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# SEMPER AUGUSTUS

## Investments Group LLC

CLIENT LETTER

August 6, 1999

### In This Letter:

Approach to Investing

Mercury General

Twelve-Month Recommendations

Contact Information

Disclaimer

### Special Points of Interest:

- ◆ Eclectic Style
- ◆ Growth Characteristics
- ◆ Valuation Parameters
- ◆ Case Study: Mercury General

### “What is the Semper Augustus approach to stock picking? Do you have a defined style?”

*Eclectic* has a nice ring to it. Our investment philosophy doesn't fit nicely into a consultant's style box. We are not a large-cap manager; we are not mid-cap or small-cap managers. Nor are we an international manager. We don't consider ourselves growth managers. The *value manager* definition is pretty accurate, but in fact we are all of the above.

In a nutshell, we like good companies that can profitably grow the value of their businesses faster than the growth rate of the domestic economy. When buying those companies, we aim to buy at some level below our estimate of the intrinsic value of the business. It's a pretty simple concept, in theory, which requires an awful lot of effort in practice. We find our companies in all market-cap tiers and we buy both domestic and international businesses.

Critical to our analysis of a company is to identify a good company and estimate profitable growth. We spend considerable time talking to management of the companies we own or are considering buying. We talk to people in the industry and those that supply to the companies as well as customers and competitors. We try to ascertain whether management adds value and delivers on goals and strategies. A dominant competitive position in industry is important. If a firm is not the number one or number two player, or doesn't have a likely probability of becoming one or two in the industry, it is generally not as attractive as the leaders. Low-cost producers or providers of services typically enjoy competitive advantage.

Profitable growth is one way to further characterize good businesses. The long-term nominal (not inflation-adjusted) growth rate of the US economy has been roughly 6.5% per year. We try to own businesses that can grow internally faster than that hurdle rate over many years.

Internal growth requires a company to generate free cash flow or cash after maintenance capital expenditures and distributions to shareholders. Companies that continually require debt or new equity capital often don't earn an acceptable return on capital over many years.

If we stopped our analysis with the economics of a business, made a qualitative judgment about management and a quantitative estimate of growth rates and simply bought, then we would be a “growth” manager. However, we are acutely aware of the price we pay for those wonderful businesses we identify. That makes us value managers as well as growth.

Traditional Graham and Dodd fundamental measures are important to an understanding of the financial strength of a company. A discounting of book value, sales, cash flow and profit to arrive at a present value for a business helps determine fair value. Our analysis requires adjustment for accounting irregularities like purchase vs. pooling accounting, option-based compensation schemes, recurring one-time write-offs, asynchronous depreciation and amortization, aggressive revenue recognition, accounting for subsidiaries, and the accounting treatment of pension funds.

We are ultimately trying to estimate the price an intelligent private investor would pay for the entire business in a private transaction. We think the markets are extremely inefficient in the short term (and very efficient in the long term). Prices will substantially deviate from our estimate of intrinsic value, both to the upside and downside. By buying a fast-growing company at a discount to our estimation of intrinsic worth, we think that over time the price of our investments will compound at a rate equal to the growth rate of the business **plus** accretion back to fair value. The challenge today is to

### FOR EXAMPLE:

If we buy a company for \$30 and we think its fair intrinsic value is \$60, we expect to ultimately double our investment plus compound at the company's internal growth rate.

If the business grows at 10% for the next 15 years, the original \$60 intrinsic value would grow to \$250, according our \$30 investment a 15.2% annual return. By paying \$60 (fair value), our compound annual return would be 10%; by paying more than \$60 today our return would be less than 10% per year.

find good businesses at good prices. As the market has favored the ultra large cap growth stocks and has been unkind to smaller businesses, we are finding decent bargains with domestic small and mid cap stocks and in Japan.

#### “Can you discuss briefly one of the companies you like today and that is priced to buy?”

We are very high on a property casualty insurer in California called Mercury General [MCY/NYSE]. We tell people of our affinity for Mercury and its savvy Chairman and CEO George Joseph and they think the company might disappear when the left coast falls into the sea! If Mercury insured structures we would likely stay away. However, 95% of their premiums written are auto insurance, primarily private passenger.

We are hard-pressed to find a better run, more profitable property casualty insurer than Mercury General. Insurance is a pretty simple business with fairly complex accounting. The business basically writes policies and collects premiums. The company pays claims and operating expenses with its premium dollars. Any premiums collected and not used for premiums and expenses are retained and invested to pay future claims and expenses. The surplus is commonly referred to as “float” and carried on the books as assets (stocks, bonds) and as liabilities (unearned premiums and reserves for future claim payments).

The auto insurance business has been brutally competitive in the last couple of years, as easy access to capital has encouraged fierce competition. Premiums have declined and many insurers have a combined ratio (claims plus expenses as a percentage of premiums earned) above 100%. Not Mercury. Mercury typically earns an under-writing profit of 8%-12% (combined ratio of 92%-88%) of premiums earned. With roughly \$2.1 billion in assets the company earns an additional 5.1% interest on these assets. We think that Mercury will write \$1.2 billion in premiums in 1999, earn 6%-7% (\$72-\$84 million pretax) on those premiums, and earn nearly \$100 million pretax in investment income. With 55 million shares outstanding, Mercury could earn nearly \$3.00 in earnings per share. At a recent price of \$33 per share, we are buying the company for less than \$2 billion or approximately 10 times current earnings.

The industry is now three years into what we call overcompeting or overcapacity. As Mercury's competitors lose more and more money on an underwriting basis, competition will slow and Mercury can profitably grow premiums, returning its combined ratio to 90%. This cyclicity is pretty typical in property casualty insurance. As the low-cost provider in

### MERCURY GENERAL [MCY/NYSE]

FINANCIAL PROFILE			
		1998 hi	\$70.00
P/C Premiums Earned	\$1.1 B	1998 low	\$33.25
Net Profit	\$177		
		<i>as of August 1, 1999:</i>	
Loss to Premium Earned	61.0%		
Expense to Premium earned	26.6%	52-wk hi	\$64.06
Underwriting Margin	12.4%	52-wk low	\$ 31.88
Total Assets	\$2.13 B	Recent Price	\$33.00
Shareholders' Equity	\$911 M	Recent Dividend Yield	\$ 2.5%
STOCK PROFILE		Market Cap	\$ 1.8 B

## **Recent Discussions:**

### ***Broad Market Profile***

**July 12, 1999 Letter**

### ***Energy/Energy Services***

**March 23, 1999 Letter:**

**Diamond Offshore**

**Schlumberger**

**Transocean Offshore**

### ***Property Casualty Insurance***

**In This Letter:**

**Mercury General**

their business with fantastic fundamentals and squeaky clean accounting (we checked— **see disclaimer**), Mercury can compete profitably in the worst of environments. Assets are under 2.5 times equity and equity represents a conservative 92% of capital.

The company sells through independent agents and is rolling out their underwriting expertise outside of California. They are now competing in Florida, Texas, Georgia, Oklahoma, Illinois, and Kansas and looking to enter Arizona. They have designed and built a proprietary automated online agent system called Starfish, which lends Mercury a competitive advantage by dealing effectively with their agents. Agents love Mercury because their premiums are low and the commissions paid are ultra-competitive.

We are looking for at least 10% growth in premiums and 12-13% growth in earnings as competition begins to subside. With the stock down from last year's high of \$70 per share, we are thrilled to have a chance to buy the business at a discount to our \$51 estimate of intrinsic value. We anticipate owning our shares for a very long time. We like the prospects for the company as they expand outside of their west coast geography. We would not rule out a buyout. George Joseph is a spry 77 years of age and owns approximately 34% and his ex-wife, two years his junior, owns approximately 17%. As the GEICO's and the Progressive's of the world seek to add market share, they may provide "retirement" liquidity to these large shareholders.

Mercury General passes all of Semper Augustus' investment tests. It is a good business with smart management that can grow its franchise profitably. We are buying it at a discount to what we believe is its intrinsic value of \$2.8 billion or \$51 per share, growing at over 10% per year.

## **HOW TO CONTACT US:**

Christopher P. Bloomstran, CFA  
314.726.0430  
fax: 314.862.1927  
1034 S. Brentwood Blvd. Suite 850  
St. Louis, MO 63117  
CPB@semperaugustus.com

Chad S Christensen  
303.893.1214  
fax: 303.893.1207  
3164 Rockbridge Drive  
Highlands Ranch, CO 80129  
CSC@semperaugustus.com

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SAI results are time-weighted returns that are gross of management fees and taxes, but inclusive of trading costs and commissions paid. Client accounts are equal weighted in the composite. Returns include the reinvestment of income. SAI published fee of 1% would reduce the annual return by 1% per year. SAI has clients that pay less than the standard fee and certain performance accounts may pay more than the standard fee. Based on fee, asset allocation, commencement of a client relationship, taxability, risk factors, and other factors; returns may differ from the composite returns. January 1, 1999 is the inception for performance returns and includes terminated, taxable, tax-exempt, and leveraged portfolios above a minimum threshold. Cash and cash equivalents were a significant investment during the period presented.

The use of "squeaky clean" is a characterization based on the Chief Investment Officer's review and should not be used as an endorsement of specific accounting policies selected by Mercury General. The term is not endorsed by, nor is it in the lexicon of, our Compliance Officer (a former public accountant).