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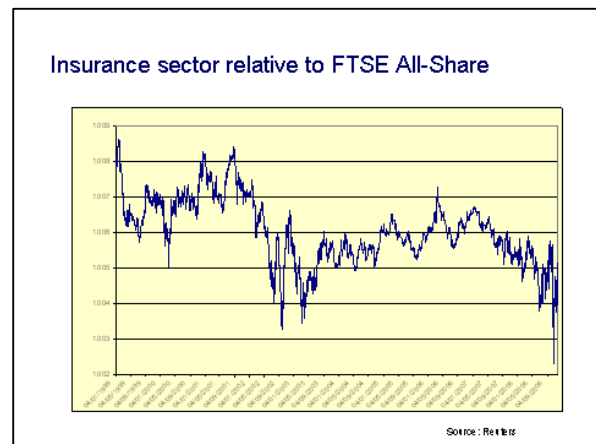
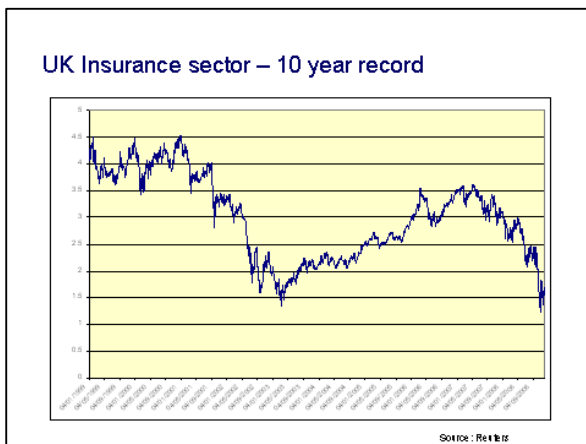
“IASB Developments & Financial Reporting from the Investor Perspective”

Colin McLean, Managing Director, SVM Asset Management Ltd

I would like to take a step back from today's debate on accounting standards and numbers. Although I am an actuary, I have come to realise in investment that it is not just about numbers, there are some other important issues, particularly in behavioural finance. In recent years I have paid more attention to the impact of psychology in investment. Indeed, over the last couple of years in the stockmarket - as investors have become disenchanted of metrics such as p/e's, yields and price-to-book - we should recognise it is increasingly important to understand behaviour and what drives that.

I hope my presentation represents some food for thought, to set alongside all the work that is being done on the numbers and the accounting. I don't think investors look just at that, I believe there is a bigger picture. I think that we should look at what issues the stockmarket behaviour of insurance companies points to, and what the underlying investor agenda might really be. For this, I am going to draw partly on behavioural finance issues but also on text analysis. I will look beyond the numbers and also at incentives as well, because I think incentives matter to investors and they draw conclusions from that.

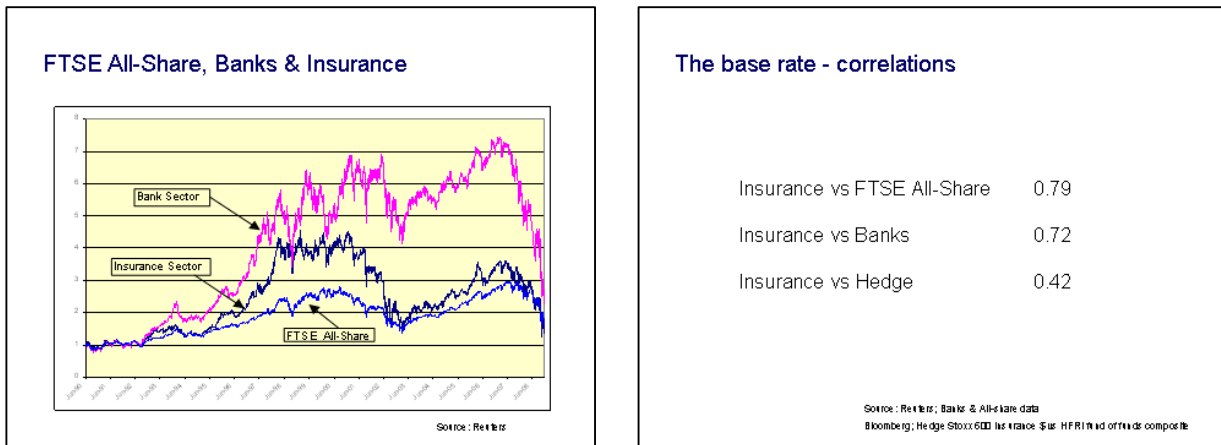
The starting point is the stockmarket performance of the insurance sector – poor, whether you look at the last five years or ten, or 20 or 25. This graph is the life sector in the UK, but it is not dissimilar to counterparts in other markets. It has not delivered a lot of value for investors - there clearly is an agenda of concern - and this has been for the most part, over a growing economy and a period in which you would expect, with a high beta, insurance to perform.



Certainly, investors are right in feeling a bit concerned about the insurance sector, and also perhaps they are not getting much comfort from the reports, or from the communications that they have from insurers. Communications may not be addressing investors' agenda. And performance is similarly disappointing if we look at it relative to the All-Share. We can see just how much returns in recent

years have fallen away. So I think there is a concern in the market that insurance performance, is not perhaps just about accounting treatments or new ways of defining remuneration.

Indeed, if we look at how the insurance sector has behaved relative to the bank sector, and alongside the All-Share, we can clearly see in fact that there is quite a high correlation between them, that they have not delivered a lot of value over the long term. I think the share prices are capturing some negative information as well. It is maybe a little bit more obvious when we look - and I have run this over the past 10 years, but numbers are very similar over 20 years - that in fact insurance also correlates quite closely with the All-Share Index and also correlates with banks.



And surprisingly perhaps, (I have used the US sector to give a Dollar based comparison with the hedge funds HFRI Index) there is correlation with the hedge fund sector as well. This is even more pronounced in looking at individual bad months. So it is reasonable to think that investors are bringing in issues from all of these other different sectors as part of their agenda of concern about insurance. That approach is quite legitimate.

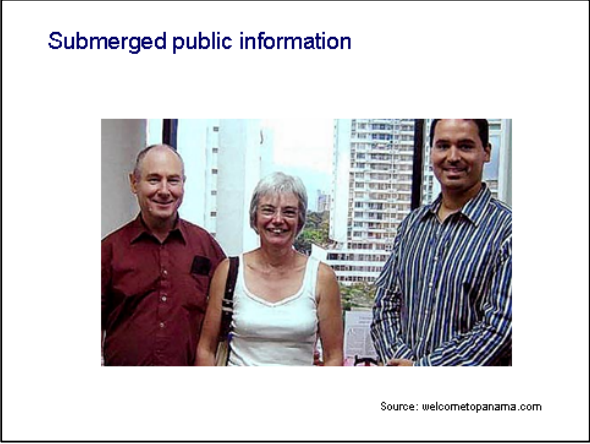
There is the concept in behavioural finance of trying to combine underlying information with specific information – the concept of the base rate. For example, currently many analysts’ individual forecasts for companies collectively add up to an unrealistic expectation for the global economy. They are not incorporating the base data of an overall downturn or recession. So you need to incorporate the bigger picture, combining data from elsewhere. It is quite reasonable that concerns and information that adversely impacts the bank sector, or even the concerns about the hedge sector, are actually all being drawn into analysis of the insurance sector as well. As much as those in management in the insurance sector might like to contrast themselves with the issues in these different areas, in fact investors perceive a lot of commonality in them and they are bringing in that base data across from other sectors into their views on insurance.

There is also the broader concept that the agenda that you see, through analysts’ reports, communications you have with the City, and what is publicly commented on in the press, may not in fact be the true agenda. It is useful to think in terms of *submerged information*. This was clear through the history of the banking crisis over the last year, through the concerns that there were with Northern Rock and then with other banks. A lot of this exhibited itself through information on the internet, blogs, and some other more critical comments on specialist sites, rather than necessarily appearing in published analyst research. So I think it is useful to look at the share price behaviour and assume that share prices are capturing something - and that information may not be what is clearly public in analysts’ research, but it may in fact represent a slightly different agenda.

I think the illustration perhaps of just how information can be submerged; being public and theoretically available to all, but actually not conspicuously available, was illustrated quite well in the case last year of the missing canoeist, John Darwin. He had been missing for 18 months. This

picture was on the internet - but not noted by the insurers or the police at the time. It took a Daily Mail reader who was enterprising enough, to go into Google Images and type in "John", "Anne" and "Panama" and this photo came up!

There are other, less trivial, examples of the wisdom of the crowd on the banking sector. I particularly liked the example that was picked up more recently in a BBC programme, when Lord Stevenson, chairman of HBOS, at its AGM in June (just three months before the bank faced collapse) reaffirmed his view that the chief executive was a "hell of a tough guy", "positioning the group well". He told the general meeting that the figures in the rights issue prospectus "could be trusted" as "we're truthful people" and that the cash call was about "old-fashioned prudence" as trading remains "resilient". A shareholder, Barry Gorman, stood up and said he was a shareholder and former bin man, and then told Lord Stevenson "you must think we're stupid". I think in that debate between the peer of the realm and the bin man it was clear who won the argument. As it actually turned out three months later, of course Mr Gorman was right; we weren't fooled.



In some cases information is hopelessly compromised by incentives. In insurance, we are all well aware of moral hazard and the concept of agency risks. Yet, these agency risks apply also to the relationship between shareholders and company management. Embedded within the accounts there is the contract on management remuneration, which is sometimes lengthy and quite opaque. Underwriters are wary of moral hazard, so we should not be surprised to find this approach also being taken by investors.

I said that I thought it was relevant to bring banking information into the insurance sector. There is a huge level of level III assets relative to equity within some of Europe's major banks. I think of this as a mystery box - we don't know what is in it really. We can only guess at what is in this cupboard, and that it is very large in relation to the equity value. We do not know the exact valuation basis, how derivatives are netted off, or what role insurance and counterparty risk plays, as these assets are not marked directly to market or transparent model. But we do know the management have been paid several million Pounds, or Euros, in some cases, for generating the profits that have come out of those level III assets. So from that I can draw some deduction about what might lie in them - whether is further profits or losses. In guessing at the hidden value of these huge assets, we are legitimately guided by the underlying incentives. So there is a lot you can compute from that embedded management contract. I think that the section of reports and accounts that covers remuneration - how it is incentivising towards accounting for earnings per share, or genuine value creation, matters. There is information there I pay attention to.

- Investor concerns**
- Corporate bond default risks
 - Asset declines
 - Impact of accounting change
 - Repairing solvency buffers
 - Dividend cuts
 - Rights issues

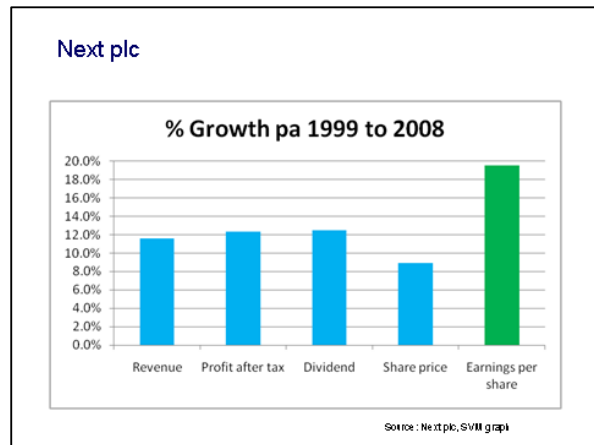
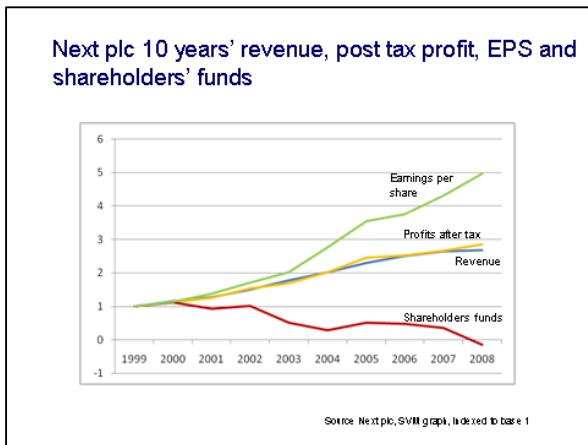
But I think this submerged agenda perhaps is not the agenda we actually see in reading most insurers' accounts. It is clear that underlying investor concerns would go some way to explain the actual share price performance that we are seeing across most of the sector. There may be a lot of submerged issues. Possibly, concerns that are drawn from other sectors; eg that if the rules on solvency are to change, or there is to be some repairing of surplus buffers as with banks, that might carry across into insurers, given the

same regulators. Dividends too, have been an issue for banks. Earlier this year, banks like Royal Bank of Scotland, boasted a 15 year record of dramatic dividend growth. But of course, it ended up in nothing. And that is really what investors are concerned about.

Sometimes, if investors' main concern is with the sustainability of dividends, actually increasing a dividend just now by 5 or 10%, may in fact make them more anxious about the sustainability of that dividend. Once a yield is 6, 7 or 8% it may not matter too much whether it is increased 5 or 10%, but it is actually the sustainability that matters. And investors would draw a line (the base data) from the other unsustainable assurances that banks gave earlier on this year about dividends. So sometimes, addressing the fundamental issues are more important, than just giving the comfort of assuming the agenda is about better earnings and better dividends.

I am going first to take a couple of examples from other companies and other sectors, but I will conclude with an insurance company example. I think these ones are relevant and illustrate some of the same issues. I think when management latch onto something they think investors want – whether it is dividends or more likely earnings per share, it doesn't take too long before we get gaming of that. The target is over-emphasised and over-rewarded, becoming detached as a measure from the underlying intention. We get that agency risk or suboptimisation, where management have worked out how they can deliver earnings per share and a while later investors realise that in fact they are not getting what they *really* wanted.

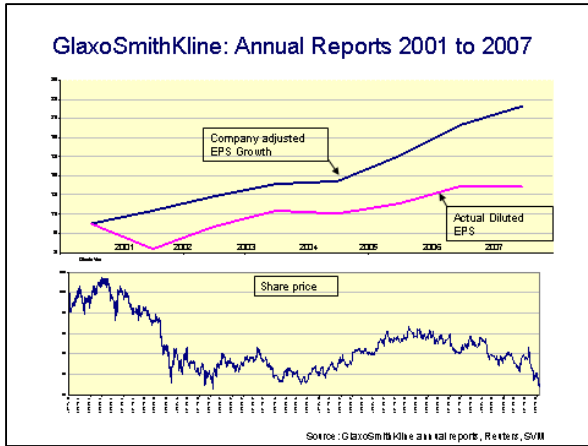
Next plc is well known, it is one of the major, high street retail clothing chains. You don't often get an analyst's report over a long enough period - 10 years - but the graph shows that the metrics I would think are representative - the profits after tax and revenue - over that period have grown reasonably consistently. Next is a growth business, that has added to space and used that well each year. So we have seen a steady growth rate, but of course it is not the growth rate that has been reported in earnings per share, and on which management have been incentivised. Earnings per share has grown somewhere ahead of that, helped a bit by new investment – but also by share buy backs in particular (and quite expensive ones). Of course, the counterpart of that is, as we see the in red line, the shareholders' funds, that in fact that is unsustainable. Of course, the cash in the business goes down and not up, as you enhance earnings per share like that, through buy backs.



So you end up with a pattern where you get a range of measures that might be a reasonable indication longer term, of how the business is developing, but the earnings per share is the wrong one. So it is not only that earnings per share can give you the wrong current value, or p/e for a business, but it can give you an impression of the wrong growth rate and also sometimes it can be smoothed as well, so an incorrect impression is given of the quality of earnings too. This is typical of many companies. Indeed, underperformance of this stock over the past four years, I think reflects investors gradually latching on to this and realising – of course they realised this with banks as well

which got down to very low ratings even before the credit crisis - the earnings weren't being delivered in a way that shareholders wanted.

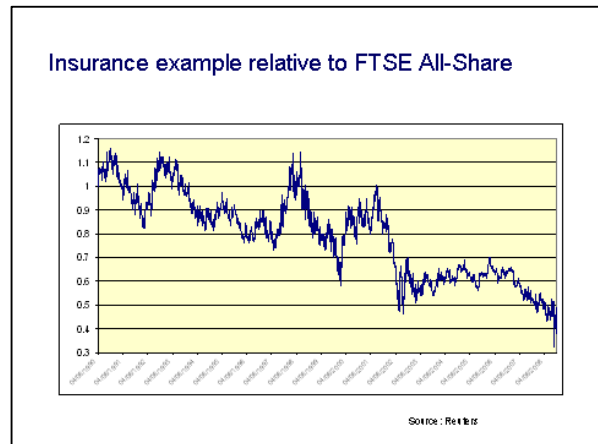
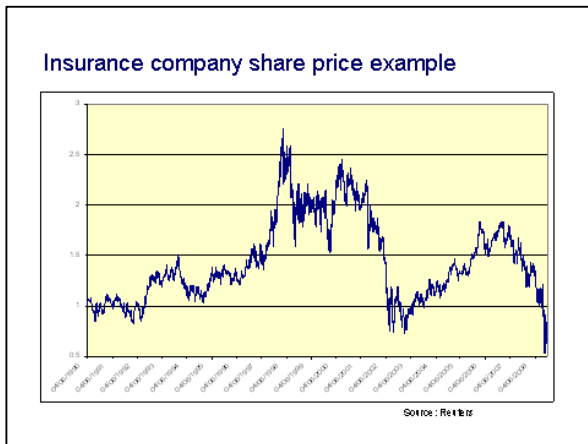
I will take another large company, which was the fifth largest in the UK for most of this period, and look over the whole reign of the previous chief executive (it is under a change of manager from May



this year), so I think it is a fair review period. And indeed, management rewards have been pretty high over this long period. When we see what the company reported each year, the word “adjusted” appears quite a lot in the report and accounts. Different types of adjustments are involved, not just the accounting changes, but more typically favourable adjustments to earnings coming from different treatment of restructuring schemes, share buy backs or currencies. Over a period of time it is quite clear that we have got a much smoother line giving the impression of more of a growth company, and indeed we will find in the balance sheet that it had deteriorated very rapidly over the last stage of buy backs as well, and the

share price in relative terms roughly halved over this period. So I don't think we should assume that investors are particularly looking for earnings per share or indeed that if a single metric that is picked out by management and incentivised, that the result will be to deliver the growth and value that we as shareholders want.

I would like now to move on to an insurance company example, as I think that this also ties in with my point on what investors are seeing in company reports. I have taken just one insurance company, which shall be nameless. It is a large one, but typical of many others across Europe. Just to illustrate first of all, that as we have seen with the overall industry sector, this has not performed that well over a reasonably long period of time of 10 years, and relatively certainly not. This is the pattern of most insurance companies. So, you would think in looking at a report from the insurer, (and indeed from all in the insurance sector) you would see a degree of contrition or candour really, describing the challenges ahead.



What is possible now, is not just analysing company accounts systematically, pulling out the numbers, but the text analysis can now also be done more easily. Indeed anyone with a PC can do this and can pull out the actual semantics that are used in the annual report. Over this lengthy period of time, given the relative performance the insurer has had, you might expect on the left hand side to see some words at least suggesting the challenges and problems in the business. But absolutely none of problems or issues in the business are addressed, and the overall tone to

investors is shown on the right hand side. That might be fair enough if the annual report is to be used purely as a marketing document and is to be reassurance for staff or customers, then that is fine. But I think companies need to accept investors need to get much more out of reports. So it certainly is not doing do the job of conveying to investors just what the risks and challenges are for the business as well as what it has achieved. It has not had a bad year, but I think the subliminal effect of this text is actually for investors to perhaps trust less and worry more. I think there is a lot more gained by candour.

Framing - words matter

Occurrences of:

Underperform	2	Achieve/achievement	85
Disappointed	0	Good/better/best	150
Bad/worse/worst	8	Excellent	15
Poor/poorly	1	Grow/growing/growth	207
Weaker/weakness	5	Improve/improvement	73
Challenge	7	Strong/stronger/strength	150
		Success	55

Source: Investors 2007 report SVM analysis

Just finally in summary, what I would say is that the key issue to improve investor communications between insurers and institutional investors, is to recognise that the accounts alone can't do that job and to some extent, their use of the language may have perverse results. There is a broader agenda; there is no point in ducking it, it is clearly reflected in the share price. Concerns need to be addressed. Sometimes the true agenda is misunderstood, such as a desire for dividend income and the way in which it has been addressed in dividend increases, may in fact be counter-productive and add to fears. Moving assets into held to maturity may avoid short term write-downs, but might actually damage confidence. Re-building trust might be more important than today's asset value. My point about metrics also applies to many companies in other sectors. Typically, we are not given long enough records - sometimes just three, four or even five years. I know it is not helped by accounting changes and discontinuity of comparables, but I think it is possible to bring out

Improving investor communications

- Investor communication is not just accounts
- Recognise and address crowd concerns
- Provide long term records of *business* progress
- Candour

some other business metrics and figures that would perhaps illustrate how management see wealth creation in the business over a period of time.

And my last point applies to all companies. I think ultimately the turnaround in the sector in the stockmarket will come, but only when investors really can believe that there is candour there, and trust what they are told about recovery or problems being genuinely resolved. I think building up a relationship with investors that is based on highlighting the problems as well as the opportunities and success, will pay off in the longer term.

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