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SCHIFF'S

INSURANCE OBSERVER

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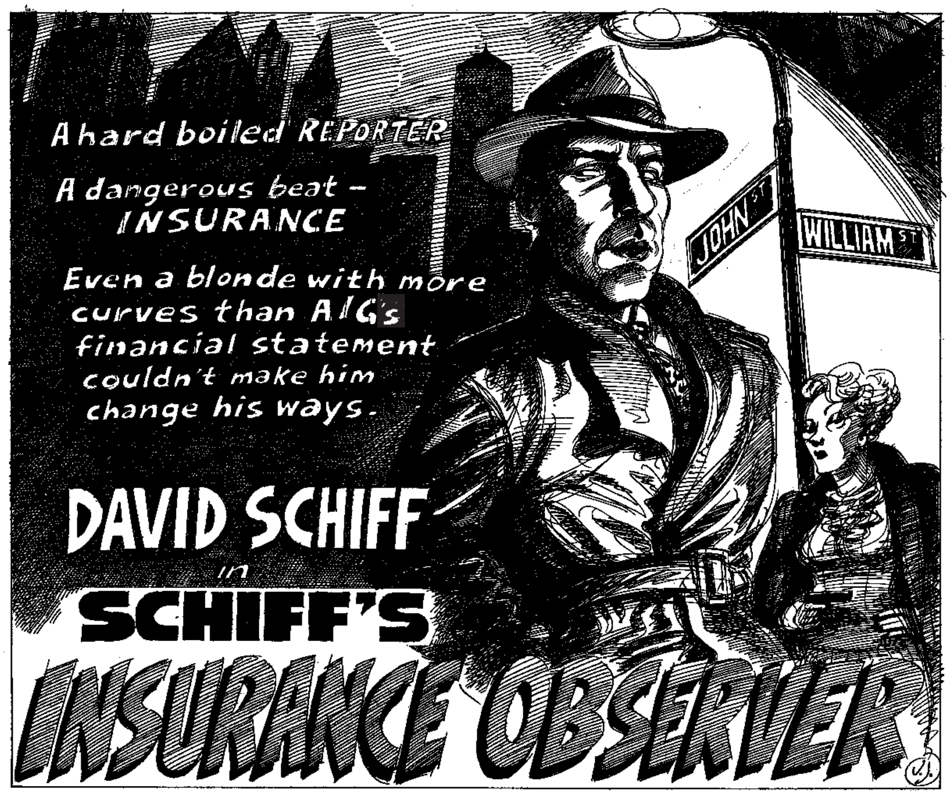
AIG and the Art of Financial Prestidigitation

Say it Ain't So, Hank

In February, we republished three articles from 1996 about AIG's relationship with Coral Re, a nebulous Barbados reinsurer to which AIG ceded about $1.6 billion in reserves. Although Coral Re looked and smelled like an AIG affiliate, AIG denied that it was. On the following pages we are republishing nine articles about AIG that were written between 1998 and 2004. (For *all* of our articles about AIG, please refer to the index in the March 15 issue.)

Although AIG has long been extremely profitable, it has also been a "black box" that appeared to have a predilection for innovative bookkeeping. If you mentioned that AIG may have engaged in some sort of legerdemain, it tended to elicit a strong reaction from 70 Pine Street, the company's headquarters. "AIG has always provided complete and accurate financial information," was a standard response. (Yelling, threatening, and bullying were also standard responses.)



On March 30, AIG issued a press release in which it admitted the ugly truth: it *did not* provide complete and accurate financial information. The press release stated that AIG entered into transactions that "appear to have to have been structured for the sole or primary purpose of accomplishing a desired accounting result." Translated into English, that means that AIG screwed around with its numbers, thereby misleading everyone who relied on them.

What follows are some examples of AIG's mischief.

AIG entered into $500 million of "reinsurance" transactions with General Re. Because no risk was transferred, the transactions weren't really reinsurance. This phony "reinsurance" made AIG's loss reserves appear greater than they would have been otherwise, giving the misleading impression that the company's reserving practices were more conservative than they really were.

Between 1991 and 2004, AIG ceded a lot of reinsurance business to a little Barbados company called Union Excess Reinsurance. These "reinsurance" transactions accounted for $1.1 billion of AIG's net income. Upon closer inspection, AIG discovered that these transactions were something of a sham. AIG doesn't know what the hell happened, but it says that it "now believes" that Union Excess's shareholders have a financial arrangement with Starr International Company (SICO)—a private holding company that owns twelve percent of AIG and is controlled by Hank Greenberg and other AIG honchos. The bottom line: it appears that there was no economic substance to the $1.1 billion of net income that AIG reported from these transactions.

The Union Excess transactions also

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raise questions that AIG has not addressed. How could AIG have failed to disclose such large "related-party" transactions to its shareholders? Did AIG's board of directors know about these transactions? If not, why didn't AIG's senior executives—who are officers, directors, shareholders, or beneficiaries of SICO—tell the board about the transactions? AIG's "Code of Business Conduct and Ethics" states that "situations which could result in conflicts of interest or the appearance of a conflict of interest should be avoided whenever possible." If an AIG officer or director is aware of anything that could reasonably be expected to create a conflict of interest, he's supposed to discuss it with the company's general counsel. Ernest Patrikis has been AIG's general counsel since 1998. His predecessor, Florence Davis, now runs the Starr Foundation, which owns 2.05% of AIG. What do they know? Or, what *don't* they know?

AIG ceded a significant amount of "reinsurance" to Richmond Insurance Company in Bermuda. Or did it just shift assets from one of its pockets to another and call it reinsurance? AIG's recent "review of operations" turned up "previously undisclosed evidence" that AIG *controls* Richmond. As a result, there was no transfer of risk, which means that AIG's financials didn't accurately portray the real income statement or balance sheet—or maybe both.

Between 2000 and 2003, AIG engaged in some nifty transactions with Capco Reinsurance Company, located in lovely Barbados. Somewhere between New York and the Caribbean these transactions magically turned $200 million of AIG's underwriting losses into $200 million of capital losses (losses from investments). That means that AIG's operating income *appeared* $200 million greater than it really was. (Operating income is of great importance, because, as Hank Greenberg pointed out in AIG's 2000 letter to shareholders, it's "the way we and the investment community look at our results." Considering that AIG's stock has often traded at thirty times earnings, it seems reasonable to say that the Capco deals inflated AIG's market cap by about $1.5 billion.

AIG had other ways to make its operating income appear larger than it really was. Between 2001 and 2003, it sold call

continued on next page

options on some of its bonds that had unrealized gains. It then entered into a series of forward transactions and swaps that, somehow, transformed $300 million of capital gains into $300 million of "investment income." (Since investment income is a component of "operating income" and capitals gains aren't, this had the effect of overstating AIG's earnings power.)

Finally, it turns out that AIG *misclassified* "certain items," and, as a result, its reported net investment income was overstated by four percent between 2000 to 2004. That doesn't sound so bad, does it? After all, what's four percent in the grand scheme of things? Well, it turns out to be a lot—$3 billion. In 2003, for example, this "misclassification" caused AIG's operating income (the key figure everyone looks at), to be overstated by about four percent—$660 million.

It's likely that there will be more revelations about the unsavory inner workings of AIG. Perhaps that's why AIG put out another press release last night. It was a letter from CEO Martin Sullivan that, we suppose, was meant to reassure shareholders that AIG wasn't a house of cards run by a gang of con men overseen by directors who are deaf, dumb, and blind. "We are committed to improving transparency and corporate governance," wrote Sullivan.

We're certain that AIG's governance and transparency will improve. The question, however, is this: "Exactly how bad are they right now?"

Sullivan also said that it was "unfortunate that current circumstances have obscured the reality that AIG's unique global franchise is sound." Alas, he got it backwards. It's unfortunate that AIG's unique global franchise obscured the reality of the company's financial condition.

Please continue to the following pages to read articles about AIG from 1998 to 2004.

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October 1998
Volume 10 • Number 4

INSURANCE OBSERVER

A Darkness on the Edge of Town

This Wheel's on Fire

If Hank Greenberg, chairman of American International Group and emperor of the insurance industry, forgot to put on clothes, it's a safe bet that no securities analyst would mention it. Saying something that might be interpreted as critical of Greenberg could be lethal to an analyst's career. Even if such an analyst weren't fired, he'd be the *only* one questioning the Great Man, and nobody on Wall Street wants to be the *only* one doing anything.

Securities analysts often travel in herds, opining on stocks with an arsenal of euphemisms including "aggressive buy," "strong buy," "buy," "outperform," "accumulate," "market perform," "strong hold," and "hold."

Although there's something known as a "sell" opinion, to the best of our knowledge it's invoked only during nuclear war or a prolonged bear market. Analysts simply aren't in the business of shouting "sell" in a crowded market. (If every security were a "hold" or a "sell," brokerage firms wouldn't transact much business.)

"...and then Hank Greenberg decided to buy SunAmerica for $16 billion in stock."

American International Group (AIG, $79) is *the* blue chip insurance stock. It's huge (a market cap of $85 billion), it's liquid (average daily volume is 1,982,636 shares), and it has been a dazzling success. Under Greenberg's long tenure, AIG has achieved remarkable growth—without a surfeit of risk. Since going public in 1969, its stock has compounded at an 18.6% annual rate.

Particularly alluring to investors, however, is the consistency with which AIG has grown: with the exception of 1984, earnings have increased every year.

A recent Zacks composite tracked 21 analysts who followed AIG. Of these, six rated the stock a "strong buy" and 12 rated it a "moderate buy"; three heretics rated it a "hold." The analysts' earnings-per-share projections for AIG were consistent. The lowest for this year is $3.45; the highest is $3.57. For 1999 the lowest is $3.85; the highest, $4.10. The consensus is $3.98.

Although Warren Buffett has said that he prefers a lumpy 20% return to a smooth 15%, many investors apparently prefer

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Nightmare at the Mutuals

If it's Tuesday, this must be Des Moines.

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just the opposite: they prize consistency and predictability (or what they perceive as such), and are willing to pay more for it. Because AIG is a fine company with a powerful global presence, and because its earnings have compounded at a 14% rate over the past decade, investors believe it's a *perpetual* money-compounding machine. They have bought the theory that AIG is a "growth" company (rather than a cyclical insurance or financial company) and as such deserves a significantly higher multiple than would otherwise be accorded. Although AIG's stock has retreated from a recent high of $102^{5}/_{16}$, it's still trading at 24 times earnings and more than three times book value (see the graph at the bottom of page 3).

Investors justify these multiples on the grounds that AIG is "safe": its earnings won't disappoint stockholders. In buying AIG, money managers are, in effect, paraphrasing an old expression once popular among purchasers of data-processing equipment: "Nobody ever lost his job buying AIG."

Despite AIG's achievements, two questions are worth asking: 1) What will happen to the company when Greenberg, who is 72, is no longer there? 2) How has AIG generated such consistent earnings growth, and what is the likelihood that this *consistent* growth will continue?

Obviously, no one knows the answer to the first question. It turns out that no one quite knows the answer to the second question, either. Some who follow AIG have told us that they can't really analyze it. Others have said that they don't even spend much time *trying* to do so—that, to a larger extent than they would for other companies, they take AIG's numbers on faith.

AIG is difficult to get a handle on. State Farm, for example, is bigger, but easily lends itself to analysis: it operates in a few lines, sells standard products, barely uses reinsurance, and invests (successfully) in high-quality bonds and stocks.

AIG, by contrast, is a sprawling omnipresence that does business in 130 countries and has 500 subsidiaries. Its Domestic General Business, which accounts for 32% of pretax income, specializes in almost every form of complex casualty coverage imaginable. AIG's life-insurance operations, which operate primarily in Japan, Taiwan, and other Asian countries, account for 34% of its pretax income. (AIG doesn't break down premium by country or product.)

AIG's Financial Services Group, which benefits from AIG's triple-A rating, leases planes, engages in a significant derivatives business, makes markets in foreign exchange and bonds and metals, manages funds, and provides private-banking services. It has grown rapidly and accounted for 15% of AIG's pretax income—$701 million last year. (That's twice what Charles Schwab & Company made in 1997.)

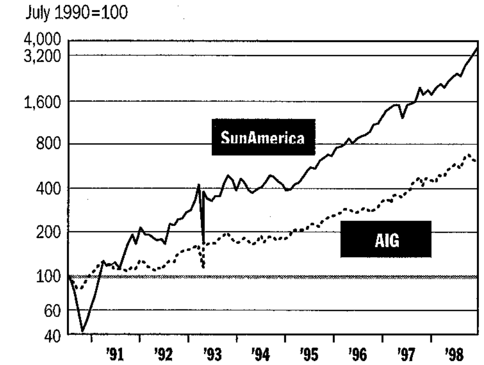
In April, Weston Hicks and Christine Lai of Sanford C. Bernstein & Company put out an 82-page report, *American International Group, Inc.: The Emperor of Financial Services*—the most comprehensive analysis we've read on AIG. [To purchase a copy, call Sandy Prasch at (212) 756-4106.] Hicks and Lai believe that AIG is a "preeminent global financial-services company" (we agree) that "stands at the threshold of increased opportunity" (we're not so sure). Their observation that AIG sells "at a substantial discount to other global franchise companies such as General Electric (30x 1998 consensus) and Coca-Cola (45x 1998 consensus)" is certainly true. We wouldn't buy GE or Coke at those multiples, however, nor would we value AIG at 30 times earnings, as Hicks and Lai suggest might be appropriate. We're hesitant to put such multiples on *anything*, much less on insurance-and-financial-services companies which, historically, have had lower barriers to entry. (Hicks and Lai acknowledge that AIG is a "perennially expensive stock," and have initiated their research coverage with an "outperform" recommendation.)

Given the cyclicality and competitiveness in AIG's businesses, it strikes us that the company, as now configured, might have difficulty achieving the growth that's expected of it. Can any financial company—especially one this large—compound its earnings per share at a 14% annual rate indefinitely? Can such a company always sidestep the risks inherent in commodity-like financial businesses? Perhaps, but at 23 times earnings, AIG's stock provides little margin for error—a margin that got even slimmer, we think, on August 19, with the announcement that AIG would be acquiring SunAmerica for stock, a transaction that values SunAmerica at 28 times earnings and five times book value.

Greenberg is not known as a man to overpay for things. (We ran into him once at Brooks Brothers during an after-hours sale.) Only four months ago, at AIG's annual meeting, he said, "As many of you know from previous meetings, we would like to increase our U.S. life insurance operations, and we have looked at companies for years, but we have a disciplined approach to acquisitions." In a nod to Wall Street's preoccupation with *reported* earnings, he added, "We do not want to pay

The SunAmerica Also Rises

Since July 1990, SunAmerica's stock has appreciated 3,548%, versus 514% for AIG's stock.



Source: Bloomberg Financial Markets August 25, 1998

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four times book value for something and have huge amounts of goodwill that we have to write off forever." Goodwill is an accounting concept; it affects *reported* earnings (the goodwill must be written off over time), but has no impact on *economic* earnings.

The SunAmerica deal, a stock swap, will not involve "goodwill." But it is an unequivocal statement of Greenberg's opinion of the relative valuation of the two companies: pound for pound, SunAmerica is worth more than AIG.

SunAmerica, run by the extremely clever Eli Broad (who once bought a Roy Lichtenstein painting at Sotheby's for $2.5-million and charged it on his American Express card, thereby getting many free miles), has been a great bull-market company. It sells variable annuities, which bullish people buy—rather, *are sold*—during good times. Although the history of the variable-annuity business is too short for anyone to know how it will fare during the busts that usually follow booms, it's logical to surmise that during a "bust" (a.k.a. "recession") people will be more concerned about *keeping* their jobs than about "investing" for their retirements.

With the SunAmerica acquisition, approximately 57% of AIG's earnings will be derived from life insurance and financial services (based on current earnings). SunAmerica is "growing at over 30% a year, and has been doing that for 31 straight quarters," noted Greenberg, in a *Wall Street Journal* interview. We note that 31 quarters ago was the first quarter of 1991—the end of the only recession in the United States during last 16 years.

Few businesses grow at 30% a year forever. With rapid growth comes risk. Although AIG can afford the risk, one wonders why, if it *could* achieve 14% annual internal growth (what everyone was already expecting), it would pay a premium price to buy into the variable-annuity business. If SunAmerica's growth were to come to a halt—stopped in its tracks by a recession, a change in the tax code, or the absence of a bull market, for example—then AIG's run of earnings increases could be broken. Then, perhaps, investors would no longer feel like paying 24 times earnings for the company.

Buying at the Top?

SunAmerica/AIG Relative Stock Performance

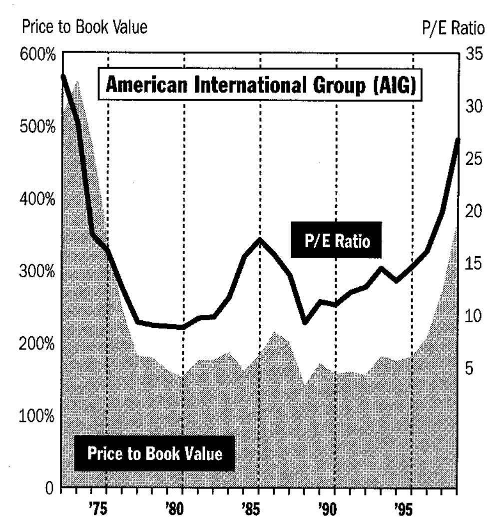
AIG is buying SunAmerica at an exchange ratio of .855 shares of AIG for each share of SunAmerica. SunAmerica is trading at the highest relative valuation to AIG in recent history.

Source: Bloomberg Financial Markets August 25, 1998

When Shelby Cullom Davis, the great insurance investor and lifelong bull, died in 1994, his largest position was AIG. During the previous 47 years, Davis—a patrician, card-carrying member of the Establishment who took the subway each morning to his office at 70 Pine Street (AIG's headquarters)—had turned $100,000 into close to $900 million. A nimble investor and trader who owned stock in hundreds of companies, he'd made his money buying equities that were out of favor, a method he called The Davis Double Play: "Find outstanding growth stocks whose value is not generally recognized," he said. "As the quality growth of these stocks becomes apparent, they sell at a higher multiple of higher earnings and thus score spectacular gains...It is no great trick to identify those companies whose earnings are growing faster than others. The trick, it seems to us, is to identify growth companies before the market recognizes them as such."

AIG: Seems Like Old Times

In 1972, AIG's shares traded at 518% of book value and 32.6 times earnings. Between 1972 and 1974, AIG's stock fell 66%, as these inflated multiples shrank, even though AIG's earnings grew. In recent years, AIG's price/book-value ratio and P/E ratio have approached levels not seen since the early 1970's.



Primary Source: Value Line August 25, 1998

Neither AIG nor SunAmerica has gone unrecognized, and The Davis Double Play can also work in reverse: if a company generally recognized as a growth company ceases to grow as expected, it would sell at a lower multiple of lower earnings, thus scoring spectacular losses (for those who bought at high prices).

"Avoid the Favorite Fifty, or its future equivalent," advised Davis. "Beware of unanimity of opinion, whether of trend or selection."

As longtime readers of this publication know, we were bullish on ten insurance stocks in late 1994, with AIG leading the list. In the last couple of years, however, our fondness for insurance stocks (and most other stocks) has disappeared: rampant speculation led to valuations that made no sense to us. Benjamin Graham's concept of "margin of safety" had supposedly become irrelevant because there *was no risk* in stocks.

No one knows whether the market's recent decline has shattered this complacency. It has, however, made us buyers of two insurance stocks: W.R. Berkley (10 times earnings, a shade over book value, and run by one of the smartest guys in the business), and EMC Insurance Group (a conservative mutual affiliate that sells for 85% of book value and yields 4.8%).

For the record, we are not buying AIG.

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September 2000
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Walk Softly and Carry a Big Multiple

An Extreme Price for Growth

It is said that markets are efficient. We won't bother to debate that. But even if they're efficient, that doesn't mean they're always rational. Markets are made by people, who are given to feelings such as optimism, fear, exuberance, and depression. Their behavior will now and then drive prices to extreme highs or lows. (Even *Schiff's Insurance Observer's* subscribers aren't always rational; several hundred have failed to sign up for our *Evening Telegraph Edition*, which is delivered by e-mail or fax and included with subscriptions at no additional charge.)

When markets become *too* irrational—when pricing, supply, or demand gets way out of whack—something usually happens. If, for example, gold were selling for $275 in London and $273 in New York, arbitrageurs would short London gold and buy New York gold. These actions would eventually result in a convergence of the London and New York prices.

Insurance can work in a similar fashion. If writing non-standard auto insurance in North Carolina is unusually profitable, the smell of money will cause numerous insurers to flock to that market. The increased competition will then drive profit margins down, or eliminate them entirely. The absence of profits will cause some insurers to exit the market, which will, in turn, reduce competition and, eventually, create an environment in which profits can be made—at least for a while.

"You suffer from the delusion that your casualty reserves are adequate."

In a brief examination, we shall turn our attention to AIG, an example of a great company whose stock trades at an extreme, optimistic, exuberant valuation that leaves little margin for safety.

There is, of course, a certain logic behind AIG's rich valuation. It has a $200-billion market cap and its stock is extremely liquid (which means that institutions can easily buy and sell in size). More importantly, AIG has a long history of steady growth. (Because AIG has never disappointed in the past, many take it on faith that it will never disappoint in the future.) AIG is a core holding of institutions and mutual funds, and, according to Zacks, is rated a "buy" by 21 of the 24 securities analysts that follow it.

Because of its virtues, AIG's shares change hands at 37.4 times earnings and 5.8 times book value—levels that are stratospheric, at least as measured by both basic math and financial history. (At a 37.4 p/e multiple, investors are earning a 2.7% yield on their investment in AIG.) To justify its current valuation, AIG *must* compound its earnings at a breathtaking rate for a long period—a feat that becomes increasingly difficult with size.

The definitive study of AIG, *American International Group: Cultivating Global Growth*, was published in May, when AIG's stock was at 74. (The report's authors,

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Alice Schroeder, Gregory Lapin, and Chris Winans, were then at PaineWebber; they are now at Morgan Stanley Dean Witter.) Their 286-page tome projects that AIG's earnings will grow at a 16% rate through 2005. If AIG does indeed do that, its current stock price, 86, will be 16 times that year's earnings. Viewed another way, if all goes as planned, in 2005 an investor will "earn" a 6.25% return, based upon AIG's current stock price.

Rather than dispute the detailed analysis of Schroeder, et al. (Schroeder, after all, is a friend, subscriber, and featured speaker at our spring conference), we'll stick to the risks of investing in AIG at its current, extreme valuation.

For starters, AIG will not be a big beneficiary of any upturn in the domestic property-casualty market, since its domestic property-casualty income is only 25% of its operating earnings. (Domestic property-casualty is projected to grow at an 8% clip.)

Although long viewed as a property-casualty company, AIG has changed its stripes, and a disproportionate amount of its future growth is expected to come from life insurance, financial services, and asset management. Domestic and foreign life insurance are projected to grow at more than a 17% pace, and earnings from asset management are projected to quadruple by 2005, and comprise 10% of AIG's earnings then (up from 5% now).

Way back in our October 1998 issue, when AIG's stock was 49, we observed that it was selling at a lofty 24 times earnings. The stock is now 86—an even loftier 37.4 times earnings.

Although AIG's earnings have expanded at a 17% annual pace over the last two years, its price-earnings ratio has expanded 60%. If AIG's p/e multiple had remained constant, its stock price would be 66 rather than 86. (If its multiple had shrunk to 20 times earnings, its stock would still be at 49.)

The bottom line: 54% of the gain in AIG's share price over the last two years has been due to the expansion of its p/e multiple, rather than to earnings growth.

Price-earnings multiples cannot expand indefinitely. Indeed, they have been known to contract. This happened to AIG (and many others) during the 1970s (see chart). During the 1990s, however, AIG's p/e multiple regained its lost ground, and then some, as AIG became *the* insurance stock.

According to Value Line, AIG's earnings have grown at a 13.5% rate over the past ten years. During that same period its p/e multiple has expanded from 10.9 times earnings to 37.4 times earnings.

An advantage of having a high p/e multiple is that a company's stock becomes a fine acquisition currency. (Berkshire Hathaway's acquisition of General Re for stock is a case in point.) Interestingly, AIG has *not* benefited much from its high multiple. Although it acquired SunAmerica for stock, SunAmerica had an even higher p/e than AIG; thus the acquisition was not immediately accretive to earnings.

AIG should earn about $5.8 billion in 2000. If it is to grow at the projected 16% next year, it must come up with an additional $900 million in earnings. (By way of comparison, Chubb's *total earnings* for next year are projected to be about $825 million.) One way AIG can grow is by using its high-p/e currency to buy earnings. AIG is acquiring HSB (formerly Hartford Steam Boiler) for $1.2 billion in stock—a price equal to 20 times earnings. Because AIG's p/e ratio is almost double that of HSB, the acquisition will be accretive to AIG's earning per share, and, in fact, should represent about 3% of AIG's earnings-per-share growth next year.

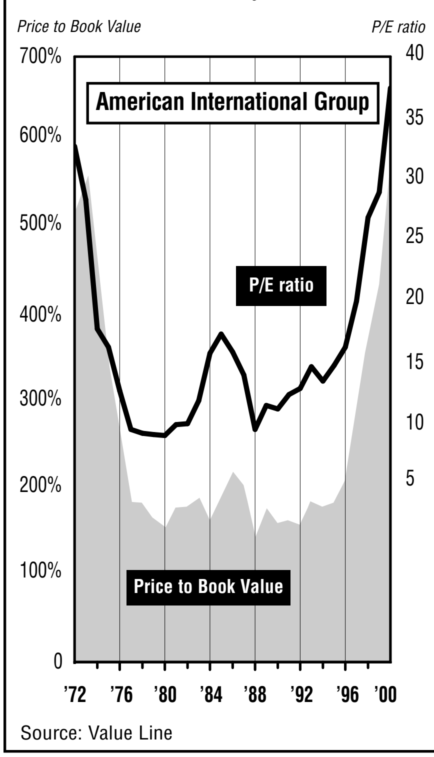
But AIG is so large that it's difficult for it to make acquisitions that, by themselves, materially alter its growth rate. At the margin, however, if it can use its stock to buy lower-multiple companies, then it can eke out incremental growth via an arbitrage of earnings' multiples.

Absent an expansion in its multiple, if AIG grows at a 14% rate forever, an investor could expect no more than a 14% annual return. If AIG's growth rate fails to achieve this difficult hurdle, it's slower growth would likely lead to a much lower multiple. (A much lower multiple could also occur if investors' exuberance subsides.)

From our vantage point, the risk of buying AIG outweighs the reward. ■

AIG: Does Anyone Remember 1972?

In 1972, AIG's shares traded at 518% of book value and 32.6 times earnings. Between 1972 and 1974, AIG's stock fell 66%, as these inflated multiples shrank, even though AIG's earnings grew. During the last two years, AIG's price-to-book-value ratio and p/e ratio have entered uncharted territory.



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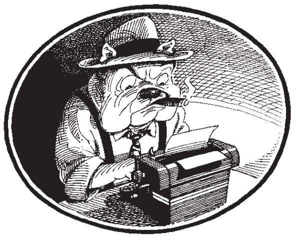

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SCHIFF'S
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April 5, 2001
Volume 13 • Number 8

AIG's 'Hostile' Takeover Attempt for American General

Is AIG's Stock Too High?

On Tuesday, after the market had closed, AIG announced an unsolicited $46-per share offer to acquire American General in a $23-billion stock transaction—a 25% premium over the closing price.

One wouldn't go so far as to call Hank Greenberg a corporate raider, but the fact remains: American General had previously agreed to be acquired by Britain's Prudential Plc. The value of that transaction—$26 billion when announced—had fallen due to the decline in Prudential's shares. Hank Greenberg, seizing the moment, made a big move at a time when his actions were likely to be met with acceptance from Wall Street, and scant resistance from American General. (Since the company was already in play, management could not easily rebuff a significantly higher offer.)

That AIG would attempt to use its richly valued stock to make acquisitions isn't surprising. On February 16 we wrote that we expected insurance companies to issue equity to take advantage of the favorable market for insurance stocks. We didn't expect AIG, "which sells for 548% of book value, to issue stock in a secondary offering. AIG is so large ($200-billion market cap) that it couldn't do an offering large enough to be meaningful. Hank Greenberg has said, however, that AIG is looking at acquisitions, and given his company's stupendous price-earnings (p/e) multiple, we'd be surprised if his currency of choice was not AIG stock."

Last September, in an article discussing the optimistic valuation accorded AIG's shares, we noted that because AIG's stock had an extremely high p/e ratio (37.4), it made a fine acquisition currency. We also noted that AIG hadn't been able to put that currency to good use. (Given AIG's multiple, almost any acquisition would be accretive to earnings the first year—although not necessarily in later years.)

In order for AIG to maintain its sky-high p/e ratio, at the very least it must continue to achieve the rapid and steady growth in earnings per share for which it is known and loved. Given AIG's size and its cyclical businesses—including property-casualty insurance, life insurance, investment, finance, financial services, and aircraft leasing—we've been skeptical (for several years) of AIG's ability to accomplish that. Consequently, we've felt that the risk in owning AIG's stock was greater than the reward.

Price-earnings ratios and cyclicity aside, acquisitions are one way for AIG to goose its earnings, at least for a while. But, as we observed, "AIG is so large that it's difficult for it to make acquisitions that, by themselves, materially alter its growth rate. At the margin, however, if it can use its stock to buy lower-multiple companies, then it can eke out incremental growth via an arbitrage of earnings multiples."

AIG's proposed takeover of American General would be an example of such an arbitrage.

Hostile?

Although AIG's offer for American General was unsolicited, there's some question as to whether it's "hostile," and whether AIG engages in hostile takeovers. *The New York Times* reported that Greenberg said his offer was "not hostile." *The Wall Street Journal* stated that "AIG has never pursued a hostile takeover."

One could get into a long discussion of what "hostile" means, which we aren't inclined to do. However, a deal is generally considered hostile if the CEO of the target doesn't want to be taken over—regardless of whether the deal is good for shareholders. We don't care if a deal is hostile or not, and neither do sharehold-

AIG's Price-Earnings Ratio

The rise and fall and rise of AIG's p/e ratio.

Year	Average annual p/e ratio
1972	32.6
1973	28.2
1974	17.5
1975	16
1976	12.4
1977	9.2
1978	8.9
1979	8.8
1980	8.7
1981	9.6
1982	9.7
1983	11.6
1984	15.5
1985	17.1
1986	15.6
1987	13.7
1988	9.2
1989	11.2
1990	10.9
1991	12.1
1992	12.6
1993	14.4
1994	13.2
1995	14.5
1996	16
1997	19.8
1998	26.7
1999	28.8
8/18/00	38.4
4/5/01	31.9

ers. They generally care about which deal gives them the best value.

Whether AIG engages in “hostile” deals, however, is a subject worth a few paragraphs. For example, AIG has been gradually increasing its ownership in 21st Century Insurance, and now has 63% of the company. Shareholders might rightly view AIG’s accumulation as a “creeping takeover”—one in which it gains control without paying the control premium that a tender offer for the entire company would necessitate.

AIG has also struck fear in the hearts of insurance companies in the past. In 1974, American Reinsurance filed suit to prevent AIG from buying more than 9.9% of American Re’s stock. In 1979, Mission Insurance Group rejected an unsolicited merger offer from AIG (which then owned 4.5% of Mission), stating that the deal was “not in the best interest of Mission and its stockholders.” (Mission was wrong.)

In 1981, AIG disclosed that it had acquired 8.53% of USLife, prompting that company’s chairman, Gordon Crosby, to state that USLife’s board was opposed to any attempt to take over the company, and that it was in USLife’s best interest to remain independent. In 1982, AIG sold its USLife shares back to USLife. (In 1997, USLife was acquired by American General in an all-stock transaction.)

In 1983, AIG bought 8% of Progressive and was planning to purchase a 12.3% stake held by American Financial. This threat prompted a group of Progressive shareholders who held a 39% interest in the company to form a bloc opposing AIG’s accumulation of Progressive shares. As a result, AIG cancelled its agreement to buy American Financial’s 12.3% stake, and American Financial subsequently sold these shares back to Progressive.

The American Re, Mission, USLife, and Progressive situations differed from that of American General in at least one respect: none of those companies was already “in play,” and AIG would have had considerable difficulty accomplishing a takeover that was unwanted by those companies. (In order to acquire an insurance company—especially one with licenses in many states—the approval of each state’s regulator is generally required. A hostile insurance takeover is time consuming, and the regulatory roadblocks can make a deal impossible. Allegheny, for example, was unable to take over St. Paul.)

E-Madness: Internet vs. Insurance—An Update

Market caps of various companies, in billions of dollars.

Internet	12/10/99	01/14/00	10/13/00	04/04/01
America Online	$205	$141	$123	$155*
Yahoo	93	93	33	7
Amazon	36	22	10	3
CMGI	23	30	5	0.65
eBay	21	17	15	8.2
E*Trade	9	7	4	1.8
InsWeb	1	0.7	0.06	0.04
Quotesmith	0.2	0.2	0.03	0.006

Insurance	12/10/99	01/14/00	10/13/00	04/04/01
AIG	$172	$177	$214	$179
Marsh & McLennan	24	28	32	25
Allstate	22	19	24	30
Cigna	15	15	18	16
Hartford	10	10	16	14
Chubb	9	10	13	12
Progressive	6	5	5	7
W. R. Berkley	0.6	0.5	0.8	1.3

*Valuation is after stock merger with Time Warner

A final thought: Greenberg had breakfast with American General’s CEO, Robert Devlin, six months ago and, according to Greenberg, there was supposed to be some follow-up, but it never occurred. One presumes that if Devlin had wanted AIG to acquire American General, then he’d have picked up the phone and asked Greenberg to make a bid.

Anyway, Hank Greenberg is a genius, and if he says that his unsolicited offer to buy American General isn’t “hostile,” then who are we to disagree?

Thoughts on Speculation

Before discussing this deal further, we want to step back and examine the current stock-market environment, speculation, and p/e multiples, because these affect AIG’s ability to complete a deal, and because they’re driving forces in the industry.

We conducted a Dow Jones News Retrieval search to see how many times the words “stock,” “market,” and “bubble” appeared in articles during March. The number—1,710—was sizable, apparently demonstrating that reporters are good at identifying a stock-market bubble after it has burst. (In March 1999, for instance, these words appeared one-third as often as they did this past March.)

Although we labeled “Internet-stock mania” a “speculative bubble” in our March 1999 issue, we didn’t profess to know *when* it would end, even though we had thoughts about *how* it would end. As we wrote, “Whether one chooses to call the current U.S. economic environment a boom, bubble, bull market, or new era, it will, in all likelihood, be followed by what will be known as a bust, bear market, recession, or depression.”

While our call was accurate, it wasn’t necessarily something one could profit from. Indeed, the price of Internet and tech stocks continued to rise sharply for the next 12 months.

In December 1999 we noted that Yahoo’s market cap—then $93 billion—was equal to those of Marsh & McLennan, Allstate, Cigna, Hartford, Chubb, St. Paul, and Progressive *combined*.

Things have changed. Yahoo is now valued at $7 billion, while the insurance companies are worth $25 billion, $30 billion, $16 billion, $14 billion, $12 billion, $9 billion, and $7 billion, respectively, or a total of $113 billion.

How could Yahoo, which had $1.1 billion in revenues in 2000, *ever* carry a $93 billion valuation? (Indeed, one must make very optimistic assumptions to justify the company’s *current* valuation.) The answer is that Yahoo’s valuation was wildly speculative, and represented investors’ frenzied and unwarranted optimism about the company’s long-term prospects. Yahoo was priced for permanent perfection, and when that didn’t materialize, its absurd p/e ratio gave the company a long way to fall before it would be priced rationally. As James Grant, editor of the marvelous *Grant’s Interest Rate Observer* recently wrote, “Booms don’t last forever: they are cut short by their own excesses… However, busts, too, generate excesses that tend to hasten cyclical reversals, or at least to exaggerate their magnitude once they start.”

continued

We bring up Yahoo not just because we've written about it in the past, but because it's a good example of an extreme. Financial history is filled with companies that sported wildly high valuations during periods of mass euphoria, and depressed valuations (or no valuation) during the ensuing busts.

The boom-and-bust cycle isn't limited to technology stocks—over the years it has embraced virtually every industry, from automobiles, oil & gas, telephones, utilities, and conglomerates, to electronics, specialty retail, entertainment, restaurants, finance, and, yes, insurance.

All of which brings us back to AIG. We first expressed concern about the company's p/e and price-to-book ratio back in October 1998 when its stock price was $49—$27 lower than it is now. We revisited the subject in our September 2000 issue, when AIG's stock was $86. Although AIG's excellent record of earnings growth is one of the factors in its stock's superior returns, it isn't the only factor. AIG's p/e ratio has been in a long-term bull market of its own; more than quadrupling since its bottom in 1979.

A recent Merrill Lynch study showed that since 1980, AIG's average p/e ratio based on *forward consensus estimates* has been 13.8. The lowest p/e ratio—6.8—was recorded in June 1982, and the highest—35.1—occurred in December 2000. Perhaps coincidentally, AIG's average p/e, according to the Merrill study, is not very different from the S&P 500's average p/e over the last 129 years—14.5.

If one can infer anything about valuations from the past it is this: they fluctuate considerably. In 1929, for example, the Dow Jones Industrial Average (DJIA) was priced at 4.5 times book value. Three years later, when the DJIA hit its all-time low, it was valued at one-half of book. (The p/e ratio wasn't meaningful in 1932, as the companies in the DJIA lost money.)

Although the S&P 500's p/e ratio has averaged 14.5 over the long term, stocks have often traded way above, or way below, that figure. Valuations, however, have historically reverted to the mean, and then some. Every period in which stocks have traded in excess of a 14.5 multiple has been followed by a period in which valuations fell well below that figure. History, of course is just a guide, not a blueprint for the future. The past does not have to repeat itself.

Thus, the history of AIG's valuation doesn't foretell how AIG's stock will be valued in the future. Nonetheless, the past is still worth considering. In 1972, AIG's p/e ratio was 32.6—about what it is today. Despite the fact that AIG's earnings continued to rise steadily, AIG's shares lost two-thirds of their value over the next two years, and AIG's stock price didn't get back to its 1972 high until 1978—even though earnings had quadrupled and book value had tripled during that period.

AIG is a great company, but there's considerable risk in owning a financial-services company selling for 32 times earnings. AIG's high valuation leaves little room for error or disappointment.

In order for AIG's shares to appreciate, two things must happen: earnings per share must grow, and the p/e ratio must remain the same or go higher. Steadily rising earnings per share are essential because investors, in anticipation of such, have bid up AIG's stock to an extreme p/e ratio, which, of course, facilitates AIG's use of its stock to acquire lower-multiple companies, thus providing a boost to earnings per share. As AIG gets larger—and it is already huge—greater than average growth becomes more difficult.

While it's wise for AIG to use its high-multiple stock to make acquisitions, one concerned with security analysis must ask a basic question: if AIG, which trades at 32 times earnings, buys American General for 18 times earnings, should AIG's 32 multiple be applied to American General's supposedly lower-growth business once that business becomes part of AIG? According to Greenberg, the answer is yes. At yesterday's conference call he spoke of cross-marketing and cost savings, and said, "I'm comfortable that two and two here will make five, if not seven."

In the 1960s, under the guise of "synergy"—a *2+2=5* equation—conglomerates, which had staggeringly high p/e ratios, acquired diverse, lower-multiple businesses including bakeries, foundries, machine shops, and insurance companies. For a while, the market was willing to apply the conglomerates' high p/e multiples to the earnings acquired from the acquisition of slower-growth businesses. Eventually, however, the merry-go-round came to a halt.

In theory, AIG—or any business with a high p/e ratio—can be a perpetual growth machine by endlessly performing the arbitrage of using its high p/e stock to acquire earnings that are selling at a lower p/e. In practice, this is difficult to do, and, of course, is dependant upon, among other things, always having a high p/e multiple.

Investors in AIG would do well to remember that AIG, which traded at 32.6 times earnings in 1972, traded at 8.7 times earnings in 1980, 9.2 times earnings in 1988, and 13.2 times earnings in 1994.

Although Yahoo traded at 100 times revenues last year, we doubt that AIG's p/e ratio has much room for expansion. Absent any change in the p/e, investors' returns will mirror AIG's growth, which many analysts peg at about 15% annually.

If that growth fails to materialize for some reason—or if earnings actually decline, as they did in 1984—it's a safe bet that AIG will trade at a much lower multiple.

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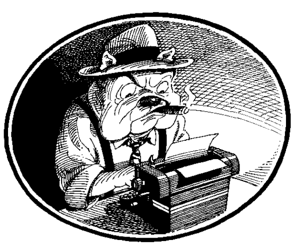

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SCHIFF'S

INSURANCE OBSERVER

May 2, 2002
Volume 14 • Number 7

The Greatest Risk is Taking Too Much Risk

AIG's Audit-Committee Report

In its reports for the years ending 2001 and 2000, AIG's audit committee disclaims virtually all responsibility for AIG's accounting, internal controls, and financial statements. It also says that it cannot assure that AIG's independent accountants are actually "independent." (The most recent audit-committee report is on page 17 of AIG's proxy statement.)

If AIG's audit committee can't express an unqualified opinion about AIG's accounting, doesn't it make sense that the public's faith in AIG's accounting should be somewhat diminished? And, if the public's faith is diminished, isn't it reasonable to expect AIG's stock to trade at a lower multiple of earnings than it would otherwise trade?

Before discussing these issues, we'll note that AIG has been the greatest success story in the insurance business. It's the largest, most important insurance organization in the world. The story of its success, however, is not readily available. Although Hank Greenberg is a legend, his achievements have not received widespread attention. *Jack: Straight from the Gut* is on the best-seller list; *Hank: Straight from 70 Pine Street*, will probably not be written.

We have great admiration for Greenberg (given his record, it's hard not to), and are planning to write a lot about AIG in the coming months. Although we'd prefer to write chronologically, publishing constraints make this difficult. Thus, this article focuses on current issues rather than on AIG's 1969 exchange offers or Greenberg's letters to shareholders in the 1970s, even though all of these subjects are of equal interest to us.

Hank Greenberg stays ahead of his competitors.

In the post-Enron Era, the minutia of accounting principles have become of greater concern to many. Investors, having recently seen several trillion dollars of stock-market value melt like butter on a hot skillet, are more skeptical of companies whose finances are complex or opaque—even those companies with fine long-term records. This wariness is logical; if you can't understand a business and analyze its financials, how can you place a value on the company?

This was not a question asked often enough during the great bull market, when the "extrapolation method" of analysis was sufficient for many "investors." (They would take recent years' *reported* earnings and project the same growth rate for many years into the future.) This method had its advantages: it was really simple and saved a lot of time that would have otherwise been spent reading balance sheets, cash-flow statements, and footnotes.

The extrapolation method has a drawback, however—it doesn't work. The footnotes, fine print, and SEC-mandated disclosures are there because they're important. Words really mean something, and when a company says something unusual—or doesn't say something usual—one should take that into consideration.

AIG has a long record of growth, but the market's opinion of its growth has varied. In 1988, AIG's stock traded at an average of 9.2 times earnings. By December 8, 2000, when the stock hit an all-time high of $103.75 (it is now $71.51), the p/e ratio had quadrupled to 42. Such a multiple is difficult to justify in any company, much less one so large that its future growth rate cannot possibly match its past.

What is the proper multiple for a highly complex, international financial-services conglomerate whose businesses are cyclical? We don't know—nor does anyone else—but the lower the multiple, the more appealing we find the stock.

In 2001, AIG's earnings did something that not one of the dozens of analysts following the company expected—they declined. The decline, the first since 1984, was a reminder that even the greatest companies are not immune to the vicissitudes of business. Investors, however, don't like being reminded that the earnings of "growth" companies do not always grow. (While a growth company's failure to grow may be irksome to growth-stock investors, it is not nearly so irksome as the failure of a growth company to maintain solvency—the condition that afflicted Enron.)

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According to the SEC, "Audit committees play a critical role in the financial reporting system by overseeing and monitoring management's and the independent auditors' participation in the financial reporting process." Financial statements are *prepared* by management and *audited* by independent accountants.

PricewaterhouseCoopers, AIG's independent accountants, says that it conducted its audit of AIG in accordance with generally accepted standards, and that the audit provides a reasonable basis for its opinion that AIG's financial statements present the company's financial condition fairly, in all material respects. This is standard lingo found in virtually every financial statement.

AIG's audit-committee report, however, provides an opinion that's ambiguous, elusive, equivocal, hedged, and oblique—qualities that aren't particularly comforting to investors or creditors. (Perhaps the only outside parties that would like the wording in the audit-committee report are the company's D&O insurers.) The report does not contain the same language found in many other audit-committee reports. In fact, AIG's audit committee's disclaimers are so extensive that they render the report virtually meaningless.

The key paragraph in AIG's audit-committee report follows. We've added italics for emphasis:

> The members of the [Audit] Committee are not professionally engaged in the practice of auditing or accounting and are not experts in the fields of accounting or auditing, including in respect of auditor independence. Members of the Committee rely without independent verification on the information provided to them and on the representations made by management and the independent accountants. Accordingly, *the Committee's oversight does not provide an independent basis to determine that management has maintained appropriate accounting and financial reporting principles or appropriate internal controls* and procedures designed to assure compliance with accounting standards and applicable laws and regulations. Furthermore, *the Committee's considerations and discussions referred to above do not assure that the audit of AIG's financial statements has been carried out in accordance with generally accepted auditing standards, that the financial statements are presented in accordance with generally accepted accounting principles or that AIG's auditors are in fact "independent."*

The disclaimers in AIG's audit-committee report aren't common. Perhaps AIG is on the cutting edge, however, and in years to come more audit committees will adopt similar verbiage.

Viewed by itself, AIG's audit-committee report is not such a big deal. But viewed in the context of AIG's inherent complexity and the inherent imprecision of insurance-company "earnings," it takes on greater meaning and is worth thinking about.

AIG' stock has declined more than 30% from its all-time high, and is now trading at the price it was three years ago—despite the fact that the company is expected to produce record earnings this year. On many occasions, AIG has benefited from having a high p/e ratio; it has been able to use its stock to make acquisitions on attractive terms. Its current p/e ratio (about 20 times projected earnings) reduces the possibility of most stock acquisitions because the effect of issuing stock at this level (relative to what AIG would receive in return) would probably be dilutive to earnings rather than accretive.

None of this is lost on Hank Greenberg, who seemingly knows everything. He is acutely aware of the importance of financial strength as well as the importance of perception. If, for example, people perceive—correctly or incorrectly—that AIG does not pay claims, it will, at the margin, hurt AIG's business. If AIG's financial strength is perceived as being weaker than it is, that can become a self-fulfilling prophecy as lenders demand slightly higher spreads, causing the company's cost of capital to rise, thereby reducing profitability. Finally, if AIG's stock price is tainted by Enronesque issues such as complexity, lack of transparency, or sheer incomprehensibility, then it stands to reason that the stock will trade at a lower multiple of earnings than it would otherwise.

While no one knows with certainty the reasons why a stock goes down (other than the obvious—that sellers were more persistent than buyers), it appears that

AIG's stock has been under pressure for several reasons: 1) it had been selling at an unusually high multiple; 2) the company reported a decline in earnings last year, 3) investors are more concerned about accounting and complexity than they have been in the past; 4) AIG is difficult to understand, and investors are less willing to accord high multiples to things they don't understand; and 5) AIG is a diversified financial company rather than a pure play on property-casualty, and therefore is not benefiting as much as some companies from the turn in cycle.

AIG's stock price appears to be of considerable concern to AIG, and the company has been attempting to respond to various criticisms. For example, it has been faulted for having too few "independent" directors. Its response: Bernard Aidinoff, a director since 1984, is now "senior counsel" at Sullivan & Cromwell (which represents AIG) rather than a "partner." And Carla Hills, a director since 1993, terminated her consulting agreement with AIG in early 2002. We doubt that these cosmetic changes will make Aidinoff and Hills better or worse directors than they were before. (Most corporate directors aren't *too* independent, anyway. If they were, they wouldn't be put on a board in the first place.)

AIG has now instituted quarterly conference calls—the first was held last week—and has provided additional disclosure in its annual report and 10-K. It has also attempted to deal with the "succession" issue by creating an Office of the Chairman, naming co-chief operating officers, and announcing several promotions. (The actuaries at *Schiff's* think that Greenberg is in better shape than most insurance-company CEOs, and won't need a successor for many years.)

It's impossible to say whether any of the changes made by AIG will have any effect on the company's stock price. As Benjamin Graham famously wrote, in the short term the market is a voting machine; in the long term it is a weighing machine.

Which brings us to the morning of April 22. AIG's stock was down several points amidst rumors that the company would miss its second-quarter earnings (it didn't), and that it was being investigated. In the early afternoon, AIG put out the following press release: "AIG's stock is trading down significantly. We have observed considerable short selling in the stock and have requested the New York Stock Exchange and the Securities and Exchange Commission to investigate this activity."

Blaming shortsellers for a decline in a company's stock is a tactic often used by highly promotional companies whose shares are overvalued, and is unusual for a company of AIG's stature, for many reasons. First of all, *shortselling is not illegal or unethical*. (At year end, AIG was short $8.3 billion of securities and commodities.) So why did AIG ask the authorities to investigate? ("No comment," said AIG.)

If AIG is so concerned about the trading activity in its stock, why didn't it ask the SEC and NYSE to investigate the considerable *buying* (and all the brokerage "buy" recommendations) when its shares were 50% higher and, apparently, trading under the influence of irrational exuberance?

Also, *how* did AIG "observe" short selling on April 22? ("No comment," said AIG.)

AIG's request that the NYSE investigate carries extra weight. Hank Greenberg is on the NYSE's board, and AIG director, Frank Zarb, is the former chairman of the NYSE's nominating committee. Section 202.03 of the NYSE's "Listed Company Manual" provides the following recommendations for dealing with rumors or unusual market activity:

202.03 Dealing with Rumors or Unusual Market Activity

If rumors or unusual market activity indicate that information on impending developments has leaked out, a frank and explicit announcement is clearly required. *If rumors are in fact false or inaccurate, they should be promptly denied or clarified. A statement to the effect that the company knows of no corporate developments to account for the unusual market activity can have a salutary effect*…[Emphasis added.]

The Exchange recommends that its listed companies contact their Exchange representative if they become aware of rumors circulating about their company...Information provided concerning rumors will be promptly investigated.

Why didn't AIG use the standard NYSE comment—that it knows of no corporate developments to account for the unusual market activity—in its press release? ("No comment," said AIG.)

After all the "no comments" we didn't bother asking AIG if it "observed" any of the alleged shortsellers reading a copy of the company's audit-committee report.

Coming soon in a future issue of Schiff's Insurance Observer*: "The Great Greenberg and the Rise of AIG."*

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SCHIFF'S

July 25, 2002
Volume 14 • Number 10

INSURANCE OBSERVER

AIG, Audit Committees, Legends, and P/E Ratios

The Tao of Hank, Part 1

On May 2 we published an article about AIG's audit-committee report. Specifically, we noted that the report's elusive, equivocal verbiage made it little more than an extensive disclaimer—exactly the opposite of what an audit-committee report should be.

Audit-committees reports are a dull subject. So dull, in fact, that to the best of our knowledge, no one else in the world had written about the disclaimers in AIG's report. (In fairness to AIG, a number of other large companies used the same evasive language.)

Our article caused a stir among insurance cognoscenti, and then created something of a commotion when *The Economist* had the good judgment to pick up our story. Although we received positive feedback from many subscribers, we were amazed that some subscribers—including respected analysts and insurance-company presidents—told us that our observations were out of line. Audit committees are not worthy of so much attention, they said, and it reflected poorly on us to be making a big deal about them.

It seems remarkable that less than three months ago learned folks still believed that the numbers in companies' financial statements were *sanctified* just because CEOs and the accountants they hired set those numbers in type.

Of course, any belief in the inviolability of corporate accounting disappeared on June 25, when WorldCom's numerical innovations became known. That audited financial statements can be manipulated so that losses become profits is nothing new. Nor is it new that many companies are run by rapacious scoundrels.

During bull markets investors happily ignore blatant warnings. In our August 1999 issue, for example, we commented on InsWeb, the Internet insurance marketplace that had just gone public and commanded a $1.5 billion market cap, even though it had virtually no revenues and expected to "incur substantial operating losses for the foreseeable future."

Thanks to the Securities Act of 1933, there was no reason for any investor to lose a penny investing in InsWeb. The Securities Act—also known as the "truth in securities" law—requires issuers to provide investors with meaningful disclosure. InsWeb dutifully carried out its responsibility, and warned investors about the toxicity of its common stock. The "risk factors" section of its prospectus came in at 8,477 words, which may be a record. (InsWeb's stock is now down 99%.)

In our May 2 article, we questioned whether the failure of AIG's audit committee to express an unqualified opinion about the company's accounting would cause AIG's stock to trade at a lower multiple of earnings. (AIG stock was then $71.51; it is now $53.38.)

Before we delve further into AIG's accounting and audit-committee report, the SEC, and related subjects, we want to make sure that readers put our thoughts in perspective. Over the years we've written about a dozen articles on AIG. We've commented on its success, complexity, mergers and acquisitions, and p/e ratio. In late 1994 we wrote that AIG's stock was cheap and that we'd bought it. (We sold it several years later.) In 1998 and 2000, we noted that AIG's p/e ratio was so high that the stock price had scant margin of safety. We've also written about companies that AIG has subsequently acquired (SunAmerica), and about AIG's mysterious offshore reinsurance transactions (Coral Re).

There are many reasons to write about AIG, not the least being that it is the largest, most important, and greatest worldwide insurance organization. AIG, by virtue of its size, scope, "AAA" rating, and nature is a fabulous (and fabulously complex) company. It is not, however,

AIG's Audit Committee Report: Caveat Emptor

The key paragraph in AIG's audit-committee report follows. Italics have been added for emphasis.

The members of the [Audit] Committee are not professionally engaged in the practice of auditing or accounting and are not experts in the fields of accounting or auditing, including in respect of auditor independence. Members of the Committee rely without independent verification on the information provided to them and on the representations made by management and the independent accountants. Accordingly, *the Committee's oversight does not provide an independent basis to determine that management has maintained appropriate accounting and financial reporting principles or appropriate internal controls* and procedures designed to assure compliance with accounting standards and applicable laws and regulations. Furthermore, *the Committee's considerations and discussions referred to above do not assure that the audit of AIG's financial statements has been carried out in accordance with generally accepted auditing standards, that the financial statements are presented in accordance with generally accepted accounting principles or that AIG's auditors are in fact "independent."*

easy to understand, and cannot be fully understood by an outsider. (Actually, it cannot be *fully* understood by an insider, either, but that's probably true of every giant multinational.) AIG's history—which we've been researching for some time—is a story of entrepreneurship, daring, audacity, internationalism, and capitalism. It is a remarkable feat that in 40 years or so, AIG, which was a loosely-knit group of foreign underwriting agencies, life insurers, and second-rate domestic insurers—managed to eclipse, by a wide margin, the titans of yesteryear: Aetna, CNA, Connecticut General, Continental, The Hartford, The Home, INA, Metropolitan, Prudential, Travelers, and USF+G. Today, AIG is worth much more than all these combined.

Hank Greenberg, who has led AIG for the last 33 years, is admired, respected, and feared. Greenberg, despite his 77 years, is not mellow; he's intense and competitive. He's also charming, charismatic, funny, and deeply concerned about every aspect of his business. He's filled with energy and enthusiasm, and, despite his involvement with big issues around the globe, seems easily aggravated by details so small you wouldn't expect the CEO of one of the world's largest companies to pay attention to them. Greenberg's attention to minutia does not seem to have hurt his company's results. Perhaps it has even contributed to his success.

If there's anyone in the industry who can be considered a living legend, it is Greenberg. This status was dramatized at *Schiff's Insurance Conference* in April, at which he was the first speaker. After Greenberg had talked for almost an hour without notes, he was asked a good question: "How do you spend your day?" He gave an answer that interested our hardboiled, skeptical audience. (We won't repeat it; you just had to be there.) It is unimaginable that the same audience would exhibit much curiosity about how other insurance CEOs spend their days.

Why do insurance mavens care what Greenberg does all day? We care because, in an industry where it's so easy to go awry and so hard to excel, AIG has accomplished what no other company has. Watching Greenberg's performance is akin to watching a sleight-of-hand artist who makes cards appear and disappear. Although you know the legerdemain isn't magic—it's the result of practice and hard work—it seems like magic.

"When the legend becomes fact, print the legend," says the newspaper editor at the end of John Ford's elegiac Western, *The Man Who Shot Liberty Valance*. But separating legends from facts is often impossible. "Once a newspaper touches a story, the facts are lost forever," Norman Mailer wrote, "even to the protagonists." So we all read about the Greenberg of legend: the World War II and Korean War veteran who's tough, hard-driving, combative, and intolerant of failure. There is, of course, much more to him.

Greenberg is a disciplined man. He is lean and fit, and his posture is perfect. He is careful about what he eats and exercises regularly. He appears to have little interest in the trappings of extreme wealth. He doesn't have the fanciest homes or the biggest art collection, and his name doesn't appear in society columns. He wears conservative suits, button-down shirts, and an inexpensive watch. He loves to ski and play tennis. He can recall names and details from 50 years ago.

Schiff's has gotten to know many insurance CEOs reasonably well over the years. One could say that they all have a reason to talk to us: to attempt to influence us or to get on our good side (the presumption being that we actually have a good side). Out of all those CEOs, we have never met anyone who has been as open as Greenberg.

And yet, there are many Wall Street analysts who are terrified of him because they believe that *if he wanted to, he could cause them to be fired*. This may or may not be true, but if it is widely believed, then isn't the effect the same as if it were true?

Many of Greenberg's competitors—sane, successful men—are also afraid of pissing him off because—mind you, this is just one example—*he controls the New York Department of Insurance and could get them tied up in a regulatory morass*. Whether he really controls the department is irrelevant to the *perception* that he does. The effect on his competitors is the same. (When we discussed this with him, Greenberg scoffed at the notion that he controls the insurance department, and grumbled something about how long it takes AIG to get filings through.)

The foregoing brings us back to our May 2 article about AIG's audit-committee report, and our musings about the effects that issues of complexity and transparency have on AIG's stock price and p/e ratio.

The gist of our article was that AIG's audit committee, in its reports for the years ending 2001 and 2000, used atypical—and in our view, inappropriate—language: "The [audit] committee's oversight does not provide an independent basis to determine that AIG's management has maintained appropriate internal controls and procedures," stated AIG's audit-committee report. "The committee's considerations…do not assure that the audit of AIG's financial statements has been carried out in accordance with generally accepted auditing standards…*or that AIG's auditors are in fact 'independent.'*" [Emphasis added.]

The audit-committee's verbiage prompted us to pose two questions: 1) If AIG's audit committee (which, like all audit committees, is comprised of "independent" directors), can't express an unqualified opinion about AIG's accounting, doesn't it make sense that the public's faith in AIG's accounting should be somewhat diminished, and 2) if the public's faith is diminished, isn't it reasonable to expect AIG's stock to trade at a lower multiple of earnings than it would otherwise?

The first question is more important, because if the answer to it is "No," the second question becomes moot. Since it is a *fact* that AIG's audit-committee report contains caveats that render it virtually meaningless, we are faced with the inevitable question: Will these caveats diminish the public's faith in AIG's accounting?

There are reasons why one could answer "No": 1) Some other large companies use identical language, and, perhaps, hundreds use similar language; 2) The caveats are there for legal reasons; 3) The financial statements are prepared by management and audited by outside accountants; 4) The audit committee merely plays an "oversight" role. Assurance about the financial statements comes from the outside accountants in the "Report of Independent Accountants" and from AIG's management in the "Report of Management's Responsibilities;" 5) The audit committee can't be expected to provide assurance that the financial statements conform to GAAP or that the accountants are actually independent; 6) The audit committee is comprised of respectable people; and, 7) One would have to be out of his mind to think that anyone gives a damn about audit-committee reports.

These responses are reasonable enough, but we continue to doubt they'll satisfy every thoughtful, intelligent investor. If that is correct, then it's reasonable to assume that the caveats in AIG's audit-committee report have *some* effect on AIG's p/e multiple, even if that effect is slight. We don't know of any way to estimate what the effect will be or how to measure it.

As we mentioned in our previous article, in the post-Enron (and now, post-WorldCom) era, accounting minutia are of greater concern to many. By itself, AIG's audit-committee report is not a smoking gun. However, no one views *anything* by itself. The audit-committee report is one piece of a large puzzle. On one hand there's AIG's great history and strong businesses; on the other hand there's the company's inherent "black-box" complexities. Investors, for good reasons, are now more wary of complexity—and of things they don't understand.

AIG's caveat-filled audit-committee report is a farce, and AIG's board made a mistake when it accepted it. Perhaps it didn't understand that the times were changing and AIG's stock, which had traded at an unusually high p/e multiple for many years, was vulnerable. We wrote numerous times over the last four years that the risk of buying AIG's shares at a stratospheric p/e multiple outweighed the reward.

AIG's p/e multiple, which had been a single-digit figure for much of the 1970s and 1980s, rose sharply after 1988, which boosted the increase in AIG's stock price over the years. (The p/e multiple eventually peaked at about 42—a figure that left virtually no margin of safety.) AIG's stock has been declining for a year and a half. Viewed another way, the company's p/e multiple has been contracting.

Beginning next month, Hank Greenberg will file a sworn written statement with the SEC personally attesting that AIG's financials are materially truthful. (Officers at 945 large companies must file the same statement for their companies.)

Beginning next year, we expect AIG's audit committee to drop the caveats and disclaimers in its report. While that won't make AIG easier to analyze, it will make the audit committee more responsible for its work. That can only be a good thing.

To be continued. Part 2 of this article will probably appear early next week.

A couple of months ago, when discussing AIG with Greenberg, we said that when valuing the company we put a lower multiple on earnings from GICs than on other earnings. Greenberg's response: "I don't think you should value the company based on the components of its earnings. It's the diversification of earnings that's important. That's what makes AIG. It's the totality...not the pieces. AIG is a great company with an unparalleled franchise. You couldn't put it together today if you wanted to."

We don't use the same method to value AIG that Hank does, but we do agree with his sentiments. Although we don't think AIG's stock is a bargain, in the interest of full disclosure we must admit that we became a shareholder yesterday. We paid $49 per share—14 times this year's projected earnings. That's higher than we like to pay, and it gives our investment a more speculative characteristic than we ordinarily prefer.

Unlike stockbrokers, who rate a stock a "buy" and then list a much higher target price, we tend to think about how much lower a stock must go before we buy more. Right now we're planning to double our investment when AIG hits 39. Of course, we may change our opinion. If we do, it is highly unlikely that we will notify you at that moment.

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SCHIFF'S

INSURANCE OBSERVER

August 16, 2002
Volume 14 • Number 11

AIG to Change Audit-Committee Report

Don't Look Back

"Your mother is responsible for your fear of Generally Accepted Accounting Principles."

American International Group can run but it can't hide, and Hank Greenberg knows that. Times have changed, and AIG is trying to change with them. Thus, in the new corporate spirit of openness and transparency, AIG has held its first quarterly conference call to discuss its earnings, created an office of the chairman, made two of its so-called "independent" directors *more* "independent," ran an all-day meeting for investors, provided new disclosures in its annual report and 10-K, and announced that it will expense stock options beginning next year.

Most of these changes are cosmetic—form over substance—but they're positive and make good sense for AIG which, due in part to its complexity and inherent impenetrability, is now viewed with considerably more skepticism than it has been for many years.

For our money, however, the most significant change that AIG will make is one that hasn't been reported: it will alter its audit-committee report in next year's proxy statement.

For the past two years AIG's board of directors has accepted—and fobbed off on shareholders—audit-committee reports that were evasive, equivocal, and not in keeping with the spirit of last year's SEC requirement that an audit-committee report be included in public companies' proxy statement.

Beginning next year, AIG's audit-committee report will, apparently, contain a positive opinion about AIG's financial reporting rather than a disclaimer designed to insulate AIG's directors from responsibility. Greenberg, who is concerned with transparency and appearances for many reasons (not the least being that the *perception* that there's something to hide affects the company's stock price and access to capital), told us he will "insist" upon a better audit-committee report. "I don't think anyone paid much attention to it," he said, referring to the myriad qualifications in AIG's audit-committee report. "We relied on outside counsel. In retrospect, that was a mistake." Greenberg, who's been in the insurance business for 50 years, didn't become The Great Greenberg by letting mistakes go uncorrected.

For those who don't recall the May 2 and July 25 issues of *Schiff's*, we'll provide a brief reminder: AIG's audit-committee report, as it is now written, is not an endorsement of the company's accounting; rather, it's a legal disclaimer for the audit committee. "The [audit] committee's oversight does not provide an independent basis to determine that AIG's management has maintained appropriate internal controls and procedures," states the audit-committee report of the world's most valuable insurance organization. "The committee's considerations…do not assure that the audit of AIG's financial statements has been carried out in accordance with generally accepted auditing standards…or that AIG's auditors are in fact independent."

If the audit-committee of the company that believes that the greatest risk is not taking one can't state that AIG's financial statements conform with GAAP, then who needs the audit committee? If the audit-committee can't determine whether or not AIG's auditors are "independent," then the members of the audit committee should be replaced by people who can make such a determination.

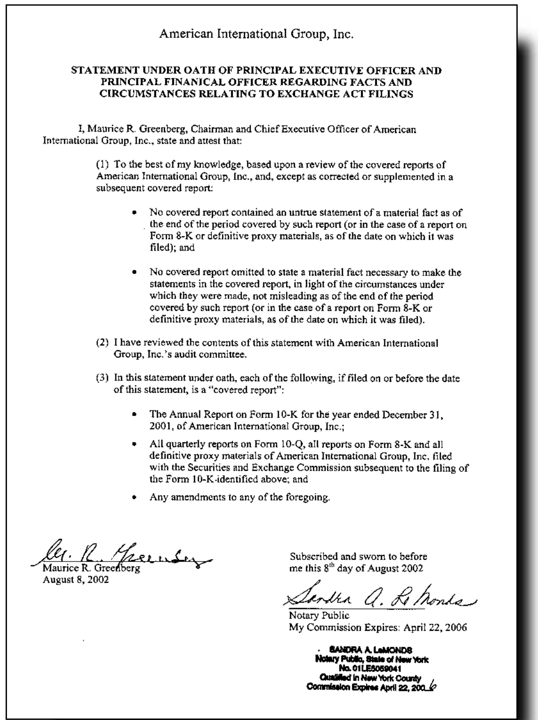
That AIG, which is worth approximately $175 billion, will change its audit-committee report is a testament to the changing times. If the stock-market boom at the end of the last millennium qualified as a "new era," then the present climate of skepticism and corporate accountability is another new era. (The future, of course, is comprised of nothing but "new eras." They come and go all the time.)

After our May 2 article, we received complaints from some subscribers, including securities analysts who were recommending AIG's stock. (According to First Call, 22 of 23 analysts covering AIG rate it a "buy.") *Schiff's* was destroying public confidence, we were told, by writing about AIG's audit-committee report, especially during a time when the market was so volatile. We were also told that the audit committee is *only* an overseer: it hires the accountants but doesn't *really* have access to financial information.

A company's board of directors and audit committee have broad authority. The audit committee can meet alone with the internal financial people and the outside accountants, request whatever information it wants, conduct investigations, hire outside counsel, and bring in other accountants or experts if it needs to. (AIG's audit committee met seven times in 2000 and four times in 2001.)

We were also told that the audit committee shouldn't *really* be held accountable because, in the end, it relies on management and the auditors. But that argument leads to a web of deniability in which no one is accountable: the audit committee relies on management and the accountants, the accountants rely on management, management relies on the accountants, management's financial statements are approved by the board, the board relies on the audit committee, the audit committe relies on management and the accountants...

A company's board of directors should serve as an overseer; it hires (or fires) the CEO, and approves budgets, major capital expenditures, acquisitions, divestitures and many other corporate actions. It has been said that a director should be a skeptical ally of management. Directors should have knowledge, background, and skills sufficient to allow them to perform their job well. Furthermore, they should devote enough time to carry out their responsibilities, and should have the temperament to speak out and act independently, regardless of the consequences.


American International Group, Inc.

STATEMENT UNDER OATH OF PRINCIPAL EXECUTIVE OFFICER AND PRINCIPAL FINANICAL OFFICER REGARDING FACTS AND CIRCUMSTANCES RELATING TO EXCHANGE ACT FILINGS

I, Maurice R. Greenberg, Chairman and Chief Executive Officer of American International Group, Inc., state and attest that:

(1) To the best of my knowledge, based upon a review of the covered reports of American International Group, Inc., and, except as corrected or supplemented in a subsequent covered report:

- No covered report contained an untrue statement of a material fact as of the end of the period covered by such report (or in the case of a report on Form 8-K or definitive proxy materials, as of the date on which it was filed); and
- No covered report omitted to state a material fact necessary to make the statements in the covered report, in light of the circumstances under which they were made, not misleading as of the end of the period covered by such report (or in the case of a report on Form 8-K or definitive proxy materials, as of the date on which it was filed).

(2) I have reviewed the contents of this statement with American International Group, Inc.'s audit committee.

(3) In this statement under oath, each of the following, if filed on or before the date of this statement, is a "covered report":

- The Annual Report on Form 10-K for the year ended December 31, 2001, of American International Group, Inc.;
- All quarterly reports on Form 10-Q, all reports on Form 8-K and all definitive proxy materials of American International Group, Inc. filed with the Securities and Exchange Commission subsequent to the filing of the Form 10-K identified above; and
- Any amendments to any of the foregoing.

M. R. Greenberg
Maurice R. Greenberg
August 8, 2002

Subscribed and sworn to before me this 8th day of August 2002

Sandra A. LeMonds
Notary Public
My Commission Expires: April 22, 2006

SANDRA A. LeMONDS
Notary Public, State of New York
No. 01LE5059041
Qualified in New York County
Commission Expires April 22, 2006

Hank Greenberg complies with SEC Order No. 4-460

In practice, many directors don't meet this standard. Boards are filled with yes-men (and token yes-women) who let CEOs do what they want. In return for doing little, directors get paid well, make useful business connections, and gain status that generally benefits them in some way or other. This is how it goes at most public companies, mutual funds, and money-market funds. Although directors are elected by the shareholders, shareholders don't usually get involved. This is particularly true of mutual funds, which rarely make an issue of corporate governance, probably because they employ the same corporate structure as the companies they invest in.

We approve of AIG's change regarding its audit-committee report, but won't give a giant company a pat on the back because it decides to operate in a more forthright manner. (Also, we don't know exactly what changes AIG will make. The new audit-committee report will appear in the proxy statement, which will be distributed next April.) Shareholders and policyholders should expect the highest standards from AIG.

Although Hank Greenberg gave little or no thought to AIG's audit-committee report before we wrote about it, the same cannot be said about every member of the audit committee. Before proceeding, however, a brief history of why audit-committee reports began appearing in proxy statements in 2001 is in order.

In 1895 the New York Stock Exchange *recommended* that listed companies give their shareholders an annual report that included a balance sheet and income statement. Five years later this became a requirement for companies seeking a new listing. The Securities Act of 1933 and the Securities Exchange Act of 1934 mandated important disclosure and created a regulatory authority—the Securities and Exchange Commission. Over the next 68 years, shareholders, activists, gadflies, corporate raiders, legislators, and regulators would seek to make companies more accountable, and the accounting they used more acceptable. It was not until 1977, however, that the New York Stock Exchange required listed companies to have an independent audit committee comprised of "outside"—but not necessarily "independent"—directors.

Change often happens slowly then suddenly, and nothing can permanently alter investors' mood swings between greed and fear. But disclosure, reform, and good regulation can protect intelligent investors and increase the markets' efficiency.

On September 28, 1998, Arthur Levitt, then chairman of the SEC, gave a speech entitled "The Numbers Game" in which he discussed the widespread practice of earnings management. "Increasingly, I have become concerned that the motivation to meet Wall Street earnings expectations may be overriding common-sense business practices," he said. "Too many corporate managers, auditors, and analysts are participants in a game of nods and winks. In the zeal to satisfy consensus earnings estimates and project a smooth earnings path, wishful thinking may be winning the day over faithful representation.

"As a result, I fear that we are witnessing an erosion in the quality of earnings, and therefore, the quality of financial reporting. Managing may be giving way to manipulation; integrity may be losing out to illusion.

"Many in corporate America are just as frustrated and concerned about this trend as we, at the SEC, are. They know how difficult it is to hold the line on good practices when their competitors operate in the gray area between legitimacy and outright fraud. A gray area where the accounting is being perverted; where managers are cutting corners; and, where earnings reports reflect the desires of management rather than the underlying financial performance of the company."

Levitt noted that the pressure for companies to meet analysts' expectations was corrupting peoples' behavior. "Almost everyone in the financial community shares responsibility for fostering a climate in which earnings management is on the rise and the quality of financial reporting is on the decline," he said. "Corporate management isn't operating in a vacuum. In fact, the different pressures and expectations placed by, and on, various participants in the financial community appear to be almost self-perpetuating.

"This is the pattern earnings management creates: companies try to meet or beat Wall Street earnings projections in order to grow market capitalization and increase the value of stock options. Their ability to do this depends on achieving the earnings expectations of analysts. And analysts seek constant guidance from companies to frame those expectations. Auditors, who want to retain their clients, are under pressure not to stand in the way."

Levitt described six practices used to manipulate or "manage" earnings: accounting hocus-pocus, "big-bath" charges, creative acquisition accounting, miscellaneous cookie-jar reserves, materiality, and revenue recognition.

He also outlined a plan of action to stem the abuses, the final item of which was strengthening the audit-committee process. "Qualified, committed, independent and tough-minded audit committees represent the most reliable guardians of the public interest," he said.

Levitt announced that as part of a comprehensive effort to address earnings management, the New York Stock Exchange (headed by Richard Grasso), and the National Association of Securities Dealers (headed by Frank Zarb), had agreed to sponsor a "blue-ribbon" panel which would "develop a series of far-ranging recommendations intended to empower audit committees and function as the ultimate guardian of investor interests and corporate accountability."

On February 8, 1999 the 11-member panel released its report, which contained numerous reforms and recommendations. Although several members of the panel made comments in an accompanying press release, we'll quote one member, Frank Zarb, because, two years later, he joined AIG's board, and became a member of its audit committee the following month. "Corporate governance is a key issue facing the management of publicly traded companies," Zarb said. "The role of audit committees is critical to that process. These recommendations are a thoughtful product of the expertise in this area."

The panel's numerous recommendations included a written charter for the audit committee, public disclosure of audit-committee activities, and an annual letter from the audit committee to shareholders.

According to the blue-ribbon panel, the audit committee was the most important participant in the financial reporting process. "A proper and well-functioning system exists," the panel said, "when the three main groups responsible for financial reporting—the full board including the audit committee, financial management including the internal auditors, and the outside auditors—form a 'three-legged stool' that supports responsible financial disclosure and active and participatory oversight. However, in the view of the [panel], *the audit committee must be 'first among equals'* in this process, since the audit committee is an extension of the full board and hence the ultimate monitor of the process." [Emphasis added.]

The blue-ribbon panel recommended that the audit committee, in its annual report, state that it "believes that the company's financial statements are fairly presented in conformity with Generally Accepted Accounting Principles (GAAP) in all material respects." This recommendation seems so basic that it's hard to believe it wasn't already a requirement.

The SEC, perhaps feeling outside pressure from the business community, did not adopt this recommendation. It noted a concern about exposing audit-committee members to additional liability, and mentioned that some commenters averred that it might be difficult for companies to find people willing to serve on audit committees if the audit-committee members were exposed to additional liability. The SEC's final rule stated that "because of concerns about liability, we did not propose the disclosure requirement recommended by the Blue Ribbon Committee, but instead proposed that the audit committee indicate whether, based on its discussions with manage-

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ment and the auditors, its members became aware of material misstatements or omissions in the financial statements."

Thus, the audit committee is not required to say that a company's financial statements conform to GAAP; it need only has to say that it isn't aware of material misstatements. Due to the watered down regulations, a company can issue an evasive, equivocal audit-committee report yet still comply with the SEC guidelines. AIG has done this for the past two years.

The recent financial and accounting scandals have produced a radical change in attitude. Regulators, legislators, institutions, and even the president of the United States are now saying they're going to do something. The NYSE recently sent out a 28-page magazine called *Your Market*, one of the purposes of which was to help restore investor confidence. "Should you have faith in public companies?" asks the headline of one article. "Without hesitation, the answer is yes," it replies. (The NYSE does not say why it failed to tell investors that they *shouldn't* have had so much faith a couple of years ago, when the market was fifty percent higher.)

President Bush, a hands-off, free-market sort of guy, is also concerned with "corporate responsibility," and talks of hunting down corporate evildoers and putting them behind bars.

The SEC now requires CEOs and CFOs of large companies to issue sworn written statements affirming that they haven't cooked their companies' books.

Speaking about AIG's recent decision to expense stock options, Greenberg told *The Wall Street Journal* that "the perception out there today, erroneously, is that not expensing stock options is wrong. *The perception is more important than the substance.*" Since outsiders can't audit AIG's books, they will always be unable to get all the substance they would like. They will have to settle for perception.

Hank Greenberg's sworn written statement (see page 2) says that AIG's SEC filings do not contain an untrue statement of a material fact, do not omit any material facts, and are not misleading.

It also says that he has reviewed his statement with AIG's audit committee. ■

The blue-ribbon panel's audit-committee report is at http://www.nyse.com/content/publications/NT00006286.html. The SEC's final rules are at http://www.sec.gov/rules/final/34-42266.htm#P122_33770.

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SCHIFF'S INSURANCE OBSERVER

April 7, 2003
Volume 15 • Number 7

Inside the AIG Proxy Statement

The Audit-Committee Report

AIG IS ARGUABLY THE greatest insurance organization in the world. As such, it deserves more scrutiny than other companies.

In its reports for the years ending 2001 and 2000, AIG's audit committee disclaimed virtually all responsibility for AIG's accounting, internal controls, and financial statements. It also said that it could not assure that AIG's independent accountants were actually "independent." (*Schiff*'s raised this issue last year and created a bit of a stir.) The language didn't sit well with investors, especially those whose eyes had been opened by a new wave of reform in corporate governance and accountability.

As we reported last August, AIG said it would change its 2003 audit-committee so that it was not merely a disclaimer of any responsibility for AIG's financials. (Remarkably, we were the only ones to report this.)

On Friday, AIG released its 2003 proxy statement, which includes a new and improved audit-committee report. The broadly evasive language is gone, as is the equivocal twaddle that had rendered the report meaningless. It has been replaced by something better, but not as good as it could be. "The [audit] committee has considered and discussed both the audited financial statements as well as the unaudited quarterly financial statements with management and the independent accountants," says AIG's audit-committee report. The report says that the committee discussed various mandated requirements with the auditors, considered whether the auditors are "independent," and recommended that the audited financial statements be included in AIG's annual report.

For what it's worth, we'll contrast AIG's audit-committee report with Coca-Cola's. We picked Coca-Cola for one reason: its audit-committee is the only one in the world that Warren Buffett is a member of. While it's debatable whether Coca-Cola uses better accounting than AIG, it does have a better audit-committee report. (The language used by Coca-Cola's audit committee may even reduce the committee's potential liability.) Here's an important excerpt from Coca-Cola's report:

> Management has reviewed the audited financial statements in the annual report with the audit committee including a discussion *of the quality, not just the acceptability*, of the accounting principles, the reasonableness of significant accounting judgments and estimates, and the clarity of disclosures in the financial statements...Members of the audit committee have expressed to both management and auditors their *general preference for conservative policies* when a range of accounting options is available. [Emphasis added.]
>
> In its meetings with representatives of the independent auditors, the committee asks... 1) Are there any significant accounting judgments or estimates made by management...that would have been made differently [by] the auditors?

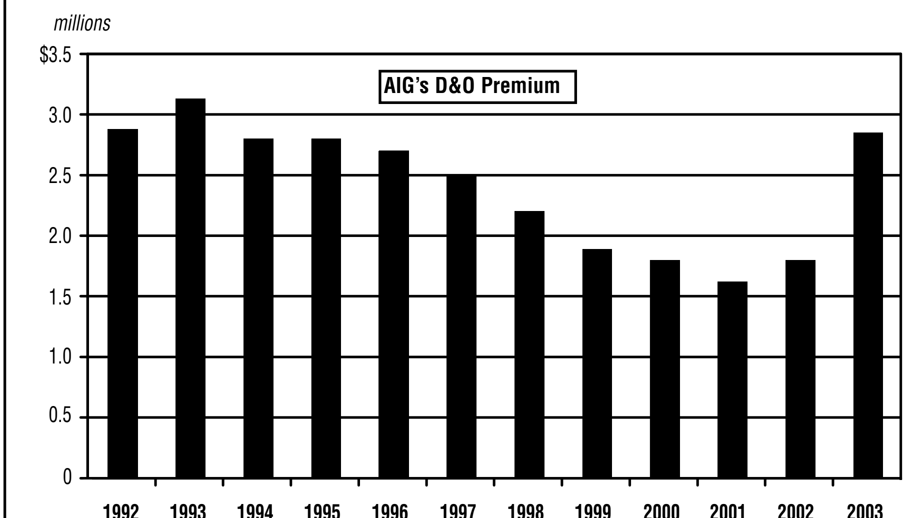
We believe that AIG, its shareholders, and the public would be better served if AIG's audit committee adopted language similar to Coca-Cola's. We'll have to wait until next year to see if it does.

Two Audit-Committee Members

ALTHOUGH AIG'S CHAIRMAN and CEO, Hank Greenberg, has dominated AIG for decades, he does not control the audit

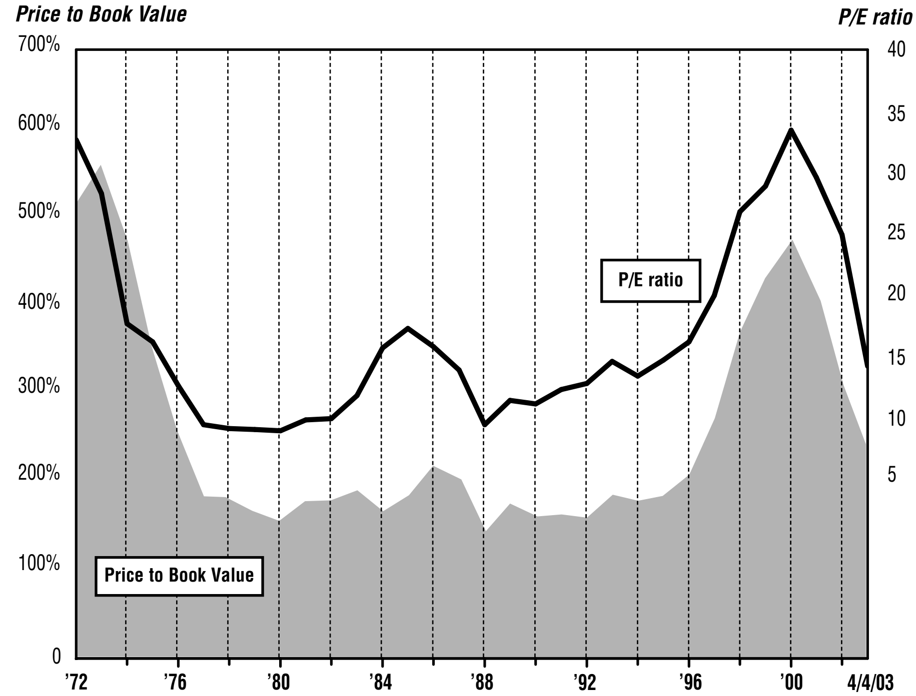
American International Group's D&O Premium: A Study in Cycles

AIG maintains a Directors & Officers policy for itself, its directors and officers, its subsidiaries, and their directors and officers. Although AIG has made several acquisitions since 1992 and is a much larger company today, its D&O premium is the same as it was in 1992. AIG has not disclosed the terms and conditions of its policies, or the limits and deductibles.



American International Group: Stock Bubble Bursts, Again

In 1972, AIG's shares traded at 518% of book value and 32 times earnings. From 1972 to 1974, AIG's stock fell 66%, as these inflated multiples shrank, even though AIG's earnings grew. In 2000, AIG's price-to-book-value and p/e ratios returned to their euphoric 1972 levels. AIG's stock is now down about 50% from its 2000 high. The price-to-book-value and p/e ratios are down significantly, too.



Primary source: Value Line

committee (at least in theory). It is made up of directors who are "independent" according to the current standards of the New York Stock Exchange. (Greenberg, for the record, is a member of the NYSE's Corporate Accountability & Listing Standards Committee.) We don't know why some members of the audit committee didn't insist on a better audit-committee report initially.

For example, Frank Zarb, senior advisor to Hellman & Friedman, was previously head of the NASD. In 1999, while at the NASD, he co-chaired a "blue-ribbon panel" that came up with "far-ranging recommendations intended to empower audit committees." The recommendations were good, but not all were adopted. (Some of the recommendations were *too* good.) Zarb is highly knowledgeable about financial matters *and insurance*. (He was CEO of Alexander & Alexander from 1994 to 1997.) His behavior on AIG's audit committee, however, seems to have been far more passive than the behavior he recommended for audit-committee members when he was running the NASD.

Carla Hills, CEO of Hills & Company, is also on the audit committee. (Like Zarb, she is on AIG's executive committee, as well.) She has had a distinguished career. She was an assistant U.S. attorney general, U.S. Secretary of Housing and Urban Development during Gerald Ford's administration, and the U.S. Trade Representative under George Bush. We have long been skeptical of her, however. She was a director of Henley Group, run by sleazy wheeler-dealer Mike Dingman. During her tenure on the board, Henley engaged in dirty accounting, and its board permitted Dingman to concoct a variety of dubious, self-enriching asset shuffles with affiliated companies. (See "The Henley Maneuver—It Helps the Rich Get Richer," *Barron's*, December 19, 1988, by David Schiff.) Hills is also a member of the infamous Time-Warner board that approved the merger with AOL—perhaps the worst deal of all time.

Some Notable Connections

MANY OF AIG'S DIRECTORS have close connections with AIG or Hank Greenberg (see the chart on page 3). Some have close *and* unusual connections. Marshall Cohen, for example, joined AIG's board in 1992, when he was president of The Molson Companies. Molson was a shareholder in Coral Re, a suspicious, curiously capitalized offshore reinsurance company that AIG ceded more than $1.5 billion in premiums to in the 1980s and early 1990s, making it one of AIG's largest reinsurers. Although Coral was formed to benefit AIG, AIG maintained—despite considerable evidence to the contrary—that Coral was not an affiliate. Coral's initial investors were offered a most unusual deal: they didn't have to put up a cent or risk money or collateral, yet they were *guaranteed* to make a profit. AIG's proxy statements did not mention the connections between Coral and Molson and Cohen, even though Cohen was on AIG's board.

AIG's 2002 proxy statement does not disclose—and perhaps is not required to disclose—that The Starr Foundation (which owns 56,957,340 shares of AIG, a 2.18% interest), gave more than $25 million to the American Museum of Natural History in 2001. (Greenberg is a trustee of the museum.) Seven past or present AIG directors were on The Starr Foundation's board at that time, and Hank Greenberg was, and still is, chairman. According to an IRS filing, he devoted 200 hours to The Starr Foundation in 2001 and received no compensation.

What makes The Starr Foundation's grant to the Museum of Natural History noteworthy, aside from its magnitude, is that Ellen Futter, the museum's president, was and still is on AIG's board, and served on its Stock Option and Compensation Committee until September 18, 2002. Setting Hank Greenberg's compensation is one of the committee's major responsibilities. Although Greenberg is very well paid, his compensation isn't particularly unusual compared to some of the ridiculous figures doled out to lesser CEOs these days. In 2002, he received $1,000,000 in salary and a $5,000,000 bonus. He also received 375,000 ten-year options to buy AIG shares at $61.30 per share. While there's no single correct way to value options, $6,000,000 seems like a reasonable valuation for this options grant, bringing Greenberg's total compensation for 2002 to $12,000,000.

In February 2003, AIG's compensation committee took unusual action. "In light of the decline in the market price of AIG common stock," says AIG's proxy statement, "the committee determined that *additional incentives were needed to retain and motivate employees*." [Emphasis added.] Instead of repricing the previously granted options, the committee granted Greenberg, who owns 45,167,862 AIG shares, 375,000 *additional* options. The proxy statement doesn't disclose whether these options carried a lower strike price than the previous options.

More Connections

THE CHART ON THIS PAGE, which does not purport to be complete, shows some of the connections between Hank Greenberg and AIG's directors. These connections are not listed in AIG's proxy statement and have been gathered from various sources. The chart does not show connections between other directors, or between directors, advisory board members, honorary directors, and AIG employees.

Four Directors Step Down

THREE AIG DIRECTORS ARE not standing for reelection this year. They are Eli Broad, Edward Matthews, and Thomas Tizzio, all of whom work or worked at AIG. Former director, Robert Crandall, the retired chairman of AMR and American Airlines, resigned from the board on October 9, 2002. AIG's board will have sixteen directors.

AIG's Important D&O Ad

ON FEBRUARY 3, AIG announced a $1.8-billion after-tax charge to increase loss reserves. About twenty-five percent of this charge was for directors and officers liability. Hank Greenberg subsequently attributed the charge to a "liability bubble" that could not have been foreseen.

In fact, AIG did foresee a difficult liability environment. What it didn't foresee was the precise magnitude of the so-called bubble. That D&O claims have surged is not just the result of a legal system run amuck; it has much to do with the grossly abusive behavior of corporate executives who have run amuck.

In 1968, the American Home Assurance Company, an AIG subsidiary, ran a striking full-page ad in *The Wall Street Journal*. (AIG has always been an extremely effective and creative advertiser.) The ad showed a small

No Degrees of Separation: Hank Greenberg's Connections with American International Group's Directors

AIG's proxy statement provides very little information about the company's directors. The chart below—which does not purport to be complete—shows some of the non-AIG connections between Hank Greenberg and AIG's directors. These connections are not listed in AIG's proxy statement.

	M.R. Greenberg	Aidinoff	Chia	Cohen	Conable	Feldstein	Futter	Hills	Hoenemeyer	Holbrooke	Smith	Sullivan	Tse	Wintrob	Wisner	Zarb
American Museum of Natural History	Trustee				Director		President									
Business Council for International Understanding	Honorary Trustee														Vice Chairman	
Center for Strategic and International Studies	Former Vice Chairman							Member								
Coral Reinsurance	Secret Affiliate?			Shareholder												
Council on Foreign Relations	Former Vice Chairman	Member			Member	Director	Member	Vice Chairman		Director					Member	Member
Federal Reserve Bank of New York	Former Chairman					Board of Advisors	Former Chairman									
Institute for International Economics	Director							Director								
New York Stock Exchange	Director				Director											Former Director
Project Hope	Director												Advisory Board			
The Asia Society	Trustee		Trustee					Trustee		Trustee						
The Starr Foundation	Chairman										Director		Director			
Trilateral Commission	Member					Member		Member		Member						
US-ASEAN Business Council	Vice Chairman							Husband is Vice Chairman								
US-China Business Council	Director							Director								

photograph of a conservative-looking businessman beneath the headline, "I just might sue every company director reading this newspaper." Here's the text of the ad:

> I am not a madman.
>
> This is not a joke.
>
> If you are a director of a major company, I've got you where I want you.
>
> At my mercy. All I have to do is own a few shares in your corporation and I can sue you and every other director and officer in the company.
>
> What can I sue you for?
>
> I can sue you for sending me a dividend payment that I think is unwarranted.
>
> I can sue you because I think your salary is too high, or for conflict of interest or for missing a few director's meetings. I can blame and sue you because of a misstatement in your company's financial report—or should I say our company? I can't begin to list all the reasons I can sue you for. And here's the saddest part. I'm not alone. There are 24 million other people out here just like me. There are 24 million stockholders in the United States and that's 24 million potential stockholder suits. And even if you should win a stockholder suit—you lose. When you take into consideration lawyers' costs, wasted time etc. At this point, you must be feeling helpless. You're not.
>
> There is a company that can help you. American Home Assurance Company. They didn't invent stockholder suits, but they have come up with some interesting solutions to them. They feature a type of insurance that every director or officer in the United States should consider. Directors and Officers Liability Insurance. They have a booklet which tells all about Directors and Officers Liability Insurance for those that qualify. You can get it by writing to Dept. A-14, American Home Assurance Company, 102 Maiden Lane, New York, N.Y. 10005. Send for it and talk it over with your insurance agent or broker. He and American Home Assurance Company are good friends to have when you have 24 million potential enemies.

AIG's ad, which pitted corporate bigwigs against their *shareholders* ("potential enemies"), generated a tremendous response from major corporations and insurance brokers. D&O coverage may have been unusual back then, but it's ubiquitous now.

Perhaps some academic will analyze D&O lawsuits and figure out whether directors and officers were emboldened because they were able to buy coverage. Did the availability of insurance create moral hazards that led to greater abuses? Did AIG's ad, unwittingly, awaken corporate directors and officers as well as shareholders and class-action lawyers?

In 1968, many public companies were not especially accountable to their shareholders—*their owners*. Although shareholders have gained some power, they're still disenfranchised. When directors miss board meetings, act as rubber stamps, overpay their CEOs, have conflicts of interest, and permit their companies' financial statements to be materially misstated, it's not surprising that they're sued.

Call it a liability bubble. Or call it a bubble in directors' and officers' malfeasance.

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SCHIFF'S

INSURANCE OBSERVER

June 23, 2003
Volume 15 • Number 10

AIG's Secret Connection with Director

$36.5 Million from Starr

Some of AIG's "independent" directors have had unusual financial relationships with AIG or its affiliates, and may not be as independent as they appear to be. AIG's failure to disclose these relationships to its shareholders raises questions about the company's corporate governance and business practices.

Schiff's has written extensively about AIG, for many reasons: AIG is the largest insurance organization in the world; it's a great company; Hank Greenberg is a brilliant guy; and, as Churchill said of Russia, AIG is a riddle wrapped in a mystery inside an enigma. In our April 7 issue we broke a story, "Inside the AIG Proxy Statement," that discussed, among other things, the undisclosed financial connection that an AIG director, Ellen Futter, had with The Starr Foundation, a charitable foundation affiliated with AIG and controlled by the folks who control AIG.

Futter, president of The American Museum of Natural History, joined AIG's board in March 1999. Between 1999 and 2001, the Starr Foundation gave $36.5 million to The American Museum of Natural History. AIG's proxy statements *have not disclosed* this , or that Greenberg is a trustee of The American Museum of Natural History.

The Starr Foundation was created by AIG's founder and is controlled by Hank Greenberg and current and former AIG officers. It owns fifty-six million AIG shares (2.1% of AIG) and is located in AIG's headquarters.

The fact that The Starr Foundation provided an enormous amount of funding to the museum *after* Futter joined AIG's board is a matter that AIG's shareholders deserve to be made aware of *by AIG*. Shareholders have a right to know how indebted their company's directors may be to Greenberg and the other AIG officers who control Starr and AIG. (Futter, who received about $145,000 in director's fees from AIG last year, was on the company's Compensation Committee until September 18, 2002. She then switched to the Nominating and Corporate Governance Committee.)

If there were doubts whether AIG's undisclosed relationship with Futter was of interest to a broader audience than *Schiff's* readers, those doubts were erased on Friday by an excellent front-page article in *The Wall Street Journal* entitled "Giving at the Office: On Corporate Boards, Officials From Nonprofits Spark Concern / When Directors' Positions Help Them Raise Funds, Danger of Conflict Follows: Aiding Ms. Futter's Museum." The article, by David Bank and Joann Lublin, noted that Futter was on the boards of four companies (including AIG) that made substantial contributions to her museum, and that these contributions "create[d] a potential conflict of interest: the possibility that money flowing from companies and their executives will make nonprofit officials beholden to the corporate management they are supposed to monitor." The long article, which contained a picture of Futter on the front page, left out a key fact we'd written about earlier—that AIG didn't disclose its unusual relationship with Futter to its shareholders.

continued

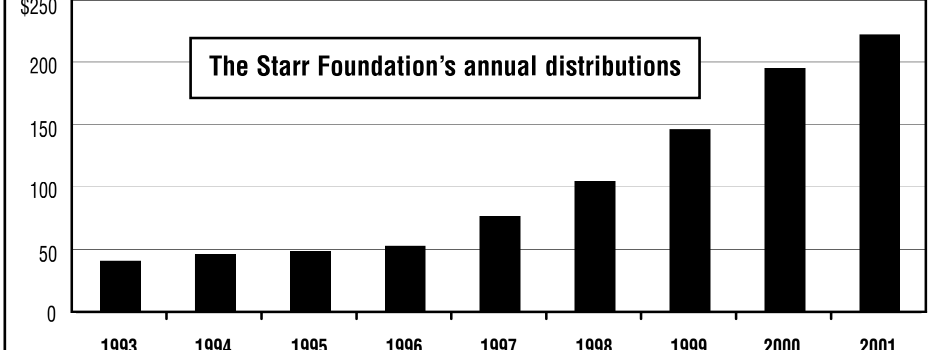
AIG and the Starr Foundation: Secret Connection with AIG Director

When AIG's founder, Cornelius Vander Starr, died in 1968, he left his estate to The Starr Foundation, which now has $3.2 billion in assets (all of it in AIG stock). The Foundation pays about $220 million of grants annually to more than 1,000 individuals and almost as many organizations.

Hank Greenberg, AIG's chairman and CEO, is chairman of The Starr Foundation, which operates out of AIG's headquarters. The Foundation's other directors are current or former AIG directors or officers.

Ellen Futter, president of The American Museum of Natural History, joined AIG's board of directors in 1999. Between 1999 and 2001, The American Museum of Natural History was the second largest recipient of funds from The Starr Foundation, receiving $36.5 million, or 6.6% of all grants paid by Starr.

AIG did not disclose these grants to its shareholders, nor did it disclose that Hank Greenberg was a trustee of The American Museum of Natural History. AIG considers Futter to be an "independent" director.



Source: The Starr Foundation's IRS Returns, Form 990-PF

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Not surprisingly, spokesmen for Futter, Starr, and AIG said, respectively, that Futter's role as an AIG director is independent of her job as president of the museum, that the donations Starr gave to the museum had nothing to do with Futter being on AIG's board, and that The Starr Foundation is independent of AIG.

We'll throw out a rhetorical question: Might the fact that The Starr Foundation gave $36.5 million to Futter's museum make her, as an AIG director, disinclined to differ with Hank Greenberg? According to an IRS filing, Greenberg is quite involved with The Starr Foundation; he devoted 200 hours to it in 2001. Does this, plus $36.5 million—a huge sum for the museum—have the *potential* to color Futter's decisions in any way?

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Definitive answers to these questions are probably unknowable. But AIG's shareholders have a right to know about potential conflicts of interest their directors have. They have a right to know about information that might affect a director's independence. They have a right to know what other financial or "charitable" connections AIG may have with its directors.

We've often been amazed by Hank Greenberg's tin ear on the subject of disclosure. Although he wasn't available to talk to us when we called today, we suspect that he would have said that AIG is a great company that has done nothing wrong; that Starr and AIG are generous, and that this *whole matter* is being blown out of proportion. He might also say that when you're as big as AIG it's impossible to disclose every little thing. And, oh yes, the New York Stock Exchange doesn't require disclosures about grants that AIG—or an AIG affiliate—gives to nonprofit organizations that AIG's directors are involved with.

Greenberg has done things his own way for a long time, and has been extraordinarily successful. When AIG was reporting rapidly growing earnings every year and the markets were going up, few seemed bothered by little things such as disclosure, corporate governance, and accounting transparency. Investors had faith in AIG because it was, after all, *AIG*, and it was run by Hank Greenberg, who *always* hit his numbers.

The Journal's article reported that the NYSE and Nasdaq are considering rules under which a director would not be considered "independent" if his corporation received more than a certain percentage of its revenues from the company whose board he's on. It isn't clear if these proposals, or others that might be adopted, would affect AIG. Ultimately, having independent directors will not create good corporate governance; good directors will. As for "independence," almost everyone on a corporate board got there because the people running the company wanted that person there. People who might shake things up—even if that's what's needed—don't get asked to be on corporate boards.

Whether Ellen Futter serves AIG's shareholders well is not the issue. The issue is AIG's lack of disclosure about the material financial connections between AIG, Starr, The American Museum of Natural History, and Futter. This absence of disclosure is troubling and raises many questions, including, "What is AIG hiding?"

AIG's proxy statement also lacks disclosure about directors' compensation: "Certain directors who are not employees of AIG also serve as directors of various subsidiaries of AIG and receive fees for their service in that capacity." The proxy doesn't say which directors serve on which subsidiaries, or how much they get paid.

AIG's shareholders deserve better disclosure. Then they can make an informed decision about whether they want to vote for a director whose organization received $36.5 million from a foundation affiliated with AIG. ■

Please go to the next page to read "No Degrees of Separation: Hank Greenberg's Connections with American International Group's Directors."

continued

No Degrees of Separation: Hank Greenberg's Connections with American International Group's Directors

AIG's proxy statement provides little information about AIG's directors. The chart below—which does not purport to be complete—shows some of the connections between Hank Greenberg and AIG's directors. *These connections are not disclosed in AIG's proxy statement*. The chart does not show connections between other directors, or between directors, advisory board members, honorary directors, and AIG employees.

	American Museum of Natural History	Business Council For Int'l Understanding	Center for Strategic and Int'l Studies	Coral Reinsurance	Council on Foriegn Relations	Federal Reserve Bank of New York	Institute for Int'l Economics	NYSE	Project Hope	The Asia Society	The Starr Foundation[3]	Trilateral Commission	US-ASEAN Business Council	US-China Business Council
Hank Greenberg[1]	Trustee	Honorary Trustee	Former Vice Chairman	Secret Affiliate?	Former Vice Chairman	Former Chairman	Director	Director	Director	Trustee	Chairman	Member	Vice Chairman	Director
Aidinoff[1,2]					Member									
Chia										Trustee				
Cohen				Share-holder										
Conable[2]					Member			Director						
Feldstein					Director	Board of Advisors						Member		
Futter	President				Member	Former Chairman								
Hills[1,2]			Member		Vice Chairman		Director			Trustee		Member	Husband is Vice Chairman	Director
Hoenemeyer[1,2]														
Holbrooke					Director					Trustee		Member		
Smith											Director			
Sullivan														
Tse									Advisory Board		Director			
Wintrob														
Wisner		Vice Chairman			Member									
Zarb[1,2]					Member			Former Director						

Sources: Various, including www.elitewatch.netfirms.com 1. Executive Committee 2. Audit Committee 3. Some disclosure in AIG's proxy

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INSURANCE OBSERVER

AIG: The Art of Manipulation?

Deceptive Earnings Releases

On Wednesday, February 11, American International Group, whose advertising slogan is "We Know Money," issued a press release containing its fourth-quarter and full-year earnings and related financial information. It was a swell press release—except for the fact that it was misleading, deceptive, and inconsistent with the way AIG had highlighted its earnings in previous press releases.

If AIG's intention was to dupe the press and the public, it appears to have succeeded. News organizations across the globe reported the figure AIG highlighted—68% growth in earnings—whereas, based on its previous releases, 14.7% growth would have been a more appropriate figure. (The media typically report companies' earnings by reprinting or summarizing press releases.)

This was not the first time that AIG presented its earnings in a deceptive way. *Schiff's* recently conducted a study of the company's quarterly-earnings releases and annual reports during the 1998-to-2003 period and determined that from the fourth quarter of 1999 through the fourth quarter of 2003, AIG used four definitions of earnings, switching back and forth among those definitions ten times. These switches improved the appearance of AIG's growth rate and made declines in earnings seem like increases. [See the chart on pages 5 and 6.]

Since the fourth quarter of 1999, AIG has issued 16 earnings releases and four annual reports. In 19 of these releases and reports, AIG highlighted the better numbers that were created by switches in the ways it defined its earnings. Perhaps it's chance, but these switches never made AIG's earnings or growth rate appear lower (even though they were lower in many cases). The figures that AIG highlighted gave a misleading impression in ten earnings releases and annual reports.

It is appropriate, when a company presents its financial results, for it to do so in a consistent manner: results from one reporting period should be comparable with those of the previous year (as they say, apples should be compared to apples). If a company constantly changes its method of reporting, then it may be difficult—or impossible—to track its progress, or lack thereof.

AIG's shares trade on the New York Stock Exchange. The NYSE's "Listed Company Manual" states that, "Unfavorable news should be reported as promptly and candidly as favorable news." It continues: "Reluctance or unwillingness to release a negative story or an attempt to disguise unfavorable news endangers management's reputation for integrity. Changes in accounting methods to mask such occurrences can have a similar impact."

We don't know if AIG *deliberately* disguised unfavorable news (i.e. masking lower earnings and a lower growth rate); but AIG's earnings releases and annual reports have, in fact, disguised unfavorable news. We can't help but note a remarkable coincidence: that the numerous switches AIG made in its earnings presentations improved the earnings or growth rate that AIG highlighted 95% of the time. What are the odds that AIG—by sheer chance—switched its standards ten times in four years, and that these switches—by sheer chance—improved the appearance of AIG's earnings or growth rate 19 out of 20 times? (The odds that a coin flip will turn up heads 19 out of 20 times are about 50,000-to-1.)

At one time AIG's quarterly earnings' releases and annual reports highlighted the company's "net income" according to Generally Accepted Accounting Principles (GAAP). Net income is a company's actual "bottom line," but it isn't always the best way of looking at an insurance company's results. Analysts often make adjustments to the bottom line in order to get a clearer picture of actual performance. It is common to exclude the effect of realized capital gains and losses on earnings. The reason for this is that the timing of gains and losses is generally discretionary, and realized gains and losses usually bear no relationship to a company's investment results in a given quarter or year. A company might have realized losses in a year in which its investment portfolio appreciated, and it might have realized gains in a year in which its portfolio declined. Since *unrealized* gains and losses aren't run through the income statement (they're a balance-sheet entry), it can be fair and useful to present "pro-forma" earnings excluding realized gains and losses—even though this doesn't conform to GAAP.

From 1992 through 1999, AIG had realized capital gains in 30 quarters and small realized capital losses in two quarters. (The losses were 1.03% and 0.47% of pretax income, in the fourth quarters of 1998 and 1999, respectively.)

In 1998 and 1999, AIG's earnings releases highlighted the company's "net income" but also provided a pro-forma figure—"income, as adjusted"—which excluded realized capital gains or losses.

In the first quarter of 2000, AIG changed the way it *highlighted* its growth rate in its press releases; it began excluding realized capital losses. (In every quarter since then AIG has had realized capital losses. These losses have often been sizable—greater than 10% of pretax income.) "AIG's First Quarter 2000 Income Excluding Realized Capital Gains (Losses) Rose 15.5%," stated the headline of the company's press release. If AIG had used its previous practice of highlighting "net income," the headline would have declared that income increased by 12.3%.

There's a big difference between a 15.5% growth rate and a 12.3% rate. Over 20 years, $100 compounded at a 15.5% rate will grow to $1,785, versus $1,018 for the same sum compounded at a 12.3% rate. All things being equal, companies with higher growth rates (or the appearance of such) invariably trade at much higher P/E ratios than those with somewhat lower growth rates. For decades, AIG has been viewed as a "growth" company, and its stock has usually traded at a much higher P/E ratio and price-to-book ratio than have the stocks of most other insurance and financial-services companies. (Often, the higher P/E ratio was justified.)

AIG's practice of highlighting the pro-forma growth in earnings by excluding realized gains and losses isn't troubling *per se*. In AIG's 2000 annual report, chairman and CEO Hank Greenberg noted that "we [AIG] and the investment community look at our results" this way. What is troubling, however, is that AIG did not subsequently highlight its earnings this way when doing so resulted in a lower rate of growth.

AIG continued to highlight the pro-forma "income, as adjusted" growth rate through the second quarter of 2001. The World Trade Center loss occurred the following quarter. AIG then highlighted its results using a pro-forma method it called "core earnings," which excluded underwriting losses related to the World Trade Center attack. In the next four quarters AIG made at least three more switches in the method it used to come up with figures that it highlighted. First it used income excluding capital losses; then it used net income. Finally, when it took a $1.8 billion loss-reserve charge in the fourth quarter of 2002, it used a new variation of pro-forma "core earnings" that *excluded* the loss-reserve charge.

In his letter to shareholders in the 2002 annual report, Greenberg dragged a red herring across the issue of the loss-reserve charge, calling it "an extraordinary reserve adjustment." He wrote that "no actuarial calculation could have predicted the ex-

continued on next page

plosion of litigation in the United States, which has resulted in an enormous increase in the frequency and severity of liability claims and judgments.”

The $1.8 billion charge, however, wasn’t for events that occurred 25 years earlier; it was for losses during the 1997 to 2001 accident years. The only thing that made the charge “extraordinary” was that AIG doesn’t usually make such large mistakes. The reserve charge was not attributable to an isolated legal judgment or to discontinued operations; it was for excess casualty (including excess workers’ comp), directors and officers liability, and “other casualty” (including healthcare liability).

AIG’s actuaries may not have picked up on Greenberg’s so-called “explosion of litigation,” but Greenberg did. He’s criticized “tort law” and the “legal system” for decades. He has written that “courts in our country continue to broaden the standards of legal responsibility and increase the size of awards,” and raised the “persistent matter of excessive liability awards by courts.” (The quotations just cited are from Greenberg’s 1977 letter to shareholders, AIG’s 1985 annual meeting, Greenberg’s 1986 letter to shareholders, and his 1989 letter to shareholders, respectively.) According to Tillinghast-Towers Perrin’s “U.S. Tort Costs: 2003 Update,” inflation-adjusted tort costs per citizen grew from $716 in 1990 to $809 in 2002.

AIG’s $1.8 billion reserve charge was the result of underwriting mistakes over five years. Was it really appropriate to treat these mistakes as “extraordinary” items that deserved to be factored out of highlighted earnings in 2002? If it *was* appropriate, then wouldn’t it have also been appropriate for AIG’s fourth-quarter 2003 earnings release to compare 2003’s earnings with the pro-forma earnings AIG highlighted in 2002? (If AIG had done that, it would have reported a 14.7% increase in earnings rather than a 68% increase.)

Page one of AIG’s 2002 annual report contains a bar chart of the company’s net income each year from 1998 to 2002. The figure for 2002 adds back the $1.8 billion loss-reserve charge, making the company’s growth have a smooth upwards trajectory. Although AIG’s chart didn’t include the charge in 2002, the charge should go somewhere. If it was appropriate to add back $1.8 billion to 2002 earnings, then $1.8 billion should have been subtracted from the 1997-to-2001 years as an acknowledgment that earnings had been *overstated* during that period.

Inconsistent Reporting

During 2003, AIG continued to switch the way it highlighted its earnings and growth. In the first quarter it highlighted “income, as adjusted” (excluding capital losses). For the next three quarters it switched to “net income”—despite the fact that Greenberg had written that the “income, as adjusted” method was the way AIG looked at its results.

We’ve noticed one constant in the way AIG has highlighted its earnings or growth: 19 out of 20 times the company used the figures that made its results look better.

On February 18, we discussed our observations with AIG and asked why the company changed its methodology so often, noting that the changes improved AIG’s figures 85% of the time. (We subsequently determined that they improved them 95% of the time.)

Two days later AIG provided a polite response: “AIG gives a thorough accounting in its quarterly earnings news releases, and it reports its results in compliance with all SEC and accounting regulations.” Because this was such a brief response, we’ll add the following: AIG is the world’s leading international insurance and financial-services organization, with operations in approximately 130 countries and jurisdictions. Its earnings releases include GAAP financial information.

On December 4, 2001, the SEC issued a release containing cautionary advice regarding the use of pro-forma financial information in earnings releases: *continued*

...It is appropriate to sound a warning to public companies...who present...their earnings and results of operations on the basis of methodologies other than Generally Accepted Accounting Principles (“GAAP”). This presentation in an earnings release is often referred to as “pro forma” financial information. In this context, that term has no defined meaning and no uniform characteristics...

...Public companies may quite appropriately wish to focus investors’ attention on critical components of quarterly or annual financial results in order to provide a meaningful comparison to results for the same period of prior years or to emphasize the results of core operations...

Because “pro forma” information is...derived by selective editing of financial information compiled in accordance with GAAP, companies should be particularly mindful of their obligation not to mislead investors when using this information...

Companies must pay attention to the materiality of the information that is omitted from a “pro forma” presentation. Statements about a company’s financial results that are literally true nonetheless may be misleading if they omit material information.

In 2003, the SEC issued the final rules for Regulation G, which deals with the use of non-GAAP financial measures. AIG’s 2003 fourth-quarter earnings release contains a “comment” on Regulation G. The company acknowledges that its press release contains non-GAAP financial measures, and that a “reconciliation of such measures to the most comparable GAAP figures” is included in accordance with Regulation G. AIG says its press release “presents its operations in the way it believes will be most meaningful and useful, as well as most transparent, to the investing public and others who use AIG’s financial information in evaluating the performance of AIG.”

If, in the past, AIG also presented its operations in the manner it believed was most meaningful, useful, and transparent, that raises questions, including the following: Why did AIG find it meaningful and transparent to make so many switches in the way it highlighted its earnings and growth rate? Why did AIG highlight “net income” in the third quarter of 1999, “income, as adjusted” excluding capital losses in the third quarter of 2000, “core earnings” excluding certain underwriting losses in the third quarter of 2001, and “net income” in the third quarters of 2002 and 2003? Is it a coincidence that these switches made AIG’s results or growth rate appear better than they otherwise would have been in 19 of 20 instances?

AIG’s “comment on Regulation G” notes that “the determination to realize capital gains or losses is independent of the insurance underwriting process... Realized capital gains or losses for any particular period are not indicative of quarterly business performance.” It goes on to say that “providing only a GAAP presentation of net income and operating income makes it much more difficult for users of AIG’s financial information to evaluate AIG’s success or failure in its basic business, that of insurance underwriting, and may, in AIG’s opinion, lead to incorrect or misleading assumptions and conclusions. The equity analysts who follow AIG exclude the realized capital gains and losses in their analyses for the same reason...”

In other words, AIG seems to be saying that if it “only” provides GAAP net income figures that might be misleading because “*income, as adjusted*” *to exclude realized gains and losses* is the more important measure of performance.

If it might be misleading to provide only GAAP figures, then isn’t it misleading (and downright sneaky) to *highlight* the growth rates for GAAP “net income” when, in fact, the growth rates for “income, as adjusted” (excluding capital gains and losses) are considerably lower?

With that in mind, let’s examine AIG’s July 24, 2003 earnings release. The headline reads, “AIG Reports Second Quarter 2003 Net Income Rose 26.4% to $2.28 Billion.” To report 26.4% growth seems spectacular. But why would AIG highlight “net income” instead of the figure it has said is more meaningful: *“income, as adjusted” (excluding gains and losses)*? Did the fact that “income, as adjusted” grew 13.9%—about half as much as “net income”—have anything to do with AIG’s decision to highlight the higher, misleading figure? Ask Hank Greenberg. And while you’re at it, ask him why AIG’s 2003 third-quarter headline declared that “Net Income Rose 26.9%,” when, in fact, “income, as adjusted” rose 15.4%?

It would have been nice if AIG explained how it came to pass that in 19 out of 20 instances it highlighted the earnings or growth rate that was most favorable. The company could have told us it was chance. It could have explained why highlighting “net income” some of the time and highlighting ever-changing pro-forma figures other times really was the best way to present its performance in a fair, honest manner. It could have said that it was “trying to put a positive spin on its results,” then tried to provide some reason why that was not deceptive.

AIG has long been respected and valued for the steadiness with which its earnings have grown. Beginning in 2000, AIG’s earnings releases and annual reports have given the impression of greater growth and consistency than that which actually occurred. AIG is a gigantic company and Hank Greenberg is a brilliant man. But people should be wary of companies that don’t present their results fairly. AIG’s manner of highlighting the most favorable figures and growth rates raises a sad question: Should AIG be trusted?

Please refer to the charts on the following pages.

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AIG: The Art of Manipulation? Deceptive Earnings Releases and Annual Reports

From the fourth quarter of 1999 through the fourth quarter of 2003, AIG used four definitions of earnings, switching back and forth among those definitions ten times. These switches improved the appearance of AIG's growth rate and made declines in earnings seem like increases.

During this period, AIG issued 16 earnings releases and four annual reports. In 19 of the 20 releases and reports, AIG highlighted the better numbers that were created by switches in the ways it defined its earnings. The highlighted figures were misleading ten times.

The table below tracks AIG's quarterly releases and annual reports. The first column describes which figures AIG highlighted in its release or annual report. Note where AIG switched the way it highlighted its earnings (i.e. net income, income as adjusted, core earnings, etc.). The second column notes the effect the switches had on the earnings that AIG's highlighted. The third column notes the result of the switches (i.e. inconsistent, misleading, etc.). The last column contains our comments.

	What Figure is Highlighted?	Effect	Result	Comments
1999 - 1Q	Net Income	Neutral		
1999 - 2Q	" "	Neutral		
1999 - 3Q	" "	Neutral		
1999 - 4Q	" "	Neutral		
Annual Report	" "	Neutral		
2000 - 1Q	Income, as adjusted (excludes Capital Realized Losses)	Improve	Inconsistent	Reports 15.5% growth in "adjusted" income instead of 12.3% growth in net income
2000 - 2Q	" " "	Improve	Inconsistent	Reports 13.1% growth in "adjusted" income instead of 10.2% growth in net income
2000 - 3Q	" " "	Improve	Inconsistent	Reports 14.6% growth in "adjusted" income instead of 9.3% growth in net income
2000 - 4Q	" " "	Improve	Inconsistent	Reports 14.8% growth in "adjusted" income instead of 11.5% growth in net income
Annual Report	1) Net Income; 2) Net Income, as adjusted (excludes Realized Capital Losses)	Improve	Inconsistent	Hank Greenberg mentions adjusted income in letter to shareholders. (Says it's "the way we and the investment community look at our results.") Reports 14.8% growth in adjusted" income instead of 11.5% growth in net income
2001 - 1Q	Income, as adjusted (excludes Realized Capital Losses)	Improve		Reports 15.2% growth in "adjusted" income instead of 13.8% growth in net income
2001 - 2Q	" " "	Improve		Reports 15.8% growth in "adjusted" income instead of 15.6% growth in net income
2001 - 3Q	Core Income (excludes 9/11 WTC loss, Realized Capital Losses, and Acquisition & Restructuring Charges)	Improve	Misleading	9/11 WTC loss. American General restructuring charges. AIG now reports "core income" instead of "adjusted" income. ("Core income" is reported ahead of "net income.") Headline of AIG's release: "Core income rose 14.1% to $1.92 million." This is an unfair comparison and inconsistent with prior reporting. An accurate headline would have been, "Adjusted income declines 18.5%."
2001 - 4Q	1) Net Income; 2) Core Income (excludes 9/11 WTC loss, Realized Capital Losses, and Acquisition & Restructuring Charges)	Improve	Misleading	Headline cites "net income." Text shows "core income" increased 13% in 2001. Core income increased 5% when 9/11 WTC loss is counted.
Annual Report	1) Core Income (excludes 9/11 WTC loss, Realized Capital Losses, and Acquisition & Restructuring Charges); 2) Net Income	Improve	Misleading	Does not show "adjusted" income, which is lower than "core income." On page 1, a five-year graph of "Net Income" uses "core income" for 2001. Since high-severity, low-frequency losses like 9/11 WTC do occur, treating them as extra-ordinary or non-recurring—which AIG has done—smoothes core earnings. In a table showing an 11-year summary of consolidated operations, the bottom line—net income—omits the charge for the WTC losses. In his letter to shareholders, Hank Greenberg writes about "Reaffirming our Corporate Values," and says, "Every year we work hard to improve our disclosure...We will always...adher[e] to the highest ethical standards, and provid[e] a thorough and accurate picture of our operations and financial performance." Annual report shows so-called core income increasing by 13%. It only increased 5% when all underwriting losses are included.

(table continues on next page)

	What Figure is Highlighted?	Effect	Result	Comments
2002 - 1Q	Income, as adjusted (excludes Realized Capital Losses)	Improve		AIG's earnings are released three days after AIG, whose stock is under pressure, issues press release claiming to "have observed considerable short selling in [AIG's] stock." AIG requests that the NYSE and SEC "investigate this activity."
2002 - 2Q	Net Income	Improve	Misleading	AIG's earnings are released one day after AIG's stock hits its year's low of $46.71 (down from an all-time high of $103.75 on December 8, 2000). Investors are skeptical of complex "black-box" financial companies like AIG, and are worried whether AIG can continue to achieve the steady growth it is known for. By reporting "net income" instead of "adjusted" income, AIG shows a 37% increase in earnings instead of a 9.8% increase.
2002 - 3Q	" "	Improve	Misleading	In the prior year's third quarter, AIG used "core income," which excluded the WTC losses and various restructuring charges. In the second quarter of 2002, however, AIG begins highlighting "net income." Because the third quarter of 2001 had been bad, AIG can expect to show sensational growth for the year by highlighting "net income." AIG reports that "net income" increased 60.8% during the first nine months of 2002. Core income—which AIG used in the previous year's third quarter—increased 11.3%.
2002 - 4Q	1) Net income; 2) Income,as adjusted (excludes Realized Capital Losses and a $1.8 billion *Loss-Reserve Charge*)	Improve	Misleading	AIG announces a $1.8 billion loss-reserve charge. In the previous seven quarters AIG had gone from reporting "adjusted" income to "core income" to "net income" to "adjusted" income then back to "net income." By highlighting "net income" for 2002, AIG once again portrayed its earnings in a misleading way. In 2001, Greenberg told shareholders that income adjusted to exclude realized capital gains and losses was the best way to view AIG's results. In 2002, AIG reports that "net income" increased 2.9% and "income as adjusted" (*excluding the reserve charge*) increased 11.9%. If AIG had reported "adjusted" income (excluding capital gains and losses) it would have shown a 4.2% decline for the year.
Annual Report	1) Income, as adjusted (excludes Realized Capital Losses and a $1.8 billion *Loss-Reserve Charge*); 2) Net Income	Improve	Misleading	On page 1, a five-year bar chart of "Net Income" uses "core income" for 2001 and 2002. (Core income was a much higher figure.) Commenting on the $1.8 billion charge to increase loss reserves, Greenberg, who has been complaining about the legal system for more than 30 years, blames society: "No actuarial calculation could have predicted the explosion of litigation in the United States." The truth: AIG underestimated its losses during 1997-2001.
2003 - 1Q	1) Income, as adjusted (excludes Realized Capital Losses)	Neutral		First time in three years that AIG doesn't highlight earnings in the most favorable way. "Income, as adjusted" (excluding realized capital gains and losses) is an apples-to-apples method of looking at the change in earnings from year to year.
2003 - 2Q	Net Income	Improve	Misleading	Misleading reporting resumes. Headline says "net income rose 26.4%." In fact, "adjusted" income rose 13.9%.
2003 - 3Q	1) Net Income; 2) Income, as adjusted (excludes Realized Capital Losses)	Improve	Misleading	Highlights earnings both ways, but first states that "net income rose 26.9%." Misleading because "adjusted" income, which Greenberg has said is the way AIG and the investment community look at the numbers, rose 15.4%.
2003 - 4Q	" " "	Improve	Misleading	AIG's headline says "net income" increased 68%. AIG doesn't provide an "income, as adjusted" figure (excluding the loss-reserve charge) like it did the previous year. Had it done so, one would have seen that, on an apples-to-apples basis, earnings increased 14.7%—far less than the 68% figure AIG trumpeted. Since AIG had highlighted the "adjusted" income figure in the previous year's release and in its annual report, it should have included comparable figures here.