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SCHIFF'S

INSURANCE OBSERVER

December 21, 2003
Volume 15 • Number 20

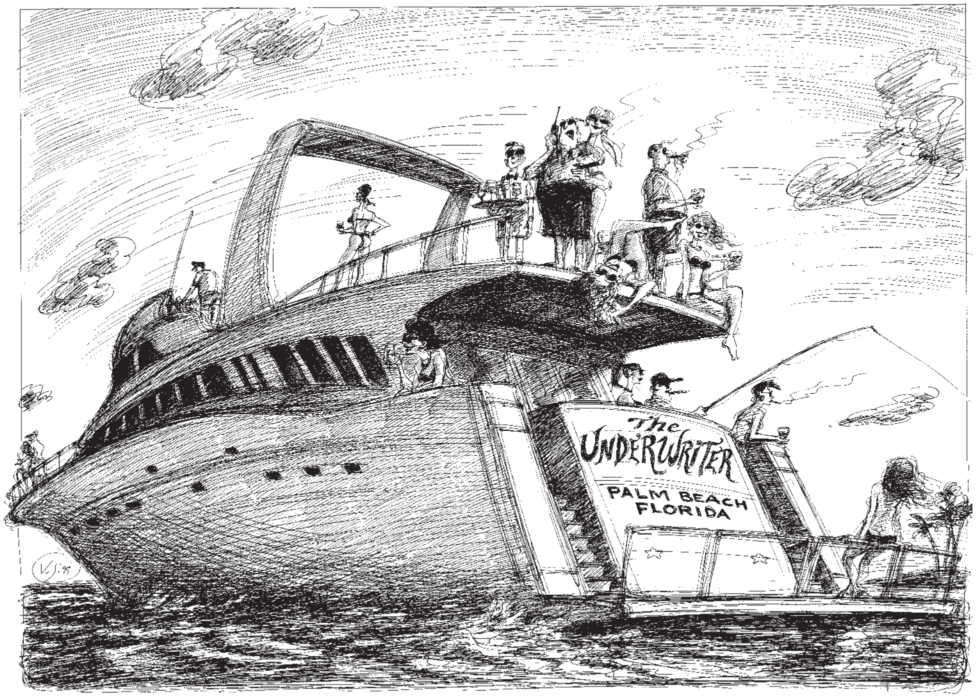
The Return of Irrational Exuberance

The Thrill is Gone

The insurance business appears quite good these days. Premiums have gone up sharply for several years. Reasonably well capitalized property-casualty companies have to do something very wrong to achieve poor accident-year results. You'd probably call this a hard market. Hank Greenberg, who runs one of the rare triple-A insurance companies, is not the sort of guy to shout "hard market" during a hard market. Based on speeches he's given recently, it sounds like his idea of a *real* hard market is one in which AIG is the only insurer still standing.

Of course, no one in the insurance business wants lower rates; insurers don't brag about their lack of underwriting restraint. The paradox of a hard market is that it sets the stage for a soft market. Good results make most insurance CEOs feel smarter; rising stocks prices make them feel richer. Before you know it, these smart, rich CEOs start to forget about risk.

So what? The insurance business has *momentum*. When current returns appear to be good—which is now the case—capital flows into insurance companies faster than Cristal flows at a P. Diddy soirée. According to our colleagues at SNL Financial, twenty-three insurance IPOs have raised a total of $12.81 billion in the last thirty months (not counting China Life's $3 billion IPO). Three insurance companies in registration are expected to raise about $1.4 billion. Several more big deals should be filed soon. One hundred and thirteen secondary offerings—common stock, preferred stock, and trust preferreds—have raised $13.52 billion since the beginning of 2002. Seven Bermuda start-ups raised $7.3 billion shortly after September 11, 2001.



"Discipline, Jenkins, discipline. That's the key to underwriting."

Clever new sources of financing have appeared. Small insurance companies have raised $1.5 billion this year via collateralized debt obligations (CDOs) created from pools of trust preferreds and surplus notes. Are the CDOs a good investment? Perhaps that's a foolish question. Maybe all that matters is that their spreads over Treasurys were wide enough to attract investors. But are these spreads enough (for investors)? Writing in the *National Underwriter*, F. Sherman Laughton, principal of WFG Capital Advisors, says these CDOs are a wonderful way for small companies to raise capital. "Even if the smaller insurers could access the capital markets on a stand-alone basis, the pooled capital offering does provide a substantial cost advantage to going it alone." According to Laughton, the CDO deals are a breeze for an insurer. "*Due diligence in a pooled capital offering is minimal* [emphasis added] and data is gathered from an insurance company via a questionnaire."

In August, Friedman Billings Ramsey raised $545 million in a private placement for Bermuda-based Quanta Capital Holdings. Two months later Quanta's U.S. subsidiary signed a 15-year lease for 57,000 square feet in Rockefeller Center. Quanta's niche is providing "specialty insurance, reinsurance, risk assessment and risk consulting products and services on a global basis."

Almost four years ago, on January 18, 2000, *Schiff's* published "The Insurance Business Stinks but Insurance Stocks are Cheap: A Visit to Graham & Doddsville." Internet stocks were soaring and insurance stocks were plunging. Although many have told us that we have a negative bias, here's what we had to say back then: "We're bullish on cheap [insurance] stocks with decent balance sheets, and have been a buyer of many over the last few quarters."

At that time, 96 stocks in SNL Financial's insurance DataSource were trading below book value. As we pointed out, many were "dicey" (Conseco, Fremont, Frontier, Paula, Reliance, and Superior National). But there were loads of perfectly good companies with respectable balance sheets trading at bargain prices. Here's a complete list of the stocks we mentioned, and their prices relative to book values: American Country (65%), Argonaut (64%), Capitol Transamerica (84%), Cincinnati Financial (99%), EMC Insurance (75%), LaSalle Re (78%), Loews (65%), NYMagic (58%), PXRE (48%), Arch Capital (70%), W. R. Berkley (75%), Zenith National (98%), Independence Holding (73%), MONY (80%), Baldwin & Lyons (93%), Donegal (52%), Harleysville (75%), Midland (77%), Old Guard (62%), and United Fire & Casualty (96%).

"When piles of securities are selling for substantial discounts to their liquidating values, something tends to happen," we wrote. What happened was that these good, ridiculously cheap stocks eventually stopped being so cheap. Four of the twenty companies listed above were taken over fairly quickly. The average total return for the remaining sixteen stocks has been 109% since January 18, 2000. During the same period the S&P 500 declined 22%. The SNL Life Index and P&C Index returned 57% and 69%, respectively.

We bring up these stocks' performance for several reasons, the first being that if you buy stocks that, for illogical reasons, are perceived as being so lackluster that they aren't worth buying even when they're trading at big discounts to conservative estimates of what they could be sold or liquidated for, you stand a good chance of making satisfactory returns with very low risk.

The prices of Internet stocks and insurance stocks in late 1999 and early 2000 said as much about the mad behavior of investors as it did about the prospects for insurance-stock investments. For many reasons—the perceived inevitability of Internet and technology stocks, the dismal prospects for the insurance business—investors were blind to the beauty of bland insurance companies that could earn decent—but not necessarily spectacular—returns.

Insurance stocks were perceived as a vast wasteland four years ago. Indeed, after our article they declined sharply for about seven weeks, making them even more compelling. Other solid companies that sold below book value then—and that we bought—included Allstate, IPC Re, and Investors Title. There were many others that were also cheap and selling for less than book value that we didn't buy for one reason or another. (It was a hectic time.) These included ACE, Aetna, Fidelity National, Old Republic, PartnerRe, Wesco, White Mountains, and XL.

In March 2000, a semblance of rationality began to return to the investment world.

Today's insurance-stock landscape is vastly different from that of four years ago. SNL Financial's insurance DataSource lists the stocks of fifty-two insurance companies currently trading below book value. But today's list is, for the most part, an assemblage of troubled companies with messy balance sheets and second-rate or third-rate businesses. Many are small and obscure: Cumberland Technologies, Standard Management, United Trust, and Yadkin Valley. Others are in poor shape: Trenwick, ESG Re, MIIX Group, and PMA Capital. Some have seen much better days: CNA, Phoenix, and UnumProvident.

The dearth of good, cheap insurance stocks tells us something about the future returns of the insurance industry as well as the state of the industry. Richly priced insurance stocks are the enemy of good operating results. When companies are able to tap the capital markets on advantageous terms they tend to do so, bringing money into the industry. The increased supply (aka "capacity") eventually meets demand, then exceeds it, forcing prices and profits down. (The whiff of softer pricing quickly elicits warnings from Hank Greenberg about underwriting profitability, tort reform, underreserving, and the need for discipline.) Of course, even if the insurance industry *could* fix prices, it couldn't fix supply. If investors believed that rates would stay at levels that offered good returns, new money would quickly enter the game to take advantage of that extra profitability, driving pricing down.

The insurance business is cyclical. Right now we're in the part of the cycle where things seem pretty good. But speculation is abundant. Most of the easy money has been made—at least for awhile. The risks have increased significantly for insurance investors and underwriters.

Sonny Liston was supposedly asked who he wanted to referee his fight with Floyd Patterson. "It doesn't matter," Liston said, "as long as he can count to ten."

Many things don't matter in the insurance business as long as you're aware of risk. It's no time to stretch for yield and higher returns. It is a time for caution. ■

To be continued tomorrow.

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