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A Bear Market in Hank Greenberg

Bring on the Bad News

On Monday evening at 8:23 p.m., AIG announced that it would take a $2.8 billion pre-tax charge ($1.8 billion after tax) to boost loss reserves, primarily for excess casualty and D&O claims from the 1997 to 2001 accident years.

AIG is a big company and can afford to take a big hit. The charge, however, will wipe out most of its fourth-quarter earnings and make 2002 the third year in a row in which AIG's earnings have stagnated. The charge has also wiped out a good deal of the confidence (or overconfidence) that investors had placed in AIG's ability to grow its earnings at a double-digit rate every year.

There's nothing necessarily wrong with an insurance and financial-services company whose earnings don't always grow (or sometimes shrink). Only wild optimists expect companies in cyclical industries to achieve 14% growth every year. The problem with many Wall Street analysts—and many investors who bought AIG's stock in recent years—is that they were wildly optimistic. Because AIG had a long string of earnings' increases, almost every analyst was willing to label the stock a "buy"—seemingly regardless of its price.

When we first expressed our concerns about the investment merits of AIG (in our October 1998 issue), its stock was in the low $40s. (It's now $51.70.) "Given the cyclicity and competitiveness in AIG's businesses," we wrote, "it strikes us that the company, as now configured, might have difficulty achieving the growth that's expected of it. Can any financial company—especially one this large—compound its earning per share at a 14% rate indefinitely? Can such a company always sidestep the risks inherent in commodity-like financial businesses? Perhaps, but at 23 times earnings, AIG's stock provides little margin for error."

Investors react badly to AIG's addition to loss reserves.

Let the record show that we were early. By August 1999, AIG's stock was in the $60s (about 28 times earnings and 430% of book value). "At one end of the insurance-stock universe there are a reasonable number of 'cheap' insurance stocks," we wrote. "Light years away, at the other end of the universe, is AIG...which is priced for perfection, or something close to that...We see a disconnect between the value of [AIG] and the [price] of its stock."

We were still too early. In September 2000, when AIG's stock was $86, we published an article entitled "Walk Softly and Carry a Big Multiple: An Extreme Price for Growth." AIG, we wrote, "is a great company whose stock trades at an extreme, optimistic, exuberant valuation that leaves little margin for safety." At that time, 21 of the 24 analysts who followed AIG rated it a "buy." (None rated it lower than "hold.") On April 5, 2001 we wrote another piece about AIG and explained why we felt that "the risk in owning AIG's stock was greater than the reward."

AIG's stock has now made a round trip from June 1998. Investors' changing perceptions are evident in the oscillations of AIG's share price: during this period it has traded as low as $34.56 and as high as $103.75. Fully diluted earnings per share from 1998 through 2002 have fluctuated far less: $1.92, $2.34, $2.52, $2.02, and $2.70 (estimated).

AIG is a fine company, and its size, importance, and financial strength are testaments to great achievement. Although AIG has tended to emphasize the steadiness of its earnings, investors may now wonder whether AIG is a "growth company" or merely a company that has grown but is exposed to the vagaries of the insurance and business cycles.

On Tuesday's conference call, Hank Greenberg referred to a "liability bubble" and a "dot.com bubble." He didn't mention that there had also been an AIG stock bubble.

In a "loss reserve study" it put out in conjunction with its announcement, AIG attempted to lay the blame for its $2.8 billion charge elsewhere: "Loss costs, and the number of class action lawsuits filed, have spiked in more recent accident years due to: 1) Irrational jury awards and liability inflation *that could not have been anticipated* in pricing (tort system out of control); 2) An explosion in medical costs and related liabilities; 3) The dot.com bubble and corporate governance-related issues that have affected D&O." [Emphasis added.]

AIG has been well aware of—and has disliked—the tort system for ages. At its 1986 annual meeting, for example, Greenberg discussed the tort system at length, criticizing "generous juries' awards." He continued: "If this country wants to have a tort system that is a lottery system, then they have to pay for it. The insurance industry—certainly not us—will not be picking up the tab for that kind of social thought. We believe that there should be some limits on pain and suffering awards... Some of the bizarre awards that have come down have made it very difficult for an insurer to price its product. How can we set rates for an insurance

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Editor and Writer . . . . David Schiff
Production Editor . . . . Bill Lauck
Foreign Correspondent . . Isaac Schwartz
Copy Editor . . . . John Cauman
Publisher . . . . Alan Zimmerman
Subscription Manager . . . . . . Pat LaBua

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: (434) 977-5877
Fax: (434) 984-8020
E-mail: Subscriptions@InsuranceObserver.com

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product where the losses may not appear for 10 or 15 years? It's very hard, today, to do that with any degree of accuracy. The whole liability field in this country has exploded."

Whatever one thinks of the tort system and so-called liability crisis, there is little doubt that AIG has benefited from it. The company has been an innovator, creating new products to deal with liability—products that wouldn't be necessary if there were no lawsuits. And the company is a leader is many casualty lines, including D&O. AIG has done a better job of pricing risk than most, and has shown restraint when prices were inadequate. It's a fact, however, that AIG's $2.8-billion charge stems from underwriting and reserving errors that AIG made in a difficult environment. There's no shame in having made mistakes, and AIG has a balance sheet that's more than sufficient to withstand a few billion dollars of losses here and there.

The investment community, however, doesn't like the idea that AIG can make mistakes that screw up a year's earnings. It had bought into the notion that AIG was a diversified growth machine whose sources of earnings were so diverse and inevitable that neither cycles nor adversity could stand in its way.

Fitch has now placed AIG's triple-A senior debt ratings on "rating watch negative," and Moody's has changed its ratings outlook from "stable" to "negative." Moody's has also placed AIG's main U.S. insurance subsidiaries' triple-A ratings under review for a possible downgrade.

Policyholders shouldn't be especially concerned about AIG's financial strength. Investors, however, should be a bit concerned. At times there are tradeoffs a company must make between growth and financial strength. Will AIG, for example, spend $5 billon or $10 billion to buy back stock if its shares trade down to 40? (Hank Greenberg, presumably, believes that AIG is *already* undervalued.) We suspect it won't, because Greenberg, wisely, is more concerned with financial strength—which ultimately gives a company flexibility—than employing additional leverage to increase earnings.

AIG hasn't been able to live up to the unrealistic expectations of many investors. But it's still a great organization with unique strengths. If AIG's stock declines a bit more (maybe 10% or 20%), we expect to be buyers.