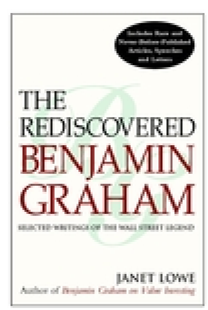
THE REDISCOVERED BENJAMIN GRAHAM *Lectures*

Lecture Number Eight

This is a transcript of a lecture from the series ***Current Problems in Security Analysis*** presented by **Benjamin Graham** at the **New York Institute of Finance** from **September 1946 to February 1947**. This content is found in abridged form in *The Rediscovered Benjamin Graham: Selected Writings of the Wall Street Legend* (Wiley, April 1999) by Janet Lowe. Alternatively, full html versions for all ten lectures are available on the publisher's website.



It follows that, in dealing with undervalued securities, the analyst is likely to become greatly interested in specific corporate developments, and therefore in proper corporate policies. And from being interested in corporate policies, he may pass over into being critical of wrong policies and actively agitating to bring about correct policies -- all of which he considers to be in the stockholders' interests. For it is true that in a fairly large percentage of cases the undervaluation in the market can be removed by proper action by or in the corporation.

Consequently, by insensible stages of reasoning, the specialist in undervalued securities finds himself turning into that abomination of Wall Street known as a disgruntled stockholder.

I want to say a word about disgruntled stockholders. The trouble with stockholders, in my humble opinion, is that not enough of them are disgruntled. And one of the great troubles with Wall Street is that it cannot distinguish between a mere troublemaker or "strike-suitor" in corporation affairs and a stockholder with a legitimate complaint which deserves attention from his management and from his fellow stockholders.

*** QUESTION: In connection with investment income, isn't it possible that the method in which that is determined might be conservative? In other words, investment income, as I understand it, would probably be income from interest, dividends, and excluding capital appreciation.

MR. GRAHAM: Yes. I am glad you raised the question, because I omitted any reference to the question of capital appreciation or depreciation in insurance company investments.

Speaking about that I would like to go back to the reasons for the popularity of insurance company shares in the 1920's. The analyses that used to be made at that time indicated that the insurance stockholder was a very fortunate person, because he had three different and valuable sources of income. One was the insurance business, which was supposed to be a very good industry, although there was no analysis of how much it contributed in earnings in those days. It was taken for granted that it was a good business for the stockholder.

Then it was said that you got the interest on money, not only your own money, but you got interest and dividends also on a lot of money that the policyholders had left with you in the form of unearned premiums and unpaid losses, and so on. Thus, for every dollar of your own, you had a total of about two dollars working for you, drawing investment income.

The third advantage was that you had extremely capable investment managements putting your money in securities and making a lot of profits for you.

Of course they made profits for you in the 1920's when the market was going up, and of course they lost a great deal of money in the early 1930's when the market was going down. The same thing happened in 1937-38, when they made a lot of money up to March '37, then they lost a great deal in the ensuing decline.

The net of all this history, I am pretty sure, is that today's sophisticated investors are not willing to pay very much for the ability of insurance managements to make capital gains for them over the years. It turns out that we do not have the type of check-ups and careful analysis of insurance company investment results that we have in the case of investment trusts, because the business does not lend itself so easily to that kind of thing. But it can be done. I am going to give you some figures on American Equitable Insurance Company over a 20 year period, to indicate how that company made out of that period of time with its investments as well as with its underwritings.

But on the whole, just answering the specific question asked, no investor today -- and I don't think any analyst -- is willing to give the insurance business any special credit for ability to make profits on the principal value of its securities. It will make profits in good years and it will lose money in bad years from that department. That may be doing it an injustice; but that I am sure is the general opinion of security analysts at the present time.

*** QUESTION: Would you care to take a minute to differentiate between premiums and underwriting profit? That is a little technical. What is underwriting profit?

MR. GRAHAM: Underwriting profit is the profit earned from the insurance business as such. It consists of the balance left after you pay the losses and the expenses of the underwriting business. It includes, moreover, a certain component known as the increase in the unearned premium reserve, which is a technicality. It is generally accepted that the liabilities shown on the balance sheet for "unearned premium reserves" include, to the extent of 40 per cent ordinarily, an amount that is really the stockholders' equity. When that figure goes up, the insurance profits for the year are increased accordingly, and conversely. Thus you really have two parts to your underwriting results: One, the straight result, and the other the equity in the increase or decrease in the unearned premium reserve.

I do want to say something about the method of calculating liquidating values, or equities, in this business, but I will delay that for a while.

QUESTION: What of the possibilities of increasing the underwriting profits, rather of raising rates in underwriting business? You always get a lull after a war, when the insurance on property has to be marked up after the replacement value advance.

MR. GRAHAM: In answering that question now, I would like to distinguish very sharply between recent results and long-term average results. The recent results of the fire business have been bad. Most companies, I think, showed losses for 1946 -- the figures are not out yet -- and about half of them, perhaps, showed losses for 1945. The results that I have been dealing with have been ten-year average figures, and I think that they pretty fairly represent what you can expect over the years in the insurance business. It may be that the results will be a little better in the next ten years than they were in the last ten years, but I don't believe that an insurance analyst or an investor ought to count particularly upon that. He should count upon their being better in the next five years than they were in the last two or three, which is of course a different matter.

QUESTION: Why do companies like the American Reserve or even the North River stay in business, then?

MR. GRAHAM: The North River Company stays in business, of course, because it has been in existence for 126 years, and has built up a large business, which has increased over the years, which has been satisfactory to the people running the business, to its agents, and to its policyholders. Whether it is now satisfactory to the stockholders I don't think has ever been asked, and I don't think such questions are asked in any of these companies.

I have read a number of reports of fire insurance companies to their stockholders. They consist generally of a one-page balance sheet and a few pages listing the securities owned. The question of how profitable is the business, is just not discussed. I suppose it would be ungentlemanly to raise the point.

QUESTION: Do your figures here show underwriting profit as reported, or is some adjustment made such as the Best adjustments for unearned premiums?

MR. GRAHAM: These include the unearned premium adjustment, which is pretty standard. In fact, the companies themselves, in many cases, indicate what that amounts to in their discussions at their annual meetings. It is really standard procedure In the casualty business there is still another adjustment, which I will mention later on -- the difference between one kind of reserve and another kind of reserve method.

QUESTION: Well, one of the reasons for stockholders not knowing anything about insurance companies is the fact, that I think, until recently they didn't publish any profit or loss statements. They just gave balance sheets on the statement, just like the bank did.

MR. GRAHAM: Yes. If I were a stockholder in an insurance company, I would like to know whether the business was profitable enough, and I would ask. But apparently the stockholders in the insurance companies don't ask that question, to the extent of requiring that the figures be analyzed or presented in the annual reports.

The casualty companies, interestingly enough, tend to publish rather elaborate reports, with a good deal of information. One reason, perhaps, is that the casualty business has been quite profitable in the last ten years.

QUESTION: Don't you think the stockholders' complacency is caused by the fact that the early investor in insurance companies -- such as continental, or what is called the "Home Group" -- has done very well over the last twenty years with his money. Whether he has been lulled to sleep is another thing, but I think that has been the cause of it.

MR. GRAHAM: I am not in a position to tell you what happened in the last twenty years to every one of these companies. But I do know that in the fire group some companies have done very badly for twenty years; and a company like North River, which I believe is pretty representative, has started off doing very well and is finishing up in a situation which does not permit it to do really well for its stockholders. I don't believe that this analysis would be subject to much change if you took other companies. You might find one or two exceptions, such as the St. Paul Fire and Marine. But they are extraordinarily few.

QUESTION: Is the competition of mutual a factor here?

MR. GRAHAM: I don't know whether that really is a factor. It might be. But the insurance companies endeavor to obtain higher rates when they need them by application to the various insurance boards, and there is always a lag in getting them.

QUESTION: The solicitors for the mutual insistently cite expenses cheaper than the stock company. That is one of their big points. That is to say, in the form of commissions to agents. Net costs to the policy holder.

MR. GRAHAM: I shouldn't be surprised if that were so. There is reason to believe that the scale of commissions paid on fire insurance policies has been too high -- the commissions paid to agents. It doesn't take a great deal of salesmanship in my opinion to sell a fire insurance policy. It does take quite a bit perhaps to sell a life insurance policy. The fire commissions have been pretty large, and I think that in some cases recently the state insurance departments have hesitated to permit premium raises on the ground that the commissions to agents have been too high. At least so I am informed, but I will not state that as a fact.

QUESTION: The casualty men always stress cost to the policyholders.

MR. GRAHAM: In the mutual, too? Well, in the casualty field, in spite of the competitions with the mutual companies, the stock companies have been able to earn a very considerable sum of money for their stockholders. Are there any other questions about that?

QUESTION: To get back to a point that might be elementary. I am not at all familiar with these industries. You have 1927 and 1945 statistics on the board. I can see why there has been a decline in investment income; but even if it is repetitious, will you explain why there has been that sharp decline in underwriting profit, and whether that is a transitory situation or will it continue?

MR. GRAHAM: The decline in the underwriting profit of North River is due to two factors: One is the profit per dollar of insurance written, which went down from about six per cent to four per cent for those two years. It is difficult to say whether that is a permanent thing or not. I am inclined to think that there is a slight tendency for that rate to go down through the years.

The more important fact is that the amount of premiums written by this company, per dollar of stockholders' equity, has been cut in two. Therefore, with the same rate of profit you would only earn half as much on your stock. That is just like saying you now have only 50 cents of sales per dollar of capital, instead of a dollar of sales.

The reason for that is very interesting, and I would like to comment on it a bit. What has happened is that these companies have built up their stockholders' equity in various ways in the period to a much greater extent than they built up their premiums. The result is that from the standpoint of good results for the stockholders, they seem to have much too much capital per dollar of business done in 1945.

Of course, the insurance companies will insist that is not true. They will say that the more capital they have the better the policyholders are, and therefore the better the stockholders are. They will also say that they expect to do very much more business in the future, and therefore they should have the capital available for the expanding business. But the fact remains that in dollars and cents you have the situation that the North River Company had $25-million of stockholders' capital and did about $9-million of business in 1945, which is a very small amount of business per dollar of capital. In 1927 they did a somewhat larger amount of business with less than half the amount of capital.

No attention has been paid to that matter by anyone, that is by any stockholder. As far as the management is concerned, the more capital they have, the better off they are. There isn't the slightest doubt about that.

QUESTION: Haven't they got more money to invest in stocks?

MR. GRAHAM: They have more money to invest in stocks, but that is no special advantage to the stockholder because he has more money of his own invested. The question is what about the rate of return, and that has gone down too, of course.

There is a better answer to your question. Because they have more capital, the amount of investment per dollar of capital goes down. The reason is that in addition to investing the stockholders' capital they invest other moneys that come out of the conduct of the business. The more capital there is in relation to the business, the less proportionate excess do they have. That is shown in this figure: In 1927 they had $1.45 of invested assets per dollar of stockholder's capital, and now they have only $1.18. So they lost out in that respect too.

Now, I might suggest that somebody should raise the question, "What can the stockholders do to get a decent return on their investment on the North River Insurance Company?" Let us assume it was a matter for the stockholders to decide, which would be a very extraordinary suggestion for anyone to make -- elementary as it sounds in theory. Here is a possible answer: Suppose you re-established the relationship between capital and premiums that existed in 1927, when things were quite satisfactory, by simply returning to the stockholders the excess capital in relation to the business done. If you did that, you would be able to get the earnings of about six per cent on your capital and to pay the four per cent dividend on your capital, which I suggested might be a definition of a reasonable return to the stockholder. That could happen because, when you take out $15 a share from the present $31 -- and you have left only $16 to earn money on for the stockholder -- you are reducing your earnings only by the net investment income on the $15 withdrawn, which is on the order of, say, 40 cents at the most. Thus you would earn about 85 cents on the remaining investment of $16 and you would get reasonably close to the six per cent which you need.

That is a method that will not recommend itself to insurance company managements, but which at least has some arithmetical validity as far as the stockholders are concerned.

Are there any other questions about this analysis with regard to the North River Company?

QUESTION: I don’t quite understand. What is the reason for the decline in the volume, dollar volume, of premiums underwritten? Is it a question of growth and competition in the industry? Would you not expect the over-all dollar amount of premiums to increase over a period of 20-odd years?

MR. GRAHAM: The situation is this: For the country as a whole net premiums written by fire companies grew in volume from $966-million in 1927 to $1,226-million in 1945. That would represent an increase of about one-third.

The North River Company had $9.1-million in premiums in 1945, and $10.9-million in 1927. That was a reduction of about 16 per cent. It is pretty clear that the North River Company individually went back in that period of time. Many of the other companies, which increased their premiums, however, increased them by absorbing other companies over the 20-year period. Also a good deal of the insurance written was taken by new fire subsidiaries of casualty companies, and so on. It may well be that the typical company which didn’t go through corporate changes, but just stuck to its old setup, might have had a situation not so different from the North River Company, namely, a decline in premiums.

It is important to point out that the rate of premiums per $1,000 of insurance went down very much from 1927 to 1945. The companies gave more to the policyholder for their money. The result is that their premium income suffered, and does not reflect the true growth in the amount of coverage extended.

QUESTION: Did North River sell additional shares during that 18-year period?

MR. GRAHAM: Yes. I made an error in my previous statement that I want to correct. I said that the North River Company had retained its old position. That was not right. They took over another company, which represents about one-fifth of their total capitalization. That means they added about 25 per cent, presumably, to their business by absorbing another company in that period of time, so they should have shown an increase in their business. Exactly why this company didn’t do it, I don’t know.

QUESTION: Isn’t the North River one of a group of companies?

MR. GRAHAM: Yes, it is operated by the Crum and Forster organization.

QUESTION: They may have stuck the premiums in some of their other companies.

MR. GRAHAM: That might be the reason. That is another interesting question that arises in the treatment of stockholders’ interest by insurance company managements. Many of the insurance companies are part of so-called “fleets” or groups of companies, and you find some very surprising things in those fleets. Some of the companies tend to be quite profitable, and others in the same group tend to be unprofitable. When you ask for an explanation, as I have done in one case, you may be a bit surprised at the kind of explanation you get. The thing that surprises me always is that the insurance people never talk in terms of what happens to the stockholder. They always talk in terms of what happens to the business as such. You can find many business reasons why Company A should be profitable and Company B should be unprofitable -- but no reason that will satisfy the stockholder of Company B, in that case.