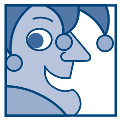

Motley Fool Income Investor™

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With
James Early
Advisor

Recommendation

Safety Insurance Group (Nasdaq: SAFT)

- A strong track record and bright future make this small insurer a premium investment. . . . . p. 2

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All Our Stocks

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Got membership questions? Email ***membersupport@fool.com*** *or call 888-665-3665.*

Will YOU Be the ONE?

On March 14, Motley Fool co-founder and CEO Tom Gardner will invite a few top Fools to give up their *Income Investor* memberships and join him in a premier "club" that gives you access to every wealth-building tool, product, and service we've developed over the past two decades — including *Income Investor.* To see if you qualify and learn more about this one-of-a-kind endeavor, simply go to mfone.fool.com.

There's Strength in Our Numbers

Dear Fellow Fools,

"Don't worry. If you fall, many people will catch you," my friend said.

I pondered whether this was supposed to be a metaphor for Chinese life, but it was just a joke: In rush hour on the Beijing subway, you can't fall. You also can't move your arms or inhale deeply. Pushing and cramming is tolerated — sport, even, for testosterone-laden 20-something males. Unlike personal-space-defending Americans, Chinese subway riders seem more willing to sacrifice space or liberty for the common good.

That changed once I got in a car. Behind the wheel in China, all semblance of rule-following collectivism vanishes. White-knuckled careening through seas of pedestrians and cuttings-off so bold I yearned for an adult diaper occurred every five minutes. More surprising than the crazy driving was that there were so few accidents; I only saw one. Perhaps when people uniformly disregard social contracts, "uniform" seems to trump "disregard" in keeping folks on the same page.

Investors Wield Power

On the roadway, in the subway, in the economy, or in the stock market, we create our own realities every time we decide what to accept and what to change. The social ramifications of dividend-stock investing don't get much airtime, but our collective resource allocation at The Motley Fool is significant. We do improve the corporate world every time we decide to reward the owners of good businesses with our capital — and deprive bad ones of it.

The strength of the U.S. stock market isn't purely the result of a strong economy or purely because of our regulators. Years of investors exercising free choice have etched an imperfect yet powerful culture of trust, transparency, and corporate behavior that attracts investors worldwide to our shores. Even if many of us here take it for granted, the pursuit of ethical, long-term profits might actually make the world a better place.

Back in Beijing, as the subway train was emptying, a girl next to me noticed that my bag's shoulder strap had slipped off. Without a word, or even a look, she kindly moved it back to my shoulder. As I contorted my body sideways to thank her, it slipped off again. She put it back once more, not looking up for a thank you or even a smile. My societal metaphor had just been delivered, revealing a quiet, persistent kindness that underlies the fray. Thank you, China.

Changing of the Guards

In separate news, I'd like to mention that Fool analyst Paul Chi has joined *Income Investor* as your newest analyst. Those of you who know Paul's work from other Fool services are likely aware of his thoroughness and charm. Meanwhile, our beloved, smart Scott Hall is moving over to *Inside Value* full-time. But Scott is leaving us with a special treat: his guest recommendation of **Safety Insurance Group** (Nasdaq: SAFT), which you'll find on page 2. Thank you, Scott, for your quiet and persistent hard work, and welcome, Paul.

Fool on,

Safety Insurance Group (Nasdaq: SAFT)

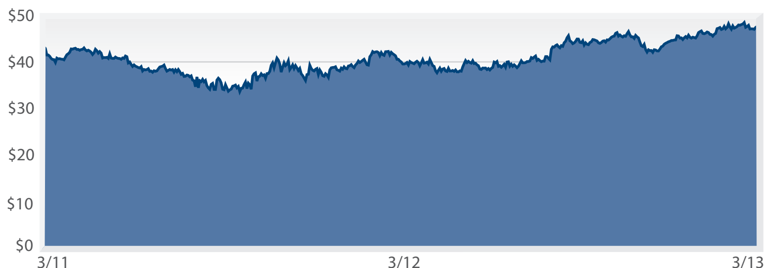
By Scott Hall and James Early

Saftey Insurance Group provides automobile and home insurance products in Massachusetts and New Hampshire.

Why Buy: Its conservative management team and the hardening insurance market bode well for this company's future.

When to Buy: Under $50

When to Sell: If prolonged low interest rates ruin returns on equity, or if the company loses its underwriting discipline in the face of competition.



Risk Rating:	Moderate
Website:	www.safetyinsurance.com
Market Cap:	$719 million
Recent Price:	$46.96
Valuation Estimate:	$58
Current Yield:	5.1%
Debt/Capital:	N/A
Payout Ratio:	57.9%
3-Year Annual Dividend Growth:	11.2%
Return on Equity:	8.6%
P/E:	12.4
5-Year Estimated Book Value Growth:	4.6%

All data as of 3/11/13

If you pay close attention to our scorecard, you'll notice that only one of *Income Investor*'s 67 recommendations is a financial company. Generally, this makes sense: Most of America's largest banks are financial black boxes that leave many questions lingering, and many insurers write long-tail policies, which obscure the ultimate losses for a decade or more. This month's recommendation, **Safety Insurance Group** (Nasdaq: SAFT), is an exception, and its 5.1% dividend yield and 24% upside make it an attractive opportunity for Income Investors today.

The Business

Safety Insurance Group is a small automobile and homeowners' insurance company based in Massachusetts. Unlike major national insurers such as **Berkshire Hathaway**'s (NYSE: BRK-B) Geico or **Progressive** (NYSE: PGR), Safety operates in only two states — Massachusetts and New Hampshire.

Despite its small national footprint, Safety is the third largest auto insurer in its home market of Massachusetts, claiming an 11% market share of automobile policies written in the state. And, more important than its market share, Safety has a long history of conservative insurance underwriting; the company has underwritten at a profit in eight of the past nine years. Warren Buffett calls that free money — and we agree.

The reason is simple, but somewhat counterintuitive: Most insurers don't make money from writing insurance. Instead, they earn profits from investing the float — the premiums policyholders pay that insurers hold on to for a while before paying out claims. Safety, however, consistently makes money from its underwriting operations, which is one reason we like its prospects so much.

The company's historically profitable underwriting isn't an accident. Safety's management team owns a combined 9% of the company, so they eat their own cooking. And, unlike direct sale insurers, the company still uses the agency model. Safety pays bonuses to agents based on the profitability of the business they bring to the company and terminates contracts with agents whose business is consistently unprofitable. In an industry where direct sales are gaining market share, the company is committed to the agency model — more on that in the Q&A.

Financials and Valuation

The insurance market has softened since 2005. Insurers, including Safety, started lowering their rates to keep business. From 2005 through 2009, Safety lowered its insurance prices around 3% to 7% every year, boosting its combined ratio — expenses as a percentage of earned premiums — from 85.4 in 2005 to 97.3 in 2009. The series of price decreases ended in 2010, when Safety was able to increase pricing on its automobile policies by 3.8% and its homeowners' policies by 3.2%. That trend has continued through 2012, with pricing increasing by 4.9% for auto policies and 4.1% for homeowners' insurance. However, pricing remains lower than in 2005.

Combined with historically low interest rates, the company's return on equity has declined from 27.5% to 8.6% today. In our valuation model, plugging in more modest pricing increases from today — enough to get a combined ratio of 92 — provides a valuation of $58 per share, 24% upside to today's price. I think that's a conservative estimate; I'm assigning no upside to any help that higher interest rates might give Safety's investment portfolio, and I'm assuming only modest insurance price increases.

One other important point to mention: Unlike long-tail insurers (think workers' comp or directors' and officers' insurance), which can still be paying claims a decade or more after a policy is written, Safety's short-tail auto and home policy claims are almost entirely paid within five years of when its policies are written. We therefore have a lot of clarity regarding whether or not Safety has been properly reserving for its losses.

Looking at the past 10 years of claims payment information, I estimate that Safety is over-reserved for its losses to the tune of $106 million, so there's very little threat that adverse loss reserve development will destroy the company's book value in the future.

Risks

With its reserve adequacy pristine, I see three big risks for Safety: a drawn-out period of low interest rates, stagnant prices for its insurance products, and catastrophic losses. As we've seen with Hurricane Sandy, major catastrophes can wreck an insurer's profitability for the quarter. Although Safety uses reinsurance to protect itself from a "once-in-140-years" storm, a string of bad catastrophe losses can wipe out a year's worth of earnings. That usually leads to price increases down the road, but it's still a risk.

The other two risks are much more mundane. If Safety fails to continue raising prices, it's going to have a hard time justifying our current valuation estimate, and we'll be forced to lower it. With interest rates as low as they are, I think that one is unlikely in the near future, but it's worth mentioning. Interest rates are a bigger risk. If they decline for a prolonged period of time, Safety's investment portfolio will be unable to earn the same returns that it does today, and we may have to give our valuation estimate a haircut.

The Foolish Bottom Line

Safety Insurance is a sleepy insurer from Massachusetts that's run by a conservative management team with a sizable stake in the company's success. With a 5.1% — and growing — dividend yield, a lack of financial exposure on our scorecard, and a hardening insurance market that's helping the company's prospects, now is the time to add some Safety to your portfolio.

Paul Chi and The Motley Fool own shares of Berkshire Hathaway.

Learn More Online

At **incomeinvestor.fool.com**, you can add SAFT to My Scorecard, discuss Safety Insurance Group with your fellow Fools and the *Income Investor* team, and see how all our stocks are doing on our improved, real-time scorecard. Plus, you'll get exclusive extras like interviews, special articles, and more!

Q&A: Safety Insurance Group

By Scott Hall and Paul Chi

Paul: You mentioned that Safety Insurance Group (Nasdaq: SAFT) has committed to the agency model. How can it effectively compete with the marketing budgets of direct sales giants such as Geico?

Scott: One of the peculiarities of the Massachusetts auto insurance market is that, before 2008, the state government set insurance rates. That kept the major direct sales players like Geico out of the market because they were unable to lower their prices, and as a result, independent agents controlled 78.8% of the market as recently as 2007, compared with 40.1% nationwide.

Even after the market was deregulated, market share has barely changed hands — 76.3% of the market is still controlled by the independent agencies, and Geico barely cracks the top 10 in market share. Over time, I suspect that will change, but with Safety's stock hovering just above book value, I think we're well compensated for the risk.

Paul: Does Safety have plans to expand outside its home markets in Massachusetts and New Hampshire?

Scott: Management keeps its cards pretty close to its chest on this one. Although the company has stated that it wants to focus on its core market of Massachusetts, it expanded its underwriting to New Hampshire back in 2008. Considering that Safety has been around since 1979 and has just entered its second market, I expect that the company will undertake any further expansion carefully.

Paul: You mentioned that Safety uses reinsurance to protect itself from 140-year events. Is the company subject to counterparty risk? How does Safety vet its reinsurers?

Scott: Safety has been pretty selective in choosing its reinsurance partners. The lion's share of the company's reinsurance comes from **Swiss Re** (OTC: SSREY), which holds an A.M. Best rating of "A", and none of Safety's reinsurers have A.M. Best ratings below "A-". Considering that even the lower of the two ratings is defined as excellent, counterparty risk is minimal.

Paul Chi and The Motley Fool own shares of Berkshire Hathaway.

Buy First Stocks: Payouts and Profits, Part 2

By Paul Chi

Income Investor Buy First Stocks

Company (Ticker)	Valuation Estimate	Yield
Hasbro (HAS)	**$50**	**3.8%**
Johnson & Johnson (JNJ)	**$71**	**3.1%**
National Grid (NGG)	**$67**	**5.7%**
Textainer (TGH)	**$54**	**4.5%**
Waste Management (WM)	**$44**	**3.9%**

Data as of 3/11/13. Learn more at incomeinvestor.fool.com.

Last month, we kicked off our two-part discussion of our Buy First stocks to see where future dividend increases might come from. Here's a brief refresher: Dividend increases can come from raising the payout ratio, increasing profitability, or a combination of the two. This time around, we'll delve into Buy Firsts **Textainer** (NYSE: TGH) and **Waste Management** (NYSE: WM).

Highly Utilized

By all accounts, things are sailing smoothly for our favorite lessor of intermodal containers. Last year was good to Textainer, which had an average utilization of 97.2% for the year, despite also having spent a record $1.2 billion growing its fleet. This spending shatters the previous record, set last year, by more than 25%. Thanks to a bigger fleet and strong utilization for the year, Textainer's earnings per share increased from $3.80 in 2011 to $3.96.

On the heels of its strong results, the company raised its dividend to $0.45 per quarter, or $1.80 annually. This marks Textainer's 12th consecutive dividend increase and represents a payout ratio of 45.5%. The company typically targets a dividend of between 40% and 50% of adjusted net income, which excludes the impact of interest-rate swaps. That balanced number allows Textainer to return plenty of cash to shareholders without inhibiting future growth.

Textainer's strategy for future dividend increases will focus on adding to profitability rather than raising the payout ratio, so the company can stay within its target payout range. On that front, Textainer's prospects look sound. The company expects utilization rates to remain strong in 2013 and will benefit from a full year of owning all the containers it acquired last year during its shopping spree.

Commodity Woes

Last year, trash collector Waste Management's earnings fell 13.7% year over year, to $1.76. The company also upped its annual dividend payment for the 10th consecutive year, to $1.46. This modest 2.8% increase was its smallest in a decade, but the new dividend still brings the payout ratio up to 83%.

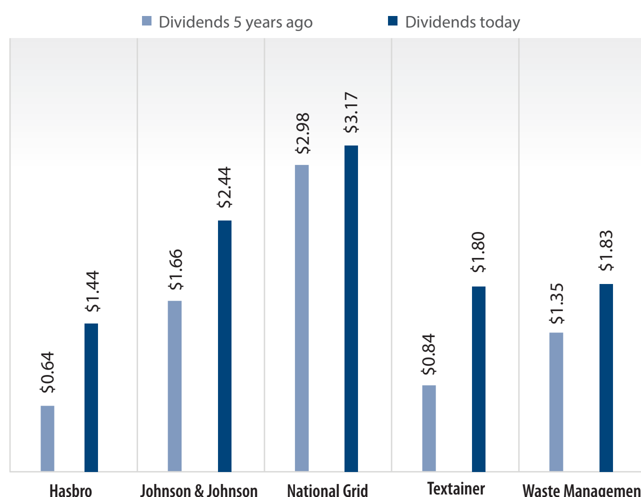
On the surface, this doesn't seem to allow much room for growth. However, things aren't that bad. For the full year, recycling and electricity commodities prices ate $0.25 per share, compared with 2011. After adjusting for negative commodities pricing and other items, adjusted earnings per share were $2.08, down from $2.14 a year earlier. The payout ratio is a more manageable 70% under that scenario. Commodities are quite volatile, and we expect ups and downs over the years — and last year was a doozy.

On the plus side, the company's traditional solid waste business expanded last year, after several years of declining volume. And the outlook is good for continued success: Waste Management expects its solid-waste division to boost earnings about 7% to 10% this year, thanks to improved pricing, cost-savings programs, and increasing volume. With higher earnings from the solid-waste business and a smaller hit predicted to come from its recycling and electricity commodities businesses, Waste Management expects earnings to bounce back in 2013.

In all, Waste Management's payout ratio has increased in recent years without commensurate jumps in earnings. We don't expect the company to raise its dividend aggressively in the short term without first cultivating higher earnings. As economic activity picks up, more trash will need to be hauled. Over the long term, Waste Management's strong competitive position should allow it to benefit from the higher amounts of trash over time and capture its share of the profits. Still, we'll keep an eye on this company to make sure the business keeps moving in the right direction.

James Early owns shares of Hasbro, Johnson & Johnson, National Grid, Textainer Group, and Waste Management. The Motley Fool owns shares of Hasbro, Johnson & Johnson, and Waste Management.

Dividend Growth of Our Buy Firsts



Profit Playbook: Does Corporate Responsibility Pay?

By James Early

Here's an excerpt from my recent interview with Xi Li, assistant professor of accounting at Temple University. Her working paper, *Active Ownership*, cowritten with Oguzhan Karakas and Elroy Dimson, suggests that companies responsive to shareholder engagements may make better investments. Visit **incomeinvestor.com** for the full audio interview.

James Early: How would you describe your paper?

Xi Li: We are looking at whether corporate social responsibility generates value or not. I'm sure all investors would be happy to know if it does. Our paper uses very innovative data, which helps us attribute firm performance and stock market performance to corporate social responsibility [CSR].

James: Your paper studies shareholder engagements. What are those?

Xi: We took data from a very big asset manager, with its own standards for CSR activities. If the manager identifies a firm that is not acting responsibly, such as if the firm is using child labor, the asset manager will contact the management of the firm ... and require ... changes to behave responsibly, such as abandoning child labor. Basically, it's an interactive dialogue with a management firm or asset manager and the company.

James: Overall, how often were this firm's engagements successful, and what was the result in terms of stock market performance of the successful engagement companies?

Xi: On average, it's about an 18% success rate. ... This rate is much lower than that of aggressive hedge fund activists, but relatively higher than passive shareholder activists, such as pension funds. On average, we observe for the engagements in general about 1.8% annual outperformance after the engagement, and of course the successful ones and unsuccessful ones have different results. So we observe about 4.4% annual abnormal return for the successful engagements, and zero outperformance for the unsuccessful ones.

James: So no penalty if it's not successful, and a 4.4% positive abnormal return in those 17% or 18% of successful engagements.

Xi: Yes, that's correct. There's no penalty, at least within the window that we observed.

James: What exactly is causing these stocks to outperform in the next year or two after the engagement?

Xi: In our paper, we specifically examine four theories that could explain the outperformance. One is that companies think CSR activities could attract consumers. Starbucks started using fair trade coffee. After [CSR-conscious] consumers observe that, they would like to buy coffee from Starbucks. They don't even mind paying a premium for their coffee.

Another thing is there are lots of shareholders who are very socially conscious, and that's at pension funds. They would really love to invest in companies that have CSR activities. A third way is that the CSR activities could improve the efficiency of the company, such as through happy employees — employees will be happier if they're treated fairly. And lastly, accepting the activism from the shareholders in itself is signaling an improvement about the corporate governance of the company. The signal is that the managers are unlikely to be entrenched because they do listen to shareholders. We find supporting results for all of these explanations after successful engagement.

James: One of the biggest challenges of studying any kind of social investing is data. Your data set is from a single institutional investor. How much might this have affected your conclusions?

Xi: We think our data provider is likely to be among the leading firms in this industry because our data provider is one of the earliest ones. Therefore, they could be the Warren Buffetts, the successful ones. And we think our documented abnormal return is likely to be the upper bound for the market reaction for CSR activism.

Editor's note: You can download the working paper at www.SSRN.com/abstract=2154724.

David Gardner, Tom Gardner, and The Motley Fool own shares of Starbucks.

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RECOMMENDATIONS

The *Income Investor* 15

These stocks have the highest upside among our Buys this month. Be sure to also consider yield and risk when you invest!

upside rank	upside	yield	risk
Veolia Environnement VE	72%	6.6%	high
Statoil STO	60%	4.6%	high
Cato CATO	58%	4.6%	moderate
Breitburn Energy Partners BBEP	45%	9.7%	high
StoneMor Partners STON	41%	9%	high
Giant Interactive GA	41%	6.6%	high
Intel INTC	38%	4.1%	moderate
Total TOT	35%	5.8%	high
ClickSoftware Technologies CKSW	32%	3.5%	high
Cisco CSCO	28%	2.6%	moderate
NuStar GP Holdings NSH	26%	7.3%	moderate
Safety Insurance Group SAFT	24%	5.1%	moderate
Oneok Partners OKS	20%	5.3%	moderate
DCP Midstream Partners DPM	19%	6.2%	moderate
Central Securities CET	18%	4.5%	moderate

Buy First

These are some of our favorites to build your portfolio around:

Hasbro HAS
Johnson & Johnson JNJ
National Grid NGG
Textainer TGH
Waste Management WM

Share your thoughts on these stocks, others in your portfolio, or those you're watching on our members-only discussion boards at **incomeinvestor.fool.com**.

16

Income Investor stock picks have had returns of more than 100% since our recommendation

57%

of *Income Investor's* active picks are beating the market

Additional Buys

These offer more investing ideas for you and may be a fit for your portfolio; they're simply not as cheap as those above.

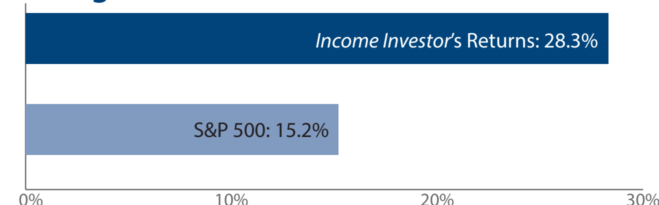
The Buckle BKE
Chevron CVX
Deluxe DLX
El Paso Pipeline Partners EPB
Emerson Electric EMR
Guess GES
Hillenbrand HI
Mine Safety Appliances MSA
Oneok OKE
Republic Services RSG
Retail Opportunity Investments ROIC
UNS Energy UNS
Wisconsin Energy WEC

Hold On!

Because of their valuation, risk, or other factors, we don't recommend buying these stocks today.

Alliance Resource Partners ARLP
Aqua America WTR
Automatic Data Processing ADP
Bank of Nova Scotia BNS
California Water Service Group CWT
Coca-Cola KO
Diageo DEO
Dominion Resources D
Douglas Dynamics PLOW
Enterprise Products Partners EPD
Flowers Foods FLO
France Télécom SA FTE
Greif GEF-B
Health Care REIT HCN
Illinois Tool Works ITW
Kimberly-Clark KMB
Magellan Midstream Partners MMP
Mattel MAT
McCormick MKC
McDonald's MCD
PepsiCo PEP
Petróleo Brasileiro PBR
Piedmont Natural Gas PNY
Procter & Gamble PG
Rogers Communications RCI
Sabesp SBS
Sasol SSL
South Jersey Industries SJI
Southern Company SO
Spectra Energy SE
Sysco SYY
Telkom Indonesia TLK
UGI UGI
Unilever UL
United Breweries CCU

Average Returns



Since inception; includes sold positions.

Risk ratings: See the July 2009 issue for more on the factors that go into these ratings and how to use them.

James Early owns shares of DEO, FLO, HAS, JNJ, NGG, PEP, SO, TGH, and WM. The Motley Fool owns shares of BKE, FTE, GES, HAS, HI, INTC, JNJ, MCD, PEP, ROIC, STON, and WM.

All data as of 3/11/13

Find more details at incomeinvestor.fool.com

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