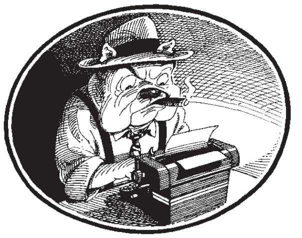

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State Farm Wants to Sell Mutual Funds

Beware of Your 'Good Neighbor'

To a New Yorker, or to any urban dweller, Bloomington, Illinois, is nowheresville. It's at the intersection of Interstates 55 and 74 in the middle of endless cornfields somewhere between Chicago and St. Louis.

From our New York viewpoint, Bloomington, and its sister city Normal, represent many of the most loathsome qualities of America: chain restaurants, fast-food joints, interstate highways, gas stations, exurbia, banal architecture, and the lack of anything to do.

As a matter of fact, there's only one reason we'd go to Bloomington, and that's to visit State Farm, arguably the greatest insurance company in America.

It's easy for many in the insurance industry to dismiss State Farm, despite its size. The company appears bland, stodgy, and somewhat corny. Also, it's a mutual, so one cannot revel in its stock's gyrations on Nasdaq or the NYSE.

Nonetheless, State Farm, which, in 79 years has grown from nothing to $43 billion in surplus—without the infusion of any outside capital—is a force to be reckoned with. It's a giant powerhouse that makes its presence felt, albeit in a rather low-key way. It doesn't make flashy moves and bold pronouncements; it isn't given to glitz or bigshot promotional gimmicks. At its core, it's a quiet Midwesterner.

Indeed, State Farm may be so "out" that it's now "in." In Berkshire Hathaway's recently released annual report, Warren Buffett discussed State Farm in his section about GEICO (which is owned by Berkshire):

> ...Finally, the competitive picture changed in at least one important respect: State Farm—by far the largest personal auto insurer, with about 19% of the market—has been very slow to raise prices. Its costs, however, are clearly increasing right along with those of the rest of the industry. Consequently, State Farm had an underwriting loss last year from auto insurance (including rebates to policyholders) of 18% of premiums, compared to 4% at GEICO. Our loss produced a float cost for us of 6.1%, an unsatisfactory result. (Indeed, at GEICO we expect float, over time, to be free.) But we estimate that State Farm's float cost in 2000 was about 23%. The willingness of the largest player in the industry to tolerate such a cost makes the economics difficult for other participants. [Editor's note: State Farm tolerates the cost because it is a mutual; it's in business to do well for policyholders, not to make money for shareholders.]
>
> That does not take away from the fact that State Farm is one of America's greatest business stories. I've urged that the company be studied at business schools because it has achieved fabulous success while following a path that in many ways defies the dogma of those institutions. Studying counter-evidence is a highly useful activity, though not one always greeted with enthusiasm at citadels of learning.
>
> State Farm was launched in 1922, by a 45-year-old, semi-retired Illinois farmer, to compete with long-established insurers—haughty institutions in New York, Philadelphia and Hartford—that possessed overwhelming advantages in capital, reputation, and distribution. Because State Farm is a mutual company, its board members and managers could not be owners, and it had no access to capital markets during its years of fast growth. Similarly, the business never had the stock options or lavish salaries that many people think vital if an American enterprise is to attract able managers and thrive.
>
> In the end, however, State Farm eclipsed all its competitors. In fact, by 1999 the company had amassed a tangible net worth exceeding that of all but four American businesses. If you want to read how this happened, get a copy of *The Farmer from Merna*.
>
> Despite State Farm's strengths, however, GEICO has much the better business model, one that embodies significantly lower operating costs. And, when a company is selling a product with commodity-like economic characteristics, being the low-cost producer is all-important. This enduring competitive advantage of GEICO—one it possessed in 1951 when, as a 20-year-old student, I first became enamored with its stock—is the reason that over time it will inevitably increase its market share significantly while simultaneously achieving excellent profits. Our growth will be slow, however, if State Farm elects to continue bearing the underwriting losses that it is now suffering.

We share Buffett's high opinion of State Farm, and actually beat him to the punch in expressing it in writing. Back in 1994 we published an article entitled *The Banality of Greatness: State Farm is There*, in which we made the case for State Farm. Since then, State Farm's policyholders' surplus has more than doubled, although earned premiums and the number of policyholders

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have increased only modestly. As for *The Farmer from Merna*, this 1955 book is not one of the best about the insurance business, and only hardcore insurance historians will be able to finish it. If you want a much shorter history, order the August 1994 issue of *Schiff's Insurance Observer*, which contains our piece on State Farm. (Better yet, purchase "The Complete *Schiff's Insurance Observer*"—everything we've ever published—for only $145.)

Among State Farm's great strengths are its simplicity, and adherence to long-term principles. It doesn't shift its strategy with the winds, embracing every new management theory or financial trend. It was founded on the premise that farmers—who live in rural areas—shouldn't pay as much for their auto insurance as people who live in the big city. State Farm has long had a cost advantage over most agency companies, and it has historically resisted any urge to enter new and unusual businesses. Instead, it has plugged away at what it does best, with excellent results.

Unlike some mutuals, State Farm is *really* run like a mutual. It respects mutuality and views its policyholders as *owners*—a word that many mutuals have grown loath to use in recent years.

In 1994, we sat down with Vincent Trosino (then State Farm's COO, now vice-chairman and president), who explained that State Farm had no plans to enter the financial-services business. "Our business in not the investment business," he said with conviction.

There's nothing wrong with changing one's mind, and State Farm has done so. Through State Farm Federal Savings Bank, the company offers online checking and savings accounts, money market funds, CDs, mortgages, car loans, and other forms of credit.

On March 15, State Farm announced it was offering a family of ten State Farm mutual funds available through its agents. The funds are prosaic: three managed equity funds, three index funds, one balanced fund, two bond funds, and a money-market fund.

Although State Farm has distinguished itself over the years by delivering value (a combination of price and service) to its insureds, its mutual funds appear to be mediocre at best. The annual operating costs for its S&P 500 Index Fund, for example, are 0.80% of assets. (This cost is borne by investors in the fund.) In addi-

State Farm: A Good Idea Catches On

Since 1993, State Farm's policyholders' surplus has more than doubled (a testament to the company's excellent investment results), while the number of auto policies has grown 4.6%, and earned auto premiums have grown 14.4%.

	Auto Premiums Earned	Policyholders' Surplus	No. of auto policies
1922	$ 12,768	$ 7,758	1,339
1927	685,922	223,153	
1932	5,795,110	1,233,385	335,952
1937	10,448,251	3,377,955	
1942	24,033,121	8,994,982	840,149
1947	69,951,025	15,978,049	
1952	128,477,169	70,342,659	2,447,380
1957	314,493,729	117,636,494	
1962	544,080,101	274,418,045	7,517,769
1967	1,054,339,745	383,634,938	
1972	2,007,403,168	1,100,847,940	13,548,047
1977	3,825,941,534	2,652,819,153	
1982	6,648,542,012	6,820,838,365	23,456,475
1987	13,053,522,194	13,985,982,488	
1993	21,924,001,917	21,269,733,369	36,252,796
2000	**25,088,959,954**	**43,722,526,498**	**37,907,305**

tion, there's a 3% initial sales charge. Contrast this with Vanguard's index fund, which has annual expenses of 0.18% and imposes no sales charge.

We question whether, in the long run, it's a wise move for a company to sell mediocre products in a way in which it has no particular advantage. State Farm's distribution channel for mutual funds—its agents—isn't a low-cost one (it's not the highest-cost one, either). Nonetheless, State Farm's mutual funds are the sort of mundane, overpriced thing we'd steer clear of.

State Farm's website (statefarm.com) includes a welcome message from Susan D. Waring, vice president, State Farm Mutual Funds, in which she says: "For us, it's all about relationships. We believe that people want to talk to someone about their financial goals and how to achieve them. It's hard to be knowledgeable and current on everything relating to financial products, and that's why we have licensed agents, investor services, telephone representatives, and sites like this to provide you with information. Our goal is to help you make informed decisions and provide solutions for all of your investment needs."

State Farm's agents are unlikely to be especially knowledgeable about investments. (For that matter, most stockbrokers aren't particularly knowledgeable about investments, either.) They may be able to do a little hand holding and make some non-lethal suggestions, but we think that the average State Farm customer would be better off dealing with Vanguard, instead. Unlike State Farm Mutual Automobile Insurance Company, which is owned by its policyholders, State Farm's mutual-fund business is a "stock company" organization. Contrast that with Vanguard, which is essentially a "mutual" organization.

State Farm has 17,000 agents, many of whom are registered to sell securities. We have no doubt that a good number of them will be successful at selling State Farm's mutual funds, and that, over time, State Farm will accumulate a reasonable amount of assets.

Our advice to State Farm agents, however, is this: Be a good neighbor. Tell people to buy their index fund from Vanguard rather than from State Farm. ■