Reducing Risk Doesn't Pay Off

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Reliance National announced recently that it will soon begin offering "earnings-protection insurance." That is, it will write insurance policies to cover companies against lower-than-expected earnings resulting from uncontrollable events ranging from a product flop, to a supplier that goes bust, to a key customer who defects.

The idea behind earnings insurance, like other forms of insurance, is to reduce risk. Earnings insurance is only the latest strategy available to risk-averse managers; in the past they have formed conglomerates and employed derivatives for the same purpose. On the surface, such strategies would seem to make sense. After all, stockholders dislike risk. In the stock market, the essence of risk is the volatility of returns. Thus, it would seem that if a company can smooth out its earnings through various forms of risk management, it will keep the stockholders happy and the stock price high. Why didn't somebody think of this before? There's got to be a catch.

Indeed there is. Stockholders don't care if earnings are hurt by uncontrollable events. At least diversified stockholders don't care. And because it is irrational not to diversify, we don't really need to worry about stockholders who don't diversify. A diversified stockholder--one who has spread his money across 20 or more different stocks--has effectively eliminated the risk that goes with investing in any individual company, without any sacrifice of return. For every company that underperforms compared with expectations, there will almost certainly be one that over performs.

If a rational investor has already avoided company-specific risk through diversification, how would he view the news that a company in diversified shareholder, earnings insurance is a waste of money.

This is not to say that there will not be takers for such insurance. Management may think that the stockholders care. The problem is that a manager whose compensation is tied to earnings may have an ulterior motive. It is obvious why he might see earnings insurance as a good idea. Fortunately for shareholders, few managers have their incentive compensation tied to earnings these days. Most receive stock options and therefore should not be much interested in any financial gimmick that might adversely affect stock price.

Earnings insurance has other problems, too. For one, smart stockholders would not view the proceeds of an insurance policy as the dollar-for-dollar equivalent of the same amount of earnings. Earnings provide shareholders not only with money, but also with information about how well a company is managed. If a disaster happens once, it can happen again. Stockholders will perceive more risk even if the insurance company ponies up the difference. The price of the stock will drop, insurance or no insurance.

What's more, earnings insurance will not cover the one risk that stockholders might like to see covered. It won't pay if the shortfall is due to fraud or other wrongdoing by management. This is a risk that can't be diversified away. Fraud always hurts; there are no gainers to balance out the losers. That's why the courts waive the business-judgment rule, which ordinarily protects management from judicial second- guessing, if there is self-dealing or a similar wrong.

Earnings insurance as a way of hedging risk is part of a trend that goes back decades. The primary motivation for the conglomerate mergers of the 1960s and 1970s was earnings management. The idea was that assembling an array of different companies under one umbrella would yield a smooth earnings stream at the holding-company level. But stockholders soon discovered that they could diversify much more cheaply and easily by adjusting the stocks in their portfolio or buying shares in a mutual fund.

Conglomerate stocks thus fell into disfavor. Why buy prepackaged diversification in the form of a conglomerate, in which the CEO has no substantive focus, when you can roll your own portfolio and adjust the mix of business with a simple phone call to your broker? In the end, the conglomerate mergers of the '60s and'70s became the targets of the bust-up takeovers of the '80s. Nor did the trend end then: Last week's breakup of RJR Nabisco came after its stock had languished for a decade since the 1988 merger. More recently, companies have turned to various derivative instruments to manage risk. Aside from the well-publicized losses of Procter & Gamble, Gibson Greetings and others from derivatives gone wrong, what do derivatives do for stockholders even when they work as intended? Not much. As far as a diversified stockholder is concerned, company-specific risks from interest rate fluctuations, currency translation, or volatile commodity prices all come out in the wash. Some companies win, some lose. Only the average matters.

A few companies seem to recognize that stockholders dislike risk management. Homestake Mining, for example, generally does not attempt to hedge with gold futures. Rather it allows the risk of changing gold prices to pass through to its investors who may hedge either by owning a stock of a gold user or through options.

First conglomerate mergers, then derivatives--earnings insurance is more of the same. Smart stockholders don’t like it. Sell short.