

Commercial Insurance Update

Topics Affecting Buyers of Commercial Insurance

MSP C 10/2008 – “State of the Insurance Market Report for 2009”

October, 2008

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State of the Insurance Market Report for 2009

By Jeffrey W. Cavnac, CPCU, ARM, RPLU, CRIS

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In the fourth quarter, most of our clients are working on their annual budgets for the following year. The purpose of this article is to provide information about the insurance industry from a historical perspective, and provide some educated guesses as to what our clients and prospective clients might expect in 2009.

Currently, the United States is suffering through what some say is the most challenging economy since the Great Depression. Major financial institutions that many thought were “bullet-proof” have gone out of business, been sold, or gone into partnership with the government.

Who would ever have thought, for example, that AIG would need nearly \$125 billion from the government to stay in business? (See The AIG Report on page 3.) At the same time, the insurance industry is well into a “soft” market cycle, and is starting to feel the effects of substantially reduced pricing.

Deteriorating underwriting results and lower investment returns are beginning to take their toll.

So what kind of shape is the insurance industry in? In order to understand what might happen in 2009, it helps to understand a little bit about the insurance business.

Insurance Cycles – Where We Are Now

Like many industries, the insurance industry is cyclical. However, the insurance cycle generally runs independently of other business cycles. If you’ve read newsletters from previous years, you may be familiar with the economics of the insurance industry. Regardless, it’s helpful to review here. I’ll be referring

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Table 1. Industry Financials (in billions)

U.S. Property/Casualty Insurance Industry Year-End Results (\$Billions)

Description	2002	2003	2004	2005	2006	Est. 2007	Est. 2008
Net Written Premium	\$369.1	\$403.8	\$421.1	\$425.9	\$443.8	\$443.6	\$439.7
Combined Ratio	107.3	100.1	98.3	100.8	92.3	93.8	98.6
Investment Income	\$39.0	\$39.3	\$40.0	\$49.8	\$52.4	\$54.5	\$56.5
Pre-Tax Operating Income	\$7.7	\$34.6	\$44.2	\$45.5	\$85.0	\$81.0	\$63.0
Policyholders Surplus	\$287.2	\$348.6	\$393.1	\$427.9	\$488.8	\$531.2	\$553.4
Return on Equity	2.5%	8.6%	8.8%	9.5%	13.9%	12.1%	8.7%

— Source: Marsh Berry 2008

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to Table 1 to give you an idea of where the insurance industry is in the underwriting cycle.

Insurance companies make money in one of two ways:

- Underwriting profits
- Investment income

An **underwriting profit** is achieved when losses plus all expenses are less than premiums. When you divide the former by the latter, you come up with what is called the **combined ratio**. A combined ratio of less than 100% means there is an underwriting profit, and a combined ratio of more than 100% means there is an underwriting loss.

The industry has generated an underwriting profit in three of the last four years. It remains to be seen if 2008 will generate an underwriting profit. Note that this period of profitability followed substantial underwriting losses in 2002 (107.3%) and 2001 (115.6%). The underwriting profit in 2006 was the best the industry had posted since the 1940s.

Insurance companies collect premiums and set aside reserves to pay future claims. This represents an insurance company's **policyholder surplus**. The insurance industry generates **investment income** from the policyholders surplus. During periods of substantial investment returns, insurance companies may be willing to underwrite at a loss because they can make up the deficit on the investment side.

Surplus is critical to understanding the economics of the insurance industry. As mentioned earlier, surplus is set aside to pay future claims, and also determines how much premium an insurance company can safely write. If the ratio of premium to surplus gets too high, the insurance company's credit rating (as quantified by

the A. M Best Company and other rating agencies) could ultimately impair the insurance company's ability to operate.

It is important to understand that the insurance industry is supply-driven. While demand for insurance remains relatively constant, supply fluctuates up and down. If surplus or supply goes down, rates tend to go up. Similarly, if surplus goes up, rates tend to go down. The industry's surplus has increased approximately 85% since 2002. This has caused insurance pricing to go down, and in some cases, to go down dramatically.

Finally, it is important to realize that the insurance industry competes with every other industry for capital. In order to attract investment dollars, the insurance industry has to demonstrate an acceptable return on equity. Most investors seek approximately 15%. Historically, the insurance industry has underperformed this objective; however, results have improved dramatically in recent years. 2006 was one of the industry's best years ever, generating a return on equity of approximately 13.9%.

The industry's operating results, however, have begun to deteriorate. If you look at Table 1, you'll note that net written premiums actually decreased in 2007, and are supposed to decrease further in 2008. This rarely happens in the insurance business.

At the same time, combined ratios are climbing. Although 2007 should be a positive year, 2008 may or may not generate an underwriting profit. Preliminary indications put the overall combined ratio for the first half of 2008 at 102.1%. This is a result of continued soft pricing, challenging market conditions, unusually high catastrophic losses, and significant underwriting losses. Policyholders surplus also declined in the first six months of 2008. Recognize that these results were

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posted prior to the AIG debacle, the impact of which remains to be seen.

Pre-tax operating income has also declined. Net income after taxes for the first six months of 2008 fell more than 50% from what was reported in 2007. This is attributable to the deteriorating underwriting results as well as declining investment returns.

Finally, return on equity, after peaking in 2006 at 13.9%, dropped to 12.1% in 2007, and is estimated to drop to 8.7% in 2008.

What Effect Will This Have on Rates?

For the last five years, rates have decreased significantly on almost all lines of coverage, with the exception of coastal properties on the Gulf Coast and in Florida as well as other catastrophic-type lines of coverage, such as earthquake.

MarketScout.com is an electronic insurance exchange that measures the average change in rates for the property and casualty insurance industry in the United States. Although this is merely an average across the entire country for all lines of coverage, it is still a good barometer of the insurance market. Table 2 shows average rate changes in September for each of the last five years.

Workers compensation rates are a major factor in the recent rate decreases. In California, for example, comp rates peaked in the second half of 2003. The average rate per \$100 of payroll was \$6.46. Rates hit bottom in the second six months of 2007, dropping nearly 62%. Rates flattened out during the first six months of 2008, and will probably increase in 2009.

What Can You Expect in 2009?

In general, the insurance industry remains in good shape. The industry is profitable and surplus is near all-time highs.

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Table 2
Average Commercial Rate Changes

Month / Year	Amount of Change
September 2004	+ 4%
September 2005	- 5%
September 2006	- 8%
September 2007	- 15%
September 2008	- 10%

— Source: Market Scout

The AIG Report

Much has been written about American International Group (AIG) and the Federal Reserve decision to lend it up to \$85 billion. Subsequently, another \$39 billion was made available.

AIG is the largest U.S. underwriter of commercial and industrial insurance. It is also involved in life insurance and retirement services, financial services, and asset management. It has over 116,000 employees, and operates in 130 countries throughout the world. Its assets are in excess of \$1 trillion.

AIG has historically held an A+ rating from A. M. Best, and until recently its financial stability was unquestioned.

How Did AIG Get into Trouble?

AIG sold credit default swaps for mortgage-backed securities which are pools of mortgages. Credit default swaps are contracts similar to insurance that provide protection against default by third parties.

As mortgage defaults rose, AIG's losses mounted, and have been estimated at \$25 billion. The potential for more losses led to downgrades in its credit rating, and forced AIG to increase the collateral it put up to pay investors' claims on swaps it sold.

AIG now must sell assets to pay back the government loan. The company has yet to indicate what assets it might sell, but certainly its profitable insurance operations have to be considered.

What about AIG's Commercial Insurance Operations?

It is important to note that AIG's commercial insurance subsidiaries are separate from its parent company. Collectively, these subsidiaries, which include Lexington, National Union and American Home insurance companies, continue to be well-capitalized with statutory surplus of \$26.7 billion. AIG has ample resources to pay policyholder claims, and continues to be rated "A" by A. M. Best.

Knowing what we know at this time, AIG remains a viable company for commercial insurance. In our opinion, it will remain a viable company as long as it retains its "A" rating. However, if its rating were to be downgraded, it could create some capacity problems in the insurance industry. ❄

— Jeffrey W. Cavnac, CPCU, ARM, RPLU, CRIS
President, Cavnac & Associates

The trends, however, are not positive. The ultimate impact of what will happen with AIG remains to be seen. If for some reason AIG were to lose its "A" Best's rating, billions of dollars of business would be out on the open market, and this alone could dramatically change the insurance marketplace.

Because of this and other factors, Standard & Poor's Ratings Services revised its outlook on the U.S. commercial lines property & casualty insurance sector to negative from stable. S&P was concerned over two issues: (1) the ongoing decline in pricing for commercial lines and (2) decreases in investment income.

Fitch Ratings feels the same way. It believes that the market has crossed a tipping point in the underwriting cycle... knowing that industry returns on capital for current accident year business has slipped to inadequate levels. Fitch anticipates that the marketplace will deteriorate further.

2009 should still be a positive year for insurance buyers. Although the industry is trending down, strong market capacity and competitive factors are still decreasing pricing in many areas. Following is a line by line analysis of what we feel you can expect in 2009.

The Admitted Market

The admitted or standard market is generally comprised of those companies that are writing mainstream or preferred business. The standard market remains competitive, and in general preferred risks are seeing premium decreases of 5% to 10% and in some cases more.

Property

Property insurance costs have dropped dramatically over the past several years. Preferred property risks may continue to see decreases in 2009. Regardless, the recent hurricane activity will impact the property insurance market, especially those properties subject to wind-driven damage. Depending on the desirability of the property risk and previous year rate decreases, we are expecting flat to 10% rate decreases in 2009.

Casualty

Casualty, which includes such things as general liability, automobile liability, and excess liability, has seen rate decreases consistently since 2004. While these rate decreases have been declining for the right account, there may be further discounts in 2009. Once again, this will depend on the individual risk, its loss history, and price decreases in previous years. As the insurance market has improved and competition has

"Admitted" versus "Non-Admitted" Insurance Companies

Insurance companies can generally operate in one of two ways: on either an "admitted" or a "non-admitted" basis.

An admitted carrier must comply with strict financial requirements of the state it is admitted in, and also be subject to participation in the state's insolvency guarantee fund and residual market mechanisms. It must also follow the state's form and rate filing requirements.

Non-admitted or "Excess and Surplus Lines" (E&S) insurance companies have elected to operate on a non-admitted basis to avoid some of the state requirements. However, just because they are non-admitted does not mean that they are non-regulated.

In California, for example, to operate on a non-admitted basis, a carrier must be on the List of Eligible Surplus Lines Insurers (LESLI). Insurance companies choose to operate on a non-admitted basis for several reasons, one of which is the ability to use the rates and forms they feel they need without obtaining state approval.

Historically, the non-admitted marketplace has taken on tougher risks that the admitted markets have not been willing to entertain.

Despite the standard markets' expanding appetite, there are still several areas that they will not approach. These include overly risky exposures such as window washers and tough products liability risks, as well as anything to do with the residential construction marketplace (or what's left of it). ✂

heated up, many of the standard carriers have also expanded their appetite into areas which have traditionally been underwritten by excess and surplus lines carriers.

Developers and Contractors General Liability

The construction industry can be divided into residential construction and everything else.

In general, rates for the construction industry have declined just as they have for the balance of the market. It appears, however, that these rates have hit bottom,

and we do not anticipate further rate decreases for construction-related risks in 2009.

Underwriting for this class of business has not changed significantly either. Most construction-related policies still have significant exclusions in addition to the standard exclusions found in the ISO Commercial General Liability Policy Form. Almost every policy excludes multi-family housing, and it is not uncommon to see exclusions for prior work or damage, subsidence, mold, silica, restricted contractual liability coverage, electromagnetic fields, and a variety of coverage restrictions for construction defects such as exterior installation and finish systems (EIFS). The list of exclusions goes on and on. It is imperative that you review the policy form on any coverage that you consider purchasing.

Professional Liability

Rates have trended down significantly for architects, engineers, accountants, attorneys, and other professionals over the last five years. We have now reached a point where underwriters are trying to retain their existing rates. In some cases they are trying to charge more, often, however, with little success.

Despite the soft market, these programs are carefully underwritten. It is imperative that your annual application for coverage accurately reflects the attributes of your firm, and most importantly, the

positive attributes or the steps you take to effectively manage your risk.

Workers Compensation

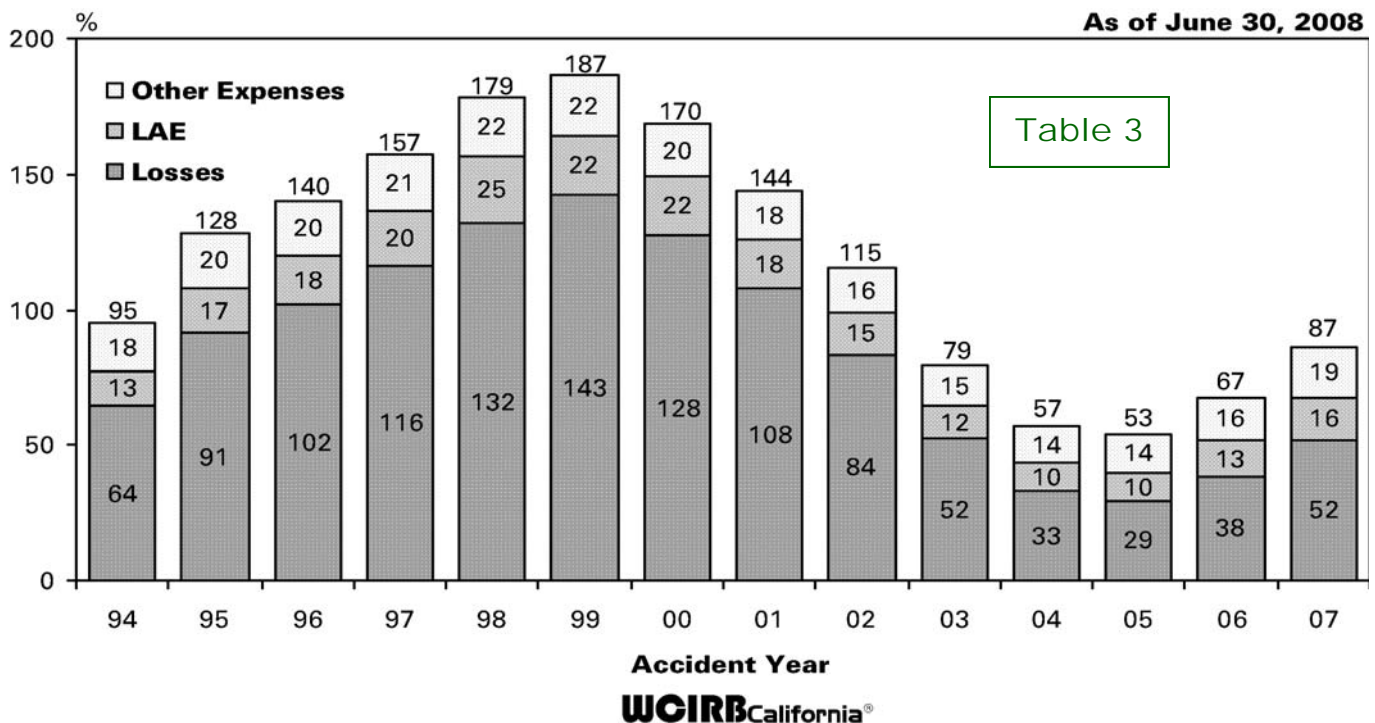
Every six months the Workers Compensation Insurance Rating Bureau (WCIRB aka “the Bureau) of California publishes and recommends loss costs for each workers compensation classification. Since 2004, each recommendation has been for a rate decrease. Collectively, these rate decreases have totaled over 60%. The Insurance Commissioner has an opportunity to review these “pure premium” rates and come up with his or her own rate recommendations.

Regardless of what the Bureau or the Commissioner decides, these rates are advisory. Insurance companies have the option of choosing whatever rate they want. Although most companies do not exactly follow the Bureau’s recommendations, overall the market tracks pretty closely with them. For many years, the industry was horribly unprofitable. From 1995 through 2002, the best combined ratio they could produce was 115% (for every dollar the industry took in, it spent \$1.15). In 1999, the combined ratio was actually 187% (see Table 3).

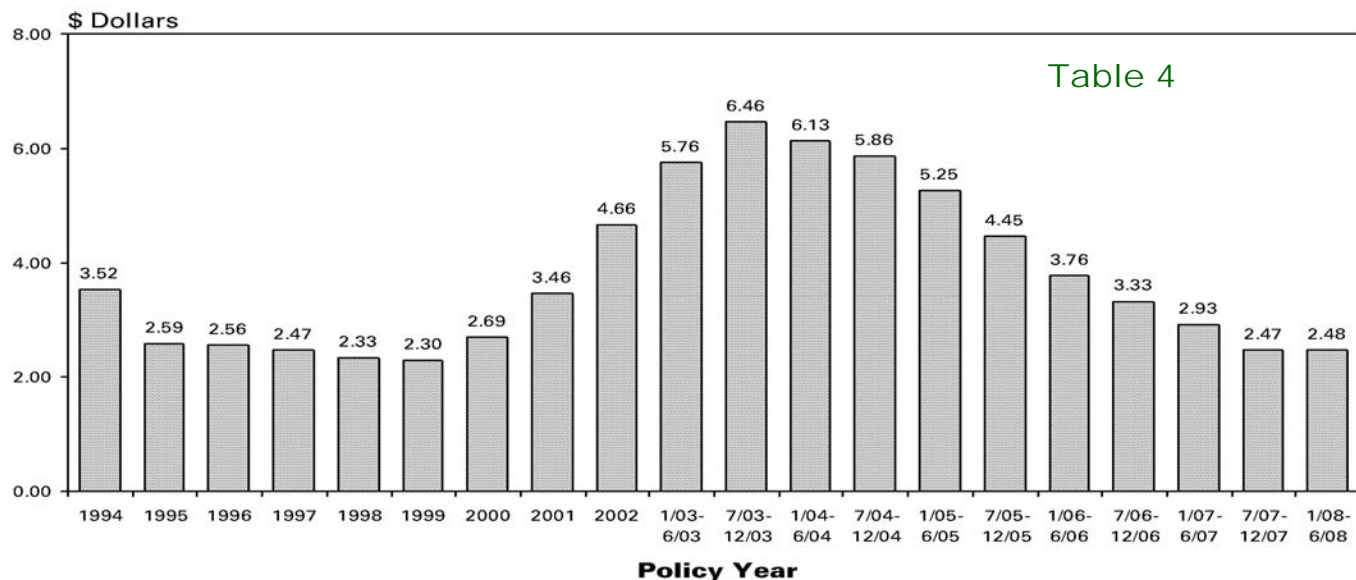
Since 2003 the industry has been very profitable, generating significant underwriting returns in each of the last five years. However, the industry has now reached the point at which underwriting profits might turn into underwriting losses.

California Workers Compensation

Accident Year Combined Loss and Expense Ratios



Average Insurer Rate per \$100 of Payroll



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Because of increased medical costs, among other factors, for the first time in five years the Bureau recommended a rate increase of 16%. Subsequently, the Insurance Commissioner recommended a smaller increase of 5%.

Whether or not an insurance company tracks with these recommendations, it should be pointed out that in California since 2003 (see Table 4), rates have decreased by over 60%. Adding 16% on top of this rate decrease still generates a net rate decrease of over 55%.

While not every insurance company will adopt the large rate increase the Bureau recommends, or the modest increase suggested by the Commissioner, it is almost certain that workers compensation rates in California will go up. Recognize, however, that net rates (the rate you pay after application of all credits and debits) are affected by a number of other factors, including your Experience Modification, and credits or debits the insurance company may apply.

Recognize as well that the average rate increase (and/or decrease) is not spread equally among all classifications. Rates vary depending on the experience of each individual classification. Assuming all other things remain equal, however, it is anticipated that workers compensation rates in California will be +5% to +20% in 2009.

Summary

Insurance costs are only one element in your “Total Cost of Risk.” The total cost of risk is what an

organization pays to identify risk, figure out ways to manage that risk, as well as the cost to transfer the risk (usually to an insurance company). In the long run, the only way to lower your total cost of risk is to lower the underlying losses that drive those costs.

I mention this only because whether or not we are in a hard or a soft market cycle, a well-run company will continue to look for ways to effectively lower the frequency and severity of their loss exposures. When rates are decreasing, it’s easy to lose focus on your risk management efforts. However, this is not the time to stop investing in risk control programs.

This article, by its nature, must be a general overview of the insurance industry. Our projections are based on assumptions that could change. In order to more accurately estimate your insurance costs in 2009, we strongly recommend that you discuss your specific situation with your insurance broker and insurance underwriters. 🌿

Disclaimer: This article is written from an insurance perspective and is meant to be used for informational purposes only. It is not the intent of this article to provide legal advice, or advice for any specific fact, situation or circumstance. Contact legal counsel for specific advice.

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Employee Benefits Market for 2009

By Patrick Casinelli, RHU, Vice President, Cavnac & Associates

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2008 has been a year of high energy costs, skyrocketing fuel prices, and other troubling developments including rising unemployment and the recent upset in our stock markets.

For the past five years, we've seen low double-digit increases in medical premiums, and we believe that this will continue into 2009. "Trend" is a figure of measurement that insurance companies use to project their future exposures and costs for payment of claims, pharmaceutical drug coverage, technology enhancements, and reserves for major catastrophic claims. Most insurance carriers expect that the trend for increases to employee benefit insurance premiums will be approximately 12-14% for HMO plans, and approximately 14-18% for PPO plans.

The primary drivers of the overall cost of employee benefit premiums include, but are not limited to, the aging work force, increases in the costs of pharmaceutical drugs and new medical technology, and the renegotiation of provider (doctors, hospitals, laboratories and other medical facilities) contracts. We will address each of these cost drivers individually.

Aging Work Force

As the average age of American workers rises, there is a subsequent increase in the occurrence of chronic illnesses such as cancer, diabetes, and heart disease. These conditions result in a need for increased medical resources such as prescription drugs, technologically advanced diagnostic tests, and other innovative medical procedures, all of which equate to a sharp rise in healthcare spending.

The U.S. Census Bureau projects that the growth rate of elderly persons is expected to increase considerably from 2010 to 2030 as the "Baby Boom" generation enters the retirement age of 65 and older.

Staggering Increase in Pharmaceutical Drug Costs

Advancements in pharmaceutical research continue to yield treatment breakthroughs that will help to battle and possibly prevent many illnesses. However, research and development costs also severely impact insurance companies and employers who offer employee benefit plans. Prescription drugs are a major cost component of HMO plans, which have traditionally allowed for

generous coverage of pharmaceutical drugs. Some of the reasons for the increase in pharmaceutical drug costs are:

- New name brand drugs developed and introduced to the market
- Wider use of prescription drugs for disease maintenance and preventive care
- People who have health insurance are far more likely to use prescription drugs than those without
- An aging work force means a higher incidence of chronic disease and medical care to treat them

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HR Tidbits...

I-9 Forms

Are you using the most current edition, which is Form I-9 (Rev. 06/05/07) N? (Look for this information at the bottom right hand side of the I-9.)

If not, you can download the latest version

www.uscis.gov/files/form/I-9.pdf

The current version expires on 06/30/09 (the expiration date is located on the upper right hand corner of the I-9).

Note: You must *always* use the *most current edition* of this form.

Do you provide new hires with *all 4 pages* of the I-9, and allow them to select and produce for inspection the documents which will show their legal right to work in the USA?

For full and complete information about the I-9 and the employer's responsibilities, download the *Handbook for Employers* online at:

<http://www.uscis.gov/files/nativedocuments/m-274.pdf>

HR Tidbits are provided by Sandra W. Rugg, SPHR-CA, Director of Human Resources, Cavnac & Associates

- Over the past ten years, direct-to-consumer marketing (banned by the FDA until 1985) has increased demand for and use of advertised drugs

New Medical Technology

While the American work force ages, life expectancy and mortality rates in the U.S. continue to improve, and people are living longer. Medical technology advancements and innovations such as new and improved methods for early detection of disease, treatments, and medications for serious illnesses have also played an important role in the increase of life expectancy.

In addition, diagnostics such as CT scans and MRIs are quickly replacing less efficient, less accurate, and far less expensive diagnostic tools. Breakthroughs in breast cancer and colon cancer screenings, improved immunizations for both children and adults, more thorough preventive care, and continuing research and development of treatments for chronic illnesses all come with high price tags.

Provider Contracts

In these economic times, medical providers have also seen their costs of doing business rise dramatically. Providers of medical care are forced to renegotiate contracts with insurers and ‘drive a harder bargain’ in order to cover their increased costs. Medical providers not only demand more money for their services from insurance carriers, they also want enhancements to those contracts, such as more authority in decision-making on claims, better terms, and a switch from “capitation” to “fee for service.”

Under a **capitation** contract, a medical group of providers is paid a flat amount monthly, depending on how many members are assigned to their group. The medical group and the providers are then responsible for coordinating care and managing the cost of care for members within the group.

Under a **fee for service** contract, the providers get paid for the actual services that they perform when they are performed. With fee for service, the provider has less risk, but that also means that the insurance company is more involved in the medical decisions and can approve or disapprove the care that is being offered.

Renegotiating causes many delays in contracting, and uneasiness for the insureds. It has also caused insurance carriers to terminate contracts which leave insureds with a more limited network of providers for medical care. Most insurance companies now have two networks available to their clients.

The first network has fewer providers (less access) at a lower premium, and the second network has more doctors (wider access) available at a higher premium amount. Often the plan designs are exactly the same in both networks. The insurance companies that run dual networks offer insureds a great opportunity to lower their premium without changing the benefit levels.

Cost Management Strategies

Rising costs force employers to make drastic choices regarding the employee benefits they offer. Following are some of the cost management strategies employers are using to combat the steady upward trend of health care costs:

- Increasing costs to employees
- Decreasing benefits to employees
- Combination of increasing costs to employees and decreasing benefits
- Absorbing cost increases

In addition, many employers are looking at different types of funding arrangements, which could include adding higher deductible plans, self-funding that deductible through a Health Reimbursement Account, or directly through a third-party administrator. Health Savings Accounts have also become a viable option, and continue to be attractive for many employers.

Summary

In summary, employee benefit costs will continue to rise in 2009. As in 2008, the industry is expecting 5-10% increases in dental plan costs, and increases of 12-18% in medical premiums. A well-structured employee benefit program increases employee satisfaction and retention, and aids in recruiting new employees.

Your employee benefits broker should help you procure the best plan at the best price, and also help you determine how much of the premium cost should be shared with your employees. In addition to price and product, human resource consulting, wellness programs and voluntary benefits, Cavnac & Associates is successfully adding value while increasing the overall satisfaction of employers and employees alike. ✂

— Patrick Casinelli is a Vice President and Principal of Cavnac & Associates
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What YOU Should Know about IRS Indexed Limits for 2009

Information courtesy of Standard Retirement Services, Inc.
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The IRS has announced the following 2009 indexed dollar limits applicable to qualified retirement plans:

Item	IRS Code Reference	2008 Limit	2009 Limit
401(k) Employee Deferral Limit ¹	402(g)(1)	\$15,500	\$16,500
457 Employee Deferral Limit	457(e)(15)	15,500	16,500
Catch-Up Contribution ²	414(v)(2)(B)(i)	5,000	5,500
Defined Contribution Dollar Limit	415(c)(1)(A)	46,000	49,000
Defined Benefit Dollar Limit	415(b)(1)(A)	185,000	195,000
Compensation Limit ³	401(a)(17); 404(I)	230,000	245,000
Highly Compensated Employee Income Limit ⁴	414(q)(1)(B)	105,000	110,000
Key Employee Officer	416(i)(1)(A)(i)	150,000	160,000
Social Security Taxable Wage Base		102,000	106,800

¹ Employee deferrals to all 401(k) and 403(b) plans must be aggregated for purposes of this limit. A lower limit applies to SIMPLE plans.

² Available to employees age 50 or older during the calendar year. A lower limit applies to SIMPLE plans.

³ All compensation from a single employer (including all members of a controlled group) must be aggregated for purposes of this limit.

⁴ For the 2009 plan year, an employee who earned more than \$105,000 in 2008 is an HCE. For the 2010 plan year, an employee who earns more than \$110,000 in 2009 is an HCE. ✨

Note: *This information is provided for informational purposes only. It is **not** intended to provide legal advice. Contact legal counsel for specific advice.*



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There are a host of retailers to choose from, including **Amazon, Best Buy, Target,** and **E-Bay,** to name only a few. You can purchase almost anything — plane tickets, rental cars, hotels, cruises, amusement park tickets, I-Tunes, DVD rentals, technology, clothing, books, flowers—even your credit report!

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Thank you for your help! Please contact us if you have any questions.



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www.serving seniors.org



Upcoming Events

New Wave Pro Wrestling Event

Fun for the entire family! All proceeds benefit the Downtown YMCA.

- WHAT** Pro Wrestling
- WHEN** Saturday, November 22, 2008
6:30 pm
- WHERE** Downtown YMCA
500 West Broadway
San Diego, CA 92101
- COST** Adults — \$10
Kids (10 and Under) — \$5
- FEATURED WRESTLERS** SoCal Crazy, Rotten Ronnie Thrash, Anchors Away, Ric Ellis, Aerial Star, Ballard Brothers, and MORE!!

39th Annual Resolution Run

Resolve to be fit for 2009! Start your year with fitness by participating in the Downtown YMCA's Resolution Run.

- WHAT** 5k Run or 1 Mile Fun Walk
- WHEN** Saturday, January 3, 2009
- WHERE** Balboa Park
Meet at 6th & Laurel
- COST:** FREE!
- QUESTIONS?** Call Alicia Gettys at **619-232-7451** or e-mail agettys@ymca.org

