

BANKNOTES

The Nelson Nash Institute Monthly Newsletter

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Insurance Companies & Bonds

By L. Carlos Lara

This LMR article was written in May 2013 and describes several relevant topics such as the Stock Market, Financial Institutions and more importantly, Bonds. While the average American does not actually understand how the Stock Market works, they know even less regarding the Bond markets and their importance in the United States. This narrative will explain and help you to understand all the necessary "Nuts and Bolts."

With the Dow Jones Industrial Average having hit an all-time high, mainstream news is tooting the party horn louder than ever. It's no wonder, this is the third strongest bull market since World War II. According to one source, the official numbers say that the amount of money being borrowed to purchase stock on the New York Stock Exchange hit a record high in April.¹ Average Americans, who know very little about investing, are finding all this good news too hard to resist and are once again getting back into the stock market. But in the face of truthful economic indicators, one has to wonder why?

"Everyone wants a piece of the action! Stockbrokers say clients are phoning in orders. Mutual-fund data show investors buying U.S. stock funds after fleeing them for years. But this time, there is a wild card: the Federal Reserve. The Fed has gone out of its way to boost the economy through massive injections of cheap money into financial markets. In many analysts' view, the Fed is the bull market's strongest pillar." —The Wall Street Journal² March 5, 2013

It's true. Huge profits will indeed be made, but the average middle-class American will not make them. Buying in at these elevated prices (prices are the main indicator of these record highs) is not only the worst time to purchase stocks, but it makes for the perfect set-up for these innocent investors to be left holding the bag when the markets turn downward. As we pointed out in our book, "How Privatized Banking Really Works,"³ this is a common phenomenon

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of the stock market. One of the main problems in all of this erroneous activity is the manner in which the stock market news is reported in the media. For example, we are told the Dow has hit 15,000, but rarely are we reminded that the Dow is just an average representing only 30 stocks. As one commentator put it, "*it's a bizarre indicator*"⁴ with obvious flaws and disconnects to the economy as a whole. Many important U.S. companies like Berkshire Hathaway, Google and Apple aren't even in the count. Nevertheless, these types of emotionally charged signals are frequently sent into the economy and tend to create a buying frenzy and inflate stock prices. The main culprit is really misinformation about the stock market itself and how it functions. Many mistakenly believe that rising stock prices indicates prosperity is ahead and that the stock market is the driving force behind corporations and American industry. Of course, nothing could be further from the truth. Most Americans don't feel this way about other products and services when they go up or down in price; why should stocks be any different?

The New York Stock Exchange, the NASDAQ, and several other stock exchanges in the United States are just that, *exchanges*. Their merchandise, if you will, is stock that has already been issued and sold. In other words, it's ***used stock***. "New" stock issues that corporations sell in return for money are not sold on these exchanges. Actual wealth, or capital, is transferred to a corporation at the time of the initial public offering of the stock, or IPO. This, however, is a one-time event. For all the daily trading these exchanges perform, they provide no capital whatsoever for American industry.

What we have to realize is that investors in the stock market are only buying and trading shares at these exchanges. Although they may be purchasing a return in dividends, their real motivation to buy a stock is for the opportunity to sell at a higher price than they paid. They love bull markets. While it is true that some professional traders have the ability to profit on prices going up or down and can exit

the market quickly, not everyone has this advantage, especially the average household. Furthermore, it is still *speculation*. No one can predict with accuracy each and every time.

After two major stock market crashes in 13 years, home prices remain at 26 percent below their level when the Dow last peaked, 14 million homeowners are underwater on their mortgages⁵, and only 5.5 million jobs have been recovered of the total 8.7 million lost since the 2008 recession. Many have discovered too late that speculation in the stock market can be an extremely risky endeavor, especially if one's entire life's savings are vested in it. For this reason, the stock market has been dominated for years by hedge funds and high-frequency institutional traders, not individuals. So how is it that individual households still wind up back in the stock market so easily and why is it that when things go bad, they are the ones who always get hurt the worst? The answer can be summed up in two words—"financial products."

Financial Institutions

Commercial banks, Wall Street investment firms and insurance companies are all *for profit* businesses that sell financial products in order to bring in large pools of money under management. Utilizing an army of government-licensed financial representatives, these institutions sell trillions of dollars in financial products. Depending on their licenses, these financial professionals can easily access products from any of these three sectors in order to assist individuals, businesses and institutions grow wealth by minimizing taxes, and providing a hedge against inflation. Substantial portions of these financial products are specially designed for retirement accounts or pension funds and tailored for individual households. Many of these financial products utilize mutual funds—a stock market product—consequently bringing the unsophisticated investor into the one arena they know very little about. Therefore, the consumer's confidence in the safety and reliability of these financial products rests almost exclusively on the financial strength of the

financial institution and the advice of their financial representative. For this reason, the financial services industry is one of the most federally regulated industries in the United States.

Working in tandem with government laws and major employers, financial institutions have designed some of these financial products with built-in tax credits, tax deferrals, or tax-free elements. The hedges against inflation are usually achieved with strategies designed for achieving higher rates of return, but they also come with higher market risks. Of course, all these services come with a cost. Naturally, one of the key competitive selling features of most financial products is a high rate of return with the least amount of risk at the lowest possible cost. All to say that rates of return are the number one buying incentive for most financial products and investments.

What do financial institutions do with all this money under management? Simply put, they use it to make a profit. Financial institutions, depending on what sector of the economy they represent, will either lend this money to others or in turn invest it in the broader financial markets. This will include investments, not only in the stock market, but real estate and bond markets as well. In this way they grow their own coffers and add to their financial strength. As you can see, this is a huge industry in which money, the lifeblood of the economy, flows in and out of giant money pools as well as our own small reservoirs.

Bonds: The Rest of the Story

This may come as a surprise, but the stock market in all of its vastness and complexity pales in comparison to the size and breadth of the *bond market*.⁶ The average investor does not always know this because investment professionals, and especially the media, are constantly talking about the stock market. This is because the stock market is a much more glamorous and engaging topic at the office water cooler, the gym or the golf course. Looking for the next hot stock makes for exciting conversations. However, more recently and in light of the recession,

bonds have been taking more of the center stage, but not necessarily in favorable light. The news media now commonly talks about bonds being downgraded and there is even growing fear of their imminent collapse. What is even more disturbing for small investors is that it has become more apparent that financial institutions invest heavily in bonds. But not just financial institutions, apparently so do other countries, with China holding the largest share. In light of this growing pessimism, I want to devote the remainder of this article to this particular investment vehicle and hopefully bring the bond market into perspective, not only for the benefit of the IBC Practitioner, but also for their clients who may be reading this as well.

Let's keep in mind that the licensed financial professional who is also an Authorized IBC Practitioner (the type listed on the Nelson Nash Institute's website) is already presenting clients with concepts that are in direct opposition to the general investment vernacular spoken by the financial services industry. For one thing, he or she is talking about a methodology that is ideally suited for the crisis environment we all find ourselves in today. "*Privatized Banking*," as the Practitioner often will call this concept, has nothing to do with investments, nor rates of interest. This information by itself is astonishing and difficult for anyone to grasp. Furthermore, they are referencing not so much a financial product, but rather a cash flow system utilizing the framework of the oldest government-approved financial product on the market and the infrastructure of one of the oldest institutions in the world. It is not a commercial bank product, nor a Wall Street investment product. It is an insurance product. However, the critical difference is that the IBC Practitioner is teaching clients how to use this particular sector and this particular product (dividend-paying whole life insurance) as a financing system for most of life's major purchases. Hence, R. Nelson Nash referred to it as *The Infinite Banking Concept®*, or IBC, and he is credited with having brought this ingenious idea to the general public. More importantly, the idea actually works exactly

as he describes it! Insurance companies many times don't even fully understand why or how their financial product is being used under this concept. They only see the sale of their product increasing without their direct impetus and simply continue to be the contractual administrators of the collected funds provided all the statutory laws in the contract remain in place. They are happy to receive the business.

However, any thoughtful person who has seriously looked into IBC eventually has to consider the investment portfolios of the insurance companies. Upon seeing that they, like all other financial institutions, invest heavily in bonds, one may conclude that they have finally discovered the Achilles Heel of the concept. "After all, aren't bonds risky?"

It cannot be denied that insurance companies do invest heavily in bonds, and it's also true that no one can withstand a *Force Majeure*, or "red status" national emergency. If such an event like that should happen, still— so long as we continue to be governed by contract law and have a thriving fiat money economy, it makes sense to first analyze the types of bonds insurance companies invest in before we pass full judgment. The problem we want to avoid is lumping all bonds together as being all one and the same. This quick analysis should give us the proper perspective we are looking for.

Types of Bonds

Before going any further, it is important to make clear that when practicing IBC, you as a policy owner are not directly investing in bonds, only the insurance company is doing that. Your policy and its guarantees are based solely on the financial strength of the insurance company so you should always conduct business with insurance companies that have impeccable credit ratings.

The Securities industry classifies the bond market into five specific bond markets.

**Government & Agency
Mortgage Backed (MBS)
Collateralized Debt Obligation (CDO)
Municipal
Corporate**

Bonds, unlike stocks, are instruments of indebtedness. The bond is a form of loan or IOU. The holder of the bond is the creditor; the issuer of the bond is the borrower. Bonds provide the borrower external funds (capital) to finance long-term projects. They pay the creditor interest and repay the principal at maturity. In our present discussion, the life insurance companies are major moneylenders.

Using this short bond definition, we can now go through our list of bond types and classify each. We should note that bonds are considered long-term investments and are interest rate sensitive. They are generally associated with fixed-income instruments and due to the fact that the Federal Reserve is deliberately keeping interest rates low, bonds are currently paying very low interest rates.

Government Bonds (or Agency Bonds), also known as U.S. Treasuries, are the bonds issued by the Treasury Department to finance current government expenditures. When we hear that Congress cannot balance the nation's budget, they borrow money to meet their expenditures by issuing this type of bond. When insurance companies buy these bonds, they are lending money to the government.

Mortgage Backed Bonds and Collateralized Debt Obligations are the type of bonds that are most associated with the 2008 financial crisis since they were principally tied to home mortgages and spun out of control when the housing market collapsed. Today, the largest portion of these now toxic assets is being held on the balance sheet of the Federal Reserve.

Municipal Bonds are bonds issued principally by

states or local governments including cities, counties, school districts, public utility districts, airports and other government entities. Many of these bonds are secured by property tax within the issuer's boundaries. They have been hit especially hard during the recession because of the large number of home foreclosures and general unemployment. Municipal bonds are generally exempt from both state and federal income taxes.

Corporate Bonds are bonds issued by a corporation to raise money to expand its business. Rather than issuing shares of stock as in an IPO, corporations can alternatively issue bonds to effectively raise money with call options that allow the issuer to redeem the debt before its maturity. Brand new entrepreneurial businesses regularly issue corporate bonds in order to raise capital as do well-established companies. Compared to government bonds, which are backed by the Federal Reserve and are not invested directly in American industry, corporate bonds are associated with a higher risk factor; consequently, they pay the creditor a higher rate of interest. Corporate bonds have a broad range of risk, ranging from investment grade to junk quality.

The most recent analysis of insurance industry portfolio asset mixes reports that the life insurance companies, as opposed to property/casualty companies, have lengthier long-term liabilities, therefore, they will invest more heavily in longer-term assets, such as bonds with 30-year maturities. As of July 2011, life insurance analysis reports show that *"Corporate bonds (43%-48%) are, consistently and by far, the largest asset type regardless of company size. And, bonds, in aggregate (that is, corporate, structured securities and U.S. government bonds), represent at least 80% of invested assets across all life company sizes."*

Life Insurance Company Investment Portfolio Mix

Corporate Bonds: 43.6%
Structured Securities: 18.5% (includes
Mortgaged Backed Securities)

U.S. Government Bonds: 18.7%
Hybrid Securities: 1.4%
Preferred Stock: 0.2%
Common Stock: 0.9%
Commercial Mortgage Loans: 8.5%
Mezzanine Loans: 0.1%
Real Estate: 0.4%
Schedule BA: 2.1% (includes private equity and hedge funds)
Affiliated: 5.6%

Total Bonds: 80.8% (Corporate, Structured Securities and U.S. Government bonds) Guided by current market indicators, the insurance companies, seeing that the economy has not recovered, continue to move the direction of their investments to safer, less-volatile and shorter durations—a *flight to quality*. Corporate bond exposure is predominantly investment grade credit risk and relatively liquid.

The mix of bond types varies between the different insurance company types. For example, municipal bonds are the largest bond type at 38.7% of total of property/casualty insurance carriers, while the life companies carry only 4.8% of municipal bonds. Life companies, on the other hand, carried as much as 10.9% of mortgage-backed securities, versus the property/casualty carriers at 4.5%.

Different individuals have different worries about our economic future, and the vulnerability of the life insurance industry depends on the specific dangers that unfold. However, keep in mind that in finance, everything is relative. Even in a scenario where the life companies take a beating, it's possible that other sectors—even the ones touted by the gurus—do worse. For example, if the U.S. economy performs so badly that major corporations default on their bonds—thus hurting the life insurers—someone invested in a 401(k) concentrated on U.S. equities will probably take a bigger hit to their portfolio, because stocks are a residual claim, after the bondholders have been paid. If instead the worry is a rapid amount of price inflation (but without a collapse of the economy), even here it's not obvious

that being “in the market” is the right move. The stock market did not perform well even in nominal terms (let alone inflation-adjusted terms) during the 1970s, and whole life policyholders are always free to take out policy loans to buy gold or other hedges if they feel the price breakout is imminent.

Conclusion

If you study the figures published by the National Association of Insurance Commissioners as far back to the 2008 crisis, what we find is that, in spite of changing market conditions, the life insurance companies have consistently adopted bonds as the preferred investment type. Corporate bonds have been the preferred bond type. Life insurance companies like bonds in general because they like matching assets to liabilities, which in itself is a very prudent strategy. The liquidity risk offered and lack of volatility found, especially in investment-grade corporate bonds, make them the bond of choice. Given the nature of the liabilities they are trying to match, which represent enormous reserves, life company asset managers tend to follow a buy and hold philosophy that has been the traditional custom for up to 200 years.

To be sure, there are possible scenarios in which the life insurance companies will suffer greatly, but shunning life insurance because of such threats only makes sense if the proposed alternative would do better in the exact same scenarios. IBC is not a gimmick or a magic bullet, but it is a surprisingly resilient approach to our volatile financial environment.

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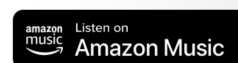
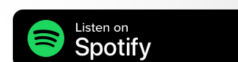
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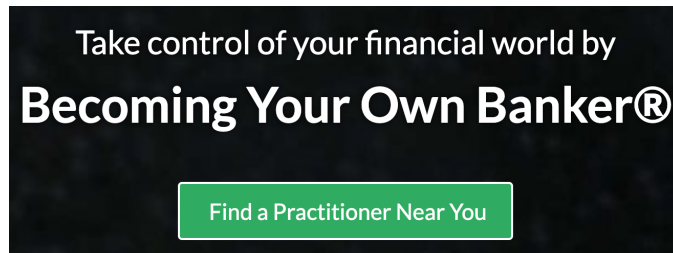
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IBC Practitioners have completed the *IBC Practitioner's Program* and have passed the program exam to ensure that they possess a solid foundation in the theory and implementation of IBC, as well as an understanding of Austrian economics and its unique insights into our monetary and banking institutions. The *IBC Practitioner* has a broad base of knowledge to ensure a minimal level of competency in all of the areas

a financial professional needs, in order to adequately discuss IBC with his or her clients.

Before you look for a practitioner, we suggest listening to the following two episodes of *The Lara Murphy Report*:

- [How-To Guide for Starting IBC, Part 1](#) How to begin your study of Infinite Banking, including finding an Authorized Practitioner.
- [How-To Guide for Starting IBC, Part 2](#) How to prepare for your first meeting with an Infinite Banking Authorized Practitioner.

The financial professionals listed below joined or renewed their membership as part of the *Authorized Infinite Banking Concepts Practitioners* team in July.

MEMBERSHIP RENEWALS

- | | |
|---|---|
| • Dane Abrigana, Granite Bay, California | • Brian Heyer, Greenville, Wisconsin |
| • Alden Armstrong, Colorado Springs, Colorado | • Mary Chow Ivanovic, Toronto, Ontario |
| • Chris Bay, Lawrence, Kansas | • Nolan Johnsrud, Pilot Point, Texas |
| • Mark Benson, Crystal City, Missouri | • Brent Kesler, Port Orange, Florida |
| • Timothy Bogert, Rochester, Michigan | • Erica Neal, Hurst, Texas |
| • Jeremiah Dew, Greenville, South Carolina | • Pedro A. Palicio, Coral Gables (Miami), Florida |
| • Kyle Fera, Fayetteville, North Carolina | • Anthony Pascale, Montreal, Quebec |
| • Sandra Fry, Odessa, Texas | • Adrienne Patel, Burlingame, California |
| • Paul Fugere, West Springfield, Virginia | • Frank Riedel, Raleigh, North Carolina |
| • JinJin Fung, Vancouver, British Columbia | • Robert Schilly, Crystal City, Missouri |
| • Angel Gonzalez, Miami, Florida | • Jed Vito, Edmonton, Alberta |
| • Scott Guldin, Irwin, Pennsylvania | • Jon Webster, Phoenix, Arizona |
| • William Hassler, Ocala, Florida | |

NEW MEMBERS

- Eduardo Melhado, Brossard, Quebec



THE FOUNDATIONS OF IBC

The Foundations of IBC is an online **video series** for the general public that provides a comprehensive introduction to the *Infinite Banking Concept*.

The first four modules are free, you can view them here: infinitebanking.org/foundations

The remaining eight modules are subscription-based, costing \$49.95 for all eight.

Or contact an Authorized IBC Practitioner and ask for a coupon code that will enable you to watch all twelve modules FREE.

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Module 3, Part 3: How to Read a Policy Illustration

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