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**FEATURES MAIN**

## The Hartford: Hedged Against Disaster

By JONATHAN R. LAING

*Hartford Financial is on firmer footing than investors might think, making the insurer's stock look like an ultracheap bet on recovery in the bond market. A chance to double your money in the next few years.*

**WANT TO MAKE A LEVERED BET** on a recovery in the bond market? For those willing to take some risk, there are few better bets than buying the stock of [Hartford Financial Services Group](#) .



Steven E. Frischling/Bloomberg News

Executives of the Hartford argue that the company's conservative approach to investment write-downs and charge-offs has kept its portfolios on a firm footing.

Hartford's stock (ticker: HIG) has been trampled in the past four months, plunging from more than 60 to a low of just over 4 in late November, largely as a result of unrealized losses on bonds in the \$89 billion general account that backs its life-insurance and property-and-casualty policies. Its shares have since limped back to around 13.

As risk spreads soared and its mark-to-market bond prices dropped in the fall, Hartford saw its unrealized gross bond losses jump from \$700 million on Dec. 31, 2007, to \$11.6 billion as of the end of October, the latest month for which figures have been disclosed. (The numbers were reported at the company's December Investor Day meeting.)

Largely as a result of these losses -- which are theoretical unless the bonds are actually sold -- the big insurer's net worth, under generally accepted accounting principles (GAAP), crumpled to \$12.6 billion. That gave the company a book value of \$41.80 a share at the end of September, down from \$19.2 billion, or \$61.20 a share at the end of 2007. Moreover, book value is believed to have slid further as a result of the bond mayhem in the fourth quarter; it now could be about \$30 a

share. The company will release fourth-quarter earnings this week.

Even with all of this, the Hartford, as the company is known, seems to be a compelling buy. That is our conclusion after closely inspecting information released by company executives at the December Investor Day. (Hartford Financial officials were unavailable for comment last week because of a quiet period before this Thursday's scheduled profit report.) Among other things, the insurer's executives talked of a springback potential in book value once bond prices recover from current panic levels.

The Hartford's bond holdings are largely of high quality, with a negligible default risk. As for impairment risk, company officials have put that at less than 15% of its \$11.6 billion unrealized loss portfolio, even under severe economic conditions. And if it were necessary to take charges on these securities, they would be incurred over several years.

A return to more normal conditions in the bond market won't boost Hartford's net worth back to year-end 2007's \$61.20 a share. The company has had to take too many earnings write-downs in the past three quarters, including \$3.5 billion in after-tax asset-impairment charges and a charge of nearly \$1 billion resulting from a shortfall in the expected results of its variable-annuity business, owing to stock-market declines. Offsetting these negatives somewhat was a largely undilutive \$2.5 billion infusion of new capital into Hartford by **Allianz** (ALV.Germany) in October. In return, the German insurer got debt and preferred shares.

Yet a return in book value to \$50 a share in the next year or two is possible, particularly if Washington's push to boost the capital coursing through U.S. financial markets and bolster asset prices finally bears fruit. Likewise, earnings should stabilize after a horrid third-quarter loss of \$2.6 billion, largely the result of bond- and stock-market losses hitting life-insurance results and Hurricane Ike hurting property-and-casualty earnings.

**MORGAN STANLEY ANALYST NIGEL DAILY** foresees Hartford Financial generating operating earnings of \$5.40 a share in 2009 and \$5.95 in 2010. His estimates are below the consensus forecasts, which contain a lot of stale assumptions. Nonetheless, Daily indicated in a recent report, the stock looks dirt cheap, and he later raised his one-year price target to 25. Based on his 2009 estimate, Hartford trades at a price-to-earnings ratio of just under 2.5 times. And the stock fetches less than half our conservative year-end book-value estimate of \$30 a share.

The Morgan Stanley analyst further asserts that, when the equity and credit markets improve, Hartford's P/E multiple could jump. Historically, the Connecticut-based insurer has traded at an average of 10 times earnings and 1.4 times book value. If it gained back most of that valuation, shares could be changing hands in the 40s. In fact, that price could be attained in a year, assuming that the company incurs no more major earnings charges. A return of book value to 50 in the next year or two could send the shares even higher. One shouldn't forget that the Hartford traded at nearly 100 just 13 months ago.

In December, Hartford Financial officials insisted that the capital-depleting \$11.6 billion in mark-to-market hits that they had been forced to take for 2008's first 10 months were largely a function of illiquidity and panic in the credit markets, rather than any fundamental problems with their investment portfolio. For example, the current prices of commercial mortgage-backed securities imply a 70% decline in commercial

real-estate values and a default rate more than seven times as great as any sustained during the other commercial real-estate busts of the past 25 years. Hartford Financial has \$11.2 billion, or 13%, of its portfolio in commercial mortgage-backed securities (CMBS). At the same time, the valuation gap between corporate bonds and U.S. Treasuries has become a canyon. It is so wide that the implied cumulative losses on, say, triple-B corporates range from 25% to 30%, versus actual cumulative losses around 5% during the five worst years of the Great Depression. Corporate debt accounts for 33%, or \$30 billion, of the Hartford's investments.

## Better Days Ahead

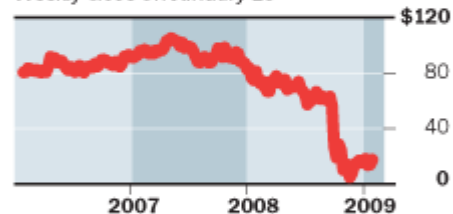
The Hartford should revive, aided by the strength of the assets backing its policies.

### Hartford Financial at a Glance

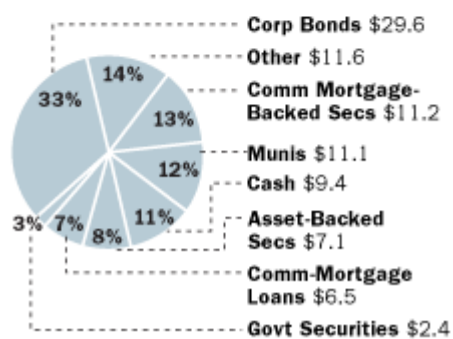
<b>Recent Price</b>	\$13.13
<b>52-Week Range</b>	\$82.24-\$4.16
<b>Stock Mkt Val (bil)</b>	\$4.0
<b>Revenue 2008E (bil)</b>	\$15.0
<b>Revenue 2009E (bil)</b>	\$22.0
<b>EPS 2008E</b>	\$4.70
<b>EPS 2009E</b>	\$6.08
<b>P/E 2009E</b>	2.2

### Hartford Fin'l (HIG-NYSE)

Weekly close on January 29



### General Account \$88.8 bil\*



\*Data is through Oct. 31, 2008.

Sources: Thomson Reuters; company reports

Adding to the perceived weakness has been the company's rigor in taking permanent securities charge-offs, after subjecting its unrealized-loss portfolio to tough tests. Unlike unrealized losses, these hit not only GAAP book values, but also reported earnings.

For its structured securitizations, like those backed by commercial mortgages and other asset-backed securities, the company first makes draconian assumptions about the economy's future, against which it tests its portfolio's viability. Among them: a 10% jobless rate, a 30% drop in commercial real-estate values, a 40% drop in home prices and other economic misery.

As far as straight corporate and real-estate debt goes, the company permanently impairs any security that shows scant prospect of recovering over the next two years. This latter standard is more onerous than those followed by most of the Hartford's competitors, but it is being scrapped for fourth-quarter 2008 results.

All this isn't to say that Hartford Financial is a paragon of financial virtue. It certainly ventured into some dicey areas, including the aforementioned \$11.2 billion in commercial mortgage-backed securities, \$2.5 billion in subprime debt and \$8.4 billion in fixed-income and equity exposure to financial-services companies. But most of its holdings in these securities remain highly rated, even after the rating agencies have finally laid waste to most vintages of similar securities. Likewise, the company's tsunami of charge-offs seems to have peaked in 2008's third quarter, when capital losses reached a sickening \$2.2 billion. The Hartford expects fourth-quarter after-tax impairments of \$250 million to \$400 million.

The collapse of the shares of the Hartford and other life insurers began in earnest in October and worsened in November. With the demise of the credit market, some investors feared the heavy hits on insurers' bond holdings would leave the companies unable to meet their insurance obligations. Another worry was that major sellers of variable annuities would be savaged. Such annuities (Hartford Financial has \$124 billion of them outstanding) combine aspects of mutual funds and life

insurance. In recent years, amid fierce competition, sellers frequently have offered buyers guaranteed minimum monthly benefits that, Wall Street fears, could be difficult to honor, given the stock market's fall.

If all this weren't enough, a Nov. 11 report by Goldman Sachs analyst Christopher Neczypor sent insurance stocks into free fall. He initiated coverage of the industry by slapping Sells on most major players.

The Hartford led off an industry counterattack at its Dec. 5 Investor Day. No, the company maintained, it has no major capital issues that would stop it from honoring all claims or lead to a credit downgrade of its life-insurance operation. Its property-and-casualty unit had \$1.1 billion in excess capital that could be infused into the life company. And the parent company has \$2.4 billion in unused credit and contingent-capital facilities that could be downstreamed.

Perhaps most reassuring, executives said they had enjoyed better-than-projected performance on their hedges, thus reducing the impact of tumbling stock prices. Short of a slide in the Standard & Poor's 500 below 700 -- it is now around 800 -- no capital infusions would be necessary.

Certainly, the Hartford's shares aren't riskless. The insurer's normalized earnings power of around \$10 a share will remain tantalizingly beyond reach for at least several years without a startling rally in both the U.S. stock and bond markets. But the battered shares could double or even triple in the interim.

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