The Shallow Draught of Investment Income

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From time to time it befalls property and casualty insurance that its leaders, underwriters, financiers or regulators discover investment income.

Always the discovery is fresh and significant, free of any sense of having seen it all before. It draws crowds. It ends at best with frustration and usually in disaster. Investment income just does not have a happy history with us and, for the simplest of reasons, we appear condemned to repeat it.

In the prehistory of property insurance and in its age of sail, discoveries of investment income were rare. The insurance transaction itself was sufficiently new and unexplored. Much of what we now take for natural law in finance was lacking in scriptural basis, of doubtful legality, badly understood and too suggestive of class warfare and other breaches of etiquette to be welcomed everywhere.

Later on, those who intuitively understood investment income also had gained proprietary rights to the conventional ignorance. They dealt with investment income intuitively, which is not to say unwisely, by letting it sustain the capital beneath their art, retaining part and paying part to shareholders. Underwriting profit, large or small, belonged to the underwriters.

Sound insurance men did not encourage, and apparently did not themselves engage in, rigorous investigation of how investment income fitted into the entire business of insurance. They spoke in a language of words and numbers which would not easily support the necessary concepts. They could not have conspired to create an atmosphere more certain to retard thought, to arouse suspicion and to bring on recurrently the madness of crowds.

That is part of our lineage, although today insurance is often treated as a simple commodity business, existing only in the present and amenable to borrowed instruments of analysis. We commence to pay for our legacy of suppressed thought. Perhaps our predecessors would better have encouraged scholarship than maintained its subject to be non-existent or hazardous or both.

Investment income now being a topic of proper conversation, the next question is what we want to say about it. What is it? Where does it come from? How does it fit into the whole business of insurance?

The first two of those questions, properly understood, are really one. Investment income is income on investments. Against the background of the subject, that tautology says a lot. Most of all it says that investment income is income on assets which have been invested, not on assets somewhere else and not on liabilities of any kind.

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Premiums written but uncollected may be good statistically and good for agency relations, but a company cannot earn investment income on them simply because it does not have them to invest.

Similarly, we should beware our slangy association of investment income with certain liabilities. With a blinding numerical precision we talk of investment income on the unearned premium reserve or on loss reserves. But only assets earn money. Liabilities do not, else beggars would ride.

Look at the insurance business. For a price, usually and mostly paid in advance, an insurer agrees to pay money in the future if something happens. The insurer never touches money equal to the full price, as some is intercepted by whoever sold the insurance, and the insurer does not touch the rest until the seller pays it over. When the money does arrive at the insurance company, it is set upon by those parts of the company which helped devise, prepare and record the insurance and those which keep the organization going.

What remains, which may be some seventy percent of the premium, is an asset available for investment and is indeed invested. How and in what it is invested is another full subject, encompassing such disciplines as risk analysis, portfolio balance, tax forecasting and numerology. For us here, the point is that what remains of the premium dollar is invested, but only when it is cash in hand.

An invested asset earns money in proportion to many things, most of which we have just excluded from consideration, but a remaining one is time. Ignoring the slander that a stock which is up today may be down tomorrow, it is generally true that the longer an asset is invested, the more it will benefit its owner by generating income which is either paid out or left to compound into appreciation in asset value.

How long does the insurance company get to keep this asset invested? Again the right answer is the simple one and the corollary of the answer to when the company could start investing. It has to stop when it has to cash in the asset to pay the proceeds to someone else. The longer the interval between collection and payment, the larger the investment income. Best of all are moneys which the insurance company never expects to cash in—moneys represented on the balance sheet by capital and surplus, whether contributed from outside or generated inside by underwriting and investment.

Now money is money, meaning it is all the same or it is fungible, and for the sake of analysis we have been speaking of accounting categories. But they are familiar categories and they have an important common character. Whenever they appear in financial statements, they represent money which the insurance company holds permanently or which is resting there a while on its passage through.

So seen, the questions what investment income is and whence it comes appear simple, as indeed they would be had we not complicated them by centuries of silence, occasional bursts of ecstatic or outraged noise and the entrapment of insurance thinking by the language supposed to express it.

The next question is how investment income fits into the whole business of insurance.

In the past we have tended toward one or the other of two opposed viewpoints. The first is that insuring is so risky that no asset should be put at serious investment risk as well. The second is that insuring and investing are two entirely separate activities, so that the investors of insurance assets should pursue investment return according to their own light. Of those two extreme views, the first may be thought of as the timidity of small companies and the second as the hubris of large ones.

Lately a sort of middle position has ascended. It is that in managing an insurance enterprise, one should regard total risks and total rewards, including premium volume, underwriting results, product mix and the balance, income and safety of investments.

Analytically, the approach is sound, indeed reminiscent of elegant risk-return modeling in portfolio selection. Given enough facts and assumptions, it can be carried through to an answer, or to a set of equivalent answers, with precision and without too much trouble. What it produces is interesting and can be useful in the service of high strategy. But for anything more dispositive or more visible in the marketplace, its allure is meretricious. We do not know how to handle it. Whatever its perfection as an artifact, as a tool in our poor hands it has two flaws, either one fatal.

The first flaw in total return theory in the practice of insurance is that it depends on quantification but does not quantify the danger of being wrong about costs, especially as they are related to future time.

The problem can be stated as one of insurance statistics. When given an unusual loss or other new event, we have to decide whether to treat it as just one more observation of an established variable, which would tend to increase statistical certainty, or as the introduction of a new variable, which would reduce statistical certainty and perhaps change the mathematics of the whole exercise.

The decision how to fit the new event or piece of information into our system of understanding will often determine whether the system will be stronger or just better able to mislead us. The system itself cannot make the choice, but our inclination as insurers to equate numerous observations with knowledge will incline us to treat the new fact as just another instance of a known variable.

It is one thing to learn from dissection and quite another to confuse the dead with the living. Our devotion to the statistical past presupposes for it a knowable relationship to the future. Today in much of liability insurance the assumption is probably wrong, and certainly in those same lines we rely the longest on the assumption.

The same problem of uncertainty can also be stated in terms of our immediate subject, investment income.

Take the item which we call investment income “on loss reserves”. If the longer an asset is invested the more it will earn, then the longer the assets represented by loss reserves are held, the more the investment income. In lately deadlier words, the longer the tail, the greater the investment income. This proposition, which is entirely true, can lead to some thrilling decisions as to product mix. For it assumes, by not addressing the question, that the reserved amounts will prove right when payment time comes.

The income on assets held against technical reserves may once have been extra income on what is known elsewhere in finance as float, with underwriting profit as a fee for the service of insurance. The old, crude system of pricing insurance, in which income and outgo were treated as though simultaneous, did not inherently favor either buyers or sellers—that depended on where its normative numbers were set. What the old system did do was treat all lines of insurance the same, which is natural since when it was devised only one line, fire, even pretended to analytical rating. Then the notion of considering investment income in ratemaking was meaningless.

Now, however, the intervals between collecting and paying vary widely among lines. To pretend today that the insurer does not get income from premium dollars in widely varying amounts as among lines seems as quaint as pretending he does not do so at all. Some insurance company or regulator is forever discovering this other income and using it to reduce the fee to be charged for the service of insurance in one line or another, especially in liability insurance. Unfortunately, the impatient competitor or regulator tends to overlook that this same investment income was helping cover changes in loss cost patterns, changes which themselves change through time.

That a problem is essentially one of compound interest can be overlooked but, once recognized, it can be worked out as precisely for a long period as for a short one. But economic, legal and other changes in loss costs do become less predictable with time, so much so that at our present stage of social mathematics we may say that, further out than a year or two, they become unknowable.

A growing, uncertain, finally unknowable cost is and ought to be terrifying to anyone who will have to pay it. As the uncertainty and hence the fear grow with time, they somewhere surpass whatever the premium dollars may have earned during that same period in the less vertiginous world of investment. Indeed the very caution in asset investment which rightly accompanies heroic loss estimation just hastens that moment—the moment when the mysterious curve of compound fear overtakes the familiar curve of compound interest.

If we count investment income to bring prices down we should also count loss uncertainty to bring prices up. Today, offsetting the two should lead a rational insurer to charge the highest insurance fee or underwriting profit, not the lowest, for liability insurance—at least where the insurer is at risk beyond his confident foresight as to rules, claim incentives and price inflation. He should do so not because he is likely to achieve the intended underwriting profit but because he is not.

The second problem with total return theory in the practice of insurance is that it ignores the most difficult part of making anything happen in a sizeable, human institution—the leadership of people.

Insurance companies teem with people, many in jobs absorbing enough without the intrusion of such exotica as total return theory, loss development, investment income, current value accounting and so forth. They are the people who have the organization's future in their hands. They want to do what is right for the company, and probably a heartening proportion of them believe that senior management knows better than they what is right. When they do what is not right for the company, it is far less likely that they defied what they knew senior management wanted than that they did not know.

Give one of those key, front-line people a simple, immediate, concrete goal and, almost in proportion to his or her dedication, that goal will be met as it is understood. It will be met regardless of its wisdom and of its long-term cost in money and in less concrete values.

The most revered such simple, concrete goal is the combined loss and expense ratio. Like some older commandments, the combined ratio is proving so difficult to live with that any sophisticate will gladly show you how crude it is in modern contexts. But it is central to the culture of insurance, and that culture is a formidable part of the real world of managing a successful insurance enterprise.

In that setting, give an insurance person a target loss and expense ratio softened by investment expectations and he or she, uninitiated to the supporting financial wizardry, will hear in the new, more tolerant ratio a directive to get business with a long tail and then will go out and buy it. Once that starts, insurance being insurance, it is hard to catch. Once caught, organizations being organizations, it is hard to turn around.

In insurance, total return theory can be a useful reference in the making of high strategy by a small group, but it cannot be shared—by design, accident or someone else's inference—with many people even in the management of the company without damaging and often very costly results.

For that reason, too, neither investment income nor investment growth can be used to attenuate the cycles in underwriting profitability. Small compensating changes in portfolio tactics are possible, with commensurately small effects. But large swings in portfolio strategy are apt to send dangerous messages through the organization—that management has given up on underwriting and is running a levered investment trust or that management can always make up for mistakes in insurance underwriting and pricing by occult manipulation of the portfolio. The gain, if any, would not justify the sacrifice in clarity and constancy as resources of leadership.

We started out with simple questions. What is investment income? Where does it come from? How does its fit into the rest of the business? In the process of trying to answer those questions we have, with fine impartiality, denounced the atavism of thinking about it too little, the scientism of thinking about it too much, and the arrogance of using it

as though we had thought about it enough. Until we have mathematics adequate to simplify our complexity and until we have control adequate to inspire our freedom, we are at best left with common sense and all the magic gone.

Invested assets earn. Undelivered, uninvested assets do not. Liabilities do not. The longer an asset is kept invested, the more it earns, but if that asset is represented elsewhere on the balance sheet by a reserve liability, then the reserve had better be right. The longer the reserve stays up, the greater the danger it will be wrong, and that danger may compound at quite a different rate than investment income.

Assets should be invested to earn as much as possible, but limited by a prudent respect for the uncertainties and risks in the way those assets were gathered. Managing to a grand balance of risk and return—unencumbered by respect for organizational complexity, for underwriting profit or for the chance of being wrong—is a good study but a bad religion.

Nothing is new here, except perhaps that investment income sounds simple. The description is imperfect and leaves us on our own more than is our custom, but investment income sounds simple because it is simple, not easy but simple, and making it sound complicated will not make it any easier.

The insurance business is complex enough that when we find a corner which can best be understood and described simply, we might rest content. We might admit to all audiences that investment income is indeed a part of the insurance business and has been all along. We might remember that it is and all along has been a supporting part of the insurance business and not the other way around, and that when we get it we do not get it for free. Finally, we might wish for all who touch insurance that they resist the temptation to be Midas, Marx or Machiavelli until they are away on safer ground.