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HEADLINE: Yeah ... but what does Alice Schroeder think?;
Q&A.

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BODY:

Morgan Stanley's all-star insurance analyst is the only one WarrenBuffett will speak to and one of the most respected--and unafraid--thinkers on Wall Street. Pouring cold water on conference calls and putting the property-casualty industry on notice, Alice Schroeder grants us an exclusive interview.

Alice Schroeder has risen fast in her eight years as a Wall Streetproperty-casualty insurance analyst. Indeed, the Morgan Stanley DeanWitter & Co. analyst was top ranked by the 2001 Institutional Investor All- America Research poll and has been a member of the All-America Research team for the past five years. She also has been twice recognized as a member of the Wall Street Journal's All-Star Analyst Team.

It's no wonder, then, that in late February, she testified at a daylong House financial services committee hearing on the lack of terrorism insurance and its effect on the economy.

"I think there may be renewed momentum (for a federal backstop)," Schroeder says. "The disruption appears to be growing and you've now got what appears to be a coalition building of labor, business, nonprofits, government and insurers. All this is saying that there's a problem and that may give the momentum what's needed."

Described as intense and driven, the Texas native is known to worklong hours and to be a relentless interrogator. "She does exhaustiveresearch on an industrywide level, and she has pretty good contacts around the insurance industry," says Tom Goggins, co-portfolio manager on John Hancock Funds' Financial Institutions investment team.

"She probably works harder than any other sell-side analyst I know, in terms of hours definitely," another institutional investor says."She's very focused on getting to the bottom of a story."

Schroeder also forms strong opinions and is unafraid of breaking with convention. "She's the first one to pour cold water on a positiveconference call," the investor says. "When she makes a negative call, she does it with a bit of passion."

But Schroeder will probably always be known for getting Warren Buffett, the Sage of Omaha and the chairman and CEO of Berkshire Hathaway, to talk to her in 1998 when she was an analyst at Paine Webber. Itcreated a stir because it was the first time Buffett had provided access to an analyst--and she's still the only analyst to whom he speaks. "Obviously she got kudos for being the one to interview Warren Buffett," the investor says.

Schroeder says she got to meet with Buffett because she was one ofthe few analysts who had continued to write research on General Re after it agreed to a merge with Buffett's Berkshire Hathaway. "Most analysts immediately, or very shortly thereafter, stopped focusing on this situation and we decided to pick up coverage of Berkshire Hathaway and began working on a report," she says.

She says she contacted Buffett in a letter and asked if she and some General Re shareholders could attend a Berkshire Hathaway investors meeting in September 1998 and if he would then be willing to meet with them. He agreed. "I think, largely by default, I was the only onedoing anything much about it. He had read my research and I was there. Half of life is just showing up."

Risk & Insurance caught up with Schroeder in early March and askedher a few questions about the state of the insurance industry.

Q: What do you think are the biggest problems facing the U.S. insurance industry this year and in the next five years?

A: The biggest short-term issue facing the industry right now is addressing terrorism exposures from an underwriting standpoint, a customer relations standpoint, and a legislative standpoint. The issue ismaking a lot of progress in all these areas, but it certainly is thebiggest challenge in my mind.

Over the next five years, the industry will be facing a radically different macroeconomic environment in which investing returns are much lower than they were in the 1990s. The industry will be looking atinflationary trends rather than at costs that are coming down. Thosetwo trends are so overwhelmingly important to the industry's economics that entire business models are going to have to be changed to address these issues.

I believe that many companies coasted through the 1990s, making money and blissfully unaware of the fact that the reason they were profitable was because they were capital rich at a time when the investment climate was showering returns on investors, and insurers were ableto cut prices at a time when costs were declining. Both of these trends have reversed.

The investing environment is much tougher now. Costs are rising, and the only way to make money now is through solid underwriting. The reinsurers are no longer the patsies at the poker game so the underwriting can't be outsourced to them anymore. Now, making a profit on a gross lines basis, before reinsurance, is going to be required. We think that some companies are not set up to do that, and these companies are going to have to rethink their whole strategy.

Q: Which companies or sectors will be most under pressure?

A: In terms of addressing the underwriting, the whole industry hasthe issue. But companies with very reinsurance-dependent strategies clearly are suffering. Some are already struggling. Mutual Risk Management is one example that is obvious. We're not predicting there willbe many that will have as significant a problem as they have. But taking responsibility for gross profitability is something we think a lot of primary insurers stopped doing and it's going to be a shock to have to do it again.

For the reinsurers, we think investing is the greater challenge. Many of them have the underwriting skills, but they just didn't exercise them. For them, many were underpricing in order to play the capital markets. And there, they're going to have to rethink their strategybecause the investing environment no longer supports the kind of underwriting practices they were engaging in. That is especially true for the European companies, which were much more heavily invested in equities.

Q: What is your opinion about Lloyd's radical reforms? Will they really improve that market?

A: Many of the things that Lloyd's is proposing seem like very obvious fixes to some of their longstanding issues: reducing leverage, reducing costs, recapturing some of the investing income on floats andraising standards. There are some obvious improvements to be gained.But when I look at forecasts I tend to haircut the cost savings and assume the cost of implementation will be more than forecast.

The biggest challenge for Lloyd's will be making the market attractive for the capital providers who don't need this discipline, to retain those capital providers, while at the same time imposing a significant enough structure to discipline the unruly who do need it-- because the structure will be a burden on those who don't need it. There has got to be offsetting attractions to keep them in the game. It canbe done, but that will be the challenge.

Q: Do you think the Overseas Partners Ltd. liquidation has implications for the market?

A: In terms of the implications for the market, while there may have been factors that were unique to Overseas Partners, I don't think they will be the last reinsurer that decides the benefits of the hardmarket are not impressive enough and the company is not well-positioned to justify continuing as a separate company. We think the investment returns that are available and some of the market positions of some of these companies and the loss severity in casualty lines--for example, in D&O, medical malpractice and other businesses combined--will offset the rate increases that are being achieved. When managementslook at that, in some cases, they are going to say, "No, the hard market is just not a good enough reason to stay in the game."

So whatever factors were specific to Overseas Partners, I think there is a more general rationale that may ultimately apply to some others.

Q: Which other companies may be in a similar position?

A: I think the least likely to want to continue are the primary insurers and others who have invested in reinsurance but are not professional reinsurers. In other words, anybody who is part-time in the business or has an investment in the business as opposed to stand-alonecompanies. We think there is evidence of that already as in the scaling back by Hartford, CNA, and St. Paul, I believe the strategy of so-called double leverage--that's the strategy of writing reinsurance on the insurance company's balance sheet--works both ways. It's not just a positive. I think that the mixed model of reinsurance plus primary is the one you'll see most of the withdrawals from. Maybe most is not the right word, but you'll see withdrawals of people who are in that model.

Q: What do you think of the way Berkshire Hathaway and American International Group Inc. have been handling the question of succession?Who do you think are the leading candidates for the top jobs to replace Warren Buffett and Hank Greenberg at those companies?

A: I won't comment on the candidates. I think these two companies are trying to strike a balance between the boards' need to have the right to change its mind about who the successor will be as events evolve and the shareholders' right to know and desire to reduce uncertainty.

It's a very difficult challenge and I think the time will come at which point the shareholders need to know. I'm not going to say what the exact date or time is. It's understandable that investors become anxious over this issue, especially when you have CEOs who are largerthan life and have accomplished so much for the shareholders.

On the other hand, investors should understand that it does no good to name a successor if there is a chance the answer could change and the existing CEO isn't going to step down right away.

When you look at companies like General Electric, the process did not become transparent to investors until the change was about to occur. One interpretation of the lack of disclosure may be that the change is not close to occurring at either of these two companies, meaning within one to two years.

It is completely understandable to me that investors find this frustrating because investors don't like uncertainty; they always want to reduce uncertainty. But I do also think we have to balance that with the need to pick the right person and the need to motivate employees, both of which may require some discretion on the part of the company.

I don't really have a dog in this fight. I'm not taking strong sides on this one except to say the point does come when it's time to say something.

Q: Do you think, then, that it may he more than one or two years before either of those CEOs step down?

A: It may be more than one or two years. I don't think either one of them has imminent plans of retiring. Not that either one of them has confessed their retirement plans to me, but they both seem very energetic and just enjoying what they are doing and it's not obvious tome why either one of them would step down right now.

There have been examples before of CEOs who were vibrant and successful and older than either of these two gentlemen. Keep in mind thatWarren Buffett is only 71 and Hank Greenberg is 76.

For someone who is clearly making good business decisions, energetic and very engaged in the job, I don't think there should be an age limit as long as they're doing a great job.

Q: How much confidence do you have in insurance industry accounting? Do you think insurers face bigger problems because of their own accounting or because of potential problems with their clients?

A: Insurance companies have not won investors' confidence for transparent accounting, particularly in the area of loss reserves. This past quarter, with the large number of reserve strengthenings, is an illustration of that. There is an amount of judgment that is an inherent part of the reserving process; there is nothing we can do about it.

But the somewhat obvious manipulations of reserves that occasionally seem to take place and the use of finite reinsurance to manage results, along with other accounting issues, I think have troubled investors and they do trouble me.

With that said, I certainly don't think insurance is the only industry that has accounting issues, and I don't think a company has a problem, nor do I think that like Enron, insurers are about to "implodein a wave of accounting scandals." I simply think that insurers would benefit from remembering that the shareholders are the owners of the company.

They're entitled to the information about the economics of the company and its results, and as the employees of the shareholders, the management does not have the right to manipulate those results to suititself.

Q: What is the biggest mistake that insurance companies and their executives make in the company's earnings statements and conference calls. What information do you want to see that is not there?

A: I could tell you a number of different suggestions for how insurance company managements could improve their conference calls, but there are two that would be most helpful. One, remember that the people you are talking to are the owners and you are giving them a report card on how you did. You should approach them respectfully and remember you are reporting to your owners.

Often I think company managements come across as though they are the owners and the shareholders are nuisances and pests who ask a bunch of questions to which they are not entitled to have answers.

The second suggestion I would make is that managements always keepin mind that analysts and investors have many alternative sources ofinformation and often don't rely on managements as their first-choice source of information. In other words, we can check and do check everything you tell us.

So saying that you won't disclose something or saying something that even slightly shades the truth can backfire because often we can find it out anyway or easily check what you were saying. We also talk to each other.

I think managements should try to provide as much helpful information as possible with as much candor as they can. That way they'll never get themselves in trouble.

Q: Why are you less bullish on property-casualty stocks than otherWall Street analysts?

A: Well, there's a presumption in that. I don't pay much attentionto what other analysts do because I don't measure myself or try to win a contest against other analysts by positioning myself. I don't know the answer to that because I don't know why other analysts have the view they have. I don't even necessarily know what their views are because that isn't how I make my decisions. I only know what I think.

But I would guess, based on what is said back to me by clients, that my view on the cycle is not that different at all from other analysts, that where I differ is on the degree to which it is already discounted into the stocks.

I believe the stocks are currently trading on the expectation thatthe cycle turn will extend through 2003 and that earnings will be good for some period beyond that. To me, it would require some piece ofnew news to justify even higher valuations because that is already known information. That's not to say that there couldn't be such news.I'm just not sure what it is.

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