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EQUITY STRATEGIES FOR LIFE INSURANCE COMPANY GENERAL ACCOUNTS

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Panelists: BRUCE LEAVITT*
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Recorder: DARYLE G. JOHNSON

With interest rates at cyclical lows, equities may provide more potential for superior returns than traditional fixed-income markets.

- Discussion of available instruments
- Alternative applications
 - for funding of fixed liabilities
 - for funding of corporate capital and surplus
- Risk/return trade-offs
- Accounting implications
- Risk-based capital (RBC) implications

MR. DARYLE G. JOHNSON: We have two people who will be speaking on equity investments for life insurance company general accounts. Bruce Leavitt began his investment career 14 years ago with Lehman Brothers. He was there eight years and then he left and joined another firm where he was involved in actively managing portfolios for four years. He joined Merrill Lynch three years ago and is now in the equity strategies area where he's responsible for the structured equity business.

Casey Sylla is vice president – securities for Northwestern Mutual Life Insurance Company. In this capacity he is responsible for all investing in private fixed-income and equity securities for the company's general account. These investments include energy, limited partnerships, private and selected public common stocks, leasing acquisitions and various mezzanine investments. Casey joined Northwestern in 1971.

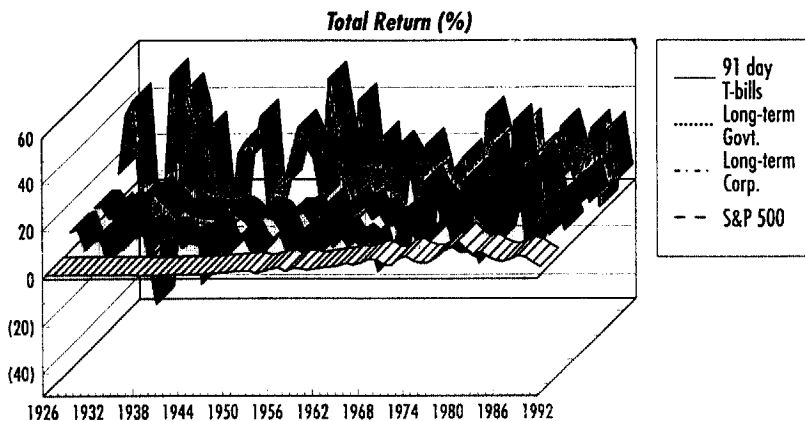
I've asked Bruce to speak from the sell side and he's going to describe the various kinds of equity investments, what their features are, and what he would see as some of the advantages and disadvantages of these various types of investments. Following Bruce, Casey will speak from the buy side and he's going to be talking about his experiences at Northwestern Mutual and how Northwestern Mutual uses these various kinds of equity investments in the general account.

I want to start by giving you just a little bit of background. Chart 1 compares the historical annual returns going back to 1926 for fixed-income investments and common stocks. The only point of this is to show how common stocks provide higher returns, generally, but are more volatile than the other forms of investments.

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CHART 1
Historical Annual Returns



Assume the same data, and look at \$100 invested back in 1926 (see Chart 2). Your investment would be worth less than \$10,000 if you had invested it in short-term investments or government or corporate bonds. However, if you had invested it in common stocks, it would have grown to about \$65,000. So it's clear, and we all know this, that equity investments provide higher returns than fixed-income instruments. There's more risk, but there's more return.

Chart 3 gives a little bit of background on U.S. life insurance company assets. At the end of 1991, total U.S. life insurance company assets were a little over \$1.5 trillion. Of that, about 13% was in separate account assets and 87% was in general account assets.

Let's have a look at common stocks held by U.S. life insurance companies (see Chart 4). Again, this is plotting data for both the general account and separate account. Of course, this session deals with equity investments in the general asset account; therefore, I wanted to show this data separately, not just in aggregate. Common stocks held in separate accounts were \$97 billion at the end of 1991 and the amount held in general accounts was \$57 billion.

If you take the amount of common stocks held in the general account and express it as a ratio of general account assets, Chart 5 shows how it would look over the last 20 years; it runs about 4%. It has ranged from a low of 3.5% in 1974 to a high of 5.7%, just two years earlier, in 1972. Market fluctuations are influencing these numbers, but common stock held in the general account has run about 4% of general account assets.

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CHART 2
Growth of \$100

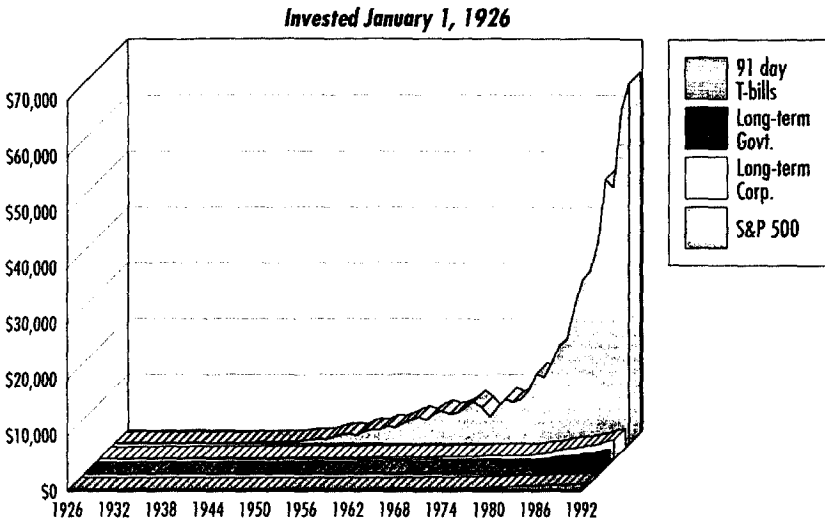
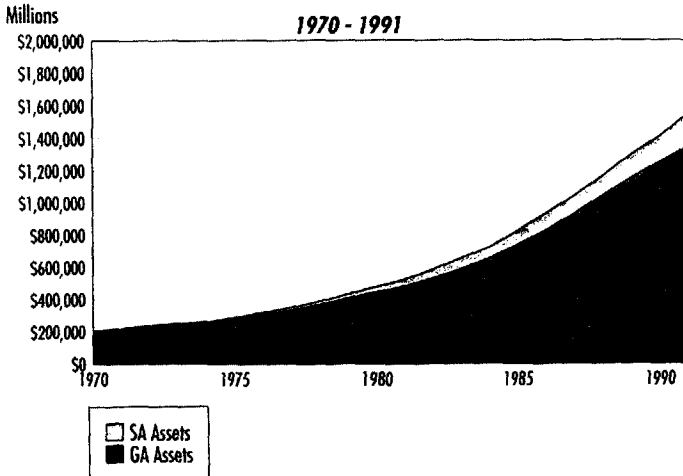


CHART 3
U.S. Life Insurance Company Assets



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CHART 4
Common Stock Held by U.S. Life Insurance Companies

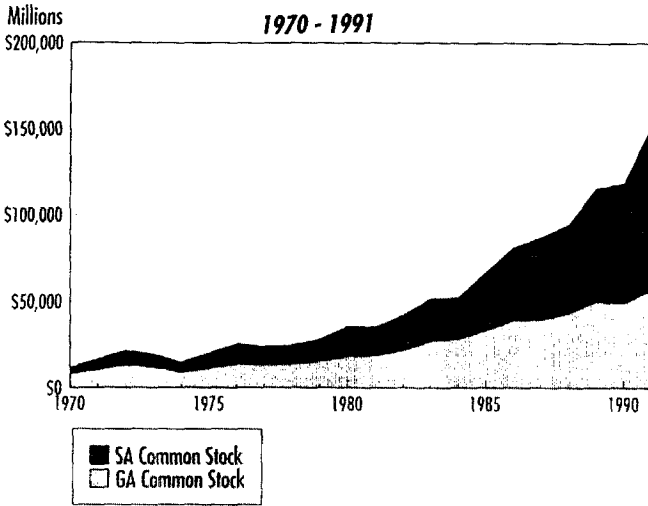
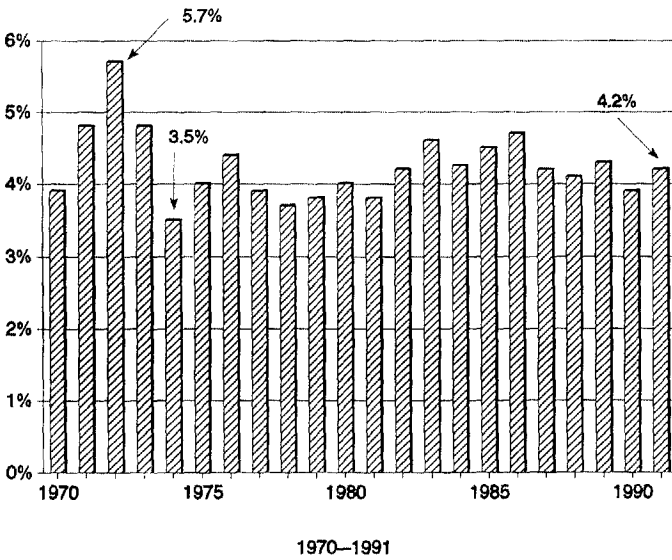


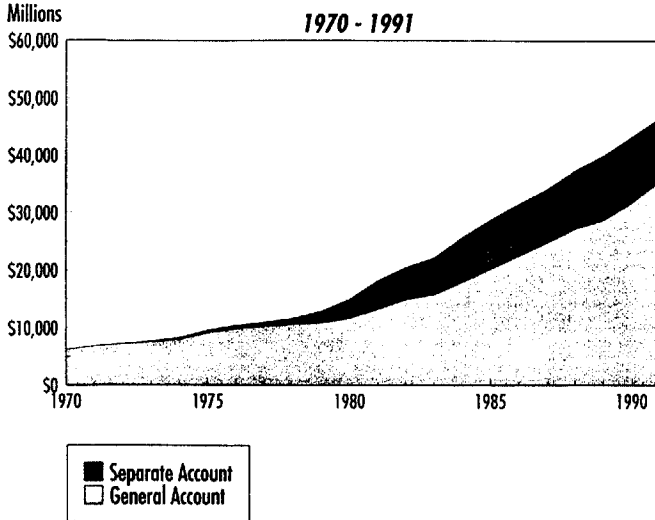
CHART 5
General Account Common Stock Related to General Account Assets



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Let's have a quick look at real estate. Chart 6 shows real estate owned by life insurance companies by general account and separate account. There is more real estate held in the general account than in separate accounts. This is equity real estate only but it does include properties occupied by the company and it does include properties acquired in foreclosure, as well as investment real estate.

CHART 6
Real Estate Owned by U.S. Life Insurance Companies



If we take real estate held in the general account and we express that as a percentage of general account assets, it appears as shown in Chart 7. It runs about 3%. Since 1970, it has ranged from a low of 2.49% in 1989 to a high of 3.28% in 1975.

If we now take the amount of common stock and real estate held in the general account, and we plot that as a percentage of capital and surplus and asset valuation reserve (AVR), Chart 8 shows what it would look like. The common stock number is 46% at the end of 1991 and the real estate number is 28% for a combined total of 74%. You can see its range from about 75% up to perhaps 90% during this particular 20-year period. Life insurance companies have been investors in equities. I've shown only common stock and real estate; they have run less than 100% of the capital and surplus that life insurance companies have -- at about 75%.

There are a number of other factors affecting equity investments that insurance companies make in the general account. One of them is the new National Association of Insurance Commissioners (NAIC) RBC requirements, which are much higher for equity-type investments and I think one or both of our speakers are going to be speaking about this topic.

CHART 7
 General Account Real Estate Related to General Account Assets

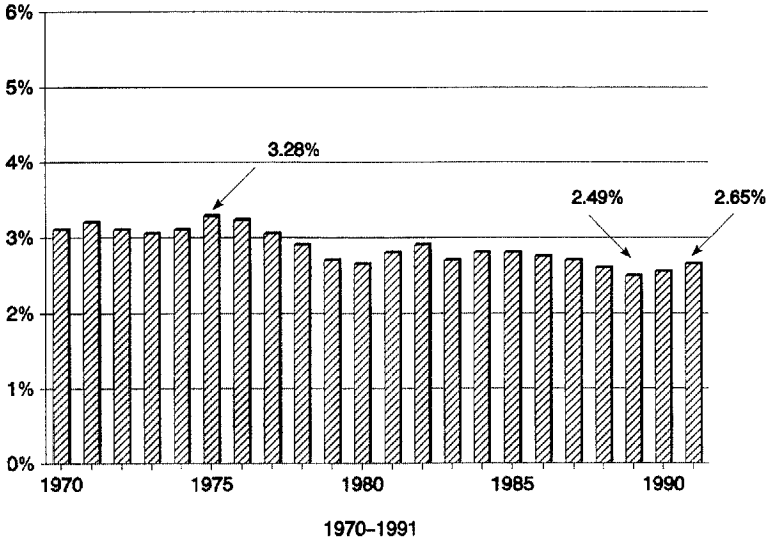
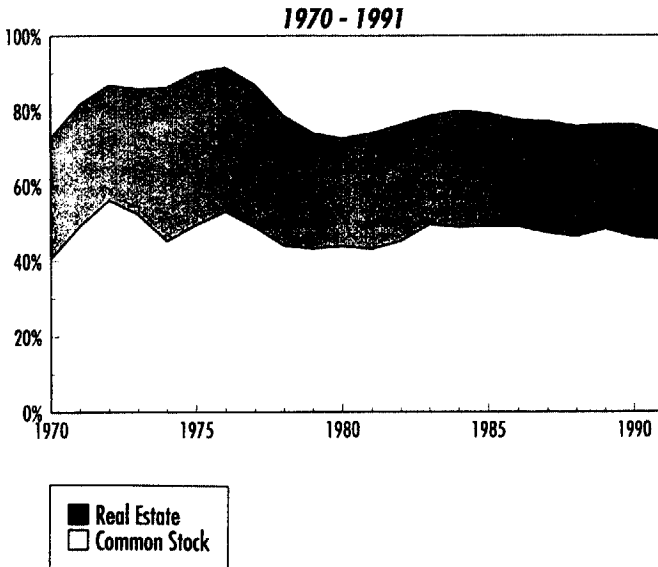


CHART 8
 General Account Common Stock & Real Estate
 as a Percent of Capital + Surplus + AVR



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These new requirements are going to affect different companies in different ways and it's going to have an influence, I think, on their behavior with respect to investing in equities. A part of the influence is going to come from how much surplus they have. Companies who have a lot of surplus and who have high RBC ratios are going to have an awful lot of flexibility and will be able to afford to invest in equities in the future much more so than companies who have less surplus and lower RBC ratios.

The session description says, "with interest rates at cyclical lows, equities may provide more potential for superior returns than traditional fixed-income markets." Well, that might be true, but while interest rates are at cyclical lows, common stocks are at an all-time high. That would be a consideration for making equity investments, at least in common stock, in addition to just interest rates being at cyclical lows. Other considerations would be company management. There are some companies that don't believe equity investments are appropriate for insurance companies, or at least not to the same extent that some other companies do. They base this mostly on sort of an intuitive belief as much as anything else. You have state insurance departments and investment regulations that have an impact on this. You have rating agencies. You have the RBC standards that I mentioned. All of these things have an impact on the amount of equity investments and the type of equity investments that insurance companies are going to be making in the general asset account.

MR. BRUCE LEAVITT: I am going to talk about equities and I'll spend a fair bit of time talking about it in general, but I'm really going to focus on Daryle's last point – what is the most efficient way, given the risk profile that most life companies have, to invest in equities? Equities offer a higher long-term return but can you live with the volatility that they provide you with? Can you live with the capital standards that nervous regulators require? Can you live with boards of directors who believe that we don't sell that many products with long liability tails, so we don't need equities?

In order to keep ourselves in business, Wall Street is always trying to find new ways of investing in equities. The most commonly talked about thing has been an out-growth of how one participates in the equity markets without suffering the high NAIC RBC charges for equities.

While I'm not going to talk about common stock, I'm going to stay with what I would prefer to think of as a new frontier for equity investment and where I think the focal point will be over the course of the next five to ten years. The easiest product and the most common one, and the first one was done about five years ago, were things that we called equity participation notes. Others have called them protected equity notes. They're all the same thing. They are notes that guarantee, no matter what you put up, that you get your initial investment back as a minimum return in five years time. Your risk on an investment like that is the capital that you've put up or the opportunity cost of that capital.

An equity participation note is nothing more than a zero-coupon bond, which is what assures that you get some minimum redemption at maturity and an option. The option is what gives you the equity participation. The things that are going to affect the participation within this is the issuer's credit quality, the term of the notes and the volatility of the underlying index.

Let's review this real fast. We have a single A bond or triple A bond. It doesn't matter. We take the coupons from that bond and we discount that back. It would be the same as saying I bought a zero-coupon bond. If I bought a five-year zero-coupon bond in today's interest rate environment, I would pay something like 75%. That means I have 25% left over. If I'm going to spend par, or 100% to buy an option, then that option is going to give me some simulated participation in a stock index or basket of stocks. When assessing the value of the option, we're going to look at a couple of things. We're going to look at, obviously, how long the option is out. We're going to look at how volatile the underlying stock or index that the option is on, and we're going to look at the current interest rate environment, because that will establish how long we're going to carry a position and financing charges.

I'll give two examples – one that will show you some income and one that won't. Actually, I'll give you three examples. Table 1 gives the Nikkei because that's where these products began. As most of you probably remember, the Japanese stock market went from somewhere around 40,000 Nikkei points down to 20,000; but it was 14,000 earlier this year. When it was at 40,000, people were reasonably nervous and looked for ways to participate in a protected manner and not risking principal.

TABLE 1
EPNs on International Indices

Underlying Equity	Nikkei 225 Index
Maturity	5 years
Issuer	A + rated issuer
Participation Level	90% of the price return of the Nikkei 225
Coupon	0%
Note	The investor is hedged against Yen/USD currency fluctuations
Underlying Equity	EAFE Index
Maturity	5 years
Issuer	A + rated issuer
Participation Level	100% of the price return of the EAFE Index
Coupon	0%

What is this first example really saying? We have a five-year bond maturity. We have an issuer who's a single A credit. In that case, five years, single A credit, as a rule of thumb in today's interest rate environment, you can figure out you've got 25% left to buy options. With that 25%, I then have to go out and get participation in the Nikkei. Why do I want to do it that way as opposed to just investing in the Nikkei if that participation is going to give me only 90%, and I'm going to have to forego my dividends, which is 0.5% on the Nikkei? There's only one reason you're going to do it and that is because you can't afford the volatility if the Nikkei drops. Four weeks ago, the Nikkei was at 21,000. It's closer to 20,000. I can't afford that volatility in my portfolio. If we think the gap is going to change, it's going to be even more difficult.

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The first concern of the give up in dividends is very real. There's no doubt that most of your colleagues on the investment side are concerned about posting numbers that show they are earning money every quarter.

We have been to countless insurance companies, as has probably every major Wall Street and European investment bank, to tell them that this is the easiest way to invest in equities. Almost every time someone says, "Well, I don't want to give up my 2.8% dividend yield on the Standard & Poor's (S&P), because over time that buffers me against a lot," and they're right. We turned around and said that makes sense. Let's say instead of having the bond mature at 100 no matter what happens, we'll have the bond mature at 120, which conveniently works out to the 3.06% yield that you see on the bottom of Table 2.

TABLE 2
Accreting Equity Participation Notes

Underlying Equity	S&P 500 Index
Maturity	6 years
Issuer	A+ rated issuer
Coupon	0%
Starting Index Value	The closing level of the S&P 500 Index on the issue.
Closing Index Value	The average closing level of the S&P 500 Index at the end of years 4,5, and 6.
Redemption at Maturity	Investors receive a redemption amount equal to 120% of the percent difference between the average closing index value and the starting index value, multiplied by the principal amount. This payment is subject to a minimum redemption of 120% of the principal amount.
$\frac{\text{Average Closing Level} - \text{Starting Level}}{\text{Starting Level}} * \text{Principal Amount} * 120\%$	

Note: The minimum yield to maturity is 3.06%.

Suddenly, this bond no longer requires me to give up my dividend yield. Of course, there's no free lunch and I've got to pay for that somehow. I pay for that in terms of participation. I'm getting a lower participation and I'm also lengthening the term.

Let me walk through that slowly. This transaction was designed to address people's needs for accruing income on an annual basis that's consistent with where the S&P would accrue income. It was designed to remove the volatility in an equity portfolio, while at the same time receiving RBC treatment consistent with bond-like capital treatment. We extended the maturity of the bond a year to take it out to six years. Instead of having the bonds mature at 100, we had them mature at 120. Therefore, it cost me 85% to buy the bond. Now I have 15% left to buy a participation on an equity index. We took the average equity close in years four, five, and six, and as long as that's higher when multiplied by its participation rate (that being the 120 that you would get as a minimum return on this) you have an equity participation. That has become a reasonably prominent theme among a number of life companies in recent months, and we think it will be a growing theme.

Now these are not the only way that people have invested in equities to get around the high RBC requirements. There are other things. Some are more expensive and some have even closer simulation. Any time you get a closer simulation to equities, it means that you're probably not getting full protection. The most common one of these has been equity swap structures. I'm not going to talk a lot about that, but I will mention them briefly.

Equity swaps are something that most insurance people are probably familiar with, because insurance companies are among the largest users of interest rate and currency swaps. An equity swap is nothing more than someone contractually agreeing to receive the return of a basket of equities in return for payment of some other form. Typically, it's done against London Interbank Offered Rate (LIBOR) which is the marginal cost of funds for many financial institutions.

These equity swaps have become reasonably prominent, but not among insurance companies because they carry a much higher RBC requirement than the equity participation notes or note-like structures.

Another structure that's been fairly common on the pension plan side and that could come into use for insurance company general accounts as the new Financial Accounting Standards Board (FASB) rules about marking to market are adopted is portfolio protection. Given the buoyant equity markets and really fixed-income markets that we've had in the last several years, the value of most pension funds has been greatly enhanced by the market and many funds have tried to lock in some of those gains or manage what would typically be called the surplus in the fund.

The way those are typically done is through a structure called a collar. They're typically done in a way that no one puts up any money. People use a terrible misnomer. They call it a costless collar. It really is a premium-free collar. A premium-free collar exists when someone says, typically a Wall Street firm like ourselves or one of our leading competitors, "If you don't want your equities portfolio to decline between now and year end, we will guarantee that it won't. In exchange you will give us any of the appreciation that portfolio has above some preestablished number."

What are the advantages? It eliminates the downside risk. There is some cost, but the cost is usually reduced by giving whatever upside there is above some percentage. The investor typically has the option to set the parameters with which he's willing to live. Relative to common stock, these obviously require substantially less capital.

The other area of quasi-equities that we've seen a tremendous amount of growth in is convertibles. This is where this pool of ideas really came from and one of the reasons it took us awhile to find insurance companies to embrace it. The convertible bond market is no different than these equity participation notes, except they're issued by the host corporation. Convertible bonds, just like equity-linked products, have substantially lower RBC requirements than do traditional equities. You can just see in Table 3 it's 0.3% versus 30%. There is a convertible preferred market, but that's probably not necessary to talk about here. It's also a much smaller market than the convertible debt market.

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TABLE 3
Advantages of Convertibles Relative to Common Stock

Substantially lower RBC Factors:				
	S&P Rating	NAIC Rating	P&C	Life
Common Stock			30%	30%
Convertible Bonds	AAA,AA,A	1	0.3	0.3
	BBB	2	1.0	1.0
	BB	3	4.0	4.0
Convertible Preferred	AAA,AA,A	1	*	2.3
	BBB	2	*	3.0
	BB	3	*	6.0

Less downside risk because of par value and yield advantage over underlying.
Better accounting: cost or amortized cost generally used. (P&C insurers use market value for perpetual preferred.)
Lower volatility than underlying equity.
Not yet finalized by NAIC.

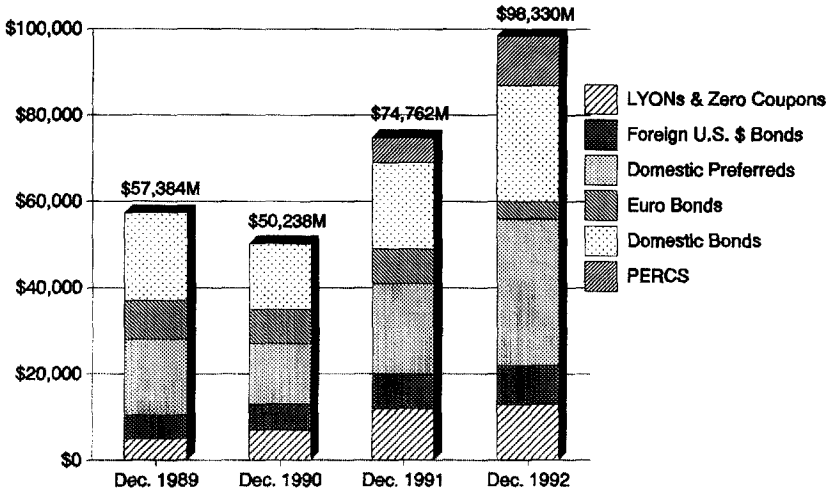
I want to point out that there are two very important things to take away from the convertible bond section. One is just the tremendous amount of growth we've seen and that growth has been fueled by insurance companies and mutual funds. It is just a more efficient way of investing in equities. It takes out a lot of the downside risk. The second is that when I began in this business, people were very afraid of buying convertible bonds. One leading reason why convertible bonds were purchased reasonably infrequently was credit. Everyone has always believed that convertible bonds belonged in the speculative section of the investment criteria. However, only a third of the convertible market is speculative grade. We have seen a tremendous acceptance of investment grade users.

The proof is always in the pudding as to why someone does these things. Because the performance does a reasonably good job of simulating the overall stock market and because of the interest components and taking out the volatility, convertible bonds have outperformed the stock market over the past three years (see Chart 9).

I believe that the NAIC-RBC formula is the crux of what's going to govern insurance company general account equity investment decisions in the future. I really think that the equity options and swaps portion will gain more acceptance than they have. The protected equity note structures, or convertibles, and equity-linked note structures will have the potential to become the dominant form of equity investments within the portfolio over the next ten years. That will be aided by the low interest-rate environment.

There is no shortage of strategies that we will all come up with over the course of the next several years to best meet everybody's needs, and we're far from there now. I don't really have much else to add, so I'm going to ask Casey to come up and fill in whatever I've missed and tell you what the truth is, because certainly you never hear the truth from Wall Street.

CHART 9
Profile of the Convertible Market



MR. CASEY J. SYLLA: I'll start with what I'd call our general account investment requirements, and I'll try to put this setting in perspective as to where the equities really fit in.

If you talked to your investment people, they'd probably give you the same list. Unfortunately, it's very difficult to meet all these objectives at the same time, but the reality is we really believe that to drive our business, we really need to produce very competitive long-term rates. As a result of that, we think about competitive long-term rates, whether they are public, private, fixed-income equity, or whatever, as having to be measured on a time-weighted total return. We spend an extraordinary amount of time, and have for many years, putting precision to valuation in measurement of what it is we have and what can it produce and yield to us.

Yield on bonds and all that nice stuff is interesting, but we want to reflect pricing and total returns. It's kind of intriguing to me as I go talk to a lot of investment personnel of other life companies, that the concept of time-weighted total return measurement is still a hazy concept. I think they're going to get there. To us, it represents one of the only ways we can really manage our risk/reward relationships between a wide variety of different investment instruments.

We think the entire portfolio has to be an inflation hedge. A very high percentage of my portfolio managers don't remember the late 1970s and the early 1980s. They've lived with a very nice wind to their back in terms of the equity and bond markets; it's really been kind of a can't-miss decade. It's been very difficult to miss in the investment operations, so we still always have an eye back, especially in our business,

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because inflation was the killer of our whole-life product which has been the backbone of our business.

We need the ability to respond to change. We must be very nimble. Changes can occur in interest rates, in inflation, in credit, in sector shifts and whatever; so we think about that in terms of our portfolio. We need a high predictable level of income. When I talk about the equities, you will see that the way we structure them really does produce current income to us; so we try to balance that with just having pure nonproducing equities.

Ample liquidity is a given, maybe more than we need. The philosophy in our shop is we don't borrow money; we don't have lines of credit. We ought to have no cash balances, but we do run cash balances and we think about liquidity a lot. Again, remember 1980 and 1981 when we had to sell bonds and give away bonds to fund policy loans. We fixed some of that, but it's still there. We need to conform to regulatory and accounting standards. The level of regulations and the time we are wasting in the investment operations to meet with all these onerous regulations is amazing to me; much of this wasn't around five years ago.

Last, the quality image. I suspect everyone in this room has that same thing to wrestle with. We're not about to ask our people in our portfolios to do anything that doesn't really smack of quality no matter how good the returns might be. These are givens and they really haven't changed in my 20 years there and they probably won't change in the future.

What has our investing history been? I'd like to tell you that we do a lot of fancy things, but we really don't. We start with some of the basics. Our common stock history goes back to the mid-1950s, a little bit before my time, but it wasn't until 1970 that we actually had a common stock department inside of our company. Prior to that, we had given some money to J.P. Morgan and Bankers Trust and the Wall Street people to manage a fairly modest common stock portfolio. We really brought this in house in 1970. It's a very active area not only in the separate account, but in the general account area as well. We try to aggressively manage that and we've gone through cycles. It's not just common stocks to us.

We've made major moves in small cap stocks from time to time when we thought it was appropriate. We have made major moves in foreign stocks and we are making those moves as we sit here and have been for some time. I'll speak a little bit about Southeast Asia and places where we think there are going to be tremendous growth opportunities, both from country index funds as well as specifics. So we do move that around. We don't just talk about common stocks in general; and it's here to stay.

Real estate is an area that really began in our company in the late 1960s. We finally figured out we were making developers rich. We were putting up all the money. They were putting up no money. By the time the building got sold, they made the money and we had the long-term fixed-rate mortgage and we sat on it for the next 25 years. We said we've got a better idea here. Since we're putting up most of the money, I think we'll take some of the action, and so we moved headlong into commercial real estate. We continue to play in commercial real estate,

notwithstanding where the industry is today. There are huge problems in this industry to be rooted out but we are still purchasing commercial real estate where we see an opportunity.

What has differentiated us from an awful lot of people in this business is we have not purchased Wall Street real estate. We have not used brokers. A lot of what I'm telling you is the good fortune of a lot of people who came before me, as well as the last 20 years, but we've had our own regional system. We have people in Memphis and in Houston. If you've got your own originating sources out there who understand the environment and the people and do your origination, I think you've got a much better shot at being successful in real estate. That's been our philosophy and maybe one of the reasons that our troubled real estate or our foreclosures run at about one-fourth the life insurance industry average. We think it's a people business, and so we continue to play.

Venture capital is an area where we don't have the manpower and probably never will have the manpower to do it in house. So we give our money away and we pay someone a fee to do it. It's been a disappointing business over 20 years but we think it's an area that we should participate in. There's a great need for it, but there have been a couple of problems.

As near as we can tell, the industry has been a single-digit return business for 20 years. We haven't seen the 30%, 40%, and 50% returns that were promised in every offering memorandum that has come in our door. It's single-digit at best. The question is how do you pick the right players? You could do better if you picked the timing. We've run some correlations; the problem with venture capital is everyone is out raising money. They all raise billions of dollars, and then they all run around investing money. They tend to all coinvest together. There's usually about six or seven of these guys. If you're in five or six different venture funds, you wake up and find out that three or four of them have invested in the same deal and so they drive prices up. If they're lucky, they get an initial public offering (IPO) or other window to get out of it. It's not been what it was supposed to be and we've really withdrawn a bit from venture as we know it. We think we've done a little bit better than the industry, but we have not made a ton of money.

Oil and gas has been a good investment area for us. It has been a 17%-plus return business -- not spectacular. Oil didn't go to \$100 a barrel and that was the prediction. There was some really good data on that and it said that oil was going and the sky was the limit, but cartels, I guess, don't work. The reality is, it's not bad. A 17% return over a 20-some-year period is not bad, but it's not exactly what it was expected to be.

Again, one of the secrets to a lot of this, we think, is direct source. We tend to find most of this stuff on our own, dealing directly with the major oil companies, with independent producers and whatever, and that is, again, a function of being in it a fair amount of time and building some infrastructure. We've got a fairly substantial oil and gas portfolio but, again, on the people side, I've got one-and-a-half people running a big portfolio. We're not very labor-intensive in these equities contrary to what a lot of people say.

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Leveraged buyout directs is a business that we got into in the late 1970s. By leveraged buyout (LBO) directs I mean we were doing the equity, the mezzanine, and the senior debt. We practically had that market to ourselves with the exception of a number of major life companies that got in early. Like everything else, it was a good idea. You couldn't miss in those days when you were buying companies for three and four times cash flow. We didn't even know what we were doing. They were good businesses that sprung out of the private placement business and became an opportunity to pick up some equities.

We looked to this and we said, "Hey, we like the senior debt. We know about subordinated debt. If we can get some equity, why not." So we did it all, but it was too good of an idea and the market was too good and, like everything else, the banks were aggressive and they pushed us out of the senior debt. Then Wall Street came along and, from an agency business, developed a principal business. If you remember, KKR and Merrill-Lynch capital partners and all of these other guys developed funds which effectively pushed us out of the equity side and left us with the mezzanine business.

We continued to participate in the mezzanine business up until about 1987 or 1988. We've very rarely been back in mezzanine. It's a simple risk/reward relationship. You've got a lot of risk, in our view, in mezzanine and you can't get enough equity to produce the upside results. When a deal goes sour, your mezzanine or your subordinated debt becomes equity in a hurry; therefore, the whole business is shifted.

The mezzanine business from 1978-83 was a 24% business, a wonderful business, a couldn't miss business. From 1983-84 to 1986 and in early 1987, it was an 18% business, and the deals since 1987-88 have been less than exciting. You really have to think about 1988-89. You went from a period where you had been taking companies that you bought at three, four and five times cash flow to buying them at seven, eight, nine, ten, and eleven times cash flow. You've repositioned to the point where you went from leverage, which was 25% equity in the deals to deals going out at 10% and less than 10% equity. You leverage the daylight and you ran into some problems. Most of the mezzanine problems are the result of companies that were bought in 1988-89 in the high price periods.

LBO LPs have been an active area of limited partnerships in the LBO business. It's been a good business for us. Again, we got in early and we're out. We're out as of 1990. It is difficult to motivate your boards and your finance companies to get into something, but I find it's even more difficult to motivate my investment people out of something. It's more important to walk away than it is to get in sometimes. The exit is critical.

We are doing some stuff in coinvesting with a lot of major firms where they're putting their firm money in right alongside of us, making strategic acquisitions in the insurance industry, the banking industry, and not charging us fees to do it. We'll pay them an origination fee, but we're no longer in the practice of paying anyone 2% to manage our money in the large LBO business. That's just because, again, we don't like the economics. It might be terrific, but given the current prices it's not an easy business for us.

In the 1980s we started in what we call strategic acquisitions. This was a little bit different. A lot of this is common-stock driven, but there's a different approach to it and we've built a sizeable portfolio. If you think about common stock people in general in our business, they are involved in credit. They read credit reports, and they do all of this stuff, but they really don't understand a lot of company fundamentals. They tend to do sector rotation and trading. They'll move in and out of deals and in and out of industries. When we talk about our strategic acquisition of common stock we're referring to taking a possible 5-10% position in a company, but it's a buy-and-hold strategy.

It's a three-to-five year or more buy-and-hold strategy but we like the fundamentals of that business. We like management, and we'll take a meaningful position in that company with it's permission. An example might be if you liked United Airlines. You can approach United Airlines and possibly do a \$50 million direct transaction with it by saying you are going to lock this up in a convertible preferred and sit on it for five years; you won't even look at it. Perhaps you like the fundamentals for United over the next three to five years. That's a strategic acquisition of a stock and it's the kind of play and the kind of move that an equity player in our common stock portfolio would not make.

By the same token, we've done a number of others where we actually have voting control in these companies, and that ranges all the way from broker/dealers to furniture manufacturers to whatever. It's really a take-off on some of the direct LBO stuff, but in this case we don't really over-leverage. We just buy into a business because we like the operations.

More recently, we've taken a strong move on the equity side in leasing. For years we used to provide the debt in a leverage lease and here this business again changed. So many players dropped out of this. We happen to like aircraft. A lot of people are real nervous right now about Delta, American, United, and Federal Express, but we happen to like wide body. We happen to like stage three. We happen to like efficient airplanes. If you can get a 2,000 basis point premium to buy lift versus buying their public debt, I'll take the lift. Because guess what? Even in bankruptcy we've seen everybody operating and they still need lift and they've been surviving. At this point in time, this is a 25-30% business and that makes a lot of sense to us. It's risk, but do we understand the risk? We evaluate the risk and get paid for it.

This is really our history. I could comment a bit as to where we are going. On the equity side, we are putting dollars in the Pacific Rim. It's a difficult market in which to lend money, so why lend money? Since you have no legal system or no accounting system, it's difficult to figure out how you're going to create loan agreements and lend money right now. It's very tough being in Singapore or China Mainland.

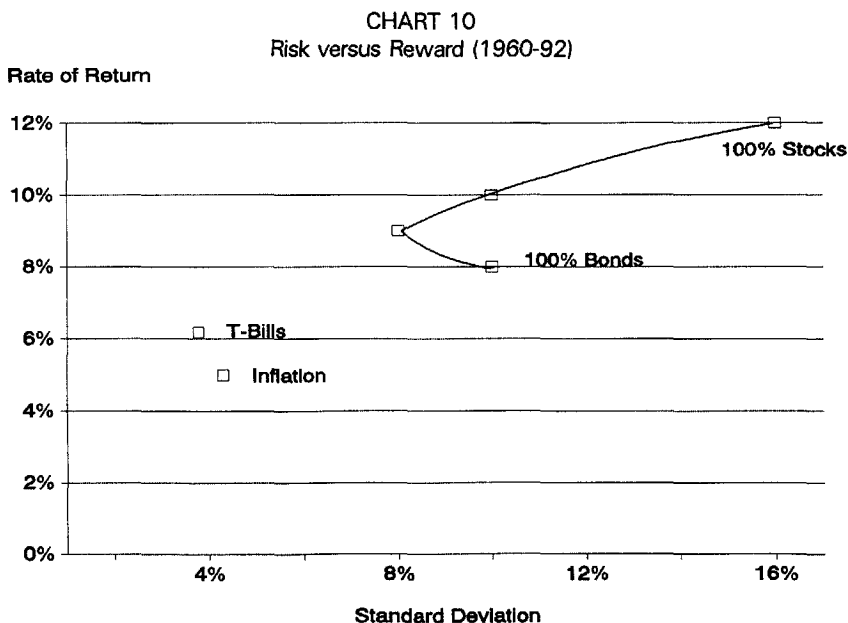
We would much prefer joint ventures, if you will, with some major U.S. firms that have had a presence there for many, many years and that also have relationships with firms in that area; so we've put together some pools of money to coinvest with people and this will be equity money. We certainly like the fundamentals and the growth potential for that area, and equities tend to perform much better in a high growth area not only in terms of real estate appreciation, but in terms of just what's

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been going on. You've had 10%, 12%, and 14% growth in many of those countries now for the last ten years.

We're doing more in the area of leasing. We're doing a lot of country-indexed funds where we don't want to bet on a company. If you like Malaysia, maybe you ought to bet on the country on an indexed basis. We don't have people smart enough in Milwaukee, Wisconsin to pick specific companies, we can find countries where we like the fundamentals and we'll do that. So those are just some things that we're doing. I commented on real estate and common stocks specifically. Let me just step back a second.

This risk versus reward chart is just the driver. You've seen Chart 10 in Finance 101 and, as simple as this thing is, we kind of believe it and we live with this efficient frontier. All this says is basically listen. Can you, in a balanced portfolio, achieve higher returns in that area, given some basket of mix between equities? Our equities are this diverse a basket. We think about all of these equities in terms of covariance, and I'll talk about how they move in different ups and downs throughout different business cycles. We're trying to extract higher returns out of a portfolio without appreciably changing the volatility or the risk level; that's all this says.



When we do this business, where do these things fit? We try to use a cluster. There's a big universe cluster, but we try to throw in our own cluster at our investment planning sessions as we're looking at new things and old things. Where are these particular investments or these sectors moving? Are we getting a fair return for the volatility and the risk? If we find some things are out of whack, such as the

mezzanine market where we think we're accepting lower returns with higher levels of risk and it doesn't fit, we must get out.

I talked a little bit about some of these returns, and I'll present them a little differently than the way in which you've seen. We think about periods of time like the 1960s. You can see what's going on Table 4. Over time, and this reflects some 32 years, we think the total return on long-term bonds has been about 7.8%; but you can see there have been periods such as between 1981 and 1992, a disinflation period, where long bonds have performed extremely well.

TABLE 4
Common Stock and Real Estate Return Correlations

	Average Total Return L-T Corp Bonds	Average Total Return Common Stock	Average Total Return Commercial Real Estate	Correlation Common Stock to Real Estate
1960-66 Low inflation	4.08%	8.61%	-0.73%	-24.15%
1967-73 Stagflation	3.95	7.03	10.94	33.07
1974-80 Hyper inflation	4.47	12.12	17.55	32.29
1981-92 Disinflation	14.06	15.37	5.24	-15.86
1960-92 All years	7.77	11.48	7.80	9.66

The best sector for us in the last two to three years has really been the junk portfolio. We have invested heavily in junk in the last two to three years. It's been a 17% total return business last year. In some ways, we're using junk as a proxy for equities, because right now equities are fairly expensive. It is just hard for us to take a look at the common stocks or a lot of other things we see and justify the prices that we're having to pay.

Anyway, you can see where bonds are and you can see where real estate is. The message is real estate works nicely with hyperinflation; i.e., 1974 through 1980. If we had all invested in real estate in the late 1960s and played it till about 1980, we would have realized terrific returns. But then we would have needed the foresight to get out of real estate. I don't know how you'd do that. You can see common stocks. I ran some new numbers on common stocks for different periods of time. If we took the last ten years, 1972-92, you'd see 11.25% for that period. The years 1980-90, have shown an 18% business. So there has been some tail-off since 1990.

I gave you some of the other numbers with respect to venture over extended periods of time, the 20 years. I talked about single digit. Again, it's back to the timing -- when do you get in and when do you get out. Northwestern Mutual strives for 25% in equity-oriented instruments no matter what the market is and we want to change the mix of that 25% from time to time. The problem is finding the right 25%.

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Now fortunately for us, we don't have some of these RBC problems, so we can accept the risk. When we started using other instruments like derivatives and everything else, we found you have to pay for those things. They don't come free, so there is a cost to that and we may have to use some of that under the new accounting guidelines. That's our targeted rate, our mix, I should say.

What are the key equity issues here? I've just talked about some of these so I'll be brief. Timing is everything – when to get in and when to get out. As I said, getting out is more difficult than getting in sometimes. Risk versus reward. We think about every one of these things and we plot them. We not only plot the quality ratings of our fixed incomes across the board on a time-weighted total-return basis and on a risk basis, but we try to plot all of our equities to see if we are, in fact, getting paid for them appropriately.

Sourcing is a big issue. Since a lot of this has to be done directly, it requires people who are knowledgeable in these businesses and the ability to find deals. Duration harvesting. People fall in love with transactions. That's my biggest problem. Again, getting out of or selling a business. When is the right time to sell it – harvesting equities that we've got or strategic acquisitions. For purposes of duration management, I don't know what to assign to a common stock other than the duration of infinity. So it's not a very good asset/liability match. We just set that off intellectually in a lot of our equities and we say the duration is long. On our fixed income, we run a modified duration of probably about five-and-a-half years on the fixed-income side, which is still a fairly substantial chunk of our assets.

On the equities, we just think it's long; but the other side of it is we hold people accountable for harvesting. Over time frames, when people make these investments in our portfolios, we want to know when their targeted exits are and we hold them accountable for those exits. We want to know why. If a mezzanine security is a five-to-seven-year hold and it's out there eight years or nine years, something is wrong; why hasn't something happened? If you make people accountable, they'll move these things. They know they have to.

Just a comment on covariance. The reason we've got such a large equity basket is things tend to move in different directions. The same thing with energy prices. Last year was a good year for natural gas. We had a lot of bad years. The bubble has been here forever. The common stocks have been good over the last number of years. If you take a look at all of these things as a large basket, you tend to have a diverse amount of different kinds of equities and they'll tend to move in different directions.

The last thing I would just comment on are the people skills. We've gone through a long period of having to retrain people who possess some of the fundamentals, the private placement work, the mortgage loan work into an equity mentality. Quite frankly, a lot of people don't make it. They don't make the transition. They're still fixed-income, risk-adverse individuals. The people who can succeed in this business have a different mind set. They will accept and they will champion risk in the organization.

Last is regulation. I'll just tell you that this is the one that I enjoy the most. It makes my life miserable. It's a bad news/good news situation. The bad news is that it's just taking an inordinate amount of time. We didn't have to deal with much of this historically and maybe what's gone on in the industry now requires the kind of regulation we're seeing. The good news is there's only a couple of these that really, I think, impact our equities. Unfortunately, you could drive a truck through some of the things. They're not going to be an impediment to us doing business and will not really inhibit a lot of people.

Certainly the RBC, where you probably have to put up significant chunks of capital between certain equities, is going to inhibit the ability. There are going to be advantaged people. There are going to be people who are kind of neutral and there are going to be disadvantaged people. Will the people who have capital and ability sit back on their haunches or use it effectively? That's a question that each company is going to have to answer. It's simple stuff and it has a long history. And, it has worked very well for us, I think, to supplement our fixed income portfolio.

MR. NICHOLAS BAUER: I was intrigued by the timing of the promotion by Wall Street (Merrill Lynch in particular) of various equity-linked or equity-participation instruments. My personal feeling is, and I agree with Mr. Sylla, that the stock market happens to be overvalued and quite vulnerable in the short-term. In addition, it seems to me that historically stock markets are very closely correlated with economic growth. I suspect that the North American economy is entering a stage of fairly slow, steady, unspectacular growth because of the baby boom wave going through. The same thing is going to drive the real estate market.

I wonder and I would appreciate the comments of both panelists as to what their view is of the likely attractiveness of these instruments. Is this a case of, once again, getting in at the wrong time?

MR. SYLLA: I agree with that comment and it is one of the reasons that, on the common stock side we have started to really look to some of the foreign markets for our activity. The bulk of our growth in terms of new commitments into the market are, unfortunately, in foreign markets. We struggle with that because we tend to be selling life insurance in the U.S. market and that is where we'd really like to deploy our assets. We get challenged about why are we looking at Mexico today and why are we looking at the Pacific Rim.

I agree with your growth scenario. Our internal numbers suggest the 1960s had a 4% real growth environment; the 1970s had 3%; and the 1980s had 2%. We're concerned that maybe the 1990s will be 2% or less in real growth. Productivity is up, but people are walking the streets; consequently you're in a fairly mature environment. So that really troubles us with respect to kind of general equities. Every time we talk about that, someone comes in and says the market is going to 5,000.

MR. LEAVITT: I won't speak to the potential for growth. We pay too many people in our research department to do that. What I will say is that the structures that we talked about probably mirror many of your concerns in two ways. Our greatest growth business is the emerging markets. I would almost rank it, if not second, certainly third in the volume of business we're doing now. The reason that the U.S.

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markets or North American markets are probably still our predominant market in terms of the absolute numbers is because people are shying away from traditional equities, because of the fear for potential declines in the market, and buying them in a format to take out some of that volatility or to buffer some of that pain.

MR. SYLLA: I would add one more comment to our concern about equities which pertains to the political landscape in the U.S. – the tax issues, the health care issues, and all of the things. There's a lot of uncertainty right now, and that really troubles us. We're trying to get a toehold into where this whole economy is going over the next two to three years.

MR. J. F. FRANCOIS VACHON: I understand you have very little, if any, liabilities that are not in U.S. dollars, Mr. Sylla.

MR. SYLLA: That's correct.

MR. VACHON: And yet you're in the foreign market.

MR. SYLLA: That's also correct, yes.

MR. VACHON: Personally, I think that's a good idea. Do you have any advice to give to people about handling the currency risk in this thing? You might have a good investment, but a declining exchange rate.

MR. SYLLA: Well, you have both. We have a currency strategy and we have people on board who manage our currency and hedge our position in certain markets. On the other hand, we don't accept a lot of currency risk, but we also find currency can be good for us. We are less concerned about the currency problems in our equity strategy than we are about currency problems with our fixed income strategy. In general, unless we see tremendous changes in currency, there's usually enough upside potential on the equities that we believe we can absorb some currency risk.

On the other hand, if you're doing a lot of fixed-income investing and you were to be investing in Spain or places like that where you've got some currency issues right now, you'd be much more sensitive because the premium that you're getting on a fixed-income versus an equity, obviously, is considerably different. We think the equity is better suited to absorb some currency risk, so we're not as sensitive to hedging on our equities as we would on some of the fixed-income stuff that we do abroad.

