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INVESTMENTS

A. What noteworthy changes have taken place in life insurance company investment policy and practice during the last ten years? How have such changes affected the risk of capital loss, the liquidity condition and the flow of cash of the companies?

B. What, if any, are the principal differences in investment policies between large and small companies? Has the growth of direct placement financing placed smaller companies at a relative disadvantage investmentwise?

C. What problems peculiar to direct placement financing have arisen in connection with such placements now on the books? What has been the manner of handling defaults in loan covenants, including those not involving nonpayment of interest or principal? Have directly placed loans produced any serious valuation problems?

D. What is the present attitude of companies toward equity investments, including common stocks, real estate ownership and options for the purchase of stock? To what extent and under what conditions are the latter requested in connection with directly placed loans?

MR. M. W. HILL pointed out that during the last ten years life insurance companies in all size groups have experienced a sharp decline in United States Government bond holdings as a percent of assets, against a substantial relative increase in mortgage loan investments and sizable increases in public utility and industrial bond holdings. He presented certain comparative data for groups of large, medium and small life companies. He stated that the largest companies increased their mortgage holdings more proportionately than the medium and small companies, since the largest companies started from a relatively lower base with respect to this type of investment. However, the largest companies still have a lower proportion of assets in mortgages than the smaller companies—29% against 42%. A substantial part of the increase in mortgage holdings has been in the form of insured mortgages.

The active real estate market of recent years, Mr. Hill stated, has increased the liquidity of mortgages, as these tend to be paid off when properties are sold. He said that mortgage loans now offer a combination of safety, liquidity and yield. Mr. Hill called attention to the fact that during the last ten years the percentage of life company assets invested in United States government bonds has declined from 54% to 9½% for the group of largest companies, from 38% to 9% for the group of medium-sized companies and from 31% to 8% for the group of small companies. There has been a substantial absolute decline in such holdings—as much as 67% for the largest companies—in spite of a near doubling of their admitted assets. A generous supply of higher yielding investments was the main factor promoting the shift from governments.

Mr. Hill also stated that public utilities have presented a great demand for capital, and their stable earnings have made their securities very popular with life insurance companies. Companies in all size categories have greatly increased their holdings of public utility securities.

The largest companies, according to Mr. Hill, have increased their industrial bond holdings very rapidly, and these are now 28% of their assets. While the medium-sized and smaller companies have also increased their holdings of industrial bonds, the proportion of assets thus invested is much smaller, being 11% and 8½%, respectively. While holdings of industrial bonds by medium and small companies are now less than their holdings of public utility bonds, the reverse is true of the group of largest companies, where industrial bond holdings are about twice public utility bond holdings. Ten years ago, public utility bond holdings of the largest companies were about twice their industrial bond holdings.

MR. D. N. WARTERS also referred to the large relative shift in assets by type during the last ten years, indicating that, for the life companies as a whole, United States government bonds had declined from 46% to 9% of assets, while corporate bonds had increased from 22% to 43% of assets and mortgages from 15% to 31% of assets. Utility bonds, as a proportion of total corporate bond holdings, have declined. Among mortgages, insured and guaranteed types of loans had increased in importance from 4% to 12% of assets in the last ten years.

Mr. Warters stated that a substantial increase in risk was represented by the decline in government bond holdings and the increase in other bond holdings particularly industrial bonds, which now amount to 22½% of assets of all the companies. He stated that it is difficult to generalize about these and that they might be subject to trouble during a business decline. He felt, as did Mr. McDiarmid, that the large volume of direct placements, particularly in the industrial field, had not yet been depression tested.

Both Mr. Warters and Mr. McDiarmid referred to the increase in company liquidity arising from the heavy return cash flow from mortgage amortization and maturities of industrial and miscellaneous bonds, as well as such utility bonds as gas pipeline issues.

Mr. Warters stated that past experience indicates the danger of long-term investment commitments without a chance to review the relationship between debt and basic security. Today's repayment provisions on mortgages and on industrial bonds provide an opportunity for such review. The substantial return flow of cash arising therefrom will give needed liquidity during a depression provided contract provisions are not greatly modified by government intervention or to meet public opinion.

Mr. Warters drew attention to the growing practice of making advance commitments, pledging future cash flow. He said that this had made companies more vulnerable to changing markets to the extent that in times of falling receipts they depend on the sale of securities to meet these commitments. He felt that the trend toward heavy advance commitments was something to be watched.

Both Mr. Warters and Mr. McDiarmid felt that the heavy activity in direct placement financing, particularly in the industrial field, made it difficult for small and medium-size companies to participate in this financing to the extent they might wish. They felt that the ability of smaller and medium-size companies to diversify in this field was limited and that the purchase of bonds of smaller industrial units, such as might be available, was not an entirely satisfactory substitute for the obligations of large and strong industrial units. However, Mr. McDiarmid felt that loans to small utilities and finance companies did not share the excess risk associated with small industrial loans.

MR. G. F. KNIGHT and MR. W. C. BROWN, speaking for medium-size and smaller companies, felt that such companies suffered no disadvantages, as compared with large companies, from the trend toward direct placements. Mr. Knight stated that loans to local independent telephone companies and other small utilities had proved a satisfactory investment field. Since entering the direct placement field, the Berkshire Life had taken care of 70% to 85% of new nongovernment bond investments in this way. At the end of 1955, such loans made up 42% of their bond portfolio and were represented by 128 cases having an average size of $235,000.

MR. F. J. McDIARMID stated that the most notable development in the last ten years had been the growth of direct placement financing. In recent years, about 90% of industrial and miscellaneous bond financing was done in this way; also, natural gas pipeline financing and other financing where competitive bidding was not required by law tended to go the direct placement route. He stated that higher yields, tighter indenture provisions and better protection against call were advantages of this type of financing, a view also shared by Mr. Warters and Mr. Knight. He estimated that the extra yield advantage obtained in direct placements was in the order of 1/2%, while Mr. Knight estimated 6/10%. Mr. McDiarmid called attention to the very great responsibility resting on those approving large private placements, especially when taken by a single company. Such placements lacked the test of the market place and rating services, assuming that these had value.

Mr. McDiarmid indicated an increasing interest in municipal bonds on the part of life insurance companies, due to the uncertainty of future federal taxation.

MR. G. E. CANNON stated that, in the past 20 years, the advantage of extra yield earned by small life companies, as compared with large companies, had largely disappeared. At present, small companies have a larger proportion of assets in mortgage loans and municipal bonds. Familiarity with local conditions gives small companies an advantage in making mortgages in their own areas. This is an advantage that the small companies should exploit.

Mr. Cannon also felt that small companies were at some disadvantage in direct placement financing, partly because the borrowing corporation sometimes desires to limit the number of lenders, a view also expressed by Mr. McDiarmid. He said that when a small company does take part in such deals, it must accept terms already worked out by larger participants. Obtaining skilled investment help was a problem with smaller life insurance companies.

MR. W. F. POORMAN stated that life company policy with respect to common stock investment differs widely, many companies owning none at all, and one large company having 7% of assets thus invested at the end of 1955. Some companies hesitating to buy common stocks were active purchasers of convertible bond issues. Their treatment under the mandatory security valuation reserve and the necessity of carrying them at market value were deterrents to the purchase of common stocks.

Mr. Poorman stated that investment in real estate, particularly purchase lease-backs, has been increasing and amounted to 2.8% of total assets at the end of 1955.

Mr. Poorman pointed out that those direct placements requiring negotiation of all terms by the lender rather than by investment bankers imposed a heavy work load on a life company investment department. Loan terms which give the investor proper protection and also are practical to the borrower have to be tailor-made for each case and are frequently very complex. These may require subsequent modifications during the life of the loan which add to the total work. Life companies have succeeded to many of the responsibilities of investment bankers. The development of investment personnel capable of handling direct placements is a major problem.

Mr. Poorman commented that direct placement contracts normally establish appropriate minimum financial standards which are designed to result in technical defaults substantially in advance of any default in interest or principal payments. When such a technical default signals credit deterioration the Central Life tends to enforce corrective action and is very reluctant to subordinate its claim, preferring to advance additional funds itself, if necessary. In extreme cases it helps to arrange the sale of the business or the borrower's equity.

Mr. Poorman stated that direct placements tend to have stricter covenants than public issues and, therefore, tend to produce more technical defaults. There may be some tendency for the regulatory authorities to overstress the seriousness of such technical defaults. On the other hand the tendency to stress financial position in the absence of market values for valuation purposes is a step in the right direction.

MR. J. C. MAYNARD said that a smaller company may operate arbitrage dealings profitably with securities of equal basic underlying security and cited public utility bonds as a suitable field for such activity.

MR. V. E. HENNINGSEN stated, in closing the discussion, that in cases where debt is created by a corporation up to a rather high level stock options may properly be requested by a lender as extra compensation for the risk involved in such a heavily indebted situation.