Article from:

The Actuary

January 1989 – Volume 23, No. 1

Editorial

Report from Holland

by Irwin T. Vanderhoof

I recently was privileged to represent the Society of Actuaries in Holland at the 100th anniversary celebration of the Dutch Actuarial Society. I'm not going to do a travelogue telling you how friendly the people are. Rather, I want to bring two important matters to your attention. First, the whole world is involved in the business we think of as particularly ours. Second, the problems we face are again problems of the profession around the world.

When we hear about the internationalization of the financial markets, we think of the British and the Japanese. During my visit, I learned that the investment of Holland in the United States is exceeded only by the investment of the Arabian oil countries. Nationale-Nederlanden, Aegon, and AMEV, the three largest Dutch companies, have substantial interest in the life industry in the United States. Many SOA members are employed by the North American subsidiaries of these companies. Linda Emory, a former SOA Vice President and now *Actuary* Editor, is on assignment at The Hague working on the international operations of Nationale. In another 10 years everyone will realize that the U.S. insurance industry is not autonomous but a part of the internationally integrated financial markets. We had better try to keep up with this trend. It's more fun, too.

Internationally, we share concern about the future of the actuary. After listening to discussions of this question within the Society, I was surprised that the principal business meeting of the Dutch anniversary celebration would feature a panel discussion on that subject. The points of view and problems were similar to those discussed here. The academics believed there should be more support for academic institutions in the development of the profession. The consultants talked about the future of consulting. The managers talked about the importance of broader training for the future actuary. Even as our business is becoming internationalized, our problems already are.

Finally I should mention some little known actuarial history. A Dutch mathematician and politician named Johan de Witt wrote the first description of the correct way to value a single premium annuity. He seemed to have all the qualities we would now desire in an actuary: mathematician, politician, manager. He published his paper in 1671. He was lynched by a mob in 1672. We should try not to draw any conclusions from those facts.

Convertible securities

by Art Berry

This article will cover the background, objectives, investment strategy, fee structure, and results to date of an investment management account dedicated to convertible securities for a major insurance company's general account. This account was established in March 1986 and funded in 10 equal monthly installments throughout the remainder of the year. This method of funding is especially helpful to the investment manager in creating the portfolio, as opposed to a substantial lump sum payment, which can create at least some pressure to commit funds very rapidly.

As mentioned, this account is invested almost solely in domestic convertible securities, both publicly issued and privately placed. This includes both convertible debentures and convertible preferred stocks, although some 90% of the securities in the account are currently bonds. In my judgment, were the need to exist, such an account could be managed with all the securities being debentures. On occasion, the account has held modest amounts of common stock derived from successful conversion of convertible securities called for redemption, at significantly higher price levels than the conversion value of the security originally held. These very small stock holdings are eliminated gradually, usually within several months following conversion.

The account has remained fully invested since inception, and it would be our intention to continue to refrain from market timing in the future. The amount of cash (short-term securities) awaiting permanent reinvestment rarely exceeds 3% to 4% of the total account value. The account is widely diversified by company and by industry group with specific weightings broadly in line with the industry sector emphasis of the equity portfolio group of the parent investment management firm. Emphasis is on small- to medium-market capitalization companies exhibiting above-average and consistent growth. Some larger restructuring candidates are also included in the portfolio.

Considerable attention is given to maintaining an overall portfolio premium level in the mid-20% range. As a result, the average convertible holding is a so-called hybrid, that is, selling at 20% to 45% above its value as a straight fixed-income security. At this level, the security contains about equally weighted elements of both a fixed-income security and an equity. Ideally, it would provide over a three- to four-year period a total rate of return composed of roughly one-half income (bond interest or preferred stock dividends) and one-half appreciation.

The account today contains some 30% in private financing securities, which give the added dimensions of 1) increased portfolio diversification, 2) enhanced current yield and potential total return, 3) reduced volatility, and 4) an ability to tailor a portfolio to the needs of the client.

The fee structure for the account consists of a modest base fee with a substantial incentive component. The latter component is an annual performance bonus equal to 20% of the excess realized return over an average of long-term government bond yields. Realized return is defined as interest income adjusted for: accrued interest on purchase and sale, accrual of discount and amortization of premium, realized capital gains and losses on sale, and losses that the insurance company would have to recognize if bonds cease to be amortizable for their statement.

This resulted in a total fee to the manager of .61 basis points in 1986 and .56 basis points in 1987.

Art Berry, not a member of the Society, is Vice President of Alliance Capital.