Corporate Finance, Module 3: “The Value of Common Stocks”

Application to Insurance

(The attached PDF file has better formatting.)

Module 3 compares growth stocks and income stocks; the difference is the percentage of the stock price that is the present value of growth opportunities. This posting applies the concepts to the insurance industry.

Question: Are insurance companies growth stocks or income stocks?

Answer: Insurers are income stocks. Product innovation is rare, and demand is steady; insurers sell the same products year after year. Table 4.6 on page 74 shows Chubb as its first income stock; most traded insurers have similar figures.

Question: What about the universal life and variable life policies, large dollar deductible workers' compensation policies, and no-fault automobile policies; aren't these innovations?

Answer: The past 30 years has just a handful for insurance product innovations. Most of these change the structure of the policy, but are not significant product innovations; contrast the changes in high tech products over the past 30 years.

Firms have life cycles, with rapid growth, high mortality, and low dividends for new firms, moderate growth and low mortality for mature firms, and low growth for declining industries.

Question: Where in the life cycle would you place insurers?

Answer: The position in the life cycle depends on the line of business.

- *Life insurance:* declining fertility, lower mortality, greater wealth, and later ages of new parents have reduced the insurance protection need, though the tax benefits remain.
- *Individual health insurance:* advances in testing for disease make it difficult to sell individual health; most health insurance is sold through employers for the tax benefits.
- *Workers' compensation:* improved workplace safety and the shift from a manufacturing to a service economy have reduced the demand for workers' compensation.

If you work for a traded stock insurer, you may want to see where it fits in Table 4.6 (page 74).

Question: Do we expect the risk adjusted return to be lower for insurers?

Answer: If the capital markets are efficient, the risk adjusted returns should be same for all stocks. Any differences reflect market imperfections.

Question: Does the corporate finance course teach us how to pick stocks?

Answer: If capital markets are fully efficient, trying to pick stocks is a negative NPV project. You do better (higher expected returns) in the long-run by investing in a stock index and *not* trying to second-guess the market. This is the most valuable advice you will ever get for investing in the stock market; Brealey and Myers provide this advice many times.

Question: Does that mean it makes no difference what we invest in?

Answer: It makes a difference; depending on your life-style, tax situation, time horizon, and liabilities, you should choose the appropriate investment strategy. The proper investment strategy is general, such as stocks vs bonds (or percentage of stocks vs percentage of bonds), high beta or low beta stocks. But trying to pick Stock Y vs Stock Z is a wasteful exercise unless you have better knowledge than other stock analysts. Brealey

and Myers say that stocks are like commodities, like wheat from different farmers. It makes no difference if you buy wheat from Farmer Y vs Farmer Z, and it often makes no difference if you buy Stock Y or Stock Z.

Question: That can't be true. The wheat from Farmer Y is the same as the wheat from Farmer Z. But Stock Y may double in price next year whereas the Stock Z price collapses.

Answer: In an efficient market, the differences in the stock returns are stochastic (random).

Question: Perhaps you and I can't pick stocks well, but I'm sure the highly experienced mutual fund managers can. Some of these talented managers make millions of dollars a year; why are they being paid so much if they can't pick stocks better than you or I?

Answer: A later module discusses why they are paid so much. Brealey and Myers show that they do little better than the average investor, and they do worse when we adjust for the extra expenses they cause.

Question: Even if they can't pick stocks better than you or I can, they surely know when to move into or out of the stock market. If I had their market timing, I would make millions.

Answer: On the contrary: the market timing of mutual fund managers is no better than that of other investors.