

## CONTENTS

Insuring  
Your Next  
Trip?

The National  
Transportation  
Speculation  
Safety Board

Easy Money

▼  
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## Fearing loss, we lose

**F**ear of loss, widely known to be more powerful than joy of profit, took my hand and escorted me to the corner of Spend and Waste. It was an easy trip. Too easy.

On March 12, I called the central reservation department of a major ski resort. Upon completing the reservation, the agent said, "That will be \$868.32, including trip cancellation insurance. Shall I charge that to your credit card?" Without thinking, I said yes. A few days later, the printed invoice demonstrated that I had committed to \$805.32 for lodging, ski rentals, ski lift tickets, and tax, plus \$63 of trip cancellation insurance. Ouch! Why did I accept the insurance?



Consider the economics. Of the \$805.32, \$252 was for lift tickets and \$117.72 was for equipment rental (total: \$369.72). For a legitimate, properly documented, last-minute cancellation, most ski areas and equipment providers will refund all or a portion of these costs. Even if the providers are willing to refund only half, I would have received a refund of \$184.86. This means that my exposure to loss was no more than \$805.32 - \$184.86, or \$620.46. If these providers are willing to make a 100 percent refund, my exposure was about \$435 (and tax), the nonrefundable rental fee for a con-

dominium. In sum, I was charged a \$63 insurance premium for protection from a potential loss of between \$435 and \$620.46. That is a whopping 10 percent (or more) of the amount insured.

Few other insurance premiums are as onerous. If the premium for \$500,000 of term-life insurance were 10 percent (\$50,000 per year), no one would buy. Most insurance premiums are much lower than trip cancellation insurance, and most other insurance contracts cover periods of at least one year. The travel policy I acquired was for the period between the date I made the reservation (March 12) and my arrival date (March 28). The 10 percent premium covered less than one month. If the statistical concept of annualization were applied, the premium would be 120 percent of the amount insured.

Trip-cancellation insurance has two benefits. The first and most emotionally appealing benefit is that these insurance contracts relieve the traveler of fear of loss, the anxiety that accompanies any business commitment that might not be fulfilled because of specified personal crises, such as a health emergency. The second benefit is to the owner-operators of condominium and hotel properties. These operators could not operate if their fees were refundable. Without 100 percent advance, nonrefundable deposits, a significant number of travelers

*continued on page 2*

**Fearing Loss, *continued from page 1***

would guiltlessly cancel, leaving behind spaces that could not be rented at the last minute. By providing insurance, and by specifically asking each customer whether to accept or to reject insurance, operators relieve themselves of disputes and bad feelings with clients who must cancel.

Although the cost of trip-cancellation insurance is high with respect to the amount insured, it is not high with respect to the cost of administering this insurance system. My premium was \$63. Perhaps half of this amount covers commissions and clerical/administrative expenses. If this assumption is correct, a little more than \$30 went to the insurance company or private insurance pool. From my \$30, and from premiums paid by hundreds of other travelers, insurance companies pay claims and the expenses of processing claims. A few claims are not legitimate. That is, some travelers cancel for minor, uninsured personal reasons, but submit claims based on other, insurable factors. As in all forms of insurance, every insured absorbs costs of illegitimate claims. The point is not to criticize these companies or their agents. The point is to ask whether financial-planning-sensitive travelers need the insurance.

I purchased the insurance on less

than 30 seconds of reflection, in violation of my own financial-planning principles. I purchased because the premium was small, and the sale was subtle. The only reference to the insurance was the agent's simple statement, "That will be \$868.32, including TravelGuard Trip Cancellation Insurance." At the time of the sale, I already was imagining my personal Rocky Mountain high and cared less about the details. I entered the intersection of Spend and Waste without careful thought. Had I thought about it, I would have recalled my previous conclusion that trip cancellation insurance, and other forms of consumer protection insurance, do not help me. I have taken two or three insurable trips every year for over 30 years, perhaps 60 to 90 trips, and not once have I needed to make a trip-cancellation claim. Not once have I been close to making a trip-cancellation claim. Not once have I met a person who has made a trip-cancellation claim. By not paying 10 percent insurance premiums on 90 trips, I saved enough money to have made 9 trips at no cost at all. Yet, at the moment of committing to a trip, I still feel anxiety about potential loss. I feel the same anxiety when I buy a stock.

A confusing issue in trip cancellation insurance is the amount insured and the amount that needs to be insured. For example, in the ski trip transaction, airline tickets were not insured, because I purchased the tickets directly from the carrier, not from central reservations. Whether required or not, I had no protection on approximately \$600 of air fare, unless the airline itself would be willing either to refund the fare or to credit the fare toward a future flight. For an international trip last fall, I was tempted, for a moment, to insure the entire cost of the land package and air fare. Fortunately, I called the travel agent, who said that the air fare was nonrefundable, but that for a period of 13 months

*continued on page 4*

**Prognostication — Easy Money**

The business of profiting from prognostication is spotlighted in two books, one brand new, the other published in 1998. The first book, *The Fortune Sellers: The Big Business of Buying and Selling Predictions*, by William A. Sherden argues that no prediction is accurate, but that televised talking heads, touring public speakers, and many writers earn fees of hundreds of thousands of dollars a year by making dramatically or glamorously produced forecasts about everything from stock prices to global warming.<sup>1</sup>

The second book, published this year, is *The Fortune Tellers: Inside Wall Street's Game of Money, Media, and Manipulation*, by Howard Kurtz. His view is that stock market prognosticators either know nothing, because they have access only to "a strange soup-like mixture of facts and gossip and rumor," or that these televised "experts" have undisclosed financial interests in the securities they discuss. His important conclusion is:

... it is up to the ordinary investor to resist the blandishments that seem to shout from every newsstand, television set, and computer screen. It's up to us to cut through the endless static. . .

[because] the corporate executives, analysts, fund managers, and journalists who turn out to be wrong will simply move on to the next mouth-watering trend, leaving the suckers behind. The fortune tellers, in short, will always be with us. Those who blindly follow them have no one to blame but themselves.

<sup>1</sup>This book and the subject of prognostication were discussed in depth in the June, 1998, edition of this newsletter (Vol. 1, No. 6). This edition is available on the web site, [www.wpam.com](http://www.wpam.com).

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# Safety

Investors need a National Speculation Safety Board. After every stock market crash, the NSSB would examine all evidence to determine who or what was at fault and then issue a report. Would people read the report? Would they heed its advice? Of course not. They would repeat their mistakes, perhaps several times, just to make sure that those specific mistakes were real.

It is human to err, and common to err twice, or even three times. Blunders are part of the marketplace, part of life itself, though entirely doltish—and preventable.

Assume that an investor placed \$10,000 in the market during the high-flying month of August, 1987, and utilized margin to purchase \$20,000 of stock. Further assume that he invested in speculative securities, a normal occurrence among those who utilize margin. Following the crash of October 19, 1987, therefore, it is highly likely that his securities were down 30 to 40 percent, or \$6,000 to \$8,000, reducing his \$10,000 equity to \$4,000 or less.

Upon later reviewing these assumed circumstances, the National Speculation Safety Board would have issued the following report:

The reported loss is a result of many factors: injudicious use of margin at a time when market prices were high by historic standards, an emotional response to recent rapid price appreciation, and failure to consider risk and to evaluate risk in the context of personal financial resources. Therefore, we find that the preponderance of evidence suggests human error.

In contrast, it is likely that the investor himself reached one or more of these conclusions: “I will never invest again” or “Market prices now are so

much lower that I must put more money in the market” or “Municipal bonds are not for me” or “I will try options as a means to quickly recover my losses.” The propensity is clear: he is likely to make the same mistake again.

To help our investor avoid making the same mistake twice, the NSSB would have published a manual entitled: *Avoidance of Error and Reduction of Inordinate Risk During Periods of Speculative Excess*. It would make these points:

- Persons seeking above-average returns must admit that humans are creatures of habit. They eat, drink, smoke, laugh and think in reasonably defined patterns that are difficult to change. Therefore, the first job of investors is to recognize their habits, to describe and to evaluate those habits in writing.
- It is essential to list habits in writing because analysis of any situation requires a written record. A written record is subject to scrutiny, but unrecorded thoughts are either forgotten or later modified to suit the ideas of a different time, mood and place.

One investor provided this list of personal habits: ‘I tend to be very emotional about the stock market. It is very difficult for me to sell either at a big profit—because I think the profit will get bigger—or at a moderate loss, because I always think the stock will recover. I am not involved with the market every day. It also seems that I lack patience. Investments such as municipal bonds and certificates of deposit do not interest me at all, even though I am aware that they can earn generous rates of interest.’

Having permanently transcribed a list of habits, this investor can deal with his situation. The habit of making emotional decisions is resolved by either pur-

chasing unemotional securities or delaying decisions to moments of quiet and reason. He can overcome the boredom of CDs and bonds by studying to

*“Don’t ever make the same mistake twice, unless it pays.”*

—Mae West

learn their real value over time. If poor investment results are caused by lack of daily attention, he can develop routines from which he will both learn and acquire a sense of relative value.

The NSSB manual would have further emphasized its point about making the same mistakes twice by citing case histories of criminals who repeat illegal activities after incarceration, athletes who cannot correct ineffective techniques, and investors who have made and lost fortunes several times during their lives.

Of course, an NSSB Guidebook would end with disclaimers, to wit:

The information in this manual has neither been approved nor disapproved by the NSSB. Use of this information may or may not produce positive results. Factual materials are taken from sources considered to be reliable, but are not guaranteed. Board members of the National Speculation Safety Board, their families, relatives, friends and colleagues, may not be held liable for losses suffered by those who use this booklet. After all, these folks have made a few mistakes themselves.

Fearing Loss, *continued from page 2*

following cancellation of my original flight reservation, I would be able to apply the air fare to any other flight on that airline. With this information, I decided not to insure the cost of the airline ticket. Nevertheless, in violation of my financial-planning principle, I insured 50 percent of the land package. Purchasing this insurance relieved inner tension.

Another form of consumer insurance is the maintenance agreement. Upon ringing up the purchase of a major appliance, retail store clerks are reminded automatically to ask whether the purchaser wants a maintenance agreement. If the first answer is no, the purchaser receives a telephone call within two weeks, again recommending the maintenance agreement. Sometimes, a second follow-up telephone call is made offering a maintenance agreement that would cover not only the recent purchase; it also would cover other already owned home appliances, albeit at a higher cost. These extra sales efforts demonstrate the high profitability of such agreements.

Like trip-cancellation insurance, maintenance agreements ameliorate the anxiety that something is bound to break or fail. This assumption is wrong because consumer appliances last a long time. After all, in the absence of a reputation for durability and reliability, an appliance will not last in the market place. Either word of mouth or *Consumer Reports* will report a deficiency, or a high frequency of

repair, and the product will not compete. In my home, we have a Maytag dryer more than thirty years old and a Hitachi large-screen TV over 15 years old. Neither has required service. I never have owned any product that would have required service during the originally proposed maintenance agreement period, nor have I ever met anyone who has benefited from a maintenance agreement. Still, being human, I feel anxiety every time I reject a proposed agreement. I always wonder if I am making the wrong decision. I feel the same when buying a stock.

In dollars committed to protection, the biggest decision consumers face is whether to acquire an extended warranty agreement on a new car. Such agreements necessarily favor dealers and manufacturers; the extended warranty would not be feasible were it not profitable. I avoid extended warranties for two reasons: to save the money and to earn interest on money saved. Also, I believe that my conservative driving style places minimal stress on automobiles, reducing the odds that major repairs will be required during the original and the extended warranty periods. This assumption of moderate wear and tear might not apply to a hard-driving, high-mileage owner.

Another form of consumer protection is the telephone line service agreement offered by local telephone companies. This agreement covers the expense of a visit by a telephone technician to repair telephone lines *inside your home* (Problems on lines outside the home usually are not the responsibility of the consumer.) The cost of this protection is approximately \$3.00 per month, a seemingly small amount. Over ten years, the cost is \$360 for one line, but we have five lines: home, business, computer, fax, and children. The line maintenance charge is \$1,800 over ten years. Compare this to the cost of a visit by a telephone line technician: about \$90. In over 30 years of home ownership, I never have required repair to telephone wires, or any other wires, inside my home. Still, \$3 per month appears to be a minor cost to reduce the fear that something might go wrong. We opted to save, and to fear.

Fear of loss motivates acquisition of all forms of insurance. Some fears are well-founded. Life insurance, health insurance, and property and casualty insurance on home and cars, are sound acquisitions. Death of an uninsured primary wage earner might economically devastate survivors. A liability claim for an automobile accident might wipe out years of savings and compromise retirement security. A major health problem, of course, always is a threat. These risks need to be insured against. On the other hand, insurance for minor risks, such as \$800 advanced for a trip, do not need to be insured, because such loss is not catastrophic. This insurance does not satisfy an economic need. Instead, it alleviates anxiety. Most of us are economically better served through fortitude than through expenditures to insure minor risks.

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*Good night Dorothy. You done good.*

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