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BUILDING THE 10%

JUNE • 2016

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Everybody's talking about it, but how should we think about the historic referendum from the perspective of Austrian economics and political liberty?

THE PROFIT POWER OF INSURANCE 'FLOAT'

BY L. CARLOS LARA

Warren Buffett learned this one trick about insurance that made him billions! (For real, read the article.)

NAVIGATING IRRATIONAL FINANCIAL MARKETS

INTERVIEW

Caitlin Long has a solid track record with investment banking but appreciates the insights of the Austrian School. She helps make sense of our crazy situation.

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LARA-MURPHY REPORT

If you wonder why we revere Mises so much, just look at the guidance he provides to us today...from back in 1958.

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ONE MORE THING

EVENTS AND ENGAGEMENTS

Learn more in person from Lara, Murphy, and other Austrian economists, at these upcoming appearances.

ABOUT LARA & MURPHY

L. CARLOS LARA is CEO of United Services and Trust Corporation, a consulting firm specializing in in business advisory services with a primary focus on working with companies in financial crisis. His background in capital formation and business rehabilitation makes him a regular speaker at credit and business conferences.

In 2010 he co-authored the highly acclaimed book, *How Privatized Banking Really Works* with economist Robert P. Murphy.

He is a co-creator of the IBC Practitioner Program for financial professionals and sits on the board of the Nelson Nash Institute.

ROBERT P. MURPHY is Research Assistant Professor with the Free Market Institute at Texas Tech University. He is co-author of *How Privatized Banking Really Works*. He is the author of *Choice: Cooperation, Enterprise, and Human Action* (Independent Institute 2015) and co-host with Tom Woods of the popular podcast Contra Krugman.

Murphy has a Ph.D. in economics from New York University. After spending three years teaching at Hillsdale College, he went into the financial sector working for Laffer Associates. With Nelson Nash, Carlos Lara, and David Stearns, Murphy is co-developer of the IBC Practitioner Program.

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READERS

"In a world without migration barriers…

probably twenty million people would try to reach the United States every year, in order to get higher wages. The inflow would reduce wages in the United States, and raise them in other countries."

—Ludwig von Mises, "Economic Policy: Thoughts for Today and Tomorrow"

In the excerpt above—taken from a lecture Mises gave in Argentina in 1958—Mises put his finger on one of the key issues underlying not only the Brexit vote but also the current American election. Now Mises was a champion of classical liberalism and saw firsthand how the "passports, please" limitations on migration had gone hand in hand with the rise of socialism and fascism in Europe. Even so, his quotation above shows the simple logic of the immediate impact of a reduction in immigration barriers, and why so many workers oppose a policy of "open borders." (Even though the efficiency of production would increase and *per capita* income would rise across the world, it would depend on the specifics to assess the impact on any particular person.)

In his lecture, after making the above observation Mises tried to offer a solution that would appeal to everyone. He did not offer a definitive answer on the question of migration, but instead focused on the international flow of *capital*. Mises had earlier pointed out that the major difference between developed and undeveloped nations is mostly a function of time. For over 100 years, the British had the highest standard of living throughout the world simply because they started saving their money sooner. They also started sooner in accumulating capital and investing in business.

Paraphrasing the rest of Mises' story he recounts that other underdeveloped countries began studying Britain's strategy and soon imitated their methods. Consequently, they too experienced a rise in their standard of living, but could not quite catch up to the British until something happened that caused the head start of Great Britain to disappear. That great event, which happened in the 19th century, was *foreign investment*.

Foreign investments helped all developing countries advance decades ahead of their time, but it also helped Great Britain all the more. He reminds us that it is a well-known fact that the U.S. railroads were built using British capital. In fact the gas companies all over the cities of Europe were British. Britain was the great industrialist leader of the nations.

But all this took a wrong turn after WWI when foreign investments were no longer made to foreign capitalists. Instead foreign investments were made to foreign governments with entrepreneurs never dreaming that they would actually default on their loans or literally seize their capital. With these new developments the history of the world changed.

Today, the system of confiscation continues with the use of foreign exchange controls or tax discrimination. But this is not exclusive to developing countries. Mises emphasizes that the problem in all countries in his time (and ours as well) is the penalty on domestic capital accumulation. Every country, including our own, now has heavy taxes or double taxes on corporations making it much more difficult to accumulate savings and capital. *"This policy of the United States is worse than bad—it is insane."*

Aside from the problem of inflation, the only strategy for more economic equality in our country and the rest of the world is industrialization. This is possible only through increased savings, capital accumulation and capital investment. There are no shortcuts, no easy way around it. We have to put in the time and work hard.

Yours truly,
Carlos and Bob

"It is the masses that determine the course of history, but its initial movement must start with the individual."
— How Privatized Banking *Really* Works

PULSE ON THE MARKET

Politics of Brexit

FAIRLY PREDICTABLE HOW PEOPLE LINE UP ON THE VOTE

One of us (Murphy) has written on the *economics* of Brexit in this issue, but the political fallout is quite interesting (and hilarious). UKIP (UK Independence Party) leader Nigel Farage gave a victory speech to the European Parliament, at one point saying, "Now I know that virtually none of you, have ever done a proper job in your lives…" At the same time, the "elite" financial commentators—including Alan Greenspan and Ben Bernanke—have lectured the British voters on what a foolish decision they made.

A great example of the mainstream media's horror is the Washington Post headline, "The British are frantically Googling what the E.U. is, hours after voting to leave it." The article then reported that there had been a surge on Google in UK-based searches for "What is the EU?" The implication of the piece, of course, was that the British voters were a bunch of ignorant fools (and probably racist, too). Further investigation by other outlets discovered that it was about *1,000 people total* in the UK who typed that into Google the day after the vote. For all we know, it could have been people who didn't even vote, and were wondering what everyone was talking about (and why the markets were way down), and some of them could've been Remain voters. But of course, the WaPo and other mainstream outlets don't like uppity voters derailing the plans for globalization, and so they jumped at the chance to ridicule the Leave camp.

Rush to Safety

"SAFE" ASSETS SURGE IN PRICE AFTER BREXIT SHOCK

As of this writing, the markets are reversing some of the initial reaction to the Brexit vote, but still gold, the US dollar, and US Treasuries are way up, while equity and commodity markets around the world are down. For example, in terms of one-month movements, gold went from $1,218 per ounce to $1,318, the dollar appreciated from $1.46 per British pound to $1.33, and the 10-year Treasury yield went from 1.84% down to 1.46%. (Note that bond prices and yields move in opposite directions, and that the USD surged against the euro and Canadian dollar as well in the immediate reaction, but fell slightly against the Japanese yen.) However, equity markets got hit hard—many down by double-digits after two days of trading—and oil fell about $2 per barrel.

PULSE ON THE MARKET

The simple explanation for all of these movements is that investors were panicked by the surprise Brexit vote, and reallocated out of riskier assets and into "safe" ones, hunkering down for much slower economic growth in the near-term. To reiterate two themes we've been emphasizing in the *LMR:* Although we have been warning since the release of our book, *How Privatized Banking* ***Really*** *Works,* that the Fed has pumped in boatloads of money into the financial system and that this threatens a much weaker dollar, we may perversely see a *stronger* dollar in the short term because of the weaknesses in the global economy.

Furthermore, this precarious situation is all the more reason to explore Nelson Nash's Infinite Banking Concept (IBC). During the storms we see coming in the years ahead, U.S.-based life insurance companies will probably stand up much better than other major financial institutions, because their assets are concentrated in safe bonds. Be sure to visit http://lara-murphy.com to learn more.

FBAR OR FUBAR?

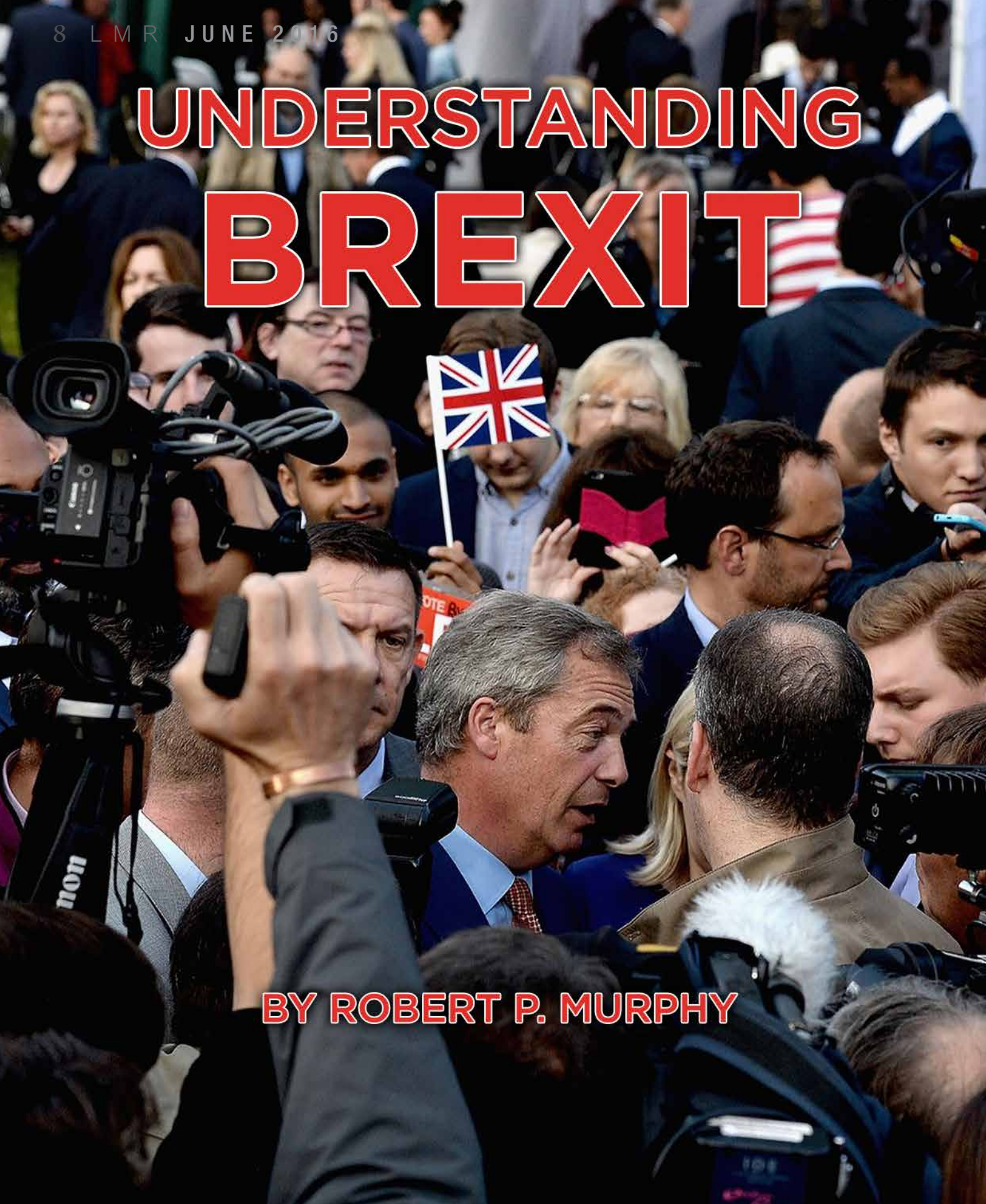
A REMINDER OF THE TIGHTENING FINANCIAL SCREWS

The Brexit vote must be seen in the context of the slide toward a uniform global regulatory and tax system, unaccountable to individual nation-States let alone individual citizens. As just one example, the following is from a Forbes article by Robert Wood:

"If you had foreign accounts in 2015 that in the aggregate topped $10,000 at any time during the year, you should file an FBAR–also called Form 114. June 30, 2016 is the filing deadline, and FinCEN now requires that you file your FBAR, Form 114 electronically. Given the Draconian FBAR penalties–that can include willful and nonwillful civil penalties and even criminal violations–FBARs are nothing to ignore."

The dream of the interventionist Keynesians (for example as laid out in Thomas Piketty's bestselling book, *Capital in the Twenty-First Century*) is to root out all "tax havens" around the globe, so that investors have nowhere to run. After all, you can't very well control people's behavior—even if you only want to help the poor, downtrodden, uninsured, etc.—if they have an escape option. This is a major reason that so many of the academic and political elites were outraged by the Brexit vote.

UNDERSTANDING BREXIT



BY ROBERT P. MURPHY

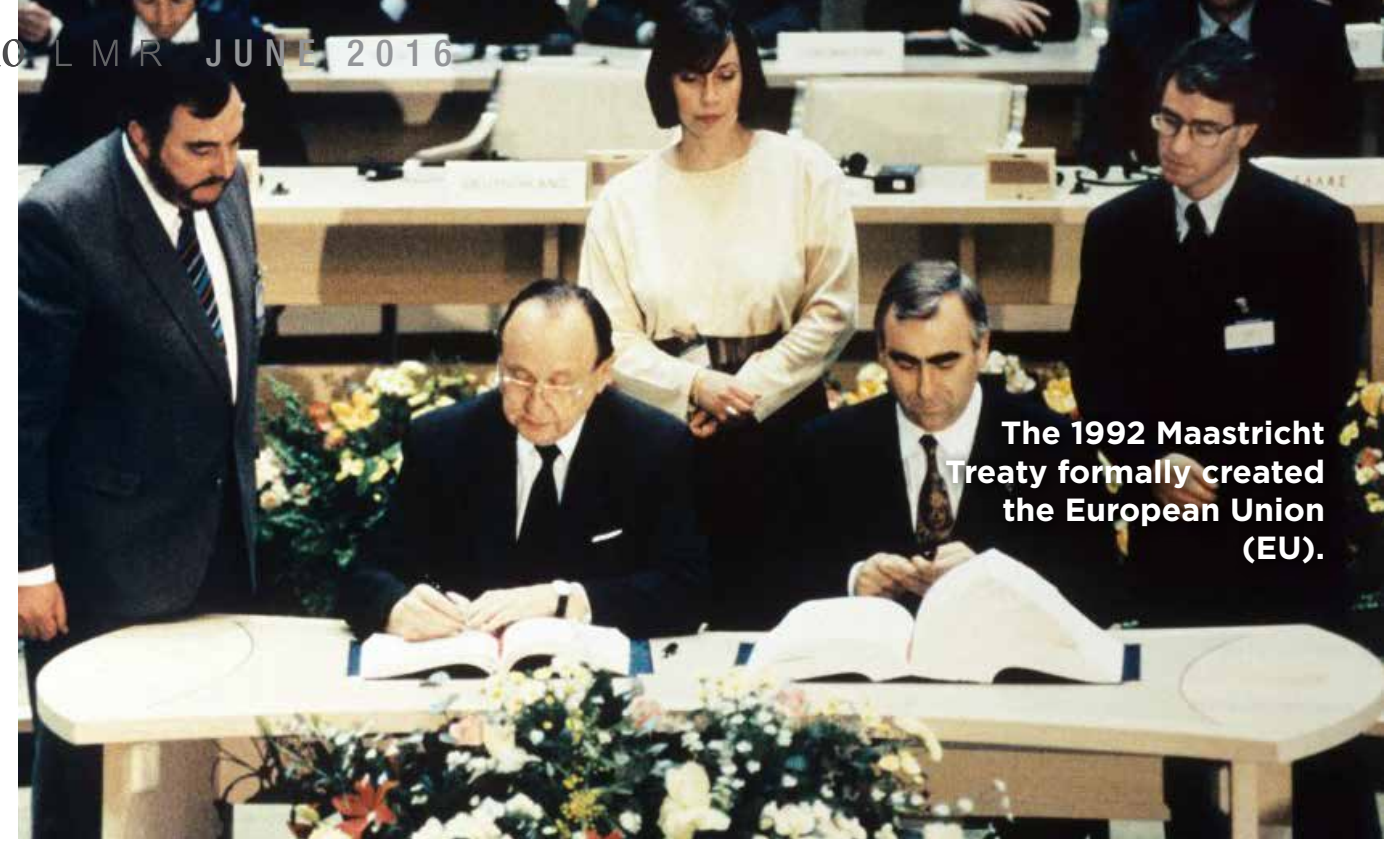
As of this writing, the financial markets continue to roil in the wake of the shocking Brexit (which is shorthand for "British exit") vote. European indices are down double-digits, while the British pound is at 30-year lows. Yet many opponents of Brexit are drawing the wrong economic lessons from the episode. Far from confirming their warnings, the response indicates just how fragile and poorly governed our financial status quo was.

It is a bit awkward for me to express my thoughts on the economic implications of the vote—which surprised most people, including me. On the one hand, the "fundamentals" of the potential fallout are modest, especially when we realize that the EU doesn't have to punish the UK at all—it hurts them to do so.

On the other hand, Carlos and I here at the *LMR* have been arguing for years that the Federal Reserve, ECB, BOE, and BOJ have been inflating giant asset bubbles across the major financial markets. We furthermore argued that by their very natures, bubbles can pop from even an innocuous bump. (The example I often used was a Chinese finance minister talking about slowing Treasury purchases, and this being mistranslated into *selling* Treasuries.)

So to summarize, I think the Brexit vote is a wonderful boon for liberty, as secession is the only practical way for people in the foreseeable future to shield themselves from powerful central States. Even in strict economic terms, there is no reason Brexit should be harmful, especially if European leaders put spite aside and responded ratio-

It's possible that this triggers a global recession that the critics then pin on the British voters, rather than on the reckless central bankers who made a crash inevitable.



The 1992 Maastricht Treaty formally created the European Union (EU).

nally. However, given the precarious condition of world financial markets on the eve of the vote, it's possible that this triggers a global recession that the critics then pin on the British voters, rather than on the reckless central bankers who made a crash inevitable.

THE HISTORICAL CONTEXT

Since World War II, there have been various schemes to maintain European peace and economic stability. These include not just the familiar NATO and UN, but also organizations such as the European Atomic Energy Community and European Economic Community (EEC). The UK joined the EEC in 1973; this is why so many people are now referring to Britain's "43-year history" in the European Union.[1]

The 1992 Maastricht Treaty formally created the European Union (EU), as well as the euro. (The treaty became effective in 1993.) However, note that EU membership and use of the euro are *not* identical—for example, Great Britain is (currently) in the EU, but uses the pound, not the euro. (This status is true for other countries such as Denmark and Sweden, which are also in the EU but have retained their national currencies.) On the other hand, Kosovo (in the Balkans) uses the euro as its currency—it had previously used the German mark after the Yugoslavian dinar crashed in value during the war against Serbia—but is not officially in the EU.

On June 23, 2016, the British public voted in a referendum on the following: "Should the UK remain a member of the European Union or leave the European Union?" In a result that shocked the world, 51.9% voted to leave, while 48.1% voted to remain.[2]

THE ECONOMIC IMPACT OF BREXIT: THE TRADE FUNDAMENTALS

First the basic economics: In terms of standard models of trade, the impact on the UK of leaving the EU is something like a perpetual 2 percent shortfall in real income for the British people—that estimate is from Paul Krugman,[3] Nobel laureate in trade theory and an *opponent* of Brexit.

Furthermore, although the UK economy is in the top-10 of the world (it matters whether you adjust currencies according to market exchange rates or "purchasing power parity"), its output accounts for less than one-twentieth of the global economy. To be sure, we would also want to factor in the loss of real income for the other EU countries due to higher trade barriers, but clearly the *direct* impacts (in terms of "fundamentals") from the Brexit vote are small potatoes for the planet. Hindered trade between the UK and remaining EU nations should hardly trigger a global recession, even though many critics of Brexit are saying matter-of-factly that this may be the outcome.

But the critics' complaints about Brexit are even shakier, because the only reason even the (modest) impacts above will happen, is if the EU punishes the UK for its vote. After all, Switzerland and the United States aren't in the EU, and nobody ever argued that this status threatened a global recession.

Indeed, if the main (alleged) benefit of staying in the EU is access to free trade with the member countries, then that proves the

If the main (alleged) benefit of staying in the EU is access to free trade with the member countries, then that proves the EU is itself a restrictionist organization.

People living in a large political unit are still making themselves poorer if they support trade barriers.

EU is itself a restrictionist organization hindering global trade flows. The classical case for free trade is a *unilateral* one. (If Country X imposes high tariffs on goods from Country Y, then that makes the people in Country Y poorer. But Country Y's government only makes its own people *poorer still* if it retaliates with its own trade barriers against goods from Country X.)

SMALL IS BEAUTIFUL

Generally speaking, the smaller the political units, the *more* likely they would engage in free trade policies. Consider the extreme case of an individual city, consisting of a few thousand residents. Clearly, if these people cut themselves off from the rest of the world with high tariff barriers and other import restrictions, they would greatly reduce their standard of living. There just aren't enough natural resources, or scope for the division of labor, that a small city can take advantage of. So any small city, considered in isolation, would have to embrace a policy of relatively open trade with the outside world, if it wanted its people to have a tolerable life.

In contrast, in a country the size of the United States (or a bloc of countries the size of the EU), it is at least *feasible* to erect high trade barriers, because there are still hundreds of millions of people "inside the wall" to create a large free-trade zone internally, and there are enough natural resources to make some people think they can get by with "buying domestic."

To be sure, people living in a large political unit are still making themselves poorer if they support trade barriers, but my point is that such policies wouldn't be as *obviously crazy* as they would be for a small city. This is the sense in which a widespread breakup

of large political organizations might plausibly lead to much freer trade, on average, over planet earth.

STIFLING REGULATIONS

Contrary to the narrative of major media outlets and outraged analysts—who have tried to paint the Brexit supporters as merely a bunch of ignorant racists—there is a respectable, free-market case that the UK will be better off *out* of the EU than inside. For example, economist Kevin Dowd wrote the following for the Independent Institute, before the Brexit vote occurred:

Economists Roger Bootle, Ryan Bourne, Professor Tim Congdon, Warwick Lightfoot, Gerard Lyons, Neil MacKinnon, Kent Matthews, and Patrick Minford are all strong supporters of Brexit. So is yours truly, as well as Professor David Blake of Cass Business School in London.

…

By any standard, the EU is governed by a corrupt and unaccountable kleptocracy. It fleeces us for many billions a year, most of which it wastes on pork-barrel projects. The EU maintains no fewer than five presidents. As a survey of recent developments will confirm, all five are contemptuous of the peoples they misgovern.

The European Union's much-vaunted handouts destroy more jobs than they create by diverting manufacturing to the continent and asset-stripping the UK economy. That won't happen any more if we British bolt the EU.

The EU's banking system is broken, its monetary policy a mess, and its currency close to collapse. For all but the willfully blind, this can be

Membership in the EU—which gave the carrot of access to markets and free movement of workers—also carried the stick of regulations imposed from Brussels.

easily verified. And these realities alone make a strong case for Brexit. So do the EU economic policies that have caused depression and mass unemployment across much of Europe, with no end in sight.

…

On the other hand, the EU allows British citizens no real say in how it is run and actually holds us back. That is hardly a sound reason for staying in the EU.

Neither is the mountain of misguided regulations the EU imposes on the UK. The EU prevents us from making our own trade deals with other countries. Like other economists, I fail to see any benefit in such an arrangement.[4]

To put it succinctly, membership in the EU—which gave the carrot of access to markets and free movement of workers—also carried the stick of regulations imposed from Brussels, where the individual member states had little direct control over the bureaucrats. It would be as if, say, Texans were still subject to the EPA and SEC, but had no representation in Congress and couldn't vote for the president.

THE HYPOCRITICAL REACTION FROM MANY PROGRESSIVES

In the wake of the vote, it has been amazing to behold progressives—who, in other contexts, are huge proponents of democracy and equality—argue that the British should never have been allowed to vote on this issue,[5] and that it would be perfectly appropriate for EU businesses to discriminate in

their dealings with people because of their national origin (i.e. consumers in Britain). Furthermore, nobody construed it as a blow against global peace and harmony when African nations severed political ties with European governments.

There is a disturbing tendency in our political discourse to attribute actions *between governments* as equivalent to actions *between individuals*. Thus, if the British people vote to dissolve political ties to the EU, that is trumpeted as an invitation to World War III. But society is not the State, and many proponents of Brexit argued that smaller political entities are what *foster* peace.

ASSET BUBBLES

To reiterate what I said in the opening, we must acknowledge that Brexit could trigger a global financial crisis *not* because of the (unnecessary) retaliatory trade policies the EU may erect, but simply because of the fragility of our banking system, especially in the wake of the 2008 crisis and the extraordinary policies that the Fed, ECB, BOE, and BOJ implemented. Yet this is hardly an argument against Brexit, it is instead an argument against building a financial network on such a shaky foundation. If my analysis of the central banks' policies is right, then even if the British had voted to Remain, something else would have popped the giant asset bubbles soon enough.

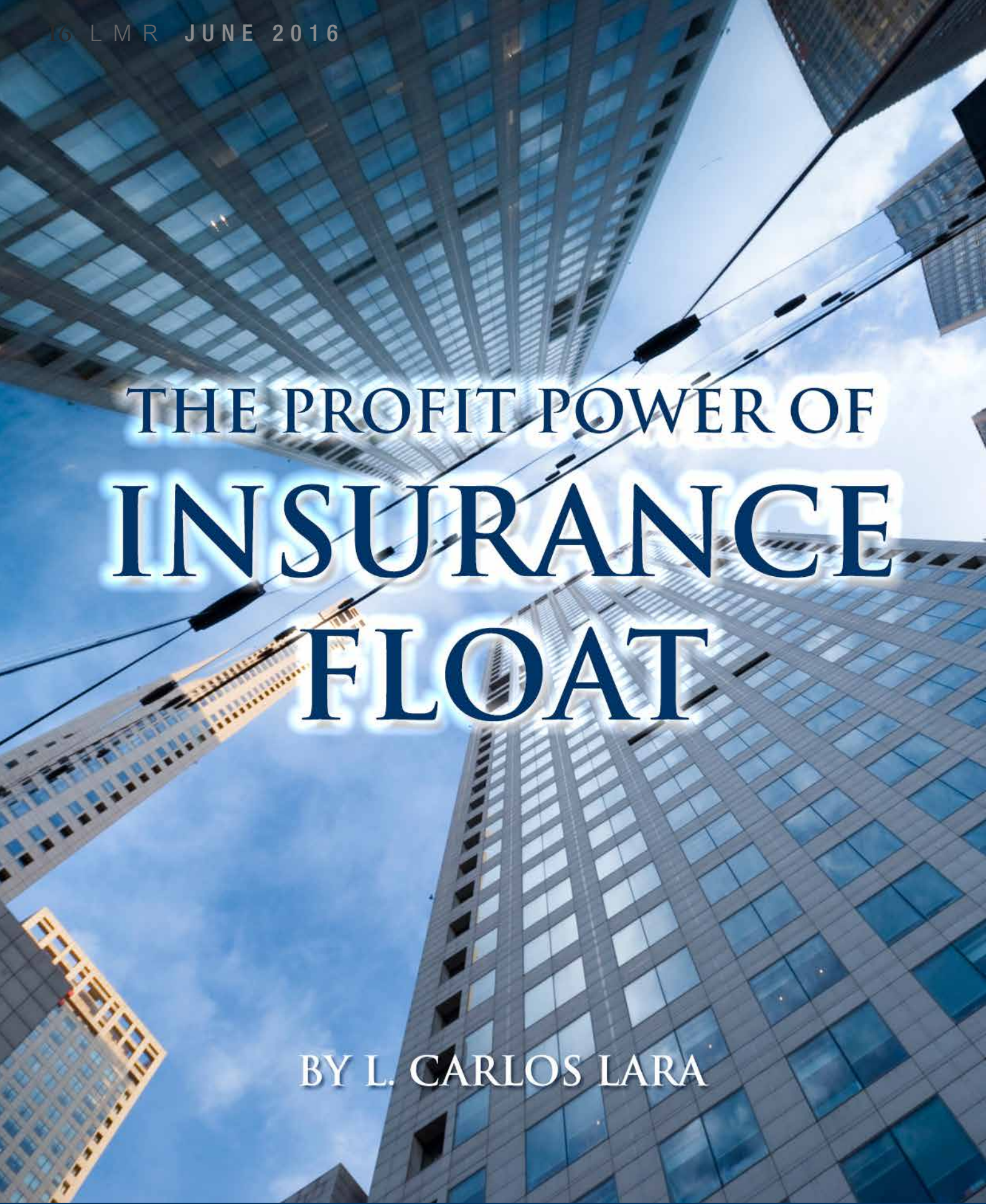
CONCLUSION

There is no reason for Brexit to lead to retaliatory trade barriers from the EU; such measures would make both the British and the remaining Europeans poorer. Dissolving political ties is not "isolationism"; the U.S. certainly engaged in global commerce after its own Brexit. And if the ultimate argument against Brexit is that the major banks can't handle it, that's an indictment of their lending practices, not the British voters.

◆◆◆

References

1. Partly to avoid repetition, and also because many analysts follow the same practice when discussing Brexit, in this column I will use the terms "Britain" and "UK" interchangeably. Here is the Internet's official distinction: "The United Kingdom is a country that includes England, Scotland, Wales, and Northern Ireland. Its official name is 'United Kingdom of Great Britain and Northern Ireland.' England, Wales, Scotland, and Northern Ireland are often mistaken as names of countries, but they are only a part of the United Kingdom."
2. The wording of the referendum, and official results, taken from this BBC article: http://www.bbc.com/news/uk-politics-36616028.
3. Paul Krugman, "Boris Is Bad Enough," New York Times, April 23, 2016, available at: http://krugman.blogs.nytimes.com/2016/04/23/boris-is-bad-enough.
4. Kevin Dowd, "Why I Am Voting For Brexit," originally appeared in Daily Caller on June 23, 2016, available at: http://www.independent.org/newsroom/article.asp?id=8803.
5. For a perfect example of this attitude, see Emily Badger, "Brexit is a reminder that some things just shouldn't be decided by referendum," Washington Post Wonk Blog, June 27, 2016, available at: https://www.washingtonpost.com/news/wonk/wp/2016/06/27/brexit-is-a-reminder-some-things-just-shouldnt-be-decided-by-the-people/. Notice that the original headline for this piece—as you can tell from the URL—was "…some things just shouldn't be decided *by the people*" (my italics), but they subsequently changed it in light of the outrage and mocking on social media.



THE PROFIT POWER OF INSURANCE FLOAT

BY L. CARLOS LARA

Regular readers of the *LMR* know that Bob and I are big proponents of the life insurance industry. As an overall sector, including property and casualty insurance, this conservative institution has thrived in this country since its inception, but especially so in the last 100 years.

When we stand back and examine its core greatness we see that its success is attributed to its profitability from its *investment income.* But after closer study we find that much of Berkshire holds to pay insurance claims in the future, but in the meantime can be put to work in stocks and long-term investments that earn returns for Berkshire's own benefit. Effectively borrowed funds at little or no cost, Berkshire's float enables the company to acquire businesses and assets beyond what its equity capital alone would permit."[1] No wonder he is often quoted as claiming that insurance is the greatest business in the world.

His skillful use of the float has enabled him to become one of the wealthiest men in the world.

it is derived from the expert management of a fascinating insurance attribute curiously called the "float." Although this financial element can certainly be found or created elsewhere, it is definitely central to the way the insurance industry works and no one has used it more effectively than Warren Buffett. His skillful use of the float has enabled him to become one of the wealthiest men in the world.

If you are now wondering what this unique financial phenomenon is, Buffett himself tells us unapologetically. "This float is money

The Float's Essence—Extended Time and Creditor Money

Back in the early 1980s, when people needed to send a check to pay an invoice they would calculate approximately how many days it would take for it to reach its recipient after they had mailed it. Then they would go further and calculate how many days it would take before their check would actually clear the bank. Believe it or not, this 7- to 10-day window of time was important to the sender because money did not actually have to be available for the check's re-

demption until approximately the 10th day. We all casually referred to this time delay on money as the *'float.'* Perhaps this simple example begins to help capture one of the key elements within the float's essence, which is the extended time before an amount that is owed needs to be actually paid.

But note that in addition to the extended time, float also makes use of "creditor money." This aspect of it reminds me of what I do in my own profession as a business consultant whenever I am working with a financially distressed business. One of my first duties is to restructure the entire balance sheet of the company by converting as much as possible of the short-term debt into long-term debt. This type of restructure provides the company an immediate infusion of working capital that I can then use to turn a much-needed profit. In this way I use creditor money and the extended time to finance the entire business.

Insurance float works the same way, but on a grander scale. As Warren Buffett explains, "insurers receive premiums upfront and pay claims later…This collect-now, pay-later model leaves us holding large sums—money we call "float"—that will eventually go to others (claims). Meanwhile, we get to invest this float for Berkshire's benefit…this combination allows us to enjoy the use of free money—and, better yet, get paid for holding it. Our float has grown from $16 million in 1967, when we entered the insurance business, to $67 billion in 2009."[2] Today, Berkshire Hathaway is a $350 billion conglomerate.[3]

One of my first duties is to restructure the entire balance sheet of the company by converting as much as possible of the short-term debt into long-term debt.

Accounting Differences: SAAP vs. GAAP

Unless you are an insurance analyst or actuary it is unlikely that you would be familiar with *Statutory Accepted Accounting Principles (SAAP)*. The word statutory here implies state regulated accounting principles. What you are most likely familiar with are the more common *Generally Accepted Accounting Principles (GAAP)*. Typically when we study company financial statements we use GAAP. However, it is absolutely necessary to understand SAAP in order to properly analyze the financial statements of an insurance company. By using SAAP as though it were a different pair of reading glasses we see a completely different financial picture, especially in regards to their balance sheets.

One important difference between these two accounting methods is that SAAP is definitely much more conservative than GAAP and is primarily focused on company solvency. Remember that insurance companies, unlike other financial institutions, operate much like giant trusts whereby they are acting somewhat like a trustee when monies are entrusted to them. Since state regulators are concerned with the policyholders much more so than the actual insurance companies, they place a great deal of emphasis on company solvency and reserves.

Also too, SAAP analysis shows that the insurance industry is a liability-driven business. Paradoxically, their liabilities are also their greatest assets. This is because virtually almost everything on their balance sheets is invested in financial assets to create income. In contrast, other businesses might take creditor money to invest in, say, product inventory or plant and equipment, or in hiring more workers. These are not income-creating assets in the direct sense that the bonds on a life insurance company's balance sheet are. The life insurance companies literally make use of almost all of their creditor money during the time they posses the money before they have to pay it back.

Since state regulators are concerned with the policyholders much more so than the actual insurance companies, they place a great deal of emphasis on company solvency and reserves.

Statutory law requires insurance companies to overstate the losses and expenses than what they would normally incur when pricing a policy.

This unique financial twist is what creates the float. In Buffett's perspective, the float really is like "free money" because it's money that earns income at "little to no cost" to the company. (We'll see below how competition enters the picture and forces down premium payments.) Yet, the float provides for three very important fiduciary type actions. First, it pays the present and future claims of the policyholders. Second, it assures the profitability of the company. Third, it increases the company's equity.

When we look at all of these elements together we get a glimpse of the success formula of the insurance industry and what ultimately creates their tremendous staying power.

Revenue, Expenses, Premiums, Claims & Profits

We all understand when we say that most businesses want more revenue coming in the door than expenses going out the door because this differential constitutes a profit. If we set aside the float for the moment, in the insurance industry the *premiums* are its revenue. Thus, the goal of the insurance business is to have more premiums coming in than "claims" going out.

In order to determine how well they are progressing along these goals and making an underwriting profit, insurance companies use a profitability ratio also known as the "Combined Ratio."[4]

$$PR = \frac{\text{INCURRED LOSSES + EXPENSES}}{\text{PREMIUM}}$$

The idea is to stay under 100%. For example, the industry average in (2013) was 97.6%, which equated to an underwriting profit for the entire sector. However, the prolonged low interest rate environment has been pushing its profitability ratio towards 100% and sometimes it goes over it. Fortunately, this is one area where the float kicks in and helps to compensate if the ratio goes over the 100% mark so that the insurer can still enjoy an underwriting profit.

Additionally, statutory law requires insurance companies to overstate the losses and expenses than what they would normally incur when pricing a policy. What this means in essence is that pricing a policy automatically creates a surplus. Consequently, insurance companies create a profit before they even invest their first premium dollar. Nevertheless, they purchase plenty of assets. Currently they own investment assets equaling $22.6 trillion worldwide and $7.3 trillion just here in the United States, with two-thirds of those purchases in bonds specifically.

If you are wondering, *why bonds?* The answer is simply asset-liability matching and *risk mitigation*. The life insurance sector's liabilities are fairly predictable outflows of cash in the form of death benefit claims, and thus having a large portfolio of dollar-denominated assets (in the form of bonds) helps to cover those future liabilities. Further, keep in mind that bonds are always easily convertible to cash in case of a crisis and therefore help maintain the company's on-going liquidity. Plus, these bond purchases not only include U.S. Treasuries, but approximately 50% are comprised of investment grade corporate bonds.

We should not end this section before clarifying one other important factor regarding the profits made from insurance float. If the insurance company is a stock company, the profits from the float go to the stockholders. However, if the insurance company is a mutual company, the profits from the float go to the policyholders since they are in essence the owners of the company.

If the insurance company is a mutual company, the profits from the float go to the policyholders since they are in essence the owners of the company.

The Length of the 'Float'

Finally we come to the determining factor for the length of time in the float. But in order to explain this last aspect let's quickly review its basic definition again. Remember that the float is the time period between when premiums are collected by the insur-

ance company and policyholder claims (creditors) have to be paid. Also, keep in mind that policyholders represent the insurance company's largest body of creditors—its liabilities.

That being understood, the length of the float correlates directly with the type of insurance policy being underwritten. Insurance terminology refers to insurance policies as either being "short tail" or "long tail" policies. For instance, property insurance is a good example of a short tail policy, because the claims are settled shortly after an event occurs. In contrast, medical malpractice insurance is a long tail policy, because a particular claim (made when a policy was in force) may be dragged through the courts for some time, before the insurer actually has to issue payment. Naturally, the longer tailed policies can earn the float for a longer period.

These types of policies do not provide much of a float due to the short duration before a claim must be paid.

Car insurance is actually a great example of a short tail policy simply because we have so many car accidents and claims are expected to be paid right away.

What would you call car insurance, a short or long tail policy? Car insurance is actually a great example of a short tail policy simply because we have so many car accidents and claims are expected to be paid right away.

Within life insurance, we can also make the distinction between short and long tailed policies. For example, a group life insurance policy is considered short tailed because it is in force for only a short term, and the benefit (a lump sum) will be paid soon after the death because the recipients have a financial incentive to expedite the process. In contrast, a whole life insurance policy is long tailed, because the company may issue the policy and begin collecting premiums *decades* be-

fore the death benefit claim is ultimately paid out. This time lag allows for an enormous use of the float.

Obviously, most insurance carriers have a mixture of both short and long tail policies consequently managing float, as we might expect, requires expertise.

Money For Nothing and Your Earnings For Free (?)

We have described the float the way Warren Buffett did—as a way for insurance companies to effectively borrow money from creditors (their customers) at "little to no cost" and use it to earn income from investment assets.

However, in reality market forces of competition come into play. Depending on the specifics, a standard policy illustration might show the owner of a whole life policy drawing out several times the cost basis of his policy over his life. For example, in the "Equipment Financing Illustration 1" from page 54 of Nelson Nash's book *Becoming Your Own Banker,* the individual puts in $160,000 over the first four years, but by age 84 has taken out more than $1.6 million in the form of dividends and partial surrenders—and still has an in-force policy with a death benefit of $2.4 million. (!) With today's interest rate environment, that kind of performance on a specifically designed WL policy is not possible, but the general principle still holds: someone who "frontloads" a WL policy will, down the road, be able to draw out many more dollars than he put in (if we disregard for the moment the time value of money).

Part of what is happening here is that the actuaries take into account expected investment returns on their portfolios when they price out a policy. To simplify things, consider the following scenario: If the life insurance company knew for sure that Jim Smith would die in exactly 30 years, and Jim Smith wanted to buy a 30-year term policy with a death benefit of $300,000, then the fixed premium they'd charge Jim Smith would be less than $10,000 per year. The insurance company would know that it would have a 30-year float on the first premium payment, a 29-year float on the second payment, and so on. So it would be willing to charge Smith a lower premium, knowing it would be earning income on the invested dollars for the next 30 years. If the life insurance company tried to charge Smith the full $10,000 each year, keeping the entire float for itself, then some rival company could undercut them and offer Smith the same policy for $9,900

per year. Ultimately, the actuaries would price the policy in line with proper discount rates, taking into account the time value of money.

We are not trying to minimize the importance of the float, and Warren Buffett certainly knows what he is doing. However, we just wanted to avoid any confusion because there can be a lot of "magical thinking" associated with the mysterious life insurance sector, and the very phrase "free money" can be loaded.

Conclusion

In this article we have examined the insurance float. I have attempted to shine the spotlight not only on its centrality within the insurance industry, but also on its tremendous profit making potential by using Warren Buffett as the prime example of the successful use of it.

In 1967 Buffett bought a small property and casualty insurance company for $8.5 million, a company we all recognize as *Government Employee Insurance Company*—GEICO. But what he bought was obviously much more than just a company. He purchased the secret to his financial success. Today that little green lizard we have all come to recognize in the GEICO commercials has become the marketing emblem to the massive financial empire known as Berkshire Hathaway.

Buffett's financial success not only proves the profit power of the insurance float, but it also allowed us an inside look at this intriguing mechanism that has contributed so much to the entire insurance industry's financial strength and staying power.

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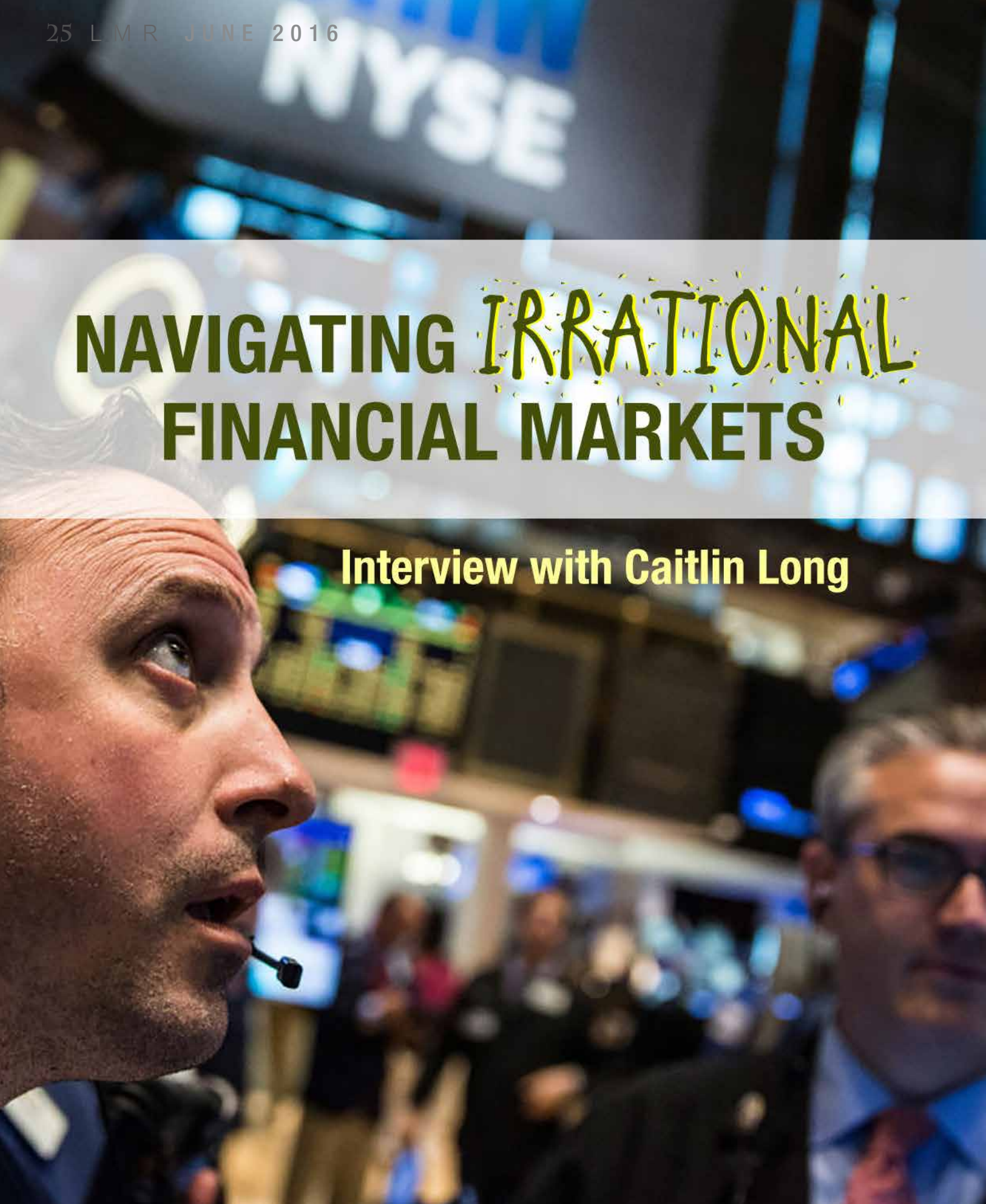


NAVIGATING IRRATIONAL FINANCIAL MARKETS

Interview with Caitlin Long

Caitlin recently left Wall Street after 22 years, having worked at Morgan Stanley, Credit Suisse and Salomon Brothers, and having attained the rank of Managing Director for 15 of those years. During her career she started and ran three new businesses, was a top-rated equity research analyst, and worked directly for co-CEOs on a business restructuring in Zurich. Caitlin received many honors, most recently from Institutional Investor (which named her to its list of the most influential people in pensions during her final three years on Wall Street, noting the clients she advised "changed pension history"). She has been active in Bitcoin since 2012 and blockchains since 2014, and continues to speak and blog about both topics at www.caitlin-long.com. Caitlin is a graduate of Harvard Law School (JD, 1994), the Kennedy School of Government (MPP, 1994) and the University of Wyoming (BA, 1990).

Editors' Note: Caitlin Long provided her answers in this interview before the Brexit referendum occurred, which is why we do not directly address such a momentous event for the financial markets.

Lara-Murphy Report: We interviewed you for the inaugural issue of the *Lara-Murphy Report!* But we didn't ask you back then: How did you learn about Austrian economics?

"I remember realizing out loud, "I need to learn how the Federal Reserve works. That's the key to understanding how this happened."

Caitlin Long: Bob, I learned a lot from your online classes! It didn't take me long to discover you! But Tim Geithner was actually the spark that got me started in Austrian economics. He was Treasury Secretary then. During a 2008 interview after the financial crisis began, he admitted that interest rates were too low before the crisis and insinuated that was a cause of the crisis. Then, a few days later, I heard him argue that interest rates should be even lower. His contradiction got me digging! So I called a friend and former client—one of the best thinkers on the buy-side—to brainstorm. I remember realizing out loud, "I need to learn how the Federal Reserve works. That's the key to understanding how this happened." My pal told me to start reading about Austrian economics, and the rest is history. Since then I've explored other alternative schools of economic thought, too, but I continue to believe the Austrians have the best assessment of what's going on. The Austrian School isn't perfect—for example, I think its misunderstanding

of the shadow banking system caused it incorrectly to predict hyperinflation after the financial crisis—but I think its diagnosis of the problem is by far the best among economic schools of thought.

I agree with Austrians that the interest rate is the most important price in any economy, because it's the traffic signal that directs entrepreneurs where to invest their capital. When interest rates are artificially distorted, capital misallocation happens. Wealth is destroyed. Interest rate distortions can persist for decades as living standards are maintained through borrowing—and that's we're living through today. Globally, we're eating our seed corn by borrowing against the equity on our balance sheets. Eventually, economies run out of balance sheet capacity to keep borrowing, and then a reset happens—but again, this process can take decades.

"I agree with Austrians that the interest rate is the most important price in any economy, because it's the traffic signal that directs entrepreneurs where to invest their capital."

Another way to phrase this is that Austrians believe balance sheets really do matter. It became clear on my journey of economic exploration that other schools of thought pretty much ignore balance sheets. Their answer is almost always to borrow/stimulate more, without considering the cost of distortions. Austrians believe in preserving capital to grow wealth.

Bob, I've heard you say that you became an Austrian because it's the only school of economic thought that has a capital theory—I fully agree!

LMR: Last time we talked, we asked you about low interest rates. So now we have to ask: What's the impact of *negative* interest rates on the financial sector?

CL: Negative interest rates are a symptom of overleveraged balance sheets—a signal that there's very little borrowing capacity left in an economy (whether in the household, business or government sectors). Since about 2012, I've expected that interest rates would turn negative eventually—and I think rates ultimately will go negative in the U.S., too. In fact we have already experienced brief periods of negative T-bill rates in the U.S. I see no reason to believe the 35-year trend of declining yields on 10-year Treasury bonds will break, because the fundamental driver of this trend is higher debt—and I don't see debt growth stopping anytime soon. That doesn't mean rates will be a one-way street lower—rates will go up periodically without breaking the larger downward trend. In fact, every time the 10-year Treasury yield has risen since 1981, it dropped again before reaching its prior peak (on a monthly basis). Lower lows and lower highs—for 35 years! Ask a mainstream economist to explain what why that hasn't mean-reverted yet!

"It became clear on my journey of economic exploration that other schools of thought pretty much ignore balance sheets."

"Since about 2012, I've expected that interest rates would turn negative eventually—and I think rates ultimately will go negative in the U.S., too."

Obviously, negative interest rates aren't good for the financial sector, whose business model is generally to earn a spread between asset returns and borrowing costs. Banks are being squeezed by higher capital requirements on both sides of that equation, while also bringing down their leverage. That's painful for banks. An example is Switzerland, which was early to experience negative interest rates and whose government bond yields are negative out to the longest maturities relative to others. For a couple of years now, Swiss banks have quietly turned away corporate depositors and charged all kinds of new fees to avoid losing money. Most banking professionals assume that negative interest rates are temporary and will mean-revert soon, but I don't agree. They can persist longer than most of us

think they can.

LMR: Many Austrian-friendly investors—such as Mark Spitznagel—have been warning that a stock market crash is imminent. How should people think about U.S. equities? There's a popular school of thought that says the market is always valued according to the best information, and so regular Joes have no business second-guessing the current level of the Dow.

CL: Well, I'm not in the business of giving investment advice so won't predict anything here, but I'll try to educate your readers about what has been happening so readers can make their own predictions. What you're really asking is whether the "efficient markets hypothesis" (EMH) is valid. I think the answer is yes, it is—BUT ONLY IF interest rates are set on the free market by the voluntary interaction of savers and borrowers. When interest rates are artificially distorted, EMH doesn't apply. I was 15 years into a Wall Street career before I figured out EMH isn't relevant because interest rates aren't set by free markets. To this day, most of Wall Street still adheres to EMH because most trading models are still based on it (for example, the Black-Scholes option pricing model presumes efficient markets). The models aren't wrong—they just don't reflect today's reality because markets cannot be efficient when interest rates are artificially distorted.

"No one knows how markets will play out because no one knows the sequence of events here in the US or overseas."

So what does this mean for the stock market? Is it overvalued? I could easily make arguments both ways—for example, since an asset's value is the discounted value of the cash flows

it generates, I could argue that all assets are overvalued since discount rates are artificially low. Conversely, I could also argue that the way financial markets price credit risk will be turned on its head when governments eventually run out of debt capacity, in which case money will migrate from public to private assets—so stocks may in fact be undervalued. No one knows how markets will play out because no one knows the sequence of events here in the US or overseas. We just know that prices are distorted—but that doesn't necessarily mean they will revert anytime soon! As a student of economic history, I realize these distortions have existed for much longer than I've been alive—and longer than my parents were alive, too. Yes, the distortions are bigger than ever today. But some Austrians have been predicting a dollar crash for decades and it hasn't happened yet.

"The US entered its period of inflation (of money and credit) with an incredibly strong balance sheet—and we've been drawing down the economy's equity for decades to support new borrowing."

I think the most interesting question is why these distortions have been able to persist—that's something about which I've done a great deal of thinking. In essence, the US entered its period of inflation (of money and credit) with an incredibly strong balance sheet—and we've been drawing down the economy's equity for decades to support new borrowing. The fact that the US economy's balance sheet still has equity (i.e., assets > debt) explains why a big correction in the US dollar hasn't happened yet.

"In other words, the Fed's balance sheet is 111.3x levered."

LMR: You brought to our attention years ago an analysis that showed even a modest rise in Treasury yields would render the Fed insolvent—meaning its assets would have a lower market value than its liabilities. Do you know what that analysis looks like today? Do people in the markets worry about things like this?

CL: Yes, that description still holds true. The Fed created what we call a "duration mismatch" by getting into the business of maturity transformation with Operation Twist in 2011, when it started buying long-dated bonds to bring down long-term interest rates. This means the assets on the Fed's balance sheet are longer-dated than its liabilities. At my last calculation, the duration mismatch on the Fed's balance sheet was about 5 years—in other words, the duration of its assets was about 5 years longer than the duration of its liabilities. The Fed's balance sheet as of June 2, 2016 had $40bn of equity capital supporting assets of $4.46 trillion. In other words, the Fed's balance sheet is 111.3x levered. The Fed doesn't mark its assets to market value, so that leverage number appears worse than it actually is on a market-value basis. But still, mathematically, it would not take a large increase in interest rates for the Fed's equity capital to be consumed by the declining market value of its bond portfolio.

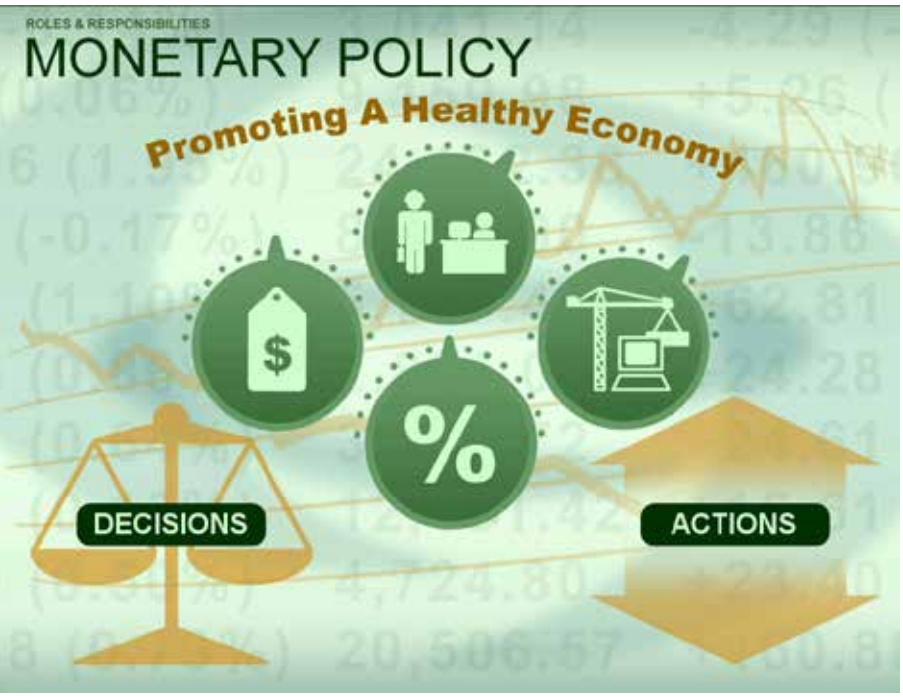
"The right way to think about these issues is to recognize that they exist, and do your best to adjust for them when putting your hard-earned capital to work."

You ask whether people in markets worry about this, and I think the answer is only a handful of people worry about it. The typical response is to point out that the Fed can write checks on itself by doing more QE if it needs to—but that actually exacerbates its leverage. I'd put this in the category of a distortion that can persist for years, with very few caring about it—until someday it matters a lot.

LMR: We keep reading doom and gloom reports on Deutsche Bank. Is this a one-off fluke or is there something more fundamental that's awry?

CL: I can't opine on a particular bank, but it's a fact that Eu-

rope's banks have been more leveraged than America's banks for quite a long time—and I think America's banks are still too leveraged as well. But, again, this does not mean the situation will correct anytime soon. Notice a theme in my answers—lots of distortions, but they're not new and Keynes was right when he said markets can stay irrational longer than you can stay solvent. I don't know what will catalyze a return to rationality, or when! In the meantime, we need to work to feed our families! We can't hide under a rock, nor should we! The right way to think about these issues is to recognize that they exist, and do your best to adjust for them when putting your hard-earned capital to work.



I've always pointed to one simple fact about Deutsche Bank, which has been true for a while—Deutsche's derivatives portfolio was roughly the same size as JPMorgan's for several years, but Deutsche had about one-third of the equity capital of JPMorgan (meaning Tier1 + Tier2 capital). Recently, this situation has improved slightly—at year-end 2015, Deutsche's derivatives notional was EUR 41.94 trillion on total risk-based capital of EUR 60.98 billion, compared to JPMorgan's at $51.14 trillion and $176.42 billion, respectively. So just on this simple measure you see that Deutsche is a lot more leveraged than JPMorgan. Now I'm not opining about JPMorgan's leverage—if you look it up in the OCC's database, you'll see that JPMorgan's credit exposure from derivatives alone was 209% of its total risk-based capital at year-end 2015. JPMorgan is one of four US banks whose credit exposure from derivatives alone exceeds its total risk-based capital (the others are Citibank NA, Goldman Sachs Bank USA and HSBC NA). Please don't make any decisions based on these facts—I

"Regulators are working to fix this—they face a delicate balance between clamping down on bank leverage and preventing an economy-wide credit contraction."

expressly disclaim any and all advice on what to do here! Caveat emptor! And again, none of this is new.

It's clear to me that regulators are working to fix this—they face a delicate balance between clamping down on bank leverage and preventing an economy-wide credit contraction. For example, on June 3rd the Wall Street Journal ran a headline story outlining a "probable" increase in the capital requirement for the biggest 8 banks in the US—on top of the myriad increases they've already had. Only time will tell if the regulators' strategy of steady, consistent increases in banks' capital requirements will have been the right one, or whether they will have been too slow. Remember that Mises said, "Economics recommends neither inflationary nor deflationary policy." In other words, deflationary policy is not the right response to a prior inflation. What's already done is done. The US economy has $61.2 trillion of credit outstanding in non-financial sectors—that's what's already done. More of that credit has taken on "moneyness" in the market for collateral than we Austrians like to admit—and I'd argue that most Austrian definitions of money mistreat much of that credit, which has taken on "moneyness" in the shadow banking system (e.g., Treasury/GSE debt functions as base money in these markets). It's an area of research that's sorely needed in the Austrian economics field. If you grant my argument, just for this moment, then you see why I believe regulators have so far have executed a successful balance between bank deleveraging and credit deflation. That's a tough balancing act, indeed!

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EVENTS & ENGAGEMENTS

JUNE 2, 2016
BRENTWOOD, TN

Lara and Murphy present on liquidity for CCC Corp.

JUNE 20-23, 2016
SANTA CLARA, CA

Murphy lectures on economic freedom at Challenge of Liberty seminar (Independent Institute)

JUNE 24, 2016
LUBBOCK, TX

Murphy lectures on economic principles for high school seminar at Free Market Institute (Texas Tech)

JULY 14-16, 2016
LAS VEGAS, NV

Murphy presents on various topics—and hosts karaoke social—at Freedom Fest

JULY 24-30, 2016
AUBURN, AL

Murphy lectures on Austrian economics at Mises University

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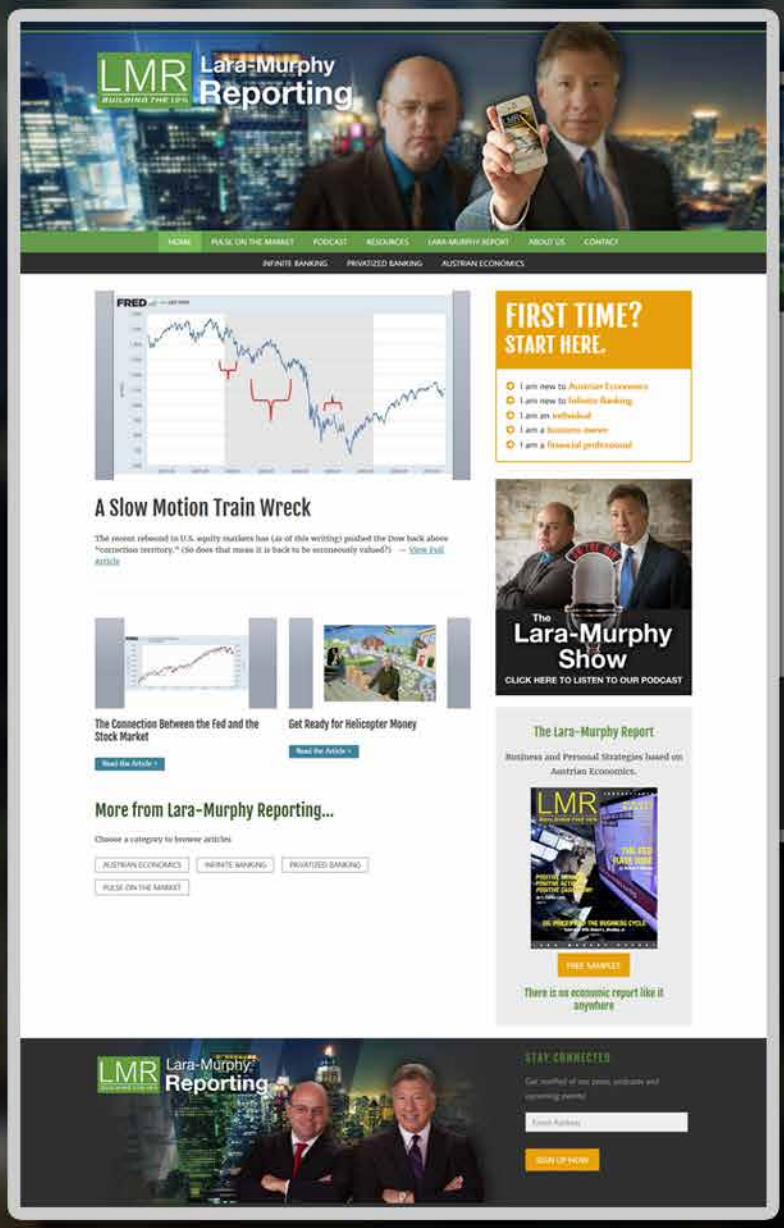

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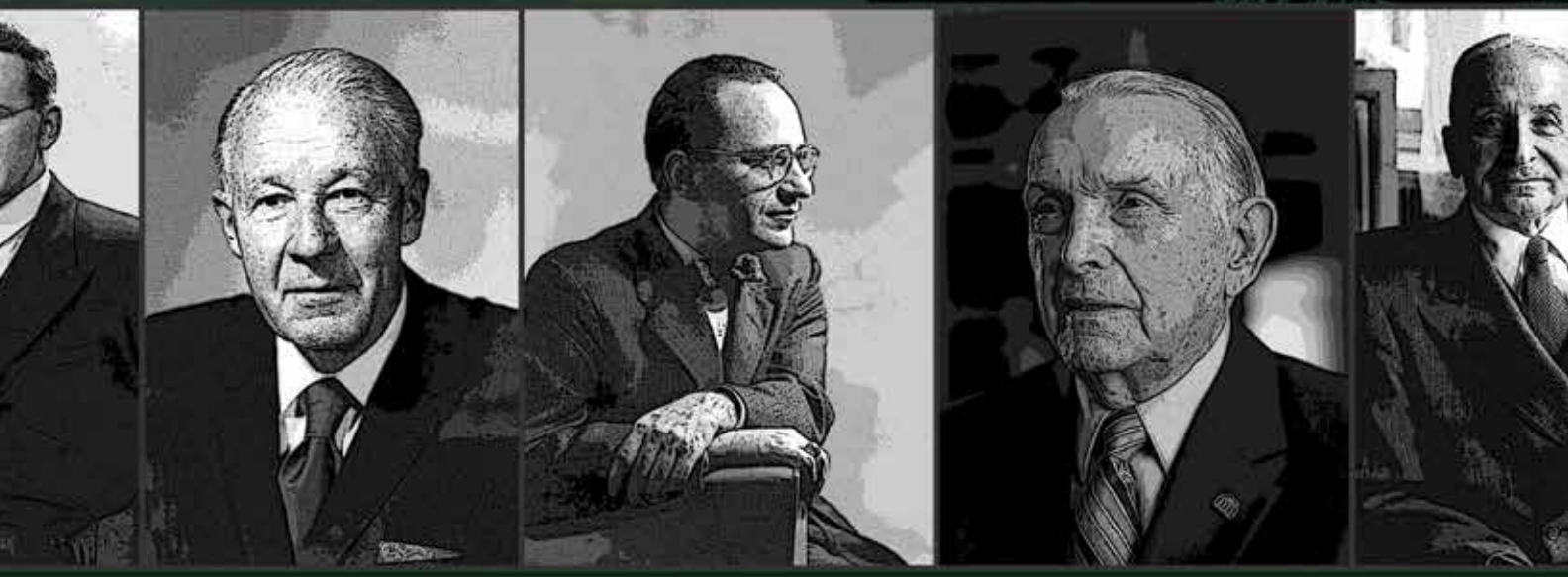

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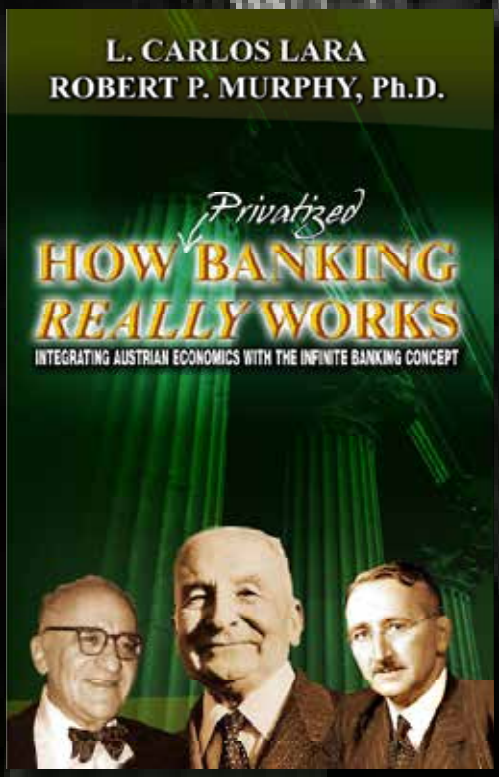

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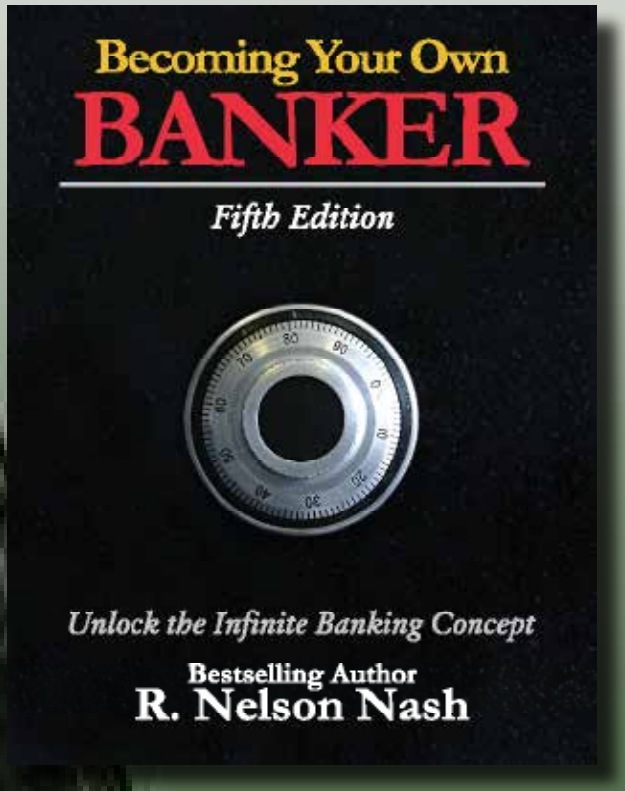

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