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Morgan Stanley

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Equity Research
North America

Industry

Insurance - Property & Casualty

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MSCI SECTOR	FINANCIALS
US Strategist Weight	17%
S&P 500 Weight	18%

Industry Overview

March 18, 2002

New Ratings System

- **Morgan Stanley Equity Research launches new ratings system**
  Our new system is designed to give context to stock ratings in a way that supports a disciplined approach to the investment process.
- **We now have three stock ratings instead of four**
  The new stock ratings are Overweight, Equal-weight, and Underweight. In North America, Europe, and Japan, stock ratings are relative to the performance of the analyst's coverage universe. In Asia/Pacific and Latin America, stock ratings are relative to the local country or regional MSCI index.
- ***Analysts' industry views and strategists' sector calls provide context***
  Our analysts will publish their views on each covered industry as Attractive, In-Line, or Cautious. Our equity strategists' recommended sector weightings will appear on all research, alongside the actual weighting in the local benchmark.
- **See inside for our Insurance - Property & Casualty stock ratings**
  The analyst's industry view is Attractive.

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Please see the important disclosures at the end of this report.

New Ratings System

Industry View

Our view on the Property & Casualty Insurance industry is Attractive, as measured on a market-capitalization basis. Our view is not a fundamental change to our opinion of the industry relative to our Neutral recommendation under Morgan Stanley's previous rating system. The reason for our Attractive industry view is simply weighting. Two stocks, American International Group (AIG) and Berkshire Hathaway (BRKa), account for 63% of the market capitalization of our coverage universe. Under our new rating system, the outlook for these two mega-cap stocks mathematically drives our overall market-cap-weighted industry view, and we have a positive outlook for both stocks. In general, on a stock-by-stock basis, we have moved to a somewhat more conservative posture, driven by valuation.

In assessing our industry view and individual stock picks, we have considered stock valuations, dividend yields, the underlying fundamentals of the industries and companies, and the economic environment. We have also looked at each stock on a risk-adjusted basis, taking into account the potential volatility of earnings that could drive its progression over the next 12–18 months.

Our recommendations are valuation-driven. Last November, we concluded that the values of most property-casualty (P-C) insurance stocks discounted the prospect of a strong upturn in the industry cycle, limiting opportunity and creating risk for investors. We continue to believe that the market is discounting a cyclical turn that will be sustained into 2003. Most stocks are again trading near their 2001 highs, and based on our valuation work, we can justify no more than an Equal-weight rating for many of the stocks, despite what we see as good underlying fundamentals. We also have considered economic sensitivity. Several of our stocks — Ambac (ABK), AIG, Hartford Financial (HIG), MBIA (MBI), Marsh & McLennan (MMC), and MaxRe (MXRE) — are more economically sensitive than traditional pure-play nonlife insurers and are affected either positively or negatively by the current economic outlook, depending on their business models or mixes.

In general, we believe most P-C insurance stocks have discounted the majority of the cyclical recovery in the insurance market that began in 2000 and accelerated after September 11. The P-C insurers are now trading at roughly 2 times book value — well above the historical average of 1.5–1.6 — for an industry that has historically barely managed to reach mid-teen-percentage returns on capital. Most important, in our view, an increasing number of stocks are looking less attractive at current valuations, compared to our residual income targets. By modeling periods beyond 2003, the residual income method projects that in later years, returns on capital begin to decline for most insurers even as earnings continue to rise.

Even under best-case scenarios, upside potential for many of the P-C stocks appears limited. Our residual income model prevents making the error of placing a peak multiple on peak earnings (as if capital could be perpetually reinvested at such peak returns). To achieve significant upside from these levels, we believe stocks would have to achieve a sustainable 15% return on equity (ROE) well beyond 2003. We think that is a highly unlikely outcome for a broad group of companies in this competitive and fragmented industry.

- A material improvement in the pricing environment — surpassing current expectations — would instead likely lead many companies to accumulate more capital than they could profitably deploy, in our view.
- Alternatively, the reason for the sustained pricing upturn might simply be ongoing losses destroying more value for a longer time than anticipated. The resulting price increases would therefore not necessarily create additional value for investors.

We do believe a more favorable outcome can be achieved by a limited number of companies. But, as we have often noted, the nature of a cyclical turn in this industry is that everybody can't be a winner. Accordingly, we are not troubled by the risk of leaving some potential upside on the table if we view the risk of overconcentrating in a stock or an industry as significant — as we do now.

For higher earnings and valuations, about a decade's worth of underpricing must be reversed and sustained, in our view. Unquestionably, pricing has improved across the board, but is this the best pricing environment ever? Will it last? And will it flow through to the bottom line? At the peak, we believe insurers can no longer earn excess returns for as long as in past cycles. Despite the largest loss in history in nearly every major line on 9/11, industry observers say that pricing in property insurance is still not at 1993–94 levels and pricing in casualty is not at 1986 levels.

In addition, the investing climate is weaker than in the past few years, so rate increases are replacing lost investment income. Loss cost inflation has not been fully priced in by insurers, and asbestos-related losses are ever-looming. On top of that, terrorism risk could limit stocks' multiple expansion somewhat, and economic forces could eventually create a pushback on higher insurance prices. As such, it is difficult for us to argue for peak valuations in this cycle.

Earnings in 2002 are unlikely to surprise positively, barring unusually low catastrophe-loss activity, we believe. Enron highlighted risks that we believe could continue to limit the upside to profits in 2002. The most obvious is the directors and officers line, where prices are rising sharply, but jury awards and loss frequency are also rising. Enron also highlighted the peripheral lines of business the insurers have entered, such as unconventional surety bonds — insurers guaranteeing the performance of a third party — and other types of financial guarantees — such as guaranteeing the debts of corporations through credit default swaps. We have yet to see significant losses from such peripheral business other than Enron, but with more defaults likely in 2002, this could remain an issue.

Rating agencies have highlighted that they will continue to take action, and therefore we expect to see more charges for asbestos in 2002 and 2003. We also believe that adjustments to 9/11 loss amounts will continue, that reinsurance disputes will continue to emerge, and that under-reserving in general has not been fully corrected by insurers. We believe the market is already beginning to write off 2002 as yet another "transitional year" and is looking toward 2003. Yet it is remarkable to think of a cyclical turn in which rates began to rise fully *four years* before results begin to show up significantly in earnings. Further, not every insurer or investor has the financial wherewithal or patience to weather four (or more) years of "but fors" and "transition years."

Many investors seem to view P-C stocks as a safe haven relative to the other segments of the equity market, one in which earnings estimates are less at risk. It may be true at this point that the downside risk, outside of a large catastrophe, is not as severe as in other industries, simply because insurers are not the biggest users of stock options or defined benefit pension plans, nor are they involved in other areas where accounting changes may *imminently* affect earnings. However, if the economy recovers, the upside potential in other industries may be greater, which could lead to sector rotation.

Highlights

Our favorite investment ideas in the group are AIG and BRKa. We believe AIG is compelling, trading (as of March 11) at 18.4 times 2003E EPS — a below-market valuation — and at a 22.6% discount to our residual-income-based price target of $90. We also believe the high level of concern over accounting issues, although possibly having more implications for our industry, should not weigh on this stock in the long term. The value of AIG's business franchises does not rest on accounting gimmicks, in our view. The absence of rating-agency concerns and AIG's minimal dependence on short-term financing are additional positives. Historically, the best time to buy AIG has been on those rare occasions when confusion and worry caused investors to doubt.

Berkshire Hathaway has some similarities to AIG; doubts over whether General Re's performance will improve have overshadowed what we believe is the company's likely future of rapidly growing operating earnings. We believe the reinsurance operations will bounce back over the next few quarters, with meaningful earnings leverage. The next few years should present a much-improved environment for BRKa, yet it remains reasonably valued, in our view. Our estimate of BRKa's intrinsic value remains $90,000, representing 25.7% potential upside. We have set this price as our published target for BRKa; we had not carried an "official" price objective previously.

With our rating on Allstate (ALL) moved to Overweight (previously Neutral), our focus shifts to personal lines. It could be hard to find a stock more out of favor than ALL; its recent missteps in homeowners and auto insurance have alienated many investors. Yet the stock appears to be discounting a worst-case scenario (absent a major catastrophe). Meanwhile, as of March 11, ALL was trading at a 21.6% discount to our estimate of its fundamental value of $45 (which represents 1.6 times 2003E book value). Because Allstate is not a broken business, we believe management will right the ship in due course. The risk is that we are too early, making ALL a 2003 story, but in 2002, investors may want to begin accumulating the stock.

We rate the property reinsurers Equal-weight based on both valuation and fundamentals. The stocks — XL Capital (XL), PartnerRe (PRE), RenaissanceRe (RNR), and IPC Holdings (IPCR) — were formerly rated Outperform. RNR and IPCR are nearing our price targets; RNR increased in value 40.9% from September 10 to March 11, while IPC rose 23.2% over that period. That compares to an 18.6% increase for an equal-weighted index consisting of four closely comparable P-C stocks. We still view both companies positively and see upside to their values, but we believe most of the outperformance versus the group has already been discounted. At more attractive current valuations, PRE and XL were more difficult calls. Our price target for XL drops to $103 from $108, as higher interest rates raised our cost of capital estimate, which in turn lowered our residual income valuation.

However much we like the companies' fundamentals, we believe the more commoditylike short-tail reinsurance industry is likely to soften faster than other parts of the industry. At a lower valuation, however, we would certainly be more positive on all of these stocks again.

Within the brokerage space, our most notable call is moving Arthur J. Gallagher (AJG) to Underweight; the stock was previously rated Outperform. We want to make clear that this is not a call to short AJG; rather, it simply reflects our view that after increasing in value by more than 100% since early 2000, the stock could lag behind the group's performance. We continue to view AJG as a well-run brokerage company with the ability to increase earnings in the double-digit-percentage range. We have reduced our target price for AJG to $35 from $38 previously, due to higher interest rates and our more cautious stance on the company's Financial Services segment.

Our revised outlook on AJG stems from our view that the period of accelerating "organic" brokerage revenue growth that prevailed over the past three years and drove multiple expansion for some the brokerage stocks will likely end this year. We believe earnings growth could also slow beginning in 2003 — an industry issue, not a Gallagher-specific issue.

As for Gallagher specifically, we are a bit more cautious about the company's Financial Services segment, which invests in real estate, synthetic-fuel partnerships, hedge funds, and the like. Our concern does not relate to the types of investments (although we admit we are not experts in this area); rather, it relates to the growth of income from the ventures. We estimate that the segment's earnings rose 95% in 2001 on a per-share basis and accounted for 30% of Gallagher's total earnings, up from 21% in 2000 and 18% in 1999. The bulk of the earnings harvested from this segment in 2001 related to tax benefits generated from the ownership and operation of synthetic-fuel partnerships. While 2002 will include some income from the sale of these same partnerships, we do not expect the earnings to be significantly higher than the tax benefit seen in 2001. We believe the company's growth relative to some of its peers is likely to slow.

We acknowledge that acquisitions could help AJG generate further earnings growth, but we believe the market tends to pay more for organic growth than it does for growth from acquisitions (which inherently bring execution risk).

We have shifted Progressive (PGR) to Underweight from Neutral previously. Progressive, in our opinion, remains one of the best-run companies we follow, but the stock's March 11 closing price was 6.5% above our fair-value estimate of $145, which is our price target. That price objective assumes that Progressive can sustain a 17% ROE for the next 15 years or so.

We now rate St. Paul (SPC) Underweight versus Neutral previously. We still like new CEO Jay Fishman's story, we project ROE of 14.5% for 2003, and we would be buyers of SPC at a lower valuation (a mid-$30s stock price). In the high $40s, however, SPC is trading 2% above our price target of $45. Our model is simply indicating that the company's expected turnaround, at least in its first few years, is largely discounted and no execution risk appears to be taken into account. Nor do we agree with the thesis that the company has over-reserved for medical malpractice runoff and would be able to release earnings and produce positive surprises beyond what we model in 2003 and beyond. We consider it at least as likely that such reserves will be needed (possibly in other lines), and therefore discount the "earnings surprise" thesis, in our opinion.

We rate the financial guarantors, ABK and MBI, Underweight; we had rated them Neutral previously. We believe there is nothing fundamentally wrong with the companies, and we do not believe the stocks have material downside prospects. However, we believe each stock's performance — relative to the other stocks in our universe — could lag. The financial guarantors are not benefiting from the same cyclical upturn as most of the other companies in our coverage universe, and on 2002E earnings and current book value, both are trading above their historic averages.

Both stocks are also sensitive to interest rates and to the economic environment. Specifically, each stock's multiples generally drop as interest rates rise, given that debt issuance slows, refinancing earnings drop, and book value generally

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declines. Given Morgan Stanley economist Dick Berner's outlook for an improving economy and higher interest rates by year-end (albeit not too much higher than current levels), we are not as sanguine about the outlook for these stocks relative to other names in our group — at least not at the current valuations.

Our rating on Philadelphia Consolidated Holdings (PHLY) goes to Underweight from Neutral, as the stock's March 11 price was 8.5% above our target price of $37. We think the stock has more than priced in the company's growth potential and ability to maintain a solidly profitable underwriting margin, but does not reflect the likelihood that ROE is likely to stay several percentage points below the 18% level of previous years because of a recent equity offering.

Companies Under Coverage

Company Name (Ticker, Price)	New Rating	Old Rating	New Target	Old Target
Ace (ACE, $42.30)	E	N	$45	–
AIG (AIG, $73.41)	O	SB	90	$90
Allstate (ALL, $37.01)	O	N	45	–
Ambac (ABK, $59.49)	U	N	64	–
Aon (AOC, $34.90)	E	N	40	–
Arthur J. Gallagher (AJG, $32.97)	U	OP	35	38
Berkshire Hathaway (BRKa, $71,600)	O	SB	90,000	–
Chubb (CB, $73.10)	E	N	82	–
Everest Re (RE, $69.80)	E	N	78	–
Hartford Financial (HIG, $65.70)	E	N	65	–
IPC Holdings (IPCR, $29.62)	E	OP	35	35
Marsh & McLennan (MMC, $107.62)	E	N	110	–
Max Re (MXRE, $15.97)	O-V	SB-V	24	24
MBIA (MBI, $56.73)	U	N	60	–
Mercury General (MCY, $42.98)	E	N	48	–
Partner Re (PRE, $54.52)	E	SB	63	63
Philadelphia Consolidated (PHLY, $40.15)	U	N	37	–
Progressive (PGR, $154.43)	U	N	145	–
RenaissanceRe (RNR, $103.95)	E	OP	115	115
SAFECO (SAFC, $32.95)	O	SB	40	40
St. Paul (SPC, $46.33)	U	N	46	–
Willis Group (WSH, $25.25)	E-V	N-V	28	–
W.R. Berkley (BER, $55.51)	O	SB	65	65
XL Capital (XL, $93.21)	E	OP	103	108

O = Overweight E = Equal-weight U = Underweight V = More volatile
SB = Strong Buy OP = Outperform N = Neutral UP = Underperform
Source: Morgan Stanley Equity Research

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ANALYST STOCK RATINGS

Overweight (O). The stock's total return is expected to exceed the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.

Equal-weight (E). The stock's total return is expected to be in line with the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.

Underweight (U). The stock's total return is expected to be below the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.

More volatile (V). We estimate that this stock has more than a 25% chance of a price move (up or down) of more than 25% in a month, based on a quantitative assessment of historical data, or in the analyst's view, it is likely to become materially more volatile over the next 1-12 months compared with the past three years. Stocks with less than one year of trading history are automatically rated as more volatile (unless otherwise noted). We note that securities that we do not currently consider "more volatile" can still perform in that manner.

ANALYST INDUSTRY VIEWS

Attractive (A). The analyst expects the performance of his or her industry coverage universe to be attractive vs. the relevant broad market benchmark over the next 12–18 months.

In-Line (I). The analyst expects the performance of his or her industry coverage universe to be in line with the relevant broad market benchmark over the next 12–18 months.

Cautious (C). The analyst views the performance of his or her industry coverage universe with caution vs. the relevant broad market benchmark over the next 12–18 months.

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