



Farm Creek Securities, LLC
Farmcreeksecurities.com
fc@farmcreeksecurities.com
89 Roton Avenue, Rowayton, CT 06853
(203) 838-1025

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Unsure About Insurance

By Ed Hynes, CFA

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Everyone buys insurance - we all have it, be it car, health, life or the service contract we bought on our latest appliance. Insurance is complicated and this article attempts to make it a little less confusing.

Insurance companies often get a bad rap, but insurance helps the economy operate smoothly. Insurance products allow individuals and businesses the opportunity to reduce risks in exchange for a premium and this allows us to allocate resources more efficiently.

Fire insurance is a good example. The chance of your home burning down is slim, but it would be catastrophic. An individual's risk is small, but the consequences are immense.

Now let's look at fire insurance from the perspective of a large group. If all the homeowners in the city acted together, an individual's risk shifts quite dramatically. The risk of a fire somewhere in town is very high. However, the consequences to each individual are very small, even if it is their own house. When someone's house burns down, everyone contributes a small amount to its rebuilding.

In essence, this is how insurance companies operate. Insurance allows individuals to trade the specific risk of their home burning down, for the group's risk. Policyholders are protected from catastrophic loss by paying a premium. These premiums allow insurance companies to pay for the few houses that do burn down.

In real life, insurance companies estimate how many houses will catch fire and then set premiums to cover costs plus a little more for their profit margin. If there are fewer fires than expected, the insurance company does well. On the flip side, a higher incidence of fires will cost the insurance company money.

The key point is that insurance companies are on the hook for their promises even if their estimates are wrong. They place a bet on the risks; and win or lose. When they lose big, they can go out of business and policyholders may or may not receive the coverage they expect. 100 years ago no one predicted the number of fires the San Francisco earthquake caused and I think Fireman's Fund was the only fire insurance company to survive.

This leads to a few observations: First, insurance companies offer products at prices where they expect to make money. If their experts are right, they win. However, in many cases, like fire insurance, it still makes a lot of sense to buy their product.

Second, remember that you buy most insurance products; you do not invest in them. With the fire insurance, you don't get your money back if no one has a fire. An insurance company's profit turns on a combination of how well they understand the risks they take on and the premiums they charge customers.

This brings us to a quick discussion of a basic insurance product called immediate annuities. Annuities come as either as immediate or deferred, referring to when payments start, immediately or some time in the future. I will discuss deferred annuities another day.

With a basic immediate annuity, the policyholder turns over a lump sum of money and receives a payment every month for the rest of their lives. As you would expect, the insurance company determines the monthly payments based upon their estimate of how long the person is expected to live. Just as an insurance company estimates how many fires are likely to occur, they estimate how long people are expected to live.

Immediate annuities are very attractive to investors who expect to live longer than average. If your family history points to your living into your 90s, these can be pretty good investments. On the other hand, if no one has ever made it to 80, I would probably take a pass. The major downside to buying an annuity is if you die relatively early.

Buying an annuity can also be attractive for your piece of mind. You do not need to worry about how long you live or how the market performs. All that risk has been transferred to the insurance company.

This leads to another point. When you buy an annuity, make sure the insurance company can handle it. For long-term insurance products make sure you pick a strong, solid company.

Variations on the basic immediate annuity are spouting up all over the place. Some of these products may be very helpful, but they are difficult to analyze. The insurance companies will make these products look really good or what some professionals call "optically appealing." Remember, no matter how optically appealing a product, insurance companies do not sell merchandise on which they expect to lose money.

Ed Hynes, CFA, is President of Farm Creek Securities, LLC based in Rowayton, CT. (203) 838-1025. This series of articles is available at farmcreeksecurities.com. Before putting money in any investment, investors should carefully consider their investment objectives; and the risks, charges and expenses of any investment. Past performance is not an indication of future performance and there are risks to investing including the loss of principal.

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