

Equity Research

INSURANCE RESEARCH

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MONTHLY INSURANCE REVIEW

FIRST QUARTER RESULTS

The Insurance Information Institute (I.I.I.) and the Insurance Services Office (I.S.O.) just reported first quarter industry results, coming in even better than our predictions, made in the April Monthly. Results are summarized on page 2.

As we estimated, premium volume continued to decelerate and was only up 4.5% from the year ago period. Commercial property rates began to decline last year in response to the excellent underwriting results and have continued to decline this year. Personal auto rates have generally remained flat, with some selective price cuts in certain states by some companies, also in response to the excellent underwriting results. Homeowners' rates also have slowed, in response to excellent underwriting results; rates were up nationally only 2.8% last year and are probably showing similar results this year. Only commercial liability rates continue to advance, and even there, rate increases have also slowed dramatically. Apparently, rates overall are now increasing more slowly than loss costs.

Additional Information available upon request.

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U.S. PROPERTY-LIABILITY INDUSTRY

(\$ MILLIONS)

<u>Property-Liability Operations</u>	<u>First Quarter</u>		
	<u>2004A</u>	<u>2003A</u>	<u>% Change</u>
Premiums Written	\$105,982	\$101,446	4.5%
Premiums Earned	100,312	93,638	7.1%
Change in Unearned Premiums	5,670	7,808	
Loss and Loss Expense	68,386	70,067	-2.4%
Underwriting Expense	26,279	24,763	6.1%
Policyholder Dividends	290	336	-13.7%
Statutory Underwriting	5,357	(1,528)	
Change in DPAC	1,418	1,952	-27.4%
G.A.A.P. Underwriting	6,775	424	
Underwriting After-tax *	4,403	276	
Tax Rate on Underwriting	35.0%	35.0%	
Net Investment Income	9,414	9,220	2.1%
Investment Inc. After-tax *	6,966	6,819	2.2%
Effective Tax Rate	26.0%	26.0%	
Pre-tax Income	16,189	9,644	67.9%
<u>Taxes</u>	<u>4,819</u>	<u>2,550</u>	<u>89.0%</u>
Operating Income	\$11,370	\$7,094	60.3%
<u>Realized Gains</u>	<u>2,220</u>	<u>703</u>	<u>216.0%</u>
Net Income	\$14,021	\$7,797	78.9%
Catastrophe Losses	\$895	\$1,500	-40.3%
Dividends Paid	2,000	1,900	5.3%
Reserves	\$427,970	\$401,921	6.5%
Cash Flow	\$17,178	\$19,097	-10.0%
Surplus	\$361,177	\$289,343	24.8%
Premiums/Surplus	1.1	1.3	
Operating Return on Ave. Equity	12.6%	9.8%	
<u>RATIOS</u>			
Loss Ratio	68.2%	74.8%	
<u>Expense Ratio</u>	<u>24.8%</u>	<u>24.4%</u>	
Combined Ratio	93.0%	99.2%	
<u>P.H.D. Ratio</u>	<u>0.3%</u>	<u>0.4%</u>	
Combined Ratio After P.H.D.	93.3%	99.6%	
Catastrophe Losses (% of E.P.)	0.9%	1.6%	

* Estimated

SOURCE: Insurance Services Office and Nutmeg Securities, Ltd. Estimates.

Underwriting results in the first quarter also were somewhat better than expected and were the best since the industry began keeping quarterly statistics since 1986. The combined ratio of 93.3% represents that everything went right for once. Catastrophe losses, at less than \$1 billion, were well below normal and significantly below last year's levels. In both personal auto and homeowners' lines, claim frequency continued at well below last year's levels, producing combined ratios for companies in the 80's and even 70's respectively, much better than the assumptions built into the premium rates. Even in the area of prior years' reserving, the industry apparently released \$1.8 billion of reserves in the quarter, as opposed to the increases in reserves that the industry made over the last several years; the release of reserves reduced the combined ratio by an additional 1.8 points. All the favorable factors produced \$5.4 billion of statutory underwriting profits compared to a \$1.5 billion underwriting loss last year.

Investment income also continued its modest growth. Positive cash flows offset declining interest rates and produced only a 2.1% gain. Although the stock market been going sideways for most of this year, the gains from last year were reflected in another quarter of significant realized gains for the industry.

Overall, adjusted operating earnings were \$11 billion, up 60% from last year, producing a return on equity for the industry for the quarter of 12.6%. Surplus also reached another record of \$361 billion, aided by retained earnings and by further increases in unrealized gains. While this return is much better than it has been for many years, it still is only approximately what the average industrial company produces. Moreover, returns are not evenly spread; there are still many companies with low single digit returns that remain under severe financial pressures.

SECOND QUARTER OUTLOOK (Page 5)

Reporting of second quarter results begins in about a week. Our estimates for the industry for the second quarter and first half are shown on page 4. This year's confession season was quiet, with only **Cincinnati Financial (CINF - \$43.45)** pre-reporting a good second quarter, even in the face of higher catastrophe losses. Overall, catastrophe losses will be much lower than a year ago; the I.S.O. indicated that through the next-to-last week in June, losses this year were only \$1.5 billion, compared to the \$5.1 billion reported last year.

We expect further modest premium growth in the second quarter. Rate increases in most lines have ceased and some modest rate cutting appears to be occurring, especially in short-tail lines and in the always-competitive personal auto market. Given that rate increases enter the earned premium and underwriting account on a lagged basis due to the industry's accounting, past rate increases are still not fully reflected in underwriting results.

There were no major reserve additions announced this quarter. Consequently, we expect the industry to report a combined ratio approaching the 95% level, unless there are further reserve releases, in which case, the combined ratio is likely to be as low as the first quarter. That compares to about the break-even level reported in the year-ago quarter. The continued improvement in underwriting results stems from the impact of last year's commercial rate increases and most importantly, the lower personal auto claims frequency, as well as the impact declining homeowners loss frequency. This should produce a return on equity for the industry of about 11% for the quarter and 11.6% for the first six months.

Investment income is likely to increase again modestly, mirroring the performance of recent quarters. Cash flow is significant, as shown by the \$18 billion positive cash flow in the first quarter and the estimated \$38 billion cash flow for the second quarter. Investment income would have been even more improved except that interest rates have declined to the lowest level in 45 years, so that new money is producing significantly less investment income and maturing and called investments are being replaced at much lower yields. Recent modest increases in long-term rates will help alleviate the pressures on investment income, but many insurers have significantly reduced their portfolio durations, sacrificing current investment income to protect asset values. We also estimate that realized gains should again be moderate; up slightly from the \$2 billion reported last year and probably in line with first quarter's results.

We also expect further positive change in the industry's surplus to new record levels. The industry's surplus remains at a high level, but the overall results belie the immense pressures that many smaller to mid-size companies are suffering. The low level of interest rates is also putting pressures on returns, but will likely have a positive effect as companies will have to reflect the lower returns in their pricing.

It now appears as if the second quarter will mark the peak of the cycle. Auto claims frequency appears to have leveled out, and while it remains below last year's levels, projections indicate that by the third quarter it will be much closer to last year's levels and by the fourth quarter it should be at levels equal to last year. Since there have essentially been no rate increases (net) this year, and severity continues to run at about 5%, we expect that third quarter auto results will be below the second quarter's levels and the fourth quarter's results will be below last year's levels. Since auto represents about 36% of the industry's premium volume, these results will have a significant influence in overall results. Additionally, we have been extremely lucky over the last two years in terms of catastrophe losses and catastrophe reinsurance pricing has declined precipitously to reflect that fact. If catastrophe results return to normal, there will be further downward pressures on underwriting results.

U.S. PROPERTY-LIABILITY INDUSTRY

(\$ MILLIONS)

<u>Property-Liability Operations</u>	<u>Second Quarter</u>			<u>First Half</u>		
	<u>2004E</u>	<u>2003A</u>	<u>% Change</u>	<u>2004E</u>	<u>2003A</u>	<u>% Change</u>
Premiums Written	\$107,500	\$101,382	6.0%	\$213,482	\$202,828	5.3%
Premiums Earned	104,000	96,381	7.9%	204,312	190,019	7.5%
Change in Unearned Premiums	3,500	5,001		9,170	12,809	
Loss and Loss Expense	72,500	72,062	0.6%	140,886	142,129	-0.9%
Underwriting Expense	26,875	25,197	6.7%	53,154	49,959	6.4%
Policyholder Dividends	520	304	71.1%	810	640	26.6%
Statutory Underwriting	4,105	(1,182)		9,462	(2,709)	
Change in DPAC	875	1,250	-30.0%	2,293	3,202	-28.4%
G.A.A.P. Underwriting	4,980	68		11,755	493	
Underwriting After-tax *	3,237	44		7,640	320	
Tax Rate on Underwriting	35.0%	35.0%		35.0%	35.1%	
Net Investment Income	9,550	9,048	5.5%	18,964	18,268	3.8%
Investment Inc. After-tax *	6,876	6,515	5.5%	13,842	13,333	3.8%
Effective Tax Rate	28.0%	28.0%		27.0%	27.0%	
Pre-tax Income	14,530	9,116	59.4%	30,719	18,761	63.7%
<u>Taxes</u>	<u>4,417</u>	<u>2,531</u>	<u>74.5%</u>	<u>9,236</u>	<u>5,137</u>	<u>79.8%</u>
Operating Income	\$10,113	\$6,585	53.6%	\$21,483	\$13,624	57.7%
<u>Realized Gains</u>	<u>2,600</u>	<u>2,196</u>	<u>18.4%</u>	<u>4,820</u>	<u>2,954</u>	<u>63.2%</u>
Net Income	\$12,713	\$8,782	44.8%	\$26,303	\$16,577	58.7%
Catastrophe Losses	\$1,500	\$5,100	-70.6%	\$2,395	\$6,300	-62.0%
Dividends Paid	2,300	2,100	9.5%	4,300	4,000	7.5%
Reserves	\$435,000	\$407,335	6.8%	\$435,000	\$407,335	6.8%
Cash Flow	\$38,409	\$39,411	-2.5%	\$52,528	\$51,088	2.8%
Surplus	\$371,590	\$312,455	18.9%	\$371,590	\$312,455	18.9%
Premiums/Surplus				1.1	1.7	
Operating Return on Ave. Equity	10.9%	8.4%		11.6%	8.7%	
<u>RATIOS</u>						
Loss Ratio	69.7%	74.8%		69.0%	74.8%	
<u>Expense Ratio</u>	<u>25.0%</u>	<u>24.9%</u>		<u>24.9%</u>	<u>24.6%</u>	
Combined Ratio	94.7%	99.6%		93.9%	99.4%	
<u>P.H.D. Ratio</u>	<u>0.5%</u>	<u>0.3%</u>		<u>0.4%</u>	<u>0.3%</u>	
Combined Ratio After P.H.D.	95.2%	99.9%		94.3%	99.8%	
Catastrophe Losses (% of E.P.)	1.4%	5.3%		1.2%	3.3%	

* Estimated

SOURCE: Insurance Services Office and Nutmeg Securities, Ltd. Estimates.

CAPITAL MARKETS

The capital markets continue to be favorable for the industry. Companies continue to refinance their debt securities, taking advantage of the current low interest rate environment, replacing old debt at much lower interest costs.

However, relatively little new equity capital has been raised recently. The only two major issues currently in registration are secondary issues. **St. Paul-Travelers (STA - \$40.47)** has announced plans to sell 6 million share of **Platinum Underwriters (PTP - \$30.36)** that they retained when PTP was spun out of STA in 2002. Also **Fairfax Financial** has announced plans to sell up to 3.5 million shares of **Zenith National (ZNT - \$48.82)**. Fairfax bought the stock from **Reliance** in the late 90's and has sat on the 40% ownership through the tough times. Since Fairfax has continued to try and disclaim control of ZNT, the sale represents a significant reduction in their ownership and liquefying a significant portion of their holding. They will use the proceeds to strengthen their other insurance operations. We continues top recommend purchase of Zenith as the company is likely to continue to benefit from the reform in the California workers' compensation market put in place late last year and early this year. The outlook for the market has induced AARIS to cancel its contract to write California workers' compensation insurance through **Everest RE (RE - \$ \$80.16)** effective this October and will then write the business through National Indemnity, a subsidiary of Warren Buffett's, **Berkshire Hathaway (BRKB - \$2,955)**.

STOCK PRICE PERFORMANCE

The stock market continued its sideways movement in June, driven by the expectations of improved strength in the economy that offset by the expectation of higher interest rates and the unsettled geo-political situation. Insurance stocks continued to perform slightly worse than the general market, with the positive outlook for property-liability earnings and improved equity levels (for the life insurers) being the positive influences. Insurance stocks have generally traded inversely with interest rates. We still surmise that the reason has less to do with the effect of rising interest rates on bond portfolios than the fact that rising interest rates generally occur in strong economic environments when the insurers' relative earnings look weak compared to industrial earnings.

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Given the changes in research practices, we will in the future be ranking the companies we cover in terms of relative performance to their peer companies, with rankings of outperform (O), market perform (M) and under-perform (U). We base these rankings on the expectation of the performance of the stock, relative to its peers over a 12-18 month time period.

Disclosure

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