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INVESTMENT-ORIENTED PRODUCTS

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- o Session will give the latest update in investment-oriented products:
  - -- Single premium whole life
  - -- Single premium variable life
  - -- Variable universal life
  - -- Annuities

MS. MARY ANN BROWN: I work in the Tillinghast New York office. We think that whole life products with competitive yields will continue to have a strong future, even though we have seen a tremendous amount of interest in investment-oriented products during the past few years. At first we saw a big influx in the development of universal life and current interest products, but lately we see a great demand in developing single premium life and annuity products, including variable products. This is partly due to the fact that a lot of companies are crediting lower interest rates on some of the interest-sensitive products than in the past, although they might still be a little higher than most feel comfortable with. Also, a lot of companies have a desire to get off the asset/ liability risk. Another reason why we have seen an increased interest in variable products is that the mutual fund industry has been attracted to the tax advantages of these life insurance and annuity products. Also, variable products can contain some of today's hotter investment choices such as stocks,

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international stocks or junk bonds. The recent single premium life insurance tax scare that you have been hearing about, and some SEC developments, have been putting a lot of these products on a faster development track, although some plans are becoming derailed until the dust clears over some of these issues.

Several companies that have been into these products have experienced huge sales results, at least by life insurance standards, by using the stock brokerage distribution channels.

It is timely that right now, as we are speaking about investment products, there is a session in Washington that is being hosted by Sutherland, Asbill and Brennan, who just hired Moore of Stark/Moore. They are discussing the future of single premium or, maybe, all life insurance products, so you may want to follow up on any development that occurs there.

Now I will introduce our panel to you. We have some of the leading players in this product arena. First we have Norse Blazzard, a Securities and Exchange Commission (SEC) attorney. He is a J.D. and a certified life underwriter (CLU) and no doubt a lot of you have heard of him. He is responsible for a lot of the state-of-the-art type SEC filings, including Harvest Real Estate Annuity, and we have worked on quite a few client projects together. Norse has been extensively involved with the design and regulatory clearance of variable life and annuity and other financial products for many years. His firm, Blazzard, Grodd, and Hasenhauer, is based in Westport, Connecticut. He previously worked as Senior Vice President and General Counsel for North American Re in California and was president of their broker-dealer group. He has also been Securities Counsel and Equity Products Manager for California Western Life. Norse is going to discuss annuity product designs and trends and give us his prognosis on some of the important proposals before the SEC that might impact these product designs.

Second, we have Rich Lambert, who is Vice President and Actuary with Pruco Life Insurance Company (a subsidiary of Prudential). He has held this position since the start of their success with variable and interest-sensitive products. Rich has been sort of a "rising star" at Pruco during his nine years there since graduation from Princeton, and has been involved for several years with variable products. He will share with you Pruco's experience with these investment products, including agent training, some sales results and the recent addition of a real estate fund option.

Third, we have another sort of rising star, John Vrysen. He is Vice President and Actuary for North American Security Life. This is the U.S. subsidiary of the Canadian company, and they are located in Boston. He is going to share with you North American's rationale for entering into the variable marketplace and discuss the process they followed to use their outside fund managers and wholesalers to distribute some of their products, which are just about approved. They have several state-of-the-art products.

MR. NORSE N. BLAZZARD: For nearly a quarter of a century I have worked in the development, regulatory clearance, marketing and administration of variable annuities and other nontraditional insurance products, with the primary emphasis on variable annuities.

Paul LeFevre once said to me that being an expert on variable annuities is sort of like being an expert on AIDS or the bubonic plague, but that was in the old days. Things have changed significantly. While I think of myself primarily as a child of the variable annuity, because that is where I started in the business, it is impossible to claim only the one discipline. The development and the impact of variable annuities have taken place at the same time that we have seen the proliferation of new interest-sensitive and investment-oriented products come to the insurance industry marketplace. For instance, although I started my career with variable annuities during the mid-1960s, I also developed variable life insurance products, administrative systems and marketing techniques during the period of 1969 to 1974. That was back in the days when we all thought that variable life insurance, as it then fit the traditional insurance whole life mold, was going to be exempted from the more onerous types of SEC regulation and federal securities laws.

Likewise, it is not possible to have worked on variable annuities without also working on single premium deferred annuities, investment annuities, savings annuities, universal life insurance, single premium whole life insurance, pension products, mutual funds, and all of the variations on these new product themes. However, I will try and limit my remarks to annuities, except as the discussion affects some of the other products that we are dealing with.

OPEN FORUM

DEFINITIONS

First of all, I want to make a definition. Even with the most knowledgeable insurance people, I find that it is advisable to define terms, so that we all have a common ground for discussion. The term variable annuity as I use it or as it is used in the industry correctly, or any other variable product for that matter, is not a product where contract values vary. I spent five hours one day with the chief of the Life Division of the New York Insurance Department trying to convince him of that fact because that definition would fit any insurance product in the modern context. A variable insurance product as it is used in the modern term is one where the investment risk is shifted from the insurance company to the policyholder. This is not my definition; this is the definition the U.S. Supreme Court used in the case where it determined that variable annuities would be subject to the tender mercies of the Securities and Exchange Commission. So, if an insurer guarantees principal and some rate of interest (it can be principal from which some loadings have been taken), then the product is not a variable product, it is a fixed insurance product.

I'm not going to bore you with a lot of the additional definitions. Being actuaries, I'm sure you know more about it than I do, but I do want to make sure that everyone understands that when we are talking about variable insurance products we are talking about products where the investment risk has been shifted from the insurance company to the policyholder; that is the legal definition.

There is one term, however, which I would like to discuss further, because I see it abused constantly. That is the term *tax deferred annuity*. Legally, tax deferred annuity applies to a product where the premiums are paid with pretax dollars as opposed to after-tax dollars. The term originally was developed to be synonymous with *tax sheltered annuity*, which qualified for favorable tax treatment under Section 403(b) of the Internal Revenue Code. Any annuity enjoys tax deferral of the inside buildup of investment yield, so to call an annuity a tax deferred annuity where the premiums are paid with after-tax dollars is, in my opinion, misleading. You may want to bear this in mind if any of you ever have the occasion to review sales materials.

This brings up one additional point. We have a great deal of wishful thinking going on today in the life insurance industry in our promotional materials and advertisements. We are telling the Internal Revenue Service and the Congress in graphic detail what we plan to do. Now I don't know how many of you see checks come in the mail for premium dollars as a result of advertisements you run, but I find it very difficult to comprehend why we have to go out and work on the assumption that the Internal Revenue Service and members of Congress do not read advertisements nor mail flyers or other promotional materials that are telling them that they have to do something about the tax status of life insurance products. Every time I go to the Internal Revenue Service to argue with them that we are really doing a good social job, they reach behind them, pull out the notebook and show me the advertisements we run. "The last tax shelter," "How you can beat the revenuers out of your hard earned money," and so on. Now it may be that taxation is a motivation for people buying these products, but I don't think we need to point that out in such graphic detail to the people who will use that information to destroy us.

CURRENT ACCEPTANCE OF ANNUITIES

I've been informed that the annuity is the oldest form of life insurance, yet over 90% of all annuities sold in history have been sold in the last ten years. In my opinion, there are a number of reasons for the increase in popularity of these products. Increased investment yield, tax bracket creep, greater investment flexibility on the part of a lot of the products and wider marketing of the product have undoubtedly been good reasons for the increase in the products' popularity. Yet the fact that the growth in the annuity sales in general corresponds with the development and introduction of the variable annuity is significant. It is significant in that I believe that the variable annuity has paved the way in the minds of the insurance industry and in the minds of the salespeople, if not in the minds of the public, to understand and accept the newer, more modern products that we are seeing come to market today.

The variable annuity was first developed in the 1950s with the intent of providing a hedge against inflation. Those of you who are old enough to remember the old *Collier's Magazine* will recall the Phoenix Mutual advertisement that showed the elderly couple sitting on the boat which said "How we retired on $150 a month for life." If any of you ever wondered what those people are doing today, if they're still on the boat, I can assure you that the boat is not in any place you would want to be.

Unfortunately, we don't have enough information to be able to determine if, in fact, the variable annuity has lived up to providing the hedge against inflation for which it was intended. But if you follow the stock market, you certainly get the idea that it probably has done so, because the basic premise that an investment in a widely diversified portfolio of common stocks held for an extended period of time would tend to keep ahead of inflation has worked, even though there have been short periods of time where that has not been true. Perhaps some of you will be able to take a look at the statistical information that is available and come up with some idea as to whether or not these products have provided the hedge against inflation for which they were designed. But we are still not seeing enough people annuitize to be able to determine if it is a valid assumption.

REGULATORY HISTORY OF ANNUITIES

Let's look at the regulatory history of annuities. Annuities and variable products in general are probably the most overregulated and fairly regulated products in the history of the insurance industry. Not only do we have the state insurance departments who do not understand the products at all, but we also have the Securities and Exchange Commission attempting to regulate it, and we have the Internal Revenue Service attempting to regulate the product defacto, and they understand it less than the other two do. I happen to disagree with the decision of the Supreme Court in which they determined that a variable annuity was an investment company security. In its infinite wisdom, that was the decision that it made. And it is still the law of the land. The reasoning of the Supreme Court in arriving at the decision that they did was that the variable annuity was not the kind of annuity that Congress intended to exempt from federal securities laws.

There have been a number of additional cases which have confirmed the fact that variable annuities and presumably variable life insurance are subject to the full preview of registration and regulation under federal securities laws. I'm going to talk about certain interpretive rulings that impact this a little bit. There are a number of rules applicable to the product both from the SEC level and from the IRS level that are relatively new. The first one I want to talk about is SEC Rule 151.

SEC RULE 151

SEC Rule 151 basically impacts traditional fixed annuities. By definition, variable annuities are securities. In the aftermath of the Baldwin-United situation, the SEC found itself under severe political pressure to regulate the kinds of products that caused the Baldwin-United problem, or at least were perceived to have caused the Baldwin-United problem. Despite the fact that SEC registration and regulation of annuities would not have done one thing to have prevented that problem, nevertheless, members of Congress and other political activists attempted to get the SEC to take some action.

As a result, the SEC issued a release on May 29, 1986 -- generally referred to as Rule 151 -- which provided a safe harbor from the registration and regulation provisions of the various federal securities laws for an annuity which met the standards outlined in that release. Many people in the life insurance industry do not realize that Rule 151 applies also to life insurance products. There is a footnote in the release that says: "Of course, the reasoning that we use here applicable to annuities is likewise applicable to life insurance products."

In order to qualify for the safe harbor provided under Rule 151, an annuity or life insurance policy must (1) be issued by a corporation which is regulated by a state insurance commissioner; (2) include certain guarantees in principal or interest sufficient for the insurer to be deemed to bear the investment risk, and (3) not be marketed primarily as an investment. When we write opinions of counsel on insurance products today, one of the things we must do is to review the sales materials, training materials, advertisements and sales practices involved in the product before we can give a clean opinion. These safe harbor definitions under Rule 151 are really little more than a restatement of the reasoning of the courts in the previous litigation that I referred to.

Rule 151 states that any annuity (or life insurance policy) which meets the safe harbor definitions is free from attack by the SEC under the federal securities laws. However, it also states that a product which does not meet the rather narrow definitional terms in Rule 151 can still be exempt from federal securities laws, if the facts so indicate. Very often we will write opinions of counsel on products which do not meet the safe harbor definition, but which, in our opinion, are still not securities, because they do not meet the general definitions of a security contained in the federal securities laws. The way an insurer determines whether or not its annuity or life insurance product is or is not a security, or whether it falls in the safe harbor of Rule 151, is to submit it to knowledgeable counsel who will review it and issue an opinion on the subject.

TAXATION OF ANNUITIES

There have been so many changes to annuity taxation in the past five years that I could spend hours reviewing them. Moreover, it is not possible in this brief time to discuss the use of annuities with qualified pension and profit sharing plans or their relatives. Briefly, increases in cash value of annuities are generally not subject to current taxation to the policyholder. Such increases are taxed only when distribution is taken -- either in the form of regular annuity payments or in a lump sum. And loans from an annuity or pledges of an annuity will be treated as lump sum distributions. Distributions (at least from annuities issued after the effective date of some of the recent legislation) are presumed to be attributable first to interest and are taxable at the time of distribution to the extent that there is interest in excess of premium payments. Only after all interest credited to an annuity has been recovered (and taxed) can the premium be recovered on a tax-free basis. In addition, there is a tax penalty on all taxable distributions which occur before the contract owner reaches age 59 1/2.

The 1984 Tax Act also imposed new tax limitations on the investments underlying variable annuities and variable life insurance. What it says, basically, is that the investments used in connection with these products must meet certain diversification standards contained in the Internal Revenue Code and the corresponding regulations that have recently been promulgated, if the annuity is to be an annuity for tax purposes and if the variable life insurance policy is going to be a variable life insurance policy for tax purposes. These diversification requirements are not logical, but they nevertheless apply. Sometimes it reminds me of the definition of a fanatic as one who redoubles his effort as he looses sight of the objective. That tends to be the case with the Internal Revenue Service and their pursuit of the elusive annuity.

SEC RATE SETTING ACTIVITIES

There are a couple of other developments that I want to discuss, such as the SEC rate setting activities that have taken place over the last couple of years, applicable to both variable annuities and variable life insurance. Despite the fact that the SEC is not given the authority to set rates on investment company products, at least not directly, they have undertaken to impose a form of maximum amount that can be charged for the so-called mortality and expense risk charge applicable to the product. Mortality and expense risk charge is what we traditionally think of as the actuarial margin built into the product.

The SEC staff took the position that it would not permit a registration to go effective that had an annual mortality and expense (M&E) charge on a variable annuity in excess of 1.25%. There are some games that we could play with expense loadings and a couple of other things, but that was the basic position that they took. This is applied similarly, although to a somewhat lesser amount, to mortality and expense risk on variable life insurance. This rate was arrived at by what was determined by the SEC staff to be the industry standard and basically they didn't want anyone to deviate from the industry standard.

On February 26 of this year, the SEC proposed a new version of an old rule applicable to the so-called start-up exemptions that you must have in order to get variable annuities, and to a certain extent variable life insurance policies, through the SEC. This new version got rid of the maximum limitation and imposed a new standard, saying that each registrant would have to disclose where the mortality and expense risk charges were with respect to the standards of the industry. They think that will be a sufficient detriment to keep everyone in line. That's presuming anybody reads prospectuses. Needless to say, the entire life insurance industry is going to be watching to determine what direction the disclosure under these new proposed rules will take. The rules don't go into effect just yet, they are still in the comment period, although the SEC is looking at the current registrations as though the rules were effective. They seem to be applying the same standards to the mortality and expense risk charges under variable life insurance as well.

This does point out one additional element that you should be aware of, if any of you are thinking of going into the variable insurance business, and that is that the SEC staff takes the position that an insurer cannot profit from any charges he makes for administration of the policies, the separate accounts or the product line; i.e., it has to be a wash-at-cost situation in so far as these charges are concerned. Now I submit to you: if you cannot profit from them, what can you do? You can only lose. This has led a number of insurers getting into the business to the conclusion that they should use the third-party administrator for their variable products, because it is permissible for a third-party administrator to profit on the administration. These costs can be passed through directly to the policyholder with no adverse consequences in so far as the SEC is concerned. So we may see that there is going to be a great growth in third-party administration of these products.

CURRENT STATUS OF THE MARKET

We have seen that the recent reductions in interest rates on fixed annuities have caused these products to lose much of their appeal. A number of insurers are still subsidizing the investment side of single premium deferred annuities, flexible premium deferred annuities, universal life insurance, single premium whole life, and so on. And there is a limit as to how much longer they are going to be able to do this. Sales of variable annuities are very strong at the moment, and we can see that variable life insurance is beginning to enjoy an increase in sales volume. The trend today seems to be toward more companies developing these variable products and offering a wide variety of investment alternatives underlying them. The policyholders can select the amount of risk that they want to take, with the ability to switch investments back and forth. They can have the same degree of security they would have in a fixed product, but with the upside potential that if economic conditions change, they will be able to change their investment orientation with it. We are seeing real estate products, gold products and commodities products all under development. Only time can tell where the future will go.

MR. RICHARD F. LAMBERT: I am going to be talking about two different topics. First, I am going to talk a little about our experience in adding a real estate investment option to our variable products at the Prudential, and about some of the regulatory problems we faced in doing that. And second, I will show you some of our recent sales results and how variable universal life has affected the mix of business that Prudential has been selling.

The first topic has to do with a relatively new investment option for variable contracts. It has a set of regulatory requirements which are significantly different from those applicable to the traditional bond, stock and money market options which just about anyone would put in their basic variable products. That investment option is real estate.

In the last couple of years, it has been increasingly common for variable life and variable annuity contracts to include a general account option as an additional investment option within the variable contract. The general account option has generally not been registered with the SEC under the Securities Act of 1933 as a security, nor has the general account been registered under the Investment Company Act of 1940. (These are two different registrations that you need to do when you have a variable product, but your general account options are exempt from both of those. If you have a variable product, you register both the product itself as security under the Securities Act of 1933 and the separate account as an investment company under the 1940 Act.) These combination contracts, as they are called, have replaced the older concept of a companion general account product, where the non-registered portion was actually contained in a separate contract. A combination contract is one where you have both a registered variable portion plus a non-registered general account portion within the same contract. In the last several years, the SEC has allowed both registered and non-registered portions to be combined in the same underlying product.

As an example of this move from companion products to combination products, we had virtual clone products when we introduced universal life and variable universal life in late 1984 and early 1985. We had a universal life contract which was entirely general account, and a variable contract that just had variable options. This was the companion approach that was popular back then. When we revised our contracts in late 1986, several other companies had broken the ground with the SEC by putting a general account option within their variable products, and we did likewise. Thus, what we had was a combination contract. We still maintain a universal life contract for our agents who are not National Association of Securities Dealers (NASD) registered, and thus cannot sell the variable products. But we expect the 80% of our agents who are registered to sell exclusively the variable product, because it has the universal life contract possibility plus all these additional variable options.

The idea of a companion real estate only variable annuity was pioneered by Integrated Resources and Merrill Lynch back in 1982 and 1983, as Mr. Blazzard mentioned previously. Both companies began issuing real estate only variable annuities that were registered as securities under the 1933 Act, but whose separate accounts were not registered as investment companies under the 1940 Act. It is important not to register a real estate separate account under the 1940 Act, because it would be virtually impossible to meet the liquidity and valuation requirements of the 1940 Act without extensive exemptions. It's possible to operate a real estate account not subject to the investment contract, that has three different regulatory aspects. We have a general account, which is not subject to the 1933 Act or the 1940 Act, a real estate option that has a prospectus, because it is subject to the 1933 Act, but it is not subject to the 1940 Act, and finally a variable contract, subject to both the 1933 Act and the 1940 Act.

The advantages of a combination contract are obvious. A client can invest a portion of the contract's funds in real estate and the remainder among stocks, bonds and money markets for greater diversification without separate contract fees. We believe that real estate is a much more attractive investment option when it's used for only a portion of the client's funds, rather than when it's an all or nothing option in a separate contract. We've made real estate available as an investment option under a life insurance contract for the first time in the U.S. Finally, by making real estate available in a broad range of contracts, we believe it will be easier to generate the large amounts of money that will be necessary to run this account efficiently.

Other than the regulatory concerns, which I will mention later, there are two big practical issues you have to face if you want to add a real estate investment option: valuation and liquidity. The valuation question is, How, and how often, will you calculate unit values for the account? The liquidity question is, How will requests for redemptions be handled, because real estate is not a very liquid asset.

For our account, we calculate daily unit values. To calculate these values, we have each property appraised once per year by an independent appraiser. Between outside appraisals, our real estate department will adjust the value of the property quarterly, based on their own internal review. Initially, we plan to do this internal review monthly until we get a larger number of properties. This should smooth out the fluctuations in unit values. We would also adjust the value of any property at any other time if some significant material information came to our attention, such as a major tenant in a building failing to renew a lease. Since we intend to invest primarily in income-producing real estate, not development projects, the periodic revaluations should result in relatively small changes in the unit value. This is because the primary source of return should be the income on the property, not the appreciation on the value of the property. As we add more properties, with appraisals spread throughout the year, the effect on the unit value should become relatively smooth and should be more comparable to that of the movement of stocks and bonds. In fact, it will probably be a lot less variable than the movement of the stock market.

As I mentioned, the more significant portion of the client's return is the income on the properties. This needs to be reflected in the unit values as well. We will make an estimate of the income on each property on a yearly basis, and then we will take this estimated net operating income and accrue it daily in the unit value calculation. Every month, we will take a look and see what the actual income on the property was, and then we'll make a true-up to the unit value to reflect any difference between actual and expected net operating income. Establishing the accounting procedures enabling us to do this was probably the most difficult part of the entire project.

We handle the liquidity problem in a number of ways. Transfers out of the account are only permitted once a year on contract anniversaries, and are subject to maximum limits. This is very similar to our treatment of transfers out of the general account option. We also maintain about 10-15% of the account's assets in liquid securities to help us handle variations in actual cash flows from expected cash flows. Finally, by investing in income producing properties and mortgages, rather than development projects, we get a continuing stream of income on the properties that will also help our liquidity position.

There are several unique regulatory concerns with a real estate investment option. The Employee Retirement Income Securities Act (ERISA) is a very good example. Insurance company assets backing a general account option are not considered to be plan assets under ERISA, nor are the assets of separate accounts registered under the 1940 Act. Assets of a real estate separate account, however, do not fall into either of these two categories. Thus, if we allow any qualified money to be invested in the account, the assets of the real estate account might be considered to be plan assets and the managers of the account might be considered to be fiduciaries. Note, I keep saying *might* instead of *will be*. We believe the Department of Labor will take this position, and for the time being we are trying to convince them that we would not be subject to ERISA. But as a temporary measure, we are keeping all money from qualified plans out of this account just to avoid any problems.

If ERISA was applicable to the account, there would be a whole host of requirements that we don't normally have to deal with in our variable contracts. One item is policy loans. Under ERISA, if the Prudential is a fiduciary with respect to a qualified pension plan, loans from any Prudential affiliate to the qualified plan, including policy loans, will be considered prohibited transactions. As an example, if a small corporate pension plan owned a traditional whole life policy, and they also owned a variable annuity that had some funds invested in the real estate account, a policy loan from the traditional contract might be considered a prohibited transaction. This would be very difficult for us to police and this is one of the reasons why we avoid putting any qualified money in our real estate account. Another restriction has to do with the use of affiliates to perform services for the account. For example, we would not be permitted to hire Prudential affiliates to perform property management services. Mr. Blazzard mentioned that one of the ways in which you can avoid some of the SEC problems is to use affiliates to perform services for the accounts. If you are subject to ERISA you aren't allowed to do that.

Another unique aspect of a real estate account is that the rules on advertising are much stricter than they are for other variable investment options. For example, unlike the other variable investment options, performance figures may not be advertised for the real estate separate account. A little background information might be useful.

Under the Securities Act of 1933, securities may not be advertised, but may only be sold by a prospectus. The only permitted advertisements are so-called "tombstone" ads that you may be familiar with from the *Wall Street Journal* or the financial pages of some other newspapers. Investment companies registered under the 1940 Act, however, are permitted certain exemptions from this general requirement as a result of SEC Rules 134 and 135 which permit certain types of information to be included in advertisements. These rules do not apply to a real estate separate account, however, since it is not registered under the 1940 Act.

The SEC staff's most recent position on advertising for the real estate account is that other than corporate logos and attention-getting headlines designed to direct the reader's attention to the textual material, advertisements for the account are restricted to very bland, limited information about the account. In particular, pictures or graphs are not allowed in advertisements. A press release is also considered to be an advertisement for this purpose, and is subject to the same limits. This put quite a limitation on us when we introduced the account and wanted to tell people about it. We had a very short press release because that is all we were allowed to put out to the press.

Another important thing with real estate is the amount of seed money needed to establish a real estate separate account. It's much larger than for a typical investment option. For a stock or bond fund, a couple of million dollars is sufficient seed money to set up a well-diversified portfolio. For our real estate account, we figured we'd need $50 to $100 million to get a reasonably diversified portfolio of real estate. In addition to IRS diversification requirements, which require at least five different investments by the end of the start up period, there are obvious investment benefits to having a portfolio of real estate diversified by type and geographic location.

There are many more items to consider. I've just briefly touched on several of the more unique and significant aspects. Two other ones I haven't talked about are state insurance law requirements and the whole process of registering the prospectus with the SEC. You can talk to Mr. Blazzard or to other very good law firms, but it is very important to have a good SEC law firm if you want to get anything like this through the SEC.

My second topic is how variable universal life has changed our mix of business in the two years since we introduced it. Sales results with our flexible premium variable life policy, which we call Variable Appreciable Life (VAL), have been spectacular. It's been successful beyond our most optimistic projections. In 1986, we sold $190 million of scheduled premium, plus we had an additional $230 million of first year drop-ins. We are on track to sell even more in 1987. We have set records in recent weeks, with over 9,000 applications per week. Our VAL policy is currently outselling (in terms of scheduled premiums) all traditional permanent policies combined.

As I mentioned in my introduction, I thought it might be interesting to look at how the composition of our business has changed since we introduced VAL two years ago; in particular, how our mix of investment options has changed and what's been happening to our other products over the last two years.

When we introduced VAL in the beginning of 1985, we had a fixed premium variable life policy and a flexible premium variable annuity, both of which had been introduced in mid-1983. After a year and a half of sales, total separate account assets for these two individual variable products stood at a very unexciting $77 million.

Graph 1 shows how our individual variable assets have grown since we introduced VAL. At the end of 1986, our variable contract assets had jumped to $1.4 billion, about half of which is from our previously unexciting variable annuity, which also took off at the same time that we started selling variable universal life. At the end of the first quarter of 1987, our variable assets were already up to $1.9 billion. Part of that is the stock market, and part is also the continuing inflow of funds into these products. The graph also shows how our clients have chosen to invest their money.

To make this a little clearer, Graph 2 shows the breakdown of assets by investment choice in percentage terms. Back in 1984, our most popular investment option was the money market option, with over one-third of all assets. Another third was split between our two managed options, conservatively managed and aggressively managed. In these options, Prudential selects the mix of money market, stocks and bonds that it believes are appropriate, based on its economic outlook. Less than 10% of assets were in stocks at that time.

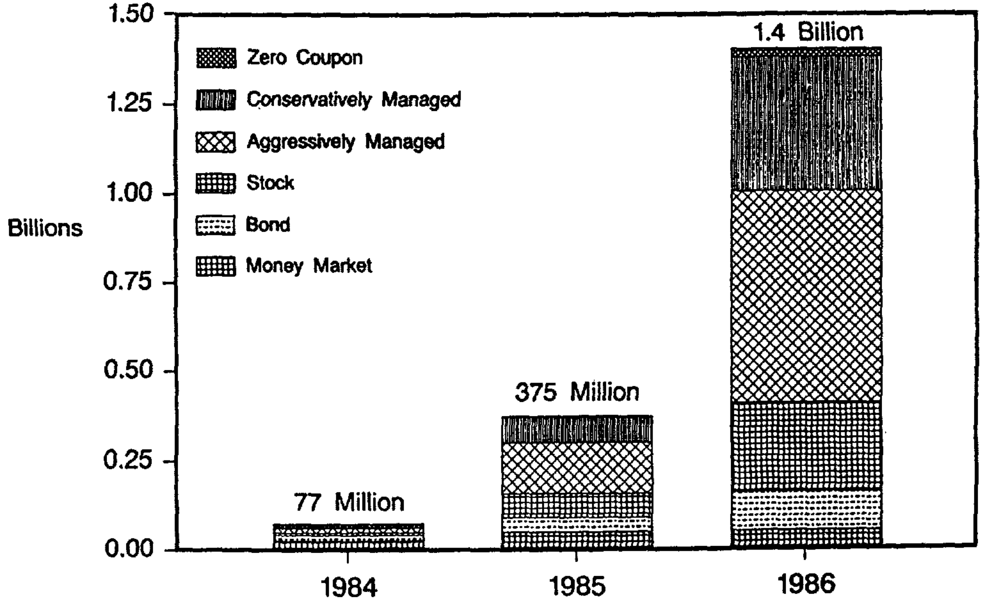
Two years later, the distribution is significantly different. We now have less than 5% in money market, about 20% in common stock, and almost 70% in our two managed options. Our most popular option is now the aggressively managed option with over 40% of all variable contract funds. The growth in the stock and managed portfolios has been primarily at the expense of money market, and to a somewhat lesser extent, of bonds.

So far most agents and clients do not seem to want to be bothered choosing their investment options, but rather are willing to let the Prudential choose for them,

GRAPH 1

Distribution of Assets

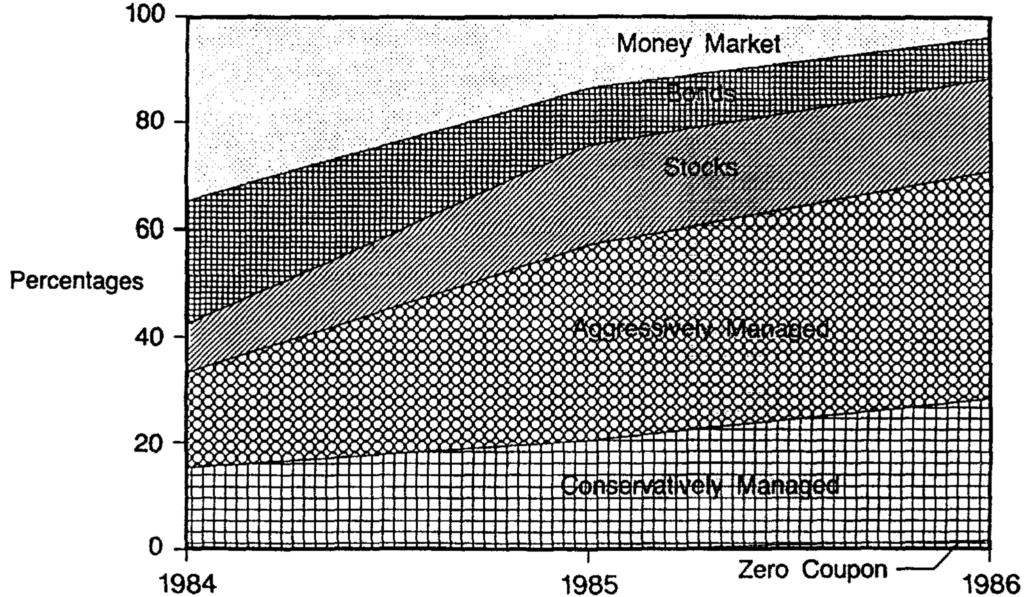
By Investment Option



GRAPH 2

Distribution of Assets

By Investment Option



as the big movement to managed funds has shown. The move out of money market and into the common stock and aggressively managed funds also shows agents more willing to recommend and their clients choosing riskier investments; and so far the stock market rally has rewarded this approach.

We believe this move to riskier investment choices reflects a greater level of comfort by our agents with investments that can go down as well as up. I've heard many companies say that their agents prefer selling guarantees to variable products; ours did also. These attitudes take time to change, but it can be done, and if you do change that attitude in your field force, there can be enormous rewards, as the following several charts will show.

Graph 3 shows quarterly life insurance sales results for Prudential since we introduced variable life in mid-1983. The chart shows scheduled premiums sold for permanent policies with face amounts of $25,000 or more. It illustrates how our mix of businesses has changed since we introduced several nontraditional investment-oriented contracts. There is obviously a seasonal trend. The fourth quarter is traditionally our biggest sales quarter because our agents are trying to qualify for awards. But you can see that the overall year-to-year trend is up. While we are selling less traditional life insurance, our total sales are going up significantly as a result of the enormous growth of nontraditional sales.

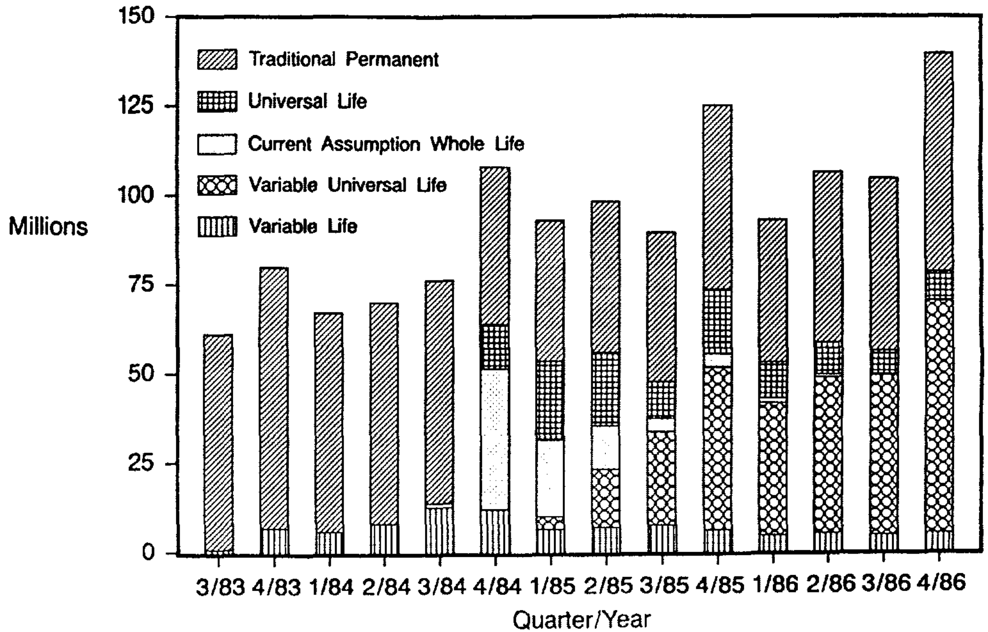
Graph 4 is a little more informative because it illustrates how the total pie is split up by products. Fixed premium variable life started very slowly in mid-1983, but eventually grew to about a little over 15% of sales a year later. In the third quarter of 1984, we introduced a current assumption whole life contract with a 12% crediting rate. It quickly became a very big seller. Three months later we introduced universal life, and it quickly cut into sales of the current assumption whole life policy. Finally, in the first quarter of 1985, we introduced variable universal life. It grew rapidly as we added more state approvals in big states, and the percentage of business in variable universal life continued to grow in 1986, although at a somewhat slower rate.

One of the most important factors in our success with variable products is agent training. When we first introduced variable life, after a massive NASD registration effort, very little sales activity happened. Most agents couldn't be bothered with this new thing called variable life. So we sent some very

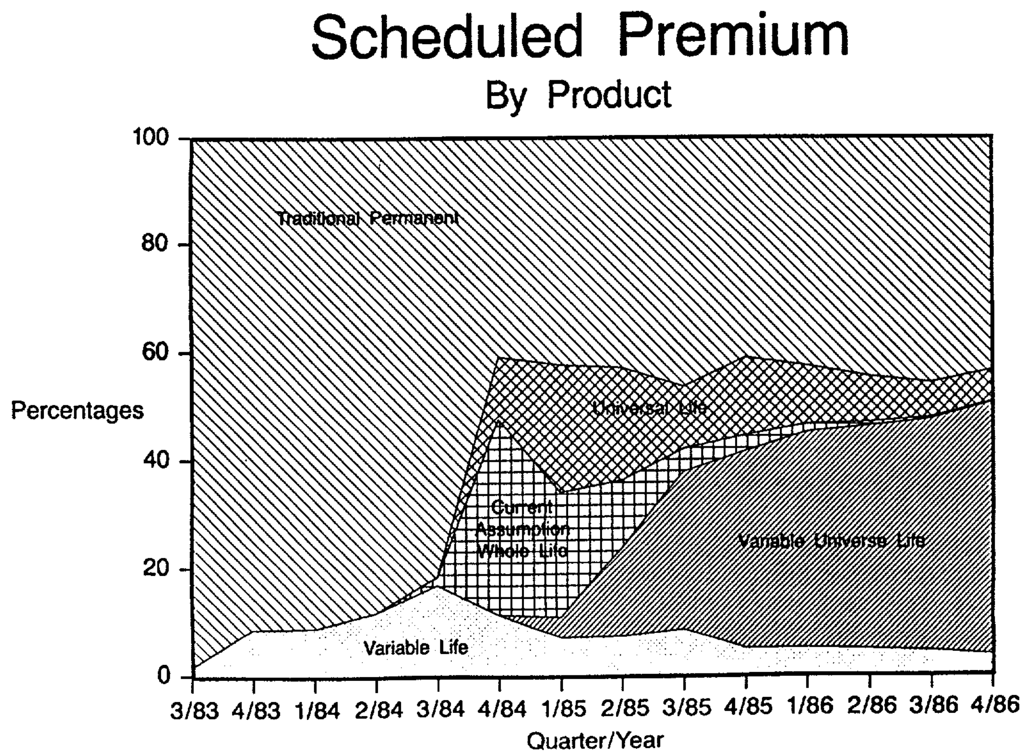
GRAPH 3

Scheduled Premium

By Product



GRAPH 4


Scheduled Premium
By Product
Percentages
100
80
60
40
20
0
Traditional Permanent
Universal Life
Current Assumption Whole Life
Variable Universe Life
Variable Life
3/83 4/83 1/84 2/84 3/84 4/84 1/85 2/85 3/85 4/85 1/86 2/86 3/86 4/86
Quarter/Year

personable marketing people out to run meetings all over the country, wherever we could get one hundred agents together. They would find agents in the audience who had sold a few variable life policies and ask them how they handled the lack of guarantees, the detailed listing of expenses in the prospectus, and all the other horrible things about variable life. When these agents from the audience said that these things really weren't a problem, they had a lot more credibility than anyone from the home office telling that to our agents. And interest in variable products started to pick up.

We still run meetings around the country, and they are so popular, our guys are often booked two to three months ahead of time. Agents come to these meetings at their own expense, because they find them useful, informative, and entertaining. And we continue to improve our agents' knowledge of variable products and maintain field enthusiasm for the products.

Although permanent life insurance, both traditional and interest sensitive, remains the primary product for our field force, there is another, growing piece of our agent-sold business, which I will call the savings market. As our agents became more comfortable selling variable products generally and had enormous sales success with variable universal life in particular, we had an even bigger explosion in the sales of our savings products. By savings products, I mean low load accumulation-type products, namely annuities, single pay life (which we introduced in 1986), first-year drop-ins on flexible premium life products and mutual funds.

Fixed dollar annuities were the traditional savings products sold by insurance companies in the past. This has changed dramatically at Prudential in the past few years. As Graph 5 indicates, mutual funds have grown to become the dominant product in this market. The new kid on the block, life insurance, is starting to grow rapidly. In the most recent quarter, life insurance has passed annuities in terms of new savings dollars.

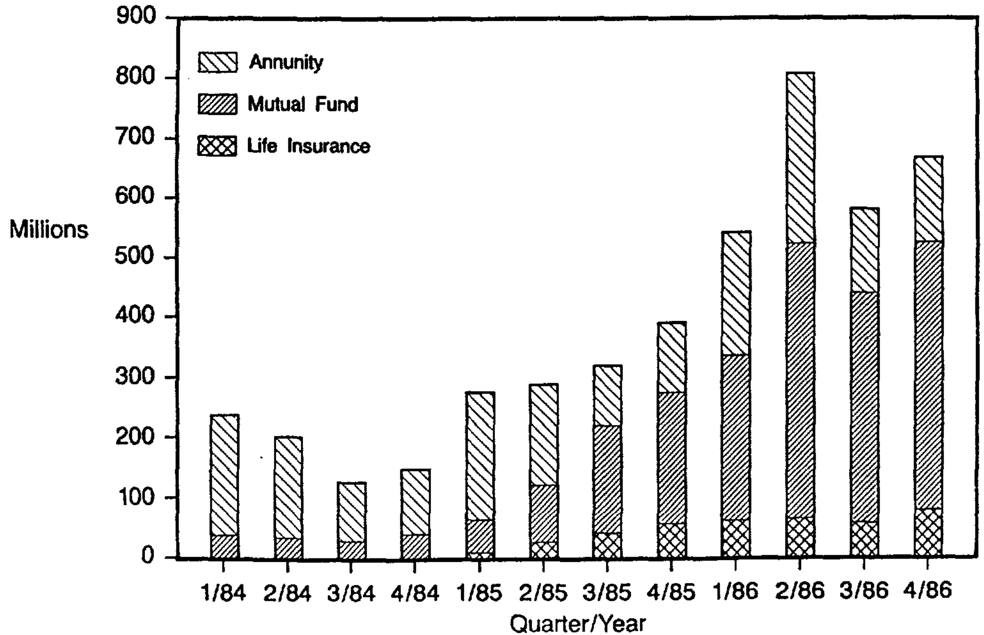
Graph 6 shows how the savings market is split up percentage wise between annuities, mutual funds, and life insurance. From the beginning of 1984 to the end of 1986, mutual funds have grown from less than 20% to over 60% of savings products sales, and life insurance has grown from nothing to about 20% of such sales. In the first quarter of 1987, which I did not have time to add to the

GRAPH 5

INVESTMENT-ORIENTED PRODUCTS

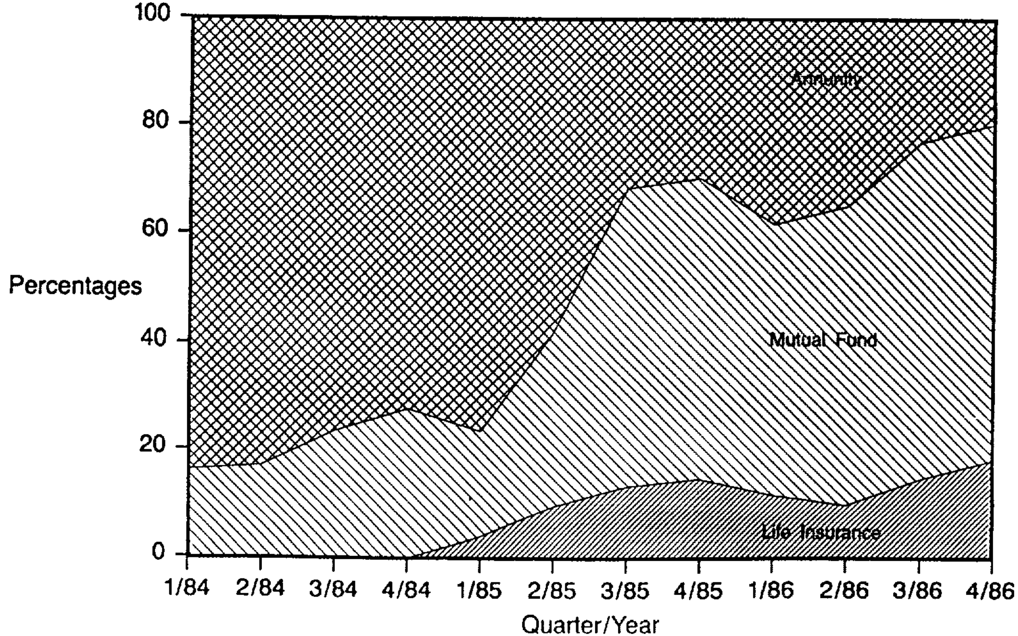
Single Premium

By Product Type



GRAPH 6

Single Premium
By Product Type



chart, the split was 61% mutual funds, 17% annuities, and 22% life insurance. With all the current publicity being given to single pay life insurance, we expect life insurance to continue to increase its portion of the savings business this year, at least until the tax law changes.

Finally, I think the next two charts, Graphs 7 and 8, tell the most interesting story about how variable universal life has affected our savings business. These charts show how our savings business is split between registered and nonregistered products. As I mentioned previously, when we introduced variable life in 1983, it took a huge effort to get our agents licensed to sell registered products and it is a continuing effort to promote the sale of registered products. Well, once our agents began selling variable products, sales of other registered products grew also. And when our agents got excited about variable universal life, sales of other registered products really took off. From less than 20% of savings products at the beginning of 1984 (Graph 8), over 95% of current savings product sales at the Prudential are now registered products. You can see that the big jump starts in the first quarter of 1985 through the last quarter of 1985, which is exactly the time when our variable universal life contract was coming online. For our agents, an NASD license is now becoming almost as essential as a life insurance license.

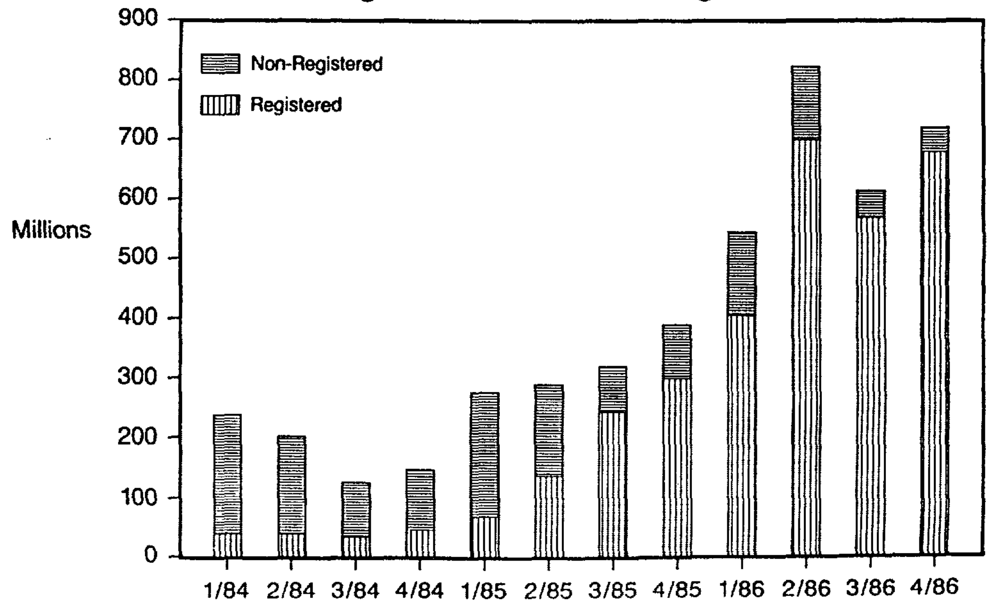
As you can see, the Prudential is firmly committed to the registered product market and has had a lot of success in it. We believe variable products are here to stay and are the products of the future. And so far our agents are having a lot of fun proving us right.

MR. JOHN G. VRYSEN: Mary Ann Brown asked me to tell you the story of how the North American Life got into variable products in the U.S. North American Life is a Canadian mutual company. We've been around since about 1881. We sell all kinds of life, health and annuity products in Canada and the U.S. In the U.S., we sell primarily individual life insurance through an independent general agency system. We don't sell any individual health products, and we haven't really sold any annuity products since the 1960s. In the early 1980s we changed to the independent general agency distribution system in the U.S. We've been trying to develop that, but we also look for other ways to expand in the U.S. In the fall of 1983, we put together a task force to look at how we could get into an investment-oriented market. So far we haven't been able to

GRAPH 7

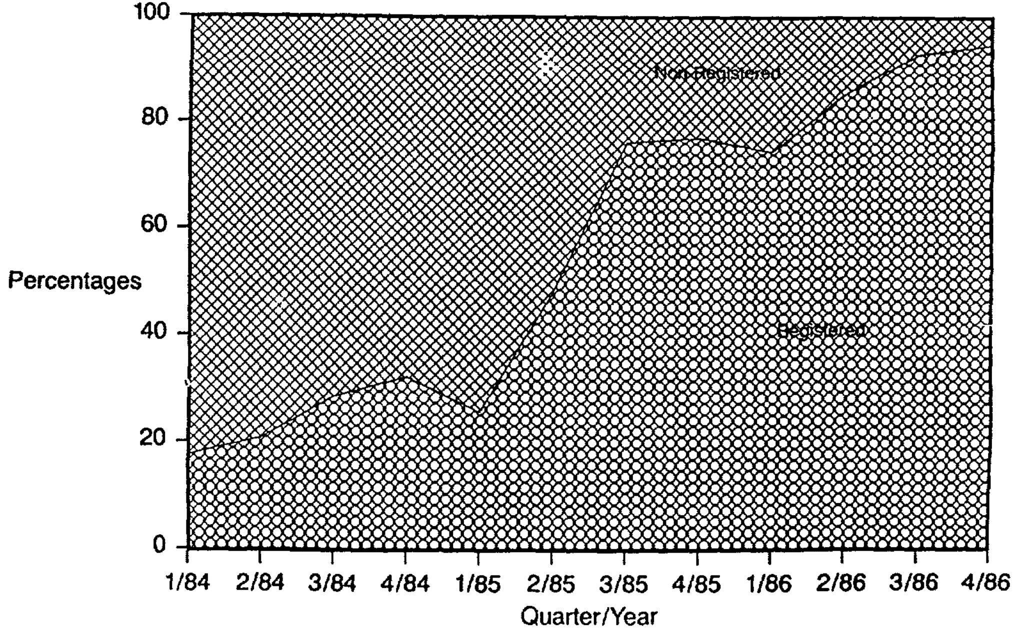
Single Premium

Registered vs. Non-Registered



Single Premium

Registered vs. Non-Registered



GRAPH 8

INVESTMENT-ORIENTED PRODUCTS

get a competitive product out there, and if it would be competitive, it wouldn't be profitable.

We put this task force together to see how we could get into that market, and how we could do it profitably. We put together two sets of recommendations, one in December 1983 and the other one in February of 1984, to the senior management committee at North American Life. We were quite ambitious at that time. We had an actuarial consultant help us out. We put together this plan, introducing about five different products in annuities, variable annuity, variable universal life, and a couple of other products. We wanted to launch all these products immediately. A lot of them involved very high levels of surplus strain, they were very risky products, and needless to say the senior management committee turned us down flat at that time.

So we went back, regrouped and said, "How can we get into the investment products in the U.S.?" We did a lot more homework and research on the subject, and finally we came up with some pretty good recommendations in the spring of 1984. We streamlined the portfolio right down to something that we could manage and we decided to start off with just the variable annuity product. That way, we could eliminate one of the big risks that the company had: disintermediation. They didn't like the single premium deferred annuity market, and with some of the things that were happening at that time, it was just a market we didn't want to get into. Variable annuity eliminated that risk. There was a fixed product margin that we could define, or we could guarantee to achieve our margin through the M&E charge. It was a good entry into the marketplace and would allow us to expand later on into other forms of variable life and mutual funds. The other thing that management liked about it was that there was a fairly low strain involved with the product. It wasn't a high-compensation-type product.

Among the things that we had committed to was the money management. Management felt that it was important to find a good U.S. independent money manager. We did have a good investment department in-house to handle our portfolio, but it was primarily concentrated on the Canadian side. We didn't have a lot of good U.S. investment expertise, and we felt that going outside, getting an independent money manager to handle the money, would be a big plus in penetrating the variable annuity marketplace.

The other thing was finding a suitable distribution system. As I mentioned, we just changed our distribution system in the U.S. in the early 1980s to an independent general agency system. The agents were geared primarily towards selling insurance products, and we didn't feel we could get enough volume from the insurance agents to justify volumes that we would need in the variable products to cover development costs, legal expenses, computer systems and everything else we needed. So we made the decision to try to develop a distribution system through the securities dealers. The way we were going to do that was to set up a wholesale network where we would have a group of wholesalers go out and do the training and provide a link between ourselves and the distributors. We viewed ourselves as basically a manufacturer of products. We would design the products. We knew there was a distribution system out there. The securities dealers were able to move lots of money through their dealers, but we needed that middle piece and we felt that the wholesaler network could provide that middle piece between ourselves as a manufacturer of the product and the ultimate distributors of the product.

We also made the decision to create a wholly-owned subsidiary through which to market these products. North American Life, as I mentioned, is a Canadian mutual company and a multinational company, and we felt that if we had to take North American Life to the SEC with all our filings, it would be a very lengthy procedure to get through. It would be a lot cleaner to get a wholly-owned subsidiary, with no problems, nothing to explain, and it would be a faster procedure. The other thing was state admissions. North American Life was only admitted in about thirty states in the U.S. and we felt it would be quicker to get a new subsidiary admitted into the various states, rather than going to the states to get North American Life admitted.

On June 27, 1984, we acquired a company whose name has been changed to North American Security Life. That is the company I work for now. At the time we acquired it, it had 29 licenses, and it had variable authority in about half of those states. We started working immediately on expansion by getting variable authority in the states in which we were licensed, which we now have, and then proceeding to get the company admitted into new states, which has been a lot slower than we had anticipated, but it's coming along.

We started working on the product itself, designing the variable annuity. The basic design feature would be similar to most popular products that were out there. The product would have a back-end load design. There were no front-end charges coming off, and the revenues we would get would come through the M&E charges. We would have a five-year surrender charge on the product, and there would be an annual administration fee to cover our administrative expenses. We decided earlier on that we didn't really want a fixed account in the product. We wanted to offer three portfolios: bond, equity and a money market type portfolio. There is that real aversion to the disintermediation risk that we wanted to steer clear of, so we decided not to have a fixed account option in the product. Being a variable annuity, the product had to be sold by registered representatives, and the product did have to be registered with the SEC.

Once we got the product basically designed, we had to set up a number of other entities: we had to set up the separate account, we had to incorporate a mutual fund, and we had to set up a broker-dealer. There were some decisions to make as to how to set up the separate account and the fund arrangement. We decided to set up the separate account and register it as a unit investment trust. We set up the separate account with three different subaccounts: bond, equity and money market. All payments into the variable annuity are then allocated to that separate account, and the separate account only invests in shares of the mutual fund that we set up. The mutual fund is registered as an open-end management investment company, again having three portfolios in which it invests.

One of the reasons why we liked this approach over the managed separate account approach that some companies took is that it did allow us to use the underlying fund for other products we planned to develop. We planned on developing both registered and nonregistered variable life products, and the SEC has taken the position that if you have a managed separate account, you can't mix variable annuity and variable life money in the same managed separate account. However, if you have different separate accounts investing in the same underlying mutual fund, then the fund itself can have variable annuity money and variable life money in it, as long as you have two distinct separate accounts that are investing in it. It allows us the benefit of having a large fund spreading our expenses over a larger base, and not having to set up a whole bunch of new funds, or managed separate accounts as we develop new products. We did set up a broker-dealer called NASL Financial Services, which is the principal underwriter of the products. The principal underwriter will then wholesale the products to other broker-dealers. We don't have any registered representatives affiliated with our broker-dealer, so we don't have to worry about any of the supervisory responsibilities which can become a real headache if you have your own field force that you have to monitor.

I mentioned that we wanted to get an independent fund manager. It was a fairly big project to go out and find a good money manager, somebody that we liked, somebody that could work well, manage the funds, and get along with us. What we decided to do was to set up a task force again (we like setting up tasks forces). We had about 20 different money managers in the U.S. that met our criteria. It had to have a good track record over the last number of years, it had to have a good name, and it had to meet a whole list of other criteria. Then we went out and talked to each of these 20 money managers, and in the very end we went with a firm called M.D. Sass Investors Services in New York.

M.D. Sass is a firm that only manages about $2 billion of assets, and most of their management has been in institutional accounts, pension funds and private accounts. They have only been around for ten years, but their track record is excellent. They are very well respected in the investment community. If you talk to a lot of other investment advisors in New York, they will be very familiar with the Sass organization. It's not a household name, which was a bit of a problem that we were concerned about, but we felt we could overcome that with some of their past track record, and some of their strategies that they had set up. We felt that it was a pretty good fit with our company. One of the reasons was that the Sass organization had a minimum account size of $10 million. They wouldn't handle any accounts that were less than $10 million, so if anyone wanted to get a Sass managed account, and they didn't have $10 million dollars to invest, they could get it through North American Security Life by investing in this mutual fund. Sass, at the same time, was looking at a way to get at some of these smaller investors, so this worked out quite well for them. We just set up one mutual fund that they manage, with three portfolios, and we take care of all the administration headaches, and keep track of who owns what piece of the fund.

One of the Sass firm's investment strategies that we like is risk-aversion. They try to maximize the return and minimize the risk. We felt that this would be a good strategy for a variable annuity policyholder, somebody who is investing his savings for retirement, and wants to get the benefit of the equity performance, without taking a real risk that the market will be very volatile. One of the things that we were able to look at, when we were analyzing Sass and determining whether to go with them or not, was the scatter chart that was prepared by the SEI organization. It compared all the money managers and their performance over the last few years. The scatter chart showed risk going across, and yield going up and down. The higher your return and the less the risk, the better it is. Sass was always in the top left hand corner of that chart, indicating he had one of the highest yields with less day-to-day variations in the yield.

Another fact that we liked was that just over the last seven years, he was rated in the top 1% of all bond money managers by SEI, and in the top 7% of all equity managers, so although Sass wasn't a household name, he had a lot of things that we could look back on. The track record is really all you can look back on; you can't really project forward.

On a shorter term basis, we were lucky. For the six months ending in December 1986, he ended up being ranked number one on both our bond and our equity portfolio. It's hard to take a look at short-term performance and project that forward, but it is a good marketing tool for us to say, "Look, this is what he did." Over the long term, when there is a really strong bull market, he is likely going to perform slightly less than average because his strategy is to try to be risk-averse; but in a volatile market he does quite well.

One of the benefits of the arrangement we have with Sass right now is the way we have structured it. We actually appointed NASL Financial Services as the investment advisor for the fund, and then we entered into a subadvisory agreement with M.D. Sass Investors Services. That way we are able to retain part of the profits, inherent in managing the funds, and help offset some of our start-up costs, and ongoing costs of administering it. One of the things that allows us to do is it gives us the flexibility of appointing new subadvisors for new funds that we established. Now we can change sub-advisors for the fund very easily, without having to give up any of the profit portion of the advisory fees.

A couple of things that we are looking at right now is the development of a real estate fund like Prudential did, although I don't know if we can come up with the $50 million or $100 million of seed money to fund that. The other thing is the development of some kind of a global or international fund. For each of those we would have to find an appropriate investment advisor that is good in their respective fields, whether it be real estate, international funds, or whatever.

The other big area was the distribution. We originally contracted with a firm to develop this distribution network for us, and we felt the concept was sound. We could be a manufacturer, the ultimate distributor was there, and we needed that middle man out there. Initially, the firm we contracted with just didn't work out, so in 1986 we started some discussions with a couple of gentlemen, Doug Wood and Scott Logan, who were very well respected in the variable annuity marketplace. They saw an incredible opportunity at this time for variable products, they were distributors, and they knew that to get variable products sold through the stockbroker community, a company needs a good wholesaler, or the middleman. A lot of companies were able to develop products at that time. It's very easy to design a variable annuity, or a variable life product, but to go to Paine Webber, or Merrill Lynch, or A.G. Edwards, or any of the brokers, and say, "Here it is -- start selling!" just doesn't work. You need somebody in the middle to do a lot of training, and the training has to be ongoing, and that is what we tried to do initially. But without the right people to penetrate that system, we were not able to do it.

These gentlemen had been doing it for a couple of years and they saw this as an opportunity, so they created their own organization called Wood Logan Associates. We bought into that company, and now have an exclusive agreement with them to distribute our products. They provide all of the marketing support, they recruit the broker-dealers, they provide all the training, promotion, and advertising, and they hold agency seminars and contests; they do the whole thing. They are basically our marketing arm, and we just have to manufacture the products. They take care of all the distribution.

The sales results are finally starting to show. It's been a long time in coming, we had a lot of false starts with our prior attempts at distribution, but with this new arrangement we signed the deal in September of 1986. It took them a few months to get their act together and get everything set up, but we sold our first policy under that arrangement in February 5 of this year, and in the month of February we sold $1 million of premiums. In March we sold $2.5 million and in April it looks like we'll sell about $5 million of new premiums. Just looking at that, I realized the numbers have been doubling each month, and if they keep doubling each month from the prior month, we will be selling about one billion in new premiums per month, at the end of this year.

As part of the new distribution agreement with Wood Logan, we made a few revisions to the product to make it more marketable to the stockbrokers. One was to make the transfer privileges a lot more flexible to allow more transfers, (we didn't have telephone authorization before) and we made our free withdrawal provision a little bit more flexible. We also introduced a few concepts of changing annuitants, beneficiaries and owners, thereby making it a lot more flexible. It's basically the same product, but just with a little more sizzle on it.

One of the things we are working on right now that we are pretty excited about is coming up with an asset allocation mechanism. One of the biggest problems the clients have when they buy a contract is that they like the product, but they are not sure where to put their money. They see our three portfolios -- bond, equity, and money market -- while other companies have got six or eight or ten different portfolios. So one of the services we are going to provide is an asset allocation which takes a look at three different investment scenarios. One is conservative, one is moderate, and the other one is an aggressive scenario, and the client doesn't have to choose where to put his money, or when to change it. He can determine what his risk-aversion is. The conservative investor is defined as somebody who's only prepared to lose about 5% of his principal during adverse market conditions, a moderate investor, 10 to 15%, and an aggressive investor is a little bit more than that. So depending on what your risk aversion is, the bigger the risk you are prepared to take, the higher your expected return. We have these asset models that are managed by Sass. They've been using them effectively with their pension clients over the years, and we are going to provide that as a service to our individual policyholders. They can sign up for this program if they want, and it takes that decision process away from them.

Very quickly I'd like to mention a couple of the other products. We just introduced a fixed annuity. There were some real concerns about that, we didn't really want to get into the fixed annuity marketplace, but as some of the marketing pressures indicated, we should have something out there, at least as a companion product. We are really downplaying its importance. It has been priced at a level just to produce an average return. We will not be competing aggressively in the marketplace, and we have reduced the commission on that product to make it even less attractive to the agents, but it is out there if anybody wants to sell it.

The real product we'd like to introduce is a market-value adjusted annuity. With a market-value adjustment in the product, we feel that it would have to be a SEC registered product, but since the distributors that we are working with are registered representatives already, we don't really have too much of a concern about registering an annuity with the SEC. And, since it will be registered anyway, we felt we'll just make it a combination product, both variable and fixed. But the fixed portion would have market value adjustments, which is something that would make us a lot more comfortable in that marketplace.

As Mary Ann mentioned, we started working on a variable life product over a year ago. I went to New York and talked with Mary Ann about some ideas I had on the variable life product. It got pushed back a number of times with different priorities and different problems that would come out, but we do have a policy form that has been drafted. We are working on our registration statement right now, and we are hoping to have that out soon.

We're looking at developing some mutual funds and some closed-end funds, which would all be managed by Sass, and sold through this distribution arrangement. So there will be a complete package of different products available; mutual funds, closed-end funds, variable annuity, and variable life. They are all using the same investments with just different wrappers around the investments, and the wrappers just determine the taxation of the product, and some of the other incidental benefits that could be achieved.

MR. LAWRENCE SILKES: Is there any difference in commissions between the variable and the traditional product with Prudential?

OPEN FORUM

MR. LAMBERT: We pay the same commission on all our variable and traditional products, so the agent has no incentive to choose one or the other.

MR. SILKES: What was the average size of the variable products?

MR. LAMBERT: Our variable life contract has a $25,000 minimum, and the average size is about $30,000 or $40,000. Our variable universal has a $50,000 minimum, and the average size is about $60,000-$70,000.

MR. JOHN J. FAHRENBACH: Mr. Blazzard, you mentioned that there might be a trend towards third-party administrators because of the cost accounting that has to go on for the registered products. Have you seen any of those organizations in place now doing that type of thing?

MR. BLAZZARD: Yes, I know of at least one that is in place at the moment that a number of my clients are using for both variable annuities and variable life insurance. I know Mary Ann has a number of clients using it, and we share a number of clients who are using this one organization. Everyone seems to be fairly happy with them; they have years of experience in this business. It's an organization on the outskirts of Philadelphia called Delaware Valley Financial Services.

MR. FAHRENBACH: Is there any trend towards those folks to be owned by a life insurance company?

MR. BLAZZARD: A lot of my clients would very much like to own them.

MR. FAHRENBACH: Would the SEC frown on that?

MR. BLAZZARD: If the company owns them, then they are now affiliated and you can no longer make a profit on it, so that is one of the ways they manage to keep their independence.

MR. FAHRENBACH: Mr. Lambert, do you sell your own funds, or do you sell funds manufactured by other people?

MR. LAMBERT: We do it all internally through Prudential's investment area.

MR. BLAZZARD: When it comes to this investment area, I might make one comment that might help along the lines Mr. Lambert was discussing. I did a study a couple of years ago as to the availability of investments for these various products, and it turns out that this will be a real bottleneck for the life insurance industry. It is important for everyone to understand that there is a difference between managing money effectively in general, and managing money effectively under the Investment Company Act. There aren't that many first quality money management organizations with Investment Company Act experience, who are not already owned by or affiliated with an insurance company. So for those of you who are thinking of getting into this business, something you should think about fairly early is, Do you want to go to market with a product that is managed by somebody nobody has ever heard of, when you will be in competition with some of the big household names in the industry?

MR. PAUL T. BOURDEAU: Mr. Lambert, what percentage of sales are from internal replacements, and what commission do you pay on internal replacements?

MR. LAMBERT: When we introduced universal life, we had a big campaign to try to discourage internal replacement, and we are quite happy with the results. Only 10 to 15% are internal replacements, most of it is new money coming in. If we can detect that there is a replacement situation, we pay reduced commission to the agent on replacement. He doesn't get full first-year commissions on that.

MR. BLAZZARD: It may be of interest to those of you who heard the discussions on the real estate products that getting a real estate product exempted from the Investment Company Act, as Mr. Lambert has stated, is critical, because you cannot have an effective product that is subject to the Investment Company Act. This took 2 years of negotiations with the SEC staff. Their initial reaction was that a variable annuity is a variable annuity is a variable annuity, are subject to the Investment Company Act, and don't bother us with any additional facts. It took a long period of time to get them to their present position. You manage the real estate portfolio effectively, and it is extremely important to recognize that not all real estate investments will be exempted from the Investment Company Act. So basically you have to make sure that you are dealing with a nonfungible pool of investments. If you are just investing in a mortgage pool, for instance, that very likely would not qualify for the exemption. It will have to consist of individually negotiated specific mortgages, or specific pieces of real estate, not just something that is fungible, because the SEC would give them the same attributes as though you were investing in securities, and then you would be subject to the Investment Company Act.