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Although it's a simple question, most economists ask like they don't know the answer.

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John Exter showed that in a financial crisis, you want liquid assets. That's what you'll find in the life insurance sector.

BECOME A FREEDOM FIGHTER

INTERVIEW

Barbara Kolm, Director of the Austrian Economics Center in Vienna, is experienced in both thinking and doing.

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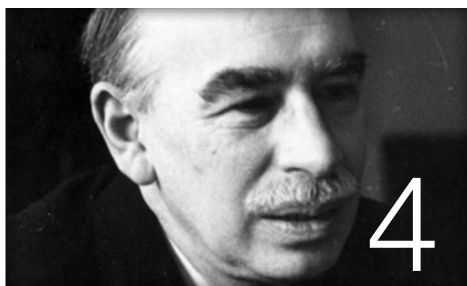
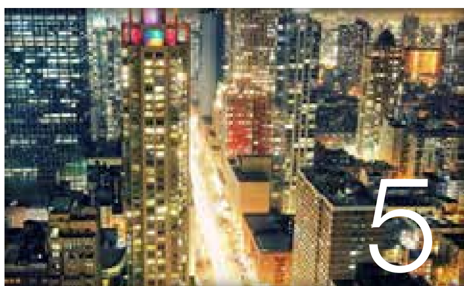


DEAR READERS

LARA-MURPHY REPORT

Magicians and con men rely on sleight of hand and misdirection. We've been pointing out the same tricks with our financial system.



ECONOMIC DEEP END

PULSE ON THE MARKET

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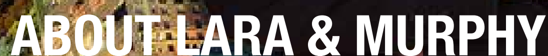
ONE MORE THING

EVENTS AND ENGAGEMENTS

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



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

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"Where did the money come from? It came—and this is the most important thing to know about modern banking—it came out of thin air."

—Murray N. Rothbard

Card tricks and sleight of hand schemes have been entertaining audiences for centuries, but great magic tricks require much more than the talent to perform them. The magician must have the talent to control the audience.

Magic is akin to a form of psychology that the magician uses to influence people's preconceived ideas. This is what made Houdini's escape act so thrilling. He played to the audience's hopes and fears and so they believed he could do the impossible. Even though common sense tells us that it's just a trick, we still want to believe that magic is real.

During the Great Depression of the 1930s, a period of time filled with disillusionment and fear, John Maynard Keynes amazed his audience by suggesting a magical idea to cure the depression problem. Genuine scholars of economics scoffed at his theory as being nothing more than hocus pocus, but government officials saw it differently. To them it was pure genius and they embraced it. Subsequently, the economic world has never been the same again.

Keynes encouraged governments, who are always broke and short of money, to borrow and spend their way to prosperity and not worry about paying it back the way a private corporation would. We see this attitude to this day from our Keynesian economists and pundits, when spending and going into debt are actually encouraged. Hard work and saving money are discouraged and penalized. It's as though Keynes made sound economics completely disappear from the face of the earth. But where was the trap door? *It came by way of counterfeiting the money.*

The trick was to increase the quantity of money enough so as to drive down the rate of interest to zero as a means to maximize investment while minimizing or wiping out savings altogether. Does all of this sound confusing?

The best way to penetrate the magical mysteries of the modern monetary and banking system is to recognize that government and its central bank are the great magicians that create money from nothing in order to pay for expenditures they can't pay with taxes alone. But as with professional magic tricks, here too it's based on a faulty perception, an illusion.

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

Spitznagel Still Spooked

AUSTRIAN BILLIONAIRE INVESTOR PREDICTS BIG CRASH

A May 16 article in the FT interviewed billionaire investor (and explicit follower of the Austrian School) Mark Spitznagel, whose Universa Fund made 20 percent—and a billion dollars—back in August on a single day when the market fell sharply. (We interviewed Spitznagel in the August 2013 *LMR*, and as a note of disclosure, Murphy was a consultant on his book *The Dao of Capital*.)

In the recent FT piece, Spitznagel is quoted as saying, *"This is the greatest monetary experiment in history. Why wouldn't it lead to the biggest collapse? My strategy doesn't require that I'm right about the likelihood of that scenario. Logic dictates to me that it's inevitable."*

Unlike his former partner, Nassim Taleb (author of the bestseller *The Black Swan*), Spitznagel does *not* believe that stock movements are random. Rather, Spitznagel relies on Austrian capital theory and option pricing theory in order to implement a "tail hedging" strategy that will pay handsomely when the unsustainable bubble collapses. Intuitively, Spitznagel thinks "the market" is underpricing the risk of an equity crash, and consequently he is able to buy put options—which give the right, but not the obligation, to sell assets at a specified price—that he believes are undervalued. But with this hedge against a "tail event" (meaning the far end of a probability distribution) in place, Spitznagel is free to "go long" on U.S. stocks.

In practice, this means that Spitznagel will underperform the market, because of the "drag" caused by his constant rolling over of out-of-the-money puts that expire worthless. However, if and when a big crash occurs, at that moment the puts in his possession will skyrocket in market value. The long string of small losses will give rise to an enormous profit—even bigger than the billion dollars Spitznagel made in a single day last August.

To be sure, the FT piece treated Spitznagel's confident predictions of an eventual collapse with amusement. Nonetheless, more and more analysts are wondering aloud whether central banks have blown up a massive equity bubble since 2009—a view that we share at the *LMR*. In May, even an establishment institution like Goldman Sachs went bearish (joining some other major investment banks), issuing an analysis warning that a 5% - 10% drawdown in the S&P 500 over the next few months was certainly plausible.

PULSE ON THE MARKET

Chaos in Venezuela

SHORTAGES AND VIOLENCE PLAGUE SOCIALIST COUNTRY

ZeroHedge and other outlets have been reporting on the deteriorating situation in Venezuela. People are reportedly hunting "cats, dogs, and pigeons" in a desperate bid to survive, as inflation and price controls have served to empty the stores of goods. Recent IMF estimates project annualized price inflation of more than 1,000 percent. Children are dying in hospitals because they lack standard medicines.

(To explain the familiar mechanism: The government starts printing money to cover its budget deficit, which in turn causes prices to rise. Then the government cracks down on "speculators" by making it illegal for prices to reflect the monetary inflation. Merchants then find themselves unable to legally charge enough to cover the higher wholesale costs of their products, so they stop stocking the shelves. Suddenly there are widespread shortages with no one able to find food or toilet paper.)

It is bad enough that government officials continue to adopt such disastrous policies, but what is insane is that Western economists also keep playing footsie with socialism. For example, back in 2007 Nobel laureate Joseph Stiglitz visited Venezuela and said, *"Venezuelan President Hugo Chavez appears to have had success in bringing health and education to the people in the poor neighborhoods of Caracas. ... It is not only important to have sustainable growth, but to ensure the best distribution of economic growth, for the benefit of all citizens."*

Here at the *LMR* our focus on Austrian economics is not merely a pedantic preference, the way we might prefer vanilla or chocolate ice cream. No, these matters of economic policy are literally life and death. Ludwig von Mises showed almost a century ago that socialism simply cannot work, and yet the world continues to suffer from disastrous ideas based on misguided altruism and simple envy.

U.S. Debt Dump

FOREIGNERS CONTINUE MASSIVE SELLOFF OF TREASURY DEBT

A CNN Money article this month reported: *"In all, central banks sold a net $17 billion. Sales had hit a record $57 billion in January. So far this year, the global bank debt dump has reached $123 billion. It's the fastest pace for a U.S. debt selloff by global central banks since at least 1978, according to Treasury Department data published Monday afternoon."*

The problem with asset bubbles—whether we are talking dot-com stocks, housing, equities, or even Treasury securities—is that they can pop very quickly.

Now to be sure, we are in a strange situation and it is not clear that the decline in foreign central bank Treasury holdings signals an imminent crash. Since the fall of 2014 the Fed has stopped inflating the monetary base; the Fed's assets have remained stable, as it merely rolls over bonds as they mature. Consequently the U.S. dollar has strengthened against other currencies, and if those central banks wish to dampen the move, they can sell down their Treasury holdings in order to obtain dollars and then buy up their own currencies in the foreign exchange markets.

Also keep in mind that if economies in Europe experience a crisis—which is entirely possible, as the continued woes of Deutsche Bank illustrate—that this would cause a global "rush to safety," meaning investors would flock again into Treasuries and push up the dollar. Perversely, even if the dollar and Treasury debt *are* in bubbles relative to the long-term picture, they might surge in price in the short-term simply because other central banks and governments have been acting recklessly since 2008 as well.

Currency War Calls

FORMER MINNEAPOLIS FED PREZ CALLS FOR CURRENCY WAR

With analysts routinely telling us central banks aren't "out of ammunition"—as if that's supposed to reassure us—we suppose it was only a matter of time before somebody explicitly called for a currency war. And yes indeed, in a May column for Bloomberg, Narayana Kocherlakota wrote: *"Bottom line: Currency depreciations would help many of the U.S.'s G7 partners a lot while hurting the U.S. little, if at all. In other words, a G7 currency war would be fine as long as the U.S. remained a pacifist."*

What makes this glib assertion even more alarming is that Kockerlakota used to be a monetary hawk relative to other Fed officials. The fact that even he is now "seeing the light" and the (alleged) benefits of monetary depreciation is disturbing. As Mises and other hard-money advocates pointed out, there is no lasting gain from inflation. You don't make your country richer by running the printing press. When rival countries begin trying to outprint each other—chasing the elusive and temporary euphoria of inflation down the rabbit hole of currency debasement—we see the absurdity of inflationism.

Why Do We Use MONEY?

by Robert P. Murphy

Although it's a pretty basic question, it's worth asking: *Why do we use money?* Once we think through the answer, it becomes clear just how awful our current monetary system is.

For those wanting a comprehensive treatment, I refer you to our book (co-authored with Carlos), *How Privatized Banking **Really** Works.* I also refer you to our new podcast, the Lara-Murphy Show, and in particular episodes 15 and 16 where we discuss how governments historically have used inflation to cover their budget shortfalls. (Everything is available at our new website, www.Lara-Murphy.com)

Once we think through the answer, it becomes clear just how awful our current monetary system is.

But for our purposes in this article, let me cover the essentials. Again I ask: Why do we use money? This is such a critical institution in our lives, and yet most people really have no idea. As we'll see, even most *economists* can't give the kind of deep answer that Austrian thinkers such as Ludwig von Mises provided.

The Shortcoming of Direct Barter

The typical way economists motivate a discussion of the *why* of money goes like this: Direct exchanges (sometimes called barter) are certainly a great thing, which provide win-win improvements on the original distribution of goods. However, the "gains from trade" in this fashion are limited.

For example, there couldn't be much specialization and division of labor if everybody were restricted to direct exchanges of goods or services that they planned on using themselves. Imagine a dentist trying to survive in a world without money. If he wanted meat, he'd have to find a butcher with a toothache. And if the dentist wanted a house, he'd have to find a team of carpenters, roofers, and bricklayers who all needed their teeth cleaned right then.

As these silly scenarios illustrate, we obviously need some way of distributing the trading of goods and services among different people, and across time. In other words, we need a way to split up sales and purchases into separate transactions. Rather than the

dentist needing to find the exact butcher and bricklayer who need dental work, with the use of money the dentist can simply sell his services to the highest bidders, and then at a later date the dentist can take his pile of money and go buy whatever *he* needs from the community.

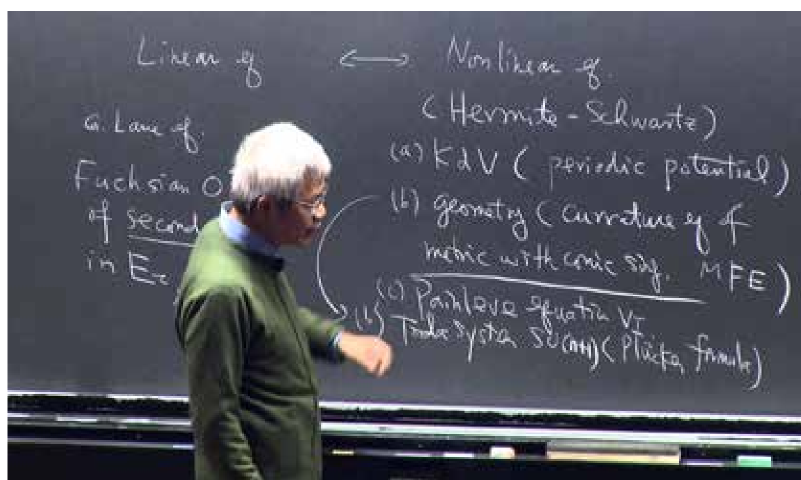
The Ivy League Leaves Us Hanging

As I said earlier, the above analysis about the dentist is not unique to the Austrian School; *all* intro economics textbooks would give some story about the limitations of direct barter. Yet ironically, if you go on to advanced study at the doctoral level, even at elite universities, you end up using mathematical models of the economy in which *money serves no purpose.*

Let me make sure you understand just *how* artificial and unrealistic these typical mainstream models are. For example, I remember at NYU in my PhD program we had a test question in macro that asked us to imagine a lone individual on a tropical island, where the only wealth was a coconut tree that shot out coconuts in a predictable pattern over time. The coconuts could not be physically carried forward into the next period (they would rot), and there was nothing the man could do to plant more trees or otherwise increase production in the future. The question also gave us the mathematical form of the man's "utility function," which specified how many "utils" he got from a specified stream of coconut consumption over time. In this setting, the exam question asked, what would be the equilibrium real rate of interest?

I hope the reader can appreciate my perplexity at this question, as I sat there in my exam. What in the heck did it even mean to talk about an interest rate, on an island with one guy, one tree, and no money?!

To end your suspense, the answer they were looking for was something like this: In each period, the interest rate had to be such that the man, when maximizing his utility, didn't want to "sell" his coconuts and then use the



If you go on to advanced study at the doctoral level, even at elite universities, you end up using mathematical models of the economy in which money serves no purpose.

proceeds to earn interest and "buy" more coconuts down the road. In other words, since we knew that (by construction) it was impossible for the guy to do anything other than to consume his endowment of coconuts each period, then in equilibrium it had to be the case that market prices were consistent with the guy voluntarily choosing precisely that course of action.

Once you learn the tricks of the trade and how to think like a mathematical economist, this type of approach is actually logical and has a certain elegance. However, I am sure most people can recognize that a model like this probably does not shed much light on "optimal Fed policy." Similarly, other macro models featured one "representative agent" who was a single individual who lived forever and consumed one good. In this type of world, there is no need for money, since there aren't even other people with whom to trade—we can't tell the story about the dentist and the butcher, since there aren't dentists and butchers in a world consisting of one "representative agent."

Here too Ludwig von Mises—and his followers in the Austrian tradition—is a giant among men

The Austrians Have the Insight

As in other arenas, here too Ludwig von Mises—and his followers in the Austrian tradition—is a giant among men. He recognized that the crucial role of money prices was that they allowed entrepreneurs to engage in *economic calculation.*

As Mises (and Hayek) pointed out during the famous Socialist Calculation Debate (which occurred in the first half of the 20th century), the central planners in a socialist government can't come up with an efficient use of society's scarce resources. Even if we stipulate, for the sake of argument, that the central planners are equipped with all of the state-of-the-art technical knowledge, and have the best of intentions, nonetheless they can't use any procedure to determine whether their production plans entail a sensible use of resources.

To see the difficulties involved, consider that there are thousands of different ways to produce and deliver specifics goods to

specific consumers. For example, even if we take it as a given that *some* oranges should be produced and distributed to individuals in Alaska, there are many different ways to do so. For example, the oranges could be grown in Florida, or in California, or even in a greenhouse in Alaska for that matter. And if the oranges *are* grown in Florida, there are different ways of transporting them to Alaska, involving trains, planes, or even mules.

The crucial point is that it's not a mere matter of engineering or agronomy to answer these questions. There are various ways it is physically *possible* to make oranges and put them into the hands of Alaskans. But in order to know *how* this should be done—including the question of how many oranges we produce and move—we must consider the *economic* consequences. Specifically, we need to consider the tradeoffs involved.

If, for example, we moved a single crate of oranges from Florida to Alaska on a supersonic jet, that would probably be wasteful or "inefficient." But the reason is that there are more important things to do with a supersonic jet. Yet "importance" in this context is something we can only discover in light of both technological facts and subjective value judgments made by the consumers.

Economic Calculation and Money

What Mises demonstrated was that these almost philosophical conundrums are solved seemingly effortlessly, day in and day out, through the use of money prices. Accountants can tell an entrepreneur how much was spent on "inputs," and how much revenue was collected from the sale of the product or service, during a given period. If revenues exceeded expenses, then that's the market's way of saying, "You have deployed scarce resources in an efficient manner."

The crucial point is that it's not a mere matter of engineering or agronomy to answer these questions.

In contrast, if a business operation is losing money, it means that those resources are more urgently desired elsewhere in the economy. That's why *other* entrepreneurs are bidding up their prices to levels that make it unprofitable to use the resources in the losing

operation. To repeat, whether a given business venture is profitable or unprofitable is *not* a technical or scientific question—it can only be answered if we have genuine market prices to associate with both the inputs and the outputs.

Mises and his followers agreed with the classical liberal respect for "sound money."

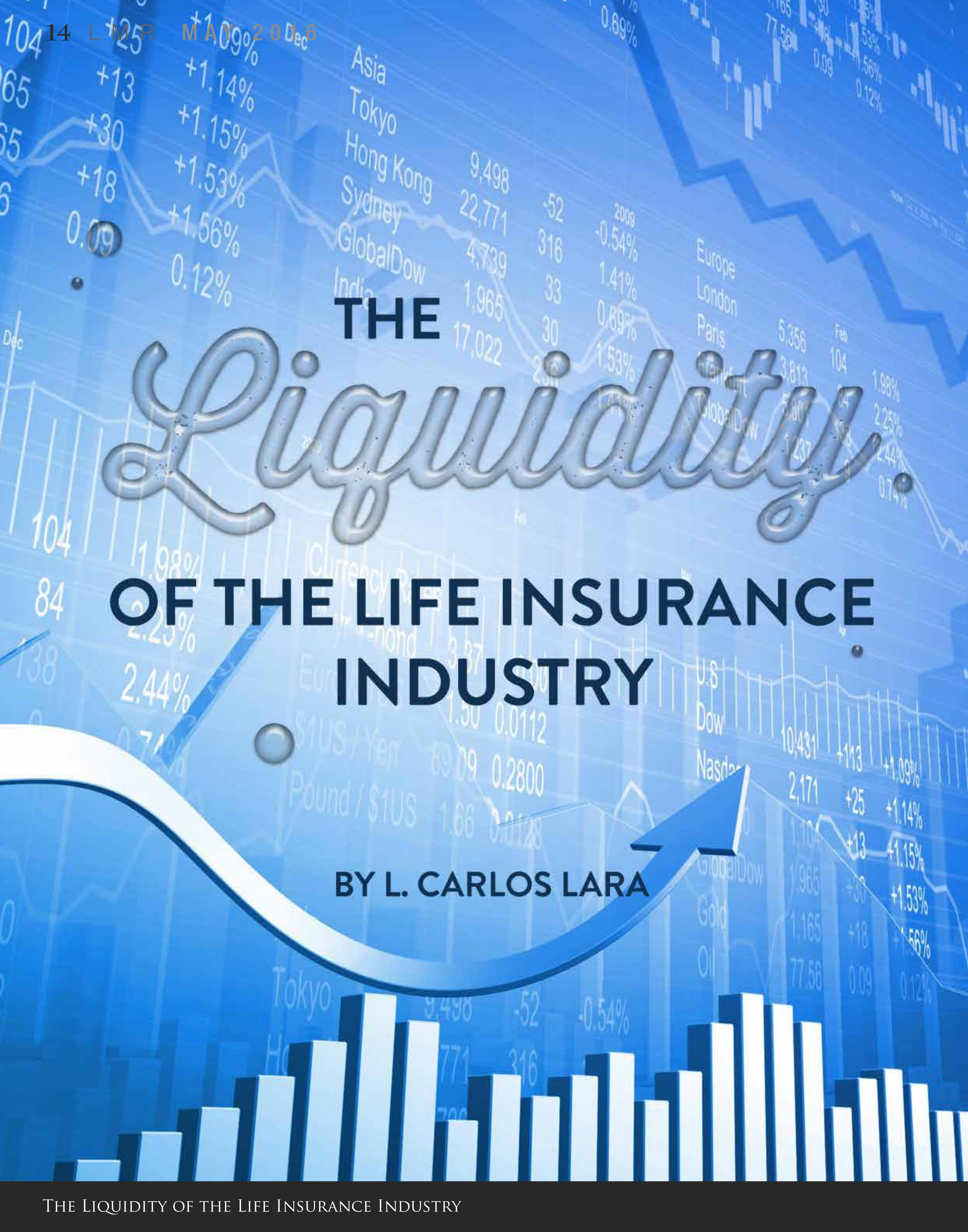
Sound Money

In this context, we see then that the social function of money is to facilitate economic calculation. Money *cannot* do this if its future purchasing power is subject to violent swings because of political intervention. It makes little sense to compare the input and output prices for a given operation, if the purchasing power of money has drastically changed during the production period. This is why Mises and his followers agreed with the classical liberal respect for "sound money," meaning money that was protected from government debasement.

Conclusion

If we don't understand the social function of money, then we can't appreciate just how badly our current monetary system serves us. Rather than trying (without success) to ensure "full employment" or to hit an arbitrary rate of annual dilution of purchasing power (also known as a price "inflation target"), the government should get out of the business of money altogether.

By returning money to the private sector, where it originated, we can bring the full power of voluntary market solutions to the production of a sound money that has desirable properties such as a predictable purchasing power. We would shudder to hand over control of science or the press to a political institution, and thus we should not let a group of Federal Reserve officials control our monetary destiny.


THE
Liquidity
OF THE LIFE INSURANCE
INDUSTRY
BY L. CARLOS LARA

Highly profitable companies can run into financial trouble if they don't have the liquidity to react to unforeseen events. Even companies with a stockpile of assets on their balance sheets will struggle with cash flow issues when markets crash if those assets are illiquid. In a moment of crisis, assets are of no value if they cannot easily be converted to cash in order to save the company.

This one contingency—*the liquidity factor*—is the main reason corporate analysts often make use of liquidity ratios when analyzing a company's financial strength. What they are examining is the ease with which a company can meet its financial obligations with the liquid assets available to them. A company can seem very solvent in normal times, and have a big cushion of shareholder equity, but if a crisis hits and the assets are very long-term and illiquid while the liabilities were short term then the company could become insolvent quickly.

Since I am familiar with these ratios and often use them to study company balance sheets, I have been most impressed with the liquidity measurements I have seen in the life insurance industry.

Since I am familiar with these ratios and often use them to study company balance sheets, I have been most impressed with the liquidity measurements I have seen in the life insurance industry. Their ratios are significantly stronger and more conservative than any other major money intermediary in our entire economy.

The structure of their balance sheets is perhaps the main reason why historically the life insurance industry has shown incredible resilience in the midst of the two worst financial catastrophes in modern history—the Great Depression of the 1930s and the 2008 financial crisis. So impressed are we with this fact that Robert and I have written extensively on this subject numerous times in the ***LMR***. (For example, see the April 2012, August 2012, January 2013, April 2013, May 2014, and October 2014 issues of the *LMR* for articles dealing with the relative strength of the insurance sector.)

DOES THE LOW-INTEREST RATE ENVIRONMENT MAKE A DIFFERENCE?

Regardless of the impressive historical record, there has been a growing concern within the last few years about the current financial stability of the life insurance industry in light of our unprecedented low interest rate environment. Quite frankly, I can understand why, and the concern expressed is logical. After all, life insurance companies do have the bulk of their assets invested in bonds (70% as of 2014), and the products life insurers offer are particularly dependent on the interest rate yields of these bonds. Consequently, not only is this a good question that deserves a good answer, but the *LMR* should be the first to address it since we advocate the stability of the insurance sector so fervently.

Not only is this a good question that deserves a good answer, but the LMR should be the first to address it since we advocate the stability of the insurance sector so fervently.

Let me begin to answer this worry by stating at least this much right now. Although it's true that this extended low interest rate environment has indeed put extra stress on the earnings of life insurance companies these last seven years, our research continues to reveal that it has not materially impacted their solvency. In fact their financial strength is as resilient as ever. In the remaining parts of this article I will explain why and also how life insurance companies are able to continue to retain their staying power.

SUMMARY OF THE MONETARY INTERVENTION BY THE FEDERAL RESERVE

The Federal Reserve is the chief instigator of our low interest rate environment. Since 2008 it has been on a campaign aimed at stimulating economic growth by deliberately pushing down the market rate of interest to historic lows. One of its most aggressive activities has been to purchase a massive amount

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> The Federal Reserve is the chief instigator of our low interest rate environment.

of assets, which has effectively pushed down the fed fund rate to zero. These open market operations, known as "quantitative easing (QE)," have ballooned the size of the Fed's balance sheet to over $4.5 trillion. According to the Center for Insurance Policy and Research (CIPR) in a newsletter dated 2014: "the 10-year Treasury plunged from a yield of 4.68% at the start of 2007 down to 1.38% in July of 2012."[1]

> The top three rating agencies are very positive about the life insurance sector.

Even though it was back up to 3.04% at the end of 2013, the 10-year Treasury has come back down again to 1.84%[2] this month, while the economy has remained anemic. The Fed's commitment under Chairman Yellen is to continue to keep interest rates low until stronger signs of economic recovery become more evident. Unfortunately, this prolonged strategy will continue to have an unpleasant impact on Life insurers and there is no way around this particular part of the problem at this time.

TOP RATING AGENCIES GIVE LIFE INSURANCE COMPANIES A THUMBS UP

Nevertheless, most market analysts still hold a very positive outlook for life insurance companies regardless of the low interest rate environment. In a recent (2015) end of the year announcement Moody's predicted a stable 2016 outlook for life insurers.[3] Fitch had an almost identical outlook for life insurers claiming that *"Fitch's stable outlook considers the industry's very strong balance sheet fundamentals, strong liability profile, and stable operating performance,"* and it continues to view *"… the industry's liquidity profile as strong."*[4] Not to be outdone Standard & Poor's (S&P) also gave life insurance companies a thumbs up in their report for 2016 by saying that, *"US life insurers can weather*

the storm!"[5] Obviously, the top three rating agencies are very positive about the life insurance sector.

Perhaps we should also mention here that approximately 50% of the life insurance industry's bond portfolio is made up of investment grade corporate bonds, which have a current yield of 3.6%. In other words, it's not all Treasuries. Lower yielding assets that mature can and are often rolled over into new conservative higher yielding investments of this type, which can improve the investment portfolio of life insurance carriers without going into riskier investments. Furthermore, the quality of these bond investments adds to their liquidity. Short of a currency crisis, they can be converted to cash quickly.

Life insurance CFOs were interviewed about their primary business concern. All participants (97%) stated that the prolonged low interest rate environment was their number one chief concern.

Still, this all seems paradoxical that credible sources such as Moody's, Fitch, and Standard & Poor's can be so optimistic about the life insurance industry in light of such prolonged interest rate lows. But before I explain why there is so much optimism among these analysts, let's first be certain we understands exactly where the damaging effects of the low interest rates are impacting the life insurance companies.

THE TOWERS WATSON LIFE INSURANCE CFO SURVEY

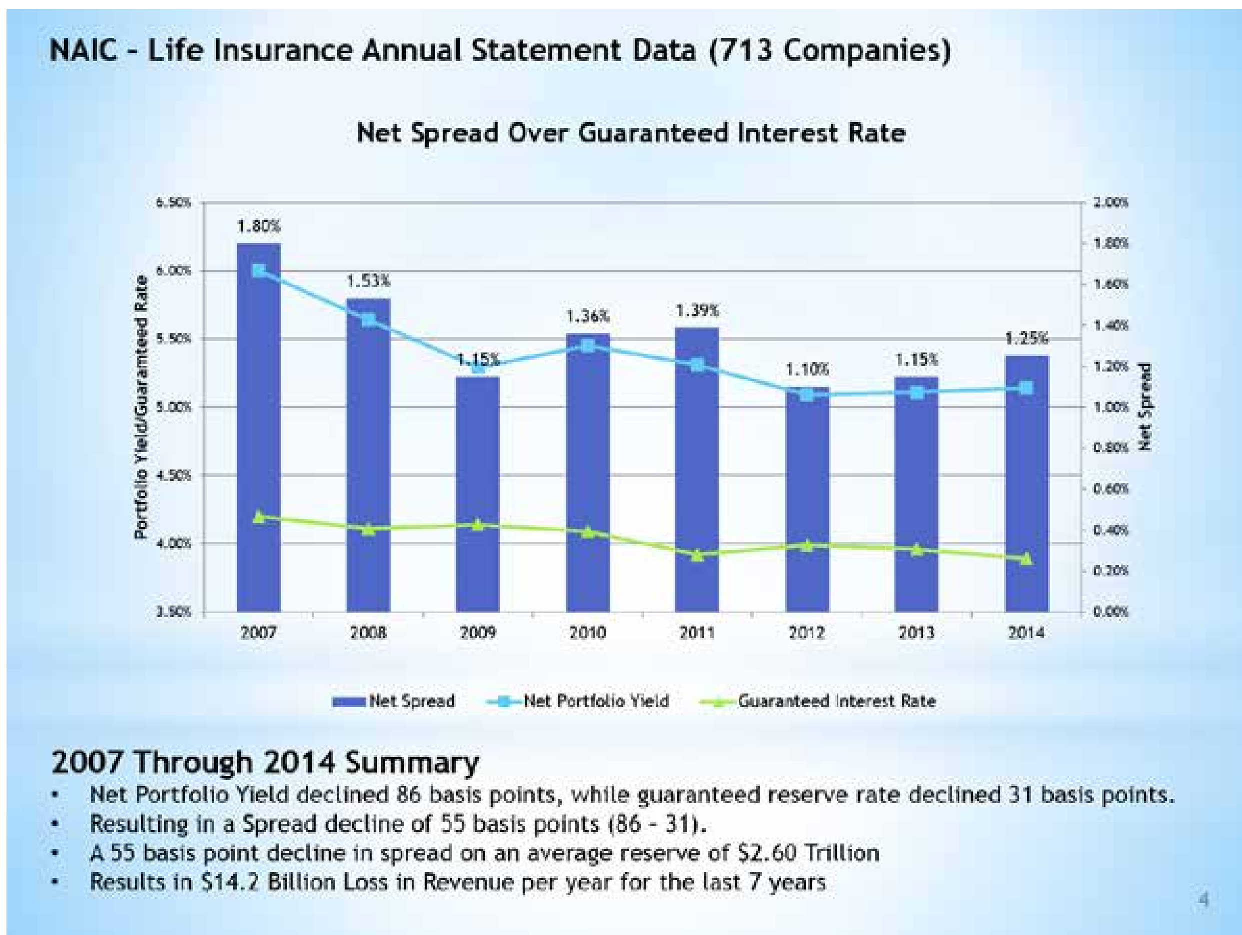
In a recent survey conducted by Towers Watson, a global professional services firm specializing in risk management, life insur-

ance CFOs were interviewed about their primary business concern. All participants (97%) stated that the prolonged low interest rate environment was their number one chief concern.[6] Here's why:

> *"Life insurer's earnings are typically derived from the spread between their investment returns and what they credit as interest on insurance policies and products. If their contractually guaranteed obligations exceed achievable returns in the capital markets for a certain length of time, life insurers' ability to meet expectations can be greatly reduced."*
>
> —*The Center for Insurance Policy and Research (CIPR)*[7]

Adding to this, a recent National Association of Insurance Commissioners (NAIC) Study of the annual financial statements of 713 life insurance companies from the periods 2007-2014 clearly indicated a squeeze in the spread between the net investment portfolio yield and the guaranteed interest rate to policy holders. Investment net spreads actually declined 55 basis points during this seven-year period or what amounted to approximately $14.2 billion in lost spread revenue per year. **(SEE: Slide 4 from the NAIC Study)**[8]

So what we see is that the pressure being felt from the low interest rate environment



NAIC Study: Slide 4

for life carriers is in their spread revenue. Keep in mind that actuaries discount all future events at some implicit rate, and therefore present assets—even "safe" ones—must generate a return in order to meet future obligations. Consequently, any damaging effects to earnings would most certainly concern a life insurance CFO.

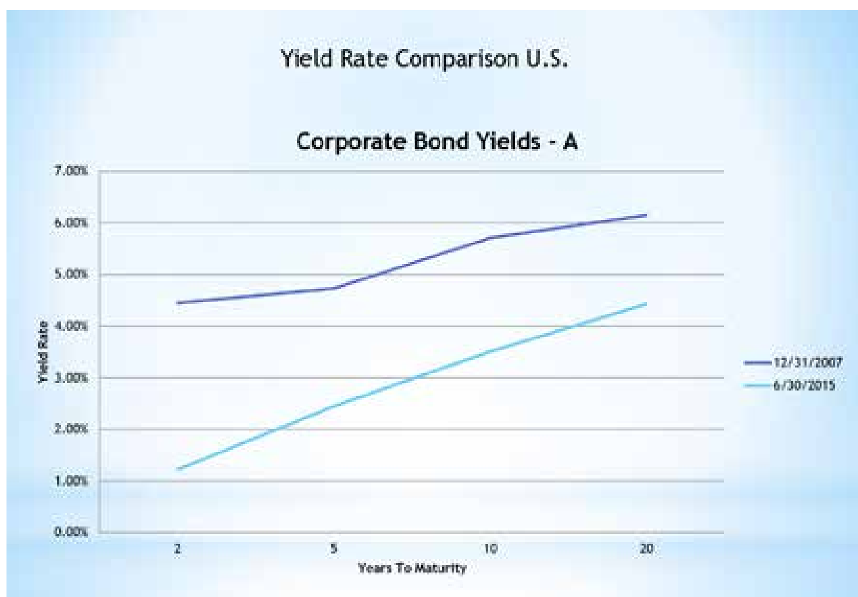
EARNINGS COMPRESSION VS. RESERVES

It's interesting to note that most life insurance portfolios have come out of the higher yielding bonds of the past and now have rolled into the current yields of 5% on average according to the NAIC study. **(SEE: Slide 6 & 7 from NAIC Study)** What is still being credited back to many policyholders is nearing almost the same interest rate earned in the capital markets. This is where the earnings compression is coming from.

Fortunately, minimum valuation interest rates going forward on new policies are determined each calendar year and locked in at policy issue. After that they do not change. These minimum interest valuations over the last six years have been gradually adjusting downward in order to relieve some of this earnings compression.

But the interest credited back to policies is still generally greater than any other interest rate offered by a similar type of safe investment in the market place, such as a bank certificate of deposit (CD), or similar vehicle. This is one reason why under this low interest rate environment new business continues to pour into the insurance sector and why those savers who are already inside the insurance sector stay inside.

Now comes one of the most important and unique attributes of life insurance companies. The principal liabilities on life insurers' balance sheets are actually ***policy reserves***—



NAIC Study: Slide 6

These minimum interest valuations over the last six years have been gradually adjusting downward in order to relieve some of this earnings compression.

Life Industry: Maturity Distribution Of Bonds

	2011	2012	2013	2014
0-1 Years	9.2%	10.4%	8.6%	8.8%
1-5 Years	27.0%	26.3%	25.3%	24.2%
5-10 Years	29.1%	28.9%	30.5%	30.6%
10-20 Years	14.3%	14.2%	15.1%	15.4%
20+ Years	20.5%	20.2%	20.7%	20.9%

Life Industry: Credit Quality of Bonds

	2011	2012	2013	2014
AAA to A-	65.0%	62.9%	61.7%	62.5%
BBB+ to BBB-	28.4%	30.8%	32.4%	31.4%
Below IG	6.6%	6.3%	6.0%	6.0%

NAIC Study: Slide 7

assets that are held in custody for policyholders to cover all present and future claims. The establishment of reserves is by law purposefully conservative in the sense that they usually result in an overstatement of future expected claim costs.. This necessarily creates excess funds, which are invested for a profit and create additional reserve cushioning.

We see this more specifically in the pricing of life insurance products where there is not only an investment-spread margin, but also a spread margin on an expense component and a mortality component. All of which are calculated greater than actually experienced by insurers and serve to create the extra surplus.

The $14.2 billion dollar spread loss per year (2007-2014), occurred against average reserves of $2.60 trillion. "While this is significant, the life insurance industry is still in a position of positive net investment income spread. Consequently, the period of the low interest rate environment created spread compression on earnings, but it did not materially impact the life insurers' solvency." CIPR Newsletter, July 2014 **(SEE: Slide 3 from NAIC Study)**[9]

NAIC - Annual Statement Data (713 Life Companies)

Year	Total Reserve ($ Trillions)	Net Asset Portfolio Yield	Guaranteed Valuation Interest Rate	Spread	Spread Revenue ($ Billions)	Cumulative Spread Lost Revenue/Profit Since 2007 ($Billions)
2007	2.10	6.00%	4.20%	1.80%	37.8	-
2008	2.30	5.64%	4.11%	1.53%	35.2	(6.2)
2009	2.46	5.29%	4.14%	1.15%	28.3	(22.2)
2010	2.57	5.45%	4.09%	1.36%	35.0	(33.5)
2011	2.74	5.31%	3.92%	1.39%	38.1	(44.7)
2012	2.78	5.09%	3.99%	1.10%	30.6	(64.2)
2013	2.88	5.11%	3.96%	1.15%	33.1	(82.9)
2014	2.99	5.14%	3.89%	1.25%	37.4	(99.4)
2014 - 2007 Ave	2.60	-.86%	-.31%	-.55%		(14.2)

3

NAIC Study: Slide 3

THE KEY TO MITIGATE RISK IN A LOW INTEREST RATE ENVIRONMENT

The life insurance industry's ability to manage the ongoing structure of their assets and liabilities is accomplished by the employment of future planning "cash-flow analysis." It is these asset liability management (ALM) programs[10] that not only help insurers mitigate low interest rate risk, but also prepares them for the rise in interest rates when they come.

In the current low interest rate environment earnings compression necessarily pushes statutory reserves on all new policy issues. Therefore future cash flow planning is not only essential, but it is a required statutory valuation law. Companies must perform an annual cash flow testing exercise by building a financial model of all of their in-force assets and liabilities and then matching them together.

What happens next is nothing short of astounding. The company must then run the financial model out several years, generally five to ten years, until any remaining in-force

liability at the end of the projection is insignificant. This is done using different interest rate scenarios and at least seven of those interest rate scenarios are provided by state insurance regulators known as "the New York 7." This amounts to 1,000+ scenario calculations. If the chief actuary determines a significant amount of mismatch exists between the assets and liabilities of the company, an additional reserve amount must be posted to cover any interest rate risk embedded in their balance sheets.

> Companies must perform an annual cash flow testing exercise by building a financial model of all of their in-force assets and liabilities and then matching them together.

These ongoing stress tests and especially the establishment of additional reserves are key components that serve to continue to fortify the financial strength of life insurers. A conclusion that is consistent with the recent optimistic outlook given to the life insurance industry by the three largest rating agencies of financial institutions.

CONCLUSION

Despite the unusual and prolonged low interest rate environment, which many experts now agree has been grievously ineffective and damaging to the economy, it is reassuring to know that the overall financial strength found in the life insurance sector coupled with their sound management techniques continue to make them resilient against major economic shocks. They have met this challenge two other times before and the confidence in them remains positive. In essence *"they can weather the storm,"* as the S&P rating agency announced.

What we must understand when we study statistical information such as this is that underneath it all we live in an economic world where our government officials are dead set

against savings and are very supportive of the investment markets. Yet most prudent analysts now see these investment markets due for a major correction. There is worry that investors will flee from these investment markets in mass. This is why we believe government laws, such as Dodd-Frank and the more recent DOL ruling, are attempting to keep investors "in the market."

As a matter of interest, the CFO Survey revealed one other intriguing fact. In addition to the low interest rate environment being a major concern, the interviews also revealed that "(87%) of them believed that there was a 50% or greater likelihood of a major disruption to the economy in the next 18 months. 27% believed that there was a 75% likelihood of a major disruption and 7% saying it was almost certain."[10]

Whether these sentiments have lessened or increased since this survey was taken is

difficult to tell. But chances are they have not abated and the concern has probably increased. It remains to be seen when exactly the financial market crash will actually hit. But if the crisis to come is as severe as many predict it will be, the life insurance industry has a much greater chance of surviving it than other major financial institutions.

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Become A FREEDOM FIGHTER

Interview with Barbara Kolm

Barbara Kolm is President of the Friedrich A. v. Hayek Institute in Vienna, and Director of the Austrian Economics Center. Having studied business administration at the University of Innsbruck and University of California, Los Angeles, she eventually became an assistant professor at the Department of Tourism and Service Economics at the University of Innsbruck. In her thesis she dealt with labor market economics.

Having always been interested in free market and liberal ideas, Kolm accepted an invitation to direct the Friedrich A. v. Hayek Institute in the fall of 2000. She expanded the activities of the Institute and restructured them by laying emphasis on the Austrian
School of Economics and providing market based solutions (education, health care, pension reform, tax reform, etc.) to a larger public. In 2006 she founded the Austrian Economics Center in Vienna, a "do" tank (as opposed to merely a "think" tank), which provides enterprises with economic research and studies on up to date topics. Apart from being a net hub to European Think Tanks, developing the Dictionary of Economic Terms, and launching the AEC´s prime product: the Free Market Road Show®, which started touring in 2007.

Kolm is an Associate Professor of Austrian Economics at the University of Donja Gorica, Montenegro and has been an elected member of the Board of Business Consultants of the Austrian Federal Economic Chamber since 1995, responsible for new market approaches and questions of training. She is a Member of the Mont Pélerin Society and President of the European Center for Economic Growth.

Lara-Murphy Report: How did you become interested in Austrian economics?

Barbara Kolm: Definitely not in an Austrian University! These are still places where Keynesian economics are taught. I have a classical libertarian family background – was educated with the moral values and the Freedom-philosophy that the Austrians cherish. When Hayek received the Nobel Prize in 1974 this was debated at our dinner table; later in my career as a businesswoman and politician the only logical way to be successful and bring about change was to follow the principles of Austrian Economics. Being invited in 2001 to reorganize the Hayek Institute was only a consequence.

"When Hayek received the Nobel Prize in 1974 this was debated at our dinner table."

Lara-Murphy Report: Can you explain what led you to found the Austrian Economics Center?

BK: There was a market niche. The Hayek Institute covered only German-speaking countries. Moreover, we were labeled and seen as the mean "Neo-libertarians" with the only focus on Hayek. It was time to bring the international and broader perspective of the Austrian School to the European public sphere. I founded the Austrian Economics Center in 2007.

LMR: You were also the creator of the Free Market Road Show, which one of us (Murphy) participated in this year. Can you explain to our readers how this started, and how it's grown over the years?

BK: We started the FMRS in 2007 for three reasons: first we wanted to export the success of the first coalition government (Freedom

"We needed to create a tangible product, that united our European Freedom fighters, Institutes and think tanks."

Party and Conservatives of 2001) that had changed Austria to a successful, attractive business location by implementing structural reforms and thereby outperforming Germany; second, as Austrians we were proud of our Austrian Economists heritage that we wanted to export; and third – and most important: we needed to create a tangible product, that united our European Freedom fighters, Institutes and think tanks.

LMR: What do you think of the prospects for liberty in Europe?

BK: In Western Europe we have been under siege for almost two decades now. The pendulum has swung back after Lady Thatcher and the liberalization of markets in Brussels 25 years ago; we see more and more socialism and redistribution; the new EU member States in the East are better off: they turned away from Communism, turned 180 degrees and embraced markets. This has been forgotten in the West.

However, there is good news, too. Young people become more and more interested in Libertarian thought – e.g. the European Students for Liberty movement is growing as is the number of pro-market think tanks and Institutes.

Fact is: neither our (EU and national) institutions nor politics have managed the three crises of the last decade well:

1) Sovereign debt crisis – with its negative consequences such as the bailouts of nations and banks, helicopter money, negative interest rates, etc.

"Never trust those who make promises with other people´s money."

2) The security crisis with Ukraine and terrorist attacks on European soil.

3) The current humanitarian crisis with war and economic refugees migrating to Europe.

LMR: You encounter many young people interested in advancing Austrian economics and political liberty. What advice do you give them?

BK: Study the theory and principles, learn from best practices and never trust those who make promises with other people´s money. Spread the word actively, become engaged and explain to everybody why individual freedom is the most valuable good that needs to be defended. In short, become a freedom fighter either by enrolling in programs on Entrepreneurship and the Austrian School or in your professional life by embracing our principals, living, and sharing them.

EVENTS & ENGAGEMENTS

MAY 10-12, 2016
ST. LOUIS, MO

Nelson Nash, Lara, and Murphy present on IBC at Freedom Advisers

MAY 21, 2016
SEATTLE, WA

Murphy presents at Mises Circle

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

SOME EVENTS MAY BE CLOSED TO GENERAL PUBLIC.
FOR MORE INFORMATION: LMREVENTS@USATRUSTONLINE.COM

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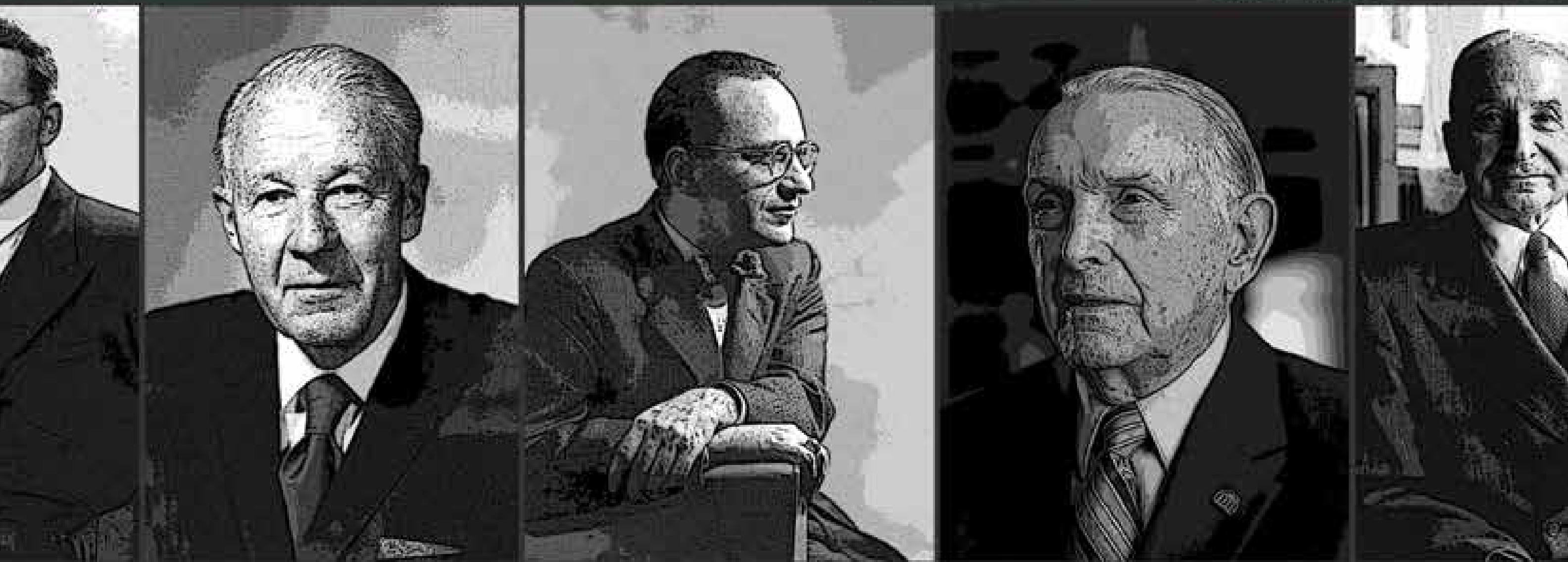

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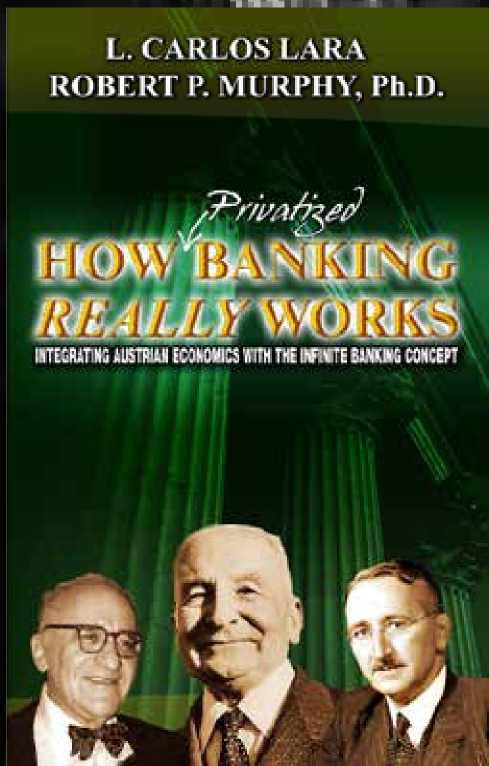

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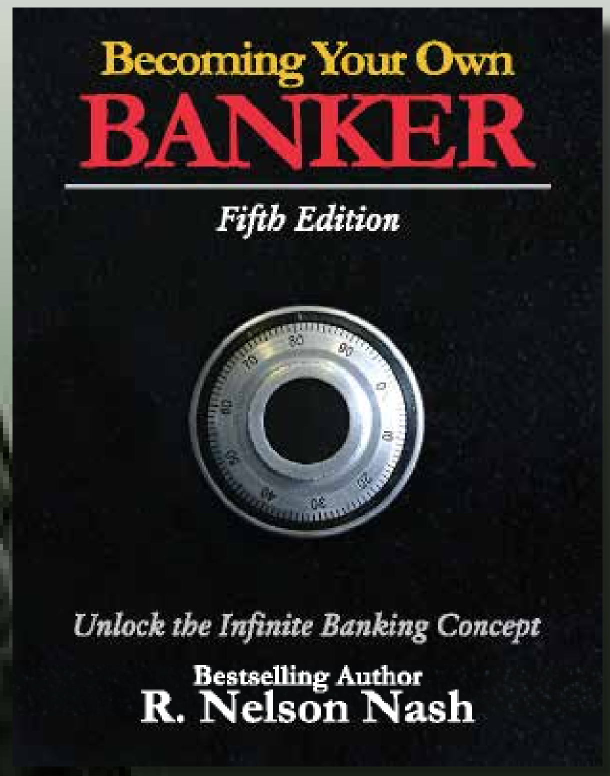

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