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RISK IS YOUR ENEMY

Speaker: MR. FRED CARR*

MR. HAROLD G. INGRAHAM, JR.: It gives me great pleasure to introduce our guest speaker, Mr. Fred Carr. Fred began his investment career in the late 1950s with Bache and Company as a registered representative. Later he served as director of research for two New York Stock Exchange member firms. In 1966 he joined Shareholders Management Corporation as a portfolio manager, rising in a couple of years to president, and he played a major role in its growth from $60 million in assets to a $1.5 billion investment management company. In 1970, he was instrumental in helping to form the University of Pennsylvania Center for the Study of Financial Institutions, in which he still remains active. He has taught at both the UCLA Graduate School of Business and the Law School. Since 1974, Fred has served as President and CEO of First Executive Corporation, a well-known California based life insurance holding company, and Executive Life Insurance Company, its wholly-owned subsidiary.

MR. FRED CARR: The actuarial profession will be playing the most important role in the changes that are going to occur in the life insurance industry over the course of the next decade. The actuary is in a unique position to understand product development on the investment side of the business, and investments today are playing a more and more important role in the structuring of the life insurance industry.

The financial services business has changed dramatically in the course of the last 15 years. The money market funds, the 800-numbers, Current Market Appraisal (CMA) accounts introduced originally by Merrill Lynch, have all led to the issue of money having the same quality as electricity. The money moves

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very quickly today in what has become an information driven society. Information is playing a larger and larger role relative to what people are able to do with their money. American business has been restructured over the course of this time also, and American business is continuing to be restructured as it relates to financial service businesses. We believe that the life insurance industry is the best of all the financial service businesses, for the long-term qualities of the liability side of the balance sheet provide substantial opportunities for those companies that can carefully monitor both the asset and the liability side simultaneously.

When I entered the life insurance business, I was always very concerned about the liability side of the balance sheet. Once the life is underwritten, you assume the risk for an indeterminate period of time. It's much harder for an investment person to understand that it's not possible to change a life once underwritten, while it has always been possible to change the course and direction of one's investment program.

Risk is changing as it relates to all the financial service businesses and as it relates to the life insurance industry. All the more reason for you to play the important role of balance between asset and liability. In our company Allan Chapman, an actuary, plays the most important role as it relates to balance between asset and liability, and Allan and I look at every cell of liability each month.

Let me try to put into reasonable perspective the risk issues as they relate to the investment side of the business. There are three important risks which need to be carefully monitored and carefully dealt with. Number one, the most devastating risk of all has been interest rate risk. I clipped out of a current newspaper an advertisement for American Telephone and Telegraph Company (AT&T), who has a debenture maturing this coming Monday, June 1st, in which they are going to pay you your thousand dollars back. These bonds were originally sold on June 1, 1947 with a 2-7/8% coupon due June 1, 1987, and on Monday you get your thousand dollars back. People sometimes misunderstand both the long-term and short-term nature of interest rate risk and duration risk. In the course of the last twenty trading days, somewhere from the middle of April to the middle of May, anyone who purchased government securities would have subjected themselves to a loss of somewhere between 12% and 15% of their principal, for about a month of trading days. These two illustrations tend to highlight tremendous dynamics that have changed in one of the most difficult risks to deal with, that of duration and maturity.

The interest rate risk will continue. This is all the more reason for the actuary to be able to carefully balance, some people use the word *match*, those investments made versus the liabilities put on the books. This is all the more need for companies to carefully decide in advance the nature of the liabilities that they choose to put on the books so that the actuary is in a position to balance. Interest rate risk over the course of the last 50 years clearly has been the most difficult risk to deal with and probably will also continue to be the most difficult risk to deal with in the future.

However, the second risk, which I call management risk, has become the most unknown risk. Management risk has been created over the course of this restructuring of American business. Management risk has been created by the fact that management groups and others have restructured companies and transferred wealth from the debt holder to the equity holder. Yesterday's *Wall Street Journal* states that Borg Warner was downgraded on two hundred million dollars of unsecured long-term debt, to single B from single A plus. Everyone who purchased Borg Warner debentures, some two hundred million dollars worth, have found the very character of the security they purchased has changed dramatically, and there's no way to deal with this risk relative to security analysis; no way to be able to understand in advance how to carefully monitor management risk.

Over the course of the last two years, seventy-five billion dollars of restructuring has occurred with transference of wealth from the debt holder to the equity holder; for example, companies which purchased debt as investment grade lost and those which purchased them as high-yield or junk securities won. With Hope Industries, another important company here in New England, the same circumstances occurred: those who purchased their debt as high-grade securities lost. It is probable that we will have this continuation of restructuring of management risk over the course of the next decade. While the trend may slow, it is far too attractive for management groups to end up with a significant stake of equity using somebody else's debt as their opportunity.

The third risk is the risk of credit quality. Credit quality has clearly been the smallest of the three risks in the past and probably will be the smallest of the risks in the future, although we do have a continuation of downgradings in terms of the large industrial companies as the process of restructuring American business continues. The Japanese have not yet been able to restructure and they need to pay that price in what is becoming a smaller and smaller world of economy.

Credit risk has been highlighted because of the tremendous deterioration of the major companies in America. It's hard to believe today that the largest industrial company in the United States when I was born, US Steel, has now become a less than investment grade credit or junk bond. Bank of America, in 1980 the largest bank in the world, is today number 17 or number 18, and has become less than investment grade credit. In 1986 $200 billion of credit was downgraded, and in the first quarter of 1987 $60 billion of credit was downgraded, as opposed to $10 billion upgraded.

Credit risk will remain, as a larger restructuring of industrial companies is needed to cope with the realities of tomorrow. In the U.S. today there are approximately 750 investment grade companies, that is companies in the first four credit areas related to Standard & Poor's and Moody's -- Triple A; Double A; Single A and Triple B. In the balance of the companies, the chairman of the Securities and Exchange Commission suggested there were another 11,300 companies who had a need for ongoing credit in the public marketplace.

Life insurance companies are going to need to be able to balance those three risks, that is interest rate, management risk and credit risk versus the liability side of their balance sheet and do it in a way that allows them a reasonable profit over a longterm period of time.

One of the recommendations that we made to regulators in the past five years has been an approach called mark to the market; i.e. marking your portfolio to market on a consistent basis. It has allowed the brokerage business in the U.S. to stay viable and healthy financially, because the reality of marking to the market, just as your banker marks your financial condition to your current situation, forces you to face the realities of what your portfolio is really worth.

Those financial industries which are not forced to mark to the market and face reality are those industries that get into great difficulty. An example is the savings and loan industry, where approximately 25% of all the companies in the industry are insolvent. Chase Manhattan this morning wrote off some portion of its foreign loans, and Citicorp has dramatically done the same in the last fortnight. They are facing in a more realistic way this need to mark to the market.

I'm not suggesting that the whole life insurance industry today be forced into a mark to the market theme. I am suggesting that over the course of the next decade or two, we as an industry need to be able to face ourselves and the context of what our portfolios are really worth versus our liabilities, if we are going to remain viable and remain contenders in what is a more and more difficult financial services environment. When I say in a more difficult environment, I'm talking about the movement of information because the client is brighter, tougher and better educated than ever before. Pretty soon the client will be able to punch computers to understand all of his alternatives and all of his options as they relate to financial services.

The balance as it relates to the liability side and the asset side are your responsibility. They are your responsibility more than anyone else's. They are your responsibility in terms of trying to balance risks.

The life business overall is going to provide substantial opportunities that haven't been here before for the consumer. All of you are aware of the Tax Reform Act of 1986 and the many opportunities that it really provides for the life industry, as opposed to the other financial service businesses. You are aware that we have a special opportunity in the context of the kinds of products and that we are going to be able to be a viable business in the future.

MR. GREGORY J. CARNEY: It seems that a matching strategy on these interest sensitive products probably is going to minimize the returns that the company would earn and probably will reduce its competitive position. Given that, how do you feel the actuary should integrate his function and knowledge with the investment officer and senior management on the anticipated liability durations, and the risks associated with the asset structure that's chosen? I'd also like to ask you a question on diversification risk and its impact on the insurance companies, specifically in the high-yield bond area. It seems to me that there could be a large portion of high-yield bonds that performed in a certain matter due to one incident. Does the diversification risk minimize or accelerate it?

MR. CARR: As it relates to matching, all of you are aware that it is not possible to match with precision or actuality every risk written (with the exception of certain instruments sold, for instance where you have a period certain). But, in the context of the sale of life insurance contracts, it is clearly not possible to be able to match but it is possible to be able to balance your investments and attempt to achieve on some reasonable basis an adequate spread of profit, as opposed to attempting to maximize profit. I think there is too much risk in attempting to maximize profit because as you attempt to maximize profit, you will start to reach toward longer term maturities. That is what essentially got the industry into much difficulty, in the purchase of thirty-year utility paper and forty-year telephone bonds. As you attempt to maximize your profit opportunities, you will take a greater and greater interest rate risk. I'm not aware of any professional institution over the course of the last fifty years that has been successful on interest rate risk, buying long-term bonds and praying. My view is that buy, hold and pray is not a good strategy and maximizing is not a good strategy relative to the profit potential.

As to the second question on high-yield securities, the Boesky situation was very unusual. The managing editor of the *Wall Street Journal* came to my office a couple of months ago and we had an opportunity to discuss the events that occurred on November 14, when Boesky pleaded guilty to a felony of insider trading. The editor wasn't able to cope with the situation that Ivan Boesky had a relationship with Drexel, Burnham, Lambert, and the latter was the biggest underwriter of high-yield securities. And so as a result those securities all became equal. The high-yield securities marketplace in general went down about 4% or 5% over the course of the next six weeks. Normally Macy's, Safeway, Beatrice Foods, all of which are high-yield credits, will take on their own investment attributes; but from time to time these unusual circumstances occur. In contrast, the purchase of Treasuries at the beginning of the year would have been perhaps three times as bad as having purchased high-yield securities at the beginning of the year. I believe what is occurring in the high-yield market today is a contraction of the market.

By and large the marketplace has been split up in terms of underwriters. All of the investment firms such as Merrill Lynch, Morgan Stanley, Prudential Bache, Kidder Peabody, and First Boston play a more important role in the sale of high-yield securities or in originating high-yield or junk bonds. But the market is contracting because we have more and more buyers of high-yield securities today. Additionally, the high-yield company issuers themselves are becoming the largest purchasers of their own securities. The recent Morgan Stanley study, the High-Yield Update, in April 1987, states that about 30% of the high-yield bonds today were created through fallen angels. Management of these fallen angels has over a course of time deteriorated the credit of the company, and has provided the marketplace with a high-yield security, even though it was never underwritten as such.

Diversification is clearly one of the most important issues as it relates to investment portfolios. One of the risks that the life insurance industry has undertaken has been 10% of the profits in the utility sector alone. I don't believe that 10% of your assets in one industry is adequate diversification even if you have 50 names in that industry. Adequate diversification over a long period of time will provide substantially more safety, but it needs to be monitored closely.

MR. FRANK J. ALPERT: I have two questions. The first one is that our customers and prospects are becoming very sophisticated in asking us about the riskiness in our asset portfolio. I'd like to know how Executive Life answers those kinds of questions. The other very different question is, if we mark the assets to market, do we have a good way of marking the liability to market also?

MR. CARR: In answer to the first question, it is increasingly important to try to provide an overview of the sort of asset strategy or investment strategy that you are using to all of your clients. We have attempted to articulate our strategy through the use of a number of instruments. If you have read our annual reports over the course of the last dozen or so years, you will find a very careful explanation of our investment strategy, and why we do the sorts of things we do.

Let me be quick to add that there is no investment strategy that is correct. Every investment determination you make is inaccurate. It is just a question of degree. But I think that your clients are entitled to a careful explanation of your investment overview or investment strategy, the approaches that you are taking in terms of trying to achieve a balance between profit and intrinsic value for the consumer. Companies who provide that investment overview for the clients will be well served, and the clients will be much more comfortable.

The second question regards marking the liabilities to market. That's a job for people in this room. I think we need to be more active in clearly understanding our liabilities. Consider the issue of a life once underwritten. Under normal circumstances the life once underwritten will become a poorer and poorer risk over the course of time. The life insurance industry has had the ability to weigh on a dollar basis what a life is worth. Clearly we need to find other ways to be able to more carefully and accurately look at what is happening in terms of the liability side, because as an investment person, I assure you that the news we get on the liability side will be worse than any of us thought it might turn out to be.

MR. DWIGHT K. BARTLETT, III: Mr. Carr, would you critique the proposed regulation in New York limiting the investment by life insurance companies below investment grade securities?

MR. CARR: Rule 130 is a limitation on the use of high-yield securities. A careful analysis of the savings and loan industry will give you an objective look at what happens to those industries that are regulated, relative to the diversification opportunities they may have. You don't use the term high-risk mortgages, but the term high-risk mortgages would be quite accurate. I'm not aware of any financial service industry that has suffered the devastation of the savings and loan industry, yet it is one of those carefully regulated industries where it is necessary to purchase a certain number of mortgages or mortgage-type instruments. If the savings and loan industry had a better opportunity at proper and adequate diversification, it is virtually impossible to believe that it wouldn't have done much better than it has done being confined to one investment. High-risk mortgages clearly have been equities parading as mortgages and have been devastating for those companies, including certain life insurance companies who have invested in 30-year fixed rate mortgages.

MR. ARNOLD A. DICKE: Obviously, regulators and most of us in the industry have a lot of concern about the policyholder expectations being met. One of the approaches that this profession and regulators are taking to try to monitor the situation is what we call the Valuation Actuary Concept, which has been put in place in Regulation 126 in New York and is being worked on further. Among the things that we are supposed to do is exclusively look at the interest rate risk that you discussed and also exclusively take account of the credit risks. What do you think of this approach towards regulating the insurance industry?

MR. CARR: Well, I think in general it is healthy. I think that providing focus on balancing both sides of the balance sheet is healthy. Whether or not that's the exact, correct approach to doing it or not, you will find out over some period of time. The older I get, the less accurate I find the realities of life are. I view this as an attempt, but a strong, objective attempt at being able to balance both sides of the balance sheet. I wasn't being facetious at the beginning of my talk when saying that I think that this group needs to play the most important role in the future of the life insurance business.

MR. ALFRED G. WIRTH*: I wonder whether the S&L's main problem wasn't mismatching earlier, and obviously a geographic diversification which is indigenous to the business by law. My second question deals with a risk that you haven't touched on -- liquidity risk. Obviously mortgages are subject to liquidity risk and so are high-yielding bonds and nearly everything else other than treasuries or stocks.

MR. CARR: First let's just tie up the loop in terms of the savings and loan industry. There is no investment that I'm aware of which should be made everyday, day after day after day and yet that's exactly what the savings and loan industry does.

As to liquidity, in our 1985 annual report we discussed liquidity at some length, trying to provide people a significant opportunity to look at liquidity. Liquidity is always misunderstood. There is no difficulty getting a bid on the assets you own. The question is, can you afford to sell at the bid that you get? It is no different than the loss that occurred with Merrill Lynch just a few weeks ago in the use of Ginnie Maes, where they split the Ginnies apart both into a corpus and a stream of income. They didn't have any difficulty getting a bid for what

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they had left; they were just very unhappy with the bid that they got. The issue in terms of liquidity is, can you afford to sell? If you look at some of the squeezed periods for certain life insurance companies -- the 1974 period and the 1980-81 period -- the squeeze really related to their ability to afford to sell, not that bids were not available. Therefore, there is all the more reason to be able to balance your assets to make certain that you have dealt with the issue of liquidity; that is the ability to afford to sell.

Second, make sure that you have an adequate amount of funding relative to anything that may occur to you as it relates to disintermediation or other unknown events, all of which can occur at some point in the future. I think that the liquidity issue can be dealt with more realistically, not by maximizing the profits, but by balancing those profits and by setting aside a certain amount of your assets relative to this issue of liquidity. My company's experience has been that we have been too liquid and it has been an expensive endeavor for us. Yet it has always been one that we have been much more comfortable with, that is, paying a price in advance of liquidity.

MR. MURRAY L. BECKER: Fred, given the world of interest rates and the credit issue you discussed, what can an insurance company do to protect its own creditworthiness to the customer?

MR. CARR: I think that a careful decision by an insurance company in advance as to how they should construct the liability side of the balance sheet will provide a substantial opportunity to carefully build a sound financial structure. The liability side is a far greater opportunity in the life insurance industry term than in virtually any other financial service business. The banking industry is becoming overnight a business where banks are essentially putting out longer liabilities. That's not true in the life insurance business. Those companies that can carefully decide how to structure the liability side of their balance sheet in such a way as to be able to balance the assets they choose against the liabilities can create a very substantial financial structure. Obviously, banks raise capital; we think capital raising is important because we put more capital into the life insurance business than any company ever. But, a careful determination in terms of a decision about assets and liability matching is the way to build a very sound financial structure for a life company.

MR. SHRIRAM MULGUND: My question relates to the interest sensitive products sold by the insurance company. Does the matching or the balancing of assets and liabilities reduce the risk of loss at the same time it reduces the chance of making a profit? The insurance companies are in competition with other financial industries, whose expenses are not front loaded. An insurance company has to spend more money in the beginning. In order to counteract that, it has to have a larger interest spread. If an insurance company were to minimize profits by balancing assets and liabilities, if it is not able to maximize profits, how can they be in competition with other financial industries?

MR. CARR: Current interest and current mortality products are desirable from the consumer's standpoint and not always desirable from the life insurance companies' standpoint. I think companies need to make careful decisions on the nature and type of the current interest and current mortality types of products that they choose to sell. Most of the people in this room can develop an asset share study that will provide reasonable information on the kind of current interest and current mortality products that a company should be selling. I've always been concerned that an important management decision, in terms of the nature and types of products that you should be selling, is the assumptions that management provides you. In our company, we are not willing to sell a product if Allan Chapman doesn't sign off on it.

We're not willing to do it because we don't believe there is any financial service business that has the ability to consistently sell products that don't make profit (although a number of them have tried). We think that companies need to specialize in those products that they are the most comfortable with, and in turn balance those products against the kinds of investment results that they are best at achieving versus those liabilities. Clearly a number of life insurance companies have offered products to the public which are not profitable, and that just cannot continue. But, that has happened in lots of industries, and sooner or later those companies get into much difficulty. I think there is plenty of room at a reasonable profit stream for life insurance companies in the current interest, current mortality mode.

MR. DICKE: The strategy of investing in high yield bonds or other riskier strategies really might well prove to be very good for the policyholder, but the problem is that the policyholder often doesn't know that one company is involved in one sort of investing and another company in another sort. Do you think that companies involved in riskier investment strategies should be forced to issue a prospectus as a mutual fund would in that type of situation?

MR. CARR: No. You made some assumptions which I'm going to have difficulty accepting because I'm not aware of any qualitative analysis proving what you said. When you use the term riskier strategy, clearly somebody who bought the American Telephone and Telegraph 2-7/8%, due June 1, 1987, embarked on a very risky strategy; they lost the use of their money and they got 2-7/8% interest. I view that as risk and I think that none of us fully appreciate all the risk that can occur. Not just in terms of high yield securities or junk bonds, which over the course of the last ten years have been less risky than treasury bonds, but also relative to high grade securities. Earlier I discussed management risks, high risk mortgages, and fixed rates over a longer period of time, and how devastating that has been. Real estate at the wrong time is generally illiquid and difficult to deal with; if you've made a mistake, you have a major mistake. There are so many risks involved relative to investing itself, that it is not possible to merely point to one area and say that's the riskiest strategy. I'm just not aware of any qualitative analysis to prove that one strategy is riskier than another.

You need certain skills to be able to make mortgages over a long period of time. Those companies that don't have strong mortgage skills should not engage in that activity at any time. At the moment, for instance, we have less than the half of one percent of our assets in mortgages. We have weak skills in making mortgages, and I don't believe that its in our best interest to embark on what appears to us to be a risky strategy without adequate skills internally. There are no investment opportunities, including treasury securities, that do not embark you on a substantial amount of risk. Risk is your enemy and you need to beat risk badly in order to win over a long period of time. I'm not aware of any low risk strategy.

MR. DICKE: Then granted that all strategies may be risky, should we all be disclosing our investment approaches at the point of sale so that the consumer has the ability to manage his risk?

MR. CARR: Absolutely. I don't know what the right forum is at all times, but the more we can articulate our investment strategy, the more we make our clients aware of of those approaches we find the most comfortable, and the way we plan to deal with risk. I think it is much healthier for the industry long term.

MR. ROBERT H. STAPLEFORD: How involved do you feel the actuary should be in tying together products designed to reflect all of those investment risks? Are we giving away too many options for policyholders without adequately reflecting them in the pricing? Obviously, you've got marketing people who want to give as much flexibility to policyholders as possible, yet if these options are of a substantial risk, are we giving away too much and not properly reflecting it in the pricing?

MR. CARR: I'm going to tell you a secret that I hope you won't tell to anybody else. Don't let the marketing people design the product. Don't tell that to anybody because I want to be able to lie to our marketing people later on. It is not possible in the dynamic society that we all need to compete in, to allow the marketing people to provide option after option and make an adequate and reasonable amount of profit. It is not possible and so you either need to come to that reality or you need to put on a blindfold, and that is just not a very fun game.

MR. STAPLEFORD: Are we wearing that blindfold today?

MR. CARR: I hope not. At our company, Allan Chapman is the person who can understand both sides of our balance sheet. Allan is a strong actuary by background and he also understands investments. He is the person that needs to make the determination in terms of profit adequacy, as opposed to marketing people. Conceivably there may be one or two companies in the audience today where the marketing people play too strong a role.

MR. ROBERT G. MAXON: You've talked a little bit about your overall investment strategy. Could you comment about synthetic options, futures, and so on, and how they play a part?

MR. CARR: They have not played a part at our company. We have not found them feasible relative to the use of various hedging strategies. We have found them to be too expensive and in effect giving up all of the profit. I must say that we've also been very concerned about future commitments. We make no future commitments. We have always been afraid of the unknown in the future and have never been willing to commit tomorrow's dollar to anything. But, so far, we believe that many of the strategies turn out to be much too expensive and gobble up all of the profit available. So we are not involved in the use of hedging techniques.

MR. ARDIAN C. GILL: Your comments here and elsewhere sound so intelligent that I wonder why the insurance industry doesn't seem to be as impressed with Wall Street. What is it that other companies are doing wrong that you are doing right?

MR. CARR: I think there are a number of acceptable strategies in the life insurance business, and there is no one yellow brick road that we all need to follow relative to finding our future. I think there are a number of opportunities for all companies in terms of being able to live comfortably and compete in what I believe is going to be a very vibrant and exciting life insurance industry. I happen to believe this is the most exciting time in the history of the life insurance industry and a very nice time to be competing in it. I think that companies need to develop strategies that are comfortable for them, and I think there are going to be times when your strategies don't work and you need to rethink your strategies.

I discussed at some length the issue of investment strategy being wrong and the need to reexamine it and understand what is occurring and what is changing. I think there are a number of roads and approaches towards successful building of life insurance companies, and I would commend you at some opportunity to read the advertisement by Cadillac Motor Car in 1914 that talks about the penalty of leadership. I think that all of us, including my company, need to pay the price of the penalty of leadership in order to build a much more vibrant life insurance industry.

MR. KIN K. GEE: It seems to me there's a trend towards marketing and advertising life insurance products as investment and away from protection of human life value. There's perhaps too much attention being focused on the current credit rate on some of our products. Can you comment on the long-term effect of this trend if it continues in the life insurance industry?

MR. CARR: I think we need to do a better job in advertising our products. We need to do a more careful job in portraying our products and in the sort of projection we make relative to the kinds of products we sell. I think it will provide greater integrity for insurance products if we are more effective and more realistic. Unfortunately, there are periods of time when the competition gets slightly abusive and people overreach in attempting to sell the kinds of products they have. In any industry, you can't sell successfully against promises forgetting your inability to meet the promises that you make. I think long term, if our industry is to be vibrant and able to compete well against an onslaught of competition from banks and S&Ls and a series of other competitors, we need to be much more objective in the illustrations, projections and promises we make to consumers.

FROM THE FLOOR: You mentioned earlier that you really were not asset driven but more liability driven. I was wondering, what techniques do you use to hedge against not only interest rate risk but also quality sector asset risk to the extent that there is a lag between when you get customers' funds and when you invest them?

MR. CARR: It is not possible to invest on a precise basis the funds that you get from the clients versus the product that they are buying. You can't get the money today and invest it exactly correctly against that product. So there is a lag, in some cases a very substantial lag, relative to the kinds of investments you choose to make versus those products. However, one of the errors of the industry over the course of the last fifty years has been an error of anxiety; that is an anxiousness to be able to invest the money quickly in some longer term instrument. I think that has turned out not to serve the industry well.

I think a more careful analysis of asset opportunities will provide much more favorable long-term results. Many industries, the life insurance industry included, have been afraid of money. They have been afraid to sit with cash and carefully and prudently choose and select among a number of asset opportunities, and I think that has not served our industry well. I think that long term we need to be more cautious, because as I had expressed earlier, these buy, hold and pray strategies have just not worked out, nor are they going to work out.

And I think that we need to balance the asset side much more carefully than we have historically, when we choose to put our money into longer term instruments. These products that we are selling which many of us hope will be on the books for thirty years aren't really going to be. I hope that's not a shock to some of the people in this audience. But some of these longer term insurance products that many of us would balance with the longer term instruments are going to be on the books for shorter periods of time. I think you need to take a harsh approach to duration rather than a longer approach to duration. Our duration at the moment, for instance, is 4.14 years. I'm not saying that's accurate or correct, but I'm saying we don't believe that certain life insurance products put on the books are going to stay there for 30 years.

FROM THE FLOOR: As a follow-up, I was specifically concerned with the stated $2 billion of guaranteed investment contract (GIC) money you put on in the fourth quarter of 1986, to the extent that there was a lag before you invested and you already locked in and promised the customer what the GIC rate would be.

MR. CARR: The nice part about the GIC money that we put on in the last six months of 1986 was that it had relatively precise terms attached to it. I view that as a much easier opportunity in terms of management than I do those instruments which are less determinate in terms of duration. We are always willing to have a lower profit margin if it requires a slow investment process and I can tell you from someone who has made more investment mistakes than anyone east or west of the Mississippi, that a slow investment process is much more effective.

FROM THE FLOOR: You made a comment that you didn't expand on. You said you felt the news in the future concerning the liability side may be far worse than the news related to the assets. Would you care to expand on that thought?

MR. CARR: I believe that whatever news we get relative to the liability side of our balance sheet in the future, will be worse than any of us would choose it to be. I can deal with the issue of having to lose the better news, but I'm not interested in focusing on expecting better news. I'd rather focus hard on expecting worse news. We'll be far less surprised and we'll be far more adequately prepared to deal with the realities of tomorrow.

MR. CARNEY: You made some comments about the exciting times that we're in now. You've been a leader in interest sensitive products and an innovator over the past few years and you've been very successful at it. Where do you think the industry is going in the future with regard to products, competition and regulation?

MR. CARR: I don't think I can answer that in detail, but I think that the products will become simpler. I think that we need to get to what I call the elegance of simplicity. As we get to the elegance of simplicity, it will be far more attractive for the consumer to buy our wares. It will be far more attractive to the consumer to buy more life insurance products or products that have a life insurance background. I think the thing that all of us need to do is work towards this elegance of simplicity. Because, I think in that we will find a greater share of market.

MR. HARRY PLOSS: You talked about risk being your enemy. I would like some of your views concerning capital and leverage relative to risk and your quantification. Second, what are your views on overcollateralization, as with collateralized mortgage obligations (CMOs) or certain other investments as a recognized way to improve investment quality? One could say there could be a business of guaranteeing bonds to improve quality; for example, converting junk to triple A. There is such a wide spread between these things compared to the default risk.

MR. CARR: You're probably not going to like my comments. The quality changes that have been made by insurance companies guaranteeing certain assets, that is taking a triple B credit and making it into a double A or triple A product, have been done by companies with a relatively small amount of capital compared to the requirements of Standard and Poor's. Many of those companies have a limited amount of capital versus the amount of liabilities.

One of the things that has occurred, perhaps a good example, is the insuring of municipal bonds. I know you are aware that's a big business. The amount of liabilities put on the books in terms of insuring municipal bonds has been enormous. While we have had no losses so far, and that industry is relatively new, I'm far less impressed with the quality of that insurance over some long period of time in what is a very dynamic society. I think that the industry long term would be better served with a larger amount of capital as opposed to a smaller amount of capital. Now, I know that the actuaries would be quick to point out to me that the industry has done well versus these long-term liabilities and that probably in many ways the industry has been overcapitalized as opposed to other financial service businesses and other financial service intermediaries. But I still believe that we need larger amounts of capital in order to better balance the unknown risks of tomorrow than we had yesterday.

MR. PLOSS: What do you think about the efficiency of pricing guarantees, say guarantees in the municipal bond market? Do you believe they are being adequately priced and there is a profit opportunity or that the competition has driven the prices down to irresponsible levels?

MR. CARR: No, I don't believe they are adequately priced. As I say, we've had no losses. It has been a terrific business. It is revenues versus no losses. They could probably stand one loss.

FROM THE FLOOR: What I have is more a clarification than a question, because I think some concepts were a little bit mingled. On the one hand we heard of the need to balance the assets and liabilities, and that you can't analyze each one by itself but rather you need to look at the two in tandem. In response to a question about risking this though, we've heard about the AT&T long bond at 2-7/8% that's risky, or that you would have done three times worse in Treasuries than high-yield over a certain period of time. Those last two comments sound like a total return-type analysis. You look at how well you would have done in treasuries versus high-yield. You look at the prices and see how well you do. While true, that really ignores the liability side. The point I'd like to make is that if that long AT&T bond had been purchased to back an annuity, where nobody can change the terms and everything is fixed, the 2-7/8% may not have turned out so bad at all. I wanted to make that comment, because sometimes it's unclear whether you should do a total return analysis or remember that you can't analyze any asset without the liability that is there behind it.

MR. CARR: I guess that's a statement and not a question. Let me tell you that I don't know who owned the 2-7/8% of June 1, 1987, but I assure you as those interest payments were made and as expenses went up in the company the results were devastating. It is conceivable that somebody in 1947 put out a contract against those 2-7/8% bonds and made money with it, but my guess is that there were damn few of those who did.

I didn't mean to be disrespectful in any way. It's always possible to take somebody's portfolio and point to one item as I pointed to an item to prove a point. I was trying to provide a more macro concept relative to long term and short term to give you some contrast.

MR. GEE: It seems a reasonably significant amount of the high-yield bonds were and are from takeovers and leveraged buy-outs. I wonder if you can share with us your thoughts on the poison pill and antitakeover procedures that are being put into place by some of the managements of companies. Second, what's the impact on the future supply of high-yield bonds?

MR. CARR: I think that the poison pill and antitakeover is unfortunately antistockholder. We use a funny term in the press which is hostile takeover. I'm not aware of any hostile takeover where somebody has bid for 100% of the shares for cash. Any of you who would like to bid 100% cash for any shares of any company that we own, we would not view that as hostile. As a matter of fact, we view it as quite friendly.

As to your second comment, relative to high-yield issues, the market is clearly contracting. The only expansion that you've had in any significant way recently has been the fallen angels; some of the examples we talked about, Texaco, Bank of America, US Steel, basically all of those companies who have brought down a substantial amount of high-yield bonds into that marketplace. But, I believe there will be a continuous contraction of the market by both the issuer repurchasing their securities and by more buyers coming into the marketplace. The high-yield or junk bond market is a very small portion of the overall debt market. If you'll look at world debt, corporate bonds probably amount to 15% of overall debt and high-yields probably amount to maybe 15% or maybe 18% of that. I do believe you are going to have contraction and that market is not going to grow in terms of importance or significance, at least for some very long period of time, because we have gone through this restructuring process.

If you look at the last twenty years, you've lost jobs in Fortune's 500 in a significant way and gained jobs with the smaller companies. But, I do think you're going to have continuous contraction.