SEPTEMBER 2012

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Simplify Complexity

Factors in Focus

Underwriters of Capitalism

by Eric D. Nelson, CFA

The insurance industry is in the business of underwriting risks that we wish to reduce exposure to or offload altogether. Home insurance protects us from fires and weather damage, health insurance from catastrophic illnesses and injury, and life insurance from the financial impact of premature death. In each case, insurance companies are aware of these risks, and charge us a premium to insure against them. The premium includes the "cost of insurance"—so companies can make whole and timely settlements in response to incident, and an additional amount so that there should be enough left over after paying claims for companies to earn a profit in excess of providing the coverage. When settlements consistently exceed the premiums collected, the risks are higher than expected, and insurers have to charge higher rates (the cost of insurance) to improve profitability.

As investors, our efforts are quite similar to insurance companies, except that we are the **underwriters of capitalism**. To see why, lets explore how markets work and what our role is as investors.

Capital stock and bond markets provide a vital source of ongoing funding for public companies, allowing them to raise money for current and future business efforts. When viewed as a whole, these businesses and the products and services they provide make up our capitalist economic system.

More specifically, stocks represent an ownership stake in a company. After going "public" through an "initial public offering" (IPO), stocks are traded frequently in the "secondary market" between buyers and sellers at agreed upon prices that constantly change to reflect the latest information. When businesses decide to issue new stock to the marketplace as a "secondary offering" in an effort to raise additional cash, prices set recently in the secondary market are the best indicator of the sale proceeds. Businesses hope that the benefits to the company from the cash infusion outweigh the loss of ownership and potential returns to the shares that were sold.

These prices also help businesses decide which form of funding they should pursue. Instead of issuing more stock, they could borrow money directly from banks or by issuing bonds to the marketplace at an agreed upon interest rate and a predetermined maturity. And similar to stocks, recent bond market purchases and sales help to indicate to a business what interest rate they will have to pay to attain a new loan.

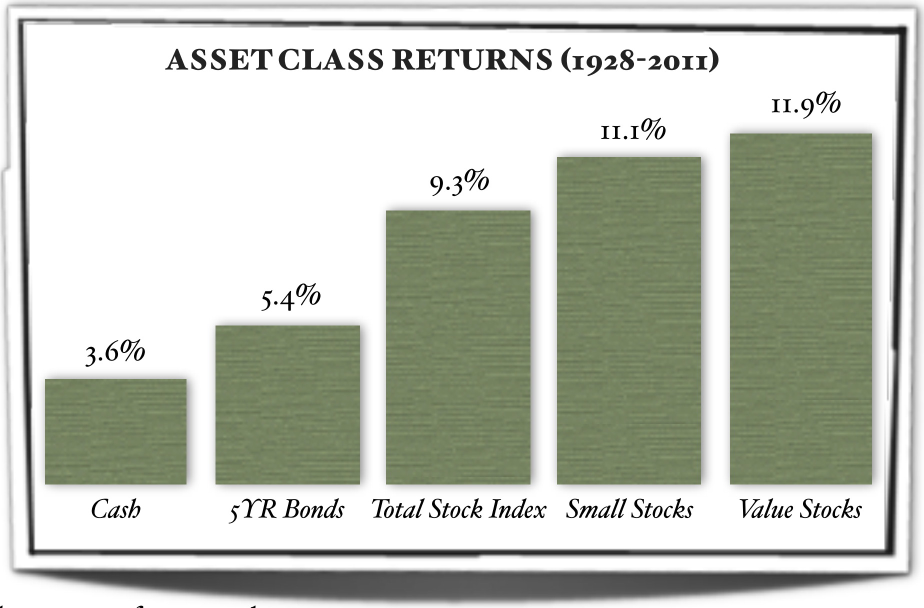
Together, the price companies receive from sales of stock and the interest rate they pay on their debt is their average cost of attaining new capital, also known simply as their "cost of capital". Businesses that are riskier have to pay more to attain funding, or have a higher cost of capital—lower stock prices and higher interest rates. Safer businesses have a lower cost cost of capital—higher stock prices and lower interest rates. As providers of this capital, investors expect to earn this "cost" as their return. When a safe business is discovered to be riskier than originally thought, the stock price falls and the interest rate rises as its cost of capital (and the expected return to the provider of that capital—the investor) goes up.

As investors, we are not guaranteed a return on our capital, or that our capital will be returned to us at all. There are risks with all companies, and in turn with all stocks and bonds. Companies go out of business, fall prey to fraudulent activities, or simply lose their competitive advantage and are unable to generate profits. And just as an insurance company bears the risks of the insurance they provide, stock and bond holders bear the risks of their investments' outcomes. If a company goes

Source of Asset Class Returns: *Cash = 1mo t-bills, 5YR Bonds = Ibbotson Intermediate Treasury Index; Total Stock Index = CRSP 1-10 Index, Small Stocks = DFA US Small Company Index, Value Stocks = 50% DFA US Large Value Index, 50% US Small Value Index. Data from DFA Returns Program 2.0. Past performance is not indicative of future results.*

bust, our stock will be worth nothing, and there may not be enough assets left to pay off our bond obligations. Simply put, we are underwriting the risks of these businesses with the expectation of earning a profit. If we held just a few stocks or a handful of bonds, we would be underwriting *companies*. But because we hold over 10,000 stocks in more than 40 different countries as well as several hundred short-term bonds in most developed markets of the world, we instead should think of ourselves more as the underwriters of *capitalism*.

And similar to insurance companies who believe they should diversify their risks by offering multiple lines of protection (auto, home, life, etc.), we believe it is prudent to diversify the risks we underwrite in our investment portfolios. So let's take a closer look at what risks those are, and what our rewards have been for taking the risks.



Stocks vs Bonds

Shares of stock are riskier than bonds. In the event of bankruptcy, bond payments and principal are senior to dividends. In many cases, stock prices are wiped out completely. Stock investors expect a higher return from stocks as compensation for taking this risk. While the investment in any one company may perform extremely well or fail miserably, investors who have underwritten the risk associated with the entire market of stocks weighted by size ("Total Stock Index") have been rewarded with almost 6% per year above risk-free cash investments and about 4% per year more than bonds. Similar results have been found outside the US market.

Big vs Small Stocks

Within the stock market, shares of smaller companies are riskier than those of larger companies. Small companies typically have less diversified lines of business (think Family Dollar Stores versus Wal-Mart) and face more challenges being approved for loans at competitive rates. Small cap stocks have relatively lower prices (higher costs of capital) than large stocks because investors expect a higher return as compensation for taking this risk. Historically this has been the case, as the market of all small companies ("Small Stocks") has outperformed the Total Stock Index by about 2% per year, with similar returns from the international markets.

Good vs Bad Companies

Large and small company stocks that are poorly run and have depressed earnings are riskier than well-run, highly profitable businesses (think American Airlines versus Apple). Similar to small stocks, these "bad" companies, known as *value stocks*, have low prices (higher costs of capital) compared to the market or higher-priced large and small *growth stocks* because investors demand a higher return for assuming the risk. Historically, this has also been the case, as a market-wide portfolio of value companies ("Value Stocks") has exceeded the return of the Total Stock Market by about 3% per year. This has also been the case in foreign markets.

Taken together, these are the primary risks, or "factors" that drive the performance of a diversified portfolio. Like a successful insurance company, investors who have been willing to underwrite the risks of capitalism on a consistent and diversified basis have been rewarded over time with exceptional profits. But these risks also offer important diversification benefits, a subject we will explore next month.

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Servō Wealth Management

3600 NW 138th Street; Suite 102
OKC, OK 73134
Phone: 405-418-8555
Fax: 405-728-2785
www.servowealth.com