked the goddam insurance business. It can really put you to sleep. I liked having all the insurance company's assets to mess around with, though. I get a big kick out of money. I like it a lot.

My brother Bobby was president of Reliance for a long time. I was crazy about old Bobby, even if he didn't do such a hot job as president. Things *really* fell apart in 1999, which is why I had to let Bobby go. It's not like I had a choice. The whole goddam company was going sour. Everyone had lost faith, for Chrissake. The one break was that the rating agencies didn't downgrade Reliance Insurance Company sooner. It was really something. Business was awful as hell. We'd grown way too fast, and had written piles of bad business. But the rating agencies hate to knock your rating down. They really do. Especially old A. M. Best. They could've demanded a million-dollar fee to keep our rating up at A-. They could've *greenmailed* me, for Chrissake. We really needed that rating. If I were a rating agency I'd lower everybody's goddam rating.

Standard & Poor's didn't know what was going on, either. They didn't lower the ratings on our bonds—which were junky as hell—until it was way too late.

The raters must have figured that I'd been in bad shape before and had managed to pull out, and that I'd just do it again.

Not everyone was so keen about Reliance. I remember reading article after article in *Schiff's Insurance Observer* about how lousy the company was. I don't subscribe to *Schiff's*. I'd rather read a good book.

I was kind of depressed on account of the fact that we had to sell our apartment. Once you get used to 34 rooms and 15 fireplaces, everything else seems small. You can start feeling *trapped* in one of the little eight-room apartments everyone else has.

I'll miss my art, too. I was really fond of the stuff. It *was* a helluva collection. On my fiftieth birthday my wife Gayfryd threw a bash at our mansion at the beach, and we hired people to dress up as the figures in my paintings. We really did.

We had a pile of important antiques, too. We've sold off just about everything that was worth anything. I don't want to give you exact numbers, but we got more than $30 million for the apartment, $50 million for the old masters, and $10 million for the antiques.

Old masters are a helluva value. When you look at what they go for compared to modern stuff, it's really something. If I was running an insurance company with an A+ rating I'd probably put a pile of dough into old masters.

I wasn't happy about the thought of selling out to Leucadia National, although if the deal *had* happened at least I'd have gotten about $90 million for my stock. That's about $90 million more than the stock is worth now. The guys who run Leucadia are tough as hell. They'll only buy a company if they can put up as little money as possible and take no risk. They're *asset strippers*, for Chrissake. It's funny. I have a reputation for that sort of thing even though I'm a *builder* of businesses. I don't have the stomach for selling assets and firing people. I really don't. Old Bobby didn't either. Maybe that's why we grew Reliance so fast. That way we didn't have to fire people.

I won't be keeping my $6 million salary, my perks, and fancy offices. It'll all be gone. The whole goddam Reliance Group has to be restructured. The creditors and banks will be all over me—just like I used to be all over other companies—and the insurance department isn't going to let us take much dough out of the insurance company.

I'm sad as hell. My apartment, my art collection, and my antiques are gone. Most of my goddam wealth—and my family's wealth—is gone. My sister and brother-in-law just sold their town house, and Bobby sold his apartment in the city and his house in East Hampton.

When you've had a lot and got used to leading a fancy lifestyle, it knocks you out to lose it. It really does. It kind of makes me wish that I never had anything. That way I wouldn't notice that I was losing so much.

When you're rich, it's easy as hell to get greedy. You start to *need* the best of everything. When you get used to flying in your own private 727, it becomes difficult to even *think* about traveling on a commercial flight.

I didn't think that all the money could disappear—that my family could lose almost a billion dollars. I always figured things would work out. It's really sad as hell that they didn't.

That's all I'm going to say. I could tell you about the midtown hotel I've been staying in, or how I've been spending a lot of time at my beach house since Reliance has fallen apart. But to tell you the truth, I'm not too interested in telling more. I'm sort of sorry I told *this* much; it makes me start missing everything. I miss Leasco and Milken and greenmail, for instance.

I think I even miss the goddam phonies on the board of Chemical Bank. ■

Steal This Insurance Company!

Demutualization and Its Discontents

Among the by-products of bull markets are the dubious ideas—usually recycled from past bull markets—that become accepted as universal truths. In the 1960s, acquisitions made by conglomerates would supposedly produce perpetual increases in earnings per share. By the beginning of the 1980s, natural resources, which had already soared in value, were certain to soar further. (*BusinessWeek*, in a now-famous cover, declared "the death of equities.") During the great era of the LBO, excessive debt was considered good because it *forced* companies to be efficient.

All of these investment movements had their apostles or manifestos. *The Magic of Mergers*, a hagiography of Meshulem Riklis—whose leveraged conglomerate would eventually collapse—was published in 1968. The Hunt brothers, whose father made a fortune in oil, went bust speculating in silver. (The Hunts did not see their attempted corner of the silver market as speculation. In a world where *paper*—stocks, bonds, money—was considered suspect, the case was made that tangible assets were the *only* rational investment.)

Last fall a new gospel—*Dow 36,000*—appeared, and rose to near the top of the Amazon.com best-seller list. (At that time, according to Amazon's website, customers who bought *Dow 36,000* had also bought *Dow 40,000*, *Dow 100,000*, and *The Long Boom*.) Why did *Dow 36,000* appear during a prolonged bull market? Where was *Dow 10,000* in early 1982, when even Dow 1,000 seemed like a stretch to many?

The Dow Jones average hasn't fared badly since last fall. *Dow 36,000*, on the other hand, hasn't fared well. It's #15,816 on Amazon's best-seller list. Now, according to Amazon, customers who have bought *Dow 36,000* have also bought *Irrational Exuberance* and *When the Dow Breaks: Insights and Strategies for Protecting Your Profits in a Turbulent Market*.

It's not coincidence that so many mutual insurers are demutualizing during a bull market (or what might prove to be the early stage of a bear market). The concepts of issuing stock, making acquisitions, and, especially, granting executives stock options have never been more in vogue. To many mutual CEOs, making deals and growing rapidly has far greater appeal—and is a hell of a lot more fun—than managing a slow-and-steady mutual. For mutual CEOs, this is the dawning of the Age of Taurus.

Between 1966 and 1991, sixteen mutual life-insurance companies demutualized. Since 1996, nine of the 15 largest mutual life insurers have done so (through a full demutualization or a mutual-holding company) or have announced plans to do so.

New Era thinking says that if mutuals *don't* demutualize they will be unable to compete successfully. This nonsense has been repeated often, particularly by investment bankers who stand to profit from the mutuals' changing financial structure. (Ironically, right before General American, a mutual-insurance-holding company, blew up last summer because of its $6.8 billion gamble on interest-rate spreads, Goldman Sachs was prepping the company for an IPO.)

Although there are 1,200 mutual insurance organizations in America (worth perhaps $250 billion), the 50 largest ones account for the vast majority of mutual surplus and premiums. Still, there are hundreds of decent-sized mutuals.

Now that the big mutuals have lost the mutual-insurance-holding-company war, the most common method of demutualizing is a full demutualization in which policyholders receive 100% of the company. (Mutual-holding companies and subscription-rights conversions are prohibited by a majority of states. They are coercive and unfair and, where permitted, tend to provoke litigation. Furthermore, they're in disrepute on Wall Street, which makes an IPO—one of the primary motivators—almost impossible.)

A mutual could also demutualize via an outright sale of the company, with the proceeds distributed to policyholders. Although such a sale would, in most instances, be the best deal for policyholders, it's the least attractive option for the mutual's management, since they lose control.

A properly executed full demutualization is a fair transaction. Policyholders give up certain rights—ownership of the mutual insurer, the right to have the company run for their benefit, and nominal voting rights—in exchange for stock, cash, or policy enhancements.

When analyzing a demutualization from the policyholders' perspective, there are two overriding issues: is the transaction the *best possible* one for policyholders, and, has the company provided policyholders with *full disclosure*?

These basic issues are so obvious that one would think that they wouldn't be issues at all. But they are. Many states' laws, for example, have been twisted so that mutual-insurance-company directors, when considering a demutualization, can take the "interests" of the "community" into consideration. (The "community," by the way, can include the CEO, executives, employees, suppliers, local charities, and so on.) "Community interest" laws are bad public policy. Just as a stock company should be run for the benefit of its shareholders, a mutual insurer should be run be the benefit of its policyholders.

Most mutual managements (and stock-company managements, for that matter) desperately want to retain control of "their" companies. In addition to the anti-takeover provisions that are part of demutualization statutes, converted mutuals wield an arsenal of other anti-takeover weapons. These usually don't serve policyholders or shareholders.

Most large insurers demutualize by distributing stock in conjunction with an IPO. Unfortunately, mutuals routinely conduct IPOs that dilute their policyholders' value. This is done by selling or issuing shares at significant discounts to book value or intrinsic value. MONY, John Hancock, and MetLife—to pick three prominent examples—all conducted IPOs in which stock was sold at a significant discount to each company's intrinsic value. (For the record, David Schiff testified at the MONY and John Hancock hearings. Since the problems in MetLife's demutualization plan were similar to those in MONY's, and since both hearings were conducted by New York's insurance commissioner Neil Levin, Schiff saw no point in attending the MetLife hearing.)

Compounding the pricing problems in all three IPOs was the fact that policyholders weren't even offered *subscription rights*—a chance to buy in at the offering price and thereby avoid economic dilution. Indeed, all three companies, or their advisors, averred that offering policyholders subscription rights (or something similar) would be so costly and cumbersome that it just couldn't be done.

One wonders about statements made on October 8, 1997 at the public hearing on proposed *mutual-holding-company* legislation held by the New York State Assembly Committee on Insurance. Wolcott Dunham, a partner at the law firm Debevoise & Plimpton, testified that the New York bill contained "additional policyholder protections not found in any other law…If there is an IPO, the company must give eligible members *subscription rights* to buy stock in the offering—unless the Superintendent concurs in the board's decision that giving subscription rights would not be in the best interest of the members." Dunham represented the Life Insurance Council of New York, which helped draft the bill. (The bill did not become law.) He also represented John Hancock and MetLife. Harry Kamen, chairman, CEO, and president of MetLife, testified that all the mutual policyholders *he knew* in New York City "would be very interested in *subscription rights* of an IPO because of the experience of the almost immediate increase in value."

That increase in value has, of course, nothing to do with any magic about insurance IPOs. Rather, it has everything to do with the fact that the stocks of demutualizing companies are usually priced at a significant discount to their true value. (Since mutual executives own no shares in the mutual, they have nothing to lose by doing an IPO at a ridiculously low valuation. It's the policyholders who lose.)

MONY went public on November 12, 1999, at $23.50 per share, a price equal to 67% of its book value. The stock is now 36 5/16 and the company is *repurchasing* shares.

John Hancock went public at $17 per share on January 28, 2000. Its stock is now 23¾. On November 17, 1999 at a hearing on Hancock's proposed demutualization, chairman and CEO Stephen L. Brown testified under oath why, as part of the complex restructuring, it was fair to cash out many policyholders instead of giving them stock: "The demographics of our policyholder base…are very heavily weighted towards smaller policyholders, older policyholders, people who we felt should not have stock forced upon them, because we feel that…any individual stock is subject to risk. And I think the people who have commented on this in the past have simply ignored the risk…"

It was sensitive of Brown to be so concerned about his policyholders that he spared them the risk of receiving shares in John Hancock at a dirt-cheap price. The small, old policyholders, according to Brown, were better off being cashed out at the offering price, thereby incurring a tax and eliminating the likelihood of future capital gains.

Six months later, in early May, Brown told a conference-call audience that Hancock was considering a share repurchase, announcing: "We believe our stock is significantly undervalued." At that moment the shares were trading around 20, eighteen percent higher than the offering price.

MetLife went public on May 5, 2000 at $14.25 per share. The stock is now 23. In late June MetLife announced a board-approved $1 billion share-repurchase plan. Presumably, MetLife's directors believe that the company's shares are undervalued. (If that's the case, what was the point of an IPO two months earlier at a much lower price?)

Why do mutuals routinely issue stock at low prices and then repurchase shares at much higher prices? The answer is that the mutuals' CEOs don't care about value; they want to take their companies public. In fact, it works out all the better if the IPO price is low. When the CEO's "performance" is measured (by stock appreciation), the record will look particularly good because the stock was starting from a depressed price. The extra appreciation will give the appearance that the CEO has delivered "value" to shareholders and will serve as a justification for a larger salary or a bigger options package.

Insurance regulators shouldn't approve flawed demutualizations like those mentioned above, but they do. They don't understand corporate finance, or their interests are aligned with the powers that be—insurance companies, industry organizations, and business associations. The way it currently works, policyholders are, for all practical purposes, disenfranchised from the demutualization process, which, for the most part, takes place behind closed doors.

If policyholders had understood what was happening, they wouldn't have approved the previously mentioned deals as they were structured. If independent (and knowledgeable) policyholder-advocate committees were created to oversee demutualizations, the results would be different.

Policyholders have not been given full disclosure in demutualizations. Instead, they're told what the company wants them to know. Full disclosure is essential because, under every state's law, a demutualization must be approved by a majority of the mutual policyholders who vote (or a majority of the votes if the vote is weighted). If a mutual omits material information in its communications to policyholders, it can't get their informed consent. Without informed consent, the vote is tainted, and so is the demutualization's legitimacy.

Mutual policyholders should be told what they might be losing in a full demutualization, and whether other transactions might achieve better financial results for them. Policyholders should be advised whether management decided *not* to seek alternatives that might have yielded greater value, and why. Policyholders should be told if their value will be diluted, or is likely to be diluted. Policyholders should also be told what their company is worth. (In corporate mergers and acquisitions, it's standard procedure to hire an investment banker to value the company.)

Demutualizations won't make a bad company good. If the incentive of stock options was all it took to achieve superior performance, then every public company would have achieved that already.

The rash of demutualizations taking place will probably end up as a boon for the insurers that remain mutual and maintain a policyholder-oriented focus.

Ten years hence, it wouldn't be surprising to see Northwestern Mutual and State Farm tout the fact that they're owned by their policyholders—unlike stock insurers, which are run for the benefit of their shareholders.

Insurance Companies' Secret 'Public' Data

What's the Industry Afraid Of?

by Isaac Schwartz

Let's start with the premise that important public documents should be easily available, preferably over the Internet. If we want to narrow this premise, we might say that public documents *already in electronic form* should be available over the Internet.

Although insurance companies are prodigious filers of "public" documents, these documents aren't easily available to the public.

The single most comprehensive insurance-company document is the annual statement, which must be filed with state insurance departments and the National Association of Insurance Commissioners (NAIC). Nonetheless, insurance companies' annual statements aren't available on insurance-department websites, insurance-company websites, or the NAIC's website.

No state requires licensed insurers to post their annual statements on the Internet. Although for most insurance companies, the cost of such a regulation would be negligible, the benefits to the public would be considerable. We recommend that legislators or regulators require insurance companies to post their annual statements on the Internet and make them freely available.

All 50 states have laws requiring insurance companies to file their annual statements by March 1 of each year. A printed copy of each annual statement and a state-specific supplement must be filed with the insurance department in every state in which an insurance company is licensed. Printed and *electronic* copies must also be filed with the NAIC. (The NAIC is a non-profit corporation whose ostensible purpose is to provide "a forum for the development of uniform policy where uniformity is appropriate." It is not a government agency, and accordingly has no regulatory authority, although it acts as a quasi-regulatory body.)

The annual statement provides a detailed look into an insurance company's business. It includes an income statement and balance sheet, data by line of business and by state, schedules of investments, paid and incurred losses, assumed and ceded reinsurance, transactions with affiliates, resisted claims, and much more. The annual statement is the primary source of information necessary to analyze an insurance company.

In some cases, the annual statement is bigger than the collected plays of Shakespeare. Prudential Insurance Company's statement, for instance, is two 8½" x 14" books, each weighing six pounds and comprising 1,000 pages. In addition, each of Prudential's 24 insurance-company subsidiaries files its own annual statement.

Index to Property and Casualty Annual Statement

Although an insurance company's annual statement is a "public" document, it isn't easy to come by. You can obtain it from the company, from the insurance department in states in which the company is licensed, or from the NAIC. Each method leaves a lot to be desired.

We recently conducted an informal survey, calling 17 large insurance companies and asking each for a copy of its annual statement. (We had policies with three of the companies.) In most cases, we identified ourself as an individual or a policyholder, rather than as a member of the press.

The companies' responses to our requests varied. Some said they didn't know what an annual statement was; others insisted that an insurance company's annual statement and its parent company's *annual report* were the same thing. Some companies didn't return our calls. Some told us to contact the insurance department. Travelers referred us to the NAIC. A State Farm employee refused to send us the company's annual statement and added, "We're owned by policyholders, not by stocks or anything." Nationwide Mutual asked us for a proposal and agreed to send us its annual statement only if we could demonstrate a legitimate research purpose. When we mentioned that we were a *policyholder*, Nationwide didn't change its stance. Nine of the 17 insurance companies we called sent us their annual statements.

Twice during the survey we identified ourself as a reporter. In those instances the insurance companies were particularly responsive, reinforcing our belief that you have a better chance of getting something from an insurance company if you identify yourself as a member of the press rather than as a normal human being. (In the future, when we encounter insurance companies that refuse to give us information, we may try identifying ourself as Special Counsel to the House Commerce Committee.)

Regardless of what response a company gave, if its annual statement had been on the Internet—preferably on a central database, but at the very least on the company's own website—our efforts, and any on the company's part, would have been unnecessary.

As we noted earlier, all insurance companies *must* file an annual statement with the NAIC in electronic format—either on diskette or over the Internet. The NAIC encourages insurance companies to file via the Internet. It estimates that 1,100 companies—25% of insurers—file their annual statements this way. If *only* the largest companies were to post their annual statements online, the

Cost to Purchase Annual Statement

The price of information is high. Below are the prices of purchasing National Union's annual statement from various insurance departments.

State	Cost
Arizona	$ 436.25
Alabama	353.25
Pennsylvania	352.59
Illinois	349.00
California	190.46
Florida	174.50
Nebraska	174.50
Indiana	103.15
Ohio	91.50
New York	87.25
Texas	83.76
Nevada	78.43
Massachusetts	69.80
Washington	62.13
Wisconsin	57.00

vast majority of policyholders would have easy access to detailed data about their companies. The 10 largest property-casualty and life-health companies represent 43% (by direct premiums written) and 34% (by assets under management) of the market. The 100 largest companies represent 84% and 85%, respectively.

Most states will provide a copy of the annual statement of any insurance company licensed in that state upon request and receipt of a fee. It can take over a month, however, for the statement to arrive.

In our neverending quest for knowledge, *Schiff's Insurance Observer* conducted another informal survey, this time researching the cost of obtaining one particular annual statement from 15 different state insurance departments. We chose National Union's, which is 349 pages. We found that the cost varies significantly from state to state.

In Wisconsin, the Office of the Commissioner of Insurance charges 25¢ per page for the first 50 pages, and 15¢ per page thereafter, making National Union's annual statement $57. The Texas Department of Insurance charges a flat rate of 24¢ per page, which comes to $83.76.

New York charges 25¢ per page, making the price $87.25. Indiana charges 10¢ per page, plus a $64 fee for "labor," bringing the cost to $103.15. California charges 29¢ per page, plus an $85 fee, which comes to $190.46.

The Arizona Insurance Department charges $1.25 per page, plus postage, bringing the cost to a whopping $436.25.

Some states copy the documents themselves; others contract out the work. The Massachusetts Division of Insurance refused to copy the annual statement or to provide information about services that would do so. We were advised that if we wanted one we would have to come in and copy it ourself. (At 20¢ per page, it would cost $69.80.)

We couldn't believe that the Massachusetts Division of Insurance, upon receipt of a public-records law request, would actually *refuse* to send us an annual statement. According to the Massachusetts' state code, "Every person having custody of any public record…shall furnish one copy thereof upon payment of a reasonable fee" (Chapter 66, Section 10a, *General Laws of Massachusetts*). A Division of Insurance representative confirmed that we had heard correctly the first time—that the Division would *not* send out an annual statement, even if one asked for it under the public-records law. We called the office of William F. Galvin, Secretary of the Commonwealth of Massachusetts, where spokesman Brian McNiff contradicted the insurance department's position, supporting the law as it is written.

The most expensive method of acquiring an insurer's annual statement is through the NAIC. (As mandated by state laws, the NAIC receives the annual statements from all insurers.) The price is $1.50 per page plus $10 shipping and handling, bringing National Union's annual statement to $533.50. The NAIC, however, offers the only one-stop shopping opportunity for those who want annual statements for *all* companies. Its property-casualty database costs $37,000; the life-health database costs $26,000. The databases include the complete annual statements for every insurance company. (State-specific supplements must be purchased from each state.)

If you prefer not to buy an annual statement, most states permit you to schedule an appointment to view prerequested documents. In New York (our worldwide headquarters) the process works like this: you send a fax to the insurance department stating exactly what you want to see. You then wait until a representative from the department calls (six business days in our case), schedule an appointment, and sign an "Application for Records" in person.

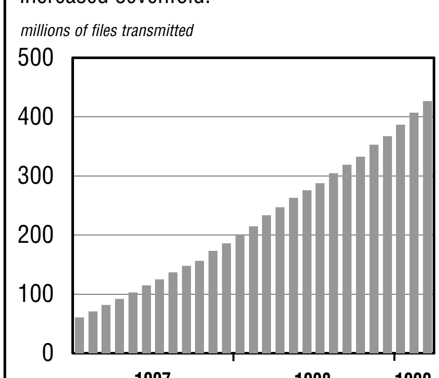
Although insurance-company filings aren't easily accessible, some governmental filings are. The SEC's EDGAR database (www.sec.gov), for example, contains detailed information on the 12,000-15,000 companies that are required to file documents with the SEC. (Insurance *companies* don't file with the SEC; insurance is regulated by the states.) Anyone with a computer and a modem can peruse detailed filings easily. The documents available on EDGAR include financial statements, registration statements, SEC decisions and releases, public comments on proposed rules, litigation releases, administrative proceedings, and various other reports filed by regulated companies and individuals. All can be viewed, printed, and downloaded for free.

Before EDGAR was created in 1995, getting SEC filings could be as difficult as getting insurance-company annual statements is today. You could try contacting the issuing company; you could go to one of the SEC's three Public Reference facilities; or you could buy copies of filings from a limited number of suppliers.

Broad disclosure of information is a good regulatory policy; it shines light on matters that might otherwise remain hidden, which helps prevent (or at least rein in) abuses. People tend to use information when it's made available. EDGAR went

A Bull Market in the SEC

The SEC's online EDGAR database was started in September 1995. Between January 1997 and March 1999 (the most recent dates for which data are available), usage has increased sevenfold.



Source: Securities and Exchange Commission online in September 1995. In January 1997, 61,000,000 files were downloaded from the EDGAR database. By March 1999, monthly usage had increased sevenfold to 427,000,000 files. (More recent data were unavailable, but usage is undoubtedly much higher today.)

The disclosure policies for bank filings are also way ahead of those of the insurance industry. Banks are required to file quarterly financial statements ("call reports") with the Federal Deposit Insurance Corporation (FDIC). The complete call report for any of the 9,058 institutions that filed with the FDIC for the quarter ending March 31, 2000 is available for free on the FDIC's website (www.fdic.gov). One year's worth of call reports, issued quarterly on CD-ROM, costs $1,816. The FDIC's website also contains historical data about the banking industry going back to 1934.

As part of our study on disclosure, we decided to get a little feedback from a legislator and a regulator to see what they had to say about our travails in getting insurance companies' annual statements. Peter Newell, an aide to Assemblyman Pete Grannis (who is chair of the New York State Assembly Insurance Committee), found the idea of putting annual statements on the Internet intriguing. He noted, however, that this "hasn't been an issue in the past because there hasn't been *consumer* demand for it."

Iowa's insurance commissioner, Terri Vaughan, chair of the International Association of Insurance Supervisors' Task Force on Enhanced Disclosure, also liked the idea. "International bodies are increasingly focused on transparency and enhanced disclosure, and on the financial stability and risk profile of all financial institutions," she observed.

Vaughan said that insurance regulators recognize the need for increased disclosure, and that rating agencies play an important role in making consumers aware of the risks inherent in the purchase of a policy.

Schiff's Insurance Observer has a simple view of insurance regulation: it doesn't work too well. Some areas are overregulated ("continuing education" for agents and brokers is one example of a big waste of time). There are plenty of insurance regulations on the books, but often the insurance departments are too underfunded—and hence too understaffed—to enforce them.

Insurance, which is regulated on the state level even though it's an interstate business, is also hurt by the powerful interests that influence regulation. If insurance were regulated on the federal level, local interests wouldn't have the same impact. Federal regulation would help to stem the "race to the bottom" in insurance regulation. (States now compete with each other, enticing carriers by having lax regulation.)

It's in the public interest for insurance companies' annual statements (and other public data) to be easily accessible. When insurance-company annual statements are available for free on the Internet, agents, brokers, policyholders, prospective policyholders, journalists, analysts, investors, and other insurance observers will be able to peruse what was once mostly unavailable.

The insurance industry is more than five years behind the SEC in disclosure practices. Insurance companies have the capabilities to post their annual statements on the Internet.

It's time for legislators and regulators to require them to do so.

Stalking the Elusive Annual Statement: A Survey of Insurance Companies

We called 17 insurance companies and asked for a copy of their annual statement. When speaking with the insurance companies' representatives, we specified that we wanted the *annual statement*, rather than the *annual report*. Nine companies sent us their annual statement.

	Did Company Send Annual Statement?	Comments	Identified Ourself As
Allstate	Yes	Agreed to send annual statement, but never did. We called a month later; this time they sent it.	Individual
Continental Casualty	Yes		Individual
Chubb	No	Refused to send annual statement.	Individual
Conseco Life	Yes		Individual
GEICO	Yes	Refused to send annual statement. We called several weeks later; this time they sent it.	Individual
Hartford Life	Yes		Individual
MassMutual	Yes		Individual
Metlife	No	Refused to send annual statement. Claimed they only send it to policyholders.	Individual
Mutual of Omaha	No	Refused to send annual statement. We called again, company agreed to send it, but sent *annual report* instead.	Individual
National Union	Yes	Sent annual statement twice!	Press
Nationwide Mutual	No	Refused to send annual statement.	Policyholder
New York Life	No	Refused to send annual statement.	Individual
Northwestern Mutual	Yes		Individual
Prudential	Yes		Press
State Farm	No	Refused to send annual statement. We called a month later, company agreed to send it, but sent *annual report* instead.	Individual
SunAmerica	No	Agreed to send annual statement, but sent *annual report* instead.	Individual
Travelers P&C	No	Agreed to send annual statement twice, but never did.	Individual