GRANT'S

INTEREST RATE OBSERVER®

Vol. 40, No. 17c 233 Broadway, New York, New York 10279 • www.grantspub.com SEPTEMBER 16, 2022

Stock with a story

Evan Lorenz writes:

It almost tipped the Great Recession into a global depression a decade-and-a-half ago, but American International Group, Inc. (AIG on the New York Stock Exchange) may prove to be a port in the storm of persistent inflation, rising interest rates, declining growth, war and Kim Kardashian's entrée into private equity. On the mega-insurer, in preview, *Grant's* is bullish.

With or without a true-blue recession, business activity in this country is cooling faster than the measured rate of inflation. Even so, stagflating America is a beacon of hope in comparison with most of its trading partners. A collapse in the Chinese housing market and continued Covid lockdowns are rocking the People's Republic, energy shortages are shutting European factories and flagging domestic demand, in company with the ever-appreciating dollar, is punishing emerging markets.

Making sense of insurance in this context is no simple matter. Assuming a minor recession and a 6% inflation rate next year, Fitch Ratings warns of lower profits on the back of weakening property and casualty insurance rates and costlier claims. In other words, "a potential modest recession will outweigh the benefits of a rising interest rate environment on investment performance." In contrast, life insurers may reap the benefits of higher reinvestment rates, or so says the Fitch analysis.

"If the economy goes into a recession and employment falls, then you have lower workers' compensation premiums," Steve Virgili, a portfolio manager at the insurance-focused fund New Vernon Wealth Management, LLC and a holder of AIG, tells me. "You have business closings and bankruptcies. That could put pressure on overall premiums."

But don't forget the silver lining: "If there is less economic activity," says Meyer Shields, who rates AIG a buy for Keefe, Bruyette & Woods, Inc., "then losses don't happen. Car accidents don't happen. Work place injuries don't happen. Net-net, you probably come out slightly ahead on underwriting profit."

Put another way, insurance is *of* the economy but not entirely *in* it, and the insurance cycle is separate and distinct from the business cycle. A decade's worth of low interest rates and elevated jury awards have lifted insurance prices, which have, indeed, climbed faster than consumer prices (*Grant's*, March 4). The June quarter marked the 19th in a row of year-over-year upticks in global insurance composite pricing, according to Marsh & McLennan Cos., Inc. While increases have moderated to the 9% range from a peak of 22% in the final three months of 2020, the industry is still pricing ahead of the CPI.

It's another point in the bulls' favor that the capital with which to soak up extra risk is shrinking. Losses on investment portfolios were instrumental in trimming global reinsurance capital by 11% in the first half of 2022, according to reinsurance broking and advisory firm Gallagher Re. Not coincidentally, reinsurance rates have been surging, up by almost 15% for renewals in the first seven months of the year. Reinsurance broker Guy Carpenter & Co., LLC calls this "the most significant shift since 2006."

Inflation, at the same time, has raised the value of risks that individuals and companies seek to protect, and that, in turn, has stoked the demand for reinsurance. Lara Mowery, Guy Carpenter's global head of distribution, tells news organization Insurance Insider that the demand for reinsurance by primary underwriters will "be 'multiples' of the typical 3%–5% expansion that has previously easily been accommodated by insurers." Perhaps, since primary carriers use the reinsurance market to offload risks, elevated reinsurance pricing will flow through to primary insurance rates.

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This isn't the first time that *Grant's* has smiled on AIG. In the March 7, 2008 issue, we called the disaster-bound giant a buy before returning to our senses two months later and issuing a timely recantation (see the issue of *Grant's* dated May 16, 2008).

When, at length, AIG required a bailout, Uncle Sam wrote checks for $182.3 billion, giving this country a 79.9% stake in its corporate problem child. Taxpayers eventually reaped a $22.7 billion profit on their involuntary investment, in the first place through selling down AIG stock, and in the second place through AIG's sales of its own business units, including AIA Group Ltd., now the largest listed life insurance company in the Asia-Pacific region.

Measured by balance sheet footings, AIG is half the company it was—$538.9 billion as of June 30, down from a peak of $1.05 trillion at year-end 2007. Even so, it remains one of the world's biggest insurers, and it comes in three parts:

On the rebound

source: The Bloomberg

general insurance ($4.8 billion in trailing adjusted pretax profits), life and retirement ($3.1 billion) and "other" (a deficit of $2.1 billion).

Commercial coverage, at last report, made up 68% of a highly diversified general insurance business, of which 54% was sourced outside North America. AIG's specialty is large and complex risks; in its personal business lines it focuses on high-net-worth individuals. The life and retirement business includes individual retirement (31.8% of the unit's second-quarter revenues), life insurance (32%), institutional products (19.4%) and group retirement (16.8%). Loss-making "other" is a miscellany of corporate overheads, portfolios in runoff and such.

AIG's release from federal confinement took place over the past 10 years. In 2012, the Treasury sold its last shares. In 2017, the Financial Stability Oversight Council decided that the company, after all, was no longer a "systemically important financial institution." However, if AIG was no longer a threat to the world, neither was it a thriving enterprise.

Insurers measure their profitability by the so-called combined ratio, which divides the sum of operating expenses and the costs to settle claims by premiums earned. A ratio of more than 100% means that a carrier is losing money on the risks it underwrites. From the vantage point of 2017, it had been 10 long years since the property and casualty insurance unit had achieved a reading of less than 100.

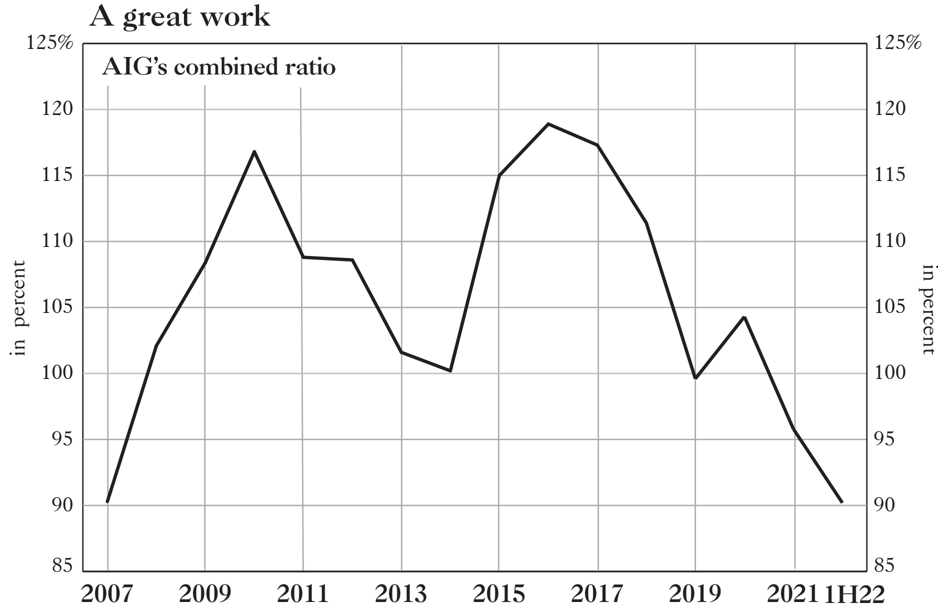
Carl Icahn, taking notice and deriding the giant as "too big to succeed," demanded that the P&C and life units be reorganized as separate companies. In response, the board of directors hired a new chief executive, Brian Duperreault, a former AIG chief actuary and all-around executive star who, upon leaving the company in 1994 after 21 years of service (there then being no sign that the incumbent CEO, Maurice R. "Hank" Greenberg, was prepared to cede him the top spot), joined ACE Ltd., an AIG competitor, and turned that business into a dynamo. Among the accomplishments on Duperreault's curriculum vitae is the revitalization of insurance brokerage firm Marsh & McLennan Cos., Inc. from 2008 to 2012. The new broom quickly recruited executives from other firms, including Peter Zaffino, the former chairman of risk and insurance at Marsh & McLennan.

"Turning around an insurance company is incredibly difficult," Shields tells me. "It's harder than maintaining a good insurance company because it is not easy to diagnose things and figure out what is going wrong. In other words, your losses are too high, but is that because your pricing is wrong? Because you don't know how to select better risks from worse risks? It could be a million things, like your relationships with agents are bad."

Zaffino was exactly the detail-oriented individual for the job. Former colleagues at Marsh & McClennan were quoted in a 2020 *Insurance Journal* article as marveling at the way he'd stride around the office "with stacks of oversize pages printed with financial figures and key data." By the *Journal*'s telling, "Zaffino says he relished all the data he had on those sheets, which helped him decide whether to accelerate the business or slow things down."

From 2017 through the second quarter of 2022, the combined ratio for AIG's general insurance unit was trans-

A great work



source: company reports

formed to 87.4% from 117.3%; it was the first time in 15 years that the combined ratio had fallen below 90%. Under Duperreault and Zaffino, AIG reorganized general insurance into business units that could better compete in the market and focused the employees on underwriting profit. It increased the use of reinsurance (including the sale of captive reinsurer Fortitude Group Holdings, LLC to Carlyle Group, Inc.), instituted a cost-cutting-cum-IT-modernization program (which the company called "AIG 200") and reevaluated problematic lines of business. From year-end 2017 through 2021, AIG trimmed its headcount to approximately 36,000 from 49,800.

Doing less of what wasn't working—where the rewards didn't adequately compensate for the risks—was another part of the big AIG improvement program. P&C insurance comes in two general varieties: "admitted," which is heavily regulated by state departments of insurance, and "excess and surplus" (E&S), which is not. Thus, starting Jan. 31, AIG quit admitted homeowners' underwriting in California on the ground that it could not adjust rates fast enough to compensate for wildfire risks; as the E&S business presents no such impediment, the company remains in the Golden State to write that flexible kind of business.

Along the way, Duperreault stepped down as CEO (in March last year) and as chairman (in December), handing those roles to his handpicked successor, Zaffino. The amount of change the duo achieved in a few short years is nothing less than extraordinary: In his 2021 letter to shareholders, Zaffino noted that the company had reduced the value of risks it insures by over $1 trillion since he joined in 2017, a figure equal to 4% of U.S. GDP.

As of June 30, the balance sheet was lightly leveraged, with total debt (including preferred shares) equal to 31.1% of total capital. In keeping with insurance-ratings protocol, AIG is rated Baa2/triple-B-plus, the lower echelons of investment grade, at the holding-company level, while the insurance subsidiaries command the equivalent of single-A or better. (Moody's typically dings an insurance holding company by three notches in relation to the operating subs.)

After a decade under government supervision, AIG has not had the opportunity to get into much trouble. Certainly, it no longer insures bonds backed by swaths of subprime mortgages and its reserves appear to be conservatively invested. At the end of the June quarter, the investment portfolio footed to $283 billion and was primarily invested in corporate debt ($126.2 billion); various mortgage and mortgage-backed securities ($97.3 billion); government and municipal paper ($32 billion); a smattering of "other invested assets" ($14.1 billion), which consist of private equity and hedge funds; short-term investments ($9.3 billion); miscellaneous bonds ($3.6 billion) and equities ($0.6 billion). What one might denote as "other bonds"—speculative-grade or non-rated—summed to $22.6 billion.

Of the 13 analysts who cover the stock, seven say buy and none says sell. Short interest amounts to 1.03% of the equity float. It would be nice to say that the insiders are as bullish as we are but, over the past 12 months, they sold 31,646 shares for proceeds of $1.8 million.

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Despite AIG's turnaround over the past five years, the stock trades at just 9.8 forward earnings. It's a discount to well-run P&C insurers like Chubb, Ltd. and Travelers Cos., Inc., which change hands at an average of 12 times the next 12 months' earnings, but in line with life insurers such as MetLife, Inc. and Primerica, Inc., which trade at an average of 9.9 times the forward guesstimate.

The bull bond market taught investors to give life insurers short shrift. Retirement products like annuities guarantee a certain level of income. Decades of low and falling interest rates have made it difficult for insurers to pay that income and generate a profit.

However, Mr. Market has taken a shine to insurers that have divested their life businesses. On Jan. 27, 2021, American Financial Group, Inc. (AFG on the Big Board) announced the sale of its annuity subsidiary to Massachusetts Mutual Life Insurance Co. for $3.5 billion. Since the announcement, AFG has generated a 120.1% total return through a combination of buybacks and special dividends versus an 7.4% return for the S&P 500.

While higher rates may one day cause investors to rerate life insurers, AIG has decided not to wait. It's rather spinning out its life business, now renamed Corebridge Financial, Inc. Last winter, AIG sold a 9.9% stake in the business to Blackstone, Inc. for $2.2 billion and, after shelving plans to list Corebridge in April, filed paperwork with the Securities and Exchange Commission to proceed with the listing this month, albeit at a valuation of $15 billion versus the $22 billion implied value from Blackstone's purchase. According to the filing, AIG will sell an additional 12% stake in Corebridge to the market soon.

"[I]n our current plan," Zaffino told his audience on the Aug. 9 earnings call, "which includes the completion of the Corebridge IPO, we expect to reduce our share count to somewhere in the range of 600 million to 650 million shares, while maintaining [total debt to capital] leverage in the 20%–25% level along with strong capitalization at the industry subsidiary company level." For reference, AIG's current share count is 771.3 million. Longer term, the company plans on using the proceeds of the sale of its 78% post-IPO stake in Core-

AIG at a glance

all figures in $ millions except ratios

	TTM*	2021	2020	2019	2018
revenue	$57,171	$52,057	$43,736	$49,746	$47,389
pretax profits	17,380	12,099	-7,293	5,287	257
net income	12,680	9,359	-5,973	3,326	-6
combined ratio	94.5	95.8	104.3	99.6	111.4
equity	46,824	68,912	67,199	67,427	57,309
total assets	538,938	596,112	586,481	525,064	491,984

* Trailing 12 months ended June 30, 2022.

source: company reports

bridge to buy back additional shares.

"They've been reluctant to let it go," Virgili tells me. "They've been talking about doing this for years, and they have been dragging their feet. Part of it is they are loathe to let go of an asset that would benefit from higher interest rates. The executives sitting around that boardroom table are saying, 'If we sell this now and the 10-year Treasury yield goes to 5%, we are going to want to jump out of a window.'"

To be clear, both the general insurance unit and Corebridge will benefit from higher rates, although the P&C unit is likely to see a faster improvement to investment income owing to its shorter-duration bond portfolio, 3.9 years versus 7.8 years. The Fed's hyperactive monetary policy following the start of the pandemic pulled AIG's overall portfolio yield to a low of 3.43% in the first quarter of 2022 from 4.36% in the final quarter of 2019. In the second quarter, yields rose 8 basis points to 3.52%, driven by a pickup of 88 basis points on new investments relative to maturing bonds.

"The magnitude—and corresponding results—of AIG's turnaround is truly unprecedented," Zaffino allowed himself to boast in his 2021 letter to shareholders. It's apparent in "our financial performance...how our leaders are driving the organization forward" and "how we are investing and preparing for a more dynamic future." Post the IPO of Corebridge, it may also be apparent in AIG's earnings multiple.

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