RECORD OF SOCIETY OF ACTUARIES
1995 VOL. 21 NO. 1

USING EQUITIES FOR LONG-TERM LIABILITIES

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Panelists will discuss implementing an equity portfolio for use as a reserve for long-term liabilities. Also covered will be valuing, pricing implications, cash-flow testing and implications on risk-based capital.

MR. PETER L. HUTCHINGS: Our first panelist is Bob Gaffney, the chief financial officer of the PMA Group. Our second panelist is George Foley. George is a partner in IAS, an investment advisory firm and consultants for the insurance industry.

MR. ROBERT J. GAFFNEY: As background, PMA Group is a regional property and casualty insurance company and reinsurance company. We also have a fledgling life company that is involved with doing long-term annuities for workers' compensation pension cases.

I'm going to start by talking about some of the big-picture issues regarding strategic planning for investments and then go to the details of looking at how one could use equities to support a long-term liability or the long-term-liability reserve section of the balance sheet.

First, I would like to start on the liability side of the balance sheet, by putting some thoughts down about the types of liabilities one faces in the industry. This is not an exhaustive list by any means and the types of liabilities I look at are generally much different from the ones that you look at. I'm looking at long-term-liability reserves for general liability policies and pension cases for workers' compensation claims, individuals who are injured and stay disabled for many years while receiving medical and long-term indemnity payments for being out of work.

You could prepare a similar chart for your own area. Basically, you face knowns, unknowns, and inflation as part of the mix. The chart first looks at the known and fixed liabilities and then looks at unknowns, the amounts, and the timings of payments that you must consider. Next is the variable liabilities, both in terms of the time of payment and the fact that they're subject to change. Finally is how inflation affects the nature of those long-term liabilities, in terms of timing and amounts, both unknown over longer periods of time.

Looking at the investment process from a strategic standpoint, the liabilities are the most important aspect that you must begin with. Once you get a better feel for the liabilities,

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then you must start looking at the investment considerations that would ultimately lead to a decision to invest in equities, fixed-income investments, real estate, or whatever. We already talked about the asset allocation and the asset-liability management process. I'm sure that you spend a great deal of time on that. The next important thing to consider is your appetite for risk when looking at equities. You can go across the spectrum from very risky investments in venture capital, for instance, to very stable long-term investments in blue chip equities. George will spend a considerable amount of time looking at the various aspects or various types of investments in the equity market once we get to that.

Next is tax implications. As you know, the dividends coming off equities have favorable tax treatment. In addition to that, there is the possibility of a capital-gains tax reduction that could also improve the overall return on equities over longer periods of time. In addition, the rating agencies' implications of risk-based capital must be considered. The property and casualty industry has just implemented the risk-based capital standards. The life industry is about one year ahead, and equities get a big haircut. I think it's 15% on the property and casualty side and it's even more severe on the life side. As for rating agencies, A.M. Best gives a big hit for equities on the property and casualty side, so that's another important consideration.

Obviously, the economic and political outlook has a big effect on the stock market. During the last several months the market has been very buoyant. The higher it gets, the more I think there's going to be a break at some point and the more it looks like it's overvalued. Of course, that's another very important consideration: the overall level or the valuation of the marketplace at the time you decide to enter into the market.

Last year we invested in the international market for the first time. We went through a search over a six-month period and finally selected the Bank of Ireland to manage our equities. The next decision we had to make was when to go into the market, which countries to go into, and what styles to use once we entered the market. These are some of the additional considerations that you have to think about once you decide to enter a particular section of the U.S. or international equity market.

Inflation projections are very important because inflation is very bad for equities. If inflation starts going up, you can bet that equities will start going down.

Another consideration is liquidity requirements. Depending on the type of stock that you invest in, they can be very liquid or they can be very illiquid. The venture-capital-type stocks are very illiquid; the blue chips and the Dows are very liquid. Even where liquidity is not a problem, depending on the timing of that liquidity need, we could be in the middle of a recession and the market could be down considerably when you need to liquidate those assets, so it's another important consideration when deciding to use equities.

MR. GEORGE F. FOLEY: When we were asked to be on the panel, we were asked to show a couple of examples. Although they may not be life related, you should be able to draw some conclusions and perhaps apply them to your book of business and your needs. What follows is from a presentation to an endowment fund. It dates itself because it has a 5% inflation rate. That's not a projection for where I think inflation is going to be this year, but it talks about how inflation plays such a big role in the liability piece of the decision, how to invest.

Some long-run expectations from SEI Corporation for the return on stocks and the return on bonds based on 70 years of historical data show that you eventually will see a deterioration of purchasing power or spending power from this particular endowment. What we were trying to address with this presentation was the spending policy for that endowment. I don't think it's any different for any type of a liability consideration; just the nature of the liability is a bit different.

We did not include a chart that was very specific to a workers' compensation book of business; I'll tell you about it briefly because I think the approach is something you could use for your liabilities. Over the years, the workers' compensation business deteriorated. It had high loss ratios, high combined ratios, a generally poor book of business, and many companies got out of the business. While all this was going on in the early 1980s through the early 1990s, one common thing was happening on the liability side: a rise in the cost of the medical payments. The portion of claim dollars for medical costs on workers' compensation rose to about 46–47% of each claim dollar by the early 1990s from the low 20% range in the early 1980s.

Why did this happen? I don't know why it happened, but we did a little study on it and found that if you invested in T-bills you got murdered and you did not stay with inflation. Your liabilities grew greater than your assets. You could not win unless you raised rates drastically.

Another thing that we found from the study was a very high correlation between the growth of CPI medical and the growth of the health care sector of the S&P 500, which includes the drug stocks and the HMO stocks. The theory, of course, was that the health care companies were getting rich from workers' compensation claims. The conclusion: workers' compensation companies should invest in the health care sector.

We wanted to try to see if there was a correlation between the wealth buildup of law firms, too, but we were unable to find any public companies at the time. But that's an application I think of when looking at the liability side. What's underlying the liability?

This presentation is designed to try to help insurance companies deal with that issue and help set the framework for how you can make asset decisions. You don't just say, "Well, I think I'd like to have 10% in stocks." As a matter of fact, most of my clients have less than 10% in stocks, but the percentages are growing. Clients are getting an appreciation for the need from a diversification standpoint, as we will show later. But this presentation is designed to help sell the concept, because we believe that over the long term, if you're an ongoing concern, if you expect to be around for the long term, your surplus will be there for the long term so start investing long term.

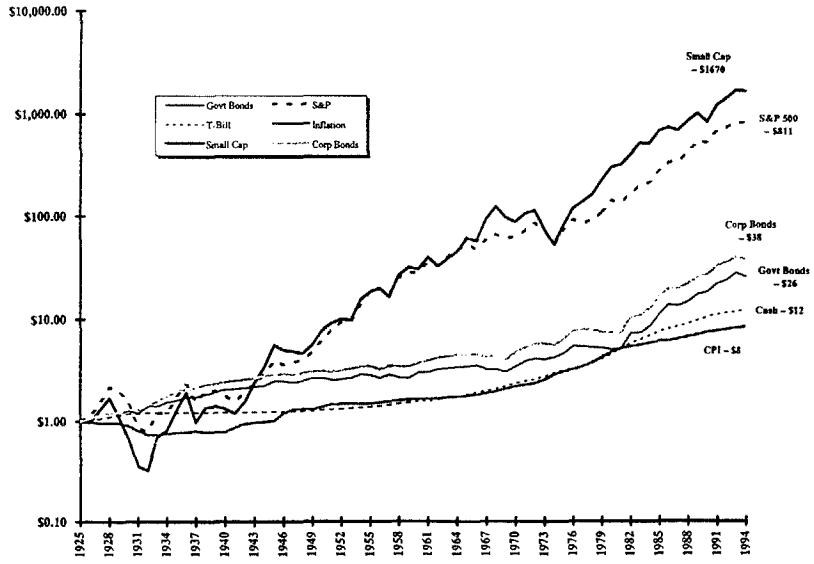
There are many things to overcome that Bob talked about, specifically, short-term volatility and selling the board of directors on this concept. It starts with talking about the strategic fit for equity investing for insurance portfolios. The asset class is designed to provide for growth. It's not designed to provide for income and certainly not stability because stock prices are more volatile than bond prices. It's aimed to maintain the purchasing power. Stocks also provide diversification because a correlation between the returns on stocks and the returns on bonds is not 100%. So if you can lower the correlation it does provide a diversification benefit.

As a point of interest, a number of initial equity investments that clients of mine have made have been designed for generating income. It can be an alternative income-producing asset class if you pick the right style, pick the right money manager, and do it the right way. As an example, back in 1993–94 when short-term money rates were about 3%, dividends on income-structured portfolios were actually paying as much as 4.5–5%. And when you factor in the dividend-received deduction (75% of dividends paid to corporations are not taxed) on the dividend received by a corporation, the after-tax effect was even greater. So people out zero to three years on the yield curve who thought they were doing better than if they had invested in stocks, merely from an income standpoint were wrong. Stocks could win that argument, but for the long term, the reason to buy stocks is for growth in price not the income. The income makes it an easier decision to start.

The biggest concern in both life and property/casualty companies is surplus stability. That's one of the reasons why that yield-oriented style was so attractive. We believe the stocks that pay higher dividends tend to be blue chip, more stable, large-cap stocks, with less price fluctuation.

This is how I know I'm right: over the long term, stocks outperform bonds (Chart 1). As consultants, the highest volatility-type stocks that we would identify are small capitalization stocks.

CHART 1
70 YEARS OF INVESTMENT PERFORMANCE
1925–1994



Source: Ibbotson.

They also had the greatest reward over the 70-year period (that's the line on the top). There's one more significant piece on this graph over the 70-year period. If you look at

the period from about 1946 through the early 1960s and again in the mid-1970s, a rate of growth on the CPI was greater than cash and actually greater than intermediate-term government bonds. You lost money and purchasing power for a significant period of time during those years.

MR. GAFFNEY: George, let me just comment on this chart also. My experience in the stock market, in particular, only goes back to the 1970s, so I can't talk about the periods way back in the 1920s. But my first experience in volatility in the insurance industry was in the mid-1970s. The two companies I worked for at that time each had large equity portfolios. In the mid-1970s there was a recession, oil shocks, 1974–76. One of my employers had a very big allocation to equities: almost one-and-a-half times surplus. As the market dropped, of course, surplus was going through the floor and the senior managers at that point didn't know what to do. They knew to not sell when the market is falling, but, at the same time, surplus was going through the floor so they were forced to sell.

Now, if you look back on those days, a couple years later the market rebounded considerably and the company found itself having to go back into the market at much higher levels. That type of scenario has repeated a few other times during the period, particularly in 1987. The company had a very big portfolio of stocks and it was supposedly protected by options. In the crash of 1987, it lost about $250 million in that one afternoon; it thought it did fairly well because the options cut the loss in half. Even so, it just points out the amount of volatility that can come in this market from investing in equities. But over the long haul, you can see where the Dow and the S&P is today if you just have the staying power to hang in there.

MR. FOLEY: We try to overcome the short-term volatility. Just look at all the valleys that are made by the small-cap line and some of the modified valleys that are made by the S&P. Then compare that with government bonds, which have had very few valleys, demonstrating much less volatility.

How do stocks and bonds compare? Table 1 is a fairly convincing table. The S&P 500 is on the left-hand side, and long-term government bonds are on the right. This is a 44-year period covered through 1994 with annual returns of stocks and bonds. The top two sections are called the highest and middle for the stock column. You can see that they clearly beat bonds in all cases in those individual years. But even stocks and bonds have negative years. If you look on the bottom right-hand side, the years 1958, 1994, and 1967 were three of the worst years in the bond market history. There's volatility there as well and that's using a 10-year government bond as a proxy.

Why are we trying to do this? Well, we're trying to maximize long-term reward from investing in equity and lower the short-term volatility. Again, we say that short-term volatility has to be reduced or it won't be acceptable for the insurance company balance sheet.

Here is how we think through the elements of the program. We choose to diversify by investment style. Equity managers are good in one particular style and bad in others, so we try to pick those who are best in a particular style and blend them together so that we have a more diverse equity portfolio. Another element that's very important is the rebalancing piece. You can pick styles and you can buy equities, but you cannot just let

them sit. That's contrary to one of the most successful equity investors, Warren Buffett, who says that when he buys a stock, he never intends to sell it. He usually owns a significant piece of the company and has a few board seats, too. He can call the shots. I can't do that with the stocks I own. I have to sell them sometimes because I can't control the direction of the company like Mr. Buffett can.

TABLE 1
RANKING OF HISTORICAL ANNUAL RETURNS
1950–94

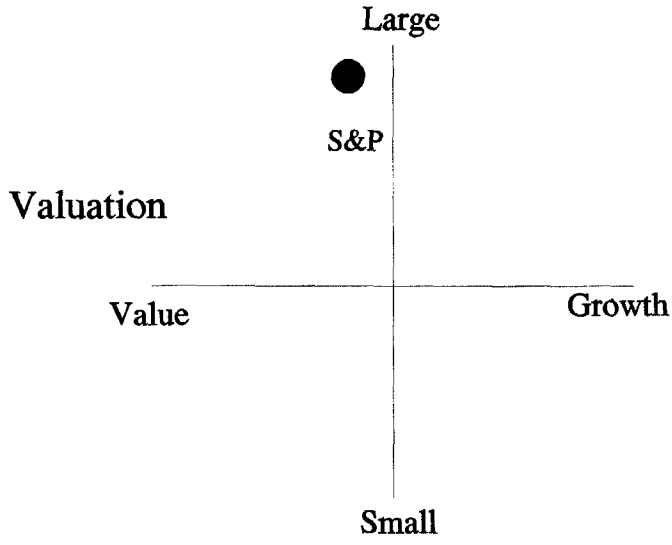
S&P 500			Long-Term Government		
	Year	**Return**		**Year**	**Return**
Highest			Highest		
Rank 1	1954	52.6%	Rank 1	1982	40.4%
Rank 2	1958	43.4	Rank 2	1985	31.0
Rank 3	1975	37.2	Rank 3	1986	24.4
Middle			Middle		
Rank 22	1988	16.8%	Rank 22	1953	3.6%
Rank 23	1964	16.5	Rank 23	1964	3.5
Rank 24	1971	14.3	Rank 24	1981	1.9
Lowest			Lowest		
Rank 43	1957	−10.8%	Rank 43	1958	−6.1%
Rank 44	1973	−14.7	Rank 44	1994	−7.4
Rank 45	1974	−26.5	Rank 45	1967	−9.2
Average		12.1%	Average		5.1%

- Annual returns of stocks and bonds have varied widely.
- Stocks under all but worst-case markets have outperformed bonds.
- Even bonds have experienced negative annual returns.

What does style mean? Here are a couple definitions (Chart 2) that we use. The composition of the S&P 500 can be shown on a style chart that we've developed. Very simply put, there are large capitalization (large cap) stocks—the IBMs, the GEs, the Mobile Oils—and there are small-cap stocks, the stocks of developing companies where there are maybe as little as $200 or $300 million in capitalization. (Capitalization is the number of shares outstanding times the market price of the stock.) The S&P tends to be a large-cap orientation. There are also, as I'm sure you've heard, different equity

management styles: value and growth. They seem to be the two poles. I think there are a few in between, but what we try to do is blend styles so that we get more toward that vortex, that middle line where it crosses. If you just invested in the S&P 500 you are oriented more toward large-cap stocks and could miss years when small-cap stocks outperformed.

CHART 2
THE COMPOSITION OF THE S&P 500 INDEX



- S&P 500 biased toward larger-cap yield-oriented stocks
- Diversified portfolio should hold stocks from all quadrants
- Lower overall portfolio risk by eliminating cap size or valuation bets

Here are some other style definitions that we use (Table 2). Yield orientation speaks for itself: dividends. This frequently overlooked style has tax advantages as we discussed earlier from the dividend on a semiannual period so that you have as much as a 3–6% yield on the stock before taxes.

Again, the dividend-received deduction helps that because you're not paying full taxes on it and this style tends to have a low turnover. Turnover is important because of capital gains treatment. A money manager who owns 200 stocks and tends to have a 150–200% turnover rate during the course of the year is paying a lot of taxes in good markets. I have seen a low turnover style with lower-performing growth stocks outperform by 200 or 300 basis points on an after-tax basis a much more active style where there's a lot of turnover.

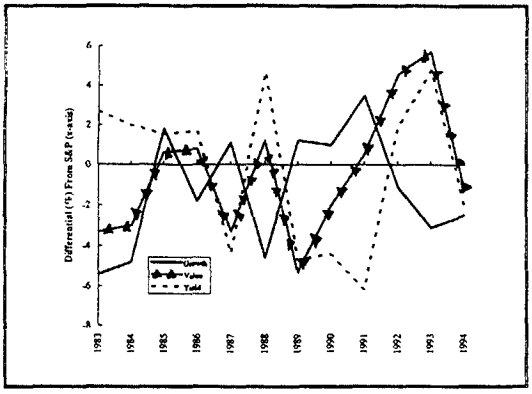
TABLE 2
EQUITY STYLE SUMMARY

YIELD • dividend-yield-oriented • low P/E ratio • low price/book ratio • low turnover	GROWTH • consistent earnings growth • low dividend • higher P/E ratio • growth is > P/E
VALUE • capital-gains-oriented • low P/E and price/book ratios • restructurings, spin-offs, asset sales • low turnover • private market value	SMALL CAP • aggressive growth • emerging markets • new technology • average market value • average market value $500 million or less

The other styles (Value and Growth) have been discussed already, but the definitions are here. Money managers don't like to be put into these categories; many will say they are partly growth and partly value. They buy value stocks because they meet these definitions but also because they think they're about to grow. IBM was a growth company, but for the last couple years it was probably considered a value stock by many managers. You saw it in portfolios of managers who tend to be value oriented, those buying lower price/earnings (PE) stocks.

Why is it all that important to break them down that way? Over time, if we categorize money managers into styles and track performance, it is possible to reduce short-term volatility by combining styles. This is diversifying the style bet. In 1991, growth was the top-performing style (Chart 3). Yield was the bottom-performing style, and value was mixed in the middle for a while. In 1992–93, the value style had a terrific run. Many postrecession stocks, cyclicals, and Rust Belt stocks outperformed growth stocks.

CHART 3
BENEFITS OF INVESTMENT STYLE DIVERSIFICATION
RELATIVE PERFORMANCE—EQUITY MANAGER STYLE VERSUS S&P 500

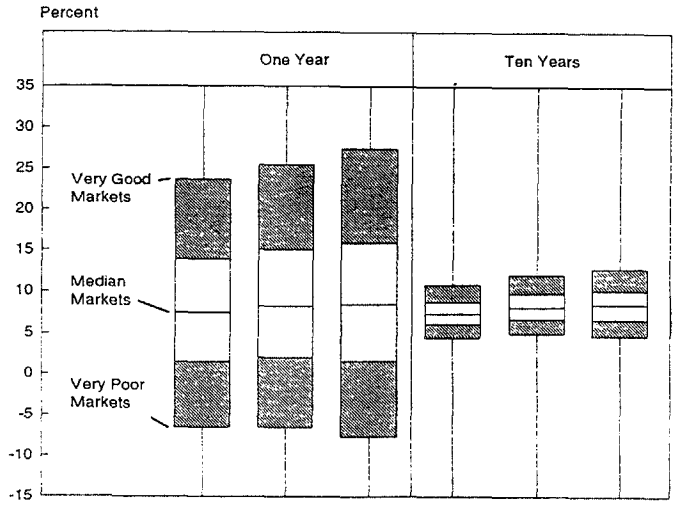


Source: SEI Total Fund Equity Universe.

We think by mixing these styles together you start to get more toward the middle of that style matrix chart. You can overweight a style, and my recommendation for companies just starting to look at stocks is to overweight toward that yield orientation.

Chart 4 helps close the sale on the idea of using stocks. It's a complicated chart, but let me just try to explain it. I'll start all the way down at the bottom, under the caption "policies." These are three different investment policies. The one on the far left is what we usually see: 5% cash and 95% bonds, a very conservative, but very typical, policy for an insurance company. Policy B gets a little bit more aggressive and suggests 5% in cash, only 75% bonds, and 20% stocks. Policy C on the right-hand side uses 20% stocks but puts 10% in small cap and 10% in broad market.

CHART 4
DISTRIBUTION OF POSSIBLE RATES OF RETURN



PROBABILITY OF EXCEEDING RATES OF RETURN SHOWN FOR EACH POLICY

		A	B	C	A	B	C
5%	(Very Good)	23.6%	25.4%	27.4%	10.8%	12.0%	12.8%
25		13.8	15.0	15.8	8.7	9.7	10.1
50	(Median)	7.4	8.2	8.4	7.3	8.1	8.4
75		1.4	1.9	1.5	6.1	6.7	6.6
95	(Very Poor)	−6.6	−6.6	−7.7	4.4	4.9	4.6

Policies

Cash	5%	5%	5%
Bonds	95	75	75
Stocks—US	0	20	10
Stocks—Small	0	0	10

Let's see what the returns would have been under those investment policies. The first big box under the caption "one-year" uses Monte Carlo simulation of, I believe, 30 years of performance to show the volatility in any one year. The most conservative investment policy, policy A, generates a median performance of 7.4% total return. With policy B, where we went into stocks for the first time, the median performance would have been 8.2%. Policy C, with small cap introduced, total return would have been 8.4%. But of significance, of course, is the fact that the ranges are wider. The range of possible outcomes on investment policy C is much wider than the other two ranges.

We're not getting into stocks for one year—we're going to get into stocks for ten years or longer. It's a long-term holding period. I don't have a duration number to give you. I tend to say it's probably in the 8- to 12-year range, if anybody ever asks me what's the duration of stocks is. It's a guess, but it's a long-term holding period. Let's look at the same thing over a ten-year period. That's on the right-hand side. You'll find much smaller ranges on all three investment policies. The most significant outcome is in a very poor market under each investment policy. The range among the policies is between 4.4% and 4.9%. And if you go over to what we consider to be the more aggressive policy, investment policy C, where small-cap stocks were introduced under a worst case, in a very poor market it was 4.6%. It outperformed bonds by about 20 basis points, but the real reward is the potential upside versus Policy A or B. So the point to make at this stage of the presentation is "good upside, limited downside."

MR. GAFFNEY: About a month or so ago I was preparing for a board meeting financial presentation and I knew that I was going to get some tough questions on the investment performance of the portfolio because of what happened to bonds last year and the fact that stocks didn't do very well either. As any good financial officer, I started thinking about all the excuses that I was going to come up with. I sat down and made a list of all the things that I need to think of when making an investment decision. I came up with 14 different items, which I'll run through very quickly: tax, discount on loss reserve, yield give-up, length of liabilities, effect on risk-based capital and Insurance Regulatory Information System (IRIS) test, overall economy, inflation, the Federal Reserve and what it's doing with interest rates, effect on earnings, regulators, A.M. Best, S&P, the NAIC, etc., interest rate volatility versus duration of our assets, slope of the yield curve (being short is very costly), *FAS 115* (and I know that we all have to deal with that now), and annual cash flow. There are probably more items, but these are just some of the things that go into making the overall investment decision.

Chart 4 summarizes the arguments for investing in equities for long-term liabilities, but it also points out the problems. Can you stand the heat of the volatility of the equity market? Can you stand the heat of board pressure when you're asked during a bad year what you are going to do to make up the loss? Can you stand the heat for the risk-based capital charge that you'll have to undertake once you invest in equities? And, also, what about the effect of the asset valuation reserve (AVR)? The timing of payments in terms of the volatility of the market. The use of derivatives to hedge that volatility. Again, *FAS 115* of the marked-to-market accounting. Now that's on the negative side. On the plus side, can you ignore the historical total return?

We've had an equity portfolio at PMA for the last 15 years and during that period of time the total return on that portfolio was 17%. That was 2% better than the S&P 500. So it does work. It's not a big part of our portfolio and that's why we can stand the volatility.

But looking historically over the years at those returns, we obviously would have liked to have had a much bigger segment of our portfolio invested in equities, if we could have stood the heat on some of these other issues. Also, can you ignore the tax advantages, in particular, if capital gains rates drop further? If you go into equities, there is the need to diversify within the equity area in terms of the various manager styles that George discussed.

I have two last comments in terms of investing in equities that I've learned over the years. You've probably heard this one before and it's very simple: buy low, sell high. Buy low, sell high sounds very simple, but once you get into this, it gets to be very difficult. That means that you should have the discipline for entering the market. You should also have the discipline for exiting the market. The next thing that I'd leave you with is, pigs get fat and hogs get slaughtered. When a stock has had a good run-up, don't try to milk every last penny out of it. If it's had its day, sell it and get onto a new rising star.

MR. HUTCHINGS: Will Rogers once said, "Making money in the stock market is easy. I buy a stock. When it goes up I sell it." Somebody said, "Well, Will, what do you do when the stock goes down?" He says, "That's easy, too. I don't buy it." In that spirit I'd like to review with you what my company has done in this area.

I work for a slightly larger than medium-sized mutual company. We are much heavier participants on the equity side of the investment portfolio than our competitors are and we have been for quite sometime. We are a portfolio rate company. We don't have assets that are segmented to back particular liabilities; however, we associate our equity position with the longest liability we have which is surplus. We have long been a relatively high-surplus company, and we have much stronger-than-average financial ratings.

When the investment department considers its equity position, this has to be done in the context of the overall portfolio. After all, there must be a connection between the risk profile of your fixed investment and the risk profile you're willing to take on the equity side. Our biggest asset by quite a bit is nonconvertible bonds and we only buy investment grade. That may not be a permanent policy, but that's been true for a very long time. Our investment department doesn't think that the tradeoff for below-investment-grade bonds is worth it in our particular situation. We're also very light by industry standards on real estate and mortgages. Because of all that, we are in a position to take the higher-than-average risk on the equity side.

We think of the equity portfolio in basically three pieces: the (obvious) common stock portfolio, a portfolio of convertible preferreds, and a portfolio of convertible bonds. Those latter two for 15 or 20 years have been a significant part of our investment mix.

To keep track of this three-part equity portfolio, we've developed something that we call an equity exposure index. It is a fraction, with the denominator as invested assets and the numerator as the total of the common stocks, plus two-thirds of the convertible preferred stock, plus one-third of the convertible bonds. Our equity exposure index has been relatively stable over time for our company. From 1984 to 1994 inclusive, it has never been less than 10% and has never been more than 14.1%. Over that same interval, our invested assets have more than quadrupled.

The composition within the equity index has changed over time. It is not easy to maintain a consistently sized portfolio of convertible bonds or convertible preferreds. Often, we buy them "out of the money." That is, the conversion feature does not become valuable until the stock runs up significantly. However, once the stock does run up, the convertible may well get converted away from us. So the portion of the portfolio that we're able to maintain in convertibles varies with market conditions. Furthermore, the supply of convertibles, at least of the type we prefer to invest in, is much less than the supply of common stocks. And, in fact, we cannot always buy as much as we like; however, we do manage the total within this equity exposure index.

How do we monitor our performance? We monitor our results in terms of total return: dividends, coupons, and change in market value. That's the obvious way to monitor the common stock portfolio, but we use that same technique to monitor both our convertible preferreds and our convertible bonds. We have indexes that we've selected from the outside that we compare our results with, and we look to outperform those indexes. That's the value that we add through our management. We've been fortunate in this respect in having very capable individuals running these various portfolios, and a somewhat more unusual fact is that this team has been together for many years.

The biggest single part of our equity portfolio is invariably our common stock portfolio. At year-end 1994, of the 12.9 equity index, 9.1% of that, or approximately three-quarters, was from common stock and the remainder was from convertible preferreds and convertible bonds. Our common stock portfolio manager also has managed The Guardian's mutual fund since the early 1970s; this mutual fund is a *Forbes* honor roll winner several years in a row. Having good people is certainly part of our equity strategy.

Having the financial strength to make the commitment to the asset class is probably even more important, and these other characteristics of the company enable us to keep these percentages at the relatively high levels I mentioned.

As I give this speech, our mutual fund is up almost 10% year to date. As people read these remarks in the *Record* they may see another number or they may see the same number with the other sign. Anything's possible. We're not timers. I trust that's clear from the numbers presented above. We are long-term participants in this market. We don't claim to know how to time the market and that's not a part of our success.

There are disadvantages to a common stock portfolio, and I believe you've heard about all of them in this session. It's always struck me as being bizarre that the risk-based capital hit for a common stock carried at market, which can be sold in days, is a bigger hit than some mortgage in or near default. I suspect the reason we think stocks are volatile is because we value stocks at market and bonds at book. If some nineteenth-century genius had come up with a convention the other way and we carried stocks at cost and bonds at market, we might be talking about bond volatility because as you saw earlier, the underlying values are quite volatile. Nevertheless, the fact remains that the regulatory structures have a long-standing bias against equities. You see it in the asset valuation reserve (AVR), risk-based capital, and many other areas. That makes a hurdle that companies have to be willing to get over before they're going to pursue the correct part of that previous chart.

A few words might be in order on how rating agencies look at the equity exposure of The Guardian. I'm not addressing Best in these remarks, but the other agencies have been certainly aware of the equity participation in our portfolio and they understand the volatility that brings with them. They have viewed it as an appropriate position for the company. When they make their list of strengths and weaknesses, this doesn't show up as a weakness. Given the total situation, the rating agencies are not unhappy with this. However, if we had significant risk in the bond portfolio, or if we had significant participation in real estate or troubled mortgages or whatever, or if we had less surplus, it might then be the case that the agencies would not be very happy with our commitment to equities. Given how our equity strategy fits into the total portfolio, this is not a part of our operation that has been called into question by any of the many, many reviewers who have come through.

There are some complicated consequences to a major position in equities, however. Most of our assets came from participating cash-value insurance, and the dividend consequences of having a major commitment to equities are a challenge. The company is in a position to share these realized capital gains with the policyholders in the form of dividends. This is a competitive advantage for us. It's one of several, but it's quite significant over the long run. The statutory financial statements don't show the benefit of realized capital gains on stocks in an orderly way as a component of life profits and earnings, so this issue can require some explaining from time to time.

Volatility is also a consideration, even though the rating agency side is not a problem for us. There have been times when the broader public has been concerned. During the memorable year of 1987, we had a rather hefty unrealized capital loss component in our financial statement and we had to explain it from time to time to the occasional agent, the occasional policyholder, and the occasional prospect. By showing them a long historical series, they could quickly see that this was an aberration. As a matter of fact, by the time we had to explain it, we had already earned most of it back. So it wasn't a big stress.

The dismal results of the early 1970s are apparent in the long-term performance graph shown earlier (Table 1). It may very well be that if the market were to go through a 1970s-style era, those of us advocating a position in equities would be under pressure. If that were to happen, I hope that managements and boards would have the vision to ride it through.

I read a comment made by the CEO of a major insurance company who said that his predecessors sold out the general account equity portfolio in the late 1970s and cost the company many billions of dollars by not being around for the good part of the curve. It takes a long time and a great deal of work to earn back billions of dollars that are lost or foregone by that kind of short-sighted management. You need the long view and a company whose finances can stand a long view.

If our company's investment department were exactly the same, but the company's financial strength or liability mix were different, we wouldn't have been able to make the mix decisions we've made and so it all must tie together. Where it can be made to pull together, the expected value spread between stocks and fixed investments is very difficult to resist and we have no intention of resisting it.

FROM THE FLOOR: I have a couple of questions. The first one is, obviously, take surplus on capital to be in the equity market. If you have a higher capital need to be in the market, which means you can spend more money to make more money, there are trade-offs. In other words, it's not obvious. If you have 20% surplus, and then go into the equity market, you bring up your total return. But your 20% surplus is not a very efficient way of spending capital.

MR. HUTCHINGS: The question is, maybe the surplus should be invested in the base business or in other businesses rather than be used as a context for raising the equity allocation percentage. Is that your point?

FROM THE FLOOR: Well, my point is, it's just not obvious. It's not clear that investing in equity would totally enhance the performance of the company. It would enhance performance of the portfolio return, but if we spend more capital to achieve that, does that mean that return on capital is not necessarily more efficient?

MR. HUTCHINGS: If the base businesses are not being permitted to grow at the rate they would choose to grow, and the reason for that is that the company is capital constrained, in an environment such as that it would be debatable to commit capital to the equity market. You might be much better off committing capital to the base businesses that you're in or perhaps businesses that you want to enter. However, if you have a portfolio of businesses with which you're satisfied and those business unit heads are not constrained in their growth or expansion and you can still afford to do this, then I think it's indicated. Does that respond?

FROM THE FLOOR: I guess the comparison is not obvious. Maybe I haven't seen anything in terms of whether the company should keep the money and invest the money in capital, similar to how your company distributes excess capital to investors, if it is not in that business.

MR. HUTCHINGS: That seems like an excellent question. From our company's perspective, one of the reasons for our high capital ratio is we're in some relatively volatile businesses, most notably group insurance, where a significant portion of our capital has been earned in that area and a significant proportion of the capital is required to back volatility in that area. So perhaps I've oversimplified our situation in my remarks here.

MR. GAFFNEY: In thinking about your question, I guess I would say that in looking at your capital you have perhaps three decisions to look at. One, as you've pointed out, return it to your shareholders or to your policy owners. Two, deploy it into existing businesses or new businesses. Or, three, keep it for a rainy day. In other words, invest it prudently today so that in the future you'll still have it available to you if you desire to grow in different areas. Putting that capital to work in the equity market would be a decision that would indicate that you don't have better uses for it and you want to hold it for a rainy day. And, in my view, depending on what segment of the equity markets that you put it into, it could be very advantageous for owners or it could be more risky if you've invested it in venture capital, for instance, as opposed to some other segment of the equity market as George discussed. Does that answer your question?

FROM THE FLOOR: Yes, I just wanted to hear your view on that because I am also a proponent of equity strategy. I plan on retiring on that. I have two other questions. One is in terms of trend. Do you foresee the stock yield over a bond yield to be widening or depressed?

MR. FOLEY: Right now? Do you mean going forward?

FROM THE FLOOR: Going forward, is the economy more mature now and will it be maturing in the future? And therefore, will stock not grow as fast, or are we getting meaner or leaner?

MR. FOLEY: There is a study available. I don't have the statistics with me about the dividend growth rate and where yields are. There does seem to be an indication that those stocks that do pay dividends, the bigger ones, and those that have had a track record of raising dividends have been a little slow in raising dividends. Although there have been a number of dividend increases in 1995, the rate of growth hasn't been as great as one might expect. People during this recovery don't think it's the same kind of recovery from recessions that we've had in the past. It's been a good deal slower, it should be much longer, and you probably will see dividend increases in the future and dividend increases beget stock price increases.

FROM THE FLOOR: My third question is, could you comment on the 8–12 stock duration?

MR. FOLEY: I simply look at it as holding period. In looking at durations, too often when we do an asset/liability management study, the company presents its liabilities and presents its current book of business in snapshot forms. And hardly ever does it contemplate growth of the business and the fact that it's an ongoing concern. The company will say that the duration of liabilities is four years, so shouldn't the duration of assets be the same? No, it shouldn't be. As a matter of fact, the duration of liabilities is probably much less than that because of the opportunity for premium growth coming in. But the real question is, what about the duration of surplus? The duration of surplus is longer when you recognize that it's an ongoing concern. Once you make that ongoing concern recognition then I would say you have unknowns out there and you may have some exposure to inflation. That's why you have to invest in equities. Getting back to the question of why I place that type of duration tag on it, I hardly ever have to. But, if somebody asks me to, I say it's a 10-year holding period. I would tend to analyze the trade-offs and the risk/reward scenarios based on the 10-year holding period. That's why I call it 10-year duration. No other reason.

If you do know what your particular company does, can I see a show of hands of how many companies do have a meaningful equity portfolio, meaning something other than just an investment in a subsidiary or one or two stocks that the chairperson has owned since he started up with the company? So it's about 5% or so of the companies. Does anyone have an equity allocation greater than 10% of investable assets?

MR. LAWRENCE M. HERSH: When the high-yield junk bonds collapsed in the early 1990s, the press had a feeding frenzy. When the press came out, companies' junk bond holdings, even if they were appropriate, became subject to scrutiny and public relations risk. If the industry was more widely invested in stocks, the short-term volatility question

could become a public relations question. The press could just grab that. It could be even worse than what happened with the junk bond market because stocks are so well known. Any comments about that?

MR. HUTCHINGS: I think the press risk that's somewhere embedded in *SFAS 115* is more frightening to me personally. I'm fairly sure that there have been times when the net worth of the entire industry on a marked-bonds-to-market basis was a minus. It was an unknown minus. It was an undisclosed minus, but it was a minus nonetheless. If we were to have another situation where an interest rate run-up produced bond market values so far underwater as to take a significant dent out of the industry's net worth, I can anticipate that that would cause press risk to use your term. I like the term. But in terms of the press risk for equities, I don't think that even those of us who are most fond of the asset class are so heavily committed to them that it would be newsworthy.

MR. GAFFNEY: As you know with bonds if the interest rate goes up the principal value drops. As long as you hold onto it until maturity you'll get your par value back. It's not so in the stock market. If stocks go down and if they don't come back, you're not going to get back the par value at some point in the future. That's one of the things that managements look at during those blip periods, in particular, in the mid-1970s and in the latter 1980s and especially in 1987. Then again, the junk bond market in the late 1980s or early 1990s was being attacked from many different sources, including the rating agencies. Coming from a big property and casualty company that had a large junk bond portfolio, management was scared to death and sold the whole thing off at the exact wrong time. If it had held onto those bonds, management would have seen them come back and perform very nicely the next year. So the press risk is compounded when the regulators, the SEC, for instance, goes after somebody or some company, and the rating agencies go after somebody. Then the press jumps on the bandwagon. It's generally in conjunction with some other events that are occurring in the company. These things just seem to feed on themselves and then compound themselves with poor operating earnings. Then the poor operating earnings are related to poor investment policies.

MR. FOLEY: The only other thing I would add there is IRIS on equity markdowns and market devaluation. I think it tests 20% or 30% devaluation. Let's say you have 10% in equities and the market goes down 20% that particular year; now you're looking at 2% of the overall portfolio declining. That's a significant amount if you're broad market. Also, think about diversification and commit to an equity program. I think you can defend the position.

MR. HUTCHINGS: One thing I neglected to mention about our own situation is that the equity portfolio that we have is very diverse in terms of the number of names and carries a beta of about 1. Beta, as you know, is a volatility measure and a beta of 1 is average.

FROM THE FLOOR: You made the comment that when rates rise bonds fall. Last year bonds took a beating and I didn't see the press grab them. That could be due to book-value accounting in a large part.

MR. GAFFNEY: Well, the comment was made about the early 1980s. I was at USF&G in the early 1980s. Many other companies, on a marked-to-market basis were actually bankrupt because of where interest rates were at that point in time. But, as interest rates came down, the portfolio recovered.

FROM THE FLOOR: I think companies had more trouble. Although I'm not aware of it, I would assume companies had more trouble with cash-flow testing this year after they took the beating on a market basis last year. Is that true for anyone? Do you find cash-flow testing to be more difficult? Also, the press becomes a kind of pressure risk to sell, regardless even if it is appropriate.

MR. HUTCHINGS: In terms of pressure, there's no question that if you take a look at companies and boards and management that got cold feet at the wrong time in whatever asset class you want to look at, I think you would find a lot of sell-at-the-bottom-type stories. I know of three or four. Everybody on the panel has a few. So I certainly agree that you want to go into a program such as this with your eyes open, and you want to understand what the consequences can be, and you want to make sure that you have the perseverance to ride through those periods. I wanted to note that in this room with a very large number of actuaries, not one single hand went up when the question was, did anybody have any trouble with their cash-flow testing? I think that's terrific.

MR. WILLIAM J. SCHNAER: I am thinking about companies that have large blocks of long-term, nondemand liabilities, property and casualty companies, for instance, immediate annuities, structured settlements, disabled life reserves. A manager of a pension fund who has similar liabilities would be considered not acting with fiduciary responsibility unless the fund were invested very heavily in equities. Yet the investment restrictions put out by most states, the accounting requirements, etc., prevent life insurance companies from doing that. And, of course, I know a number of reinsurers that are making a good living taking advantage of that seemingly paradox. It seems as if there is something in the accounting rule that is preventing companies from doing better for their policyholders and that without the accounting structure, they could be held liable for it, especially, say, in a mutual company.

MR. HUTCHINGS: I absolutely agree with that point. I mentioned some of the accounting disadvantages of stocks versus bonds, and some of these are of relatively recent vintage. We can't blame this all on whoever invented the rest of this in the nineteenth century. Many of these anti-common-stock mindset decisions have been made in this decade. In the fact of evidence to the contrary, it seems to be an industry tradition, and I believe it has worked to the detriment of policy holders and companies alike. It's created artificial barriers. Companies that would like to be in the market to a greater extent aren't willing to or able to because of these accounting barriers such as marking one asset to market but not the other.