The Actuary

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THE Actuary

Get ready for *Contingencies*

by Dana H. Murphy

In June, when champagne corks pop in celebration of the centennial of the actuarial profession, there will be something else to celebrate: the launch of the profession's sparkling four-color magazine, *Contingencies*. The inception of a first-class publication like *Contingencies* marks a coming of age for the profession.

Published by the American Academy of Actuaries, the magazine will provide the profession with much-needed visibility. The mailing list for *Contingencies* comprises approximately 12,000 practicing actuaries, most of whom are SOA members. In addition, the publication will be sent to the CEOs and CFOs of the Fortune 1000 corporations, as well as chief underwriters, risk managers, regulators, and influential members of Congress. Although published by the Academy, the magazine will cover all aspects of the actuarial profession, including research and other activities of the Society of Actuaries.

Contingencies will be published bimonthly, with the first issue scheduled for mailing in May 1989. Most issues will contain three feature articles showcasing the diversity of actuarial science and demonstrating the applicability of that science to complex social issues. Whenever possible, the topics will reflect the most pressing concerns of the day, as evidenced by media coverage and public debate. Also, each issue will have a more technical "workshop" article highlighting a new area of actuarial research. Like most professional journal articles, "workshop" papers will be peer-reviewed.

Continued on page 4 column 1

Have we seen the golden age of convertibles?

by W. Theodore Kuck

Most investors give convertible securities less prominence than stocks and bonds in their investment portfolios. The attention span given to learning the intricacies and finer points of this hybrid security is quite narrow. In fact, most of us may not even know that a "golden age" existed or whether it has peaked. It's far beyond our immediate concerns. Besides, why should anyone care?

Every serious investor should care. A closer look at this security class reveals some interesting, relevant and timely information. Convertibles have, in fact, experienced somewhat of a golden age that can safely be measured over 13 years. Lipper Analytical Services, Inc., which monitors the performance of mutual funds by asset class, has revealed that for the 13 years ending December 31, 1987, convertible mutual funds, on average, outperformed the Standard and Poor's 500 Stock Index 16.2% to 15.5%, respectively, on an annualized compounded basis. Further study reveals even more spectacular returns for the nine years ending 1983. For this period, annualized compound returns of convertible mutual funds were 19.9% to the S&P 500's 15.8%. Not only did convertible portfolios experience such attractive returns, but our own evidence of managed convertible portfolios indicates that the standard deviation of convertible returns versus stock returns shows risk levels of convertibles averaging only 70% of the S&P 500 stocks. Traditional beta calculations as a measure of portfolio risk also confirm this. These points lead to the conclusion that convertibles have provided superior returns with less risk.

These attractive total return figures started a stampede of money into convertible mutual funds. Although institutional-size capital, including insurance companies and pension funds, has been slow to move and reluctant to address the perceived complexities and rewards of this asset class, individuals were quickly attracted to the opportunity to realize these kinds of total returns. The impact of mutual fund assets

Continued on page 2 column 2

In this issue:

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Golden age cont'd

under management was dramatic. (See Chart 1).

The golden age for convertibles was at hand, at least for convertible issuers. Seeing the window of opportunity for raising capital, corporations issued approximately $13.2 billion of new convertible offerings in the three-year period ending 1984 but more than doubled that amount to $28.1 billion in the three-year period ending 1987.

Continued on page 3 column 1

CHART 1

Asset Growth of Lipper Convertible Mutual Funds

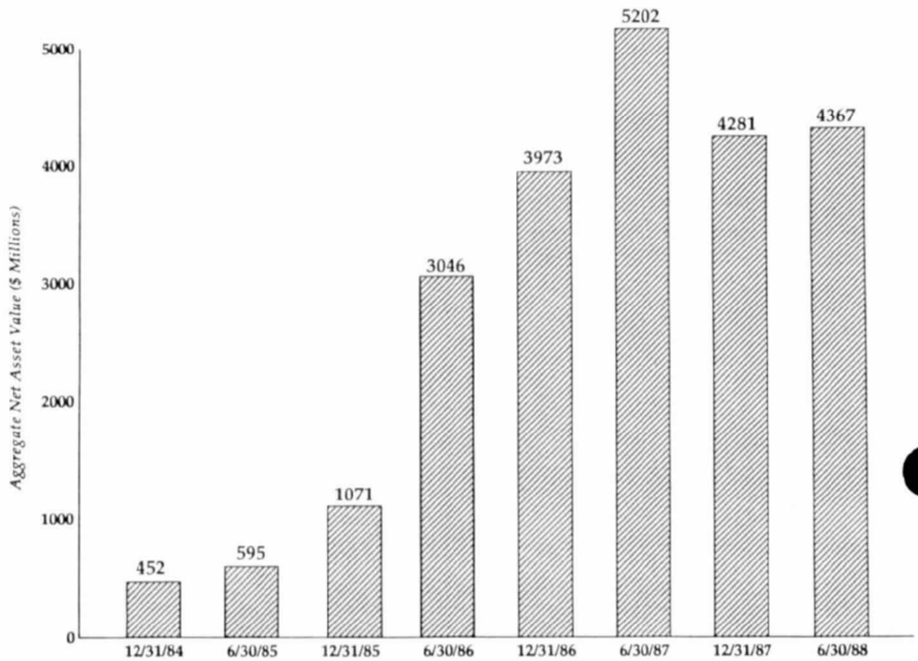
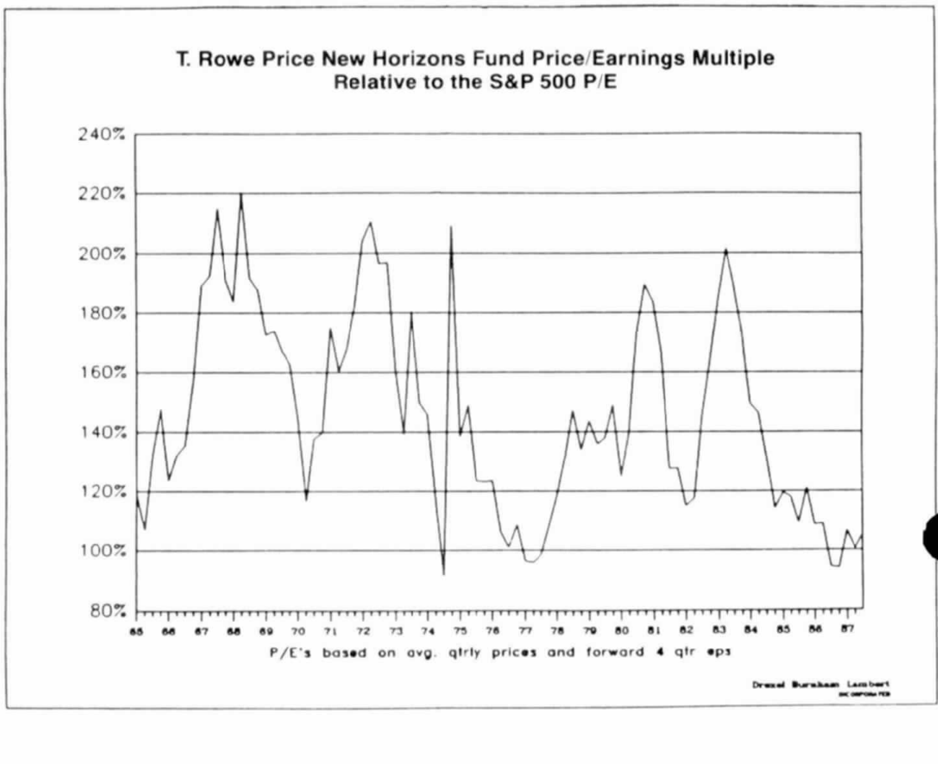


CHART 2



Golden age cont'd

However, somewhat to the dismay of convertible mutual fund investors, as well as many institutional investors, was the less than stellar total return performance during the last few years. Clearly, deterioration occurred in the relative performance of convertibles to the S&P 500. A casual observer would respond that the reason for performance disappointment is obvious – too many new players, too many new issues and too little analysis. Stating it differently, were not investors throwing more and more money at new issues with abandon, leading to disaster?

Certainly, this was part of the problem, but more fundamental changes were occurring in the period after 1983. They gave rise to a favorable reevaluation on convertible securities and resulted in a very positive market outlook for convertible assets by year-end 1987 and for the foreseeable future. The discussion of those fundamentals will require a little more knowledge of the convertible issuer universe.

In the years since 1983, the issuance of convertibles has been concentrated among larger issues and larger issuers. However, even at the end of 1987, the useable (for investment purposes; i.e., liquidity and marketability) universe of convertible issues was definitely skewed to smaller company issuers. We estimate that 72% of all convertibles now outstanding were issued by companies whose market capitalizations are smaller than 80% of the S&P 500 companies by market capitalization. In short, convertible securities is a small capitalization universe. Addressing the relative performance of convertibles requires first addressing the relative performance of their underlying stocks. (See Chart 2.)

Chart 2 shows the relative price/earnings multiple of the T. Rowe Price New Horizons Fund versus the S&P 500. This fund is often recognized as a good proxy for small capitalization stocks in total. Notice the long periods during which small capitalization stocks' price/earnings multiples were rising relative to the broader larger capitalization universe of the S&P 500, and vice versa. With the exception of the 1981-1982 period of extremely high interest rates, the period from 1976 to 1983 was a strong period of outperformance for small capitalization stocks. Notice that over the period represented on this chart, relative P/E's peaked at approximately a 200% level and troughed at 100%. From 1983 (a peak year) to 1987, steady deterioration occurred in this ratio with it reaching a trough again in 1987. The conclusion is perhaps obvious: 1975 to 1983 was also a golden age for small capitalization stocks; since 1983, the luster has faded. In fact, in such small capitalization industries as technology, the pain for investors has been sharp and long. Another view of this is shown in Chart 3.

The Value Line Composite Stock Index is a broad-based smaller capitalization universe than its larger-cap counterpart, the Dow Jones Industrial Index. Notice on this relative performance chart that the pattern for smaller stocks, described in Chart 4, is also seen here with the relative outperformance of The Value Line Index from 1975 to the 1983 peak and then

Continued on page 4 column 1

CHART 3

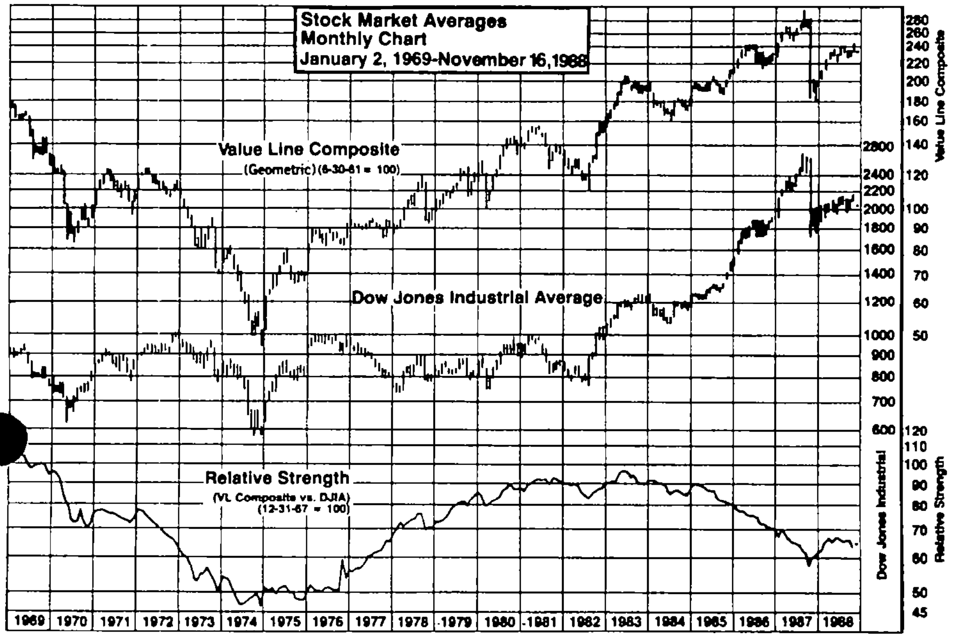
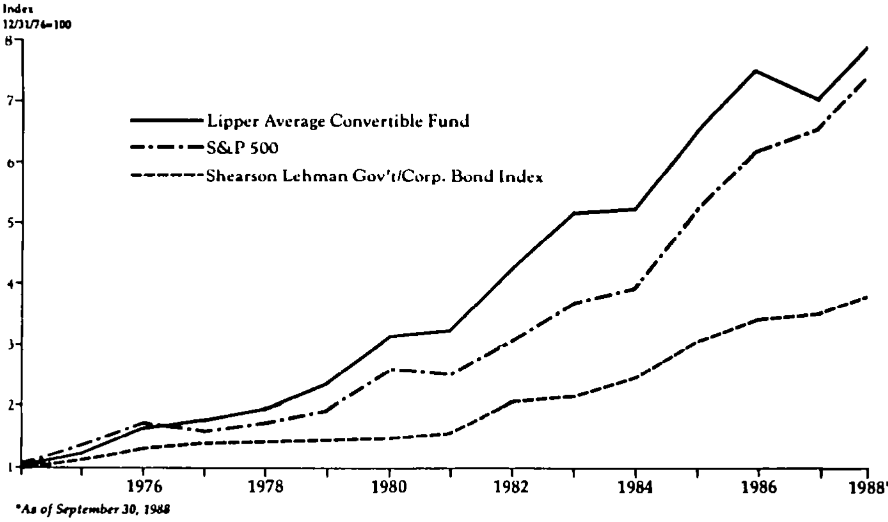


CHART 4

Lipper Average Convertible Fund Versus S&P 500 Index

Cumulative Total Return-1975-1988



*As of September 30, 1988

Golden age cont'd

troughing again in late 1987. This pattern of performance for small capitalization stocks also held for convertibles. Furthermore, during the first half of 1988 small-cap stocks and convertibles had strong rebounds. Through June 30, 1988, the convertible mutual fund average performance was 13.0% versus 10.5% for the Dow Jones Industrials and 12.6% for the S&P 500. The Value Line Composite Stock Index was up 19.1%.

No trends like the one that began in late 1987, of course, continue in a straight line forever, and since June 30, small capitalization stocks and convertibles have moderated their relative outperformance. However, it is our belief that the longer-term patterns of superior relative performance for convertibles and small-cap stocks were put in place over several years and that the golden age is only in its early stages.

W. Theodore Kuck, not a member of the Society, is Managing Director, Equitable Management Association.

Contingencies *cont'd*

While written for actuaries, the content of *Contingencies* will be selected and edited so it also is accessible to the wider audience on the mailing list. In particular, the editors will aim to place each topic within the broadest possible context, so that those not yet initiated into the delightful world of actuarial logic can see how the kind of analysis that actuaries perform every day can be used to make high-level decisions in both government and society at large.

Each issue of *Contingencies* will also contain departments that will appeal to both actuarial specialists and generalists, plus a roundup of the latest legislative and regulatory news. Regularly featured interviews with state insurance commissioners will supplement the nationally focused material, along with interviews profiling actuaries in unusual lines of work. This sort of interview can suggest new employment possibilities to actuaries and underscore the profession's diversity to the nonactuarial audience. Finally, just for fun, puzzles will stimulate the reader's gray matter to its peak efficiency.

Continued on page 4 column 2

Contingencies *cont'd*

The editorial content will be enhanced by the eye-catching design selected for *Contingencies*, which will stand out among the competing publications displayed on a busy executive's coffee table.

The magazine also will fill a crucial need for another group: advertisers. For advertisers, *Contingencies* will reach an affluent and influential audience.

The in-house editors of *Contingencies* work closely with the magazine's Editorial Advisory Board to reach important decisions that will shape the eventual look and content of the magazine. Right now, most design elements for the finished publication have been determined; an advertising sales representative has been selected; and the titles for the first year's feature and "workshop" articles have been selected. Here are a few details about the progress we've made to date.

Designing *Contingencies*

We have engaged a magazine designer, Bono Mitchell, to work with us in making decisions about the many elements that determine the look and feel of a publication. We have selected a "nameplate," the logo that appears on the cover of a magazine.

Because *Contingencies* is a hybrid publication – between a journal and magazine – the cover design demonstrates characteristics of both kinds of periodicals. The cover design has some of the formality of a journal, but other elements – such as the inclusion of "sell lines" (brief phases indicating article content) – are more typical of a magazine.

Inside, the format is appealing and accessible, but dignified. The publication has its own singular identity, but avoids the extremes of idiosyncrasy. The departments have several format features that allow the reader to open the magazine to any point and know what kind of material he or she is reading. Further, each department has its own identifying design element (a small silhouetted picture, known in publishing as a "bug"). The design of feature material will vary from article to article and issue to issue, depending on content. Drawings or photographs will be used as illustrations. Other elements, such as typography, will remain constant among articles to unify the total publication and to clearly separate articles and advertisements.

In hope of attracting and holding the widest possible audience and to keep the design simple and elegant, tables and charts will be kept to a reasonable minimum. With the notable exception of the "workshop" pieces, references will not be included at the ends of articles. When tables and charts are necessary to particular articles, our designers will put their heads together to develop an attractive way to present them.

Determining editorial content

Although we hope *Contingencies* will have considerable leeway to respond to important new issues as they reach the public eye (and, in some instance, to anticipate and promote public awareness of an issue), we have prepared a roster of feature articles and "workshop" pieces that will appear in the first year of *Contingencies*. Here is a sampling of tentative titles for articles:

- Features
  - AIDS Victims: A Class of Uninsurables?
  - Something to Celebrate – 100 Years in the Actuarial Profession
  - Three Years Down the Road, Tort Reform Hasn't Really Changed Things
  - The Real Effects of FASB's Accounting Rules
  - New Accounting Standards for Retiree Health Care Costs – Imminent Hazard for Corporate Balance Sheets
  - How Good Are the Life Insurance Rating Agencies?
  - Preserving the Solvency of HMOs
  - Dividend Illustrations – What Do They Really Mean?
- "Workshop" articles
  - What Is the Appropriate Level of Assets in a Pension Plan?
  - Claims-Made Reserving for Medical Professional Liability
  - Explicit Methods for Handling Inflation

Of course, we hope that actuaries in a variety of areas will submit manuscripts or story ideas to *Contingencies*; diversity in style and substance is one of our aims.

Advertising

Early in the planning stages for *Contingencies*, we assessed the magazine's potential advertising revenues. Publications costs are high for a four-color magazine, and we

Continued on page 5 column 1